



## Legislative Fiscal Bureau

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Joint Committee on Finance

Paper #331

### **Three-Tier Liquor Distribution System (General Fund Taxes -- Excise Taxes and Regulation of Tobacco and Alcohol)**

[LFB 2005-07 Budget Summary: Page 213, #3]

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#### **CURRENT LAW**

Under current law, alcohol beverages are generally distributed to consumers under a three-tier distribution system: the manufacturer may sell only to a wholesaler or rectifier; the wholesaler or rectifier may sell only to a wholesaler or to a retailer; and the retailer may sell only to the consumer. With specific exceptions, no person may sell outside of the three-tier system. The Department of Revenue (DOR) issues intoxicating liquor wholesalers' permits authorizing the sale of intoxicating liquor at wholesale from the premises described in the permit to intoxicating liquor retailers and to other wholesalers. With limited exceptions, a manufacturer may not hold any direct or indirect interest in a wholesaler and a manufacturer or wholesaler may not hold any direct or indirect interest in a retailer.

Current law also provides that any person who violates any provisions of Chapter 125 of the Wisconsin statutes (which regulates alcohol beverages) for which a specific penalty is not provided is to be fined not more than \$1,000 or imprisoned for not more than 90 days or both. In addition, a court may revoke a license or permit issued to a person under Chapter 125. However, if a person is convicted of a felony under Chapter 125, in addition to the penalties provided for the felony, a court must revoke any alcohol beverage license or permit issued to the person. Finally, DOR has general authority to, after notice and an opportunity for hearing, revoke, suspend, or refuse to renew a permit issued under Chapter 125 for any violation of the provisions of Chapter 125 or Chapter 139 (which imposes state taxes on alcohol beverages).

## **GOVERNOR**

Modify current law with respect to the three-tier liquor distribution system as it relates to wholesale sales of intoxicating liquor (wine and distilled spirits).

The bill would create new provisions related to intoxicating liquor wholesale permits. Specifically, the bill would provide that any intoxicating liquor sold by a wholesaler must be physically unloaded at the wholesaler's premises prior to being delivered to a retailer or to another wholesaler and that the wholesaler's premises must be capable of warehousing intoxicating liquor. In addition, a wholesaler would be required to annually sell and deliver intoxicating liquor to at least 10 retailers that do not have any direct or indirect interest in each other or in the wholesaler. DOR would be prohibited from issuing a wholesaler's permit to an applicant unless the applicant represented an intention to satisfy this minimum sales and delivery requirement. DOR would also be prohibited from renewing a wholesaler's permit unless the permittee demonstrated that it had satisfied the requirement.

The bill would prohibit an intoxicating liquor retail licensee or permittee from receiving a benefit from a violation of these provisions with knowledge of the circumstances giving rise to the violation. A retailer in violation of this provision would be subject to the general penalties provided under state law with respect to alcohol beverage regulation, including a fine of up to \$1,000, or imprisonment for not more than 90 days, or both. In addition, a court could order a retail licensee or permittee who violates these provisions to forfeit an amount equal to any profit gained by the violation. As under current law, a court could order that the retail license or permit be revoked.

A wholesaler who violated the new wholesale provisions would be subject to a fine of up to \$1,000, or imprisonment for not more than 90 days, or both. A court could also order the wholesaler to forfeit profits gained by the wholesaler or by a retail licensee or permittee from the violation. As under current law, a court would generally have the option to order the wholesaler's permit to be revoked. However, in the case of a wholesaler that violated the requirement to annually sell and deliver intoxicating liquor to at least 10 retail licensees or permittees that do not have any direct or indirect interest in each other or in the wholesaler, the bill would require that the wholesaler's permit be revoked.

The penalties for wholesalers and retailers described above would not affect the authority under current law or under the bill, as described below, of DOR or a municipality to revoke, suspend, or refuse to renew or issue an intoxicating liquor license or permit

The bill would require DOR to promulgate rules to ensure coordination between the issuance and renewal of intoxicating liquor wholesalers' permits and the enforcement of the requirements described above. The rules would have to require that all applications for issuance or renewal of intoxicating liquor wholesaler permits must be processed by DOR personnel generally familiar with activities of intoxicating liquor wholesalers. DOR would also be required to establish by rule minimum requirements for warehouse facilities on premises described in wholesaler permits and for periodic site inspections of such facilities.

The bill would create a new mechanism for suspending or revoking liquor wholesale permits based upon written allegations, including allegations of third parties, without a hearing. Under this mechanism, any person could file a sworn written complaint with DOR alleging that an intoxicating liquor wholesaler had violated the requirements related to warehousing of intoxicating liquor prior to a sale and the minimum number of required sales to retail licensees or permittees. The complaint would have to identify the specific legal basis and sufficient facts for DOR to determine whether there was cause to find that a violation had occurred. DOR would be required to provide a copy of the complaint to any wholesaler against whom allegations were made, along with a notice of the time available to such a wholesaler to show cause as to why the wholesaler's permit should not be revoked or suspended. Under the bill, a wholesaler against whom allegations were made could file a sworn written response within 30 days of receiving a copy of the complaint.

Generally, within 60 days of receiving any response from a wholesaler notified of a complaint under these provisions, or, if no response were made, within 60 days of the date on which a response was due, DOR would have to make a written decision as to whether a violation has occurred and either dismiss the complaint or take action as provided under the bill. However, DOR could extend the time period for making a decision by an additional 60 days as long as, prior to the original due date for the decision, the Department provided notice that an additional 60 days was needed for the investigation. Any decision would have to include findings of fact and conclusions of law and state all reasons for the decision. DOR would have to provide a copy of the decision to the complainant and to any wholesaler against whom allegations were made.

If DOR found the allegations true and sufficient, the Department would be required to either suspend -- for not less than 10 days nor more than 90 days -- or revoke the wholesaler's permit and give notice of the suspension or revocation to the wholesaler. The bill would specify that such a revocation or suspension would be a contested case under Chapter 227, the state statutes governing administrative procedure and review.

Under current law, upon request by the Secretary of Revenue, the Attorney General may represent this state or assist a district attorney in prosecuting any alcohol beverages violation, but DOR is not authorized to prosecute such violations. The bill would authorize DOR to represent the state in prosecuting violations of the wholesaler requirements created by the bill, and specify that such action would be brought to the Circuit Court in Dane County. The bill would also create a private cause of action on behalf of wholesalers, retailers, and trade associations allowing them to bring an action to enforce the new provisions if a complaint were made to DOR and DOR failed to render a decision on the complaint within the time required under these provisions. The bill would specify that the complainant would be entitled to recover reasonable attorney fees if found to be the prevailing party.

These provisions would take effect the day after publication of the bill.

## **DISCUSSION POINTS**

1. The alcohol beverage industry is subject to laws and regulation under federal and

state laws at every stage, including production, distribution, and retail sales. The general regulatory structure began following the repeal of Prohibition in 1933, in an effort to prevent pre-Prohibition abuses in the distribution system from re-emerging.

2. One of the primary concerns from pre-Prohibition times related to the market power of manufacturers. According to historical information on the industry, retail outlets were often owned and operated by brewers and distillers. Often such outlets were "tied houses," serving as exclusive outlets of absentee owners under contract to sell exclusively the products of one manufacturer. Such outlets, under tremendous pressure to increase sales, were seen by some as disreputable establishments with little regard for local laws and influence.

3. The 21<sup>st</sup> Amendment to the U.S. Constitution repealed Prohibition and granted states the power to regulate the channels of distribution of alcohol beverages within state borders. Nineteen states, referred to as liquor control states, allow only the state itself to bring distilled spirits and, generally, wines into the state. The remaining states, including Wisconsin, and the District of Columbia operate under private enterprise systems of distribution, from manufacturer/distiller to wholesaler to retailer.

4. As described above, Wisconsin law currently specifies that a manufacturer may sell only to a wholesaler or rectifier; the wholesaler or rectifier may sell only to a wholesaler or to a retailer; and the retailer may sell only to the consumer. With limited exceptions, a manufacturer may not hold any direct or indirect interest in a wholesaler and a manufacturer or wholesaler may not hold any direct or indirect interest in a retailer.

5. Under 1999 Wisconsin Act 9, the Legislature adopted modifications to Chapter 135 of the Wisconsin statutes on dealership practices to explicitly state a commitment to the three-tier liquor distribution system. AB 100 would reinforce this commitment by enacting bona fide wholesaler requirements. Specifically, the bill would require that: (a) any intoxicating liquor sold by a wholesaler must be physically unloaded at the wholesaler's premises prior to being delivered to a retailer or to another wholesaler; (b) the wholesaler's premises must be capable of warehousing intoxicating liquor; and (c) a wholesaler must annually sell and deliver intoxicating liquor to at least 10 retailers that do not have any direct or indirect interest in each other or in the wholesaler. Requirements such as the proposed requirement that intoxicating liquor be physically unloaded at the wholesaler's premises are sometimes referred to as "at rest" provisions. The "at rest" provisions are in response to a concern that "virtual wholesalers," wholesalers essentially existing on paper only, could be (or have already been) established in the state to effectively by-pass the middle tier of the distribution system required under state law. The intention under AB 100 is to guarantee that all wholesalers in the state would be actual wholesalers with warehousing capability.

6. Some holders of permits as Wisconsin liquor wholesalers, however, also obtain a second permit as an alcohol beverage warehouse. An alcohol beverage warehouse permit authorizes the permittee to store and warehouse alcohol in the warehouse premises covered by the permit, but does not authorize the sale of alcoholic beverages. Under AB 100, a wholesaler that also has an alcohol beverage warehouse permit and that has physically unloaded and warehoused intoxicating

liquor at the alcohol beverage warehouse would still be required to physically unload the liquor at the address shown on the wholesaler's permit. For such wholesalers, the "at rest" provisions under AB 100 could prove to be burdensome. An alternative would be to modify the bill to specify that any intoxicating liquor sold by a wholesaler must be physically unloaded at the wholesaler's premises or at an alcohol beverage warehouse for which the wholesaler also has a permit prior to being delivered to a retailer or to another wholesaler.

7. The proposed "at rest" provisions bear some similarity to a current provision related to beer. Under current state law, all shipments of beer to a wholesaler in this state, whether shipped to the wholesaler from inside this state or from outside the state, must be unloaded in and distributed from the wholesaler's warehouse in this state. However, the at-rest requirements for beer do not set a minimum number of retailers that a wholesaler is required to sell to, as would be the case under the proposed at-rest requirements for intoxicating liquor.

8. In addition to the requirements related to the physical unloading of intoxicating liquor at a wholesaler's premises and the minimum number of retail licensees and permittees that a wholesaler would have to sell to and make deliveries to in a year, the bona fide wholesaler requirements under AB 100 would expand the penalties that could be imposed for violations of such provisions. In addition to the general penalties under Chapter 125 that currently apply in the absence of a specific penalty, the following would apply with respect to the bona fide liquor wholesaler requirements: (a) a court could order a retail licensee or permittee who violates these provisions to forfeit an amount equal to any profit gained by the violation; and (b) a court could order a wholesaler in violation of these provisions to forfeit profits gained by the wholesaler or by a retail licensee or permittee. As under current law with respect to violations of Chapter 125, generally, a court could revoke a retail license or permit or a wholesaler permit for violations of these provisions. However, in the case of a wholesaler that violated the requirement to annually sell and deliver intoxicating liquor to at least 10 retail licensees or permittees that do not have any direct or indirect interest in each other or in the wholesaler, the bill would mandate that the wholesaler's permit be revoked.

9. Currently, the only third parties that are specifically authorized to make written complaints and, in so doing, trigger a response from government authorities related to alcohol beverages are residents of a municipality related to a retail alcohol beverage license issued by the municipality. In such cases, a complaint is made to the municipality issuing the license and the complaint resolution process includes a summons and hearing before the municipal governing body or a duly authorized committee of the city council.

10. A duly authorized employee of DOR may also file a complaint related to alcohol beverage retail licenses with the clerk of circuit court for the jurisdiction in which the premises of a person holding an alcohol beverage license is situated. The clerk of court is required to issue a summons and, unless the person against whom the complaint has been made fails to respond, a hearing before the circuit court is scheduled.

11. There are currently no provisions related to imposing penalties specific to liquor

wholesalers or suspending or revoking intoxicating liquor wholesalers' permits. Therefore, if DOR received a complaint related to a liquor wholesaler, this general provision would apply. DOR could file a complaint with the circuit court and would be required to provide notice and an opportunity for a hearing before taking any action to suspend or revoke a permit.

12. AB 100, however, would provide a specific mechanism applicable to intoxicating liquor wholesalers' permits based upon written allegations, including allegations of third parties. Under these provisions, there would not be a hearing. Instead, under the proposal, the following process would occur: (a) DOR would have to provide a copy of the complaint to the wholesaler against whom the complaint had been made; (b) the wholesaler would have 30 days after receiving the copy of the complaint from DOR to show cause as to why the wholesaler's permit should not be revoked or suspended; and (c) DOR would have 60 days after receiving a response (or, if no response were made, 60 days after a response was due) to make a decision as to whether a violation had occurred and either dismiss the complaint or take action as provided under the bill.

13. Under AB 100, DOR could take action to suspend or revoke a license without a hearing of the complaint. The bill would specify that such a revocation or suspension would be a contested case under state laws governing administrative procedure and review, which would mean that all parties desiring to contest the case would be afforded an opportunity for a hearing. However, the review of the court in a contested case is confined to the record. Therefore, such a hearing would be one in which the review would be limited to a review of DOR's decision, which would have been made without an evidentiary hearing. Consequently, it is possible that, under these provisions, a wholesaler against whom a complaint had been made could have his or her license suspended or revoked without ever having the opportunity to present evidence on his or her behalf (other than through the written response to DOR that would have to be made within 30 days after receiving a copy of the complaint). The lack of an evidentiary hearing could be a violation of due process requirements under the United States Constitution. An alternative would be to eliminate the provisions under AB 100 related to revocation or suspension of intoxicating liquor wholesalers' permits, in which case current law (which provides for a hearing) would apply.

14. As described above, the Attorney General may currently represent this state or assist a district attorney in prosecuting any alcohol beverages violation as requested by DOR, but DOR is not authorized to prosecute such violations. The bill would authorize DOR to represent the state in prosecuting violations of the wholesaler requirements created by the bill, and specify that such action would be brought to the Circuit Court in Dane County. It should be noted, however, that AB 100 would not include funding to cover any associated costs. In addition, as current law requires either the attorney general or a district attorney to represent the state in prosecuting alcohol beverage violations, DOR attorneys do not currently have experience in prosecuting such cases. If the provisions related to authorizing DOR to represent the state in prosecuting violations under the proposed wholesaler requirements were deleted, either the attorney or a district attorney would represent the state in prosecuting such violations, as would occur under the current law provisions with respect to violations of Chapter 125 generally.

15. In addition, the bill would create a private cause of action on behalf of wholesalers,

retailers, and trade associations allowing them to bring an action to enforce the new provisions if a complaint were made to DOR and DOR failed to render a decision on the complaint within the time required.

16. It is estimated that the bill's provisions would have no effect on state or local revenues.

17. One exception to the three-tier liquor distribution system relates to direct shipments of wine permitted under reciprocity agreements between Wisconsin and other states. Under current law, DOR is authorized to enter into agreements with other states that allow a winery in one state to ship to individuals in the other state up to 9 liters of wine per year. The wine tax is paid by the wine shipper to the state from which the wine is shipped. Out-of-state wineries shipping into Wisconsin under reciprocity agreements are required to submit annual reports to the state detailing such sales. Currently, Wisconsin has reciprocal agreements with the States of California, Oregon, and Washington.

18. On May 16, 2005, the United States Supreme Court issued a decision that overturned state liquor laws in New York and Michigan giving preferential treatment to in-state wineries. In both states, in-state wineries were allowed to ship wine directly to consumers. In Michigan, out-of state wineries were prohibited from making direct shipments to Michigan consumers. In New York, out-of-state wineries were permitted to make direct shipments of wine if they maintained a New York office (which no wineries had done and which the Court found so financially burdensome for small wineries as to amount to a prohibition). The decision held that the direct shipment laws of the two states discriminate against interstate commerce in violation of the Commerce Clause of the U.S. Constitution. It is not yet clear what affect the decision may have on three-tier distribution system with respect to wine (or other intoxicating liquor or beer) or the reciprocity agreements for direct shipments of wine.

## **ALTERNATIVES**

1. Approve the Governor's proposal.
2. Approve the Governor's proposal and also approve any of the following choices:
  - (a) Eliminate the provisions under AB 100 related to complaints under the bona fide liquor wholesaler provisions. This alternative would eliminate the proposed complaint process and the provisions that would permit a complaining party to bring an action to enforce the bona fide wholesaler provisions and recover attorney fees if found to be the prevailing party;
  - (b) Eliminate the bill's provisions that would authorize DOR to represent the state in prosecuting violations under the proposed wholesaler requirements. As a result, either the Attorney General or a district attorney would represent the state in prosecuting such violations, as occurs under current law with respect to violations of Ch. 125.

(c) Specify that intoxicating liquor sold by a wholesaler must be physically unloaded at the wholesaler's premises or at an alcohol beverage warehouse for which the wholesaler also has a permit prior to being delivered to a retailer or to another wholesaler (the underlined language would be added to the Governor's proposal).

3. Maintain current law.

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