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Compliance Issues with Direct Shipment of Alcohol to Customers

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In the alcohol business, direct shipment of alcohol by producers to consumers is most often a separate market operating under different rules with little enforcement. Unfortunately, that kind of scenario, like the trade practice issue I previously covered, often results in compliance problems where good operators get undercut by those who do not play by the rules.

This "alternative market system" was originally created in response to the stated concerns of very small wineries who said they could not get their product into the three-tier regulated market. Because these wineries were so small and lacked the capital to promote their product, large wine distributors were reluctant to carry their products.

Many states created a license to permit out-of-state entities to ship wine into their state. In addition, shippers were often licensed separately with requirements to label the package (saying it contained alcohol) and to check ID upon delivery.

But now there are indications that major compliance issues exist. These are primarily due to substantial shipments by unlicensed businesses, unreported revenue and failure to check ID by shippers.

In early 2015, the Illinois Liquor Control Commission sent over 100 cease and desist letters to retailers, wineries, and fulfillment houses. They had evidence that the 100 entities were shipping alcohol from out of state without a license.

A recent study by The Hill Group, commissioned by the Michigan Beer and Wine Wholesalers, found in 26 controlled buys, there was an "unexpectedly-low level of compliance. For example, only 1 of 15 unlicensed vendors refused to ship wine to a Michigan consumer, none of the deliveries had the appropriate labeling on the delivered package, and individuals under the age of 21 were able to order, purchase, and receive shipments of alcohol."

In a recent study conducted by the University of North Carolina, "The study participants successfully purchased alcohol on 45 out of 100 tightly controlled attempts. They did not use fake IDs, and they had to provide their real IDs when asked. Only 12 orders failed immediately when the participant placed the online order or shortly afterward."

While this "alternative market" is a very small percent of all alcohol sales, it is growing rapidly. According to the company ShipCompliant, sales have increased from 2 million cases in 2010 to 4.29 million cases in 2015.

A look at wineries in Washington State helps illustrate this market. Washington is the second largest wine producing region in the nation. Today there are over 900 wineries...300 more than existed in 2009. Most of Washington's wine is sold by five companies which produce over 200,000 cases per year and three of those operations are owned by one company, St. Michelle. However, 87% of the wineries produce fewer than 10,000 cases per year and about half are truly boutique operations making less than 1,000 cases. With over 900 wineries and only so much shelf space in retail establishments, distributors cannot possibly serve all that want their distribution.

Given this growth and the indications of unlicensed and non-compliant activity, this is a good time to review and assess these issues:

Public safety

Direct shipping laws usually have a requirement that ID be checked upon delivery to ensure the recipient is 21. Often the shipper just drops the product at the door. It does seem unlikely that many underage youth are direct shipment customers given that the average bottle price was \$38.23 in 2015, according to Ship Compliant. Nevertheless, the 21 age restriction is an important law and failure to follow it is a serious matter. A greater concern may be the growth of in-state shipping services delivering all forms of alcohol directly to homes. It would be important to determine whether these companies are diligent about checking ID. An unresolved legal issue is how much state control is retained over shipping of alcohol given federal preemption laws related to shipping.

Product Safety

The 3-tier system has a sterling record with regard to product safety and it is the distributor's duty to track all bottles and cans. The ability to track product from production to sale to the consumer; and, to check quality and effect needed recalls is often glossed over. But it is a unique and very important aspect of the American system. Unlicensed operators in the system share some of the same economic incentives as counterfeiters and introduce real risk to the marketplace. In other countries, people die or are gravely injured by tainted alcohol products from unlicensed, unscrupulous vendors. Not too long ago over 30 people died in the Czech Republic from tainted alcohol purchased from retailers. There is no comparable quality control mechanism for direct shipment and the involvement of unlicensed operators is very worrisome.

Tax and fee payments

Unlicensed operators do not pay license fees nor are they likely to pay excise or sales tax. If they sell to underage youth or don't pay taxes,

what are the real penalties? Again, no one really knows the extent of revenue loss. But, the Michigan study indicated that it could be as high as \$4 million in annual lost excise and sales tax in that one state.

Unfair competition

When unlicensed operators ignore the rules they are able to take business from legitimate licensees. This is not only unfair, but can put good operators out of business.

The time is ripe for a focus on enforcement and a reassessment of this "alternative market."

Enforcement is needed in order to identify the compliance issues in a given state. It may not be necessary for the enforcement effort to be costly or extensive. The states that license shippers often require them to share "carrier reports" that list the address of the shipper and the customer. These lists can be compared to the list of licensees to identify who is shipping illegally. It is a simple, inexpensive way of monitoring shipments. It would also be advisable to conduct some compliance checks by ordering products from both licensed and unlicensed vendors to identify which regulations are most often violated. Once an understanding of compliance is gained, a state could begin the process of addressing any needed changes in processes, rules or laws.

Sources:

"Wine Direct Shipping Research and Analysis," The Hill Group, Inc. for the Michigan Beer & Wine Wholesalers Association, November 2015.

"2016 Direct to Consumer Wine Shipping Report," ShipCompliant and Wines & Vines.

"Illinois sends over 100 cease and desist letters", by Jeff Carroll, VP of Compliance, ShipCompliant, Feb. 2 2015.

<https://www.washingtonwine.org/wine/facts-and-stats/state-facts>

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