The Dangers of Common Ownership in an Uncommon Industry

Alcohol Policy in America and the Timeless Relevance of Tied-House Restrictions

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About the Author

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I. Introduction

"Plus ça change, plus c'est la même chose"
- *Jean-Baptiste Alphonse Karr, Les Guêpes, January 1849*

It has long been acknowledged that alcohol is unlike any other consumer commodity.[1] In fact, alcohol is the only commodity to ever be the express subject of an amendment to the United States Constitution and it has been the subject of two.[2] Alcohol is such a distinct commodity because of the rigid dichotomy between its equally substantial economic and social impacts. The alcoholic beverage industry provides employment for millions of Americans, contributes over $46 billion directly to state and local revenues annually, and is suggested to be responsible for over $455 billion yearly in total U.S. economic activity.[3] On the other hand, the alcoholic beverage industry brings with it a hefty societal price tag as it plays a key role in the causation of death, disease, addiction, poverty, family instability, crime and violence, and costs the U.S. about $249 billion annually.[4] The Centers for Disease Control and Prevention estimates over 88,000 people a year lose their life to alcohol.[5] Simply stated, alcoholic beverages are the source of many benefits and many problems.

Because of its incongruous affects, sensitive nature, and volatile past, the Constitution explicitly places commerce in alcoholic beverages in a class of its own.[6] Today however, the state-based regulatory system that, for decades, has effectively balanced the economic and social aspects surrounding the production and consumption of alcoholic beverages in the U.S. has become the central focus of a barrage of attacks from special interest groups with tunnel vision towards economic advantage. These groups generally consist of some very powerful alcoholic beverage suppliers, wholesalers, retail chains, consolidated international conglomerates, equity investment firms, and the like seeking to engage in currently prohibited integration tactics to increase their profits by gaining market shares and control. They argue that alcohol laws such as trade practice and *"tied-house"* restrictions (which were established precisely to prevent the integration, power, and control they pursue) are outdated, inefficient, and no longer necessary in the modern "globalized" marketplace. However, though civilization has certainly evolved over time, alcohol is still intoxicating and not much has changed with regards to the use and related ills of this unique commodity. Nor have there been changes to the underlying tendencies and motives of the business firm that profits on alcohol's sale.

Alcoholic beverages have been produced and consumed for thousands of years and have been a prominent commodity in America since its inception. In fact, when the Puritans set out for the new world, they stockpiled the Mayflower with more beer and wine than water;[7] rum production was early Colonial New England's most prosperous industry;[8] and in 1753, a traveler noted that all but three of the forty-eight beverages he'd come upon on his vast journey contained alcohol.[9]

Conversely, addressing the harms associated with the use of alcoholic beverages has been a perpetual source of deliberation for just as long. For over two thousand years, strategies have been implemented to reconcile the paradox between the benefits and harms posed by alcoholic beverages.[10] Ancient Greek literature frequently warned against excessive drinking and Britain was forced to confront an alcoholism epidemic in the mid-eighteenth century when cheap spirits flooded the market and gin consumption reached eighteen million gallons.[11] In Colonial America, laws were established to require towns to license suitable persons to sell alcoholic beverages,[12] and taverns were perceived as institutions that, despite their benefits, should be carefully regulated by law to prevent all sorts of abuses.[13] "Temperance movements have come and gone; organized efforts for moderation, backed by moral suasion have had their day; but in all the long struggle with one of the most difficult human problems law has remained our chief weapon in trying to curb the social consequences of excess."[14]

Likewise, business firms and the concept of global trade have also existed for thousands of years.[15] The roots of capitalism and its notions of equity investments, wealth maximization, and integration date back to well before the colonization of America.[16] The corporate form was born over four hundred years ago, with the objective being control over supply and demand as a means of amassing economic power and lessening competition[17]. Notably, America was colonized as a "promised land" where "the tendencies of Western capitalism could find fullest and most uncontrolled expression."[18] For decades, giant corporations have sought control over the global economy and have held weighty power over the democratic process.[19] Nowadays in the United States, natural business competitors are largely owned by a small group of investment firms with institutional investors possessing a high (70% to 80%) and growing interest in all publicly traded firms.[20] Alcohol is still alcohol. Corporations are still created to maximize profit. Balancing these two conflicting realities remains an important policy goal today.

Hyperbole is a fluent language for those in the alcohol industry seeking to change the system for their benefit. Nevertheless, despite the rhetoric on all sides, the fact endures that alcohol is sold differently today than it was fifty years ago, and it will be sold differently fifty years from now. The unfaltering constant, as history has shown, is the imperativeness that any such change be subtle, consensus driven, and rooted in public safety concerns. Contrary to the claims of those pushing for substantial deregulation of the alcoholic beverage control system, the circumstances and concerns that ultimately led to the creation of tied-house prohibitions and strict trade practice regulations in the U.S. have not dissipated and the primary goals of the business firm continue to be profit maximization and the accumulation of power and control. Arguments that the regulatory scheme (which for the past eighty-plus years has served to minimize many ills associated with alcoholic beverages while simultaneously fostering the proliferation of a robust and diverse industry) is outdated, inefficient, and no longer needed in the twenty-first century marketplace are misguided at best. Because of modern corporate trends towards increased integration; the rising popularity of mutual funds, defined contribution and benefit plans, private equity funds, hedge funds, and crowd funding; and a growing globalized push for international free trade with little to no emphasis on social welfare, the re-emergence of the "*tied-house*" and its accompanying evils remains very likely in an unfettered alcoholic beverage marketplace. "Alcoholic beverages can still be abused, and such abuse can be encouraged or facilitated by the unconstrained pursuit of profit."[21] Thus, the alcoholic beverage control system and its emphasis on restricting vertical integration within the industry is more relevant today than ever before and critical to ensuring the continuation of a healthy and prosperous marketplace while thwarting a recurrence of the conditions that once led to Prohibition.

As eloquently proclaimed by Abraham Lincoln: "It has long been recognized that the problems with alcohol relate not to the use of a bad thing, but to the abuse of a good thing." Hence, it is imperative that regulators and legislators proceed with great caution in contemplating changes to the alcoholic beverage control structure so as not to inadvertently diminish the ability of government to curtail harm to its people; they must be careful to not passively yield to purely economic motives of special interest groups. Similarly, the courts should act diligently in rendering very narrow and fact specific opinions in response to alcoholic beverage control related challenges; they must refrain from serving as de facto policy makers and hindering the ability of the states to control alcoholic beverage commerce within their borders in a manner that promotes temperance and encourages orderly market conditions for the benefit of their respective people.

II. History of the Pre-Prohibition Alcohol Industry in the United States and Its Most Notorious Invention, the "*Tied-House*"

"So we beat on, boats against the current, borne back ceaselessly to the past"
- F. Scott Fitzgerald, The Great Gatsby

Alcohol has always been a popular and valuable commodity deeply embedded in the U.S. economy; it has also always been a cause of immense societal burden and concern. Political and social debate throughout the early years of the country centered on how best to control the production, sale, and use of alcoholic beverages with kaleidoscopic ideologies vacillating widely from laisse-faire to prohibition. Improvisation was the modus operandi of policy makers as they swiftly and frequently enacted, amended, and replaced laws in response to pleas from various special interest groups. With the constant flux in law and policy prior to the Twenty-First amendment, an effective alcohol control system could not exist and aspirations to establish a stable and orderly alcoholic beverage marketplace, altruistic as they may have been, remained elusive.

During the 1800's, fierce competition in the alcoholic beverage industry motivated suppliers towards aggressive control and marketing tactics. Hard-pressed to expand sales and earn profits, suppliers integrated into the retail business by acquiring ownership interests and otherwise gaining control by incentivizing retail dealers to promote and sell their alcoholic beverage products to the exclusion of others.[22] This was routinely accomplished through the provision of financial assistance, steep discounts, credit extensions, leases, equipment, advertising materials, and other beneficial support. One way or another, retailers quickly became beholden to sell no other products than those of the supplier to which they were tied. Proving to be an economically successful strategy, suppliers relentlessly pushed for the opening of more retail outlets and continued tying themselves to them to further pump massive volumes of their products into local communities. By the late 1800's, it was not rare for there to be one saloon for every 150 to 200 Americans where a common practice was to "give" patrons highly salted food with the hidden agenda of furthering intemperate drinking.[23] Tragically, this conduct led to exorbitant levels of intoxication and the saloon became a breeding grounds for other crime such as prostitution and gambling.[24] These "*tied-houses*" and the hands-on involvement of suppliers in the retail sector triggered intense price wars that delivered an abundance of extremely cheap alcohol, encouraged a proliferation of excessive consumption, and subsequently fostered an overwhelming public sentiment that alcohol was the predominant source of all evil and disrepute in society. The general communal opinion of the time is well summarized by then Salvation Army General, Evangeline Booth, who is quoted as saying:

> Alcohol as a drink has drained more blood, hung more crepe, sold more houses, plunged more people into bankruptcy, armed more villains, slain more children, snapped more wedding rings, defiled more innocence, blinded more eyes, twisted more limbs, dethroned more reason, wrecked more manhood, dishonored more womanhood, broken more hearts, blasted more lives, driven more suicide, and dug more graves than any other poisoned scourge that ever swept its death-dealing waves across the world. [25]

By the end of the nineteenth century, the U.S. alcohol industry had evolved into a vertically integrated enterprise where most retailers were tied to one of a few suppliers who wielded their significant financial strength and political influence to proceed virtually unrepressed in pressuring their own retailers to increase alcohol sales, and consequently, alcohol consumption, through whatever means and at whatever the social cost.[26] "The manufacturer knew nothing and cared nothing about the community. All he wanted was increased sales. He saw none of the abuses, and as a non-resident he was beyond local social influence."[27] The byproduct was a "nation of drunkards" where Americans spent more money on alcohol each year than the expenditure of the entire federal government.[28] The "saloon" had become a menace to society.[29] "Behind its blinds, degradation and crime were fostered, and under its principle of stimulated sales, poverty and drunkenness, big profits, and political graft found a secure foothold."[30] The standard of living rapidly deteriorated in communities across America and attempts to control the alcohol problem via moderation advocacy failed. Public outrage reached a boiling point, a war on alcohol was waged, and the temperance movement ultimately demanded, and won, an outright national ban on the manufacture, sale, and transportation of alcohol through the ratification of the Eighteenth Amendment to the U.S. Constitution on January 16, 1919.

III. Prohibition: America "Goes Dry" and Thirteen Turbulent Years Ensue

"Prohibition only drives drunkenness behind doors and into dark places,
and does not cure it or even diminish it"
- *Mark Twain*

Though rooted in noble motive, the Prohibition Act was severely defective and proved to be devastatingly unsuccessful. Rather than ridding society of alcohol's attendant evils, it exacerbated them. Chaos, lawlessness, corruption, violence, demoralization, illness and death escalated. The illicit nature of alcohol commodities increased their profitability and an unprecedented black market emerged as organized crime fiefdoms fought for control over a flourishing bootleg industry. The people blatantly ignored the alcohol ban and public officials frequently accepted bribes in exchange for turning a blind eye to the rampant criminal activity. The alcohol trade became more lucrative than ever before, societal costs increased exponentially, and government revenue collections drastically declined. Before Prohibition, excise taxes on liquor sales were a major source of state budgetary funding. With Prohibition in effect, that revenue was immediately lost. At the national level, Prohibition resulted in the loss of $11 billion in revenue collections and cost $300 million to enforce.[31] "In the attempt to bring about total abstinence through prohibition, an evil even greater than intemperance resulted – namely, a nation-wide disregard for law, with all the attendant abuses that followed in its train."[32]

The most significant problem with Prohibition was its failure to adequately assess public sentiment; the people were not ready for total abstinence. It quickly became apparent that a law not reflective of prevailing community standards would not be obeyed and could not be enforced. Thus, in 1929 President Herbert Hoover, who initially supported the Eighteenth Amendment, formed the National Commission on Law Observance and Enforcement (also known as the Wickersham Commission) to evaluate the U.S. criminal justice system under Prohibition. In its 1931 report, the Commission found that the abolition of the commercialized alcohol industry, which originated in a movement for temperance, was the obvious source of existing abuses. It noted a substantial and incompatible difference between temperance and prohibition: "Temperance assumes a moderate use of alcoholic beverages but seeks to prevent excess... [p]rohibition makes no distinction between moderate and excessive use."[33] Ultimately, the Commission was not ready to give up on Prohibition, but concluded that the support of public opinion and ample appropriations for suitable enforcement were critical.

Even so, the forces of change gradually continued to gather strength. To many, the tipping point came in the form of a bombshell proclamation penned by John D. Rockefeller, Jr. that made national headlines on June 7, 1932 for its support of repeal of the Eighteenth Amendment.[34] Rockefeller's announcement was so momentous because it signaled a major ideological shift from a man that was a leading philanthropist, lifelong teetotaler, prominent contributor to the Anti-Saloon League, and champion of Prohibition (the magnitude of this shift can be equated to the impact that would come from modern day staunch anti-drug advocates announcing their support for marijuana legalization and the implementation of a control structure). A *New York Times* article reported that his declaration had a "deep significance" and was "likely to have a powerful influence" because "Mr. Rockefeller's good life and works, his sincerity, his modesty, his devotion to and constant aid of all good causes have placed him beyond suspicion and above envy."[35] Rockefeller Jr. expressed his initial hope that prohibition would advance temperance and be supported by public opinion, but noted that his hopes had been disappointed as drinking had increased, the speakeasy had replaced the saloon two or three-fold, a vast army of lawbreakers had emerged, and respect for the law had been greatly lessened as typically law abiding citizens openly and unabashedly denounced the ban on alcohol.[36] In concession, he gave his support to a resolution that proposed repealing Prohibition and giving the states control over alcohol commerce as he opined that it would be "so difficult for our people as a whole to agree in advance on what the substitute should be, and so unlikely that any one method will fit the entire nation."[37] He resolved that it was his hope, "that the tremendous efforts put forth in behalf of the Eighteenth Amendment by millions of earnest, consecrated people will be continued in effective support of practical measures for the promotion of genuine temperance."[38] Many people hailed Mr. Rockefeller's courage and called on others to follow his lead.[39] William Randolph Hearst avowed that "this letter will do more than any document which has appeared in the whole discussion of the prohibition question."[40]

In February of 1933, sensing Prohibition's imminent repeal, but understanding that a well-thought plan of control was necessary to preclude a return of the practices that prompted it, Rockefeller Jr. commissioned Raymond B. Fosdick (an attorney) and Albert L. Scott (an engineer) to extensively study America's numerous failed experiences with alcohol and research alcohol regulatory systems around the world to identify the optimal devices of control for America to implement going forward. Their profound, nonpartisan report, *Toward Liquor Control*, emphasized the prevalence of an "irreconcilable and permanent conflict" between the insatiable desires of the business firm for increased profits and community desires for social control, and thus concluded that constraint of the "profit-motive" to the fullest extent possible would pave the most promising road to efficacious control.[41] They submitted that divorcing the profit-motive from the retail sales of alcoholic beverages would be the only viable means of impeding "an endless guerilla warfare between a nation fighting for temperance and a traffic that thrives on excess."[42] Fosdick and Scott stressed that tied-houses must be strictly prohibited and that opportunities for the evasion of that prohibition, or for a supplier to otherwise exert influence over a retailer, must be promptly foreseen and foreclosed.[43] They also submitted that a nationwide system was not suitable for the regulation of a commodity as sensitive as alcohol as it did not allow for the crucial consideration of vastly diverse local sentiments; they professed that each state, not a remote federal government, must design the system.

Considering the documented overwhelming lack of public support, it is not surprising that the era of Prohibition was relatively short lived, culminating with its repeal via ratification of the Twenty-First Amendment on December 5, 1933.

IV. Post-Prohibition Alcohol Control: The Emergence of the Modern State-Based Control System

"I ask especially that no state shall by law or otherwise authorize the return of the saloon in its old form or in some modern guise."

- *Franklin D. Roosevelt, Presidential Proclamation*[44]

Ratification of the Twenty-First Amendment did not resolve America's colossal alcohol issue, but by substituting an unenforceable national ban for a more moderate approach of legalization and state-based control, it opened the door for the development of a practicable control structure that would end the long-lived wild goose chase for temperance and an orderly marketplace. "The Twenty-First Amendment made a fundamental change, as to control of the liquor traffic, in the constitutional relations between the states and national authority."[45]

In relinquishing to the states control over alcohol commerce, Congress placed resolving the country's alcohol problem squarely in their laps. The states were given free rein to decide if or how alcoholic beverage commerce would be allowed within their borders, but with two overarching missions – end the lawlessness of Prohibition and prevent a repeat of the business and social practices that led to it. To do so, it was vital that each state devise a legal framework that would be flexible enough to adequately fill the demand for alcohol, but restrictive enough to curtail business strategies that would fuel aggressive sales techniques and excessive drinking.[46] In tackling this monumental challenge, the states relied heavily on *Toward Liquor Control*. What emerged is a collection of fifty different state alcohol marketplaces built on the same core principles, but narrowly tailored to best reconcile the highly incongruous economic and social interests in a manner that would be most acceptable to their respective citizenry. Of paramount significance is that in enacting their comprehensive post-Prohibition regulatory control systems, the policy makers of each state demonstrated a keen awareness of the dire impact of vertical integration within the alcoholic beverage industry and sought to foreclose opportunities for a reversion to the pre-Prohibition structure by mandating segregation of the manufacturing, wholesale, and retail segments of the industry into what is commonly known as the "*three-tier system.*"

Eighteen states opted for a monopoly (or state-based "control") model whereby the state maintains control over the wholesaling or retailing of some or all categories of alcoholic beverages.[47] Thirty-two states chose a "licensing" model whereby qualified private entities obtain licenses from the state to operate in a specific segment of the alcoholic beverage industry. All fifty states and the federal government have regulatory created systems to separate different roles into different licenses, each with their own service functions. Each state enacted tied-house prohibitions and related trade practice regulations intended to serve as the fulcrum of their three-tier system. Though the specific wording of the tied-house and trade practice regulations differ from state to state, the underlying core objectives are consistently to: protect the public health, safety, and welfare by advancing an environment for temperance; provide for orderly and diverse market conditions that optimize consumer choice; foster responsible competition, a level playing field, and honesty and fair dealing in the alcohol industry; curtail monopolistic tendencies that cultivate undue influence; and, neutralize economic forces that are naturally inclined to gravitate towards profit maximizing practices that promote intemperate alcohol consumption to the determent of the public.[48] The three-tier system has seen challenges, but has been called "unquestionably legitimate" by the U.S. Supreme Court and other federal courts.[49]

The states' goal in structuring a three-tier system and enacting trade practice regulations was not to unreasonably burden alcoholic beverage commerce, but to provide for a legal means of obtaining alcohol while also encouraging moderation to limit alcohol abuse. Their central objective was to safeguard the public from potential harm by reducing economic incentives to maximize sales through restricting the ability of a member in one segment of the alcoholic beverage industry from being able to interfere with market operations or exert control or weighty influence over the business decisions of an industry member in another segment. The states sought to promote the separation, independence and stability of the three tiers. To that end, the various trade practice regulations typically contain language aimed at preventing vertical integration, whether forward or backwards, and schemes of common ownership or mutual financial interest, whether direct or indirect and even if "only de minimis", between entities (or their members, officers, shareholders, affiliates, managers, etc.) in different segments of the alcohol industry. These laws are also housed in the Federal Alcohol Administration Act.[50] Restricted financial interests are not just limited to capital or equity investments, but also typically include exclusivity agreements, leases, credit extensions, loans, consignment sales, quota sales, or the provision of other things of value such as: discounts or preferential pricing, rebates, furniture, fixtures, equipment, advertising materials, special services, gifts, entertainment, travel and any other mechanism that may conceivably create a tied-house arrangement. In *Cadena v. TABC*, the Texas Court of Appeals explained, "the intent of the statutes is to prohibit relationships that would not necessarily confer actual control, but which would create the potential for influence or alignment of business interests."[51]

Those not fluent in America's tumultuous past with alcohol and those with ulterior motives often view the trade practice regulations as obsolete or illogical and overly intrusive of commerce; they breezily reject them as trivial and push for alcohol to be treated like other commodities. However, these regulations are the apparatus that ultimately curbed the alcohol trade's parasitic reliance on excessive consumption and allowed for the alcoholic beverage industry to grow and prosper for the past eighty-three years without being perceived as the ubiquitous scourge of society or becoming the perpetual hot-button political issue that it was prior to Repeal. Because of the trade-practice regulations: large, powerful corporations are not able to dominate the marketplace; consumers have a wide array of products to choose from; large and small suppliers are equally able to get their products to the market; retailers are free to determine what products they will stock and how they will place them and small retailers can compete with their larger counterparts; and, the states can mitigate the public health and safety dangers that afflicted the pre-Prohibition saloon by preventing communities from being inundated with cheap alcohol. As the Louisiana Third Circuit Court of Appeals well summarized in *Manuel v. State*, the tied-house "results in a push to maximize sales and stifle competition" that runs counter to the goal of temperance, but with the trade practice regulations and separation of the three segments of the alcoholic beverage industry "individual firms do not grow so powerful in practice that they can out-muscle regulators" and "competition, a diversity in products, and availability of products are enhanced as the economic incentives are removed that encourage wholesalers and retailers to favor the products of a particular supplier (to which wholesaler or retailer might be tied) to the exclusion of products from other suppliers."[52]

Despite any arguments to the contrary, several recent enforcement findings prove that the trade practice regulations are not obsolete or illogical, and actually further beneficial competitive commerce. The addictive nature of alcohol has not changed. Similarly, the corporate mentality and core objective has and always will be to increase profits and executives invariably will be tempted to go to extreme measures to do so, including finding every means available to skirt laws, push their limits, or abolish them. What has changed is an increase in consolidation of a significant amount of money into private equity firms attempting to infiltrate multiple segments of the alcoholic beverage industry. Yet, this change is not a plausible enough justification to make drastic amendments to the alcoholic beverage control system and working around a desire to consolidate money into private equity funds should not be a primary concern of state regulators. When dealing with alcoholic beverages, the strong proclivity to engage in pay-to-play schemes aimed at squeezing out competition who cannot afford to compete is problematic and can have devastating effects on public health and consumer choice. For example:

- In an investigation that spanned over a year and concluded in late 2016, regulators determined that a Massachusetts beer distributor and several retailers were involved in a pay-to-play game and had paid tens of thousands of dollars and offered other inducements to retailers to carry its products to the exclusion of others. The distributor's and retailers' actions, regulators noted, harmed small businesses and limited consumer choice.[53]

- In March of 2016, the Washington State Liquor and Cannabis Board cited a major global beer supplier for exerting undue influence over an alcoholic beverage retail dealer to sell the supplier's products to the exclusion of others at multiple event venues. The Board's investigation uncovered that the supplier had entered into an illegal exclusivity agreement with a retailer wherein the supplier would pay the retailer a fee in exchange for being the exclusive beer sponsor at events operated by the retailer's affiliated caterer. The agreement required prominent placement of the supplier's name and logo, gave the supplier exclusive right to rent-free use of venues, and prohibited the public promotion of any other beer supplier/distributer at events (private or otherwise) operated by the retailer or a third party.[54]

- In the early years of this decade, an extensive trade practice violation investigation by Arizona regulators uncovered a wide-spread practice of alcohol companies seeking to induce retailers to carry their products to the exclusion of others by providing the retailers with free products, furniture, and other valuable gifts such as entertainment and gift cards. The practice became so prevalent that retailers began demanding extensive gifts as a precondition to carrying a supplier's products.[55]

- A 2014-2015 investigation by the California Department of Alcoholic Beverage Control resulted in an alcoholic beverage distributor being charged with twenty counts of illegally providing off-sale retail licenses with refrigerated coolers.[56] Similar complaints have recently been lodged against dozens of California retailers.

- In 2011, regulators determined that several major liquor suppliers had committed tied-house violations in the Las Vegas area by collectively furnishing nearly $2 million in inducements through a third party to a retailer and its subsidiary corporations. Through their investigation, the regulators concluded "that the purpose of the inducements was to obtain preferential product display and shelf space" and posed "an artificial barrier to open and fair competition especially for small to medium-sized companies that cannot pay such fees."[57]

- In 2015, news broke that a prominent U.S. big-box retailer, known for its low-cost leader philosophy, had increased pressure on all its suppliers to cut prices to facilitate revenue production by selling larger volumes of products at the lowest possible price.[58]

If manufacturers, distributors, and retailers will go to these extremes to limit competition and maximize profits, imagine what they would do if tied-house prohibitions were weakened or eliminated. To fully comprehend the timeless relevance and immense social and economic values of this uniquely American structure one need only compare the alcoholic beverage industry in the U.S. to that of other industries in the country and to the alcoholic beverage industries across the oceans and borders.

Proof of a Robust and Stable U.S. Alcoholic Beverage Market Place

- The U.S. alcohol industry is experiencing an explosion of new industry members and brands. There are over 6,000 breweries in the U.S. with approximately 92% of those being small craft breweries. 85% of all beer sold within the U.S. in 2015 was domestically produced. The industry grew by approximately 700 breweries from 2014 to 2015.[59] There are over 7,762 wineries in the U.S. with approximately 78% of those being boutique wineries. 15 states have more than 100 wineries each.[60] Today in the U.S., there are over 769 craft distilleries; ten years ago, there were only fifty.[61] As of 2014, there were nearly 30,000 alcoholic beverage wholesaler facilities and at least 640,000 retailers operating in the U.S.[62]

- U.S. Consumers have an expansive array of brands of alcoholic beverage products to choose from at restaurants, bars, and other retail outlets as there are over 142,440 registered products.[63] Furthermore, a 2015 bipartisan national survey shows that 91% of American Adults consider it easy to find a wide variety of alcoholic beverage products in their community and 84% believe that there are more local and craft beers and liquor available in their community now than ever before.[64]

- Prior to the establishment of the current alcoholic beverage control system, at no point in America’s long history with alcohol had there been a system that garnered wide-spread and on-going public support. Currently though, 89% of American adults believe that it is very important to keep the alcohol industry regulated; 70% believe alcohol should not be sold just like other consumer goods; and 81% support the rights of individual states to determine their own laws and regulations regarding the manufacturer, distribution and sale of alcohol.[65]

- The U.S. market is currently the principal global focus because it has the most competitive landscape, a reasonable tax structure, and a regulatory environment that promotes product integrity and diversity.[66] This stability in regulation and availability is also supported by the annual Gallup survey which shows the rate of “nondrinkers” to be remarkably steady over the past eighty years with roughly one-third of Americans not drinking.[67]

- Studies on alcohol policies have generated compelling evidence that alcohol control measures positively reduce the rates of alcohol-related problems.[68] Because of the restrictions on vertical integration within the U.S. alcoholic beverage industry and the independence and competition that it fosters, prices have remained relatively inelastic over time as private business interests are restrained from exerting dominance over the marketplace to increase supply and decrease prices. However, statistical data strongly suggest that deregulation could incite price elasticity and that a downward trend in pricing would have a negative impact on public health.[69]

<u>As Compared to the Alcohol Industries in the United Kingdom and Mexico</u>

- Due to steady deregulation over the past five decades, the United Kingdom is now dealing with significant increases in alcohol related diseases, death, intoxication, violence, public disorder, and crime.[70] Four large retailers came to control 75% of the alcohol market and engage in price wars that persistently drive prices drastically lower.[71] This "low-cost" leader model requires high volume sales with heavy promotion and has led to an influx of cheap alcohol that fosters binge drinking and encourages people to "pre-load" at home before going out and after on-premise closure times.[72] Alcohol has come to be treated as any other commodity, social problems have become acute, and governmental endeavors to control the alcohol crisis have faced strong resistance from powerful market forces that, having been unleased, have become extremely difficult to control.[73] In 2012, U.K. Prime Minister, David Cameron, decreed: "Binge drinking isn't some fringe issue… [t]he crime and violence it causes drains resources in our hospitals, generates mayhem on our streets and spreads fear in our communities. My message is simple. We can't go on like this. We have to tackle the scourge of violence caused by binge drinking. And we have to do it now."[74]

- In the U.K., supermarkets are demanding more profit and investment from suppliers to list their brands. In response, suppliers are promoting and advertising more, cutting supply costs, and cutting their overhead to keep their listings. This has resulted in many smaller brands being squeezed out (approximately 18% of suppliers have lost their listings), less competition, less product diversity, less consumer choice, and massive job loss.[75]

- In Mexico, nearly every retail alcoholic beverage outlet has an exclusive agreement with one of two beer manufacturers (Anheuser Bush InBev NV and Heineken NV), who jointly control 98% of the Mexican beer market. Because of these exclusive agreements, craft beer products have been largely unavailable in the marketplace and consumer options have been very limited. In 2013, Mexico's Federal Competition Commission reached an agreement with the two manufacturers to cap the exclusivity deals and to allow retailers to sell craft beers, but the agreement includes major exceptions so there is not likely to be much increase in competition or product diversity.[76]

As Compared to Other U.S. Industries

- In the U.S. soft drink industry, there are only 151 companies that manufacture flavoring syrup concentrate and only 1,209 companies that blend ingredients. The market is dominated by two companies (Coke and Pepsi) who, in 2010, made up 73% of the total market share.[77] These companies pay, or otherwise induce, retailers to carry only their products. Therefore, one cannot get a Pepsi at McDonalds and one cannot get a Coke at Taco Bell. Additionally, there is very little growth or diversity because it is extremely difficult for new players to enter the cola market.

- Deregulation of the media industry has resulted in a handful of powerful conglomerates owning nearly all the media outlets in the U.S. The result has been a lack of diversity in viewpoints and diminished media integrity.[78]

- Vertical integration in the livestock industry has displaced the decision-making authority from the farmer to the processor and essentially made the farmer a quasi-employee of the processor. Vertical integration in the livestock industry has also been called a threat to the family farm that causes profits to flow away from local communities thereby hindering economic growth in rural areas.[79] The world's largest meatpacker now controls 24% of all cattle produced in the U.S. and its power has made it nearly impossible for ranchers to make a living as small operators.[80]

Public Policy of Segregating Industry Segments Not Limited to Alcohol

- Several states have enacted laws to mandate some degree of divorcement between the refinery and retail segments of the petroleum industry out of concern that vertically integrated refinery-retailers would set higher wholesale prices for independent gas stations so that the integrated gas station could sell gas at lower prices than its competitors and ultimately drive them out of business.[81]

- The 2010 federal Patient Protection and Affordable Care Act prohibits future physician investment in hospitals and caps existing physician investments in hospitals.[82] Also, as of 2012 several states completely bar non-certified public accountant (CPA) ownership in a CPA firm and most others place strict limitations on non-CPA ownership of firms.[83]

- Many states have laws that prohibit auto manufacturers from owning dealerships that were enacted in recognition of the potentially oppressive power of automobile manufacturers and distributors in relation to their affiliated dealers. The intent of these statutes is "eliminating industry practices which may be reasonably thought to operate unfairly or coercively" and are "designed to protect franchisees from having to succumb to dictation by manufacturers pressing their own interests in disregard of the health of other elements in the trade and perhaps ultimately of the welfare of the public."[84]

- Federal and state anti-trust laws serve to prevent monopolies and anti-competitive practices and prohibit tying arrangements, exclusive agreements, and price discrimination in other industries.

V. The "Not So Subtle" Corporate Agenda and A System Under Fire

"Corporations are not in business to be social-welfare organizations;
they are there to make money"
- *Dr. Ben Carson*

Despite its proven success, the alcoholic beverage control structure in the U.S. is becoming increasingly under pressure as large corporations and investment firms make a concerted push for deregulation to weaken the regulations that restrict vertical integration, common ownership, and mutual financial interests. The vigor of this push likely ebbs and flows from economic factors and the revelation that global and complex supply chains are precariously susceptible to economic downturns.[85] A turbulent business climate leaves corporations, who have an absolute fiduciary responsibility to maximize wealth, scrambling to gain control and a competitive edge. Thus, it is not startling that they chafe at the strict alcoholic beverage control systems when they think more money can be made with less public health or fair market regulations.

Opponents to the trade practice regulations generally argue that they are outdated because they conflict with free-trade policies; unnecessary because under the modern corporate form, parent and subsidiary companies are separate entities and one cannot influence the operations of the other; and, illogical because the complexities of modern business arrangements and the pervasiveness of investment funds renders them unenforceable. They suggest that integration or common interests amongst the segments of the alcoholic beverage industry should only be precluded if actual financial or administrative control can be concretely proven by regulators. They further suggest that passive or de minimis cross-ownership interests should be permitted. Though clever, these arguments are invalidated by reality.

Corporations are not breathing beings and are not capable of cognitive thought. Regardless of how complex a corporation's structure becomes, it is still ultimately comprised of people (stockholders) who significantly influence its activities by electing its board of directors to serve as an agent of their interests.[86] Diversifying a corporation into multiple subsidiaries does not diminish this influence; it extends it, as an ownership interest in a parent company also conveys an interest in its subsidiaries. Common ownership links are blurring firm boundaries as institutional investors, popularly referred to as "passive shareholders", become the single largest shareholder of corporate firms even though the individual ownership stakes of institutional investors in public companies are often 5% or less.[87] Evidence of actual practice debunks the claim that these interests are genuinely passive as it has been proven that managers of these firms "actively and regularly engage with their portfolio companies behind the scenes" in shareholder activism to influence the corporations in which they own shares.[88] Also, because they are the largest investors in most firms, their voting rights give them substantial power and control.[89] The consolidation in the asset management industry via many relatively de minimis overlapping ownership interests, implemented by simple unregulated acquisition of stocks by common shareholders, is economically equivalent to partial mergers and has potentially large anti-competitive effects.[90] "The most likely interpretation of the evidence is that firms, absent engagement, attempt to limit competition – their profits and survival depend on it."[91]

Admittedly, their ingenuity is applaudable. However, businesses cannot be permitted to use the guise of "modern corporate maneuvering" or shell games as an end-run around the very clear objectives of tied-house prohibitions and trade practice regulations. Accordingly, legislators and regulators should refrain from creating more exceptions to these regulations that would enable increased opportunities for vertical integration, common ownership interests, or the exertion of influence over the market. They should closely study efforts to amend tied-house restrictions to include a "de minimis threshold" for common ownership or common financial interests across segments of the alcoholic beverage industry and maintain a shrewd awareness that once a regulation is removed, reenactment will likely be impossible or, in the least, extremely difficult. Though appearing facially reasonable, "de minimis" is rather difficult to define and could further complicate enforcement efforts in today's marketplace where a seemingly small ownership interest of 5% or less actually equates to millions of shares worth billions of dollars and wields enormous power.[92] Empirical evidence shows that although isolated changes in alcohol control may have little effect, contemporaneous small changes will likely have a negative synergistic effect.[93] Also, it should be emphasized that implementation of prophylactic solutions to potential tied-house issues, rather than requiring state regulatory personnel to judge individual instances of common ownership and prove the presence of impermissible influence or control, is well within the power provided to the states by the Twenty-First Amendment.[94]

Having been mostly unsuccessful in the legislative arena across the country, those seeking deregulation have taken their plight to the courts in hope of obtaining a more favorable outcome. To date, the courts have largely refrained from inserting themselves into the policy making process as they "have long recognized that the State has broad power to control the liquor business and restrict the scope of its operation."[95] However, a small shift in judicial philosophy could irrevocably shake the foundation of the alcoholic beverage control structure that, for over eighty years, has effectively minimized the evils of alcohol in America while simultaneously enabling diversity, growth, and profitability within the industry. Some examples of current and past legal challenges to the tied-house prohibitions and trade practice regulations are:

Cadena v. TABC: In this case, pending a ruling by the Texas Supreme Court, Cadena ("OXXO") is challenging the Texas Alcoholic Beverage Control's ("TABC") denial of its retail alcoholic beverage applications due to cross-tier ownership. OXXO, a convenience store chain, is the wholly owned subsidiary of FEMSA who, through several intermediary companies, also holds a non-controlling 20% stock interest in Heineken brewer's two parent companies and appoints 20% of the members to their Boards of Directors. OXXO and its amici argue that: (a) "the *sole concern* of tied-house statutes is the avoidance of monopolies and cross-tier control;"[96] (b) "the relationships are "simply too remote and attenuated to implicate historical tied-house concerns relating to control;"[97] (c) "the only interest sufficient to offend the tied-house prohibitions is one that would allow actual financial or administrative control among the tiers;"[98] (d) "mere stock ownership, regardless of the extent of that ownership" does not give rise to a prohibited interest "in the business of a subsidiary unless the corporate veil is pierced;"[99] and (e) "given the complexities of modern corporate relationships and the prevalence of mutual funds and similar types of investments, it would be practically impossible to enforce the statute against every violator."[100] However, the Court of Appeals ruled against OXXO finding that "a permit to manufacturer, distribute, or sell alcoholic beverages is a *privilege* granted by the legislature" and "the legislature's expressly stated intent is to strictly prohibit *any* overlapping ownership and related practices… that give rise to the potential for influence and inducement."[101] The Court clarified that the term "interest" must logically extend beyond ownership interests and "broadly encompasses any commercial or economic interest that provides a stake in the financial performance of an entity engaged in the manufacture, distribution, or sale of alcoholic beverages… while controlling interests certainly run contrary to that objective, the legislature seems to have viewed even the potential for a lesser degree of influence and incentive arising from a prohibited interest to also be incompatible."[102] The Court pointed out that "veil-piercing principles are inapplicable to regulatory regimes" as the economic realities underlying the transaction at issue should not be disregarded.[103]

Notably, Heineken acquired OXXO parent company's Mexican beer operation in 2010 in a stock deal valued at $6.91 billion and OXXO has more than 10,700 stores in Mexico that represent about 15% of Heineken's sales volume in the country.[104]

Wal-Mart Stores Inc. v TABC: In this litigation pending in the Western District of Texas, Wal-Mart and three of its subsidiaries are challenging state laws that prevent them from holding numerous retail alcoholic beverage permits or from holding multiple permit classifications. Wal-Mart is arguably completely unconcerned with or oblivious to the social consequences of a market full of cheap alcohol as they claim that they "help people save money and live better by purchasing quality products at competitive prices."[105] It is clear that the company is primarily focused on boosting alcohol sales at a time when chains are facing tough web-based competition because alcohol tends to draw shoppers to stores.

McLane Co Inc. v. TABC: In this litigation pending in the Western District of Texas, McLane, a wholesale dealer, is challenging a state law that prevents it from having common ownership interests with licensees in the retail segment. McLane is indirectly wholly owned by Berkshire Hathaway, an investment holding company, which holds stock ownership in Wal-Mart and Costco equating to tens of millions of shares valued at over $3 billion. They argue that TABC, in its enforcement of a statute that expressly prohibits any common ownership interest, has "taken the three-tier system to an absurd and unlawful extreme."[106] Prior to filing this litigation, McLane had unsuccessfully attempted to obtain a safe-harbor or de minimis exception to the clear tied-house prohibition from the Texas legislature.

New Midwest Rentals, LLC v. Iowa Alcoholic Beverage Division. In this 2016 case, New Midwest Rentals, LLC ("NMR") challenged the refusal of the Iowa Alcoholic Beverage Division ("IABD") to renew its retail beer permit upon learning that the owner of NMR had an ownership interest and a managerial relationship with a California winery. IABD based its refusal to renew the retail beer permit on a state tied-house statute that prohibits cross-tier ownership interests. NMR argued that the legislative intent behind the statute was limited to prohibiting manufacturers of a particular beverage from controlling retailers of the same beverage and that the legislative intent is not advanced by prohibiting a wine manufacturer from owning or operating a convenience store that only sales beer. However, the District Court upheld IABD's denial because the words of the statute unambiguously prohibit wine manufacturers from owning or operating a retail beer outlet and there is no exception for a retail beer outlet that does not sell wine. The Court noted, "[i]f the legislature had intended to create such an exception, it would have done so by amendment" and "whatever its benefits, alcohol certainly carries risks."[107]

Auen v. Alco Bev. Div.: In this 2004 case, a challenge was brought against an administrative rule promulgated by the Iowa Alcoholic Beverage Division ("IABD") that further defined the phrase "directly or indirectly be interested in the ownership" with the intent of removing from the tied-house restrictions remote corporate connections and certain instances of cross-tier ownership between members of different segments of the alcoholic beverage industry and their subsidiaries or affiliates. The Iowa Supreme Court held that the IABD's rule was invalid because the underlying statute did not permit it to promulgate a rule allowing a tied-house arrangement between industry members, their subsidiaries or affiliates, and retailers even where the relationship is remote or de minimis because by choosing the language "directly or indirectly be interested in the ownership" the legislature meant to prohibit any ownership interest, no matter how remote or de minimis.[108]

In the Matter of Rihga International v. New York State Liquor Authority: In this 1994 case, Righa Royal Hotel ("RRH") challenged the denial of a retail alcoholic beverage permit due to cross-tier ownership resulting from three unrelated alcoholic beverage manufacturers holding indirect ownership interests that each aggregated less than 10% in the ownership of RRH. RRH argued that the manufacturer's ownership interest were de minimis in size and RRH agreed to refrain from purchasing the products of the stockholding manufacturers. Thus, the denial of its retail alcoholic beverage permit failed to fulfill any statutory objective. However, New York's highest court found that the denial was proper even if the interests were de minimis because the legislature, which had previously amended the operative statute twice, did not grant an exception. The Court noted, "it is for the legislature, not the courts to update the provisions and restrictions."[109]

S.A. Disc. Liquor Inc. v. TABC: In this 1983 case, a Texas alcoholic beverage retailer challenged a law that prohibited it from selling wholesale quantities of alcoholic beverages to out-of-state purchasers for resale. The retailer argued that the prohibition violated the commerce clause and was an impermissible exercise of police power. The Court disagreed and held that the restriction was permissible as it eliminates the possibility of tied-house relationships or vertical integration and thus prevents companies with monopolistic tendencies from dominating all levels of the alcoholic beverage industry.[110]

Affiliated Distillers Brands. In this 1970 case, Affiliated, a wholly owned subsidiary of alcoholic beverage manufacturer, Schenley, sought to wholesale the parent manufacturer's products to retail dealers in New Jersey, but was stopped from doing so by a NJ tied-house statute prohibiting cross-ownership between the manufacturing and wholesaling tiers of the alcoholic beverage industry. Affiliated argued that the prohibition violated due process and could not affect temperance because it only dealt with stages of distribution that were removed from the consumer. However, the NJ Supreme Court upheld the law as constitutional because:

> [t]ied-houses between manufacturers and suppliers are not so remote from the ultimate consumer that increased sales could not result… If Affiliated could operate as an arm of Schenley without profit or at a small profit, other wholesalers would be unable to compete in sales of Schenley products to retailers. At the same time, sales stimulation at the retail level (due to a retailer's large profit on Schenley products) would result in a larger share of the market for Schenley.[111]

The Court noted that "[t]hough equal protection and due process challenges are applicable to actions arising in this area, these protections must be viewed in light of the broad power of the legislature to regulate the sale of intoxicating beverages."[112] The Court further commented: "The statute fosters temperance and helps stabilize the liquor industry and in setting its policy the legislature accepted widely held views as to sound liquor control aimed at preventing practices that are undesirable in the liquor field as tending to stimulate consumption."[113]

VI. Conclusion

"Those who cannot remember the past are condemned to repeat it."

- *George Santayana, The Life of Reason, 1905-1906*

To clearly understand where we are and logically plan where we are going, we must first fully comprehend where we have been. We must not arrogantly assume that we have eternally eradicated the root of our forebears' woes and we must not become ambivalent to their plight, lest we find ourselves right back where they started. The current commonly held belief by some in the alcoholic beverage industry that the "free market" alone is now the panacea for society's alcohol related tribulations is a wonderful figment of utopian desire, but as elusive as the proverbial green light at the end of the dock. Should we commence down the path of deregulation under this pretext, we will undoubtedly be borne back into the past.

"In recent years, discussions of alcohol policy have too often ignored or downplayed the need to understand both the nature of the agent and its harmful properties, with an implicit acceptance of the idea that alcohol is only an ordinary commodity like any other marketable product."[114] They have disregarded the facts that the centuries old problems related to alcoholic beverages have not dissipated, and the well settled goal of the business firm to maximize profits remains key. The economic and social impact dichotomy concerning alcohol has not been absolved and a strong public sentiment that alcohol is not a run-of-the-mill consumer product still prevails. Although two-thirds of American adults drink, the wide-spread consensus is that "the public is better served by well-ran companies that emphasize responsibility rather than hawking huge volumes of cheap swill to get the masses drunk."[115]

There is absolutely no merit to arguments that the alcoholic beverage trade practice regulations, aimed at preventing a recurrence of the pre-Prohibition tied-house, are outdated or no longer necessary. As the recent evidence discussed herein has shown, businesses still tend towards tactics that minimize competition and increase control over the market, even in a highly-regulated environment. Thus, one can only imagine (or simply look to the occurrences in the U.K. and Mexico for a concrete example) the measures they would take towards this end in a deregulated and unencumbered marketplace. Moreover, the evidence discussed has demonstrated that vertical integration, even if only minimal or "de minimis," in the alcoholic beverage industry still presents significant negative societal consequences. The data is clear that alcohol controls affect the rates of alcohol-related problems.[116] For these reasons, the Louisiana Third Circuit Court of Appeals confirmed the ongoing value of the three-tier system, and the trade practice regulations that facilitate it, by noting:

> Without the three-tier system, the natural tendency historically has been for the supplier tier to integrate vertically. With vertical integration, a supplier takes control of the manufacturer, distribution, and retailing of alcoholic beverages, from top to bottom. The result is that individual retail establishments become tied to a particular supplier. When so tied, the retailer takes its orders from the supplier who controls it, including naturally the supplier's mandate to maximize sales. A further consequence is a suppression of competition as the retailer favors the particular brands of the supplier to which the retailer is tied to the exclusion of other suppliers' brands. With vertical integration, there are also practical implications for the power of regulators. A vertically integrated enterprise comprising manufacture, distribution, and retailing is inevitably a powerful entity managed and controlled from afar by non-residents. The three-tier system was implemented to counteract all of these tendencies.[117]

Although the periods of Prohibition and Repeal have faded into the abyss of collective memory and are now merely an abstract concept for most Americans, the issues and concerns that gave rise to them remain very real. Just as we continue to take public health precautions against a recurrence of contagious diseases such as the Plague that wreaked havoc across the globe centuries ago, so to should we continue to enforce regulations aimed at preventing a recurrence of America's pre-Prohibition alcohol epidemic. Free-trade and capitalism work well to maximize consumer welfare with regards to most commodities and less government interference may be viewed ideal. However, history has proven time and again that this is not the case when it comes to alcoholic beverages where strict government regulation is essential to reconciling the non-synergistic social and economic interests. For-profit corporations have a fiduciary responsibility to increase return on investment; there exists no parallel duty of social responsibility. Thus, it is incumbent upon government to shield society from the harms and costs associated with excessive use of alcoholic beverages. The past is replete with examples of people duplicating the failures of their predecessors, and they suffered similar consequences. America cannot afford to let this be the case with alcohol control. Undoubtedly, many will continue to view the uniquely American alcoholic beverage control laws as illogical. Nevertheless, the regulations are squarely rooted in the tragic experience of our ancestors; they are not the brainchild of fanatical moralists– hence, the logic is timeless.

Endnotes

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