

# CONSUMER NEWS

By Ryan Eddings\*

## Wine Lovers Win Battle, Could Lose War

Oenophiles in twenty-four states<sup>1</sup> won a major battle in their war to secure full access to all of America's 3,000-plus independent wineries<sup>2</sup> after the Supreme Court struck down state laws in New York and Michigan that discriminated between in-state and out-of-state wineries.<sup>3</sup> The decision could potentially open new markets for small independent wineries, some of whom challenged the state laws in question. At the same time, the ruling could also provide consumers much broader variety of wines available at lower prices. However, the equal treatment that consumers and producers sought when challenging the laws might also completely shut them out of new markets altogether.

Over the past few years, small wineries joined with wine lovers to challenge state laws prohibiting the direct shipment of wine into certain states from out-of-state wineries. As the lawsuits worked themselves through the federal courts, a split developed among the federal appellate courts.<sup>4</sup> The Supreme Court set out to resolve this split when it agreed to hear *Granholt v. Heald* late in 2004. This was a consolidated case challenging the constitutionality of direct

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<sup>1</sup> *Granholt v. Heald*, 125 S.Ct. 1885, 1893 (2005).

<sup>2</sup> Steve Forbes, *Fact and Comment*, FORBES MAG., Jan 10, 2005, at 23, available at 2005 WLNR 1066249.

<sup>3</sup> Charles Lane, *Justices Reject Curbs on Wine Sales*, WASHINGTON POST, May 17, 2005, at A01.

<sup>4</sup> See Scott F. Mascianica, *Why All the Wine-ing? The Wine Industry's Battle With States over the Direct Shipment Issue*, 17 LOY. CONSUMER L. REV. 91 (2004).

shipment laws in Michigan and New York.<sup>5</sup>

The state laws challenged by the wineries arose after Congress repealed Prohibition with the Twenty-First Amendment in 1933, which permits states to regulate both the sale and importation of alcohol within its borders.<sup>6</sup> Most states implemented a three-tiered distribution system requiring wine to pass from manufacturer to distributor to retailer.<sup>7</sup> However, recently some states, including New York and Michigan, have loosened those laws as they apply to in-state wineries.<sup>8</sup> These states now allow in-state wineries to by-pass the three-tiered system altogether and sell their wine directly to consumers, while prohibiting out-of-state wineries from doing the same.<sup>9</sup> As a result, in-state wineries can sell their wine for considerably cheaper than out-of-state wineries.<sup>10</sup> Meanwhile, the consolidation that occurred among wine wholesalers over the past twenty years has meant that it is no longer economical for wholesalers to carry wine from small wineries, as their wine is

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<sup>5</sup> *Granholm*, 125 S.Ct. at 1891.

<sup>6</sup> U.S. CONST. amend. XXI, § 2 (“The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited.”).

<sup>7</sup> *Bridenbaugh v. Freeman-Wilson*, 227 F.3d 848, 851 (7th Cir. 2000).

<sup>8</sup> *Granholm*, 125 S.Ct. at 1893. Under the Michigan law, in-state wineries are eligible for a “wine maker” license that allows them to ship wine directly to Michigan residents. The cost of the license varies, but small wineries can purchase a license for around \$25. A similar-sized out of state winery can purchase an “outside seller of wine” license for \$300, but this license only gives the holder the ability to sell wine to a licensed wholesaler.

Under the New York law, in-state wineries may sell their wine directly to consumers. An out-of-state winery must sell its wine through the three-tiered system, unless the wine it is made from grapes, of which at least 75% were grown in the State of New York, or if the out-of-state winery becomes a licensed New York winery. To be a licensed New York winery, the out-of-state winery would have to establish “a branch factory, office or storeroom within the state of New York.”

<sup>9</sup> *Id.* at 1892.

<sup>10</sup> See Sandra Silfven, *High Court Decants Cases Over Direct Shipment of Wine in Michigan and New York*, DETROIT NEWS, Dec. 9, 2004, at A1 (three-tiered system increases price by 35%); See also Fred Tasker, *U.S. Supreme Court Will Decide Whether Wine Lovers in Florida and 23 Other States Can Buy Wine Through the Internet or 800 Numbers*, THE MIAMI HERALD, Feb. 10, 2005, at Sec. A (direct shipment of wine would reduce prices by up to 21%).

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generally available only in a limited supply.<sup>11</sup> Accordingly, many smaller wineries turned to the internet to generate sales and took advantage of the highly efficient logistical systems created by private carriers such as Federal Express and the United Parcel Service to ship their product.<sup>12</sup> Now the small out-of-state wineries seek to open up even more markets by having laws that discriminate between in-state and out-of-state wineries declared unconstitutional.

In front of the Supreme Court, the states defended their laws by arguing that the Twenty-First Amendment granted states the power to discriminate against out-of-state liquors.<sup>13</sup> The Court dismissed this argument and concluded that the purpose of the “Twenty-First Amendment was to allow States to maintain an effective and uniform system for controlling liquor by regulating its transportation, importation, and use.”<sup>14</sup> The Court went on to hold “[t]he Amendment did not give States the authority to pass nonuniform laws in order to discriminate against out-of-state goods, a privilege they had not enjoyed at any earlier time.”<sup>15</sup> The Court further concluded that the State regulations ran afoul of the Commerce Clause of the United States Constitution.<sup>16</sup> Under the Twenty-First Amendment, States may regulate the importation and sale of alcohol, but it must “treat liquor produced out of state the same as its domestic equivalent.”<sup>17</sup> The Court found this discriminatory effect to be the fatal flaw of the New York and Michigan laws.<sup>18</sup> Because the laws favored in-state wineries over out-

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<sup>11</sup> Federal Trade Commission, POSSIBLE ANTICOMPETITIVE BARRIERS TO E-COMMERCE: WINE, July 2003, p. 6., available at <http://www.ftc.gov/os/2003/07/winereport2.pdf> (“...to the extent that some smaller wineries may have problems getting wholesalers to carry their labels, those problems may reflect fixed costs that make it uneconomical for a wholesaler to carry lesser-known wines that are available only in small quantities.”)

<sup>12</sup> *Granholm*, 125 S.Ct. at 1892-93.

<sup>13</sup> *Id.* at 1902.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> U.S. CONST. art. I, § 8 cl. 3 (granting Congress the power “[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.” The inverse of the Commerce Clause, often referred to as the Dormant Commerce Clause, has been interpreted to prohibit states from regulating interstate commerce.).

<sup>17</sup> *Granholm*, 125 S.Ct. at 1905.

<sup>18</sup> *Id.* (“The instant cases, in contrast, involve straightforward attempts to

of-state wineries, they ran contrary to the Commerce Clause and could find no shelter under the Twenty-First Amendment.<sup>19</sup> The Court was also not persuaded by the states' argument that the laws were necessary to ensure compliance with their tax collection scheme and that the laws minimize the risk of minors purchasing alcohol over the internet, as such goals could be achieved without violating the Commerce Clause.<sup>20</sup>

With the announcement of the Court's decision, some wine industry insiders and consumers assumed that the floodgates had been opened. W. Reed Foster, President of the Coalition for Free Trade and chairman emeritus of Ravenswood Winery, used a biblical analogy to express his pleasure with the decision: "In this David versus Goliath battle, the ruling is a triumph for America's wine farmers."<sup>21</sup> Others called it a "historic day for the U.S. wine industry."<sup>22</sup> And at least one wine wholesaler got in the mood and commented that as a result of the decision, "[t]he nation's wineries will be better able to satisfy consumer demand, wine lovers will have access to a broader selection of wines, and retailers and wholesalers will ultimately grow their business. . . ."<sup>23</sup>

Though the Court's decision undoubtedly provides wine consumers everywhere with reason to celebrate, many will still have to celebrate with in-state wine or wine purchased through their state's three-tiered distribution system. The Court's ruling did nothing more than invalidate state laws which discriminate between in-state and

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discriminate in favor of local producers.").

<sup>19</sup> *Id.* at 1907 ("States have broad power to regulate liquor under § 2 of the Twenty-first Amendment. This power, however, 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. If a State chooses to allow direct shipment of wine, it must do so on evenhanded terms. Without demonstrating the need for discrimination, New York and Michigan have enacted regulations that disadvantage out-of-state wine producers. Under our Commerce Clause jurisprudence, these regulations cannot stand.").

<sup>20</sup> *Id.* at 1905-07.

<sup>21</sup> Press Release, Coalition for Free Trade, *Family Wineries, Consumers Triumph in U.S. Supreme Court Ruling Supporting Wine Direct Shipping* (May 16, 2005), available at <http://www.coalitionforfreetrade.org/press.html> (The Coalition for Free Trade is a non-profit organization whose goal is to legalize the direct shipment of wine from out of state wineries to all states where it is currently prohibited.).

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

out-of-state wineries. Indeed, the Court went so far as to point out that it was not declaring the three-tiered distribution system unconstitutional.<sup>24</sup> And while the victors are busy celebrating, some states, and the interest groups that supported them, are plotting their next move.

The Coalition for a Safe and Responsible Michigan, a self-described grassroots organization of concerned citizens that seek to protect their communities by promoting safe and responsible alcohol sales in Michigan, said that the Court's decision "reaffirmed Michigan's right to regulate the sale and distribution of alcohol within its borders."<sup>25</sup> Some wine wholesalers agreed that the decision reaffirmed the authority of the states to regulate the sale and distribution of alcohol.<sup>26</sup> These organizations will likely lobby state legislators to entirely repeal the direct shipment of wine. President and CEO of the Wine and Spirits Wholesalers of America, Juanita D. Duggan, hinted at just such a strategy when she painted the dilemma "as a choice between supporting face-to-face transactions by someone licensed to sell alcohol or opening up the floodgates."<sup>27</sup> Such efforts likely find inspiration in the way in which the New Jersey state legislature answered the same decision in 1994, when it completely prohibited the direct shipment of wine within the state, rather than allow out-of-state wineries to ship directly to its citizens.<sup>28</sup>

Not all observers believe that states will completely outlaw the direct shipment of wine.<sup>29</sup> While wine wholesalers have a strong economic incentive to block all shipments, small in-state wineries that have built their business through the direct shipment of wine to in-state consumers have an interest in maintaining their ability to ship directly to consumers. Like out-of-state small-wineries, they may

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<sup>24</sup> *Granholm*, 125 S.Ct. at 1905 ("We have previously recognized that the three-tier system itself is "unquestionably legitimate." quoting *North Dakota v. United States*, 495 U.S. 423, 432 (1990)).

<sup>25</sup> Press Release, Coalition for a Safe and Responsible Michigan, *Supreme Court: State to Decide Question of Internet Alcohol Sales* (May 16, 2005), available at [http://www.safeandresponsible.org/csr\\_release\\_final\\_05\\_15\\_05.pdf](http://www.safeandresponsible.org/csr_release_final_05_15_05.pdf).

<sup>26</sup> Press Release, Wine and Spirits Wholesalers of America, *States Must Treat In-State and Out-of-State Alcohol Producers the Same: Court Holds Three-Tier System: "Unquestionably Legitimate"* (May 16, 2005), available at <http://www.wswa.org/public/media/20050516.html>.

<sup>27</sup> Press Release, *supra* note 26.

<sup>28</sup> NJ stat § 33:1-28.1 (2005)

<sup>29</sup> Lane, *supra* note 3.

have difficulty persuading wholesalers to carry their product. More importantly, part of the impetus behind the laws allowing for the direct shipment of wine from in-state wineries was to foster domestic wine production.<sup>30</sup> Legislators might be reluctant to pass a law that could destroy the fledging industry that they previously cultivated.

Each state's decision on whether to allow the direct shipment of out-of-state wine holds significant ramifications for consumers. Consumers have unquestionably benefited from access to a wider range of products that have been made cheaper by passing through a more efficient distribution system. With the Court's decision in *Granholm*, wineries at the very least can now compete for customers on a more level playing field. Ideally, state legislatures can craft legislation that will further the state interests of tax collection and compliance with the drinking age without proscribing the ability of consumers to purchase wine from any winery around the country. Such a compromise would truly be reason to celebrate.

## **Court Ruling Allows Cable Firms to Restrict Access to their Networks**

The broadband cable industry and the Bush administration scored a major victory over the summer when the Supreme Court ruled<sup>31</sup> that broadband cable service is not a "telecommunications service."<sup>32</sup> Though the ruling probably looks like nothing more than an exercise in semantics to the average user of broadband cable networks, the Court's decision will likely have significant ramifications in regards to the quality of broadband service offered and the price the consumer pays for it.

Broadband cable internet service transmits data at a much higher rate of speed than traditional dial-up internet service that uses a standard telephone line.<sup>33</sup> In the United States, there are two primary broadband internet services available to consumers: cable

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<sup>30</sup> *Dickerson v. Bailey*, 336 F.3d 388, 402 (5th Cir. 2003) (legislative intent of statute permitting in-state direct shipment of wine was to "help the Texas wine industry.").

<sup>31</sup> *National Cable & Telecomm. Ass'n v. Brand X Internet Servs.*, 125 S.Ct. 2688 (2005).

<sup>32</sup> Yuki Noguchi, *Cable Firms Don't Have to Share Networks, Court Rules*, WASHINGTON POST, June 28, 2005, at D01.

<sup>33</sup> *National Cable*, 125 S.Ct. at 2695.

modem service and digital subscriber line (DSL) service.<sup>34</sup> Cable modem service sends data between consumers and the internet using a network of television cable lines owned by cable companies.<sup>35</sup> DSL service transmits data between consumers and the internet using local telephone lines owned by local telephone companies.<sup>36</sup>

The Brand X case was born after the Federal Communications Commission ruled in March 2002 that broadband cable internet service was an “information service,” not a “telecommunications service.”<sup>37</sup> Important in the FCC’s March 2002 decision was The Communications Act of 1934,<sup>38</sup> as amended by The Telecommunications Act of 1996,<sup>39</sup> which draws a distinction between an “information service”<sup>40</sup> and a “telecommunications service.”<sup>41</sup> The distinction is important because telecommunication carriers are regulated as common carriers under the Communications Act.<sup>42</sup> Under the regulations, a telecommunication carrier must, among other requirements, share its communication lines with its competition.<sup>43</sup> This is the same regulation that requires telephone companies to share their telephone lines with other service providers.<sup>44</sup> On the other hand, carriers that merely provide

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<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *In the Matter of Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities*, 17 FCC Rcd 4798, 4821-22 (2002).

<sup>38</sup> The Communications Act of 1934, 48 Stat. 1064 (1934).

<sup>39</sup> The Telecommunications Act of 1996, Pub. L. No. 104–104, 110 Stat. 56 (1996).

<sup>40</sup> 47 U.S.C. § 153(20) (“The term ‘information service’ means the offering of a capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information via telecommunications, and includes electronic publishing, but does not include any use of any such capability for the management, control, or operation of a telecommunications system or the management of a telecommunications service.”).

<sup>41</sup> 47 U.S.C. § 153(46) (“The term ‘telecommunications service’ means the offering of telecommunications for a fee directly to the public, or to such classes of users as to be effectively available directly to the public, regardless of the facilities used.”).

<sup>42</sup> *National Cable*, 125 S.Ct. at 1296.

<sup>43</sup> Noguchi, *supra* note 32.

<sup>44</sup> *Id.*

information services are not subject to the same regulations under the Act.<sup>45</sup>

After the FCC's ruling, multiple parties challenged the decision, some arguing that broadband cable service providers were subject to common carrier regulations, others arguing that the broadband providers were subject to local regulations, and one other party arguing that DSL should likewise be deemed an information service.<sup>46</sup> The Ninth Circuit ultimately decided that broadband cable service was a telecommunications service and vacated the FCC's ruling.<sup>47</sup> The Supreme Court then granted certiorari.<sup>48</sup>

In a six-to-three decision, the Supreme Court found that the Ninth Circuit had applied the wrong case law in reaching its opinion.<sup>49</sup> In its place, the Supreme Court employed a much more deferential standard. Specifically, the Court applied the *Chevron*<sup>50</sup> framework, which recognizes a presumption that when Congress leaves ambiguity in a statute meant to be implemented by an agency, Congress understood that the ambiguity would be resolved by the agency.<sup>51</sup> It also intended to grant to the agency whatever degree of discretion was required by the ambiguity.<sup>52</sup> Applying the two-part *Chevron* analysis,<sup>53</sup> the Court first found that the FCC's interpretation of the statute was permissible as the statute was ambiguous.<sup>54</sup> Next, the Court found that the FCC's interpretation was a reasonable one.<sup>55</sup> Accordingly, the FCC's March 2002 ruling was reinstated,

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<sup>45</sup> *National Cable*, 125 S.Ct. at 1296.

<sup>46</sup> *Brand X Internet Servs v. FCC*, 345 F.3d 1120, 1127 (9th Cir. 2003).

<sup>47</sup> *Brand X*, 345 F.3d at 1132.

<sup>48</sup> *National Cable & Telecomm. Ass'n v. Brand X Internet Servs.*, 125 S.Ct. 654 (2004).

<sup>49</sup> *National Cable*, 125 S.Ct. at 2701.

<sup>50</sup> *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

<sup>51</sup> *National Cable*, 125 S.Ct. at 2700.

<sup>52</sup> *Id.*

<sup>53</sup> *Chevron*, 467 U.S. at 843-45 (The first step determines if the statute's plain terms "directly address the precise question at issue." If the statute is ambiguous on this point, the court will defer to the agency's interpretation, so long as the interpretation is "a reasonable policy choice for the agency to make.").

<sup>54</sup> *National Cable*, 125 S.Ct. at 2704.

<sup>55</sup> *Id.* at 2705.

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effectively freeing broadband cable providers from being forced to grant access to their broadband networks to independent providers.

After the opinion was released, consumer groups lamented the Court's decision and made dire predictions that the ruling would harm consumers. The non-partisan media policy group, Free Press, stated that the Court's decision was a "grave error" and noted that since the FCC's March 2002, the United States fell from third to sixteenth in the world for broadband adoption.<sup>56</sup> In addition, Americans now pay ten to twenty percent more for broadband access on a per megabit basis than consumers in Japan or Korea.<sup>57</sup>

Ben Scott, policy director for Free Press, said that the decision might be "the trigger that reverses a century of communications policy and undermines the bedrock principle of democratic media, which is nondiscriminatory access for all."<sup>58</sup> Other commentators predict that the ruling will lead to a situation in the United States where each community has only one or two broadband providers: the phone company and the cable company.<sup>59</sup> There is fear that in this situation, each company's "business interests inevitably will lead to discrimination of content."<sup>60</sup> Consumers may have had their first experience with such interests when consumers of a certain "voice over internet protocol" service complained that they were unable to complete their calls because their broadband service provider was blocking the internet phone service.<sup>61</sup>

On the other hand, the cable companies and their supporters took a more optimistic perspective on the future of broadband internet access. Rob Stoddard, Senior Vice President of the National Cable & Telecommunications Association noted that "the rapid deployment of cable's high-speed Internet access service has been driven largely by the light regulatory touch applied to the service by Congress and the FCC."<sup>62</sup> His comments were echoed by others in

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<sup>56</sup> Press Release, Free Press, *Brand X: Statement of Consumer Groups on Supreme Court's Decision*, June 27, 2005.

<sup>57</sup> *Id.*

<sup>58</sup> Noguchi, *supra* note 32.

<sup>59</sup> Dan Gillmor, *Brand X Judgment Threatens Free Flow of Information*, THE FINANCIAL TIMES, July 13, 2005, available at 2005 WLNR 10936253.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> Rob Stoddard, Letter to the Editor, *Brand X Decision Was a Win for Consumers*, ROCKY MOUNTAIN NEWS, July 23, 2005, at 2C, available at 2005

the industry.<sup>63</sup>

According to the cable companies, the Court's ruling will actually foster greater growth and innovation within broadband technology, both of which will benefit consumers.<sup>64</sup> The nature and technology involved in a broadband network requires frequent and costly upgrades.<sup>65</sup> If cable firms are forced to make these initial investments and then share the constructed network with freeriding competitors who never had to build a network, the cable firms will have little incentive to invest in their own networks.<sup>66</sup> Without this investment, broadband innovation will come to a halt.<sup>67</sup> The Court's decision frees the cable firms of the need to share their lines, and, in theory, should promote investment into broadband networks.

Furthermore, the cable companies note that competition has been maintained as consumers currently have multiple options when choosing a broadband internet service, including DSL, as well as terrestrial and satellite-based wireless broadband services.<sup>68</sup> While this may be true, there is evidence that as many as 60 percent of broadband consumers purchase their internet service from the company that is already providing the cable service to their home.<sup>69</sup>

Whether the decision, and the FCC's underlying interpretation, fosters broadband development in the way its supporters claim will not be known for some time. But it is clear that for the time being, consumers will have a more limited selection when choosing a cable broadband internet service provider. And experience has taught us that when competition is prevented,

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WLNR 11561961.

<sup>63</sup> Jeff Smith, *Worry Lines Court Ruling Could Spur or Squelch Broadband Competition*, ROCKY MOUNTAIN NEWS, July 11, 2005, at 1B, available at 2005 WLNR 11346300 ("Steve Davis, Qwest senior vice president of public policy, believes that cable modem service has grown faster than the DSL Internet service offered by the Bells because it's been 'completely unregulated . . . while we've been very, very tightly regulated.'").

<sup>64</sup> Miguel Helft, *Dismal US Broadband Usage Wasn't Helped by Court Ruling*, SAN JOSE MERCURY NEWS, July 6, 2005, at A2, available at 2005 WLNR 10586623.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> *National Cable*, 125 S.Ct. at 2696.

<sup>69</sup> Hope Yen, *High Court Will Hear Internet Cable Cases*, PHILADELPHIA INQUIRER, December 4, 2004, at D03, available at 2004 WLNR 13343201.

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consumers usually suffer.

## **Court Ruling May End Free Online Music Party**

For those who can afford to use it, the internet has provided consumers with easy access to an unprecedented array of goods at bargain prices. For much of its existence, the internet has offered a means of acquiring copyrighted music for free, prices that even the best sale at the local record store could not match. The deal was evidently too good to pass up for millions of Americans. Unfortunately, like all good parties, the music had to stop sometime, which may have happened when the Supreme Court recently ruled that “one who distributes a device with the object of promoting its use to infringe copyright . . . is liable for the resulting acts of infringement by third parties.”<sup>70</sup>

Music file sharing via the internet was made possible when the Motion Picture Experts Group made the format MPEG-3 (abbreviated as MP3) the standard for digital audio recordings in 1987.<sup>71</sup> After the standard was set, song recordings were digitized and placed on an audio compact disk (CD). Once on the disk, the MP3 files could be downloaded directly onto a computer’s hard drive.<sup>72</sup> This process is known as “ripping.”<sup>73</sup> The compressed format of the MP3 file allows for quick and easy transfer of the file between computers, either via email or another file transfer protocol.<sup>74</sup> The first widely popular file transfer software was Napster,<sup>75</sup> which at the

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<sup>70</sup> *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.*, 125 S.Ct. 2764, 2770 (2005).

<sup>71</sup> *A&M Records, Inc. v. Napster*, 239 F.3d 1004, 1011 (9th Cir. 2001).

<sup>72</sup> *A&M Records*, 239 F.3d at 1011.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> Napster was purchased by Roxio, Inc., in 2004, who then launched Napster as a legal music subscription service. At the time of publication, Napster sells memberships for \$9.95 a month and provides over one million downloadable audio files. The files are playable for as long as the consumers membership is active. See May Wong, *Newer Napster – The Once-Renegade Music Provider is Going Legit With Roxio’s Purchase of the Company and All of its Perks*, THE MIAMI HERALD, Sept. 21, 2004, at 8C, available at 2004 WLNR 6309749. For information on the Napster subscription service, see <http://www.napster.com>.

time was a “peer-to-peer”<sup>76</sup> file-sharing network that consumers could download and operate free of charge.<sup>77</sup> In 2000, record companies and music publishers sued Napster as a vicarious and contributory copyright infringer.<sup>78</sup> In this suit, Napster was found liable because it knew that its system was used to infringe on copyrighted material, and despite the fact that Napster’s centralized file-management system provided it with the power to prevent the infringement, it allowed the infringement to continue.<sup>79</sup>

After the *Napster* ruling, new file-sharing networks emerged that were decentralized – meaning that files could be shared directly between users without routing the transfer through a centralized server.<sup>80</sup> One such service was Grokster.<sup>81</sup> Operating without centralized servers kept operating costs low and transfer speeds high, which have also been aided through the development of high speed broadband internet access.<sup>82</sup> Video files, which are larger than music files, can now also be shared between users, as well as almost any other digital file.<sup>83</sup> Because the networks are decentralized, Grokster, and the other software producers, have no way of knowing which files are available on the network.<sup>84</sup> Accordingly, Grokster and other software developers assumed that their ignorance would insulate them from liability under the *Napster* decision.

Movie studios and recording companies sued the developers of Grokster and Morpheus, another peer-to-peer file sharing software program, alleging vicarious and contributory copyright infringement.<sup>85</sup> The district court found that the developers were not liable for contributory copyright infringement as there was no evidence that they had any material involvement in the

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<sup>76</sup> Often abbreviated as P2P.

<sup>77</sup> *A&M Records*, 239 F.3d at 1011.

<sup>78</sup> *Id.*

<sup>79</sup> David Leit and Matthew Savare, *Grokster Decision Affects All Tech Companies*, 181 N.J.L.J. 1013 (2005).

<sup>80</sup> Leit & Savare, *supra* note 79.

<sup>81</sup> *Grokster*, 125 S.Ct. at 2770.

<sup>82</sup> *Id.*

<sup>83</sup> *Id.* at 2771.

<sup>84</sup> *Id.* at 2772.

<sup>85</sup> *Metro-Goldwyn-Mayer, Inc. v. Grokster, Ltd.*, 259 F.Supp.2d 1029, 1031 (C.D. Cal. 2003).

infringement.<sup>86</sup> At the same time, the developers were not liable for vicarious copyright infringement since they had no ability to control or supervise the transfers made by users, thanks to the decentralized nature of the networks.<sup>87</sup> The decision was appealed to the Ninth Circuit, where it was affirmed, using much of the same analysis that was developed in the *Napster* decision.<sup>88</sup> The Ninth Circuit specifically pointed to the Supreme Court's *Sony-Betamax*<sup>89</sup> ruling, where the Court stated that the sale of video tape recorders could not give rise to contributory copyright infringement, even where the manufacturer of the recorders knew that they were used for infringement, so long as the devices are "capable of substantial" or "commercially significant noninfringing uses."<sup>90</sup> The Ninth Circuit found that Grokster and Morpheus were not only capable of substantial noninfringing uses, but such uses were commercially viable.<sup>91</sup>

The Supreme Court was not persuaded by the Ninth Circuit's rationale. In a unanimous decision, the Court reversed the lower courts' decisions and held that peer-to-peer network developers such as Grokster and Morpheus could be held liable when consumers use their software to obtain copyrighted works without permission.<sup>92</sup> In so holding, the Court noted that nothing in the *Sony-Betamax* decision precluded the Court from considering evidence of intent, and further stated that the decision did not foreclose common-law fault-based liability rules.<sup>93</sup> The Court found that one such rule, the inducement rule, was particularly applicable to its decision.<sup>94</sup> The Court read the inducement rule to mean "that one who distributes a device with the object of promoting its use to infringe copyright, as shown by clear expression or other affirmative steps taken to foster

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<sup>86</sup> *Grokster*, 259 F.Supp.2d at 1043.

<sup>87</sup> *Id.* at 1045-46.

<sup>88</sup> *Metro-Goldwyn-Mayer, Inc. v. Grokster, Ltd.*, 380 F.3d 1154 (9th Cir. 2004).

<sup>89</sup> *Sony Corp. of America, v. Universal City Studios, Inc.*, 464 U.S. 417 (1984).

<sup>90</sup> *Grokster*, 380 F.3d at 1160.

<sup>91</sup> *Id.* at 1162 ("Indeed, even at a 10% level of legitimate use, as contended by the Copyright Owners, the volume of use would indicate a minimum of hundreds of thousands of legitimate file exchanges.").

<sup>92</sup> *Grokster*, 125 S.Ct. at 2782-83.

<sup>93</sup> *Id.* at 2779.

<sup>94</sup> *Id.* at 2780.

infringement, is liable for the resulting acts of infringement by third parties.”<sup>95</sup> The fact that Grokster and Morpheus marketed their products at known copyright infringers<sup>96</sup> without developing tools to filter out copyrighted materials,<sup>97</sup> combined with the revenue generated from advertising sales<sup>98</sup> convinced the Court the software developers clearly intended infringement and took affirmative steps to foster that infringement.<sup>99</sup> These active steps were sufficient to overcome “the law’s reluctance to find liability when a defendant merely sells a commercial product suitable for some lawful use. . . .”<sup>100</sup>

The decision was hailed as a victory by the recording and motion picture industries, who claimed that internet file sharing was hurting their sales.<sup>101</sup> For example, MGM presented evidence during the Grokster litigation that over 100 million copies of either Grokster or Morpheus had been downloaded by consumers, with billions of files shared over the network every month.<sup>102</sup> The scale of the file-sharing was alleged to be the cause of recording industry revenues falling by 25 percent since the emergence of file-sharing software in 1999.<sup>103</sup> In addition, Dan Glickman, President and CEO of the Motion Picture Association of America, called the decision “good news for consumers” and said that the decision would “ensure a future of quality and choice for consumers in the United States and around the world.”<sup>104</sup>

Aside from possibly illustrating a withdrawal from the

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<sup>95</sup> *Id.*

<sup>96</sup> *Id.* at 2781.

<sup>97</sup> *Grokster*, 125 S.Ct. at 2781.

<sup>98</sup> *Id.* at 2782

<sup>99</sup> *Id.*

<sup>100</sup> *Id.* at 2779.

<sup>101</sup> Scott Morrison, *Grokster ruling delights entertainment industry: Judgment welcomed by victims of piracy but not as onerous as technology companies feared*, THE FINANCIAL TIMES, June 28, 2005, p. 10, available at 2005 WLNR 10137431.

<sup>102</sup> *Grokster*, 125 S.Ct. at 2772.

<sup>103</sup> Deborah Charles, *Court Rules Against File-Trading Networks*, REUTERS, June 27, 2005.

<sup>104</sup> Press Release, Motion Picture Association of America, *Statement from MPAA President and CEO Dan Glickman RE: Supreme Court ruling on MGM v. Grokster*, June 26, 2005, available at [http://www.mpaapress.org/MPAAPress/2005/2005\\_06\\_27a.doc](http://www.mpaapress.org/MPAAPress/2005/2005_06_27a.doc).

recording and motion picture industries previous tactic of suing its own customers, it is difficult to see how the decision is “good news for consumers.” In a joint statement following the decision, the Consumer Federation of America, Consumers Union, and Free Press, said that the decision will “pose a significant challenge to consumers, innovators and the economy.”<sup>105</sup> The consumer organizations noted that peer-to-peer networks offer an efficient and inexpensive distribution system that threatens the “anticompetitive oligopoly” of large, dominant media companies.<sup>106</sup> According to the consumer groups, the lawsuit was actually an assault on competition with the film and music industries fighting to “maintain their near monopolistic control over the prices consumers pay and the choices consumers make.”<sup>107</sup> They point to the example of the inflated prices of music CDs charged by the recording industry while they simultaneously fight the adaptation of newer, more efficient distributions systems such as peer-to-peer file transfer networks.<sup>108</sup> Thus, not only must innovators and entrepreneurs bear the costs of developing and distributing new file-sharing software to consumers, they must now also bear the costs of defending lawsuits brought by media groups if consumers use their software for illegal purposes.<sup>109</sup>

Under the Court’s *Grokster* ruling, it is not enough that software developers create software that can be used for substantial legal purposes. Now these developers and their networks will be scrutinized by the judicial system actively assessing “their marketing activities and business models.”<sup>110</sup> As a result, innovation and competition will be stifled. While the decision gives the film and recording industries the resolution they sought, such a result is rarely, if ever, desirable or beneficial to consumers.

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<sup>105</sup> Press Release, Consumer Federation of America, Consumers Union, and Free Press, *Statement of the Consumer Federation of America, Consumers Union and Free Press On the Supreme Court’s Decisions in MGM v. Grokster*, June 27, 2005, available at <http://www.hearusnow.org/other/newsroom/internetbroadband/00/>.

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> Press Release, Electronic Frontier Foundation, *Supreme Court Ruling Will Chill Technology Innovation*, June 27, 2005, available at [http://www.eff.org/news/archives/2005\\_06.php](http://www.eff.org/news/archives/2005_06.php).

<sup>110</sup> *Id.*