# Franchise Laws, Self-Distribution Restrictions and the Three-Tier System

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# Overview

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1. Origins of alcohol regulation in the United States
2. Prohibition and repeal
3. Tenants of post-Prohibition regulation
4. Evolution into three-tier
5. Franchise laws
6. Self distribution
7. The nano challenge

# Origins of alcohol regulation in the U.S.

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- Americans were **serious consumers** from the dawn of the Republic
  - In the 18th and early 19th Century, hard cider was the "everyday" drink, supplemented by whiskey
  - By mid-century, central and eastern European immigrants had made beer king, with whiskey holding strong
- Don't forget that the first tax imposed by the United States was a tax on whiskey, and led to **The Whiskey Rebellion**
- Congress imposed the first federal excise tax on beer during the Civil War to help fund the war effort

# The growing prohibitionist movement

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- America first flirted with prohibition in the 1840s and 50s, but the movement lost steam as the Civil War loomed
- In the last decade of the 19th Century, the sentiment for prohibition again gained political strength as a wave of "**progressive**" ideas swept America between 1890 and World War I
  - Some were good and long-lasting
    - Women's suffrage
    - Legal status for unions
    - Antitrust law
  - Some not-so-good
    - A preoccupation with eugenics (*i.e.*, scientific racism)
    - An obsession with the gold standard

# Prohibition arrives

- Prohibition benefitted from an unusual confluence of political forces
  - The old stalwarts of prohibition since the early 1800s – mainline Protestant churches – remained supportive
  - Social crusaders supported prohibition as a way to liberate families from the yoke of alcohol-addicted men
  - The popularity of various drinks among recent immigrant groups (*e.g.*, beer among German-Americans, wine among Italian-Americans) made prohibition attractive to nativist sensibilities
  - Industrialists joined the cause in the name of improving worker productivity and safety
- So Prohibition (now capitalized as a specific historic event) arrived on a wave of massive, bi-partisan political support
  - Both women's suffragettes (on the left) and the KKK (on the right) supported Prohibition, along with numerous groups in between

# Prohibition

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- Ratified in 1919, the **18th Amendment** represented a bold attempt to change widespread and longstanding behaviors for the perceived betterment of society
- Congress quickly passed the infamous **Volstead Act** to codify and enforce Prohibition
  - But Congress never appropriated nearly enough to seriously enforce Prohibition on its own
  - Local law enforcement often had personal, political and financial reasons not to enforce the law
- Prohibition soon bred disrespect for the law (as “respectable” citizens flouted Prohibition), fueled a massive, violent organized crime underworld, and moved consumption towards more dangerous products (illegally-produced “bathtub gin”)

# Repeal



By the early 1930s, the tide had turned:

- The "secondary effects" of Prohibition (corruption of government officials, violent organized crime networks, etc.) increasingly were seen as a bigger problem than alcohol abuse
- The overreach of attempting to legislate away alcohol was apparent
- The **Great Depression** (like the Civil War) made the control of alcohol a less-pressing national priority
  - Excise tax revenues from alcohol were missed
  - A legalized industry could bring legitimate employment to many

# The 21st Amendment

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- The **21st Amendment** repealed Prohibition, and its second clause authorized states to control the traffic in alcohol within their borders
- The language in Clause 2 (so debated today) was lifted almost verbatim from 1913's **Webb-Kenyon Act**
- Contrary to popular myth, the 21st Amendment does not require any particular regulatory framework (control v. open, three-tier, etc.)

# The Federal Alcohol Administration Act

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- After an early (struck as unconstitutional) attempt to regulate alcohol through the National Recovery Act, Congress enacted the **Federal Alcohol Administration Act** (FAA Act) in 1935
- The FAA Act created the familiar federal regulatory framework we known today (basic permits, COLAs, advertising mandatories, etc.)
- The Act regulated trade practices between “industry members” (producers, importers and wholesalers) and retailers, but did not separate the upper tiers at all

# *Towards Liquor Control*

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- The states, too, needed to confront the question of how to regulate the newly-legalized alcohol industry
- A primary influence in drafting new laws came from ***Towards Liquor Control***, a treatise published in 1933 (just before Repeal) and funded by the Rockefeller Foundation
  - It advocated a strict “control” system for all distilled spirits, fortified wines, and “strong” beers
  - For table wine and “3.2 beer,” it favored a liberal licensing system
  - In a license system, it favored “tied house” (separate retailer) laws, but never contemplated three-tiers

# Basic tenants of post-Prohibition regulation

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- No fear of big government
  - Framers had no problem with big bureaucracies with large numbers of government workers
  - Even "nationalization" (*e.g.*, control systems) was considered perfectly acceptable
- Primary state control, with a federal overlay
  - Public reacted against the failed national "solution" of Prohibition
- Excise taxation at multiple levels

# Basic tenants of post-Prohibition regulation

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- Pre-approval mechanisms throughout
  - Created almost a presumption against applicants
- Bias against advertising and marketing
- Beer and wine were favored over distilled spirits
- Structural separation between retailers and others
  - A favored regulatory approach of the time
    - *E.g.*, banking, insurance, telecommunications
  - No evidence of separations between the upper two tiers

# System has evolved, but never fundamentally changed

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- The history of the system since 1933 is one of remarkable consistency, with evolution, but few revolutionary changes
- Arguably a monument to special-interest lawmaking, as vested interests have perpetuated and embellished a system with little reference to original policy goals
- Remarkable inertia (from a brewer's perspective, some good and some bad)
  - Few excise tax increases
  - Decline of local brewers and presence of structural separations led to mandatory three-tier
  - Little change in "control" systems (at least until 2011)

# Evolution of three-tier

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- I have yet to find evidence of mandatory three-tier systems in the 1930s
  - Brewers could sell to retailers and/or hold wholesale licenses
- But changes came in the decades after World War II
  - "Tied-house" structural separations provided precedent and infrastructure
  - Wholesalers gained in local political clout
  - Decline of regional brewers reduced brewer political power
  - Rise of national brewers (who did not self-distribute locally) removed the business case for brewer self-distribution
- Yet even today, mandatory three-tier is far from universal

# Further evolution

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- Since at least 1970, developments have been driven by several economic and consumer developments
  - Consolidation at the mainstream supplier tier, yet massive fragmentation as small suppliers proliferate
  - Consolidation at the wholesale and retail tiers
  - American's growing interest in wine specifically, and specialty products generally
  - Growing "back to local" consumer sentiment
- The results have driven developments forward in a somewhat inconsistent manner

# The rise of franchise laws

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- So, beginning more than three decades after repeal, states began enacting laws severely limiting the ability of beer (and in some cases wine and spirits) suppliers to terminate their wholesalers
  - We believe that Massachusetts enacted the earliest such law (Section 25E) in 1971
- At the time, the NBWA began advocating for such laws on a national level
- At one point, the USBA endorsed a “model” act that formed the base line for a number of current state beer franchise laws (*e.g.*, Illinois & Texas)

# Enactment of select state beer franchise laws

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- Florida – 1987
- Illinois – 1982:  With seemingly continuous strengthening since enactment
- Massachusetts – 1971
- New York – 1996:  With a promise to later enact relief for small brewers – a promise finally fulfilled in 2012
- Pennsylvania – 1980:  With an exemption for in-state brewers
- Texas – 1981:  Bill supported by the USBA, but since amended to depart from the USBA model

# Beer franchise laws today



- Today virtually every jurisdiction has enacted a beer franchise law, with most coming into existence in the 1970s-1990s
  - California is a "half franchise" state
  - No beer franchise in Alaska, the District of Columbia, and Hawaii
- Few of these statutes addressed their application to small brewers when they were enacted
- Note the example of wine and spirits, where franchise law enactment has slowed, and even reversed in many places (*e.g.*, Arizona, Illinois, Washington wine)

# So what's next on franchise?

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- Recall two of the forces driving change today
  - Wholesaler-tier consolidation
  - Supplier-tier fragmentation below the level of the international giants
- These two forces make the premise of franchise increasingly laughable
  - Giant companies like Reyes Holdings do not need un-waivable statutory protection from small brewers; the only bargaining power disparity is of the wholesaler over small brewers
  - Analogy to a true "franchise" – where franchisee (think McDonalds) is wholly dependent on its relationship with the franchisor – breaks down completely

# So what's next on franchise?

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- Small brewers are starting to get traction in a few state legislatures; promising examples of meaningful reform
  - New York – Brewers with 3% or less of a wholesaler's and sales producing less than 300,000 bbls/yr. can terminate without cause, with compensation
  - North Carolina – Brewers producing less than 25,000 bbls/yr. exempt
  - Washington – Brewers producing less than 250,000 bbls/yr. exempt
- Moreover, the number of small brewer exemption bills has proliferated, with measures introduced in Massachusetts, Montana, North Dakota, and Pennsylvania

# So what's next on franchise?

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- The case is compelling
  - Wholesalers do not need protection from craft brewers
  - Small suppliers, not wholesalers, are the new local face of the industry
  - History has shown that exempting small brewers from franchise protection does not undermine the system
- Resist the temptation to make distinctions between in-state brewers and all others
  - Do not divide craft brewers against each other
  - Distinctions between in- and out-of-state producers problematic under the dormant Commerce Clause

# Self distribution



- We may be going “back to the future”
  - In the 1930s-40s most brands were local, and many almost certainly were self distributed
  - Wholesalers grew with the rise of regional and national brands
- As national brewers had less need for self distribution, many states began extending the reach of tied-house laws to separate the upper-two tiers
  - For a time, few small brewers were around to protest

# Where do we go on self distribution?

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- Some brewers can efficiently and economically distribute in their local markets
- There are far too many brands and too few wholesalers to realistically expect the three-tier system to accommodate every new product
  - Self distribution helps "incubate" and grown brands before they are ready for mainstream, three-tier distribution
  - Success or failure should depend on consumer acceptance, not artificial barriers to entry
- Craft brewers will usually choose to abandon self distribution after a period of growth, but should not be forced to

# Where do we go on self distribution?

- Self distribution by even the largest craft brewers will not jeopardize the system
  - Loss of some fractional percentage of business will not put mainline wholesalers out of business if they retain their flagship supplier's brands
  - In any event, beer wholesalers, like car dealers, are evolving into multi-brand operations that do not depend on any single or even a few suppliers
- The absence of a mandatory three-tier for beer in many states, including California, Colorado, and New York, has not undermined the viability of independent wholesalers

# The challenge of the “nano” brewery

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- The continued proliferation of very small craft (or “nano”) breweries presents a new challenge for the system
  - Call it “hyper” fragmentation at the small end of the supplier tier
- The system simply cannot handle so many brands
  - Wholesalers – today usually just two per territory – cannot handle the number of SKUs and product complexity
  - Most retailers lack the shelf space
- The challenge will be to accommodate consumers’ thirst for ultra-local, ultra-niche products within the system

# Where do we go with nanos?

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- The wine industry may point the way to the future
  - With over 7,000 wineries in America, many are not reaching the market through conventional three-tier channels (where distribution is even more concentrated)
  - Most small wineries derive substantial revenue outside the three-tier system
- The privileges that may allow nano brewery survival are
  - Off-sale privileges for growlers and other packaged product
  - On-premise parties, tastings and tours
  - Sales at farmer's markets and other local venues
  - Direct-shipping privileges

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# Thank you for your time and attention


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