REPORT

OF

DIVISION OF CRIMINAL JUSTICE
ANTITRUST TASK FORCE

TO STUDY THE

ALCOHOLIC BEVERAGE INDUSTRY

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PART I

DIVISION OF CRIMINAL JUSTICE ANTITRUST TASK FORCE
TO STUDY THE ALCOHOLIC BEVERAGE INDUSTRY

I. INTRODUCTION

On November 29, 1976, following local and national disclosures concerning allegedly illegal trade practices within the alcoholic beverage industry, then Attorney General, William F. Hyland, announced that the Department of Law and Public Safety would undertake an investigation into the practices of the industry within this State. On November 30, 1976, following discussions with Joseph H. Lerner, Director of the Division of Alcoholic Beverage Control, the Attorney General announced that the Department would seek two objectives in connection with the investigation:

> "(1) to determine whether there are violations of existing rules and regulations that require the administrative attention of the Division of Alcoholic Beverage Control; and
>
> (2) to determine whether existing statutes and regulations should be amended or supplemented in any respect to improve control over trade practices of the industry...."

In pursuit of the first objective the actual investigation of the industry and its adherence to the present regulatory scheme was begun in December, 1976, and is continuing. The investigation has been a cooperative effort involving members of the Attorney General's staff as well as representatives of the Divisions of Criminal Justice and Alcoholic Beverage Control.

Thereafter, in August of 1977, the Attorney General established this Task Force to accomplish the second objective of the investigation, using as its basis the extensive information gathered from the Department's ongoing industry-wide investigation.

In addition to this Department's ongoing investigation, numerous licensees in, and suppliers of alcoholic beverages to, New Jersey are presently the subject of investigation by the Securities and Exchange Commission, the Federal Bureau of Alcohol, Tobacco and Firearms, both the Civil and Criminal Divisions of the Internal Revenue Service, and alcoholic beverage supervising authorities in other states. Under this State's law, the industry is being primarily scrutinized for violations of Title 33, while existing trade practices are being reviewed in light of the "New Jersey Antitrust Act."

II. LEGISLATIVE AND REGULATORY BACKGROUND

An immediate consequence of the repeal of Prohibition was to render both the federal and state governments on December 5, 1933, without any practical control over the manufacture, sale or consumption of alcoholic beverages.[1] While the Federal Government took until August 29, 1935, to enact the Federal Alcohol Administration Act (27 U.S.C.A. §201 to 212), New Jersey acted more expeditiously in passing "An Act Concerning Alcoholic Beverages" on December 6, 1933, which is now essentially Title 33 of the New Jersey Statutes, P.L. 1933, c. 436, as amended.

The first state commissioner of alcoholic beverage control was charged with supervising the "manufacture, distribution and sale of alcoholic beverages in such a manner as to promote temperance and eliminate the racketeer and bootlegger." N.J.S.A. 33:1-3. During the almost 45 years since this basic direction was given, a vast array of rules and regulations have been developed to regulate the alcoholic beverage industry. While many of the rules and regulations

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1. The exceptions to this were the Wilson Act, 27 U.S.C.A. § 121, subjecting alcoholic beverages to state law when they enter the state and the Webb-Kenyon Act, 27 U.S.C.A. § 122, forbidding shipment of alcoholic beverages into a state in violation of its laws.

have been updated by the Division of Alcoholic Beverage Control,[2] the underlying principles and trade practices have not been reviewed in a comprehensive fashion since the initial legislative enactment. This report is intended to serve as an impetus to and a comprehensive review of the State's regulatory scheme. What follows will focus on the distribution and sale of alcoholic beverages from the supplier (manufacturer, distiller and/or importer) to the wholesaler, and from the wholesaler to retailer, with an emphasis on current trade practices, i.e. those which have existed since approximately 1974.

At the outset it should be noted that New Jersey, along with 31 other states and the District of Columbia, is a "license" state. A "license" state authorizes various levels of private enterprise to distribute or sell alcoholic beverages. Eighteen other states are "control" or "state-monopoly" states, in which some or all aspects of distribution are performed by the state governments themselves. Pennsylvania, for example, handles all aspects of distribution and sale of distilled spirit products itself. In Mississippi, on the other hand, the state is the wholesaler of

2. The most recent revisions were effective January 27, 1978.

alcoholic beverages, but private enterprises are licensed to sell at retail. While some jurisdictions have similar regulatory schemes, no two can be said to be identical.

As a final background note, according to 1977 industry published statistics, New Jersey was the eighth highest consumer of distilled spirits and had the 18th highest potential per capita consumption of distilled spirit alcoholic beverages.[3] New Jersey has 3.42% of the nation's population and consumes 3.73% of its distilled spirits, a slight decrease from the 1975 figure of 3.82%. Of the 32 taxing states, New Jersey has the tenth highest excise tax on spirits: $2.80 a gallon.[4] The total state revenue from excise taxes on all alcoholic beverages for the fiscal year 1977 was approximately $54 million.[5]

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3. The "consumption" statistics used by the industry measure the volume of alcoholic beverages entering the distribution system in a state. Whether all the beverages are actually sold to resident consumers is not known and thus actual consumption is assumed.

4. As of December 1977 the lowest were New Mexico and Maryland at $1.50; the highest were Minnesota at $4.39 and Massachusetts at $4.05 per gallon.

5. Additionally, there is a 5% Sales Tax on the "Minimum Consumer Resale Price," which created approximately $50 million in revenues in fiscal 1977 from alcoholic beverages.

Attention can now be turned to the characteristics of the industry itself. It should be borne in mind, however, that certain difficulties were encountered in bringing the necessary information together. Part of the problem stemmed from the fact that New Jersey, unlike 20 of the 32 license states, does not require detailed brand ownership or label registration. Rather, New Jersey adopts Federal requirements. See, N.J.A.C. 13:2-27.1. Thus, there is no information of the kind which might be found on a registration application which would disclose the actual owners and wholesalers of each product marketed to consumers. As a result of the scarcity of information in this State at the supplier (distiller, importer) level and the concomitant investigative burden created, extensive efforts were required simply to identify the "brand owners" and their channels of distribution.

III. CHARACTERISTICS OF THE INDUSTRY

A. Licensing Structure

As a "license" state, New Jersey conducts regulatory activities at both the state and municipal levels. As of July, 1978, the Division of Alcoholic Beverage Control in the State Department of Law and Public Safety (the "ABC") had issued 663 "State" licenses.[6] In addition, the ABC issued approximately 2,300 limited and unlimited solicitors permits.[7] These licenses generated approximately $2,888,000 in revenues through license fees for the fiscal year ending June 30, 1977 to the ABC. New Jersey municipalities, as primary "retail" level license issuing authorities, had received 12,018 license renewal applications[8] which in 1977 generated $7.7 million in revenues to the municipalities.

As of July 1, 1978, there were 78 plenary wholesale licensees in New Jersey.[9] A plenary wholesale license entitles the holder to sell or to distribute all

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6.

Plenary Brewery	4	State Beverage Distributor	90
Limited Brewery	1	Plenary Retail Transit	94
Plenary Winery	11	Broker's	2
Limited Winery	1	Transportation	161
Limited Distillery	3	Public Warehouse	34
Rectifier and Blender	7	Warehouse Receipts	6
Plenary Wholesale	78	Additional Warehouse	62
Limited Wholesale	58	State Municipal	33
Wine Wholesale	18		

7. Solicitor's permits are salesmen's licenses. An "unlimited" permittee may sell all types of alcoholic beverages, while "limited" permits are restricted, most often to beer sales.

8. Club--1435; Plenary Retail Consumption--7806; Retail Consumption (Broad "C")--595; Seasonal--24; Limited Retail Distribution--161; Plenary Retail Distribution--1997.

9. The other classifications of licenses with less expansive wholesale application that may sell spirit or wine products to retailers are: limited wholesale, wine wholesale, and vintner. In addition, state beverage distributor licensees may sell unchilled beer to retailers or the public. See, N.J.S.A. 33:1-11.

types of alcoholic beverages to retailers and other wholesalers and to maintain warehouse and salesroom facilities.

The number 78 is deceptively large in describing the actual sales activity at the wholesale level of the industry. By way of illustration, approximately one-half of the 78 plenary wholesale licenses are held by suppliers in a dormant or almost dormant status.[10] Most of the remainder are held by subsidiaries of New Jersey parent companies. More specifically, based on an examination of New Jersey Alcohol Excise Tax records for a three-year period ending in 1976, investigative efforts have determined that five separate groups of wholesalers, each group financially interlocked from within, holding 24 plenary

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10. The reason for the retention by distillers of wholesale licenses in a dormant state and the absence of applications on their part in recent times for new wholesale licenses may be a consequence of the imprecise result our courts reached in Affiliated Distillers Brands Corp. v. Sills, 106 N.J. Super. 458 (L. Div. 1969), aff'd in part, reversed in part on other grounds 56 N.J. 251 (1970), amended in part on other grounds and adhered to in part, 60 N.J. 342 (1972). In the end, the court struck down some, but not all of the portions of N.J.S.A. 33:1-43, which had governed the extent to which there could be interlocking financial control between manufacturers, wholesalers and retailers. This decision left the law unsettled, and impelled most members of the industry to cling to the status quo. In any case, a supplier who desires to maintain its own sales representatives to the retail level or otherwise "solicit" sales must secure a wholesale class license. See, N.J.S.A. 33:1-2.

wholesale licenses, sold in excess of 80% of all distilled spirits purchased by retailers in the State. With the addition of one more group of four smaller separate wholesale entities that are interlocked by product line but not financial control, the six groups controlled in excess of 87% of all distilled spirits and 40% of wine products sold to retailers.

B. Pricing Structure

Although an understanding of the licensing structure of the industry is important, no assessment of the regulatory structure would be meaningful without an analysis of the industry's pricing structure.

1. Affirmation. Of the 33 "license" states and jurisdictions, New Jersey is one of 18 that has adopted the principle of "affirmation." Affirmation is said to have had its birth through the 1958 "Des Moines Warrantee," an agreement created at the request of the "monopoly" states by which suppliers "warrant" that they are offering their products to those states at the lowest price they are being offered for sale anywhere in the nation. Affirmation is essentially a practice through which a supplier establishes the price for its

products (charged f.o.b. point of shipment to wholesalers) and "affirms" that it will offer to sell at that price in those states which require price parity. See, N.J.A.C. 13:2-36.1 and .2. The "affirmation" price is not only the price "at which" a case of a particular product will be sold to wholesalers in "affirmation" states, but is the lowest price that the article will be offered for sale anywhere in the United States from the same shipping point. In short, affirmation is the linchpin of the entire pricing structure on a nationwide basis.

Viewed another way, statutes or regulations establishing affirmation can be regarded as being "national" in impact. For while pursuant to the 21st Amendment the adoption or rejection of the principle of affirmation is said to be entirely within the discretion of each state, the result is that affirmation's existence in one state prohibits sales at a price lower than the "affirmed" price in any other. Therefore, if New Jersey were not an affirmation state and any other state was, a supplier could not sell an "affirmed" product at a price lower to a New Jersey wholesaler without violating affirmation elsewhere.

New Jersey adopted affirmation on July 1, 1967, by way of an Alcoholic Beverage Control Regulation and Bulletin.[11] See, N.J.A.C. 13:2-36.1 *et seq*. Brand owners are not required to file the price in New Jersey "under oath" as in some of the other jurisdictions. Although affirmation in New Jersey currently only applies to distilled spirits, it had been suggested in the September 8, 1977 proposed revisions to the ABC Regulations for wines. It has never applied to malt alcoholic beverages in this State.

2. Minimum Retail Pricing. In addition to filing the affirmation price, a "brand owner" in New Jersey (usually the supplier,

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11. This adoption followed an unsuccessful constitutional attack by a supplier on the first affirmation statute. See, *Joseph E. Seagram & Sons, Inc. v. Hostetter*, 384 U.S. 35, (1966) rehearing denied, 384 U.S. 967 (1966).

distiller or importer) also files and thus "establishes" the minimum price to the consumer. Thus, the brand owner establishes both the price at which its products enter commerce and the price at which its products are sold to consumers.

No retailer in this State may sell a bottle or case of a product to a package consumer[12] at a price below that posted for the article. The Division of Alcoholic Beverage Control publishes (at industry expense) a quarterly book containing the minimum retail consumer prices.[13] N.J.A.C. 13:2-33.1 et seq. The ABC actively enforces the minimum retail consumer price and, to a lesser extent, the affirmation price.

3. Wholesale Pricing. The Division of Alcoholic Beverage Control also publishes quarterly (at industry expense) a wholesale price book.[14] N.J.A.C. 13:2-36.3. This book

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12. The price at which drinks are sold to bar customers is essentially uncontrolled.

13. "New Jersey Minimum Consumer Resale Prices."

14. "New Jersey Wholesale Price List."

is the result of product price filings by the wholesalers, thus establishing the price "at which" products will be sold to retailers. For a short period of time, prior to the printing of the book, all wholesalers are permitted access to each other's proposed price filings and may alter their own filings to "meet competition." See, N.J.A.C. 13:2-36.5. The net result is that almost every individual product offered for sale to retailers by all of the different wholesalers is available only at the same price.

C. Marketing Activity

1. Creation of "Banks". The economic structure of the liquor industry, fostered by price filings at the state level and affirmation at the national level, presents opportunities for manipulation of substantial profits at various levels. There appears to be tacit agreement among industry members that the costs of marketing activities used to generate these profits, such as advertising, discounting and other promotional tools, are intended to be shared. Notwithstanding the existence of other disclosed devices for distributing the

cost of these activities, the industry has conceived its own internal balancing mechanism, known generally as the "bank."

In theory, the "bank," also known as the "vehicle," "thing," "X-factor" or "merchandising reserve," is the result of an understanding, tacit or otherwise, between the supplier and wholesaler, based on their "individual business judgment," that certain amounts of money, depending on the product and its marketability, will be set aside by the wholesaler for use in promoting a supplier's product(s). The funds in a "bank" may be used in promoting all of the products of a supplier, all of the products of a division of a supplier, or simply a single product line of the supplier, depending on the agreement reached. A record of a "bank's" existing balance or previous adjustments may be kept by either or both of the parties, although these "transactions" frequently go unrecorded. In any case, "bank" funds are not deposited in any normal commercial banking institution. No ledger reflecting a "bank's" existence would be recognized in professional accounting procedures as bearing directly upon a supplier or wholesaler's financial stability. If a "bank" is expected to have a balance at the end of the wholesaler's normal business year either party may seek to have adjustments made to balance it out at zero, otherwise the balance is simply carried over or considered income to the wholesaler when excess funds remain. From a wholesaler's point of view, money left in the "bank" by the supplier, i.e. money not expended in promotions, is the wholesaler's profit. If a wholesaler owes money to the "bank," that amount is normally carried over to the next year as the wholesaler's obligation. If the supplier owes the "bank" money and, therefore, owes a wholesaler for promotional expenditures, every attempt is made by the wholesaler to receive a "credit" to balance the "bank."

2. Funding a Bank-Supplier Activity. In recent times, in order to fund a "bank" directly, three mechanisms have been used. The first is "accruals," which

are founded upon adjustments to the price of a product made by the supplier in setting its "affirmation" and "consumer" prices. The second is special purchase allowances (S.P.A.), which, assuming compliance with affirmation, are lawful purchase discounts to the wholesaler. The third is "depletion credits," which are payments by the supplier to the wholesaler at a per case rate upon sale to retailers of certain of the supplier's products which had already been in the wholesaler's inventory. Depletion credits are also lawful if timely "filed" with regulatory authorities. What follows is a more detailed explanation of these devices.

a. Accruals - "Accruals," sometimes known as the "X-factor," are a prevelant method of funding a "bank" on behalf of a supplier. "Accruals" are based on a built-in excess of profit over the "anticipated" industry mark-ups, as determined by the "brand owner," often in conjunction with its wholesalers. In New Jersey, wholesalers and retailers <u>expect</u> certain mark-ups on all alcoholic beverages depending upon size and type. Since the brand owner usually sets the affirmation price and the minimum retail price to the consumer, the "building in" of an amount which can accrue to the "bank" is relatively simple.

For example:

\$100.00	Affirmation price to wholesaler per case
.40	Cartage
8.40	State Excise Tax
\$108.80	
19.58	Assuming an anticipated 18% wholesale mark-up
\$128.38	Wholesale price to retailers
38.51	Assuming an anticipated 30% retail mark-up
\$166.89	Consumer price per case
13.90	Consumer price per bottle

If a supplier establishes the consumer price at \$13.99 per bottle, by working back, the wholesale price to retailers can be \$129.14. The difference of \$.76

per case, which would otherwise be the wholesaler's profit, is expected to be "accrued" to the bank in favor of the supplier. Thus, the profit margins of the wholesaler and the retailer are further controlled by the supplier through utilization of the "accrual" method. This aspect of the pricing mechanism is not disclosed to, or otherwise regulated by the ABC.

b. Special Purchase Allowances - Special Purchase Allowances, (SPA's) are temporary reductions of the case price of a product (by size and proof) to the wholesaler only. See, N.J.A.C. 13:2-36.7. SPA's are required to be filed by the supplier with the ABC and, theoretically, are offered nationwide to all wholesalers of the supplier's given product as a result of affirmation. Because anticipated profit ratios are intended to be maintained as expected throughout the distribution structure, the amount of the reduction per case becomes another funding vehicle to a "bank" in favor of the supplier. In the example given above, an SPA of $5.00

a case would be reflected as: $95.00 f.o.b. point of shipment. If the same "accrual" adjustments were made as in the paragraph following the example, the "bank" would be funded by $5.76 per case.

c. Depletion Credits. Depletion credits are short term inducements offered by suppliers to wholesalers only. Notice of an offer of a depletion credit is required to be filed with the ABC. See, N.J.A.C. 13:2-36.7. If a wholesaler reduces its inventory of a product on which the credit is offered, that wholesaler receives a credit in its favor in the amount offered multiplied by the number of cases sold. In theory, the wholesaler can bill the supplier for reimbursement in the amount of the credit or request a credit memorandum. In fact, such a credit is often applied internally to a "bank."

3. Debits to the Bank - Wholesaler Activity

a. Post-Offs or "postdowns," as they are sometimes known, are short-term reductions in the price "at which" a given product is offered for sale by the wholesaler to the retailer only. Postdowns are filed with the ABC and are permitted in the second or third month of a quarter following the ABC's publication of the "Wholesale Price List" and "Minimum Consumer Resale Price Book." See, N.J.A.C. 13:2-36.8. The amount of the postoff multiplied by the number of cases of the product sold at discount becomes a credit to a "bank" in favor of the wholesaler.

On many occasions, postoffs are run in conjunction with SPA's or depletion credits. In such instances, a credit to a "bank" created by the supplier from an SPA (or other trade discount) is often calculated to offset the cost incurred by the wholesaler from a postoff. In effect, the SPA or depletion credit will pay in part or in whole, for the postoff.

The decision to postoff is theoretically within the sole discretion of the wholesaler, who is required to file the same with the ABC. See, N.J.A.C. 13:2-36.8. However, more often than not, the supplier "suggests" the appropriate time and product for a postoff. When SPA's or depletion credits are offered in conjunction with postoffs, suppliers have often "suggested" postoffs per case in an amount greater than the the trade discount offered. The wholesaler frequently "kicks-in" in an amount (which would otherwise be its profit), so as to comply with the wishes of the supplier or other wholesalers to increase the reduction to the retailer. That excess expenditure would be a credit in favor of the wholesaler to a "bank."

b. Promotional Expenditures Other Than Discounts. In addition to postoffs, the most frequent charge against a "bank," which creates credits in favor of a wholesaler, are the wholesalers non-trade discounting expenditures for promotion of a supplier's products. Promotional activities may be entered into with or without the suggestion or approval of the supplier, depending on the existing business relationship between them. The expenditures made most frequently are: point-of-sale advertising materials, napkins, sip-stix salesmen's contests and bonuses, truck painting, advertising, promotional dinners, and airline and military sales credits.

4. Bank Records. Recordkeeping with respect to such types of "banks" is based on tradition and the necessities of the business relationship. Some "banks" are written on some form of ledger, others are constructed through existing business records relating to purchases, SPA's, depletion credits, and other elements at the time an existing balance is required. A third type can be viewed as "self-actuating."

A formal "paper bank" is usually a ledger maintained in written form in a key employee's desk.[15] When the "bank" is balanced at zero or an amount agreed to by the parties is periodically reached, the previous ledger is destroyed and a new ledger begun.

Constructing a "bank" through existing records is necessitated only when there is a dispute over whether an imbalance requires funding or expenditures on the part of either party to the agreement.

A self-actuating "bank" technically is not a "bank," but rather a recognition by a wholesaler that it has an "obligation" to absorb the cost of certain promotional activities, such as a suggested postoff, without the benefit of an immediate corresponding "credit." Eventually, at the time of an SPA or the accumulation of accruals, this "bank" will be balanced and its debits will act to set off the "credits" generated by promotional activity. No formal records are maintained, although it is said that the parties "know where they stand."

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15. At least one form and type of bank is known to be computerized.

5. The Marketing Structure and Banks. While the "bank" may or may not be legal as individually operated, the relationships and activities sustained by "banks" are undesirable. The methods of funding "banks" and the uses to which the resulting funds are put, are particularly suspect and often violate national and State public policies. As an example, the supplier justifies "funding" a wholesaler by accepting or requesting deceptive bills and by maintaining misleading records. The wholesaler, in turn generates the deceptive billings and accepts payments under the guise of legitimate business transactions. Often the funds are used for "promotional" activities which themselves violate provisions of the existing regulatory scheme. The role of "banks" can be further understood with an examination of the marketing relationships between the brand owner and the wholesaler.

In general, suppliers in this State grant some form of a "franchise" to wholesalers to market particular products or product lines. Most New Jersey wholesalers do not have written distributorship agreements with domestic product suppliers. Formal written agreements more frequently exist among wholesalers and foreign national suppliers. In those instances, the wholesaler usually becomes the "brand owner" or importer, for purposes of posting prices at the State level, and with the federal government for its regulatory requirements, since the wholesaler has become, in effect, the "supplier." Not only does this arrangement allow the wholesaler to make a supplier's profit but a wholesaler's profit on sales to retailers as well. In addition, this arrangement allows the wholesaler a much coveted exclusive franchise to sell the product involved. An "exclusive" can exist in the normal domestic supplier-wholesaler situation as well.

(1) <u>Exclusive Franchises</u>

Where a wholesaler can offer a publicly attractive "exclusive line" of products or an exclusive on a product rather than product lines offered by numerous wholesalers, an advantageous marketing tool can be enjoyed. Likewise, there is higher probability of "bank" activity in some form on the part of the wholesaler and the "exclusive" brand owner, since both receive discernible benefits by promotional activities. The advantage of being an "exclusive" distributor, or one of the few carrying a popular product, is that it adds significant leverage to a wholesaler's sales force when marketing other products which are readily available through other wholesale outlets. For this reason a wholesaler holding an exclusive product franchise is more likely to endeavor to please the brand owner by agreeing with its suggested promotional activities.

While under present New Jersey law a "franchise" (the right to distribute a product), exclusive or otherwise, cannot be removed by a brand owner from a wholesaler without the risk of an ABC proceeding to establish good cause,[16] the brand owner may at any time dilute the exclusiveness of the franchise by permitting one or more other wholesalers to carry the product line. Because a sound and happy distribution network is in the best economic interests of the brand owner, dilution of an exclusive franchise as a "punishment" rather than simply a "good marketing judgment" is said to be rare.

If a brand owner seeks to enforce compliance with its suggestions concerning the "bank," wholesale pricing, promotional or other aspects of marketing with respect to any of its wholesalers, it can selectively refuse to give

16. See, N.J.S.A. 33:1-93.6 and .7.

otherwise normal commercial accommodations. Since wholesalers secure 30% to 50% of their multimillion dollar business during the November-to-January holiday period, delivery orders can be "delayed or lost," Christmas or other special-wrapped packaging "may be unavailable," or supplier's terms for payment can be stiffened rather than relaxed, to communicate dissatisfaction.

(2) Wholesalers' "Sister-House" Distribution System. It is difficult to understand the present wholesale distribution system without some historical background. As a result of economic growth following the Depression and the repeal of Prohibition, the marketing structure in New Jersey included over one hundred active wholesalers. Each small wholesaler

typically had a plenary wholesale license, several "multiply-wholesaled"[17] products, a few products or lines under a limited or "exclusive" franchise, and a limited geographical area which it served because of antiquated transportation systems. As time passed, it became clear that many of these operations could not continue to be economically viable. Instead of simply permitting the entities to fail, larger wholesalers began acquiring the smaller distributorships. In so doing, however, the larger wholesalers did not merge these businesses into their own, because a merger would result in the loss of the wholesale license of the business being purchased. The loss of this license would lead, in turn, to the loss of whatever limited or "exclusive" product franchises

17. Multiply-wholesaled products are those on which more than one wholesaler has the right of distribution.

were held by the business being purchased. To avoid this result the larger wholesalers held each of the businesses as a subsidiary. These subsidiaries have come to be known as "sister-houses" because of a common "parent" holding company or ownership. Thus, most major wholesaler "groups" are comprised of "sister-houses," each of which has a plenary wholesale license, and the limited franchise to sell one or more lines or products.

Labor agreements with liquor salesmen support the "sister-house" system by prohibiting more than one solicitor employed by an individual "sister-house" from soliciting retail sales from the same retail account. The result is that "houses" rather than products form the basis of the industry's sales efforts. Consistent with this approach, solicitors of the other "sister-houses" of the same parent are permitted to compete with each other. This contributes to the plethora of solicitors within the industry.

There are approximately 12,000 licensed retail accounts to service and 1,200 licensed "unlimited"[18] solicitors. Each solicitor is apt to be offering many of the same products and competing against other solicitors including those in "sister-houses." The result is an overabundance of solicitors servicing the same accounts with the same products, theoretically at the same prices. In effect because of the ratio of retail accounts to licensed solicitors, salesmen often are compelled to "meet" competition by engaging in illicit marketing practices, e.g. kickbacks to retailers of portions of sales commissions.

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18. Authorized to solicit sales for all types of alcoholic beverages.

(3) Inability to Legally Meet Competition. While the solicitor is provided a low base salary or "draw," he or she secures most compensation through a commission, which on spirits is currently somewhat less than 5%. Since the price of the product is the same, and delivery or other legal product services comparable in each wholesale house, the necessity to make a "deal" in order to produce a sale can be strong. Equally strong is the incentive for the wholesalers and the suppliers to promote "interest" for their respective product lines. Since 1939 it has been unlawful in New Jersey for anyone selling alcoholic beverages, except malt beverages,[19] to, directly

19. The malt beverage portion of the industry has historically enjoyed the benefit of somewhat more liberal regulations, apparently because original post-prohibition legislative thinking concluded that beer consumption was less offensive than that of other beverages with higher alcohol content. The 1933 Commission, which prepared the initial New Jersey legislation, stated in its report:

> "[w]e have set up a plan which if enacted into law and carried out according to its true intent by the officials entrusted with the operation thereof will make relatively easy the sale and consumption of beer, ale and natural light or fermented wines; and make relatively difficult the sale and consumption of distilled liquors and fortified or treated wines...." New Jersey Alcoholic Beverage Commission, Report on Alcoholic Beverage Control and Taxation, (November 20, 1933).

or indirectly, offer any discount, rebate, free goods, allowance, or inducement to any retailer over and above that which is available to the entire retail level of the industry. See, N.J.S.A. 33:1-90. Thus, today, with respect to the wine and spirit suppliers and wholesalers, ABC regulations prohibit sales contests and a broad variety of inducements to purchase, which are, for the most part, acceptable trade practices in other industries. See, in general, N.J.A.C. 13:2-36.10, .13 and .14.

While these types of restrictions can theoretically benefit the industry by reducing advertising and promotional costs, they tend to be contradictory to modern marketing techniques[20]

20. In 1952 the misdemeanor offense of "commercial bribery" was downgraded by the legislature to a disorderly persons offense. N.J.S.A. 2A:170-88.

and often the result is that ABC violations occur for lack of lawful promotion alternatives. In short each licensee, within its own sphere of influence, reacts to and does whatever it deems necessary to meet real or imagined competition. The reaction of the industry while not excusable, is understandable.

IV. ILLICIT TRADE PRACTICES

Historically, those individuals who were members of the alcoholic beverage industry during the pre-Prohibition and Prohibition periods continued to do business thereafter under post-Prohibition era regulatory schemes. In gathering the following information, investigators have found that in the ensuing 45 years prevailing "Prohibition Era" attitudes of management have been changing in favor of more modern principles of marketing. While the industry has been undergoing this internal transition, however, State regulations and the mechanism for enforcing them have not been substantially altered. Most industry trade practices reflect the industry's attempt to "modernize" its marketing methods. Such marketing practices have caused the industry often to find itself running afoul of an inflexible regulatory scheme.

A. Illicit Arrangements Between Suppliers and Wholesalers

1. Billbacks. In order to maintain a productive

wholesale network, suppliers have made payments through "billback" arrangements with wholesalers. The industry has referred to this as an agreement to maintain or "guarantee" profits. While this conduct has occurred more frequently with wholesalers who have franchises for non-exclusive or semi-exclusive products, it is applicable to all product lines and supplier-wholesaler relationships. Conceptually, both the "bank" and affirmation are involved. A periodic review of the bank informs the parties of existing or projected obligations to purchase, promote or reimburse. Since "legal" reimbursement to a wholesaler of funds expended on behalf of the supplier's product over and above its anticipated profits requires the supplier to initiate SPA's or depletion credits (which are nationwide in impact and cost due to affirmation), other mechanisms have developed. Suppliers pay third party bills for wholesalers as well as accept and issue credit or checks on false, misidentified,or deceptive bills supplied by the wholesaler or a related company. Reimbursement under this "bill-back" scheme may be made to other subsidiaries of the same parent company or through third party entities (e.g., an advertising company). The net effect of this scheme is to reduce the cost of the product to the wholesaler below the affirmation price and to provide "an incentive" to the wholesaler.

2. Manipulation of Freight Charges. Similar reductions can be achieved through manipulation of freight obligations. Since the affirmation prices are f.o.b. at a particular location, suppliers have invoiced products at one location while they are actually stored further from or closer to the wholesaler, or they have absorbed the freight costs themselves. As with direct monetary incentives, the effect of prepaid or discounted freight charges is the equivalent of a reduction of the affirmation price.

3. Extension of Credit. Another method of reducing the wholesaler's cost below the affirmation price is through lengthy extensions of credit. By lengthening the payment period for inventory purchased from a supplier, often without any interest, a wholesaler's cash flow and reserve are improved, thus improving its competitive position. Wholesalers have, on occasion, used any such reserve funds to make short term investments, to earn additional profits. Through such credit arrangements, a supplier can "reward"

or "punish" wholesalers, and provide another incentive to purchase its wares.

4. Loan Agreements. Suppliers have not only improved but have actually controlled the financial condition of wholesalers through direct or indirect loan agreements. In addition to aiding a good distributor in times of financial need by providing banking "suggestions," e.g. offering to guarantee loans, loan arrangements have been provided directly from suppliers for wholesalers seeking to purchase other wholesale licensees.

5. Marketing Activities of the Supplier's "Missionary Man." Finally, through its "missionary man," (a sales representative licensed as a solicitor) the supplier may enter into a myriad of illicit marketing activities. These range from organizing contests[21] for salesmen to giving cash rebates and free goods to retailers. Using the "missionary man" a supplier is able to develop a direct relationship with retailers and with personnel of wholesalers, and thus better "promote" its product.

B. Illicit Arrangements Between Wholesaler and Retailer.

The relationship between a wholesaler and retailer is to a large extent determined by the commercial

21. Sales or promotional contests are prohibited in connection with distribution of all but malt alcoholic beverages. See, N.J.A.C. 13:2-36.13 and 37.4.

leverage which may be exerted by either party. Since consumer demand activates retailer demand, the larger the line of consumer-demanded "exclusive" products distributed by a wholesaler, the less inclined it will be to see a need to engage in illicit conduct. At the same time, any retailer purchasing $50,000 a year or more from a wholesaler is a valued or "preferred account." In order to maintain or secure preferred type accounts, activities designed to induce or "accommodate" retailers continue.

1. Extension of Credit. Under ABC regulations, retailers are required to make payment for delivered goods within a month following delivery. *N.J.A.C.* 13:2-39.1. If a wholesaler fails to receive full payment within that time, it is required to notify the ABC, *N.J.A.C.* 13:2-39.5, whereupon the retailer is placed on a "default list" published for the industry by the ABC. *N.J.S.A.* 13:2-39.3. Until removal from this list through payment of any delinquent balance, a retailer on default may be delivered alcoholic beverages by any wholesaler only on C.O.D. terms. *N.J.A.C.* 13:2-39.4. A retailer who remains in "default" for 39 continuous weeks is entered on the Division's "non-delivery list." *N.J.A.C.* 13:2-39.3.

Wholesalers are forbidden to deliver any alcoholic beverages to a retailer on the "non-delivery list." N.J.A.C. 13:2-39.4. The regulatory function on this credit-notice system is intended to preclude consignment sales and reduce silent wholesaler interests in retailers (e.g., the acquisition of a share for cancellation of debt) resulting from extensive credit obligations, and to provide the wholesale industry with stability in its accounts receivable. In practice, however, this credit-notice system is manipulated in favor of preferred accounts and encourages "wash sales," that is sales in the name of third party retailers.

Wholesalers may not report initial defaults to the ABC; therefore, some defaults never "officially" come to exist. To preserve recordkeeping integrity, invoices are often "rolled." That is, the computer may be given input indicating that the initial invoice is paid and be directed to issue a new bill in the same amount with a new date. Alternatively, original billing may be through a "memo" or non-computer issued document and not "officially" recorded or billed until a later date. In this way the payment period for the retailer can be extended beyond the permissible 30 days. In other instances, wholesalers deliver thousands of dollars of merchandise to retailers believing, or knowing in advance, that the retailer will not pay for months, well aware that this will violate the ABC's credit regulations.

2. Manipulation of Return and Breakage Credits. Other accommodations made to retailers concern credits given to retailers who have allegedly "returned" merchandise which supposedly arrived damaged or distressed or as the result of delivery or ordering errors. Investigation of these transactions through manual examination of thousands of invoices or review of coded computer printouts is an arduous task. In theory, to receive a "breakage" credit, retailers traditionally have had to return to the wholesalers the "sealed-tax-stamped-neck" of each broken bottle, thus, somewhat simplifying investigative efforts. Because of enforcement activities in this area, however, retailers have requested and received from wholesalers the necks of bottles broken in a warehouse. Thereafter, false breakage requests may be submitted to the ABC for approval and credit memoranda or product replacements provided to retailers

relating to sales which never existed.

Current ABC regulations prohibit the return by retailers to wholesalers for credit or replacement of any non-malt alcoholic beverages except upon the approval of the ABC.[22] A return of merchandise should occur as a result of delivery or ordering errors or because the merchandise is distressed; that is, product defect disclosed after retailer receipt (e.g. no labels, discolored, etc.). In practice, in order to accommodate preferred accounts, wholesalers have issued credit or replacement invoices and accepted returns long after the physical delivery date without notifying or soliciting the approval of the ABC. Wholesalers have also "exchanged" products without ABC approval. This practice usually involves the return of a "size" of a product in exchange for another "size" of the same (i.e. half gallons for quarts). On occasion, exchanges have occurred with different brands or gallonage. In addition to relieving specified retailers of undesirable inventory,

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22. N.J.A.C. 13:2-36.11 More recently, it appears that retailer accommodation has been secured through the submission of reasons to the ABC that are "known to be approvable." Prior to amendment, this regulation permitted "returns" in periods of 12 days, and 48 hours without ABC approval.

all this activity is nothing short of rebating or the provision of special allowances to select retail accounts of the wholesaler.

3. House Accounts. When rebates, free goods or other inducements have been provided to retailers, through or by wholesalers, the cost has often been charged against a "bank" or the commission account of a "houseman." Traditionally, a "houseman" has been a licensed solicitor assigned for servicing a good portion of the wholesaler's "preferred" accounts. The houseman is compensated by a prearranged guaranteed salary, including income tax considerations, (*e.g.*, if the houseman earns $40,000 in commissions but rebates half, the wholesaler might pay a $20,000 salary plus allow for tax consequences on the remaining $20,000.). The commissions generated by a houseman's sales have been set aside into a fund or "house account," which has then been used to offset the cost of illicit activities. This type fund may also be established by using commission accounts that do not exist but are shown on the computer printouts as though they did, and by commissions or bonuses earned by solicitors who are really managers and thus wholly

compensated by salary. See, N.J.A.C. 13:2-37.1.

When a "house-account" has been used to obtain extra funds from commissions on sales to retailers in conjunction with a "billback" scheme to obtain funds from the supplier, a wholesaler can amass a substantial amount of money over its cost of doing business through which illicit activity can be financed. While the corporate wholesaler itself may, in addition to these practices, distribute small gifts or gratuities to retailers for "special occasions,"[23] the use of money from a "cash box" for rebating has in more recent times become rare. Serious enforcement problems remain, however, especially with respect to the corporate wholesalers' failure to police the activities of lower level management or employee-solicitors.

C. Illegal Practices of Solicitors

As previously indicated, the illicit activities of the solicitors appear to stem from an economic necessity to induce sales where products are essentially fungible and no difference exists between "legal" marketing services or prices of products. To this end, the solicitor may

23. Flowers, baby blankets, pajamas, savings bonds, fruit baskets, etc. for Christmas, Bar Mitzvahs, store "openings," births, deaths and illnesses.

work alone, with the wholesaler, the "houseman," sales manager or a supplier's "missionary man," to promote sales.

1. Kickbacks to Retailers. In order to secure or maintain accounts, it is not uncommon for solicitors to "kick back" or rebate to important retailers two to three percent of the purchase price of goods (which amounts to about one-half of the commission for the sale). See, N.J.A.C. 13:2-37.3. This type of activity occurs both with and without open approval or knowledge of the employer. More than likely, the employer makes an affirmative effort not to learn of the specifics of such transactions. Other rebating or inducement activities of solicitors are generally not tied to specific retail accounts but to specific promotional efforts through which an individual solicitor may benefit. For example, if a trip or prize of considerable value is offered in a sales contest, a solicitor may "spend" some money in inducements to meet sales quotas to win the award.[24] See, N.J.A.C. 13:2-37.4.

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24. Not many solicitors work full-time on behalf of their wholesaler-employers. While the practice is not encouraged by their employers, account servicing can often be accomplished in less than half a working week. Many solicitors, therefore, have income from other employment sources.

2. Manipulation of Breakage Credits

Solicitors participate with co-employees or wholesaler management in the improper return of allegedly broken merchandise. They frequently perform the physical transportation of the goods and provide the retailer with a "reason" for the credit or replacement known to be "approvable" by the ABC. See, N.J.A.C. 13:2-36.11.

3. Involvement in Improper Credit Extensions.

Solicitors have actually loaned money to accounts or obtained loans for retailers from the wholesaler. Additionally, they have helped retailers obtain credit extensions beyond the 30-day limit by telephoning their employer's credit department on the last day falsely stating that payment was in hand.

4. Use of Wash Sales. Another type of credit violation is the "wash sale." Using the wash sale, the solicitor secures alcoholic beverages for a retailer on the "non-delivery" or "default" lists. By placing an order through a friendly third party retailer, the solicitor secures products at wholesale cost. After delivery of the merchandise to the "friendly " retailer, that retailer's bill is paid in cash, and the alcoholic beverages are diverted to the intended party. See, N.J.A.C. 13:2-23.12. The solicitor later receives payment from the "defaulting"

retailer under the terms previously agreed upon. This scheme can also be used by a solicitor to divert goods to be later given away free or at a discount as an inducement to other retailers.

5. Buy-Back Arrangements With Retailer. Another more expensive form of inducement is the "buy-back." Here, pursuant to an agreement, a solicitor, following the purchase of a specific amount of a product by a retailer, "buys back" from the retailer, at the consumer price, another specific amount of the product. The same goods can thereafter be given as a free inducement to a second or third retailer. Under this scheme, the solicitor would offer to sell one retailer ten cases and "buy back" two, which could then be offered free or at a discount to another retailer to induce a purchase of eight cases. Obviously, the more expensive an inducing activity becomes the more inclined a solicitor will be to seek help from other financial sources. In many instances, the best source for such "assistance" is the "missionary man."

6. Use of the Supplier's"Missionary Man." The "missionary man," or brand owner's representative to the State, is licensed as a solicitor. Therefore, not only does he have access to the sales force of the wholesaler franchising his employer's products but he also has direct access to the

retailer. He is usually a salaried employee of the brand owner with a reasonably large expense account and access to other marketing incentive resources. His function is to move his employer's products through commerce by motivating the sales force and, if one exists, to review "bank" activities.

In addition to marketing and promotional activities approved by the supplier, the "missionary man" often has his own personal program of incentives geared to increase sales. By falsifying expense vouchers, "missionary men" have generated funds to pay for cash rebates, free goods and "buy-back" activities. These inducements may be extended to retailers alone, in conjunction with a solicitor or wholesaler, or both. Where a wholesaler is engaging in "bank" adjustments or "profit guaranteeing" through false "bill backs," the "missionary man" is often the one who authorizes these transactions on behalf of the supplier. For this reason the "missionary man" is frequently one of the few who can decipher the false bills submitted for payment. Where the supplier's corporate practice includes the direct payments of "cash" for rebating, the "missionary man" serves as the courier or "bagman," and identifies potential recipients. Of particular interest to the "missionary man," and therefore to both the wholesaler and its solicitors, is the securing of "the well" at retail accounts. The "well" is that portion of a bar where "house poured" brands are stored. When a solicitor secures the retailer's "well," the brand of product he is marketing is sold to those consumers who do not request a product by name but only by type. Therefore, any hotel or restaurant with a large volume bar trade and any retail distributor (package store) with high volume and enough space to install a display, are targets of the "missionary man."

D. Illicit Practices of Retailers

Retailers' relations with solicitors and customers are not without trade violations.

1. Condoning Kickbacks. To begin with, there would be no rebates if some retailers did not accept or, indeed, demand them. Often retailers play one solicitor or wholesale house against another in order to secure the most favorable "deal." See, N.J.A.C. 13:2-36.10.

2. Customer Discounts. Retailers have also been known to sell below the mandatory minimum price to special consumers. See, N.J.A.C. 13:2-33.5. These sales frequently occur during the holiday period when businesses make sizable purchases for gifts. Even the average consumer is occasionally provided free liquor or mixers, specialties or prohibited novelties to induce future purchases. See, N.J.A.C. 13:2-23.16.

3. Inducements to Increase Bar Consumption. Finally, some retail consumption licensees stretch the limits of regulatory restrictions by marketing their goods through the provision of unusual "happy hours," free meals and varied but sometimes questionable forms of entertainment. Others increase profits by raising prices and deliberately selling to minors, running "after hours" speakeasies, or by serving alcoholic beverages to intoxicated customers. See, N.J.A.C. 13:2-23.1 and 24.6.

V. MARKETING OF MALT ALCOHOLIC BEVERAGES

The distribution of malt alcoholic beverages in this State is exempt from many of the strictures imposed upon the distribution and sale of wine and spirit products by Title 33 and ABC regulations. While neither brewers nor wholesalers[25] are bound by "affirmation" and "wholesale" price filing requirements (See, N.J.A.C. 13:2-36.1,36.2 and 36.3), their products are price protected through minimum consumer resale prices. See, N.J.A.C. 13:2-33.1 et seq. At the same time, rebates, discounts and other allowances to retailers are not prohibited. See, N.J.S.A. 33:1-90, N.J.A.C. 13:2-36.10. Also, "package" sales of malt beverages may be made during hours prohibited to spirit and wine products. See, N.J.S.A. 33:1-40.3, N.J.A.C. 13:2-38.1 et seq.

Investigation has revealed that discounting and rebating through cash and free merchandise has occurred among brewers, distributors and retailers in this State. While certain of these trade practices for malt beverages are not contrary to Title 33, they may be subject to curtailment or control by antitrust laws and federal regulatory agencies.[26]

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25. Most wholesalers who distribute beer are State Beverage Distributors. See, N.J.S.A. 33:1-11.

26. In April and May of 1977, the federal Security and Exchange Commission, filed civil complaints against Joseph Schlitz Brewing Company and Anheuser-Bush, Inc., alleging that large amounts of questionable inducement payments had been made to retailers nationwide "in possible violation of local liquor laws." In September, 1977, the New York State Liquor Authority sanctioned the F & M Schaefer Brewing Company for $160,000 in illegal rebates and allowances to retailers. In March, 1978, a Federal Grand Jury in Milwaukee indicted the Joseph Schlitz Brewing Company, charging 747 counts of alleged conspiracy, alcohol and tax offenses.

REPORT

OF

DIVISION OF CRIMINAL JUSTICE
ANTITRUST TASK FORCE

TO STUDY THE

ALCOHOLIC BEVERAGE INDUSTRY

RECOMMENDATIONS

PART II

I. INTRODUCTION

The Task Force has reviewed the alcoholic beverage industry, concentrating on trade practices and the existing regulatory structure. The purpose of the recommendations and suggestions which follow is to serve as a catalyst for much needed industry and regulatory reform. In presenting its views, the Task Force has been constrained by a desire not to cause violent economic disruptions within the alcoholic beverage industry and not to suggest solutions to problems which cannot be brought about through alterations within this State's regulatory system.

In preparing this Report, the Task Force considered numerous alternatives before formulating proposals set forth. We believe that the recommendations contained in this report will facilitate elimination of corrupt industry trade practices, yet modernize the ability to market within the alcoholic beverage industry in a manner generally considered legitimate.

II. GENERAL RECOMMENDATIONS

It is recommended that the State reexamine the existing method of pricing alcoholic beverages. The

Task Force is of the view that the present structure encourages artifically high prices without any corresponding social benefit. While the free market concept has been believed potentially to have an adverse effect on temperance,[27] the Task Force has concluded otherwise. The Task Force has found no empirical data which would justify the conclusion that any minimal reduction in consumer price would unduly increase consumption or foster intemperance in New Jersey.[28] On the other hand, the generally accepted view within the contemporary economic community is that the demand for alcoholic beverages is relatively inelastic, and, therefore, any anticipated price reduction would have no meaningful relationship to increased consumption.[29]

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27. As one of the concepts underpinning the initial legislation in 1933, the objective "to promote temperance" has been legislatively reinforced through the recent implementation of the "Alcoholism Treatment and Rehabilitation Act," approved February 9, 1976, N.J.S.A. 26:2B-7 et seq.

28. It is anticipated with the introduction of casino gaming within this State and the accessibility of alcoholic beverages within Casino Hotels, that raw statistics on per capita consumption in New Jersey will increase, as did those for the State of Nevada. The Task Force, therefore, cautions against the assumption that an increase in purchase gallonage bears any real relation to the likely retail price reduction which would occur by elimination of retail price maintenance.

29. The Task Force is not unmindful that the economic view that consumption of alcoholic beverages is inelastic rather than elastic was rejected by our courts for "little supporting evidence" in 1964. Grand Union Co. v. Sills, 81 N.J. Super. 65 (Law Div. 1963), aff'd. 43 N.J. 390, 402 (1964).

2. The present regulation by the ABC of the payment obligations of retailers to wholesalers through "default" and "non-delivery" lists serves as bill collecting mechanism for the wholesale level. The provision of this "service" to the wholesale level of the industry is performed at public expense. In the view of the Task Force the cost alone merits its abolition. Moreover, the existing system provides wholesale business entities economic advantages at government expense not available to any other industry in the State.

3. The Task Force recommends that licensing qualification criteria be expanded to include financial reliability and management ability, as well as other qualification criteria generally considered necessary for entry into sensitive industries. Such an initiative will diminish any governmental need to manage industry credit practices.

4. The Task Force finds that the convoluted marketing system resulting from the franchise relationships between suppliers and wholesalers in this State gives a false impression of competition in the industry, and in fact fosters illicit activities on the part of individual members of its sales force. We believe that it would be in the public interest for the State to modify the existing wholesale structure by requiring merger of "sister-house" subsidiaries into their parent corporations, with the assumption of existing "franchise rights" by the resulting parent entity.

5. In order to strengthen the regulation of trade practices historically susceptible to abuse and relieve the Division of Alcoholic Beverage Control of the obligation to investigate trade practices which are not regulated in other complex industries, the Task Force recommends that the industry be afforded greater latitude in marketing and promoting its products.

6. The Task Force recommends periodic affirmative disclosure reports by licensees and the introduction of formal brand or label registration statements. There should be little difficulty in accomplishing this reporting since both the industry and the ABC are engaging in more modern approaches to their respective functions. The use of computers and the speed and complexity of business information requires that the industry initiate self-policing activities.

III. DISCUSSION OF RECOMMENDATIONS

A. Elimination of Price Maintenance

Although the existing price structure contributes to the stability of the industry, it is apparent that mandatory price controls encourage the illegal trade practices previously discussed in Part I of this Report. In considering ways in which the present pricing structure within this state could be modified, we have reviewed programs creating mandatory mark-ups at each level of the industry, and "passing-through" discounts from the supplier to the retailer or even the consumer, as well as abolition of wholesale and retail price maintenance.

As noted in Part I consideration of the pricing structure necessarily must begin with a discussion of affirmation. While the Task Force is opposed to affirmation, it can see no way to change this national system through revision of State law. Moreover, if New Jersey alone were to remove itself from the umbrella of affirmation, the potential for economic detriment rather than benefit would exist. Specifically, if affirmation were removed, the price to a wholesaler in New Jersey of a supplier's "affirmed" products could go no lower than the affirmation price applicable to other states. Investigators relying on specific industry information believe that prices would, however, go higher.[30] Thus, the elimination of affirmation in New Jersey alone at the present time would effect no apparent

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30. When the nation's first affirmation statute was constitutionally challenged by a distiller, the Supreme Court was not presented with sufficient factual information to resolve an apparent conflict between the Twenty-first Amendment and the Commerce Clause. In Joseph E. Seagram & Sons, Inc. v. Hostetter, 384 U.S. 35 (1966) rehearing denied 384 U.S. 967 (1966), the court noted:

> ...We need not now decide whether the mode of liquor regulation chosen by a State in such circumstances could ever constitute so grave an interference with a company's operations elsewhere as to make the regulation invalid under the Commerce Clause...

benefit, economic or otherwise.[31]

Finally, in reexamining the pricing structure of the industry, the Task Force had to consider the existence and effects of "banks," particularly as they relate to establishing the price "at which" alcoholic beverages are sold by wholesalers to retailers and "below which" retailers cannot sell to

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(Footnote continued from page 5)

> ... The serious discriminatory effects of [the affirmation statute] alleged by appellants on their business outside New York are largely matters of conjecture. It is by no means clear, for instance, that [affirmation] must inevitably produce higher prices in other States, as claimed by appellants, rather than the lower prices sought for New York. It will be time enough to assess the alleged extraterritorial effects of [affirmation] when a case arises that clearly presents them...Id. 382 U.S. at pp. 42-43.

Note, the plaintiff in the above case was a supplier complaining of interferences with business practices obviously geared towards profit. Interestingly, the competing interests discussed in the Seagrams case were not those of the general public in consumerism or of the State in promoting free enterprise.

31. Proposals to modify affirmation have been suggested, however. Of particular interest is the concept of "rolling affirmation," wherein the affirmation price is based on averaging the base price over a period of time. This concept would permit seasonal marketing of products by price in different geographical areas of the country and yet maintain the uniform affirmation price nationwide for the operative period. Such a proposal while attractive, is, at least for the present, not feasible due to existing affirmation laws in other jurisdictions.

consumers. The Task Force finds that the current system actually encourages operation of "banks." While the "bank" may or may not be legal as individually operated, the relationships and activities sustained by the "banks" are undesirable. At the very least, the "bank" is a device for hiding the true relationship between the product supplier and its franchisees, and represents an all too convenient mechanism for price manipulation.

Since the supplier usually establishes both the "affirmation" and "minimum consumer" prices, a "bank" funded through profit structuring can be eliminated, absent highly sophisticated and expensive enforcement efforts, only by making it economically undesirable or unnecessary.[32]

Even independent of "bank" considerations, the current "Wholesale Price List" mechanism is suspect. Wholesalers presently have the benefit of establishing the prices "at which" their products will be sold uniformly to retailers. Then, prior to publication of the filed prices, they may be amended to "meet competition." See, N.J.A.C. 13:2-36.5. Historically, with rare

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32. In the Task Force's view, the existing price scheme unnecessarily gives to the supplier the power to dictate gross profit ratios to other levels of the industry. While we have not directly confronted the legality of the entire pricing system in this report, we note that a similar system in California has recently been found in violation of the Sherman-Antitrust Act by that State's own Supreme Court. See, Rice v. Alcoholic Beverage Control Appeals Board, 146 Cal. Rptr. 585 (Sup. Ct. 1978).

exception, the result has been the absence of any difference in the final "published" prices for brand name products among wholesalers. In short, this price "filing" mechanism authorizes horizontal "price-fixing." (See Footnote No. 32). The Task Force recommends abolition of the "Wholesale Price List" as enforced by the ABC.

In considering the question of whether to recommend the continuance of retail price maintenance, the Task Force was aware of the potentially harmful effect which it was said immediate elimination could have on "small retailers." These retailers have previously enjoyed some protection from the Legislature from forms of competition through centralized marketing enterprises.[33] Considering the Legislature's general repeal of "fair trade" as an acceptable principle of retail sales,[34] the Task Force has commissioned a study of the economic impact on "mom and pop" retailers based upon termination of retail and wholesale price maintenance within this State. (See, Appendix page 74 infra).

Without "fair trade," the Task Force expects "mom and pop" retailers to devote most of their efforts to the marketing of highly visible nationally advertised products and leave highly discounted products to the large retail licensees, who engage in that activity now through the

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33. In 1962, for instance, the legislature sought to protect the small entrepreneur from the "chain" stores by prohibiting the same person from holding a beneficial interest in more than two retail licenses. See, N.J.S.A. 33:1-12.31, and Grand Union Co. v. Sills, 81 N.J. Super. 65, (Law Div. 1963), aff'd. 43 N.J. 390 (1964).

34. The "Fair Trade Act" N.J.S.A. 56:4-1 et seq was effectively repealed in the 1975 (L. 1975, c. 107). Cf. N.J.S.A. 33:1-23.1.

use of "private label brands."[35] It is further expected that a reduction in the average retail price of nationally advertised products will occur, and that such a reduction will not substantially increase total resident consumer purchases, but rather initiate consumer activity to "jump-up" to higher priced "status" brands.

To maintain a balance in marketing capabilities and prevent extreme pricing disparity through "loss leaders," the Task Force recommends a prohibition against sales "below cost" and sales "tied" to any alcoholic or non-alcoholic beverage product.[36] While the Task Force foresees no serious increase of resident consumption as a consequence of its proposals, should pricing policies without price maintenance run contrary to the public interest, an adjustment in taxing initiatives could "stabilize" prices at the optimum level.

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35. "Private label" or "house" brands are alcoholic beverages bottled and labeled for individual retail licensees. The legal significance of the "private label" in terms of present pricing regulation is that it can be "owned" by the retailer. As such, the retailer may sell to consumers at any price in excess of its actual cost without publication in the "Minimum Consumer Resale Price Book." If, however, the label is the property of a wholesaler or a chain of retailers (a "proprietary label") and is therefore intended to be offered for sale in more than one retail outlet, the price must be filed in the "Minimum Consumer Retail Price Book." Nevertheless, that product can then be "filed" for sale at any price, usually as low as possible, as long as it is in excess of cost. See, N.J.A.C. 13:2-33.1 et seq.

36. In the absence of required price filings it will be necessary to carefully re-define "below cost." "Tie-in" sales tend to promote purchases of a "tied" product not particularly wanted by the consumer, hence where alcoholic beverages are concerned, they are offensive. When the "tied" or "tying" product is non-alcoholic, aside from "inducement" issues, ABC investigation of whether or not the combined cost of the tied and tying product, e.g. spirits and mixers, is "below cost" will require expensive enforcement efforts. See, N.J.A.C. 13:2-23.15.

B. Elimination of Governmental Credit Management

An area enforced by the ABC at significant expense is the financial obligations of retailers to wholesalers. See, N.J.A.C. 13:2-39.1 et seq. In most other industries such activity is governed by normal commercial relationships.[37] It is the Task Force's conclusion that industry stability is no longer a valid justification for the ABC's continued "service" as credit manager for the wholesale level of the industry in the State.[38] The traditional position has been that credit intervention is necessary to prevent the evils of "tied-house." [39] See, N.J.S.A. 33:1-43. However, as discussed

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37. The Legislature did not find it necessary to support the gaming industry through participatory supervision of its at least as sensitive credit procedures in promulgating the Casino Control Act. See, N.J.S.A. 5:12-101.

38. Even when faced with the severe economic consequences of lengthy suspension, industry members have not raised a challenge to the authority of the ABC to "regulate" this area, but in fact concede it. See, F & A Distributing Co. v. Div. of Alcoholic Beverage Control, 36 N.J. 34, 36 (1961).

39. The evils of "tied-house" are said to have been brought to light in the immediate post-Prohibition era, when brewers became landlords to tavern licensees. In order to insure distribution of entire brewing capacities, brewers required "tenants" to purchase specific minimum amounts of beer. The result was that beer was virtually given away by retailers, thus fostering intemperance. The concept envisions a general prohibition against supplier or wholesaler interests in the retail level. See, Grand Union Co. v. Sills, 43 N.J. 390, 398 (1964), Affiliated Distillers Brands Corp v. Sills, 106 N.J. Super. 458, 478 (Law Div. 1969) aff'd in part, reversed in part on the grounds 56 N.J. 251, 258-59 (1970) amended in part on other grounds and adhered to in part 60 N.J. 342 (1972).

in Part I the ABC does not actually regulate credit transactions (for there are to be none), but it enforces payment within a month of delivery. Unless violations are uncovered through tedious examination of invoices and computer printouts, the ABC is not aware that a retailer is in default of payment unless a wholesaler so informs it, i.e. enforces payment.

Another position set forth is that the continuance of this regulatory function is an intended quid pro quo for the wholesalers' assumption of the burden of collecting the 5% sales tax on alcoholic beverages.[40] Even if the Legislature so intended, if the "Minimum Consumer Resale Price" is abolished, as proposed, there would be no basis on which to assess a sales tax under the present law. See, N.J.S.A. 54:32B-2(d). Under such circumstances the Task Force proposes as an alternative to returning collection of sales tax to the 12,000 retail licensees, the abolishment of sales tax on alcoholic

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40. When originally promulgated the Sales and Use Tax Act N.J.S.A. 54:32B-1 et seq, treated alcoholic beverages the same as other non-exempt commodities or services. It was subsequently amended so as to tax sales and receipts from all alcoholic beverages (except draught beer in barrels which are not taxed, N.J.S.A. 54:32B-2(e)(2)(B)) on the price filed as the Minimum Consumer Resale Price with the ABC. N.J.S.A. 54:32B-2(d). Therefore, receipts from sales of drinks of alcoholic beverages in taverns or restaurants were made tax exempt (N.J.S.A. 54:32B-3(c)), because the tax had been collected on the consumer "bottle" price.

beverages. To balance the loss of State revenue, a corresponding increase in Alcoholic Beverage Excise Taxes should be enacted.[41] See, N.J.S.A. 54:43-1.

Returning to the question of credit relations supervision, the Task Force also recommends the abolition of present regulations regarding the return and exchange of non-conforming or distressed merchandise. See, N.J.A.C. 13:2-36.11. As discussed in Part I of this Report, this area is also subject to the direct control of the businesses involved. A more reasonable approach would be to offer to the industry the opportunity to conduct enterprise in a businesslike fashion.[42] If confronted with both the opportunity and reality of free competition, the Task Force believes that the industry has sufficiently come of age so as to conduct itself in a fashion consistent with public policy.

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41. This would be consistent with the tax treatment of cigarettes, which are exempt from sales tax when subject to tax under the Cigarette Tax Act. See, N.J.S.A. 54:32B-8(y) and N.J.S.A. 54:40A-1 et seq.

42. This area of regulation is also said to be designed to prohibit "tied-house" activity. The Task Force believes that a re-examination of the economic impact of "tied-house" prohibitions are in order. For example: A multi-national corporation producing "spirit" products through a subsidiary in another state, could have another subsidiary barred from purchasing an interest in a "beer and wine" restaurant chain, not serving "spirits," in New Jersey. See, N.J.S.A. 33:1-43.

C. Expansion of Licensing Qualification Criteria And Applicant Investigation.

Enforcement concerns as to the accuracy and accessibility of information relating to retail licensees have been drawn to the attention of the public by the Atlantic City Joint Alcoholic Beverage Task Force. That Task Force was formed in September, 1977 to investigate the qualifications of holders and potential transferees of alcoholic beverage retail licenses within Atlantic City and to supplement other law enforcement activities associated with the implementation of the Casino Control Act (N.J.S.A. 5:12-1 et seq). See also, N.J.A.C. 13:2-3.10.

The Atlantic City Task Force has preliminarily reviewed regulatory files relating to the approximately 250 retail licensees within that city. Their initial examination disclosed that most retail license applications were deficient on their face. That Task Force referred to the Division of Alcoholic Beverage Control numerous files for administrative action, which have resulted to date in suspensions for various terms of at least 6 licenses and the cancellation of one. Other action by the ABC has required the termination of employment or removal of otherwise disqualified ownership interests in 13 cases.

The work of the Atlantic City Joint Task Force[43]

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43. Composed of members and staff of the Atlantic County Prosecutor's Office, the ABC, and Divisions of State Police and Criminal Justice.

indicates a lack of proper investigation of license applicants at the local level.[44] It has also brought to light a need to expand licensing criteria to include financial reliability and management ability, which this Task Force so recommends. This Task Force further recommends that local authorities be provided with criteria, i.e. a checklist, which they must find have been affirmatively met, including such considerations as financial reliability and management ability. More extensive disqualification criteria should be enacted; in this regard consideration should be given to standards included in the Casino Control Act, N.J.S.A. 5:12-1 et seq.

Another weakness in the licensing mechanism brought to light by investigators is the apparent inconsistency in N.J.S.A. 33:1-34[45] favoring corporations. The present statute essentially leaves to the corporate licensee's discretion the decision of whether or not to notify the ABC and/or local authorities of any changes in corporate stockholdings. While stock in "publicly traded" entities may warrant special attention, the Task Force recommends that this statute be amended to carefully limit "exempt" situations, remove the exercise of discretion from the corporate licensee and require the investigation of new stockholders as a license holder.

44. The statutory obligation to investigate applicants for retail licenses rests on the local municipal issuing authorities. N.J.S.A. 33:1-24.

45. "Whenever any change shall occur in the facts as set forth in any application for license, the licensee shall file with the director and the other issuing authority, where applicable, a notice in

If the citizens of the State can be assured that entry into the alcoholic beverage industry is predicated on affirmative findings of financial soundness, business acumen, and the absence of disqualifying characteristics generally considered as barriers to sensitive enterprises, the Task Force believes that traditional notions that require prohibitions such as those which gave birth to concepts such as "fair trade," and credit restrictions, etc., will give way to an acceptance of sound, modern business techniques.

D. Elimination of "Sister Houses"

As disclosed in Part I the Task Force found that the convoluted marketing system resulting from the franchise relationships between suppliers and wholesalers in this State gives a false impression of competition in the industry and fosters illicit activities on the part of individual salesmen. For these reasons the Task Force believes that it would be in the public interest for existing wholesale licenses to be merged so as to eliminate "sister-house" subsidiaries. This initiative

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(Footnote continued from page 14)

writing of such change within 10 days after the occurrence thereof said change, when so notified, shall thereupon become part of said application for license to the end that subsequent changes must likewise be so notified; but no notice need be given by corporate licensees of changes in stockholdings therein unless and until the aggregate of such changes, if made before the time of said application, would have prevented the issuance of the license." (Emphasis added).

would permit actual competition among wholesalers and solicitors rather than require the continuation of competition based on escalating personal or corporate rebating. If this recommendation is adopted, in fairness, the State should recognize that existing franchises held by "sister-house" subsidiaries of a parent wholesaler are to be viewed as property of that parent company.[46] This consolidation of "sister-houses" would shift the direction of marketing efforts toward "product lines" rather than among "multiply-wholesaled" products. While this recommendation may reduce the presently existing force of solicitors, it is believed that its implementation will serve the public interest. Not only would this step reduce the operating costs of wholesalers within this State, but more importantly, such a consolidation of existing wholesale licenses into parent companies would offer the remaining sales force specific products to market and thus reduce their need to engage in illicit activity in order to earn a reasonable living.

E. Expansion of Permissible Promotional Activities

It has been almost impossible for agents of the ABC or, for that matter, any other regulatory agency, to police accurately the sales and marketing activities which have

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46. See, N.J.S.A. 33:1-93.6 et seq, Canada Dry Ginger Ale, Inc. v. F & A Distributing Co,., 28 N.J. 444, (1958) James M. McCunn & Co. Inc. v. Fleming & McCaig, Inc. 81 N.J. Super. 97 (App. Div. 1963) American B.D. Co. v. House of Seagrams, 107 N.J. Super 264 (App. Div. 1969) aff'd. 56 N.J. 164 (1970).

traditionally existed in this industry. Of particular concern are salesmen's contests and relatively inconsequential promotional programs designed for retailer use. Current ABC regulations generally prohibit promotional contests by retailers and wholesalers. See, N.J.A.C. 13:2-23.16 and 36.13. In addition, salesmen are prohibited from receiving a bonus which is tied in any way to a sales activity spanning a period of less than 90 days. N.J.A.C. 13:2-37.2.[47] The effect of the latter proscription is that it becomes very expensive for the wholesaler to conduct an incentive program for salesmen which has to continue for a 90-day period.[48] Thus, short-term promotions are almost impossible. The Task Force believes that these restrictions are unnecessary to accomplish public policy goals in light of the marketing activities historically used in other industries.

It is suggested that in order to limit the possibilities of illicit activity, promotional activities be divided into two permissible categories. In the first category would be placed promotional activities, like contests, which offer rewards of substantial economic value, for example, a trip valued at several hundred

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47. Promotional restrictions apply to wholesalers of "other than malt alcoholic beverages," *i.e.* liquor and wine. Such businesses employ approximately 1,200 salesmen and cannot conduct *any* sales incentive programs, except in relation to their minimal "imported" beer sales. See, N.J.A.C. 13:2-36.13.

48. The expense is the result of the duration of price reductions and "post-offs" to retailers as part of the promotion.

dollars. This proposal is designed to reward the individual salesman based on the success of his or her marketing activities alone. Furthermore, if the prize is of significant value, the solicitor will be less likely to attempt to transfer it illicitly to a retailer as an inducement to purchase. The Task Force also recommends the removal of the requirement that such bonuses be required to encompass sales occurring over a period of at least 90 days.

In the second category would be placed promotional activities involving "sales gifts" which are intended to be made available for distribution to retailers through salesmen or which are to be provided directly from wholesalers to retailers based on a marketing program. Under present ABC regulations, advertising materials and specialities such as napkins, sip sticks, key rings, may be provided to a retailer in a yearly amount not in excess of $100 in value. Advertising signs and displays and other items which have "no utilitarian or intrinsic value" may be provided to a retailer in amounts which do not total more than $200 yearly. See, N.J.A.C. 13:2-24.1. The Task Force recommends that a class of specific items be created upon which there is placed no dollar limit. In order to minimize enforcement efforts and to insure the integrity of any proposed marketing endeavors, however, we recommend that all such items be imprinted on their face with the logo of the product supplier, brand owner or wholesaler offering the promotion. By allowing more promotional items to be made available to retailers, the Task Force hopes to eliminate numerous expensive and unfruitful enforcement activities.

In addition, any product supplier or wholesaler intending to use such promotional items should be required to file with the ABC, prior to conducting such activities, a statement disclosing the general outlines of their marketing programs. Finally, the Task Force recommends that any other type of marketing program not specifically permitted by statute or regulation be permissible with the prior approval of the Director of the ABC. The Task Force also believes that such broadened, legitimate marketing activities will be more in harmony with industry requirements.[49]

F. Brand Registration and Industry Affirmative Disclosures

As noted in Part I, at the outset of the ongoing investigation difficulty was encountered

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49. While the alcoholic beverage industry is sensitive, the State Legislature has recently promulgated similar restrictions under the Casino Control Act relating to junket activity. See, N.J.S.A. 5:12-102.

by investigators in determining, other than by rumor or hearsay, "who" the industry was. This was true with regard to suppliers, their products, the wholesalers of each product, and the 12,000 retail licensees. The Department of Law & Public Safety undertook an immediate initiative to solve identification problems with respect to the retail level by directing the computerization of application records previously stored in a manual fashion.[50]

To increase the effectiveness of the ABC in regulating the supplier, the Task Force recommends the introduction of formal brand and distributorship registration by suppliers[51] to replace the present practice of merely adopting Federal label filings. See, N.J.A.C. 13:2-27.1 The Task Force further recommends that the present wholesale license fees be adjusted to reflect this additional form of licensing. See, N.J.S.A. 33:1-11. As noted in Part I

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50. The ABC Licensing Information System (ABC/LIS) is expected to be operational in January, 1979. The joint project between the ABC and the Division of Systems and Communication and members of the Attorney General's staff has already designed a new computerized license application which was used for renewals this year.

51. The Task Force is aware that many members of the distilled spirits industry are adopting the use of the "Universal Code for Alcoholic Beverages" (UCAB) which is patterned after the Universal Product Code (UPC) already familiar to supermarket shoppers. We understand that the UCAB is designed to be compatible with Federal Bureau of Alcohol, Tobacco and Firearms identification numbers, and recommend that strong consideration be given to the incorporation of the UCAB in proposed New Jersey brand registration requirements.

of this Report many suppliers maintain wholesale class licenses in order to legitimately "solicit" sales. See, N.J.S.A. 33:1-2. This proposed new brand registration license could serve to authorize such solicitations, but fees should correspond to anticipated loss of State revenues due to wholesale license retirements.[52]

The Task Force additionally recommends that present wholesale class license fees be modified to reflect a balance between business size and sales, and the costs of enforcement. A plenary wholesale licensee with sales of $70 million a year pays the same license fee as a wholesaler with less than $1 million in sales, i.e. $7,000. The Task Force proposes that such fees be tied to sales by gallonage and that all applicants for transfers or new licenses be required to pay a fee commensurate with the cost of attendant investigation of qualification.

With the advent of more modern marketing techniques and lifting of "fair trade" restrictions as proposed, it is incumbent upon the industry affirmatively to disclose its trade practices to the ABC for monitoring and

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52. We note further that this proposal would provide enforcement "leverage" over brand owners who have declined to seek any license in this State, but merely authorize their wholesaler-distributors to act on their behalf.

enforcement purposes. The Task Force therefore recommends that quarterly reports on marketing and pricing practices be required of both the supplier and wholesale levels of the industry similar to disclosures provided by major public entities to the Federal Securities and Exchange Commission, i.e. Forms 8-K and 10-K. The Task Force recommends a reexamination of the penal sanctions of Title 33 so as to insure that sufficient criminal penalties and meaningful civil sanctions are available as a deterrent to conduct contrary to public policy in all aspects of New Jersey's alcoholic beverage industry.

Finally, with the advent of Casino Gaming and the removal from the ABC of direct control over consumption of alcoholic beverages in Casino Hotels,[53] the Task Force recommends that the industry be required to maintain records of sales to Casino Hotels, so as to assist the Casino Control Commission in its supervisory functions, and to insure the integrity of "consumption" statistics that will necessarily be examined if the proposals set forth in this Report are adopted.

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53. See, N.J.S.A. 5:12-103.

IV. CONCLUSION

The foregoing recommendations and proposals reflect the Task Force's confrontation of areas of significant public policy impact in the regulatory system of the alcoholic beverage industry. In preparing this Report, the Task Force has solicited the assistance and views from numerous sources including "unofficial" input from significant industry membership. The Task Force believes that the proposals as set forth in their entirety reflect an equitable balance between competing interests of the industry and the citizens of the State.

REPORT

OF

DIVISION OF CRIMINAL JUSTICE
ANTITRUST TASK FORCE

TO STUDY THE

ALCOHOLIC BEVERAGE INDUSTRY

APPENDIX
An Excerpt from
The Estimated Impact of Repeal of
"Fair Trade" on the Small Retailer

I.

PREFACE

In its Report the Task Force advised that it had commissioned a study of the economic impact on small retailers, i.e. "mom and pop" liquor stores, of its recommendation to repeal "Wholesale Price Lists" and "Minimum Consumer Resale Prices," otherwise known as "fair trade" in the alcoholic beverage industry of this State. To that end, the Task Force employed the services of an economic analyst and acquired the consulting expertise of a university Economics Professor. The analysis that follows is an excerpt of their efforts in conjunction with the Task Force, based on available statistical data.*

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*This excerpt contains analytical references to statistics relating to the State of California. While the information is nonetheless valid, that jurisdiction no longer has a functioning 'fair trade" mechanism.

THE EFFECT OF RESALE PRICE MAINTENANCE ON LIQUOR PRICES

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A number of states, recognizing the detrimental effects of retail price maintenance, have in recent years repealed "fair trade" laws affecting liquor and other products. By 1977, it appears that only five states effectively enforced laws maintaining retail liquor prices, although a number of other states set minimum markups or retained other regulations which probably had some effect on liquor prices. In order to determine the effect of resale price maintenance (RPM) on liquor prices, average brand-name liquor prices in those five states with effective RPM were compared with five "matched" states without effective price maintenance laws. Liquor prices will be affected by factors other than RPM, and this "matching" process is designed to eliminate as many of these extraneous factors as possible. The prices charged in the five RPM states and the matched non-RPM states are shown in Table 1.

TABLE 1

Average liquor prices (dollars per fifth) in five states with effective retail price maintenance (RPM) and in five "matched" states without effective RPM. (Numbers in parentheses are the legal age populations in each state, in millions).

States with RPM			States without RPM		
Calif.	(13.9)	$7.08	N.Y.	(12.9)	$6.25
N.J.	(5.2)	7.21	Ill.	(7.1)	5.90
Mass.	(4.1)	6.85	Wis.	(3.2)	6.33
Conn.	(2.5)	6.97	Md.	(2.6)	5.82

TABLE 1 (Continued)

States with RPM			States without RPM		
Kan.	(1.5)	\$6.97	Col.	(1.6)	\$6.29
Unweighted avg.		\$7.02	Unweighted avg.		\$6.12
(Total population of RPM states: 28.3 million)			(Total population of non-RPM states: 27.4 million)		

The average of tax-inclusive prices charged for eight major liquor brands, determined by a nationwide survey in 1977. Data provided by DISCUS, the Distilled Spirits Council of the United States, Inc.

According to Table 1, the average brand-name price per fifth in RPM states in 1977 was 90 cents higher than in non-RPM states. This statement must be qualified, however. Factors other than RPM, such as the cost of doing business, liquor prices in adjacent states, the legal restrictions on entry into the liquor retailing business, the number of wholesale and retail outlets, etc., will also affect liquor prices; and indeed such factors lead to the considerable variation in the prices shown in Table 1. Prices in RPM states, for example, range from \$6.85 to \$7.21 a fifth, while in non-RPM states the range is \$5.82 to \$6.33. Moreover, a sample of only ten states is an imperfect representation of U.S. liquor prices. Standard statistical tests are available to analyze small samples such as this, however, and the use of such a test* indicates that there is essentially zero probability that RPM does not lead to increased liquor prices.# That is, according

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* t-test of significance between two sample means, with 8 degrees of freedom.

$t = 7.33 \quad v = 8$

to the data presented in Table 1, there is virtually a 100 percent probability that resale price maintenance increases brand-name liquor prices. The same statistical test indicates that there is a 95 percent probability that RPM increases brand-name liquor prices by at least 67 cents per fifth, and a 75 percent probability that RPM increases brand-name liquor prices by at least 81 cents per fifth.

The conclusion that resale price maintenance increases retail liquor prices has also been reached by Ferguson,# who estimated that RPM raised 1963 liquor prices by an average of 36 cents to 56 cents per fifth.

James M. Ferguson, "Analysis of Interstate Differences in Retail Liquor Prices: Collusion and State Regulation," University of Rochester Working Paper Series No. 7419, June 1974.

THE EFFECT OF ELIMINATING RESALE PRICE MAINTENANCE IN NEW JERSEY

I. The effect on liquor prices

The exact amount by which New Jersey liquor prices would fall if RPM were abolished cannot, of course, be predicted. A very conservative estimate, based on the analysis of the data contained in Table 1, is that in the absence of RPM, New Jersey brand-name liquor prices would fall by at least 67 cents per fifth. (Analysis of the data in Table 1 indicated that there is only a five percent chance that RPM has increased average brand-name liquor prices by less than 67 cents per fifth). Such an estimate may well be too conservative. At present, New Jersey liquor prices are among the highest in the contiguous United States --in 1977 only the partially-dry states of Arkansas and Tennessee had higher average liquor prices than did New Jersey--so that the abolition of RPM may lead to price savings above even the ninety cent average price differential between RPM and non-RPM states. Nearby states without RPM have average liquor prices which are well below the $7.21 New Jersey average. The eight-brand average in New York State is $6.25, in Maryland $5.82, in Washington, D.C. $6.02; these figures suggest that brand-name liquor prices could fall by a dollar per fifth, or more, if RPM were eliminated.

II. The effect on liquor consumption

In general, price reductions may be expected to lead to increased consumption of any product, including brand-name liquor. In a geographically small state such as New Jersey, however, any prediction of the effect of price changes is complicated by the ability of residents to switch purchases to, or from, adjacent states in response to relative price changes. It is likely, for example, that residents of New Jersey who work in the states of New York or Pennsylvania--both of which have lower liquor prices than New Jersey--purchase appreciable quantities of liquor in those states. To the extent that lower New Jersey prices lead commuters to simply substitute New Jersey purchases for (say) New York purchases, then no increased consumption results. Other consumers respond to high brand-name prices by purchasing private-label brands. Again, to the extent that lower brand-name prices lead consumers to reduce their consumption of private labels, no increased consumption results. There are, however, a large number of New Jersey residents who purchase brand-name products within the state, and lower prices may lead those consumers to increase their purchases.

Whether consumers will respond to a price reduction by buying a great deal more of a product, or by buying very slightly more, depends upon that product's price elasticity. Price elasticity is defined as the percentage increase in consumption which would be caused by a one-percent fall in a product's price. For example, a price elasticity of 5 indicates that consumers would react to a one-percent price reduction by increasing the volume of their purchases by five percent, while a price elasticity of 0.5 indicates that consumers will increase their purchases by only one-half of one percent if price is cut by one percent.

There have unfortunately been only two statistical studies which attempt to estimate recent liquor price elasticities in North America.* One study, by Simon,** concluded that the liquor price elasticity in the U.S. during the period 1955-61 was approximately 0.8. A second study, by Lau,# found that the liquor price elasticity in Canada during the period 1949-69 was approximately 0.2. Both

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* A third study, by W.A. Niskanen (Taxation and the Demand for Alcoholic Beverages, P-182, Rand Corp., Santa Monica, CA, 1960) covers only the period 1934-54; Niskanen estimates the liquor price elasticity to be approximately 1.7. A fourth study, by R.M. Lidman ("Economic Issues in Alcohol Control," Report No. 7 for the Social Research Group, School of Public Health, University of California, Berkeley) attempts to estimate the liquor price elasticity in the state of California during the period 1953-75. Lidman was unable to obtain California price data and so was forced to assume that California price changes were identical to changes in average U.S. prices--a highly unrealistic assumption. He concludes that the liquor price elasticity in California is less than 0.1; but given the serious data problems in the study this result can only be regarded as suggestive.

** J.L. Simon, "The Price Elasticity of Liquor in the U.S. and a Simple Method of Determination," Econometrica, 34(1), January 1966.

H. H. Lau, "Cost of Alcoholic Beverages as a Determinant of Alcohol Consumption," in R.S. Gibbins et. al. (eds.), Research Advances in Alcohol and Drug Problems, New York: Wiley, 1975. Lau concludes in his study that the liquor price elasticity is approximately 1.7, but as Lidman (op. cit.) has pointed out, Lau misinterpreted his own analysis; his regression analysis actually indicates that the price elasticity is approximately 0.2.

of these studies indicate that liquor purchases are relatively insensitive to price changes.

In 1976, 15,900,000 gallons of distilled spirits were legally sold in New Jersey. An undetermined fraction of that volume was made up of private-label sales. As a probable upper limit on the effect which eliminating RPM could have on New Jersey liquor consumption, assume that brand-name prices fall by fifteen percent (slightly over one dollar per fifth)*, assume that private-label prices are driven down by a similar percentage, and assume that the price elasticity of liquor is 1.0, a figure which probably represents a reasonable upper limit for that elasticity. Given these "upper limit" assumptions, the elimination of RPM could increase liquor consumption in New Jersey by fifteen percent, or roughly 2.4 million gallons. If on the other hand, the liquor price elasticity is as low as 0.2, and if liquor prices fell by only 67 cents per fifth (a nine percent drop), then the elimination of RPM would increase consumption by approximately 300,000 gallons or slightly more than two percent. It is, unfortunately, not possible to indicate which of these two scenarios is more likely.

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*This could be defended by the claim that since New Jersey's prices are higher than the average RPM state's, they should fall by a greater than average amount when RPM is removed.

III. The effect on New Jersey liquor sales

Regardless of the effect which lower prices have on New Jersey consumption, it may be safely predicted that the sales volume of New Jersey retailers will rise by more than the amount of the consumption increase. Since it is more convenient to purchase liquor near one's residence, a fall in New Jersey liquor prices will cause some commuters to shift their buying from New York or Pennsylvania to New Jersey; and a substantial fall in New Jersey prices would generate purchases from out of state residents. Although it seems unlikely that the price elasticity of liquor is greater than 1.0, so that a one-percent drop in prices will probably increase liquor consumption by less than one percent, sales of liquor in New Jersey could very well increase by more than one percent for every percentage drop in prices. This is because of the increased demand from commuters and out-of-state residents. This increased demand will offset, to some extent, the effect of the lower prices, so that the profits of New Jersey liquor retailers will not be reduced by as much as they would be if New Jersey were an isolated geographical area.

In spite of the increased sales volume generated by lower prices, it is likely that the end of RPM will mean reduced profits for liquor retailers. In general, this should not be grounds for concern; by eliminating price competition, resale price maintenance allows retailers to earn excessive profits, and the elimination of those excess profits is to be desired.

Small retailers frequently argue that without RPM they "cannot survive," that in the absence of resale price maintenance they would quickly be driven out of business by larger establishments and chain stores. This argument, though clearly self-serving, warrants some attention, since the public may wish to preserve small businesses even if doing so requires somewhat higher prices. In the next section the effect which the elimination of RPM would have on small retail stores is examined.

IV. The effect on small retailers

There is no evidence that the abolition of resale price maintenance affects the ability of small retailers to effectively compete against their larger rivals. The U. S. Senate Judiciary Committee, recommending the repeal of exemptions in the antitrust laws which permit state fair trade laws, reported that*

> ...statistics gathered by the Library of Congress indicate that the absence of fair trade has not harmed small business. Using Dun and Bradstreet data, the Library of Congress found the 1972 firm failure rate in "fair trade" states which have the nonsigner provision was 35.9 failures per 10,000 firms, in "fair trade" States without the nonsigner provision the rate was 32.2 failures per 10,000 firms, while the failure rate in free trade States averaged 23.3 failures per 10,000 firms--in other words "fair trade" States with fully effective laws have a 55 percent higher rate of firm failures than free trade states.
>
> Finally, the traditional argument that fair trade protects the "mom and pop" store from unfair competition is not borne out by statistics. Between 1956 and 1972 the rate of growth of small retail stores in free trade States (including states which repealed "fair trade" during this period) is 32 percent higher than the rate in "fair trade" States.

"Mom and Pop" liquor stores--retail liquor establishments without payroll employees--do not appear to be at any significant disadvantage in non-RPM states. Table 2 lists the number of non-payroll retail liquor stores per million gallons of legally-sold spirits in each of the five RPM states and in the matched non-RPM states.

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* 1975 U. S. Code Cong. & Admin. News, at 1571.

TABLE 2

Number of retail liquor stores without payroll* per million gallons of legally-sold spirits** in five RPM states and five "matched" non-RPM states.

States with RPM		States without RPM	
California	8.51	New York	27.90
New Jersey	13.58	Illinois	18.15
Massachusetts	10.61	Wisconsin	24.69
Connecticut	88.67	Maryland	7.75
Kansas	83.42	Colorado	29.62
Unweighted avg.	40.96	Unweighted avg.	21.62
Weighted avg.	18.29	Weighted avg.	22.69

The most striking characteristic of Table 2 is the great variability in the number of non-payroll establishments per million gallons of sales, from 7.75 in Maryland to 88.67 in Connecticut.

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*Bureau of Census, 1972 Census of Retail Trade. The Bureau defines a package good store as a retail firm which derives fifty percent or more of total gross revenues from bottled liquor sales. This significantly understates the total number of retailers, but is a very reasonable simplification to utilize as it considers only those stores that substantially rely on liquor sales.

**Distilled Spirits Council of the U.S., 1976 Annual Statistical Review. The 1972 DISCUS Review is available, however more recent data was utilized. The relevant characteristics remained consistent (i.e., no change in RPM status), therefore the "recentness" criterion was favored over strict consistency.

This is hardly surprising, however, since the number of "mom and pop" stores in each state will be affected by a large number of factors, including population density, wage rates, consumer buying habits, and so on. The simple averages calculated in Table 2 indicate that RPM states have 41 non-payroll stores per million gallons sold, compared to 22 in non-RPM states. Because of the great variability in the data, however, it cannot be said with any confidence that the RPM states and non-RPM states are significantly different in terms of non-payroll liquor stores.# Moreover, the larger simple average in the RPM states is due primarily to the effects of the relatively small states of Connecticut and Kansas. If instead of calculating a simple average, one calculates the number of non-payroll stores per million gallons of sales for all five RPM stores taken together (a "weighted average") and compares that statistic to the non-RPM weighted average, the RPM states are seen to have <u>fewer</u> "mom and pop" retail stores per million gallons sold. Neither statistic is "better" than the other; both suggest that the number of "mom and pop" retail stores in any state is affected much less by RPM than by other factors.

In any case, Table 2 indicates that New Jersey already has fewer non-payroll liquor stores per million gallons of sales than do four of the five non-RPM states considered. There is no reason

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#The unweighted averages are not significantly different at the 90 percent confidence level, (t=1.025 (degrees of freedom)=V=8).

to believe that the abolition of RPM would cause that number to be reduced further.

The size of a non-payroll establishment is limited by the proprietor's ability to manage his/her affairs, and one would not expect resale price maintenance to have any significant effect on the average size of non-payroll retail stores. Table 3 suggests that RPM and non-RPM states do not differ significantly in this regard.

TABLE 3

Average Sales Revenue ($1,000) of retail liquor stores without payroll*

States with RPM		States without RPM	
California	87.25	New York	27.90
New Jersey	76.39	Illinois	51.05
Massachusetts	54.05	Wisconsin	57.25
Connecticut	77.12	Maryland	96.43
Kansas	70.78	Colorado	62.96
Unweighted avg.	73.12	Unweighted avg.	68.67

Standard statistical tests indicate that there is no significant difference between the sales revenue per non-payroll liquor store in RPM states and non-RPM states.**

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*1972 Census of Retail Trade, op. cit.

** t=0.46, V=8.

Liquor stores with payroll employees appear to be somewhat larger in non-RPM states, as is shown in Table 4.

TABLE 4

Average Sales Revenue ($1,000) of retail stores with payroll*

States with RPM		States without RPM	
California	258.2	New York	261.3
New Jersey	271.1	Illinois	385.6
Massachusetts	315.4	Wisconsin	256.4
Connecticut	146.1	Maryland	341.0
Kansas	92.4	Colorado	225.3
Unweighted avg.	216.6	Unweighted avg.	293.9

The non-RPM average of 294 is significantly greater than the RPM average of 217: there is less than a ten percent probability that payroll stores in non-RPM states are no larger than in RPM states.**

Retail stores with payroll employees tend to be somewhat larger in non-RPM states, and there tend to be fewer stores, as is shown in Table 5.

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* 1972 Census of Retail Trade, op. cit.

** $t = 1.51$, $V=8$.

TABLE 5

Number of retail liquor stores with payroll per million gallons of legally-sold spirits* in five RPM states and five "matched" non-RPM states

States with RPM		States without RPM	
California	91.36	New York	82.59
New Jersey	104.32	Illinois	55.45
Massachusetts	100.43	Wisconsin	58.74
Connecticut	141.07	Maryland	70.52
Kansas	279.09	Colorado	78.51
Unweighted avg.	143.25	Unweighted avg.	69.16
Weighted avg.	104.74	Weighted avg.	70.78

The difference between the average number of payroll liquor stores in RPM states and non-RPM states is quite significant: the probability that non-RPM states have fewer payroll liquor stores per million gallons of spirits sold is greater than 95 percent.**

Although New Jersey has a smaller-than-average number of payroll retail stores (104 per million gallons of spirits sold versus an average of 143 in the five RPM states), it does not seem unlikely that the end of RPM in New Jersey would further reduce that number. The non-RPM states seem, for the most part, to be able to support 60 to 80 payroll stores per million gallons of spirits sold. A twenty percent reduction in the number of payroll liquor stores in New Jersey--the elimination of some 330 payroll establishments--would be required to bring New Jersey in line with non-RPM states.

* 1972 Census of Retail Trade, op. cit.; 1976 Annual Statistical Review, op. cit.

** $t = 2.09$; $v = 8$.

The remaining stores would of course be larger than they are at present in order to serve the increased number of consumers.

This should not be interpreted as an indication that twenty percent of all retail establishments will close. The twenty percent is of the 1659 establishments with employees that fit the Bureau of Census "fifty percent of sales" criterion. An additional 216 non-payroll stores fit this criterion, a group claimed above to be unresponsive to RPM removal. These 1659 stores are less than half of the figure that the Bureau of Census provides for the total number of payroll establishments offering liquor for sale, 3965. This understates the total by the 216 non-payroll stores, and the non-payroll establishments that do not meet the fifty percent minimum. This number also does not include hotels, clubs, or many entertainment and service oriented establishments. The total number of "on-off" and "off-premise" licenses was 10426* in 1976.

Twenty percent is the figure for the most sensitive part of the liquor industry, i.e., stores without the "convenience" role of "mom and pop" stores and with more than fifty percent of their sales in liquor. The great majority of licensees (i.e., clubs, hotels, bars, and restaurants) should be unaffected by RPM discontinuation. Non-payroll firms should be unaffected. We would also expect the profitability of stores less dependent on liquor (e.g., less than fifty percent of sales) to be much less sensitive.

Therefore, an outside estimate, which is based on the application of the twenty-percent figure to the total payroll firms

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* DISCUS, 1976; The figure as of 5/24/78 was 10559, Division of Systems and Communications, (ABC/LIS) New Jersey.

offering liquor for sale, implies the likely failure of less than eight percent of establishments licensed. The more probable final figure is the slightly more than three percent of all licenses. Stores with only small percentages of revenues resulting from liquor sales should have little trouble surviving without Resale Price Maintenance.

The implication of Tables 2 through 5 is that "mom and pop" retail stores are essentially unaffected by resale price maintenance, either in number of establishments or size of establishment. Retail liquor stores with payroll employees, on the other hand, are smaller in number in non-RPM states, and the surviving stores tend to be somewhat larger. This finding is not inconsistent with data reported by Robert Morris Associates,* which indicates that of 98 retail liquor stores surveyed, the 28 "medium-sized" establishments were less profitable than either the group of smaller stores or the larger establishments.** It may be that small or medium-sized payroll stores are less efficient than either non-payroll stores or large payroll stores and therefore tend to be most vulnerable to the forces of competition.

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*Robert Morris Associates, "1977 Annual Statement Studies," Philadelphia

**This finding should be interpreted with caution, however, since the "smallest" group of stores in the Robert Morris sample has average sales revenue of nearly $440 thousand. This is six times as large as the average non-payroll establishment listed in Table 3.

SUMMARY OF ANALYSIS

The end of resale price maintenance in New Jersey may be expected to have the following effects.

(1) Brand-name liquor prices will fall, perhaps by a substantial amount. A very conservative estimate, based on a statistical analysis of the effect of RPM on brand-name liquor prices in ten states, is that average prices will fall by at least 67 cents per fifth. A more optimistic estimate, based on an examination of brand-name prices in neighboring states without RPM, is that average prices could fall by as much as $1.25 per fifth.

(2) Liquor consumption will rise by an essentially unpredictable amount. Depending upon the amount of the average price reduction and upon the price elasticity of liquor, New Jersey consumption could rise by as much as 2.4 million gallons per year (a fifteen-percent increase over current consumption), or by as little as 300 thousand gallons per year (an increase of slightly less than two percent).

(3) Liquor sales volume and hence State tax revenues--will rise by more than the amount of the consumption increase, since some New Jersey residents now purchasing liquor in New York or Pennsylvania may be expected to switch their purchases out of state and some out of state residents may be expected to purchase liquor in New Jersey.

(4) Liquor store profits* will be reduced, but there is no evidence that a significant number of family-run stores will fail if RPM is eliminated. "Mom and Pop" liquor stores exist in essentially equal numbers in states with resale price maintenance and in similar states without RPM. The number of liquor stores with payroll employees will probably be reduced. There will be some increase in the average size of the remaining payroll establishments, in order to satisfy the increased consumer demand. The failure rate figure should translate into between three and eight percent, when the base used is the total number of licenses that make provision for off-premise liquor sales. The actual figure should be much near to three percent, as the sample used was the most vulnerable store type (retail outlets with over fifty percent of sales in liquor).

*There is some chance that total revenue could increase if the elasticity is greater than one. There is no reasonable chance that profits will increase, as the cost to the retailer of each bottle will account for much of this revenue.

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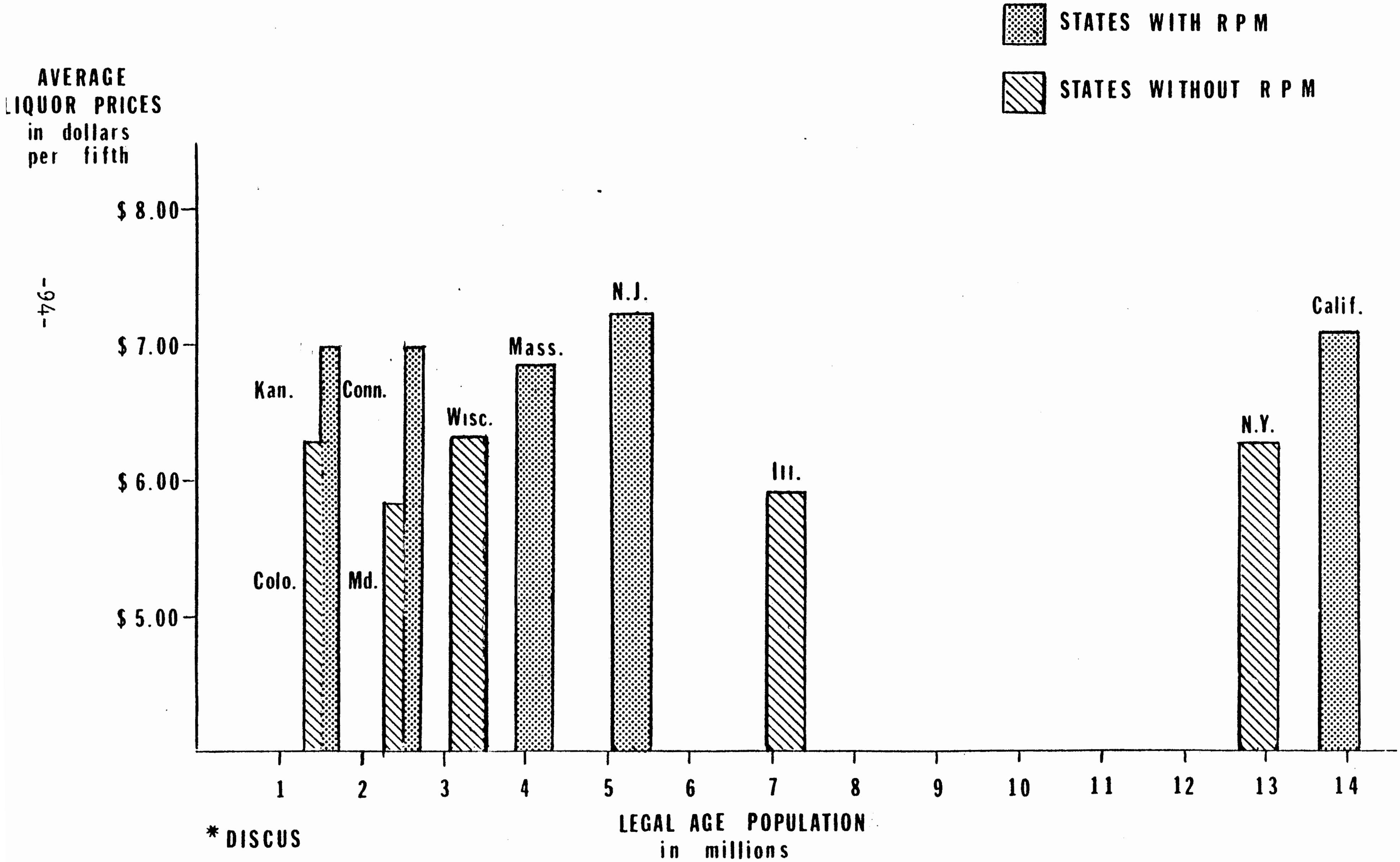
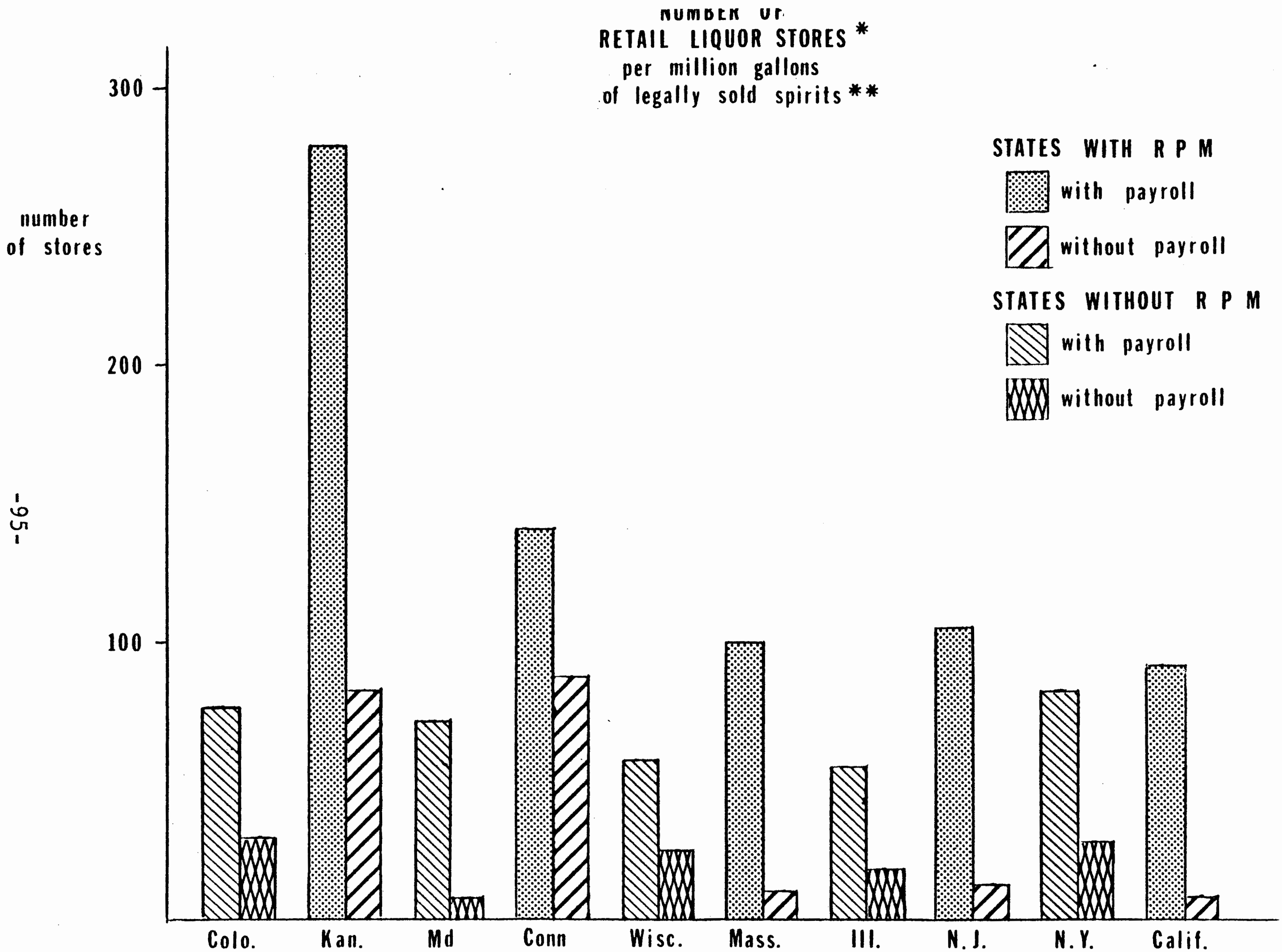
AVERAGE LIQUOR PRICES
1977*



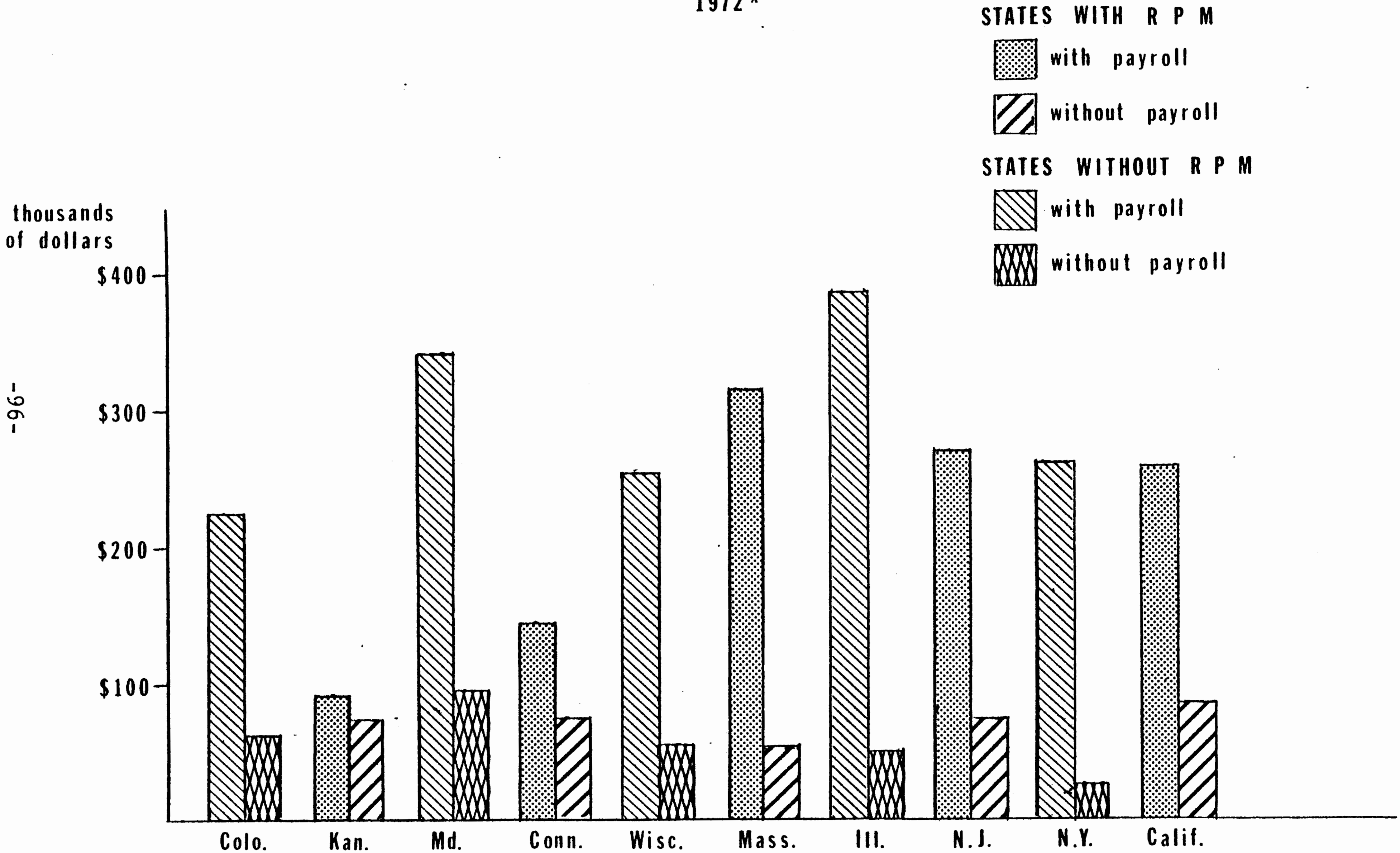
* DISCUS



* 1972 Census of Retail Trade

** DISCUS

AVERAGE SALES REVENUE
OF RETAIL STORES
1972*



*Census of Retail Trade

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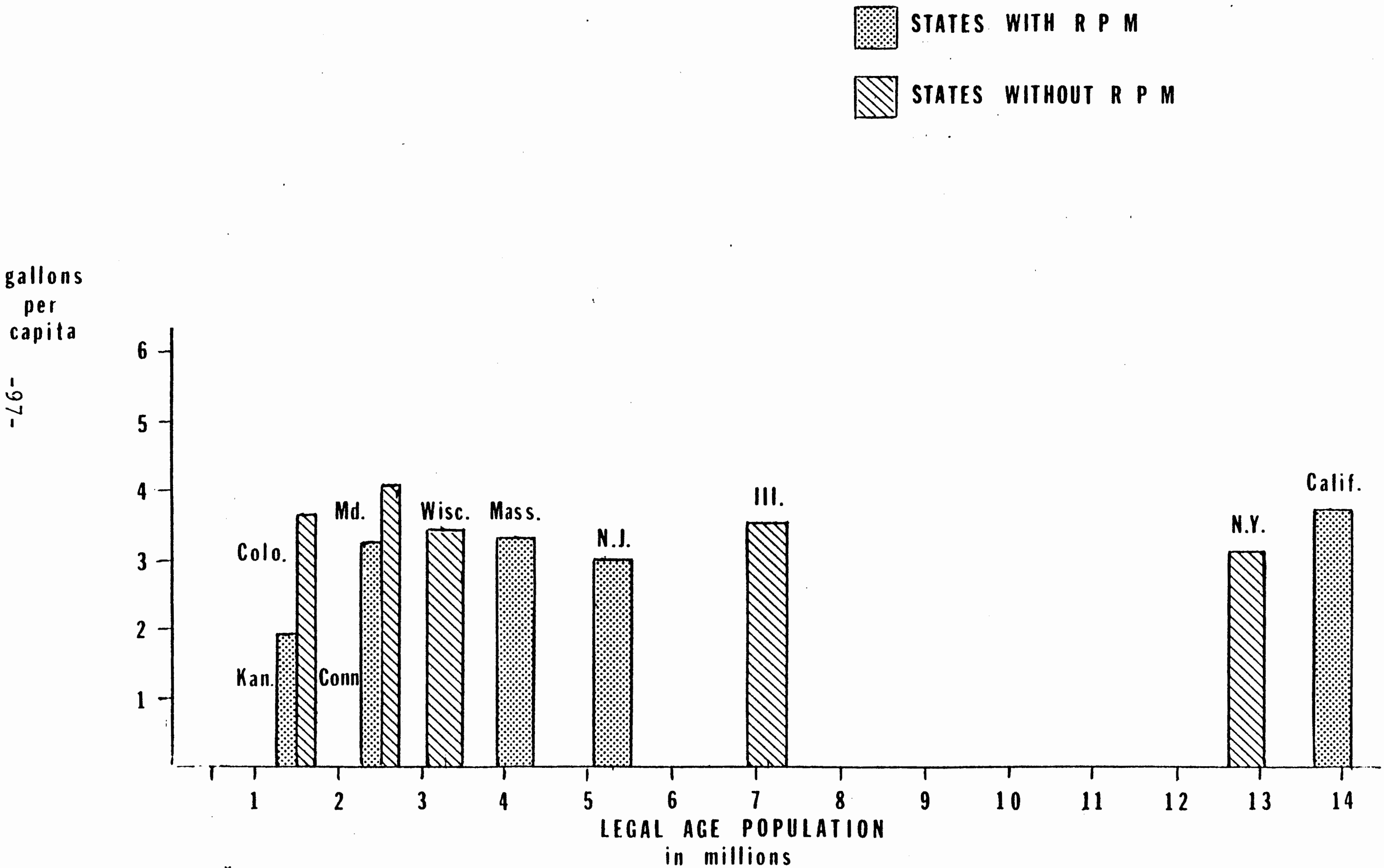

*The 1978 Liquor Handbook