



Yin & Yang of Beer Distribution and Franchise Laws

By Barry Kurtz and Bryan H. Clements



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Beer distribution is one of the most highly regulated industries in the United States. Attorneys advising brewers, distributors, and retailers must understand the myriad regulations that make beer distribution different from a traditional franchise relationship.

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 Distribution Relationships

The typical definition of a franchise is a business relationship under which the franchisee's business will be substantially associated with the franchisor's trademark; the franchisee pays the franchisor a fee to engage in the business and utilize its trademark; and 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 FTC Rule on Franchising, known simply as the FTC Rule. It is also regulated at the state level through pre-sale registration, disclosure statutes and franchise relationship laws.

Thirteen states, referred to as registration states, require franchisors to register their franchise offering documents before offering or selling franchises within their borders, while 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.

Distribution, as an all-purpose business relationship, is not regulated by federal or state laws. However, the distribution relationships involving various products are highly regulated at both the federal and state levels, including, for example, petroleum products, automobiles and alcoholic beverages.

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.

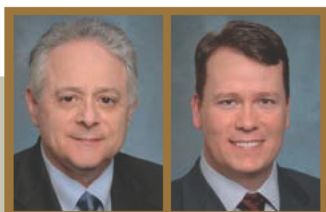
U. S. Beer Distribution: A Three-Tier System

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. 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.¹ In a decision handed down in



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May 2005, the U.S. Supreme Court, in *Granholm v. Heald*, found the three-tier distribution system to be “unquestionably legitimate.”²

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. California, for example, is a license state.

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 manufacturer'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.³ There are usually numerous types of retail licenses, as well as separate licenses for craft brewers⁴ 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 beer distribution relationships, resembling the imbalance of power that exists in franchising relationships. 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: territorial protections, transfer protections, termination protections, and 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.

The California Alcoholic Beverage Control Act, for example, provides that a brewer or supplier that unreasonably withholds consent “or unreasonably denies approval of a sale, transfer, or assignment of any ownership interest in a beer wholesaler's business with respect to that [brewer's] brand or brands, shall be liable in damages to the [distributor].”⁵ 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.⁶

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.⁷

Most states' statutes bar brewers from modifying, not renewing or terminating any beer distribution agreement unless 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, which generally does not exceed 30 days, to cure the failure. Filing for bankruptcy, failing to comply with the franchisor's system in a way that may damage the franchisor's reputation, underreporting 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.

Although California has passed the California Alcoholic Beverage Control Act (ABC Act),⁸ which contains some protections for beer distributors, California statutes designed to protect beer distributors against unreasonable termination are noticeably less comprehensive than most other states.

As stated above, most states require a brewer have good cause to terminate the distribution agreement. However, California is one of five states whose beer statutes do not have such a requirement.⁹ The ABC Act does provide, however, that "No sale or distribution agreement shall be terminated solely for a beer [distributor's] failure to meet a sales goal or quota that is not commercially reasonable under the prevailing market conditions."¹⁰

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, for any reason,

of the beer distribution agreement by the brewer. 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.¹¹ 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 unrecouped 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. For example, California law provides that in the event a franchisor

wrongfully terminates or fails to renew a franchisee's franchise agreement in violation of the California Franchise Investment Law "the franchisor shall offer to repurchase from the franchisee the franchisee's resalable current inventory ... at the lower of the fair wholesale market value or the price paid by the franchisee."¹²

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. Beer distributors are substantially better protected than traditional franchisees with regard to dispute resolution protections and remedies for wrongful acts.

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.

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. 

¹ Charlie Papazian, *The Future of Beer Distribution in America* (published date unknown), http://www.globalbeeralliance.com/craftbrewing/pdf/Future_of_beer_distribution.pdf (humorously, the U.S. beer distribution scheme is sometimes referred to as the "four-tier system of beer distribution," citing the four tiers as brewers, distributors, retailers and beer drinkers).

² *Granholt v. Heald*, 544 U.S. 460 (2005).

³ *Id.* at 476 (holding that New York and Michigan laws that permitted in-state wineries to ship wine directly to consumers, but prohibited out-of-state wineries from doing the same, unconstitutionally violated the Commerce Clause).

⁴ See California Dept. of Alcoholic Beverage Control, "List of License Types" available at <http://www.abc.ca.gov/permits/licensetypes.html> (last visited May 11, 2014) (California Alcoholic Beverage Control website listing all of various licenses required in California).

⁵ West's Ann. Cal. Bus. & Prof. Code §25000.9.

⁶ See Iowa Code Ann. §123A.6(2) "[U]pon the death of a wholesaler, a brewer shall not deny approval for any transfer of ownership or management to a designated member, including the rights under the agreement with the brewer."

⁷ Wis. Stat. Ann. §125.33(10)(b-c).

⁸ West's Ann. Cal. Bus. & Prof. Code §23000 et seq.

⁹ See Gary Ettelman and Keith B. Hochheiser, "The Legal Buzz: Miller & Coors II, To Sell Or Not To Sell (That Is The Question)," available at http://www.e-law.com/articles_buzz_MillerCoors2.htm (last visited May 11, 2014) (stating five states, including California, Kansas, Missouri, Oklahoma and Wisconsin do not require that termination may be effected only if "good cause" exists. Of note, New York passed the Small Brewer's Bill in 2012 allowing small brewers to terminate without "good cause", provided they pay the distributor the fair market value of the lost distribution rights).

¹⁰ West's Ann. Cal. Bus. & Prof. Code §25000.7.

¹¹ Idaho Code Ann. §23-1110(2).

¹² West's Ann. Cal. Bus. & Prof. Code §20035.



Test No. 68

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- The FTC Rule on Franchising imposes specific pre-sale disclosure requirements on franchisors selling franchises in five states.
 True False
- All types of distribution relationships are highly regulated at the federal and state levels.
 True False
- Unlike with franchising, states take a primary role in regulating beer distribution.
 True False
- All 50 states regulate the sale and distribution of beer within their borders.
 True False
- Distributors existed as early as 1919, purchasing alcohol from brewers and selling to retailers.
 True False
- The 21st Amendment repealed the 18th Amendment and gave states authority to regulate the distribution of alcoholic beverages.
 True False
- The three-tier system consists of brewers, distributors, and consumers.
 True False
- The purpose of the three-tier system is to prevent pre-Prohibition marketing tactics, to generate revenues for the states, to facilitate state and local control over alcoholic beverages, and to encourage temperance.
 True False
- In *Granholm v. Heald*, the Supreme Court found the three-tier system unconstitutional.
 True False
- In states with smaller populations, large retailers may act as distributors to smaller retailers.
 True False
- California is one of 32 licensing states able to approve and sell licenses to businesses in each tier.
 True False

- States balance the power between brewers and distributors through protections of territory agreements and transfers or sales of distribution rights, protections against unreasonable termination, and dispute resolution protections for distributors.
 True False
- Most states require brewers to grant distributors an exclusive sales territory for their brands.
 True False
- The California Alcoholic Beverage Control Act provides that a brewer or supplier that unreasonably withholds consent or unreasonably denies approval of a sale or transfer of distribution rights cannot be held liable for damages.
 True False
- The California Alcoholic Beverage Control Act (ABC Act) provides that a distribution agreement cannot be terminated solely for failure to meet a reasonable sales goal or quota.
 True False
- California requires brewers to have good cause for terminating a distribution agreement.
 True False
- Beer distributors have the legal right to compensation upon termination, for any reason, of the beer distribution agreement by the brewer.
 True False
- Beer distributors are substantially less protected than traditional franchisees with regard to dispute resolution protections and remedies for wrongful acts.
 True False
- In states without any franchise relationship laws, franchisees must rely on injunctive relief, common law fraud and breach of contract remedies to address the franchisor's wrongful acts.
 True False
- In California, if a franchisor wrongfully terminates a franchise agreement, the franchisor has no obligation to repurchase inventory.
 True False

MCLE Answer Sheet No. 68

INSTRUCTIONS:

- Accurately complete this form.
- Study the MCLE article in this issue.
- Answer the test questions by marking the appropriate boxes below.
- Mail this form and the \$15 testing fee for SFVBA members (or \$25 for non-SFVBA members) to:

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