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

Marc Sorini
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Overview

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2. Prohibition and repeal
3. Tenants of post-Prohibition regulation
4. Evolution into three-tier
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Origins of alcohol regulation in the U.S.

- Americans were **serious consumers** from the dawn of the Republic
  - In the 18\textsuperscript{th} and early 19\textsuperscript{th} 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

- 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
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”).
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

- 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.).
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 mandates, etc.).

The Act regulated trade practices between “industry members” (producers, importers and wholesalers) and retailers, but did not separate the upper tiers at all.
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

- 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

- 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

- 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

- 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

- 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

- 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

- 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?

- 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?

- 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?

- **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?

- 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

- 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?

- 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
Thank you for your time and attention

Marc Sorini
202.756.8000
msorini@mwe.com