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DISCUSSION DRAFT

MARKETING PRACTICES ADVISORY - MPAXXX

Three Tier System - Prohibited Relationships

This advisory is in response to informal verbal requests from the industry to clarify the legality of certain business practices currently occurring in the Texas marketplace. Under the three tier system, a tied house relationship is illegal, and business relationships other than those authorized by the Alcoholic Beverage Code (Code) are prohibited by §11.01(c) of the Code. Section 6.03(i) of the Code emphasizes it is public policy of this state to maintain and enforce the three tier system and prevent the creation or maintenance of a tied house as described in §102.01 of the Code.

The Commission is aware that, facing market pressure to get their product on the shelf, members of the manufacturing tier, directly or indirectly, may be reimbursing retailers for advertising costs and compensating retail employees with bonuses for promoting the retail sale of the manufacturer's brands. Wholesalers and distributors may face pressure from manufacturers and large chain retailers to engage in unlawful activities such as agreeing to lower price margins, or to act as a pass-through for advertising and marketing fund dollars. In addition, these wholesalers and distributors may be asked to unlawfully serve as a conduit for control or private label brands, which can result in product exclusivity.

These prohibited practices are of concern to the agency as they violate tied house and related provisions of the Code and the Commission's Administrative Rules (Rules). TABC has dedicated a specialized audit team to focus exclusively on investigating marketing schemes that may be in violation of provisions of the Code. The agency continues to promote voluntary compliance by the industry with the Code and Rules; however, the agency will fulfill its mission and investigate and pursue administrative charges against industry members found to be in violation. Violation of a provision of the Code or Rules can result in suspension or cancellation of a permit or license under Code §§11.61(b)(2), 61.71(a)(1), 61.74(a)(1), and 61.75.

The following are common examples of prohibited relationships that have been noted during investigations conducted by the agency.

Upper Tier Sponsored Retailer Cash and Credit Incentive Programs: The manufacturing tier works directly with the retailer or indirectly through the wholesale tier to pass funds to the retailer as bonus payments to sales staff for encouraging and promoting the sale of their products over competitors' brands. A common unlawful scenario entails a manufacturer offering a \$5.00

bonus per bottle sold, where \$3.00 is kept by the retailer and \$2.00 is passed on to the retail sales employee. Retail employees use the following types of staging techniques to ensure the sale of the incentivized product is pushed over others: product shelf location, store display arrangement, advertisement, and special tag pricing. Code sections associated with violations of this nature may include:

- 102.16(a) - Unlawful agreements between tier members
- 102.01(h), 102.07(a)(2), 102.15(a)(1) - Prohibited relationships between tier members
- 104.03 - Conspiracy, Unlawful Benefit to Retailer

Control/Associate/Private Brand: As used here, these terms refer to alcoholic beverages that become exclusive to a retailer or group of retailers. Unlawful scenarios include controlling product distribution through pricing schemes which may be based on volume discounts, using just-in-time warehouse product stocking, and/or executing unlawful agreements between members of the retail tier and the manufacturer of the product. In some cases, the retailer unlawfully controls the quality, recipe, production, wholesale price, and distribution of the product. Code and Rule sections associated with violations of this nature may include:

- 102.16(a) - Unlawful agreements between tier members
- 102.01(h), 102.07(a)(2), 102.15(a)(1) - Prohibited relationships between tier members
- 104.03 - Conspiracy, Unlawful Benefit to Retailer
- 12.06, 62.14 - Illegal Contract/Alternating Brewing/Manufacturing
- Rule 45.73(e) – Private Retail Label – Malt Beverage Product

Advertising: The manufacturing tier influences or controls advertising by the retailer for a specific brand through either direct reimbursement of advertising costs to the retailer, indirect payment by the upper tier member to a third party advertising company on behalf of the retailer, or reimbursement to the retailer through middle tier pass-through schemes disguised as credit invoices or invoices for the sale of non-alcohol products. Code sections associated with violations of this nature may include:

- 102.16(a) - Unlawful agreements between tier members
- 102.01(h), 102.07(a)(2), 102.15(a)(1) - Prohibited relationships between tier members
- 104.03 - Conspiracy, Unlawful Benefit to Retailer

Manufacturing/Brewing/Distilling without a License or Permit: The retailer or distributor/wholesaler deals directly with the manufacturer, brewer, winery or distillery to make a malt beverage, wine or distilled spirits product. The retailer or wholesaler (who may or may not own the trademark or recipe) controls the price margin and distribution of the product. The retailer or wholesaler may unlawfully be paying directly for materials, including bottling, labels, contents, etc. Code and Rule sections associated with violations of this nature may include:

- 102.16(a) - Unlawful agreements between tier members
- 102.01(h), 102.07(a)(2), 102.15(a)(1) - Prohibited relationships between tier members
- 104.03 - Conspiracy, Unlawful Benefit to Retailer
- 11.01, 12.01, 14.01, 61.01, 62.01 – Failure to hold proper permit or license to engage in authorized manufacturing, brewing and distilling activities
- Rule 45.73(e) – Private Retail Label – Malt Beverage Product

Unlawful Agreements or Contracts: Agreements and contracts, written or unwritten, are commonplace in the industry and the majority are legal. They become unlawful when they affect the independence of another tier or create an uneven playing field in the marketplace. Examples of unlawful agreements include those restricting the product for distribution to a specific retailer, or controlling retail or wholesale price point margins. Code and Rule sections associated with violations of this nature may include:

- 12.06, 62.14 - Illegal Contract/Alternating Brewing or Manufacturing
- 102.16(a) - Unlawful agreements between tier members
- Rule 45.73(e) Private Retail Label – Malt Beverage Product

Illegal Manufacturing/Brewing Agreements: Malt beverage producers with no license or permit unlawfully strike a deal with existing brewers or manufacturers to manufacture a malt beverage product. Code sections associated with violations of this nature may include:

- 12.06, 62.14 - Illegal Contract/Alternating Brewing or Manufacturing
- 11.05, 61.16, 101.76, 109.53 - Subterfuge/Unauthorized use of license/permit

Consignment: Unlawful product consignment occurs when either the retailer does not pay the upper tier member until the product is sold or the product is returned to the upper tier member for credit if it is not sold. The latter situation is typically the result of charitable, religious or civic organization events sponsored by the upper tier. The upper tier basically oversells their product to the third party retailer, picks up the excess product after the event, and either issues a credit for what was not sold or delays invoicing the retailer for the product to avoid the appearance of consignment. Obviously, if the promotion involved beer, a cash law violation would also occur. Please note that upper tier members are prohibited from sponsoring events at a retailer's regularly permitted/licensed premises. Code sections associated with violations of this nature may include:

- 101.68 - Consignment sales
- 104.03 – Conspiracy, Unlawful Benefit to Retailer
- 102.31 - Cash Law

This Advisory is issued pursuant to Texas Alcoholic Beverage Code §5.57. It represents the opinions of the staff of the agency. It has not been approved by the commission and is not a rule. The agency will not bring an enforcement action because a practice is inconsistent with this Advisory, but may bring an enforcement action if the practice violates the Texas Alcoholic Beverage Code or the Rules in Chapters 31 – 50 of Title 16, Part 3, of the Texas Administrative Code. This determination will be made on an individual case basis and is dependent on the facts of the particular case. This Advisory does not represent pre-approval of any specific activity.

The agency hopes this opinion will assist the industry in its endeavors. For additional information or questions regarding this Advisory, please contact TABC in writing at P.O. Box 13127, Austin, TX 78711, by email at marketing.practices@tabc.texas.gov, by phone at 512-206-3411 or by facsimile at 512-206-3349.