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BOOK REVIEWS

TRANSCRIPT OF KEN STARR SPEECH ON THE COMMERCE CLAUSE

*Kenneth W. Starr**

Thank you, Dean Polsby, for that wonderful introduction. The Dean is one of my very favorite people. I have known of him for many years. In his days at Northwestern, he held the Kirkland & Ellis Chair, and we at Kirkland are very proud of that. To the delight of the Commonwealth of Virginia and George Mason University, he decided to come teach here a few years ago. I also have a very soft spot in my heart for George Mason and for Don Boudreaux and Todd Zywicki in particular. When I began writing a book a number of years ago, Todd approached me and suggested that I join the faculty here at the Law School, and so George Mason became my academic home for several years. I do feel as though I am an extended member of the family, and I am a great admirer of the Mercatus Center. It is a privilege for me to reflect with you for a few minutes on the Commerce Clause as it relates to e-commerce.

I come with a mixed report on the Commerce Clause[1] and the importance of judges in the interpretation of the Commerce Clause and e-commerce. You will hear during the course of the day about various industries and the application of some of these principles. I want to be somewhat of a modern-day Paul Revere and sound an alarm, despite all of the wonderful work that is going on at the FTC and Jerry Ellig's path-breaking work in the wine industry.

Let us turn immediately to Mr. Ellig's abstract on the economics of wine shipping.[2] In the very first sentence of the abstract, he states that the biggest barriers to on-line sales of wine are *state laws*. There it is. If you remember anything from this presentation, it should be this: states are, in fact, obstacles to the free flow of commerce.

We were warned about this in *Federalist No. 10*.[3] Please bear in mind that James Madison, in his more insightful years, believed and explained to us in *Federalist No. 10* the importance of a national economic union. He wrote about the advantages of a vast commercial republic, and that the in-

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1 U.S. CONST. art. I, § 8, cl. 3.

2 Alan E. Wiseman & Jerry Ellig, Abstract, *How Many Bottles Makes a Case Against Prohibition? Online Wine and Virginia's Direct Shipment Ban* (FTC Bureau of Econ., Working Paper No. 258, 2003).

3 THE FEDERALIST NO. 10 (James Madison).

struments of oppression were more likely to gain power and influence in smaller jurisdictions.[4] Thus, in the small republics, the enemies of freedom could gain the ascendancy. Remember, in Madison's analysis, he was not just speaking of the overreaching majority. Madison warned that in a small republic, even a small group can seize the controls of power.[5] Is this not what we see in state capitols across the fertile plain from sea to shining sea? We were warned about that.

One of the great instruments of the national economic union is the Commerce Clause, as interpreted by the judges who are, in turn, using the work of the universities. This work is in part the product of those who move, happily, from George Mason University to across the river to the Office of Policy Planning at the Federal Trade Commission, and then back to George Mason. If that is the revolving door, then it would be great to see it continue, as it has been such a good and powerful influence on the economy over these recent years.

The analysis begins with the text of the Constitution, Article I, Section 8. The Congress, not the courts, shall have power to lay and collect taxes.[6] Duties, imposts, and excise taxes to pay the debts—that is a full-time job. All of these taxes must be uniform throughout the country.[7] Congress shall also provide for the common defense, which everyone—no matter how libertarian—likely agrees we need, and promote the general welfare.[8]

After the opening paragraph, there are some bullets that follow in this enumeration of powers. The first bullet, which I think Congress takes to heart, is "to borrow money on the credit of the United States,"[9] meaning on *our* credit. The next bullet is "to regulate the commerce with foreign nations, and among the several states, and with the Indian tribes,"[10] that is, Article I, Section 8. High up in the list of the enumerated powers is the express power to regulate commerce between the states. So, *Congress* needs to act, not the courts.

Some of us that are veterans of litigation involving the direct shipment of wine, who have been involved behind the scenes, in the policy debate, or in court, know that the instrument that judges have used to regulate commerce is the dormant Commerce Clause.[11] That is the principle of the national economic union as articulated at its founding. The essential goal of the Annapolis convention and that of Philadelphia was, in fact, to have a

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4 *Id.*

5 *Id.*

6 U.S. CONST. art. I, § 8, cl. 1.

7 *Id.*

8 *Id.*

9 U.S. CONST. art. I, § 8, cl. 2.

10 U.S. CONST. art. I, § 8, cl. 3.

11 *See, e.g.*, Hunt v. Wash. State Apple Adver. Comm'n, 432 U.S. 333 (1977); *see also*, Cooley v. Bd. of Wardens of Phila., 53 U.S. 299 (1851).

common market—a national economic union.[12] But the text of the Constitution delegates that regulatory role to Congress, not to judges. This begs the question, "Do judges have a role outside of interpreting the statutes enacted by Congress?" Is there, in fact, a role for judges in regulating commerce?

The lawyers here all know this, but as we march down memory lane, in 1824, the Supreme Court considered *Gibbons v. Ogden*, a very important case in terms of building the national economic union and overriding the exercise of state regulatory power.[13] In 1824, the question was whether a federal license preempted a state license. Of course, it is now apparent that it does. Justice Johnson's concurring opinion includes a robust view of the Commerce Clause and the baleful consequences of state regulation.[14] Culminating in 1851, in *Cooley v. the Board of Wardens of Philadelphia*, there was a very muscular approach to the interpretation of the Commerce Clause that provided a role for judges.[15] According to *Cooley*, judges also play a role in maintaining and facilitating the national economic union through the interpretation of the Commerce Clause and its values.[16] At a minimum, the courts should prevent discrimination on the part of one state against the commerce flowing out from another state.[17] And thus was born what is now called the dormant Commerce Clause.

Granholm v. Heald concerns these issues.[18] *Granholm*, the wine case, centers around the dormant Commerce Clause and the relationship with the Twenty-First Amendment, particularly Section 2, which repealed the noble experiment with prohibition. That is the background to this case.

There is an entire body of law that embraces the notion of the dormant Commerce Clause as an appropriate and legitimate domain for the judiciary in the role of judges and litigators. This body of law guards against a law passed by one of the states that is discriminatory, or as the law has developed, places an undue burden on interstate commerce. All seemed well until nine years ago when Justice Thomas, in a very stirring dissenting opinion, speaking for Scalia and Rehnquist, said some very nasty things about the entire idea of the dormant Commerce Clause.[19] Justice Thomas refused to use the term dormant—he referred to it as the "negative" Com-

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12 *The Annapolis Convention* (Sept. 11, 1786), *available at* http://www.yale.edu/lawweb/avalon/annapoli.htm (last visited Aug. 21, 2007).

13 Gibbons v. Ogden, 22 U.S. 1 (1824).

14 *Id.* at 222-40.

15 *Cooley*, 53 U.S. 299.

16 *Id.*

17 *Id.* at 313 (noting that if there were discrimination, the Court could hold that the legislative act was not a fair exercise of legal discretion).

18 Granholm v. Heald, 544 U.S. 460 (2005).

19 Camps Newfound/Owatonna, Inc. v. Town of Harrison, 520 U.S. 564, 609-40 (1997) (Thomas, J., dissenting).

merce Clause.[20] The dormant Commerce Clause, or the negative Commerce Clause, finds itself under a very withering assault. Thomas called it an illegitimate assertion of judicial power for which there is no grounding in the text of the Constitution, which instead says that Congress shall have this power.[21] Absent Congressional action, there is no power and the judges should remain out of the debate.

The following are pertinent quotes from Thomas' 1997 dissent. Speaking for powerful minds, Justice Thomas said that "[t]he negative Commerce Clause has no basis in the text of the Constitution, makes little sense, and has proved virtually unworkable in application."[22] That is a pretty thorough indictment. He continues, "[T]he expansion affected by today's holding further undermines the delicate balance in what we have termed 'Our Federalism.'"[23] Friends of the common market, get your muskets ready because you need to march to the village green when you hear any judge talking about "Our Federalism."

Thomas continues, "I think it worth revisiting the underlying justifications for our involvement in the negative aspects of the Commerce Clause, and the compelling arguments demonstrating why those justifications are illusory."[24] Thomas then conducts what he views as a powerful originalist examination of the jurisprudence of the text of the Constitution and concludes that there is no justification for the body of law.[25]

Thomas even draws from some of the great liberals of the court of yesteryear. In a dissenting opinion, Justice Hugo Black, joined by Felix Frankfurter and William Douglas—and if those three agree, then every reasonable person should agree—criticized "the negative Commerce Clause as arising out of 'spasmodic and unrelated instances of litigation [that] cannot afford an adequate basis for the creation of integrated national rules' that '*Congress alone*' is positioned to develop."[26] This is the nationalist vision. The very Article I-centric view of Justice Hugo Black, who served in the United States Senate, and the "our federalism" pro states' rights vision of Clarence Thomas fused together to create a Paul Revere warning: one of the most powerful instruments for the maintenance of our national economic union could come to an end by virtue of the good faith distrust of judicial power. We do not trust judges to engage in this type of interpretative exercise.

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20 *Id.*

21 *Id.* at 609-10.

22 *Id.* at 611.

23 *Id.* at 611-12.

24 *Id.* at 612.

25 *Camps Newfound/Owatonna*, 520 U.S. at 612.

26 *Id.* (quoting McCarroll v. Dixie Greyhound Lines, Inc., 309 U.S. 176, 189 (1940) (emphasis added)).

The house here may very well be divided on that issue. There may be those that think that Justice Thomas has it exactly right, and if Thomas agrees with Hugo Black, then the conclusion presented here must be wrong.

We should not be so quick to embrace the Justice Thomas vision. First, without a simply shameless appeal to stare decisis, court after court, since 1851, has in fact accepted the legitimacy of the dormant Commerce Clause.[27] Thus, there is a Burkean tradition—as opposed to a later day inspiration—that one has a constitutional right to fill in the blank, which one might not have discerned or previous generations have not before discerned. There might be a sense that judges are making up a particular right. Agree with that right and you might disagree with that right. Let me be specific. This house might be divided over whether the Constitution protects same sex marriage or enables people of the same gender to be married. It is a very lively issue.

That particular, recently-asserted right is not found in or protected by any common law, statutes, or state constitutions existing today. Therefore, there was an absence of what Benjamin Cardozo, a great common law jurist who was willing to depart from the text all too frequently, said when his very great mind was faced with determining the meaning of substantive Due Process in *Snyder v. Massachusetts*.[28] He spoke of the authentic way that society expresses itself in law; not in moral philosophy, not in Rawlsian or Dworkian philosophy, not in Gallup polls, but in statutes, common law, and constitutions. So we look to the body of law, which shows that there has been a dialogue for decades between the courts and Congress in interpreting the dormant Commerce Clause. Congress has not been dormant in this process. And thus when the courts say that the channels of commerce must be kept open—that the Constitution has by its own force and power a sense to protect the national economic union against "our federalism" state obstructionism—in response, Congress has been willing to go along with that interpretation. Take, for example, state insurance—the great *Paul v. Virginia*[29] case that was overruled by *United States v. South-Eastern Underwriters* in the 1940's.[30] Congress intervened, saying it disagreed with a particular interpretation of the dormant Commerce Clause and reserved the regulation of insurance to the states.[31] Some interesting questions were raised about what constitutes insurance, but what is impor-

27 Cooley v. Bd. of Wardens of Phila., 53 U.S. 299 (1851). *See generally* Baldwin v. G.A.F. Seelig Inc., 294 U.S. 511 (1935) (New York's price protection on milk was invalid as a protectionist measure); Pike v. Bruce Church, Inc., 397 U.S. 137 (1970) (Arizona's cantaloupe packing law placed an excessive burden on interstate commerce); Philadelphia v. New Jersey, 437 U.S. 617 (1978) (a New Jersey statute limiting the ability of waste disposal services to manage out of state waste was invalid per se as facially discriminatory).

28 Snyder v. Massachusetts, 291 U.S. 97, 122 (1934).

29 Paul v. Virginia, 75 U.S. 168 (1868).

30 United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944).

31 *Paul*, 75 U.S. at 183.

tant is that Congress, instead of simply enacting the McCarran-Ferguson Act of 1945,[32] could have enacted the anti-negative Commerce Clause law. In other words, Congress could have instructed the courts to not intrude into its territory by interpreting the Commerce Clause, which gives the power to Congress.

To the contrary, Congress over the decades has smiled on the courts' work in keeping the channels of commerce open. Special interest groups are very quick to run to Congress and complain about what the "run-away judges" are doing. In doing so, the interest groups ask Congress to sanction the development of their *Federalist No. 10* factions.

It is much easier to control the legislature in Austin, Texas, or in Lincoln, Nebraska, than it is to control the seat of Federal Government. It is extremely difficult to get a law passed through Congress, but it is not hard at all to get an act passed through a state legislature. For instance, Nebraska does not even have a bicameral system. To get a law passed in the state, you are in good shape if you do it the right way, the *Federalist 10* way. Hire the right people and talk to the right members. I recently spoke to the Chair of the California Senate Judiciary about this, and he said, "If you want to get something done in California, a state of 37 million people, you look up your representative and find out his or her birthday. You send your representative a birthday card, and then call him or her up and leave your member of the General Assembly a message on his or her birthday saying, 'Just calling to wish you a happy birthday.' The next time you want something done, I guarantee you, just tell that representative what you need." He was saying this a bit facetiously, but even so, what he was getting at is this truism: you can get the attention of a state legislator much more easily than you can his federal counterpart even though some state legislators represent more people than Representatives of the U.S. House.

My basic point is this: we should pause a moment and look with a Burkean/Cardozo-like sense and be respectful of this great tradition. In contrast to the interpretation of the First Amendment, the Fourth Amendment, and virtually any other part of the Constitution, there is a democratic safety check on the use of the dormant Commerce Clause power, which has been a part of our Constitutional traditions since 1824 and certainly part of our laws since the 1850's. Congress can say, "Stop it, right now," but historically they have not done that.

The Wine Wars present issues that are quite worrisome. Thoughtful people share the view of a thoughtful Justice, out of an excessive concern about the exercise of judicial power, that the use of the dormant Commerce Clause in this context is a "pox on this entire enterprise."[33] This concern

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32 McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015 (2005).

33 Camps Newfound/Owatonna, Inc. v. Town of Harrison, 520 U.S. 564, 609-40 (1997) (Thomas, J., dissenting). Justice Thomas worried that the decision "brought within the supervisory authority of the federal courts state action far afield from the discriminatory taxes it was primarily designed to

stems from the idea that there is no basis in the text of the Constitution for the dormant Commerce Clause, but let us go back to Constitutional Law 101. Where is freedom of association in the text of the Constitution? Where is freedom of marriage in the text? It is inaccurate to say that if I cannot find it in the literal language, then the judiciary cannot exercise that power. There are too many exceptions to that particular rule.

There is this powerful democratic check, which I think should in fact cause grave concern about the entire thrust of the Justice Thomas jurisprudence. This really is a very strong initiative by Justice Thomas, who has cemented the concerns first expressed by Justice Scalia in 1987,[34] only a year after he had been named to the High Court likely without the occasion to really think about these issues. Thus, there are some very bright minds, who many here would tend to find very congenial on some of the issues, who are quite deeply concerned.

The purpose of this conference, as I understand it, is two-fold: to encourage research and to foster dialogue. We certainly are beginning the process of dialogue, but I also want to encourage research.

This research has actually begun with respect to the erroneous nature of the Thomas critique of the Commerce Clause jurisprudence of the Supreme Court of the United States. But it has only just begun and is at most in its adolescent level. Happily, one of the leaders in the effort to critique the Thomas jurisprudence comes from a former Thomas clerk.[35] While he has the highest respect and affection for his former boss, he has made the case for why Thomas is utterly wrong with respect to his position on the dormant Commerce Clause. James Chen, of the University of Minnesota Law School, has written a couple of articles on the subject, and I want to share some of his thoughts in closing. He is building on the research and analysis of Professor Brannon Denning. One of the things that Justice Thomas argues is not to worry, that even if the dormant Commerce Clause was jettisoned, there are other textual foundations in the Import-Export Clause[36] that would allow the courts to do the same work as they have done through the dormant Commerce Clause jurisprudence.

This excerpt is from one of Professor Chen's articles: "In a pair of thoughtful . . . articles, Professor Brannon Denning has skillfully skewered Justices Scalia and Thomas's proposals. [P]rofessor Denning exposed the limitations of the Import-Export Clause. [In another issue] Professor

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check." *Id.* Chapman University School of Law Professor, Dr. John C. Eastman, shares a similar view. *See* John C. Eastman, *A Fistful of Denial: The Court Takes a Pass on Commerce Clause Challenges to Environmental Laws*, 2004 CATO SUP. CT. REV. 469 (2004).

34 Tyler Pipe Indus. v. Wash. State Dep't of Revenue, 483 U.S. 232, 254-65 (1987) (Scalia, J., dissenting).

35 *Faculty Profiles—James Chen*, University of Minnesota Law School, *available at* http://www.law.umn.edu/facultyprofiles/chenj.htm (last visited Aug. 21, 2007).

36 U.S. CONST. art. I, § 10, cl. 2.

Denning showed how the Privileges and Immunities Clause . . . cannot supplant the dormant Commerce Clause. These articles demonstrate that the Import-Export and Privileges and Immunities Clauses, at least absent 'major rethinking,' are 'not . . . up to the task of displacing the dormant Commerce Clause as the doctrinal basis for the Court's regulation of state protectionism . . . .'"[37]

Thus, that is the evil today: "our federalism," in terms of our national economic economy, means state protectionism. Additional research needs to be done in this area as well. To what extent does *Federalist No. 10* live in state capitols across the United States? To what extent have state legislatures become clear and present dangers in various and sundry ways of the free and efficient flow of goods and services across the fertile plain? That is a very large subject. We tend to be very industry-specific. Why not begin with industry-specific and learn what states are doing in these different arenas as they try to regulate and protect particular interests?

I want to commend these beginning jurisprudential analyses to you in the hope that this will stimulate further research. In a great dormant Commerce Clause opinion, Benjamin Cardozo went back to the founding and had a great Burkean respect for the generations that have gone before.[38] Cardozo, in his wonderful way, said that it is the philosophy of this nation that we "sink or swim together."[39] Despite Justice Thomas's use of a few snippets of Jackson's opinions to suggest that he was no fan of the dormant Commerce Clause, Justice Jackson, fairly viewed, was quite willing to use the judicial power to protect free markets. In the words of Justice Jackson, as quoted by Jim Chin, "Justice Jackson contrasted the 'material success' attributable to the preservation of a 'federal free trade unit' with the 'fantastic rivalries and dislocations and reprisals [that otherwise] would ensue.'"[40] It was Holmes who said famously that the Republic would not fall if the court lacked the *Marbury v. Madison* power to strike down an Act of Congress, but that the Republic might fall if that power did not in fact attend the work of state legislatures and state governors.[41]

In closing, let me simply say that whenever you hear the words "our federalism," just remember "Boss Hog." *That* is "our federalism." And remember the earlier and correct Madison articulation, before his later apostasy, of a vision of a vast commercial republic with a powerful judiciary, not enforcing its vision of a good society nor a Rawlsian sense of jus-

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37 Jim Chen, *A Vision Softly Creeping: Congressional Acquiescence and the Dormant Commerce Clause*, 88 MINN. L. REV. 1764, 1766 (2004).

38 Baldwin v. G.A.F. Seelig Inc., 294 U.S. 511 (1935).

39 *Id.* at 523.

40 Chen, *supra* note 37, at 1768 (quoting H.P. Hood & Sons, Inc. v. DuMond, 336 U.S. 525, 538-39 (1949)).

41 OLIVER WENDELL HOLMES, COLLECTED LEGAL PAPERS 295-96 (1921).

tice, but keeping the lines of commerce open.[42] We should be mindful of Samuel Johnson's admonition that "there are few ways in which a man can be more innocently employed than in getting money."[43]

Thank you very much.

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42 *See* THE FEDERALIST NO. 10, *supra* note 3, at 2.

43 JAMES BOSWELL, THE LIFE OF SAMUEL JOHNSON 323 (Christopher Hibbert ed., Penguin Classics 1979) (1903).

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AUTOMOBILE DISTRIBUTION RESTRICTIONS: AN ECONOMIC PERSPECTIVE

*Debra J. Holt**

Automobile purchases represent the second largest expenditure, after home purchases, for many consumers. Annual sales of new and used autos were approximately $747 billion in the United States in 2005.[1] All states regulate the distribution of autos. Empirical analyses of some of these state regulations have found that they harm consumers.[2] There have been recent moves to extend, or strengthen, these regulations to inhibit emerging Internet-based competition. One analysis of online auto referral services found their use can reduce the average auto price by two percent.[3] Other Internet innovations in the sales and distribution of autos have the potential to generate even greater savings. Additionally, people are showing an increasing willingness to use the Internet and even purchasing new or used cars over eBay. In 2003, eBay was selling 1,000 cars per day with the average car selling for $8,000.[4] In August 2006, eBay announced that the two millionth passenger vehicle had been sold through its service in the U.S and that vehicles are being sold on average every sixty seconds.[5]

Attempted inhibition of new forms of competition that have the potential to significantly benefit consumers raises important policy questions. This paper reviews the existing economics literature relevant to this policy issue while recognizing that more research in this area is needed.

The paper begins with a review of the theories of vertical restraints and franchise contracts. These theories provide a general understanding of manufacturers' and dealers' incentives to adopt various contracts or agreements along with their effect upon consumers. The second section discusses empirical evidence on the effects of vertical restraints and includes specific analyses of auto dealer restrictions. The third section reviews eco-

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1 ESTIMATES OF MONTHLY RETAIL AND FOOD SERVICES SALES BY KIND OF BUSINESS: 2005 U.S. CENSUS BUREAU, *available at* http://www.census.gov/mrts/www/data/html/nsal05.html (last visited Aug. 21, 2007).

2 *See* Frank Mathewson & Ralph Winter, *The Economic Effects of Automobile Dealer Regulation* (U. Toronto Dep't Econ. & Inst. for Pol'y Analysis, Working Paper No. 8907, 1989), *also in* ANNALES D'ECONOMIE ET DE STATISTIQUE (1989); ROBERT P. ROGERS, BUREAU OF ECON., FED. TRADE COMM'N, THE EFFECT OF STATE ENTRY REGULATION ON RETAIL AUTOMOBILE MARKETS (1986).

3 Fiona Scott Morton, et al., *Internet Car Retailing*, 49 J. INDUS. ECON. 501 (2001).

4 Christopher Adams, et al., *Vettes and Lemons on eBay*, February 2, 2006, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=880780 (last visited Aug. 21, 2007).

5 eBay Inc., *Two Millionth Passenger Vehicle Sold on eBay Motors*, August 8, 2006, *available at* http://investor.ebay.com/releasedetail.cfm?ReleaseID=206868 (last visited Aug. 21, 2007).

nomic research on the Internet's impact on automobile distribution and consumer welfare.

I. THEORY OF VERTICAL RELATIONSHIPS

A. *Theory of Vertical Restraints*

Mathewson and Winter (1984) is the first theoretical economic analysis of restraints—retail price maintenance (RPM), exclusive territories, quantity forcing, and franchise fees—in vertical relationships.[6] When both upstream and downstream industries are competitive, there is no role for restraints. The authors consider an environment in which the manufacturer has monopoly power and the retailers are imperfectly competitive in a spatially differentiated market.

In their model, retailers provide essential information to the consumers. This information includes advertising or sales effort or other retailer services that cannot be easily provided by manufacturers.[7] Manufacturers also cannot costlessly monitor the retailers' provision of information. Some portion of a retailer's advertising or sales effort may reach customers outside its market area. The authors assume that vertical integration is costly.[8]

First, consider benchmark values for price (P^*), distance between retailers ($2R^*$), and level of advertising effort (A^*) obtained by solving the profit maximization problem of a (costlessly) vertically integrated manufacturer. Their first result is that these values are identical to those that would obtain with a monopoly manufacturer and a free-entry (zero profit) retailer equilibrium. In the remainder, they compare the outcomes of imperfect competition in retailing with these benchmark values.

With imperfectly competitive retailers, the wholesale price alone (p_w) is not a sufficient instrument to achieve P^*, R^*, and A^*. Retailers will set $A < A^*$ while the price may be above or below P^*. Why? There are three externalities that drive a wedge between equilibrium and optimal values for price and advertising levels.

- Vertical. The retailer ignores additional manufacturer profit (p_w - c) when P or A are changed. This externality, known as the double marginalization problem, tends to make $P > P^*$ and $A < A^*$.

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6 Frank Mathewson & Ralph Winter, *An Economic Theory of Vertical Restraints*, 15 RAND J. ECON. 27 (1984).

7 Of course, manufacturers do advertise directly to consumers. The "essential information" in this model refers to any information that the retailer can provide consumers more efficiently than manufacturers.

8 They consider two types of equilibria throughout—Loschian and Nash. I only discuss the Nash equilibria.

- Horizontal pecuniary. Competition at the retail level drives prices below what would be set by the integrated manufacturer or a manufacturer facing competitive (zero profit) retailers. Each retailer has to be concerned about neighboring retailers lowering prices and thus capturing some of his customers. This externality leads to $P < P^*$.

- Horizontal spillovers. Each retailer provides services (advertising or sales effort) to some customers who will buy from another retailer. This spillover leads to $A < A^*$.

Consider the effect of the externalities one at a time. Suppose there are only the vertical externalities, with no advertising spillovers, and that retailers expect all prices to move together. Then the optimal (benchmark) outcome can be achieved with either a franchise fee or quantity forcing. With a franchise fee, the manufacturer sets the wholesale price equal to its (constant) marginal cost and extracts the rents through the franchise fee. Because $c = p_w$, the externality is neutralized so P^*, R^*, and A^* are achieved. With quantity forcing, the manufacturer sets the target $q = q(P^*,A^*,R^*)$ and sets p_w to extract the rents. This strategy works because the retailers are at the efficient rate of substitution between advertising and prices—it is just the levels that are inefficient. Quantity forcing moves the advertising and the price to efficient levels without affecting the marginal rate of substitution.

Now introduce the pecuniary horizontal externality in addition to the vertical externality. The intuition behind the vertical restraints sufficient to neutralize both externalities is straightforward. In the benchmark cases, the manufacturer either sets retail price directly because the manufacturer also owns the retail operations, or indirectly, through the wholesale price when retailers are independent, because of zero retail profits with free entry. (The retailers have no costs aside from the wholesale price.) In the imperfectly competitive, unintegrated retail market, each firm perceives price elasticity to be greater than the market demand elasticity. Thus, the pecuniary horizontal externality leads to $P < P^*$. However, the optimal outcome can be achieved with either exclusive territories plus franchise fees or with exclusive territories plus quantity forcing. The exclusive territories lead to each retailer perceiving the same demand elasticity as the manufacturer, so the price is optimal. The quantity forcing or franchise fees solve the vertical externality as before.

There is another approach to neutralizing both the vertical and horizontal pecuniary externalities. RPM with either franchise fees or quantity forcing is sufficient to achieve the optimal outcome. With franchise fees, the manufacturer sets $p_w = c$ to neutralize the vertical externality and then sets $P = P^*$ to neutralize the horizontal one. With quantity forcing and RPM, the manufacturer sets $q(P^*,A^*,R^*)$ and $P = P^*$, which leaves the retailer no choice except to choose A^*. Since p_w has no incentive effect on the retailers, $p_w > c$.

Finally, add informational externalities. Retailers will advertise (inform) less than is optimal because other retailers are reaping the benefits of some of their advertising efforts. Manufacturers could elicit optimal advertising by setting $p_w < c$, but that action would exacerbate the tendency to set retail prices too low due to the horizontal pecuniary externality. However, the three externalities can be jointly neutralized by either RPM plus franchise fees with $p_w < c$ or RPM plus quantity forcing at $q(P^*,R^*,A^*)$. The intuition here is similar to the previous case. The argument is that RPM plus franchise fees are identical to the previous case with the exception that now $p_w < c$ in order to compensate the retailer for the "lost" advertising efforts. As in the previous case, once the retailer is forced to set P^* and $q(P^*,R^*,A^*)$, setting $A = A^*$ is the best he can do.

Rey and Tirole (1986)[9] study vertical restraints (retail price maintenance and exclusive territories) in a somewhat richer model. They depart from the principal-agent framework and argue that it implicitly assumes much that is of interest in the vertical relationships. Aside from the framework, their model differs from that of Mathewson and Winter in several dimensions:

- It includes an explicit model of the (possibly) imperfect competition among retailers. There are numerous geographic markets. Each market has two spatially differentiated retailers.

- It includes a retail distribution cost.

- It includes uncertainty. Retailers face uncertain demand and distribution costs. The retailers realize demand and distribution cost after signing the contract with the manufacturer but before setting the retail price.

- It ignores horizontal externalities.

The authors find that, with uncertainty (and risk neutral retailers), manufacturers may prefer exclusive territories (in addition to a two-part pricing franchise agreement) even when the retailers are perfectly competitive. The social planner still prefers competition. More generally, they show that retail price maintenance and exclusive territories are not equivalent instruments in this uncertain environment. They also exhaustively examine the private and social rankings of competition (with franchise), retail

9 Patrick Rey & Jean Tirole, *The Logic of Vertical Restraints*, 76 AM. ECON. REV. 921 (1986).

price maintenance, and exclusive territories as retailer risk aversion and differentiation vary. Private and social rankings do not always coincide.

B. *Theory of Franchise Contracts*

Mathewson and Winter (1985)[10] develop a simple principal-agent model of franchising and find minimal sets of sufficient conditions to yield predictions that fit the fact pattern of actual franchise behavior.

In the simplest model, the principal determines the brand through national advertising and does not have the option of later decreasing brand quality. Vertical integration into retailing is impractical. The agent (franchisee) observes whether local demand is high or low (post contract), whereas the principal cannot observe demand. Both know the distribution of demand. The agent provides a value-added service (quality) that affects demand. Both horizontal and vertical free-riding are possible. The agent can free ride when demand is high by shirking on local quality provision and announcing that demand is low.[11] The principal can monitor the agent's provision of quality, but not costlessly. The optimal contract requires that the agent make an upfront payment to the principal to lease the brand. If free-riding is detected, the contract imposes penalties on the agent. This contract does not resemble actual franchise contracts, which include profit sharing and sometimes a flat franchise fee. Therefore, asymmetric information about local demand is not sufficient to explain profit-sharing contracts.

In actuality, agent wealth constraints are necessary and sufficient for profit-sharing franchise contracts in this framework. It is simplest to illustrate with the case of zero wealth. The agent cannot make any up-front payment so the principal must provide incentives through rewards instead of punishments. The incomplete contract must do two things: 1) provide sufficient surplus to the principal to compensate for the lease of the brand; and 2) compensate the agent sufficiently in states with high demand so that he has no incentive to shirk and misrepresent them as low demand states. The optimal contract will give zero profits to the agent in the low-demand states; the payments to the principal constitute the lease payments. The contract will give positive profits to the agent in the high-demand states so that the agent will have an incentive to declare the correct level of demand and not shirk on quality. That is, the agent's profits in the good state must be greater than the gain obtainable by mis-declaring and shirking. So a wealth constraint leads to a profit-sharing contract. This contract may lead to rents accruing with the agent if the expected payments in high-demand

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10 G. Frank Mathewson & Ralph A. Winter, *The Economics of Franchise Contracts*, 28 J. L. & ECON. 503 (1985).

11 Horizontal free-riding is not essential to any of the results in this paper.

states are greater than the opportunity costs. This prediction is consistent with the observation of queues of potential franchisees.

Other characteristics of the equilibrium with zero wealth and costly (but non-noisy) monitoring are:

- national brand quality and local quality in the high demand state are set optimally;
- local quality in the low demand state is set below the optimal level;
- as the frequency of monitoring, ρ, increases, the quality in the low demand state rises, approaching the optimal level as ρ approaches one;
- profit-sharing contracts are optimal even when $\rho = 0$; and
- there is a role for the principal to impose maximum retail prices and/or minimum retail hours.

Similar results, including a profit-sharing contract, are obtained in a model without binding wealth constraints but with a reverse moral hazard problem. The moral hazard problem for the principal can occur if monitoring is noisy (and the principal has an incentive to collect a fine when the agent is telling the truth) or if the principal cannot commit to maintaining the national brand (which provides an incentive to abscond with the performance bond).

II. EMPIRICAL ANALYSIS OF VERTICAL RELATIONSHIPS

Beales and Muris (1995)[12] look at the "bargaining power argument" for regulating franchisers—in particular, restricting their ability to terminate franchisees even in circumstances allowed by the franchise contract. The bargaining power argument has not been a part of the economics literature on franchise agreements and other vertical contracts, but it has been a significant part of the legal justification for restrictions on franchisors. The authors cite a typical legal opinion, "the franchise relationship frequently amounted to a contract of adhesion unilaterally imposed on reluctant dealers by an all-powerful distributor."[13]

Beales and Muris attempt to determine whether there is empirical support for this bargaining power justification for regulation of franchise

[12] J. Howard Beales III & Timothy J. Muris, *The Foundations of Franchise Regulation: Issues and Evidence*, 2 J. CORP. FIN. 157 (1995).

[13] Munno v. Amoco Oil Co., 488 F. Supp. 1114, 1118 (D. Conn. 1980).

agreements. First, they look at characteristics of franchisees to see whether they appear to be as powerless as the legal opinions presume. They find that:

- the majority had obtained outside assistance (usually legal) to evaluate the franchising opportunity;
- many had other franchising options under consideration when the current one was chosen;
- many had previous experience as a franchisee;
- over eighty percent had attended or graduated college;
- the lower end of the franchisees modal income range was greater than U.S. average income; and
- the majority of franchisees were content with their relationship.

Therefore, most of the franchisees appear to be fairly sophisticated and to have good outside options. Combined with the fact that virtually all franchise contracts are standardized, this implies that franchisees are not powerless. Rather, they have contractual terms that are reasonable because the best educated and most experienced have a disproportionate impact on the contract terms.

Second, the authors ask whether data on franchise terminations and non-renewals support the efficiency or opportunistic explanation for terminations. An efficient termination occurs when the franchisor detects free-riding (suboptimal quality provision) by a franchisee. They define opportunistic termination as any non-efficient termination. They use data on terminations (by both franchisor and franchisee) in thirteen industries over eight years. Their independent variables include: growth in number of outlets (should increase free-riding); growth in sales per outlet (should decrease free-riding); and, proxies for appropriable rent (should increase opportunistic terminations). Their results do not support or reject the opportunism hypothesis—the estimated coefficients are often of the wrong sign, are statistically insignificant, and are not stable with respect to small changes in the specification. They do get a robust, significant, and negative coefficient on the "growth in outlets" variable, suggesting that, if opportunism is a factor, it is tempered by the franchisor's need to maintain his reputation to attract additional good franchisees. This result is consistent with the economics literature.

Arruñada, Garicani, and Vázquez (2001)[14] empirically analyze the contracts between auto manufacturers and their dealers. They examine twenty-three dealer networks and consider both pecuniary and non-pecuniary dimensions of the contracts. (Contracts are uniform within each network.) Their results are consistent with the principal-agent theories of franchise contracts. For example, long-time manufacturers of high-quality cars—who have greater costs associated with opportunistic behavior—hold greater rights in their franchise contracts than manufacturers with lower reputational costs.

Lafontaine and Slade[15] assess the state of empirical research on the effects of vertical restraints. They examine a comprehensive set of papers that estimate the impact of vertical restraints on consumers. While more research is needed in this area, existing results are quite consistent. They find that "privately imposed vertical restraints benefit consumers or at least do not harm them." In contrast, "when restraints are mandated by the government, they systematically reduce consumer welfare or at least do not improve it."[16]

Cooper, Froeb, O'Brien and Vita[17] also survey empirical research on the effects of vertical restraints (and vertical integration).[18] Their assessment of this literature is as follows:

- most studies find evidence that vertical restraints/vertical integration are pro-competitive;
- this efficiency is often plausibly attributable to the elimination of double-markups or other cost savings;
- a number of studies also find evidence consistent with "dealer services" efficiencies; and
- instances where vertical controls were unambiguously anticompetitive are difficult to find.

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14 Benito Arruñada, et al., *Contractual Allocation of Decision Rights and Incentives: The Case of Automobile Distribution*, 17 J.L. ECON. & ORG. 257 (2001).

15 Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy*, (September 2005) (unpublished paper, *available at* http://www2.warwick.ac.uk/fac/soc/economics/staff/faculty/slade/wp/ecsept2005.pdf (last visited Aug. 21, 2007)).

16 Note that dealer restrictions are vertical restraints imposed by states at the behest of dealer organizations.

17 James C. Cooper, et al., *Vertical Antitrust Policy as a Problem of Inference*, 23 INT'L J. INDUS. ORG. 639 (2005).

18 The set of papers they consider somewhat overlap those examined by Lafontaine and Slade.

The empirical literature strongly supports the benefits of private vertical restraints; it also raises concerns that restraints on vertical relationships imposed by government entities can be harmful to consumers. We now turn to research on one example of the latter case—restrictions on the relationship between automobile manufacturers and their dealers.

A. *Empirical Analysis of Dealer Restrictions*

Mathewson and Winter (1989)[19] develop a simple franchising model in which auto dealer regulation (such as Dealer Day in Court laws) can have positive or negative effects.

The need for regulation may arise because complete *ex ante* contracts between manufacturers and dealers are not feasible. This model focuses only on the manufacturer's decision of when to add an additional dealer due to growing population. Regulation serves the public interest if it is protecting dealers and consumers from manufacturer hold-up. Regulation serves private interests if it is enacted because of dealer rent-seeking. The model generates three equations describing the demand for regulation and regulation's subsequent impact on prices. The public interest and private interest explanations for regulation imply opposite signs on one coefficient in each of the two estimated equations—the theory gives no prediction on the signs of other coefficients. Their estimates support the private interest explanation for auto dealer regulation.

Suppose the manufacturer and dealer were able to write a complete contract at the time the dealer entered a new, unserved territory. The contract would specify that a second dealer would enter when demand increases enough that the present value of quasi-rents accruing to two dealers minus the additional capital cost of the second dealer equals the present value of quasi-rents accruing to a single dealer. That is, $2V_2(D_C) - K = V_1(D_C)$, where D_C is the threshold level of demand and V_i denotes the present value of quasi-rents to a dealer when there are i dealers. With incomplete contracting, the manufacturer faces a trade-off. Ignoring reputation effects, the manufacturer will want to install a second dealer when the present value of the second dealer's quasi-rents equals the capital cost of the second dealer. That is, when $V_2(D_H) = K$, where D_H is the threshold level of demand in the incomplete contracting environment without reputation (pure hold-up). Obviously, $D_H < D_C$; by the definition of hold-up, a manufacturer will establish a competing dealer when demand is lower than they would have agreed to in a complete contract. But potential future dealers are only willing to pay what they observe current dealers can expect to accrue—and these quasi-rents are lower than achieved with D_C. The expected losses to the manufacturer increase as the expected number of future dealers

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19 Mathewson & Winter, *supra* note 2.

increase. Therefore, the value of reputational capital increases with both expected population growth and current dealer profits. With reputational effects, the incomplete contracting threshold level of demand satisfies $V_2(D_I) - K - (R(V_1(D_I),G) - R(V_2(D_I),G)) = 0$, where G is the expected growth rate and $R(\cdot)$ represents reputational capital. The first term in the expression is the present value of quasi-rents when there are two dealers at the threshold level of demand in the incomplete contract; the second term is the additional capital cost of the second dealer; and, the third term is the reputational cost from the decrease in profits of the first dealer. If reputational effects are strong (due to high expected growth, for example), then the decision under incomplete contracting may be close to that under complete contracting. In particular, if the loss in profits to the current dealer from hold-up are equal to the loss the manufacturer takes in reputational capital, then $D_I = D_C$. Otherwise, $D_I < D_C$.

Now consider a regulatory board to which a dealer can appeal the installation of a second dealer. In this model, the board considers the profits of both the established dealer and the manufacturer with weights r_d and r_m. The dealers know the board's preferences and will appeal only in the event they will prevail, excluding delay tactics.[20] The regulatory threshold demand is given by $r_d \cdot (V_2(D_R,G) - V_1(D_R,G)) + r_m \cdot (V_2(D_R,G) - K) = 0$.

Under the pure public interest hypothesis for regulation, in which the regulation protects dealers and consumers from manufacturer hold-up, $r_d = r_m$ and $D_I < D_C$. Then the regulatory threshold condition reduces to $2V_2(D_R,G) - K = V_1(D_R,G)$, which is equivalent to the complete contracting condition. Thus, pure public interest regulation is efficient. Under the pure private interest hypothesis for regulation, where the regulation is enacted because of dealer rent-seeking, $r_d > r_m$ and $D_I = D_C$. In this case, $D_R > D_C$ and pure private interest regulation is inefficient.

Assume that the demand for regulation increases as $| D_R - D_I |$ increases; for example, if the regulatory board chooses a much higher level of demand for new dealer entry than the manufacturer under the incomplete contract, then the existing dealer has a greater incentive to appeal to the regulator. Under the pure public interest scenario, this distance is decreasing in G; that is, with higher growth rates, the manufacturer's reputation becomes more important and thus D_I moves closer to D_R. Under the pure private interest scenario, this distance is increasing in G; that is, D_I is efficient but existing dealers can use the regulatory process to exclude dealers and earn higher profits. Therefore, we should see regulation in states with low expected growth rates if regulation is motivated by pure public interest and in states with high expected growth rates if regulation is motivated by dealers' profit seeking. Under the pure public interest hypothesis, prices will fall as a result of regulation (with some lag) because entry is not de-

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20 Delay tactics are ignored.

terred by manufacturer's hold-up behavior. Under the pure private interest hypothesis, prices will rise as a result of regulation because some entry will be barred. Thus, we have predictions for the sign of the coefficient on expected growth in a regulation equation and for the sign of the coefficient on lagged regulation in a price equation.

In Mathewson's and Winter's estimated equations, the signs are consistent with the pure private interest hypothesis. The results in the regulation equation are highly significant; those in the price equation are marginally significant. The estimated price effect of regulation is seven to ten percent. The main drawback to their paper is the authors' use of state-level data. They acknowledge the aggregation problems, but did not have access to the proprietary, disaggregated data used by Rogers.

Rogers[21] tests the effect of state laws restricting the rights of manufacturers to introduce new dealers (RMA laws) using data on sales of nine Chevrolet models in local geographic markets. (In rural areas, the geographic markets are defined as counties; in urban areas, they are defined as Standard Metropolitan Statistical Areas.)

Rogers introduces three possible effects of RMA laws. They could inefficiently cause prices to rise if:

- dealers already have some market power and removing the threat of entry allows them to increase prices; or
- dealers do not necessarily have market power, but demand is growing and individual marginal costs are increasing so prices will rise when entry is barred.

RMA laws may be efficient if:

- they correct an imbalance in bargaining power between dealers and manufacturers.

The third postulated effect of RMA laws is based on the argument that dealers have specialized investments that cannot be easily transferred to alternative uses, so a manufacturer may attempt to increase sales by adding dealers while causing existing dealers to make below-normal profits. However, as Rogers points out, this argument is inconsistent since the manufacturer is unlikely to be able to attract the new dealers by offering below-normal profits. The efficient rationale for RMA laws is better formulated in Mathewson and Winters discussed above.

Rogers devises an empirical approach that allows him to distinguish among the different hypotheses regarding the effects of RMA and to esti-

21 ROGERS, *supra* note 2.

mate the impact of RMA laws on prices and consumer welfare. He estimates a demand and supply equation for each geographic area and Chevrolet model combination. The estimated elasticities yield estimates of the impact on consumer welfare. Rogers concludes that the laws led to price increases of approximately six percent and that the cost to consumers could be as much as $3.2 billion per year (in 1985 dollars).[22] The coefficients on an RMA dummy interacted with a population growth indicator suggesting that the effect of RMA laws is to raise prices because entry is barred (or limited) when demand is growing. There is no evidence for the bargaining power justification for RMA laws. (This result is consistent with the Mathewson and Winter research discussed above.)

Unfortunately, Rogers' paper contains almost no reference to the theoretical literature on vertical restraints and franchise relationships. He also pays insufficient attention to the suitability of the independent variables. These weaknesses were exploited in WEFA's "evaluation" paper discussed below.

Wharton Econometric Forecasting Associates, Inc. ("WEFA")[23] attempted to undermine the credibility of Rogers' analysis.[24] Their objections are both theoretical and empirical. Of their theoretical criticisms, only one is coherent—that Rogers' report ignores the provision of quality by the dealer and the potential that the RMA laws increase quality sufficiently to justify any price increase. While it is true that Rogers ignored the quality issue, economic theory indicates that the level of quality is likely optimal without state intervention because the franchise contract includes instruments that should mitigate the externalities that would otherwise lead to free-riding and lower quality. There is no economic basis for confidently predicting whether quality provision would rise or fall in response to RMA laws. WEFA provides no evidence on quality response, but simply asserts that RMA laws will lead to an increase in quality. Even if quality increases in response to RMA laws, it is still necessary to show that the pre-RMA level was sub-optimal.

Some of WEFA's criticisms of Rogers' empirical work are the sort that could be made of almost any data analysis and primarily reflect the fact that available data are rarely ideally suited to the project at hand. Other criticisms dealing with possible multi-collinearity may be more serious. One criticism is quite important—that Rogers was only able to conclude that either 1) RMA laws combined with high population growth rates lead to higher prices, or 2) high population growth rates lead to higher prices. WEFA argued that the test should be whether RMA laws lead to increases

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22 The often quoted price increase of six to seven percent caused by RMA laws is not weighted by sales. The sales-weighted price increase is around 3.8%.

23 Wharton Econometric Forecasting Assocs., Inc., *An Evaluation of the FTC's Analysis of the Effects of RMA Laws on Auto Markets*, A.B.A. (1990).

24 WEFA's study was prepared for the National Automobile Dealer Association.

in dealer margins because prices could increase for idiosyncratic reasons in different locations. Also, the Rogers specification was not capable of determining whether prices were rising in high growth areas without RMA laws.

Mathios (1987)[25] responded to all of WEFA's comments. Most importantly, he effectively showed through new estimations that Rogers' results continue to hold in specifications that distinguish between RMA and non-RMA high-growth areas and in those that estimate the effects on price-cost margins instead of prices. The other WEFA criticisms are not susceptible to argument by re-estimation, but Mathios' rebuttals are convincing—especially given the robustness of the price effect estimates. In many ways Mathewson and Winter (1989) also serves as a good rebuttal to the WEFA critique—they show that RMA laws should increase price in high growth areas but not in zero or low growth areas, which is consistent with Rogers' result.

III. THE INTERNET'S IMPACT ON AUTOMOBILE DISTRIBUTION

Kwoka[26] surveys the state of the automobile industry through the 1990s, current and anticipated effects of the Internet on both the selling and production of automobiles, auto distribution restrictions and their impact on both traditional and Internet-assisted sales, recent efforts by dealers to impose additional restrictions on Internet sales or brokering, and estimates of consumer savings from each incremental use of the Internet in sales—from simple information provision up through Internet purchases of made-to-order cars.

In 1999, the U.S. automobile market was moderately concentrated with a Herfindahl-Hirschman Index (HHI) of approximately 1795. The market shares of the six largest manufacturers were: GM—29.2 percent; Ford—23.8 percent; Chrysler—15.6 percent; Toyota—8.7 percent; Honda—6.4 percent; and Nissan—4.0 percent. Global concentration increased during the 1990s through both acquisitions and other links.[27]

U.S. companies have largely overhauled their production processes in response to the competitive challenge presented by Japanese and other Asian car manufacturers. These changes have led to higher quality autos and lower costs. However, according to Kwoka, U.S. cars still lag behind Japanese in quality. Further, the introduction of hybrid cars by both Honda

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25 ALAN MATHIOS, FED. TRADE COMM'N, RESPONSE TO WHARTON ECONOMETRIC FORECASTING ASSOCIATES' COMMENTS ON THE BUREAU OF ECONOMICS STUDY OF RELEVANT MARKET AREA LAWS, 145 (1990).

26 John E. Kwoka, Jr., *Automobiles: The Old Economy Collides with the New*, 19 REV. INDUS. ORG. 55 (2001).

27 *Id.* at 57.

and Toyota suggests we may continue to witness greater innovation by non-U.S. companies.

Distribution in the 1990s, however, was largely unchanged from the earliest days. Manufacturers predict demand, then assemble and transport autos to franchised dealers who are expected to sell what is delivered. Dealers hold inventories of 1.5 to 2 months sales in order to better match walk-in customer demand.[28] This is a high-cost system because of the inventory requirements and the slow response to consumer demand. The Internet has the potential to improve the distribution system as well as further change the production process.

The Internet's impact on auto sales can range from information provision to a true B2C, "build to order" system. Prior to the Internet, consumers obtained information on quality, features, and invoice prices from publications like Consumer Reports and Edmunds. With the Internet, this information became more widely available to consumers—much of it provided by the manufacturers themselves. This *pure information* role of the Internet lowered search costs for consumers, but did not otherwise affect the traditional practices.

The second Internet role in car sales was the introduction of *referral services* like Autobytel and Autoweb. These services match a customer with an allied dealer (that has the desired car) in return for a referral fee from the auto dealer. Empirical studies (Scott Morton, et. al.) have found that these referral services can save consumers two percent (about $450) off the price of a new car even though this represents an additional layer in the supply chain.[29]

The third role for the Internet involves *online pricing*. Companies like Cars Direct and CarOrder post prices of participating dealers. This eliminates the need for the consumer to determine prices through time consuming visits and individual negotiations—a considerable reduction in search cost. More importantly, it represents the first time dealers have been brought into direct competition with each other. These services should result in much more competitive cost-based pricing.

The next step in Internet involvement was *online buying services*. Both CarsDirect and CarOrder are now online buying services, as is Amazon. This differs from online pricing in that the service, instead of the consumer, searches for the lowest price, arranges the sale, and, in some cases, arranges for delivery. In this business model, the dealer remains in its traditional role—though with much less market power. State laws typically prohibit these online services from receiving cars directly from manufacturers. CarsDirect and CarOrder are vertically integrated. They purchase dealerships in many areas in order to be able to obtain direct shipments of autos. These dealerships primarily serve as regional distribution centers for

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28 *Id.* at 56.

29 Morton, *supra* note 3, at 502.

online sales. Estimates of the savings to consumers of online buying services range from around $500 to $1,300 per car.[30]

The final (as yet unrealized) step would be a *build-to-order* system. Such a system would work much the way Dell's online computer sales now work. A consumer lists preferences (probably online), a price is agreed upon, parts suppliers would be notified (by Internet) of any special needs, and finally the automobile is assembled to specification and delivered to the customer in approximately 10 days. The potential cost savings of build-to-order are immense—there is a reduction in (costly) dealer infrastructure, virtual elimination of inventories, and elimination of the costs of overproduction. It is estimated that the build-to-order system could save consumers $1,500 to $2,000 dollars in addition to the savings from using an online buying service.[31]

An integrated online supply exchange, Covasint, is already being used by GM, Ford, and DaimlerCrysler for purchases of everything from office supplies to complex auto components. They intend to broaden the role of Covasint to cover all phases of supply chain management. The cost savings could be as much as 15 percent of the companies' annual purchasing costs.[32]

The over 20,000 U.S. auto dealers have managed to obtain protection from competition and entry in most states. It is now clear—as shown in the empirical studies above—that these restrictions increase automobile prices. The cost in higher auto prices likely understates the total cost to consumers; the dealers' market power allows them to charge more for services as well, raising the lifetime cost of the automobile. Now these restrictions are much more important, and costly, because they are delaying or preventing the development of significantly more efficient alternative modes of distribution.

One more efficient innovation that is hindered by distribution restrictions is Internet referral services. Scott Morton, Zettelmeyer, and Risso[33] examine the impact of Internet referral services on automobile pricing. Internet car referral services offer information about individual cars, including invoice prices and market conditions. Consumers submit a purchase request to the referral service which then forwards it to a contractually linked dealer. The dealer then contacts the consumer with a non-binding price quote. The dealers pay a fixed annual fee plus an additional fee for

30 Kwoka, *supra* note 26, at 62.

31 *Id.* at 63.

32 *Id.* at 64.

33 Morton, *supra* note 3; Fiona M. Scott Morton, et al., *Consumer Information and Price Discrimination: Does the Internet Affect the Pricing of New Cars to Women and Minorities?* (Yale SOM Working Paper No. ES-15, 2002), *available at* http:papers.ssrn.com/sol3/papers.cfm?abstract_id=288527 (last visited Aug. 21, 2007); Fiona M. Scott Morton, et al., *Cowboys or Cowards: Why are Internet Car Prices Lower?* (Yale SOM Working Paper No. ES-16, 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=288601 (last visited Aug. 21, 2007).

each sale resulting from a referral. The dealers are given an exclusive territory by the referral services, thereby gaining customers that would have otherwise shopped at a local competitor. The referral services monitor the performance of the dealers through follow-up questionnaires and terminate contracts if the dealer is not making enough sales to referrals or if there are sufficient consumer complaints. The referral services also require that the dealers have sales resources devoted exclusively to Internet referrals and that those sales people receive commissions based on volume of sales instead of profit margin.

Scott Morton, Zettelmeyer, and Risso used data from Autobytel.com[34] for 1999, which contains customer information, desired car, date of request, and the dealer that received the referral. They also used data from J.D. Power and Associates consisting of every new car transaction at over 1,000 California dealers in 1999 and early 2000. The combined dataset contains over 360,000 auto purchases, of which over 10,000 buyers submitted a purchase request through Autobytel.com.

There are several reasons to expect that prices will be lower for customers who use referral services—the services provide more information at a lower cost, the referral services' contracts with dealers contain incentives for lower prices, Internet sales may be less costly for dealers (because of less time spent with the customers), and the referral services are more likely to contract with low-cost dealers. There are two countervailing forces. First, people may utilize the referral services because of strong preferences for convenience and may be relatively less price sensitive, and, second, the Internet may attract people who are inept bargainers, so dealers could price higher to Internet referrals. The authors hypothesize that dealers contracting with referral services will have lower offline prices than other dealers and that consumers who have used a referral service will pay a lower price than other customers at the same dealer. Note that a finding that average online prices are lower than offline prices (conditional on the dealer) does not mean that the referral services are having an impact on prices—it could just as easily be the case that those people who normally bargain for the lowest prices are the same ones who use the online referral services. In order to conclude that referral services are having an impact on price, it is necessary to show that the distribution of prices changed for dealers who participate in the referral network.

Scott Morton, Zettelmeyer, and Risso's analysis shows that Internet referral services have changed the pricing behavior of dealers—they offer lower prices to customers who arrive through an Internet referral. Conditional on the dealer and the specific car, a referral customer pays about 1.5% less than other customers.[35] When one includes the impact of being directed to a lower cost dealer by Autobytel.com, the savings are about two

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34 Autoweb.com and Carpoint.com are also Internet referral services.

35 Morton, et al., *supra* note 3, at 517.

percent. Price dispersion at a dealership decreases as the fraction of referral customers increases, indicating that the referral service is affecting these prices.

Their second paper[36] examines the effect of Internet referral services on prices paid by women and minorities (using the same basic data as before). They first analyze offline pricing of autos and find that African-American and Hispanic customers pay about two percent more than others. Income, education, and other demographic characteristics explain sixty-five percent of that difference. However, online minority users of Autobytel.com pay the same as white users regardless of education, income, etc. The study controls for selection effects since Internet users may not be representative of a given group. The authors conclude that the Internet referral services are most beneficial to those groups who are currently least likely to be using the Internet.

Their third paper[37] continues the examination of the personal characteristics of those who benefit most from Internet auto referral services. It is possible that Internet referral services disproportionately attract those who are good bargainers in the offline world ("cowboys")—alternatively they may disproportionately attract those who are poor bargainers or dislike bargaining ("cowards"). If the users of referral services are primarily the former, then the welfare benefits are less than if they are primarily the latter. Controlling for selection effects, the third study shows that the referral services attract a disproportionate share of those with a high cost to collecting information and bargaining. Price savings to the "cowards" are greater than the average savings by about one percent.

IV. CONCLUSION

We see that vertical restraints can be efficient. Empirical evidence suggests they tend to improve consumer welfare when the restraints are imposed by manufacturers but tend to have a negative impact on consumers when imposed by the government at the behest of retailers or dealers. In particular, consumer harm has been found to result from state auto distribution restrictions. We are just beginning to see the effects of the Internet on competition in the automobile market. Evidence suggests that consumers are benefiting from Internet-based competition; many expect the consumer gains from Internet competition to continue to grow. Thus, extension of distribution restrictions to the Internet is an important policy concern.

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36 *Consumer Information and Price Discrimination*, *supra* note 33.

37 *Cowboys or Cowards*, *supra* note 33.

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NEW CARS AND OLD LAWS: AN EXAMINATION OF ANTICOMPETITIVE REGULATORY BARRIERS TO INTERNET AUTO SALES

*John T. Delacourt**

In the early days of the Internet, most e-commerce tended to follow a mail-order catalogue model. The products available for purchase and sale tended to be relatively inexpensive, of uniform quality, and easily deliverable. Perhaps the most familiar examples are books and CDs. As the quality of Internet communications improved and consumers became more comfortable with the medium, product offerings became more varied. Indeed, the prospect of making major, complicated purchases online, like the purchase of a new car, now seems not only possible, but inevitable. Unlike sales of books and compact discs, new vehicle sales are highly regulated. Accordingly, the first wave of online vehicle entrepreneurs soon discovered that state franchise law prohibits many, if not most, innovative approaches. For example, franchise laws forbidding direct-to-consumer sales by vehicle manufacturers are on the books in every state. Many states severely restrict, or outright prohibit, brokering, referrals, and certain forms of new vehicle advertising. As a result of these restrictions, the development of a robust market for Internet sales of new vehicles has been stalled and, in some respects, halted. Indeed, the development of the industry has been dictated not by what consumers want, but by what state franchise law permits.

Not surprisingly, this regulatory stalemate has initiated a dialogue regarding the underlying objectives of certain provisions of franchise law. This inquiry is not so sweeping as to call into question *all* of franchise law. Rather, it focuses on the consumer impact of the specific provisions of franchise law that have most severely restricted Internet sales models. However, as former FTC Commissioner Thomas Leary noted, the response of proponents of these provisions—primarily, though not exclusively, franchised new vehicle dealers—has been curious. Rather than pointing to a pro-consumer rationale for the objectionable provisions, they insist that consumers simply do not want to purchase automobiles over the Internet.[1]

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* Special Counsel, Kelley Drye Collier Shannon. Prior to joining Kelley Drye Collier Shannon, Mr. Delacourt served as Chief Antitrust Counsel in the Federal Trade Commission's Office of Policy Planning.

1 Commissioner Thomas Leary, Panel Discussion at the Federal Trade Commission Public Workshop: Possible Anticompetitive Efforts to Restrict Competition on the Internet 393 (Oct. 8, 2002), *available at* http://www.ftc.gov/opp/ecommerce/anticompetitive/021009antitrans.pdf (last visited Aug. 21, 2007) [hereinafter Tr.] (observing that the National Automobile Dealers Association "spend[s] a

They further assert that the overwhelming majority of consumers are unwilling to make such a substantial purchase without at least a test drive, and assurance that a dealer will be available to provide warranty service. However, despite the fact that many consumers would agree with this reasoning, and will continue to purchase new vehicles from franchised dealers, this argument still fails as a matter of logic. If consumers did not want to purchase new vehicles online, there would be no need to enact restrictive franchise laws that prohibit them from doing so. It also fails as a matter of fact. Recent poll data demonstrate that there is strong consumer demand for Internet vehicle sales.[2] More importantly, in the one segment of the vehicle market in which franchise law does not govern—used vehicles—online sales have grown dramatically.[3] Such growth is especially striking because used vehicles, with their unique and individualized service histories, are much *less* suited to Internet sales than commoditized, new vehicles.

Upon further review, there appears to be only one true rationale for the restrictive provisions of state franchise law: to protect the existing distribution system, where manufacturers sell to dealers and dealers sell to consumers. Those who subscribe to this rationale argue that it is expressly anti-consumer, because its sole purpose is to eliminate competition from Internet vehicle sellers that would otherwise lower prices, improve service, and spur innovation. Supporters, on the other hand, argue that it is pro-consumer, as the long term effect of Internet competition will be to drive

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great deal of time talking about the essential role that dealers play in the consumer transaction," and noting that "if that is true, and I suspect it is true, then it's not clear to me why anybody would be interested in legislation that speaks about this matter"). On October 8-10, 2002, the Federal Trade Commission conducted a public workshop entitled *Possible Anticompetitive Efforts to Restrict Competition on the Internet.* More information is available on the workshop's homepage—including transcripts of the workshop and all of the panelists' written statements—at http://www.ftc.gov/opp/ecommerce/ anticompetitive/index.shtm. *See also* Harry Stoffer, *State Franchise Laws under FTC Scrutiny: Critics Say the System Keeps Car Prices High, but Dealers Disagree*, AUTOMOTIVE NEWS, Oct. 21, 2002 (summarizing workshop automobiles panel).

2 *See* MARK COOPER, CONSUMER FEDERATION OF AMERICA, BRINGING NEW AUTO SALES AND SERVICES INTO THE 20TH CENTURY 8 (2002), *available at* http://www.ftc.gov/ opp/ecommerce/anticompetitive/panel/cooper.pdf (last visited on Aug. 21, 2007) (In a 2001 Consumer Federation of America poll, 78% of respondents indicated that they thought that "consumers should have the ability to purchase cars directly from manufacturers or third parties using the Internet" and 51% "strongly" so. Only 16% disagreed. Likewise, 78% of respondents indicated that they oppose "laws that require all car sales to go through car dealerships" and 59% "strongly" so. Only 19% disagreed.); Editorial, *Tire-Kicking on the Web*, WALL ST. J., Aug. 31, 2000 (statewide survey in Texas showed nearly 70% support for online vehicle sales). *See also* Donna Harris, *Results of Internet-Sales Study Carry Caveat for Dealers*, AUTOMOTIVE NEWS, Nov. 8, 1999 ("Though the dealers got their restrictions passed [in the state of Georgia], the manufacturers discovered the Internet could help build a pro-consumer case against franchise laws. Consumers don't care about franchise laws, but they do feel they have a right to shop over the Internet."). *But see* James Lust, Tr., *supra* note 1, at 398 (In a 2002 Consumer Report survey, 93% of new car buyers ranked their overall buying and dealership experience from very to "moderately" satisfying.).

3 *See* discussion *infra* Section I.C.2.

traditional dealers from the market, leaving consumers without access to test drives, warranty service, and a variety of other important dealer services. In either case, the issue is one more appropriately addressed by consumer preference than by state franchise law. It is clear that franchised new vehicle dealers offer a variety of valuable services many consumers want and routinely rely on. However, an increasingly large body of evidence regarding online sales of used vehicles demonstrates that there are existing, alternative sources of these services available to consumers who choose to buy online. While these alternatives are not necessarily identical to franchised dealer services in all respects, they provide consumers with sufficiently reliable substitutes to justify experimentation with Internet vehicle sales models. Such experimentation is further justified by projections of dramatic consumer savings, ranging from $1,000-$2,600 per vehicle, or $18-$44 *billion* industry-wide. In contrast, restrictive franchise laws that essentially function to prohibit Internet sales, impose tremendous costs on consumers that, in light of the potential savings, are alarmingly disproportionate to the potential harms they seek to prevent.

I. CURRENT STATUS OF ONLINE VEHICLE SALES

A. *The Existing Distribution System*

The existing new vehicle distribution system in the United States reflects the reality that an automobile is an expensive product. Because an automobile represents such a substantial investment for a typical consumer, an automobile purchase generally entails a relatively long-term commitment. Consumers are unlikely to make such a substantial, long-term investment in a vehicle without some assurance that expert repair and maintenance service will be readily available. Thus, in order to sell, service, and repair their products, automobile manufacturers required an extensive network of local dealerships.[4] In 2002, this existing distribution network was of sufficient scale to accommodate an estimated 16.8 million new vehicle sales.[5]

Dealers have historically performed a number of important services for both manufacturers and consumers. Manufacturers, for example, rely on dealers to stock and display their wares. Indeed, maintaining an inventory of the manufacturer's products in a manner that is both appealing and geo-

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4 MARK COOPER, DIRECTOR OF RESEARCH, CONSUMER FEDERATION OF AMERICA, A ROADBLOCK ON THE INFORMATION SUPERHIGHWAY: ANTICOMPETITIVE RESTRICTIONS ON AUTOMOTIVE MARKETS 8 (2001), *available at* http://www.consumerfed.org/pdfs/internetautosales.pdf (last visited Aug. 21, 2007).

5 National Automobile Dealers Association ("NADA"), Comments Submitted by the National Automobile Dealers Association Regarding Competition at 8 (2002) (on file with author).

graphically proximate to consumers is a dealer's primary responsibility. In addition to inventory maintenance and local level marketing efforts, dealers are the primary source of warranty repair service, and a significant source of post-warranty repair service. For their part, consumers rely on dealers for detailed product information, as well as a first-hand examination of the vehicle in the form of a test drive. Beyond the initial purchase, consumers may continue to rely on the dealer for a variety of ancillary services, including repairs, replacement parts, accessories, and even financing.[6]

B. *Online Alternatives*

As in other industries, the rise of the Internet has already had a dramatic impact on the typical vehicle purchase. Many of the changes spurred by online alternatives have substantially benefited consumers, but they have also presented challenges to the traditional, dealer-oriented distribution system. While some of these alternatives have already begun to flourish, state regulatory barriers have severely restricted the growth of other alternatives.[7]

1. Information-Only Sites

Perhaps the most ubiquitous, and least controversial, online alternative in the automotive context are informational websites. As recently as 2001, an estimated 62% of new car buyers researched their purchase online before visiting a dealer, up from 54% in 2000. This figure was expected to grow to 75% in 2003, which would account for over 11 million new vehicle sales.[8] Informational websites may be maintained by a variety of entities, ranging from vehicle manufacturers and dealers to individual enthusiasts with a particular interest in specific makes and models. From a consumer perspective the most useful sites tend to be operated by professional third parties, such as Edmunds.com, consumerreports.com, and kellyblue-

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[6] *Id.* at 23 ("Consumers voluntarily pay more for value-added services provided by dealers, such as help with financing, the ability to test-drive a vehicle, a reliable service facility, handling trade-ins, providing loaner cars and the ability to shop through inventory and drive a vehicle off the lot on the same day.").

[7] Karen Lundegaard, *Changing Lanes: Toyota Hopes to Avoid the Potholes that Have Plagued Its Competitors' Online Efforts*, WALL ST. J., Apr. 23, 2001 ("[P]lans from auto makers to move beyond plain marketing sites and into online sales have largely gone nowhere because of dealers' concerns that the auto companies will bypass them altogether and sell directly to consumers, and because most states have laws preventing just that from happening.").

[8] GENERAL MOTORS ("GM"), GENERAL MOTORS WRITTEN COMMENTS FOR THE FEDERAL TRADE COMMISSION PUBLIC WORKSHOP: THE INTERNET 1 (2002), *available at* http://www.ftc.gov/opp/ecommerce/anticompetitive/comments/gm.pdf (last visited Aug. 21, 2007).

book.com.[9] Many of these sites provide detailed information, such as model descriptions, options, colors, financing options, and used vehicle valuations free of charge.[10] More importantly these sites frequently provide detailed price-related information, such as the dealer's invoice price, details on dealer incentives and holdback specific to a particular time and geographic location, and an estimate of market price.[11] This wealth of information puts consumers in a much better bargaining position long before they enter the showroom.

2. Internet Referral Services

A slightly more active alternative is the Internet referral service. While referral services typically operate websites that provide a variety of vehicle information, they also take one additional step toward a completed sale. After obtaining the consumer's contact information and a description of the type of vehicle the consumer is seeking, the referral service passes this information on to a local dealer, who then contacts the consumer to complete the sale. The consumer is under no obligation to accept the dealer's initial offer, or even to work with the dealer selected, and may continue to bargain if so inclined.[12] Typically, the most successful referral services—such as Autobytel.com, CarPoint.com, and Autoweb.com—do not charge consumers for this service. Instead, the dealer pays for the service. In the event of a successful transaction, the referral service receives a fee for the "lead."[13] A referral service may also enter into a more long-term relationship with a dealer, where the participating dealer pays a flat subscription fee for the stream of leads that the referral service promises to

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9 FIONA SCOTT MORTON, YALE SCHOOL OF MANAGEMENT, STATEMENT FOR THE FEDERAL TRADE COMMISSION: POSSIBLE ANTICOMPETITIVE EFFORTS TO RESTRICT COMPETITION ON THE INTERNET 1, *available at* http://www.ftc.gov/opp/ecommerce/anticompetitive/panel/morton.pdf (last visited Aug. 21, 2007).

10 NADA, *supra* note 5, at 14.

11 MORTON Statement, *supra* note 9, at 1. *See also* Fiona Scott Morton, Tr., *supra* note 1, at 404 (describing advantages of informational websites over print publications, noting that "for example, you can get a market price that is specific to the exact configuration of the car you're looking for in the geographic area in which you live at the time at which you're asking, which Consumer Reports simply couldn't provide in a printed version, not with all those dimensions.").

12 *Id.* at 1.

13 EVAN SCHULZ, ECONOMIC STRATEGY INSTITUTE, AUTOMOBILE RETAIL AND PRODUCTION IN THE AGE OF E-COMMERCE 12 (2001), *available at* http://www.econstrat.org/index.php?option=com_content&task=view&id=183 (last visited Aug. 21, 2007).

provide.[14] Still other referral services, typically those operated by manufacturers, may not charge dealers to participate at all.[15]

3. Third Party Brokers

Third-party brokers provide another online service. Rather than merely serving as a passive intermediary between consumer and dealer, as referral services do, Internet brokers take an active role in the transaction. After obtaining the consumer's contact information and a description of vehicle preferences, the broker conducts a search of local dealers to identify a car that fits the consumer's criteria. The broker then negotiates the price and other terms of sale with the dealer.[16] One of the principal benefits of this arrangement is that the brokers can quote the consumer a specific price for a specific vehicle, which the consumer can instantly accept or reject.[17] Typically, the broker does not actually take title to the vehicle. Rather, the broker purchases through a preferred dealer, who then delivers the vehicle to the customer directly. In some instances, the broker may charge the consumer a fee for this service. In other instances, the broker may simply take the difference between the price negotiated with the consumer and the price negotiated with the dealer as a commission.[18] A number of firms—including CarsDirect.com, CarOrder.com, and Cars.com—attempted to implement a third party broker model in the later 1990s, but regulatory barriers have increasingly stifled this approach.[19]

4. Direct-to-Consumer Sales

By far the most ambitious online alternative, however, would be direct-to-consumer sales. In contrast to the other alternatives—all of which contemplate the use of one or more intermediaries, whether a dealer, broker, or referral service—this model contemplates a sale directly from the vehicle manufacturer to the consumer. Some commentators have suggested that consumers might some day be able to purchase an automobile the way many of them currently purchase another expensive, complicated piece of equipment: a computer. Using the Internet, consumers could select the

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14 MORTON, *supra* note 9, at 1. *See also* James Lust, Tr., *supra* note 1, at 443 (noting that a participating dealer is required to pay Autobytel "$837 a month . . . or over $10,000 a year.").

15 GM, *supra* note 8, at 2 (GM does not charge dealers an enrollment fee to participate in GMBuyPower.com, and also provides free dealer training.).

16 SCHULZ, *supra* note 13, at 13.

17 MICHAEL E. ROVINSKI, GENERAL MOTORS CORP., STATE AUTOMOBILE MANUFACTURER/DEALER LAWS AND E-COMMERCE 5 (2003).

18 SCHULZ, *supra* note 13, at 13.

19 *Id.*

vehicle and options they prefer, just as they might purchase a built-to-order PC.[20] Other commentators have expressed greater skepticism regarding the viability of such a model. For example, skeptics of direct-to-consumer sales have raised concerns regarding both technical feasibility and consumer acceptance. They argue that manufacturers will be unable to respond to build-to-order requests with sufficient speed[21] and they assert that consumers will continue to demand a laundry list of value-added dealer services.[22] With respect to this latter concern, proponents of direct-to-consumer sales contend that dramatic price reductions associated with eliminating dealers from the supply chain will ultimately win consumer support. Furthermore, the savings would spur renewed interest in alternative sources of true value-added dealer services. To date, however, there has been little experimentation with direct-to-consumer approaches, primarily because state regulatory barriers are both prevalent and severe.

C. *State Regulation*

1. New Vehicle Sales

a. Consumer Protection Law

Although consumer protection concerns are often raised in support of franchise law, state "lemon" laws are actually the principal source of con-

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20 *See, e.g.*, ROBERT D. ATKINSON, PROGRESSIVE POLICY INSTITUTE, THE REVENGE OF THE DISINTERMEDIATED: HOW THE MIDDLEMAN IS FIGHTING E-COMMERCE AND HURTING CONSUMERS 6 (2001) *available at* http://www.ppionline.org/documents/disintermediated.pdf (last visited Aug. 21, 2007) ("[I]f consumers could use the Net to choose the car and the components they want (as consumers do now when buying a Dell or Gateway PC), the industry could cut out millions, if not billions, of dollars in costs related to inventory and sales."); Mark Cooper, Tr., *supra* note 1, at 435 ("[T]he example that I like to use is the PC. If you think back to PC sales in the early 1980s, some people thought they would impose a franchise model on them. You'll remember IBM wanted to have franchise stores and the claim was that we had to have exclusions and limits on the number of stores because there would be free-riding. And, of course, the efficiency of distribution in the PC industry absolutely blew that away."); MORTON, *supra* note 9, at 4 ("In the very long run, manufacturers will likely create systems that can build a car to order in a short amount of time."). *But see* GM, supra note 8, at 3 ("GM believes that the current franchise system of 'bricks and mortar' dealerships will remain the way cars and trucks are sold in America for the foreseeable future.").

21 NADA, *supra* note 5, at 6 ("Minimizing production time is essential to make this [direct-to-consumer] option appealing, however, and the concept of a two week order-to-delivery schedule is far from reality. In fact, the time period from order to delivery is on the rise. It has increased in the past year to 53 days from 47 days.").

22 *See* discussion *infra* Section II.B.

sumer protection in the automotive context.[23] These laws are essentially intended to bolster consumer bargaining power with manufacturers and to address concerns that manufacturers might otherwise respond inadequately, or unduly slowly, to consumer complaints regarding defective vehicles. Lemon laws have now been enacted in all fifty states.[24] They require automobile manufacturers to provide refunds or replacement vehicles if, after a reasonable number of repair attempts, the vehicle still fails to satisfy the terms of the warranty. Once the consumer has satisfied the statutory requirement of notice and has made a reasonable number of repair attempts, the burden shifts to the manufacturer to demonstrate that the vehicle is not a lemon.[25] Because lemon laws do not prohibit or otherwise impede Internet sales of new vehicles, and there is general consensus that the costs they impose are roughly commensurate with their benefits, lemon laws have not been a principal focus of legal scholarship or antitrust scrutiny. Likewise, the substantial bodies of law addressing automobile safety and environmental compliance have not been a source of competitive concern, as these laws have not been interpreted in a manner that discriminates against e-commerce business models.

b. Franchise Law

In contrast to consumer protection laws, the web of inconsistent, and often highly restrictive, state franchise laws poses a significant obstacle to Internet sales of new vehicles.[26] Franchise arrangements, including the use of exclusive territories, are not unique to the automobile industry. What is unique is the degree to which franchise arrangements that originally had

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23 Mark Cooper, Tr., *supra* note 1, at 431 ("Consumer protection is provided primarily by lemon laws and warranties, which are contracts between manufacturers and consumers, not dealers."). While lemon laws are primarily retrospective in nature, it bears noting that consumers are shielded by legal protections both before and after a new vehicle purchase. Lemon laws are sufficiently dependable and well-established that they allow consumers to rely on less formal pre-purchase consumer protection, such as test drives and truth-in-advertising requirements.

24 Louis J. Sirico, Jr., *Automobile Lemon Laws: An Annotated Bibliography*, 8 LOY. CONSUMER L. REP. 39 (1995-1996).

25 Elizabeth E. Vollmar, *Lemon Laws: Putting the Squeeze on Automobile Manufacturers*, 61 WASH. U. L. Q. 1125, 1129-30 (1983-1984).

26 Scott Painter, Tr., *supra* note 1, at 412 ("There are 50 different interpretations of franchise law in 50 different states, and therefore, it's very difficult to do business in a multi-state environment and navigate franchise law."). *But see* BRIAN SHAFFER, NATIONAL AUTOMOBILE DEALERS ASSOCIATION, AN ASSESSMENT OF FRANCHISE LAWS AND INTERNET AUTO SALES 2 (2001) *available at* http://www.nada.org/pdf/shaffer_report.pdf ("Franchise laws, while certainly of benefit to dealers, were enacted and exist in the public interest, including the interest of consumers, local communities, and small businesses. Auto dealers owe no apologies for the limited protection they receive from government regulation. Similar protections against unrestricted entry are afforded many community-based industries, such as physicians, hairdressers, taxicabs, hospitals and some utilities.").

their basis in private contracts have, over time, become codified in state law. As one panelist observed, "[b]etween 1969 and 1980, approximately 40 states enacted legislation to protect the exclusive franchises that had lost their economic rationale. The voluntary franchise relationships were turned into mandatory restrictions imposed by state law."[27] While it could be argued that a system of exclusive franchises was necessary to *launch* the automobile industry, the industry has changed dramatically since that time. Consequently, opportunities to experiment with new approaches have been severely limited by state laws that essentially enshrine the original dealer-manufacturer compromise.

It is also notable that the concerns addressed by franchise law are separate and distinct from the concerns addressed by consumer protection law.[28] In the automobile context, consumer protection law is directed primarily toward preventing fraud and addressing various safety concerns. In contrast, the purpose of franchise law is to protect dealers who have made substantial investments in real estate, facilities, and inventory[29] from unfair competition from manufacturers.[30] Indeed, the National Association of Automobile Dealers noted in its written statement that "when contemplating the removal of [some components of dealer franchise laws], a fair assessment of the costs and benefits *must include other factors beyond the impact on consumers*."[31] This is not to suggest that franchise laws do not have a significant impact on consumers. As one panelist noted, "although franchise laws have little or nothing to do with the consumer, the consumer

27 COOPER, *supra* note 2, at 3.

28 James Lust, Tr., *supra* note 1, at 397-98 ("[M]y first order of business this morning is to correct a hand-out piece that you have. There's a line in there that suggests that dealers want franchise laws in order to stop the manufacturers' unscrupulous practices with the consumer. That is not true. I've never heard a dealer say that. I've never heard an organization say that."). *But see* Bill Wolters, Tr., *supra* note 1, at 423 (noting that an automobile purchase "requires a brick and mortar presence with trained employees, a dealer who is responsible to the community, and the oversight of a myriad of state and Federal agencies to protect their consumers. The consumer deserves the protection and they can only get that from a franchise dealer.").

29 SHAFFER, *supra* note 26 at 7 ("Operating costs of dealers include commercial rents or mortgage loan servicing, inventory carrying costs, advertising, utilities, salaries, management and other aspects of typical retailing overhead."); Bill Wolters, Tr., *supra* note 1, at 421 ("Dealers have an average investment of just over a million dollars in plant and facility and they have about $5 million in inventory."). *But see* Howard Beales III & Timothy J. Muris, *The Foundations of Franchise Regulation: Issues and Evidence*, 2 J. CORP. FIN. 157 (1995) (identifying a close alignment between the economic incentives of dealers and manufacturers that rebuts the need for a specialized body of franchise law to protect dealers).

30 Letter from Scott Painter, Built-to-Order, Inc., to author 2, *available at* http://www.ftc.gov/opp/ecommerce/anticompetitive/panel/s_painter.pdf (last visited Aug. 21, 2007). *See also* Scott Painter, Tr., *supra* note 1, at 412 ("Franchise law was basically enacted to really protect franchisees from unlawful competition from their franchisers, the OEMs.").

31 NADA, *supra* note 5, at 2 (emphasis added). *See also id.* at 1 (noting that the primary concern addressed by franchise law is not consumer protection, but rather "[s]ales channel conflict.").

is ultimately affected as it relates to new automobiles."[32] Unfortunately, with respect to Internet sales of automobiles, the consumer may often be adversely affected. While it is certainly not the case that online vehicle sales and dealer franchise laws are completely inconsistent, or wholly incompatible, a number of specific provisions of franchise law do appear to have a substantial anti-consumer impact.

i. Restrictions on Advertising

Truthful, non-deceptive advertising is often one of a consumer's most important sources of product information.[33] This general rule certainly holds true in the automotive context, in which advertising about a vehicle's features, safety rating, and, perhaps most importantly, price, can function as a potent pro-competitive force. And yet restrictions on vehicle advertising imposed by state franchise law have hindered the effectiveness of Internet advertising, particularly with respect to price. Two manufacturer-dealer joint ventures are illustrative of this point.

In 2001, Ford and General Motors, working with their dealers, sought to offer special pricing over the Internet, via FordDirect.com and AutoCentric.com, respectively. The goal of both ventures was the same: to give consumers real inventory data, binding prices, and the option of completing the vehicle purchase over the Internet.[34] Ford proposed to offer Internet customers a no-haggle "e-price"—somewhere below the manufacturer's suggested retail price but above the invoice price.[35] As the companies soon discovered, these plans ran afoul of advertising restrictions in a number of states that required advertised prices to be available to *all* consumers, not merely those who purchase through a particular distribution channel, such as the Internet. As a result of these restrictions, Ford retreated from its e-pricing strategy in a number of states, including California, Georgia, Massachusetts, Nevada, Tennessee, and Washington.[36] In these states, the company adopted an Internet referral service model, rather than a more interac-

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32 Painter letter, *supra* note 30, at 2.

33 *See* FTC Staff Comments to the Food and Drug Administration on Advertising and First Amendment Issues at 4 (Sept. 13, 2002), *available at* http://www.ftc.gov/os/2002/09/fdatextversion.pdf (last visited Aug. 21, 2007).

34 *See* Lundegaard, *supra* note 7.

35 Jeffrey Ball, *E-Business: Ford, Auto Dealers Join Forces to Create Web Site*, WALL ST. J., Aug. 28, 2000. A competing manufacturer, which opted *not* to pursue an e-pricing strategy, frankly acknowledged that the discount available for online purchases is attributable, in large part, to a reduction in dealer mark-up. *See* Lundegaard, *supra* note 7 (Toyota's Vice President of Corporate Communications stated that "[w]e believe that the dealer's margin is the dealer's business. By establishing an e-price you've eliminated [manufacturer's suggested retail price] and shrunk the margin for the dealers right out of the box.").

36 Donna Harris, *FordDirect Settles E-Price Issue*, AUTOMOTIVE NEWS, Apr. 2, 2001.

tive approach, and advertised vehicles at the dealer's sticker price, rather than the more competitive e-price. Due to restrictions on the payment of referral fees, discussed in greater detail below, the referral service model adopted in Texas was even more limited.[37]

ii. Restrictions on Referrals

Restrictions on referral fees also appear to have a negative impact on consumers. Limitations on payments for potential leads directly target the primary revenue source of Internet referral services. This jeopardizes the continuing viability of this online alternative. Such restrictions may take a number of forms. The most direct would be an outright ban. Some states have accomplished this result by simply prohibiting third parties from accepting payment in connection with a consumer's vehicle purchase.[38] Other states have taken the slightly less restrictive approach of permitting referral fees, but prohibiting them from being paid on a per transaction basis. Internet referral services operating in these states comply with the restriction by charging participating dealers a flat monthly fee.[39] Such arrangements can be extremely inefficient, particularly when combined with a regulatory requirement that all participating dealers be charged the *same* monthly fee.[40] Finally, some states take the additional step of actually dictating the particular dealer to whom a consumer can be referred. Such laws typically *require* the Internet referral service to provide the consumer's contact information to the most geographically proximate dealer, regardless of the consumer's preference. In addition to depriving Internet referral services of much of their value to the consumer, some commentators have noted that these laws may raise consumer privacy issues.[41]

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[37] *Id.*

[38] *See, e.g.*, MD. TRANSP. CODE ANN. § 15-101(g)(1)(ii) (2003) (defining a "vehicle salesman," requiring a state license, as any individual who "induces or attempts to induce any other person to buy or exchange an interest in a vehicle . . . and receives or expects to receive a commission or other compensation from either the seller or the buyer of the vehicle."); VA. CODE ANN. § 46.2-1537 (2003) ("It shall be unlawful for any motor vehicle dealer or salesperson licensed under this chapter, directly or indirectly, to solicit the sale of a motor vehicle through a pecuniarily interested person, or to pay, or cause to be paid, any commission or compensation in any form whatsoever.").

[39] Debra J. Holt, *The Internet and Auto Sales: Benefits and Barriers*, 19 J. PRIVATE ENTERPRISE 21, 25 (2003).

[40] *Id.* at 26 ("A Mercedes dealership on a prime location would pay the same fee as a Hyundai dealer on an out-of-the-way street. Therefore, the referral service has an incentive to ration referrals, particularly the more valuable ones. This enforced pricing policy also makes the referral affiliation less attractive to the low cost dealer selling less expensive cars since they would have to pay the average value of referrals.").

[41] John Whatley, Tr., *supra* note 1, at 418-19 ("There have been attempts to direct consumer contact leads to the nearest dealer regardless of what the consumer wants, even if the consumer does not want the contact to go to that dealer. That raises, I think, consumer privacy issues, and also, because we

iii. Restrictions on Brokering

Restrictions on brokering are another common component of state franchise law that limits consumer choice. In California, for example, an Internet referral service need not be licensed as a dealer and is even permitted to charge a per referral fee. However, if the firm takes the next step of actually handling the sales transaction and accepting a commission, it must be licensed as a dealer. Furthermore, any staff involved in the transaction must be licensed as salespeople.[42] Other states are even more restrictive. Texas, the nation's second largest auto market,[43] does not provide for licensed brokering, but rather prohibits *all* brokering outright. Any firm other than a licensed dealer that charges a fee or commission for arranging an automobile sale is deemed to be engaged in unlawful brokering. Indeed, the definition of "brokering" under Texas law is broad enough to encompass and prohibit conduct that is more commonly associated with Internet referral services. For example, any fee charged for a referral is considered a prohibited commission, because some referrals may result in actual sales.[44] Such restrictions are an unexpected and counterintuitive component of franchise law. After all, the principal objective of franchise law is to codify the historical bargain between manufacturers and dealers to which brokers were not a party.[45] An equally unexpected result is that dealers, rather than brokers, have been among the primary enforcement targets. The Texas Motor Vehicle Board, for example, warned six dealers that they could be subject to fines of up to $10,000 per day for dealing with an Internet broker.[46] A short time later, the three major U.S. auto manufacturers each sent letters to their domestic dealers reminding them of the prohibitions in their franchise agreements against selling vehicles to third party intermediaries.[47]

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have the technology to direct the leads where the consumer wants them, we don't think the states should be in the business of telling us to disregard those preferences.").

42 Donna Harris, *Texas OKs Rules for Net Services*, AUTOMOTIVE NEWS, Feb. 14, 2000.

43 Jennifer Montgomery, *Dot-Competition Bypasses Texas: Dealer Protection Rules Prohibit Direct Auto Sales over the Internet*, HOUS. CHRON., Mar. 19, 2000 (noting that 1.3 million new cars and trucks were sold in Texas in 1999).

44 Harris, *supra* note 42 (also noting that two broker services, Carsdirect.com and Carorder.com were expressly prohibited from doing business in Texas, explaining that both are "considered brokers because they buy cars from dealers for resale to consumers").

45 Painter letter, *supra* note 30, at 3 ("[A]lthough franchise law was never intended to protect franchisees from competition from 3rd parties, it is now being interpreted in just this manner."); *see also* Scott Painter, Tr., *supra* note 1, at 439 ("[F]ranchise law was never intended to affect the relationship of a dealer to a third party independent. Its foundation in law is the breach of a contract.").

46 Montgomery, *supra* note 43.

47 SCHULZ, *supra* note 13, at 13.

iv. Restrictions on Direct-to-Consumer Sales

Perhaps the most universal, and fundamental, restriction imposed by automotive franchise law, however, is the prohibition on manufacturer sales of new vehicles. Direct-to-consumer sales are prohibited in all fifty states, as every state has passed a law requiring new vehicle sales to be accomplished through a licensed dealer.[48] Dealers contend that such laws are necessary to protect their substantial, long term investments in fixed assets and inventory from exploitation by opportunistic manufacturers. The National Automobile Dealers Association, for example, has stated that "after relying upon and benefiting from their franchised dealers' investments in these facilities, [some] manufacturers have tried to use the Internet as a way to market directly to retail customers without making their own investments in local facilities. This circumvention of the franchised dealer by manufacturers is unfair, particularly because of the manufacturers' requirement that their dealers' investment in facilities be adequate."[49] However, most states interpret the prohibition on direct-to-consumer sales as extending even to situations in which this dealer reliance rationale is not applicable, such as when a manufacturer is a new entrant in a given market and, therefore, has not yet asked dealers to make investments of any kind.[50] Furthermore, most states prohibit a manufacturer from being licensed as a dealer, except under special, limited circumstances.[51] This fact also seems to undercut the dealer reliance rationale, as such laws preventing manufacturers from actively taking the same, retail-level financial risks that they are supposedly imposing on dealers. Nevertheless, dealer efforts to pass such laws gained significant momentum in the late 1990s, in response to the increasing threat of direct-to-consumer Internet sales. These efforts reached their peak in 2000, when no less than twenty state legislatures passed bills either placing new restrictions on direct-to-consumer sales or tightening existing restrictions.[52]

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48 ROVINSKI, *supra* note 17, at 3.

49 NADA, *supra* note 5, at 13.

50 ROVINSKI, *supra* note 17, at 3 ("For example, if a manufacturer such as Puegeot decided to distribute its products in the United States, the state automobile manufacturer/dealer laws would require it to establish a network of dealerships to sell and service its products, notwithstanding that it theoretically could prefer to pursue a model in which it sold its vehicles directly via the Internet.").

51 SOLVEIG SINGLETON, CATO INSTITUTE, WILL THE NET TURN CAR DEALERS INTO DINOSAURS?: STATE LIMITS ON AUTO SALES ONLINE 2 (2000), *available at* http://www.cato.org/pubs/briefs/bp58.pdf (last visited Aug. 21, 2007) (noting that state franchise laws prohibit manufacturer-owned automobile dealerships in approximately 40 states); *see also* ROVINSKI, *supra* note 17, at 3 (noting that state laws may permit a manufacturer to invest in a dealership with an individual, provided that "the individual will operate the dealership and liquidate the manufacturer's ownership interest within a reasonable time.").

52 Donna Harris, *Dealers Halt Threat from Factory Stores*, AUTOMOTIVE NEWS, Nov. 6, 2000 (noting that dealers' lobbying efforts in 2000 were "unprecedented" and likely motivated by "concerns that automakers might use the Internet to compete with dealers in the future"). *See also* John Whatley,

v. Restrictions on Sales of Ancillary Services

In addition to banning direct-to-consumer sales of new vehicles, many state franchise laws go one step further by banning manufacturer sales of ancillary services.[53] These bans are often broad enough to encompass not only warranty service and parts, but also services that are not unique to the automotive context, such as financing. Arizona's automobile franchise law, for example, prohibits manufacturers from selling "a vehicle *or product, service or financing* to any retail consumer."[54] Such restrictions are even harder to justify than bans on manufacturer sales of new vehicles, as the typical rationale for franchise restrictions—the need to "level the playing field" between manufacturers and dealers—is not applicable. Manufacturers have no particular leverage with which to limit, or restrict, dealer sales of financing service, so it is not clear that dealers are in need of protection. While a clear consumer protection or dealer reliance rationale for these restrictions is missing, the financial consequence is clear. While service and parts made up only 12% of dealer sales in 2001, they accounted for almost 47% of dealer profits.[55] It is equally clear that sales of many of these services are even better suited to a direct-to-consumer Internet model than sales of new vehicles themselves,[56] as they do not present delivery challenges of the same scale.

2. Used Vehicle Sales

While experimentation with Internet models for the sale of new vehicles has been severely restricted by state franchise law, this is not the case with used vehicles. The difference in regulatory treatment has led to surprising and counterintuitive results in the marketplace. Absent the regulatory hurdles created by state franchise law, one would expect to see greater consumer willingness to purchase *new* vehicles—identical, fungible commodities protected by manufacturer warranties—sight unseen, over the Internet. In contrast, used vehicles, with their individualized service histo-

Tr., *supra* note 1, at 417 ("[A]t the height of the Internet frenzy, if you can call it that, 25 states passed legislation" prohibiting direct-to-consumer sales and manufacturer ownership of dealerships.).

53 COOPER, *supra* note 2, at 11 (noting that "[r]estrictive laws have been extended to block out competition for financing, extended service and parts," and that "[i]nsurance and finance charges are another area in which dealers are pressing efforts to restrict competition").

54 ARIZ. REV. STAT. ANN. § 28-4460(B)(2) (2001) (emphasis added). *See also* discussion *infra* Section I.D.2.b.

55 Jonathan Fahey, *Dealers 1 Internet 0*, FORBES, Apr. 29, 2002, at 56-7.

56 John Whatley, Tr., *supra* note 1, at 418 (expressing concern regarding "regulation of other products and services than the new vehicle by dealer franchise law" and noting that "[s]ome of those are distributed over the Internet by manufacturers, and we're very concerned by any restriction on those products and services").

ries and significant maintenance issues, would seem particularly ill-suited to Internet sales. Furthermore, heightened concerns regarding fraud would also seem to counsel in favor of an individual, in-person inspection of each vehicle. Yet, in spite of this conventional wisdom, it is the *used* vehicle sector that has managed to flourish online.[57] The Internet auction site eBay, for example, hosted an estimated 300,000 used vehicle sales in 2002.[58] Although it was less than three years old at the time, the eBay Motors unit already accounted for almost a quarter of the value of all the goods sold on the entire site.[59] Other automotive sites, such as Cars.com, Carsdirect.com, and Autobytel.com have also begun to focus on used vehicles. AutoTrader.com, for example, has created the largest online classified listing service for automobiles, which currently lists over 2.2 million used vehicles.[60]

This substantial body of experience with Internet sales of used vehicles imparts a number of lessons. The first is that, from a consumer perspective, the principal advantages of buying online are present regardless of whether the vehicle is new or used. For example, Internet listings of used vehicles tend to provide a greater amount of information than more traditional means. While newspaper listings may be limited to a few lines of text, Web listings may feature *pages* of text, combined with digital images that document the vehicle's condition from top to bottom.[61] Similarly, use of the Internet can substantially reduce search costs associated with a used vehicle purchase. Conceivably, a consumer in Ohio could identify a suitable vehicle in Texas,[62] which is simply not a possibility if one is thumbing through the classifieds or visiting a local dealer. Used vehicle purchasers may also avail themselves of the convenience of actually completing the transaction online—a service currently available from eBay Motors—rather than merely being referred to a dealer.[63] Most importantly, consumers have resorted to Internet sales of used vehicles because of the potential cost savings. As in the case of new vehicle sales, these savings are largely attribut-

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57 Scott Painter, Tr., *supra* note 1, at 455 ("I think that if you look at new versus used, the used category online is incredibly robust by comparison. It's impossible to regulate it because franchise law does not cover it.").

58 Nick Wingfield & Karen Lundegaard, *Improbably, eBay Emerges as Giant in Used Car Sales: The Web Auctioneer Wins Drivers Seeking Deals on Wheels, and Plans for Long Haul*, WALL ST. J., Feb. 7, 2003 (noting that in a fragmented market, these sales figures place eBay "among the largest used-car sellers in the country").

59 *Id.* (further noting the eBay Motors accounted for $100 million of eBay's total revenue of $1.2 billion in 2002).

60 *Id.*

61 *Id.*

62 *Id.* (describing instance in which—to save $3,000 on a truck—an eBay customer flew 1,100 miles from Columbus, Ohio to Fort Worth, Texas and drove the vehicle 18 hours back home).

63 *Id.* (noting that, while most sites merely provide vehicle advertising, [c]ar buyers on eBay actually commit to buying vehicles on the Internet).

able to a more streamlined distribution chain, where the consumer purchases directly from the source. In the used vehicle context, the source typically is the previous owner or a finance company, rather than an intermediary.

The second lesson is that the rapid growth of used vehicle sales online would not have happened if used vehicle sales were regulated in the same manner as new vehicle sales. Like advertising of new vehicles, Internet advertising of used vehicles does not recognize geographical borders and would likely violate exclusive territory provisions.[64] Likewise, Internet auction sites that list used vehicles often charge a listing fee, as well as a "success" fee in the event of a sale.[65] If the transactions involved new vehicles, these would likely be regarded as prohibited commissions or as referral fees. Individuals or firms negotiating the terms of used vehicle sales would likely run afoul of anti-brokering laws in the new vehicle context, or would be required to be licensed as dealers. Even provisions barring direct-to-consumer sales would likely come into play, as captive finance companies, which operate as divisions of the major automobile manufacturers, are among the largest online sellers of used vehicles.[66] As previously mentioned, such transactions, if they involved new vehicles, would be prohibited in every state.

The third lesson is that, given the opportunity, even dealers will use the Internet to reduce costs by streamlining the distribution chain. While captive finance companies are among the largest online sellers of used vehicles, franchised new car dealers are among the largest buyers.[67] Prior to the rise of the Internet, most dealers obtained used vehicles, among other means, through traditional automobile auction companies. They soon discovered, however, that by purchasing the vehicles from the finance company directly, they could save as much as $300-700 per transaction.[68] Similar to franchised dealers in the new vehicle context, traditional auction companies argue that Internet models do not provide a true substitute—at least not a complete substitute—for their services. Auction companies argue that they add value to the used vehicle transaction in a variety of

64 Wingfield & Lundegaard, *supra* note 58 (noting that "three-quarters of all car sales on eBay involve out-of-state transactions").

65 *Id.* (noting that eBay customers pay a $40 listing fee and a $40 success fee if the auction closes with a winning bidder).

66 Arlena Sawyers, *Online Used Car Sales Squeeze Auctions: Captives Set Up Web Sites to Sell Vehicles to Dealers*, AUTOMOTIVE NEWS, Oct. 13, 2003 (noting that captive finance companies have "increas[ed] their reliance on Internet websites to sell off lease vehicles to dealers," and that "[a]n estimated 585,000 used vehicles a year are sold on those websites").

67 James Lust, Tr., *supra* note 1, at 457 ("The only people that should buy used cars online are the dealers, and they do. They buy them online untested, undriven. But there is also an understanding that those cars are as represented or they go back.").

68 Sawyers, *supra* note 66.

ways.[69] Some dealers agree, and continue to obtain used vehicles through this channel. What the traditional auction companies have not done, however, is to seek protectionist legislation that would *require* dealers to purchase through this channel. Instead, they have sought to use the power of the Internet to enhance their own competitiveness, and to develop new and innovative means of adding value to the used vehicle transaction.[70] This approach has permitted the full benefit of advances in Internet technology to be realized in the used vehicle context, and constitutes a substantially more pro-consumer alternative than most current regulation in the new vehicle context.

D. *Recent Litigation*

Attempts to prohibit or restrict online vehicle sales have been the subject of a number of recent lawsuits. Interestingly, the nature of the restrictions at issue in these lawsuits reflects the trend toward public restraints on competition, in lieu of less effective private restraints, noted by former FTC Chairman Timothy Muris.[71] Private parties that have failed to limit competition from online vehicle sales through their own actions, whether as a result of antitrust enforcement actions or the simple inability to sustain collusive private conduct over time, have increasingly sought governmental assistance to accomplish the same ends. Legal challenges to these latter, public restraints have proven much less successful.

1. Private Restraints

One of the first legal challenges to a private effort to limit online vehicles sales was the Commission's *Fair Allocation System* case.[72] The *Fair Allocation System* matter arose out of efforts to prevent a particular Idaho automobile dealership—Dave Smith Motors—from selling at low prices and marketing on the Internet. At issue were concerns among dealers competing with Dave Smith, whose prices and Internet advertising were attracting car buyers from a broad geographic area, and thus taking sales that

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69 *Id.* (For example, auction companies typically "pick [the used] vehicles up, check them in, do the condition reports, and do the reconditioning.").

70 *Id.* (noting that, "[t]o remain competitive, some auction companies have devised their own electronic auction channels").

71 *See* Timothy J. Muris, Chairman, Federal Trade Commission, *State Intervention/State Action B A U.S. Perspective*, Prepared Remarks for the Fordham Annual Conference on International Antitrust Law & Policy, New York, NY 2-4 (Oct. 24, 2003), *available at* http://www.ftc.gov/speeches/muris/fordham031024.pdf (last visited Aug. 21, 2007).

72 *Fair Allocation Syst., Inc.*, Docket No. C-3832 (Oct. 30, 1998) (consent order), *available at* http://www.ftc.gov/os/1998/10/9710065.do.htm (last visited Aug. 21, 2007).

would otherwise have gone to Dave Smith's competitors. These competitors then asked Chrysler to allocate vehicles based on a dealer's expected sales in its local area, rather than allocating vehicles based on a dealer's expected total sales. This would have substantially reduced the number of vehicles available to a dealer like Dave Smith. Chrysler refused.[73]

In response to Chrysler's refusal, 25 dealerships—located primarily in Idaho, Montana, and eastern Washington—formed Fair Allocation System, Inc. ("FAS"). FAS's primary objective was to force Chrysler to modify its vehicle allocation system in the manner requested. FAS members threatened to refuse to sell certain Chrysler vehicles, and to limit the warranty service they would provide to customers, unless Chrysler yielded to their demands.[74]

In October 1998, FAS's conduct was brought to the attention of the FTC, which filed suit. The Commission's complaint alleged that FAS's threatened action against Chrysler was a *per se* illegal group boycott in violation of Section 5 of the FTC Act.[75] As the Commission explained, "[t]he goal of the boycott was to limit the sales of a car dealer that sells cars at low prices and via a new and innovative channel—the Internet."[76] The case was ultimately resolved by consent order, pursuant to which FAS was prohibited from participating in, facilitating, or threatening any boycott of any automobile manufacturer or consumer.[77]

2. Public Restraints

a. Restrictions on Direct-to-Consumer Sales

Other legal challenges to prohibitions on online vehicle sales have focused on public restraint—specifically, state laws restricting the business practices of automobile manufacturers. The first such case, *Ford Motor Co. v. Texas Dept. of Transp.*,[78] dealt with Ford's efforts to sell pre-owned vehicles over the Internet. The Texas Department of Transportation ("DOT") concluded that Ford's conduct violated the Texas Motor Vehicle Commission Code. The fact that it was being carried out over the Internet did not alter that conclusion.

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73 *Fair Allocation Syst., Inc.*, Docket No. C-3832 at & 2 (Oct. 22, 1998) (complaint), *available at* http://www.ftc.gov/os/1998/10/9710065cmp.htm (last visited Aug. 21, 2007).

74 *Id.* at & 5.

75 *Id.*

76 *Fair Allocation Syst., Inc.*, Docket No. C-3832 at 1 (Oct. 30, 1998) (analysis to aid public comment), *available at* http://www.ftc.gov/os/1998/08/9710065.ana.htm (last visited Aug. 21, 2007).

77 *Fair Allocation Syst., Inc.*, FTC Docket No. C-3832 (Oct. 30, 1998) (consent order), Part II, www.ftc.gov/os/1998/10/9710065.do.htm (last visited Aug. 21, 2007).

78 Ford Motor Co. v. Texas Dep't. of Transp., 106 F. Supp. 2d 905 (W.D. Tex. 2000).

Specifically, Ford sought to institute a direct-to-consumer distribution system for pre-owned vehicles. Using a website know as the "Showroom," Ford allowed customers to view pre-owned vehicles for sale or lease and set a no-haggle price. After receiving a deposit, Ford would transfer the vehicle to a dealership where the customer could purchase it after a test drive. Ford held title to the vehicles at all times, while the designated dealer merely took title by assignment.[79] The Texas DOT concluded that Ford's activities violated the Code provision prohibiting any firm from "engag[ing] in business as, serv[ing] in the capacity of, or act[ing] as a dealer," without first obtaining a license. It also noted that merely securing a license would not remedy the problem, as the Code expressly prohibited a manufacturer from owning or controlling a dealership, either directly or indirectly.[80]

Ford challenged the objectionable Code provisions on constitutional grounds, including dormant Commerce Clause and Equal Protection claims. With respect to Equal Protection, Ford argued that it was being unreasonably singled out and excluded for the pre-owned vehicle market based on its status as a manufacturer of new vehicles. As evidence of the fact that curbing disproportionate market power of manufacturers was not the true motivation behind the Code provision, a less legitimate state interest, Ford pointed to the fact that the Texas DOT had approved a competing manufacturer's website—GM Driversite—that also offered no-haggle pricing for displayed vehicles.[81] Again, the court was not persuaded. The court explained that the General Motors' site was operated by an outside contractor—DeMontrond Enterprises, Inc.—which had successfully applied for a Texas dealer's license.[82]

With respect to the dormant Commerce Clause, Ford asserted that the Internet, like phone lines and the mail, is an instrumentality of interstate commerce, and that the Texas law discriminated against interstate commerce by effectively shutting down Internet competitors in favor of local dealers.[83] However, the court disagreed and cited *Exxon v. Governor of Maryland*[84] for the proposition that curbing the disproportionate market power of manufacturers vis-a-vis franchised dealers was a legitimate state interest.[85] In reaching this conclusion, the court colorfully observed:

> [T]he plaintiff is prohibited from selling motor vehicles to consumers by mail, phone calls, leafleting, skywriting, or drum signals. The Court rejects the plaintiff's argument that an activity which is appropriately regulated through any other medium becomes sacrosanct when

79 *Id.* at 907.

80 *Id.* at 908.

81 *Id.* at 909.

82 *Id.* at 909-10.

83 *Id.* at 908.

84 Exxon v. Governor of Maryland, 437 U.S. 117 (1978).

85 *Ford Motor Co.*, 106 F. Supp. 2d at 908-09.

> accomplished through the Internet. If the Court were to accept the plaintiff's interpretation . . . then all state regulatory schemes would fall before the mighty altar of the Internet.[86]

Though less flippant in its treatment of the dormant Commerce Clause issue, the Fifth Circuit reached the same conclusion in *Ford Motor Co.* The court held that the Code's restrictions did not unduly burden interstate commerce in light of the two legitimate state interests they tended to advance: (1) preventing manufacturers from using their superior market position to compete with dealers, and (2) protecting Texas consumers from fraud and unfair practice.[87] The court also cited *Exxon* for the proposition that a violation of the dormant Commerce Clause will be found only when a state discriminates against similarly situated in-state and out-of-state interests (i.e., interests at the same level of distribution).[88] However, in a concurring opinion, Judge Jones criticized *Exxon* as being "woefully out of step" with the Supreme Court's more recent cases, and further observed that "[i]t should be obvious that the flow of interstate goods is diminished when barriers to entry totally prevent fair competition by a class of potential distributors."[89]

b. Restrictions on Referrals and Sales of Ancillary Services

The second case addressing a public restraint on Internet vehicle sales—*Alliance of Automobile Mfrs. v. Hull*[90]—also involved a state statute prohibiting manufacturers from owning new car dealerships. The Arizona statute at issue in this case also involved a number of more sweeping provisions, each enforceable by criminal sanction.[91] Specifically, the statute included:

- an "influencing and controlling" provision prohibiting manufacturers from controlling any aspect of the final amount charged not only for a new vehicle, but also for "[other] products, trade-ins, services or financing";[92]

- a "leads forwarding" provision requiring manufacturers to forward all leads on prospective retail customers to a dealer within the same geographic area as the prospective customer;[93] and

86 *Id.* at 909.
87 Ford Motor Co. v. Texas Dep't of Transp., 264 F.3d 493, 503 (5th Cir. 2001).
88 *Id.* at 500-01.
89 *Id.* at 512 (Jones, J., concurring).
90 Alliance of Automobile Mfrs. v. Hull, 137 F. Supp. 2d 1165 (D. Ariz. 2001).
91 *Id.* at 1169.
92 ARIZ. REV. STAT. § 28-4460(B)(3).
93 *Id.* at § 28-4460(B)(5).

- an "aftermarket services" provision prohibiting manufacturers from making direct-to-consumer sales not only of new vehicles, but also of aftermarket products and services, including replacement parts, warranty service, and financing.[94]

The court's discussion of these provisions offered little in the way of an anti-fraud or consumer safety rationale beyond the blanket observation that "[t]he Arizona Legislature has determined that consumers are best served by independent licensed automobile dealers,"[95] and that "the legislative purpose of this statute" appears to be "to further structure and regulate the automobile industry."[96] Defendant manufacturers challenged all three provisions on constitutional grounds.

With respect to the "influencing and controlling" provision, plaintiffs asserted a First Amendment violation. Specifically, plaintiffs argued that the provision prevented manufacturers from publishing pricing information about vehicles and other products on their websites.[97] However, the court declined to address the First Amendment claim on evidentiary grounds, holding that plaintiffs had failed to adequately identify both the allegedly unconstitutional speech restriction and the manner in which the statute would affect that speech as applied to these facts.[98]

With respect to the "leads forwarding" provision, plaintiffs asserted violations of the Fifth Amendment Takings Clause and the dormant Commerce Clause.[99] With respect to the Takings Claim, the court concluded that there was simply no authority to support the assertion that "leads" constitute property.[100] The Commerce Clause analysis was equally succinct, with the court concluding that, even if the provision did discriminate against out-of-state dealers, the effect was merely incidental to the state's legitimate goal of "preventing manufacturers from undermining the efforts of dealers."[101]

Finally, with respect to the "aftermarket services" provision, as in *Ford Motor Co. v. Texas Dept. of Transp.*, plaintiff manufacturers asserted both Equal Protection and dormant Commerce Clause claims. On the Equal Protection issue, plaintiffs asserted that their claim was distinguishable from *Exxon* on grounds that the provision was not merely singling them out for disparate treatment from dealers, but from a whole host of other aftermarket service providers, such as used parts suppliers, banks, and credit

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94 *Id.* at § 28-4460(B)(2).

95 *Alliance of Automobile Mfrs.*, 137 F. Supp. 2d at 1168.

96 *Id.* at 1175.

97 *Id.* at 1170.

98 *Id.* at 1170-72.

99 *Id.* at 1169.

100 *Id.* at 1175.

101 *Alliance of Automobile Mfrs.*, 137 F. Supp. 2d at 1175-76.

unions.[102] The court disagreed, however, concluding that this analysis "miss[es] one important detail.[103] There exists an underlying agreement, the automobile franchise regulations, which controls the manufacturer-dealer relationship and protects dealers from competitive business practices by manufacturers."[104]

On the Commerce Clause issue, plaintiffs specifically cited the provision's impact on Internet sales, alleging that it "'unduly burden[ed] the manufacturers' . . . ability to conduct commercial activities on a national and global basis, via the Internet."[105] Once again, plaintiffs asserted that their claim was distinguishable from *Exxon*. The plaintiffs explained that rather than challenging the state's authority to prohibit manufacturers from selling new vehicles, their challenge was limited to the prohibition on manufacturer sales of ancillary services, such as aftermarket parts and financing.[106] The key distinction was that at least part of the justification for the Supreme Court's decision in *Exxon* was the asymmetry in bargaining power between dealers and manufacturers. Retail automobile dealers make substantial investments in facilities they cannot recover without cooperation from automobile manufacturers, on whom they are totally dependent for their supply of product. A dealer offering aftermarket parts or financing is not subject to such dependence. Accordingly, the dealer's own ability to contract provides adequate protection. This rationale explains why state governments have historically permitted automobile manufacturers to compete against their dealers in these markets. However, the court disagreed, holding that it "fails to find a distinction between the sale of vehicles and the sale of aftermarket parts and services relating to those vehicles. In both instances, the manufacturer is competing with the dealer."[107]

II. ANALYSIS OF ONLINE VEHICLE SALES

A. *Potential Consumer Benefits*

Purchasing goods and services via the Internet has a number of relatively obvious, non-product specific advantages. It is generally more convenient than other alternatives. Consumers can shop from the comfort of their own home. The relatively low cost of distributing text and images over the Internet, as well as audio and video files, also makes the Internet,

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102 *Id.* at 1173-74.

103 *Id.* at 1174.

104 *Id.*

105 *Id.* at 1173.

106 *Id.* at 1168-69.

107 *Alliance of Automobile Mfrs.*, 137 F. Supp. 2d at 1173-74.

in general, a superior source of product information. But to some degree, these advantages are unique to the new vehicle market.

1. Lower Consumer Search Costs

One such benefit is lower consumer search costs. For a price-sensitive consumer, making a substantial purchase like a new vehicle is a major undertaking. Comparison shopping may require trips to more than one dealership, which may involve substantial travel, information gathering from sales personnel, administrative paperwork, and haggling. It may also raise additional concerns, such as the need to arrange for transportation or to secure child care. Moving from a brick-and-mortar to an Internet model can reduce, or eliminate, many of these search costs. Abundant product information is available online free of charge, and can be located and evaluated more easily than through traditional print publications.[108] By taking advantage of a more value-added Internet alternative—such as a referral service, broker, or direct-to-consumer model—consumers can also obtain valuable pricing information without the need to haggle or survey their local dealerships.[109] The degree to which the Internet magnifies a consumer's ability to comparison shop was perhaps best demonstrated by one panelist's description of a third party broker operation. As the panelist explained, the CarsDirect.com website was visited by "80,000 people a day shopping for a car. Most car dealers would love 80,000 customers to walk on their lot. Our close rate on that was between 200 and 300 vehicles a day. That close rate would be miserable in physical senses, but because it didn't cost us anything more to have one customer than 80,000 customers, it was scaleable."[110] The flip side, of course, is also true. Just as the Internet can provide a seller with access to potential buyers, it can also dramatically expand a buyer's access to multiple sellers.

2. Increased Consumer Bargaining Power

A second potential benefit is increased consumer bargaining power. By providing consumers with superior access to pricing information, use of the Internet puts some consumers in a position to strike a better deal. Price transparency substantially enhances a consumer's leverage, as a consumer armed with accurate pricing and cost information will almost always nego-

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108 Holt, *supra* note 39, at 32.

109 *See, e.g.*, MORTON, *supra* note 9, at 2 ("By using Autobytel.com, search costs become very low. Within seconds a consumer can request a price quote, and a day later receive it in the comfort of their home or office.").

110 Scott Painter, Tr., *supra* note 1, at 411.

tiate a better price.[111] Stated more technically, use of the Internet provides a new vehicle consumer with significantly better information regarding the seller's "threat point"—the point at which the seller is indifferent between accepting a deal and walking away.[112] By using the Internet to obtain this information, rather than print publications, the haggling process, or various psychological cues, a consumer may enter negotiations knowing that the dealer's threat point is much lower than the consumer might otherwise have anticipated.[113] Furthermore, at least one study suggests that "coward consumers" (those likely to fare poorly in the traditional bargaining process) are transformed into "cowboy consumers" (more successful negotiators) because of Internet models that arm them with pricing information."[114] The study concludes that the consumers who use Internet referral services are *not* the same consumers who would obtain lower prices anyway, even in the absence of the Internet. Rather, "coward consumers" opt for Internet alternatives because "they know that they would do poorly in the traditional channel, perhaps because they have a high personal cost of collecting information and bargaining. This group disproportionately uses [Internet channels] because its members are the ones with the most to gain."[115]

3. Lower Vehicle Prices

The third, and most notable, potential benefit of Internet sales is significantly lower vehicle prices. Although the accuracy of some of the most aggressive projections of consumer savings remains subject to debate,[116] the sheer size of the dollar figures has managed to generate significant attention. Most estimates have taken the form of a percentage savings on the total vehicle cost, and, due to the relatively expensive purchase price of a new motor vehicle, these savings can translate to hundreds, and potentially thousands, of dollars per transaction. Not surprisingly, the estimates of

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[111] Painter letter, *supra* note 30, at 3.

[112] Holt, *supra* note 39, at 33-34 ("The purely informational role of the Internet gives the potential buyer significantly better information about the seller's threat point B and also about his own threat point through better information about prices he is likely to be able to obtain from another dealer.").

[113] *Id.* at 34.

[114] Florian Zettelmeyer, Fiona Scott Morton, & Jorge Silva-Risso, National Bureau of Economic Research, *Cowboys or Cowards: Why Are Internet Car Prices Lower?* (Nat'l Bureau of Econ. Research, Working Paper No. 8667, 2001) *available at* http://papers.nber.org/papers/w8667.pdf (last visited Aug. 21, 2007).

[115] *Id.* at 22; Fiona Scott Morton, Tr., *supra* note 1, at 405 ("These are consumers who are disproportionately consumers who would have paid somewhat above average prices, and they go to Autobytel and they end up paying slightly below average prices.").

[116] SHAFFER, *supra* note 26, at 1 (criticizing the Consumer Federation of America's estimate of potential consumer savings attributable to direct-to-consumer Internet models as speculative, overstated, and based on out-of-date research).

consumer savings differ significantly depending on the type of Internet alternative being employed. By using an information-only site, for example, a consumer can save an estimated $300-$400.[117] These savings are attributed largely to the Internet's role as a superior tool for price comparison. In contrast, a consumer can save 2.2%, or nearly $500 on the average car, on total vehicle cost by using an Internet referral service.[118] These savings are attributed largely to lower search costs and increased bargaining power, as well as a referral service's tendency to direct consumers to lower cost dealers. Estimates of the savings resulting from use of a third party broker are even larger, ranging from $500-$1,300 per vehicle. These savings are attributed to the elimination of significant dealer costs, such as rent and commissions.[119] However, the most aggressive and controversial projections of consumer savings are those attributed to direct-to-consumer models. Estimates of the savings that could be realized from direct manufacturer sales to consumers range from 6% of vehicle cost, or roughly $1,500 per vehicle,[120] to the more aggressive projection of $1,000-$2,600 per vehicle.[121] Taken collectively, these per vehicle figures translate to aggregate consumer savings of $18-$44 billion annually.[122] These tremendous savings are attributed to the elimination of such fundamental dealer costs as inventory, field support, sales commissions, advertising, and overhead.

B. *Potential Consumer Harm*

Opponents of online vehicle sales generally rely on two principal arguments. First, opponents argue that new vehicle dealers have historically required the protection of franchise law to counterbalance the disproportionate market power of manufacturers. Furthermore, they argue that the Internet simply provides a new and innovative means by which manufacturers can leverage that unfair market power. Secondly, opponents argue that Internet vehicle sellers will "free ride" on the value-added services offered by traditional dealers. For example, a consumer might test drive a

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117 STEVE DELBIANCO & MICHAEL J. TAVILLA, THE NETCHOICE COALITION, THE STATE OF ECOMMERCE 2002: BEYOND THE BUBBLE, BEWARE THE BARRIERS 10 (2002) *available at* http://www.netchoice.org/Library/Barriers.pdf (last visited Aug. 21, 2007).

118 Zettelmeyer, Morton, & Silva-Risso, *supra* note 114, at 15.

119 Holt, *supra* note 39, at 35 (estimating $500-$1,300 per vehicle); Atkinson, *supra* note 20, at 7 (noting that CarOrder.com estimates $500 per vehicle).

120 COOPER, *supra* note 4, at 38; DELBIANCO & TAVILLA, *supra* note 117, at 11.

121 SCHULZ, *supra* note 13, at 24 ("[O]ne can generate a range of potential savings available from greater reliance on B2C e-commerce, for automobile retail and distribution, of between $1,048 and $2,579 per vehicle . . . While there is some debate about how these gains might eventually be distributed, few can argue that the consumer will fail to enjoy a healthy portion of them.").

122 SCHULZ, *supra* note 13, at 24 (estimating $18-$44 billion); DELBIANCO & TAVILLA, *supra* note 117, at 11 (estimating $24 billion); COOPER, *supra* note 4, at 38 (estimating $20 billion).

vehicle at a traditional dealer before making the actual purchase online. Both of these arguments are the subject of vigorous debate on their merits.[123] However, even without addressing the merits, it is clear that neither argument articulates a theory of *consumer* harm. In order to reach an effect on consumers, opponents of online sales must add another layer to their reasoning. Essentially, they argue that unfair dealing by manufacturers and free riding by Internet sellers will drive traditional dealers from the marketplace, leaving consumers with no alternative source of the many value-added services that dealers currently provide.[124] Unfortunately for the opponents, the current existence of multiple, non-dealer sources of these services strongly suggests that they have overstated their argument.

1. Lack of Test Drive Capability

The first service that will allegedly disappear in the face of Internet competition is the test drive. Opponents of online vehicle sales argue that only a franchised dealer, with a brick-and-mortar presence and a readily available inventory of vehicles, will be able to offer this service. In the short term, they contend, Internet sellers will continue to free ride, relying on traditional dealers to provide test drive service, free of charge, to their customer base. However, in the long term dealers will not be able to withstand the slow drain of sales and will begin to close their doors. With dealer test drives no longer available, consumers will be forced to purchase new vehicles sight unseen. This will not only increase the overall level of dissatisfaction with new vehicle purchases, but will depress sales industry-wide because most consumers will be reluctant to make a purchase averaging over $20,000 without at least "kicking the tires."[125]

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123 *See, e.g.*, Beales & Muris, *supra* note 29 (finding no empirical support for the proposition that franchise regulation is needed to protect dealers from manufacturers); Holt, *supra* note 39, at 28-29 (concluding that, although free riding is a legitimate concern, there is no reason to conclude that state imposed restrictions on Internet sales are an appropriate response).

124 *See, e.g.*, Letter from James Lust to author, 1-2, *available at* http://www.ftc.gov/opp/ecommerce/anticompetitive/panel/lust.pdf (last visited Aug. 21, 2007) ("It is particularly misleading to suggest that consumers would continue to receive the same high level of service as it presently provided by independent franchised dealers if such direct sales became prevalent. Franchised dealers are dependent on the revenue generated by the sale of new motor vehicles. The profit that a dealer makes on the sale of ancillary items such as parts and service are crucial to financial viability. Without new motor vehicle sales, I do not think that the franchise system can exist."); NADA, *supra* note 5, at 15 ("The potential for the Internet to facilitate business whose primary focus is to sell products rather than provide the full range of services is a major concern to dealers.").

125 *See* NADA, *supra* note 5, at 4 (noting that "[i]t is highly unlikely that everyone will boot-up their PC's and buy online B without as much as a test-drive" and that "it is widely agreed that a dominant segment of the car-buying public will wish to physically see what they are buying"); Bill Wolters, Tr., *supra* note 1, at 436-37 ("[T]he great majority of the people want to come to a dealership and drive

There are a number of flaws with this analysis. The first is the assumption that, once legally authorized, Internet models will completely supplant the traditional, brick-and-mortar model. A more likely alternative is that the two models will exist side-by-side. While it is likely the Internet sellers will draw some sales away from traditional dealers, there is no reason to assume that the incremental loss of these sales will drive traditional dealers to extinction. Indeed, it is likely that many consumers will continue to regard a test drive as an important element of a new vehicle purchase and will continue to patronize traditional dealers.

A second flaw in their argument is their assumption that a test drive at a franchised dealership is the only possible way that consumers can inspect and examine new vehicles. Rather than going to a dealer, a consumer might simply borrow a friend's car for a test drive. Consumers that are more enterprising might determine what makes and models are being offered by local rental car agencies, and satisfy their curiosity in that way. A further possibility is that specialty test drive services will emerge to fill the gap, operating either in conjunction with, or independently of, Internet sellers.[126] Rather than following the traditional dealership model, one would imagine that such services would have fewer locations and a significantly smaller inventory.[127] Although the conventional wisdom is that offering *free* test drives is a critical component of a dealer's marketing strategy, it is hardly unthinkable that some consumers would be willing to pay for such a service, particularly if doing so was the cost of access to preferential Internet pricing.[128]

Finally, the assumption that no appreciable number of consumers will be interested in purchasing a vehicle without a test drive has not been borne out by the facts. At least one third party broker model has succeeded in selling vehicles over the Internet sight unseen.[129] A more significant piece of evidence is the growing number of online transactions involving used vehicles. For example, a consumer purchasing a used vehicle on eBay must typically commit to the purchase before taking a test drive or conducting an

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a car and compare models, and then go to the next dealership and do the same thing. And you need a representative inventory in order to do that, and that's why dealers do it.").

126 *See, e.g.*, Fiona Scott Morton, Tr., *supra* note 1, at 448 ("You could imagine a set of cars at a shopping mall that people could test drive.").

127 For example, CarOrder.com's business model called for the company to maintain a small number of locations with a few cars available for test drives, rather than "parking lots full of cars." *See* Montgomery, *supra* note 43.

128 Another possibility is that, upon completion of an online sale, the manufacturer could pay a test-drive fee to the dealer responsible for the territory in which the Internet customer resides.

129 Scott Painter, Tr., *supra* note 1, at 446 ("One of the things [CarsDirect.com] had to look at in our business was, absolutely, will customers buy cars without having test driven them. It was the number one issue to raising money, and we raised more money than any Internet company pre-IPO in the entire bubble.").

in-person inspection.[130] Yet, in spite of this limitation, eBay Motors has hosted hundreds of thousands of such transactions.[131] One would expect to see even greater consumer willingness to forego a test drive in the new car context, as the need for an in-person inspection is less acute.

2. Lack of Vehicle Delivery Capability

Opponents of online vehicle sales also argue that, in the absence of a network of franchised dealers, Internet sellers will have no means by which to deliver new vehicles. They argue that an automobile is not like a book or compact disc, which can be easily packaged for delivery through the mail or via private delivery service.[132] Rather, delivery of individual vehicles to individual consumers would be both prohibitively expensive and exceedingly slow. With respect to the speed of delivery, critics of online sales note that this may often be a critical consideration for the consumer, rather than a mere issue of preference or convenience. Consumers seeking a replacement vehicle as a result of accident or theft, for example, could potentially suffer significant harm—in terms of missed work, rental car charges, and other costs—because of delivery delays.[133] These consumers need access to brick-and-mortar dealers, where they can purchase a replacement vehicle on short notice and drive it off the lot the same day.[134] Opponents of online sales also note that a significant percentage of new vehicle sales involve trade-ins, which, like vehicle delivery, cannot be managed without a physical presence.[135] An Internet seller that does not maintain a physical location where vehicles can be picked up, likewise, does not maintain a physical location where trade-ins can be dropped off.

This analysis also has a number of flaws. Once again, it rests on the assumption that dealer sales and Internet sales are an either/or proposition. A more likely result, in the absence of restrictive franchise regulation, is that the two models will come to co-exist. Consequently, consumers that place a high priority on immediate delivery, including victims of accident

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130 Wingfield & Lundgaard, *supra* note 58.

131 Todd Cohen, Tr., *supra* note 1, at 711 "There was a statement made yesterday during the auto panel that no one would buy a used car without test driving it. Over 100,000 cars have been sold this year on eBay without a test drive.").

132 NADA, *supra* note 5, at 3.

133 *Id.* at 4.

134 Although it is worth noting that not even dealers can provide *all* consumers with immediate, same-day delivery. For example, it is not uncommon for popular models to go on back-order for months or even years.

135 NADA, *supra* note 5, at 5 ("The purchase of a motor vehicle, either new or used, is actually a series of transactions. With a new car, a trade-in is often involved. This requires an individual to examine the trade-in and determine its value. This cannot be done over the Internet."); James Lust, Tr., *supra* note 1, at 443 (57% of all automobile transactions involve a trade-in).

or theft, will still have the traditional brick-and-mortar distribution channel as an option. But consumers who wish to purchase online will have a variety of delivery options. Once again, the body of experience with Internet sales of used vehicles is instructive. Some consumers may be willing to deliver themselves to the vehicle, rather than vice versa, particularly if the savings on the vehicle cost are substantial. One admittedly less common anecdote involved a consumer flying from Columbus, Ohio to Fort Worth, Texas to pick-up a truck purchased on eBay.[136] Consumers may also choose to take advantage of independent vehicle shipping services.[137] While such service is relatively expensive, consumers may be willing to accept a heightened delivery cost as a tradeoff for access to preferential Internet pricing. Finally, Internet entrepreneurs have been active in developing their own solutions to the delivery problem. Some future-looking Internet models, for example, contemplate individualized delivery,[138] while at least one existing Internet business has managed to develop a system to accommodate trade-ins.[139]

3. Lack of "Make Ready" Capability

A third area of concern is "make ready" capability. One of the dealer's responsibilities under the current distribution system is to inspect vehicles received from the manufacturer and perform a variety of services to ensure that they are road-worthy. This "make ready" function has both a safety and a regulatory component. The safety component consists primarily of examining the vehicle for defects. A dealership employee, often a certified technician, checks the fluid levels, the brakes, the transmission, the electrical system, and other key operating systems to ensure that the vehicle is safe to drive.[140] The regulatory component primarily consists of complying with titling and registration requirements imposed by state law. Again, a dealership employee is responsible for ensuring that clear title is conveyed, the vehicle is appropriately registered, an accurate odometer reading is disclosed, license plates are obtained, and consumer information needed

136 *See* Wingfield & Lundegaard, *supra* note 58.

137 *Id.* (noting that automobile hauling company Dependable Auto Shippers, which charges about $650 to ship a car from Texas to New York, currently delivers approximately 75,000 vehicles a year, including a significant number for eBay users).

138 For example, CarOrder.com's business model called for the company to maintain a small number of "loading areas for flatbed trucks that could deliver cars to the buyers' homes." *See* Montgomery, *supra* note 43.

139 Scott Painter, Tr., *supra* note 1, at 457 (indicating that Build-to-Order accepts trade-ins "sight unseen").

140 Bill Wolters, Tr., *supra* note 1, at 426.

for safety and recall notices is transmitted to the manufacturer.[141] Opponents of online vehicle sales argue that these critical services simply cannot be provided without a brick-and-mortar presence.[142] Furthermore, they argue, "make ready" service requires a level of specific, expert knowledge of both automotive maintenance and motor vehicle regulation that only a local franchised dealer can provide.

The principal flaw with this argument is that most of the services that constitute the "make ready" package are not delivered on a one-time-only basis. Vehicle maintenance and regulatory compliance are continuing responsibilities that the consumer must periodically attend to throughout the life of the vehicle.[143] Given that consumers are expected to adhere to a schedule of routine maintenance and regulatory compliance, including annual, or even semi-annual, visits to oil change facilities and the Department of Motor Vehicles, it is illogical to assume that *only* dealers are qualified to perform these functions in the first instance. Some consumers may value "make ready" service quite highly, and they will likely continue to purchase new vehicles from traditional dealers. While others, in order to take advantage of preferential Internet pricing, will likely be willing to experiment with alternative "make ready" providers. For example, many states already require annual road-worthiness and emissions inspections, and they allow a wide variety of service providers to conduct these inspections.[144] It is also worth noting that franchised dealers themselves have been willing to forego something that looks very similar to "make ready" service in the used vehicle context. Prior to the rise of the Internet, franchised dealers obtained used vehicles from traditional automobile auction companies, which performed a service analogous to dealers' own "make ready" function.[145] Increasingly, dealers have been willing to use the Internet to bypass this link in the distribution chain.[146]

4. Lack of Warranty Service Capability

A final concern is that, by driving a significant number of brick-and-mortar dealers out of business, Internet competition will deprive consumers of the sole capable provider of warranty service. Opponents of Internet

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141 NADA, *supra* note 5, at 5; Memorandum from Bill Wolters to author 3 (Sept. 30, 2002), *available at* http://www.ftc.gov/opp/ecommerce/anticompetitive/panel/wolters.pdf (last visited Aug. 21, 2007).

142 NADA, *supra* note 5, at 3; Bill Wolters, Tr., *supra* note 1, at 425-26.

143 SHAFFER, *supra* note 26, at 7 (noting that "today's vehicles will average 145,000 miles over a 13-year lifespan" and that "[d]uring the entire duration of ownership, there is the need for product maintenance and safety assurance").

144 Holt, *supra* note 39, at 27.

145 Sawyers, *supra* note 66.

146 *See* discussion *infra* Section I.C.2.

sales argue that manufacturers will uniformly refuse to modify the terms of their vehicle warranties to authorize service by any entity other than a franchised dealer. They assert that the reason for this manufacturer preference is two-fold. First, modern motor vehicle designs are extremely complex, such that only service personnel with specialized knowledge of a particular manufacturer's products are qualified to repair and maintain those vehicles. As one panelist explained: "I do take issue with . . . the idea that anybody can do the service. Anybody can't do the service. I disagree with that immensely. Our techs, we have 11 technicians, 10 of them do GM service. Just GM service because it's so specialized to the GM product."[147] Second, they argue that only franchised dealers are sufficiently dispersed geographically to accommodate the warranty service needs of the major automobile manufacturers' customer base. Franchise dealerships are present in almost every domestic market, from densely-populated metropolitan areas to small rural communities. Therefore they can supply a reliable safety net of warranty service providers that no other auto repair outlet can match.[148]

Like the argument that *only* dealers can provide "make ready" service, the argument that dealers are uniquely suited to provide warranty service is undercut by the fact that repairs and routine service are not a one-time-only event in the life of a vehicle, whether covered by warranty or not. Therefore, it is possible to draw conclusions regarding the availability of non-dealer alternatives by examining consumer conduct in the post-warranty period. It is clear that a substantial number of consumers choose non-dealer service providers for their future maintenance needs once warranty coverage is no longer a consideration.[149] This suggests that non-dealer repair centers are also sufficiently geographically available to provide new vehicle consumers with reasonable assurance that a service provider will be available when they need repairs. Arguments regarding the inherent superiority of dealer service are no more persuasive. While it is certainly true that a manufacturer may be reluctant to authorize inadequately-knowledgeable, or insufficiently-trained, service personnel to perform warranty work, it does not necessarily follow that franchised dealers are the *only* alternative. A more sensible and pro-competitive approach would be to ensure the quality of service through a system of technician and service center certifications.[150] Indeed, given the pervasiveness of this approach in the post-warranty service context, the notion that *only* franchised dealers can ensure quality in

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147 James Lust, Tr., *supra* note 1, at 444. *See also* NADA, *supra* note 5, at 4-5.

148 *See* Wolters, *supra* note 141, at 1-2; Montgomery, *supra* note 43 (quoting the Director of Enforcement for the Texas Motor Vehicle Division as opining that "If the car dealer isn't there, somebody from Midland could have to drive all the way to Dallas to get their warranty work done.").

149 Mark Cooper, Tr., *supra* note 1, at 431-32 ("The minute people get off warranty, where do they go? They don't go back to the dealer. They go to the nearest favorite independent service provider two-thirds to three-quarters of the time. The minute they escape the exclusion, they take their business elsewhere.").

150 *Id.* at 432.

the essentially identical warranty service context is not credible. If dealer service is truly superior, then it should remain the choice of a significant number of consumers, even in a competitive marketplace.

III. RECOMMENDATIONS

Although automotive franchise laws were enacted primarily to regulate the relationship between manufacturers and dealers, rather than to perform a consumer protection function, it is clear that these laws have a substantial impact on consumers. With respect to Internet sales of new vehicles, that impact has too often been negative. Consumers continue to express a strong interest in purchasing vehicles online, as demonstrated most clearly by the rapid growth of Internet sales of used vehicles. The regulatory environment with respect to state franchise laws should facilitate, and not obstruct, consumer preference. This approach would permit consumers who prefer the existing distribution system to continue patronizing franchised dealers. At the same time, it would permit those who would prefer to experiment with Internet models to enjoy the potential benefits that this new medium provides. Based on these conclusions, state policymakers and law enforcement agencies should consider the following steps:

- *Make consumer welfare the focal point of franchise legislation.* Franchise law must necessarily address the manufacturer-dealer relationship, but the interests of these parties should not be allowed to trump the interests of consumers. Franchise law essentially constitutes an exercise of state power to codify terms and conditions that would otherwise be the subject of private contract. To the extent that states elect to exercise this power, they should do so with the interests of consumers in mind.

- *Apply rigorous cost-benefit analysis to franchise legislation.* In addition to its other, primary functions, automotive franchise law does provide some benefits to consumers. However, as in any regulatory scheme these benefits must be carefully weighed against the costs they impose. For example, access to test drives and warranty service are *bona fide* benefits. Nevertheless, a regulatory scheme that provides these benefits at the expense of Internet sales, which could save consumers an estimated 10% per vehicle, is not in the public interest.

- *Allow consumer preference, rather than state regulation, to guide the development of new vehicle sales alternatives.* States should reject the view that automobiles are somehow "different" and constitute a unique product category that is not amenable to Internet distribution. While it is likely that many consumers will continue to prefer to purchase new vehicles from franchised dealers, a decision to make resort to this channel of distribution mandatory, by action of state law, cannot be justified on consumer protection grounds. A more flexible, market-driven approach will enhance consumer welfare by allowing Internet-related efficiencies to be more fully realized in the new vehicle market.

- *Limit the scope of franchise law to the parties it was originally intended to govern.* Automotive franchise laws were initially enacted to govern the relationship between manufacturers and dealers. Other parties were not included in the original negotiations—the results of which were subsequently codified as state law—and did not enjoy the benefit of the bargain. Therefore, the requirements and associated costs of franchise law should not be extended to third parties, such as Internet referral services and independent brokers.

- *Limit the scope of franchise law to the products and services that it was originally intended to encompass.* Automotive franchise laws were initially enacted to encompass the sale of new vehicles only. Without preferential or, in some instances, exclusive rights to new vehicle sales, it was argued, dealers would not be able to recover their substantial investments in fixed assets and inventory. Internet sellers, who were not party to this original bargain, should not be further disadvantaged by expanding the scope of dealers' exclusive rights to encompass ancillary services, such as aftermarket parts and financing.

- *Amend or repeal the specific provisions of franchise law that pose the most significant barriers to Internet vehicle sales.* These provisions include restrictions on advertising, referrals, brokering, and direct-to-consumer sales. Such restrictions are not justified by a *bona fide* consumer protection rationale, but rather serve primarily to insulate franchised dealers from Internet competition. In addition to limiting consumer choice and significantly increasing search costs, these restrictions have prevented new vehicle consumers from realizing substantial costs savings, estimated to be as much as $18-$44 billion per year.

By adopting these recommendations, states could enhance consumer welfare, promote robust competition in the new vehicle market, and satisfy their legitimate regulatory concerns.

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PROTECTIONISM AS A RATIONAL BASIS? THE IMPACT ON E-COMMERCE IN THE FUNERAL INDUSTRY

*Asheesh Agarwal**

INTRODUCTION

Does a state have a legitimate interest in protecting established local merchants from new competitors? What if new competitors could offer consumers lower prices, greater choices, and increased convenience? What if evidence undercuts any argument that the state, by limiting competition, benefits anyone but the established local merchants? In other words, does the Constitution protect a state's ability to engage in rank protectionism?

Courts have recently addressed this issue in ways that could shape the future of online commerce. In four recent cases, courts considered whether licensing casket vendors serves a rational basis for purposes of constitutional scrutiny. At issue were state regulations that allowed retail casket sales only through a vendor who holds a funeral director's license and operates a physical funeral establishment. The evidence indicates that, as applied to standalone casket vendors, the regulations significantly raise the cost of entry to new competitors but offer consumers no demonstrable benefits.

In three of these cases, courts barred states from applying the regulations to standalone casket vendors. These courts found that the regulations advanced no legitimate state interests. As these courts determined, the licensing and physical establishment requirements bore no relation to any legitimate state interest in the business of selling caskets, and therefore did not promote consumer welfare. The courts also pointed out that protectionism, rather than the public interest, appeared to motivate the regulations. They further emphasized that states had far less restrictive, more pro-competitive means of achieving any legitimate health or safety goals. They noted, for instance, that states could simply set standards for casket quality.

Caskets, however, are not an open-and-shut case. A fourth court upheld the regulations, even without evidence that the regulations benefited casket buyers. Instead, this court concluded that economic protectionism

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for licensed funeral directors, by itself, qualified as a legitimate state interest. The court noted that state and local governments often dispense various financial and regulatory benefits to certain businesses at the expense of others. According to the court, judges would cripple state and local governments by examining the actual effect of such protectionist regulations.

These cases could impact the future of e-commerce in the funeral industry. Consumers spend approximately $10 billion on funerals and funeral-related expenses annually.[1] Next to a home and car, funerals rank among Americans' most expensive lifetime purchases, with traditional funeral costs amounting to more than $5,000, including $2,000-3,000 for an average casket.[2] Some mahogany or metal caskets cost as much as $10,000. Using the Internet, however, independent vendors often sell caskets at significantly lower prices than funeral homes, the most common vendors. Funeral homes typically mark up their casket prices from 300 to 400% over the wholesale price—roughly twice the markup charged by online vendors. Online vendors may also offer consumers greater variety, such as individualized caskets with particular themes or non-standard linings. Online vendors also offer an array of less tangible benefits, such as the convenience and privacy of shopping from home at any hour of the day.

The ultimate outcome of these licensing issues could also affect e-commerce in other industries. In the funeral industry, advocates of regulation argue that funeral licensing protects consumers by preventing high-pressure sales tactics and ensuring proper burials. In many e-commerce markets, including caskets, policymakers have expressed concerns that consumers could suffer from more common fraud online, or that they could receive lower quality goods and services, which in some cases could affect consumers' health and safety. Policymakers also worry that consumers may lack an adequate legal remedy against out-of-state suppliers. Finally, some brick-and-mortar stores contend that online vendors could free ride by letting brick-and-mortar retailers bear the costs of providing display rooms and services to select a casket, only to turn around and sell the same or similar product online. Such free riding arguably could harm consumers in the long-run.

Moreover, although at some level each industry is unique, at bottom the issues are the same: in the name of consumer protection, entrenched brick-and-mortar competitors attempt to use state regulations to limit com-

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[1] Federal Trade Commission (FTC), *Funerals: A Consumer Guide* 1, 4 (June 2000), *available at* http://www.ftc.gov/bcp/conline/pubs/services/funeral.shtm (last visited Aug. 21, 2007) [hereinafter *FTC Funeral Guide*]; GAO, *Death Care Industry* 2 (Aug. 2003). More information is available at the homepage for the FTC's workshop on e-commerce, http://www.ftc.gov/opp/ecommerce/anticompetitive/index.shtm (last visited Aug. 21, 2007). A transcript of the workshop can be found at http://www.ftc.gov/opp/ecommerce/anticompetitive/021009antitrans.pdf (last visited Aug. 21, 2007) [hereinafter Tr.].

[2] *Average Profit Slipped to 8.08% in 2001*, FFDA REPORTS, THE AMERICAN FUNERAL DIRECTOR, June 2002.

petition from potential new entrants. For example, at a workshop devoted to regulation of e-commerce hosted by the Federal Trade Commission (FTC), speakers identified a variety of specific concerns in a range of industries. Although no speaker defended pervasive regulation of all e-commerce, speakers in different industries argued that their particular industry uniquely required greater regulation:

- *Caskets.* "A casket is not just a commodity like a shirt or a pair of shoes; it is a product for a special specific event at a very sensitive and specific time."[3]

- *Wine.* "I want to call attention to the one fact about wine that makes it different from all other commodities that will be discussed . . . that difference being it is an alcoholic beverage. In addition, none of the other commodities and services . . . discussed here has been the subject of a constitutional amendment."[4]

- *Automobiles.* "[T]he Internet . . . cannot replace services provided by . . . [auto] dealers. We are not selling books, CDs or wine, but a very sophisticated product, a sophisticated product that has over 10,000 moving parts, electronic and mechanical, with a transaction price averaging $25,800."[5]

- *Legal Services.* "I think it is essential to keep in mind that we aren't talking about contact lenses or caskets or wine bottles . . . we're talking about something very different when we're talking about access to the justice system."[6]

If the judiciary blesses protectionism as a rational basis for restricting e-commerce, entrenched brick-and-mortar competitors may not have to trouble themselves with justifying barriers to new entry.

Finally, as in other e-commerce markets, licensing and physical presence requirements raise the costs of entry for any potential online competitor. By forcing online competitors to satisfy costly regulatory requirements in multiple states, licensing can add tens of thousands of dollars to the cost of entering a market. Approximately ten states, for example, permit retail casket sales only through a vendor who has a funeral director's license or operates a physical funeral establishment. Such regulations can especially hamstring online vendors, whose business models may depend on shipping goods to consumers across the country from a central location. And the

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3 Robert Vandenbergh, Tr., *supra* note 1, at 461.

4 Scott Painter, Tr., *supra* note 1, at 200.

5 James Lust, Tr., *supra* note 1, at 403.

6 Catherine Lanctot, Tr., *supra* note 1, at 590.

costs do not stop at licensing and brick-and-mortar requirements: in South Carolina, a prospective casket vendor must complete an apprenticeship that lasts "a minimum of twenty-four months" to obtain a funeral director's license.

This article analyzes four recent cases involving state regulation of casket sales. Section II discusses the rational basis test and evaluates supporting non-protectionist rationales for funeral regulations. Section III concludes by discussing ways in which courts could more closely scrutinize state regulations that restrict e-commerce consistent with the rational basis test.

I. THE CASKET CASES

In each of the four recent funeral cases,[7] state statutes and regulations limited casket sales to licensed funeral directors and erected significant obstacles to obtaining a license. Typically, the state required a casket vendor to obtain a funeral director license and operate a physical funeral establishment as a prerequisite to selling caskets. The plaintiffs—casket vendors and consumers—primarily argued that the statutes violated the Equal Protection, Due Process, or Privileges or Immunities Clauses. They argued that the licensing requirements were unrelated to any legitimate state interest because the requirements had no rational relation to the business of selling caskets. The states countered that their laws advanced legitimate consumer protection goals, such as protecting grieving consumers from overreaching sales tactics and ensuring the safe disposal of human remains.

The plaintiffs focused on the absence of a legitimate state interest. The plaintiffs did not seriously allege that the statutes discriminated against out-of-state competitors in violation of the Commerce Clause, or that the statutes discriminated against, for example, a discrete and insular minority. In *Powers v. Harris*, the plaintiffs argued that Oklahoma's statutes violated the Commerce Clause, but a federal district court held that it lacked jurisdiction to adjudicate this claim because Oklahoma had never enforced its statutes against out-of-state vendors. The plaintiffs did not appeal that ruling.

Accordingly, all four courts analyzed the regulations under the rational basis test. The U.S. Sixth Circuit Court of Appeals, the U.S. District Court for the Southern District of Mississippi, and the U.S. District Court for the Northern District of Georgia each struck the statutes. These courts concluded that the licensing requirements advanced no legitimate state interest,

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[7] Craigmiles v. Giles, 312 F.3d 220 (6th Cir. 2002), *aff'g* 110 F. Supp. 2d 658 (E.D. Tenn. 2000); Powers v. Harris, 379 F.3d 1208 (10th Cir. 2004), *cert. denied*, 125 S. Ct. 1638 (2005); Casket Royale, Inc. v. Mississippi, 124 F. Supp. 2d 434 (S.D. Miss. 2000); Peachtree Caskets Direct, Inc. v. State Bd. of Funeral Serv., No. Civ. 1:98-CV-3084-MHS, 1999 WL 33651794 (N.D. Ga. Feb. 9, 1999).

and that in any event, the states had less restrictive means of achieving their goals. In the fourth case, U.S. Court of Appeals for the Tenth Circuit held that economic protectionism alone qualified as a legitimate state interest for constitutional purposes.

A. *The Rational Basis Test*

Under the rational basis test, a regulation is constitutional if it bears some rational relation to a legitimate state interest. A statute enjoys a strong presumption of validity, and is valid "if there is any reasonably conceivable state of facts that could provide a rational basis." To justify such a statute, the state need not provide "an exquisite evidentiary record" but only "rational speculation linking the regulation to a legitimate purpose, even unsupported by evidence or empirical data."[8]

The Supreme Court has applied the rational basis test to uphold state legislation that arguably promotes the public's health and safety even without evidence of a salutary effect. In the seminal case of *Williamson v. Lee Optical*, for example, the Court upheld an Oklahoma law requiring an optometrist or ophthalmologist license to fit eyeglass lenses without a written prescription.[9] The law effectively benefited optometrists and ophthalmologists at the expense of opticians. The district court held that the law violated the Fourteenth Amendment's Due Process Clause because, among other reasons, there was no rational reason why opticians could not fix lenses on their own without a prescription. On appeal, the Supreme Court acknowledged that Oklahoma's law "may exact a needless, wasteful requirement in many cases."[10] The Court upheld the law, however, on the grounds that the legislature may have had legitimate concerns about the public's health and safety. As the Court put it, "[t]he legislature might have concluded that the frequency of occasions when a prescription is necessary was sufficient to justify the regulation . . . [or] that eye examinations were so critical, not only for the correction of vision but also for the detection of latent ailments or diseases, that every change in frames and every duplication of a lens should be accompanied by a prescription from a medical expert."[11] Accordingly, the law was constitutional because it conceivably advanced the public good: "It is enough that there is an evil at hand for correction, and that it might be thought that the particular legislative measure was a rational way to correct it."[12] The Court did not discuss whether it would have upheld the law had its sole effect, or its only reasonably con-

8 *Craigmiles*, 312 F.3d at 224.

9 Williamson v. Lee Optical, 348 U.S. 483 (1955).

10 *Id.* at 487.

11 *Id.* at 487.

12 *Id.* at 487-88.

ceivable effect, been to divert business away from opticians and to optometrists and ophthalmologists.

B. *Funeral Cases Striking Licensing Regulations under the Rational Basis Test*

In the recent funeral cases, the courts had before them a large evidentiary record, including empirical information, regarding the funeral regulations' actual impact. The leading case, *Craigmiles v. Giles*, involved the Tennessee Funeral Directors and Embalmers Act. The Act forbade anyone from selling caskets unless they obtained a state funeral director license. To obtain such a license, an applicant had to complete either (1) one year of study at the only mortuary school accredited in Tennessee, plus a one-year apprenticeship with an existing funeral director, or (2) a two-year apprenticeship. After the two years, the applicant then had to pass a funeral arts test. Most of the applicant's training, however, had little to do with selling caskets. Expert witnesses testified that no more than 5% of the mortuary school's curriculum involved caskets and urns, and less than 15% of the questions on the funeral test dealt with caskets and urns. Much of the remaining coursework dealt with extraneous issues such as embalming or "restorative art."[13]

Nathaniel Craigmiles operated two independent casket stores that sold caskets, urns, flower holders, and other funeral merchandise. His stores did not embalm bodies or arrange funeral services. Based on the Tennessee Act, however, the Tennessee Funeral Board issued a cease-and-desist order to bar Craigmiles from selling caskets or other merchandise. Craigmiles and other plaintiffs sued on the ground that the statute, as applied to him, violated the Due Process, Equal Protection, and Privileges or Immunities Clauses of the Fourteenth Amendment.

In applying the rational basis test, the court found that Tennessee's Act was "nothing more than an attempt to prevent economic competition." In the first place, the court found that the statute did not promote public health and safety. The plaintiffs did not embalm or otherwise handle the bodies. The court stated that, in theory, low quality caskets could potentially threaten public health if they leaked, but the court noted that the Act imposed no safety standards on caskets; the Act did not require that consumers use any particular type of casket or, indeed, any casket at all. Moreover, the Act had the practical result of increasing casket prices, which likely led consumers to buy relatively less protective caskets. For similar reasons, the court also discounted the state's consumer protection rationale. Addressing concerns about fraud, the court held that the Act's licensing requirement was overbroad because general consumer protection laws already applied to

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[13] *Craigmiles*, 312 F.3d at 222.

retailers, and the state could always apply more stringent laws to retailers without requiring licensing. In any event, consumers would still have to consult a licensed funeral director for arranging services and handling the body.[14]

After disposing of the Act's proffered rationales, the court concluded that Tennessee's actions were simply "naked attempts to raise a fortress protecting the monopoly rents that funeral directors extract from consumers." The court found that "[t]he licensure requirement imposes a significant barrier to competition in the casket market" by "protecting licensed funeral directors from competition on caskets." As the court explained, "dedicating two years and thousands of dollars to the education and training required for licensure is undoubtedly a significant barrier to entering the Tennessee casket markets." These entry barriers led to higher prices for consumers. As the court found, "funeral home operators generally mark up the price of caskets 250 to 600%, whereas casket retailers sell caskets at much smaller margins."[15] As part of this discussion, the Sixth Circuit stated that "Courts have repeatedly recognized that protecting a discrete interest group from economic competition is not a legitimate governmental purpose."[16]

Courts used similar reasoning to invalidate funeral regulations in Georgia and Mississippi. In *Peachtree Caskets Direct, Inc. v. State Board of Funeral Service of Georgia*, a federal district court in Georgia enjoined enforcement of Georgia's licensing scheme because "neither the statute nor any rules of the [Board] contain standards for the design, construction, or sale of caskets or alternative containers."[17] Similarly, in *Casket Royale, Inc. v. Mississippi*, a federal district court in Mississippi acknowledged that the state had a legitimate interest in the prompt disposition of human remains and consumer protection, but held that the state's licensing scheme bore no rational relationship to those purposes. For example, Mississippi "failed to show that the licensing requirement in any way speeds the process of burial . . . [or provides] any evidence that unlicensed dealers slow burial or cremation."[18] In addition, although Mississippi had expressed concern about vendors soliciting dead bodies, its license requirement did not prevent licensees from soliciting casket sales. As a result, the court concluded that Mississippi's law protected funeral homes at the expense of consumers: "As a result of this [licensing] requirement, consumers in Mississippi are offered fewer choices when it comes to selecting a casket. Consequently, there is less price competition among the sellers of caskets. Ultimately, the con-

14 *Id.* at 224-25.

15 *Id.*

16 *Id.*

17 *Peachtree Caskets*, No. Civ. 1:98-CV-3084-MHS, 1999 WL 33651794 at *1.

18 *Casket Royale*, 124 F. Supp. 2d at 438.

sumer is harmed by this regulation as one is forced to pay higher prices in a far less competitive environment."[19]

In addition to these court cases, an opinion from the Texas Attorney General similarly concluded that, under Texas law, the state should allow vendors to sell caskets without a license. As the Attorney General explained, "while a casket indeed constitutes funeral merchandise, the simple sale of a casket, without more, is not an act of funeral directing and accordingly does not violate" Texas law.[20] The opinion noted that the "sale does not directly involve the disposition of a body," and "what distinguishes a funeral director is 'the duty . . . to take charge of,' and prepare for burial or other disposition, a dead human body."[21]

C. *Funeral Cases Upholding Licensing Regulations under the Rational Basis Test*

In contrast to these decisions, the Tenth Circuit recently held that licensing requirements do, in fact, further a legitimate state interest: economic protectionism. In *Powers v. Harris*,[22] the court considered Oklahoma's Funeral Services Licensing Act, which required that anyone engaged in the sale of funeral merchandise, including caskets, have a funeral director's license and operate out of a licensed funeral establishment. To obtain a license, a candidate must, among other things, graduate from an accredited program of mortuary science, complete sixty college semester hours at an accredited institution of higher education, pass two exams, and complete a one-year apprenticeship in a funeral home, "during which the applicant must embalm 25 bodies." Under the Act, a "funeral establishment" must have a fixed physical location, preparation room for embalming bodies, merchandise-selection room with at least five caskets, and adequate space for public viewing of human remains.[23] The Act extends to intrastate sales only. Out-of-state vendors can sell caskets directly to Oklahoma consumers, and Oklahoma vendors can sell caskets to out-of-state consumers.

The plaintiff, an online casket vender based in Oklahoma, charged that the Act bore no rational relation to Oklahoma's proffered rationale of protecting consumers. Like the plaintiffs in *Craigmiles*, the plaintiffs pointed out that less than 5% of the education and training requirements related directly to selling caskets. Oklahoma, like Tennessee, countered that the regulations were not "wholly irrelevant" to the state's interests because

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19 *Id.* at 440. *See also* Office of Mississippi AG, Opinion No. 2003-0588, 2003 WL 22970542 (applying *Casket Royale* to Mississippi regulations).

20 Tex. Atty. Gen. Op. JC-0505 (2002) at 1.

21 *Id.* at 2.

22 *Powers*, 379 F.3d 1208.

23 *Id.* at 1213.

some funeral consumers may be vulnerable to overreaching sales tactics. Oklahoma also argued that the state deserved "leeway to approach a perceived problem incrementally."[24]

Unlike *Craigmiles*, however, the *Powers* court ignored the question of whether the state's statutes actually served the interests of consumers. Instead, the court stated that it was "obliged to consider every plausible legitimate state interest that might support the [Act]—not just the consumer-protection interest forwarded by the parties."[25] Accordingly, the court proceeded directly to consider "whether protecting the intrastate funeral industry, absent a violation of a specific constitutional provision or a valid federal statute, constitutes a legitimate state interest."[26]

In a decision that could have Grandpa Munster turning over in his coffin, the *Powers* court held that naked protectionism qualifies as a legitimate state interest. "[T]he Supreme Court has consistently held that protecting or favoring one particular intrastate industry, absent a specific federal constitutional or statutory violation, is a legitimate state interest."[27] As the court explained, "dishing out special economic benefits to certain in-state industries remains the favored pastime of state and local governments."[28] Therefore, "in practical terms, we would paralyze state governments if we undertook a probing review of each of their actions."[29] To strike Oklahoma's protectionist scheme for funeral homes would have the effect of threatening licensing schemes for all professionals, including doctors, electricians, or plumbers.[30] Faced with the prospect of unlicensed accountants or even lawyers, the court upheld the Act's constitutionality because "[t]here can be no serious dispute that the [Act] is 'very well tailored' to protecting the intrastate funeral-home industry."[31]

The court criticized *Craigmiles* for relying on cases involving interstate, not intrastate, commerce. "Our country's constitutionally enshrined policy favoring a national marketplace is simply irrelevant as to whether a state may legitimately protect one intrastate industry as against another when the challenge to the statute is purely one of equal protection."[32] The court also criticized *Craigmiles* for examining the motives of the state's legislature, rather than considering every conceivable rationale for the state's actions.

In a concurring opinion, Judge Tymkovich criticized the majority for adopting an "unconstrained view of economic protectionism as a 'legiti-

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24 *Id.* at 1216 (citation omitted).

25 *Id.* at 1217.

26 *Id.* at 1218.

27 *Id.* at 1220.

28 *Powers*, 379 F.3d at 1221.

29 *Id.* at 1218.

30 *Id.* at 1222.

31 *Id.* at 1223.

32 *Id.* at 1220.

mate state interest.'"[33] According to him, the majority had created "an almost per se rule upholding intrastate protectionist legislation." In contrast to the majority, Judge Tymkovich's believed that courts should uphold a protectionist effect only where "the discriminatory legislation arguably advances either the general welfare or a public interest."[34] Although conceding that "[c]onsumer interests appear to be harmed rather than protected by the limitation of choice and price encouraged by the licensing restrictions on intrastate casket sales,"[35] Judge Tymkovich nevertheless found that Oklahoma had demonstrated its legitimate interest in promoting the general welfare by bringing enforcement actions under the Act against funeral directors. In other words, the fact that Oklahoma had brought enforcement actions demonstrated that Oklahoma was serious about it enforcing its law.

Aside from *Powers*, one other recent decision held that states have a legitimate, non-protectionist rationale in requiring a license to sell a casket. In South Carolina, a state administrative law judge enjoined a stand-alone casket store from selling caskets because the store did not have a license as a "funeral establishment."[36] The administrative court held that the state had a "legitimate interest" in requiring licenses for casket vendors because a casket "directly impacts sanitation."[37] Finally, in 1998, the Oklahoma Court of Civil Appeals upheld the state's casket sales restriction based on health and sanitation concerns.[38]

II. PROTECTIONISM AS A RATIONAL BASIS

Based on the great weight of authority, states lack a rational basis when applying funeral director and funeral establishment licensing schemes to standalone casket sales, including online casket sales. In the first place, the evidence undercuts any plausible argument that such regulations benefit consumers or otherwise promote the general public good. Indeed, the empirical evidence suggests that the regulations actually harm consumers by raising prices and reducing variety and convenience. With one exception—and a questionable one at that—the case law provides no support for the

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33 *Id.* at 1225.

34 *Powers*, 379 F.3d at 1225.

35 *Id.* at 1227.

36 South Carolina Dep't of Labor v. Workman, No. 98-ALJ-11-0634-IJ, 1999 WL 459728, *5 (S.C. Admin Law Div. May 20, 1999). South Carolina permits third parties to sell caskets "at-need" but not "pre-need." The state requires third-party sellers to hold a license to sell retail caskets, which is not the same as a funeral director's license but involves some costly requirements. *See* S.C. Code Ann. 19 §§ 40-19-265 (discussing permit requirements for funeral homes); 32-7-10 et seq (discussing pre-need funeral contracts).

37 *Workman*, 1999 WL 459728 at *8.

38 State v. Stone Casket Co. of Okla. City, 976 P.2d 1074 (Okla. Civ. App. Div. 1 1998).

idea that intrastate protectionism, by itself, qualifies as a legitimate state interest.

A. *The Effects of Casket Regulations*

The evidence thoroughly undercuts the rationale for requiring casket vendors to obtain a funeral director's license or open a physical funeral establishment.

1. Overview of State Regulations

State regulation of Internet casket sales varies widely. It appears that no state has enacted specific statutes or regulations for online casket sales. Instead, if the state regulates online sales, the state does so by applying existing regulations designed for brick-and-mortar, third-party vendors.[39] Iowa, for example, regulates pre-need casket sales from third-party vendors, and applies the same regulations to Internet sales.[40] Overall, only a handful of states have regulations that apply to online casket sales. According to a Government Accountability Office survey, sixteen states regulate third-party sales of funeral goods, and ten states regulate all third-party sales of funeral goods.[41]

In those ten states, statutes restrict the intrastate sale of caskets exclusively to licensed funeral directors.[42] Typically, these states require a license for anyone engaged in funeral directing, and then define the practice of funeral directing to include the sale of funeral-related merchandise, including caskets. For example, Louisiana defines "funeral directing" as "the operation of a funeral home, or . . . any service whatsoever connected with the management of funerals, or . . . the purchase of caskets or other funeral

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39 Steven Sklar, Tr., *supra* note 1, at 477.

40 *Id.*

41 GAO, *supra* note 1, at 13. Of the states that do not regulate all third-party sales, some exempt Internet sales, at-need sales, and sales in which the consumer takes possession of the goods within a fixed period of time.

42 Clark Neily, *Summary of Remarks Regarding Online Casket Retailers, Competition on the Internet Workshop* (2002), *available at* http://www.ftc.gov/opp/ecommerce/anticompetitive/panel/neily.pdf (last visited Aug. 21, 2007); Mark Krause, *Preliminary Comments Regarding the FTC Public Workshop: Possible Anticompetitive Efforts to Restrict Competition on the Internet* (2002), *available at* http://www.ftc.gov/opp/ecommerce/anticompetitive/panel/krause.pdf (last visited Aug. 21, 2007). According to testimony, these states include Alabama, Delaware, Idaho, Louisiana, Maine, Oklahoma, South Carolina, Vermont, Virginia, and Minnesota. Anecdotal evidence, however, suggests that only four states—Oklahoma, Louisiana, Virginia, and South Carolina—have been enforcing these statutes. All of the workshop panelists' written statements are available at http://www.ftc.gov/opp/ecommerce/anticompetitive/agenda.shtm (last visited Aug. 21, 2007). *See also* Funeral Service Insider, January 19, 2004, at 5 (quoting Neily).

merchandise, and retail sale and display thereof . . . ."[43] Similarly, Delaware's statute states that "no person shall engage in the practice of funeral services . . . unless such person has been duly licensed," and then defines "funeral services" as "those services rendered for the . . . burial, entombment or cremation of human remains, including the sale of those goods and services usual to arranging and directing funeral services."[44] On its face, therefore, Delaware's statute appears to prohibit third-party casket sales.

Applicants must spend significant amounts of time and money complying with such licensing requirements.[45] Oklahoma's regulations require, among other things, that an individual graduate from an accredited program of mortuary science, complete sixty college semester hours at an accredited institution of higher education, pass two exams, and complete an embalmer or funeral director apprenticeship, "during which the applicant must embalm 25 bodies."[46] Such requirements consume time and money. In South Carolina, a licensee must complete an apprenticeship that lasts "a minimum of twenty-four months."[47] Other states also require that a funeral director have training in embalming, a specialty that has little relation to the business of selling a casket.

In addition to requiring a funeral director's license, some states also require that a casket seller operate out of a licensed "funeral establishment." Louisiana, for instance, prohibits anyone from engaging in the business of funeral directing "unless such business is conducted by a duly licensed funeral establishment."[48] An "establishment," in turn, must have "adequate parlors or chapel," a "display room," and an "embalming room," among other features.[49] South Carolina requires that every funeral establishment have all of the aforementioned features, as well as "at least one motor hearse for transporting casketed remains."[50]

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43 La. Rev. Stat. Ann. § 37:831 (2004).

44 Del. Code Ann. tit. 24, §§ 3101 (7), 3106 (a).

45 *See* David Harrington and Kathy Krynski, *The Effect of State Funeral Regulations on Cremation Rates: Testing For Demand Inducement in Funeral Markets*, 45 J.L. & Econ. 199, 208 (2002).

46 Powers v. Harris, No. CIV-01-445-F, 2002 WL 32026155, at *12 (W.D. Okla. 2002); Brief for FTC as Amici Curiae Supporting Defendants, Powers v. Harris, 2002 WL 32157040 (No. CIV-01-445-F) at *12-13.

47 S.C. Code Ann. § 40-19-230(B)(4) (1976).

48 La. Rev. Stat. Ann. § 37:848(C) (2004).

49 La. Admin. Code tit. 46, § 101(B) (2005).

50 S.C. Code Ann. § 40-19-20(11)(d) (1976).

2. The Consumer Protection Rationale

Despite the claims of some states and funeral directors, there is little or no evidence that these requirements promote consumer welfare.[51] Many consumers are not as vulnerable or uninformed as the advocates of regulation assume.[52] Indeed, a consumer savvy enough to try and purchase a casket from someone other than his or her funeral director is likely to be relatively well-informed. Moreover, to the extent that some consumers are vulnerable or uninformed, more stringent state licensing likely compounds the problem. Stringent licensing raises barriers to entry, reduces competition, and eases the way for funeral directors to employ aggressive sales practices.[53] Finally, most licensing requirements have little relation to the business of selling caskets. Even if licensing funeral directors provides some consumer protection or public health benefits, licensing independent casket retailers provides no analogous benefits. Accordingly, the empirical evidence deeply undermines the argument that state licensing of casket retailers promotes a legitimate state interest.

a. Sales Pressure

Some states and funeral homes argue that grieving consumers need protection from aggressive sales tactics. They contend that consumers may lack the ability to comparison shop or resist sales pressure, or in other words, that funeral purchasers are "ignorant, beleaguered, and dissatisfied."[54] However, the funeral director, as a trained, informed professional, may manipulate the customer's emotions to sell things that customers would not purchase when in a calmer state of mind, or may selectively disclose only the more expensive options, including caskets. In *Powers*, for instance, the district court found that "at least in some instances, Oklahoma funeral homes have employed sharp practices in their dealings with consumers purchasing caskets."[55]

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51 *See* Steven M. Simpson, *Judicial Abrogation and the Rise of Special Interests*, 6 Chap. L. Rev. 173, 179 (2003) ("Laws restricting casket sales to licensed funeral directors are a more recent phenomenon, but their benefit to funeral directors is clear. Casket sales are extremely lucrative for funeral directors").

52 Fred S. McChesney, *Consumer Ignorance and Consumer Protection Law: Empirical Evidence from the FTC Funeral Rule*, 7 J. L. & Pol. 1 (1990).

53 *See, e.g.*, David Harrington & Kathy Krynski, *The Effect of State Funeral Regulations on Cremation Rates: Testing For Demand Inducement in Funeral Markets*, 45 J. L. & Econ. 199, 205 (2002).

54 McChesney, *supra* note 52, at 20.

55 Powers v. Harris, No. CIV-01-445-F, 2002 WL 32026155, at *4 (W.D. Okla. 2002). *See also* Steven Sklar, Tr., *supra* note 1, at 477.

The best empirical evidence, however, suggests that many consumers can and do make rational funeral purchasing decisions.[56] Consumers often benefit from prior experience when making choices regarding funerals. For example, an FTC staff survey found that over 60% of respondents had been involved in at least one prior funeral arrangement.[57] Moreover, only 11% of respondents arranged funerals alone; many first-time consumers receive help from friends and relatives.[58] In addition, because the majority of deaths are not unexpected or sudden, consumers can gather information and arrange funerals deliberately and in advance.[59] Consumers gather information about individual funeral directors the same way they gather information about other goods and services, through experience, reputation, and referrals.[60] Funeral directors' trade associations even survey consumers to gauge their satisfaction with prices and relay consumer feedback to individual funeral homes.[61] Moreover, consumers purchase many goods and services at the time of a funeral from non-funeral directors, such as airline tickets and flowers, with no reported problems.[62]

One of the most significant tests of the "ignorant consumer" hypotheses lies in a comprehensive assessment of the effects of the FTC's Funeral Rule. The Funeral Rule essentially requires that funeral directors disclose itemized price lists and provide a final statement of goods and services. The Rule also requires that funeral directors refrain from various types of misrepresentations, from requiring the purchase of certain goods and services as a condition for receiving other goods and services, and from embalming for a fee without prior approval.[63] The FTC enacted the rule to protect ignorant and harried consumers from exploitation by aggressive and knowledgeable funeral directors. Yet by most measures, the rule led to little change in consumer shopping or purchasing behavior.[64] In fact, the rule appears to have increased consumer spending on funerals—a result difficult to square with the notion that, prior to the rule, funeral directors were selling consumers unwanted merchandise.[65] The rule generated no

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56 *See* McChesney, *supra* note 52.

57 *Report on the Survey of Recent Funeral Arrangers*, Federal Trade Commission III-5 (April 28, 1988). Similarly, a study released by the Batesville Casket Company observed that "[m]ore than 44% of Baby Boomers have made funeral arrangements for someone close to them. Interestingly, nearly one in seven Gen Xers (14%) have also been involved in funeral planning." *New Consumer Research*, MORTUARY MANAGEMENT, January 2002, at 32.

58 *Id.* (noting that "only 11% of the respondents made all the funeral arrangements by themselves").

59 McChesney, *supra* note 52, at 23-24.

60 *Id.* at 29.

61 *Id.* at 15, 31-32, 43.

62 Neily, *supra* note 42, at 471.

63 16 C.F.R. § 453.

64 McChesney, *supra* note 52, at 43-48.

65 *Id.* at 48-51.

increase in consumer satisfaction, which surveys showed already exceeded 90% prior to the rule's enactment.[66]

Finally, the fact that some funeral homes may engage in aggressive sales tactics does not support calls for licensing independent casket sellers. Licensing independent casket sellers, and particularly online vendors, appears to have no relation to the perceived problem of aggressive funeral homes. Ignorant, grief-stricken consumers are unlikely to comparison shop for caskets at multiple websites.[67] Licensing requirements for independent casket retailers could, however, reduce the flow of useful information to consumers who want to shop around. Independent casket sellers provide consumers with an additional set of competitive options and an alternative source of information. Online casket vendors allow consumers to search available models and compare prices without having to interact with sales staff at all. Regulations that increase barriers to independent casket sales tend to deprive consumers of this alternative information source and increase consumer vulnerability to manipulation.

The FTC filed an amicus brief in the *Powers* case, and argued precisely this point in order to refute a particularly novel consumer protection theory. Oklahoma argued that casket sellers must have funeral director's licenses to ensure that casket purchasers are protected by the FTC's Funeral Rule.[68] The Funeral Rule applies only to businesses that supply both funeral goods and funeral services, which is precisely what funeral directors do. Former FTC officials have questioned whether the rule was really justified by funeral market conditions.[69] Regardless of the merits of the rule, requiring independent casket sellers to have funeral director's licenses does not further the goals of the Funeral Rule. The FTC's brief summarized as much:

> The fundamental purpose of the Rule is to protect consumers by giving them full information in order to promote greater competition. In adopting the Rule, the Commission determined that, without adequate information, consumers could find themselves at the mercy of individual funeral directors, who, in turn, would be insulated from meaningful competition. The Rule sought to remedy that problem by helping to ensure that funeral directors faced genuine competition, to the ultimate benefit of consumers.
>
> The purpose and effect of the challenged portion of the FSLA [Funeral Services Licensing Act] is precisely the opposite. Rather than promote competition, the FSLA prohibits it. Rather than protect consumers by exposing funeral directors to meaningful competition, the FSLA protects funeral directors from facing any competition from third-party casket sellers.

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66 *Id.* at 52-57.

67 Daniel Sutter, *State Regulations and E-commerce: The Case for Internet Casket Sales in Oklahoma*, 20 J. PRIVATE ENTERPRISE 31, 29 (2005).

68 Powers v. Harris, No. CIV-01-445-F, 2002 WL 32026155, at *19 (W.D. Okla. 2002). (Defendants' Motion to Dismiss Plaintiffs' First Amended Complaint and Brief in Support).

69 *See* McChesney, *supra* note 52; Timothy J. Muris, *Rules Without Reason: The Case of the FTC*, 6 Regulation 20, 25 (1982).

> Rather than promote consumer choice, the FSLA forces consumers to purchase caskets from funeral directors. Whatever ends the FSLA can be said to be advancing, it is not advancing the ends of the FTC's Funeral Rule.[70]

Indeed, it is likely that Oklahoma's licensing requirement would not even have subjected independent casket sellers to the Funeral Rule, since the rule explicitly applies only to "funeral providers" who furnish both "funeral goods and funeral services."[71] Even if the Funeral Rule produces consumer benefits, therefore, licensing casket sellers would not produce any benefits due to the Funeral Rule.

b. Grief Counseling

Some states and funeral homes have expressed concerns about the mental health of consumers buying caskets online. They argue that funeral directors are trained to comfort people during a time of loss. In addition, some grief counselors believe that consumers should visit funeral homes to ease the grieving process,[72] and others worry that online sales might "trivialize the gravity of death."[73] A Maryland regulator testified that the "difficulty with an Internet sale is that we may not have the opportunity for this give and take and personal exchange."[74]

There is little empirical evidence specifically on this point, and survey data could help to determine its validity. As a logical matter, however, this concern appears poorly grounded. Even in states that allow online sales, most consumers continue to purchase caskets through funeral directors. Moreover, virtually all consumers arrange for funeral services through a licensed funeral director (of course, for the small subset of consumers who do not arrange services through a licensed director, it is irrelevant whether that director has a license or not). Therefore, even if online casket sales were permitted, those consumers apt to prefer personal interaction could continue to receive the benefit of interacting with licensed funeral directors.[75]

Furthermore, consumers can receive psychological help from people other than licensed funeral directors—in the Sixth Circuit case, one of the unlicensed funeral vendors was an ordained minister.[76] Independent casket sales and online casket sales simply allows consumers to choose where to

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70 Amicus Brief of FTC, *supra* note 46, at 2.

71 16 C.F.R. § 453.1(j).

72 Bob Tedeschi, *Some Web Merchants Fill a Void, and Make a Profit, by Selling Coffins and Other Funeral Supplies Online*, N.Y. TIMES, Feb. 3, 2003, at C5.

73 Eve Tahmincioglu, *The Online Way of Death*, SALON.COM, Apr. 28, 2003.

74 Steven Sklar, Tr., *supra* note 1, at 501.

75 Craigmiles v. Giles, 312 F.3d 220, 228 (6th Cir. 2002).

76 Craigmiles v. Giles, 110 F. Supp. 2d 658 (E.D. Tenn. 2000).

buy a casket, and there is no logical reason to believe that consumers who purchase caskets from independent vendors will receive relatively less grief-counseling, either from licensed funeral directors or others.

c. Health and Safety

Some states and funeral homes contend that licensing promotes health and safety, because proper disposal of human remains affects the environment and the public.[77] The evidence, however, shows that caskets themselves do not protect consumer health and safety. "Caskets have not been shown to play a role in protecting public health, safety, or sanitation, nor have they been shown to aid in protection of the environment."[78] In *Craigmiles*, the district court found that "the record contains no evidence that anyone has ever been harmed by a leaky casket."[79] At the FTC workshop, no one presented evidence demonstrating a link between public health and caskets, or evidence that consumers suffered harm in states that did not require a license to sell a casket.

Moreover, although the rational basis test grants states leeway in deciding how to address a problem, many states do not require the use of a casket in a burial at all. In both Oklahoma and Tennessee, for example, consumers can provide their own casket, or none at all.[80] Similarly, Georgia sets no standards for the design or construction of caskets.[81] A state's concern about the potential safety effects of leaky caskets is certainly undercut if the state does not regulate casket quality directly, or even require that the deceased be buried in caskets at all.

In any case, even if caskets did damage the environment, a casket retailer would not need specialized training to sell them. "Selling a casket is not rocket science. You don't need to be a funeral director, to be educated at a mortuary school to do these things."[82] None of the federal courts that considered the issue found that selling a casket required specialized training. The court in the Oklahoma case, for example, concluded that "very little specialized knowledge is required to sell caskets."[83] Currently, "none

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77 *Craigmiles*, 312 F.3d at 224-28 (discussing Tennessee's arguments).

78 Powers v. Harris, No. CIV-01-445-F, 2002 WL 32026155, at *3 (W.D. Okla. 2002). *See also* NYC Department of Consumer Affairs, *The High Cost of Dying: Rising Prices and Consumer Deception in the Funeral Industry: Proposals for Reform* Feb. 1999, at 20 (noting that "there is no such thing as a 'protective' casket").

79 *Craigmiles*, 110 F. Supp. 2d at 662.

80 *Id.*

81 Peachtree Caskets Direct, Inc. v. State Bd. of Funeral Serv., No. Civ. 1:98-CV-3084-MHS, 1999 WL 33651794 at *1 (N.D. Ga. Feb. 9, 1999).

82 Mark Krause, Tr., *supra* note 1, at 499.

83 *Powers*, No. CIV-01-445-F, 2002 WL 32026155 at *5. *See also* Casket Royale, Inc. v. Mississippi, 124 F. Supp. 2d 434, 438 (S.D. Miss. 2000) ("surely no special skills are necessary for this duty").

of the training received by licensed funeral directors regarding caskets has anything to do with public health or safety."[84] Less than 5% of the education and training requirements for a license relate to selling a casket.[85]

In terms of logistics, independent casket retailers can provide caskets in a timely manner. Independent casket retailers face the same types of shipping and inventory issues as funeral directors. The fact that a casket comes from an independent seller "does not present any unique problems for funeral directors or for customers."[86] In *Casket Royale*, the court found that "Defendants have failed to show that the licensing requirement in any way speeds the process of burial. More importantly, Defendants have failed to provide any evidence that unlicensed dealers slow burial or cremation."[87]

Finally, there is no difference in quality between caskets sold by independent vendors and those sold by funeral directors.[88] For most caskets, the manufacturer, not the retailer, provides a warranty, which will seldom if ever address the protective qualities of the caskets.[89] A casket is a "glorified box" that "does not differ from any other product in the marketplace."[90] In *Craigmiles*, the Sixth Circuit concluded that "there is no evidence in the record that licensed funeral directors were selling caskets that were systematically more protective than those sold by independent casket retailers. Indeed, the only difference between the caskets is that those sold by licensed funeral directors were systematically more expensive."[91]

d. Legal Remedies Against Online Fraud

Some funeral homes and states maintain that consumers could suffer from fraud or other abuses if they buy caskets from independent sources. They suggest that injured consumers would have no legal remedy unless

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84 *Craigmiles*, 110 F. Supp. 2d at 663.

85 *Powers*, No. CIV-01-445-F, 2002 WL 32026155 at *5; Craigmiles v. Giles, 312 F.3d 220, 222 (6th Cir. 2002) (casket and urn issues constituted no more than 5% of mandatory curriculum for funeral directors).

86 *Powers*, No. CIV-01-445-F, 2002 WL 32026155 at *6.

87 *Casket Royale*, 124 F. Supp. 2d at 438.

88 *Craigmiles*, 312 F.3d at 226.

89 Joanne Kimberlin, *Monopolistic Funeral Homes Have the Law on Their Side, Critics Say*, THE VIRGINIA PILOT, Aug. 21, 2001; *Craigmiles*, 110 F. Supp. 2d at 664; Brown, Tr. 498. *See also Aurora Introduces New 25 Year Warranty for Metal Caskets*, MORTUARY MANAGEMENT, April 2003, at 32 (the Aurora casket warranty states "There is no scientific or other evidence that any casket with a sealing device will preserve human remains."); *Batesville Casket Updates Warranties*, MORTUARY MANAGEMENT, January 2003, at 30 ("Batesville will no longer describe its gasket-equipped metal caskets as 'protective'").

90 *Casket Royale*, 124 F. Supp. 2d at 438; Craigmiles v. Giles, 110 F. Supp. 2d 658, 663 (E.D. Tenn. 2000).

91 *Craigmiles*, 312 F.3d at 226. *See also Casket Royale*, 124 F. Supp. 2d at 438.

casket sales are limited to funeral directors subject to regulatory oversight. Like any retailers, however, casket sellers—including independent casket vendors—are subject to the same general consumer protection laws as any other business, including state contract and consumer protection laws.[92] Many of these laws provide for private rights of action.[93] At the FTC's workshop, for example, no one presented evidence indicating that these laws do not provide sufficient remedies for consumers, or that jurisdictional concerns present any greater difficulties in this market than in any other.[94]

3. The Competitive Effects

Although the funeral regulations offer consumers little or nothing in the way of consumer protection, they could affect casket prices and the variety of caskets available to consumers. In addition, regulation could prevent consumers from enjoying the convenience of searching for caskets at all hours from the comfort of their homes.

For several reasons, online purchases might lead to lower casket prices for at least some consumers. Online shopping allows consumers to conveniently compare several sellers' prices, thus raising the odds that the online shopper will find a lower price than they would at a small number of local sellers.[95] E-commerce could also lead to generally lower retail margins and prices online by reducing the cost of searching price and nonprice attributes. Because state funeral director licensing serves as a barrier to entry, permitting online casket sales would likely reduce prices below what brick-and-mortar vendors charge.[96] Finally, an Internet casket retailer may simply have a fundamentally different business model that incurs less of the traditional retail costs, such as physical showrooms and sales staff. Each of these factors could lead to lower online prices.[97] Dr. Randall Kroszner,

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92 *See Casket Royale*, 124 F. Supp. 2d at 440; *Craigmiles*, 110 F. Supp. 2d at 664; Amicus Brief of FTC, *supra* note 46, at 15.

93 Powers v. Harris, No. CIV-01-445-F, 2002 WL 32026155, at *13 (W.D. Okla. 2002).

94 Moreover, the Federal Trade Commission has authority under Section 5 of the FTC Act to bring an enforcement action against a casket seller who makes false or misleading claims about the products or services it provides. 15 U.S.C. § 45. The Commission also has authority under its unfairness jurisdiction to stop marketing practices that cause or are likely to cause substantial consumer injury, which is not reasonably avoidable by consumers and is not outweighed by countervailing benefits to consumers or to competition. 15 U.S.C. § 45(n). *See also* Unfairness Policy Statement, appended to International Harvester Co., 104 FTC 949, 1070 (1984). Many state attorneys general have similar authority.

95 A similar point has been made in the context of online wine sales. *See* Alan Wiseman & Jerry Ellig, *Market and Nonmarket Barriers to Internet Wine Sales: The Case of Virginia*, 6 BUS. & POL. 1070 (2004).

96 Harrington, *supra* note 53.

97 *See* Michael D. Smith, Joseph Bailey & Erik Brynjolfsson, *Understanding Digital Markets: Review and Assessment*, *in* UNDERSTANDING THE DIGITAL ECONOMY: DATA, TOOLS, AND RESEARCH 97 (E. Brynjolfsson and B. Kahin, eds., 2000); Debra J. Holt, *The Internet and Auto Sales: Benefits and*

formerly a Member of the White House Council of Economic Advisers, testified that the Internet allows some suppliers to operate more efficiently: "on both the supply and demand side, e-commerce has helped to lower overhead costs and operating costs, and lower research costs."[98] If brick-and-mortar casket sellers perceive online sales as a substantial competitive threat, they may respond with lower prices.

Two recent economic studies have examined the effects of casket sales restrictions on Internet casket sales. Analyzing survey data from funeral directors' Generalized Price Lists in six southern states, two economists found that a state requirement that casket sellers have licenses increases the price funeral homes charge for a plain, cloth-covered wood casket by about \$261. The potential Internet savings, however, are even larger. A regression analysis finds that funeral directors charge about \$1,045 for a plain wood casket in restrictive states, but that similar caskets are available online for about \$440. Even after accounting for the fact that funeral directors in non-restrictive states charge higher prices for their services, the consumer in a non-restrictive state could still save \$344 on the cost of a funeral by buying the casket online.[99] Funeral homes in restrictive states also charge about \$124 more for a cardboard box for cremation.[100] In the same vein, in restrictive states, funeral directors had merchandise receipts per death that were \$175 higher than in non-restrictive states.[101]

Another study, conducted by an expert witness in the *Powers* case, compared an online vendor's prices for 30 caskets with prices for the same caskets sold in 14 Oklahoma funeral homes. The funeral homes' prices were, on average, 68% higher than those of the Internet retailer. Funeral home prices for the same casket varied significantly, with an average price spread of 52%.[102] Thus, a consumer who comparison shopped at several funeral homes could achieve significant savings, but while a consumer who comparison shopped on the Internet could achieve even larger savings.

Moreover, anecdotal evidence also suggests that online casket prices are often lower than brick-and-mortar prices. Third-party casket sellers typically charge significantly lower prices than funeral homes for compara-

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Barriers, 19 J. OF PRIVATE ENTERPRISE 21 (2003); Daniel Sutter, *State Regulations and E-commerce: The Case for Internet Casket Sales in Oklahoma*, 20 J. OF PRIVATE ENTERPRISE 31 (2005).

98 Randall Kroszner, Tr., *supra* note 1, at 79.

99 Judith A. Chevalier & Fiona M. Scott Morton, *State Casket Sales and Restrictions: A Pointless Undertaking?* 12-13 (NBER Working Paper No. W12012, 2006), *available at* http://www.nber.org/papers/w12012 (last visited Aug. 21, 2007).

100 *Id.* at 14.

101 *Id.* at 22. The statistical significance of this coefficient is 94 percent—1 point shy of the traditional 95 percent confidence level that economists conventionally label "statistically significant." The higher receipts per death for merchandise were balanced by lower receipts per death for services, discussed in section C.1.b. infra.

102 *See* Sutter (2005), *supra* note 97, at 34.

ble caskets.[103] Some independent vendors undercut established funeral home prices by as much as 50%.[104] One court found that funeral homes mark up their casket prices from 250 to 400%, and sometimes as high as 600%, whereas online vendors mark up their caskets by substantially less.[105] In *Casket Royale*, the court concluded that, "as a result of this requirement, consumers in Mississippi are offered fewer choices when it comes to selecting a casket . . . . Ultimately, the consumer is harmed by this regulation as one is forced to pay higher prices in a far less competitive environment."[106]

Similarly, surveys imply that online casket sales have helped reduce brick-and-mortar prices. In a 2004 survey of funeral homes, 71% of those responding stated that they had reduced markups on caskets in response to third-party sellers.[107] In the same survey, 41% of respondents stated that their average casket markup exceeded 200%, whereas two years ago, 68% of them had markups higher than 200%.[108] In *Powers*, the district court found that "as long as independent sellers stay in the market, casket sales from independent sources . . . place downward pressure on casket prices as a result of increased competition. This downward pressure may result, and in other states has at times resulted, in lower casket prices."[109] Finally, according to one economist, "[e]nough people are now browsing for caskets [on the Internet] that an owner of a brick-and-mortar funeral home told me that more and more people are coming to his funeral home with pictures (and prices) of caskets they found on the Internet." Even if customers feel that negotiating over prices is disrespectful to the deceased, "funeral directors see the prices and understand that they need to respond to them."[110]

Aside from lower prices, online casket sales also offer consumers a greater variety of caskets. When consumer tastes are heterogeneous, increased variety makes consumers better off, "especially . . . when the additional customization or versioning can be produced at very low or zero

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103 *See Report of Daniel Sutter, Ph.D. at 4*, filed in Powers v. Harris, No. CIV-010445-F, 2002 WL 32026155 (W.D. Okla. Dec. 12, 2002).

104 Mei Fong, *E-Business: The Web @ Work* / Casket Royale, WALL ST. J., Aug. 27, 2001, at B4. In the same article, one online vendor commented that when consumers purchase a casket from an affiliated retailer, rather than buying directly, shipping adds an average of $350 to the total cost. Many online vendors discount casket prices by much more than that amount.

105 Craigmiles v. Giles, 110 F. Supp. 2d 658, 664 (E.D. Tenn. 2000).

106 Casket Royale, Inc. v. Mississippi, 124 F. Supp. 2d 434, 440 (S.D. Miss. 2000)

107 *FSI's Third Party Seller Survey*, FUNERAL SERVICE INSIDER, April 19, 2004, at 3.

108 *Id.* The survey also found that 19% of respondents had urged other funeral homes to boycott casket suppliers who dealt with third-party sellers.

109 Powers v. Harris, No. CIV-010445-F, 2002 WL 32026155 at *6 (W.D. Okla. Dec. 12, 2002). *See also* Rob Kaiser, *Funeral Homes, Retailers Clash in Casket Market / Few Consumers Opting to Visit Outside Sources*, CHI. TRIB., Mar. 16, 2003, at 1 (reporting that some funeral homes, in response to pressure from independent vendors, have reduced markups on caskets from around 400% to 200%, although these funeral homes may have simultaneously increased prices for services).

110 Harrington, *supra* note 53, at 7.

marginal costs."[111] Consumers can purchase individualized caskets with non-standard interior linings, such as fur or leather, or particular themes, such as western or Victorian themes.[112] They also can purchase caskets with humorous themes; one casket is emblazoned with the words "Return to Sender."[113] Consumers may not find such caskets through funeral homes, which may have only a certain number of samples available to show. Although it is difficult to quantify the benefits of product variety in this market, at least some consumers appear to highly value the ability to personalize their loved ones' caskets. One consumer, for instance, spent several hundred dollars having his father's casket painted with the colors of his father's favorite university.[114] Other consumers may have religious reasons for wanting a certain style of casket. Accordingly, while the extent of competition's effect on price is not clear, competition certainly increases consumer choice.

Finally, the Internet offers consumers a variety of intangible benefits. Some consumers may prefer the privacy of shopping for a casket online.[115] Some consumers may feel less pressure from salespeople by shopping for a casket over the Internet.[116] Finally, as in many industries, consumers may prefer the convenience of shopping online. For both pre-need and at-need sales, consumers can search the Internet twenty-four hours a day from the convenience of their homes.[117] Similarly, online sales could lower consumers' "coordination costs" by allowing family members in different parts of the country to select a casket jointly.

B. *Protectionism*

The weakness of the consumer protection rationale, particularly when coupled with the adverse effect on consumers, leaves protectionism as the sole "rational basis" supporting the application of funeral licensing regulations to standalone casket sales. Aside from *Powers*, however, no court decision—and certainly no Supreme Court decision—has ever held that

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111 Yannis Bakos, *The Emerging Landscape for Retail E-commerce*, 15 J. ECON. PERSPECTIVES 69, 79 (2001).

112 *News Briefs*, MORTUARY MANAGEMENT, Mar. 2000, at 21-22.

113 Harrington, *supra* note 53, at 8.

114 Robert Schoenberger, Casket Industry Gets Creative as More Turn to Cremations, THE COURIER-J., Oct. 31, 2003, at 1F. *See also* Peter Kilborn, *Funerals With a Custom Fit Lighten Up a Solemn Rite*, N.Y. TIMES, Feb. 11, 2004, at A14 (stating that "families are shunning the somber, one-size-fits all rituals and customs of traditional funerals").

115 Lisa Carlson, Written Statement 1, *available at* http://www.ftc.gov/opp/ecommerce/anticompetitive/panel/carlson.htm (last visited Aug. 21, 2007).

116 David Harrington, Tr., *supra* note 1, at 474; Steven Sklar, Tr., *supra* note 1, at 500-01.

117 *See* Eve Tahmincioglu, *The Online Way of Death*, SALON.COM, Apr. 28, 2003.

protectionism, by itself, qualifies as a legitimate state interest.[118] For example, the *Powers* majority cites *Williamson v. Lee Optical*[119] for the proposition that a state may legitimately try to free a profession "from all taints of commercialism." The majority also cites two tax cases in which states taxed different types of property at different rates, and one case in which New Orleans created a grandfather exception for longtime vendors of push-cart foodstuffs. Although all of these cited decisions allowed governments to discriminate in favor of certain economic interests, none of them supports the majority's sweeping proclamation.

As the *Powers* concurrence explained, in all of those cases "the discriminatory legislation arguably advance[d] either the general welfare or a public interest."[120] In *Williamson*, for example, the Supreme Court invoked the "evil at hand for correction," namely consumer safety, to uphold the state's regulation of eye care. In *Fitzgerald v. Racing Association of Central Iowa*,[121] the Supreme Court upheld differential tax rates because the tax rates arguably protected the reliance interests of river-boat owners and could have fostered general economic development. Likewise, in *City of New Orleans v. Dukes*,[122] the Court invoked historical preservation and economic prosperity. In *Nordlinger v. Hahn*,[123] the Court invoked neighborhood preservation, continuity, stability, and protecting the reliance interests of property owners. In all of these cases, the Court upheld the challenged legislation, at least in part, because the legislation promoted some public benefit. As these decisions illustrate, the Court allows states play favorites, but only where the states have at least a colorable argument that the legislation helps the public at large.[124]

The *Powers* majority is correct, however, to point out that there is little authority for the proposition that the Constitution bars purely intrastate protectionism. As the court pointed out, most of the authority on this issue involves interstate discrimination and the dormant Commerce Clause. Nevertheless, there are several reasons why courts should reject protectionism as a rational basis. In the first place, the Constitution's history and text both favor free-market competition, as manifested in the Commerce Clause and elsewhere, and that background can and should inform the interpretation of other constitutional clauses in the absence of more specific language. "It has long been accepted that the Commerce Clause . . . directly limits the power of the States to discriminate against interstate commerce.

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118 *See* Powers v. Harris, 379 F.3d 1208, 1220-21 (10th Cir. 2004); *see also id.* at 1225 (Tymkovich, concurring).

119 Williamson v. Lee Optical, 348 U.S. 483 (1955).

120 *Powers*, 379 F.3d at 1225.

121 Fitzgerald v. Racing Ass'n of Cent. Iowa, 539 U.S. 103 (2003).

122 City of New Orleans v. Dukes, 427 U.S. 297 (1976).

123 Nordlinger v. Hahn, 505 U.S. 1 (1992).

124 *See generally* Comment, Powers v. Harris: *How the Tenth Circuit Buried Economic Liberties*, 82 DENVER U. L. REV. 585 (2005).

This 'negative' aspect of the Commerce Clause prohibits economic protectionism—that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors."[125] To stress this aspect of the Commerce Clause, James Madison wrote that it "grew out of the abuse of the power by the importing States in taxing the non-importing, and was intended as a negative and preventive provision against injustice among the States themselves."[126] Although the Constitution does not expressly address intrastate protectionism, the Founding Fathers' concern about the evils of interstate protectionism suggests they would disfavor it.

Similar sentiments underlie other portions of the Constitution, including the Contracts Clause and Equal Protection Clause. The Supreme Court has noted that one element of the Court's Contracts Clause inquiry is whether "the state law was enacted to protect a basic societal interest, not a favored group,"[127] and that "[t]he requirement of a legitimate public purpose guarantees that the State is exercising its police power, rather than providing a benefit to special interests."[128] Likewise, in a number of cases, the Supreme Court has held that the Equal Protection Clause prevents discrimination against particular groups. For instance, in *City of Cleburne v. Cleburne Living Center*, the Court held that the city lacked a rational basis for requiring group homes for the mentally challenged to obtain a special use permit.[129] While online vendors are not a "suspect class" or a discrete and insular minority, there is substantial evidence that new entrants are disfavored in the legislative process.

Finally, as a policy matter, basic economics teaches that protectionism harms consumer welfare. By blessing protectionism as a rational basis, *Powers* would effectively lower the costs to companies of obtaining protectionist legislation and, thus, encourage more of it. Under *Craigmiles*, in contrast, companies must at least go to the trouble of articulating a colorable public welfare argument to support protectionist legislation. This requirement may well help to forestall at least some of the more egregious types of rent-seeking legislation.

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[125] New Energy Co. v. Limbach, 486 U.S. 269, 273 (1988). *Accord* Bacchus Imports, Ltd. v. Dias, 468 U.S. 263, 271 (1984) ("One of the fundamental purposes of the Clause 'was to insure . . . against discriminating State legislation.'") (quoting Welton v. Missouri, 91 U.S. 275, 280 (1876)); Baldwin v. G.A.F. Seelig, Inc., 294 U.S. 511, 522 (1935).

[126] 3 M. Farrand, Records of the Federal Convention of 1787, vol. III, p. 478 (1911) (cited in West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 193 n.9 (1994)).

[126] Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 242 (1978).

[128] Energy Reserves Group, Inc. v. Kan. Power & Light, Co., 459 U.S. 400, 412 (1983).

[129] City of Cleburne v. Cleburne Living Ctr., 473 U.S. 432, 447-50 (1985).

C. *Rational Basis with a Bite*

The *Powers* court also expressed concern about how to cabin the application of the rational basis test to prevent a return to the *Lochner* era of full-blown economic substantive due process. After all, the Constitution does not enact Milton Friedman's "Capitalism and Freedom," and even if it did, the legislative branch, not the judiciary, is best suited to apply a particular economic theory. There is likely no simple, bright-line rule for determining when a law impermissibly furthers purely protectionist goals and when the law permissibly furthers both protectionist and non-protectionist goals. Even in the casket context, for example, one could colorably argue that the state has a rational basis in fostering long-term relationships between licensed funeral directors and grief-stricken consumers, and that the state deserves discretion in determining how to do so.

Nonetheless, the casket cases reveal some principles that may help to provide some manageable limits. In particular, courts could decide to apply the rational basis test to strike protectionist legislation only if some or all of the following factors are present: evidence of an intent to benefit one group of people at the expense of others, i.e., protectionism;[130] evidence refuting the law's ostensible public-interest rationale; the presence of less restrictive alternatives to satisfy the law's ostensible purpose; evidence showing a harm to competition and consumers; and, perhaps, evidence that the law may interfere with interstate commerce. Finally, with respect to laws that may impair e-commerce, courts may want to consider whether a statute is merely a legacy law whose application to a new form of commerce, unless expressly required by the statute's text, would make little sense.

Many of these factors have been fleshed out in equal protection and interstate commerce cases such as *Cleburne* and *Pike v. Bruce Church, Inc.* For instance, in *Yamaha Motor Corp. v. Jim's Motorcycle, Inc.*, the court considered a Virginia motorcycle dealer franchise law that allowed any existing franchised dealer in Virginia to protest the establishment of a new dealership for the same brand anywhere in Virginia. The court applied the *Pike* balancing test, which requires courts to closely scrutinize state statutes if the statute's burdens fall predominantly on out-of-state interests. Applying the test, the court held that the law unduly burdened interstate commerce, in violation of the dormant Commerce Clause, because the law allowed in-state dealers to restrict competition at the expense of out-of-state manufacturers.

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130 *See* Comment, *Exhumation Through Burial: How Challenging Casket Regulations Helped Unearth Economic Substantive Due Process in Craigmiles v. Giles*, 88 MINN. L. REV. 668 (2004); Comment, Powers v. Harris: *How the Tenth Circuit Buried Economic Liberties*, 82 DENVER U. L. REV. 585 (2005).

Furthermore, a 2005 Supreme Court decision, *Granholm v. Heald*, demonstrates that courts could apply manageable tests to more closely scrutinize state regulation that impairs the flow of e-commerce in order to benefit local economic interests. In *Granholm*, the Court considered statutory schemes in New York and Michigan that allowed in-state vendors, but not out-of-state vendors, to ship wine directly to consumers. As the Court recognized, "[s]tate bans on interstate direct shipping represent the single largest regulatory barrier to expanded e-commerce in wine."[131] The Court also recognized that the bans had the effect of protecting intrastate wineries and wholesalers from competition. Because the plaintiffs alleged that the statutes discriminated against interstate commerce, the Court analyzed the statutes under the rubric of the dormant Commerce Clause. The Court ultimately held that the statutes violated the Commerce Clause by giving in-state vendors an advantage over out-of-state competitors, and that the Twenty-First Amendment, which repealed Prohibition, did not authorize the discriminatory treatment.

In analyzing the statutes under the Commerce Clause, the Court applied a different framework than that used to analyze purely intrastate statutes under the Equal Protection or Due Process Clauses. Instead of deferring to the state legislature and requiring only "rational speculation" to uphold the legislation, the Court demanded evidence of a rational basis for the law. "Our Commerce Clause cases demand more than mere speculation to support discrimination against out-of-state goods. The burden is on the State to show that the *discrimination* is demonstrably justified."[132] The Court holds discriminatory statutes to a higher standard for several reasons. For example, from a public choice standpoint, more rigorous scrutiny makes sense because out-of-state residents may lack the ability to defend their interests in another state's legislature.[133]

Although *Granholm* analyzed the wine statutes using a different, more rigorous test than that used to analyze the casket statutes, courts could use portions of *Granholm* to analyze any licensing scheme that impairs the flow of e-commerce under the rational basis test. First, and perhaps most importantly, *Granholm* recognized that e-commerce benefits consumers and that

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131 *See* Granholm v. Heald, 544 U.S. 460, 468 (2005) (quoting an FTC report).

132 *Id.* at 492 (citations and internal quotations omitted).

133 The public choice point has been discussed most thoroughly in debate over the "state action" immunity from federal antitrust laws, where scholars have noted that extensive state action immunity could allow a state to impose costs on citizens of other states who are not represented in its legislature. *See, e.g.*, Frank Easterbrook, *Antitrust and the Economics of Federalism*, 26 J. L. & ECON. 23 (1983); Robert P. Inman & Daniel J. Rubinfeld, *Making Sense of the Antitrust State-Action Doctrine: Balancing Political Participation and Economic Efficiency in Regulatory Federalism*, 75 TEX. L. REV. 1203 (1997); Thomas M. Jorde, *Antitrust and the New State Action Doctrine: A Return to Deferential Economic Federalism*, 75 CAL. L. REV. 227 (1987); Federal Trade Commission State Action Task Force, Report of the State Action Task Force, 35-40 (2003), *available at* http://www.ftc.gov/os/2003/09/stateactionreport.pdf (last visited Aug. 21, 2007).

pre-existing state regulatory schemes can prevent new entrants from competing via the Internet. The Court noted, for example, that "[wholesaler consolidation] has led many small wineries to rely on direct shipping to reach new markets. Technological improvements, in particular the ability of wineries to sell wine over the Internet, have helped make direct shipments an attractive sales channel."[134] Second, the Court also recognized that a state ban on direct shipping "substantially limits the direct sale of wine to consumers, an otherwise emerging and significant business," even though the "wine producers in the cases before us are small wineries that rely on direct consumer sales as an important part of their businesses."[135] Indeed, without direct shipping, many smaller wineries would find distribution "economically infeasible."[136]

Having acknowledged the importance of e-commerce to both consumers and some producers, the Court may become more willing to force states to articulate plausible reasons for restricting e-commerce, even for regulations that ostensibly apply only to intrastate transactions. In particular, *Granholm* may serve as a template for the types of empirical evidence that courts will consider, and perhaps require, in the course of evaluating licensing schemes that affect e-commerce under the rational basis test.[137] Although the rational basis test does not require states to provide empirical evidence supporting their laws, nothing prevents courts from considering empirical evidence that may affirmatively undercut the laws' rationale. For example, New York and Michigan had argued in *Granholm* that interstate direct shipping allowed minors to buy wine online, and had provided some anecdotal evidence in support. In finding these assertions "unsupported," the Court relied heavily on a study of the wine industry by the FTC. The FTC's Wine Report canvassed over a dozen states that permitted interstate direct shipping and found that none of them had reported any problems with direct sales of wine to minors.[138] The Wine Report also relied on other surveys and basic economic principles to conclude that minors were more interested in beer and spirits rather than wine, and that minors had far more direct means of obtaining alcohol than the Internet. In effect, the Wine Report undermined all of the states' speculative, non-protectionist arguments against direct shipping. The Court's complete embrace of the Wine Report and skepticism of the states' arguments suggests that, in the future, the Court may be amenable to using such evidence even when evaluating state laws under the more lenient rational basis test.

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134 *Granholm*, 544 U.S. at 467.

135 *Id.* at 468.

136 *Id.*

137 *See id.* at 492.

138 *See id.*; Federal Trade Commission, *Possible Anticompetitive Barriers to E-commerce: Wine* (July 2003).

The *Granholm* decision may also increase the burden on states to justify treating in-state and out-of-state vendors differently. The Court found that, even if direct shipping increased underage drinking, the states could not justify banning interstate direct shipping while allowing intrastate direct shipping. As the Court noted, "minors are just as likely to order wine from in-state producers as from out-of-state ones."[139] Arguably, this rationale also could apply to sales of online caskets. In *Powers*, Oklahoma banned intrastate unlicensed vendors from selling caskets directly to Oklahoma consumers, but never tried to prohibit out-of-state unlicensed vendors from selling caskets directly to Oklahoma consumers. The record contained no evidence of any problems with any sales from out-of-state vendors. Based on *Granholm*, a court could well find that the lack of problems from out-of-state vendors undermines the plausibility of a state's need to limit intrastate sales, even under the rational basis test. In the Internet world, all commerce is, in a sense, interstate commerce.

In fact, courts could very well conclude that all e-commerce is "interstate commerce" for constitutional purposes. In the funeral industry, at least, some of the physical peculiarities of Internet casket sales often necessitate interstate commerce. Some Internet casket sellers develop networks of brick-and-mortar funeral homes that handle deliveries. In any given transaction, the funeral home handling the delivery often may ship the casket to a local market far from its physical location—in many cases, far enough to cross state lines. One of Funeral Depot's funeral home partners, for example, will deliver only outside of its local market.[140] In addition, the states typically do not limit their statutes and regulations solely to intrastate sales, although in *Powers*, the district court held that it lacked jurisdiction to evaluate the Commerce Clause claim because Oklahoma had not enforced its regulatory scheme against out-of-state vendors. In another case, however, perhaps a declaratory judgment suit, a court could find that the risk of such enforcement could "chill" interstate sales enough to raise a Commerce Clause issue.

Finally, *Granholm* may force states to consider less restrictive regulatory alternatives if those states attempt to limit e-commerce with onerous licensing schemes.[141] "[I]mprovements in technology have eased the burden of monitoring out-of-state wineries. Background checks can be done electronically. Financial records and sales data can be mailed, faxed, or submitted via e-mail."[142] As the court explained in *Craigmiles*, the existence of less restrictive, pro-competitive alternatives increases the burden

139 *Granholm*, 544 U.S. at 492.

140 David E. Harrington, *Brick-and-Mortar Barriers to Internet Casket Sales: Are State Funeral Regulations Part of the Mortar?*, Paper presented at the Southern Economic Association (November 19, 2005) (manuscript on file with authors).

141 *Granholm*, 544 U.S. at 492.

142 *Id.*

on the state to justify more onerous rules.[143] This analysis ultimately could affect state regulation of a number of industries, such as automobiles (where most states prohibit manufacturers from selling new cars directly to consumers and instead require them to sell through a licensed car dealer), real estate (where many states require dealers to obtain a license), teaching, or telemedicine.

III. CONCLUSION

Both as a matter of law and of policy, naked protectionism is not a legitimate state interest for purposes of the rational basis test. In finding that it was, *Powers* simply misread Supreme Court precedent that requires states to provide at least a plausible public good rationale for legislation, even if that legislation also has protectionist purposes. By using established jurisprudence from other areas of law, including the dormant Commerce Clause and Equal Protection lines of cases, courts can apply the rational basis test more appropriately when scrutinizing regulations that impair the flow of e-commerce.

143 Craigmiles v. Giles, 110 F. Supp. 2d 658, 664 (E.D. Tenn. 2000).

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CASKET SALES RESTRICTIONS AND THE FUNERAL MARKET

*Daniel Sutter**

ABSTRACT

States impose a variety of regulations on the funeral industry. In 1997, 13 states restricted competition by allowing only licensed funeral directors to sell caskets. Restrictions on entry into the casket market may sustain a regulatory cartel, but its impact on consumers may be minimal given other types of regulation on the industry. Funeral homes might earn one rent on funerals and respond to competition in casket sales by increasing the prices of other funeral services. However, an empirical investigation shows that a casket sales restriction does increase receipts and establishments, in states that also stringently regulate the licensing of funeral directors, although only the effect on establishments is statistically significant. Three states have recently had their casket sales restrictions invalidated by courts. A detailed examination of these states suggests that judicial deregulation has reduced funeral home revenues and particularly accelerated the decline of cemeteries.

I. INTRODUCTION

The death care industry is highly regulated in the United States, yet economists have paid scant attention to the regulation of this industry. Economists' lack of interest is surprising given the size of the funeral industry ($13 billion in revenues in 1997) and the reality that everyone will, one day, require the industry's services.[1] States impose a variety of regulations

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[1] Economic studies of funeral industry regulation include Fred McChesney, *Consumer Ignorance and Consumer Protection Law: Empirical Evidence from the FTC Funeral Rule*, 1 J.L. & POL. 1 (1990); Robert B. Ekelund Jr. & George S. Ford, *Nineteenth Century Urban Market Failure? Chadwick on Funeral Industry Regulation*, 12 J. REG. ECON. 27 (1997); David E. Harrington & Kathy J. Krynski, *The Effect of State Funeral Regulations on Cremation Rates: Testing for Demand Inducement in Funeral Markets*, 45 J. L. ECON. 99 (2002); Daniel Sutter, *State Regulations and E-commerce: The Case for Internet Casket Sales in Oklahoma*, 20 J. PRIV. ENTER. 25 (2005); David E. Harrington, *Brick-and-Mortar Barriers to Internet Caskets: Are State Funeral Regulations Part of the Mortar?* (paper presented at 2005 Southern Economic Association Meetings, Washington, DC) (2005); Asheesh Agarwal, Jerry Ellig & John Delacourt, *Buried Online: State Laws that Limit E-commerce in Caskets*, 14 ELDER

on the funeral industry. Forty-nine states, for instance, require funeral directors to obtain a government license, and the training required to obtain a license can take up to six years. The variation of state regulatory regimes provides a natural venue for cross-sectional analysis.

This paper focuses on a law that thirteen states had in place in 1997 that permitted only licensed funeral directors to sell caskets. The common rationale for this regulation was to protect consumers from manipulation at a very traumatic moment. However, allowing only licensed funeral directors to sell caskets creates a barrier to entry, which should adversely impact consumers. Yet, caskets comprise only one component of a funeral, and funeral homes could respond to competition on caskets by raising the prices of other services, the so-called one rent hypothesis.[2] Therefore, the marginal effect of this one funeral industry regulation may be minimal.

I examine the effect of funeral regulations, and casket sales restrictions specifically, on funeral industry receipts per death, the number of business establishments, and total employment in the death care industry. Overall, states with casket sales restrictions resemble other states. However, casket sales restrictions affect the industry when states strictly regulate the licensing of funeral directors. An extra year of training to obtain a license increases the number of establishments by 10% and increases receipts per death by almost 5%. I also examine changes in the funeral industry between 1997 and 2002, and find that revenues for the entire industry, and for cemeteries in particular, declined sharply. Courts in three states stopped enforcing casket sales restrictions after 1997. A detailed comparison shows that deregulation appeared to reduce funeral home revenues and particularly hastened the decline of cemeteries. Harrington and Krynski, recently found evidence that state funeral regulations contribute to demand inducement by funeral service providers at consumers' expense.[3] My results provide further evidence that funeral regulations serve industry, and not consumer, interests.

II. GRIEVING CONSUMERS AND THE FUNERAL INDUSTRY

Regulation of the funeral industry has long been justified on the grounds of consumer protection.[4] Caskets and funeral services have often,

L. J., forthcoming (2006); Judith Chevalier & Fiona Scott Morton, *State Casket Sales Restrictions: A Pointless Undertaking?* NATIONAL BUREAU OF ECONOMIC RESEARCH WORKING PAPER NO. 12012 (2006).

2 *See* Chevalier & Morton, *supra* note 1.

3 Harrington & Krynski, *supra* note 1.

4 Ekelund & Ford, *supra* note 1. Public health has also been advanced at times as motivating funeral regulation, but dead bodies pose virtually no health risk; *see* DARRYL J. ROBERTS, PROFITS OF DEATH: AN INSIDER EXPOSES THE DEATH CARE INDUSTRIES (1997); *see also* Institute for Justice, *Requiem for a Cartel: Challenging Oklahoma's Casket Monopoly* (2002) (*available at* http://www.ij.org).

although not exclusively, been purchased on an as-needed basis, immediately following the death of a loved one. Many consumers may be grief-stricken after the death of a loved one; therefore, they may not behave as utility-maximizing consumers. The grief-stricken consumer may be emotionally unable to search to find the lowest price for caskets and funeral services. He or she may, instead, simply purchase all funeral services and products from one funeral home. The grief-stricken consumer will have little market information regarding funeral services and prices at the time of purchase. This lack of information can lead to over-paying for funeral services in a market with price dispersion; the grief-stricken consumer who happens to go to a high-priced funeral home will pay more for funeral service. Grief-stricken consumers may also be vulnerable to other forms of manipulation by unscrupulous funeral directors, who could misrepresent legal requirements regarding embalming or cremation or overstate the protective capability of caskets. Funeral directors may be able to price discriminate among grief-stricken consumers or could manipulate distraught consumers into spending significantly more on a funeral (as a sign of their love for the departed family member).[5]

All businesses would like to induce consumers to spend more on their products. The relevant question is the extent to which competition or regulation provides an environment more conducive to demand inducement. Grief-stricken consumers are vulnerable to demand inducement in an unregulated market, but not all consumers purchase funeral services on an at-need basis. Maintaining a loyal customer base is also important in the funeral industry, so funeral homes could establish a reputation for not exploiting grief-stricken consumers.[6] Regulation can also protect grief-stricken consumers. The training required to obtain a funeral director's license is a sunk investment, which would be forfeited if state regulators determine the funeral director has overcharged vulnerable consumers. However, regulated professions can use occupational licensing to restrict entry and generate a wealth transfer from consumers.[7] Regulated professions also control information to help sustain cartel prices; restrictions on advertising and a lack of emphasis on price competition reduce firm gains from cutting prices.[8] Whether funeral industry regulation on the whole benefits consumers or the industry is an open question. Anecdotal evidence of successful

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5 For a description of funeral industry practices designed to exploit customers, *see* Roberts, *supra* note 4. Over-payment by grief-stricken consumers might be appear to be only a wealth transfer, but if these consumers purchase more funeral services than a fully informed, rational consumer, the situation could be considered similar to over-purchase of expert services as in Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J. L. & ECON.67, 67-88 (1973).

6 *See* McChesney, *supra* note 1.

7 *See* MILTON FRIEDMAN, CAPITALISM AND FREEDOM (1962); S. DAVID YOUNG, THE RULE OF EXPERTS: OCCUPATIONAL LICENSING IN AMERICA (1987).

8 *See* Lee Benham & Alexandra Benham, *Regulating Through the Professions: A Perspective on Information Control*, 18 J. L. & ECON.421, 421-47 (1975).

demand inducement under regulation abounds,[9] and a Federal Trade Commission regulation (the "Funeral Rule") was issued to counteract anti-consumer actions by regulated funeral homes. Harrington and Krynski find that cremation rates are lower in states that require more years of training to become a funeral director (cremation is typically less lucrative than a traditional funeral).[10] They conclude that state regulations facilitate demand inducement.

I focus on one component of state regulation of the funeral industry, a law (in effect in 13 states in 1997) allowing only licensed funeral directors to sell caskets. Such a restriction prevents sales of caskets by independent casket retailers and cemeteries. The number of independent casket retailers nationwide has been increasing since the FTC ruled in 1994 that funeral homes could not impose a charge on customers purchasing a casket elsewhere. Entry into the market should increase competition and reduce casket prices. Independent casket retailers, who are not licensed funeral directors, do not have the quasi-rents generated by the license at stake and thus, *may* be more inclined to exploit grief-stricken consumers. However, since grief-stricken consumers, by definition, tend not to comparison shop, only price-searching consumers will buy caskets from independent retailers. Consequently, the consumer protection rationale for this regulation is particularly weak, and the regulation is likely to be anti-competitive.

Selling caskets above cost, may not hurt consumers, given the remaining regulation of the funeral industry. Consumers purchase caskets and funeral services in fixed proportions (they are perfect complements); consumers should consider caskets and services as components of a composite commodity and care about the price of the bundle, not the components. The funeral industry may be earning one rent.[11] If funeral industry regulation sustains a cartel allowing funeral homes to earn an economic profit (or rent), the proportion of profit attributed to caskets, as opposed to other funeral services, is arbitrary. In states prohibiting independent casket retailers, funeral homes might earn their rent by substantially marking up the list price of caskets. In states where funeral homes face competition from casket retailers, funeral homes could sell caskets at marginal cost and raise the price of other funeral services, keeping the overall price of a funeral unchanged.[12] Thus, casket regulation may have no effect on funeral costs, given the impact of other regulations.

The one rent argument, though, may not hold. Caskets may offer a more effective margin on which funeral directors could induce demand than

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9 *See* Roberts, *supra* note 4.

10 *See* Harrington & Krynski, *supra* note 1.

11 Chevalier & Morton, *supra* note 1, discuss in detail the one rent argument and its application to funeral regulation.

12 Specifically, funeral homes could increase the amount of their nondeclinable charge for services; the FTC prevents funeral homes from imposing a handling fee on caskets bought elsewhere.

other funeral services, and competition in the casket market may therefore reduce funeral costs. Although caskets and funerals are consumed in fixed proportions, the quality of each component varies. Grieving consumers might view casket quality differently than service quality and have different elasticities of demand for quality on the two components. Consumers might be more inclined to spend more for a casket (to protect their loved one) than on a more elaborate funeral service. Funeral directors may more readily identify consumers willing to pay more for caskets, than those willing to pay more for elaborate funeral services and, thus, be better able to price discriminate among customers on caskets than funeral services. In addition, since maintaining customer loyalty is important in the industry, funeral homes will want to ensure that their customers do not realize they have been overcharged if they are earning profits.[13]

The probability that customers realize that they have been overcharged might well differ between caskets and funeral services. Customers might have a higher probability of recognizing an overcharge on flowers or catered food, since they purchase caskets infrequently and probably have less information about the range of prices and types of caskets available. Moreover, at least in the short run, funeral homes might face a coordination problem in raising the price of their services or nondeclinable fee in response to competition on caskets. Although all funeral homes might prefer to raise their service fees, the first home that does so risks losing customers (at least price searching customers) if other homes do not follow suit.

Consequently, the impact of a casket retailing law on the funeral industry is an empirical question. Chevalier and Morton, recently found substantial evidence in support of the one rent argument.[14] They found that casket sales restrictions had no significant effect on the cost of funerals by using data from an industry survey, funeral receipts from the economic census, or funeral home stock prices. If the one rent hypothesis is valid, the marginal effect of a casket sales law is minimal. Note, however, that consumers may be better off with competition for caskets, even if the cost of funerals is not lower in unregulated states. Consumers may respond to lower prices of caskets by purchasing a nicer casket or spending more on other funeral services. Thus, consumers would be getting more value for their funeral purchases, even though spending per funeral was unchanged and the one rent hypothesis appeared valid. I now turn to my empirical investigation.

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13 *See* McChesney, *supra* note 1. As Darby and Karni discuss, reputation in the market works best with experience goods when consumers observe quality upon consumption, not credence goods, when quality remains unobserved even after consumption. Darby & Karni, *supra* note 5

14 Chevalier & Morton, *supra* note 1.

III. VARIABLE DEFINITIONS AND DATA SOURCES

In this paper, I report my analysis of the effect casket sales licensing laws have on the funeral industry. I consider industry performance by state in the 1997 and 2002 Economic Censuses. The Death Care Industry (NAICS #8122) is divided into two five-digit subcategories, Funeral Homes and Other Funeral Services (81221) and Cemeteries and Crematories (81222). The first of these categories is further subdivided into Funeral Homes (8122101) and Other Funeral Services (8122102). A prohibition on independent casket retailers should benefit funeral homes and, thus, the Funeral Homes segment should exhibit the greatest impact. The Economic Census, however, only reports receipts and employment for classification for some states, due to the small number of Other Funeral Services establishments in the remaining states.

I examine three measures of industry performance: receipts per state deaths in each year; establishments per million state residents; and employees per million state residents. I estimate determinants of these variables for the available states under the Funeral Homes classification and for two years under the other industry segments.[15] Receipts per death is my main performance measure of interest, since it reflects the cost to consumers of funerals. Regulation can also affect the number of establishments in an industry, by protecting small retailers against competition from large rivals. Following Anderson and Johnson,[16] I also examine determinants of establishments per million residents as a secondary test of the effect of regulation. Receipts per death might exhibit greater annual fluctuations due to the demographics and preferences of the families of the deceased, which state demographic variables only measure imperfectly. The number of funeral industry establishments might provide a better indication of a permanent impact of regulation than receipts. Analysis of employees per million residents provides evidence on any labor rent-sharing in the funeral industry, which was shown to be prevalent in the trucking and airline industries during their periods of heaviest regulation.[17]

The funeral industry is subject to a variety of state regulations. Thirteen states, as of 1997, allowed only licensed funeral directors to sell caskets, although courts in three states overturned these laws between 1997

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15 Note that Alaska and Wyoming are excluded because receipts were not reported for these states for either of the Death Care Industry categories.

16 Rod W. Anderson & Ronald N. Johnson, *Antitrust and Sales-Below-Cost Laws: The Case of Retail Gasoline*, REVIEW OF INDUSTRIAL ORGANIZATION 14:3, 189-204 (1999).

17 *See* Thomas Gale Moore, *The Beneficiaries of Trucking Regulation*, 21 J. L. & ECON. 327 (1978); Nancy S. Rose, *Labor Rent Sharing and Regulation: Evidence from the Trucking Industry*, 95 J. POL. ECON. 1146 (1987); David Card, *The Impact of Deregulation on the Employment and Wages of Airline Mechanics*, 39 INDUS. & LAB. REL. REV. 527 (1986).

and 2002.[18] The National Funeral Directors Association contends that several state casket laws have never been enforced.[19] An important question, then, is the classification of the states with laws on the books that have not been enforced. A law cannot be expected to affect industry behavior if not enforced, which suggests that only states that have enforced their laws should be counted as having a casket sales restriction. On the other hand, the existence of a law on the books makes it possible that a challenge could be brought when necessary, for instance, against an Internet casket retailer. I define my CASKET dummy variable to equal one for the eight states in 1997, and the five states in 2002 that actually enforced their casket retailing restrictions. For robustness, I also consider a definition of the CASKET variable that includes all states with a casket sales restriction on the books—which is how Chevalier and Morton[20] define their variable—but which potentially dilutes the impact of the law when enforced. An increase in receipts, number of establishments, or number of employees is evidence that casket sales laws do impact the industry, while an insignificant effect of the regulation is consistent with the one rent hypothesis.

I include two other variables describing state funeral regulations. YEARS is the number of years of training required to become a licensed funeral director in the state. An increase in the required training creates a greater barrier to entry, which should increase receipts per death. EMBALM is a dummy variable, which equals one if states require either funeral directors to be embalmers or funeral homes to have embalming rooms. Both of these regulations increase barriers to entry in the funeral industry. Harrington and Krynski, find that embalming regulations affect county level cremation rates and because cremation is cheaper on average than traditional burial, these regulations should also affect funeral industry revenues.[21] I interact CASKET with YEARS because a prohibition on independent casket retailers should have greater impact in states with larger funeral business regulatory barriers to entry. Allowing only licensed funeral directors to sell caskets is a trivial restriction if obtaining a funeral

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[18] Institute for Justice, *supra* note 4.

[19] National Funeral Directors Association, *Comments Regarding Competition*, Federal Trade Commission (2002). The states were Alabama, Georgia, Louisiana, Mississippi, Oklahoma, South Carolina, Tennessee, and Virginia. Since 1997, courts have halted enforcement of casket retail restrictions in Georgia, Mississippi, and Tennessee. The status of the law in South Carolina is uncertain, as a portion of the law regarding the type of establishment a funeral director must operate was invalidated. States with licensing requirements on the books, include Delaware, Idaho, Maine, Minnesota, and Vermont (Institute for Justice, *supra* note 4), and possibly Massachusetts (National Association of Funeral Directors).

[20] Chevalier & Morton, *supra* note 1.

[21] The source for the state regulations is also Harrington & Krynski, *supra* note 1.

director's license is easy. Chevalier and Morton do not consider an interaction between these two funeral industry regulations.[22]

A dummy variable, DUMMY2002, is included for the observations for the 2002 Economic Census. This variable controls for any nationwide factors that might change between the two censuses (for instance, business cycle effects). As e-commerce was substantially more developed in 2002 than it was five years earlier, DUMMY2002 also should capture any impact of e-commerce on the funeral industry, both for direct sales of merchandise and the availability of information.

I also employ several control variables. CREMATION is the cremation rate in a state in a given year. Cremation is less expensive than traditional burial, so a higher cremation rate in a state is expected to reduce receipts per death, and may also reduce the number of establishments and employees.[23] INCOME is per capita personal income in the state in 1997 and 2002, measured in thousands of 2002 dollars. I expect that higher income should increase funeral spending. COLLEGE is the percentage of state residents over age 25 in the 1990 and 2000 Census who graduated from a four-year college or university. The propensity of individuals to fit the grief-stricken consumer prototype might differ (and presumably fall) with education. The percentage of WHITE state residents in 1997 and 2002 controls for differences in attitudes toward burial across races. METRO is the percentage of state residents in 1997 and 2002 residing in metropolitan areas. The price of land is higher in urbanized areas and this might raise costs and, in turn, raise funeral industry receipts in highly urbanized states. BORN IN STATE is the percentage of state residents in the 1990 and 2000 Censuses who were born in the state. A larger percentage of state natives are expected to increase receipts of those states' funeral industries for two reasons. First, burials and funerals do not always occur in the state of residence at death; instead, if many people choose to be buried in their state of birth, fewer funerals per death will occur in states with a low percentage of state born residents. Second, geographic mobility during one's lifetime could also affect preferences for funeral arrangements, with geographically mobile families less likely to choose traditional burial. OVER65 is the percentage of state residents in 1990 and 2000 over age 65, which provides a good proxy of long-run demand for funeral industry services. MORTGAGE is the median mortgage payment for owner-occupied single

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[22] Chevalier & Morton, *supra* note 1. As Harrington, *supra* note 1, explains, Internet retailers typically form a network of funeral homes which will order the casket and deliver it to the customer's location. Thus, the ability to recruit funeral homes into such a network is crucial for Internet retailing. Additional years of training increase the value of a funeral director's specific investment and, consequently, the cost of running afoul of state regulators. Thus, more stringent training requirements for funeral directing should make it harder for Internet retailers to recruit local funeral homes and increase the impact of casket sales laws.

[23] The source for this variable is the state-by-state cremation rates reported on the website of the Cremation Association of North America, *available at* http://www.cremationassociation.org.

family homes in 1990 and 2000, in 2002 dollars, and is included as a control for land values, which should affect the cost of burials relative to cremations.[24] JEWISH, CATHOLIC, and PROTESTANT are the percentage of state residents who are adherents of each faith in 1990, and are included as controls for differences in attitudes toward burial and cremation across faiths.[25] Table 1 presents summary statistics for the variables used in this study.

IV. ANALYSIS

Table 2 presents a comparison of the average receipts per state resident death in states with a casket retailing prohibition and states with no restriction. Receipts per death for Funeral Homes are 11% higher in states with casket restrictions ($4,985) than in states without the restrictions ($4,478). Receipts per death in states with a casket sales restriction are 7% higher for the Death Care Industry as a whole, 6% higher for the Funeral Homes and Other Funeral Services, and almost 10% higher for Cemeteries and Crematories. None of the differences, however, are statistically significant at the .10 level in a two-tailed test for a difference in means. However, this evidence suggests that casket sale prohibitions benefit the death care industry at the expense of consumers, and specifically benefit funeral homes within that industry.

I turn now to regression analysis. Tables 3 through 6 present the analysis of the Death Care Industry as a whole, Funeral Homes and Funeral Services, Funeral Homes, and Cemeteries and Crematories segments of the industry. Each table includes a regression of the determinants of receipts per death, establishments per million state residents, and employees per million residents. I am particularly interested in the impact of casket sales restrictions and any changes in the industry between 1997 and 2002, which might reflect the growing influence of e-commerce.

Funeral industry regulation exerts its most significant effect on the number of establishments in each of the various industry segments, which probably provides the best indicator of the long run or permanent impact of regulation. None of the regulatory variables are ever individually signifi-

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24 The percentage change in deaths between 1990 and 1997 was tried as a control variable, but was never significant; thus, it is not included in the regressions presented here. The latter variable was included because Jonathan Gruber and Maria Owings found evidence of demand inducement by physicians (more babies delivered by Caesarian section) in states with a declining number of births. Jonathan Gruber & Maria Owings, *Physician Financial Incentives and Cesarean Section Delivery*, 27 RAND J. ECON. 99 (1996). A declining market for deaths did not seem to produce demand inducement in the funeral industry.

25 The source for church membership is Martin B. Bradley, CHURCHES AND CHURCH MEMBERSHIP IN THE UNITED STATES 1990 (1992), while state populations are taken from THE STATISTICAL ABSTRACT OF THE UNITED STATES.

cant in a regression of receipts for any segment of the industry, and only YEARS is ever significant in a regression of employees. A casket sales restriction significantly increases the number of establishments through the CASKETS*YEARS interaction term for the Death Care Industry as well as the Funeral Homes and Funeral Services and Funeral Homes portions of the industry. A casket sales restriction has an impact on the industry only when combined with barriers to entry for funeral directors. This is not surprising, since allowing only licensed funeral directors to sell caskets should not matter much unless obtaining a funeral director license is difficult. An extra year of training to obtain a license increases the number of establishments in the Death Care Industry as a whole by about 9% of the mean in states that restrict casket sales, and increases the number of Funeral Homes by about 8% of the mean in states that do so. The negative (but insignificant) point estimate for CASKETS, partially offsets the impact of the interaction with funeral director training. Thus, overall, states with casket sales restrictions do not look radically different from states without casket restrictions, consistent with Chevalier and Morton's[26] results when an interaction term is not included. Nevertheless, a casket sales restriction does matter when combined with more significant barriers to entry to funeral directing.

Of the other regulations, YEARS significantly reduces the number of establishments in the Death Care Industry and Cemeteries and the number of employees for Funeral Homes and Other Services and the Funeral Homes portions of the industry. EMBALM significantly increases establishments for the Death Care Industry and for Cemeteries. These variables are not significant in any of the other regressions.

The dummy variable for the 2002 Economic Census attained significance five times. The most consistent result was the contraction of the cemeteries portion of the industry between 1997 and 2002. The magnitude of the contraction of this portion of the industry is large and statistically significant. The point estimates of DUMMY 2002 indicate contractions of 30%, 21%, and 38% of the mean for receipts, number of establishments, and number of employees, respectively. Receipts for the Death Care Industry as a whole also significantly fell by 9% between the two Censuses. Cremation has been increasingly popular in the United States over the past several decades, and the DUMMY2002 variable may be capturing this trend, particularly the impact of fewer burials on the Cemeteries portion of the industry. The effect on revenues for the Death Care Industry as a whole, and for the Funeral Homes and Services segment of the industry (a $213 per death reduction, which is not quite statistically significant), suggests that e-commerce could be reducing funeral spending as well.

The two most consistently significant control variables are BORN IN STATE and CREMATION. BORN IN STATE is a positive and significant

26 Chevalier & Morton, *supra* note 1.

(at the .01 level) determinant of receipts, number of establishments, and number of employees in each segment of the industry. Thus, a state with a higher proportion of life-long residents has a larger funeral industry. CREMATION is a negative and significant (at the .10 level or better) determinant of receipts, number of establishments, and number of employees for the Death Care Industry as a whole and for the Funeral Homes and Other Services and Funeral Homes portions of the industry. Cremation is a less expensive option than traditional burial, and a higher state cremation rate reduces the size of a state's funeral industry. Interestingly, CREMATION is insignificant in each regression (although with negative point estimates) for the Cemeteries and Crematories portion of the industry. The next most consistent control variable is OVER65, which is positive and significant ten times (and has a positive point estimate the two times it is not significant). Not surprisingly, a larger elderly population increases the size (number of establishments and employees) of the funeral industry in each case, although the effect on funeral home receipts is insignificant. INCOME is positive and significant eight times and negative and significant once, so income generally increases the size of the funeral industry, with the exception of the Cemeteries portion of the industry. The other consistent determinant was COLLEGE, which decreased the measure of the funeral industry each of the four times it attained statistical significance. METRO and WHITE were each significant nine times but with no pattern in terms of direction of effect. WHITE significantly reduced receipts per death in three out of four sets of regressions. A larger METRO population significantly reduced the number of establishments in each segment of the industry, which suggests that rural funeral homes might operate below minimum efficient scale.[27] MORTGAGE, which was included as a proxy for land value, attained significance only three times, but increased receipts in the Death Care Industry and for Cemeteries, consistent with a higher cost of land increasing the price of burials.

The one consistently significant religious affiliation variable was JEWISH, which significantly reduced the size of the funeral industry eight times and was never both positive and significant at the same time. In particular, a larger JEWISH population in a state reduced the size of the Funeral Homes and Services portion of the industry, but was not a significant determinant for the Cemeteries and Crematories portion of the industry. The other notable result was that CATHOLIC and PROTESTANT were negative and significant determinants of receipts, number of establishments, and number of employees in the cemetery portion of the industry.

Inclusion of CREMATION, as an explanatory variable, greatly reduced the impact of the regulatory variables, particularly CASKETS and CASKETS*YEARS. Without CREMATION included as a control vari-

[27] Therefore, Internet retailing of caskets might be most beneficial to rural residents with fewer funeral homes offering a smaller selection of caskets in their local markets.

able, CASKETS was often negative and significant for receipts and number of establishments and CASKETS*YEARS positive and significant. The magnitude of the coefficients showed that the overall effect of a casket sales law becomes positive in states requiring 3 to 4 years training to become a funeral director. Harrington and Krynski[28] found that funeral regulations induce demand for funeral services by reducing the cremation rate; in more highly regulated states, funeral directors were more readily able to convince families to choose a more expensive burial. CREMATION, then, may be capturing some of the impact of funeral regulation. This reinforces the point made above that casket sales restrictions increase the potential for an industry cartel when entry into funeral directing is also tightly regulated.[29]

V. JUDICIAL DEREGULATION AND THE FUNERAL INDUSTRY

Between 1997 and 2002, state and federal courts combined to partially deregulate three of the eight states that had previously enforced a casket sales restriction. Thus, we have an opportunity to observe the impact of partial deregulation of the industry at a time when the new technology of the Internet is affecting traditional business operations. In this section, I examine in further detail the eight states which had enforced casket sales laws and this judicial experiment in deregulation.

Table 7 reports receipts per death (in 2002 dollars) in 1997 and 2002 for the Death Care Industry, Funeral Homes and Other Funeral Services, and Cemeteries and Crematories for these eight states. The first three states (Georgia, Mississippi, and Tennessee) had their casket sales restriction voided by courts, while the last five (Alabama, Louisiana, Oklahoma, South Carolina, and Virginia) continued to enforce the restriction. The most salient feature is the reduction in real spending on funerals and burials in these states; in seven of the eight states, real receipts per death fell between 1997 and 2002 for the death care industry as a whole. This reflects the statistically significant result for the 2002 dummy variable in Table 3. Four of the eight states, had a reduction in receipts per death of over 10%. Much of the reduction in receipts is for the cemeteries and crematories portion of the industry. All states saw a reduction in real receipts per death, while six states had a reduction in excess of 24%, led by Georgia's 41% decline.

The deregulated states appear to differ little from the states still enforcing a casket sales restriction. For instance, two of the deregulated and two

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28 Harrington & Krynski, *supra* note 1.

29 I also estimated these regression models with a CASKETS law variable that counted the five states with laws on the books, but that have never been enforced as having a law, which is how Chevalier and Morgan define their casket variable. Chevalier and Morton, *supra* note 1. In these specifications, the CASKETS and CASKETS*YEARS variables were smaller, and the overall fit of the regressions poorer, which suggests that states actually enforcing the laws is a better definition.

of the still regulated states experienced declines in receipts per death in excess of 10%. The states which stopped enforcing their casket sales restriction experienced greater proportional declines in cemetery spending, which seems counterintuitive because a collapse of a funeral home casket cartel should shift more funeral spending to the cemetery portion of the industry. Perhaps funeral homes have responded with greater attention to customers when the casket cartel has been undermined, leading to revenue losses for cemeteries.

Many families turn to a local funeral home, and, thus, numerous local geographic markets exist within each state. These markets provide extra observations I wish to use to evaluate the effect of abolishing the casket sales restriction. To explore this possibility, I collected data on the Death Care Industry, Funeral Homes and Funeral Services, Funeral Homes, and Cemeteries and Crematories for all metropolitan statistical areas (MSAs) in each of the eight states and included in both the 1997 and 2002 Economic Censuses. A total of fifty MSAs were included in both Censuses: 33 in the states which did not have their casket laws invalidated by the courts and 17 in the three "deregulated" states.

Table 8 reports the average percentage change between 1997 and 2002 in receipts, number of establishments, and number of employees in each of the four industry categories. The table also reports the number of MSAs included in each average, since totals are not reported for receipts and employees when the number of establishments is too small. Each measure increased less, or declined more, in the deregulated states. For instance, for the Death Care Industry, receipts increased 5% in regulated states and declined an average of 3% in the deregulated states, establishments increased 13% and 5%, and employees fell by 2% and 19% in regulated and deregulated states respectively. For each measure of the segments of the industry generally, a ten percentage point differential exists between the regulated and deregulated states. The Cemeteries segment of the industry experienced considerable contraction in the deregulated states, most notably a decline of over 50% in employment, consistent with the results in Table 6. If the casket sales restrictions had been helping maintain a funeral cartel, then deregulation should result in reduced prices, greater efficiency, the elimination of excess employees and establishments, and perhaps lower spending on funerals. This appears to be what has occurred in comparing MSAs in deregulated and still regulated states. However, one caveat is required here; the differences in Table 8 are based on very small sample sizes and, consequently, are not statistically significant.

VI. CONCLUSION

Allowing only licensed funeral directors to sell caskets creates a barrier to entry which appears on its face to be anti-consumer. Yet, this is one of many regulations imposed on the funeral industry, and the fallacy of the second best warns that eliminating this one regulation, while maintaining other funeral industry regulations, may not benefit consumers. Funeral homes may simply increase their charges for services to offset lost profits on casket sales.

An empirical examination of the funeral industry suggests that casket retail restrictions affect the funeral industry. In particular, casket sales restrictions increase the number of establishments, a measure of the permanent impact of regulation, in states that also impose more stringent training requirements on funeral directors. This is expected, since the number of training years indicates the size of the barrier to entry created by allowing only licensed funeral directors to sell caskets. Some evidence of a similar effect exists for receipts per death. The cremation rate in a state is an important determinant of funeral spending, and regulation may influence the cremation rate and, thus, indirectly affect the industry as well. A detailed comparison of the three states in which courts halted enforcement of these laws shows that the funeral industry experienced slower growth (or greater decreases) than in those states with casket regulations still in effect. Again, these results support the proposition that casket sales laws help support a funeral industry cartel.[30]

The judicial deregulation of casket sales in three states provides some evidence that casket regulation has sustained a funeral industry cartel. The judicial decisions in the casket cases appear to have had an impact on the funeral industries in these states remarkably quickly, within just a couple of years. Potential Internet casket retailing could help explain the rapid impact of deregulation. This factor, however, creates a potential puzzle because relatively few caskets are sold over the Internet.[31] Traditionally, the funeral industry has been designed around a professionalism model supported by occupational licensing, and, in this model of service delivery, customers rely on the professional to guide their purchases and not induce demand. Occupational licensing restricts the flow of market information, in part because consumers do not think they need to shop around.[32] The court challenges in these deregulated states could have helped alert consumers to the possibility of shopping for funeral products and services, and Internet retailers provide a convenient, low-cost way for consumers to acquire market information. Even if few consumers purchase caskets on-line, Internet retailers could provide consumers valuable information to guide their purchase at brick-and-mortar funeral homes.

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30 Interestingly, casket manufacturing is extremely concentrated, although caskets exhibit no obvious returns to scale in production. Regulatory cartelization of the funeral industry may well help sustain concentration in casket manufacture.

31 *See* Harrington, *supra* note 1; *see also* Chevalier & Morton, *supra* note 1.

32 *See* Benham & Benham, *supra* note 8.

Summary Statistics				
Variable	*Mean*	*Standard Deviation*	*Minimum*	*Maximum*
Receipts				
Death Care Industry	5,770	1,180	2,500	8,550
Funeral Homes & Services	4,080	894	2,250	6,410
Funeral Homes	4,200	838	2,270	6,290
Cemeteries	1,050	513	203	3,230
Establishments				
Death Care Industry	94.10	39.40	22.70	197.00
Funeral Homes & Services	67.30	27.70	13.80	138.00
Funeral Homes	66.20	27.50	13.00	137.00
Cemeteries	26.80	14.10	4.17	86.60
Employees				
Death Care Industry	577	191	211	1,270
Funeral Homes & Services	412	139	178	778
Funeral Homes	399	133	176	773
Cemeteries	165	191	211	494
CASKETS	0.135	0.344	0	1
YEARS	2.970	1.290	0	6
EMBALM	0.750	0.438	0	1
CREMATION	28.40	16.40	3.22	63.30
INCOME	28.30	4.43	20.30	42.30
METRO	68.90	20.10	23.50	100.00
JEWISH	1.35	1.89	0	10.20
CATHOLIC	19.20	13.40	2.26	63.10
PROTESTANT	34.60	17.00	11.60	75.70
WHITE	80.40	13.50	26.40	97.70
COLLEGE	22.30	4.60	12.30	34.60
BORN IN STATE	62.20	13.20	21.30	80.20
MORTGAGE	918.00	235.00	558.00	1,640.00
OVER65	12.80	1.68	8.50	18.50

Table 1

Mean Receipts Per Death		
Industry Classification	*States with Casket Sales Restriction*	*States with no Casket Sales Restriction*
Funeral Homes	$4,985 *(n=8)*	$4,478 *(n=52)*
Funeral Homes and Other Funeral Services	$4,931 *(n=13)*	$4,631 *(n=83)*
Cemeteries and Crematories	$1,170 *(n=13)*	$1,092 *(n=83)*
Death Care Industry	$6,102 *(n=13)*	$5,722 *(n=83)*

Table 2

Death Care Industry			
Variable	*Receipts*	*Establishments*	*Employees*
CASKETS	-920.000 *(2.28)*	-21.000 *(1.29)*	82.100 *(0.50)*
YEARS	85.800 *(1.16)*	**-3.420 *(2.17)*	-7.090 *(0.73)*
EMBALM	-172.000 *(0.60)*	*2.860 *(1.72)*	-41.300 *(1.16)*
CASKETS*YEARS	266.000 *(1.12)*	**9.410 *(2.17)*	10.400 *(0.23)*
DUMMY2002	*-523.000 *(2.59)*	-4.700 *(1.05)*	-27.000 *(0.56)*
CREMATION	*-28.400 *(1.84)*	**-0.848 *(2.61)*	**-6.480 *(2.02)*
INCOME	**102.000 *(2.25)*	*1.260 *(1.72)*	-9.590 *(0.72)*
METRO	6.490 *(1.13)*	***-0.816 *(6.40)*	**3.560 *(2.59)*
COLLEGE	-19.300 *(0.77)*	-0.507 *(0.98)*	-3.930 *(0.76)*
WHITE	-15.700 *(1.32)*	***0.745 *(5.84)*	-0.828 *(0.39)*
BORN IN STATE	***53.400 *(5.09)*	***0.986 *(4.72)*	**4.670 *(2.09)*
MORTGAGE	**1.540 *(2.18)*	-0.0006 *(0.04)*	0.0828 *(0.39)*
OVER65	*97.100 *(1.88)*	***8.530 *(7.01)*	***56.800 *(4.31)*
JEWISH	**-113.000 *(2.12)*	-1.140 *(1.26)*	**-38.800 *(2.55)*
CATHOLIC	-10.800 *(0.95)*	-0.113 *(0.56)*	-2.280 *(0.55)*
PROTESTANT	-4.230 *(0.33)*	**-0.626 *(2.04)*	-5.030 *(1.62)*
CONSTANT	-304.000 *(0.16)*	-57.100 *(1.05)*	199.000 *(0.51)*
Adjusted R^2	0.665	0.883	0.589
Number of observations, n=96. *, **, and *** indicate significance at the .10, .05, and .01 level respectively. Absolute t-statistics based on White's heteroskedasticity consistent standard errors are in parentheses.			

Table 3

Funeral Homes And Funeral Services			
Variable	*Receipts*	*Establishments*	*Employees*
CASKETS	-720.000 *(1.02)*	-10.000 *(0.83)*	24.300 *(0.24)*
YEARS	63.500 *(0.99)*	-0.965 *(1.35)*	*-9.480 *(1.92)*
EMBALM	-141.000 *(0.65)*	1.320 *(0.46)*	-16.200 *(0.94)*
CASKETS*YEARS	213.000 *(1.17)*	*5.320 *(1.72)*	17.200 *(0.75)*
DUMMY2002	-213.000 *(1.33)*	-0.838 *(0.32)*	***86.900 *(3.81)*
CREMATION	**-25.800 *(2.01)*	***-0.752 *(3.16)*	**-4.130 *(2.61)*
INCOME	***136.000 *(3.71)*	**1.640 *(2.38)*	8.040 *(1.65)*
METRO	**-10.800 *(2.31)*	***-0.547 *(7.91)*	-0.171 *(0.31)*
COLLEGE	-33.300 *(1.63)*	*-0.646 *(1.71)*	*-4.350 *(1.73)*
WHITE	-2.300 *(0.29)*	***0.450 *(6.42)*	*-1.030 *(1.76)*
BORN IN STATE	***29.000 *(3.37)*	***0.461 *(3.27)*	***2.770 *(2.75)*
MORTGAGE	0.439 *(0.67)*	-0.0086 *(0.82)*	**-0.191 *(2.58)*
OVER65	54.200 *(1.37)*	***5.610 *(7.63)*	***30.100 *(6.25)*
JEWISH	***-122.000 *(2.73)*	**-1.540 *(2.48)*	***-20.200 *(4.48)*
CATHOLIC	12.400 *(1.40)*	0.103 *(0.63)*	-1.730 *(1.12)*
PROTESTANT	13.000 *(1.26)*	-0.248 *(1.21)*	-2.120 *(1.46)*
CONSTANT	-138.000 *(0.08)*	-24.800 *(0.85)*	243.000 *(1.29)*
Adjusted R^2	0.708	0.894	0.796
Number of observations, n=96. *, **, and *** indicate significance at the .10, .05, and .01 level respectively. Absolute t-statistics based on White's heteroskedasticity consistent standard errors are in parentheses.			

Table 4

Funeral Homes						
Variable	*Receipts*		*Establishments*		*Employees*	
CASKETS	674.000	*(0.39)*	-8.510	*(0.75)*	141.000	*(1.06)*
YEARS	101.000	*(0.93)*	-0.964	*(1.41)*	*-18.000	*(1.72)*
EMBALM	-131.000	*(0.28)*	1.630	*(0.58)*	43.300	*(1.05)*
CASKETS*YEARS	-127.000	*(0.27)*	*5.050	*(1.67)*	-24.700	*(0.72)*
DUMMY2002	125.000	*(0.42)*	0.869	*(0.33)*	19.300	*(0.54)*
CREMATION	*-25.600	*(1.76)*	***-74.000	*(3.16)*	**-3.410	*(2.37)*
INCOME	***179.000	*(3.15)*	**1.600	*(2.39)*	*10.900	*(1.89)*
METRO	**-15.900	*(2.33)*	***-0.544	*(8.03)*	-0.139	*(0.21)*
COLLEGE	**-49.000	*(2.12)*	*-0.658	*(1.77)*	-4.390	*(1.33)*
WHITE	-16.500	*(1.50)*	***0.461	*(6.41)*	-1.190	*(1.43)*
BORN IN STATE	**45.700	*(2.51)*	***0.482	*(3.51)*	***4.360	*(3.25)*
MORTGAGE	-0.839	*(0.83)*	-0.0076	*(0.83)*	-0.0525	*(0.44)*
OVER65	7.940	*(0.10)*	***5.510	*(7.75)*	***35.800	*(4.19)*
JEWISH	**-89.800	*(2.13)*	**-1.440	*(2.37)*	***-17.000	*(4.48)*
CATHOLIC	5.570	*(0.34)*	0.0872	*(0.54)*	***-6.320	*(3.10)*
PROTESTANT	-0.100	*(0.01)*	-0.261	*(1.30)*	-2.120	*(1.24)*
CONSTANT	2370.000	*(0.70)*	-26.500	*(0.93)*	-67.800	*(0.20)*
Adjusted R^2	0.721		0.896		0.803	

Number of observations, n=96 for establishments, 60 for receipts and employees.
*, **, and *** indicate significance at the .10, .05, and .01 level respectively.
Absolute t-statistics based on White's heteroskedasticity consistent standard errors are in parentheses.

Table 5

Cemeteries And Crematories			
Variable	*Receipts*	*Establishments*	*Employees*
CASKETS	-200.000 *(0.63)*	-11.000 *(1.21)*	83.400 *(1.02)*
YEARS	22.400 *(0.61)*	*-2.480 *(1.95)*	8.760 *(1.34)*
EMBALM	-31.300 *(0.32)*	**6.610 *(2.19)*	-31.100 *(1.37)*
CASKETS*YEARS	52.500 *(0.58)*	4.090 *(1.39)*	-20.900 *(0.92)*
DUMMY2002	***-310.000 *(2.84)*	*-5.520 *(1.92)*	***-62.800 *(2.99)*
CREMATION	-2.650 *(0.65)*	-0.093 *(0.83)*	-1.700 *(1.25)*
INCOME	*-34.400 *(1.93)*	0.0043 *(0.01)*	-6.430 *(1.31)*
METRO	***17.300 *(6.42)*	***-0.268 *(3.17)*	**2.300 *(4.45)*
COLLEGE	14.000 *(1.14)*	0.135 *(0.55)*	1.150 *(0.48)*
WHITE	***-13.400 *(2.71)*	***0.295 *(3.56)*	-1.110 *(1.40)*
BORN IN STATE	***24.400 *(5.75)*	***0.530 *(5.51)*	***3.580 *(4.18)*
MORTGAGE	***1.100 *(2.81)*	0.008 *(0.88)*	0.0982 *(1.08)*
OVER65	*42.900 *(1.84)*	***2.870 *(6.02)*	***13.700 *(3.10)*
JEWISH	8.490 *(0.39)*	0.396 *(0.86)*	-3.080 *(0.74)*
CATHOLIC	***-23.200 *(4.94)*	**-0.242 *(2.30)*	***-4.870 *(3.72)*
PROTESTANT	***-17.200 *(4.09)*	***-0.378 *(3.14)*	**-3.690 *(2.58)*
CONSTANT	-166.000 *(0.31)*	**-32.900 *(2.00)*	67.400 *(0.38)*
Adjusted R^2	0.726	0.673	0.556
Number of observations, n=96. *, **, and *** indicate significance at the .10, .05, and .01 level respectively. Absolute t-statistics based on White's heteroskedasticity consistent standard errors are in parentheses.			

Table 6

Effect Of Casket Deregulation On Receipts Per Death By State

Variable	*Death Care Industry*		*Funeral Homes & Other Services*		*Funeral Homes*		*Cemeteries & Crematories*	
	1997	*2002*	*1997*	*2002*	*1997*	*2002*	*1997*	*2002*
Deregulated States								
Georgia	6,533	5,374	4,810	4,356	4,753	4,301	1,723	1,017
Mississippi	5,301	4,943	4,883	4,647	4,864		418	296
Tennessee	6,541	5,721	5,352	4,893	5,337	4,803	1,189	828
Regulated States								
Alabama	6,499	5,232	5,202	4,318			1,297	914
Louisiana	5,907	5,982	4,588	4,709			1,318	1,273
Oklahoma	6,063	5,288	5,047	4,538	4,966	4,405	989	751
South Carolina	6,535	5,895	5,121	5,027	5,106		1,414	868
Virginia	7,067	6,511	5,491	5,028	5,443	5,004	1,575	1,483

Table 7

Mean Comparisons Of Metropolitan Areas In States With Casket Restrictions				
Variable	*Regulated States*		*Deregulated States*	
	#MSAs	*%Change*	*#MSAs*	*%Change*
Death Care Industry				
Receipts	13	+4.750	7	-2.800
Establishments	33	+12.820	17	+4.490
Employees	13	-1.730	7	-19.380
Funeral Homes & Other Services				
Receipts	19	-1.540	7	-13.200
Establishments	33	+21.820	17	+9.520
Employees	19	+3.200	7	-16.250
Funeral Homes				
Receipts	11	-2.470	2	-24.280
Establishments	33	+21.810	16	+2.730
Employees	11	+6.850	2	-33.620
Cemeteries & Crematories				
Receipts	10	-18.940	4	-28.120
Establishments	33	+4.830	17	-0.081
Employees	10	-43.640	4	-54.140

Table 8

THE DORMANT COMMERCE CLAUSE AS AN *EX ANTE* RULE

Michael S. Greve[*]

I.

In the Michigan and New York wine cases,[1] the Supreme Court reaffirmed, albeit without explicit discussion, the existence of a "dormant" Commerce Clause in the form of an antidiscrimination rule. Wholly apart from the Twenty-First Amendment issue in those cases, the affirmation of the dormant Commerce Clause was not an entirely foregone conclusion. Justices and legal scholars have expressed considerable dissatisfaction with the dormant Commerce Clause *in toto*, with its interpretation as an antidiscrimination rule, and with what they view as the meandering course of the Supreme Court's case law. The Clause, critics have said, is not actually in the Constitution; it is a debatable inference at best and a wholesale judicial invention at worst. The antidiscrimination principle has been criticized as excessively broad and under-inclusive at once. Furthermore, critics contend the Supreme Court's decisions are inconsistent and perhaps incoherent.

I am inclined to think that as constitutional inferences go, the dormant Commerce Clause is about as good as it gets, and the Supreme Court's decisions over the past decades, while hardly beyond cavil, strike me as no more erratic than the Court's case law on federal preemption or equal protection. Dean Starr's contribution to this volume covers this ground more eloquently than I could hope to do. I therefore approach the subject from a somewhat different perspective—specifically, from a Buchananite "constitutional choice" perspective. Constitutional choice theory asks what rules prospective citizens of a constitutional order would choose in an *ex ante* position, under conditions of uncertainty about their future places in society.[2] From that vantage, the anti-discrimination rule embodied in the dor-

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1 Granholm v. Heald, 544 U.S. 460 (2005).

2 The *fons et origo* of this perspective—at least in the modern literature—is JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY (1962), *available at* http://www.econlib.org/LIBRARY/Buchanan/buchCv3Contents.html (last visited Aug. 21, 2007); *see also* GEOFFREY BRENNAN & JAMES M. BUCHANAN, THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF A FISCAL CONSTITUTION (1980), *available at* http://www.econlib.org/library/Buchanan/buchCv9Contents.html (last visited Aug. 21, 2007). An excellent overview of the burgeoning constitutional choice literature is DENNIS C. MUELLER, CONSTITUTIONAL DEMOCRACY (Oxford University Press 1996), *available at* http://www.questia.com/PM.qst?a=o&d=96561690 (last visited Aug. 21, 2007).

mant Commerce Clause looks like a good choice. Quite probably, that rule would beat the available alternatives in any pair-wise comparison.

Two preliminary remarks are in order. First, a constitutional choice perspective focuses on the yes-or-no of an anti-discrimination principle rather than its precise location in the Constitution. While the Constitution contains two explicit anti-discrimination rules which, jointly and separately, work toward a comprehensive dormant Commerce Clause, they fail to do more of that work chiefly on account of restrictive judicial interpretations. The Import-Export Clause, which bars state duties on imports and exports without congressional consent, has been held—in what plainly seems to have been an erroneous decision—to apply only to foreign but not interstate commerce.[3] (It also applies only to taxes but not regulations, although the Founders did not attribute much significance to that distinction.)[4] The Privileges and Immunities Clause has a limited reach because it fails to protect corporations, which are "citizens" for some purposes, such as federal diversity jurisdiction, but not for purposes of the Privileges and Immunities Clause. These issues present important questions of constitutional interpretation. One can argue that the dormant Commerce Clause is a gap-filling extension of a general principle well-recognized in the Constitution[5]—or that the explicit guarantees forbid an extra-textual inference beyond whatever their true scope may be. My present question, though, is not one of constitutional interpretation, but rather what constitutional choices prospective citizens might make *ex ante*. The answer, I suggest, is some anti-discrimination rule whose closest approximation in current constitutional law is the dormant Commerce Clause.

Second, since there is some doubt as to whether the Supreme Court's cases actually articulate a dormant Commerce Clause rule, I should say what I take the rule to be. The Supreme Court has said that its essential meaning is that no state may treat in-state economic market participants differently (that is, better) than out-of-state actors.[6] The clearest violations are statutes that discriminate facially between in-state and out-of-state commerce, as in the wine cases. But the prohibition also extends to facially neutral state measures that constitute intentional discrimination.

3 Woodruff v. Parham, 75 U.S. 123 (1868); *see also* Camps Newfound/Owatonna v. Town of Hamilton, 520 U.S. 564, 624-37 (1997) (Thomas, J., dissenting) (arguing that Woodruff was wrongly decided and that the Import-Export Clause should be understood to apply to interstate commerce.).

4 *See* Calvin Johnson, *Homage to Clio: The Historical Continuity from the Articles of Confederation into the Constitution*, 20 CONST. COMMENT. 463, 508-09 (2004).

5 *See, e.g., id.* at 478 (arguing that "the dormant commerce clause continues by implication from the Articles of Confederation into the Constitution"); Brannon P. Denning, *Confederation-Era Discrimination Against Interstate Commerce and the Legitimacy of the Dormant Commerce Clause Doctrine*, 94 KY. L. J. 37 (2005).

6 Or. Waste Sys., Inc. v. Dep't of Envtl. Quality, 511 U.S. 93, 99 (1994) (defining discrimination as the "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.").

Like other anti-discrimination rules, the dormant Commerce Clause principle is supported by second-order principles to control against over-inclusiveness on one side and evasion on the other. First, the rule permits discriminatory state laws when no non-discriminatory means are available to protect a legitimate state interest.[7] One can understand this exception in analogy to the "operational necessity" defense in equal protection law, which permits the racial segregation of prison inmates or the race-conscious selection of personnel in penal institutions, for obvious and compelling reasons.[8] Second, the anti-discrimination principle is buttressed by "anti-sham" rules to protect against brazen evasions of the core principle.[9] The most important of these rules is the bar against state laws that discriminate in purpose *or effect*. The "balancing" test of *Pike v. Bruce Church*[10] fame and the "combined effects" doctrine of *West Lynn Creamery v. Healy*[11] serve the same anti-circumvention purpose. To be sure, some Supreme Court opinions seem to describe those analyses as separate rather than ancillary tests, and the dormant Commerce Clause does not apply to all forms of discrimination. But those sorts of questions arise under (and over) all anti-discrimination principles, such as the Equal Protection Clause or the Privileges and Immunities Clause.[12]

So understood, the dormant Commerce Clause is preferable, *ex ante*, to the following alternatives: (1) no constitutional, judicially enforceable Commerce Clause limitations on state regulation at all; (2) a generalized judicial balancing test; and (3) more restrictive alternatives, such as an "exclusive" interstate commerce clause (the prevailing understanding for much of the nineteenth century) or an "origin principle" (the European model). I consider these in turn.

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7 Maine v. Taylor, 477 U.S. 131 (1986).

8 *See, e.g.*, Wittmer v. Peters, 87 F.3d 916 (7th Cir. 1996).

9 On the analogous role and use of "anti-sham" in international free trade regimes *see* Michael Trebilcock & Robert Howse, *Trade Liberalization and Regulatory Diversity: Reconciling Competitive Markets with Competitive Politics*, 6 EUR. J. OF LAW & ECON. 5 (1998).

10 Pike v. Bruce Church, Inc., 397 U.S. 137 (1970).

11 West Lynn Creamery v. Healy, 512 U.S. 186, 215 (1994). For a similar reading of the case *see* Maxwell L. Stearns, *A Beautiful Mend: A Game Theoretical Analysis of the Dormant Commerce Clause Doctrine*, 45 WM. & MARY L. REV. 1, 126-27 (2003).

12 The comparison to the anti-discrimination rule of the Equal Protection Clause helps to illuminate the point of the effects test—namely, to "smoke out" illicit motives without probing the legislators' minds. (There is no *separate* "disparate impact" test either under the Fourteenth Amendment or the dormant Commerce Clause.) The limited *scope* of the anti-discrimination principle has a precise analogy in the Privileges and Immunities Clause, which also does not (and cannot) define its own reach. *See, e.g.*, Baldwin v. Fish and Game Commission of Mont., 436 U.S. 371 (1978); Saenz v. Roe, 526 U.S. 489 (1999).

II.

It has been argued that the Constitution neither has *nor needs* a dormant Commerce Clause.[13] *Ex ante*, citizens will want protection against state protectionism and discriminatory legislation, for substantially the same reason they will want free entry to and exit from the various states. Citizens will desire the global gains of the federal arrangement, which can be procured only if states surrender the parochial, opportunistic gains that might be had from mutual aggression. However, the citizens may want to block defections from the rule by *political* rather than judicial means. Under this view, the protection against discriminatory state legislation can and should be left to Congress, acting under the Supremacy Clause and its copious enumerated powers.

The principal and, to my mind, decisive reply to this argument is that citizens neither have *nor want* a federal government with the requisite monitoring and policing capacity. Citizens have a fragmented, lumbering government because they fear that the output of a more cohesive system would consist chiefly of faction-driven dross, and only rarely of public-regarding legislation. Sacrificing a few good laws seems a small price to pay for preventing a flood of bad ones.[14] The calculus changes, however, with respect to those subsets of junior-government conduct known *ex ante* to cause more harm than good. Here, the system's general strength—the impediments to prompt, energetic federal intervention—turns into a weakness.

One cannot get a handle on this problem by adjusting the federal legislative equilibrium across the board; less of one type of risk invariably means more of the other. For this reason, Article I, Section 10 of the Constitution designates specific forms of state legislation for special treatment. It subjects some types of state legislation (including impairments of contract obligations, debtor relief laws, *ex post facto* laws, and treaties among states or between states and foreign nations) to an absolute prohibition and others to a qualified prohibition: no state law without congressional consent. State laws subject to this proviso include duties on imports or exports, duties of tonnage, the maintenance of standing armies in times of peace, and state compacts.[15] At the time, this arrangement was called a "Negative," as in "negative Commerce Clause." State laws turn into pumpkins when Congress does nothing.

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[13] The most-cited—and most sophisticated—argument to that effect is Edmund W. Kitch, *Regulation and the American Common Market*, *in* REGULATION, FEDERALISM, AND INTERSTATE COMMERCE 17-19 (Dan A. Tarlock, ed., 1981). *See also* Martin H. Redish & Shane V. Nugent, *The Dormant Commerce Clause and the Constitutional Balance of Federalism*, 1987 DUKE L.J. 569, 571 (1987).

[14] THE FEDERALIST NO. 73 (Alexander Hamilton).

[15] U.S. CONST. art. I, § 10, cl. 2, 3.

Virtually all the classes of state legislation subject to the prohibitions of Article I, Section 10 tend to have pronounced state-external effects. *Ex ante*, everyone would be better off if no state were allowed to engage in the prohibited behavior. *Ex post*, individual states, by popular or interest group demand, are highly likely to defect and to invite comparable defections by other states. Since the ordinary operation of the federal legislative process is unlikely to provide an effective remedy, the Constitution addresses the political risk by reversing the legislative default rule. Whereas ordinary state enactments take force until and unless Congress says "no," "suspect" state laws are subject to a wholesale, *ex ante* prohibition or take effect only if and when Congress says "yes." The proponents of such legislation have to win twice: in the state, and in the larger federal arena.

Obviously, the dormant Commerce Clause differs from the constitutional (qualified) prohibitions in its institutional configuration. The Court, rather than Congress, serves as a first line of defense against suspect state legislation. And of course, the Court performs that function in the ordinary fashion of deciding cases and controversies; it does not sit as a general review-and-approval board. The enforcement mechanism poses a difficult choice problem: *Ex ante*, would one prefer a congressional approval requirement or judicial enforcement? In other words, would one prefer an extended Import-Export Clause (covering regulation as well as taxation) or, alternatively, the dormant Commerce Clause (or an extended Privileges and Immunities Clause)? While the trade-off is too conjectural and contingent to permit a constitutional choice solution, either option will beat the "no special rule" option. The best bet *ex ante* is that individuals will prefer constitutional protection from state exploitation, enforced judicially or through a congressional consent requirement, to "no special rule." They will do so for precisely the reasons that animate the textually specified injunctions contained in Article I, Section 10.

III.

Given the need for some special protection against state protectionism and mutual exploitation, one could ask why that protection should take the form of an anti-discrimination rule. Some forms of "discrimination" are okay; direct state subsidies are an example.[16] Conversely, some forms of *non*-discriminatory state legislation have nonetheless been held to violate the dormant Commerce Clause.[17] Similarly, the dormant Commerce Clause

16 West Lynn Creamery v. Healy, 512 U.S. 186, 199 (1994); New Energy Co. of Ind. v. Limbach, 486 U.S. 269, 278 (1988) ("Direct subsidization of domestic industry does not ordinarily run afoul" of the negative Commerce Clause.).

17 Pike v. Bruce Church, Inc., 397 U.S. 137 (1970); Kassel v. Consol. Freightways Corp., 450 U.S. 662 (1981).

has been invoked as a protection against political risks such as interstate trade wars and, in earlier times, discrimination against economic interests that are underrepresented in the enacting state's political process.[18] Other decisions, however, have emphasized the state threat to *economic* union.[19] Those risks run in tandem much of the time, but not always. More fundamentally, the dormant Commerce Clause implicates incommensurate constitutional interests—the interest in local self-government over some range and the economic interest in procuring gains from cooperation. Considering all the values in the federalism portfolio, maybe one should look for an efficient frontier.[20] A simplistic screen test ("discrimination—yea or nay") may ill suit that purpose. So why not have an all-encompassing balancing test, which presumably would acknowledge the salience of state discrimination without making everything hang on that question? In other words, why not choose Felix Frankfurter's dormant Commerce Clause?[21]

The answer has to do, not with the dormant Commerce Clause *per se*, but with broader arguments about the trade-offs between rules and standards: you trade the risk of under- and over-inclusiveness against the risk of possibly more accurate, but also less predictable, standards and balancing tests. My own preference is for rules. That option seems particularly compelling when the choice concerns not the application or interpretation of pre-existing rules, but the choice of the rules themselves. At the constitutional choice level, the option for standards is an option for an unconstrained choice, with no baseline, by whosoever is authorized to make it. "No baseline" is, of course, the battle cry of the modern Progressives' Constitution, or at any rate the program of the pragmatic wing of that intellectual movement.[22] Perhaps, Cass Sunstein and Justice Stephen Breyer might

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18 *See* Stearns, *supra* note 11; John Hart Ely, *Choice of Law and the State's Interest in Protecting Its Own*, 23 WM. & MARY L. REV. 173 (1981).

19 *E.g.*, Baldwin v. G.A.F. Seelig, Inc., 294 U.S. 511 (1935); H.P. Hood & Sons v. Du Mond, 336 U.S. 525 (1949). *See generally* Richard B. Collins, *Economic Union as a Constitutional Value*, 63 N.Y.U. L. REV. 43 (1988).

20 I have borrowed the metaphor from Robert P. Inman & Daniel L. Rubinfeld, *Making Sense of the Antitrust State Action Doctrine: Balancing Political Participation and Economic Efficiency in Regulatory Federalism*, 75 TEX. L. REV. 1203, 1229-31 (1997).

21 Perhaps the clearest illustration of Justice Frankfurter's approach is his dissent in H.P. Hood v. Du Mond, 336 U.S. 525, 564 (1949) (Frankfurter, J., dissenting). Instead of focusing on the question of whether the state law at issue did or did not discriminate (which in fact had more than a single plausible answer in that case), Frankfurter would have remanded the case to the lower courts for an exhaustive determination of numerous factual questions. *Id.* In the course of his opinion, Frankfurter argued that even in such cases as *Baldwin*, 294 U.S. 511, which dealt with a state law that Justice Cardozo described as the equivalent of an outright state tariff, "discrimination" should be viewed as merely one element in a broader calculus. *H.P. Hood*, 336 U.S. at 569.

22 For a more extended exposition and critique, see Michael S. Greve, *How to Think About Constitutional Change Part 1: The Progressive Vision*, 23-1 FEDERALIST OUTLOOK, June 2005, *available at* http://www.aei.org/publications/pubID.22622/pub_detail.asp (last visited Aug. 21, 2007); Greve, *How to Think About Constitutional Change Part 2: Originalism, Pragmatism, and the Constitution*, 23-2

do better at the federalism frontier than political institutions, or the Supreme Court, under some general rule. However, the constitutional choice problem is not to optimize the results, given beneficent and sensible rulers. The problem is to restrict the range of equilibrium outcomes, given a pathological political process and non-Herculean judges. From that vantage, unconstrained balancing is not a plausible constitutional choice.

IV.

An anti-discrimination rule is arguably under-protective. For example, there are obvious benefits to an interstate commerce rule that bars states from defecting from an interstate equilibrium that yields substantial network efficiencies. However, those kinds of defections are not easily captured under an anti-discrimination rule.[23] Another set of problems is exemplified by *Exxon v. Maryland*,[24] where Maryland barred petroleum producers and refiners from operating gas stations in the state. In that case, the Supreme Court determined that the statute discriminated neither against interstate commerce (only among out-of-state suppliers) nor between in-state and out-of-state competitors (there were no refiners or producers in Maryland at the time). Arguably, though, the statute is the *kind* of state interference with interstate commercial transactions that ought to be barred. One way to accomplish that result is an exclusivity rule—that is, a rule making the states' external commerce, as opposed to their purely internal commerce, inherently and exclusively a federal prerogative.[25] This exclusivity rule prevailed for much of the nineteenth century. It has much to commend it, both in the abstract and against the theoretical backdrop of *The Federalist*: if one thinks *ex ante*, and with Madison, that states are far more faction-prone than the federal government the case for exclusivity is indeed powerful.

The trouble with an exclusive commerce power is that it presupposes something *not* (exclusively) federal. That something, presumably, is what *The Federalist* and John Marshall in *Gibbons v. Ogden* called the "purely internal" commerce of the states.[26] The same distinction and assignment of

FEDERALIST OUTLOOK, June 2005, *available at* http://www.aei.org/publications/filter.all,pubID.22942/pub_detail.asp (last visited Aug. 21, 2007).

23 The paradigmatic case is Kassel v. Consolidated Freightways Corp. of Del., 450 U.S. 662 (1981). Maxwell Stearns has re-conceptualized the problem posed by *Kassel*-style cases as the state appropriation of quasi-rents, which are appropriable because of the pro-competitive policies of other states. *See* Stearns, *supra* note 11, at 69-81. That artful construction fits the pesky network cases underneath the anti-discrimination umbrella, and a great deal can be said in its favor. I only doubt whether justices have thought or will begin to think of the cases in that fashion.

24 Exxon Corp. v. Governor of Md., 437 U.S. 117 (1978).

25 The argument was made in *Exxon*, 437 U.S. at 125, although to no avail.

26 THE FEDERALIST NO. 14 (James Madison); Gibbons v. Ogden, 22 U.S. 1, 204 (1824).

authority is fundamental to all constitutional choice models of "competitive" or "market-preserving" federalism.[27] But despite its intuitive appeal, the internal-external distinction has not had a happy history. The principal example, as it happens, is that of *Heald*—booze. Alcohol regulation was the origin of the "original package" doctrine, which held that goods were exclusively in interstate commerce, and therefore beyond the states' jurisdiction, as long as they remained in their "original package."[28] An otherwise sensible Supreme Court thought the doctrine necessary because there had to be *some* line to stabilize exclusive powers on either side of the state-federal line. In practice, however, the original package doctrine provided neither legal nor political stability. It became implausible long before Progressive ideology and New Deal politics took their toll on the Supreme Court's Constitution. In one seminal ante-bellum case, a dissenting justice mused what the Court should do about articles of commerce that never make it into a "package" (original or otherwise), such as steam engines or grand pianos.[29] Over time, the greater, systemic problem emerged: the doctrine handed out-of-state producers an unwarranted advantage over in-state producers (whose products could be regulated at any stage of manufacture and sale) and, moreover, disabled states from policing legal regimes that were prohibitionist, rather than protectionist. On that account, the implausible original package doctrine caused much political wrangling and havoc. No one seriously laments its demise.[30] Other doctrines that aimed to stabilize the internal-external distinction—the distinction between "property" and "commerce," or between the "direct" or "indirect" state regulation of interstate commerce—have not fared much better.

The history of the dormant Commerce Clause over the past seven decades can be understood as a sustained effort to move from subject-matter limitation to neutrality, from exclusivity to anti-discrimination. Despite the wayward trend of much constitutional law, this particular shift seems salutary, principally for a pragmatic reason: a modern economy will bring far more pressure on the internal-external distinction than that distinction can bear. However, even in a sea of concurrent state and federal powers, the political risks that "exclusivity" was meant to tackle still remain. An anti-discrimination rule is one way of addressing these issues.

The hard conceptual question is whether one can have a dormant Commerce Clause anti-discrimination rule *without* an underlying exclusivity assumption. One problem is the derivation of the dormant Commerce

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27 Barry Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 J.L. ECON. & ORG. 1, 5 (1995).

28 Brown v. Maryland, 25 U.S. 419, 441-42 (1827).

29 Thurlow v. Massachusetts (*The License Cases*), 46 U.S. 504, 612-13 (1847) (Daniel, J., dissenting).

30 The doctrine has been officially discarded. *See* Michelin Tire Corp. v. Wages, 423 U.S. 276 (1976).

Clause. If that construct does *not* come from an exclusive Commerce Clause, then where exactly does it come from? A second, more serious problem is the inherent logic. Distinctions between "direct" and "incidental" regulations on commerce lingered in dormant Commerce Clause analysis long after they had been officially discarded in "straight" Commerce Clause cases.[31] The best explanation of that otherwise perplexing adherence to pre-*Wickard*[32] distinctions is that one cannot do without them. Countless state laws have incidental effects on interstate commerce and may make out-of-state parties marginally worse off than in-state actors. Since it cannot be the purpose of the dormant Commerce Clause to mow down all such state laws, one needs some means of comparing the magnitude and directness of the effects with the purpose of the regulation. "Discrimination," one could say, occurs when the external effects are sufficiently pronounced, direct, and out of proportion to the state's purported interests.[33]

A third difficulty deserves mention: if the Commerce Clause were truly non-exclusive over its entire range, Congress could freely authorize the states to violate the dormant Commerce Clause. (To say that only Congress itself may violate the anti-discrimination principle is to say that the Commerce Clause is exclusive after all.) But that corollary cannot be right. Even scholars who have little sympathy for the "Old Court" and its Commerce Clause have concluded that there is *some* set of non-delegable, and in that sense exclusive, commerce regulations.[34] Going further, one scholar has argued that while Congress itself may obviously "violate" the dormant Commerce Clause, it may *never* authorize the states to do so—any more than it could authorize the states to violate the Privileges and Immunities Clause.[35] That position, which implies that the Commerce Clause is exclusive *in toto*, cannot be right either. After all, Congress can authorize states to do *some* things that would otherwise be unconstitutional. For example, a state tax on the instruments of the United States would presumably be constitutional if Congress were to permit it.[36]

So which is it? The Supreme Court's position is that Congress may, apparently without substantive restriction, authorize state violations of the dormant Commerce Clause provided it expresses that intent in a clear

31 Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970), itself portrayed the balancing test that way.

32 Wickard v. Filburn, 317 U.S. 111 (1942).

33 For a fuller exposition of this point see Daniel A. Farber and Robert E. Hudec, *Free Trade and the Regulatory State: A GATT's-Eye View of the Dormant Commerce Clause*, 47 VAND. L. REV. 1401, 1412 (1994).

34 See 1 LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW § 6-2, at 1039 (3d ed. 2000) (Congress may not authorize Massachusetts to regulate national air traffic).

35 Norman R. Williams, *Why Congress May Not "Overrule" the Dormant Commerce Clause*, 53 UCLA L. Rev. 153 (2005).

36 Without such authorization, it is obviously not. M'Culloch v. Maryland, 17 U.S. 316 (1819).

statement.[37] A rough equivalent of that doctrine is Mark Tushnet's theory of a "weakly" exclusive Commerce Clause.[38] It is easy to criticize these positions, but difficult to do much better. Perhaps, the best advice is the suggestion that for all practical purposes, one need not do much better. Messiness on the margins "is not the same as chaos."[39] A rule that works in the general run of cases is far preferable to no rule at all.

V.

The United States is not alone in confronting the problem of harmonizing state autonomy with free trade principles. Europe, too, has faced this problem. In response, the European Union acquired its own version of the dormant Commerce Clause much like the U.S. did—by judicial edict. The European version, however, is bolder in two respects. First, the Constitution has a Supremacy Clause. The European Treaties do not, and so the European Court of Justice (ECJ) invented one.[40] Second, the ECJ's regime is more draconian than the U.S. anti-discrimination rule, at least with respect to the sale of goods. Member-states may not interfere with the marketing and sale of goods—not even by means of non-discriminatory legislation—so long as articles of commerce comply with the law of their country of origin.[41] From a free trade perspective, this so-called origin principle—a close cousin of the "Delaware principle" of contractual choice in corporate law—has a considerable advantage over an anti-discrimination rule: all else equal, it has greater potential to break down "qualitative" trade restrictions (in other words, regulatory barriers that function as the equivalent of tariff barriers). The origin principle is a kind of global contract regime in disguise because the producer's home state rules travel with the product, wherever it may be sold. Unlike an anti-discrimination rule, the origin rule generates pronounced Tiebout-competitive effects on the producer side. Producers will sort themselves into the jurisdiction whose rules are preferred by the largest number of buyers everywhere. As that competitive dynamic unfolds, jurisdictions adapt in a hurry, lest their producers wander off into those jurisdictions whose rules promise to match the largest number of buyers and sellers.

The origin principle is probably desirable when the task at hand is to break down entrenched parochial regimes expeditiously, which explains

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37 Prudential Ins. Co. v. Benjamin, 328 U.S. 408 (1946).

38 Mark V. Tushnet, *Scalia and the Dormant Commerce Clause: A Foolish Formalism?*, 12 CARDOZO L. REV. 1717 (1991).

39 Farber & Hudec, *supra* note 33, at 1438.

40 Case 6/64, Costa v. Ente Nazionale per L'Energia Elettrica (ENEL), 1964 E.C.R. 585.

41 Case 120/78, Rewe-Zentral AG v. Bundesmonopolverwaltung fur Branntwein, 1979 E.C.R. 649.

why the ECJ adopted it. However, it is not at all clear that the origin principle is the best *ex ante* choice under all sets of assumptions. On the consumption side, the principle produces a kind of forced entry by the foreign producers of goods and services on their home turf's terms. (It is almost as if the Privileges and Immunities Clause entitled citizens entering a state to drag their home state law after them.)[42] On the production side, the origin principle unleashes rapid and pervasive factor mobility, at least in theory. The point of constitutional choice is to ensure political stability. While it is hard to tell how much stability is enough and how much is too much, it is entirely plausible to think that citizens, *ex ante*, might prefer more stability than the origin principle would likely permit.[43]

Second, and arguably more important, the origin principle is hard to justify as a *constitutional* choice. Its economic justification (the global gains from free trade) holds up only over the range in which contracts promise to work well and without significant third-party effects and externalities. However, regulatory economists disagree vehemently about the conditions under which the origin principle will prove efficient or, more modestly, superior to a centralized regime.[44] For example, a leading proponent of the U.S. corporate law model has proposed to extend that model to corporate disclosure obligations and the anti-fraud provisions that travel with those obligations, *but not* to the regulation of brokerage houses, where state regulators may not always enforce adequate consumer protections.[45] One may want to be more bullish, or less so, on this particular set of issues, but the argument for or against an origin-based regime in most settings cannot be *ex ante*. It will have to rest on a wide variety of contingent empirical facts and circumstances, and the choices will involve complicated trade-

42 The actual Privileges and Immunities Clause confers no such right. Its forerunner, the Fourth Article of Confederation, provided in relevant part that "the people of each state shall have free ingress and regress to and from any other state, and shall enjoy therein all the privileges of trade and commerce, *subject to the same duties, impositions and restrictions as the inhabitants thereof respectively* . . . ." Articles of Confederation art. IV (emphasis added). One side of the coin is that outsiders will not be subject to discriminatory impositions; the other side is that they cannot claim immunity from whatever non-discriminatory restrictions a state may choose to impose on its own inhabitants.

43 This argument is a common theme of the Freiburg School of constitutional political economy. *See, e.g.*, Viktor Vanberg, *ECONOMIC CONSTITUTIONS, PROTECTIONISM AND COMPETITION AMONG JURISDICTIONS*, *IN*, COMPETITION AND STRUCTURE: THE POLITICAL ECONOMY OF COLLECTIVE DECISIONS: ESSAYS IN HONOR OF ALBERT BRETON 364 (Gianluigi Galeotti, Pierre Salmon and Ronald Wintrobe eds., Cambridge University Press 2000).

44 For applications of the principle *see, e.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (The AEI Press 1993); Barry E. Adler & Henry N. Butler, *On the "Delawarization of Bankruptcy" Debate*, 52 EMORY L.J. 1309 (2003); Larry Ribstein, *From Efficiency to Politics in Contractual Choice of Law*, 37 GA. L. REV. 363 (2003); Robert H. Sitkoff & Max Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356 (2005).

45 Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L. J. 2359 (1998).

offs. And surely, one's enthusiasm for the origin principle and unencumbered choice of law will wane when it comes to areas where contracts themselves are suspect, such as antitrust law. The notion that conspirators in restraint of trade should be able to choose their own jurisdiction and to reap the rewards in all sister-jurisdictions has very little to commend it. *Parker v. Brown*, which comes perilously close to embracing such stratagems, is a constitutional disgrace, not a model.[46]

Even if one were more confident about these issues, it would be unwise to write a limited-range principle into a Constitution. The Constitution fails to spell out the precise scope and content of anti-discrimination norms—"Full Faith and Credit," "Privileges and Immunities"—not because everyone understood what was meant, as *soi disant* originalists sometimes insist, but primarily because everyone understood that misplaced concreteness and specificity can be fatal to constitutional stability. Every general non-discrimination rule will have to make exceptions down the road, but an origin principle would have to specify its own range of application in the Constitution itself. A principle of that kind is not an attractive *ex ante* choice: it presumes far too much knowledge about a messy and changeable world.

VI.

In suggesting that a general anti-discrimination rule against state protectionism and exploitation is a sensible constitutional choice, I find myself in good company. When asked to speak to a European audience on America's constitutional lessons, Justice Scalia started on a predictably diffident note: there might be no such lessons, and in any event he would not be the person likely to give unsolicited advice to foreign jurists and policymakers. (Justice Scalia often reminds public audiences that he is not an Italian jurist. He is an American jurist.)[47] Still, he urged the Europeans to do themselves a favor and write a dormant Commerce Clause into their governing legal instruments.[48] Even Justice Scalia, it turns out, likes the dormant Com-

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46 Parker v. Brown, 317 U.S. 341 (1943). For a similar critique of *Parker*, see Frank Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON 23 (1983). On the choice of second-best jurisdictional rules for antitrust see generally COMPETITION LAWS IN CONFLICT: ANTITRUST JURISDICTION IN THE GLOBAL ECONOMY (Richard A. Epstein & Michael S. Greve eds., The AEI Press 2004).

47 Antonin Scalia, Letter to the Editor, BOSTON HERALD, March 29, 2006, *available at* http://news.bostonherald.com/galleries/?title=Letter (last visited Aug. 21, 2007).

48 Antonin Scalia, Remarks at the International Conference on Federalism 2002 (August 27-30, 2002), *in* FEDERALISM IN A CHANGING WORLD: LEARNING FROM EACH OTHER 539, 542 (Raoul Blindenbacher & Arnold Koller eds., McGill-Queen's University Press, 2002).

merce Clause. His skepticism about the construct rests on jurisprudential rather than substantive grounds.[49]

Recognizing the need for some *ex ante* rule against state exploitation and aggression, the protection should take the form of an actual rule, not a balancing formula. That rule should cohere with the structure of the Constitution, including its federalist architecture. It ought to be stable, and it ought to work tolerably well over the general run of cases. The anti-discrimination rule fits those criteria better than the available alternatives. At least so long as one thinks of constitutional choice not as an *a priori* blackboard exercise but as a series of choices from a menu of alternatives, the dormant Commerce Clause is a highly plausible choice.

As cautioned at the outset, the *ex ante* argument does not answer the charge that the dormant Commerce Clause is not the choice our Constitution actually made. Nor will that argument do much to dissuade critics who view the existing dormant Commerce Clause as incoherent. Even so, a constitutional choice analysis helps to put those criticisms in perspective: it suggests that the principal constitutional design problem is *not* the scope and shape of a dormant Commerce Clause. The anti-discrimination principle serves its purposes well enough. If the charge is inconsistency and incoherence, the reply is: compared to *what*? Rather, the design problem is the "positive" Commerce Clause and its exercise.

No one would want the judiciary to superintend the nation's commerce on an on-going basis. The interventions would be sporadic and the rules against state infractions would be under-enforced. Moreover, anti-discrimination formalisms might backfire. The Supreme Court cannot liberate wine markets on its own. It can only hold in-state vintners hostage to the anti-discrimination regime. When regulating states decide to shoot those hostages by prohibiting in-state direct wine shipment along with shipments from out-of-state, the game is up.[50] One way or the other, the federal political process will have to do much of the work. The constitutional design task, in other words, is to figure out institutional arrangements that will affirm and extend *ex ante* preferences with a modicum of regularity. And here lies the real failure. Sometimes, Congress entrenches state cartels that would otherwise collapse for economic reasons or by force of the dormant Commerce Clause.[51] At other times, Congress bestirs itself to break down state barriers to trade—but only by means of creating national

49 *Id.* at 542 ("I have no doubt that this 'discriminatory state laws' branch of our negative Commerce Clause jurisprudence reaches a proper result, though I would prefer to rest it not upon such policy grounds (sound though they may be), but upon the provision in our Constitution which prohibits states from discriminating against out-of-state citizens.").

50 Some states have responded to Granholm v. Heald, 544 U.S. 460 (2005), by harmonizing "down" rather than "up." For example, see S. Res. 297, 2005-2006 Sess. (Kan. 2006), profiled in David Klepper, *Few Toast State's New Wine Law*, WICHITA EAGLE, June 13, 2006. For another example, see Patricia Sabatini, *Pa. May Lift Ban On Wine Shipments*, PITTSBURGH POST-GAZETTE, June 9, 2006.

51 *See, e.g.*, McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1013 (1945).

regulatory cartels. With very rare exceptions, the outcome is harmonization rather than free trade. We have a Commerce Clause because we need it, but we have found no way of ensuring that Congress will use that power for the purposes for which it was intended. Compared to *that* constitutional choice dilemma, the dormant Commerce Clause is a piece of cake.

THE ECONOMICS OF DIRECT WINE SHIPPING

Jerry Ellig & Alan E. Wiseman***

ABSTRACT

The most significant barriers to online wine sales are state laws that prohibit direct-to-consumer wine shipping. In 2003, Virginia legalized interstate direct shipment, and this change provided an opportunity to test whether these laws significantly affect competition. Previous analyses found that Virginia's direct shipment ban deprived consumers of greater variety and lower prices available online; legalization reduced the spread between online prices and prices at brick-and-mortar retailers in Northern Virginia. This article compares online and offline prices from 2002 and 2004 that include shipping and transportation costs. We find that after accounting for these costs, the online-offline price difference fell but did not disappear. On average, substantial price savings were still available online for the more expensive wines, which constitute almost half the sample. It is unclear whether the remaining price difference reflects a lag in adjustment to the change in law, legitimate competitive advantages of brick-and-mortar wine shops, or aspects of Virginia's law that make online competition less robust than it could be.

INTRODUCTION

The most significant barriers to online wine sales are state laws that prohibit direct-to-consumer wine shipping.[1] *Granholm v. Heald* established that states cannot ban interstate direct wine shipping if they permit intrastate direct wine shipping. Since the decision was announced in June 2005, many States have liberalized their wine shipping laws, and debate is ongoing in other state capitols. As of May 2006, interstate direct wine shipping was prohibited in eighteen states, permitted on a limited basis in twenty-one

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1 POSSIBLE ANTICOMPETITIVE BARRIERS TO E-COMMERCE: WINE, A REPORT FROM THE STAFF OF THE FEDERAL TRADE COMMISSION 3 (2003). In the interest of full disclosure, we should note that we were two of the coauthors of the FTC staff report.

states and Washington, D.C., and permitted on a reciprocal basis in eleven states.[2]

States that choose to allow interstate direct wine shipping can attach a variety of conditions that may hamper online competition. They can require out-of-state shippers to buy licenses or permits, require shippers to notify their in-state wholesalers before selling direct to consumers, require registration of individual brands or labels eligible for direct shipment, limit volumes shipped by a winery or received by individual consumers, permit shipping only for wines not handled by an in-state distributor, allow direct shipment by wineries but not by retailers, require shippers or consumers to remit sales and excise taxes, prohibit ordering via the Internet, prohibit or require shipment via a common carrier, or require various kinds of record-keeping for online sales.[3]

Different state laws may have different effects on interstate wine sales and consumer welfare. At one extreme, a state may be nominally open to direct shipping but impose such severe restrictions that few shippers find it economical or practical. On the other hand, at some point a state's law is liberal enough that most shippers can comply at minimal cost, and most adult consumers in the state can order the types and quantities of wines they desire. But at what point is a state's law liberal enough that consumers get the most benefits obtainable from e-commerce in wine?

One way of answering this question is to analyze price convergence. If laws prohibiting interstate direct shipping actually reduce competition, then we would expect prices in brick-and-mortar stores to be higher than online prices when interstate direct shipping is illegal. If a state then legalizes direct shipping and the law effectively increases competition, the online-offline price spread should narrow as brick-and-mortar stores adjust their prices to become more competitive with online sellers. The less burdensome the law is, the more likely the price spread will diminish in the face of robust competition between online and offline sellers.

Virginia's legalization of interstate direct wine shipping in 2003 provides a natural experiment for analyzing the price effects of direct shipping laws. In 2002 and 2004, we gathered price data on a sample of highly popular wines sold both online and in Northern Virginia stores. The 2002 data revealed that Virginia's prohibition of interstate direct shipment deprived consumers of significant cost savings available online.[4] Legalization of direct shipment in 2003 reduced the average 2004 retail price difference

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2 A "reciprocal" state permits direct shipment only from states that also allow its wineries or retailers to ship to their consumers. "Limited" states allow direct shipment from shippers in any state as long as they meet other qualifications in the law. For examples, *see* http://www.wineinstitute.org/programs/shipwine/ (last visited Aug. 21, 2007).

3 *See* http://www.wineinstitute.org/programs/shipwine/ for a comprehensive list.

4 Alan E. Wiseman & Jerry Ellig, *Market and Nonmarket Barriers to Internet Wine Sales: The Case of Virginia*, 6 BUS. & POL. 24-27 (2004).

between the lowest-priced online sellers and brick-and-mortar stores in Northern Virginia by between twenty-six and forty percent. Virginia brick-and-mortar retailers also began pricing their products as a function of interstate shipping costs following the legalization of direct shipment.[5] Shipping costs clearly account for some of the remaining price difference. Thus, online and offline prices may be as close together as is possible, given the shipping costs associated with online purchases. In this article, we analyze whether legalization of interstate direct shipment has caused online and offline prices to converge, once shipping and transportation costs are taken into account. If prices have fully converged, then Virginia's law has made online sales as competitive as possible with brick-and-mortar sales. If prices have not fully converged, either some barriers to competition remain, or the different sales channels offer nonprice benefits that consumers value.

I. LEGAL BACKGROUND ON DIRECT SHIPMENT

After the Twenty-First Amendment repealed prohibition in 1933, States moved quickly to establish legal and regulatory frameworks for handling the distribution and sale of alcohol within and across state lines. Most States adopted what has come to be known as the "three-tier" system. Under this system, all alcohol coming into a state has to come from the producer (tier one), then go to a distributor (tier two), and finally go to a retailer (tier three) before arriving in the hands of any potential consumer. Vertical integration between the tiers was generally prohibited. A winery could not set up its own distribution network or establish its own retail centers that bypassed existing distribution systems.[6] By the 1980s, almost every State had adopted some variant of the three-tier distribution system. With the exception of Alaska, California, and Rhode Island, direct interstate shipments of wine to consumers were generally illegal.

The legal landscape of direct shipment changed dramatically in 1986 when California passed legislation prohibiting direct shipment of wine from other states to California residents, unless exporting states allowed their residents to receive direct shipments from California wineries. This legislation paved the way for the current "reciprocity" agreements between eleven states for direct interstate shipments of wine from producer and/or retailer

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5 Alan E. Wiseman & Jerry Ellig, *The Politics of Wine: Trade Barriers, Interest Groups, and the Commerce Clause*, 69 J. POLITICS (forthcoming 2007).

6 There are some exceptions to this ban on vertical integration. In certain states, state-owned liquor stores also perform the wholesaling function, receiving shipments direct from distillers. Many states permit wineries and breweries to sell to the public for on- or off-premises consumption in tasting rooms, brew-pubs, or at festivals, but this exception is not broad enough to permit them to establish their own retail networks. Finally, some states, such as California, allow wineries to bypass the distributors and deal directly with retailers.

to consumer.[7] Other states (and the District of Columbia) eventually relaxed their prohibitions on interstate direct shipments to allow limited quantities of wine and alcohol to be imported without going through the state-sanctioned (or state-administered) distribution system.[8] By 2000, interstate direct shipment was legal in about half of the states.

A handful of states banned interstate direct shipment while permitting intrastate direct shipment. Claiming Section 2 of the Twenty-First Amendment gave them complete autonomy over alcohol within their borders, these states allowed in-state wineries (and sometimes retailers) to ship directly to in-state consumers while prohibiting out-of-state sellers from engaging in similar activities. Proponents of these laws argued they were necessary and appropriate given that in-state wine sellers were easier to monitor for taxation and other law-compliance purposes. Alternatively, opponents argued bans on interstate direct shipping were a clear violation of the Commerce Clause.[9]

These competing views met in court with mixed results. In 2002 and 2003, federal courts found that such laws in Michigan, Texas, North Carolina, and Virginia were unconstitutional violations of the Commerce Clause.[10] In contrast, the Second Circuit decided in 2003 to uphold New York's discriminatory direct shipment ban.[11] Texas, North Carolina, and Virginia subsequently legalized direct interstate shipping to comply with the federal court decisions. Michigan, on the other hand, petitioned the Supreme Court for certiorari, as did the plaintiffs in the New York case.

These contradictory federal circuit decisions were resolved in May 2005, when the U.S. Supreme Court ruled in a five to four vote that such discriminatory laws were, indeed, an unconstitutional violation of the Commerce Clause. In its decision, the Court stated that "Section 2 [of the Twenty-First Amendment] does not allow States to regulate direct shipment of wine on terms that discriminate in favor of in-state producers."[12] The decision placed the onus on those states with discriminatory laws to re-

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7 Reciprocity states recognize two-way shipping rights between jurisdictions and guarantee that shipping from other reciprocal states is acknowledged. The particular shipping rights depend on the kind of wines being shipped, relative alcohol contents, etc.

8 Non-reciprocity states that still allow interstate shipment typically allow limited direct wine shipments through personal importation laws that allow consumers to receive wine from another state, subject to certain conditions.

9 U.S. CONST. art. I, § 8.

10 *See* Heald v. Engler, No. 00-CV-71438-DT (E.D. Mich. Sept. 28, 2001), *rev'd*, 342 F.3d 517 (6th Cir. 2003); Dickerson v. Bailey, 336 F.3d 388 (5th Cir. 2003); Beskind v. Easley, 325 F.3d 506 (4th Cir. 2003), Bolick v. Danielson, 330 F.3d 274 (4th Cir. 2003).

11 Swedenburg v. Kelly, 358 F.3d 223 (2nd Cir. 2003).

12 544 U.S. 12 (2005). Unlike Michigan, New York allowed out-of-state wineries to ship to New York consumers if they opened an in-state branch office and warehouse, but this policy was still considered discriminatory because it forced out-of-state firms to bear additional costs in comparison to in-state firms.

evaluate them and decide how best to synchronize their practices for both in-state and out-of-state sellers.

As of July 2003, interstate direct shipment of beer and wine to Virginia consumers became legal for licensed shippers. Wineries, breweries, and "anyone authorized to sell beer or wine at retail in their state of domicile" can apply for a license to ship directly to Virginia consumers, and applications must identify the particular brands for which permission is sought. An applicant who does not "own or have the right to control" distribution of the brands in the application must provide the written consent of the winery or brewery, and any winery or brewery whose brands are distributed by a Virginia wholesaler must notify the wholesaler when they seek a license to ship those brands or grant another applicant permission to ship.[13]

With respect to shipments, a licensee can ship no more than two cases per month to a Virginia customer, and the shipments must be made via a common carrier approved by the Virginia Board of Alcoholic Beverage Control.[14] Packages containing alcohol must be labeled as such in sixteen point type or larger, and the recipient must show proof that he is at least twenty-one years old and sign an acknowledgement of receipt. Finally, the common carrier must refuse delivery to any recipient who appears to be under twenty-one and refuses to present proof of age.[15]

Under the law, licensees must also remit sales and excise taxes to the state.[16] Virginia taxes retail sales at a rate of four percent,[17] and the excise tax on wine is forty cents per liter, or thirty cents for a 750 ml bottle.[18] The excise tax on liquor, in contrast, is equal to twenty percent of the sales price.[19]

II. WINE DATA AND PREVIOUS FINDINGS

This study uses price data on two comparable samples of highly popular wines. While sales and market share data for individual wines are not publicly available, *Wine and Spirits* magazine surveys restaurants annually to identify the top-selling wines and publishes the results in its April issue each year. The wines in our sample come from the magazine's thirteenth and fifteenth annual polls, published in 2002 and 2004, respectively. *Wine and Spirits* surveys approximately 2,000 restaurants to find out their top ten

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[13] VA. CODE ANN. §§ 4.1-112.1.A, B, *available at* http://leg1.state.va.us/cgi-bin/legp504.exe?000+cod+4.1-112.1.a.

[14] VA. CODE ANN. § 4.1-112.1.A.

[15] VA. CODE ANN. § 4.1-112.1.C.

[16] VA. CODE ANN. § 4.1-112.1.D.

[17] VA. CODE ANN. § 58.1-603.

[18] VA. CODE ANN. § 4.1-234.A.

[19] VA. CODE ANN. § 4.1-234.B.

selling wines in the last quarter of the year. For each of the ten wines listed in the restaurant's response, *Wine and Spirits* assigns a point value ranging from ten for the best-selling wine to one for the tenth best-selling wine, and identifies the "Top 50" wines as those that receive the most mentions per 100 responses, with the point values used to break ties.[20]

By using the point values assigned to wines, we were able to generate a list of the "Top 50" most popular wines based on the fifty highest-point recipients. Creating such a list actually yields a sample of more than fifty bottles—eighty-three in 2002 and seventy-eight in 2004. The difference follows from the recognition of all relevant bottles that fall under a given winery's varietal when *Wine and Spirits* identifies the most popular Chardonnays, Merlots, and so forth.[21] After eliminating bottles that were no longer available for sale, not available both online and offline, or misnamed, we had sixty-seven bottles for 2002 price comparisons and sixty-three bottles for 2004 price comparisons.

Our research teams collected price data during the summers of 2002 and 2004. Brick-and-mortar prices were gathered by searching web pages or by personal visits to every Virginia "wine retailer" listed in the Yahoo! Yellow Pages within ten miles of McLean, Virginia, a relatively affluent area in the middle of the Northern Virginia suburbs of Washington, D.C.[22] Online prices were gathered by visiting each winery's website and also by employing Winesearcher.com, a shopbot with access to prices at hundreds of online wine retailers. Our price comparisons compare the lowest available online price with the lowest brick-and-mortar price for each bottle, and the 2004 online price is the lowest price charged by an online seller who actually ships to Virginia.

Taxes and transportation costs could potentially affect the online-offline price differential, and the comparisons account for these. In 2004, any seller shipping legally into Virginia from out-of-state was expected to remit sales and excise taxes. We therefore performed the comparison without sales taxes (since sales taxes would be equal for online and offline retailers) and assumed both online and offline retail prices incorporate excise taxes. For 2002, when interstate direct shipping was illegal, we opted to compare all prices without sales taxes, to ensure tax differentials would not drive the results. The price differentials we calculated in 2002 do not adjust

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[20] More details on each sample can be found in Wiseman & Ellig, *supra* notes 4 and 5.

[21] For example, Kendall-Jackson Vineyards' Chardonnay received 226 points for 2004, making it the second most popular wine overall, but Wine and Spirits recognized two bottles, the "California Grand Reserve" and the "California Vintner's Reserve," and hence both were included in our sample.

[22] Contrary to Milyo and Waldfogel's experience in gathering liquor price data, store managers were generally cooperative and often curious about the study, so our research team was able to gather the data without being asked to leave the stores. *See* Jeffrey Milyo & Joel Waldfogel, *The Effect of Price Advertising on Prices: Evidence in the Wake of* 44 Liquormart, 89 AM. ECON. REV. 1084 (1999).

for Virginia's forty cents/liter excise tax on wine, but this tax is quite small compared to the price differentials we found.

We adjusted the prices to reflect transportation and shipping costs for both online and offline purchases. For each bottle available online, data was collected from United Parcel Service[23] on the cost of shipping boxes of the appropriate size and weight to represent a single bottle, a half case, and a case of wine to McLean, Virginia from the zip code where the online vendor offering the lowest price was located via standard ground, 2nd day air, and 3rd day air shipping services. For brick-and-mortar stores, transportation costs were calculated using the standard government mileage reimbursement rate for automobile travel. Such calculations may overstate travel costs to the extent consumers combine multiple errands in one car trip, or they may significantly understate transportation costs because they ignore the opportunity cost of the consumer's travel time.[24]

Tables 1a and 1b provide descriptive statistics for each year's prices.

2002 Descriptive Statistics					
Variable	*Mean*	*Std. Dev.*	*Min.*	*Max.*	*Obs.*
Lowest Online Price	25.969	20.980	7.970	129.990	79
Lowest Offline Price	28.290	23.916	8.490	169.990	68
Transportation Costs (1 Bottle)	1.655	2.512	0.073	7.300	68
Transportation Costs per Bottle (6 Bottles)	0.276	0.419	0.122	1.217	68
Transportation Costs per Bottle (12 Bottles)	0.138	0.209	0.006	0.608	68
Ground Shipment Costs (1 Bottle)	5.960	0.583	4.530	6.300	79
3rd Day Air Shipment Costs (1 Bottle)	9.985	1.714	6.350	10.980	79
2nd Day Air Shipment Costs (1 Bottle)	13.215	1.943	8.560	14.310	79
Ground Shipment Costs per Bottle (6 Bottles)	2.834	0.685	1.493	3.248	79
3rd Day Air Shipment Costs per Bottle (6 Bottles)	5.532	1.294	2.557	6.287	79
2nd Day Air Shipment Costs per Bottle (6 Bottles)	7.033	1.617	3.232	7.940	79
Ground Shipment Costs per Bottle (12 Bottles)	2.504	0.711	1.051	2.932	79
3rd Day Air Shipment Costs per Bottle (12 Bottles)	4.737	1.150	2.072	5.404	79
2nd Day Air Shipment Costs per Bottle (12 Bottles)	6.115	1.532	2.594	6.982	79

Table 1a

23 *Available at* http://www.ups.com.

24 Research in transportation economics reveals that individuals attach widely varying valuations of travel time, suggesting that opportunity costs of travel may vary widely across consumers. *See* Kenneth A. Small, Clifford Winston, & Jia Yan, *Uncovering the Distribution of Motorists' Preferences for Travel Time and Reliability: Implications for Road Pricing* (University of California, Irvine Working Paper, 2002).

2004 Descriptive Statistics					
Variable	*Mean*	*Std. Dev.*	*Min.*	*Max.*	*Obs.*
Lowest Online Price	21.997	15.115	7.690	99.990	72
Lowest Offline Price	24.214	15.882	7.990	89.990	63
Transportation Costs (1 Bottle)	1.743	2.423	0.075	7.500	63
Transportation Costs per Bottle (6 Bottles)	0.290	0.404	0.013	1.250	63
Transportation Costs per Bottle (12 Bottles)	0.145	0.202	0.006	0.625	63
Ground Shipment Costs (1 Bottle)	6.246	0.705	5.040	6.890	72
3rd Day Air Shipment Costs (1 Bottle)	10.008	3.401	5.040	13.030	72
2nd Day Air Shipment Costs (1 Bottle)	14.423	2.962	5.040	16.970	72
Ground Shipment Costs per Bottle (6 Bottles)	1.890	0.573	1.167	2.428	72
3rd Day Air Shipment Costs per Bottle (6 Bottles)	3.966	1.957	1.167	5.693	72
2nd Day Air Shipment Costs per Bottle (6 Bottles)	6.277	2.111	1.167	8.176	72
Ground Shipment Costs per Bottle (12 Bottles)	1.597	0.596	0.801	2.156	72
3rd Day Air Shipment Costs per Bottle (12 Bottles)	3.339	1.734	0.801	4.863	72
2nd Day Air Shipment Costs per Bottle (12 Bottles)	5.386	1.989	0.801	7.191	72

Table 1b

In a previously published study, we found noticeable and statistically significant differences between online and offline prices in 2002, when interstate direct shipment to Virginia was illegal.[25] Tables 2a-d calculate the 2002 cost savings or price premium associated with online purchase of the entire sample and various sub-samples: bottles costing at least $20, bottles costing at least $40, and bottles costing less than $20 (offline prices). All of these differentials include transportation costs for purchases at brick-and-mortar stores and shipping costs for online purchases.

Several generalizations emerge from the tables. First, a consumer buying the entire sample could have saved more than three dollars per bottle in 2002 by purchasing online and shipping via ground, the least expensive method.[26] Second, the price savings are even larger for the expensive wines costing more than twenty dollars or forty dollars per bottle offline. For these wines, significant savings are available even when shipping via air. Third, shipping costs impose a heavy price penalty for online purchases of the less expensive bottles, priced under twenty dollars offline.

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[25] For more extensive discussion, *see* Wiseman & Ellig, *supra* note 4. Tables 2a-e are drawn from this source.

[26] This price difference is obviously much larger than Virginia's excise tax of thirty cents per 750 ml bottle, which would be reflected in the brick-and-mortar price but not in the online price.

Table 2e calculates the cost savings a consumer could have achieved in 2002 by comparison shopping and purchasing each bottle from the cheapest source, online or offline. Since some bottles were less expensive in brick-and-mortar stores, the savings from comparison-shopping are larger than the savings from buying exclusively online. The comparison shopper could have saved an average of two dollars and twenty-one cents to four dollars and thirty cents per bottle, or eight to fifteen percent of the average bottle price.[27] The two dollar and twenty-one cent per bottle savings from comparison shopping and shipping online purchases via 3rd day air contrasts markedly with the two dollar and forty-four cent price premium paid when purchasing one of each bottle online and shipping by 3rd day air.

Clearly, Virginia's prohibition of interstate direct shipment deprived consumers of access to noticeable and statistically significant price savings.

2002 Cost Savings (Extra Expenses) Per Bottle When Shopping Online For Entire Sample (N=67)				
Category	*Mean*	*Std. Dev.*	*Min.*	*Max.*
Online Savings (no transportation costs)	**5.838	10.579	-2.200	83.000
Online Savings (UPS Ground - 1 Bottle)	1.507	11.560	-8.427	82.686
Online Savings (UPS 3rd Day Air - 1 Bottle)	*-2.443	11.518	13.107	78.006
Online Savings (UPS 2nd Day Air - 1 Bottle)	**-7.256	10.556	16.510	68.690
Online Savings per Bottle (UPS Ground - 6 Bottles)	**3.342	10.701	-5.436	80.749
Online Savings per Bottle (UPS 3rd Day Air - 6 Bottles)	0.706	10.720	-8.475	77.711
Online Savings per Bottle (UPS 2nd Day Air - 6 Bottles)	-0.767	10.748	-10.128	76.058
Online Savings per Bottle (UPS Ground - 12 Bottles)	**3.543	10.633	-5.126	80.567
Online Savings per Bottle (UPS 3rd Day Air - 12 Bottles)	1.353	10.644	-7.598	78.095
Online Savings per Bottle (UPS 2nd Day Air - 12 Bottles)	0.110	10.668	-9.176	76.517

Table 2a[28]

[27] Time spent comparison shopping is a cost to consumers. If savings are not significant enough to compensate for the time spent comparison shopping, these savings will not occur in practice.

[28] A double asterisk (**) indicates significance greater than the ninety-five percent confidence level. A single asterisk (*) indicates significance greater than the ninety percent confidence level (two-tailed test).

2002 Cost Savings (Extra Expenses) Per Bottle When Shopping Online For Wines Greater Or Equal To $20.00 (Offline Price) (N=36)				
Category	*Mean*	*Std. Dev.*	*Min.*	*Max.*
Online Savings (no transportation costs)	**9.435	13.376	-2.000	83.000
Online Savings (UPS Ground - 1 Bottle)	**5.512	14.348	-8.008	82.686
Online Savings (UPS 3rd Day Air - 1 Bottle)	1.526	14.268	-12.688	78.006
Online Savings (UPS 2nd Day Air - 1 Bottle)	-3.693	13.234	-16.310	68.690
Online Savings per Bottle (UPS Ground - 6 Bottles)	**7.027	13.446	-5.200	80.749
Online Savings per Bottle (UPS 3rd Day Air - 6 Bottles)	*4.396	13.432	-8.238	77.711
Online Savings per Bottle (UPS 2nd Day Air - 6 Bottles)	2.912	13.450	-9.891	76.058
Online Savings per Bottle (UPS Ground - 12 Bottles)	**7.194	13.371	-4.907	80.567
Online Savings per Bottle (UPS 3rd Day Air - 12 Bottles)	**5.005	13.361	-7.380	78.095
Online Savings per Bottle (UPS 2nd Day Air - 12 Bottles)	3.654	13.367	-8.957	76.517

Table 2b

2002 Cost Savings (Extra Expenses) Per Bottle When Shopping Online For Wines Greater Or Equal To $40.00 (Offline Price) (N=9)				
Category	*Mean*	*Std. Dev.*	*Min.*	*Max.*
Online Savings (no transportation costs)	**20.607	23.817	7.000	83.000
Online Savings (UPS Ground - 1 Bottle)	*17.881	24.827	2.263	82.686
Online Savings (UPS 3rd Day Air - 1 Bottle)	13.573	24.596	-1.678	78.006
Online Savings (UPS 2nd Day Air - 1 Bottle)	6.969	23.461	-6.310	68.690
Online Savings per Bottle (UPS Ground - 6 Bottles)	**18.388	23.804	5.376	80.749
Online Savings per Bottle (UPS 3rd Day Air - 6 Bottles)	*15.762	23.683	2.772	77.771
Online Savings per Bottle (UPS 2nd Day Air - 6 Bottles)	14.280	23.648	1.119	76.057
Online Savings per Bottle (UPS Ground - 12 Bottles)	**18.448	23.711	5.677	80.567
Online Savings per Bottle (UPS 3rd Day Air - 12 Bottles)	*16.262	23.628	3.204	78.095
Online Savings per Bottle (UPS 2nd Day Air - 12 Bottles)	*14.990	23.572	1.627	76.517

Table 2c

2002 Cost Savings (Extra Expenses) Per Bottle When Shopping Online For Wines Less Than $20.00 (Offline Price) (N=31)				
Category	*Mean*	*Std. Dev.*	*Min.*	*Max.*
Online Savings (no transportation costs)	**1.661	2.183	-2.200	6.000
Online Savings (UPS Ground - 1 Bottle)	**-3.144	3.496	-8.427	6.000
Online Savings (UPS 3rd Day Air - 1 Bottle)	**-7.053	3.670	-13.107	1.320
Online Savings (UPS 2nd Day Air - 1 Bottle)	**-11.393	2.807	-16.510	-5.580
Online Savings per Bottle (UPS Ground - 6 Bottles)	**-0.934	2.414	-5.436	3.316
Online Savings per Bottle (UPS 3rd Day Air - 6 Bottles)	**-3.578	2.656	-8.475	1.392
Online Savings per Bottle (UPS 2nd Day Air - 6 Bottles)	**-5.039	2.824	-10.128	2.455
Online Savings per Bottle (UPS Ground - 12 Bottles)	-0.697	2.362	-5.126	3.644
Online Savings per Bottle (UPS 3rd Day Air - 12 Bottles)	**-2.888	2.532	-7.598	1.948
Online Savings per Bottle (UPS 2nd Day Air - 12 Bottles)	**-4.220	2.742	-9.176	1.112

Table 2d

2002 Cost Savings (Extra Expenses) Per Bottle When "Comparison Shopping" For Entire Sample (N=67)			
Category	*Mean*	*Std. Dev.*	*Max.*
Online Savings (no transportation costs)	**5.974	10.509	83.000
Online Savings (UPS Ground - 1 Bottle)	**3.569	10.582	82.686
Online Savings (UPS 3rd Day Air - 1 Bottle)	*2.207	9.762	78.006
Online Savings (UPS 2nd Day Air - 1 Bottle)	1.629	9.224	74.676
Online Savings per Bottle (UPS Ground - 6 Bottles)	**4.201	10.249	80.749
Online Savings per Bottle (UPS 3rd Day Air - 6 Bottles)	**2.752	9.828	77.711
Online Savings per Bottle (UPS 2nd Day Air - 6 Bottles)	*2.276	9.571	76.058
Online Savings per Bottle (UPS Ground - 12 Bottles)	**4.303	10.225	80.567
Online Savings per Bottle (UPS 3rd Day Air - 12 Bottles)	**3.020	9.886	78.095
Online Savings per Bottle (UPS 2nd Day Air - 12 Bottles)	**2.477	9.655	76.517

Table 2e

Further analysis reveals that Virginia's legalization of interstate direct shipment increased competition. In a forthcoming paper, we compared posted online and offline retail prices in 2002 and 2004, excluding transportation and shipping costs. Comparing the percentage difference between the lowest online and offline prices, the price spread fell by six and nine-tenths percentage points, or almost forty percent, between 2002 and 2004. Comparing the percentage difference between the lowest online price and the average offline price, the spread fell by five to six percentage points, or about twenty-six percent. Both analyses control for average brick-and-mortar bottle price and popularity; the reduction in the percentage price spread appears to be uniform, regardless of average brick-and-mortar bottle price or popularity.[29]

Legalization of interstate direct shipping in Virginia clearly benefited consumers—not just by giving consumers access to out-of-state sellers, but also by placing competitive pressure on in-state brick-and-mortar sellers. But is the price convergence full or partial? On average, the wines in our sample are still less expensive online. Shipping costs may, however, eat up much of the apparent savings. Resolving this issue requires an analysis that includes transportation and shipping costs, analogous to our 2002 study.

III. HAVE PRICES FULLY CONVERGED IN VIRGINIA?

Tables 3a-e calculate the online-offline price differentials in 2004, including transportation and shipping costs. As in Tables 2a-e, transportation costs are calculated using the standard mileage rate, and shipping costs are calculated from the United Parcel Service (UPS) website.

The calculation of shipping costs for online purchases introduces a potential complication into the analysis for 2004. Since interstate direct shipment is now legal, it would be more accurate to use shipping costs sellers actually charged rather than estimating them from the UPS website. In theory, this would also allow us to account for any markups, handling fees, insurance, or other charges added by online sellers. In practice, however, we were unable to obtain actual shipping costs from most sellers' websites without actually placing an order. (We did not have the requisite research funding to purchase a bottle, half-case, and case of sixty-seven different wines.) Our research assistant followed up by phone with many online sellers to find out if they imposed additional handling or insurance charges—few said they did. In any case, the virtue of using the UPS website to calculate shipping costs in both years is that it helps ensure that any differences in results for 2002 and 2004 reflect real price differences rather than merely different methods for estimating shipping costs.

The 2004 results are qualitatively similar to the 2002 results. Table 3a shows that the consumer could achieve some savings by purchasing the entire sample online and shipping it via ground, the least expensive option. Air shipment raised the price of online purchases, so online purchases cost about the same as or more than purchases in a brick-and-mortar store. From Tables 3b and 3c, the price savings on the more expensive wines were large enough that the online shopper could save money even if the wine were shipped via air. Table 3d shows, in 2004 as in 2002, shipping costs

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29 Wiseman & Ellig, *supra* note 5.

imposed a substantial price penalty for online wine purchases costing less than twenty dollars offline. Finally, Table 3e reveals that one could achieve substantial savings by comparison shopping and purchasing each bottle from the lowest-cost source, online or offline, instead of buying everything in local stores.

In most cases, the dollar cost savings for 2004 in Tables 3a-e were less than the dollar cost savings for 2002 in Tables 2a-e. A direct comparison of these dollar figures, however, is not quite appropriate. The 2002 and 2004 samples are comparable, but not identical. The differences in dollar cost savings may simply reflect a slight difference in the price distributions in the two years, rather than a true change in the price spread.[30] Nevertheless, we are confident that much of the reduction in the online savings stems from price convergence because the percentage differences between online and offline retail prices fell between 2002 and 2004.[31] Comparing Table 2e to Table 3e, the average dollar cost savings from comparison-shopping also decreased following the legalization of direct shipment. Whereas in 2002 these cost savings were approximately eight to fifteen percent of the average brick-and-mortar bottle price, the cost savings in Table 3e amount to approximately zero to seven and six-tenths of one percent of the average brick-and-mortar bottle price, depending on the quantity purchased and the shipping method employed.

While the difference between online and offline prices has decreased substantially following legalization of direct shipment in Virginia, online and offline prices clearly had not fully converged as of 2004. On average, substantial price savings were still available online for the more expensive wines, which constitute almost half the sample. There are several possible explanations for this incomplete convergence.

First, it may take more than one year for both the online and offline markets to fully adjust to interstate direct shipment. All of the lowest 2004 online prices came from vendors who ship to Virginia. Thus, the transition issue raised by our price results is not simply one of waiting for more online sellers to get Virginia permits. Rather, it may just take more time for prices to reach equilibrium. Testing this explanation would require gathering a new data set in a subsequent year to see if the price differentials have eroded further.

Second, brick-and-mortar wine shops may be able to charge a sustainable price premium due to legitimate competitive advantages. For instance, brick-and-mortar retailers might provide information, tasting, or other services consumers value. Further, many consumers may be willing to pay more in order to get their wine immediately from the store instead of waiting for delivery. The absence of online price savings for less expensive

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[30] It is important to note that price distributions of the online samples (with regard to mean and variance) are not statistically different between 2002 and 2004.

[31] *See* Wiseman & Ellig, *supra* note 5.

wines is consistent with this explanation, as information or services are likely more important in connection with more expensive wines. Faced with the possibility of paying more than twenty dollars for an entire bottle that may not match his own tastes, the consumer may treat an expensive wine as more of a "search good" than an "experience good."[32]

Third, some aspects of Virginia's direct shipment law may make online retailers a less potent competitive threat than they could be. As a result, brick-and-mortar stores may receive a price premium because they perceive that they will lose little business to online sellers charging a noticeably lower price.

For example, many provisions of Virginia's law, such as the requirement that wineries notify their Virginia distributors if they or other parties have applied for a direct shipping permit for a brand handled by that distributor, affect which and how many sellers will seek to ship to Virginia consumers. While such provisions might affect the competitiveness of the wine market, they could not obviously explain the price differentials calculated from our 2004 data, because the online price data are from sellers who actually ship to Virginia.[33]

The quantity limits are the most likely provision in Virginia's law that might help explain our price results. An out-of-state seller cannot ship more than two cases of wine per month to an individual Virginia consumer. This constraint may be especially binding on out-of-state retailers, who might otherwise sell more than two cases at a time to a consumer seeking to stock up on several different bottles in the same order. If this type of consumer makes up a substantial portion of the market for wines costing more than twenty dollars, then the brick-and-mortar retailer may be able to charge a higher price than the online vendor because the consumer can bring home more than two cases at a time from the local retailer. Consistent with this argument, it is worth noting that in almost every case, the least expensive online source for each wine was a retailer, not the winery.[34]

Further research would be required to substantiate or reject any of these three explanations. Our intuition is that the first two explanations are

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32 An "experience good" is a frequently purchased and often relatively inexpensive good that a consumer can learn about by trying without bearing a huge expense. A "search good" is a more substantial, and often less frequent purchase for which it is worthwhile for the consumer to invest time and effort in search activity to verify quality. *See* Phillip Nelson, *Advertising as Information*, 78 J. POL. ECON. 311 (1974).

33 One possibility, however, is that the current online market that ships into Virginia is less competitive than it otherwise would be in the absence of any regulations, because certain aggressive competitors are kept out of the market, and the exclusion of these competitors leads to higher brick-and-mortar prices than what would otherwise be obtained. Given the large number of retailers that do currently ship into Virginia, however, we find such a scenario relatively implausible.

34 In 2002, we found only six bottles that were less expensive on the winery's website than at an online retailer. In 2004, no bottles were less expensive on the winery's website than at an online retailer.

quite plausible. The third one may be, but only if a substantial number of customers who visit local wine stores buy substantial amounts of wine (more than two cases per visit).

2004 Cost Savings (Extra Expenses) Per Bottle When Shopping Online For Entire Sample (N=63)				
Category	*Mean*	*Std. Dev.*	*Min.*	*Max.*
Online Savings (no transportation costs)	**3.048	5.608	-11.000	25.990
Online Savings (UPS Ground - 1 Bottle)	*-1.450	6.674	-13.590	26.525
Online Savings (UPS 3rd Day Air - 1 Bottle)	**-5.170	6.746	-19.730	20.385
Online Savings (UPS 2nd Day Air - 1 Bottle)	**-9.588	6.640	-23.670	16.445
Online Savings per Bottle (UPS Ground - 6 Bottles)	**1.453	5.594	-11.297	24.799
Online Savings per Bottle (UPS 3rd Day Air - 6 Bottles)	-0.599	5.480	-12.643	21.534
Online Savings per Bottle (UPS 2nd Day Air - 6 Bottles)	**-2.913	5.457	-15.127	19.051
Online Savings per Bottle (UPS Ground - 12 Bottles)	**1.601	5.508	-11.441	24.453
Online Savings per Bottle (UPS 3rd Day Air - 12 Bottles)	-0.120	5.400	-11.838	21.745
Online Savings per Bottle (UPS 2nd Day Air - 12 Bottles)	**-2.169	5.366	-14.166	19.418

Table 3a

2004 Cost Savings (Extra Expenses) Per Bottle When Shopping Online For Wines Greater Or Equal To $20.00 (Offline Price) (N=27)				
Category	*Mean*	*Std. Dev.*	*Min.*	*Max.*
Online Savings (no transportation costs)	**5.884	7.245	-11.000	25.990
Online Savings (UPS Ground - 1 Bottle)	2.251	8.031	-10.460	26.525
Online Savings (UPS 3rd Day Air - 1 Bottle)	-1.481	7.315	-12.675	20.385
Online Savings (UPS 2nd Day Air - 1 Bottle)	**-5.909	7.275	-16.615	16.445
Online Savings per Bottle (UPS Ground - 6 Bottles)	**4.403	7.080	-11.297	24.799
Online Savings per Bottle (UPS 3rd Day Air - 6 Bottles)	*2.372	6.548	-11.297	21.534
Online Savings per Bottle (UPS 2nd Day Air - 6 Bottles)	0.034	6.449	-13.840	19.051
Online Savings per Bottle (UPS Ground - 12 Bottles)	**4.482	6.994	-11.441	24.453
Online Savings per Bottle (UPS 3rd Day Air - 12 Bottles)	**2.786	6.544	-11.441	21.745
Online Savings per Bottle (UPS 2nd Day Air - 12 Bottles)	0.698	6.413	-13.597	19.418

Table 3b

2004 Cost Savings (Extra Expenses) Per Bottle When Shopping Online For Wines Greater Or Equal To $40.00 (Offline Price) (N=7)				
Category	*Mean*	*Std. Dev.*	*Min.*	*Max.*
Online Savings (no transportation costs)	**12.869	6.535	5.000	25.990
Online Savings (UPS Ground - 1 Bottle)	**10.405	8.309	-0.685	26.525
Online Savings (UPS 3rd Day Air - 1 Bottle)	*5.606	8.299	-3.575	20.385
Online Savings (UPS 2nd Day Air - 1 Bottle)	1.376	8.017	-7.515	16.445
Online Savings per Bottle (UPS Ground - 6 Bottles)	**11.438	6.568	3.701	24.799
Online Savings per Bottle (UPS 3rd Day Air - 6 Bottles)	**8.827	6.461	1.746	21.534
Online Savings per Bottle (UPS 2nd Day Air - 6 Bottles)	**6.471	6.291	0.212	19.051
Online Savings per Bottle (UPS Ground - 12 Bottles)	**11.386	6.430	3.980	24.453
Online Savings per Bottle (UPS 3rd Day Air - 12 Bottles)	**9.205	6.341	2.250	21.745
Online Savings per Bottle (UPS 2nd Day Air - 12 Bottles)	**7.069	6.150	1.091	19.418

Table 3c

2004 Cost Savings (Extra Expenses) Per Bottle When Shopping Online For Wines Less Than $20.00 (Offline Price) (N=36)				
Category	*Mean*	*Std. Dev.*	*Min.*	*Max.*
Online Savings (no transportation costs)	**0.921	2.418	-7.000	6.000
Online Savings (UPS Ground - 1 Bottle)	**-4.225	3.537	-13.590	5.240
Online Savings (UPS 3rd Day Air - 1 Bottle)	**-7.938	4.743	-19.730	2.350
Online Savings (UPS 2nd Day Air - 1 Bottle)	**-12.347	4.529	-23.670	-1.590
Online Savings per Bottle (UPS Ground - 6 Bottles)	**-0.760	2.538	-9.378	5.251
Online Savings per Bottle (UPS 3rd Day Air - 6 Bottles)	**-2.827	3.071	-12.643	3.296
Online Savings per Bottle (UPS 2nd Day Air - 6 Bottles)	**-5.124	3.181	-15.127	1.763
Online Savings per Bottle (UPS Ground - 12 Bottles)	-0.560	2.488	-9.131	5.255
Online Savings per Bottle (UPS 3rd Day Air - 12 Bottles)	**-2.299	2.904	-11.838	3.525
Online Savings per Bottle (UPS 2nd Day Air - 12 Bottles)	**-4.320	3.059	-14.166	2.366

Table 3d

2004 Cost Savings (Extra Expenses) Per Bottle When "Comparison Shopping" For Entire Sample (N=63)			
Category	*Mean*	*Std. Dev.*	*Max.*
Online Savings (no transportation costs)	**3.720	4.769	25.990
Online Savings (UPS Ground - 1 Bottle)	**1.991	4.431	26.525
Online Savings (UPS 3rd Day Air - 1 Bottle)	**1.991	4.431	26.525
Online Savings (UPS 2nd Day Air - 1 Bottle)	0.413	2.259	16.445
Online Savings per Bottle (UPS Ground - 6 Bottles)	**2.635	4.464	24.799
Online Savings per Bottle (UPS 3rd Day Air - 6 Bottles)	**1.737	3.661	21.534
Online Savings per Bottle (UPS 2nd Day Air - 6 Bottles)	**1.007	2.944	19.051
Online Savings per Bottle (UPS Ground - 12 Bottles)	**2.671	4.427	24.453
Online Savings per Bottle (UPS 3rd Day Air - 12 Bottles)	**1.871	3.766	21.745
Online Savings per Bottle (UPS 2nd Day Air - 12 Bottles)	**1.203	3.071	19.418

Table 3e

IV. CONSUMER WELFARE CAVEATS

This study has examined only the price effects of direct-to-consumer wine shipment. A full analysis of consumer benefits would also include variety, convenience, and other factors that affect consumer welfare. For example, analysis of both the 2002 and 2004 samples reveals that some of the wines available online could not be found in Northern Virginia stores. In 2002, fifteen percent of wines available online could not be found in the stores; in 2004, it was twelve and one-half percent.[35] We did not inquire whether some or all of these wines might be available from brick-and-mortar retailers via special order, as our goal was to find out whether a consumer could simply walk into the store and buy the wine without additional effort. Our result confirms what intuition suggests: it is not physically possible for a retailer to stock every wine a consumer might want to buy, even from a sample of top-selling wines. E-commerce thus expands the product variety available to consumers.

If anything, our results understate the extent of the variety benefit, because our sample consists only of top-selling wines in restaurants. Thousands of wines produced in smaller volumes are even less likely to find their way onto store shelves due to distributors' hesitation to carry wines from smaller producers.[36]

Our price results do not account for the value of convenience. To the extent some consumers find it more convenient to search for and order

[35] *See* Wiseman & Ellig, *supra* note 4, at 20; *see also* Wiseman & Ellig, *supra* note 5.

[36] *See* Wiseman & Ellig, *supra* note 4, at 5.

wines online rather than visit a store, this convenience is also a consumer benefit attributable to direct shipment.

Finally, we should note that our analysis of consumer welfare is not necessarily the same as an analysis of social welfare. To the extent that alcohol consumption involves various negative or positive externalities, lower wine prices and more convenient purchasing options could affect the level of these externalities. An analysis of direct shipment's effects on social welfare would need to take these effects into account, in addition to the benefits it confers on wine consumers.

Strident assertions about underage drinking to the contrary[37], we know of no controlled analysis that examines whether direct wine shipment has any effect on the level of alcohol-related externalities. A much touted 2000 study of alcohol "home delivery," based on surveys in small communities in Wisconsin and Minnesota, actually says nothing about whether home delivery is a significant source of alcohol for minors.[38] The study does not specifically deal with Internet sales or direct shipping. Indeed, much of the "home delivery" in the study appears to be delivery of keg beer by local brick-and-mortar merchants. In 2003, Federal Trade Commission (FTC) staff carefully examined the relevant literature and data as part of a comprehensive analysis of Internet wine sales. The FTC staff report found that states could deal with policy concerns such as underage drinking by requiring age verification and an adult's signature upon delivery, rather than banning direct shipment.[39] In 2004, a committee of the National Academy of Sciences recommended that states permitting Internet sales and home delivery of alcohol should:

- require all packages for delivery containing alcohol to be clearly labeled;

- require persons who deliver alcohol to record the recipient's age and identification information from a valid government-issued document (such as a driver's license or ID card); and

- require recipients of home delivery of alcohol to sign a statement verifying receipt of alcohol and attesting that they are of legal age to purchase alcohol.[40]

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37 *See, e.g.*, http://www.wswa.org/public/media/cyberbuzz/ (last visited Aug. 21, 2007).

38 Linda A. Fletcher et. al., *Alcohol Home Delivery Services: A Source of Alcohol for Underage Drinkers*, 61 J. STUD. ALCOHOL 81 (2000).

39 FTC Staff Report, *supra* note 1, at 31-38.

40 INST. OF MED., REDUCING UNDERAGE DRINKING: A COLLECTIVE RESPONSIBILITY 174-75 (Richard J. Bonnie & Mary Ellen O'Connell eds., 2004), *available at* http://fermat.nap.edu/catalog/10729.html (last visited Aug. 21, 2007).

The best available evidence, therefore, suggests underage access or alcohol-related externalities can be controlled through measures that are much less restrictive than an outright ban on direct shipment. Legalization of Internet sales and direct shipment would likely be a net positive for overall social welfare as well as the welfare of wine consumers.

V. CONCLUSIONS

Legalization of interstate direct wine shipment to Virginia consumers has narrowed, but not eliminated, the differences between online and offline prices for a sample of highly popular wines. For wines costing less than twenty dollars per bottle, shipping costs make online purchases more expensive than purchases in local stores. For wines costing twenty dollars or more, brick-and-mortar stores collect a price premium that exceeds the shipping costs associated with online sales.

There are three possible explanations for this result: (1) wine markets and prices have not yet fully adjusted to legalization of interstate direct shipment in Virginia; (2) brick-and-mortar stores offer information and services for which consumers are willing to pay a premium; and (3) some aspects of Virginia's law, such as the two case per consumer per month shipping limit, give local retailers an advantage over out-of-state shippers.

Our findings are consistent with economic theories that emphasize the potential for e-commerce to increase the competitiveness of markets, reduce prices, and enhance consumer welfare.[41] Regardless of which explanation accounts for the remaining price differences, it is clear that legalization of interstate direct shipment has generated substantial benefits to Virginia consumers.

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41 *See, e.g.*, research summarized in Alan E. Wiseman, THE INTERNET ECONOMY: ACCESS, TAXES, AND MARKET STRUCTURE (2000); *see also* Michael D. Smith, Joseph Bailey, & Erik Brynjolfsson, *Understanding Digital Markets: Review and Assessment* in UNDERSTANDING THE DIGITAL ECONOMY: DATA, TOOLS, AND RESEARCH (2000). For specific applications to Internet wine sales, *see* Alan E. Wiseman & Jerry Ellig, *How Many Bottles Make a Case Against Prohibition? Online Wine and Virginia's Direct Shipment Ban*, (Federal Trade Commission, Bureau of Economics Working Paper #258 2003).

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E-COMMERCE IN WINE

*James Alexander Tanford**

I. INTRODUCTION

The first major battle of the wine war is now history. The rebels unexpectedly routed the States' forces and their powerful wholesaler allies and won a convincing victory in Granholm v. Heald.[1] Trade barriers blocking e-commerce in wine that once seemed invincible have been torn down, or at least damaged.

The assault on wine trade barriers began in 1998 in Indiana, of all places. Two lawyers from the Hoosier state and a handful of wine consumers declared war on laws that prohibited ordering wine over the Internet and denied them access to hundreds of small producers. Somewhat unexpectedly, the plaintiffs won the initial battle.[2] News of the victory spread through the wine world, and new recruits began arriving. Cases were filed in Florida, Michigan, North Carolina, Texas, Virginia and New York. The wine industry, which had at first been reluctant to get involved, joined the fray.

The intoxicating feeling of victory was quickly replaced by the hangover of three defeats in a row. The plaintiffs lost in Florida[3] and Michigan,[4] and suffered a devastating defeat as the Seventh Circuit reversed and va-

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* Professor of Law, Indiana University-Bloomington, and Counsel of Record for the plaintiffs in Granholm v. Heald. My co-counsel in Granholm was Robert D. Epstein, who helped develop every one of these issues over nearly eight years of litigation. I also owe debts of gratitude to Clint Bolick, Ken Starr, Jim Seff, Kathleen Sullivan, and Tracy Genesen, all of whom participated with us in crafting the Supreme Court argument, and to the army of legal scholars and lawyers who wrote a total of 26 briefs in the case—including Paul Bender, Susan Estrich, Stuart Banner, Steven Diamond, Drew Days, Miquel Estrada, Carter Phillips, Viet Dinh, and the firms of Dickstein Shapiro, Gibson Dunn & Crutcher, Morrison & Foerster, Jenner & Block, Sidley & Austin, Patton Boggs, Pillsbury Winthrop, King & Spalding, and Kirkland & Ellis. As counsel of record, I read every one of those briefs. It is inevitable that some of the ideas, citations, and phrases used in this Article should properly be attributed to them but are not because I have misplaced the mental citation. Finally, special thanks to Dean Lauren Robel who supported my work on the Granholm case and defended me when I was attacked personally by the wine wholesalers.

1 Granholm v. Heald, 544 U.S. 460 (2005).

2 Bridenbaugh v. O'Bannon, 78 F. Supp. 2d 828 (N.D. Ind. 1999).

3 Bainbridge v. Bush, 148 F. Supp. 2d 1306 (M.D. Fla. 2001).

4 Heald v. Engler, 2001 U.S. Dist. LEXIS 24826 (E.D. Mich. 2001).

cated the plaintiffs' initial victory in Indiana.[5] The trade barriers held. Momentum shifted to the states. Wine industry support faltered, and rebel supplies ran low—one more defeat, and the revolution would be over.

That one additional defeat never happened. The rebels won the next eight decisions—in the district courts of Virginia,[6] North Carolina,[7] Texas,[8] and New York,[9] and in the courts of appeals for the Fourth,[10] Fifth,[11] Sixth,[12] and Eleventh[13] Circuits. State officials in Texas and North Carolina surrendered, but others fought on. Then, the Second Circuit surprisingly upheld New York's law to set up a split in the Circuits,[14] and the battleground shifted to the Supreme Court. Fighting in the Supreme Court is unlike any other kind of litigation. It is covered on the front pages of the *New York Times* and *Wall Street Journal*. It is fought behind the scenes at the highest levels of government. Alliances must be formed because you need all the friends you can get to support you with amicus briefs.[15] It is politics writ large. Luckily for the rebels, former Solicitor-General Kenneth Starr arrived in the nick of time, bringing with him his small band of Washington troops who were experienced in this kind of in-fighting.[16] The Federal Trade Commission (FTC) also supplied much-needed ammunition in the form of a strong, and judicially noticeable, report on the anti-competitive effects of state barriers to e-commerce in wine and the availability of non-discriminatory regulatory alternatives.[17] The forces converged on the Supreme Court, filing 26 briefs. Then, on May 16, 2005, the Court released its decision. The rebels had won a decisive and unequivocal victory for consumers and the free market. In a broad and sweeping decision, the Su-

5 Bridenbaugh v. Freeman-Wilson, 227 F.3d 848 (7th Cir. 2000). Ironically, this anti-free market opinion was written by J. Frank Easterbrook, who was one of the founding scholars of the law and economics movement.

6 Bolick v. Roberts, 199 F. Supp. 2d 401 (E.D. Va. 2002).

7 Beskind v. Easley, 197 F. Supp. 2d 464 (W.D.N.C. 2002).

8 Dickerson v. Bailey, 212 F. Supp. 2d 673 (S.D. Tex. 2002).

9 Swedenburg v. Kelly, 232 F. Supp. 2d 135 (S.D.N.Y. 2002).

10 Beskind v. Easley, 325 F.3d 506 (4th Cir. 2003).

11 Dickerson v. Bailey, 336 F.3d 388 (5th Cir. 2003).

12 Heald v. Engler, 342 F.3d 517 (6th Cir. 2003).

13 Bainbridge v. Turner, 311 F.3d 1104 (11th Cir. 2002).

14 Swedenburg v. Kelly, 358 F.3d 223 (2d Cir. 2004) (the court acknowledged that it was taking the disfavored position and setting up a split in the Circuits).

15 Perhaps the oddest allies in this case were the liquor dealers, evangelists, and high school principals who supported the states.

16 Kenneth Starr is now the Dean of the Pepperdine Law School. In 2004, he was in the Washington office of Kirkland & Ellis. His associates were Kannon Shanmugam (now a deputy Solicitor-General), Susan Kearns Engel, Steven Engel, and Jennifer Atkins.

17 Staff of the Federal Trade Commission, *Possible Anticompetitive Barriers to E-commerce: Wine* (July 2003), *available at* www.ftc.gov/os/2003/07/winereport2.pdf (last visited Aug. 21, 2007) [hereinafter *FTC Report*]. It is based on "testimony from all sides of the wine issue, including wineries, wholesalers, state regulators, and a Nobel laureate in economics." *Id.* at 2.

preme Court held that trade barriers banning direct shipment of wine ordered through e-commerce are unconstitutional.

Now what? The Supreme Court had knocked down trade barriers in Michigan and New York. Ohio,[18] Pennsylvania,[19] Massachusetts,[20] and Florida[21] surrendered. But, in New Jersey,[22] Indiana,[23] Kentucky,[24] Maryland,[25] Arkansas,[26] Arizona,[27] Maine,[28] and Delaware,[29] the fighting continued as lawmakers and their wholesaler allies scurried to shore up their defenses, adopted new strategies, and vowed to fight to the death against opening the wine market to e-commerce. After all, what state would want the terrible consequences of an open market—free trade, competition, increased product availability, lower prices, and a diminution in the power currently held by the cartel of oligopolist wholesalers?

This article will look at the history of wine regulation in the United States, and what difference *Granholm v. Heald* makes. Based on the continued resistance to open markets in a dozen states, it assumes that *Granholm* was not the end of the fight. Consequently, the article looks ahead and wonders where the next battles are likely to take place. It will conclude with thoughts about the continued stability of the underlying structure that led to the wine wars—the three-tier distribution system that gives so much power to the wholesalers.

II. BACKGROUND

A. *The Commerce Clause*

The Commerce Clause provides that "Congress shall have Power . . . to regulate Commerce . . . among the several States . . . ."[30] Although the Constitution says nothing about whether states have power to regulate interstate commerce simultaneously, the Supreme Court has always held that this provision grants exclusive power to Congress. The states may not in-

18 Stahl v. Taft, No. 2:03CV597, 2006 U.S. Dist. LEXIS 17014 (S.D. Ohio 2006).

19 Cutner v. Newman, 398 F. Supp. 2d 389 (E.D. Pa. 2005).

20 Stonington Vineyards v. Jenkins, No. 1:05CV10982 (D. Mass. 2005).

21 Bainbridge v. Bush, 148 F. Supp. 2d 1306 (M.D. Fla. 2001).

22 Freeman v. McGreevey, No. 2:03CV03140 (D.N.J. filed 2003).

23 Baude v. Heath, No. 1:05CV0735, 2005 U.S. Dist. LEXIS 43947 (S.D. Ind. 2005).

24 Huber Winery v. Wilcher, No. 3:05CV289, 2006 U.S. Dist. LEXIS 43947 (W.D. Ky. 2006).

25 Bushnell v. Ehrlich, No. 1:05CV03128 (D. Md., case dropped in 2006).

26 Beau v. Moore, No. 4:05CV903 (E.D. Ark. 2005, stayed Sept. 28, 2006).

27 Black Star Farms, LLC v. Morrison, No. 2:05CV02620 (D. Ariz. filed 2005).

28 Cherry Hill Vineyard v. Baldacci, No. 1:05CV153, 2006 U.S. Dist. LEXIS 51657 (D. Me. 2006).

29 Hurley v. Minner, No. 1:05CV00826, 2006 U.S. Dist. LEXIS 69090 (D. Del. 2006).

30 U.S. CONST. art. I, § 8.

terfere with it.[31] This is known as the "dormant" Commerce Clause principle, first articulated in *Gibbons v. Ogden*.[32] Simply put, states cannot discriminate against interstate commerce, provide economic protection to in-state businesses, erect tariffs or trade barriers to the products of other states, or otherwise impose significant burdens upon interstate commerce.

The reason is historically obvious. The Framers denied states the power to erect local trade barriers in "the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation."[33] The new country must be made a single economic unit. This was the "one object riding over every other in the adoption of the Constitution."[34] In an oft-quoted passage, the Court summarized this historical guiding principle as follows:

> Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his exports, and no foreign state will by customs duties or regulations exclude them. Likewise, every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any. Such was the vision of the Founders; such has been the doctrine of this Court which has given it reality.[35]

The Founders believed that, to succeed as a new nation, the "peoples of the several states must sink or swim" together as a single national economic unit.[36] This guiding philosophy has evolved into several specific jurisprudential principles relevant to state efforts to restrict buying wine over the Internet.

1. States may not discriminate against interstate commerce

The most obvious principle derived from the dormant Commerce Clause is that a state may not discriminate against the products of other states through regulations that give economic advantages to local products and producers. Such a system is the very essence of the tariff and trade barrier problem the Founders were trying to eliminate. Therefore, the Su-

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31 *See* Associated Indus. of Mo. v. Lohman, 511 U.S. 641, 646-47 (1994); S.C. Highway Dep't v. Barnwell Bros., Inc., 303 U.S. 177, 185 (1938) (Commerce Clause "by its own force" prohibits certain state actions that interfere with interstate commerce).

32 Gibbons v. Ogden, 22 U.S. 1, 231-32, 239 (1824).

33 Hughes v. Oklahoma, 441 U.S. 322, 325-26 (1979).

34 *Gibbons*, 22 U.S. at 231 (essential "to keep the commercial intercourse among the States free from all invidious and partial restraints"). *See also* West Lynn Creamery v. Healy, 512 U.S. 186, 193 n.9 (1994) (citing James Madison).

35 H.P. Hood & Sons, Inc. v. Du Mond, 336 U.S. 525, 539 (1949).

36 Baldwin v. G.A.F. Seelig, 294 U.S. 511, 523 (1935).

preme Court has repeatedly held that a state law that discriminates against interstate commerce "is virtually *per se* invalid,"[37] and "at a minimum . . . invokes the strictest scrutiny."[38] There are few constitutional issues on which the Court has been more consistent and united.[39]

In the context of commerce, discrimination simply means "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter,"[40] or otherwise places an out-of-state product or producer at a "substantial commercial disadvantage" compared to in-state products and producers.[41] Discrimination does not have to be intended, and the offending statute need not have been enacted in a deliberate attempt to give in-state interests a competitive advantage. Because the intent of the legislature is not relevant, "a court need not inquire into the purpose or motivation behind a law to determine that, in actuality, it impermissibly discriminates against interstate commerce."[42] Instead, discrimination is a question of the practical impact of a regulation on out-of-state businesses compared to in-state ones.[43] The Court focuses "on whether a challenged scheme is discriminatory in effect, . . . measured in dollars and cents, not legal abstractions."[44]

A regulation is discriminatory if it satisfies any of the following criteria:

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[37] *See* Or. Waste Sys. v. Dep't of Envtl. Quality, 511 U.S. 93, 100 (1994); C & A Carbone, Inc. v. Town of Clarkstown, 511 U.S. 383, 402 (1994) (O'Connor, J., concurring).

[38] New Energy Co. v. Limbach, 486 U.S. 269, 278-79 (1988).

[39] *See* S. Cent. Bell Tel. Co. v. Alabama, 526 U.S. 160 (1999) (discriminatory tax struck down); Fulton Corp. v. Faulkner, 516 U.S. 325 (1996) (discriminatory tax struck down); *West Lynn Creamery, Inc.*, 512 U.S. 186 (discriminatory milk pricing law struck down); *Or. Waste Sys., Inc.*, 511 U.S. 93 (discriminatory solid waste rule struck down); Kraft Gen. Foods, Inc. v. Ia. Dep't of Revenue & Fin., 505 U.S. 71 (1992) (discriminatory dividend rule struck down); Fort Gratiot Sanitary Landfill, Inc. v. Mich. Dep't of Natural Res., 504 U.S. 353 (1992) (discriminatory landfill law struck down); Chem. Waste Mgmt., Inc. v. Hunt, 504 U.S. 334 (1992) (discriminatory hazardous waste law struck down); New Energy Co. v. Limbach, 486 U.S. 269, 278 (1988) (discriminatory tax exemption struck down); Armco, Inc. v. Hardesty, 467 U.S. 638 (1984) (discriminatory tax struck down); Hughes v. Oklahoma, 441 U.S. 322 (1979) (discriminatory wildlife law struck down); City of Philadelphia v. New Jersey, 437 U.S. 617 (1978) (discriminatory trash shipment rule struck down).

[40] *Or. Waste Sys.*, 511 U.S. at 99.

[41] *New Energy Co.*, 486 U.S. at 275.

[42] Associated Indus. of Mo. v. Lohman, 511 U.S. 641, 653 (1994).

[43] *Chem. Waste Mgmt., Inc.*, 504 U.S. at 344 n.6; *Hughes*, 441 U.S. at 332; *C & A Carbone, Inc.*, 511 U.S. at 402 (O'Connor, J., concurring).

[44] *Associated Indus. of Mo.*, 511 U.S. at 654.

a. Products from other states are banned or totally excluded from the local market.[45]

b. The effect of the regulation is to impose higher costs on out-of-state products than local ones. The Supreme Court has called state laws that raise the price of out-of-state goods in relation to in-state goods "paradigmatic examples" of discrimination against interstate commerce.[46]

c. The regulation requires out-of-state products to be processed locally before being sold, distributed or allowed to have market access.[47]

d. The regulation serves no practical purpose other than "mere economic protectionism" of local interests.[48]

e. The law embargoes local products and prevents them from leaving the state.[49]

Discrimination is not justified simply because the regulation also serves legitimate local concerns. The Court has repeatedly struck down laws that, in the process of advancing state interests, discriminated against nonresidents.[50] The Court has held that a State can validate a discriminatory law only by showing that the law advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.

> [When] discrimination against commerce . . . is demonstrated, the burden falls on the State to justify it both in terms of the local benefits flowing from the statute and the unavailability of nondiscriminatory alternatives adequate to preserve the local interests at stake. . . . [F]acial discrimination by itself may be a fatal defect, regardless of the State's purpose, because "the evil of protectionism can reside in legislative means as well as legislative ends." At a mini-

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45 City of Philadelphia v. New Jersey, 437 U.S. 617 (1978).

46 West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 193 (1994). *Accord* Or. Waste Sys., Inc., v. Dep't of Envtl. Quality, 511 U.S. 93 (1994).

47 *C & A Carbone, Inc.*, 511 U.S. at 383.

48 Bacchus Imps. v. Dias, 468 U.S. 263, 276 (1984).

49 Hughes v. Oklahoma, 441 U.S. 322, 337 (1979).

50 H.P. Hood & Sons, Inc. v. Du Mond, 336 U.S. 525 (1949) (New York cannot exclude Vermont dairy products even in the name of protecting public health); *Hughes*, 441 U.S. at 337 (Oklahoma cannot embargo its minnows even in the name of protecting a scarce resource); Hunt v. Wash. State Apple Adver. Comm'n, 432 U.S. 333, 351 (1977) (North Carolina cannot restrict advertising for Washington apples even to prevent consumer confusion); *City of Philadelphia*, 437 U.S. 617 (1978) (New Jersey cannot exclude Pennsylvania garbage to conserve diminishing landfill space); Chem. Waste Mgmt., Inc. v. Hunt, 504 U.S. 334 (1992) (Alabama cannot exclude hazardous wastes from other states in the name of public safety).

> mum such facial discrimination invokes the strictest scrutiny of any purported legitimate local purpose and of the absence of nondiscriminatory alternatives.[51]

The burden is upon the state to show not just that regulation is justified, but that "the *discrimination* is demonstrably justified."[52] Understandably, the "standards for such justification are high."[53] The state must make "the clearest showing" that there is no nondiscriminatory alternative,[54] and its justification must "pass the 'strictest scrutiny.'"[55]

The Supreme Court has only rarely found that a state has met its burden of proving the need to discriminate against interstate commerce, and then only upon an extensive factual record clearly demonstrating the absence of workable alternatives. In *Maine v. Taylor*,[56] the Court upheld a ban on out-of-state baitfish based on expert testimony that imported baitfish could introduce non-native parasites that could harm Maine fish and that there was no known way to prevent it other than a total ban. In *Sporhase v. Nebraska ex rel. Douglas*,[57] the Court upheld an embargo against exporting ground water to other states based on evidence that there was only enough water for the state's own citizens because of a drought.

2. States may not engage in economic protectionism

The second principle derived from the dormant Commerce Clause is closely related to the first—States may not engage in economic protectionism.[58] They may not protect local industry by erecting barriers to interstate competition,[59] nor may they pass laws designed to make sure their own citizens are not at a disadvantage compared to consumers in other states.[60] Although the Court occasionally uses economic protectionism and discrimination interchangeably, the two concepts are slightly different. For example, a law requiring automobile manufacturers to offer the same rebates in Indiana as they offer in Illinois, Ohio, and Kentucky does not discriminate against interstate commerce, but it does protect the interests of local car dealers who might otherwise lose customers to big-volume dealers just across the border in Chicago, Louisville, and Cincinnati. Also, a law that disadvantages an out-of-state business for the benefit of an in-state

51 *Hughes*, 441 U.S. at 336-37 (citations omitted).
52 *Chem. Waste Mgmt., Inc.*, 504 U.S. at 344 (emphasis in original).
53 New Energy Co. v. Limbach, 486 U.S. 269, 278 (1988).
54 C & A Carbone, Inc. v. Town of Clarkstown, 511 U.S. 383, 393 (1994).
55 Or. Waste Sys. v. Dep't of Envtl. Quality, 511 U.S. 93, 101 (1994).
56 Maine v. Taylor, 477 U.S. 131, 140-43 (1986).
57 Sporhase v. Nebraska ex rel. Douglas, 458 U.S. 941, 956-57 (1982).
58 City of Philadelphia v. New Jersey, 437 U.S. 617, 623-24 (1978).
59 Bacchus Imps. v. Dias, 468 U.S. 263, 276 (1984).
60 Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth., 476 U.S. 573, 580 (1986).

business of a different type (e.g., out-of-state wineries vs. in-state wholesalers) is not discriminatory, because the two businesses are not similarly situated, but it is still protectionist.

3. States may not directly regulate interstate commerce

The third principle derived from the dormant Commerce Clause is that a state's power to regulate commercial transactions stops at the state's borders. No state may directly regulate interstate commerce or commerce taking place in other states. Any such extraterritorial effect makes a state regulation virtually per se invalid.

> [O]ur cases concerning the extraterritorial effect of state economic regulations stand at a minimum for the following propositions: First, the "Commerce Clause . . . precludes the application of a State statute to commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the state . . . ." Second, a statute that directly controls commerce occurring wholly outside the boundaries of a State exceeds the inherent limits of the enacting State's authority and is invalid regardless of whether the statute's extraterritorial effect was intended by the legislature. The critical inquiry is whether the practical effect of the regulation is to control conduct beyond the boundaries of the State.[61]

Under this principle, the Court has invalidated a state law on minimum liquor pricing that had the practical effect of regulating the price at which manufacturers could sell liquor in other states,[62] a state law regulating takeovers of companies doing business in Illinois that would have affected some transactions occurring outside the state,[63] and a state milk-price statute that effectively regulated milk prices in neighboring states.[64] The extraterritorial principle is an outgrowth of the nineteenth century doctrine that states lacked constitutional authority to regulate acts of interstate commerce, that is, actual shipments of goods in their original packages moving between states.[65]

4. States may not unnecessarily burden interstate commerce

The fourth principle derived from the dormant Commerce Clause is that no state may impose significant economic burdens on interstate commerce that exceed the local benefits of regulation. When the state exercises its police powers to protect public health or its taxing power, e.g., by ban-

61 Healy v. Beer Inst., 491 U.S. 324, 336 (1989).

62 *Brown-Forman Distillers Corp.*, 476 U.S. at 579-80.

63 Edgar v. MITE Corp., 457 U.S. 624, 643-46 (1982).

64 Baldwin v. G.A.F. Seelig, 294 U.S. 511, 528 (1935).

65 Bowman v. Chi. & Nw. Ry., 125 U.S. 465, 496-97 (1888); Vance v. W.A. Vandercook Co., 170 U.S. 438, 444-45 (1898).

ning smoking in public places or imposing high taxes on cigarettes, that regulation will often serve both a legitimate state interest and have a negative impact on interstate commerce. Fewer cigarettes will be sold if smoking is banned or the price is raised, harming commerce in tobacco. The Court recognizes that "incidental burdens on interstate commerce may be unavoidable when a State legislates to safeguard the health and safety of its people."[66] If those burdens are significant, however, they may violate the Commerce Clause even if nondiscriminatory.

> When, however, a statute has only indirect effects on interstate commerce and regulates evenhandedly, we have examined whether the State's interest is legitimate and whether the burden on interstate commerce clearly exceeds the local benefits. We have also recognized that there is no clear line separating the category of state regulation that is virtually per se invalid under the Commerce Clause, and the category subject to the *Pike v. Bruce Church*[67] balancing approach. In either situation the critical consideration is the overall effect of the statute on both local and interstate activity.[68]

B. *Commerce in Alcoholic Beverages*

1. Free Trade in the Nineteenth Century

Throughout most of the nineteenth century, alcoholic beverages were treated as ordinary commercial products, and the normal principles of dormant Commerce Clause jurisprudence applied. In 1886, the Supreme Court in *Walling v. Michigan*[69] struck down a state law that imposed a tax on nonresidents engaged in the business of selling liquor to be shipped into Michigan, but not on persons whose principle place of business was within the state. The Court stated that "If this is not a discriminating tax . . . it is difficult to conceive of a tax that would be discriminating,"[70] declared the tax unconstitutional, and rejected the argument that the tax should be treated differently because its purpose was to discourage the use of intoxicating liquors.[71] It relied for its holding primarily on a non-liquor case, *Welton v. Missouri*,[72] involving a tax on traveling peddlers, and there is no suggestion that the Court thought of sewing machines any differently than bottles of wine. The taxes were "restraints" that usurped the power of Congress to be the sole regulator of commerce among the states.

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66 City of Philadelphia v. New Jersey, 437 U.S. 617, 623-24 (1978).

67 Pike v. Bruce Church, 397 U.S. 137, 142 (1970).

68 Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth., 476 U.S. 573, 578-79 (1986).

69 Walling v. Michigan, 116 U.S. 446, 460 (1886).

70 *Id.* at 454.

71 *Id.* at 459-60.

72 Welton v. Missouri, 91 U.S. 275 (1876).

> We have so often held that the power given to Congress to regulate commerce . . . is exclusive in all matters . . . especially as regards any impediment or restriction upon such commerce, that we deem it necessary merely to refer to our previous decisions on the subject, the most important of which are collected in *Brown v. Houston*, 114 U.S. 622, 631, and need not be cited here. We have also repeatedly held that so long as Congress does not pass any law to regulate commerce among the several States, it thereby indicates its will that such commerce shall be free and untrammeled; and that any regulation of the subject by the States, except in matters of local concern only, is repugnant to such freedom.[73]

States could restrict the manufacture and sale of alcohol within their own borders as part of their police power, as long as such regulations did not affect interstate commerce.[74]

With the rise of the temperance movement, this distinction between local regulation and interstate commerce became a problem. The few states that wanted to restrict liquor were surrounded by states where it was plentiful. As soon as a state passed a dry law, its citizens simply ordered their liquor from wet states. If the dry states passed laws prohibiting their citizens from ordering alcohol from wet states, the Supreme Court simply struck them down as restraints upon interstate commerce. In *Bowman v. Chi. & Nw. Ry.*,[75] the Court held that it was beyond the power of states to restrict or prohibit the importation of liquor from one state into another. The Court acknowledged that states could not effectively enforce their own dry laws unless they could also prohibit imported liquor, but it held that the Constitution simply did not give states the right to do so.[76] The Court extended this rule to liquor imported for *commercial use* (re-sale) in *Leisy v. Hardin*.[77] In the Court's view, a transaction was either part of interstate commerce or a matter of local concern only; it could not be both.[78] Once it acquired the status of interstate commerce, a package of liquor did not lose that character until it was opened and mingled with the general property of a state. As long as it remained in its original package, liquor was therefore immune from state regulation until sold.[79]

2. The Wilson Act and its interpretation: 1891-1912

The practical result of *Bowman* and *Leisy* was that states could not effectively enforce their dry laws. Anyone could circumvent them by importing liquor through interstate commerce. To close this loophole, Congress

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73 *Walling*, 116 U.S. at 455.

74 Thurlow v. Massachusetts, 46 U.S. 504, 577 (1847); Mugler v. Kansas, 123 U.S. 623, 661-63 (1887).

75 Bowman v. Chi. & Nw. Ry., 125 U.S. 465, 499-500 (1888).

76 *Id.* at 500.

77 Leisy v. Hardin, 135 U.S. 100 (1890).

78 *See* Wilkerson v. Rahrer, 140 U.S. 545, 555 (1891).

79 *Leisy*, 135 U.S. at 108-10, 119, 124.

enacted the Wilson Act, which authorized states to regulate imported alcohol "to the same extent and in the same manner" as local alcohol.[80] The Wilson Act provided:

> [All] intoxicating liquors . . . transported into any State or Territory . . . shall upon arrival in such State or Territory be subject to the operation and effect of the laws of such State or Territory enacted in the exercise of its police powers, to the same extent and in the same manner as though such . . . liquors had been produced in such State or Territory, and shall not be exempt therefrom by reason of being introduced therein in original packages or otherwise.

The Wilson Act had a narrow focus. It was intended merely to overturn *Bowman* and *Leisy* and close the loophole that allowed residents of dry states to evade local prohibition by importing their liquor from wet states. It did not change the basic principle that the dormant Commerce Clause applied to alcoholic beverages.[81]

The Wilson Act did not accomplish its purpose, however, because the Supreme Court construed it narrowly as empowering States to regulate only the *resale* of imported alcohol in its original package, not the direct *shipment* of alcohol to consumers. In *Rhodes v. Iowa*,[82] the Supreme Court revisited the same Iowa law that was struck down in *Bowman*. It construed the words "upon arrival" in the Wilson Act to mean that state law could attach to an interstate shipment of liquor only after delivery, and not before. Therefore, Iowa could not impose its own regulations until the recipient attempted to re-sell the liquor. Even after crossing state lines, a shipment of liquor was still interstate commerce, and retained its character as interstate commerce until delivery was completed. The importation, transportation and receipt of a package were all core aspects of interstate commerce and could not be regulated by the states without a clear statement from Congress that it intended to remove the immunity of interstate commerce from transportation and importation as well as from resale in the original package.[83]

The *Bowman/Leisy* loophole remained largely intact. Although a dry state could prohibit the resale of imported liquor after it was delivered, the state was still powerless to stop its citizens from personally evading dry

80 26 STAT. 313, ch. 728 (1890), now codified at 27 U.S.C. § 121.

81 *See* Scott v. Donald, 165 U.S. 58, 100-01 (1897) ("the state cannot, under the [Wilson Act], establish a system which . . . discriminates between interstate and domestic commerce" in liquor and creates preferences for domestic products); Vance v. W.A. Vandercook Co., 170 U.S. 438, 455-57 (1898) (Wilson Act does not authorize states to burden interstate commerce in liquor through extensive and inconvenient regulations); Adams Express Co. v. Kentucky, 214 U.S. 218 (1909) (regulations barring delivery of alcohol to inebriate could not be enforced against interstate shipper).

82 Rhodes v. Iowa, 170 U.S. 412 (1898).

83 *Id.* at 423-24. *See also* Louisville & Nashville R.R. Co. v. F. W. Cook Brewing Co., 223 U.S. 70 (1912) (regulations barring transportation of alcohol into dry county could not be enforced against an interstate shipper).

laws by mail-ordering liquor. As the number of dry states grew, the wholesale evasion of those dry laws grew to an estimated 20,000,000 gallons of liquor per year shipped through interstate commerce.[84]

3. The Webb-Kenyon Act of 1913

The political pressure from the dry states and the temperance movement to close the *Bowman/Leisy/Rhodes* loophole was intense, and Congress went back to the drawing board to try again. They came up with the Webb-Kenyon Act,[85] which provided:

> That the shipment or transportation . . . of any spirituous . . . or other intoxicating liquor of any kind, from one State . . . into any other State . . . which . . . is intended, by any person interested therein, to be received, possessed, sold, or in any manner used, either in the original package or otherwise, in violation of any law of such State . . . is hereby prohibited.

The Webb-Kenyon Act, like the Wilson Act before it, had a narrow focus. It was intended to overturn *Bowman, Leisy*, and *Rhodes*. The names of those cases came up repeatedly during Congressional debates.[86] Congressman Webb explained that the bill was intended to address the problem that, "under the present law and decisions, no State can interfere with the interstate shipment of liquor until it has been actually delivered to the consignee [and] no State official is permitted to touch any interstate shipment of liquor [even if] consigned to a 'blind tiger,'[87] 'bootlegger,' or 'speak-easy.'"[88] Senator Kenyon likewise explained that the bill was intended simply to remove the immunity afforded to interstate transportation of liquor under the Commerce Clause, and to allow dry States to prevent their citizens from evading local prohibition.

> I am not concerned at all with the question of whether a State in the exercise of its police power might adopt a law prohibiting the manufacture or sale of intoxicating liquors. If it does do so, it ought to be able to make that law effective. . . . If intoxicating liquors can be freely shipped into a State which has a prohibitory law and the State government is powerless to prevent it . . . then, indeed, it is time for some further amendment to our Constitution.[89]

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84 49 CONG. REC. 699-700 (1912) (statements of Sen. Sanders).

85 37 STAT. 699, codified as 27 U.S.C. § 122 (2006).

86 *See* 49 CONG. REC. at 764-67; 49 CONG. REC. 2529, 2689-90, 2794-96, 2807, 2817, 2834, 2909-10 (1913).

87 A blind tiger was a restaurant that sold illegal liquor. The name supposedly derives from the practice of placing a stuffed tiger in the window or on the tables to alert patrons that bootleg booze was available in the back room. *See* SINCLAIR LEWIS, ELMER GANTRY *passim* (1927).

88 H.R. REP. NO. 62-1461, at 2.

89 49 CONG. REC. 761 (1912).

No one at the time understood Webb-Kenyon to delegate power to states to discriminate against, burden, or regulate interstate commerce, because such delegation was thought to be beyond the power of Congress. At the time of Webb-Kenyon, the understanding was that state regulation of alcohol under the police power and federal regulation under the commerce power were mutually exclusive. Each had absolute authority within its own sphere. Congress could not constitutionally delegate authority to states to regulate interstate commerce.[90] Instead, Congress exercised its own authority over commerce to prohibit shipments of alcohol from wet to dry states, depriving them of their character as interstate commerce. That way, states could regulate such shipments as soon as they crossed the border under their police powers.[91] The limited purpose of the Webb-Kenyon Act is clear from its title: "An Act divesting intoxicating liquors of their interstate character *in certain cases*"—namely those covered by *Bowman, Leisy* and *Rhodes*, where alcohol was being shipped into a dry state.[92]

Nor did anyone at the time suggest that the Webb-Kenyon Act would change the *Walling v. Michigan* rule that wet states could not discriminate against interstate commerce in liquor.[93] No one suggested that it changed the rule in *Vance v. W.A. Vandercook Co.*[94] and *Adams Express Co. v. Kentucky,*[95] that wet states in which liquor was legal could not burden or regulate interstate commerce in liquor. In the debates in Congress, in which *Bowman* and *Rhodes* were repeatedly mentioned, these other lines of cases are not mentioned at all. Indeed, when Senator Root expressed concern over the scope of the Act,[96] he was assured by his colleagues that the bill was a narrow one that merely allowed dry states to prohibit imports upon

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90 49 CONG. REC. 767 (1912) (statements of Sen. Kenyon); *id.* at 2912 (statements of Sen. Thornton).

91 *Id.* at 2912-13 (statements of Sen. Kenyon); *id.* at 2917 (statements of Sen. Stone).

92 37 STAT. 699, ch. 90 (1913) (emphasis added).

93 Indeed, there were few such laws. Webb-Kenyon was passed in 1913, at the height of the temperance movement. Several states had adopted state-wide prohibition. *E.g.*, GA. CODE ANN. § 1770nn (1907); N.C. REV. LAWS § 2058 (Pell 1908). Most other state liquor codes focused on local option laws that gave communities the power to ban the sale and use of alcohol. *E.g.*, MASS. REV. LAWS ch. 100, §§ 13, 48 (1902); N.M. STAT. ANN. §§ 2927 et seq. (1915); ANN. CONSOL. LAWS OF N.Y., §§ 13, 23 (1917); GEN. CODE OHIO §§ 6097, 6108 et seq. (1910); S.D. REV. CODE § 2856 (1903); PIERCE'S WASH. CODE § 5713 (1905). A few laws prohibited shipments into dry areas by anyone, but neither discriminated against out-of-state sellers nor imposed burdensome regulations on them. *E.g.*, KY. STAT. §§ 2554, 2557a, 2569a (Carroll 1915); ANN. CONSOL. LAWS OF N.Y., §§ 13, 23 (1917). The remaining state liquor laws were classic police power regulations, aimed at moral issues that did not implicate interstate commerce, e.g., banning sales to minors and habitual drunkards, MO. STAT. ANN. § 3017, outlawing sales to Indians, e.g., ANN. CONSOL. LAWS OF N.Y. § 29 (1917); and prohibiting such unseemly activities as women playing banjos in saloons. N.M. STAT. ANN. § 2906 (1915).

94 Vance v. W.A. Vandercook Co., 170 U.S. 438 (1898).

95 Adams Express Co. v. Kentucky, 214 U.S. 218 (1909).

96 49 CONG. REC. 2915 (1913).

the same terms as they prohibit domestic sales.[97] The bill would only "remove the restrictions which now bind the action of the States in their efforts to honestly enforce their lawful prohibition enactments,"[98] by "imposing the condition that the goods shall be so subjected to the laws of a State [but] not in any sense whatever delegating authority to the State to control by its legislation interstate commerce."[99]

There were few opportunities for the courts to interpret Webb-Kenyon in the six years from when it was enacted to when it was mooted by Prohibition. The few cases that were decided adhered to the view that the Act merely gave states power to ban direct shipments of alcohol into dry areas, overturning *Bowman* and finally closing the loophole that had allowed citizens in dry states to evade local prohibition laws through interstate commerce. The Act had no application beyond that.[100] The Supreme Court held that it did not give states power to prohibit shipments into counties where possession and use of alcohol was legal,[101] and did not change the general rule that the States may not regulate commerce wholly interstate.

> It would be difficult to frame language more plainly indicating the purpose of Congress . . . . Such shipments are prohibited only when . . . they shall be possessed, sold or used in violation of any law of the State wherein they are received. Thus far *and no farther* has Congress seen fit to extend the prohibitions of the Act in relation to interstate shipments.[102]

4. Prohibition

In 1919, the Eighteenth Amendment was ratified, and the "Noble Experiment"[103] of nationwide Prohibition began. Section 1 provided:

> After one year from the ratification of this article the manufacture, sale, or transportation of intoxicating liquors within, the importation thereof into, or the exportation thereof from the United States and all territory subject to the jurisdiction thereof for beverage purposes is hereby prohibited.

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97 *Id.* at 2916 (statements of Sen. Stone).

98 *Id.* at 2807 (statements of Rep. Webb).

99 *Id.* at 702 (statements of Sen. McCumber).

100 James Clark Distilling Co. v. W. Md. Ry. Co., 242 U.S. 311, 322 (1917) (Act's "only purpose was to give effect to state prohibition" laws). *See also* Brennen v. S. Express Co., 90 S.E. 402 (S.C. 1916) (Act does not apply unless there is a state law prohibiting receipt, possession, sale, or use of liquor); McCormick & Co. v. Brown, 286 U.S. 131, 142 (1932) (Act "referred to the prohibitory laws of the States, the enforcement of which it was intended to aid").

101 Seaboard Air Line Ry. v. North Carolina, 245 U.S. 298, 303 (1917).

102 Adams Express Co. v. Kentucky, 238 U.S. 190, 199 (1915) (emphasis added).

103 The phrase is generally attributed to Herbert Hoover. *See* OXFORD DICTIONARY OF MODERN QUOTATIONS 104 (1991) (1928 letter to Sen. Borah).

The Amendment had three big loopholes. First, it did not prohibit possession or consumption of liquor. Second, it gave everyone wealthy enough to do so (such as the Senators themselves) one year to stock their personal wine cellars so they could take advantage of the first loophole. Third, it was limited to sale "for beverage purposes," and did not prohibit selling alcohol for medicinal purposes, so that even those who could not afford to stock their cellars under the second loophole could at least get a prescription for whiskey to calm their nerves and help ward off the flu.

Section 2 provided:

> The Congress and the several states shall have concurrent power to enforce this Article by appropriate legislation.

This simple provision altered the Constitution in a significant way. For the first time, it gave Congress police power. The traditional wall of separation between state police power and federal commerce power had been breached.

C. *The Twenty-First Amendment and the Repeal of Prohibition*

Prohibition was, of course, a national disaster. The idea was absurd from the beginning, and it was so widely ignored, evaded, and corrupted, and ran so contrary to basic American notions of individual liberty, that it delegitimized the entire U.S. legal system.

> [The] Eighteenth Amendment . . . is the first provision ever written into the Constitution which affects directly the life and habits of the people. . . . [T]housands of people who never drank before started immediately to drink as a protest against this infringement of their personal liberty.[104]

Prohibition survived barely 13 years. Congress drafted the Twenty-First Amendment to repeal it in 1933, and it was ratified by state conventions later that same year.[105]

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[104] RATIFICATION OF THE TWENTY-FIRST AMENDMENT TO THE CONSTITUTION OF THE UNITED STATES: STATE CONVENTION RECORDS AND LAWS 191 (Everett S. Brown ed., 1938) [hereinafter RATIFICATION OF THE TWENTY-FIRST AMENDMENT] (statement of Mr. Darnall, President of Maryland Convention). *See also* 76 CONG. REC. 4514 (1933) (Rep. LaGuardia arguing for repeal "because of the widespread violation of the law by the criminal element [and the] universal disregard of the law by well-meaning, law-abiding people.").

[105] Article V of the Constitution provides that Amendments may be ratified either by 3/4 of the state legislatures, or by conventions in 3/4 of the states. Although repeal had wide popular support, the drafters feared the state legislatures were too easily captured by the temperance movement and would be reluctant to vote for repeal once it was cast as a moral issue, so they took the unusual step of writing into

Section 1 of the Twenty-First Amendment repealed the Eighteenth, and national prohibition ended. But, what about state prohibition? Several states wished to remain dry, as they had been before Prohibition, and they feared a return to the *Bowman/Leisy/Rhodes* doctrine under which they would be powerless to prevent their citizens from evading local dry laws through interstate commerce.[106] Merely re-enacting the Webb-Kenyon Act might not be adequate because it could be repealed by Congress or held unconstitutional by the Supreme Court. Senator Borah reminded his colleagues that the constitutionality of Webb-Kenyon had initially been sustained only by a divided Court, its continued constitutionality was in doubt, and the Congress could not be counted on to maintain it indefinitely.[107]

So, Congress added section 2 to the Amendment to write Webb-Kenyon into the Constitution permanently.[108] It provides:

> The transportation or importation into any State . . . for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited.

This language is virtually identical to the Webb-Kenyon Act, 27 U.S.C. § 122:

> The shipment or transportation . . . of any . . . intoxicating liquor . . . from one State . . . into any other State . . . to be received, possessed, sold, or in any manner used . . . in violation of any law of such State . . . is hereby prohibited.

The legislative history shows without doubt that the purpose of Section 2 was the same as Webb-Kenyon—"to assure the so-called dry States against the importation of intoxicating liquor into those States."[109] Senator Blaine reiterated this point many times during his introduction of the Amendment, stating that "[t]he Committee felt . . . that we could well afford to guarantee to the so-called dry States the protection designed by Section two," and "I am willing to grant to the dry States full measure of pro-

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the Twenty-First Amendment the requirement that it be ratified by state conventions. U.S. CONST. amend. XXI, § 3. It is the only Amendment to ever have been ratified in this manner.

106 *See* 76 CONG. REC. 4170-71 (1933) (Senator Borah argued that after repeal, the dry states would need to be able to fend off attempts to evade their prohibition laws by illegally importing alcohol as had been allowed under the Bowman/Rhodes line of cases); *id.* at 4171 (Senator Wagner argued that the Amendment should give "the dry States . . . assurance that they will be protected" from decisions like Bowman).

107 76 CONG. REC. 4170.

108 76 CONG. REC. 4141 (1933) (statement of Sen. Blaine on behalf of drafting committee); Craig v. Boren, 429 U.S. 190, 205-06 (1976).

109 76 CONG. REC. at 4141 (statement of Sen. Blaine on behalf of drafting committee). *See also* Duncan Baird Douglass, *Constitutional Crossroads: Reconciling the Twenty-First Amendment and the Commerce Clause to Evaluate State Regulation of Interstate Commerce in Alcoholic Beverages*, 49 DUKE L.J. 1619, 1631-36 (2000) (reviewing historical reasons for enactment of Section 2).

tection, and thus prohibit the wet States from interfering in their internal affairs respecting the control of intoxicating liquors."[110] The House sponsor, Rep. Robinson, repeated the same message, stating that "Section 2 attempts to protect dry States."[111] Every other House member to speak on Section 2 specifically agreed that its purpose was to aid and protect dry states in permitting them, if they wish, to exclude all liquor traffic in their domain.[112]

Congress also made it clear that the Amendment had *nothing to do with interstate commerce among wet states.* Senator Glass, who wrote Section 2, explained its limitation:

> Liquors may be shipped across a State in interstate commerce from one wet State to another wet State, but [Section 2] as I have drafted it prohibits the shipment of intoxicating liquors into a State whose laws prohibit the manufacture, sale, or transportation of liquors.[113]

In the state ratifying conventions, the delegates consistently delivered the same message: Prohibition had been a societal and legal disaster. Socially, it had trampled on individual liberties, done nothing to advance temperance, led to rampant crime, and caused widespread disrespect for authority. Legally, it had upset the natural order of things by violating the sacred principle that only the states, not the federal government, could exercise the police power. The delegates called for a return of the police power to the states so that they could regulate alcohol in ways that promoted temperance realistically without infringing individual liberty.

The core concern of the state delegates was temperance. It is mentioned in 17 of the 19 recorded debates[114] and by almost every speaker. For example, Gov. Cross of Connecticut said the Amendment would "promote temperance."[115] Mr. Marshall of Indiana said that "prohibition did not bring temperance," but its repeal would.[116] Gov. Ritchie of Maryland said repeal was a "victory in the interest of temperance in the true sense."[117] Mr. Butler of New York said, "With repeal, the movement for true temperance will be resumed."[118] Gov. Comstock of Michigan said, "We want a regulated traffic in liquor, one that makes for temperance and not for license."[119] Similar

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110 76 CONG. REC. at 4141.

111 *Id.* at 4518.

112 *Id.* at 4523 (Rep. McSwain); *id,* at 4526 (Rep. Tierny); *id.* at 4159 (Rep. Garber).

113 *Id.* at 4219.

114 Only nineteen of thirty-eight states kept records of their debates, which are collected in RATIFICATION OF THE TWENTY-FIRST AMENDMENT, *supra* note 104.

115 *Id.* at 62.

116 *Id.* at 142.

117 *Id.* at 194.

118 *Id.* at 304.

119 *Id.* at 229.

sentiments were expressed by delegates in Idaho,[120] Missouri,[121] Colorado,[122] Florida,[123] Iowa,[124] Kentucky,[125] New Jersey,[126] Utah,[127] Virginia,[128] and Washington.[129] In New York, the convention ended with Rev. Quinn calling on God to "direct our people to the true idea of temperance and sobriety."[130] Interestingly, some delegates thought that the promotion of low-alcohol drinks like beer and wine in lieu of hard liquor was the key to temperance.[131]

Delegates also expressed concern that the Eighteenth Amendment had given police power to the federal government. This violated the natural constitutional order in which states had exclusive police power. The wisdom of this natural order had been confirmed by the total ineptitude of the federal government's attempts to stop bootlegging during Prohibition. To many delegates, this was the more important issue,[132] and it found expression in 13 of the 19 recorded conventions. Mr. Montgomery of Pennsylvania said that "the Constitution of the United States was most wise in reserving to the several states the police power and in delegating or granting no police power to the Federal Government," and that the Twenty-First Amendment would restore this traditional balance.[133] Mr. Wadsworth of New York said that prohibition had "invited the states to surrender a very important part of their police power."[134] Mr. Riter of Utah said that prohibition "transferred from the states to the federal government police power in regard to control and prohibition of personal conduct of citizens."[135] Similar remarks were made by delegates in Illinois,[136] New Jersey,[137] Iowa,[138]

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120 RATIFICATION OF THE TWENTY-FIRST AMENDMENT, *supra* note 104, at 100 (expressing the need to adopt policy "which will promote true temperance").

121 *Id.* at 249 ("I take it that all of you believe in temperance.").

122 *Id.* at 41 (declaring that "we must work for a new form of temperance").

123 *Id.* at 70 (stating that "we are fighting the battles of temperance").

124 *Id.* at 153 (defining the vote as "for temperance as opposed to prohibition").

125 *Id.* at 166 ("We shall have before us the duty [to] teach . . . temperance.").

126 RATIFICATION OF THE TWENTY-FIRST AMENDMENT, *supra* note 104, at 281 ("promoting temperance").

127 *Id.* at 401 (declaring the need to "find new ways for encouraging temperance").

128 *Id.* at 439 (noting that "prohibition retarded rather than promoted temperance").

129 *Id.* at 457 (recommending to "re-establish the broad teachings of temperance").

130 *Id.* at 319.

131 *Id.* at 281, 299.

132 *See* 76 CONG. REC. 4144 (1933) (statements of Sen. Wagner) ("The question which has troubled the American people since the eighteenth amendment was added to the Constitution was not at all concerned with liquor. It was a question of government; how to restore the constitutional balance of power and authority in our Federal system which had been upset by national prohibition.").

133 RATIFICATION OF THE TWENTY-FIRST AMENDMENT, *supra* note 104, at 355.

134 *Id.* at 305.

135 *Id.* at 411.

136 *Id.* at 112.

137 *Id.* at 282.

Kentucky,[139] Michigan,[140] New York,[141] and Virginia,[142] and by members of Congress.[143]

Section 2 was not seen as creating a new order. The states wanted the *old* order restored, in which they had exclusive police power and the federal government had exclusive power over interstate commerce. Mr. Byrnes of Missouri said, "You are here to *restore* to its original purity, that sacred civil document, the Constitution of these United States."[144] Mr. Thatcher of New York, referring to the allocation of police power exclusively to the states, said, "[T]here are certain cardinal principles in the Constitution of the United States that must not be violated, and with that realization, may there be a final end to all experiments involving that great document."[145] Mrs. Gaylord of Missouri called for "*the return* to each state of its former right to regulate and control the manufacture, sale and transportation of intoxicating beverages within its own borders."[146] Mr. Robinson of Connecticut said the Twenty-First Amendment would "*return* to the people of the several states . . . their constitutional right to govern themselves in their internal affairs."[147] Mrs. Todd of Kentucky said that the "very essence of Repeal is that the people of the States shall *again* be allowed to legislate for themselves in matters concerning control and regulation of alcoholic beverages."[148]

State delegates pledged to exercise their reclaimed police power over alcohol in ways that would promote temperance without unduly infringing individual rights. Mr. Goolrick of Virginia said that the "failure of prohibition . . . may be found in the fact that it was . . . restrictive of the individual rights and privileges of the people."[149] To avoid making the same mistake, Mr. Goolrick recommended that the new system should be "liberal but at the same time . . . tend to promote temperance."[150] Mr. Haldeman of Kentucky proclaimed that the new system would restore "the personal liberty of

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138 *Id.* at 160.

139 RATIFICATION OF THE TWENTY-FIRST AMENDMENT, *supra* note 104, at 169.

140 *Id.* at 228.

141 *Id.* at 293-94, 306.

142 *Id.* at 439.

143 *See* the Congressional debates over a proposed section three to the Twenty-First Amendment which would have given Congress concurrent police power to regulate alcohol, but the idea was roundly criticized. 76 CONG. REC. 4144, 4143-46 (1933) (statements of Sens. Blaine, Walsh and Wagner); *id.* at 4155 (statements of Sens. Walsh and Brookhart); *id.* at 4161-62 (statements of Sens. Brookhart and Norris); *id.* at 4173 (statements of Sens. Borah and Black).

144 RATIFICATION OF THE TWENTY-FIRST AMENDMENT, *supra* note 104, at 260 (emphasis added).

145 *Id.* at 293-94.

146 *Id.* at 247 (emphasis added).

147 *Id.* at 50 (emphasis added).

148 *Id.* at 172 (emphasis added).

149 *Id.* at 439.

150 RATIFICATION OF THE TWENTY-FIRST AMENDMENT, *supra* note 104, at 439-40.

the American citizen."[151] Gov. Ritchie of Maryland pledged that now "the safeguards of the liberties of the American people were going to be preserved and maintained."[152] Gov. Comstock of Michigan said that "we have decided to go back and try personal liberty once more, the personal liberty we had before Prohibition."[153] Given this history, it is ironic that modern state officials are arguing that this Amendment justifies their efforts to restrict individual liberty in a way that does not promote temperance.

D. *Commerce in Alcoholic Beverages After the Twenty-First Amendment*

Interpreting and applying Section 2 of the Twenty-First Amendment to state regulation of commerce in liquor turned out to be harder than its legislative history would suggest. Section 2 says that:

- The transportation or importation of intoxicating liquors into any State
- for delivery or use therein
- in violation of the laws thereof
- is hereby prohibited.

In historical context, the meaning is clear—the transportation or importation of liquor from a wet state into a dry state is prohibited. But the courts have not always approached the interpretation of this Amendment from a historical perspective. If one looks just at the text, three problems of interpretation arise.

First, does the power to "prohibit" transportation and importation include the lesser power to "allow but heavily regulate" transportation and importation?[154]

Second, what phrase does "in violation of the laws thereof" modify? If it modifies the words "delivery or use therein," then the Twenty-First Amendment authorizes a state to prohibit importation only in the narrow circumstances that the importation would violate laws relating to the *delivery or use* of alcohol. Relatively few state regulations would be justified.

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151 *Id.* at 169.

152 *Id.* at 193.

153 *Id.* at 228.

154 *Compare* State Bd. of Equalization v. Young's Mkt. Co., 299 U.S. 59, 63 (1936) ("Surely the State may adopt a lesser degree of regulation than total prohibition."), *with* Bridenbaugh v. Freeman-Wilson, 227 F.3d 848, 853 (7th Cir. 2000) ("The greater power to forbid imports does not imply a lesser power to allow imports on discriminatory terms.").

On the other hand, if the phrase "in violation of the laws thereof" modifies the words "transportation and importation," a quite different meaning emerges—states have the power to prohibit importation, if the importation would violate the *laws relating to transportation and importation.* Such a reading would justify a broad range of state regulation on interstate commerce.

Third, what is the meaning of the word "laws"? Although the drafters and ratifiers understood it to mean "dry laws" only, the text does not contain that limitation. If interpreted to mean *all* laws, then the Amendment is far more sweeping.

1. The early "broad power" cases

Immediately after the ratification of the Twenty-First Amendment, the Supreme Court decided three cases on the amendment's scope: *State Bd. of Equalization v. Young's Mkt. Co.*,[155] *Indianapolis Brewing Co. v. Liquor Control Comm'n*,[156] and *Ziffrin, Inc. v. Reeves.*[157] In *Young's Mkt. Co.*, the Court ignored the legislative and ratification history of the Amendment and looked only at its text:

> The plaintiffs argue that limitation of the broad language of the Twenty-First Amendment is sanctioned by its history; and by the decisions of this Court on the Wilson Act [and] the Webb-Kenyon Act. . . . As we think the language of the Amendment is clear, we do not discuss these matters.[158]

The Court held that Section 2 gave states broad power to regulate liquor and interpreted the power to "prohibit" as also including the power to "adopt a lesser degree of regulation than total prohibition."[159] That regulation could include attaching conditions to the act of transportation itself,[160] and state power was not limited to enforcing dry laws.[161] The early cases gave the Amendment such a broad reading that it looked like states could regulate, restrict, and burden interstate sales and deliveries of liquor in any

155 *Young's Mkt. Co.*, 299 U.S. 59 (1936).

156 Indianapolis Brewing Co. v. Liquor Control Comm'n, 305 U.S. 391 (1939).

157 Ziffrin, Inc. v. Reeves, 308 U.S. 132 (1939).

158 *Young's Mkt. Co.*, 299 U.S. at 63-64.

159 *See id.* at 63.

160 *See id.* at 62 (finding that the Amendment confers "upon the State the power to forbid all importations which do not comply with the conditions which it prescribes.").

161 *See id.* (finding that plaintiffs "request us to construe the Amendment as saying, in effect: The State may prohibit the importation of intoxicating liquors provided it prohibits the manufacture and sale within its borders; but if it permits such manufacture and sale, it must let imported liquors compete with the domestic on equal terms. To say that, would involve not a construction of the Amendment, but a rewriting of it.").

way they wanted, "unfettered by the Commerce Clause"[162]—perhaps even allowing discrimination against out-of-state interests.[163]

2. The modern "limited power" cases

Almost immediately after its trio of cases in the 1930s that gave the Twenty-First Amendment a broad non-historical reading, the Supreme Court began to retreat from that extreme position. In *William Jameson & Co. v. Morgenthau*, the Court rejected the proposition that "the Twenty-First Amendment . . . gives to the States complete and exclusive control over commerce in intoxicating liquors, unlimited by the Commerce Clause."[164] It held in *U.S. v. Frankfort Distilleries, Inc.*, a restraint-of-trade case involving liquor price fixing in Colorado, that the Twenty-First Amendment "has not given the states plenary and exclusive power to regulate the conduct of persons doing an interstate liquor business."[165] Whatever impact the Amendment had, state power was not "unfettered" by the Commerce Clause as unwisely suggested in *Ziffrin*. The federal Commerce power was unaffected, and its scope was limited to dormant Commerce Clause issues.[166]

The Court also made it clear that the Twenty-First Amendment gave states no authority to infringe upon constitutionally protected areas other than commerce, such as equal protection, free speech, the Establishment Clause, due process, or the import-export clause. In *Dep't of Revenue v. James B. Beam Distilling Co.*, the Court struck down a Kentucky law taxing Scotch whisky that violated the export-import clause.[167] The *Young's Market* cases were relegated to a brief footnote. In *Wisconsin v. Constantineau*, the Court struck down a Wisconsin law permitting the sheriff to issue notices forbidding the sale of alcohol to habitual drunkards without giving them an opportunity to be heard as violating Due Process.[168] In

162 *Ziffrin*, 308 U.S. at 138-39.

163 *See Young's Mkt. Co.*, 299 U.S. at 63 (stating in dicta that a state might "permit the domestic manufacture of beer and exclude all made without the State"). At the same time, the Court was careful to say that it was not deciding the discrimination issue and was not stating a general principle that state regulatory power was unlimited. *See id.* at 62 (finding the case did not present a question of discrimination prohibited by the Commerce Clause); Indianapolis Brewing Co v. Liquor Control Comm'n, 305 U.S. 391, 394 (1939) (declining to consider the issue of discrimination); *Young's Mkt. Co.*, 299 U.S. at 64 (stating that the Amendment had not "freed the States from all restrictions upon the police power").

164 William Jameson & Co. v. Morgenthau, 307 U.S. 171, 172-73 (1939).

165 U.S. v. Frankfort Distilleries, Inc., 324 U.S. 293, 299 (1945).

166 *See* Collins v. Yosemite Park & Curry Co., 304 U.S. 518, 538 (1938) (state could not regulate liquor headed for Yosemite National Park); Hostetter v. Idlewild Bon Voyage Liquor Corp., 377 U.S. 324 (1964) (state could not regulate sale of duty-free liquor at airport).

167 Dep't of Revenue v. James B. Beam Distilling Co., 377 U.S. 341, 345-46 (1964).

168 Wisconsin v. Constantineau, 400 U.S. 433 (1971).

Craig v. Boren, the Court struck down an Oklahoma law setting the beer drinking age at 21 for males and 18 for females as violating the Equal Protection Clause, commenting that the Twenty-First Amendment was simply irrelevant to anything other than commerce.[169] In *Larkin v. Grendel's Den, Inc.*, the Court struck down a Massachusetts law that permitted nearby churches to veto the issuance of liquor licenses as violating the Establishment Clause, dismissing the Twenty-First Amendment issue in a cursory footnote.[170] And, in *44 Liquormart, Inc. v. Rhode Island*, the Court struck down a Rhode Island law prohibiting liquor advertising as violating the First Amendment, commenting that the Twenty-First Amendment did not give states license to violate other provisions of the Constitution.[171]

The tone of the Court's discussion of the Twenty-First Amendment also changed—from commenting on its broad authority to commenting on its obvious limitations. Thus, in *Hostetter v. Idlewild Bon Voyage Liquor Corp.*,[172] in which the Court held that states could not regulate duty-free liquor at airports, the Court acknowledged the "broad-power" language of the *Young's Market* trio, but then said:

> To draw a conclusion . . . that the Twenty-First Amendment has somehow operated to "repeal" the Commerce Clause wherever regulation of intoxicating liquors is concerned would, however, be an absurd oversimplification. . . . Both the Twenty-First Amendment and the Commerce Clause are parts of the same Constitution. Like other provisions of the Constitution, each must be considered in the light of the other, and in the context of the issues and interests at stake in any concrete case.[173]

In *324 Liquor Corp. v. Duffy*,[174] the Court stated:

> The Court has rejected the view that the Twenty-First Amendment has somehow operated to 'repeal' the Commerce Clause wherever regulation of intoxicating liquors is concerned. Instead, the Court has engaged in a pragmatic effort to harmonize state and federal powers. The question in each case is "whether the interests implicated by a state regulation are so closely related to the powers reserved by the Twenty-First Amendment that the regulation may prevail, notwithstanding that its requirements directly conflict with express federal policies."[175]

Despite this retrenchment, the Court left the *Young's Market* cases themselves untouched for fifty years. Then, in the 1980s, it revisited the

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169 Craig v. Boren, 429 U.S. 190, 204-09 (1976).

170 Larkin v. Grendel's Den, Inc., 459 U.S. 116 (1982).

171 44 Liquormart, Inc. v. Rhode Island, 517 U.S. 484, 516 (1996).

172 Hostetter v. Idlewild Bon Voyage Liquor Corp., 377 U.S. 324 (1964).

173 *Id.* at 331-32. The language is quoted favorably in later cases, *see, e.g.*, Bacchus Imps. v. Dias, 468 U.S. 263, 275 (1984); Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth., 476 U.S. 573, 584 (1986).

174 324 Liquor Corp. v. Duffy, 479 U.S. 335 (1987).

175 *Id.* at 346-47 (citations omitted).

core question of the balance between the Twenty-First Amendment and the dormant Commerce Clause in another trio of cases: *Bacchus Imports, Ltd. v. Dias*,[176] *Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth.*,[177] and *Healy v. Beer Institute*.[178] This time, the result was quite different.

In *Bacchus Imports, Ltd. v. Dias*, the Court took up the issue left open by *Young's Market*: Can states discriminate against interstate commerce and give economic protection to local liquor producers? At issue was a Hawaii law that imposed a 20% tax on liquor imported from other states, but which exempted locally-produced brandy, rum, and wine. Fifty years earlier, the Court had intimated that such a law would be constitutional.[179] Now it held to the contrary, that the law was discriminatory and protectionist and therefore violated the dormant Commerce Clause. This time, the Court took into account the history of its passage and ratification, and found nothing in either the text or the history of the Twenty-First Amendment suggesting that it had given states absolute power over alcohol or had displaced the nondiscrimination principle of the dormant Commerce Clause. Indeed, it held quite clearly that "one thing is certain: the central purpose of the provision was not to empower States to favor local liquor industries by erecting barriers to competition."[180] The Court retreated from the rhetoric of early cases that state power was unlimited and unfettered. Instead, it wrote of a limited Twenty-First Amendment that gave states power to regulate only when state interest clearly outweighed the federal interest in unrestrained interstate commerce, saying "It is by now clear that the Amendment did not entirely remove state regulation of alcoholic beverages from the ambit of the Commerce Clause."[181]

In *Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth.*, the Court held that the Twenty-First Amendment also did not authorize states to regulate interstate commerce directly and that liquor laws with "extraterritorial" effect violated the dormant Commerce Clause. The New York law at issue effectively fixed nationwide liquor prices by providing that no distiller could sell liquor to a New York distributor at a price higher than the price charged anywhere else. Since several other states also had such laws, their combined effect provided that no distiller could sell its liquor anywhere at a discount. Thus, a few state laws controlled liquor prices everywhere. The Court held that "When a state statute directly regulates . . . interstate commerce, or when its effect is to favor in-state economic interests over out-of-state interests, we have generally struck down the statute with-

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176 *Bacchus*, 468 U.S. 263.

177 *Brown-Forman Distillers Corp.*, 476 U.S. 573.

178 Healy v. Beer Institute, 491 U.S. 324 (1989).

179 State Bd. of Equalization v. Young's Mkt. Co., 299 U.S. 59, 63 (1936) (dictum) (A state "may permit the domestic manufacture of beer and . . . subject the foreign article to a heavy importation fee.").

180 *Bacchus*, 468 U.S. at 275.

181 *Id.*

out further inquiry" as violating the dormant Commerce Clause.[182] The Twenty-First Amendment did not alter this rule.

In *Healy v. Beer Institute*, the Court reiterated the holdings of *Bacchus* and *Brown-Forman* that, if a state liquor law discriminated against interstate commerce, regulated commerce in other states, or provided economic protection to local businesses, it was invalid. *Healy* involved a price affirmation law like the one in *Brown-Forman*, which was also discriminatory because it did not require in-state distillers to make such an affirmation. The Court held the law unconstitutional and concluded that it could not be saved by the Twenty-First Amendment.[183]

3. Dicta in non-Commerce Clause cases

At the same time the Supreme Court was whittling down the scope of the Twenty-First Amendment in dormant Commerce Clause cases, it was inserting contrary dicta in non-Commerce Clause cases. Even while it was striking down every restrictive liquor law that came before it, the Court was paying lip service to the old rule that states had virtually unlimited power to regulate commerce in liquor. In *California Retail Liquor Dealers Assn. v. Midcal Aluminum, Inc.*, the Court struck down a price-posting statute as violating the Sherman Act, despite saying that "The Twenty-First Amendment grants the States virtually complete control over whether to permit importation or sale of liquor and how to structure the liquor distribution system."[184] In *Capital Cities Cable, Inc. v. Crisp*, the Court struck down an Oklahoma law prohibiting cable TV companies from broadcasting liquor commercials as violating the Federal Communications Act, despite saying that "[t]he States enjoy broad power under § 2 of the Twenty-First Amendment to regulate the importation and use of intoxicating liquor within their borders."[185] In *44 Liquormart, Inc. v. Rhode Island*, the Court struck down a state law prohibiting advertising the sale price of liquor on First Amendment grounds, despite saying that "the Twenty-First Amendment . . . grants the States authority over commerce."[186]

182 *Brown-Forman Distillers Corp.*, 476 U.S. at 579.

183 *Healy*, 491 U.S. at 341-42.

184 Cal. Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc., 445 U.S. 97, 110 (1980).

185 Capital Cities Cable, Inc. v. Crisp, 467 U.S. 691, 712 (1984).

186 44 Liquormart, Inc. v. Rhode Island, 517 U.S. 484, 515 (1996). *See also* North Dakota v. United States, 495 U.S. 423, 431 (1990) (Supremacy Clause case; dictum in plurality opinion that "within the area of its jurisdiction, the State has 'virtually complete control' over the importation and sale of liquor and the structure of the liquor distribution system." (Citing *Young's Market Co.*)).

4. The (brief) re-emergence of the Webb-Kenyon Act

The Webb-Kenyon Act had been re-enacted in 1935 following the repeal of Prohibition,[187] but it was assumed to be superfluous because it duplicated the language of the Twenty-First Amendment. If the Twenty-First Amendment were not strong enough to sustain the constitutionality of a restrictive state liquor law, then a mere statute could not save it. The Webb-Kenyon Act was therefore ignored for 60 years. It was not mentioned in a single Supreme Court liquor case after 1936 except as a historical curiosity.[188] Despite these less than sterling credentials, the states rediscovered Webb-Kenyon when looking for ways to defend their discriminatory wine shipping regimes. They argued that when Congress passed the Act, it had delegated power to states to regulate commerce in alcoholic beverages as they saw fit, even in ways that discriminated against interstate commerce.

The argument was implausible. Nothing in the Act specifically says that states may discriminate against interstate commerce in liquor, and the legislative history reflects universal agreement in Congress that Webb-Kenyon did no such thing.[189] The usual rule is that the courts will not read a Congressional statute as authorizing discrimination unless such intent is clearly and unequivocally stated that "Congress certainly has the power to authorize state regulations that burden or discriminate against interstate commerce, but we will not assume that it has done so unless such intent is clearly expressed."[190] Indeed, the one previous time this argument had been made, the Supreme Court rejected it in a cursory footnote.[191]

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187 37 STAT. 699, ch. 740 (1935).

188 Craig v. Boren, 429 U.S. 190, 205-06 (1976); Hostetter v. Idlewild Bon Voyage Liquor Corp., 377 U.S. 324, 333 n.11 (1964); Dep't of Revenue v. James B. Beam Distilling Co., 377 U.S. 341, 345 n.7 (1964).

189 *See* discussion *supra* Part II.B.3.

190 Hillside Dairy, Inc. v. Lyons, 539 U.S. 59, 66 (2003) (citations omitted); New York v. United States, 505 U.S. 144, 171 (1992) (States' authority to discriminate must be expressed with "unambiguous intent" by Congress); Wyoming v. Oklahoma, 502 U.S. 437, 458 (1992) (Congress must manifest "unambiguous intent" to allow States to discriminate).

191 *James B. Beam Distilling Co.*, 377 U.S. at 345 n.7 ("There is nothing in . . . the language of either the Wilson Act or the Webb-Kenyon Act to support the view that Congress intended by those laws to consent to state taxation upon importation of liquor.").

III. THE WINE WAR

A. *Background*

1. History of the three-tier system

Before Prohibition, there had been competition in the alcoholic beverage trade, which led to (gasp!) lower prices, abundant product availability, and lots of beer-drinking. Everyone was happy, except those in the temperance movement. After Repeal, supporters of temperance argued that all the free trade and unregulated competition that had existed before Prohibition was responsible for excessive consumption, and if we did not want to return to the sinful days of the "saloon," we'd better find a way to restrict competition, raise prices and reduce availability. So, the states created the three-tier system—manufacturers had to sell only to wholesalers who sold to retailers, and no one could have any business interest in more than one tier. Competition among wholesalers was outlawed. Prices were fixed. And there were plenty of local entities handling liquor the states could tax.

Exactly what "problem" the three-tier system was supposed to solve was unclear. Its advocates talked about preventing the return of those nineteenth century dens of iniquity called "saloons," but creating three distribution tiers was irrelevant to this issue. It also did not work; saloons are quite common in most cities. Its advocates also talked about preventing a return to the evil of the "tied house," an arrangement whereby a beer manufacturer would directly own and control a pub or inn that sold only its products. Why anyone thought this was an evil is not explained anywhere—the only argument advanced was that the manufacturer would pressure the innkeeper to sell as much beer as possible, leading to excessive drinking, but the argument is absurd. Was the assumption that the innkeeper would otherwise try *not* to sell beer, thereby going broke? Anyone in the business of selling alcohol is driven by the same profit motive—to sell as much as possible. Creating a three tier system does not miraculously turn manufacturers, wholesalers, and retailers into board members of the Temperance League. In any event, the three-tier system did not end tied houses—it just tied them to wholesalers instead of manufacturers.

Two justifications for the system are most plausible. First, because organized crime had taken over broad control of all aspects of the liquor industry during Prohibition, creating multiple tiers and prohibiting ownership in more than one tier could dilute the mob's post-Prohibition influence. Second, the creation of a mandatory wholesale distributor system gave the states a local, easily taxed entity, helping raise revenue that was sorely needed after five years of the Great Depression.

The three-tier system made the wine war inevitable. If all wine must pass through a local wholesaler to reach consumers, it creates a bottleneck.

When there are too many wineries and too few wholesalers, the system will fail because the wholesalers will service the large volume producers and the small wineries will be frozen out of access to the market if they are denied direct access. Their only recourse will be a legal war.

2. The wine industry today

The inevitable happened, of course. There are now 25,000 different wines produced in the United States. There are more than 4,000 wineries.[192] Consumer interest and demand has skyrocketed,[193] and the three-tier system cannot handle it. The number of wholesalers is steadily shrinking. Compared to the 1960s, there are now six times as many wineries but only one-sixth the number of wholesalers.[194] That has turned the three-tier distribution system into the three-tier non-distribution system. What started out as a system to allow controlled and regulated distribution has become its major obstacle.

Of the 25,000 wines, only about 500 make it through the system to retail shelves. Fifty large wineries dominate the market and provide 90% of the wine that is handled by the three-tier system. Fewer than 100 wineries have stable national distribution in any form.[195] Three thousand wineries have no wholesaler at all, even in local markets. Small wineries can sometimes obtain temporary wholesale distribution to major markets developing a consumer demand *without* the product actually being available—for example, by being mentioned favorably several times in a publication such as *Wine Spectator*—but nothing will get those wines to Indiana or Arkansas.[196] Without a wholesaler, a winery may sell only to tourists who stop by, and in small quantities to individual consumers by direct shipment.

However, state regulatory systems were not set up for direct shipping. All sales were supposed to go through wholesalers. In 1986, California passed the first law permitting direct shipments, but only from states that,

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192 Brief for WineAmerica et al. at 5-6, Granholm v. Heald, 544 U.S. 460 (2005). Most of the growth in wineries has taken place outside of California, in states like Oregon, Texas, Michigan, New York, and Washington. In Texas alone, the number of wineries has gone from six in 1980 to ninety-one today. There are now wineries in all fifty states.

193 The circulation of the *Wine Spectator* has gone from 150,000 in 1994 to nearly 375,000 in 2004 with a readership of more than one million. *Wine Spectator Advertising Information: Paid Circulation Has Grown Rapidly*, WINE SPECTATOR (2003), *available at* http://www.winespectator.com/Wine/Images/Graphics/ads/WS_NAT_EKIT.pdf (last visited Aug. 21, 2007).

194 At its peak, there were around 5,000 wholesalers. Now there are approximately 400. Alan E. Wiseman & Jerry Ellig, *Market and Nonmarket Barriers to Internet Wine Sales: The Case of Virginia*, 6:2 BUSINESS AND POLITICS at 5 (2004), *available at* http://www.bepress.com/bap/vol6/iss2/art4 (last visited Aug. 21, 2007); *FTC Report*, *supra* note 17, at 6.

195 Wiseman & Ellig, *supra* note 194, at 5.

196 *See FTC Report*, *supra* note 17, at 23-25.

on a reciprocal basis, allowed its citizens to import California wines.[197] A dozen other states passed similar laws.[198] A few states began to allow direct shipping more generally,[199] and a few allowed its citizens to ship back wine purchased in person on site at the winery's tasting room.[200] Most states refused to permit any form of direct shipping, though. Wine could only be distributed by wholesalers, even if that meant 3,000 wineries were kept out of the market.

Foreclosed from national distribution, many small wineries turned their attention to developing a local market. In many areas, they have become valuable local resources, bringing employment and tourism to economically depressed rural areas. They are credited with transforming the economy of the Finger Lakes district of New York, the Willamette Valley of Oregon, and the Columbia River Valley in Washington. They generate new tax revenues for the states. They attract tourists and contribute as anchor sites in tourist areas, by offering restaurants, bed-and-breakfasts, inns, boutiques, and craft businesses. For every $3 a winery receives in gross revenue from all sources, tourists will add roughly $1 to the local economy.[201] Accordingly, the states began to find ways to assist the growth of local wineries—creating wine grape councils, wine trails, reduced license fees, and the right to sell directly on the premises without having to find a wholesaler.

3. The Internet opens new supply routes, but the wholesalers close them

Then came the Internet. Its emergence as a national distribution channel has substantially increased consumer access to rare, unusual, and high-end wines. Direct shipments from wineries to consumers are estimated at over $500 million annually, or 3% of the wine market.[202] The vision of the Founders had been that some day we would become a single national economic unit, with producers in every state having access to the markets in every other.

> Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation. . . . Likewise, every consumer may look to the free competition of every producing

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197 CAL. BUS. & PROF. CODE § 23661.2(b) (repealed following *Granholm*).

198 *E.g.*, IOWA CODE § 123.187 (2003).

199 *E.g.*, N.H. REV. STAT. § 178:14 (2003).

200 *E.g.*, ARIZ. REV. STAT. § 4-203.04(J).

201 Brief for WineAmerica et al., *supra* note 192, at 7, n.6 (citing Bill Nelson & Cary Greene, *Components of a Model Winery Law*, VINEYARD AND WINERY MANAGEMENT (Vol. 29, No. 3, May/June 2003)).

202 *FTC Report*, *supra* note 17, at 5.

> area in the Nation to protect him from exploitation by any. Such was the vision of the Founders; such has been the doctrine of this Court which has given it reality.[203]

The Internet was about to make this vision a reality.

The possibility of a true national Internet wine market threatened the wine wholesalers' privileged (and lucrative) position as wine's exclusive distributor. They reacted quickly, by going to the state legislatures with proposed legislation[204] that would ban direct Internet sales. Wholesalers plied gullible legislators with stories of tax evading scofflaws and anonymous bootleggers using the Internet to sell booze to kids with impunity, and they made large campaign contributions.[205] Most state legislatures passed prohibition laws easily.

Small wineries were frustrated. Consumers were frustrated. The wholesalers had demanded and obtained statutory protection against Internet competition, thereby changing the system from one that distributed wine to one that prevented distribution. The stage was set for *Granholm*.[206]

B. *Granholm v. Heald*

1. The case

In 2000, thirteen wine consumers challenged Michigan's law prohibiting direct interstate wine sales and shipments. They were fed up with laws that denied them access to the hundreds of small producers whose wines were not distributed by the wholesalers, but were readily available on the Internet. They were joined by a small California winery that did not have a wholesaler in Michigan and, consequently, was completely excluded from the market.[207]

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203 *See* H.P. Hood & Sons, Inc. v. Du Mond, 336 U.S. 525, 539 (1949).

204 *E.g.*, IND. CODE § 7.1-5-11-1.5(a) (2003) (provided that: "It is unlawful for a person in the business of selling alcoholic beverages in another state or country to ship or cause to be shipped an alcoholic beverage directly to an Indiana resident who does not hold a valid wholesaler permit under this title. This includes the ordering and selling of alcoholic beverages over a computer network.").

205 The wine and spirits wholesalers trade associations are the second-largest contributors to state political campaigns in the U.S. *See* Vijay Shanker, Note, *Alcohol Direct Shipment Laws, the Commerce Clause, and the Twenty-First Amendment*, 85 VA. L. REV. 353, 361-64 (1999) (wholesalers contribute substantial amounts of money to state legislative candidates; most state laws prohibiting small wineries from direct shipping were actually drafted by lobbyists for the wholesalers).

206 Granholm v. Heald, 544 U.S. 460 (2005); Heald v. Engler, 342 F.3d 517 (6th Cir. 2003), *cert. granted*, 72 U.S.L.W. 3507 (U.S. May 24, 2004) (No. 03-1116); argued together with Swedenburg v. Kelly, 358 F.3d 223 (2d Cir. 2004), *cert. granted*, 72 U.S.L.W. 3600 (U.S. May 24, 2004) (No. 03-1247).

207 *Granholm*, 544 U.S. at 468.

Michigan was among two dozen states that prohibited direct interstate shipment of wine to consumers.[208] It was chosen as a test case because its law was among the most discriminatory and least defensible. At the same time that Michigan was preventing out-of-state wineries from selling and shipping directly to consumers, it allowed its own 40 in-state wineries to do so.[209] Michigan also allowed its 7,500 in-state retailers[210] to ship wine directly to consumers. The Commerce Clause is at its strongest and the Twenty-First Amendment its weakest when states discriminate, so this was the ideal place to attack. Similar lawsuits were filed by consumers and small wineries in other states with discriminatory regimes—New York,[211] Texas,[212] Florida,[213] Indiana,[214] North Carolina,[215] and Virginia.[216] The Wine Wholesalers intervened to try to protect their lucrative monopolistic position from competition.

The initial skirmishes in district court produced mixed but encouraging results—five consumer victories and only two losses. On appeal, the consumers prevailed in the 5th and 6th Circuits,[217] lost in the 2nd and 7th,[218] and fought to a draw in the 4th[219] and 11th.[220] The Michigan and New York cases were consolidated and went to the Supreme Court.

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208 *See id.* at 467.

209 A list of Michigan wineries can be found at http://www.michiganwines.com/Wineries/wineries.html (last visited Aug. 21, 2007).

210 The number of retail licenses comes from the MICH. LIQUOR CONTROL COMM'N, ANNUAL FINANCIAL REPORT 2003 at 10, *available at* http://www.michigan.gov/documents/annual_report_2003_final_86520_7.pdf (last visited Aug. 21, 2007).

211 Swedenburg v. Kelly, 358 F.3d 223 (2d Cir. 2004).

212 Dickerson v. Bailey, 336 F.3d 388 (5th Cir. 2003).

213 Bainbridge v. Turner, 311 F.3d 1104 (11th Cir. 2002).

214 Bridenbaugh v. Freeman-Wilson, 227 F.3d 848 (7th Cir. 2000).

215 Beskind v. Easley, 325 F.3d 506 (4th Cir. 2003).

216 Bolick v. Roberts, 199 F. Supp. 2d 401 (E.D. Va. 2002).

217 Dickerson v. Bailey, 336 F.3d 388 (5th Cir. 2003); Heald v. Engler, 342 F.3d 517 (6th Cir. 2003).

218 Swedenburg v. Kelly, 358 F.3d 223 (2d Cir. 2004); *Bridenbaugh*, 227 F.3d 848 (7th Cir. 2000).

219 Beskind v. Easley, 325 F.3d 506 (4th Cir. 2003) (holding North Carolina's Alcohol Beverage Control laws unconstitutional for discriminating against out-of-state wine manufacturers and sellers, but vacating the District Court's ruling of striking down the main provisions of the state's direct-shipment bans).

220 Bainbridge v. Turner, 311 F.3d 1104 (11th Cir. 2002) (reversing the District Court's finding that the ban on interstate shipments was constitutional, but remanding the case to give the state further opportunity to prove that the ban advanced an important state interest).

2. The plaintiffs' argument: discrimination violates the Commerce Clause

The plaintiffs' argument was simple: this was a case of discrimination. Michigan allowed its in-state wineries to sell directly to consumers without going through a wholesaler, and to ship those purchases to residences. However, it prohibited out-of-state wineries from engaging in these same commercial activities. Because this scheme discriminated against interstate commerce and gave economic advantages to local wineries, it was invalid under the Commerce Clause and could not be saved by the Twenty-First Amendment. Plaintiffs relied primarily on *Bacchus Imports v. Dias*,[221] and Justice Scalia's concurring opinion in *Healy v. Beer Institute*,[222] for the proposition that the dormant Commerce Clause applied with full force to state laws that discriminated against interstate commerce in wine.[223]

Plaintiffs advanced three related legal arguments as to why the wine shipment law met the constitutional definition of discrimination. First, Michigan gave in-state wineries easier and less costly access to the market. Out-of-state wineries had to sell their wine through separate wholesalers and retailers, both of which marked up the price before reselling the wine to consumers.[224] State laws that raise the price of out-of-state goods in relation to in-state products are "paradigmatic examples" of discrimination against interstate commerce.[225] Second, if an out-of-state winery could not find a wholesaler willing to distribute its wine—and there are 3,000 who cannot—it is totally excluded from the market. State laws that cause local goods to have a larger share of the market are also classic examples of discrimination against interstate commerce.[226] Third, the law protected the economic interests of Michigan wholesalers by shielding them from competition.[227] Protectionism is also a classic example of unconstitutional discrimination.[228]

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221 Bacchus Imports v. Dias, 468 U.S. 263, 275-76 (1983).

222 Healy v. Beer Institute, 491 U.S. 324, 344 (1989).

223 *See also* Vijay Shanker, *supra* note 205, at 379 (direct shipment prohibitions violate Commerce Clause).

224 *See* James Molnar, *Under the Influence: Why Alcohol Direct Shipment Laws Are a Violation of the Commerce Clause*, 9 U. MIAMI BUS. L. REV. 169, 186 (2001) (quoting Wall Street Journal as calling this the most expensive distribution system for any package good).

225 West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 193 (1994).

226 Exxon Corp. v. Maryland, 437 U.S. 117, 126 n.16 (1978).

227 Plaintiffs introduced evidence that the wholesalers were the ones who drafted and proposed the ban on direct shipments, and engineered its passage. The wholesalers have considerable political clout. *See* Vijay Shanker, *supra* note 205, at 361-64 (wholesalers contribute substantial amounts of money to state legislative candidates; most state laws prohibiting small wineries from direct shipping were actually drafted by lobbyists for the wholesalers).

228 City of Philadelphia v. New Jersey, 437 U.S. 617, 624 (1978).

3. The States' argument

The argument advanced by the states was more complicated. They conceded that the wine distribution rules treated in-state and out-of-state wineries differently, to the disadvantage of nonresidents. They conceded that, if the product were shirts instead of wine, the prohibition against direct Internet sales would be unconstitutional. Nevertheless, they argued that there was no Commerce Clause violation in this case and, even if there had been, the Twenty-First Amendment trumped the Commerce Clause and gave them unlimited power to regulate or ban the importation of alcoholic beverages.

a. No discriminatory intent

Michigan argued that it did not enact the wine shipment rule with the intent to engage in economic protectionism, but rather with the intent to regulate an alcoholic beverage. The different treatment was the accidental by-product of the state's legitimate decision that everyone needed to be located in Michigan to be regulated effectively. Michigan's attorneys pointed to the line in *Bacchus* that liquor regulations enacted for "mere economic protectionism" were not entitled to the same deference as those enacted pursuant to the Twenty-First Amendment.[229] They argued that *Bacchus* did not apply, because Michigan's statutes were not enacted with the intent to discriminate, but were an attempt to regulate under Twenty-First Amendment powers.

b. The Twenty-First Amendment trumps the Commerce Clause

Michigan's second argument was that the Twenty-First Amendment trumped the Commerce Clause under the authority of the *Young's Market* line of cases from the 1930s.[230] The state characterized the current case law as inconsistent, pointing to the "broad authority" dicta in several non-Commerce Clause cases[231] for the argument that *Young's Market* was still good law. To the extent that *Bacchus* deviated from this principle, they argued, it was wrongly decided and should be abandoned.

In the alternative, Michigan argued that, even if the Twenty-First Amendment does not trump the Commerce Clause in all situations, it does so in this case, where the laws at issue relate directly to "importation." The Twenty-First Amendment speaks specifically to importation, singling it out

229 Bacchus Imps. v. Dias, 468 U.S. 263, 276 (1984).

230 *See* discussion *supra* Part II.D.1.

231 *See* discussion *supra* Part II.D.3.

as an area of exclusive state regulation. Michigan characterized this as the "core concern" of the Amendment, arguing that at least laws specifically advancing this core concern are immune from strict Commerce Clause scrutiny.[232]

c. The ban is necessary to protect state interests

However, Michigan's primary argument was that discrimination was justified because it was reasonably necessary to advance legitimate local purposes—keeping alcohol out of the hands of minors, raising revenue, and generally protecting public health and safety.

i. Youth Access

Michigan and other states asserted as their primary interest, that the restrictive distribution laws were needed to prevent youth access to alcohol. They argued that underage drinking is a serious problem, that minors have easy access to credit cards and the Internet, and that the anonymity of electronic purchasing and common carrier shipping would allow minors to avoid having to prove their age. Restrictive regulations were needed to prevent an epidemic of minors receiving wine shipments from out-of-state wineries over the Internet.

There were four problems with this argument.

First, most states allowed in-state retail wine sellers to take orders by mail, telephone, and Internet, and ship or deliver them within the state.[233] There were over 7,500 wineries and retailers authorized to make home de-

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[232] This argument was dubious from the beginning. The core concern of the Twenty-First Amendment is clearly empowering states to enforce local dry laws, not for wet states to regulate importation procedures. *See* Dickerson v. Bailey, 336 F.3d 388, 404 (5th Cir. 2003) (core concern of § 2 is "the promotion of temperance"); Wine Indus. of Mich. v. Miller, 609 F.2d 1167, 1170 (6th Cir. 1980) (only significant purpose of the Twenty-First Amendment was to permit "dry" states to enforce local prohibition); Duncan B. Douglass, *supra* note 109, at 1631-36 (review of legislative history of Twenty-First Amendment shows that it was meant to refer only to state dry laws); Vijay Shanker, *supra* note 205, at 375 (1999) (temperance is the core purpose of the Twenty-First Amendment). Nor does the Court engage in constitutional interpretation by taking a single word out of context. *See* United States v. Balsys, 524 U.S. 666, 673 (1998). It is the meaning of the whole of § 2 that matters, and in the overall context of the Amendment, the power to regulate importation is a means to an end, not an end in itself. The means chosen to advance a state's legitimate interests are not immune from scrutiny and legitimate ends "may not be accompanied by discriminating against interstate commerce." *City of Philadelphia*, 437 U.S. at 627. *Accord* Chem. Waste Mgmt., Inc. v. Hunt, 504 U.S. 334, 340-42 (1992).

[233] MICH. COMP. LAWS § 436.1537; MICH. COMP. LAWS § 436.1111(7); MICH. ADMIN. CODE r. 436.1011(6)(b).

liveries in Michigan.[234] If minors were ordering wine for home delivery, it would not matter if it came from in-state or out-of-state sources, since minors are not likely to be seeking only one particular label.[235] It was going to be hard for states to justify the in-state/out-of-state distinction.

Second, the argument lacks evidentiary support. Available data show that minors consume mostly beer and hard liquor, and relatively little wine. They rarely buy any kind of alcohol by direct shipments, which take several days to arrive, because their purchases tend to be spontaneous and made for immediate consumption. They are far more likely to have someone over the age of 21 buy it for them or obtain it from a local retail outlet that does not check identification. Minors also can obtain alcohol easily at parties, from friends and family, and by stealing it.[236] On-line ordering of small quantities of inexpensive wine—the types of purchases minors would be likely to make—is also more expensive than local purchases. The FTC estimates that "[m]inors would have to pay a hefty premium, from 33-83%, to purchase a bottle of wine costing less that $20 online and have it delivered to them via 2nd Day Air."[237]

Third, the evidence from those states that allow direct shipping did not confirm Michigan's fears. The experience in those states showed no increase in youth access because of direct shipping of wine.[238]

Fourth, even assuming a few minors occasionally obtained a few bottles of wine by Internet from out-of-state wineries, Michigan's total ban on all interstate shipments under all circumstances was overbroad. Michigan barred shipments that had been purchased face-to-face at a winery tasting room, after showing an I.D, as well as "anonymous" Internet purchases. It barred shipments to adults as well as minors. In other situations in which states want to shield minors from harmful products, such as pornography, the Court has been reluctant to burden legitimate adult access in order to prevent occasional youth access. It has generally required that states narrowly tailor their restrictions so that legal adult access is burdened in only the most limited ways.[239] The kind of literature or beverages available to

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234 MICH. LIQUOR CONTROL COMM'N, ANNUAL FINANCIAL REPORT 2003 at 10, *available at* http://www.michigan.gov/documents/annual_report_2003_final_86520_7.pdf (last visited Aug. 21, 2007).

235 *See* Susan Lorde Martin, *Wine Wars—Direct Shipment Of Wine: The Twenty-First Amendment, The Commerce Clause, And Consumers' Rights*, 38 AM. BUS. L.J. 1, 7 (2000).

236 The studies are summarized in REDUCING UNDERAGE DRINKING: A COLLECTIVE RESPONSIBILITY 166-68, 175-76 (Richard J. Bonnie & Mary Ellen O'Connell eds., 2004), *available at* http://www.nap.edu/books/0309089352/html (last visited Aug. 21, 2007).

237 *FTC Report*, *supra* note 17, at 33.

238 *Id.* at 26-29.

239 *See* 44 Liquormart, Inc. v. Rhode Island, 517 U.S. 484, 507 (1996); Lorillard Tobacco Co. v. Reilly, 533 U.S. 525, 563 (2001); Reno v. ACLU, 521 U.S. 844, 875 (1997); Ashcroft v. Free Speech Coalition, 535 U.S. 234, 252 (2002).

adults cannot be limited to those that would be suitable for distribution to children.

ii. Loss of tax revenue

The second interest asserted by the states was tax collection. They argued that the ban on interstate direct shipments was necessary to ensure that taxes would be paid. The states believed that their own resident businesses (local wineries, retailers, and wholesalers) would pay taxes on sales, but that non-resident businesses would not. The argument was speculative, because it was being made by states that had not tried to collect taxes from out-of-state businesses on direct sales. It was also contradicted by the evidence from states that allowed direct shipping and required that taxes be paid. The latter reported no problems with tax evasion.[240]

iii. Enforcing the Dram Shop Act

Michigan also asserted that the direct shipment ban was necessary to enforce its dram shop act because it feared that out-of-state sellers would not be subject to suit. The argument is not really a legal one, since Michigan had long-arm statutes that would technically give its courts jurisdiction over any out-of-state person who committed an act resulting in a tort in the state.[241] Federal diversity jurisdiction would similarly give injured plaintiffs access to federal court.[242] Rather, the argument was more a worry that, as a practical matter, it would be more difficult and more expensive to sue and to collect a judgment from an out-of-state defendant.

iv. Maintaining an orderly market in the interest of public health

The states made a fourth argument that a ban on direct shipping from out-of-state wineries was necessary to maintain an orderly and regulated market because unregulated liquor traffic posed a danger to public health and safety. They argued that the people who sell potentially dangerous products need to be identified, investigated, regulated, and held accountable.

240 *See FTC Report*, *supra* note 17, at 38-40 (no reports of significant tax evasion by direct shippers).

241 MICH. COMP. LAWS §§ 600.705, 715.

242 28 U.S.C. § 1332 (2004).

The problem with this argument is that the dangers of an unregulated traffic in liquor justify licensing and regulation, not a total ban on shipping, and certainly not a ban on interstate shipping only. It cannot be the case that only out-of-state wine is dangerous if sold directly to the public. The Supreme Court has consistently rejected the public safety argument as justification for *discriminating* against out-of-state businesses—e.g., excluding other states' harmful waste from landfills,[243] keeping large out-of-state trucks off local highways,[244] or excluding potentially unwholesome out-of-state food products.[245] Although health and safety considerations are entitled to weigh in dormant Commerce Clause balancing, "if a state *discriminates* against out-of-state interests . . . such facial discrimination will be subject to a high level of judicial scrutiny even if it is directed toward a legitimate health and safety goal."[246] A state may regulate a dangerous product, of course, but must do so evenhandedly. There is "no valid health and safety reason for limiting the amount of waste . . . from outside the State, but not the amount . . . from inside the State."[247] If an out-of-state shipment deserves to be restricted, so does a similar in-state shipment.

4. Plaintiffs' rebuttal: Reasonable nondiscriminatory alternatives

In response to the states' argument that they needed to discriminate against out-of-state wine shippers in order to advance important state interests, plaintiffs relied on a series of Commerce Clause cases holding that discrimination is constitutionally authorized only if there are no reasonable non-discriminatory alternatives.[248] The plaintiffs asserted that each of the states' interests could be advanced without totally banning interstate wine shipments.

Youth access can be minimized by adopting procedural safeguards such as age verification, labeling of boxes as containing alcohol, requiring adult signatures upon delivery, and conducting stings. The FTC had found that these methods were an effective alternative to a total ban.[249] A delivery

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243 C & A Carbone, Inc. v. Town of Clarkstown, 511 U.S. 383, 393 (1994); Fort Gratiot Sanitary Landfill, Inc. v. Mich. Dep't of Natural Res., 504 U.S. 353 (1992); City of Philadelphia v. New Jersey, 437 U.S. 617, 624 (1978).

244 Kassell v. Consol. Freightways Corp., 450 U.S. 662, 667 (1981); Raymond Motor Transp., Inc. v. Rice, 434 U.S. 429 (1978).

245 Baldwin v. G.A.F. Seelig, Inc., 294 U.S. 511, 522-23 (1935); Dean Milk Co. v. Madison, 340 U.S. 349, 353-54 (1951).

246 GMC v. Tracy, 519 U.S. 278, 307 n.15 (1997) (emphasis added).

247 *Fort Gratiot Sanitary Landfill, Inc.*, 504 U.S. at 367.

248 Hughes v. Oklahoma, 441 U.S. 332, 336-37 (1979); New Energy Co. v. Limbach, 486 U.S. 269, 278 (1988); Chem. Waste Mgmt., Inc. v. Hunt, 504 U.S. 334, 344 (1992); *C & A Carbone, Inc.*, 511 U.S. at 393; Or. Waste Sys., Inc. v. Dep't of Envtl. Quality, 511 U.S. 93, 101 (1994).

249 *FTC Report*, *supra* note 17, at 26-29.

driver for a common carrier can be trained to check IDs just as effectively as a liquor store employee. This alternative is in use in many states.[250]

Tax collection can be accomplished by adopting regulations requiring out-of-state suppliers to obtain permits and to collect and remit taxes. The FTC Report found that this alternative effectively protected tax revenues in a less restrictive manner than a direct ban on out-of-state shipments.[251] New Hampshire has used this alternative for several years[252] and reports that, not only has it not lost any tax revenue by allowing direct shipping, it has actually seen wine tax revenue increase—by $121,635 in 2003—as former illegal shippers begin shipping legally.[253]

Dram shop acts and other private forms of accountability can be protected through long-arm jurisdiction statutes that give local courts jurisdiction over any out-of-state person who causes a tort arising from the illegal sale of alcohol.[254] Federal diversity jurisdiction would give injured plaintiffs access to federal court.[255]

Public health and safety can be protected by holding out-of-state wineries to the same standards as local wineries. Shippers can be required to apply for a state license, submit financial documents, submit to a police background check, have liability insurance, post bonds, submit sales reports, and abide by state laws regulating sales and deliveries. And, states can police unsafe interstate sales in the same way they police unsafe local sales—through stings.[256]

5. The problem of enforcement

The argument over alternatives boiled down to a question of enforcement. Michigan argued that the nondiscriminatory alternative of licensing and regulation might look reasonable on paper, but would not work in reality because states lacked the ability to hold out-of-state wineries accountable. They can threaten to put a local winery out of business, but have little threat to hold over an out-of-state winery. They can make surprise inspections of local wineries, but not those located across the country. Out-of-state wineries would ignore state regulations with impunity, knowing there was little a state could do to punish them for transgressions. The amicus

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250 *See, e.g.*, N.H. REV. STAT. ANN. § 178:27(II) (2003); N.C. GEN. STAT. § 18B-1001.1(c) (2004); N.D. CENT. CODE § 5-01-16(5) (1987); S.C. CODE ANN. § 61-4-747(c)(2) (Law. Co-op. 2003); VA. CODE ANN. § 4.1-112.1(C) (Michie 2003); WYO. STAT. ANN. § 12-2-204(d)(iii-iv) (2003).

251 *FTC Report*, *supra* note 17, at 38-39.

252 *See* N.H. REV. STAT. § 178:14-a(II).

253 Gary Dennis, *Wine Online*, MANCHESTER UNION LEADER, Sept. 14, 2004, at F1 (quoting John Byrne, N.H. Liquor Commissioner).

254 *E.g.*, MICH. COMP. LAWS §§ 600.705, 600.715.

255 28 U.S.C. § 1332 (2004).

256 *See FTC Report*, *supra* note 17, at 35-36.

brief filed by 33 states went so far as to claim that "States have only two choices: restrict direct shipments by out-of-state wineries or leave this potentially dangerous product virtually unregulated as long as it is shipped directly to a consumer from out of state."[257] This lack of enforcement ability justified discrimination, the states argued.

The argument was problematic. When *Granholm* was being argued, 26 states allowed some form of direct shipping and reported no enforcement, accountability, or compliance problems.[258] Most required direct shippers to get a state license in order to sell in the state, which would be revoked if the winery misbehaved.[259] This kind of deterrent threat works for in-state businesses and should work for out-of-state businesses as well. The cost of noncompliance—loss of a license and thousands of dollars in future sales—outweighs the immediate benefit of illegally shipping one case of wine, and it therefore should be sufficient to deter illegal commercial activity.[260]

There are also three indirect enforcement routes. First, states can ask the Tax and Trade Bureau (TTB) to proceed against a winery's federal basic permit. Every winery must hold such a permit,[261] which can be revoked if a winery violates state laws.[262] Furthermore, the TTB has assured the states that it will act on any complaints.[263] Second, states can use the Twenty-First Amendment Enforcement Act that gives jurisdiction to federal courts to order out-of-state wineries to comply with state laws.[264] The National Alcohol Beverage Control Association has called this "an effective tool to use in preventing the illegal interstate flow of alcohol beverages."[265] Third, states can file complaints with the regulatory agency in the shipper's home state. Shipments to minors may violate the laws of the state in which the shipment originates as well as the state in which it is received.[266] Many states also require their own licensees to comply with the laws of other states,[267] and provide for sanctions if such laws are violated.[268] Some states

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257 Brief of Ohio and 32 Other States as *Amici Curiae*, at 10.

258 *See FTC Report*, *supra* note 17, at 29-31.

259 *E.g.*, S.C. CODE ANN. § 61-4-747 (Law. Co-op. 2003); NEB. REV. STAT. §§ 53-124(11), 53-160, 53-194.03 (2004).

260 *See* Timothy F. Malloy, *Regulation, Compliance And the Firm*, 76 TEMP. L. REV. 451, 453-54 (2003).

261 27 U.S.C. § 203 (2006).

262 26 U.S.C. § 5271(e) (2006).

263 BATF Ruling 2000-1 (2000).

264 27 U.S.C. § 122a (2004).

265 *FTC Report*, *supra* note 17, at 30.

266 *See, e.g.*, CAL. BUS. & PROF. CODE § 23661.2; COLO. REV. STAT. ANN. § 12-47-104(1); 235 ILL. COMP. STAT. 5/6-29(b); WASH. REV. CODE § 66.12.200.

267 *E.g.*, DEL. CODE ANN. tit. 4, § 104(a), (b) ("No sale of alcoholic liquor shall be made to a person in a state or a division of a state where such sale is prohibited by law."; "No shipment of alcoholic liquor shall be made into a state or into a division of a state where such shipment is prohibited by law.").

provide for reciprocal enforcement—if a local winery loses its privileges in another state, its home-state license may not be renewed.[269]

The states clinging to their protectionist regimes made no argument that there was anything unique about their circumstances that would make enforcement more difficult for them than for other states. They merely argued that each state was entitled to decide for itself how much risk to take. However, the argument ran contrary to the Supreme Court's previous holdings that the practical and economic difficulties in inspecting and holding accountable out-of-state businesses do not justify discrimination.[270]

6. The economic argument

The wine war is about commerce, which is an economic activity. I know nothing about economics, and cannot tell a monopoly from a cartel or a rent from a profit. Luckily, an amicus brief was filed in *Granholm* by three Nobel laureates in economics and the Chair of the Economics Department at George Mason University.[271] The brief summary of the economic argument that follows is taken primarily from that brief.

a. E-commerce generally

E-commerce generally has been a boon to consumers and small businesses. Retail e-commerce sales have been growing at a huge rate and in the second quarter of 2004 amounted to $15.7 billion. Online retail sales are growing at ten times the rate of their "brick-and-mortar" counterparts. As of 2002, e-commerce among businesses had reached roughly $1 trillion per year. E-commerce is available for virtually all products, whether expensive, cheap, new, used, plentiful, or rare. Online commerce has brought consumers wider availability of products and greater price competition. Consumers now have the ability to do nationwide comparison shopping for nearly everything they buy. E-commerce has proved essential to many

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268 *See* N.H. REV. STAT. ANN. § 178:27(VIII) ("Upon notification by authorities in another state which imposes a reciprocal enforcement policy, a New Hampshire licensee proved to be making illegal direct shipments to consumers and licensees in said state shall be subject to action by the liquor commission. Such actions may include fines and suspension and revocation of New Hampshire liquor licenses.").

269 *E.g.*, ARIZ. REV. STAT. § 4-203.04(C); LA. REV. STAT. ANN. § 26:359(G).

270 Dean Milk Co. v. Madison, 340 U.S. 349, 354-55 (1950).

271 Brief for George A. Akerlof et al. as amici curiae supporting petitioners, Eldred v. Ashcroft, 538 U.S. 916 (2003); as amici curiae supporting respondent, Granholm v. Heald, 544 U.S. 460 (2005).

small businesses, who have gained access to larger markets without having to pay fees to middlemen or setting up additional distribution channels.[272]

b. E-commerce in wine

In its recent report on state barriers to e-commerce in the wine industry, the Federal Trade Commission noted that "state bans on interstate direct shipping represent the single largest regulatory barrier to expanded e-commerce in wine."[273] The *Wall Street Journal* called the three-tier distribution system for wine the most expensive distribution system for any package good in the country.[274]

When the three-tier system was created in 1933, there were few wineries and many distributors, and it worked well. However, the wine industry has recently seen a remarkably high degree of new market entry by wineries and an increase in demand by consumers. At the same time, the number of distributors has fallen due to industry consolidation. The number of wholesalers has dropped from several thousand in the 1950s to a few hundred today. In some regions, the distributor market may be approaching near-monopolistic conditions.[275] The limited number of distributors gives them increased bargaining power, which enables them to select only the most cost-efficient wines for distribution—primarily those produced in large quantities by the biggest wineries and wine consortiums. Thirty U.S. wine companies now supply over 90 percent of the wine sold at retail, and the top three firms account for 60 percent of volume.[276]

State regulatory interventions further impede competition at the wholesale level. Many states have enacted laws that grant wholesalers preferential contract rights, establish exclusive territorial arrangements between wholesalers and wineries, and deter price cutting.[277] The FTC has been critical of some of these measures due to their anti-competitive effects.[278]

The leading (indeed, the only) empirical study of wine shipment bans was done in Virginia by Allan E. Wiseman and Jerry Ellig. They found that

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272 Brief for American Homeowners' Alliance et al. at 7-9 as amici curiae supporting respondents, Granholm v. Heald, 544 U.S. 460 (2005) (quoting various federal government sources).

273 *FTC Report*, *supra* note 17, at 3.

274 *See* James Molnar, *supra* note 224, at 186 (quoting WALL ST. J.).

275 *FTC Report*, *supra* note 17, at 6.

276 Gina M. Riekhof & Michael E. Sykuta, *Politics, Economics, and the Regulation of Direct Interstate Shipping in the Wine Industry*, CORI WORKING PAPER 03-04 at 7, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=481947 (last visited Aug. 21, 2007).

277 DOUGLAS GLEN WHITMAN, STRANGE BREW: ALCOHOL AND GOVERNMENT MONOPOLY 27-28 (2003).

278 *FTC Report*, *supra* note 17, at 6-7.

wine availability was higher online.[279] Direct shipping restrictions do not reduce the aggregate supply of wine—there is more than enough wine available locally to get everyone as drunk as they wish. Rather, the shipping bans compress the range of choice. Inventory costs and the diseconomies of scale prevent wholesalers and retailers from offering anything close to the breadth of choice of wines and vintages actually for sale somewhere. Given the economic necessities, the distribution network generally limits choices to a small number of well-known brands. This market fails to serve the needs of consumers of high-end wines, who purchase wine for future rather than immediate consumption, and who view a broader selection as important. Direct shipment barriers force upon these consumers high opportunity costs in the form of lost income or foregone leisure time associated with travel to distant specialty wine stores or wineries. Opening those barriers increases competition, which will force current local market participants to increase selection and supply a greater variety of wines.

Wiseman and Ellig also found some price advantages for online purchases, at least of high-end wine bought by the case.[280] However, because of the high cost of transportation, small quantities of low-end wine were cheaper if purchased locally. If trade barriers were eliminated, general economic theory suggests that increased competition should generally reduce prices.[281] Similarly, economic rents accruing to distributors because of their monopolistic position will be eroded, further reducing the price to consumers to some degree.[282] Actual price effects will vary because of transportation costs. When wine is purchased by a consumer over the Internet and shipped directly, the transportation costs are the same for a case of "Two-Buck Chuck"[283] and a case of Screaming Eagle.[284] On the other hand, when wine is purchased by a wholesaler and shipped through the three-tier system, transportation costs vary by the type of wine. Economies of scale mean that the distribution costs for high-volume low-end wine is less per case than for small lots of expensive high-end wine. Direct shipping is therefore more likely to benefit consumers of high-end wine, which is handled in small lots, than for consumers of low-end wine, which is more efficiently handled in large quantities.

No one can predict the consequences of deregulating the wine market—after all, many economists predicted consumer gains from airline deregulation, but whether or not the effect has actually been beneficial is de-

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279 Wiseman & Ellig, *supra* note 195, at 20-22.

280 Wiseman & Ellig, *supra* note 195, at 22-28.

281 *FTC Report*, *supra* note 17, at 16-17.

282 *See id.* at 23.

283 Nickname of the popular Charles Shaw brand of wines, which are sold for less than $4.00 per bottle in Trader Joe's supermarkets.

284 Among the most highly-rated and high-priced wines produced in the United States.

batable.[285] Nevertheless, the economist amici reached three conclusions. *First,* the demise of state protection of the three-tiered system will generate greater diversity of distribution arrangements, greater product availability for consumers, and expanded market opportunities for wineries. *Second*, an expanding market is not a zero-sum game, so increased competition will not necessarily harm the wholesalers. The current three-tiered system might flourish if relieved of the expense of handling boutique wines and defending their turf from Internet competition. The broader availability of "boutique" wines would tend to sharpen consumer awareness and appreciation, redounding to the benefit of all segments of the wine industry. *Third*, in a freer market, "better" wines produced by more efficient wineries would tend to expand at the expense of "worse" wines whose market position is currently being propped up by advertising and artificial market control.[286]

Assuming, arguendo, that the mandatory three-tier system originally had a legitimate purpose—to reduce consumption and limit the influence of organized crime—even the best regulatory systems often outlive their usefulness and mutate into a means of protecting private rather than public interests.[287] This is clearly the case with the mandatory three-tier system. It is held in place and defended by special interest groups.[288] Riekhof and Sykuta have found that the economic interests of the wholesalers have played the most significant role in the enactment of direct shipment bans against nonresidents, and that the relative size of the native wine industry was significantly correlated to the adoption of laws allowing in-state direct shipping. Legislative considerations of the public interest have been conspicuously absent.[289]

The nondiscrimination principle serves as a safeguard against "naked" interest group transfers that serve no public purpose, but merely transfer wealth from unorganized constituencies such as consumers to highly organized interests such as liquor distributors.[290] It also protects against interstate exploitation in which states seek to impose costs on (non-voting) outsiders,

285 *E.g.*, Michael E. Levine, *Is Regulation Necessary? California Air Transportation and National Regulatory Policy*, 74 YALE L.J. 1416 (1965).

286 Brief of George A. Akerlof et al., *supra* note 271, at 14-15 (citing Dale M. & Philip L. Martin, *Inside the Bottle: The Wine Business*, CHOICES 30, 33 (Fall 2002)).

287 *See id.* at 17-18 (citing Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. 335 (1974); George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. 3 (1971)).

288 *See id.* at 18-19 (citing Bruce Yandle, *Bootleggers and Baptists: The Education of a Regulatory Economist*, REGULATION 12 (May/June 1983)).

289 *See id.* at 19-20 (citing Gina M. Riekhof & Michael E. Sykuta, *supra* note 271, at 4, 22, 26).

290 *See id.* at 22 (citing Cass Sunstein, *Naked Preferences and the Constitution*, 84 COLUM. L. REV. 1689 (1984)).

by regulating on an extra-territorial basis or exempting in-state interests from burdensome taxes and regulations.[291]

7. The *Granholm* decision

On May 16, 2005, the Supreme Court announced its decision in *Granholm v. Heald.*[292] The Court ruled in favor of consumers and small wineries. It struck down Michigan's total ban on interstate direct shipping as discriminatory in intent, and it struck down New York's physical-presence rule[293] as discriminatory in effect. The Court applied its traditional Commerce Clause jurisprudence. The Twenty-First Amendment did not override or even weaken the Commerce Clause, and did not authorize states to discriminate against nonresidents and protect local economic interests. The Court held that all of the states' asserted interests in banning interstate sales could be advanced through the nondiscriminatory alternative of even-handed licensing and regulatory laws. States could not constitutionally give their own wineries preferential access to the market.

Granholm dealt with only one issue in Commerce Clause jurisprudence: discrimination against interstate commerce.

> We hold that the laws in both States discriminate against interstate commerce in violation of the Commerce Clause, Art. I, § 8, cl. 3, and that the discrimination is neither authorized nor permitted by the Twenty-First Amendment.[294]

The Court did not address other closely related issues, such as whether the mandatory wholesaler requirement is a local processing rule prohibited by *C & A Carbone, Inc. v. Town of Clarkstown, N.Y.*,[295] or an invalid form of economic protectionism that violates *Philadelphia v. New Jersey.*[296] Nor did it comment on other Commerce Clause issues outside the umbrella of discrimination, such as whether wine distribution laws improperly regulate

291 *See id.* at 22 (citing Saul Levmore, *Interstate Exploitation and Judicial Intervention*, 69 VA. L. REV. 563 (1983)).

292 The decision was only 5-4, but the margin is not that slim. Two of the dissenting Justices are now gone from the Court (Rehnquist and O'Conner), and a third (Stevens, who is 86 years old) may retire soon as well.

293 In New York, the state argued that all wineries were being treated the same, because any winery that established a physical presence in the state could sell and ship wine directly to consumers. Brief for State of N.Y. at 37-40, 2004 WL 2190371.

294 Granholm v. Heald, 544 U.S. 460, 466 (2005).

295 C & A Carbone, Inc. v. Town of Clarkstown, N.Y., 511 U.S. 383 (1994).

296 Philadelphia v. New Jersey, 437 U.S. 617, 624 (1978). See also Bacchus Imps. v. Dias, 468 U.S. 263, 276 (1984).

commercial transactions occurring outside the state[297] or impose significant burdens on interstate commerce that exceed local benefits under the *Pike v. Bruce Church* balancing test.[298]

The decision strongly favored consumers, small wineries, and the free market. The Court held that states cannot disadvantage out-of-state wineries by denying them a reasonable means of access to the consumer market equivalent to the market access enjoyed by local wineries. It is a violation of the Commerce Clause "to allow in-state wineries to sell wine directly to consumers in that State but to prohibit out-of-state wineries from doing so,"[299] or to "to allow local wineries to make direct sales to consumers in New York on terms not available to out-of-state wineries."[300] The Court said that the "mere fact of nonresidence should not foreclose a producer in one State from access to markets in other States," even if the product is an alcoholic beverage.[301] It is a violation of the Commerce Clause for a state "to grant in-state wineries a competitive advantage over wineries located beyond the State's borders"[302] or to give "in-state wineries access to the State's consumers on preferential terms."[303]

The Court was unimpressed by the states' asserted need to ban or heavily regulate interstate wine sales in order to prevent youth access, collect taxes, and maintain an orderly market. Although these are legitimate state interests, the Twenty-First Amendment "does not allow States to ban, or severely limit, the direct shipment of out-of-state wine while simultaneously authorizing direct shipment by in-state producers."[304] Discrimination against interstate commerce "is neither authorized nor permitted by the Twenty-First Amendment,"[305] which "does not allow States to regulate the direct shipment of wine on terms that discriminate in favor of in-state producers."[306] Nor may states prohibit direct sales by out-of-state wineries or make them "impractical from an economic standpoint."[307] Nor was any

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297 *See* Healy v. Beer Institute, 491 U.S. 324, 336 (1989); Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth., 476 U.S. 573, 578-79 (1986).

298 Pike v. Bruce Church, 397 U.S. 137 (1970).

299 *Granholm*, 544 U.S. at 465-66.

300 *Id.* at 470.

301 *Id.* at 472.

302 *Id.* at 466.

303 *Id.* at 474.

304 *Id.* at 493.

305 *Granholm*, 544 U.S. at 466.

306 *Id.* at 476.

307 *Id.* at 466. The Court viewed discrimination as a question of economic effect. It described the Michigan regime as requiring "all out-of-state wine, but not all in-state wine, to pass through an in-state wholesaler and retailer before reaching consumers. These two extra layers of overhead increase 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." *Id.* at 474. It described New York's requirement that out-of-state wineries establish a distribution operation in New York as "additional steps that drive up the cost of their wine. . . . For most wineries, the

particular power over interstate commerce found in the Webb-Kenyon Act.[308]

This ruling was solidly connected to the Court's general Commerce Clause jurisprudence, with no suggestion that the Twenty-First Amendment changed this in any way.[309] Like other laws, a state liquor law that discriminates against interstate commerce will be valid only if the state can prove, "based on concrete evidence,"[310] that it advances "a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives."[311] There is no presumption of validity because the state is regulating an alcoholic beverage that poses a risk to minors.

> Even were we to credit the States' largely unsupported claim that direct shipping of wine increases the risk of underage drinking, this would not justify regulations limiting only out-of-state direct shipments.[312]

There is no presumption of validity because of the state's interest in tax collection and other legitimate interests.

> Increased direct shipping, whether originating in state or out of state, brings with it the potential for tax evasion. . . . If licensing and self-reporting provide adequate safeguards for wine distributed through the three-tier system, there is no reason to believe they will not suffice for direct shipments. . . . The States have not shown that tax evasion from out-of-state wineries poses such a unique threat that it justifies their discriminatory regimes. . . . Michigan and New York offer a handful of other rationales, such as facilitating orderly market conditions, protecting public health and safety, and ensuring regulatory accountability. These objectives can also be achieved through the alternative of an evenhanded licensing requirement. . . . [I]mprovements in technology have eased the burden of monitoring out-of-state wineries. Background checks can be done electronically. Financial records and sales data can be mailed, faxed, or submitted via e-mail.[313]

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expense of establishing a brick-and-mortar distribution operation in one State, let alone all fifty, is prohibitive." *Id.* at 474-75.

308 *Id.* at 483. ("The Wilson Act reaffirmed, and the Webb-Kenyon Act did not displace, the Court's line of Commerce Clause cases striking down state laws that discriminated against liquor produced out of state.").

309 *See id.* at 472. ("Time and again this Court has held that, in all but the narrowest circumstances, 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 latter.'"); *id.* at 473 ("Allowing States to discriminate against out-of-state wine 'invite[s] a multiplication of preferential trade areas destructive of the very purpose of the Commerce Clause.'"); *id.* at 476 ("State laws that discriminate against interstate commerce face 'a virtually *per se* rule of invalidity.'"); *id.* at 475 ("New York's in-state presence requirement runs contrary to our admonition that States cannot require an out-of-state firm to become a resident in order to compete on equal terms.").

310 *Granholm*, 544 U.S. at 493.

311 *Id.* at 489.

312 *Id.* at 490.

313 *Id.* at 491-92.

The Court acknowledged that even-handed regulatory systems requiring wine to be distributed through state-run outlets or a privatized three-tier system were, in theory, legitimate exercises of state authority under the Twenty-First Amendment.[314] However, such a system must work in practice—giving out-of-state wineries reasonable and realistic access to the state market. If the state prohibits wineries from distributing their wine directly to consumers, it must provide an alternative method that actually distributes the wine, rather than one that prevents distribution.[315]

Finally, the Court inserted dictum on a matter not briefed or argued: reciprocity laws that allow direct shipping only from states that grant reciprocal direct shipping privileges.

> States should not be compelled to negotiate with each other regarding favored or disfavored status for their own citizens. . . . Rivalries among the States are thus kept to a minimum, and a proliferation of trade zones is prevented. . . . The perceived necessity for reciprocal sale privileges risks generating the trade rivalries and animosities, the alliances and exclusivity, that the Constitution and, in particular, the Commerce Clause were designed to avoid. State laws that protect local wineries have led to the enactment of statutes under which some States condition the right of out-of-state wineries to make direct wine sales to in-state consumers on a reciprocal right in the shipping State. . . . The current patchwork of laws-with some States banning direct shipments altogether, others doing so only for out-of-state wines, and still others requiring reciprocity—is essentially the product of an ongoing, low-level trade war. Allowing States to discriminate against out-of-state wine "invite [s] a multiplication of preferential trade areas destructive of the very purpose of the Commerce Clause."[316]

IV. WHAT NEXT?

A. *Does It Matter How States Level The Playing Field?*

States have had a variety of legislative reactions to *Granholm*'s command to create a level economic playing field that does not discriminate against nonresident wineries. Some have leveled up, extending direct sales and shipping privileges to out-of-state wineries and opening their markets to competition from nonresidents. Others have leveled down, extending the ban on shipping to local wineries and closing the direct sales market to everyone. Still others have leveled sideways, opening the door to some interstate shipments upon terms that appear facially nondiscriminatory, but which, as a practical matter, will still give preferential market access to local wineries. Although there are many small variations, the three patterns are:

First: Anyone may ship wine with a direct shipping permit (leveling up). Any winery may take Internet orders and ship them by common car-

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314 *See id.* at 465-66, 488-89.

315 *See id.* at 473-74.

316 *Granholm*, 544 U.S. at 473.

rier to consumers if it gets a state permit. The permit generally requires that the shipper verify age, remit taxes, label boxes as containing alcohol and requiring an adult signature, and file periodic reports with the state regulatory agency.[317] These laws appear constitutional unless the regulations attached to the permit are so burdensome that they have the practical effect of excluding many small wineries from the market. For example:

a. *Permit cost.* In North Carolina, a direct shipper permit is free.[318] But in Nebraska, it is $500.[319] Where the fee is high, it will exclude from the market small nonresident wineries with only limited sales in the state. Although the Supreme Court has said that a state can constitutionally pass on the legitimate costs associated with licensing and inspections,[320] the state probably cannot make the process so burdensome and expensive that it has the practical effect of excluding nonresident wineries.

b. *Case limits.* In Minnesota, a winery may ship no more than two cases of wine per year to any one customer.[321] In Indiana, a winery may ship no more than 3,000 cases per year to all customers.[322] Such limitations appear arbitrary and have the effect of limiting the nonresident wineries' market access. The quantity restrictions give limited, rather than full, access to the market and preserve most of the wholesalers' monopolistic position as the only distribution route for most major wine brands. The statutes therefore seem to violate the rule against "mere economic protectionism"[323] and must be justified as necessary to promote an important state interest that cannot be advanced by nondiscriminatory means. It is difficult to imagine what legitimate interest the states will assert in creating case limits.

c. *Production limits.* Kentucky will issue small winery shipping permits only to wineries with annual production of 50,000 gallons or less,[324] though all Kentucky wineries produce less than 50,000

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317 *E.g.*, N.H. REV. STAT. ANN. § 178:14-a (2006); CAL. BUS. & PROF. CODE § 23661.3 (2006).

318 N.C. GEN. STAT. § 18B-902(d) (2006).

319 NEB. REV. STAT. § 53-124 (12) (2006).

320 Dean Milk Co. v. Madison, 340 U.S. 349, 354-55 (1951).

321 MINN. STAT. ANN. § 340A.417(a) (2006).

322 IND. CODE § 7.1-3-26-12 (2006).

323 Bacchus Imps. v. Dias, 468 U.S. 263, 296 (1984); City of Philadelphia v. New Jersey, 437 U.S. 617, 624 (1978).

324 KY. REV. STAT. ANN. § 243.155(1)(b) (2006).

gallons per year.[325] Maryland will issue winery permits with direct sales privileges only to wineries with an annual production limit of 27,500 gallons—which happens to be the annual production figure of the largest in-state winery that sells direct and does not use a wholesaler.[326] By contrast, Indiana sets permit eligibility at a whopping 500,000 gallons a year[327]—the annual production level of its largest winery. As with case limits, these annual production limits are protective of local wineries. It is hard to fathom a legitimate state interest in them.

Second: No one may ship wine (leveling down). Some states have simply closed the electronic market. No wine may be bought over the Internet and shipped. If a consumer wants to buy wine, the consumer must hitch up the wagon, drive to the winery, and purchase it on site.[328] Although even-handed on their face, these laws discriminate against nonresident wineries and exclude them from state markets "in practical effect" because no one can actually afford to drive 2,700 miles from Maine to California to pick up a few bottles of Latcham Zinfandel. Some states compound this problem by limiting the quantity of wine that an individual may personally bring back into the state,[329] which rules out even a once-a-year wine buying trip to stock a wine cellar that might be economically feasible. The attempt to level down still leaves local wineries with preferential access to the market—even if it is not as preferential as it used to be.

One aspect of leveling down deserves special attention. If a state eliminates the ability of its own wineries to ship wine directly and limits all wineries alike to face-to-face sales, it gives them a superficially appealing argument that this is a nondiscriminatory rule designed to assure that all purchasers must show identification in order to prevent youth access. However, the argument fails to stand up to scrutiny. The face-to-face requirement as a practical matter excludes distant out-of-state wineries from the market, but it still meets the Supreme Court's definition of discrimination. That means the state must prove that there is no reasonable alternative to closing the market—i.e., that adopting procedural safeguards such as electronic age verification,[330] labeling of boxes as containing alcohol, re-

325 Chris Smigell et al., *Kentucky Wine Purchasing and Production Survey*, UNIV. OF KENTUCKY HORTICULTURE DEPT., *available at* http://www.uky.edu/Ag/NewCrops/winecontent04.pdf (last visited Aug. 21, 2007).

326 MD. CODE ANN., art. 2B, § 2-101 (2006).

327 IND. CODE § 7.1-3-12-4.

328 *E.g.*, KY. REV. STAT. ANN. § 243.155 (2006); ME. REV. STAT. ANN., tit. 28-A, § 1355(3) (2006).

329 *See* IND. CODE § 7.1-5-11-15 (2006) (2 case limit per trip); N.J. STAT. ANN. § 33:1-2(a) (no personal transportation at all, except from reciprocal states).

330 *See, e.g.*, http://www.choicepoint.com/business/financial/ageverif_fs.html (last visited Aug. 21, 2007).

quiring adult signatures upon delivery, and training drivers in proper age verification, would not be an effective way to limit youth access.[331] The argument would also run into the problem that the Court requires states, in exercising their power to limit youth access to harmful materials, to tailor their restrictions narrowly, so legal adult access is not overly burdened.[332]

Third: Anyone may ship wine that was purchased face-to-face (leveling sideways). An emerging trend is to permit direct shipping, but only if the consumer purchases the wine in a face-to-face transaction on the winery's premises.[333] This scheme benefits a few citizens who happen to vacation in Napa Valley and prefer to ship wine home rather than carry it back themselves. However, it does nothing for the average consumer who cannot afford the time and money to drive 2,000 miles to California in the first place. It also completely fails to address the commerce issue, because it does not increase access to the local market for out-of-state wineries. Once local residents have traveled all the way to the out-of-state winery, they could buy the wine and carry it home even without this new law. Giving the customer the option to ship it rather than carry it back does not open market access to any new wine or winery.

B. *Reciprocity Laws*

Before *Granholm*, 13 states had reciprocity laws.[334] These laws typically provide that an out-of-state winery may ship directly to consumers only if the winery is located in a state that affords reciprocal direct-shipping privileges. The Supreme Court in *Granholm* said in dictum that these laws were "generating . . . trade rivalries" and creating "an ongoing, low-level trade war . . . destructive of the very purpose of the Commerce Clause."[335] In light of this dictum, reciprocity laws cannot survive. Indeed, California changed its reciprocal law to a direct-shipping permit law immediately following the *Granholm* decision.[336]

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331 *FTC Report*, *supra* note 17, at 29, 34 (recommending this alternative).

332 *E.g.*, 44 Liquormart, Inc. v. Rhode Island, 517 U.S. 484, 507 (1996); Lorillard Tobacco Co. v. Reilly, 533 U.S. 525, 563 (2001); Reno v. ACLU, 521 U.S. 844, 875 (2002); Ashcroft v. Free Speech Coalition, 535 U.S. 234, 252 (2002).

333 *E.g.*, KY. REV. STAT. ANN. § 243.155 (2006); MISS. CODE ANN. § 67-5-11 (2006).

334 California, Colorado, Hawaii, Idaho, Illinois, Iowa, Minnesota, Missouri, New Mexico, Oregon, Washington, West Virginia, and Wisconsin.

335 Granholm v. Heald, 544 U.S. 460, 473 (2005).

336 CAL. BUS. & PROF. CODE § 23661.3 (2006).

C. *How Far Can* Granholm *Be Extended?*

1. The easy cases

Granholm held that, in the context of laws prohibiting out-of-state wineries from shipping directly to consumers, the usual Commerce Clause rules applied. States cannot discriminate by intent or in practical effect against out-of-state wineries and give local wineries preferential market access unless there is no nondiscriminatory alternative. The Court rejected the states' arguments that the ban was necessary to prevent youth access, preserve tax revenues, assure an orderly market for the protection of public health and safety, or because of the inability to force nonresidents to comply with state laws. The Court also rejected the argument that the Twenty-First Amendment gave state liquor laws affecting interstate commerce any added presumption of validity or that alcohol regulations were exempt in any way from the rule against discriminatory regulations. The implication is that the Court will apply the same dormant Commerce Clause principles to state regulation of liquor that it applies to state regulation of other dangerous products, such as toxic waste. The Court does not say this explicitly, so the question is, how far is the Court likely to extend this principle?

The easier issues are those that merely vary the context in which state laws discriminate. For example, the result should be the same if one simply varies the kind of license held by the shipper. If a state cannot discriminate against out-of-state *wineries* by allowing only in-state wineries to ship directly, then it is hard to see how it can discriminate against out-of-state wine *retailers* by allowing only in-state retailers to ship directly to customers.[337] Similarly, if one merely varies the type of potential customer who wants to receive the shipment, the result should be the same. If a state cannot discriminate against out-of-state wineries by allowing only in-state wineries to sell directly to *consumers*, then it is hard to see how it can discriminate against out-of-state wineries by allowing only in-state retailers to ship directly to *restaurants* or *wine retailers*.[338]

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337 Several lawsuits have been filed raising this issue. *E.g.*, Siesta Vill. Mkt., LLC v. Perry, No. 3:06CV0585, 2006 WL 1880524 (N.D. Tex. July 7, 2006); Coulombe v. Jolly, 447 F. Supp. 2d 1117 (C.D. Cal. 2006). However, there is one difference between retailers and wineries—retailers do not hold a federal permit like wineries do, so one avenue of enforcement is not available to the states. *See* § III, B. 4, *supra*.

338 Lawsuits have been filed in several states raising this issue. *E.g.*, Baude v. Heath, No. 1:05CV0735, 2005 WL 4889256 (S.D. Ind. Sept. 23, 2005); Beau v. Moore, No. 4:05CV0903, 2005 WL 2807186 (E.D. Ark. Oct. 26, 2005).

2. The intermediate cases

Somewhat less certain is the fate of variants of the New York law struck down in *Granholm*. New York's physical presence rule discriminated as a matter of practical effect[339] because it would be prohibitively expensive for an out-of-state winery to comply with it. If requiring a nonresident winery to establish a physical presence in order to have access to the state market constituted "discrimination" because it was so burdensome that its practical effect was to close the market to nonresidents, then other kinds of burdens may have the same discriminatory effect. There are two problems inherent in extending this principle. First, these are fact-sensitive issues that may depend on proof. Second, there may be many situations where the practical effect is not all-or-nothing. Several aspects of state shipping laws fall into this category.

a. *Direct shipping permit fee.* In North Carolina, a direct-shipper permit is free[340] and burdens no one. In Texas, the fee is $75.[341] This, too, seems to burden no one. But a permit to ship to Nebraska costs $500.[342] If a winery wants to sell directly to consumers and restaurants in Indiana, the permits will cost $700.[343] For in-state wineries, the bulk of whose business is sales in Indiana, the expense is justified. But what about out-of-state wineries? Some may do enough business in Indiana to justify the expense but others, who make only a few sales each year, do not. Many small wineries will continue to be excluded from the state.

b. *On-site purchase rules.* In Kentucky, wine may be shipped only if the purchase was made on site in a face-to-face transaction.[344] It is potentially expensive, both in terms of time and money, for a consumer to have to travel to a winery to buy wine. Consumers who live in Louisville will probably be willing to drive the 15 miles to the Huber Winery in Indiana, but probably will not be willing to travel 1,800 miles to buy wine in Oregon. Again, some wineries will continue to be excluded as a practical matter from the local market.

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339 The "practical effect" test is part of the Supreme Court's standard definition of discrimination against interstate commerce. *See* Associated Indus. of Mo. v. Lohman, 511 U.S. 641, 654 (1994).

340 N.C. GEN. STAT. § 18B-902(d) (2006).

341 TEX. ALCO. BEV. CODE ANN. § 16.02 (1995).

342 NEB. REV. STAT. § 53-124 (11) (1943).

343 The winery will need a $500 farm winery permit, IND. CODE ANN. § 7.1-4-4.1-15 (2006), a $100 direct shipper permit, IND. CODE ANN. § 7.1-3-26-8, and a $100 small wine wholesaler permit, IND. CODE ANN. 7.1-4-4.1-13(c) (2006).

344 KY. REV. STAT. ANN. § 243.155 (2006).

c. *Delivery in own vehicle rules.* The flip side of the on-site purchase rule is the rule in some states forbidding the use of common carriers and limiting sellers to deliveries using their own vehicles.[345] The result is the same. It is just as expensive and inconvenient for a winery employee to drive to the consumer as for the consumer to drive to the winery. Huber Winery might send its truck 15 miles to Louisville to make deliveries, but no Oregon winery is going to drive 1,800 miles to deliver a case of Pinot Noir. Laws that require wineries to use their own vehicles and employees to deliver wine also make direct sales impossible as a practical matter to most out-of-state wineries, and the state market will remain closed to them.

3. The hard cases

The harder issues will involve the validity of state laws that severely level down and treat in-state and out-of-state wineries equally badly. The *Granholm* litigation was about practical discrimination—in-state wineries could sell wine directly to consumers without going through a wholesaler, and out-of-state wineries could not. But, what happens if a state cuts off the in-state wineries' ability to sell directly? Although only Maryland has gone so far as to forbid its own wineries from selling directly to *consumers* at their tasting rooms,[346] a number of states have cut off their own wineries' abilities to sell directly to *restaurants and retailers*, requiring that everyone alike use wholesale distribution for this purpose.[347] States passed these laws in anticipation of a future *Granholm*-like lawsuit charging them with discrimination against out-of-state wineries with respect to direct sales to retailers. By requiring in-state and out-of-state wineries alike to use wholesalers, discrimination has been eliminated and *Granholm* does not apply.

However, just because *Granholm* does not apply does not mean the Commerce Clause does not apply. It would be a mistake to read *Granholm* as saying that state alcohol regulations are immune from Commerce Clause scrutiny unless they discriminate. To the contrary, *Granholm* stands for the proposition that *all* traditional Commerce Clause principles apply to liquor just like other products. Therefore, if the Twenty-First Amendment does not authorize states to violate the Commerce Clause's antidiscrimination principle, then it also does not authorize states to violate other central principles of the Commerce Clause.

345 *E.g.*, FLA. STAT. ANN. § 561.57(2) (2006).

346 MD. ANN. CODE, art. 2B, § 2-204 (2006).

347 *E.g.*, in 2006, Mississippi amended its native winery law to prohibit direct sales by its own wineries to retail permittees. *See* 2006 MISS. S. B. 2454, amending MISS. CODE ANN. § 67-5-11 (2006).

Closing down the direct-sale market and requiring every winery to use a wholesaler violates several core Commerce Clause principles. First and foremost, it is an act of economic protection that serves little purpose except to line the wholesalers' pockets. Economic protectionism violates the Commerce Clause.[348] Second, it creates a local processing rule that requires wine that could more efficiently[349] be distributed directly from the out-of-state wineries to be distributed exclusively by in-state wholesalers. Local processing rules violate the Commerce Clause.[350] Third, it imposes significant burdens on interstate commerce by raising costs and limiting market access, which exceed local benefits. The Supreme Court in *Granholm* rejected the states' claims that requiring wholesale distribution was necessary to prevent youth access, collect taxes, and maintain an orderly market. It is difficult to see any other local benefits to mandatory wholesale distribution the state could come up with. When the burdens outweigh the local benefits, such laws typically violate the Commerce Clause.[351]

V. CONCLUSION

At the core of the *Granholm* litigation is the question of whether the three-tier distribution system for wine created in 1933 is *really* "unquestionably legitimate?" Despite the dicta in *Granholm* and other cases that say so, there is good reason to doubt the efficacy of such boilerplate language. The Court has not said the three-tier distribution system is unquestionably legitimate *for all purposes*, including preventing distribution of out-of-state wines. The evidence is overwhelming that requiring wineries to distribute through a wholesaler closes the market to most out-of-state wineries, serves no public interest, and economically benefits only the wholesalers. It is a classic protectionist, anti-competitive trade barrier to out-of-state products and a local processing rule. It violates almost every doctrine of the Court's dormant Commerce Clause jurisprudence, frustrates the intent of the Framers to create a single national economic union, and survives on the flimsy premise that the Twenty-First Amendment authorized states to regulate commerce in alcoholic beverages any way they see fit.

In *Granholm,* the Court said once again that the Twenty-First Amendment did not override the dormant Commerce Clause and did not give states broad regulatory authority over interstate commerce. States may

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348 Bacchus Imps. v. Dias, 468 U.S. 263, 276 (1984).

349 Wiseman & Ellig, *supra* note 195, at 22-28. It is more efficient for the 90% of wineries that are small and sell wine in small quantities, not for the major producers.

350 C & A Carbone, Inc. v. Town of Clarkstown, 511 U.S. 383 (1994).

351 Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth., 476 U.S. 573, 578-79 (1986).

not regulate wine distribution any way they see fit for any purpose. As the history of the Twenty-First Amendment shows, the Amendment was intended to give states power to regulate *local* production and sale within their borders, and to prohibit interstate commerce *in violation of local dry laws*. One cannot realistically argue that the Twenty-First Amendment gave wet states the power to erect trade barriers that prevent nonresidents from selling wine, to give preferential access to the market to local wine sellers, or to protect the economic interests of in-state wholesalers. That is what the three-tier system does, and *Granholm* suggests that its days may be numbered.

PUBLIC VERSUS PRIVATE RESTRAINTS ON THE ONLINE DISTRIBUTION OF CONTACT LENSES: A DISTINCTION WITH A DIFFERENCE

*James C. Cooper**

I. INTRODUCTION

Due to the difficulty involved with creating standardized lenses, eye care professionals (ECPs) previously fit each pair of contact lenses a patient purchased. As a result, consumers almost invariably purchased eye exams and contacts in a bundle from their ECP. Beginning in the late 1980s, however, technological improvements began to eliminate the need for lenses to be fitted individually and subsequently transformed contact lenses of the same brand and prescription into commodities.[1] Now, a consumer with a valid prescription can purchase contact lenses from an array of merchants, including optical chains, independent ECPs, warehouse clubs, mass merchandisers, and online vendors.

Since their appearance on the scene, online contact lens vendors have faced two distinct types of foreclosure. First, some states considered laws that would raise online contact lens sellers' costs by requiring online firms to be licensed as optometrists or by preventing online sellers from shipping lenses directly to consumers. The second type of restriction comes not at the hands of the state, but rather from contact lens manufacturers themselves. Some manufacturers adopted policies that prevent online sellers from distributing their lenses.

Although at first blush these two restrictions may appear to have identical effects on competition, they do not. The key distinction is that government-imposed restraints on competition among contact lens sellers is the result of a political process, whereas unilaterally imposed vertical restraints are the product of private contracting. As is widely recognized, manufacturers have incentives to enter into contracts that limit distribution to enhance interbrand competition. A voluminous body of literature pointing to

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[1] Contact lenses—like books and CDs—are differentiated products and specific brands compete against one another. Once a consumer has been prescribed a certain brand of lens, however, that lens can be treated as a commodity because it is the same regardless of where it is purchased. For example, a Focus Toric lens of a certain prescription is identical at every location it is sold; a consumer will treat the lens as a commodity, and if retailers are undifferentiated as well, she will purchase the lens from the seller with the lowest price.

the efficiencies of vertical restraints had a profound influence on antitrust law, and as a result, courts analyze unilateral vertical restraints (except express minimum resale price maintenance) under the rule of reason. The same cannot be said for government-imposed restraints; these most often are the result of lobbying by threatened incumbent sellers that wish to stifle competition. Left to their own devices, these retailers have an incentive to enter into an agreement to eliminate online rivals completely, or at least raise costs.[2] Of course, antitrust law prohibits this conduct. However, government action that achieves the same result is generally beyond the reach of antitrust law.[3] Seen through this lens, government-imposed restraints on online distribution are best understood as government enforcement of a cartel, which would be condemned under the *per se* rule if accomplished through private means.[4]

In this paper, I explore the differences between the two types of restraints and provide empirical evidence as to the likely consumer harm from government intervention into contact lens markets. First, I examine the likely costs of government-imposed restraints on online sellers by estimating consumer savings from online merchants. Because online sellers offer prices roughly thirty percent lower than the most widely used offline channels, depriving consumers of the option to purchase contacts online would lead to serious consumer harm. I also examine whether calls for government regulation that would prevent contact lens manufacturers from distributing their lenses to online merchants are justified by looking at prices for comparable lenses.[5] I find no evidence that limited distribution policies allow any class of offline sellers to charge supracompetitive prices for Proclear or Biomedics55 lenses.

Section two of this paper provides a brief background on the contact lens industry. Section three discusses some of the effects of state laws, and presents empirical evidence regarding the magnitude of savings consumers can enjoy from purchasing their lenses online. Section four examines arguments surrounding the limited-distribution lens controversy and presents empirical results, which suggest that ECPs do not take advantage of their customers. Section five summarizes the material and concludes the paper.

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[2] *See In re* Disposable Contact Lens Antitrust Litig., No. MDL1030, 2001 WL 493244 (M.D. Fla. Feb. 8, 2001); *In re* Fair Allocation Sys., Inc., No. C-3832, 1998 WL 762046 (FTC. Oct. 22, 1998).

[3] *See* E. R.R. Presidents' Conference v. Noerr Motor Freight, Inc., 365 U.S. 127 (1961); United Mine Workers of Am. v. Pennington, 381 U.S. 657 (1965).

[4] *See, e.g.*, United States v. Gen. Motors Corp., 384 U.S. 127 (1966); Seagood Trading Corp. v. Jerrico, Inc., 924 F.2d 1555 (11th Cir. 1991).

[5] *See, e.g.*, Contact Lens Consumer Protection Act, S. 2480, 109th Cong., § 7A(a) (2d Sess. 2006), which would require contact lens manufacturers to make their lenses available in a "commercially reasonable and nondiscriminatory manner" to "prescribers, entities associated with prescribers, and alternative channels of distribution."

II. OVERVIEW OF THE CONTACT LENS INDUSTRY

A consumer needs a prescription from an ECP to purchase contact lenses. The current contact lens fitting process includes an examination to determine eye health, lens power, and contact lens curvature and diameter. ECPs use a "fitting set," or a sample pair of contact lenses, as a diagnostic tool to determine whether the prescription is correct. Typically, a follow-up appointment is scheduled to assure visual acuity, fit, and comfort. Contact lens prescriptions specify patient-specific parameters (e.g., power, curvature, and diameter), and a specific brand name. Contact lens prescriptions last between one and two years.[6] Data indicates that seventy to eighty percent of contact lens wearers purchase less than a year supply at a time, so most will purchase lenses at least twice during the length of their prescription.[7]

Contact lenses are classified into two major categories—spherical and specialty. Spherical lenses contain a single refractive power and are by far the most commonly prescribed lens. Varieties of specialty lenses include toric (to correct astigmatism), multifocal (to correct near and far-sightedness simultaneously), cosmetic tint, and extended wear. According to industry data, spherical lenses account for seventy percent of dispensing visits and fifty-seven percent of total soft lens sales in 2003.[8] Within the specialty segment in 2003, toric, cosmetic tint, and multifocal lenses accounted for 16, 9, and 5 percent, respectively, of contacts lenses dispensed.[9] Most consumers wear lenses that are removed nightly and disposed of according to a replacement schedule. Lenses that require biweekly replace-

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6 Under the Fairness to Contact Lens Consumers Act (FCLCA), 15 U.S.C. § 7601 *et seq.* (2006), unless there are special health-related circumstances, a contact lens prescription must last at least one year.

7 According to this data, in 2004, surveyed ECPs reported that after the exam 64% of patients purchased a six-month supply, 20% purchased a year's supply, and 6% purchased a three-month supply. Additional data provided to the FTC also suggests that consumers purchase less than a year's supply of contact lenses, showing that only 12% of consumers from a national survey purchased a year's supply at once, whereas 31% purchased lenses two times a year, and 43% purchased 3-4 times a year. FED. TRADE COMM'N, THE STRENGTH OF COMPETITION IN THE SALE OF RX CONTACT LENSES: AN FTC STUDY 5-6 (2005), *available at* http://www.ftc.gov/reports/contactlens/050214contactlensrpt.pdf (last visited Aug. 21, 2007).

8 OPTISTOCK, MARKETWATCH REPORT (2003) reports that clear spherical accounted for approximately 70% of patient visits where a lens was dispensed for the first three quarters of 2003. Similarly, CooperVision notes that specialty lenses account for 43% of U.S. soft lens market sales. Cooper Cos., Inc., Annual Report (Form 10-K) 17 (2004). The disparity in data for sales and lenses dispensed may reflect the fact that specialty lenses typically are more expensive than spherical lenses.

9 Cooper Cos., *supra* note 8.

ment are the most popular option, followed by lenses that are replaced monthly.[10]

When contact lenses were introduced, they were made of rigid material that required an ECP to custom fit each pair. In 1971, the FDA approved the first soft contact lenses. Still, at this early stage of development, soft lenses were manufactured in a manner that did not always accurately reproduce the original prescription. These early lenses were designed to last for long periods, so consumers generally purchased lenses from their ECP after an exam, and replaced them infrequently. Technological improvements have solved standardization problems, eliminating the need for an ECP to fit each replacement pair at the end of the fitting process; now, the replacement lenses of a particular brand and prescription are identical, no matter where purchased. In this manner, the evolution in contact lens technology has allowed the sale of lenses to become unbundled from the fitting exam. Now, a consumer with a valid prescription can purchase contact lenses from an array of merchants, including optical chains, independent ECPs, warehouse clubs, mass merchandisers, and online vendors.

Although the technology to unbundle lenses from the exam has existed for over a decade, the laws of several states have made it difficult for consumers to receive a copy of their contact lens prescription, which is necessary to purchase lenses from someone other than the prescribing ECP.[11] Further, there is anecdotal evidence that some prescribing ECPs have been hesitant to let their patients know that their prescriptions are portable.[12] It was not until 2004, when Congress passed the Fairness to Contact Lens Consumers Act (FCLCA), that prescribing ECPs in all states were required to release contact lens prescriptions to their patients.[13] Under FCLCA, contact lens prescriptions are portable; ECPs must provide patients with a copy

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10 OPTISTOCK, MARKETWATCH REPORT 9 (2003) reports that for the first three quarters of 2003, two-week and monthly replacement lenses account for 64% and 20% of new contact lens fits, respectively. FTN MIDWEST RESEARCH SEC. CORP., MONTHLY CONTACT LENS INDUSTRY SURVEY 7 (2004) reports that of the ECPs surveyed, 62% said that two-week disposables were the most common lenses prescribed, while 22% said monthly disposables were the most common lenses prescribed.

11 *See, e.g.*, Hardy v. City Optical, Inc., 39 F.3d 765 (7th Cir. 1994) (an ECP claimed that Indiana law prevented him from releasing contact lens prescriptions to patients who wanted to purchase lenses at cheaper outlets).

12 *See* 1-800 CONTACTS, Inc. Comments on Issues Related to the Contact Lens Study Mandated by the Fairness to Contact Lens Consumers Act, 69 Fed. Reg. 21833 (Apr. 22, 2004), *available at* http://www.ftc.gov/os/comments/contactlensstudy/509969-0011.pdf (last visited Aug. 21, 2007). *See also* STAFF OF FED. TRADE COMM'N, POSSIBLE ANTICOMPETITIVE BARRIERS TO E-COMMERCE: CONTACT LENSES 23-25 (2004), *available at* http://www.ftc.gov/os/2004/03/040329clreportfinal.pdf (last visited Aug. 21, 2007) (discussing anecdotal evidence that even in states that explicitly allowed prescription release before FCLCA, some prescribers refused to release contact lens prescriptions to their patients).

13 H.R. 3140 108th Cong. § 2(a)(1) (2003); 15 U.S.C. § 7601 *et seq.*, (2006) (The FCLCA prohibits ECPs from tying contact lens sales to eye examinations and requires ECPs to release their patients' prescriptions.).

of their contact lens prescription to allow them to purchase their lenses from whomever they wish.

Recent data indicate that 36 million Americans—almost thirteen percent of the population—wear contact lenses (FTC 2005). According to Census Bureau (2004) data, U.S. shipments of all contact lenses were valued at $1.9 billion in 2002,[14] and estimates place annual U.S. soft contact lens sales between $1.4 and $1.8 billion.[15]

There are four major contact lens manufacturers: Bausch & Lomb, CooperVision/Ocular Sciences,[16] Ciba Vision, and Vistakon. Contact lenses are sold to consumers through several outlets. According to public data, independent ECPs (both optometrists and ophthalmologists) account for approximately sixty-eight percent of sales, with the remaining offline channels, such as optical chains, mass merchandisers, and warehouse clubs accounting for between eighteen and twenty-five percent of sales.[17] The same data indicate that online and mail order outlets account for between eight and thirteen percent of sales.[18]

III. STATE-IMPOSED RESTRAINTS ON INTERNET DISTRIBUTION

There are two ways in which the online distribution of contact lenses may lead to lower prices. First, online sellers may have lower costs, which are passed onto consumers in the form of lower prices. Although they have to pay for transportation, online firms are likely to have lower per-unit overhead costs than common brick-and-mortar contact lens sellers. For example, optical chains and independent ECPs typically are located in malls or professional office complexes and may not enjoy sufficient volume to enjoy average costs as low as online sellers.

Aside from cost differences, online sellers also may offer lower prices because they have to compete more intensely. In most models of consumer search, given search costs and knowledge of the price distribution, a consumer determines how many stores to visit and purchases from the lowest price firm observed; he will visit an additional store only if the expected

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14 This estimate is consistent with private research, which projected U.S. sales of contact lenses in 2003 to reach $1.92 billion, or 11.8% of total U.S. retail optical sales. *See The State of the Optical Market*, 20/20 MAGAZINE, Jan. 2003, http://www.2020mag.com/ViewContent/tabid/136/content_id/172/Default.aspx (last visited Aug. 21, 2007) (referencing JOBSON OPTICAL RESEARCH, THE STATE OF THE OPTICAL MARKET (2nd Qtr 2003)).

15 CooperVision reports that total U.S. sales of soft lenses are $1.4 billion. Cooper Cos. Inc., *supra* note 8, at 18. The 2002 Census data lists U.S. soft contact lens sales at $1.8 billion. U.S. CENSUS BUREAU, 2002 OPHTHALMIC GOODS MANUFACTURING, NO. EC02-311-339115 (RV), MANUFACTURING INDUSTRY SERIES 6 (Dec. 2004).

16 CooperVision recently acquired Ocular Sciences.

17 *See* FED. TRADE COMM'N, *supra* note 7, at 11.

18 The FTC Study notes that "mail order and Internet" sellers comprise 13% of contact lens prescriptions filled and 8% of sales. *Id.*

gain (from a price lower than the lowest one observed to date) is greater than the cost of search.[19] When consumers face no costs to obtain an additional price quote, stores must set their prices on the assumption that anyone visiting their store already knows—or will soon discover—the lowest price offered. Accordingly, in the case of homogeneous goods, all stores must meet the lowest price offered or make no sales. When consumers face positive search costs, they will visit fewer stores, which in turn increases the probability that a given store's price will be the lowest that a consumer will observe during his search. Because high search costs reduce competitive pressures, it follows that consumers' search costs are positively related to margins and price dispersion.[20]

It is reasonable to assume that the Internet allows consumers to compare competing online merchants' prices more cheaply than offline stores. Visiting an online merchant's website to find a price almost certainly takes less time than visiting or even calling an offline merchant for the same information. Additionally, "shopbot" websites like Shopping.com or BizRate.com allow consumers to compare large numbers of online competitors' prices with the click of a mouse. The online firm, then, must set its prices on the assumption that anyone visiting its website has seen—or will see—the lowest online price offered. Accordingly, we would expect online prices for homogeneous goods to be lower and less dispersed than those offline. Indeed, in the limiting case where all online consumers are perfectly informed about competitors' prices and view all online vendors as perfect substitutes, a zero-profit Bertrand equilibrium obtains.[21] Overall, the empirical work in this area, which largely compares online and offline prices of books and CDs,[22] has arrived at no consensus that online prices are

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19 *See* Dale O. Stahl, II, *Oligopolistic Pricing with Sequential Consumer Search*, 79 AM. ECON. REV. 700 (1989); Kenneth Burdett & Kenneth L. Judd, *Equilibrium Price Dispersion*, 51 ECONOMETRICA 955 (1983); John A. Carlson & R. Preston McAfee, *Discrete Equilibrium Price Dispersion*, 96 J. POL. ECON. 1303 (1983); Steven Salop & Joseph Stiglitz, *Bargains & Ripoffs: A Model of Monopolistically Competitive Price Dispersion*, 44 REV. ECON. STUD. 493 (1977).

20 Several economists have found empirical support for this prediction by identifying proxies for consumers' knowledge of price distributions. *See* Bev Dahlby & Douglas West, *Price Dispersion in an Automobile Market*, 94 J. POL. ECON. 1418 (1986); Theresa Van Hoomiseen, *Price Dispersion and Inflation: Evidence from Israel*, 96 J. POL. ECON. 1303 (1988); Alan T. Sorensen, *Equilibrium Price Dispersion in Retail Markets for Prescription Drugs*, 108 J. POL. ECON. 833 (2000).

21 *See* Yannis Bakos, *Reducing Buyer Search Costs: Implications for Electronic Marketplaces*, 43 MGMT. SCI. 1676 (1997), who catalogues several claims by commentators as to how the Internet would bring about "frictionless" markets, where prices are driven to marginal cost.

22 *See, e.g.*, Karen Clay et al., *Prices and Price Dispersion on the Web: Evidence from the Online Book Industry*, 49 J. INDUS. ECON. 521 (2001); Erik Brynjolfsson & Michael Smith, *Frictionless Commerce? A Comparison of Internet and Conventional Readers*, 46 MGMT. SCI. 563 (2000); Zoonky Lee & Sanjay Gosain, *A Longitudinal Price Comparison for Music CDs in Electronic and Brick-and-Mortar Markets: Pricing Strategies in Emergent Electronic Commerce*, 19 J. BUS. STRATEGIES 55 (2002); Joseph P. Bailey, Intermediation and Electronic Markets: Aggregation and Pricing in Internet Commerce (May 1998) (unpublished Ph.D. thesis, Massachusetts Institute of Technology), *available at*

lower or less dispersed than offline prices, and the results often are sensitive to assumptions about transportation costs and weighting.[23] However, one recent study finds evidence that contact lens consumers face lower search costs online than offline.[24]

If online sellers of contact lenses offer lower prices than their offline counterparts, and if consumers are aware of this price disparity, then offline sellers will be forced to compete. If, however, offline sellers can acquire government regulation to increase their online rivals' costs—for example, by imposing licensing or physical store requirements—the status quo can be maintained. Herein lies the incentive to procure regulation. Indeed, it is commonplace for threatened incumbent firms to seek government protection from competition. State imposed barriers to competition are relatively cheap to acquire and are enforced by the state. Moreover, attempts to acquire, and actions taken pursuant to, state-imposed restrictions often are beyond the reach of antitrust laws. Thus, anti-competitive, state-imposed restrictions can exist in the open without fear of punishment. For this reason, raising rivals' costs via the government process is likely to represent a

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http://www.iconocast.com/AAAPDF/phdthesis.pdf (last visited Aug. 21, 2007); Alan E. Wiseman & Jerry Ellig, *Legislative Action, Market Reaction and Interstate Commerce: Results of Virginia's Natural Experiment with Direct Wine Shipment*, Presentation at the Midwest Political Science Association (Apr. 20, 2006), *available at* http://www.mercatus.org/repository/docLib/MC_RSP_RP-DirectWineShipment_051224.pdf (last visited Aug. 21, 2007).

23 For example, an early examination of the issue finds books, CDs, and software to be significantly more expensive and prices to be more dispersed online. *See* Bailey, *supra* note 22. Clay et al. (2002) examine offline and online prices for best sellers and niche books and find similar results when taxes are added to offline purchases and shipping & handling costs are added to online purchases. *See* Clay et al., *supra* note 22. They do not weight observations by share or add transportation costs to online prices. Alternatively, in a careful study that samples prices over several months and geographic regions, Brynjolfsson and Smith (2000) find online prices for popular and niche books and CDs to be lower and less dispersed than their offline counterparts. *See* Brynjolfsson & Smith, *supra* note 22. This result holds regardless of whether transportation and shipping & handling costs are added, or whether online prices are weighted by share. *See* Glenn Ellison & Sara Fisher Ellison, *Lessons About Markets from the Internet*, 19 J. ECON. PERSP. 139 (2005); Anita Elberse et al., *The Impact of the Internet on Horizontal and Vertical Competition: Market Efficiency and Value Chain Recognition*, *in* THE ECONOMICS OF THE INTERNET AND E-COMMERCE (ADVANCES IN APPLIED MICROECONOMICS) (Michael R. Baye ed., 2002) for thorough reviews of the relevant literature. A related literature examines how the Internet has affected the prices of offline goods. *See, e.g.*, Austan Goolsbee & Jeffrey Brown, *Does the Internet Make Markets More Competitive? Evidence from the Life Insurance Industry*, 110 J. POL. ECON. 481 (2002); Fiona Scott-Morton et al., *Internet Car Retailing*, 49 J. INDUS. ECON. 501 (2001). Austan Goolsebee & Peter Klenow, *Evidence on Learning and Network Externalities in the Diffusion of Home Computers*, 45 J.L. & ECON. 317 (2002) examines the extent to which online prices affect offline prices for computers.

24 *See* James C. Cooper, *Prices and Price Dispersion in Online and Offline Markets for Contact Lenses* (FTC Bureau of Economics Working Paper No. 283, 2006), *available at* http://www.ftc.gov/be/workpapers/wp283.pdf (last visited Aug. 21, 2007).

relative bargain compared to engaging in behavior that otherwise may encourage antitrust scrutiny.[25]

The Internet's disruption of many traditional forms of distribution has led many entrenched business models to call for government regulation to hinder innovative rivals.[26] A few states have considered new regulation or interpreted old regulation in a manner that has the potential to raise online sellers' costs of doing business. For example, in 2002 the Connecticut Department of Public Health considered whether to allow nonlicensed vendors to sell contact lenses online, or whether the state would require online sellers to be licensed as a Connecticut ECP.[27] Further, North Carolina, Tennessee, Mississippi and Washington have laws or regulations that "purport to require anyone selling contact lenses to hold a valid ECP license issued by the state," and Alaska and Georgia have considered similar laws.[28] Additionally, current Georgia law requires that contact lens sales take place in a "face-to-face" transaction,[29] and Arizona and New Hampshire require that nonresident sellers of contact lenses register with the state optometry board and hold a valid optometry or pharmacy license from their home state.[30] Although the extent to which states enforce these restrictions against online sellers of contact lenses is unknown, these laws have the potential to raise online sellers' costs of serving consumers in these states, which is likely to cause them to raise their prices.

To quantify some of the potential costs of state-imposed restrictions on Internet contact lens vendors, I collected a sample of the prices online and offline sellers charge for some of the most popular disposable lenses. Specifically, during the week of November 29—December 5, 2004, price information was collected for a six-month supply of ten of the most widely-worn contact lenses from 20 online and 14 offline retailers. A six-month supply was chosen based on public data that suggest this to be the most commonly purchased quantity of lenses.[31] Six spherical lenses (Acuvue,

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25 *See* Susan A. Creighton et al., *Cheap Exclusion*, 72 ANTITRUST L.J. 975, 990 (2005) ("One of the most effective ways for a firm to acquire or maintain market power is to use the rules of government against its competitors.").

26 For example, wine distributors fought for restrictions on direct shipment of wine in several states. *See* Wiseman & Ellig, *supra* note 22. Further, real estate brokers have recently attempted to enact laws to protect them from competition from new business models. *See* Maureen K. Ohlhausen, *Competition Issues in Real Estate Brokerage*, THE ANTITRUST SOURCE, Nov. 2005, *available at* http://www.abanet.org/antitrust/at-source/05/11/Nov05-Ohlhausen11=29.pdf (last visited Aug. 21, 2007).

27 *See* Comments of the Staff of the Fed. Trade Comm'n to the Connecticut Board of Examiners for Opticians (Mar. 27, 2002), *available at* http://www.ftc.gov/be/v020007.shtm (last visited Aug. 21, 2007).

28 *See* 1-800 CONTACTS, Inc. Comments on Issues Related to the Contact Lens Study Mandated by the Fairness to Contact Lens Consumers Act, *supra* note 12, at 31.

29 GA. CODE ANN. § 31-12-12(h) (2006).

30 *See, e.g.*, ARIZ. REV. STAT. ANN. § 32-1773 (2006); N.H. REV. STAT. ANN. § 327:31 (2006).

31 *See* U.S. Census Bureau, *supra* note 15.

Acuvue2, Acuvue Advance, Frequency55, Biomedics55, Proclear Compatible), three toric lenses (Frequency55 Toric, Softlens66 Toric, Focus Toric), and one multifocal lens (Softlens Multifocal) were selected for the study. The mixture of spherical and specialty lenses is roughly consistent with consumer purchasing patterns. No publicly available data exist on market shares of individual lenses, but the lenses sampled were chosen to be among the most frequently purchased and are thus likely to capture a large proportion of actual consumer purchasing patterns.

Table 1 presents summary statistics of price information collected. For online observations, prices that include shipping and handling are presented in parentheses. Online prices for all lens types are less than offline prices taken together, but warehouse clubs offer the lowest average prices of any channel. Further, hybrid pricing (whereby online vendors co-operate with a brick-and-mortar outlet) is substantially more costly than it is for pure online merchants. In fact, a closer examination of the data reveals that with the exception of Wal-Mart online, hybrid sites' pricing reflects the pricing of their offline counterparts.

In addition to the channel in which a lens is sold, unobserved cost and demand conditions that are specific to each lens will affect pricing. Accordingly, I estimate the following model:

$$(1) \qquad p_{ij} = C + \alpha_i + \beta_1 \mathrm{CHANNEL}_k + e_{ij}$$

where p_{ij} is the price of lens i at outlet j, *CHANNEL* is a matrix of dummy variables equal to one if outlet j is within channel k and zero otherwise, and α_i is a lens-specific effect to capture unobserved cost and demand factors specific to each lens that may affect prices.

Results presented in Table 2 show that online sellers offer lenses at prices that average about 20 percent less than offline sellers. The first three columns report the results of estimating a specification of (1) with *CHANNEL* equal to one if the outlet is a pure online merchant (as opposed to a hybrid arrangement) and zero if it is an offline merchant.[32] The estimated coefficient on *PUREONLINE* is highly significant in all specifications and R^2 values indicate a good fit for the data. For all lenses, online prices are $23.64 or twenty-one percent lower than offline prices on average. Although the absolute difference between average online and offline prices is about $14 greater for specialty lenses than spherical lenses, the discount from online sellers is twenty-two percent in both cases.

There is significant heterogeneity in the outlets that sell contact lenses. For example, warehouse clubs and mass merchandisers sell a host of goods in addition to contact lenses, whereas independent ECPs and optical chains

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32 Regressions were also run on the log of p_{ij} and results are extremely similar in terms of statistical significance and magnitudes.

specialize in the sale of ophthalmic goods. Further, regardless of whether they specialize in the sale of ophthalmic goods, each type of offline outlet has a distinct business model. Thus, although pure online prices are less than average offline prices, this result is likely to obscure differences in pricing that exist among offline channels. Columns 4-6 in Table 2 report the results of regression on dummies controlling for hybrids and each offline channel. Estimated coefficients represent each channel's average difference in pricing from pure online sellers. With the exception of the estimated coefficient on *WAREHOUSE*, all channel effects are highly significant and as measured by R^2 and F-statistics, the model appears to fit the data fairly well.

The results indicate that hybrids and all offline channels—except warehouse clubs—offer higher prices than pure online merchants across all categories of lenses. The online discount varies from twenty-eight to thirty-five percent compared to independent ECPs and optical chains, twenty-four to thirty percent compared to retailers, and sixteen to twenty-eight percent compared to hybrids.[33] Warehouse club prices for spherical and specialty lenses are on average $4.01 cheaper and $0.10 more expensive than pure online prices, respectively, but neither difference is statistically significant. F-tests (not reported) do not reject the hypothesis that optical chains, independent ECPs, and mass merchandisers offer similar prices for all lenses and for specialty lenses, but do find that mass merchandisers offer statistically significantly lower prices than independent ECPs and optical chains for spherical lenses.[34]

Estimates of price differences that do not take into account consumers' costs of obtaining the good may not provide a realistic picture of the actual trade-offs that consumers face. To purchase contacts offline, a consumer must incur the cost of physically traveling to the outlet. Although online shopping eliminates the need for consumers to travel to a store, the consumer pays for the online outlet to deliver the contact lenses to him.[35]

To account for the total cost of online purchases, shipping and handling fees for the standard delivery option were added to online prices.[36] Estimating offline travel costs is more complicated. One must take into

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[33] This finding is consistent with that of X. Pan et al., *Can Price Dispersion in Online Markets Be Explained by Differences in E-tailer Service Quality?*, 30 J. ACAD. MKTG. SCI. 433-45 (2002), who also find that hybrid sites offer higher prices than pure online sellers. They conclude that this is likely a result of consumers placing greater trust in the recognizable brand names associated with hybrids.

[34] That independent ECPs and optical chains offer statistically equivalent pricing may be an artifact of Virginia's regulation prohibiting commercial optical goods sellers from employing an ECP directly. According to discussions with some industry representatives, in instances where the ECP is not an employee of the optical chain, the optical chain may call the ECP to sell all replacement lenses as part of the compensation scheme.

[35] This price may be explicit in the form of a shipping and handling fee, or may be built in to the price of the lens in cases where online outlets offer free shipping.

[36] Many online stores offer free shipping.

account both direct transportation costs (i.e., gas, depreciation) as well as the opportunity cost of time associated with a trip to the store. I use the government reimbursement rate of $0.38/mile to estimate direct costs.[37] Henscher has estimated that value of transit time for leisure trips (including shopping) is between twenty-six and forty-two percent of the average wage.[38] Small concludes that weekend time in transit is more highly valued than transit to work, and has offered fifty percent of the average wage as an approximation for the value of time in a journey to work.[39] Using the Bureau of Labor Statistics $17.75 average hourly wage and taking the mid point of Small and Henscher's estimates of the value of travel time yields an opportunity cost of time for travel to purchase contact lenses of $6.75 per hour.

Using these estimates and assuming that the trip is five miles round trip and takes half an hour, the full price for offline purchases is an additional $5.26.[40] Of course, this assumes that the only purpose of the trip is to purchase contact lenses. If, alternatively, consumers can spread the fixed cost of travel over other shopping activities (e.g., grocery shopping while at Wal-Mart, clothes shopping while at the mall, running errands adjacent to an eye doctor's office or receiving an eye examination), this estimate is likely to be too high. Accordingly, I reran the previous price regressions under three scenarios for the allocation of travel time: (1) full allocation; (2) half allocation; and (3) zero allocation.[41]

Estimated online savings by channel based on these different travel cost assumptions are reported in Table 3. Regardless of how offline transportations costs are allocated, pure online merchants still offer lower prices than all offline channels save warehouse clubs. With full allocation of transportation costs to an offline purchase, the pure online option advantage is greater than in the results reported in Table 2, reflecting the fact that online merchants can deliver lenses to consumers more cheaply than consumers can deliver themselves to brick-and-mortar outlets. The price savings from purchasing online, however, diminish as consumers allocate a lesser percentage of a given trip to the purchase of lenses. With only half of a trip's cost allocated to the contact lens price, offline prices are closer to online prices than in the baseline model, without transportation or shipping

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37 This method follows Brynjolfsson & Smith, *supra* note 22, and Wiseman & Ellig, *supra* note 22.

38 David A. Hensher, *Behavioral Value of Travel Time Savings in Personal and Commercial Automobile Travel*, *in* THE FULL COSTS AND BENEFITS OF TRANSPORTATION 274 (David L. Greene, et al. eds., 1997).

39 KENNETH A. SMALL, URBAN TRANSPORTATION ECONOMICS 44-45 (1992).

40 I implicitly assume that the time to actually complete the online and offline purchases are identical.

41 The zero allocation may be most appropriate for warehouse clubs or mass merchandisers, where a consumer purchases so many items in addition to contact lenses that the allocation of travel costs to the contact lenses approaches zero.

and handling costs included. In fact, with a fifty percent or lower allocation of trip costs to the price of lenses, warehouse club prices for spherical lenses are—statistically—significantly less than pure online prices. Under reasonable assumptions regarding actual transportation costs, warehouse clubs offer eight to twelve percent discounts over pure online outlets for spherical lenses. Still, even with zero offline transportation costs allocated to an offline purchase, consumers pay thirty to forty percent more to purchase from offline outlets—other than warehouse clubs—than from online sellers.

Overall, the data suggest that contact lens consumers who currently purchase their lenses from independent ECPs, mass merchandisers, and optical chains can save around $60 a year if they purchased online.[42] Many consumers may prefer to purchase from higher-priced offline outlets, perhaps because they offer greater service or convenience. Indeed, independent ECPs, mass merchandisers, and optical chains collectively represent around eighty percent of all contact lens sales. State laws, however, should not raise the price of contact lenses for those who choose to purchase online. Further, to the extent that online pricing acts as a competitive constraint on offline pricing, laws that impede online sellers would impose substantial costs on both online and offline shoppers.

IV. LIMITED DISTRIBUTION STRATEGIES

Some contact lens manufacturers limit the retail distribution of their lenses to outlets that have some form of eye care service. Perhaps the most prominent example is OSI/Cooper,[43] which distributes its Biomedics and Proclear lenses only through retailers that have ECPs on the premises.[44] Although limited distribution lenses are not available to pure online sellers (*e.g.*, 1-800 CONTACTS or Coastal Contacts) through traditional wholesale channels, these sellers may be able to obtain supplies on the "grey" market from retailers and distributors that are willing to resell their supplies of these lenses. This policy disadvantages pure online vendors by forcing them either to be unable to serve customers with prescriptions for these lenses or to pay higher wholesale prices on the "grey" market. To the extent that these online vendors end up either not selling limited distribution lenses or charging higher prices for them than they otherwise would, limited distribution polices also inconvenience consumers who receive Proclear or Biomedics prescriptions and have strong preferences for purchasing their lenses from pure online merchants. Critics of limited distribution

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42 The estimates are based on a six-month supply, so doubling these estimates produces yearly savings.

43 Coopervision acquired OSI in January 2005.

44 *See* FED. TRADE COMM'N, *supra* note 7, at 14-16.

policies, moreover, argue that by disadvantaging pure online sellers, this practice essentially locks consumers into purchasing from their prescribers.

Although appealing on its face, the lock-in theory of harm from limited distribution practices does not mesh well with the actual marketplace facts. Further, because these distribution restrictions are the result of unilateral manufacturers, rather than concerted retail action, economics supports a presumption—one adopted by antitrust laws—that this behavior is efficient. Most importantly, the data appear to belie the notion that offline sellers are able to extract supracompetitive prices from their clients by prescribing these limitedly distributed lenses.

A. *Lock-in Theory of Harm from Limited Distribution*

As discussed earlier, contact lens consumers require a prescription to purchase contact lenses. Thus, the full price of contact lenses includes the contact lens fitting examination plus the cost of contacts for the life of the prescription. Although consumers easily can determine the price of an eye examination before purchasing one, they will not know the price of their contact lenses until they have already purchased the examination. Because consumers lack the specialized skill to determine which contact lens is appropriate for them, they must rely on their prescribing ECP to make the selection for them. Furthermore, as long as a consumer's lenses comfortably correct her vision, she may never discover that she has been prescribed the most profitable lens rather than the one that best fits her needs. Even if she discovers that other, less expensive alternatives exist to the lenses that she has been prescribed, moreover, she may assume that a unique ocular condition requires her current lenses.

In credence goods markets like these, experts may have an incentive to "over-treat" their patients by diagnosing a high-priced treatment when only the low-priced treatment was needed.[45] Thus, if ECPs enjoy higher margins on limitedly-distributed lenses because they face less retail competition, ECPs may take advantage of their informational advantage and prescribe limited distribution lenses even when such a prescription is not in their patient's best interest. The over-treating equilibrium in credence goods models, however, depends on the crucial assumption that the consumers cannot

[45] Darby and Karni, coined the phrase "credence" qualities as "those, which although worthwhile, cannot be evaluated in normal use. Instead, the assessment of their value requires additional costly information." Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L. & ECON. 67, 68-69 (1973). The archetypal example of a credence good is an automobile repair. A consumer's car does not run and only the mechanic knows whether the repair needed is a new engine or merely a $100 part. Regardless of what work is done, the car will run, and the consumer will never know whether the new engine was necessary to restore the car to working order. For an excellent review of the credence good literature *see* Uwe Dulleck & Rudolf Kerschbamer, *The Economics of Credence Goods*, 44 J. ECON. LITERATURE 5 (2006).

purchase the treatment and the diagnosis from separate parties. When this condition does not hold, there is no incentive for the expert to fraudulently diagnose the high priced treatment because there is no guarantee that the consumer will purchase the treatment from him; if competing experts sell treatment based on other experts' diagnoses, competition prevents experts from earning supracompetitive margins from fraudulent diagnosis.

Significantly, the assumption of non-portable diagnoses does not hold in the market for contact lenses; federal law mandates that ECPs release contact lens prescriptions to consumers. Because FCLCA gives consumers the right to have their prescription filled by whomever they chose, there is no guarantee that they will fill prescriptions for limited distribution lenses from their prescribing ECP rather than from a competing offline seller offering a better price.[46] Thus, prescribing ECPs must set prices for limitedly distributed lenses on the assumption that if his prices are too high, consumers will go elsewhere.

Although Proclear and Biomedics55 are not available to online sellers through normal distribution channels, they are available to consumers through most online and offline sellers sampled. For example, Biomedics55—or its private label equivalent—is available from all offline and nearly all online outlets sampled, including all optical chains sampled, Wal-Mart, Sam's Club, BJ's, Target, and Sears. These lenses also are sold on Wal-Mart's, BJ's, and America's Best's websites. Proclear lenses were found at 88 percent of online sellers' sites, and were available at all but three offline stores (Wal-Mart, Sam's Club, and Pearle). As shown in the previous section, warehouse clubs and online sellers charge equivalent prices for lenses. Thus, even if OSI/Cooper were completely successful at keeping online firms from selling Biomedics55 and Proclear lenses, offline competition is still likely to be sufficient to prevent offline sellers from earning supracompetitive margins on these lenses.

Even if a specific consumer is unaware that his prescription is portable and that alternative sellers exist, competition will constrain an ECP's pricing for contact lenses as long as a sufficient proportion of his patients know that they can purchase replacement lenses elsewhere and the ECP cannot distinguish between informed and uninformed patients.[47] Further, if a par-

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46 Prior to FCLCA, several states also mandated prescription portability.

47 Whether equilibrium is characterized by uniform supracompetitive prices, uniform competitive prices, or some firms charging high prices and some firms charging low prices depends on such factors as the proportion of informed consumers, consumer demand functions, firms' cost curves, the number of firms, and consumer search costs. *See* DENIS W. CARLTON & JEFFERY M. PERLOFF, MODERN INDUSTRIAL ORGANIZATION 431-42 (Addison Wesley 3d ed., 2000); Steven Salop & Joseph Stiglitz, *Bargains and Ripoffs: A Model of Monopolistically Competitive Price Dispersion*, 44 REV. ECON. STUD. 493 (1977). Some empirical evidence suggests that most consumers know that they can use a prescription from an ECP to purchase contact lenses elsewhere. *See* 1-800 CONTACTS, *supra* note 12, at 10, attach. 33, app. C. (national survey of contact lens wearers used in expert report filed in *Contact Lens*

ticular seller is insulated from retail competition because its consumers are unaware that options exist, this would hold for all lenses it sells, not merely limited distribution lenses; any rent attributable to high search costs is unrelated to limited distribution polices.

There are other reasons to be skeptical of the lock-in theory as well. First, it assumes that ECPs can choose a lens for a patient without regard to the patient's preferences because the patient will not know when a choice violates his or her preferences until after the prescription is written. However, some consumers may have enough knowledge of lens prices and attributes to inform their ECPs before hand of their preferences. For example, advertisements for national brands of lenses are commonplace and consumers may discuss lens options with friends or co-workers. Further, 1-800 Contacts offers information on its website regarding the limited distribution policies of OSI and CooperVision.[48] Thus, some consumers may possess sufficient knowledge about contact lens brands to ask their prescribing ECP for a specific, widely available brand. Consumers also may be able to gain information regarding which ECPs are likely to prescribe lenses that are widely available. Online sellers have an incentive to assure that consumers receive prescriptions that they can fill online. For example, 1-800 CONTACTS and Cole National have set up a "doctor's referral network" where customers of 1-800 CONTACTS in need of a new prescription will be referred to a network of optometrists associated with Cole National.[49] In return, Cole will refer patients in need of replacement contact lenses to 1-800 CONTACTS, although patients are free to purchase lenses elsewhere.

Second, a rational ECP will inappropriately prescribe a limited distribution lens only if the expected gain from an increased margin is greater than any expected loss in terms of repeat business. It is not clear that contact lenses are necessarily credence goods. For example, consumers can learn from advertisements, friends, family, and co-workers whether they have paid a higher-than-average price for their contact lenses, and some may be able to discern whether the intrinsic quality of their lenses (e.g., whether it is made of a new polymer) merits the price premium that they were charged. If consumers can detect that they have been victims of ECP opportunism, the ECP will risk losing not only repeat contact lens sales, but also repeat exam and eyeglass business, which comprise the vast majority

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MDL shows that 76% of those surveyed were aware that lenses can be purchased elsewhere and that 68% were aware that they could purchase lenses from mail-order companies).

48 For example, with respect to OSI's Biomedics 55, 1-800 CONTACTS provides the following information on its website:

> If you are interested in wearing a different contact lens, one available any place you chose to shop, you might consider requesting a prescription for a different brand during your next exam. In addition, if your eye care provider will only prescribe a contact lens that he/she believes you can't buy anywhere else, you might want to go elsewhere for your eye care.

See http://www.1800contacts.com/product.aspx?itm+001528&cv=000360 (last visited May 10, 2006).

49 *See* 1-800 CONTACTS, *supra* note 12, at attachment 52.

of optical revenue.[50] Further, the ECP risks losing other customers who learn of this opportunistic behavior.[51] Because most contact lens prescriptions last one year, for this type of behavior to make economic sense, the incremental margin for limited distribution lenses would have to be substantial.

Finally, competition between ECPs for contact lens fittings constrains ECPs' ability to lock consumers into high-priced lenses. Because the market for eye examinations is highly fragmented, it is unlikely that any individual ECP would possess the power to charge supracompetitive prices for examinations. Thus, even if they are able to lock consumers into high-priced lenses, ECPs are likely to compete for the opportunity to charge supracompetitive prices for such lenses by reducing the price charged for fitting until all excess profits from the high-priced lens prices are dissipated.[52]

B. *The Law and Economics of Limited Distribution*

There are sound reasons to doubt whether the necessary conditions for the lock-in theory of harm from limited distribution policies obtain. Additionally, economic theory and empirical evidence provide a basis for a rebuttable presumption that limited distribution policies benefit consumers by enhancing interbrand competition.

1. Increasing Incentives to Provide Valuable Services

Because a manufacturer and a retailer may have different incentives to generate additional sales, a manufacturer may find it efficient to place restrictions on the distribution of its product. By placing limits on intrabrand

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50 *See* Jobson Optical Research, *supra* note 14, at 4, 12 (in 2002, contact lens sales generated $1.96 billion and eye examinations generated $3.6 billion). An ECP also may lose eyeglass sales considering that most contact lens wearers also are likely to wear eyeglasses. Frames and eyeglass lenses together accounted for 84.5% of retail optical sales in 2003, compared with just 11.8% for contact lenses. *See* Jobson Optical Research, *supra* note 14, at 1.

51 It is not necessary that all consumers in the market know which ECPs have a reputation for behaving opportunistically for those ECPs to be driven from the market. All that is required to deter providing the low quality good at the high quality price is that a sufficient proportion of consumers can differentiate between ECPs that take advantage of consumers' lack of information and those that do not, and that ECPs cannot present different offers to informed and uninformed consumers. Whether equilibrium without ECPs acting opportunistically obtains is also a function of such factors as consumer demand functions, information costs, and firms' costs curves. *See, e.g.*, Russell Cooper & Thomas W. Ross, *Price, Product Qualities and Asymmetric Information: The Competitive Case*, 51 REV. ECON. STUD. 197 (1984); *Yuk-Shee Chan & Hayne Leland, Prices and Qualities in Markets with Costly Information*, 49 REV. ECON. STUD. 499 (1982).

52 *See* Carl Shapiro, *Aftermarkets and Consumer Welfare: Making Sense of Kodak*, 63 ANTITRUST L.J. 483, 493-94 (1995).

competition, a manufacturer can enhance interbrand competition with its rivals.

Retail promotion and service is an important complement to many consumer goods. To reach an optimal level of output, a manufacturer often will find it efficient to provide those consumers who are just indifferent between purchasing or not with extra services to make the purchase worth their while. For instance, relatively uninformed consumers of high-end electronic equipment may require expert assistance to determine the proper product for them; without such assistance they may choose not to purchase at all. A manufacturer also may desire a retailer to take steps to assure that a product maintains the level of quality that consumers expect from a given brand. For example, a brewer may insist that a retailer store its beer in a certain way to preserve its quality. Without proper storage, total demand for the beer (i.e., not merely demand at the one retail location) would be lower because consumers would be likely to associate the poor quality not with the retailer's inadequate storage, but with the manufacturer's product.[53]

In many cases, however, retailers will have less of an incentive to engage in sales-generation efforts than manufacturers. For instance, when the manufacturer's profit margin for additional sales is large in relation to the retailer's (as may be the case for branded products), the retailer rationally will provide a lower level of promotion than is optimal for the manufacturer.[54] Further, because retailers do not reap all of the benefit from a manufacturer's reputation, they are likely to have an incentive to provide suboptimal efforts to maintain a level of quality that is associated with a manufacturer's brand name.[55] Thus, a manufacturer will need to compensate the retailer for expending the desired effort and would like to enter into a contract that spells out the services that a retailer must perform. Because retail service provisions can be complex and difficult to measure, often a manufacturer will find it impracticable to specify in a contract the exact type and level of promotional services it desires from retailers.

One solution to this problem is for a manufacturer to have distribution policies that insulate retailers from intrabrand (other sellers of that manu-

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53 *See, e.g.*, Adolph Coors Co. v. Fed. Trade Comm'n, 497 F.2d 1178 (10th Cir. 1974).

54 For example, one study reports that apparel manufacturers' average gross profit margin is forty-six percent compared with only nine percent for "multiple apparel retailers." Robert Gertner & Robert Stillman, *Vertical Integration and Internet Strategies in the Apparel Industry*, 49 J. INDUS. ECON. 415 (2002). The authors note that this disparity in compensation for marginal sales "will limit the incentive of retailers to invest in developing and promoting their websites unless there is some form of co-op funding or restructured pricing." *Id.* at 427.

55 This phenomenon may be likely to arise in a franchise context. For example, although a restaurant franchisee using low-quality ingredients would lose repeat sales at its outlet, it may also cause fewer patrons to visit other franchisees' outlets as well. The low-quality franchisee does not internalize the full costs of actions that depreciate the brand name capital of the franchisor. *See* Benjamin Klein, *The Economics of Franchise Contracts*, 2 J. CORP. FIN. 9 (1995); Paul H. Rubin, *The Theory of the Firm & the Structure of the Franchise Contract*, 21 J.L & ECON. 223 (1978).

facturer's product) competition. In this way, a manufacturer can provide its retailers with sufficient compensation to create incentives to supply the desired retail service.[56]

Limited distribution policies also can prevent discounters from free-riding on a full-service retailer's efforts to increase demand.[57] Under this "special services free-riding" argument, absent exclusive territories, a consumer may come to the full-service retailer to learn about the product from a knowledgeable and attentive sales staff but purchase from a discounter that offers lower prices because it does not provide any service. Insulated from discounters, full-service retailers can capture the full return to their service efforts, thereby helping to assure that the optimal level of service is achieved.[58]

The empirical literature tends to support the notion that vertical integration and restraints like resale price maintenance and exclusive dealing/exclusive territories tend to reduce price and/or induce demand-increasing investments. As two economists who have recently reviewed the relevant studies conclude:

> The evidence supports the conclusion that in these markets, manufacturer and consumer interests are apt to be aligned, while interference in the market is accomplished at the expense of consumers (and of course manufacturers). This is probably true because manufacturers have every incentive to develop lean and efficient distribution systems to reach the ultimate consumers, which entails imposing vertical restraints on retailers when such restraints enhance dealer services and efficiency more generally, and encouraging retail competition by eschewing restraints when such competition yields lower distribution and sales costs.[59]

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56 *See* Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J.L. & ECON. 265 (1988).

57 *See* Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86 (1960). *See also* Isaksen v. Vermont Castings, Inc., 825 F.2d 1158, 1161-62 (7th Cir. 1987) (describing how minimum resale price maintenance can also be used to assure dealers provide the proper level of service by preventing discounters from free-riding).

58 Empirical studies of online marketing strategies find that manufacturers have tended to pursue Internet retailing in a way that preserves incentives to provide retail service. For example, one study finds that high-end fragrance producers that have restrictive distribution practices in the physical world are more likely to practice similarly restrictive distribution strategies online, such as offering their product online only through their own website at an equal or higher price than is available elsewhere. *See* Judith Chevalier & Dennis Carlton, *Free Riding and Sales Strategies for the Internet*, 49 J. INDUS. ECON. 441 (2001); *see also* Robert Gertner & Robert Stillman, *Vertical Integration and Internet Strategies in the Apparel Industry*, 49 J. INDUS. ECON. 415 (2002).

59 Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Public Policy and Empirical Evidence*, *in* HANDBOOK ANTITRUST ECON. (forthcoming 2005), *available at* http://www2.warwick.ac.uk/fac/soc/economics/staff/faculty/slade/wp/ecsept2005.pdf (last visited Aug. 21, 2007). *See also* James C. Cooper et al., *Vertical Antitrust Policy as a Problem of Inference*, 23 INT'L J. INDUS. ORG. 639 (2005) (reviewing the literature and reaching a similar conclusion).

2. Antitrust Treatment

In the United States, a plaintiff can challenge vertical restraints under section 1 of the Sherman Antitrust Act as an unreasonable restraint of trade, or under section 2 as exclusionary conduct in furtherance of monopoly power. Under either cause of action, a plaintiff must show that the agreement in question is likely to harm competition.

In the seminal case *Cont'l T.V., Inc. v. GTE Sylvania Inc.*,[60] the Supreme Court overruled *United States v. Arnold, Schwinn & Co.*,[61] and held that non-price vertical restrictions were to be judged under the rule of reason. Under the rule of reason, a plaintiff must show that the agreement is likely to have "genuine adverse effects on competition."[62] In support of its abandonment of per se treatment, the Supreme Court observed in *Sylvania* how exclusive territories had the potential to "induce competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer."[63] A few years later, in *Monsanto Co. v. Spray-Rite Service Co.*, the Court again endorsed vertical restrictions that encourage retail service, supporting a manufacturer's right to terminate a discounting dealer to prevent free riding: "independent action is not proscribed. [A supplier] has a right to deal, or refuse to deal, with whomever it likes as long as it does so independently."[64]

A supplier's unilateral decision to restrict the distribution channels in which its product is available will raise antitrust concerns only if a plaintiff can show that such a restraint is likely to harm interbrand competition and that this harm outweighs any procompetitive benefits.[65] Concerted efforts

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60 433 U.S. 36 (1977).

61 388 U.S. 365 (1967).

62 Fed. Trade Comm'n v. Ind. Fed'n of Dentists, 476 U.S. 447, 460 (1986). *See also* Virgin Atl. Airways, Ltd v. British Airways PLC, 257 F.3d 256, 264 (2d Cir. 2001) (plaintiff is required to show that the agreements in question "had an actual adverse effect on competition as a whole in the relevant market"); P. AREEDA & H. HOVENKAMP, VII ANTITRUST LAW at ¶ 1503a (2d ed. 2003) ("Every antitrust suit should begin by identifying the ways in which a challenged restraint might possibly impair competition.").

63 *GTE Sylvania, Inc.*, 433 U.S. at 55.

64 465 U.S. 752, 760-61 (1984).

65 *See* Business Elecs. Corp. v. Sharp Elecs. Corp., 485 U.S. 717, 727-28 (1988); *see also* Ezzo's Invs., Inc. v. Royal Beauty Supply, Inc., 243 F.3d 980, 988 (6th Cir. 2001) (affirming summary judgment for defendant where plaintiff failed to present evidence that defendant had "sufficient market power to affect competition within the relevant market," or that defendant's restrictive distribution polices "had an effect on interbrand competition."); Generac Corp. v. Caterpillar Inc., 172 F.3d 971, 977 (7th 1999) (to prevail in a rule of reason challenge to territorial restrictions on distribution, a plaintiff "must demonstrate, at a minimum, that its agreement with Caterpillar has an anticompetitive, welfare-reducing effect that is not overcome by any pro-competitive, welfare-enhancing consequences of the agreement."). For challenges to a dominant firm's vertical restraints under section two of the Sherman Act, a plaintiff must first show a causal link between the monopolist's actions and its market power.

by retailers to boycott or otherwise coerce manufacturers to disadvantage discounters, however, is a *per se* violation of the antitrust laws.[66] The plaintiffs in *In re Disposable Contact Lens Antitrust Litig.* proceeded on such a theory.[67] There, plaintiffs alleged that "the ECP community threatened to boycott any manufacturer that did not implement an ECP-only distribution policy," and that the manufacturers and ECP community had "reached a tacit, if not express agreement . . . to restrict sales to alternate channels."[68] This type of an arrangement clearly has no pro-competitive virtue, but it is important to distinguish such joint conduct from unilateral business decisions by contact lens manufacturers not to deal with certain distributors. Whereas the latter conduct enjoys a rebuttable presumption of efficiency based on economic theory and empirical evidence,[69] we presume that agreements among competitors to suspend the normal give and take of the marketplace will lead to consumer harm.[70]

C. *Empirical Evidence*

Although there are strong theoretical reasons to be skeptical that limited distribution policies harm consumers, theory alone cannot rule out such harm. Ultimately, it is an empirical question whether limited distribution policies leave offline sellers with insufficient competition to force pricing to the competitive level. In this subsection I examine some data that tend to

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That is, the monopolist's conduct must "reasonably appear capable of making a significant contribution to creating or maintaining monopoly power." United States v. Microsoft Corp., 253 F.3d 34, 79 (D.C. Cir. 2001) (quoting Phillip E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 651c, at 78 (1996)). However, even if conduct tends to promote the accretion of monopoly power by excluding rivals, it does not necessarily run afoul of section two. As with all actions brought under the Sherman Act, "a monopolist's act must have an 'anticompetitive effect.' That is, it must harm the competitive *process* and thereby harm consumers." *Microsoft Corp.*, 253 F.3d at 58. *See also* Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 605 (1985) (whether "conduct may properly be characterized as exclusionary cannot be answered by simply considering its effect on [the plaintiff]. In addition, it is relevant to consider the impact on consumers and whether it has impaired competition in an unnecessarily restrictive way.").

66 *See Gen. Motors Corp.*, 384 U.S. 127 (1966); *Seagood Trading Corp.*, 924 F.2d 1555 (11th Cir. 1991).

67 No. MDL1030, 2001 WL 493244 (M.D. Fla. Feb. 8, 2001).

68 *Id.* at *3.

69 *See* Lafontaine & Slade, *supra* note 59, at 23 ("While more empirical evidence is needed before we can draw a final conclusion, and in particular before we can rule out the possibility that vertical restraints lead to foreclosure or anti-competitive behavior more generally, the empirical evidence suggests that in fact a fairly relaxed attitude towards restraints may well be warranted.").

70 *See Ind. Fed'n of Dentists*, 476 U.S. at 459 ("Absent some countervailing procompetitive virtue," an impediment to "the ordinary give and take of the market place . . . cannot be sustained under the Rule of Reason.") (internal quotations and citations omitted).

cast further doubt on the viability of the lock-in theory of consumer harm from limited distribution lenses.

A difficulty with any empirical examination of the effects of limited distribution policies is to determine the correct "competitive" benchmark. That is, merely finding that sellers charge higher prices or enjoy larger margins for Proclear and Biomedics than those of Acuvue lenses does not provide any information unless all these lenses are identical in every respect save their distribution policies.[71] This, of course, is not the case. To make any inferences from price and margin data, we must account for all factors that may influence these variables. Further, it is important to recognize that even if limited distribution policies allow offline sellers to charge more for Proclear and Biomedics lenses than they otherwise could, these policies may be efficient mechanisms to assure that retailers provide services that consumers value. In this way, finding that offline sellers enjoy higher margins for limited distribution lenses is merely a necessary, not a sufficient condition to conclude that limited distribution policies for contact lenses harm consumers.

I calculated margins for the lenses sampled by subtracting the wholesale list prices from lens prices.[72] Figures 1, 2, and 3 show average margins for a six-month supply of lenses charged by all offline retailers, optical chains and independent ECPs, and only independent ECPs, respectively. The rankings of margins are nearly identical for each sample: Acuvue spherical lenses and Biomedics55 have the lowest margins and Softlens multifocal and toric products are substantially higher than others. Low margins for Acuvue spherical lenses may reflect the fact that these lenses are the most widely advertised, and margins are inversely related to consumer price information.[73] The relatively high Softlens margins may represent a business strategy by Bausch & Lomb to compensate ECPs for providing greater effort in marketing these lenses. Further, it is likely that fitting multifocal and toric lenses takes more training and effort than fitting spherical lenses, and that ECPs pass a portion of this expense on to consumers. Proclear margins average $38 to $39, which is higher than all spherical lenses save Frequency55. However, there is no statistical differ-

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[71] Even if ECPs do not earn higher margins on sales of limited distribution lenses, they may enjoy higher profits if limited distribution policies increase the probability that a consumer purchases the lens from the prescribing ECP. However, if ECPs face less elastic demand for limited distribution lenses than for other lenses, rationally they would set higher prices for these lenses. Standard economic models of pricing behavior predict that margins are inversely related to demand elasticity. In this manner, measuring margins is an indirect method of measuring whether demand is less elastic for limited distribution lenses than for other lenses.

[72] List prices come from TYLER'S QUARTERLY, INC., SOFT CONTACT LENS PARAMETER GUIDE (Jun. 2004).

[73] *See* Cooper, *supra* note 24.

ence between Proclear margins and those of Acuvue Advance, another lens which is likely to be a close competitor of Proclear.[74]

To control for other factors that might influence margins in addition to limited distribution policies, I regressed margins on various controls. The dependent variable is the price of lens *i* at outlet *j*. I used several variables to control for factors that may be associated with higher margins. I included dummy variables equal to 1 if lens *i* was a toric or a multifocal lens. It is likely that sellers would include higher margins for specialty lenses to compensate them for the additional effort and training that fitting these lenses often require. These lenses also are more likely to be associated with intellectual property that would lead to higher margins, some of which sellers will likely capture. The variables *H2O* and *DK* control for water content and oxygen permeability respectively—both of which are generally associated with new lens polymers that increase eye breathability and comfort. To the extent that lenses with high *DK* values and water content lenses represent "new" technology, they are likely to be linked to lower demand elasticities because they compete with fewer lenses. The variable of main interest is a dummy equal to 1 if the lens is Biomedics55 or Proclear. If insulating offline retailers from online competition allows offline retailers to enjoy higher margins on these lenses, then these coefficients should be positive. Results are reported in Table 4.

Columns 1 and 2 represent baseline regressions, and merely mimic the patterns exhibited in Figures 1 through 3. Averaged together, margins of Biomedics55 and Proclear are not statistically different from those of other lenses, conditioned on whether the lens is a toric or a multifocal. However, taken separately, margins for Proclear lenses are on average $7.75 higher than other spherical lenses. Because outlet pricing is likely to be a function of store-specific cost and demand factors—independent ECPs and optical chains have quite different business models and cost structures than mass merchandisers and warehouse clubs—Column 3 includes store-effect dummies. Accounting for store-effects doubles R^2, suggesting that variation in outlets is responsible for at least as much variation in margins as is variation in lenses. The inclusion of store dummies also causes the coefficient on Proclear to fall by nearly half and become insignificant.

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[74] A t-test for equality of means for two samples fails to reject the hypothesis that Proclear and Acuvue Advance margins are equal: all online, t = -1.31 (p = 0.80); independent ECPs & optical chains, t = -0.40 (p = 0.30); independent ECPs, t = -0.33 (p = 0.25). Proclear Compatibles are made from omafilcon A, which is purported to have superior qualities with regard to preventing dry eyes. Acuvue Advance is made from galyfilcon A, which is marketed as Hydraclear and likewise is purported to be unique in its moisture retention abilities. *Compare* ad for Proclear Compatibles on CooperVision's website at http://www.coopervision.com/us/patient_clensesbycat.asp?id=8 (last visited Aug. 21, 2007) with ad for Acuvue Advance on 1-800 CONTACTS' website at http://www.1800contacts.com/lens/acuvue-advance.htm (last visited Aug. 21, 2007). *See also* FTC Study, *supra* note 7, at 26 n. 81 (noting that ECPs interviewed by FTC staff identified Proclear and Acuvue Advance as similar lenses).

Column 4 includes *DK* and *H2O* to control for factors related to lower demand elasticities. As expected, *DK* and *H2O* have positive and significant effects on margins, and the inclusion of these variables turns the coefficient on Proclear negative, but insignificant. Columns 5 and 6 repeat the regression in column 3 (without *DK* and water content controls) but for only optical chains and independent ECPs. Consumers purchase the vast majority of lenses through these channels, so a focus on margins for limited distribution lenses in these outlets may give a more accurate depiction of the market. These regressions indicate that neither optical chains nor independent ECPs appear to earn higher margins on limited distribution lenses than on other spherical lenses.

To the extent that wholesale price data do not accurately reflect true transaction prices, I took a hedonic approach and examined the prices that sellers charge for lenses of similar qualities. A cursory examination of average lens prices does not reveal any pattern. Figure 4 shows average lens prices charged by all offline retailers, optical chains and independent ECPs, and Figure 6 shows lens prices of independent ECPs alone. In all three retailer samples, Proclear sells for around \$89, which is \$10 to \$13 less than Acuvue Advance, its closest substitute in the sample. Proclear consistently ranks as the highest priced spherical lens. The price of Biomedics55 is more variable, ranging from \$80 to \$88. The data indicate that mass merchandisers and warehouse clubs charge lower prices for these lenses than optical chains and independent ECPs (whose average price is within \$1). Acuvue, Acuvue2, and Frequency55 lenses are priced the lowest, and, not surprisingly, toric and multifocal lenses are the most expensive.

To control for quality differences that might be driving price differences, I used a hedonic regression which estimates price as a function of attributes consumers are likely to value. The dependent variable is the price of lens i at outlet j. I used several variables to control for quality differences likely associated with higher prices. *DK* and *H2O* control for comfort, and I included dummy variables equal to 1 if lens i is a toric or a multifocal lens. The variable of main interest is a dummy equal to 1 if the lens is Biomedics55 or Proclear. If limited distribution policies allow offline merchants to raise prices above what they would be, given the quality of these lenses, then the coefficient should be positive. Results are reported in Table 5.

The first three columns of Table 5 present results based on the sample of all offline outlets. The coefficient on limited distribution is positive, but insignificant in the first column of Table 5. As predicted, the coefficients on all quality controls are positive, reflecting the fact that consumers are willing to pay more for these attributes. Because the manufacturers may enforce the limited distribution polices on Biomedics55 and Proclear differently, the second column in Table 5 presents results controlling for each of these lenses individually. In this specification, Proclear prices are not statistically different from other lenses conditioned on quality, but Biomedics55 lenses are $13.45 more expensive than lenses with similar attributes. Column 3 includes store fixed-effects to control for store-specific costs and demand factors that are likely to be affecting lens prices. Including these effects increases R^2 by fifteen percentage points, suggesting that, like for the margin regressions, interstore differences are an important component of overall price variation. The estimated coefficient on Proclear remains negative, doubles in value, and becomes significant.[75] The coefficients on Biomedics55 and the quality variables remain essentially unchanged in magnitude and significance. Columns 4 and 5 report results of regressions on samples containing only independent ECPs and optical chains. In both subsets, Proclear lenses are more expensive and Biomedics55 lenses are less expensive than lenses of similar quality, but the coefficient on Biomedics55 for the independent ECP sample is not significant.

* * *

Taken as a whole, the data do not support an inference that limited distribution policies allow offline sellers to charge supracompetitive prices for Biomedics55 or Proclear. Most importantly, once store-specific cost and demand factors are taken into account, there is no statistical difference between margins on limited distribution lenses and other spherical lenses. Although, in several specifications, Biomedics55 lenses appear to be more expensive than lenses with similar attributes, Proclear lenses are less expensive. Looking at margins, moreover, we see that the relatively high price for Biomedics55 is driven by its relatively high wholesale price. Indeed, Frequency55—consistently the lowest priced lens—appears to have the highest margins for spherical lenses. What is more, if CooperVision and OSI had similar policies in place and were similarly successful in enforcing them, we would expect to see similar effects. Given that Proclear lenses are much less widely available than Biomedics55, it seems unlikely that CooperVision's policy with regard to Proclear was significantly less ineffective than OSI's policy with Biomedics55.

Even taking the estimated $7 higher margin for Proclear without controls for store effects, it is important to recall that finding higher margins is merely a necessary, not a sufficient condition for consumer harm. If the limited distribution policy allows some merchants to earn higher margins on Proclear lenses, this may represent compensation for providing enhanced consumer services. Further, one has to ask the question whether it makes economic sense to risk a repeat patient—who may purchase glasses and exams in the future—for a $14 gain. Overall, Cooper/OSI's limited distribution policy appears more likely designed to maintain manufacturer reputation rather than to provide merchants with higher margins.

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75 This is likely to be an artifact of the fact that Proclear is unavailable at both Sam's Club and Wal-Mart, two of the lowest-priced stores in the sample.

Of course, the data do have some limitations. First, the offline sample is limited to Northern Virginia, so the results may not be representative of how all offline stores price limited distribution lenses. Second, the wholesale prices are not transaction prices. If actual wholesale prices are substantially less for limited distribution lenses than those used in this study, then margins would be understated. Third, although the sample is likely to capture a large percentage of actual consumer purchases, it is not comprehensive. Although there is no *a priori* reason to expect it, a broader range of control lenses (i.e., those without limited distribution policies) may yield different results. Finally, this study is static, capturing only a snapshot of the market at the end of 2004. Future work could examine whether the effect of limited distribution policies has changed over time.

V. CONCLUSION

In this paper I have presented empirical evidence that should cast doubt on the need for government intervention into contact lens markets. In some states, offline sellers have attempted to procure government regulation to hinder online rivals. Because consumers can purchase lenses online for up to 30% less than they can from the most widely used offline outlets, any state action that limits online sellers' ability to compete has the potential to impose substantial costs on consumers. At the same time, contact lens manufacturers' unilateral policies not to make their lenses available to online sellers do not appear to allow offline sellers to charge supracompetitive prices for these lenses. There are strong reasons to believe that limited distribution practices are efficient. Thus, regulation to force manufacturers to sell their lenses to all takers appears misplaced.[76]

Although both government and private unilateral restraints on Internet distribution are similar because they disadvantage online sellers, in one important respect they are quite different: one reduces competition among retailers, while the other is likely to enhance competition among manufactures. Clearly, this is a distinction that matters.

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[76] *See* Lafontaine & Slade, *supra* note 59, at 23 ("[I]t is clear from the evidence that the notion that governments should impose restraints on manufacturers in order to protect their dealers and consumers should be viewed with skepticism by all those who believe that the role of government should be to intervene in situations where market failures are so such magnitudes that the inevitable costs of intervention are warranted.").

Summary Statistics

	All Lenses				*Spherical*				*Specialty*			
Channel	*Mean*	*Std. Dev.*	*Minimum*	*Maximum*	*Mean*	*Std. Dev.*	*Minimum*	*Maximum*	*Mean*	*Std. Dev.*	*Minimum*	*Maximum*
All Online	87.92 *(91.70)*	38.90 *(38.31)*	29.90 *(33.85)*	259.96 *(259.96)*	65.51 *(69.57)*	16.37 *(15.95)*	29.90 *(33.85)*	103.96 *(103.96)*	119.85 *(123.23)*	39.45 *(38.84)*	69.98 *(74.98)*	259.96 *(259.96)*
Pure	84.40 *(84.97)*	35.72 *(35.25)*	29.90 *(33.85)*	191.96 *(201.96)*	63.57 *(68.00)*	15.51 *(15.51)*	29.90 *(33.85)*	95.80 *(101.75)*	113.93 *(117.45)*	35.51 *(35.09)*	69.98 *(74.98)*	191.96 *(201.96)*
Hybrid	103.85 *(106.38)*	48.42 *(47.85)*	39.98 *(39.98)*	259.96 *(259.96)*	74.19 *(76.62)*	17.73 *(16.43)*	39.98 *(39.98)*	103.96 *(103.96)*	147.20 *(149.86)*	46.44 *(45.39)*	106.91 *(106.91)*	259.96 *(259.96)*
All Offline	107.95	45.82	31.86	280.00	81.89	16.56	31.86	112.00	146.36	48.41	73.52	280.00
Warehouse	83.18	36.51	31.86	180.00	60.11	13.83	31.86	80.00	114.91	34.16	73.52	180.00
Mass Merchandiser	108.38	43.01	69.92	216.00	79.39	10.49	69.92	99.80	148.23	38.28	90.00	216.00
Optical Chain	109.02	40.84	40.00	239.80	86.61	15.77	40.00	112.00	143.37	43.91	88.00	239.80
Independent ECP	115.63	50.86	44.00	280.00	86.56	13.89	44.00	112.00	158.61	55.29	76.00	280.00
All Channels Combined	96.55	43.11	29.90	280.00	72.69	18.32	29.90	112.00	131.13	45.26	69.98	280.00

Notes: Unit of observation is price of lens *i* at outlet *j*. Observations are not weighted for intrachannel shares. Statistics including shipping and handling costs are in parentheses. Statistics for *All Channels Combined* are computed without including shipping and handling costs.

Table 1

Regression Results For Lens Price

	LENS TYPE			*LENS TYPE*		
	All	*Spherical*	*Specialty*	*All*	*Spherical*	*Specialty*
PURE ONLINE	***-23.64 *(2.14)*	***-17.85 *(1.79)*	***-32.02 *(4.45)*	—	—	—
HYBRID	—	—	—	***19.33 *(4.73)*	***10.31 *(3.29)*	***32.21 *(10.19)*
WAREHOUSE	—	—	—	-2.30 *(3.13)*	-4.01 *(2.95)*	0.10 *(6.13)*
MASS MERCHANDISER	—	—	—	***22.90 *(2.50)*	***15.28 *(3.20)*	***33.43 *(6.40)*
OPTICAL CHAIN	—	—	—	***26.60 *(2.50)*	***22.63 *(2.10)*	***32.29 *(5.52)*
INDEPENDENT ECP	—	—	—	***30.57 *(3.39)*	***22.33 *(2.35)*	***42.54 *(7.41)*
Constant	***84.85 *(2.66)*	***81.73 *(2.36)*	***117.26 *(5.49)*	***60.52 *(2.14)*	***63.97 *(1.70)*	***85.65 *(4.00)*
R^2	0.84	0.64	0.75	0.85	0.72	0.75
F	***81.61	***59.97	***62.33	***84.37	***63.45	***47.06
Obs.	279.00	165.00	114.00	311.00	184.00	127.00

Notes: Unit of observation is price of lens *i* at outlet *j*. Observations are not weighted for intrachannel shares. Robust standard errors in parentheses. *** significant at 1% level; ** significant at 5% level. For *All* and *Spherical* regressions, Acuvue lenses is the omitted category for lens fixed-effects. For *Specialty* regressions, Focus Toric lenses is the omitted category for lens fixed-effects.

Table 2

Regression Results For Price With Transportation And Shipping & Handling Included By Offline Channel

	100% ALLOCATION			*50% ALLOCATION*			*ZERO ALLOCATION*		
	All	*Spherical*	*Specialty*	*All*	*Spherical*	*Specialty*	*All*	*Spherical*	*Specialty*
Constant	***64.70 *(2.06)*	***68.37 *(1.56)*	***173.81 *(3.84)*	***64.70 *(2.06)*	***68.37 *(1.56)*	***173.81 *(3.84)*	***64.70 *(2.06)*	***68.37 *(1.56)*	***173.81 *(3.84)*
HYBRID	***17.82 *(4.52)*	***8.31 *(2.89)*	***31.39 *(9.80)*	***17.82 *(4.52)*	***8.31 *(2.89)*	***31.39 *(9.80)*	***17.82 *(4.52)*	***8.31 *(2.89)*	***31.39 *(9.80)*
WAREHOUSE	1.09 *(3.11)*	-3.18 *(2.96)*	1.83 *(6.11)*	-3.72 *(3.11)*	**-5.81 *(2.96)*	-0.79 *(6.11)*	**-6.35 *(3.11)*	***-8.44 *(2.96)*	-3.42 *(6.11)*
MASS MERCHANDISER	***24.11 *(3.47)*	***16.11 *(3.22)*	***35.16 *(6.39)*	***21.48 *(3.47)*	***13.48 *(3.22)*	***32.53 *(6.39)*	***18.85 *(3.47)*	***10.85 *(3.22)*	***29.90 *(6.39)*
OPTICAL CHAIN	***27.78 *(2.52)*	***23.45 *(2.10)*	***33.34 *(5.56)*	***25.15 *(2.52)*	***20.82 *(2.10)*	***31.37 *(5.56)*	***22.52 *(2.52)*	***18.19 *(2.10)*	***28.74 *(5.56)*
INDEPENDENT ECP	***31.79 *(3.40)*	***23.16 *(2.36)*	***44.30 *(7.44)*	***29.15 *(3.41)*	**20.53 *(2.36)*	***41.67 *(7.44)*	***26.52 *(3.41)*	***17.90 *(2.36)*	***39.04 *(7.44)*
R^2	0.85	0.74	0.76	0.85	0.72	0.75	0.85	0.70	0.75
F	***83.92	***66.54	***48.10	***82.24	***59.85	***46.67	***81.03	***53.98	***45.42
Obs.	311.00	184.00	127.00	311.00	184.00	127.00	311.00	184.00	127.00

Notes: Unit of observation is price of lens *i* at outlet *j*. Robust standard errors in parentheses. *** significant at 1% level; ** significant at 5% level. For *All* and *Spherical* regressions, Acuvue lenses is the omitted category for lens fixed-effects. For *Specialty* regressions, Softlens Multifocal lenses is the omitted category for lens fixed-effects.

Table 3

Margin Regression Results

	All Offline				*Optical Chains + Independent ECPs*	*Independent ECPs*
	(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
LD	1.03 *(3.43)*	—	—	—	—	—
PROCLEAR	—	**7.75 *(3.43)*	4.05 *(3.11)*	-4.57 *(4.14)*	2.43 *(3.25)*	-0.01 *(4.15)*
BIOMEDICS	—	-4.74 *(4.34)*	-5.72 *(4.05)*	-1.90 *(4.79)*	-4.19 *(5.23)*	-3.67 *(7.39)*
DK	—	—	—	**0.32 *(0.13)*	—	—
H20	—	—	—	***1.12 *(0.35)*	—	—
TORIC	***15.56 *(4.98)*	***15.56 *(5.00)*	***14.52 *(3.85)*	***13.22 *(4.10)*	***13.91 *(5.01)*	**15.44 *(6.12)*
MULTI	***53.41 *(10.59)*	***53.41 *(10.64)*	***52.64 *(6.84)*	***79.18 *(10.85)*	***59.77 *(8.37)*	***66.99 *(9.86)*
Store Effects	N	N	Y	Y	Y	Y
Constant	***30.91 *(2.16)*	***30.91 *(2.16)*	***34.57 *(4.49)*	*-37.38 *(21.96)*	***28.58 *(4.47)*	***65.59 *(8.17)*
R^2	0.328	0.337	0.662	0.692	0.628	0.708
F	***11.290	***9.970	***11.740	***12.090	***8.290	***11.840
Obs.	134.000	134.000	134.000	134.000	96.000	57.000

Notes: Unit of observation is price of lens *i* at outlet *j*. Robust standard errors in parentheses. *** significant at 1% level; ** significant at 5% level; * significant at 10% level.

Table 4

Hedonic Price Regression Results

	All Offline			*Optical Chains + Independent ECPs*	*Independent ECPs*
	(1)	*(2)*	*(3)*	*(4)*	*(5)*
LD	5.75 *(3.76)*	—	—	—	—
PROCLEAR	—	-4.34 *(4.96)*	**-8.65 *(3.79)*	***-12.73 *(4.29)*	*-10.73 *(5.57)*
BIOMEDICS	—	***13.45 *(5.01)*	***12.32 *(4.37)*	***14.81 *(5.72)*	12.16 *(7.99)*
DK	***0.95 *(0.14)*	***1.08 *(0.16)*	***1.07 *(0.12)*	***1.15 *(0.15)*	***0.89 *(0.20)*
H20	***1.18 *(0.40)*	***1.56 *(0.49)*	***1.64 *(0.33)*	***1.97 *(0.41)*	***1.41 *(0.23)*
TORIC	***51.13 *(5.17)*	***50.91 *(5.19)*	***49.37 *(3.71)*	***48.10 *(4.76)*	***48.96 *(7.13)*
MULTI	***171.84 *(14.14)*	***181.23 *(11.48)*	***181.70 *(10.36)*	***196.18 *(12.87)*	***187.80 *(15.81)*
Store Effects	N	N	Y	Y	Y
Constant	-15.29 *(25.16)*	-40.13 *(31.08)*	**-40.70 *(20.42)*	*-47.14 *(25.77)*	-9.22 *(32.25)*
R^2	0.779	0.785	0.901	0.897	0.910
F	***57.000	***48.670	***50.010	***42.170	***57.350
Obs.	134.000	134.000	134.000	96.000	57.000

Notes: Unit of observation is price of lens *i* at outlet *j*. Robust standard errors in parentheses. *** significant at 1% level; ** significant at 5% level; * significant at 10% level.

Table 5

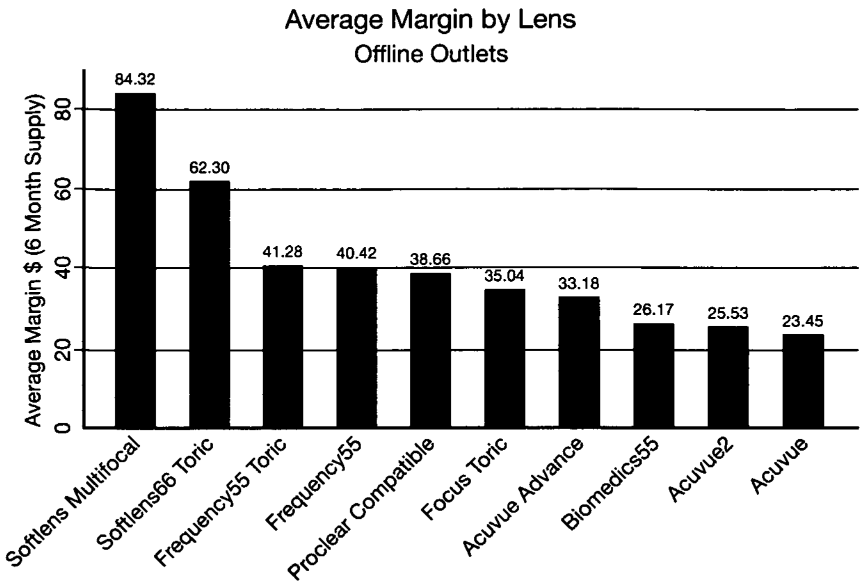

Figure 1

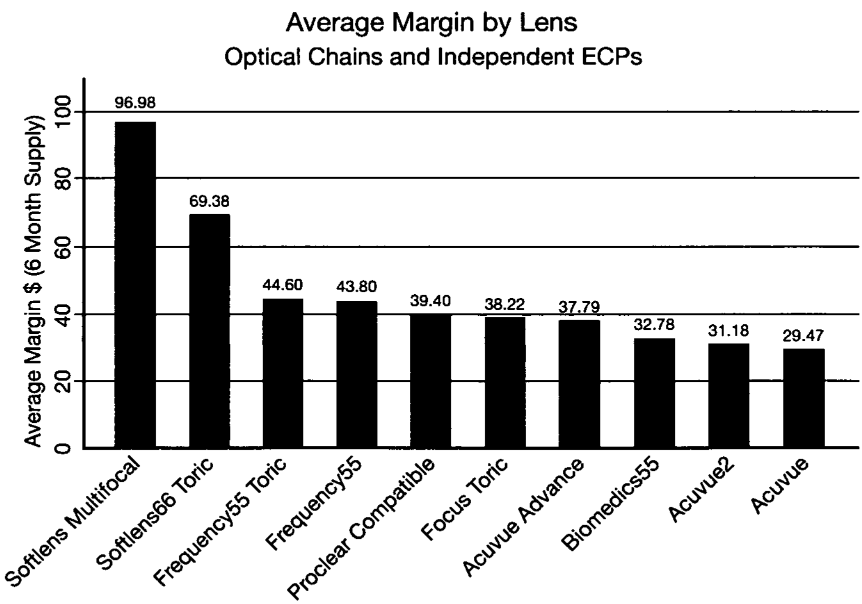

Figure 2

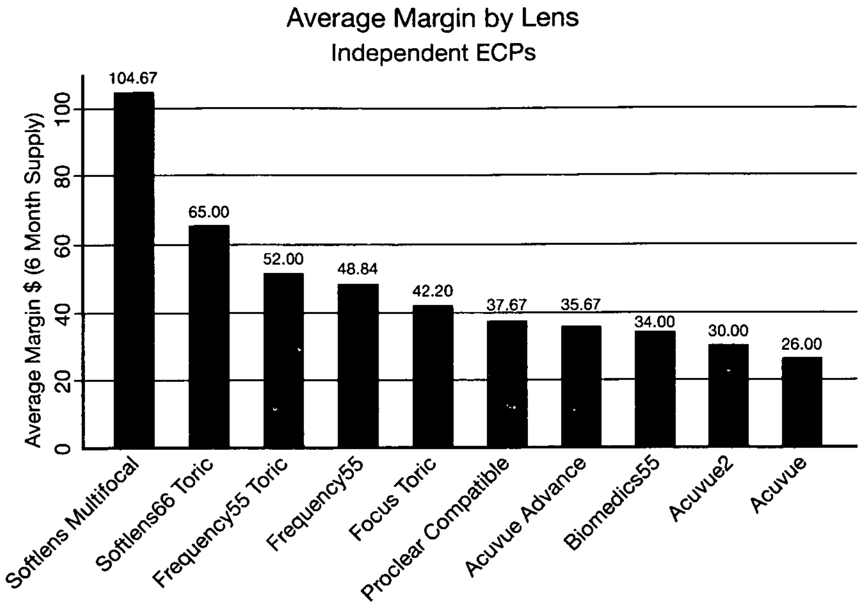

Figure 3

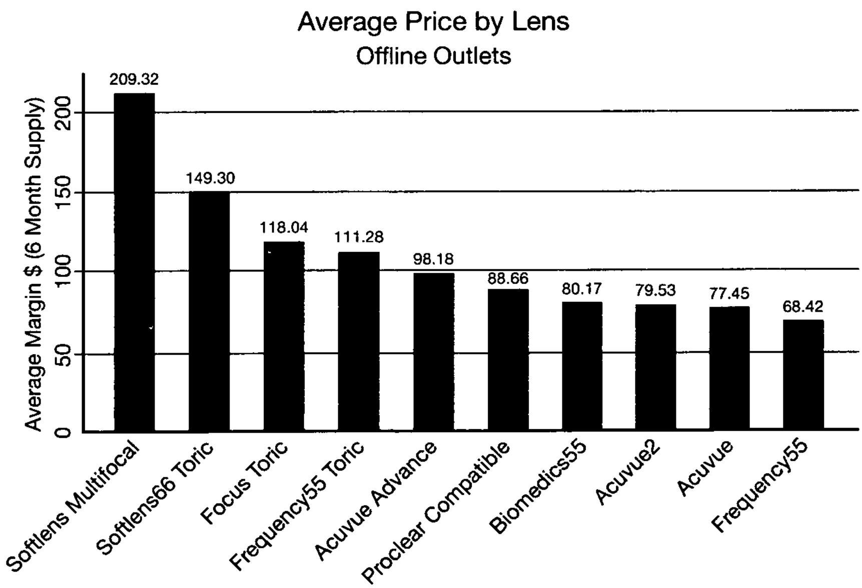

Figure 4

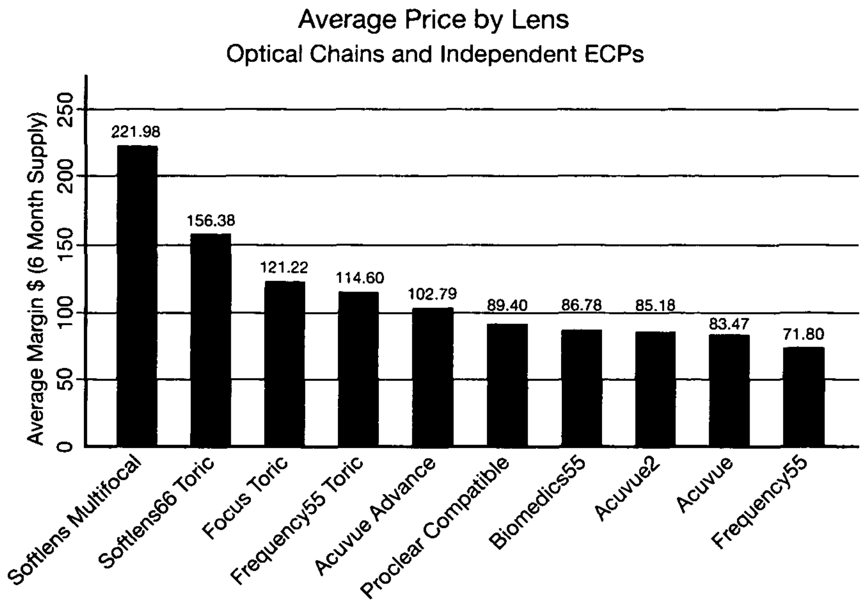

Figure 5

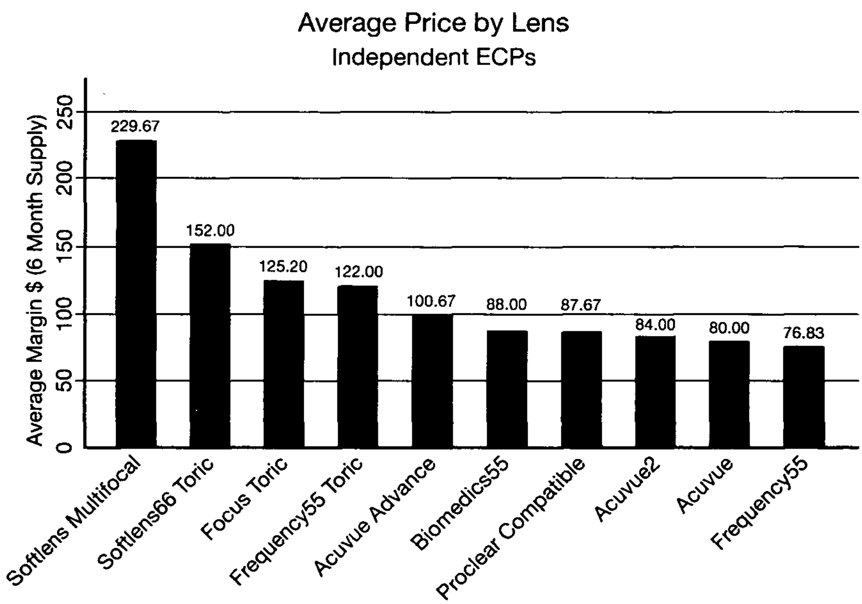

Figure 6

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REAL ESTATE BROKERAGE AND E-COMMERCE: A FRAMEWORK FOR EMPIRICAL ANALYSIS

*R. Richard Geddes**

ABSTRACT

Although e-commerce has evolved rapidly in many industries, residential real estate brokerage has lagged behind. Several causes for this slow development have been identified, including state legislation and possible collusive behavior facilitated by the Multiple Listing Service. Empirical studies have not yet examined the expected welfare benefits from moving to Internet-based real estate brokerage. In this paper, I provide a framework for analyzing the social benefits from movement to Internet-based commerce in residential real estate. I first examine welfare gains that would accrue if Internet commerce lowered the cost of search relative to full-service brokers. I adapt a model of real estate brokerage suggested by Miceli[1] to account for lower search costs using the Internet. Real estate brokerage is characterized by relatively free entry, but also by commissions that are typically fixed, which generates economic rents. I examine a second possible source of social savings from Internet competition: a reduction in the number of excess brokers, and the elimination of wasteful non-price competition between brokers for listings. Existing literature on the social cost of excess brokers suggests that such savings are likely to be large.

I. INTRODUCTION

E-commerce has evolved rapidly in some industries, including travel and stock brokerage. Other industries, such as legal services and residential real estate brokerage, have lagged behind. Because buyers can screen houses more rapidly online than in person, and sellers can reach many more potential buyers, the Internet has the potential to lower the search costs associated with buying and selling houses. The concomitant gains from e-commerce in this industry are likely to be large. Scholars have identified several potential causes of this slow development in real estate brokerage, including state legislation requiring minimum levels of service, prohibitions

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* Associate Professor of Policy Analysis and Management, Cornell University, Ithaca, NY. The author is grateful to Jerry Ellig and Kenneth Heyer for helpful comments and suggestions.

1 Thomas J. Miceli, *The Welfare Effects of Non-Price Competition Among Real Estate Brokers*, 20 J. AM. REAL EST. & URB. ECON. ASS'N 519, 519-32 (1992).

on brokers offering rebates to customers, as well as discrimination against innovative brokerage models and online brokers who seek to join Multiple Listing Services.[2]

I provide a framework for examining the potential welfare gain in moving from a traditional model of real estate brokerage to a model where the Internet plays a larger role in lowering transaction costs, which are the costs of arranging exchanges between buyers and sellers.[3] I identify two major sources of gains through increased e-commerce. The first is associated with greater consumer or producer surplus generated by lower search costs for home buyers, sellers, or both. These search cost savings are reflected in shifts in the supply and demand curves for housing.

The second source of welfare gains results from the elimination of non-price competition in real estate brokerage. Brokerage can be characterized as an industry with prices typically fixed above average costs (thus generating economic profits), but with relatively free entry. The resulting economic rents will be bid away through a variety of non-price mechanisms, including excessive entry into brokerage and excessive expenditures in "prospecting" to obtain available listings.

In the next section, I provide an overview of the traditional approach to real estate brokerage, and review how the Internet is likely to change that traditional approach. In Section III, I extend existing research on real estate brokerage to include the effects of the Internet. I analyze several cases, which differ on the basis of the expected effects of Internet search on the supply of, or demand for, housing. Section IV provides a framework for analyzing the effects of Internet search on non-price competition in brokerage. Previous studies estimate the welfare loss from non-price competition in various cities.[4] Under the assumption that Internet-based business models would bring price flexibility to the real estate brokerage industry, those estimates offer a guide to the savings from such a change. Section V concludes.

II. REAL ESTATE SALES IN THE UNITED STATES

Real estate brokerage is a major industry in the United States. In 2004, the estimated revenue of the industry was $60 billion.[5] Residential real estate has traditionally been sold with the assistance of a real estate

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[2] Robert W. Hahn, Robert E. Litan, & Jesse Gurman, *Bringing More Competition to Real Estate Brokerage*, 35 REAL EST. L. J. 86 (2006).

[3] Transaction costs include search costs, bargaining costs, and monitoring and enforcement costs, among others. I focus on the effect of Internet use on search costs, but there may be effects on other elements of transaction costs.

[4] Chang-Tai Hsieh & Enrico Moretti, *Can Free Entry Be Inefficient? Fixed Commissions and Social Waste in the Real Estate Industry*, 111 J. POL. ECON. 1076, 1076-77 (2003).

[5] Hahn et al., *supra* note 2, at 87.

agent, who provides a bundle of services to buyers and sellers. The seller typically enters into an exclusive agreement with the agent, called the listing agent, who acts as the seller's representative in dealing with potential buyers. The services provided by agents include advertising the house and holding open houses, negotiating the price, and helping with contracting and closing issues. The seller's agent is paid a prearranged fee, which she splits with the buyer's agent. The fee has traditionally been six percent of the sales price.[6]

A key component of selling real estate is the use of a local Multiple Listing Service (MLS). The MLS is a computerized compendium of local homes for sale,[7] and it is maintained and paid for by local Realtors. When a homeowner contracts with a Realtor, the Realtor will post details about the home on the region's MLS. Potential buyers are then able to search the local MLS for possible homes. This system, in effect, multiplies the options available to home buyers, and it therefore increases the probability of a sale to sellers. Each listing on the MLS also details the share of the commission that an agent will receive if he or she brings a willing buyer and completes a sale.[8] Access to the MLS remains crucial to the process of selling a home.

There is evidence suggesting that information technology is playing an increasing role in facilitating real estate transactions. One survey shows that about seventy percent of home buyers use the Internet to assist in their home searches.[9] There are several ways in which Internet use is likely to lower transaction costs in the residential real estate market, and buyers, sellers, and brokers are all likely to benefit from them.

First, increasing Internet use allows potential buyers to obtain more information about homes at lower cost, and to screen them more carefully, prior to physical inspection with an agent. This will have two effects on transaction costs. Because buyers will be better informed before they physically examine a house, the agent will spend less time per sale, thus increasing the broker's productivity. Empirical evidence is consistent with the notion that brokers utilizing more computer technology enjoy superior productivity and higher profit margins.[10]

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6 *Id.*

7 The United States has about 800 local MLSs; *see* Clay Risen, *Home Page: Realtors vs. the Internet*, NEW REPUBLIC, May 2, 2005, at 14-15.

8 Shane Ham & Robert D. Atkinson, *Modernizing Home Buying: How IT Can Empower Individuals, Slash Costs, and Transform the Real Estate Industry*, PROGRESSIVE POL'Y INST. POL'Y REP. (Mar. 2003). http://www.ppionline.org/ppi_ci.cfm?knlgAreaID=140&subsecID=900055&contentID=251396 (last visited Aug. 21, 2007).

9 NAT'L ASSOC. REALTORS, NATIONAL ASSOCIATION OF REALTORS PROFILE OF HOME BUYERS AND SELLERS (2004).

10 *See* John D. Benjamin et al., *Technology and Real Estate Brokerage Firm Financial Performance*, 27 J. REAL EST. RES. 409 (2005); *see also* G. Donald Jud, G. Stacy Sirmans, & Daniel T. Winkler,

Second, buyers themselves are likely to experience lower transaction costs from Internet use. Internet-based companies such as eRealty and ZipRealty, acting as buyers' agents, give potential buyers access to the MLS over the Internet.[11] Because buyers can obtain more information via the Internet prior to visiting a home, they will need to visit fewer homes to make their decisions, thus lowering the search costs associated with a particular home purchase.[12] Buyers often receive a direct monetary benefit from this arrangement, in addition to the enjoyment of lower search costs, because Internet realty companies typically rebate a third of the commission they receive from the seller's agent.[13]

Third, increasing Internet use helps to lower home sellers' transaction costs. This can occur through the disaggregation of real estate services. Here, sellers have the option of paying a lower commission in exchange for more limited, "a la carte" service. For example, Internet-based firms, such as forsalebyowner.com, will place sellers' listing information in the MLS for a flat fee.[14] Other firms that charge flat fees for specific services, such as closing contracts, have also emerged. Internet-based firms, such as LendingTree, specialize in particular parts of the process. Texas Discount Realty, for example, gives sellers three options. The first is the firm's most limited service option: For a flat fee of $595, the firm will list a seller's property on the MLS and several other websites. Texas Discount Realty also provides sellers with a lockbox and other basic services. The second option, for $495 and a three percent commission paid to the buyer's agent, allows all Realtors in the area to market the property to their buyers, while the seller retains the right to sell the property herself. The third option is essentially a full-service option, but with fees between four and six percent depending on the details and complexity of the transaction.[15]

A la carte service lowers transaction costs because sellers are able to choose only the services they want. If sellers are able to perform some functions at lower cost on their own (perhaps because they have experience

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The Impact of Information Technology on Real Estate License Income, 5 J. REAL EST. PRAC. & EDUC. 1 (2002).

11 These sites are authorized to display MLS data. *See* Ham & Atkinson, *supra* note 8, at 9.

12 *Cf.* Randy I. Anderson, Ken H. Johnson, and Leonard V. Zumpano, *Internet Use and Real Estate Brokerage Market Intermediation*, 12 J. HOUSING ECON. 134 (2003) (comparing home buyers who used the Internet to search for homes with those who did not. They found that those using the Internet located more homes meeting their needs in the same amount of time).

13 *See* Ham & Atkinson, *supra* note 8, at 9. Studies show that buyers using the Internet require fewer accompanied home visits, and spend less time overall working with a realtor. *See* Blanche Evans, *CAR Report Shows Increased Use of Internet By Homebuyers*, REALTY TIMES (June 2004), *available at* http://realtytimes.com/rtapages/20040630_carreport.htm (last visited Aug. 21, 2007).

14 Hahn et al., *supra* note 2, at 90 n.12.

15 *See* TEXASDISCOUNTREALTY.COM, HOME SELLERS, *available at* http://www.texasdiscountrealty.com/sellers1.htm (last visited Aug. 21, 2007).

selling homes), or through other professionals, then disaggregation of services will lower their transaction costs.

Finally, the Internet allows buyers and sellers to use alternative business models that do not rely on the MLS, and do not require licensed Realtors. An owner may place an electronic classified ad on a non-MLS website, such as Craigslist, which potential buyers can search. This allows buyers and sellers to locate and negotiate with one another directly. If buyers and sellers can complete the transaction on their own, then these alternative approaches reduce transaction costs by eliminating the broker's role entirely. Buyers and sellers will pay no commissions, and they will typically share the cost savings. There are indications that this business model is appealing to many in the residential real estate market, and the business press has reported increased use of the Internet to sell residential real estate.[16]

This discussion suggests that the Internet is likely to have an important impact on overall transaction costs in the real estate brokerage industry. Indeed, one study estimates that residential real estate transaction costs could be cut in half by greater use of information technology.[17]

However, barriers to the expansion of alternative business models in real estate remain. Eleven states have banned the practice of giving customers rebates on commissions.[18] Other state legislatures have enacted minimum service requirements, which would effectively prohibit a la carte service.[19] There are still other barriers to Internet-based business models in real estate, such as discrimination against online brokers who want to join Multiple Listing Services.[20]

Moreover, the National Association of Realtors has contemplated a so-called opt out rule that would have the effect of limiting competition from websites.[21] The rule would allow listing agents to withhold their listings from websites of designated companies, such as those operating over the Internet. That is, when a buyer conducts a search, she would not be able to observe all the available homes that matched the search because some listings would not appear.

Although real estate transactions lend themselves to Internet use, due mainly to potentially lower search costs, the development of these alterna-

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16 Timothy J. Mullaney, *Real Estate's Turf War Heats Up: How Old-line Agents are Undermining Advances by Online Discount Brokers*, BUSINESS WEEK, Apr. 18, 2005, at 38; Clay Risen, *Home Page: Realtors vs. the Internet*, NEW REPUBLIC, May 2, 2005, May 9, 2005, at 14-15.

17 Ham & Atkinson, *supra* note 8, at 1.

18 Jon Birger, *How Come We Still Pay This Man 6%?*, MONEY MAGAZINE, June 1, 2005, *available at* http://money.cnn.com/magazines/moneymag/moneymag_archive/2005/06/01/8260926/index.htm (last visited Aug. 21, 2007). *See* N.Y. REAL PROP. LAW § 442 (2004) for an example.

19 Hahn et al., *supra* note 2 at 90.

20 *Id.*

21 *See, e.g.*, United States v. Nat'l Assoc. of Realtors, No. 05C-5140, 2006 U.S. Dist. Lexis 86963 (N.D. Ill., decided Nov. 27, 2006).

tive Internet business models has been stunted by the institutional responses outlined above. Therefore, the social cost generated by extant barriers to growth of e-commerce in real estate remains an important policy question. Below, I provide a framework for analyzing the potential welfare gains from enhanced use of the Internet in residential real estate transactions.

III. A FRAMEWORK FOR ANALYZING THE WELFARE GAINS FROM INTERNET SEARCH

I provide a framework for analyzing the effects, relative to the traditional approach, on home buyers, sellers, and brokers, of using the Internet to search for homes. I rely on the basic framework developed by Miceli,[22] who focuses on the effect of introducing brokers into the real estate market, and on the welfare effects of non-price competition among brokers for listings. He assumes that housing is a homogeneous good, and that the role of brokers is to lower buyers' and sellers' search costs. I modify that framework to take Internet competition into account. I assume that, just as brokers lower search costs relative to home owner-only sales, the Internet lowers search costs relative to broker-only sales, and that those savings manifest themselves as shifts in the supply and/or demand curves.

Following Miceli, it is useful to first compare the case where buyers and sellers do not use a broker ("For Sale By Owner" or FSBO) with the case where brokers are used. Assuming linear demand and supply curves:

$P_d = a - bQ$ is demand for FSBO, and

$P_s = c + dQ$ is supply for FSBO,

where P_d is the price buyers are willing to pay for a particular quantity Q, and P_s is the price that induces sellers to supply a particular quantity Q. In addition, a and c are intercepts (or the point at which the demand and supply curves respectively strike the vertical, or price, axis when quantity is zero), while b and d are the slopes of the demand and supply curves, respectively.

Brokers are assumed to affect the housing market by lowering transaction costs. Because of these lower transaction costs, sellers are willing to accept a lower price for any particular quantity, and buyers are willing to pay a higher price for any particular quantity, resulting in a shift to the right in both curves.[23]

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22 Miceli, *supra* note 1.

23 For simplicity, this is assumed to result in parallel shifts in the curves.

However, to provide these services, brokers charge a commission, α, which is a fraction of the sale price. The commission acts like an ad valorem tax on real estate sales. It not only shifts the supply curve to the left, but also affects its slope, since the net price that sellers receive is $P(1-\alpha)$. Assuming a parallel shift in the curves caused by the presence of brokers in the market (a change in intercept but not slope), the relevant curves for buyers and sellers when using a broker are:

$P_d = a' - bQ$ is demand with brokers, and

$P_s(1-\alpha) = c' + dQ$ is supply with brokers

where $c' < c$ and $a' > a$.

The Housing Market with and without Brokers

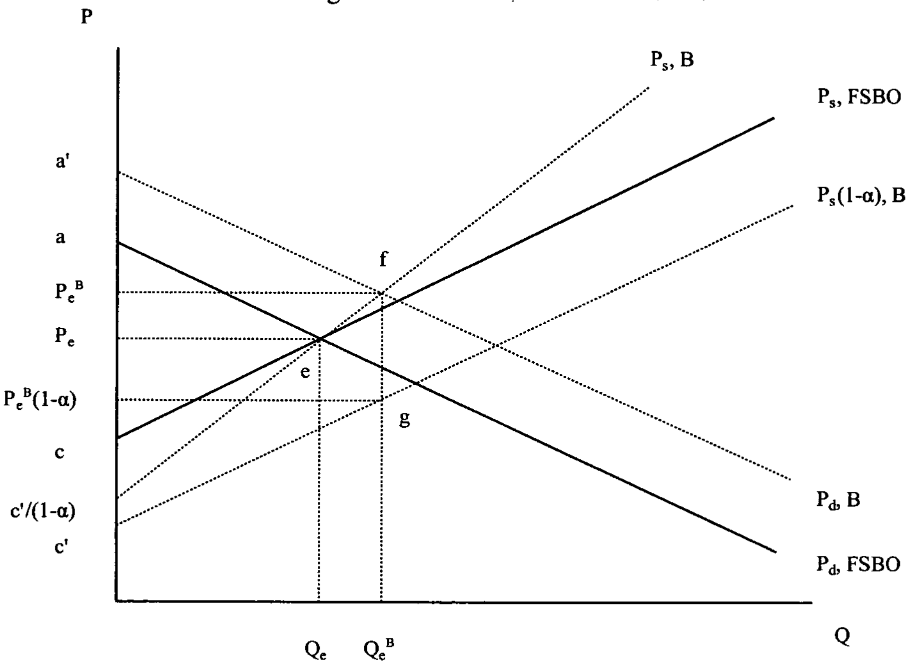

Figure 1

These curves are displayed graphically in Figure 1, which is identical to Miceli's Figure 1.[24] Equilibrium for FSBO occurs at point e (coordinates Q_e and P_e) while equilibrium with brokers occurs at point f (coordinates Q_e^B

24 Miceli, *supra* note 1, at 522.

and P_e^B). There are several notable results apparent in this graph. If the commission rate α is increased, all else equal, the supply curve with brokers will shift to the left. This will result in a higher equilibrium price and lower equilibrium quantity relative to sale by owner.

The commission revenue earned by brokers is the difference between the price as read off the supply curve with brokers (P_e^B) and the net price received by sellers ($P_e^B(1-\alpha)$), or the vertical distance (f - g). The total commission revenue earned by brokers is therefore:

$$[P_e^B - P_e^B(1-\alpha)]Q_e^B \text{ or } \alpha P_e^B Q_e^B.$$

An increase in the commission rate α will have an ambiguous effect on total commission revenue. Although a higher commission rate will increase equilibrium price by shifting supply to the left, it will reduce equilibrium quantity, so the net effect is unclear. This is an important result to keep in mind in the analysis below. Intuitively, one may suspect that brokers would be unambiguously worse off by a change that is likely to lower commission rates (as increased e-commerce in brokerage may do), but that intuition is incorrect. If the increase in the quantity of homes sold due to a fall in commission rates is sufficiently large, then overall broker revenue may rise. Indeed total surplus (home buyer plus home seller surplus) when using brokers may be larger or smaller, depending upon the size of the commission and the magnitude of the shifts in the curves. However, in equilibrium, the increase in surplus must be greater than the amount paid to brokers in commissions (which reflects the amount by which brokers lower transaction costs) or buyers and sellers would be better off not using brokers.

I use this basic model to consider how surplus and commission revenue will change if Internet brokerage is introduced. I rely on Figure 1, but remove the FSBO curves. I assume that competition from the Internet will reduce the commission rate by half, from six to three percent.[25] If buyers and sellers were faced with the choice of paying a six percent fee but receiving the services of a broker, or searching by themselves on the Internet, but still paying six percent, they would clearly all prefer the broker, assuming some disutility from search. Therefore, the relevant choice is between using a traditional broker ("broker-only search," labeled B) and paying a six percent commission, or using the Internet ("Internet search," labeled I) while paying a reduced commission. Below, I consider four cases regard-

[25] I do this mainly for simplicity. However, Ham and Atkinson estimate that the introduction of information technology into the real estate market would cut transaction costs in half. Ham & Atkinson, *supra* note 8, at 9. Also, Paul M. Anglin and Richard J. Arnott determined that the commission rate that is theoretically optimal is three percent. *See* Paul M. Anglin & Richard J. Arnott, *Are Brokers' Commission Rates on Home Sales Too High? A Conceptual Analysis*, 27 REAL EST. ECON. 719, 736 (1999).

ing the anticipated effects of Internet search on the supply and demand curves for housing.

Case 1: Internet Search Does Not Lower the Search Costs of Either Home Buyers or Sellers

Under Case 1, I assume that the price home buyers are willing to pay, and the price at which sellers are willing to sell, are unaffected by the substitution of Internet search for broker-only search. That is, in this case Internet search does not lower transaction costs relative to broker-only search. The demand curve and supply curve for housing will thus be the same with or without Internet search. This case is useful to examine because it illustrates how a reduction in the commission rate alone affects the real estate market.

The Housing Market with Internet and Broker-Only Search;
Case 1, Lower Internet Search Costs Do Not Affect Supply or Demand Curves

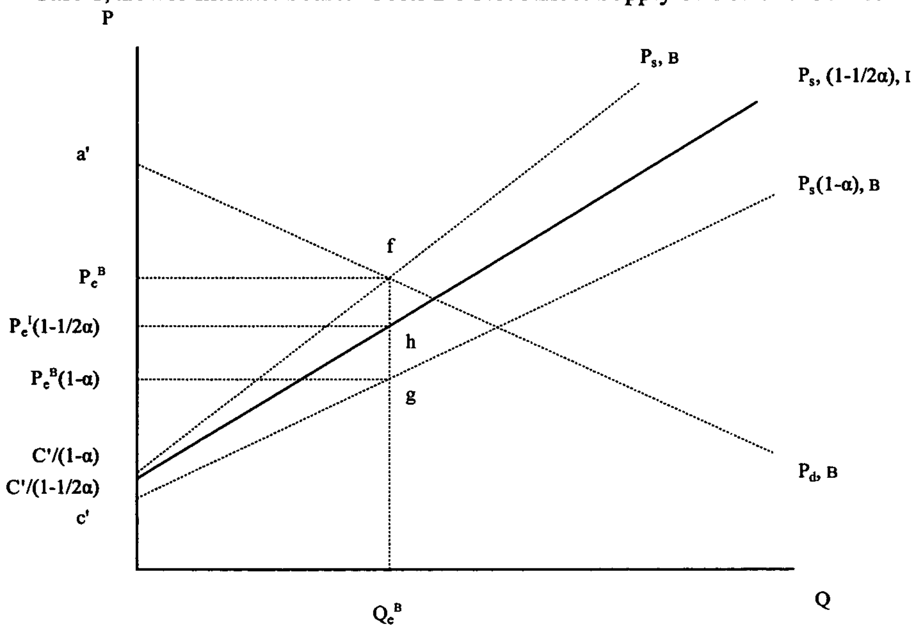

Figure 2

Under the above assumption, the price received by sellers after paying the lower commission using the Internet is $P_s(1-\frac{1}{2}\alpha)$, I, which has a steeper slope than the curve labeled $P_s(1-\alpha)$, B, but is less steep than the supply curve with brokers. The line showing the net price received by brokers with Internet competition becomes:

$$P_s(1-\frac{1}{2}\alpha)=c'+dQ$$

These curves are displayed in Figure 2. Dotted lines are used to illustrate broker-only search, while solid lines illustrate Internet search. Point f is the equilibrium under broker-only search, which here is the same as under Internet search. From Figure 2, it is clear that moving from brokers to Internet search, holding supply and demand curves constant, will reduce the commission revenue received by brokers (and paid by sellers), since the brokers receive a smaller commission rate on the same number of units. Moving from brokers to Internet search will leave consumer (i.e., home buyers') surplus unchanged, but will increase producer (i.e., sellers') surplus.[26] The commission revenue is a transfer from home sellers to brokers. However, Internet searches increase overall welfare relative to broker-only searches because the increase in sellers' surplus is a net social gain.

Although this is a useful benchmark, it may not be the most interesting case if one believes that e-commerce is likely to reduce transaction costs relative to a broker-only approach, as discussed in Section II. If the Internet lowers transaction costs, it will be reflected in shifts in either the supply or demand curves. I consider these possibilities below.

Case 2: Internet Lowers Sellers' Search Costs Relative to Broker-Only

I now assume that buyers' search costs are not affected by Internet usage, but that sellers' search costs are reduced by Internet search relative to broker-only search. In this case, the minimum price that sellers are willing to accept (for a given quantity) will fall relative to the use of only brokers, causing the supply curve to shift outward. Sellers will then pay $1/2\alpha$ in commissions.

This situation is illustrated in Figure 3, in which the supply curve for Internet usage (P_s, I, shown as a solid line) lies to the right of that for broker-only search. This will also shift the net price line for sellers to the right (labeled $P_s(1\text{-}1/2\alpha)$, I). This latter line will, at all points, lie one-half as far below P_s, I as $P_s(1\text{-}\alpha)$, B does below P_s, B. The equilibrium shifts from point f to h, so that the equilibrium price falls and the equilibrium quantity rises relative to brokers only.

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26 Producer (home seller) surplus increases because the slope of the net price line with Internet search exceeds that of the net price line with broker-only search.

The Housing Market with Internet and Broker-Only Search;
Case 2, Lower Internet Search Costs Shift Supply

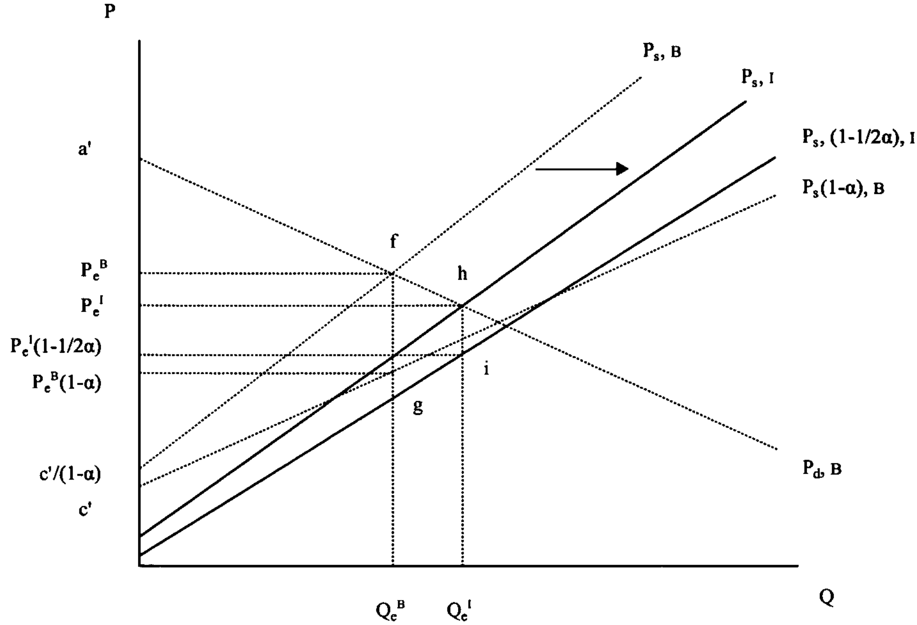

Figure 3

Home buyers will be unambiguously better off relative to traditional broker-only transactions, since consumer surplus increases by the area $P_e^B fhP_e^I$.[27] The change in seller's surplus will depend on the magnitude of the shifts. If, as shown in Figure 3, sellers receive a higher net-of-commission price on more housing units, producer surplus will clearly rise. If, instead, the shift in supply is such that the price received by sellers falls relative to the broker-only equilibrium, then producer surplus may fall even though the number of homes sold rises.[28]

Again, one may suspect that brokers would clearly be worse off under this change. However, unlike Case 1, Figure 3 illustrates that the effect is ambiguous. Commission revenue is $\alpha P_e^B Q_e^B$ with brokers, and $(1/2\alpha)P_e^I Q_e^I$ with Internet search. The equilibrium price brokers receive is less with Internet search ($P_e^B > P_e^I$)—and the commission rate falls from

[27] The measurement of this area requires an estimate of how much Internet search is likely to lower equilibrium housing prices ($P_e^B - P_e^I$). Assuming a linear demand curve, the consumer surplus gain is then $(P_e^B - P_e^I)Q_e^B + 1/2(P_e^B - P_e^I)(Q_e^I - Q_e^B)$.

[28] The intercepts for the P_s, I, line and the $P_s(1-1/2\alpha)$, I line are not labeled to avoid cluttering the diagram.

α to ½α—but brokers receive those commissions on a larger number of housing units ($Q_e^B > Q_e^I$). Thus, the effect on brokers is ambiguous because the number of homes sold rises as transaction costs on sales (which include commissions) fall. Although brokers may be better off overall with Internet competition, there would likely be a redistribution of commission revenue among brokers depending upon their degree of Internet usage as well as a host of other factors, such as the quality of service.

Case 3: Internet Lowers Buyers' Search Costs Relative to Broker-Only

I now assume that sellers are unaffected by Internet search, but that the Internet lowers home buyers' search costs. In this case the price that buyers are willing to pay rises (holding quantity constant), which results in a rightward shift in the demand curve for housing. The commission rate will again fall to ½α. The supply curve will remain the same as with brokers, but the net price that sellers receive will increase due to the lower commission rate.

The Housing Market with Internet and Broker-Only Search;
Case 3, Lower Internet Search Costs Shift Demand

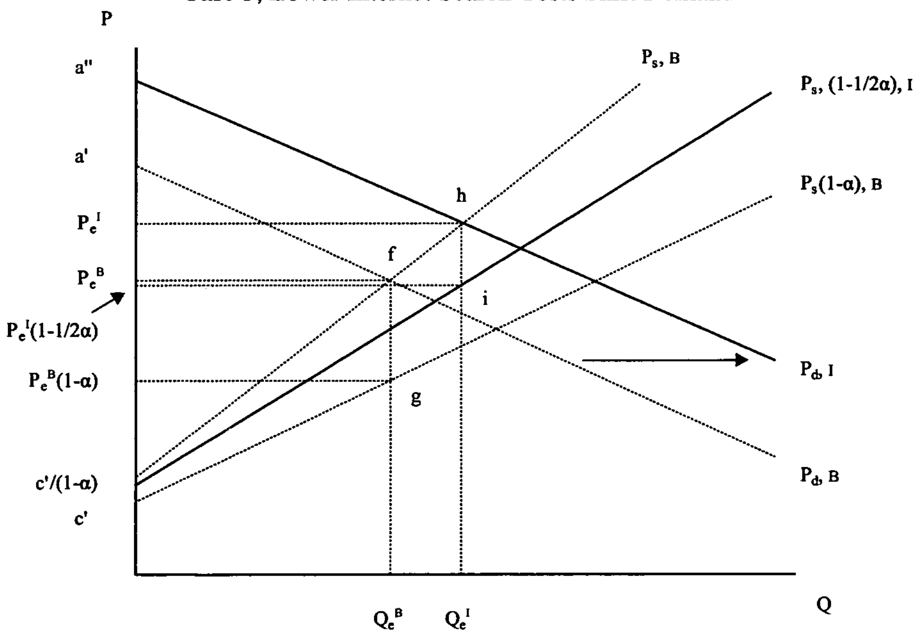

Figure 4

This situation is displayed in Figure 4, where the equilibrium using brokers is at point f, and sellers receive the price given by point g. The new

(Internet) equilibrium is at point h, with price P_e^I, and sellers receive the price given by point i. Both price and quantity are higher than under the new equilibrium. Home sellers receive a higher price, $(P_e^I(1\text{-}1/2\alpha)) > (P_e^B(1\text{-}\alpha))$, on a larger number of units, so producer (sellers') surplus increases. As in Case 2, brokers receive a smaller commission on a larger number of housing units, so the effect on commission revenue is ambiguous, as is the effect on buyer's surplus.

Case 4: Internet Lowers both Buyers' and Sellers' Search Costs Relative to Broker-Only

I next examine the case where the use of the Internet lowers search costs for both buyers and sellers, thus causing both the supply and demand curves to shift outward. Given the discussion in Section II, this is a likely scenario.

The Housing Market with Internet and Broker-Only Search;
Case 4, Lower Internet Search Costs Shift both Supply and Demand

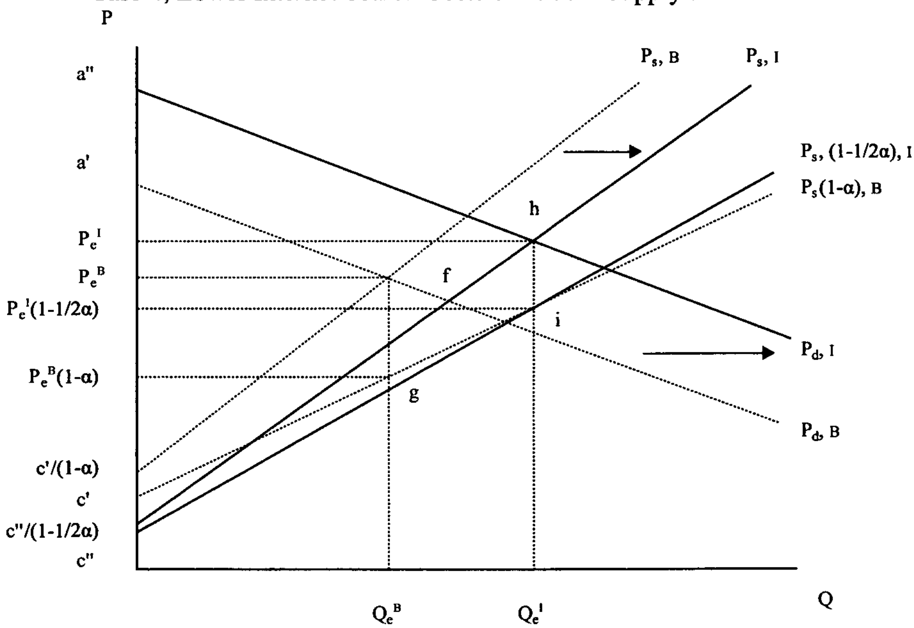

Figure 5

This situation is illustrated in Figure 5. While the shift in supply tends to reduce equilibrium price, the shift in demand tends to increase it, so the net effect on price is unclear (Figure 5 displays an increase, from f to h). The effects on equilibrium quantity, however, are mutually reinforcing. In this case, the positive effects of an increase in quantity are more likely to dominate any negative price effects on buyers' or sellers' surplus relative to either Case 2 or Case 3. The gains in buyers' and seller's surplus will thus be larger in this case than in the above cases. In the example shown, the change in buyers' surplus is the area (a"hP_e^I - a'fP_e^B), while sellers gain area ($P_e^I(1-1/2\alpha)$ic") - ($P_e^B(1-\alpha)$gc'). Brokers are also more likely to gain overall relative to Case 2 or Case 3 because of the substantial rise in equilibrium quantity.

The Effects of Non-Price Competition

Although welfare gains induced by shifts in the supply and demand curves, along with lower commission rates, are likely to be important, they are not the only source of social gains from increased Internet use. An additional source is the reduced welfare loss from the elimination of non-price competition that may occur when Internet use enhances price-based competition. I discuss ways of estimating those welfare gains below.

Numerous commentators have noted the small observed variation in broker's commission rates.[29] That small variation can be interpreted as a sign of limited price competition.[30] However, the industry also exhibits relatively low barriers to entry. The only entry barrier is a licensing examination, which is not onerous.[31]

A key question is why the commission remains fixed at a relatively high rate when entry into the brokerage business is competitive. There does not appear to be a consensus in the academic literature on this question. However, several possible explanations have been suggested. One is based on tacit collusion among agents. If the listing agent offers to discount the commission, other agents can, via the MLS, pass over the listing. This could sustain a collusive commission rate.[32] Thus, the MLS may play a unique rôle in facilitating collusive agreements.[33] There is anecdotal evidence supporting this explanation, with discount listing agents making claims of blackballing.[34] One agent claimed that, when he abandoned dis-

29 *See* Hsieh & Moretti, *supra* note 4, at 1083-85.

30 *See id.* at 1085-87. *See also* Anglin & Arnott, *supra* note 25, at 720.

31 Hsieh & Moretti, *supra* note 4, at 1081.

32 *See* Anglin & Arnott, *supra* note 25, at 720-21.

33 It is not clear, however, why the MLS would not be equally useful in encouraging competition. Since it makes commissions transparent, enterprising brokers could observe offered commission rates and undercut them.

34 *See* FED. TRADE COMM'N, THE RESIDENTIAL REAL ESTATE BROKERAGE INDUSTRY, FED. TRADE COMM'N STAFF REP. (1984); CONSUMER FED'N AM., DISCRIMINATION BY TRADITIONAL REAL ESTATE BROKERS AGAINST ALTERNATIVE BROKERS: AN ASSESSMENT (1993). *See also* Jon Birger, *The 4 ½ % Solution*, CNNMONEY.COM, Oct. 1, 2004, *available at* http://money.cnn.com/magazines/moneymag/moneymag_archive/2004/10/01/8186561/index.htm (last visited Aug. 21, 2007); *see also*

counting and resumed charging the standard six percent, "In one week I've had more showings and more offers from other Realtors than I had in the previous two months."[35] A fixed commission may also be easier to sustain if few sellers realize that the rate is negotiable.

An alternative explanation is offered by Anglin and Arnott,[36] who develop a matching model of real estate brokerage in which the role of agents is to match buyers and sellers. They use a general equilibrium model that allows them to compute the optimal commission rate and compare it to the prevailing rate. They show that, due to externalities and frictions that are endemic to search-and-matching models, the optimal commission rate diverges from the prevailing rate. Their model shows that the commission rate that maximizes social welfare is below the prevailing rate.

Although the academic literature is unsettled, I proceed under the assumption that, whatever the reason, commission rates are relatively fixed. Under conditions of free entry, economic rents will be created if rates are set above average cost. Free entry will then generate non-price competition for those rents. Non-price competition may take the form of excessive brokers entering, or of non-price competition among brokers for listings, such as door-to-door canvassing, phoning, and mailing, among other activities.[37] Rents are thus dissipated through non-price competition, resulting in an additional form of social waste.[38]

Figure 6 displays the equilibrium listings per broker on the horizontal axis, and the prices and cost per listing on the vertical axis. The price received by brokers under a broker-only approach is αP_e^B, and AC^B indicates the average cost per listing under a broker-only approach. Miceli shows that, if brokers expend resources in an attempt to acquire listings, then the equilibrium number of listings per broker will occur at a point where the average cost of an additional listing exceeds its marginal cost.[39] This is denoted by point q_e^B in Figure 6. If the equilibrium number of listings per broker occurs at a point such as this, then economic rents are generated.

Aaron Farmer, Remarks at the Dep't Justice/Fed. Trade Comm'n: Competition Policy and the Real Estate Industry Workshop (Oct. 25, 2005).

35 Birger, *supra* note 18.

36 Anglin & Arnott, *supra* note 25.

37 *See* Hsieh & Moretti, *supra* note 4, at 1088-89 (documenting other expenditures on prospecting, such as handing out free pumpkins for Halloween and free notepads featuring the broker's picture. To the extent that the cost to brokers of this type of prospecting exceeds its benefits to potential customers, its elimination will result in a social welfare gain.). *But see* Geoffrey K. Turnbull, *Real Estate Brokers, Nonprice Competition and the Housing Market*, 20 REAL EST. ECON. 293 (1996) (analyzing a model under which non-price competition takes place in a quality-of-service dimension, and finds that a higher commission rate may either increase or decrease social loss).

38 This form of wasteful non-price competition has been exhibited in regulated industries, such as airlines prior to deregulation. *See, e.g.*, George W. Douglas & James C. Miller, ECONOMIC REGULATION OF DOMESTIC AIR TRANSPORT: THEORY AND POLICY 529-31 (1974).

39 Miceli, *supra* note 1, at 526.

Those rents are indicated by the area $\pi = \alpha P_e^B fgAC^B$. Under the assumption that rents are competed to zero through various forms of non-price competition,[40] and if Internet-based competition causes commissions to fall to the point where economic profits are bid to zero, then area $\alpha P_e^B fgAC^B$ is a good approximation of the welfare gains from introducing Internet competition.

The Effects of Non-Price Competition in Brokerage

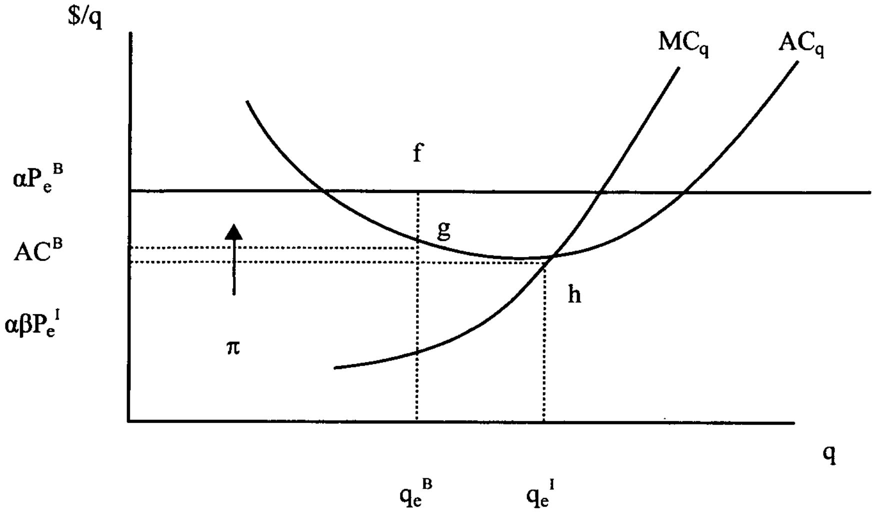

Figure 6

Suppose the commission under Internet search is some fraction (β) of its current level, which may be the ½ assumed above. Then, the new equilibrium price received by brokers with the Internet is $\alpha\beta P_e^I$. At this point, $\alpha\beta P_e^I = AC_q = MC_q$, and the industry is in its long-run competitive equilibrium. There is no welfare loss due to non-price competition.

To obtain an estimate of the area π, which provides an estimate of the welfare loss avoided by Internet use, information on commission revenue (area $\alpha P_e^B f q_e^B 0$, where 0 is the origin) and total cost (area $AC^B g q_e^B 0$) are needed. The most difficult aspect of developing such an estimate is obtaining accurate information on costs. Recent literature provides insights into this question. Hsieh and Moretti focus on the social loss from excess entry of real estate brokers into high-housing-cost cities.[41] They note that, given

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40 Hsieh & Moretti, *supra* note 4, at 1117 (higher commissions for each housing transaction in a high-housing cost city will be fully dissipated through entry of brokers and wasteful prospecting activities). Specifically, they find that 2/3 to 3/4 of the higher commissions in a city where the price of land has increased is dissipated through wasteful entry).

41 *Id.* (they focus on social losses stemming from expenditures of agents' time, but do not consider expenditures on things, such as promotional items used in prospecting).

fixed commissions, brokers are able to earn dramatically more in high-housing-cost cities. If the rent-dissipation hypothesis is correct, this will generate greater entry and, in turn, lower productivity (as measured by houses sold per hour worked) than in low-housing-cost cities. They find evidence supportive of those predictions and, after estimating costs, provide estimates of the welfare loss associated with excess entry of brokers for the year 1990.[42]

To estimate costs, Hsieh and Moretti use their most robust estimate of the effect of higher housing prices on agent productivity. They find that an increase of ten percent in housing price lowers the productivity of agents by seven percent, and they infer that marginal costs will increase by three percent for each ten percent increase in housing price.[43] The authors assume that, if a benchmark city in which there is no excessive entry can be identified, then the cost in city j can be estimated using:

$$COST_j = \frac{S_j w_j}{prod_b}\left[1 + 0.3\ln\left(\frac{P_j}{P_b}\right)\right]$$

where S_j is the number of housing sales in city j, w_j is the real estate agent's reservation wage, $prod_b$ is the productivity of agents in the benchmark city, P_j is the price of housing in city j, and P_b is the price of housing in the benchmark city.[44] The second term formalizes the inference that thirty percent of the added price of housing relative to the benchmark city translates into higher costs. For a city where agent productivity is less than the benchmark city, social loss can be calculated by taking the difference between costs as estimated here and broker's total earnings in that city. If those differences are summed over all cities, an estimate of total social losses from excessive entry is obtained.[45] This also provides an estimate of the likely savings in moving to an Internet-induced equilibrium based on price competition.

Because they do not know which city has an efficient brokerage industry, Hsieh and Moretti report a range of estimates of total welfare loss based on varying assumptions about broker productivity in the benchmark city. For example, if the benchmark city used is Athens, Georgia[46] (which is in the 90th percentile of the broker's productivity distribution), then the estimated total social loss from excess broker entry in 1990 is \$8.2 billion. If the benchmark city used is Pittsburgh, Pennsylvania,[47] which is at the me-

42 *Id.* at 1116.
43 *Id.* at 1115.
44 *Id.*
45 *Id.* at 1116.
46 Hsieh & Moretti, *supra* note 4, at 1116.
47 *Id.* at 1117.

dian of the productivity distribution, then the estimated loss is $2.6 billion. If the benchmark city used is Des Moines, Iowa, which is in the 25th percentile of the distribution, then the estimated loss is $1.1 billion.[48] Keeping in mind that these estimates are from 1990, the authors suggest that the social loss from excess entry of agents under fixed commissions and, consequently, the welfare gain from the introduction of flexible commissions under Internet search, are likely to be substantial. These estimates do not include potential losses from any excessive "prospecting" activities that may occur, so they should be viewed as the lower bound of social losses from non-price competition. This analysis also points to the importance of focusing on cost information from brokerage operations in order to calculate social costs from excessive entry.

IV. SUMMARY AND CONCLUSIONS

I have offered frameworks for analyzing two potential sources of welfare gains likely to emerge under increased use of the Internet in real estate brokerage. In the first case, gains are generated from the lower transaction costs associated with Internet brokerage. There are three main sources of such gains. First, potential home buyers can obtain information at lower cost if they use the Internet. Buyers will be better informed when they examine a house with an agent, so agents need to show fewer houses per sale, thus increasing their productivity. Buyers themselves will also enjoy lower transaction costs since they will need to visit fewer homes before making a purchase. Second, sellers' transaction costs will decline to the extent that Internet use facilitates the offering of a la carte services, which allow sellers to pick and choose the services they desire. A number of fee-for-service, or menu pricing, firms that offer flat fee prices to perform specific services have emerged. These services might include contract closing or listing a property on the MLS. Third, the Internet facilitates the use of non-MLS based websites for the posting of available properties. Accordingly, buyers and sellers are more likely to transact directly, lowering transaction costs.

Another source of welfare gain examined here is the elimination of wasteful non-price competition created when there is a free-entry-with-fixed-commission structure of residential real estate. That competition takes the form of an excessively large number of real estate agents entering the industry as well as expenditures on prospecting by agents in competition for listings. Estimates using 1990 data suggest that the social loss from excessive agent entry range from $1.1 billion to $8.2 billion. Because they do not include expenditures on prospecting activities, these should be

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48 *See id.* (as the benchmark city's productivity falls, the marginal cost increases, so that the number of cities in which socially wasteful entry does not occur rises. This lowers the estimate of social loss.).

viewed as lower-bound estimates of the probable savings from increased Internet competition.

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BOOK REVIEW

Charles Ferguson's *The Broadband Problem: Anatomy of a Market Failure and a Policy Dilemma. (2004)*

*Scott Wallsten**

The rapid pace of change in broadband markets and the Internet makes research and writing on the subject challenging. Reviewing Charles Ferguson's 2004 book, *The Broadband Problem*, in late 2006 seems, at first blush, a bit late.[1] To his credit, Ferguson raises several issues that remain actively debated more than two years later—an eternity in Internet time. Because these issues remain contentious and because I believe Ferguson's arguments are flawed, a review of this book is instructive.

Ferguson argues that broadband investment and adoption in the United States have been too slow and, as a result, the U.S. will ultimately be left at a competitive disadvantage, relative to other countries. The main piece of evidence suggesting the U.S.'s broadband problem was its relatively low rank among other countries, measured by the number of broadband subscribers per capita. That was true when Ferguson put pen to paper and it remains true today, causing considerable consternation.

A constellation of issues, Ferguson believes, has created the U.S. broadband problem. In particular, he asserts that the legacy telecommunications companies (incumbent local telecommunication carriers, or ILECs) retaining monopoly control over the nation's communications infrastructure have captured regulators and have suppressed innovation because they are loathe to cannibalize their own legacy voice services. He concludes with thirteen policy recommendations, most of which involve additional regulation of the nation's communications infrastructure, including requiring in-

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1 Robert W. Crandall reviewed this book soon after its release in 2004.

cumbents to open up their broadband infrastructure networks to competitors.

While Ferguson's book contains useful features—such as a thoughtful discussion of intellectual property rights—its analysis overall displays little understanding of the economics or political economy of broadband markets or the regulations governing them. The book begins with a fact—the low U.S. rank in terms of broadband penetration per capita relative to other Organization for Economic Co-Operation and Development (OECD) countries—but from there Ferguson makes arguments that are largely unsupported by evidence, and policy recommendations that could exacerbate the very broadband problem he believes already exists.[2]

This review is organized into four sections. The first section discusses the underlying assumption that the relatively low international broadband ranking by itself demonstrates a problem. The second section discusses the broadband market. The third section dissects Ferguson's analysis of the regulatory system and its problems related to lobbying and conflicts of interest. The fourth section considers Ferguson's policy recommendations. Finally, the review concludes by agreeing, while not all is perfect in the broadband market, additional competition, not new regulation, is the way to improve it.

I. IS THERE A U.S. BROADBAND PROBLEM?

When Ferguson's book was published in 2004, the U.S. ranked twelfth in terms of broadband subscribers per capita among OECD countries.[3] According to the most recent OECD data, in June, 2006 the U.S. rank remained unchanged.[4] In addition, consumers in other countries are able to purchase Internet access with higher advertised maximum bandwidths.

These comparisons are problematic for at least four reasons, as I have argued elsewhere.[5] First, many factors, such as population density, affect the costs of building broadband infrastructure and supplying bandwidth.

Second, the available quantity, quality, and price of broadband services are determined not only by supply characteristics and available tech-

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2 Actually, the book begins by asserting that the "failure to deploy" broadband technology fast enough is responsible "for the U.S. economy's recent problems," although the book offers no support for this claim.

3 *OECD Broadband Statistics, December 2004*, Organization for Economic Co-operation and Development, *available at* http://www.oecd.org/home/ (last visited Aug. 21, 2007) (follow "Statistics" hyperlink; then follow "Information Communication and Technology" hyperlink; then follow "More" hyperlink; then follow "OECD Broadband Statistics, December 2004" hyperlink).

4 *OECD Broadband Statistics to December 2006*, Organization for Economic Co-operation and Development, *available at* http://www.oecd.org/sti/ict/broadband (last visited Aug. 21, 2007).

5 Seth Sacher & Scott Wallsten, *What U.S. Broadband Problem?*, AEI-Brookings Joint Center Publications (July 3, 2006).

nologies, but also by demand. The book, however, omits a serious discussion of demand characteristics. Ferguson contends that "the market could absorb the full rate of technical change delivered by the technology curve, were broadband services to reflect this technical progress,"[6] and lists a variety of bandwidth-intensive services that could be offered using proven technologies. The existence of a proven technology does not, however, necessarily imply that the demand is sufficient to create a viable market for that technology.

Some people are not willing to pay for state-of-the-art technologies. Ferguson asserts that the presence of people using old technologies indicates a problem. Early in the book he laments that in 2003, "about two thirds [of U.S. households with Internet access] still depended upon modems."[7] Yet, a survey by the Pew Internet and American Life Project found that in 2006, nearly 60 percent of dialup users claimed to have no interest in broadband connections.[8] To be sure, people who use narrowband connections because they have no broadband options could reflect a public policy problem if broadband access generates positive externalities. It is, in part, for that reason that policy must promote competition by removing arbitrary barriers to entry, as discussed in more detail below. Nevertheless, the Pew survey highlights that not everyone has the same demand for broadband and that some are, for the moment, content with narrowband.

Third, the data on which Ferguson's international comparisons are based are questionable. Data provided by the Federal Communications Commission (FCC) have limitations.[9] Nevertheless, the FCC is far more forthcoming about its data collection and aggregation procedures than the OECD or the International Telecommunications Union (ITU), which generate the international rankings. The ITU and OECD provide almost no information on their data sources or methodologies. In other words, it is almost impossible to determine the accuracy of cross-country comparisons.

In addition, advertised available bandwidths (speeds) are not the same as actual available speeds. Kende finds that advertised speeds are typically higher than actual available speeds, and that the gap increases as advertised speeds increase.[10] The report suggests the gap across countries between actual speeds is much lower than the gap in advertised speeds.

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6 CHARLES H. FERGUSON, THE BROADBAND PROBLEM 33 (June 2004).

7 *Id.* at 4.

8 John B. Horrigan, *Home Broadband Adoption 2006*, Pew Internet and American Life Project (May 28, 2006), *available at* http://www.pewinternet.org/pdfs/PIP_Broadband_trends2006.pdf (last visited Aug. 21, 2007).

9 For example, the FCC releases data on the number of providers at the zip code level, but it is not possible to determine the level of head-to-head competition using these data. See, for example, FLAMM, *infra* note 26, for an excellent discussion of this issue.

10 Michael Kende, *Survey of International Broadband Offerings*, Analysis Group, Washington, DC.

Fourth, the rapid pace of broadband investment in the U.S. is inconsistent with a complacent industry intent on avoiding competition. According to the FCC's most recent data, by the end of 2005 there were more than 50.2 million high-speed lines—up from less than three million in 1999 and more than twice the number at the beginning of 2003. While many complain that the FCC's definition of "high-speed" is too slow; the most recent data also show that more than half of all these lines provide at least 2.5 mbps (megabits per second) of bandwidth in at least one direction.[11]

While artificial barriers may be slowing broadband investment and adoption, as discussed below, the simple existence of differences across countries is not, by itself, evidence of a "broadband problem."

II. THE BROADBAND MARKET AND COMPETITION

The book argues that the U.S. has a broadband problem because the ILECs retain monopoly control over the nation's communications infrastructure, which creates an incentive for them to under invest in broadband so as to not threaten their stream of monopoly rents from legacy voice services. As Ferguson says, "telephone companies artificially restrict the broadband services they offer . . . because in the presence of inexpensive broadband services Internet-based telephony . . . would destroy the market for traditional phone service."[12]

Were the ILECs true monopolists, then the assertion could have some merit.[13] While the ILECs may have market power in some areas, the evidence suggests that overall they face stiff competition.

Ferguson argues that the ILECs collect monopoly rents from their voice services. Market conditions suggest otherwise. In particular, the ILECs face competition for voice services from wireless companies and, increasingly, from cable providers. According to the FCC, the number of switched access lines provided by the ILECs have been inexorably decreasing. By the end of 1999, the ILECs provided around 181 million lines. By

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[11] The FCC defines "high-speed" as a connection that exceeds 200 kbps (kilobits per second) in at least one direction. Few would call that true broadband.

[12] FERGUSON, *supra* note 6, at 21.

[13] Even in the case of a pure monopolist the answer is not automatically clear. Questions about market structure and innovation have been the subject of tremendous amounts of research. Innovation and research is susceptible to a classic market failure—a firm may not be able to fully appropriate the returns on its investment as others use and extend its discoveries, and may therefore under invest in research relative to some social optimum. In some cases, a monopolist is less likely to suffer from this failure as it will be able to appropriate a larger share of the returns on its investments. The old AT&T was able to fund fundamental science and basic research at Bell Labs because it had few concerns about others benefiting from its investments. Nevertheless, competitive industries are generally more innovative than more concentrated industries, and we have certainly witnessed the benefits of competition in telecommunications.

the end of 2005, that number had fallen to about 144 million.[14] At the same time, the number of mobile subscribers increased from about 16 million in 1999 to 213 million in 2005.[15]

ILECs also face intense competition for broadband provision from the cable television (CATV) industry. Ferguson largely brushes this competition aside. In particular, he relegates discussion of CATV and broadband to about thirteen of the book's 216 pages. Ferguson dismisses CATV by asserting that it faces the same desire to avoid cannibalizing its existing services and that "the structure of the broadband services market is such that the CATV industry's initial residential broadband offerings, including its competition with the ILECs since 1998, probably represent both very limited competition and an exceptional situation that cannot be extrapolated to business markets into the long-term future, or to markets for higher performance and symmetric services."[16]

Disregarding competition between CATV and the ILECs in broadband seems as unjustified in 2007 as it did in 2004. According to the FCC, in June 2004 CATV had nearly 19 million high-speed lines while the ILECs had just over 11 million. In other words, Ferguson claims that the CATV industry was not a serious broadband competitor, despite having nearly 75 percent more subscribers than the ILECs.

The impacts of this competition on diffusion were obvious even in 2004. The number of subscribers to high-speed lines had increased from less than three million in 1999 to more than 32 million by June 2004.[17] By December 2005, that number had increased to more than 50 million. Such rapid growth is hardly consistent with an industry bereft of competition and dominated by a monopolist with the desire and ability to suppress investment.

Demand continues to grow for broadband services, changing the nature of the ILECs' businesses. Ferguson seems to recognize this change when he notes that "digital services are a rapidly growing fraction (currently [then] approximately 20-25 percent) of total ILEC revenues . . . ."[18]

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14 Industry Analysis & Technology Division Wireless Competition Bureau, *Local Telephone Competition: Status as of December 31, 2005* Table 1 (July 2006), *available at* http://www.nrri.org/dspace/bitstream/2068/1031/1/Local+Telephone+Competition_Status+as+of+December+31+2004.pdf (last visited Aug. 21, 2007). Verizon has even begun to sell some of its switched access lines, which suggests that those lines are not especially profitable. *See* Verizon Communications, *2006 Interactive Annual Report* 24, *available at* http://investor.verizon.com/financial/annual/2006/downloads/06_vz_ar.pdf (last visited Aug. 21, 2007).

15 FCC Wireless Telecommunications Bureau, *Eleventh Annual CMRS Competition Report* (September 26, 2006), *available at* http://gullfoss2.fcc.gov/edocs_public/openAttachment.do?link=DOC-267612A1.pdf (last visited Aug. 21, 2007).

16 FERGUSON, *supra* note 6, at 146.

17 Local Telephone Competition, *supra* note 14, at Table 1.

18 FERGUSON , *supra* note 6, at 62.

The rapidly falling number of switched-access voice lines, growing demand and competition for providing broadband connections, and increasing shares of revenues from data services suggests that it would probably be foolish for the ILECs to avoid broadband in order to prop up legacy services.

III. CONFLICTS OF INTEREST AND POLICYMAKING

Ferguson believes that the ILECs have the ability to exert market power in part because of problems related to conflicts of interest. He identifies two major issues. First, regulated firms hire economists and other analysts, making the researchers' work, he argues, suspect. Second, the revolving door between industry and regulatory agencies creates a cozy regulatory environment—essentially, that the regulators have been captured or are at least unduly influenced by the regulated firms.

Conflicts of interest and biases are important issues that extend beyond telecommunications policy. Ferguson argues that research conducted by anyone who has ever consulted a telecommunications firm must be considered suspect. But the problem is more complicated than this view implies.

Disclosure of financial support is important, especially when research is conducted specifically at the request of an organization with a financial interest in the issue. But at what point is a researcher so indebted to a particular company that her research can no longer be considered objective? Does a single consulting engagement disqualify someone from ever conducting research in a particular area? Does working for an organization that receives financial support from companies in the industry of study disqualify the researcher?[19] These are difficult questions to answer.

Robert Hahn reviews the issues of disclosure and conflicts of interest and concludes that while disclosure is important, it should not substitute for considering arguments on their own merits.[20] In contrast to this advice, Ferguson brushes aside the long, substantive economics literature on regulation, antitrust, and telecommunications because "[t]he ILECs also have retained as consultants a high fraction of the most prominent economists in the United States who specialize in industrial organization, antitrust policy, and regulatory economics."[21] While it is important to know sources of financial support and potential conflicts of interest, their potential existence

[19] While I have received no financial compensation for writing this article, I have consulted for a number of telecommunications companies and have worked for organizations that receive financial support from the telecommunications industry.

[20] Robert W. Hahn, *The False Promise of "Full Disclosure,"* 115 HOOVER INST. POL'Y REV. 39 (Oct.-Nov. 2002).

[21] FERGUSON, *supra* note 6, at 113.

is no excuse for failing to understand and argue the substance of those issues.

Equally as important, nobody is completely free of bias. Consider Charles Ferguson. He states that he has "no financial interest in any telecommunications firm, and [does] not lobby for, consult to, or represent any firm, industry group, or interest in any segment of the telecommunications or media industry."[22] He also notes that most of his net worth is in the form of Microsoft stock, which Microsoft gave him when it acquired his former software company, Vermeer Technologies.[23] Ferguson does not mention—though it is no secret—that at Vermeer he developed FrontPage, a popular software program for building websites.

As an entrepreneur, Ferguson benefited from strong intellectual property protection, and recognizes its importance. He worries that widespread broadband "raises enormous problems of piracy and digital intellectual property theft that could seriously interfere with fair compensation to creators and distributors of music, art, software, film, literature, journalism, and other works that can be distributed in digital form."[24] It is conceivable, for example, that if intellectual property had been less strongly protected, Ferguson may have made less money from FrontPage or perhaps not even invented it in the first place.

His support for strong intellectual property protection stands in stark contrast to his demand that infrastructure providers be forced to share their networks with competitors.[25] He worries about maintaining incentives for innovation through strong intellectual property rights, but does not worry at all about the impact infrastructure sharing requirements could have on incentives to invest in broadband infrastructure.

These inconsistent views highlight two points. First, hands-on experience can lead to considered views, as with Ferguson's experience with software and his opinions on intellectual property. Second, because nobody is completely without bias, decisions must be based on the merits of the argument, not based on who makes the argument.

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22 *Id.* at 125.

23 *Id.*

24 *Id.* at 207.

25 "[F]ederal policy should set a date after which (a) all new ILEC-constructed local telecommunications infrastructure will be subject to the requirement that its external technical interfaces be defined and controlled by an independent body, and (b) collocation and interconnection rights will be granted on an unrestricted basis to all who wish to obtain them." *Id.* at 194.

A. *Ferguson's Recommendations Are More Likely to Create than to Solve a Problem*

Ferguson advocates two main sets of regulations. First, he proposes strict new unbundling rules for incumbents, divestiture of some of their assets, and an "independent body" to oversee the creation of an "open-architecture, competitive local broadband system." Second, he would like regulatory agencies and the judiciary to have more in-house expertise with high-tech industries.

These recommendations are not accompanied by, nor do they cite, any analyses suggesting that they might yield net benefits. In 2004, there was little empirical research on the impacts of broadband policies, but the book does not appear to recognize that there may be costs, as well as benefits, to these proposals.[26]

Consider forced unbundling. There is widespread agreement that facilities-based competition is necessary for a vibrant market.[27] The basic argument in favor of forced unbundling is that it can allow competitors to gain a toehold in the market to acquire customers while they build out their own facilities. The counter-argument is that requiring firms to give competitors access to their networks reduces the incentive for firms to invest in their networks by reducing the potential returns on their investments. Today, that debate is effectively over in the U.S., as the courts and regulators do not require firms to sell access to new broadband networks at regulated rates.[28]

In Europe, however, the unbundling debate still rages. In recent empirical work, I found that strict unbundling regulations were associated with less, not more, broadband investment. Consistent with the importance of competition, some regulations ensuring interconnection by competitors were correlated with increased broadband penetration.

Given the failure of unbundling in the U.S. and the debates over its possible effectiveness under any conditions, the type of strict unbundling that Ferguson suggested would be unwarranted and unwise.

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26 *See* Kenneth Flamm, *The Role of Economics, Demographics, and State Policy in Broadband Availability* (Feb. 2005), *available at* http://bear.cba.ufl.edu/centers/purc/documents/Flamm-flammbb 0205.pdf (last visited Aug. 21, 2007); *and see* Scott J. Wallsten, *Broadband and Unbundling Regulations in OECD Countries* (AEI-Brookings Joint Center for Regulatory Studies, Working Paper No. 06-16, June 2006), *available at* http://www.aei-brookings.org/admin/authorpdfs/page.php?id=1284 (last visited Aug. 21, 2007) (for a more recent analysis of broadband policies).

27 *See* Debra J. Aron & David E. Burnstein, *Broadband Adoption in The United States: An Empirical Analysis* (March 2003), *available at* http://www.si.umich.edu/tprc/papers/2003/180/aron -burnstein_broadband_adoption_paper.pdf (last visited Aug. 21, 2007) (one of the first empirical analyses demonstrating the importance of facilities-based broadband competition).

28 *See* Thomas Hazlett, *Rivalrous Telecommunications Networks With and Without Mandatory Sharing*, 58 FED. COMM. L.J. 477 (2006) (arguing that ending forced unbundling immediately increased investment by the ILECs and cable companies).

Ferguson also recommends that regulatory agencies and the judiciary have more expertise in high-tech industries. Perhaps this is a worthy goal. The issue of how best to deal with science in courts is an open and important question, and not limited simply to high-tech agencies.

More generally, the question remains how the government should obtain information about the industries it regulates. Effective regulation requires obtaining detailed information. The industry, however, has far more information than the regulator. This unavoidable information asymmetry means that the regulator must have close contact with the regulated firms. If the contact is too close the regulator risks being captured by the industry it is supposed to regulate. With too little contact and insufficient understanding of the industry, the regulator risks mandating unrealistic obligations and seriously distorting investment.[29]

Ferguson believes that the regulators have been captured by industry, largely as a result of lobbying and the revolving door. Even assuming this is true, some of his major recommendations—such as strict mandatory unbundling and divestiture of some assets—would likely worsen problems associated with lobbying. Meanwhile, his recommendation for more expertise in regulatory agencies related to high-tech industries is inconsistent with his desire to reduce connections between regulated firms, industries, and researchers.

Putting aside the complexities of dealing with conflicts of interest, inconsistencies between Ferguson's analysis of the current regulatory framework and his proposed solutions reveal some of the difficulties in addressing conflict-of-interest issues. Ferguson is concerned about the revolving door between government and industry. At the same time, he laments the lack of specialized knowledge about high-tech industries in regulatory agencies and the judiciary. Ferguson therefore recommends that "[f]ederal policy should require greatly increased high-technology expertise . . . in the federal regulatory system. This applies particularly to FCC and FTC commissioners, federal judges, and the senior staff of regulatory and antitrust organizations." If anyone with industry experience is suspect, however, it is not clear from where the expertise Ferguson desires would come.

Finally, because Ferguson's suggestions would do little to change the underlying incentives responsible for current regulatory conditions, additional regulations are unlikely to solve the problems he identifies. More regulation could lead inexorably to additional information requirements by regulators, more companies with a stake in the outcome of regulatory decisions, and more lobbying. In other words, Ferguson's suggestions, if implemented, could lead to worsening of the very conditions he deplores.

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[29] *See* George Stigler, *The Theory of Economic Regulation*, 2 BELL J. OF ECON. & MGMT. SCI. 3 (1971); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976) (discussing these and other issues in their seminal works on the economics and political economy of regulation).

IV. CONCLUSION—COMPETITION IS IMPORTANT

While Ferguson's analysis of the market and its regulatory framework is flawed, his goal—ensuring intense competition among broadband providers—is desirable. The evidence to date suggests that strict unbundling regulations in the U.S. largely discouraged investment. For incumbents in particular, those rules reduced the potential returns from broadband infrastructure, making such investments less attractive. For competitors, these rules made it more attractive to access the incumbents' lines than to build out their own infrastructure. In any event, these rules have now largely been discarded, at least for new infrastructure.[30]

Deregulation appears to be bearing fruit. Both cable companies and the ILECs are investing heavily in their broadband infrastructure, substantially boosting the amount of bandwidth available to consumers. Verizon, for example, is laying fiber optic cables directly to customers' premises. FiOS, as they call it, already offers customers broadband up to 50 mbps, and ultimately can offer much more. The company has estimated that it will invest $18 billion in this network by 2010.

The key to ensuring competition is not additional regulation. Policy makers should ensure that artificial barriers do not block entry or investment. For example, the FCC should continue to move more spectrum into the market. Some of that spectrum is likely to be used to provide additional wireless broadband services.

Broadband investment has likely contributed to economic growth and will continue to do so. Laws and regulations that affect it should be considered carefully to avoid creating the very problems they were intended to resolve.

[30] *See, e.g.*, Jerry Hausman and Gregory Sidak, *Did Mandatory Unbundling Achieve Its Purpose? Empirical Evidence from Five Countries*, 1 J. COMP. L. & ECON. 173 (2005); Hazlett, *supra* note 28. *See* George S. Ford & Lawrence J. Spiwak, *The Positive Effects of Unbundling on Broadband Deployment* (The Phoenix Center for Advanced Legal & Economic Public Policy Studies, Policy Paper No. 19, 2004), *available at* http://www.phoenix-center.org/pcpp/PCPP19Final.pdf (last visited Aug. 21, 2007) (some positive effects of unbundling).

BOOK REVIEW

A LONG TAIL MEANS MORE CHOICE, AND THAT'S A GOOD THING

A review of Chris Anderson's *The Long Tail: Why the Future of Business is Selling Less of More. (2006)*

*Jerry Brito**

Wal-Mart is the single largest retailer of music in the United States, accounting for 20 percent of music sales annually. However, of the 30,000 new albums released each year, in any one of its stores Wal-Mart carries only 750 of them.[1] The reason is simple: shelf space.

If a particular CD will sell only once or twice a year, Wal-Mart, along with every other brick-and-mortar store, cannot afford to dedicate limited shelf space to it. Even a specialty retailer, such as Barnes & Noble, will only carry the top ten percent of all books available. In a world of limited shelf space, we are exposed only to hits and best-sellers.

The concept that Chris Anderson, editor of *Wired* magazine, develops in *The Long Tail: Why the Future of Business Is Selling Less of More* is that the Internet has made the costs of storage and distribution negligible, thereby making it viable for retailers to offer consumers more than just hits. Because its music is stored digitally, the iTunes music store has practically infinite shelf space, and therefore, it can offer consumers more than 3.5 million tracks. Amazon.com can offer millions of books because its shelves are at a few massive warehouses around the country and because they simply have third party vendors ship directly to consumers.

While brick-and-mortar stores such as Wal-Mart can only carry items at the "head" of the demand curve; online retailers can also offer the long tail of the curve, which is composed of less popular goods. What Anderson

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1 CHRIS ANDERSON, THE LONG TAIL: WHY THE FUTURE OF BUSINESS IS SELLING LESS OF MORE 156 (July 2006).

found, however, was that sales of long-tail goods account for a surprisingly large percentage of an online retailer's total sales.

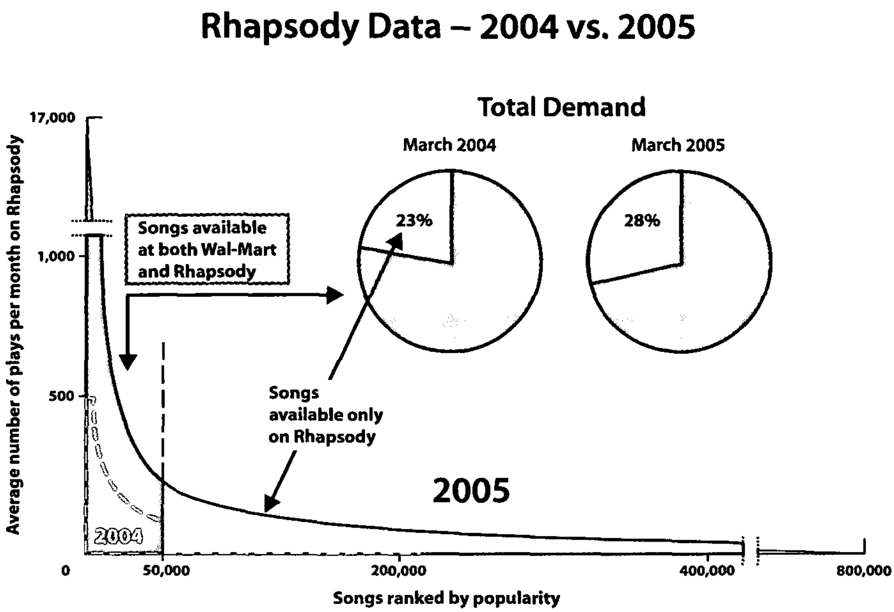

Figure 1

The effect of this new abundance of choice, Anderson argues, is that consumers now have the opportunity to stretch further afield from mainstream hits and find less popular fare that they may enjoy more than the hits. Consumers will not only discover new options, but will also be able to indulge niche interests that they have always had, but previously could not easily satisfy. As a consequence, hit-driven business models, which have thrived by appealing to the lowest common denominator, will be threatened by the segmentation of markets into uncountable niches.

Given a choice between watching the Super Bowl or the world ping pong championships, a ping pong aficionado will more than likely choose the latter, even though in a previous era of only four television channels, he would have been content to watch the Super Bowl along with almost every other American. If most consumers face the same calculus, the Super Bowl as a mass phenomenon is in trouble.

Anderson's insight is simple but profound, and helps explain many growing cultural trends, from the rise of blogs, to the success of MySpace and YouTube. In the book, he presents the argument both compellingly and enjoyably. While he uses copious anecdotes, the data is not far behind. Anderson endorses the application of the Long Tail concept not only to cultural goods—on which he focuses, and to which the theory is certainly applicable—but also to labor markets and national security.

"Open-source software projects such as Linux and Firefox are the Long Tail of programming talent, while off-shoring taps the Long Tail of labor," he writes. But what is being measured on the axes of these curves? Hours worked? Salary paid? Production achieved? It is unclear. In one example, Anderson attributes the explosion of choice to globalization, the growth of demographic diversity, and the Long Tail. To illustrate globalization and demography, he cites the increasing variety evident in cars, consumer goods, and the number of possible permutations of Starbucks coffee drinks. When it comes to explaining the influence of the Long Tail, however, he returns to iTunes, Netflix, and Amazon, which along with eBay and Google, serve as his faithful pedagogical companions throughout the book. Since he claims the almost universal applicability of his principle, and although he devotes one short chapter to the effort, greater treatment of the Long Tail outside of media and e-commerce would have been welcome.

One aspect of Anderson's book that has drawn little commentary, but that should indeed draw much praise, is the inclusion of several rejoinders to some popularly held economic misconceptions. In a chapter titled "The Paradise of Choice," Anderson challenges the idea that consumers are made worse off by an over-abundance of choice, particularly as expressed in Barry Schwartz's *The Paradox of Choice*. A grocery aisle with 50 different types of cereal, the bromide goes, is oppressive to consumers who are paralyzed with indecision. As Anderson explains, however, as long as consumers are given a way to navigate variety—such as Amazon's or Netflix's recommendation systems, or Google's eerily omniscient search—they are happy with infinite choice.

Similarly, Anderson takes issue with the type of pessimism that can be found in Robert Putnam's *Bowling Alone* or Cass Sunstein's *Republic.com*, contending that, given access to specialized niches, society will fragment and common culture will be destroyed. In reality, just the opposite seems to be happening. With the help of the Internet, individuals are finding thriving niche communities that matter to them and in which they genuinely want to participate. While we might lose superficial water cooler conversations about what happened on *Dallas* last night, we gain spirited debates on the discussion page associated with the Wikipedia entry for "wine." Not only do its participants create an enjoyable new community unconstrained by the shackles of geography, but the rest of us benefit as well.

One final economic myth that Anderson addresses is the popular idea that because of falling production and distribution costs, we are seeing the end of scarcity. This idea has been influential in the modern "commons" movement, popularized by Lawrence Lessig and Yochai Benkler.[2] While such a model might be appropriate for intellectual property and other non-

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[2] LAWRENCE LESSIG, THE FUTURE OF IDEAS 76, 84, 219 (Random House 2002) (2001); Yochai Benkler, *Overcoming Agoraphobia: Building the Commons of the Digitally Networked Environment*, 11 HARV. J.L. & TECH. 287, 321-22 (1998).

rival goods, it is not universally applicable. For example, because the advance of technology has radically increased the communications capacity of radio spectrum, Benkler and others have suggested that scarcity is no longer applicable and the airwaves can be treated like a commons.

Throughout *The Long Tail* Anderson makes much of "virtually infinite shelf space," but ultimately Anderson acknowledges that the operative word is "virtually." The scarce nature of some goods can be reduced to an incredible extent such that they become virtually free, but even a transformational reduction in cost does not end scarcity.

"If the abundant resources are just one factor in a system otherwise constrained by scarcity, they may not challenge the economic orthodoxy," Anderson writes. "They are then like learning curves and minimized transactions costs—drivers of production efficiency that serve to lower prices and increase productivity but do not invalidate the laws of economics."

The Long Tail is intelligently written and an enjoyable read, and the much needed ripostes make it only better. Although he seems to sometimes overstretch its applicability, Anderson's insight is nonetheless important as it could hold the key to the future of cultural production. One area to which it can be applied is academic publishing. Niche fragmentation is the thing that allows venues like this very Journal to thrive. At the same time, the production practices of the past (including the painfully slow time to press) might have to be rethought in the face of technologies of instant dissemination, ranging from the Social Science Research Network for academic publications to innumerable Internet blogs. No matter the future's ultimate direction, we at least can be sure that we'll continue to be treated to more choice.