



GETTING Hitched: CHOOSING A DISTRIBUTOR, DISTRIBUTOR AGREEMENTS AND FRANCHISE LAW PRIMER

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I. Introduction.

With very limited exceptions, beer distribution in the United States is governed by franchise laws which require breweries to distribute their products through a single wholesaler in a territory. In essence, there are State laws which mandate a middle man monopoly. In Pennsylvania, franchise laws are especially strong and the Pennsylvania Liquor Control Board has opined that once you enter into a franchise relationship with a wholesaler that agreement is in perpetuity unless you have good cause to establish that the wholesaler has breached the material terms of your relationship. Because of these laws, which were born after the repeal of prohibition when large brewers had unfair negotiating power over small wholesalers, today's beer industry can be a very difficult world for a brewery to navigate to successfully distribute their products. This discussion is to educate you on some of the obscure yet important issues involving beer franchise law so you can establish a criteria in choosing a distributor and entering into an effective distributor agreement that protects your interests as best as possible under the law.

II. Conspiracy of Silence versus Secondary Rights and Self-Distribution.

In Pennsylvania, a Pennsylvania manufacturer is allowed to distribute its own product as long as it has not appointed an importing distributor (this is the legal term for a wholesaler in Pennsylvania) under a primary or exclusive agreement in a territory. If you are not clear in entering into an agreement with an importing distributor, this will be interpreted as a primary agreement and you will not be able to distribute your own products in the territory identified in that primary agreement. While the law permits you to appoint an importing distributor as a secondary distributor of your products, that is no longer a viable option in the Pennsylvania distribution industry. With the proliferation of craft beer bands, a new brewery has to demonstrate that it has flavorful products, an effective business and plan for marketing before a wholesaler will agree to take on the representation of their brands in the market. Twenty years ago, wholesalers would compete for a new brewery's products, but now they receive multiple solicitations a week from new breweries to carry their products. As a result, wholesalers have



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become very selective in choosing the suppliers that they want to represent. It is highly unlikely that any sophisticated wholesaler will accept anything less than a primary or exclusive distributor agreement in exchange for taking on the new brewery's brand in the marketplace. Yes there are exceptions; however, those exceptions only inure to breweries with significant market pull that have not entered into a market.

In light of the above market factors, there is a clear unwritten agreement among wholesalers that they do not accept secondary agreements from breweries entering the marketplace. This is not a conspiracy among wholesalers to manipulate its brewing partners; it is a simple fact of the marketplace that wholesalers must now be more selective in their portfolios to appropriately manage their costs, supplier's expectations, and effective distribution in their marketplace.

III. The Written Agreement.

While franchise laws mandate that a brewery cannot terminate a wholesaler except for good cause which is defined as a breach of the material agreement between the parties, it is very important to enter into an effective distributor agreement that would give you some control over the distribution relationship and provide you leverage when the wholesaler seeks to sell your brands to another wholesaler. Yes, wholesalers can sell your brands to another wholesaler without your consent unless it is addressed in a written agreement. These brand rights trade from five to ten times the gross profit of your brand and the values may vary depending upon growth, margins and market potential. By way of example, if your wholesaler is selling 1,000 cases of your beer in a market at \$6.00 margins, the wholesaler will value your brands at no less than \$50,000.00. There are also other important terms that can be contained within the distributor agreement that can give you significant rights in distributing your products outside the scope of an exit strategy. Some of these topic areas are addressed below for your consideration.

A. The Territory Grant. Please do not grant state-wide distribution rights to any wholesaler. When entering into a market, try to understand the wholesalers which service each county in a particular market. In fact, there may be reason even to split up counties or begin with a test market. Ask for your wholesaler's portfolio of brands for each county and see how your brands fit with those portfolios. Each wholesaler has its strengths and weaknesses. Research and focus on the number of deliveries per week to multiple counties they may service in a "territory". Maybe they only deliver once a week or every other week in a county, but every day in others. It is advisable to visit the market and speak directly to major retail accounts and ask them about their service provider. Do your homework and find out where the wholesaler's strengths are and make sure you have enough capacity to build a successful partnership. I also recommend that you carve out any locations which may exist in the territory or future sites which the brewery may operate in the territory. This is especially important now that breweries can set up storage locations and sell direct for on-premise consumption. You may even want to consider major venues being excluded for the retention of direct service to those large retail accounts; however, the wholesaler may be the best access for those larger venues/retail accounts.



B. Term. Although the Pennsylvania Liquor Control Board has opined that distributor agreements are in perpetuity, I suggest that you begin placing a term of years on the agreement in the event that the Pennsylvania Legislature amends any of the terms of the Liquor Code to permit such terms. It is likely that a wholesaler may object to this language.

C. General Terms of Sale. There are many different areas which you can address through terms of sale which should apply to all brewery businesses. These areas are as follows:

i. Specify placement and acceptance of orders and typical lead times associated with such orders. Typically, wholesalers pay for the products plus freight and taxes;

ii. Understand that in Pennsylvania, all terms must be C.O.D. which means that the distributor must pay upon receipt of the product. Electronic Funds Transfers (“EFT”) program is typical;

iii. Make sure you appropriately address cooperage and identify appropriate deposits for kegs and pallets; and

iv. Be sure you include terms that the distributor is responsible for all taxes associated with the distribution, including unforeseen taxes which may be the responsibility of the brewer according to the taxing authority. For example, the Pennsylvania Malt Beverage Excise Tax taxes beer sold and delivered in the Commonwealth and that tax is clearly imposed on the brewer and not the wholesaler. While the brewer may be responsible for the tax, it is appropriate to provide terms that require the wholesaler to reimburse you for that tax.

D. Trade Designation and IP. Make sure you have provisions which appropriately address protections for ensuring that your trade designations and intellectual property are appropriately managed by the distributor.

E. Marketing and Operating Standards.

i. You may want to consider an annual business planning process to discuss and agree to distribution (the number and types of accounts you want to have your beer) and volume goals. This could include per case investment by the wholesaler which, at a minimum, should be \$1.00 per case. You may want to consider a cooperative program with your own investment. You want to make sure who is responsible for payment of point of sale and other marketing materials. All the above items can be addressed in an annual business plan which should include:

a. a sales report comparing the current year versus the previous year in units (by brand and package);

b. distribution reports by channel (on and off premise accounts, chain accounts, and convenience) by account, brand and package;



- c. reports of accomplishments during the immediately past year and projection of opportunities for the upcoming year;
 - d. monthly sales forecasts for upcoming year (by brand and package and channel); and
 - e. budget for upcoming year (point of sale, advertising, sponsorships, sales incentives).
- ii. You should include terms that require the distributor to take necessary actions to ensure quality control related to the products, including the observance of out-of-code dates, stock rotation, and storage of your products. You should include how you address over age products in the market. The distributor should be responsible for monitoring the same and removing them from the market at their cost.

iii. You should ensure that you are receiving appropriate sales, depletion and inventory records. These sales records should include information concerning the velocity of the product sales to particular accounts and records which may identify call frequency, promotion, merchandising, price discounting and other competitive activity. You should specify whether you require such reports on a weekly or monthly basis.

F. Termination Provisions. This will be mostly governed by state law. You should address how products will be repurchased at the termination of the distribution agreement and you may also want to address an attorney fee shifting provision in the event that a termination challenged by the distributor fails in court. Termination provisions of the franchise law are the most onerous upon a small business. Although you can give notice that within 90 days you will be terminating the wholesaler for good cause, that wholesaler is allowed to challenge that good cause in court and obtain an injunction against your brewery requiring the brewery to continue to sell products to the wholesaler pending the litigation. Litigation costs and expenses typically exceed tens of thousands of dollars and enter into the hundreds of thousands of dollars.

G. Assignment Provisions in the Wholesaler-to-Wholesaler Transaction.

Although no court has adjudicated this particular issue in the United States, it is recommended that you include a right of first refusal in any wholesaler-to-wholesaler transaction. A right of first refusal would give you flexibility and leverage in a wholesaler-to-wholesaler transaction; that is, you would include provisions in your agreement that would allow you to purchase back the brands at the value being paid by the purchasing wholesaler to the selling wholesaler in order that you could assign the brands to a wholesaler of your choosing in the territory. This right in and of itself could give you leverage with the purchasing wholesaler in addressing marketing issues and developing a more aggressive marketing plan in consideration of your waiving your right of first refusal when you are requested to consent to the transaction. In the event you would be able to purchase back your brands, you would be permitted to resell those brand rights to a wholesaler of your choosing and, hopefully, the whole transaction would be revenue neutral to the brewery.



IV. Summary.

Franchise laws in the Commonwealth of Pennsylvania and elsewhere demand that you carefully choose your wholesale partner. You should also ensure that you have appropriate distribution agreements in place to protect your rights. You should carefully consider the wholesaler's strengths and its weaknesses in determining what territory to grant a wholesaler and, under no circumstances, should you grant large territories without appropriate due diligence. Choosing the right wholesaler and granting appropriate territories are likely to lead to a mutually beneficial brewery/wholesaler relationship.

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