75 Years After Prohibition

The Regulatory Hangover Remains

By Susan Cagann and Rick Van Duzer

It's a typical day. A venture capitalist wants to buy a farm, grow some grapes, and maybe sell some wine. A local chef wants to increase profits by buying and selling private label wines. A winery is fighting with one of its distributors and wants to dump them. A private equity firm is investing in a company that owns hotels, restaurants, and grocery chains. The manager of a sports arena has just received a lucrative sponsorship offer from a beer company, but regulators are threatening enforcement proceedings. A spirits brand owner is launching a national marketing program including sweepstakes and sales incentive programs. A café owner decides she can improve her bottom line by serving homemade lemoncello to her afternoon customers.

Easy enough. You rely on your years of business judgment and legal expertise to help craft a plan to accomplish your clients' objectives, right? Not so fast. The state and federal regulators are not cooperating either with you or with each other, an archaic web of "tied house" laws complicate what should be relatively straightforward solutions, trade practice regulations handcuff your creativity, and the franchise laws of five different states need to be researched, considered, and satisfied before you can do anything. Welcome to the world of wine, beer, and spirits law.

The regulatory and legal maze impacting the manufacture, distribution, and sale of alcohol products had its genesis in pre-Prohibition America. In the days when Carrie Nation took an axe to barrels in Kansas saloons, alcohol was blamed by the burgeoning temperance movement as the source of virtually all societal ills, particularly the destruction of the family. The tied house was the villain of the temperance movement. Tied houses were bars or public houses that served the products of a single manufacturer. The manufacturer typically owned the house and controlled all aspects of its operation. Some public houses, legend has it, went as far as to serve heavily salted sandwiches to encourage their patrons to drink—go figure. The only way to stop this debauchery, according to the temperance movement, was to prohibit the sale and consumption of alcohol altogether.

But Prohibition proved not to be the answer. When it was repealed in 1933, extraordinary power to regulate commerce in alcohol was conveyed to the states. States chose widely divergent paths in wielding their newfound power. The resulting system was designed to address the evils of demon rum and its destructive powers. All evil influence was presumed to flow down from powerful manufacturers to wholesalers and from wholesalers to local retailers. Lawmakers created new rules to govern the entire system of production, marketing, sales, and distribution. The policy goals behind the new rules were orderly market conditions, limits or prohibitions on vertical integration, avoiding dominance by suppliers over retailers through bribery or predatory marketing practices, product integrity, temperance, and taxation. In the wake of Repeal, federal and state legislatures also promulgated laws designed to avoid the evils of Prohibition where alcohol trafficking fell under control of bootleggers and organized crime. While market forces have changed dramatically since 1933, the maze of state regulations has not kept pace. The result is a legal minefield.

Permitting and Licensing Systems

Federal, state, and local governments have developed programs to keep tabs on persons trafficking in alcoholic beverages. These programs—while simple at first blush—can throw wrenches into mergers, stall acquisitions, dampen profit projections, and hinder operating efficiencies. Thorough assessments of the regulatory impact on business transactions enable clients to work around or through these regulatory roadblocks.

Cagann is special counsel and Van Duzer is a partner at Farella Braun + Martel LLP in San Francisco. Their respective e-mails are scagann@fbm.com and rvanduzer@fbm.com.

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The federal permit system applies to manufacturers of wine and spirits, importers, and wholesalers of distilled spirits, wine, or malt beverages. The permitting process is designed to keep permits out of the hands of persons with criminal convictions or with financially unstable businesses. Permits are obtained from the Department of Treasury Alcohol and Tobacco Tax and Trade Bureau (TTB). The applicant must disclose direct and indirect owners and establish that it has sufficient financial resources to conduct its business. Applicants are investigated thoroughly. These same rules are invoked in mergers and acquisitions of beverage alcohol companies. Within 30 days of any direct or indirect change in control or ownership, the change must be reported to the TTB. The new owners, officers, and directors must be vetted and approved by TTB. Any owner of greater than 10 percent indirect interest in a business must be disclosed even if the interest is held in a remote parent entity. Some exceptions are made for government pension funds and publicly traded companies.

State permission also is required. At the state level, owners, officers, and directors must be fingerprinted for each state in which a state license is required. There is no federal clearinghouse for determining eligibility to participate in these businesses. If your client acquires a retail chain operating 1,800 stores in 28 states, its shareholders, officers, and directors must follow unique qualification processes in each jurisdiction.

State systems will vary. States grappled with the issue of whether to adopt private licensing systems or state-controlled systems, where sale and distribution would be performed by the state. Eighteen states opted to control the sale of distilled spirits at the wholesale level. Twelve states control retail off-premise sale through government-operated package stores or designated outlets. "Control states" include Alabama, Idaho, Iowa, Maine, Michigan, Mississippi, Montana, New Hampshire, North Carolina, Ohio, Oregon, Pennsylvania, Utah, Vermont, Virginia, Washington, West Virginia, and Wyoming.

Other states permit private industry to manufacture, import, wholesale, and retail alcoholic beverages. Many, however, prohibit or constrict vertical integration in the industry. "License states," as they have come to be known, issue licenses and sharply defined privileges to each tier of the distribution system—supply, wholesale, and retail. Most of these states prohibit a supplier from owning an interest in a retailer or a wholesaler.

In the context of mergers and acquisitions, state licensing can create deal quagmires.

The licensing structure permits states to empower their agencies to evaluate the character, fitness, and financial responsibility of each license applicant. States also enacted laws to prohibit a person convicted of a felony or crime involving liquor laws, gambling, prostitution, or other crimes against morality from holding direct or indirect interests in a license. Several states prohibit a retailer from employing anyone with a felony conviction. State licensing authorities may take into account proposed locations of premises and may limit the concentration of licenses. Some states limit the number of licenses that can be held by any particular company and create barriers to chain retailers holding more than one license. A handful of states have concurrent licensing processes with local governments where both the local government and the state government issue licenses.

In the context of mergers and acquisitions, state licensing can create deal quagmires. A fund or private equity company may be prohibited from holding significant interests in a winery and in a hotel or retail chain. Some states prohibit members of boards of directors of an entity with operations in one tier from owning interests in another tier. During acquisitions, officers, directors, and any other person with greater than a 10 percent ownership interest in the acquiring company should be vetted to ensure they do not hold any personal investments or other interests that could disqualify the person from holding an interest in the assets that are purchased. Spouses of significant shareholders also must be eligible. In California, for example, a spouse cannot be a peace officer or district attorney or hold management responsibilities in another tier.

While prohibitions on vertical integration are the rule, exceptions do exist. Some states with powerful constituents in a particular sector have passed laws with expansive privileges. In the winery context, California, Colorado, New York, Pennsylvania, Oregon, Virginia, and Washington have granted wineries great flexibility in their ability to market and sell wine. The expanded privileges can include the right to serve as their own distributors, sell direct to consumers at retail on-site and through the Internet, and the right to own off- and on-premise businesses.

Formula and Label Approvals

In addition to licensing requirements, distilled spirits, beer, and wine must be bottled, packaged, and labeled in strict conformity with federal labeling regulations. A supplier must obtain prior approval of labels. Advertising must meet regulatory standards for labeling and may not contain any statement inconsistent with the product labels. The responsible advertiser must be identified. A supplier cannot stop though at federal compliance. Thirty states require a supplier to register its labels.

Federal and state laws have many content restrictions on labeling and advertising products. For example, Santa Claus and God may not be used on a wine or distilled spirits label in a particular jurisdiction. Words such as "powerful" or "strong" may not be used to describe the product itself. Interpretations wax and wane based

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upon agency policy. Wine labels depicting artful reclining nudes were approved by the federal government for several years only to be rejected by a new administration. Cooperative advertising bearing the brand name of a product and a retailer is prohibited in most jurisdictions. Many states do not allow advertising the proof of an alcoholic beverage while others require it.

Trade Practice

In addition to literally prohibiting vertical integration, many rules were promulgated to prohibit cross-tier influence. Federal law provides the platform from which state trade practice laws follow. The laws constrain relations between the three tiers—suppliers, wholesalers, and retailers. Federal law identifies acts by supply-tier members that are means to induce retail-tier members to buy alcohol products and mandates that they are unlawful if they have an exclusionary effect on trade. The prohibited acts include exclusive outlets, tied houses, commercial bribery, and consignment sales.

Unlawful inducements under the federal tied house prohibitions include holding a direct interest in a retail licensee or the property of a licensee, furnishing things of value to a licensee, paying a retailer for display space or advertising, guaranteeing loans, extending credit, or requiring quota sales. Federal regulations then enumerate exceptions to the unlawful means to induce. Suppliers, for example, may offer product displays of less than $300 per brand; point-of-sale advertising materials; equipment if sold at cost; a specified number of samples; combination packaging; educational seminars; consumer tastings; consumer promotions such as coupons, prizes, and refunds; stocking and rotation services; and outside signs not exceeding $400 in cost. In order to establish a tied house violation at the federal level, the government must establish that there has been an unlawful inducement and the inducement resulted in the exclusion of a competitor's product.

Each state has adopted its own trade practice rules. Unlike the federal prohibitions, which require an exclusionary impact, state laws tend to establish prohibited practices as a strict liability crime. Each state prohibits a manufacturer or wholesaler from providing an item of value to a retailer. Suppliers are prohibited from paying retailers for advertising or display space. The regulations then are followed by numerous exceptions to these general prohibitions. For example, California's Alcoholic Beverage Control Act defines its tied house restrictions as prohibiting a discrete ownership interest in on- and off-sale licensees and providing items of value directly or indirectly to such licensees. These prohibitions are followed by 40 statutory exemptions to the rule.

In practical terms, a supplier cannot run a national marketing campaign without customizing certain elements to address vagaries in state law. Sweepstakes offer a good example. Sweepstakes are a popular promotional vehicle. Most states permit sweepstakes in beverage alcohol marketing campaigns. Some states require prior approval with significant lead time. Others prohibit alcoholic beverages as prizes and all require the winner to be of legal drinking age. Yet the prize in a California sweepstakes sponsored by a wine supplier cannot exceed one dollar in value. Couponing presents another challenge. Rules differ state by state as to whether mail-in coupons, instant redeemable coupons, or coupons with purchase of alcohol are allowed. California permits all three forms with no dollar value limit. Texas prohibits all three forms of coupons.

Distribution

What could possibly be next for these consumer products? Once you have a federal permit, a state license, approved labels, and compliant advertising programs, you need a distribution network. This means working with distributors as most states will not allow a winery, brewer, or distiller to sell its products direct to retailers.

Practices that would be considered anticompetitive restraints on commerce for any other consumer product pervade beverage alcohol regulation. Many states require retailers to purchase all beverage alcohol products from the state itself (control states), or from licensed wholesalers. Many states create protection for the wholesaler tier. These include exclusivity mandates, minimum price margins, constraints on termination rights, and privilege exclusivity. Many states prohibit discrimination by a trade member toward members in another tier even with legitimate business justification. Others compel transparency with respect to the distribution relationship by compelling disclosure and posting of pricing and discounts, and appointment of wholesalers and filing of private contracts between suppliers and their wholesalers.

The stakeholders in the three-tier systems have changed in form and power since Repeal of Prohibition. Initially, wholesalers were local businesses highly effective at influencing the passage of legislation to protect their investment in contributing to the success of a brand. Many states have passed some form of legislation known as "franchise regulation" governing formation and conclusion of the relations between suppliers and wholesalers. The purpose underlying these protections ostensibly was to check the power of suppliers over the other tiers. Absent such regulations, the supplier-wholesaler relationship is established by the parties and may or may not be evidenced by a written contract. If a dispute arises, the parties resolve the dispute in court or arbitration under generally applicable contract laws. Franchise laws create additional protections.

Generally franchise laws require the formal appointment of a wholesaler, notification to the state of such appointment and permission of the state to terminate the relationship. In many franchise states, a supplier cannot "dual," that is, appoint two or more wholesalers in a specific geographic area. Twenty-one states have adopted some form of franchise laws that benefit beverage alcohol distributors. Many of these states require that the franchise

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fee be paid if a supplier terminates a wholesaler without good cause. Most franchise laws cannot be waived in contracts between suppliers and distributors.

In the consolidating world of suppliers and distributors, these and other state laws respectively constrain and protect the parties' expectations in mergers and acquisitions. Many state laws do not include a change in control in the supplier or distributor as good cause to terminate. Larger companies may find themselves required to deal with several distributors in a given geographic area. As distributors consolidate, many brand owners find themselves captive in distribution houses where a competitive brand has more influence or attention. In a franchise state, the brand owner generally cannot change distributors without litigating the issue of good cause or paying a fee to leave.

The collateral consequences of these legislative efforts are hurting Internet retail businesses.

While distributors are consolidating, the number of small wineries and craft breweries has grown considerably. Many smaller suppliers cannot command the attention of large distribution houses and chain retailers. Many of these small suppliers have turned to direct-to-consumer sales as an alternative trade channel in order to build or maintain their brands.

Sales to Consumers

Wineries have embraced the Internet and mail-order businesses as a high margin trade channel. Small wineries without distributors have gravitated to the direct-to-consumer channel as the only viable means by which to market their goods. In the last 10 years, many states have permitted interstate wine shipments to local consumers. Several states permitted in-state wineries to ship to consumers but did not confer such privileges on out-of-state wineries. Challenges were brought against the laws of two of those states—Michigan and New York. Michigan permitted in-state wineries the privilege to ship to in-state consumers. New York permitted in-state wineries and out-of-state wineries with "a branch, factory, office or storeroom" within New York to ship directly to New York consumers. The cases were consolidated and presented to the Supreme Court. In 2005, the Court declared such differential treatment between in-state and out-of-state wineries explicit discrimination against interstate commerce and found the regulations unconstitutional under the Commerce Clause in *Granholm v. Heald*, 544 U.S. 460 (2005).

Since *Granholm*, the fight has shifted to state legislatures. There, states are faced with leveling up and allowing both in- and out-of-state wineries to sell direct to consumers or leveling down and prohibiting all direct-to-consumer sales. The collateral consequences of these legislative efforts are hurting Internet retail businesses. Typically these businesses were riding the wave of liberalized direct shipping laws. The post-*Granholm* legislative efforts often have resulted in the restriction of direct shipping privileges to wineries only. Internet retailers now are litigating these restrictions with mixed results.

Conclusion

Consolidation has produced economically powerful retail and wholesale tiers that need little or no protection from the influence of suppliers. Nevertheless, wholesalers—squeezed on both ends—have reacted to their powerful customers and suppliers by seeking additional protections in the form of state franchise laws and mounting opposition to the liberalization of direct shipping. Craft brewers, wineries, and distillers are beginning to flex their collective muscle to bring much-needed changes to state licensing and trade regulations. Yet, to date, no nationwide attempt to streamline the regulation of the sale and distribution of alcoholic beverage businesses has taken hold. Until that happens, there will always be a place in the industry for knowledgeable, creative lawyers capable of finding their way through legal and regulatory obstacles to effective real-life business solutions. BLT

Please see page 1 for information on the upcoming BLT Live teleconference on this topic.

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