



BASICS OF WINE DISTRIBUTION LAW

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Recent legal struggles over direct shipping of wine to consumers and the subsequent opening of many states to direct-to-consumer shipment has not altered the fact that the vast majority of wine consumed in the U.S. passes through the three-tier distribution system.

Accordingly, understanding the legal fundamentals of this "conventional" wine distribution system is a must for any winery, large or small, hoping to become more than a niche player in the U.S. market.

Variations in state distribution systems

Before entering into a relationship with a broker or wholesaler to serve a particular market, a winery should conduct due diligence about that market. An important component of that due diligence is examining the legal framework of the state's distribution system.

So-called "control" states establish a government monopoly for the wholesale distribution and sale of wine. In addition, some control states also feature "state stores" as the exclusive off-premises retail channel for wine. The map identifies the control states for the distribution of grape table wine (12% alcohol by volume). Maryland presents a special case as it is a control jurisdiction for wine in a single county — the wealthy Washington, D.C. suburb of Montgomery County.

Control states permit wineries to sell directly to the state. Nevertheless, virtually all wineries appoint brokers to assist them in serving control state markets. Control state brokers often are affiliated with large wine wholesalers like Southern Wine & Spirits,

Republic National Distributing Company, and Young's Market. Brokers can assist with listing the wine with control state authorities, help market the brand in the state, and perform many promotional functions handled by wholesalers in other states.

In non-control or so-called "open" or "license" states, wineries from outside the state generally must sell to an in-state wholesaler. The wholesaler, in turn, sells the wine to retailers (hence the "three-tier system" of supplier [winery], wholesaler, and retailer).

A small number of states permit direct-to-retailer sales by out-of-state wineries, often as a way to preserve in-state self-distribution privileges without overt discrimination subject to a Commerce Clause Challenge.

As a practical matter, however, most wineries determine that the only way to reach a meaningful number of retailers outside their immediate vicinity is through wholesalers.

Implications of wine franchise laws

Several legal distinctions significantly impact how a winery should approach wholesalers in the open states. The most important distinction separates "franchise" from "non-franchise" states. These terms do not refer to general franchise laws that protect franchisees like McDonald's restaurants from arbitrary termination by franchisors.

Such general franchise laws usually apply only where the relationship involves payment of a "franchise fee" or the existence of a "community of interest" between the franchisor and franchisee, elements rarely present in the usual winery-wholesaler relationship. (Wisconsin, however, has a general dealership statute that may apply to relations between Wisconsin wholesalers and relatively large wine suppliers.)

In the wine industry, a "franchise state" generally refers to a state whose law includes specific statutes or regulations that significantly limit the ability of a wine supplier to terminate or refuse to renew its relationship with a wholesaler.

Defining exactly what constitutes a "franchise" jurisdiction involves some measure of line drawing (this chart lists Maryland as a non-franchise state even though a state regulation requires wineries to provide wholesalers with at least 30-day notice prior to termination). Nevertheless, the general consensus counts 22 wine franchise states.

Stated in simplified terms, wine franchise laws usually restrict the ability of a winery to terminate or not renew a wholesaler agreement to "good cause" or "just cause." "Cause" usually is defined or interpreted by the courts as a deficiency in performance. Notably, a winery's unilateral business needs do not constitute "cause" in most places.

Prior to a termination for all but the most serious grounds, wine franchise laws generally require the winery to provide written notice prior to termination (most commonly 60 to 90 days) and give the wholesaler an opportunity to "cure" the deficiencies that justify termination. Immediate termination usually is restricted to the most serious of wholesaler deficiencies, such as bankruptcy, fraud, or conviction of a crime.

Wine franchise laws also may limit a winery's ability to object to changes in a wholesaler's ownership or management, or a sale or assignment of the wholesaler's brand distribution rights to another party.

In most cases, winery objections must be "reasonable," and the law may discount objections if the proposed new owner(s) or other transferee(s) meet the criteria required by the winery of its other wholesalers.

Conversely, wine franchise laws may also apply to successor-owners and/or importers of a brand of wine. In such states, even a complete change in the entity selling a particular brand of wine into the state does

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not allow a change in the brand's distribution in the absence of "cause."

Perhaps most important, wine franchise laws usually do not permit any waiver of the laws' protections via contract, written or otherwise. Moreover, these laws usually place the burden on the winery to justify any termination.

Finally, in some states local regulatory bodies decide whether a winery possesses "cause" to terminate a wholesaler. Many of these local authorities have a reputation for favoring [local and usually politically-connected] wholesalers in termination disputes. In the remaining franchise states, wholesalers can go to court to challenge a termination under the franchise law.

Courts usually are empowered to award monetary damages to compensate wholesalers for a wrongful termination of their rights, and generally can order "injunctive relief" that may temporarily or even permanently stop a termination.

Injunctive relief may be hard to obtain against a small winery, however, because the wholesaler usually will have trouble showing the kind of "irreparable harm" required to justify an injunction.

Franchise laws make it very difficult and potentially costly to terminate a wholesaler in a franchise state. As a result, in franchise states, wholesalers are accustomed to buying, selling, and swapping wine brand distribution rights. This practice provides a non-contentious way to change wholesalers if the wholesaler is willing to contemplate a swap or a sale at a realistic price.

Franchise laws also heighten the need for winery due diligence before appointing or even selling to a wholesaler in a franchise state. In effect, the appointing winery should look at wholesaler appointments in franchise states as a potentially permanent "marriage" in the territory. Wineries accordingly should proceed with caution and do their best to ensure that a particular wholesaler in a franchise market is the right one.

Termination rules in non-franchise states

Termination of wholesalers in non-franchise "open" states generally presents fewer obstacles. Absent unusual circumstances or an agreement that limits the winery's ability to terminate a wholesaler, the general rule allows a winery to terminate after a "reasonable" period of time upon "reasonable notice." The law rarely defines these requirements with precision and their application accordingly will depend on the particular facts and circumstances of a relationship.

Nevertheless, a relationship of several years usually will be considered a reasonable amount of time, and written notice of not less than 30 days generally is considered a reasonable notice period where a multi-brand wholesaler loses a single supplier.

Use of contracts

The differences between franchise and non-franchise states also can affect a winery's views on entering into a written agreement with a given wholesaler. Today, much of the wine industry still operates under "hand-

shake deals" between suppliers and their wholesalers.

Only the largest wineries use contracts in all states as a norm, often because their agreements include sophisticated performance, incentive, and other mechanisms.

In non-franchise states, the absence of a contract may produce some uncertainty, but the usual ability to terminate a wholesaler with relative ease makes a contract less necessary in a non-franchise state than a franchise state. In franchise states, however, a winery should consider the benefits of a written agreement if it believes it possesses the bargaining power to obtain reasonably favorable terms.

In the absence of a written agreement, a winery often possesses little evidence of the performance standards it expects of its wholesalers. That lack of clear standards can greatly hinder the winery's ability to demonstrate "cause" to terminate.

Even where litigation seems remote, a winery's ability to credibly demonstrate "cause" provides great leverage that can help persuade a wholesaler to transfer brand distribution rights (via a sale or a swap) to a successor wholesaler more to the winery's liking.

Exclusivity

Another basic item of legal due diligence involves determining whether a state requires wholesaler appointments on an exclusive basis. In general, exclusive appointments are the industry norm regardless of state law.

By giving a wholesaler an exclusive territory, the wholesaler has a greater incentive to engage in brand-building

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activities because it likely will reap the sales benefits from those activities. Without this assurance, a wholesaler may expend efforts to open retail accounts and build awareness of a brand, only to see another company benefit from those efforts.

Nevertheless, the theoretical ability to appoint other wholesalers for the same brand in the same territory — usually called “dualing” — may give a winery leverage over a wholesaler. While this leverage may not be crucial in non-franchise states, in the few franchise states where dualing is permitted, it provides the winery with significant leverage and a way to work around a non-performing wholesaler.

On the subject of exclusivity, three unusual states deserve special mention. Minnesota and Oklahoma are so-called “reverse franchise” states. In these states, the law mandates that a winery sell products to any and all wholesalers that want the brand.

In practice, many brands effectively go through a single house. In theory, however, every wholesale customer in the state can buy an available wine. West Virginia also presents a unique circumstance — its law explicitly prohibits exclusive territories for wine sales.

Other legal issues

As the foregoing hopefully illustrates, the laws of individual jurisdictions vary greatly when it comes to distributing wine through three-tier (or control) channels. The issues highlighted above do not capture all of the many differences between the states — from trade practice restrictions to licensing peculiarities to brand registration requirements.

Armed with some understanding of the legal distribution landscape, however, wineries can better equip themselves for the challenges and rewards of distributing through the three-tier system. ■

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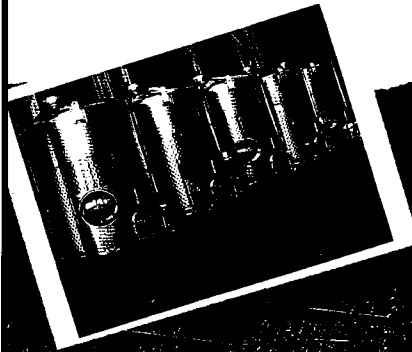
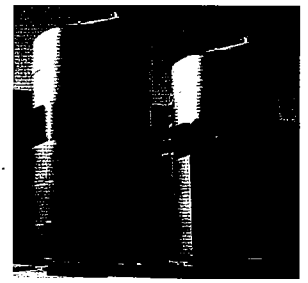
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