

TIME TO UNTIE THE HOUSE?

Revisiting the Historical Justifications of
Washington's Three-Tier System Challenged by
Costco v. Washington State Liquor Control Board

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Revisiting the Historical Justifications of Washington’s Three-Tier System Challenged
by *Costco v. Washington State Liquor Control Board*

When local retailing giant Costco filed suit against the Washington State Liquor Control Board earlier this year it sent shock waves throughout the beverage alcohol industry because the case is a challenge to regulations and practices that have been in place since the end of Prohibition. Under Washington’s current regulations, retailers cannot buy alcohol products directly from manufacturers, but must instead buy from distributors. Costco’s lawsuit asserts that it can deliver beverage alcohol to the consumer far less expensively if market forces are allowed to operate without the limitations imposed by state regulation.

While advocates for distributors complain that changes to the status quo could dramatically reduce jobs in that industry, retailer groups 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.

The target of the Costco suit is Washington’s “Tied House” laws that seek to prevent vertical integration in the liquor industry by forcing the separation of the three tiers of product manufacture and delivery – (1) beverage alcohol producers, (2) wholesalers and distributors, and (3) retailers. This separation of the tiers of production and sales in the alcohol industry is deeply rooted in the history of liquor legislation at both the federal and state levels. So established is the three-tiered system that its desirability has been rarely challenged by the industry, both regulators and businesses –

until now. The Costco lawsuit caused an immediate frenzy of analysis from legal and industry observers about the economic and legal impact of the clash between federal marketplace principles and states' rights.

For its part, the Washington State Liquor Control Board defended its position through a statement released on February 24, 2004. In this statement, the Board fell back on historical justifications:

Many of these laws have been in effect since the 1930s, when the 21st Amendment to the U.S. Constitution gave states the right and responsibility to regulate all aspects of alcohol sales, distribution and consumption within their borders.

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. Many states have adopted three-tiered distribution systems to accomplish these goals. In such systems, producers sell to distributors who then sell to retailers.

Without question, the analysis of the merits of the Costco suit and its impact on the economic welfare of the industry players will be dominated by the practical aspects of how these laws function in today's economy. However, as today's marketplace impacts are debated, the historical basis for the laws should not be ignored. On the eve of a potentially profound change in beverage alcohol industry, now is an appropriate time to revisit the reasons these laws were enacted almost 70 years ago and to analyze whether those justifications are still valid today.

As any large producer, distributor, or retailer of beverage alcohol will tell you, state liquor regulations vary greatly throughout the country. This is due, in large part, to the freedom provided to the states through the Twenty-First Amendment, enacted to repeal Prohibition. The Amendment reads:

Amendment 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.

The express words of Section 2 of the Amendment, by referencing the “laws” of the states, have been determined by the courts to grant to the states constitutional permission to closely regulate the interstate commerce of beverage alcohol in a way that would be forbidden for any other product.

Despite differences in the approaches taken by the states in liquor regulation, there are several concepts that permeate liquor regulations across the board. One of these concepts is the “three-tier” system. The strict separation of liquor manufacturers and producers from wholesalers and distributors from retailers is rooted, in large part, in the perceived evils associated with the “Tied House.” The “house” may be tied to the producer by, obviously, joint ownership, but also more indirectly through undue influence.¹

The purpose of the federal tied-house laws has been explained as follows:

The Members of Congress debating the bill [in 1935] repeatedly stated that the tied house provision was designed to prevent control by alcoholic beverage producers and wholesalers over retail outlets, especially saloons. As Congressman Treadway, minority spokesman for the bill, explained:

Probably some of the Members wondered what the meaning may be of “tied house,” the first two words under (b). To my mind that

is one of the best features of this bill if it accomplishes what it is intended to accomplish. Subsection (b) is intended to prevent distillers, brewers, and wholesalers controlling the dispensation of whisky or beer, as the case may be, by exercising dominion and control over the place at which the liquor is sold.²

Thus the essence of the “tied house evil” was vertical integration. According to the 1935 Senate Report, “The tied-house provisions * * * relate to the acquisition by industry members of control over theretofore independent retail establishments * * *.”³

There were many symptoms of the “tied house evil” that Congress believed it was curing in 1935. Political corruption was one such symptom:

Before prohibition, a vast number of the retail outlets of the country where liquor was sold for consumption of the premises had fallen into the hands of the distillers and the brewers. The larger distillers and brewers controlled scores, hundreds, and possibly thousands of such outlets. That inevitably threw them into politics, inevitably led them to seek control of State and municipal legislation, and brought about an unhealthy political condition which ... was one of the first causes of prohibition.⁴

Another evil of the tied house was the “forced increase in alcoholic beverage sales resulting from the ‘tied-house.’”⁵ This would, in turn, lead to a runaway proliferation of saloons and bars.⁶

Finally, irresponsible ownership of retail outlets was yet another evil addressed by the legislation. Said one senator:

Is not it true that in the old days a lot of the opposition to liquor and beer arose because of the fact that the brewers would put in a sort of a sorry fellow who had no responsibility and no money to buy his equipment, and they would pay for his license and put him in his business, and he was usually the fellow who violated all the Sunday laws and every other kind of law? That is why the thing grew up. This evidently is based on that theory, that a man ought to have some personal responsibility to run a grog shop, not depending on the brewer financing him.⁷

Thus the “tied house evils” -- political corruption, proliferation of saloons, increase in alcohol consumption, and irresponsible ownership of retail outlets -- were the

result, in the view of the Congress in 1935, of the “purchase of control or exclusive selling rights from ostensibly independent retailers in need of financial assistance.”⁸ The predominant focus, then, of the federal tied house laws was curbing the influence of the powerful liquor producers and their abuses of the meek retailers. By demanding complete separation of the industry tiers -- the producers, the distributors, and the retailers -- these abuses could be controlled and minimized. The resulting structure of rigid separation between the three tiers of the beverage alcohol industry has been preserved both at the federal level and at the state level ever since.

While other industries may have restrictions on vertical integration, those restrictions are generally imposed through traditional state and federal anti-trust laws. “Liquor is different” is the usual explanation for the disparate treatment under the law. Or as explained by the Washington State Liquor Control Board in response to Costco’s legal challenge, “alcohol is not just another commodity like potato chips ...”. While it is true that no other legal and widely consumed product has had the checkered history of beverage alcohol (such as the “great experiment” of Prohibition), whether this “difference” of liquor is sufficient to justify the continued anti-free market structure of the industry is a valid question.

Times have changed in the beverage alcohol industry; 2003 is not 1933. The beverage alcohol industry of the 21st Century bears little resemblance to the industry that existed in the 1930s – over time there has been a clear shift of power away from the producers and toward wholesalers and retailers.

The beer, wine, and spirits industry has changed substantially since the three-tier laws were enacted. While there were once few producers and many wholesalers, the opposite is true now, at least in wine and beer. In 1950 there were 5,000 alcohol wholesalers nationwide, today there are

only 170 with the result that in some regions retailers are served by as few as two wholesalers. Conversely the numbers of breweries has grown from 401 to 1,522 while the number of wineries has quadrupled.⁹

Perhaps nowhere is this proliferation of small producers more evident than in Washington's growing wine industry. In 1981, there were 19 wineries in Washington State. By 2001, that number had grown to 170 wineries. Today there may be as many as 240 Washington wineries.

Again, the historic justifications for the tied-house laws -- political corruption, proliferation of saloons, increase in alcohol consumption, and irresponsible ownership of retail outlets -- were all tied to the influence of powerful and affluent producers and correspondingly weak retailers. The industry's dramatic shift toward smaller, more numerous, producers and more powerful distributors and retailers turns the historical paradigm on its head.

Once it can be established that the historical conditions that justified the tied house laws have not only evaporated, but in fact have completely reversed, the question becomes, "do these laws serve any useful purpose in a wholly different economic climate?" Those benefited by the system, notably distributors, understandably defend the three-tiered system and may be able to articulate valid justifications under today's marketplace reality for continuing the system. The Costco suit, however, represents the growing movement of dissenters who view state and federal beverage alcohol regulation as archaic and based on societal concerns that simply do not exist today. And, as the Costco suit illustrates, at least some of these dissenters have the financial capability to legally challenge the well-entrenched status quo.

The ultimate impact upon Washington's beverage alcohol producers of tinkering with the system is far from certain. What is certain is that releasing the beverage alcohol industry from the tied-house laws nationwide would completely change the rules of the marketplace. While Washington's producers currently do have a modest ability to market their own products to retailers, they have no similar ability in many other states. On the one hand, these laws afford a measure of protection from out-of-state competition by providing somewhat freer access to retailers than that allowed to out-of-state producers. On the other hand, Washington wines could enjoy broader access to markets in other states if the rigidity of the industry is softened across the board. Competition could also occur on the merits of the product, or quality of the wine, rather than on the whims or prejudices of the middle-tier distributors. Furthermore, breaking down the prohibitions on ownership between tiers could allow Washington entrepreneurs to develop their own wineries while at the same time, forming distribution companies or retail outlets.

Beside the obvious creation of a rigid industry structure, there are also less tangible by-products of the three-tier system that impacts both business and government, like a cumbersome process for liquor licensing. Rooted in the historical concern for common ownership among the tiers, the state liquor laws create a lengthy and expensive licensing process through which state liquor investigators are compelled to thoroughly review the applicant for evidence of an ownership interest in a different tier of liquor industry. Such invasive inquiry can be a headache for regulators and businesses alike when the applicant happens to be a corporation operating in several states with multiple layers of ownership entities. If investors several layers removed from the license

applicant happen to have connections with organized crime and use a hidden hand to direct corporate operations, one can understand the state's interest in uncovering that connection. But when an investor in a license applicant happens to have a spouse with some stock ownership of Anheuser-Busch, the energy expended by the state to discover this interest makes little sense. Adjustment of the three-tiered system could subject applicants for retail liquor licenses to more reasonable inquiry about investments and the licensing process would also be more streamlined and economical as both regulators and applicants could focus on issues of serious concern like criminal influence. Oppressive marketplace abuses caused by undue integration of industry tiers could be addressed through the anti-trust laws, like all other businesses.

Admittedly, there are problems with the overly simplistic solution of erasing these laws from Washington's and other states' statutes. And there is no guarantee that any such broad sweeping changes will result from the Costco suit. The current merits of the three-tier system will doubtlessly be briefed and examined in the course of the litigation. Certainly the way changes to the system will impact the economics of today's beverage alcohol industry and what they could mean to the future will be hotly debated. This debate, however, should not move forward without at least glancing backward. The historical justifications from the 1930s marketplace that created the current three-tiered system may not be dispositive of whether the system should be retained, rejected, or altered. But as we stand, perhaps, on the threshold of dramatic change to beverage alcohol regulations, neither should these historical justifications be ignored.

¹ Washington codified its tied-house laws at RCW 66.28.010, which states, in part:

No manufacturer, importer, or distributor, or person financially interested, directly or indirectly, in such business; whether resident or nonresident, shall have any financial interest, direct or indirect, in any licensed retail business, unless the retail business is

owned by a corporation in which a manufacturer or importer has no direct stock ownership and there are no interlocking officers and directors, the retail license is held by a corporation that is not owned directly or indirectly by a manufacturer or importer, the sales of liquor are incidental to the primary activity of operating the property as a hotel, alcoholic beverages produced by the manufacturer or importer or their subsidiaries are not sold at the licensed premises, and the board reviews the ownership and proposed method of operation of all involved entities and determines that there will not be an unacceptable level of control or undue influence over the operation or the retail licensee; nor shall any manufacturer, importer, or distributor own any of the property upon which such licensed persons conduct their business;

² *National Distributing Company v. U.S.*, 626 F.2d 997, 1008 (D.C. Cir. 1980)(emphasis added).

³ *Id.* at 1009.

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* at 1008-09.

⁸ *Id.* at 1010.

⁹ Newkirk & Atkinson, "Buying Wine Online," Progressive Policy Institute (Jan. 2003).