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## CHALLENGES TO THE 3-TIER SYSTEM

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# AFTER 75 YEARS, WHAT IS THE FUTURE OF THE THREE-TIER SYSTEM?

By Garrett Peck

**EDITOR'S NOTE:** For 75 years, the industry has successfully served the consumer by distributing product through a three-tier system established to meet the social concerns associated with our products. Our industry has been reasonably insulated from attacks of neo-Prohibitionists, because of the responsible way we conduct our business. However, recently, we have been increasingly subject to a cottage industry of state-by-state lawsuits demanding “free trade, lowest price” remedies without con-

sideration of the social issues. Add to this the Internet and the industry’s effort to find a fair and responsible way to use it and we find ourselves in one of the most fragile moments in the history of the three-tier system.

The following is a summary of these issues. Our hope is that by bringing *The Beverage Network* reader a clearer understanding of the issues, we will help to raise another fair and balanced voice that will be in our common long term interests.

## TIMELINE: 75 Years of Repeal

**April 7, 1933**  
Cullen Act declares 3.2% beer to be “non-intoxicating”

**December 5, 1933**  
Utah ratifies the Twenty-first Amendment. Prohibition is repealed.



**1933 – 1935**  
States establish their alcoholic beverage control (ABC) regulations, and the three-tier system is created

**1934**  
Distilled spirits industry releases the first code of responsible practices. Seagram’s launches the first “drink moderately” campaign

**1935**  
Federal Alcohol Administration Act provides framework for regulating alcohol under the Treasury Department. The beer can is invented

**W**hile the three-tier system has worked remarkably well for the past 75 years, it has recently come under attack, as a number of court cases have played out across the country. The most recent and significant challenge came from Costco Wholesale Corporation, which sold \$867 million in wine in 2007. More than any other case, Costco posed a challenge to the three-tier system, for key parts of Washington State’s alcohol controls would have been removed.

The Costco case and the issue of direct shipping are changing – or seeking to change – the landscape of the three-tier system. Before delving into those and other significant industry court cases, it’s important to understand the foundation of this system and how – and why – it continues to weather storms on so many fronts.

The U.S. marks the 75<sup>th</sup> anniversary of Repeal on December 5, 2008 when Utah became the 36<sup>th</sup> state to ratify the Twenty-first Amendment, sending Prohibition to the history books. The Repeal amendment gave the states the sole right to regulate alcohol. Just because Prohibition ended in 1933 didn’t mean that there was a great love-fest for alcohol. People wanted Repeal out of a desire for law and order, and to create jobs during the dark days of the Great Depression. Much of American society strongly distrusted the industry.

States wanted to prevent the alcoholic beverage industry from becoming vertically integrated again. The laws implementing the terms of the Twenty-first Amendment were designed specifically to prevent producers of beer, wine and spirits from controlling every level of the marketing chain. The three-tier system was instituted to prevent “tied houses” and to bring about competition.

Dr. Peter Cressy, president/CEO of the Distilled Spirits Council of America (DISCUS), commented, “I think the three-tier system is one of the great things that came out of the Repeal of Prohibition. It has worked well and our members continue to support it.”

The legal front has picked up in recent years as individuals and groups have challenged state regulations. According to Craig Wolf, president/CEO of the Wine & Spirits Wholesalers of America (WSWA), “It’s not about the individual laws – they vary from state to state. It’s about the system of alcohol distribution set up after the Twenty-first Amendment. What is at stake is the state’s ability to regulate, and the state’s ability to control alcohol within its borders.” President/COO Wayne Chaplin of Southern Wine & Spirits of America, the largest distributor in the U.S. with operations in 30 states, said, “Our belief is that the three-tier system is the best system in the world for brand proliferation and choice, and keeps the market open for large brands as well as entrepreneurs with new products.” At the same time, it adds a layer of protection for product quality and safety. He concluded, “The three-tier system provides a level of stability for distribution.”

“What we’ve got now is a viable system that ensures competitive pricing, orderly markets, and an awful lot of access to market,” said Craig Purser, president of the National Beer Wholesalers Association (NBWA). “I don’t believe you’d have that experience if you didn’t have a three-tier system of distribution.” Enter the most significant challenge to the three-tier system: Costco.

### Costco and Self-Distribution

Costco, currently the nation’s largest wine retailer, is also a major retailer of beer and spirits. Its business strategy is simple: “In almost every other area, we buy direct from our suppliers and then sell direct to consumers,” said Associate General Counsel John Sullivan. This maximizes the company’s efficiencies and cuts out the middleman in many cases, which can lead to lower prices. “But in many jurisdictions, it’s very difficult to do that,” he explained, particularly in the realm of alcohol self-distribution. Many states’ regulations closely regulate alcohol prices to prevent low-balling, as too low prices can encourage greater drinking.

In 2005, Costco challenged nine Washington State Liquor Control Board regulations that it viewed as anti-competitive. These policies put restraints on the market, such as banning volume discounts, requiring prices to be posted and held constant for 30 days (“post and hold”), and requiring a 10% markup in prices. It won the first round in this court battle, known as *Costco Wholesale v. Hoen*, in April 2006 when a lower court threw out Washington’s regulations over antitrust concerns.

Costco owns warehouses to move merchandise in and out of its own stores. Its distribution model not only eliminates beer, wine and spirits wholesalers, but can also undercut many retailers who can’t compete with Costco’s low prices. After the 2006

**1939**

Gallup begins its annual poll of American drinking habits, revealing that the majority of American adults 18 years of age and older drink alcohol (2007 results: 64%)

**December 7, 1941**

Pearl Harbor bombed. Breweries and distilleries join in the war effort. Distilleries convert to making industrial solvents.



**1948**

Distilled spirits industry voluntarily elects not to advertise on television

**1959**

Once the last dry state, Oklahoma amends state constitution to become wet. Coors introduces the aluminum can



**1970**

U.S. lowers the voting age from 21 to 18, and most states follow by lowering drinking age to 18

**May 24, 1976**

Napa Valley wines stage stunning upset over France at the Judgment of Paris

## “What we’ve got now is a viable system that ensures competitive pricing, orderly markets, and an awful lot of access to market.”

— Craig Purser, president of the National Beer Wholesalers Association (NBWA)

ruling in favor of Costco, about two dozen states filed briefs in support of Washington, for many of them have similar rules that could be challenged if Costco prevailed.

The Liquor Control Board (LCB) appealed to the federal Ninth Circuit Court of Appeals, which overturned nearly the entire decision in January 2008. The only provision struck down was post and hold. The rest of Washington’s practices were upheld. A victory? Yes, but not the end of the battle.

David Hankins, Senior Counsel in the Attorney General’s Office of Washington State, was part of the team who handled the appeal. He stated, “We fought for the right to change through the democratically-elected legislature. As long as it’s the legislature and there’s a process, that’s fine. Our position was that it shouldn’t be in court.” The appellate court agreed, stating that these were issues for the state legislature to decide.

Wolf from WSWA issued a statement applauding the appeals court decision: “Costco argued on the basis of its own bottom line in this case. But the fact is that the deregulation of alcohol sought by Costco, which the court noted offered ‘limited selection’ in a ‘no frills’ environment, would have resulted in fewer choices for consumers, fewer independent retailers in the marketplace and fewer options for small to mid-size suppliers who would be unable to penetrate a big box-dominated marketplace.” He noted that the *Costco* case is not about the consumer, as lower prices have never been the end-all-be-all: “What consumers really want is selection and variety. Lowering prices for the sake of lowering them brings about bad

consequences. Our products should be affordable, but not abused.”

Costco filed a motion for rehearing to the Ninth Circuit in February. According to Sullivan, “The court was wrong in limiting its ruling to ‘post and hold.’ The other restraints should have come down with it.” Whether Costco appeals to the U.S. Supreme Court is still an option for the future. Ultimately, the company may get what it wanted, not from the courts but from the state legislature. In the wake of the decision, the Washington State Liquor Control Board convened a task force that recommended lifting the commercial restraints that Costco challenged. But this is far different from having a legal precedent that plaintiffs can then use in future cases to challenge the three-tier system.

### Direct-to-Consumer: Direct Threat or Niche?

In 2005, the U.S. Supreme Court issued its decision in *Granholm v. Heald*, the most significant court case dealing with alcohol since Repeal. Marc Swedenburg, son of plaintiff and owner of Swedenburg Winery Juanita Swedenburg, explained how Michigan and New York effectively blocked out-of-state wineries from shipping to consumers, while allowing their own wineries to engage in direct shipping. The Supreme Court struck down this practice, deciding that a state couldn’t give preference to its own producers over another state’s. Although the Constitution’s Commerce Clause requires free trade between

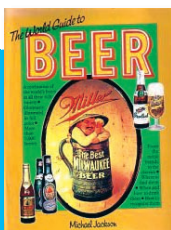
the states, the court recognized that the Twenty-first Amendment allows states to regulate alcohol on a non-discriminatory basis. Therefore, it is fine for a state to shut down wine shipments entirely as long as the same rules are applied to in-state wineries, or allow them for wineries regardless of their location.

*Granholm* was really about commercial discrimination. The Supreme Court acknowledged and reinforced the three-tier system as legitimate. The actual commercial impact has been low. Jeremy Benson, executive director of Free the Grapes!, an association that lobbies “to augment the three-tier system with legal, regulated shipments,” believed that the direct-to-consumer market is only 3% of the wine market. WSWA’s Wolf concurred: “The market for direct sales to consumers remains very small. A winery that can survive on direct shipments alone is an exception.”

According to the Wine Institute, the U.S. retail wine market in 2007 stood at \$30 billion. At 3% of the wine market, direct shipments account for less than \$1 billion in sales. California produces 90% of American wines, so that state has by far the most to gain from free trade. Direct shipment is really about direct shipment of California wine. The other 49 states divvy up the remaining ten percent.

Wine America president Bill Nelson noted how *Granholm* opened markets for direct-to-consumer shipping. “We’ve moved from 27 to 35 states because of the Supreme Court decision. The problem is many states have set up convoluted bureaucracies,” which can serve as trade barriers. He decried the “blizzard of paperwork” – the sales reports and permits that every small winery must file with every state in order to sell in that state. “If you try to obey the letter of the law, you just get killed,” he stated.

Benson from Free the Grapes! noted, “Wineries have the option of shipping into states that represent 81% of U.S. wine con-



1977  
Michael Jackson publishes his first book, *The World Guide to Beer*

1978  
Robert Parker, Jr. begins reviewing wine

1979  
President Jimmy Carter signs home brewing into law. Craft Beer Revolution begins



1980  
Mothers Against Drunk Driving (MADD) forms

1984  
MADD’s campaign succeeds in lifting drinking age from 18 to 21

1988  
Alcohol Beverage Labeling Act requires government health warnings on all alcoholic containers

sumption, up from 50% in January 2005.”

However, New York wines are still notoriously difficult to find outside the Empire State. “The vast majority of New York wineries are small, and the traditional three-tier system does not work for them economically,” New York Wine & Grape Foundation president Jim Trezise said. “Direct sales, either at the winery or online, are by far the best, so for most there is little financial incentive to get into the traditional system.”

Juanita Swedenburg, following the *Granholm* decision, remarked, “There must be a place for the little guy. It’s not going to put the wholesalers out of business. We still need the three-tier system.” Her son Marc, who has run the winery since Juanita’s

beer to consumers, and if it does, will the mechanisms still be in place to protect youth from gaining access to alcohol?” Like a lot of people, he wondered if direct shipments will lead to more issues for the industry. One of these issues is verifying the age of recipients of direct shipments; in a recent case, *Rowe v. New Hampshire Motor Transport*, the Supreme Court ruled that states could not independently force a third party carrier to take responsibility for the product because carriers in interstate commerce are regulated by federal law, not state law, and are not the sellers of the product. In any case, *Granholm* specifically addressed wineries – not retailers – but the effects of the case have trickled down to retailers.

tailers to Illinois will become illegal.) Texas was one of these states. It allowed in-state retailers to direct ship, but blocked out-of-state retailers from doing the same. A Florida-based company sued Texas to gain access. In January 2008, a Texas District Court judge used the Supreme Court’s decision in *Granholm* as the basis for the ruling in *Siesta Village Market v. Perry*, declaring that retailers had to be treated equally, whether in or out-of-state. To further complicate matters, the judge upheld Texas’s requirement that retailers first purchase their wine through a Texas-licensed wholesaler. The case was important as it extended *Granholm* protections from wineries to retailers, while also reinforcing the three-tier system: retailers still must go through wholesalers.

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death in June 2007, shared, “There is a ton of potential for shipment of wines through the Internet.” But in the three years since winning the case, “Our little business hasn’t seen a large increase,” he said. Swedenburg explained that his mother’s stance was more principled than commercial.

*Granholm*’s impact on wholesalers and the three-tier system has been low. “No wholesalers have ever gone out of business because of direct shipment to consumers,” explained Wolf. “We don’t view it as taking the place of wholesalers.” Southern Wine & Spirits’ Wayne Chaplin pondered the future after *Granholm*: “Will that lead to direct shipment of spirits and direct shipment of

According to Tom Wark, executive director of Specialty Wine Retailers Association (SWRA), the plaintiffs in retailer-to-consumer shipping cases are relying on the precedent set by the *Granholm* case. Regarding the issue of overstepping the wholesaler, Wark said, “There are no retailers that are suggesting that states not have the broad ability to regulate the sale of beverage alcohol. Retailers just want to be included and are asking to pay state taxes. They are asking for the privilege to submit themselves to the state’s legal jurisdictions.”

Currently only fourteen states allow retailers to direct ship. (On June 1<sup>st</sup>, direct-to-consumer shipments from out-of-state re-

## The Next Battlegrounds

Following the Washington State’s Ninth District court decision, states, wholesalers and much of the alcoholic beverage industry breathed a sigh of relief. Despite challenges to interpretations of the law and specific state regulations, the three-tier system is on solid ground. Yet other legal battles are pending in the wake of *Costco* and *Granholm*.

Everyone is watching the case in Massachusetts, *Family Winemakers of California v. Jenkins*. This challenges the state’s 30,000-gallon production cap that prevents large wineries from shipping to consumers (large wineries tend to already have distribution). The large wineries are using *Granholm* to claim that the states are discriminating against them based on their size. A decision is expected this spring.

A lawsuit in Maryland, *TFWS, Inc. v. Peter Franchot, et al* – better known as the *Trone* case – is challenging that state’s ‘post and hold’ and volume discount bans. “It’s been languishing up and down the appeals courts for ten years now,” remarked NBWA’s Purser. NBWA and WSWA recently filed a joint amicus brief in the case, citing the Ninth Circuit’s decision in *Costco*. They

**1991**  
Federal excise taxes raised on alcoholic beverages, and haven’t been raised since

**1996**  
Seagram’s becomes the first distiller to advertise on television; today, spirits companies advertise on major cable networks nationwide

**1998**  
*Sex & the City* debuts on HBO, emblematic of the country’s Cocktail Culture and urban hipness

**2004**  
The movie *Sideways* drives ever larger numbers of Americans to wine tourism, cult wines and Pinot Noir



**May 15, 2005**  
U.S. Supreme Court issues decision in *Granholm v. Heald* about interstate wine shipments

**December 5, 2008**  
75<sup>th</sup> anniversary of Repeal

### The Twenty-first Amendment

The Eighteenth Amendment established Prohibition in 1920, and thirteen years later, the country ended the “noble experiment,” as President Herbert Hoover called it. It was the only constitutional amendment ever repealed.

Newly-elected President Franklin Delano Roosevelt ran on a Repeal platform to reestablish law-and-order and to reopen the breweries and distilleries to boost the economy during the worst days of the Great Depression. The Twenty-first Amendment sailed through Congress.

The amendment not only repealed Prohibition (Section 1), it gave states regulatory control over alcohol (Section 2), thus giving birth to the three-tier system, and provided a seven-year window for the states to ratify the amendment (Section 3). It didn't take nearly that long. Michigan was the first state to ratify it in March 1933, and nine months later, on December 5<sup>th</sup>, Utah became the 36<sup>th</sup> state to vote for Repeal. Prohibition was over.

### Article XXI

**Section 1.** The eighteenth article of amendment to the Constitution of the United States is hereby repealed.

**Section 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.

**Section 3.** This article shall be inoperative unless it shall have been ratified as an amendment to the Constitution by conventions in the several States, as provided in the Constitution, within seven years from the date of the submission hereof to the States by the Congress.

wrote, “No one believes that the terms and conditions for the sale of intoxicating liquor should be established by the greediest seller and the thirstiest drinker, and neither state nor federal law has ever permitted such a regime.” The case began in 1999, and has proceeded through four District Court proceedings and four appeals.

**“Will [the Granholm decision] lead to direct shipment of spirits and direct shipment of beer to consumers, and if it does, will the mechanisms still be in place to protect youth from gaining access to alcohol?”**

— Wayne Chaplin, President/COO, Southern Wine & Spirits of America

There is a Michigan case pending (involving the same plaintiff as in the Texas case) called *Siesta Village Market vs. Granholm*. The judge's ruling could open up the state to retailers beyond Michigan's borders.

In New York, there is *Arnold's Wines v. Boyle* which is challenging discrimination against out-of-state retailers. In the case, a federal district judge upheld a statute that gives retailers located in New York the right to sell, deliver and transport wine directly to New York consumers, but denies that right to retail businesses – such as the Indiana wine retailer who brought suit – that are lo-

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— Tom Wark, executive director,  
Specialty Wine Retailers Association (SWRA)

cated outside the state.

The Specialty Wine Retailers Association headed by Wark is the main advocate for “fair wine shopping laws and consumer access to wine,” but who are its allies in these battles? He remarked, “Consumers are always the allies of a free and fair market. You have to look far and wide to find a consumer who will not want to be able to purchase a product that he or she desires.”

### The Road Ahead

Looking ahead to the future, Wark shared, “I know that for the next 5 years we're going to see a great deal of litigation on the issue of direct shipping and the reach of the three-tier system.”

Costco's Associate General Counsel Sullivan believes that “the persistence of the three-tier system has been greatly exaggerated.” He added, “The part of our case remaining that relates most directly to the three-tier system is the request that licensed retailers be permitted to sell to other licensed retailers. The district court denied our claim on that ground and that has been sustained on appeal. Whether that issue is impacted by any future proceedings in the matter remains to be seen.”

Wolf does not believe that Costco will win on the appeal, but said that in the event of more litigation, “wholesalers will continue to stand up and fight for the responsible, accountable three-tier system.” He noted that the consumer needs a large retailer selection because competition in the marketplace is important and, in turn, allows for a more diverse product selection. And, according to Wolf, there is another very important factor in the Costco debate: customer service. “Costco and other big box stores are not about service. Independent retailers really educate customers about their products. Without that, the consumer loses.”

Despite the many court battles, the three-tier system has emerged intact, having served the public's interest well over these past 75 years. It has provided a steady source of revenue for the government, provided competition at every level, and above all, has provided consumers with a tremendous number of choices at various prices and at the highest quality. Yet the legal challenges aren't over. Bill Nelson of Wine America concluded, “At some point, the law will clarify, and there will be fewer lawsuits.” ■