

## Background: Tied-House Law

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*“Tied-House” refers to federal and state laws, regulating how alcoholic beverages are marketed and how the various tiers of the industry interact. The term comes from a practice in England where a bar may be tied, by ownership links or contractual obligations, to a specific manufacturer. Prior to Prohibition, this practice was allowed in the United States.*

### Prohibition

From colonial times until the onset of Prohibition, alcohol beverages were sold in a largely uncontrolled atmosphere; manufacturers of spirits and beer served small geographic areas and frequently owned their retail outlets. There were essentially only two tiers in this “system”: supplier and retailer.<sup>1</sup> A huge number of the retail outlets fell under the influence of larger distillers and brewers,<sup>2</sup> in some cases suppliers would furnish equipment, pay license fees, and give rebates to retailers who handled only their brands. This close interaction approximated the vertical integration of the tied-houses of England.

“Tied-house critics complained that it encouraged over-consumption of alcohol, as tied-houses offered ‘free lunch’ if you bought a drink to promote business,”<sup>3</sup> and other consumption incentives to their customers. The abuses of the practice of tied-house arrangements “were regarded in large measure as responsible for the evils which led to prohibition.”<sup>4</sup>

Unfortunately for proponents of Prohibition, the 18<sup>th</sup> Amendment to the U.S. Constitution [National Prohibition Act of 1920] did not end commercial alcohol beverage consumption. Consumption moved into the shadows, production went off-shore or underground, prices sky-rocketed, and excise tax revenue from alcohol transactions all but evaporated.

During the depression, discussion in Congress about alcohol beverages moved away from the moral and societal costs, to considerations of the potential revenue to be gained by ending prohibition making a dent in unemployment and raising federal revenues.

Ratification of the 21<sup>st</sup> Amendment in late December 1933, repealing Prohibition and the adoption of the Federal Alcohol Administration Act<sup>5</sup> gave broad authority to the states to regulate the production, importation, distribution, retail sale, and consumption of alcohol beverages.

### Alcohol Regulation: Tied-House

In an attempt to prevent the vertical integration of ownership, and revert to an environment viewed as a catalyst for the Temperance movement, tied-house restrictions were enacted. The most fundamental element of tied-house laws was the creation and maintenance of a three tier system, in which alcoholic beverages are sold by suppliers to wholesalers, and by wholesalers to retailers. The three tiers being: supplier, wholesaler and retailer.<sup>6</sup> Under the current post-Prohibition alcoholic beverage regulatory regime, tied-houses are generally illegal in the United States. Tied-house restrictions essentially forbid any form of vertical integration in the alcoholic beverage industry. “By enacting prohibitions against tied-house arrangements, state legislatures aimed to prevent two particular dangers: the ability and potentiality of large firms to dominate local markets through vertical and horizontal integration .... And the excessive sales of alcoholic beverages produced by the overly aggressive marketing techniques of large alcoholic beverage concerns...”<sup>7</sup>



## The States

The basic approach of all states was to establish control and regulate the channels of distribution from the time that the product reached their borders until it reached the hands of the consumer. In implementing their alcohol regulations, states took two basic paths. A small group of states ('control' states) opted to become wholesalers and retailers themselves for wine and spirits, establishing a state monopoly of the wholesale and retail portion of the distribution chain. However, a larger number of states opted to allow all alcoholic beverages to be distributed and retailed privately under a scheme of state licensing and regulation. California falls into this later category. (Beer is sold at a retail level in all states).

Regardless of form, all states prohibited both suppliers and wholesalers from having any interest in retail establishments, and in general, enacted provisions similar to those of the Federal Alcohol Administration Act prohibiting free goods, gifts, unfair trade practices, commercial bribery, excessive credit, consignment sales and other practices that tend to result in tiered houses or exclusive outlets.

By prohibiting a vertically integrated system at the supplier and wholesaler levels, the states added additional insurance against anti-competitive practices by large, dominant suppliers, against monopolistic control of the market and against the development of the tied-house.

## California

In this state, the Alcohol Beverage Control Act governs tied-house and other elements of the law pertaining to alcoholic beverages. The Act was instituted for "the protection of the safety, welfare, health, peace, and morals of the people of the State, to eliminate the evils of unlicensed and unlawful manufacture, selling, and disposing of alcoholic beverages, and to promote temperance in the use and consumption of alcoholic beverages."<sup>8</sup> The Act generally prohibits a manufacturer or distributor from: a) holding any ownership interest in a retail establishment; b) furnish or guarantee fulfillment of any financial obligation to any retail licensee, c) have an ownership interest in any equipment or lease of retail premises; or d) pay retailers for advertising. While California law is explicit in the separation of the three tiers, it also contains several exemptions to the state's tied-house laws. These exemptions have been granted over the years and include issues which benefit all three levels of the supply

chain, as well as restaurants, entertainment venues, retailers, and charitable organizations. (See table below.)

| CA Tied-House Exception Examples |  |
|----------------------------------|--|
| Bus & Prof                       | Description  |
| § 25503.22                       | Ownership: Allows a person to have an interest in a California retail license if that person also holds an interest in an out-of-state wholesale license   |
| § 25503.41                       | § 25503.41 Ownership: Any person that operates an out-of-state winery and produces distilled spirits out-of-state may also hold an interest in up to 12 brew pubs within California  |
| § 23396.3                        | Brewpubs: Permits a small-scale brewery operation that generally producing 15,000 barrels a year, intended for local and/or regional consumption, some include a restaurant or pub on their manufacturing plant.<br>Vintners: Permits vintners to sell their wines at farmers' markets under a special permit issued under specified conditions. |
| § 25503.5                        | Tastings: Permits customer education classes and tastings to be held by manufacturers and distributors on retail premises.   |
| § 25503.6                        | Advertising: Permits manufacturers, wineries and distillers to purchase advertising space from certain on-sale retailers, for specified entertainment venues (e.g. stadiums, arenas, amusement parks theatres, studio facilities).   |
| § 25600                          | § 25600 Promotions: Allows manufacturers to provide advertising items of up to a specified value per unit original cost to consumers: beer (\$3), wine (\$1), and spirits (\$5).   |

## Challenges

While the established three tier system has been working relatively well, it still faces challenges. The most notable challenges come from attempts to use the Internet for direct marketing of product, through attempts to short-circuit the normal distribution chain, and global challenges to the system.

With the growth of the Internet, some have become concerned that some manufacturers have attempted to use this direct avenue sell to customers. The state's Alcohol Beverage Control Board has warned its licensees that selling product across the internet through an unlicensed third party is an illegal act.<sup>9</sup> This was highlighted again in a recent rule adopted by the ABC, stating that manufacturers cannot pay online storefronts licensed to sell as retailers for loading content, posting any material, or any advertising whatsoever. The retailer only can receive money from its markup and sale of the products.<sup>10</sup>

In 2004, Costco sued the State of Washington ( Costco v. Hoen) claiming its tied-house laws forced the retailer to charge higher prices for beer and wine, and prohibited them from buying directly from out of state manufacturers. In 2006, the 9th

Circuit Court of Appeals upheld eight out of nine provisions in Washington's regulatory scheme, making it a huge win for states rights advocates. Currently, Costco is backing a ballot initiative that would repeal Washington's tied-house laws. Advocates for distributors complain that changes to the status quo could dramatically reduce jobs in that industry; some retailers see advantages to the changes that could result from Costco's suit. Beverage alcohol manufacturers may have different perspectives depending on their size — smaller brewers and wineries may perceive a benefit from the current structure of the industry, but larger manufacturers may see increased flexibility and profits from a more open alcohol market.<sup>11</sup> While, California's alcohol beverage regulatory system does not have many of the restrictions challenged by Costco in Washington State, success of the initiative would have dramatic ramifications for the industry across the country.

On the global stage, the liberalization of the U.S. alcohol beverage distribution system has been raised in recent trade negotiations by the European Union (EU), which generally operates in a less restrictive free-market environment. Some have argued that the "tied-house" laws are at odds with the General Agreement of Trade and Services (GATS) treaty, these individuals may turn to the World Trade Organization (WTO) for a ruling on whether the three tier system will be allowed to stand in the United States.<sup>12</sup>

## Conclusion

In the commercial chain, there is no doubt that wholesalers derive the greatest benefit from the continuation of the three-tier system. Without that requirement many distributors may find themselves driven out of business or become wholly owned by manufacturers. However, the consumers also benefit from having access to a wider distribution of products and at lower prices stemming from a more competitive market. In addition smaller suppliers have the potential to access the 300,000 wine and spirits retailers in the United States.

While some have advocated that alcohol should operate in a purely free-market environment, history has shown us that alcohol is not just another commodity in the marketplace. As one article put it: "The 21st Amendment reaffirms that alcohol is not just another commodity like potato chips and that its sale and distribution should occur in a fair and orderly marketplace to discourage over-consumption and protect public safety."<sup>13</sup>

1. Nat'l Distributing Co. v. United States Treasury Dep't, 626 F.2d 997, 1008-1010 (D.C. 1980).
2. National Distributing Company v. U.S., 626 F.2d 997, 1008 (D.C. Cir. 1980).
3. Winery Owner Founders on Tied-House Laws, Paul Franson, winesandvines.com, August 25 2009.
4. H.Rept. No. 1542, Federal Alcohol Control Bill, pp.11 and 12.
5. PL74-401, 27 Title 201 et seq.
6. Tied-house: Pillar of Alcohol Regulation, S. Schorske, Vineyard & Winery Management, Jan/Feb 1997.
7. California Beer Wholesalers Assn. v. Alcoholic Beverage Control App. Bd., 5 Cal. 3d 402, 407-408 (1971).
8. CA Business and Professions Code § 23001.
9. CA Business and Professions Code § 23300.
10. CA ABC Regulation, June 5, 2009, <http://www.abc.ca.gov/trade/Advisory-Third%20Party.pdf>.
11. Time to Untie the House?, E. Price, Bar News-Washington State Bar Association, June 2004.
12. Three Tier or Free Trade?, S. Schorske & A. Heckathorn, Vineyard & Winery Management, Jan/Feb 2005.
13. Time to Untie the House?, E. Price, Bar News-Washington State Bar Association, June 2004.