

The Yin and Yang of Beer Distribution Law and Franchising



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Despite commonalities with traditional franchising arrangements, beer distribution and franchising call for specialized expertise.

BEER DISTRIBUTION LAWS differ from traditional franchise laws that govern restaurant, retail and service businesses in many ways, but they do share some commonalities. As a matter of fact, many states now regulate the relationship between those who brew or import beer into a particular state, known as brewers, and those who receive beer, warehouse beer and distribute beer to retailers, known as distributors, by way of special relationship statutes that have been patterned after, and closely resemble, the relationship statutes many states have passed to protect franchisees in traditional franchise relationships.

COMPARING TRADITIONAL FRANCHISE RELATIONSHIPS AND BEER DISTRIBUTION RELATIONSHIPS

• The typical definition of a franchise is a business relationship under which: (i) the franchisee's business will be substantially associated with the franchisor's trademark; (ii) the franchisee pays the franchisor a fee to engage in the business and utilize its trademark; and (iii) the franchisee will operate the business under a marketing plan or system prescribed in substantial part by the franchisor.

Franchising is regulated at the federal level by the Federal Trade Commission (“FTC”), which imposes very specific pre-sale disclosure requirements on franchisors selling franchises in any state by way of its amended Federal Trade Commission Rule on Franchising, known as the “FTC Rule,” and at the state level through pre-sale registration and disclosure statutes and franchise relationship laws. For example, 13 states, referred to as “registration states,” require franchisors to register their franchise offering documents before offering or selling franchises within their borders, and 17 states have franchise relationship acts, in one form or another, aimed at protecting franchisees from unfair treatment after they sign a franchise agreement. Many states still have no franchise specific laws whatsoever and rely on the FTC Rule and on state remedies for fraud and breach of contract to address problems that arise in franchise relationships.

In a typical distributorship arrangement, the distributor operates an independent business under its own trade name and purchases and resells the supplier’s products according to its own procedures, not according to the supplier’s system or prescribed marketing plan. The distributor’s business is generally not associated with the supplier’s trademark in the eyes of the customer, and it is unlikely that the distributor will pay a fee to engage in selling the supplier’s products.

Unlike franchising, and as further discussed below, states take the primary role in regulating beer distribution. All 50 states regulate the sale and distribution of beer within their borders. Because of the dramatic brand consolidation that has occurred in the beer industry, many states address the distribution of beer separately from wine and liquor making the beer distribution industry one of the most highly regulated industries in the United States. To complicate matters, the differences among the states in terms of their statutes, regulations, licensing schemes, taxes and control processes result in a legal minefield that can be difficult to navigate

for brewers, distributors, retailers and the attorneys who advise them.

U. S. BEER DISTRIBUTION: AN INTRODUCTION TO THE THREE-TIER SYSTEM

- Prior to 1919 and the passage of the 18th Amendment, brewers and producers of alcoholic beverages sold their products directly to retailers, which led to anti-competitive business practices and unscrupulous marketing tactics aimed at inducing excessive consumption. In part to combat that problem, the states ratified the 18th Amendment ushering in the prohibition era and outlawing the manufacture, distribution and sale of alcoholic beverages. The 21st Amendment repealed the 18th Amendment in 1933 and gave states the primary authority to regulate the distribution of alcoholic beverages, including beer, within their borders. The three-tier system of alcohol production, distribution and sale was born.

The three-tier system is designed to prevent pre-prohibition style marketing tactics, to generate revenues for the states, to facilitate state and local control over alcoholic beverages and to encourage temperance. Its three tiers consist of brewers (top tier), distributors (central tier) and retailers (bottom tier). Brewers produce the product and sell it to distributors, also called wholesalers, who then sell the product to retailers (retail stores, taverns, etc.), who, in turn, sell the product to consumers. In many states, importers are treated as brewers, placing importers in the top tier of distribution. In less-populated states, however, large retailers may act as distributors by distributing beer products to smaller retailers, thus creating a four-tier distribution system. In a decision handed down in May 2005, the U.S. Supreme Court, in *Granholm v. Heald*, 544 U.S. 460 (2005), found the three-tier distribution system to be “unquestionably legitimate.”

LICENSING STATES vs. CONTROL STATES

- Although state statutory and regulatory schemes establishing the three-tier system vary substantially,

states generally fall into one of two categories: license states and control states.

There are 32 license states that regulate alcohol distribution using a hierarchical licensing system through which these states approve and sell different licenses to businesses in each tier. Determining which licenses are needed is no easy task. It is common for states to require brewers, distributors and retailers to hold multiple licenses. Under a typical licensing scheme, brewers who brew beer in another state, but who wish to sell it in the license state, must obtain a manufacture's license, or register with a regulatory body, in advance of signing a distribution agreement with a distributor to distribute its beer. Beer distributors/wholesalers are required to purchase a beer wholesaler's license, which allows for the distribution of beer only, but must purchase an additional license to distribute distilled spirits or wine. There are usually numerous types of retail licenses, as well as separate licenses for craft brewers and special events.

Eighteen states operate as control states. Although control states also have licensing requirements, the difference between control states and license states is that at some point in the distribution process, these states obtain a direct interest in the revenues obtained through distribution by taking an ownership stake as distributors or retailers of the product. These states are also known to exert greater control over the conditions of sale and promotion of alcohol within their borders. By way of example, Pennsylvania and Utah are sometimes referred to as "sole importers" and require their citizens to purchase alcoholic beverages through state stores.

RELATIONSHIP LAWS: SPECIFIC PROTECTIONS FOR BEER DISTRIBUTORS THAT MIRROR FRANCHISEE PROTECTIONS • An inherent imbalance of power exists between the contracting parties in both the beer distribution and franchising contexts. To address

this problem in the beer distribution context, many states have passed legislation aimed at balancing power in favor of distributors by requiring good faith dealings between the parties to distribution agreements. Not unlike franchising, which requires franchisees to make a substantial initial investment to get up and running, beer distribution requires a substantial investment in infrastructure by beer distributors, which is one of many reasons why most states have an array of statutes, rules and regulations aimed at balancing power in favor of distributors. These balancing protections may, in general, be boiled down to four categories: (i) territorial protections; (ii) transfer protections; (iii) termination protections; and (iv) dispute resolution protections/remedies.

Territorial Protections

To begin with, all states protect distributors by allowing brewers to grant distributors an exclusive sales territory for their brands. In fact, most states require brewers to grant distributors an exclusive sales territory for their brands. This differs substantially from franchising, however, considering Franchisors *may* grant exclusive territories to their franchisees, but rarely do. The fact that states generally require brewers to provide distributors with an exclusive territory in which no competitors may distribute the brewer's beer, but franchisors are not required to provide exclusive territories to their franchisees, and typically do not, demonstrates the degree to which beer distributors enjoy even greater legal protections than do franchisees.

Transfer Protections

Most states also limit brewers' ability to prevent distributors from transferring their distribution rights under distribution agreements. Typically, states allow brewers to require distributors to provide them with written notice and obtain their prior approval before transferring any substantial portion of the distribution rights licensed under the

distribution agreement to another distributor, or in advance of a change of ownership or control of the distributor. However, in most states, brewers may not withhold consent or unreasonably delay a distributor transfer if the transferee meets reasonable standards and qualifications required by the brewer which are nondiscriminatory and are applied uniformly to all distributors similarly situated. In addition, most state beer distribution statutes allow distributors and their owners to transfer, bequeath or devise their interest in the distribution business, and the distribution agreement, without the need to obtain the brewer's consent, and sometimes without notice.

Although the transfer related protections provided to beer distributors tend to exceed those afforded to franchisees in most jurisdictions, a few states do extend transfer protections to franchisees by statutory provisions that resemble those commonly provided to beer distributors. Interestingly, though, transfers tend to be less contentious in the franchise context and franchisors are usually willing to consent to franchise agreement transfers to qualified buyers provided the franchisor receives payment of a transfer fee and the buyer signs the franchisor's then-current form of franchise agreement for the remainder of the term existing under the seller's franchise agreement.

Termination Protections

Protecting distributors against having their distribution agreements terminated or not renewed without good cause is, perhaps, the most significant protection states provide beer distributors. Some states limit the definition of good cause, and thus the right of the brewer to terminate the agreement, to instances in which the distributor has committed fraud, been convicted of a felony, filed for bankruptcy or knowingly distributed the brewer's products outside of its exclusive territory. Most states' statutes bar brewers from modifying, not renewing or terminating any beer distribution agreement un-

less the brewer acts in good faith. Termination and non-renewal restrictions are interpreted broadly and good cause is universally interpreted narrowly in the beer distribution context. As a result, beer distribution agreements take on a perpetual duration, more or less, in many states.

While less than a majority of the states provide specific statutory protections against the early termination of a franchise agreement by the franchisor, most states require a franchisor to have good cause to terminate a franchise agreement before its expiration. Good cause generally includes the failure of the franchisee to comply with any lawful requirement of the franchise agreement after notice and a reasonable opportunity to cure, which generally does not exceed 30 days. Filing for bankruptcy, failing to comply with the franchisor's "system" in a way that may damage the franchisor's reputation, under reporting sales or selling unauthorized products are just a few additional examples of acts that may constitute good cause for a franchisor to terminate a franchise agreement.

Dispute Resolution Protections/Remedies

The remedy that primarily differentiates beer distribution law from franchise law is the legal right beer distributors have to *reasonable compensation* upon termination of the beer distribution agreement by the brewer, for any reason. In general, reasonable compensation payments are equivalent to one to three years' worth of the beer distributor's profits, calculated as one hundred percent of the beer distributor's gross margins on each case of the brewer's products sold to customers, multiplied by the number of cases of product actually sold by the beer distributor to customers during the twelve months prior to the termination. If the brewer terminates a beer distribution agreement in bad faith, or for any reason other than good cause, the brewer must also pay the distributor the fair market value of "all assets, including ancillary businesses, relating to the transporting, storing and marketing of [brewer's]

products” and the goodwill of the distributor’s business. Clearly, these protections go a long way toward shifting the balance of power back toward distributors in the beer distribution relationship.

In the franchising context, the remedies available to wrongfully terminated franchisees vary substantially from state to state. Wrongfully terminated franchisees may recover damages, such as lost profits and unrecovered expenses, but may also recover payments for goodwill, attorneys’ fees and punitive damages according to the facts and the laws governing the franchise agreement. In some states, franchisors may be required to repurchase inventory if they wrongfully terminate a franchisee. The level of protection from, or recourse pertaining to, any wrongful acts committed by franchisors that is available to franchisees depends entirely upon the state in which the franchisee is located and which state’s laws govern the injured franchisee’s agreement. In states without any franchise relationship laws, however, franchisees must rely on injunctive relief, common law fraud and breach of contract remedies to address the franchisor’s wrongful acts. Accordingly, then, it is clear that beer distributors are substantially better protected with regard

to dispute resolution protections and remedies for wrongful acts.

CONCLUSION • While beer distributorship arrangements are distinctly different from traditional franchise arrangements, it is clear there are certain commonalities. Clearly the three-tier system of beer distribution can trace its origins to the prohibition era and the 21st Amendment, but modern beer laws governing beer distribution relationships between brewers and distributors have been patterned after franchise relationships laws. After all, brewers resemble franchisors in that they tend to hold a lion’s share of the power in the beer distribution business relationship. Accordingly, we can expect more and more states to pass relationship laws aimed at further balancing power in favor of distributors, as we continue to see in franchising, and to require good faith dealings between the parties in each of these contractual arrangements. Considering that trend, and the complexity of and differences among these statutes, it is easy to see why expert legal advice from an attorney specializing in this area of the law is essential at every step for those doing business in the beer distribution industry or in franchising.

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