No. 03-16-00786-CV

In the Court of Appeals for the Third Judicial District Austin, Texas

Texas Alcoholic Beverage Commission and Sherry Cook, in her Official Capacity as Executive Director of Texas Alcoholic Beverage Commission,

Appellants,

v.

Live Oak Brewing Co., LLC; Revolver Brewing, LLC; and Peticolas Brewing Co., LLC

Appellees.

On Appeal from the 98th District Court, Travis County

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Statement of the Case

Nature of the Case:	Plaintiffs asserted a constitutional challenge to Texas Alcoholic Beverage Code § 102.75(a)(7) under article I, section 17 and article I, section 19 of the Texas Constitution. CR.32.[1]
Course of Proceedings:	Plaintiffs and Defendants filed motions for summary judgment. CR.53 (Plaintiffs); CR.338 (Defendants). The trial court held a hearing on the motions. CR.600
Trial Court:	250th Judicial District Court, Travis County The Honorable Karin Crump
Trial Court Disposition:	The trial court granted in part and denied in part both Defendants' and Plaintiffs' motions for summary judgment. CR.576. The court dismissed Plaintiffs' article I, section 17 and attorney's fees claim, CR.577, but held that Texas Alcoholic Beverage Code § 102.75(a)(7) is facially unconstitutional under article I, section 19 of the Texas Constitution, CR.576-77.

Statement Regarding Oral Argument

Oral argument would aid the Court in the resolution of this appeal because this case raises issues of first impression in an undeveloped area of Texas constitutional law. The contours of the economic liberty right recognized in *Patel v. Texas Department of Licensing & Regulation*, 469 S.W.3d 69 (Tex. 2015) are at the heart of this appeal and have not yet been addressed by this Court. Oral argument would aid the Court in resolving those issues.

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[1] References to the clerk's record are cited as "CR." followed by the record page number(s).

Issues Presented

1. Does the fundamental economic liberty right recognized in *Patel* apply to business entities like Plaintiffs?

2. Did Plaintiffs establish that Texas Alcoholic Beverage Code § 102.75(a)(7) facially violates the due course of law guarantee in article I, section 19 of the Texas Constitution?

3. Did Plaintiffs prove that there is no rational basis for section 102.75(a)(7) or that the law is unconstitutionally oppressive as applied to them?

Introduction

In 2013, the Legislature responded to the growing craft brewery presence in Texas by enacting a five-bill legislative package that resulted from a hard-fought compromise among craft brewers, distributors, legislators, and other stakeholders. On the whole, the legislation dramatically expanded the rights of small brewers like Plaintiffs. Among other things, the 2013 enactments allow Plaintiffs to self-distribute beer directly to retailers and to sell beer directly to consumers at their breweries for on-site consumption.

Plaintiffs, however, were unhappy with a provision, codified at Texas Alcoholic Beverage Code § 102.75(a)(7), that expressly prohibits all brewers, large and small, from accepting payment for distribution territories. Plaintiffs challenged the law on the theory that it facially violates fundamental economic liberty rights under article I, section 19 of the Texas Constitution that the Texas Supreme Court recognized in *Patel*. The trial court's subsequent facial invalidation of section 102.75(a)(7) was error for three independent reasons.

First, the economic liberty interest recognized in *Patel* applies to individuals, not business entities like Plaintiffs. Holding otherwise would (1) significantly expand *Patel*, (2) contradict economic substantive due process jurisprudence of the Texas Supreme Court and the United States Supreme Court, and (3) create serious practical problems.

Second, the *facial* invalidation of section 102.75(a)(7) was error because *Patel* does not apply to facial challenges. In any event, Plaintiffs did not even

attempt to prove that the law operated unconstitutionally in every circumstance.

Third, Plaintiffs failed to establish that section 102.75(a)(7) has no rational basis or that its application to them is unconstitutionally oppressive. For any of these three reasons, the trial court's judgment should be reversed and Plaintiffs' lawsuit should be dismissed.

Statement of Facts

I. The Three-Tier System

A. The Three-Tier System Was Created to Prevent Return of Pre-Prohibition Vertical Integration in the Alcohol Industry.

The alcohol industry has long "'been the subject of severe legislative restraints.'" *Cadena Comercial USA Corp. v. TABC*, 449 S.W.3d 154, 163 (Tex. App.—Austin 2014, pet. granted) (quoting *Mayhue's Super Liquor Store, Inc. v. Meiklejohn*, 426 F.2d 142, 147 (5th Cir. 1970)). Until the Eighteenth Amendment ushered in national prohibition, regulation of the alcohol industry was largely imposed at the state and local level and was characterized by "kaleidoscopic change." Raymond B. Fosdick and Albert L. Scott, TOWARD LIQUOR CONTROL 2 (Harper & Bros. 1933). After Prohibition ended in 1933 with the ratification of the Twenty First Amendment, States once again took the lead in regulating the alcohol trade. U.S. Const. amend. XXI, § 2. Since then, the predominant approach among States has been a comprehensive licensing system that divides the industry into manufacturer/brewer, distributer/wholesaler, and retail tiers—the three-tier system. *See Granholm v. Heald*, 544 U.S.

460, 466 (2005) (noting that many States "regulate the sale and importation of alcoholic beverages . . . through a three-tier distribution system" that is "preserved by a complex set of overlapping state and federal regulations"); Carole L. Jurkiewicz and Murphy J. Painter, *Why We Control Alcohol the Way We Do*, SOCIAL AND ECONOMIC CONTROL OF ALCOHOL: THE 21ST AMENDMENT IN THE 21ST CENTURY 13-14 (Carole L. Jurkiewicz and Murphy J. Painter, eds., CRC Press 2008) (32 States and District of Columbia). The United States Supreme Court has repeatedly declared the three-tier system "'unquestionably legitimate.'" *Granholm*, 544 U.S. at 489 (quoting *North Dakota v. United States*, 495 U.S. 423, 432 (1990)).

The three-tier system was designed, in part, to prevent the return of the "'tied house'"—a pre-Prohibition scheme in which retailers were either owned by or under contract to exclusively sell the alcohol of a particular manufacturer. *See S.A. Disc. Liquor, Inc. v. TABC*, 709 F.2d 291, 293 (5th Cir. 1983) (explaining that the three-tier system is intended to "avoid the harmful effects of vertical integration in the intoxicants industry" and to "prevent[] companies with monopolistic tendencies from dominating all levels of the alcoholic beverage industry"); Fosdick, *supra*, at 29 (recommending that States strictly separate alcohol manufacturers from retailers to prevent the return of the tied house "by all available means").

The strong reaction against the tied house stemmed from the social and political evils that arose from tied houses and saloons before Prohibition, when alcohol manufacturers "exercise[d] tremendous influence over those retailers

that they did not directly control through ownership by extending credit and other financial incentives." Evan T. Lawson, *The Future of the Three-Tiered System as a Control of Marketing Alcoholic Beverages*, SOCIAL AND ECONOMIC CONTROL OF ALCOHOL: THE 21ST AMENDMENT IN THE 21ST CENTURY 32 (Carole L. Jurkiewicz and Murphy J. Painter, eds., CRC Press 2007). Fierce competition led to "drastic increases in consumption, which led to drunkenness and financial ruin, impoverishing the working man and his family." *Id.* Alcohol manufacturers also used their financial might "to corrupt political power to protect itself from building public outrage." *Id.* The saloon, the retail component in the tied house, was described as "a menace to society" where "degradation and crime were fostered," and "its principle of stimulated sales" produced poverty, drunkenness, and political graft. Fosdick, *supra*, at 10; *see also* CR.327-28 (explaining purposes for the three-tier system).

Texas enacted a three-tier system, now codified in the Texas Alcohol Beverage Code (the Code), shortly after ratification of the Twenty First Amendment. *See Dickerson v. Bailey*, 336 F.3d 388, 397 (5th Cir. 2003) ("The Texas legislature first enacted this code in 1935"). The Code is "an exercise of the police power of the state for the protection of the welfare, health, peace, temperance, and safety of the people of the state," and the Legislature has commanded that the Code be "liberally construed to accomplish this purpose." Tex. Alco. Bev. Code § 1.03. The purpose of Texas's three-tier system is to "prevent the creation or maintenance of a 'tied house.'" *Id.* § 6.03(i).

B. Operation of the Three-Tier System

The Code separates the alcohol industry into three tiers: alcohol manufacturers (including brewers),[2] wholesalers/distributors, and retailers. *See* Tex. Alco. Bev. Code § 6.03(i) (declaring that it is "the public policy of this state . . . to maintain and enforce the three-tier system (strict separation between the manufacturing, wholesaling, and retailing levels of the industry)"). Tied houses are strictly forbidden, and Texas law defines a "tied house" broadly to include "any overlapping ownership or other prohibited relationship between those engaged in the alcoholic beverage industry at different levels, that is, between a manufacturer and a wholesaler or retailer, or between a wholesaler and a retailer . . . ." *Id.* § 102.01(a). Reinforcing that broad prohibition, the Code charges TABC with ensuring "strict adherence to a general policy of prohibiting the tied house and related practices." *Id.* § 102.01(b). As this Court recently observed, "[t]hese provisions reflect the legislature's determination that the three tiers are to remain independent of each other." *Cadena*, 449 S.W.3d at 163.

As brewers, Plaintiffs occupy the manufacturer tier of the three-tier system.[3] Brewers may produce beer in unlimited quantities, but they generally

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[2] Tex. Alco. Bev. Code § 1.04(17).

[3] A business must have a brewer's permit to produce ale/malt liquor, Tex. Alco. Bev. Code § 12.01(a), and a manufacturer's license to make beer, *id.* § 62.01, but for purposes of this appeal there is no relevant difference between beer and ale; Plaintiffs produce both and challenge a statute that applies to both equally. *See* CR.56 n.1; Tex. Alco. Bev. Code § 102.81 (applying the relevant provisions "to agreements concerning ale and malt liquor in the same

must sell their beer through distributors. Tex. Alco. Bev. Code § 12.01(a)(3); *id.* § 62.01(a)(1). Small brewers and large, multi-national brewers operate under the same licensing system. One exception favors small brewers like Plaintiffs: brewers that produce fewer than 125,000 barrels of beer per year may obtain a permit to self-distribute up to 40,000 barrels to retailers. *Id.* § 12A.02(a), (b); *id.* § 62A.02(a), (b).

Under the Code, the business relationship between a brewer and a distributor includes a distribution agreement and a territorial agreement. *See id.* § 102.71(2), (5). The territorial agreement is a designation of "territorial limits in this state within which the brands of beer the licensee manufactures may be sold by general, local, or branch distributor's licensees." *Id.* § 102.51(a). A brewer may not assign all or part of a territory to more than one distributor. *Id.* § 102.51(b). The territorial agreement must be filed with TABC. *Id.*

The distribution agreement is the contract between the brewer and distributor "pursuant to which a distributor has the right to purchase, resell, and distribute any brand or brands of beer offered by a manufacturer." *Id.* § 102.71(2). With a few limitations explained below, *infra* at 10-11, the terms of distribution agreements are not dictated by the Code. Among the considerations important in negotiating a distribution agreement include the quality

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manner as they apply to agreements concerning beer"). For simplicity in this briefing we generally refer to beer and ale collectively as "beer" and manufacturers and brewers collectively as "brewers," unless further distinction is warranted.

and quantity of storage that the distributor can provide, the geographic reach of the distributor, the distributor's understanding of and commitment to the brewer's beer, the number of other beers distributed, and the capacity of the distributor for growth. CR.132-33; CR.293. The distribution schedule, marketing campaigns, and the duration and termination of a distribution agreement are also important terms subject to agreement. *See, e.g.*, CR.652 (distribution and marketing); Tex. Alco. Bev. Code §§ 102.73, .74, .77 (termination). Distribution agreements are not required to be filed with or disclosed to TABC.

C. Preserving the Three-Tier System

The three-tier system contains an inherent tension: it must ensure strict separation among the tiers while also accommodating business among the tiers. It has long been recognized that these dueling interests create challenges to maintaining the integrity of the system. In recommending a strictly divided alcohol industry, the authors of TOWARD LIQUOR CONTROL noted the insidious nature of tied houses, warning that there are "many devices used by brewers and distillers" to achieve the effect of a tied house. Fosdick, *supra*, at 29. The United States Supreme Court has likewise acknowledged "the exceptional problems involved in successfully regulating trade in intoxicating liquors." *Carter v. Virginia*, 321 U.S. 131, 137 (1944).

The Legislature has addressed these challenges in various ways in the Code, including a capacious definition of "tied house," Tex. Alco. Bev. Code

§ 102.01(b), commanding a broad construction of the Code, *id.* § 1.03, and proscribing activity that may threaten the three-tier system. For example:

- A licensee in one tier may not hold (even indirectly) "an ownership interest in the business or corporate stocks, including a stock option, convertible debenture, or similar interest, in a permit or business of a permittee of a different level who maintains licensed premises in Texas." *Id.* § 102.01(c).

- A licensee in one tier also may not own any premises, fixtures, or equipment of a licensee in another tier, and those things may not be obtained with a loan or on the credit of a licensee in a different tier. *Id.* § 102.01(e), (f).

- A permittee in one tier may not enter an agreement that would result in its management or control "in any form or degree" of the "business or interests" of a permittee in a different tier. *Id.* § 102.01(h).

Imbalances among the tiers also pose a threat to the three-tier system. *See* Lawson, *supra*, at 34 ("[P]rotecting each tier of the industry from domination by the other is vital to maintaining the three-tiered system."). In the beer business, "power in beer distribution relationships tends to be unbalanced, tipping heavily in favor of brewers." Barry Kurtz and Bryan H. Clements, *Beer Distribution Law As Compared to Traditional Franchise Law*, 33 Franchise L.J. 397, 399 (2014).

"Large, powerful brewers tend to dominate," *id.*, and massive consolidation in recent years has only increased the size and power of a few dominant brewers. For example, in 2015, Anheuser-Busch InBev and SABMiller, the world's two largest brewers, merged to create a company that accounts for

29% of global beer sales and is three times larger than the next largest competitor. *See* Chad Bray and Michael J. de la Merced, *Anheuser-Busch InBev and SABMiller to Join*, DealBook, NEW YORK TIMES (Oct. 13, 2015), https://www.nytimes.com/2015/10/14/business/dealbook/anheuser-busch-inbev-sabmiller-beer-merger.html; *see also* Jonathan Chew, *These are all the beers a combined AB InBev-SABMiller would brew*, FORTUNE (Sept. 16, 2015), http://fortune.com/2015/09/16/sabmiller-ab-inbev-beer-merger/.

Craft brewers are not immune to this consolidation trend. In fact, MillerCoors, one of the world's largest brewers, recently acquired Plaintiff Revolver Brewing. Greg Trotter, *MillerCoors strikes yet another deal, adds Texas-based Revolver Brewing*, CHICAGO TRIBUNE (Aug. 11, 2016), http://www.chicagotribune.com/business/ct-millercoors-craft-beer-0812-biz-20160811-story.html. A spokesman for MillerCoors revealed that the mega-brewer "already shares some distribution" with Revolver, and that distribution was a "consideration" in the investment. *Id*. Anheuser-Busch InBev is also on a craft-brewery buying spree, having purchased nine craft breweries since 2011, the latest of which is Houston-based Karbach Brewing. John Kell, *Anheuser-Busch InBev Buys 9th Craft Brewer*, FORTUNE (Nov. 3, 2016), http://fortune.com/2016/11/03/ab-inbev-buys-karbach-craft/.

To address the imbalances in the beer business, "many states have passed legislation aimed at balancing power in favor of distributors." Kurtz, *supra*, at 402; *see also* Brian D. Anhalt, *Crafting A Model State Law for Today's Beer Industry*, 21 Roger Williams U. L. Rev. 162, 163-64 (2016) (explaining that States

passed laws "requiring the inclusion of statutorily mandated distributor protections" because "a small number of large breweries dominated the market, holding a natural bargaining advantage over a large number of small distributors").

Texas responded to this perceived danger by enacting the Beer Industry Fair Dealing Law. Kurtz, *supra*, at 402 & n.25 (citing Tex. Alco. Bev. Code § 102.71). The purpose of the law, codified in chapter 102, subchapter D of the Code, is to "promote the public's interest in the fair, efficient, and competitive distribution of beer within this state" by ensuring the independence of distributors from brewers. Tex. Alco. Bev. Code § 102.72(a). To that end, the law provides that manufacturers and distributors may not "restrict or inhibit, directly or indirectly, the right of free association among manufacturers or distributors for any lawful purpose." *Id.* § 102.78. The statute also bars certain conduct. A brewer, for example, may not:

- unreasonably prohibit a distributor from selling other brewers' beer, *id.* § 102.75(a)(2);
- fix the price at which a distributor may sell beer to retailers, *id.* § 102.75(a)(3);
- force distributors to accept delivery of beer that the distributor did not order, *id.* § 102.75(a)(5);
- adjust the price at which the brewer sells beer to a distributor based on the price at which the distributor sells the beer to a retailer, *id.* § 102.75(a)(6); or
- accept payment for the assignment of territorial rights, *id.* § 102.75(a)(7).

Plaintiffs challenge only this last restriction—receiving payment for territorial rights—on the ground that it violates their substantive due process rights under *Patel*. CR.49-50.

II. The Challenged Law

A. In 2013, the Legislature Enacted a Package of Laws Promoting the Craft Beer Industry in Texas.

During the 83rd legislative session, craft brewers, distributors, legislators, and other stakeholders hammered out an all-or-nothing agreement on a package of five bills aimed at reforming beer regulations to promote the craft brewery industry. *See, e.g.*, Elena Schneider, *Beer Distributors, Craft Brewers Reach Deal*, TEXAS TRIBUNE (March 11, 2013), https://www.texastribune.org/2013/03/11/beer-distributors-craft-brewers-reach-tentative-de/; *see also* CR.268-69 (SB 639); CR.134-35.

Four of the bills expanded the rights of small brewers like Plaintiffs:

- Senate Bill 515 allowed holders of brewpub licenses to self-distribute beer to distributors and retailers. S.B. 515, Act of May 20, 2013, 83d Leg., R.S., ch. 750, 2013 Tex. Gen. Laws 1896.
- Senate Bill 516 allowed small brewers of ale/malt liquor (producing up to 125,000 barrels per year) to self-distribute up to 40,000 barrels directly to retailers. S.B. 516, Act of May 20, 2013, 83d Leg., R.S., ch. 533, 2013 Tex. Gen. Laws 1443.
- Senate Bill 517 allowed small manufacturers of beer (producing up to 125,000 barrels per year) to self-distribute up to 40,000 barrels directly to retailers. S.B. 517, Act of May 20, 2013, 83d Leg., R.S., ch. 534, 2013 Tex. Gen. Laws 1444.

- Senate Bill 518 permitted small brewers (up to 225,000 barrels annually) to sell their beer for on-site consumption (up to 5,000 barrels annually). S.B. 518, Act of May 20, 2013, 83d Leg., R.S., ch. 535, 2013 Tex. Gen. Laws 1446.

The fifth bill, Senate Bill 639, prohibited brewers from adjusting the price of the beer they sell to distributors based on the price for which the distributors sell the beer to retailers (so-called "reach-back pricing"), and it also prohibited brewers from accepting payment for the assignment of territorial rights.[4] S.B. 639, Act of May 20, 2013, 83d Leg., R.S., ch. 555, 2013 Tex. Gen. Laws 1494.

The Texas Craft Brewers Guild agreed to accept passage of SB 639 in exchange for passage of the four pro-craft beer bills (SB 515, 516, 517, 518). CR.134-35. The bills were enacted together, as the passage of one was made contingent on the passage of all the others. CR.269. After passage, a representative of the Texas Craft Brewers Guild hailed the legislative package as "a victory for Texas craft brewers." Ronnie Crocker, *Debate over SB 639 continues among craft brewers*, HOUSTON CHRONICLE (March 14, 2013), http://blog.chron.com/beertx/2013/03/debate-over-sb-639-continues-among-craft-brewers/; *see also* Shelby Cole, *Craft Brewers Celebrate New Beer Laws*, TEXAS TRIBUNE (Feb. 7, 2014), https://www.texastribune.org/2014/02/07/craft-brewers-celebrate-new-beer-laws/ (reporting that

[4] Senator Carona, the bill's author, characterized the provision as a clarification of existing law. CR.312.

"[t]he Texas Craft Brewers Guild predicts the new laws will have an enormous economic impact in Texas").

B. Plaintiffs Asserted a Constitutional Challenge to the Territorial-Assignment Restriction.

Not all craft brewers were happy with every feature of the legislative compromise, and Plaintiffs soon sued to challenge SB 639's territorial-assignment restriction, codified at Texas Alcoholic Beverage Code § 102.75(a)(7). CR.3. Plaintiffs asserted two Texas constitutional claims. First, they alleged that the prohibition on accepting payment for territorial assignments was a taking under article I, section 17 on the theory that distribution territories are compensable property rights. CR.48-49. Second, Plaintiffs alleged that section 102.75(a)(7) violated their substantive due process rights under article I, section 19. They argued that the territorial-assignment restriction lacked a rational basis because it was simply a transfer of wealth to distributors and it did not advance any legitimate governmental interest. CR.49-50.

After discovery, cross-motions for summary judgment, and a hearing, the trial court issued a final judgment dismissing Plaintiffs' takings claim, but it also ruled—without explanation—that § 102.75(a)(7) facially violates the due course of law provision in article I, section 19 of the Texas Constitution.[5] CR.576-78. Defendants timely appealed. CR.667-69.[6]

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[5] The court also dismissed Plaintiffs' request for attorney fees. CR.577.

[6] Plaintiffs did not appeal the dismissal of their takings claim or their attorney's fees claim.

Summary of the Argument

The trial court erred in holding that section 102.75(a)(7) facially violates the due course of law guarantees of article I, section 19 of the Texas Constitution for three independent reasons: (1) *Patel* protects the substantive economic liberty of individuals, not business entities, like Plaintiffs, that are creatures of state law; (2) Plaintiffs failed to establish that section 102.75(a)(7) is facially unconstitutional; and (3) Plaintiffs failed to surmount the "high bar" set forth in *Patel* to prove that 102.75(a)(7) is not rationally related to the State's legitimate interest in maintaining the three-tier system or that the law is unconstitutionally oppressive. For any of these reasons, the Court should reverse the trial court's judgment and render judgment dismissing Plaintiffs' lawsuit.

Standard of Review

When the trial court grants one motion for summary judgment and denies the other, "reviewing courts consider both sides' summary-judgment evidence, determine all questions presented, and render the judgment the trial court should have rendered." *Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd's London*, 327 S.W.3d 118, 124 (Tex. 2010). When considering a constitutional challenge to a statute, "[c]ourts must extend great deference to legislative enactments, apply a strong presumption in favor of their validity, and maintain a high bar for declaring any of them in violation of the Constitution." *Patel*, 469 S.W.3d at 91. Challenged statutes also must be considered within

the "statutory and historical context" of the Code and the three-tier system. *Cadena*, 449 S.W.3d at 163.

Argument

I. *Patel* Does Not Govern This Case.

A. The Economic Liberty Interest Recognized in *Patel* Belongs to Individuals, Not Business Entities like Plaintiffs.

The substantive economic right recognized in *Patel* is reserved only for individuals; it is not enjoyed by business entities like Plaintiffs who are creations of Texas law, not natural persons. The substantive economic liberty interest addressed in *Patel* is analytically distinct from the procedural component of the due course provision. *See, e.g.*, *Barshop v. Medina Cty. Underground Water Conservation Dist.*, 925 S.W.2d 618, 632 (Tex. 1996); *see also, e.g.*, *Patel*, 469 S.W.3d at 84 (citing early Texas Supreme Court cases that involved an individual's right to contract).

There is no history of the United States Supreme Court or Texas courts recognizing fundamental economic liberty rights in business entities. To the contrary, the United States Supreme Court has repeatedly rejected the notion that a substantive economic liberty interest applies to corporations, even during the *Lochner* era. *See, e.g.*, *Nw. Nat'l Life Ins. Co. v. Riggs*, 203 U.S. 243, 255 (1906) ("[T]he liberty guaranteed by the 14th Amendment. . . . is the liberty of natural, not artificial, persons."); *W. Turf Ass'n v. Greenberg*, 204 U.S. 359, 363 (1907) ("[T]he liberty guaranteed by the 14th Amendment against depri-

vation without due process of law is the liberty of natural, not artificial, persons."); *Hague v. Comm. for Indus. Org.*, 307 U.S. 496, 527 (1939) ("[T]he liberty guaranteed by the due process clause is the liberty of natural, not artificial, persons."). Judge Easterbrook, writing for the Seventh Circuit, put it succinctly: "Corporations do not have fundamental rights; they do not have liberty interests, period." *Nat'l Paint & Coatings Ass'n v. City of Chicago*, 45 F.3d 1124, 1129–30 (7th Cir. 1995). Here, as in *National Paint*, Plaintiffs' interest is an "interest in obtaining the maximum return on investment", but "[t]hat is not a 'fundamental' right." *Id.*

Extending fundamental liberty rights to business entities would be deeply problematic. As creatures of Texas law, Plaintiffs' nature, character, and authority are subject to change by the Legislature, and therefore they cannot have the exact same liberties as natural persons. The law by which they are organized may be altered from time to time by the Legislature, and the terms and character of their existence may change pursuant to the desires of their owners. The Court therefore cannot extend a liberty interest to Plaintiffs without expanding *Patel* well beyond the scope of that decision's plain text, and contrary to the consistent conclusions of the United States Supreme Court and the Texas Supreme Court regarding the scope of economic liberty interests.

B. *Patel* Applies Only to As-Applied Constitutional Challenges, Not to the Facial Challenges Plaintiffs Asserted.

Plaintiffs raised a facial challenge to section 102.75(a)(7). *See* CR.50 (requesting a judgment declaring that the statute is unconstitutional "insofar as it prevents brewers from charging distributors for territorial rights to distribute their beer"). To prevail on such a claim, Plaintiffs are obliged to satisfy the exacting standard for facial challenges. *See Tenet Hosps. Ltd. v. Rivera*, 445 S.W.3d 698, 702 (Tex. 2014) ("A facial challenge claims that a statute, by its terms, always operates unconstitutionally."). They cannot avoid that burden under the guise of a *Patel* claim.

Patel addressed as-applied challenges. *Patel*, 469 S.W.3d at 87 (expressing the standard for "an *as-applied* challenge to an economic regulation statute under Section 19's substantive due course of law requirement"). Facial challenges were not even mentioned in *Patel*, and for good reason. *Patel* was concerned with protecting an individual's right to exercise her fundamental economic rights in a given setting. Its standard rests on a presumption that the reviewing court will need to assess a plaintiff's evidence in order to determine whether the law is unconstitutionally oppressive as applied to that plaintiff. *See id.* (requiring proof of "the statute's actual, real-world effect as applied to the challenging party"); *id.* (noting that the constitutional determination will usually "require the reviewing court to consider the entire record, including evidence offered by the parties"); *id.* at 90 (concluding that the threaders "met their high burden of proving that, as applied to them," the law "is so

oppressive that it violates Article I, § 19 of the Texas Constitution"). Plaintiffs have dressed up their facial challenge as an oppression claim under *Patel*. Such a facial claim is simply incompatible with *Patel*, however, due to the need for Plaintiffs to prove oppression with evidence.

II. Plaintiffs Failed to Establish That Section 102.75(a)(7) Is Facially Unconstitutional.

The trial court invalidated the territorial-assignment restriction on its face, permanently enjoining enforcement of section 102.75(a)(7) "against Plaintiffs and *all other producers of beer, ale, and malt liquor*." CR.577 (emphasis added). That was error. Assessed under the proper standard, Plaintiffs fell woefully short of establishing the facial unconstitutionality of the statute.

Facial challenges to statutes are disfavored in the law, and the plaintiff faces the exceedingly difficult task of "demonstrating that the statute is unconstitutional in *all* of its applications." *HCA Healthcare Corp. v. Tex. Dep't of Ins.*, 303 S.W.3d 345, 349 (Tex. App.—Austin 2009, no pet.) (emphasis added); *see also United States v. Salerno*, 481 U.S. 739, 745 (1987) ("A facial challenge to a legislative Act is, of course, the most difficult challenge to mount successfully, since the challenger must establish that no set of circumstances exists under which the Act would be valid.")

Plaintiffs' facial challenge must fail because they did not even attempt to show that there are "no set of circumstances" under which section 102.75(a)(7) would be valid. For example, Plaintiffs never alleged, much less demonstrated, that section 102.75(a)(7) is oppressive for large brewers like

MillerCoors or InBev. *See, e.g.*, CR.84 (arguing that the law "unduly burdens craft brewers"). What's more, Plaintiffs made no attempt to show that the law is oppressive to craft brewers that have already entered territorial assignments without receiving compensation, or that the law is oppressive to craft brewers that *supported* the legislation. *See* CR.170 (speculating that a craft brewer on the legislative committee of the Texas Craft Brewer's Guild did not oppose the statute because "he had already given up all of his distribution rights"). That is fatal to their facial challenge. *See HCA Healthcare*, 303 S.W.3d at 351 (rejecting the facial challenge because the plaintiffs "have not argued, much less demonstrated," that the statute operated unconstitutionally for every relevant medical dispute).

III. Plaintiffs Also Failed to Meet Their Burden Under *Patel*.

Even if the Court were to conclude that *Patel* applied to Plaintiffs' claim, Plaintiffs nevertheless failed to overcome the "high burden" set forth in *Patel* for invalidating a statute under the due course of law guarantees of article I, section 19. *See* 469 S.W.3d at 87. In setting forth the economic liberty standard, the Supreme Court in *Patel* took pains to clarify that it was not lowering the standards for constitutional challenges: "Courts must extend great deference to legislative enactments, apply a strong presumption in favor of their validity, and maintain a high bar for declaring any of them in violation of the Constitution." *Id.* at 91. In order to clear that "high bar," Plaintiffs must demonstrate either that (1) the statute fails traditional rational-basis review or (2) the "actual, real-world effect" of the statute "as applied to the challenging

party" is "so burdensome as to be oppressive in light of the governmental interest." *Id.* at 87. As explained below, Plaintiffs fell short on both prongs of this standard.

A. Section 102.75(a)(7) Is Rationally Related to the Legitimate Government Interest in Promoting the Three-Tier System.

1. The State has a legitimate interest in protecting the vitality of the three-tier system.

The United States Supreme Court has consistently deemed the three-tier system "'unquestionably legitimate.'" *Granholm*, 544 U.S. at 466 (quoting *North Dakota v. United States*, 495 U.S. at 432).[7] There can be little doubt, then, that protecting the vitality of the three-tier system is a legitimate governmental interest. *See Neel v. Tex. Liquor Control Bd.*, 259 S.W.2d 312, 316 (Tex. Civ. App.—Austin 1953, writ ref'd n.r.e.) (affirming the government's legitimate interest in "prevent[ing] the evils of the 'tied house'"); *Aug. A. Busch & Co. v. TABC*, 649 S.W.2d 652, 654 (Tex. App.—Texarkana 1982, writ ref'd n.r.e.) (recognizing "the public interest is served by the prohibition of vertical integration within the alcoholic beverage industry"); *Actmedia, Inc. v. Stroh*, 830 F.2d 957, 965 (9th Cir. 1986) (acknowledging a State's "'substantial' interest in exercising its twenty-first amendment powers and regulating the structure of the alcoholic beverage industry").

[7] The validity of the three-tier system and the prevention of the tied house are not in dispute, and Plaintiffs disavowed any intent to challenge them. CR.644.

In the trial court, Plaintiffs raised two arguments in an attempt to show that section 102.75(a)(7) serves no legitimate governmental interest; both are unavailing. Plaintiffs first argued that the statute has no conceivable connection to reducing overconsumption of alcohol, which Plaintiffs claimed is the only legitimate interest for section 102.75(a)(7). CR.70. That argument misses the mark for two reasons.

First, temperance, while certainly a legitimate interest, is not the only interest at stake. Bolstering the three-tier system is itself a legitimate governmental interest, as explained above, because maintaining strict separation among tiers is an effective method of preventing tied-house problems.

Second, a law need not directly or measurably impact the ultimate aim of the larger statutory scheme in order to serve a legitimate interest. This Court addressed a similar argument in a challenge to another three-tier provision in *Neel v. Texas Liquor Control Board*. In that case, the plaintiff argued that "there is not [a] substantial relationship between the legislative policy of preventing a 'tied house' and the statutory provisions prohibiting cash purchases by a retail dealer who is, as appellant is, delinquent in his wholesale accounts." *Neel*, 259 S.W.2d at 317. The Court rejected that argument on the ground that the statute served as a deterrent to conduct that could undermine the three-tier system, "thus encouraging the legislative policy which the statute proclaims." *Id*. The same reasoning applies here.

On rational-basis review, the constitutionality of a statue does not turn on its "ultimate effectiveness," but instead "whether the enacting body could

have rationally believed at the time of enactment that the ordinance would promote its objective." *Mayhew v. Town of Sunnyvale*, 964 S.W.2d 922, 938 (Tex. 1998) (citing *Williamson v. Lee Optical of Oklahoma, Inc.*, 348 U.S. 483, 487–88 (1955)); *see also Limon v. State*, 947 S.W.2d 620, 628 (Tex. App.—Austin 1997, no pet.) (Under rational-basis review, statutes "are set aside only if they are based solely on reasons *entirely unrelated* to the pursuit of the State's goals and only if no grounds can be conceived to justify them." (emphasis added)). As explained below, section 102.75(a)(7) is, at the very least, conceivably related to bolstering the three-tier system, so Plaintiffs' argument that it furthers no legitimate governmental interest must fail.[8]

Plaintiffs also argued that the statute lacks a legitimate purpose because it is simply economic protectionism: "a classic case of politically connected industry insiders—the distributors' lobby—abusing the legislative process to get a private financial benefit with no benefit to the public." CR.71. That argument is no more than a conclusory accusation, however, and with no evidence to support it, the argument fails.

In any event, Plaintiffs' argument is as ironic as it is erroneous, given the legislative history and Plaintiffs' own testimony. The challenged law was part

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[8] Plaintiffs also argued that maintaining the three-tier system is not a legitimate interest because it is simply regulating for the sake of regulation. CR.452-53. But like their lead argument, however, this contention fails because many courts, including this Court, have recognized the value in protecting the three-tier system. *See, e.g.*, *Neel*, 259 S.W.2d at 316.

of a hard-fought, five-bill legislative compromise among craft brewers, distributors, and others that, on the whole, significantly expanded the rights of small brewers. *See supra* at 11-12; *see also* CR.134-35 (chronicling the agreement and how it came about). Post hoc attacks on beneficial legislation that could have done more is the sort of "poor grace" that this Court has frowned on. *See Neel*, 259 S.W.2d at 317.

2. There are abundant conceivable rational bases for the territorial-assignment restriction.

Plaintiffs also failed to establish that section 102.75(a)(7) lacks a rational basis. Rational-basis review is exceedingly deferential, and Plaintiffs must overcome a strong presumption that the challenged statute is constitutional. *Patel*, 469 S.W.3d at 87.

Under rational-basis review, the Court "must uphold the law 'if there is any reasonably conceivable state of facts that could provide a rational basis for the classification.'" *Mauldin v. Tex. State Bd. of Plumbing Exam'rs*, 94 S.W.3d 867, 873 (Tex. App.—Austin 2002, no pet.) (quoting *FCC v. Beach Commc'ns, Inc.*, 508 U.S. 307, 313-14 (1993)). A law does not fail rational-basis scrutiny just because there is "an imperfect fit between means and ends," *Mauldin*, 94 S.W.3d at 873 (quoting *Heller v. Doe*, 509 U.S. 312, 321 (1993)), or "because it 'is not made with mathematical nicety or because in practice it results in some inequality.'" *Beach Commc'ns*, 508 U.S. at 316 n.17. "The problems of government are practical ones and may justify, if they do not require, rough accommodations—illogical, it may be, and unscientific." *Id.*

Under rational basis, legislatures also have "leeway to approach a perceived problem incrementally." *Id.* at 316; *see also Williamson*, 348 U.S. at 487–88 (holding "the law need not be in every respect logically consistent with its aims to be constitutional"). Nor is a legislature required to choose between "attacking every aspect of a problem or not attacking the problem at all." *Dandridge v. Williams*, 397 U.S. 471, 486–87 (1970). Thus, it is perfectly acceptable for the Legislature to address perceived threats to the three-tier system as they arise.

There are ample rational justifications for the territorial-assignment restriction. The Legislature could have rationally concluded that allowing brewers to accept large cash payments for territorial rights might threaten the strict separation between the manufacturer and distributor tiers by creating at least the perception of a prohibited investment by a distributor in a brewer's business.[9] *See* Tex. Alco. Bev. Code § 102.01. Plaintiffs argue that they need cash for territorial rights in order to "invest in [the] brewery so that you can expand and meet the new market that [it has] entered into" with the distributor. CR.652. It takes little imagination to perceive how such an arrangement could render the distributor effectively an investor in the brewer's expansion and financially tied to the brewer's success.

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[9] The Legislature may have been reacting to a newly-discovered threat to the three-tier system. TABC was not aware of any instances of territorial assignments being sold until the issue was raised during the legislative session. CR.304-05. And Senator Carona, the bill's author, characterized the provision as a clarification of existing law. CR.312.

For example, if a distributor paid $1,000,000 for a territorial assignment in Houston, it would be rational for the Legislature to think that the distributor would have an expectation that the brewer invest the money to grow capacity for the Houston market to ensure that the brewer could provide a sufficient volume of beer for the distributor to make that territory profitable. The Legislature could rationally conclude that such an implicit *quid pro quo* would threaten the three-tier system. Indeed, the fact this was occurring at all was news to TABC,

MillerCoors's recent acquisition of Plaintiff Revolver Brewery brings to mind additional potential rational bases for section 102.75(a)(7). The Legislature might have concluded, for example, that allowing brewers to sell territorial assignments could lead to an imbalance between the tiers because large brewers might demand such large payments for territorial rights—either directly or through smaller brewers they own, like Revolver—that they would be able to dominate distributors.

The Legislature also could have concluded that prohibiting the sale of territorial assignments would level the playing field for small brewers and distributors alike. For example, the Legislature could have been concerned that a craft brewer (like Revolver) that is owned by a large brewer (like MillerCoors) may be able to demand large sums for its territorial assignments due to the distributors' relationship with its parent, whereas a small brewer (like Live Oak), with no affiliation to a mega-brewer, may not have the same sway. Similarly, for distributors, the Legislature could have reasonably concluded that

prohibiting payment for territorial assignments would level the playing field for small distributors that have more modest financial resources than larger distributors.

Additionally, the Legislature may have rationally concluded that the recent expansion of rights for small brewers (e.g., self-distribution and direct sales to customers at breweries) could create an imbalance between the manufacturer and distributor tiers. It would have been rational for the Legislature to conclude that section 102.75(a)(7) may counteract any such imbalance.

The State certainly "has no obligation to produce evidence to sustain the rationality" of a law, and the Legislature's action "may be based on rational speculation unsupported by evidence or empirical data." *Lens Express, Inc. v. Ewald*, 907 S.W.2d 64, 69 (Tex. App.—Austin 1995, no writ) (quoting *Heller*, 509 U.S. at 320 (quotations and citations omitted)). Even so, any of these (or a host of other) possible reasons supply a conceivable rational basis for the law that the Plaintiffs did not negate. Plaintiffs did not even attempt to negate every conceivable justification for section 102.75(a)(7), and so their rational-basis claim must fail.

B. Plaintiffs Did Not Establish That Section 102.75(a)(7) Is Unconstitutionally Oppressive.

As with the rational-basis standard, Plaintiffs bear a "high burden" in establishing that section 102.75(a)(7) is unconstitutionally oppressive. *Patel*, 469 S.W.3d at 87. The substantial governmental interest in protecting the three-

tier system is well established, *see supra* at 20, any yet Plaintiffs offered no evidence that the statute imposed *any* burden on them, much less an oppressive burden.

1. The territorial-assignment regulation is fundamentally different from the barrier to entry at issue in *Patel*.

The statute challenged in this case is fundamentally different from the cosmetology law struck down by the Supreme Court in *Patel* in a number of significant respects. First, it was undisputed in *Patel* that nearly half of the statutorily mandated training hours were entirely irrelevant to eyebrow threading. 469 S.W.3d at 88-89. The Supreme Court thus concluded that this unrelated but mandatory training "combined with the fact that threader trainees have to pay for the training and at the same time lose the opportunity to make money actively practicing their trade" amounted to an oppressive burden. *Id.* at 90.

Section 102.75(a)(7), in contrast, imposes no such burdensome requirements. Rather, the statute simply limits one aspect of a multi-faceted business relationship between licensees in different tiers. It is undisputed that section 102.75(a)(7) has not prevented Plaintiffs from operating their breweries, distributing their beer, growing their businesses, or even accessing the capital they seek.

Additionally, section 102.75(a)(7) does not impose irrelevant regulatory barriers to engaging in a person's chosen trade, as was the case in *Patel*. Instead, the law narrowly targets specific conduct that could undermine the three-tier system.

2. Plaintiffs have not established that section 102.75(a)(7) is so burdensome as to be unconstitutionally oppressive.

Patel did not establish a bright light test for oppression, but it was clear that a statute must be more than "harsh" or "unreasonable" to be unconstitutionally oppressive. *Id*. at 90. Plaintiffs have not met their "high burden" of proving oppression here. Plaintiffs argued in their summary judgment motion that section 102.75(a)(7) is oppressive because it imposes "massive financial burdens on Plaintiffs in exchange for zero or immeasurably tiny public benefits." CR.80. Plaintiffs are wrong on both counts. As explained above, *see supra* at 20-26, section 102.75(a)(7) rationally advances a significant governmental interest by guarding the vitality of the three-tier system and preventing an opportunity for prohibited tied-house relationships.

Plaintiffs also failed to establish that section 102.75(a)(7) imposed "massive financial burdens," CR.80, or that the law "require[s] them to give away millions of dollars of intangible property rights," CR.84, for several reasons.

a. Plaintiffs have no property rights to their territories

As an initial matter, the notion that Plaintiffs must give away any property rights, CR.84, is mistaken. Plaintiffs have no property rights in territories they

assign to distributors. The trial court correctly dismissed Plaintiffs' takings claim on that ground, CR.577, and Plaintiffs did not appeal that ruling.

Plaintiffs were granted and operate under licenses that are privileges, not property rights. *See* Tex. Alco. Bev. Code § 6.01(b) ("A license or permit issued under this code is a purely personal privilege and is subject to revocation or suspension if the holder is found to have violated a provision of this code or a rule of the commission."); *id.* at § 11.03 ("A permit issued under this code is a purely personal privilege and is subject to revocation as provided in this code."); *id.* at § 61.02(a) ("A license issued under this code is a purely personal privilege and is subject to revocation as provided in this code.").

Time and again, Texas courts have held that government-issued licenses and permits are not property rights. *E.g.*, *House of Tobacco, Inc. v. Calvert*, 394 S.W.2d 654, 657 (Tex. 1965) (holding that a license to sell cigarettes was a privilege, not a constitutional property right); *Jones v. Marsh*, 224 S.W.2d 198, 201 (Tex. 1949) (explaining that a "license or permit to sell beer or other intoxicating liquor is a privilege and not a property right," and collecting cases); *State v. Moore Outdoor Properties, L.P.*, 416 S.W.3d 237, 246 (Tex. App.—El Paso 2013, pet. denied) ("As a general rule, a license or permit is a privilege, not a property right."); *Hallco Tex., Inc. v. McMullen County*, 94 S.W.3d 735, 738 (Tex. App.—San Antonio 2002), aff'd, 221 S.W.3d 50 (Tex. 2006) (explaining that "a permit to dispose of waste does not create or constitute a 'property interest' or any other entitlement" because the authorizing statute does not extend any such rights). Accordingly, the Code's requirement that

territories be assigned to distributors without compensation is not a deprivation of any kind.

b. Plaintiffs are not compelled to assign any territories.

Plaintiffs are also not compelled to assign any territorial rights. To the contrary, Plaintiffs now self-distribute the vast majority of their beer, thanks to the 2013 legislative compromise. CR.128 (Peticolas self-distributes 100%); CR.166 (Live Oak distributes about 90% of its beer); CR.201 (Revolver self-distributes about 94%).

Plaintiffs each produce less than 125,000 barrels of beer annually, so they are able to self-distribute up to 40,000 barrels per year under. Tex. Alco. Bev. Code § 12A.02; *id.* § 62A.02. In fact, Plaintiffs can self-distribute *all* of their production if they wish, and Peticolas does just that. *See* CR.128 (Peticolas self-distributes 100%); CR.165 (Live Oak sells about 10,000 barrels per year); CR.201 (Revolver sells about 15,000 barrels annually). The territorial-assignment restriction in no way compels Plaintiffs to assign (or "give away") any territorial rights and, they may continue to self-distribute as long as they want, provided they remain within the statutory limit, and none of the Plaintiffs even alleged such growth is imminent.

c. Plaintiffs failed to establish any value for their territories.

Plaintiffs presented no evidence that their territories are worth "millions of dollars." *See* CR.84. Although Plaintiffs conceded that there are experts that can appraise the business value of distribution territories, *see* CR.175, no

Plaintiff engaged any expert to establish the value of their territorial assignments, nor did any Plaintiff personally undertake an appraisal of their territories, *see, e.g.*, CR.146 (Peticolas admitting that it had not "formally gone through the process" of valuing its territorial assignments), CR.175 (Live Oak conceding that it has never sought a formal valuation of its territorial rights).

Plaintiffs' valuation "evidence" consisted chiefly of hearsay, rumor, and speculation about the sale and value of territorial rights. *See, e.g.*, CR.131 (heard reports about another brewer's sale); CR.147 (speculation about value of territorial rights); CR.207 (no personal knowledge of breweries selling territorial rights). Indeed, Plaintiffs presented no evidence of any brewer selling territorial rights except for Live Oak's testimony that it sold its Houston territory to distributors for $250,000.[10] CR.166, 176. But that evidence does not establish the value of Live Oak's other territories, and it certainly does not prove the value of the other Plaintiffs' territories.

In light of the significant governmental interest in reinforcing the three-tier system, Plaintiffs' attempt to establish oppression fell well short of the mark. Unlike *Patel*, section 102.75(a)(7) does not prevent Plaintiffs from operating, growing, or even obtaining the capital they seek; it simply limits a source of capital. That is not unconstitutional oppression.

[10] Plaintiff Peticolas even admitted that it has never entered—or sought—a distribution agreement with any distributor. CR.132.

* * *

Under either traditional rational-basis review or *Patel*'s oppressiveness standard, Plaintiffs failed to prove that, as applied to them, section 102.75(a)(7) violates the due course of law guarantee of article I, section 19 of the Texas Constitution.

Prayer

The Court should reverse the trial court's judgment and render judgment for Appellants.

Respectfully submitted.

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