

## The “E-Tier” System The Cutting Edge of Alcoholic Beverage E-Commerce



By Sara Schorske

DEMAND IS strong and constantly growing for alcoholic beverage e-commerce. Consumers are falling in love with shopping on line. Wine sellers, excited about the huge internet marketplace, are eager to offer Web-savvy, sophisticated wine drinkers the wines they want and can't get any other way. But as the future of wine on line rushes to meet us, longstanding regulatory barriers still stand in the way.

Many great minds, and some deep pockets, are working to level those barriers (or at least tunnel through them). I have had the privilege of helping many of these intrepid business people. And I have found that, no matter how sophisticated they are, none of them has ever been quite prepared for the enormity of the legal obstacles they confront. Thankfully, great minds are not easily discouraged!

In the hopes of expediting the ultimate success of their efforts, and empowering many more people to join in

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the creative effort, this article is dedicated to explaining the obstacles in depth. Knowledge is power. Let's use it!

### **Where Are the Battle Lines Drawn?**

In the early days, wineries pinned their hope on the concept of reciprocal shipping: a user friendly way to ship wines to consumers on a very limited scale. That approach gradually lost favor with both the regulators and the suppliers, the regulators, because the flow of wine under reciprocity was impossible to regulate, and the suppliers, because the channel was so restricted. Many of the reciprocal laws exclude retailers (the biggest segment of the direct shipping market), half of them prohibit advertising, and all of them severely limit the quantities that can be shipped. Reciprocity is a wonderful support to tasting room sales, but you can't base your business on it!

Since the limitations of reciprocity began to be apparent, the battle has spread to many fronts. In some states, efforts to enact shipper's licenses have been successful. A variety of companies have attempted to blaze a path through the three tier system. Beer Across America and Geerlings & Wade were two early pioneers using different three-tier approaches. Cellarmasters was an example of a company that aspired to streamline the cumbersome process for small wineries by serving as a middleman. They tackled

the regulatory negotiations, logistical complications, and compliance reporting so each small winery wouldn't have to. More recently, the wholesale tier has gotten involved by supporting WineShopper, an internet-based wine shopping service using the three tier model.

Free trade organizations continue to make progress waging the freedom fight in federal courts around the country. Their efforts are based on the theory that judicial interpretations will eventually catch up with American culture and rule in favor of freer commerce in alcoholic beverages across state lines. Rather than approaching the courts on behalf of suppliers seeking to open the doors of free trade, these organizations have enlisted consumers and their lawyers to challenge the barriers.

There is another option being pursued today. Some suppliers have adopted the practice of consummating sales to out of state consumers in the supplier's state, arranging for the consumer to take possession in the supplier's state, and referring them to a service that helps the consumers to ship their wine to themselves. This plan takes the supplier off the firing line and keeps the shipments so small and so widely scattered that the chances of interception by the Law are slim to none. Even if such a shipment is ever seized, the loss of the case of wine is the only risk. No regulatory

agency is going to sue its own citizens, or send them to jail. This option works, but it is a hassle for the customer, so most suppliers see this strategy as a stop gap measure, useful only until a better solution can be found.

### **The Razor's Edge: Selling Through the Three Tier System**

For now, the torturous process of selling through the three tier system remains the only legal way to reach consumers in many states. States like New York and Florida are too good to ignore just because they've resisted reciprocity and have no shipper's licenses. Therefore, the rest of this article is going to focus on the obstacles within the three tier system that face suppliers who "try to do it right."

A single winery could conceivably take on this challenge, but it's not likely. Any winery large enough and with enough resources to tackle a problem of this immensity probably already has such good market presence that it doesn't need to depend on direct shipping. Therefore, my clients in this area are more likely to be wineries' customers: catalog and internet

merchants who want to feature your wine, along with many others, on their order forms. These folks aren't vintners, but they are an important part of the wine business, and their success helps the industry as a whole.

What are the obstacles they face? Here is a bird's eye view. If you are faint of heart, grab a glass of wine now, before you proceed!

### **Sidetracked by "At Rest" Laws**

Ideally, a winery or retailer would like to receive an order and promptly ship a box of wine straight to the consumer's home or office. But direct shipping through the three tier system is a euphemism at best, because the shipments are often anything but direct.

Thirty six states have an explicit or implied "at rest law." These laws require wine coming into the state to "come to rest" in a wholesaler's warehouse. In many cases, the time spent at the wholesaler's warehouse can be minimal. In some cases, at rest laws may be satisfied by "kissing the dock." But some of the laws require a stop-over of 24, 48, and even 72 hours be-

fore delivery to a retailer. This adds time and logistical complications to every shipment.

### **"Primary Source" Monopolies**

Thirty-two states have either a primary source law, or a brand registration requirement with an identical effect. Primary source laws require in-state wholesalers to purchase wines only from the manufacturer or the manufacturer's exclusive agent. Some states interpret this requirement to apply to the entire country; in those states, wholesalers must buy from a national marketer or manufacturer only. Others will allow a supplier to sell into their state as long as the supplier has exclusive representation of the brand in that state. In no cases can there be more than one primary source for a brand in a particular state.

Primary source roadblocks are encountered in a variety of ways. One of the most common is this: A winery already sells its wine in a particular state. An internet marketer calls and wants to cut a deal to offer a particular product on its web site. What could be greater, right? How often do retailers come to you with a big order?

The problem is, if the marketer uses a three tier scheme to sell into that state, he will be subject to three tier restrictions. Your winery is already the primary source, and there can't be two of those in one state! Especially if the state has a brand registration requirement (and 29 do), primary source laws present a real challenge.

### **Franchise Hoops to Jump Through**

Thirty-six states have franchise laws that regulate the relationship between suppliers and wholesalers. These laws range greatly in the regulatory obstacles they represent. Some are simply a matter of notifying the authorities of your chosen distributor (and sometimes, its assigned territories). Others specify wholesaler-favorable procedures for changing distributors or modifying the terms of your agreement. A handful of states have such strict franchise laws that it's literally easier to reincarnate than it is to change distributors.

Franchise laws have a huge effect on three tier e-commerce, because by definition three tier strategies depend on the use of a wholesaler in each state to clear the order (report the gallonage, pay the taxes, and deliver to the re-

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tailer). This presents two problems for wineries. First, if the winery already has a wholesaler in the state, an e-tailer selling its wine is constrained to respect the existing relationship. Second, and just as worrisome, if the winery doesn't have a wholesaler in the state, the e-tailer's choice of wholesaler may commit the winery to a future relationship with that same wholesaler, should it ever decide to sell through conventional channels into the state. Neither wineries nor wine e-tailers can afford to underestimate these problems.

### **Licensing and Reporting Burdens**

You've heard of "fine print," haven't you? The fine print is the part of any otherwise great deal that confirms the feeling "this is too good to be true." In three tier direct shipping, the requirements of supplier licensing, along with the associated responsibilities of price posting, label registration, and shipping reports, are the fine print. Each internet or mail order marketer that plays by the three tier rules is subject to the bewildering array of compliance reporting requirements. Unfortunately, in order to have a wide selection and a changing assortment of products, the marketer may face a pile of paperwork whose sheer magnitude and complexity cannot be justified by the quantities of each item being sold. This is especially true for marketers who specialize in rare wines.

### **Delivery Hassles**

Some three tier marketers follow the Geerlings & Wade lead and become retailers in the states where they sell. But even three tier marketers who use independent retailers to consummate the final phase of their sale face the challenges of state laws that regulate alcoholic beverage delivery.

Many states have laws affecting the means by which a retailer may deliver. In some states, retailers can use common carriers (although in some of these, the regulatory burden placed on the carriers is significantly daunting).

In some states, retailers can deliver with their own trucks. Again, restrictions apply! For example, in Maryland, a retailer may deliver only within the county where it is located, and in Maryland, counties are pretty small. In Colorado, there is a detailed procedure that must be followed by any retailer making deliveries. In Oregon, deliveries cannot be made the same day the order is taken (unless delivered by an on-

sale retailer delivering a meal at the same time).

In other states, deliveries are strictly prohibited. In these areas, consumers must literally go to the package store to pick up their order. If that isn't a wet blanket on "direct shipping," I don't know what is!

And that reminds me: e-tailers that plan to get retail licenses had better be prepared to have at least a minimal storefront operation. Nearly every state requires that the retailer be prepared to service consumers on a drop in basis. So far only two I know of—Washington State and Texas—recognize the legality of a purely internet based retail licensee.

### **"Tied House" Nightmares**

Loyal readers of this column are already familiar with the term "tied house." For newcomers, tied house refers to legal restrictions on the relationship between manufacturers or wholesalers and retailers. The restrictions apply both to ownership interest and to "things of value" given in the course of business. Both kinds of restrictions must be considered by three tier marketers.

First, ownership restrictions: In California, it is legal to hold both a retail and a wholesale license. There, many catalog and internet retailers also act as wholesalers, either to supplement their retail business with sales to restaurants, or to better control their source of supply. That's great as long as the company operates only in California, but it can be a major problem when expanding into other states.

Every state has tied house restrictions on ownership interests. In almost all states, a company can hold either a wholesale or a retail license, but not both. In some cases, the states are concerned only with conflicting licenses held within that state. But other states look beyond their own borders. Those states will not issue either a retail or a wholesale license to a company that already holds both elsewhere. The company is prohibited from getting a retail license because of its existing wholesale license. And it's prohibited from getting a wholesale license because of its existing retail license.

Second, things of value: Many three tier marketers are suppliers who rely on independent retailers to complete the last leg of the transaction for them. But is it legal for the marketer, as a supplier, to solicit sales and provide orders to the retailer? The three tier marketer must convince state regulators that it is.

### **Finally, Helping Is in the Wholesalers' Best Interests!**

Traditionally, wholesalers have been the wine industry's biggest foe when it comes to direct shipping. Lately, however, they have been promoting WineShopper, their solution for helping direct shippers reach their customers through the three tier system. And a few months ago, WineShopper joined forces with its largest winery-backed competitor, Wine.com.

Finally, what's in the wholesalers' best interests is beginning to coincide with the wineries' and consumers' best interests. Finally, they have a vested interest in using their considerable political clout to promote legislation lightening some of these burdens. What about an exemption from brand registration for an item available in limited quantity on-line only? Similar exemptions could ameliorate other particularly troublesome requirements, as long as reporting and taxes are not jeopardized, and everyone in the "e-tier" system gets their cut of the action.

It's the best thing they could do for direct shippers who are trying to play by the rules. Tell a wholesaler! ❀