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&

DISTRIBUTOR PRODUCTIVITY LETTER

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Rodman v. Jaglom

Filed on September 1, 2003



Dear Client:

This is a bit of a departure from our usual editorial at Beer Business Daily, but as yesterday's report on the weather and Kosher beer illustrates, the end of summer gives us some breathing room to become more philosophical in our coverage.

There is little doubt that the most important issue facing the beer industry in the U.S. today is how recent court decisions will affect the future of the three tier system. Federal courts in several states have weighed-in on the matter thanks to wine drinkers who wish to purchase their wine direct on the Internet.

With the exception of Indiana, the circuit courts have consistently ruled that direct shipping exemptions for in-state wineries are unconstitutional, since the so-called Commerce Clause of the Constitution prohibits states from creating laws which favor in-state companies.

With this in mind, we have brought together two regular contributors to Beer Business Daily, who are among the best strategic and legal minds in the business, to debate the issue. Mark H. Rodman of Beverage Distribution Consultants is an industry consultant who has kept his active mind in this issue for the better part of forty years. Drew Jaglom is an attorney specializing in distribution (See contact information at sidebar).

Ed. Note: While this issue is long, it is arguably the most important issue facing the three-tier system, not only for distributors but for small and medium sized brewers. I would encourage you to read it in its entirety (I know Rodman runs long, but his points are valid).

THE DEBATE BEGINS

Beer Business Daily on August 28th quoted its regular legal expert Drew Jaglom of Tannenbaum Helpert Syracuse & Hirschtritt LLP. BBD note Drew has repeatedly warned in BBD pages that in-state exemptions to alcohol control laws are the weak link in state three-tier regulations, as they are readily seen by judges to violate Commerce Clause provisions.

RODMAN TAKES EXCEPTION TO JAGLOM'S EXCEPTION FOR SAVING CONSTITUTIONALITY—CARVE OUTS OF SMALL BREWERS: I don't disagree with your take as Harry published it and in an earlier statement of your position in our ongoing debate on the future of the 3-Tier system. You said:

"...the fundamental issue [is] there is nothing wrong with a mandated three-tier system, including requiring retailers to buy from wholesalers, so long as the mandate is even-handed. That is pretty clearly protected by the 21st Amendment and indeed is probably within the powers of a state even without that constitutional grant of authority."

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Our Panel

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My problem is your “solution” lacks legal, business and political pragmatism.

Equally troublesome, at least for me, is your low level of concern about the consequences of a carve out for all small brewers regardless of whether they produce in-state or out-of-state....

First, I seriously doubt industry lobbyists and empathetic politicians can dredge up competent, persuasive economic evidence to support in reliable fashion a bright line neatly delineating between those “small” producers and their brands that are likely to have difficulty finding distribution and those though “small” who but don’t. If maturity hasn’t yet impaired my recall that would mean some 1,430 US small micro and brew pub producers could sell direct to consumers and fewer than 20 would be subject to a ban. The placement of any such bright yellow brick road to retail trade acceptance and consumer popularity seems patently arbitrary and capricious. For starters, just look at the composition of the “Hot Brands” lists over the past decade. Yesterday’s “less than 60,000 bbl. brewer”, with only local civic pride patronage going for it, today is fast approaches the 1.4MM bbl. mark and qualifies as one of America’s 4th-5th-6th largest brewers. And of the same “barrels-to-best-of-breed” heritage are once tiny Sierra Nevada, Spoetzi-Shiner, Bridgeport, Alaskan, Fat Tire and once upon a time even Leinenkugel and Sam Adams

And, there is what I call the “Point/Frederick/Iron City/Dogfish dilemma”, brewers who’ve no trouble getting distribution within one state or region, but hit a solid brick wall other places. The hot-and-cold, geographic checker board experiences of the 4 just named brewers clue why lesser tests of smallness and therefore the likelihood of distribution difficulties don’t work either whether the measure be stated in terms of some fractional market share or a preferential quota of 5-, 10- or 15,000 annual barrels.

Noteworthy also is the \$660,000 so-called Small Brewer FET Exemption is completely lost once a brewer-control group hits an aggregate 2MM bbls. Why shouldn’t the line be drawn at that point? Because, the practical effect would be only the three major domestic giants and their biggest import rivals would be subject to differential treatment. Practically, no way that’s going to happen!

An analogy works here: If the big industrialized nations can’t short of fisticuffs carve-out tariff and trade barrier exemptions for tiny, emerging nations –even to raise their health and living standards to morally acceptable levels--, no way the big beer producers gratuitously are going to let a single emerging rival or brand catch a break. And thus far I’ve mentioned only domestics. But, as you know, increasingly global beer marketers are digging deep into their worldwide portfolios to launch in this county labels little known in the USA and without the slightest of followings in even the biggest, most diverse USA imported beer markets. The most recent illustration I’ve heard about is a label from Brazil called “A Marca Bavaria”, which starts small but rapidly gains acceptance. Should we extend “small brewer” exemption to such a label brought to market by a deep-pocketed multinational? Before saying “yes” recall the once teeny-weenie shares held by Presidente and Pilsner Urquell. And, if 50 states’ worth of small producer pleas for carve-outs for their beers come forth trying to painlessly to solve a constitutional impasse, it’s a certitude the wine and spirits people won’t stand idly by. One needs to take account of the implications of the fact that more than a handful of today’s top-dog high-end niche vodkas began their climb to prominence with sales of only a few thousand cases.

The Wall Street Journal pointed me to a site called Vodka.com, which now lists 500 vodka brands. Some are elite and arcane from Russia and USA market mavens with established clout. Others are born in a slew of United Nations members with miniscule chances of any but nationalistic followings Is there sound reason for Congress and each state to newcomer copy-cats among the gourmet spirits entrepreneurs of the world the same treatment so they can go where the Gray Goose goes?

JAGLOM ANSWERS: You miss my point with your rhetoric. While a small brewer remains small, they’re exempt. When they grow big enough, they’re not.

And a bright line is no more arbitrary and capricious than saying if you steal something worth \$499 it’s a misdemeanor, but if it’s worth \$500 it’s a felony. Any line is arbitrary at the margin, but they are drawn and upheld all the time.

RODMAN REJECTS SMALL IS GOOD, BIG IS BAD: Sure, but we're not talking about the penalties for kiting checks or speeding. We're addressing inevitably "protectionist" economic policy rules for regulation of mainstream legal commerce. Public safety and health are equally impacted whether or not beer is treated the same as wine and spirits and whether drinkers and retailers selling to drinkers can buy direct.

The issues are closer to the culpability of Enron's and World Com's bankers and corporate lawyers than to armed robbery and murder. Simply, now that computers can track shipments to and from any where in the world and assure tax collections, we're talking victimless "white collar crime".

My view is the industry must convince state politicians where to draw a line. I submit a modicum of persuasive, competent proof will be called to support where the divided treatment kicks in, because I assume you'll concede in a small players' exemption to direct shipping it is feasible to argue that even though not facially discriminatory or protectionist, "as applied" such formulations as you suggest discriminate again and burdens with competitive disadvantage those few big nationwide marketers who fall above the bright line. It's the regulations not the banned business practice that creates a victim.

The big domestic guys and their foreign counterparts lose the business opportunities of selling direct, and national power retailers are deprived of the business opportunities of access to their popular brands at lower delivered costs. Your formulation's "protectionist" tendencies then call for scrupulous examination of the true motivations behind the legislation, the evidence submitted to justify and support its ends, and then "strict scrutiny" becomes the test.

Since when under the Commerce Clause, due process and equal protection can a state proclaim "big business" doesn't get to play on a level field under the same rules that govern their small business rivals?

Indeed, I know of only one Supreme Court opinion back in the Arab Oil Embargo days of the early 1970s where a state law rigidly structuring a consumer goods industry to prohibit vertical integration into retail was upheld, despite the reality that only "victims" of the Maryland rule were the 17 major worldwide integrated oil companies

To be straightforward, rules are inherently simple and the exception to the direct ship prohibitions dangerously over-simplifies a highly complex and profound and highly polarized problem of political-economy on which even experts militantly disagree: Are the 70-year old reasons for state mandated 3-Tier systems stale and outmoded and unjustifiably stifling consumer choice, denying retailer efficiencies, and deadening interstate and global market forces?

JAGLOM RETORTS: I'm not convinced. The standard for legislation under the state's general police power, let alone the 21st Amendment, is that there be a "rational basis" for the legislation, not your "competent, persuasive economic evidence to support in reliable fashion a bright line neatly delineating . . ." (Why am I not surprised that you make a two word standard into a lengthy paragraph?)

Surely there is a rational basis for determining that small wineries or brewers have difficulties obtaining distribution that larger suppliers do not. Or, moving to the franchise law context, that distributors need protection against the superior market power and bargaining leverage of large suppliers that they do not need when dealing with smaller ones.

Different states may well draw the lines differently, but I don't see that as a problem, any more than it is a problem that the states with general business franchise registration laws (not beer laws) define franchises differently, or that California exempts franchisors with a net worth of more than \$5 million, while in North Dakota it's \$10 million, and other states have no net worth exemption at all.

But do go on . . .

NOT TO DISAPPOINT, RODMAN CONTINUES: Earlier in this brief reply [Ed. Note: this is

sarcasm, I take it], I used an important adjective, namely “reliable”. I use it because if your solution is followed, ostensibly “protected” small brewers would have to make sizable investments of their already sparse resources in a shift to the various direct distribution options. And in doing so, they certainly will have to forego opportunities by burning bridges with their middle tier. Can the small producers truly rely on the constitutionality of a carve-out for them?

Thirty eight years of experience teaches me, once a small marketer dives into the thicket of direct distribution —either to consumers or to power retailers—there is no going back to distributors, especially in bottle law states. For them, I sense your “solution” is in reality a nightmare. Finally, there are two other absolutely, positively critical concerns that most fear to mention. Not me. While I concede your “solution” is an overdue band aid, which our national and state beer trade associations need apply quickly, it does little to overcome the appeal by the real players in the “direct shipping” controversy.

These strategic thinkers realize if, under the 21st Amendment or with pure Commerce Clause wisdom, our industry can’t successfully defend direct-to-consumer prohibitions, there will be no victory for beer people when comparable constitutional grounds are used to attack bans on direct-to-licensed-retailer transactions and logistics. The passion play characters I allude to are the wannabe direct buying big box retail chains and the giant economies-of-scale-driven suppliers who yearn for this high-volume, low-delivered cost chain business. Your solution fails to address the core theme of their still fledgling media and political attack on state mandated 3-tier systems, namely rules are responsible for an outmoded “mind-boggling mishmash of state rules and regulations”.

Imagine the truly Rube Goldberg maze were a single large state to choose to exercise its police power to define a qualifying “small brewer” as one annually producing less than 5,000 bbls., while 3 others set the bar at the 15,000 bbls. and another 10 exercise their states’ rights discretion to apply the FET head-start of 60,000 bbls! Here the solution you offer doesn’t resolve but exacerbates the present situation.

Just look at the heavy hitters the adversaries have brought to the table, starting with some cable TV and an appearance in Washington sure to catch Congressional, FTC and international media attention. The pro-direct shipping roster includes Clint Bolick, counsel in the Virginia and New York cases along with Free the Grapes new counsel former appellate judge and Independent Counsel, Ken Starr. Defending state rights to control alcohol is conservative scholar and Swedenburg advisor Judge Robert Bork and former White House counsel, Washington insider and outside counsel to WSWA, Boyden Gray.

Wow, were I to only earn 15% of their collective hourly legal fees. I wonder who is paying this big freight and what is the expected return on that investment. Do they make that kind of money in Benton Arkansas?

Worse, [the solution you offer] hands even more system-killer ammunition to global drinks marketers like the DISCUS/World Spirits Alliance people. Their avowed priority starts with the view such state laws violate US trade treaties made by the Administration, ratified by Congress and embodied in “implementation” acts passed by a free-trade House and the Senate. They argue in effect that such laws must fall under the Supremacy Clause of the Constitution.

I tend to agree that is the primary peril of globalization, the apparently undiscerning US government drive to embrace free trade and market access while overriding local and small business interests, and DISCUS/WSA’s expectation that the European Union members will drive deregulation of the US drinks business.

The EU-headquartered drinks companies see nothing but facial and “as applied” conflicts between state alcohol laws and the US Constitution’s “Supremacy Clause” --as implicated by its provisions regarding the Executive’s treaty-making powers and Congress’ authority under the Import-Export Clause.

They assert in effect the 21st Amendment’s supposedly plenary empowerment of state alcohol control rules is irreconcilable with these provisions “in the same Constitution”. And so, whatever band aid you want to apply to save state’s rights under the Commerce Clause also

has to pass muster under the Constitution's provisions giving the federal government exclusive jurisdiction to regulate foreign trade.

Your "small business exemption" gets a "D-" in that test. Worse, than that, our trade representatives completely let our government's trade treaty policies get ahead of conflicting state law under what is called "Fast Track". But that's another critique for another time in September. For now I simply say, rather than being debated in Congress, which Fast Track say it can't, the constitution conflict over US trade treaties' "non-tariff trade barriers" that are embedded in state 3-Tier laws can and likely will first come to a head in private civil litigation. This grumpy old curmudgeon's speculation is the most plausible venue will be an attack on state regulatory regimes resting on their practical negative effect on some behemoth EU drinks supplier's efforts to consolidate and downsize its US distribution system.

Using the currently popular "spin cycle", the argument will be the contested state law "in practical effect" is extraterritorial in application and all but vetoes the multinational supplier's capacity to become more efficient, productive, and competitive in "a seamless global market".

ONE LAST NOTE FROM JAGLOM: The "nightmare" for small brewers is a red herring. No one is talking about requiring the little guys to go direct, only permitting them to do so if they choose.

And the concern of direct to retail and GATS are legitimate, but a small supplier/large supplier distinction at least makes the direct-to-retail scenario less pervasive than if the entire law goes down.

As for GATS, the question of whether the President and Senate can by treaty void state decisions made under the 21st Amendment is an interesting one, whose resolution is not at all clear. But if GATS supersedes the 21st Amendment, the implications are dire for control states and all three tier structures, whether they discriminate between in state and out, small suppliers and large, or not. So let's fix what we can now.

Ed. Note: And I thank both Mark and Drew for taking the time to debate this important issue for our readers. Which position do I favor? I'll leave that to another issue of BBD since we are way over our usual length. Remember that we gain a sell day at the end of this month.

Until tomorrow, Harry

MTD Sell Day: 1 Sell Days This Month: 22 Sell Days This Month Last Year: 21

YTD Over/Under Sell Days: -1 .. This Month Ends on a: Tue .. Last Year This Month Ended on a: Mon.



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