Traditional Franchise and Beer Distribution Relationships: A Legal Comparison

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Beer distribution laws differ from traditional franchise laws in many ways, but the two regimes 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 in that state (known as distributors) by way of special relationship statutes that have been patterned after, and closely resemble, the relationship statutes some states have passed to protect franchisees in traditional franchise relationships.

The Franchise Relationship

Traditional franchise relationships are not limited to the distribution of a single product or service and are common in the restaurant, retail and service industries. Under California law, a franchise is a contractual business relationship pursuant to which (1) the franchisee's business will be substantially associated with the franchisor's trademark; (2) the franchisee pays the franchisor a fee to engage in the business and utilize its trademark; and (3) the franchisee will operate the business under a marketing plan or system prescribed in substantial part by the franchisor.[1]

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,"[2] and at the state level through pre-sale registration and disclosure statutes and franchise relationship laws. For example, 13 states (or 14, depending on the criteria used), referred to as "registration states," require franchisors to register their franchise offering documents before offering or selling franchises within their borders,[3] and 17 states have franchise relationship acts, in one form or another, aimed at protecting franchisees from unfair treatment after the franchise relationship is formed.[4] 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.

The Distribution Relationship

Distribution, as an all-purpose business relationship, is not regulated by specific federal or state laws. 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. In the eyes of the customer, the distributor's business is not substantially associated with the supplier's trademark, and the distributor is unlikely to pay a fee to engage in selling the supplier's products.

Certain distribution relationships, however, involving particular products (including, for example, those

involving petroleum products, automobiles, and beer and other alcoholic beverages), are highly regulated at both the federal and state levels.

Petroleum Marketing Practices Act

The federal government is the primary regulator of distribution relationships involving petroleum products. Congress enacted the Petroleum Marketing Practices Act (PMPA)[5] in 1978 to protect petroleum distributors and retailers. The PMPA defines a "franchise" as a contract between (1) a refiner and a distributor; (2) a refiner and a retailer; (3) a distributor and another distributor; or (4) a distributor and a retailer, pursuant to which a refiner or distributor, as petroleum franchisor, allows a retailer or distributor, as petroleum franchisee, to use a trademark owned or controlled by the petroleum franchisor in connection with the sale, distribution, or consignment of gasoline or another motor fuel.[6] The PMPA applies to contracts with terms of three years or longer and prohibits petroleum franchisors from terminating a petroleum franchise, or failing to renew one, except in accordance with its provisions.[7]

Automobile Dealers' Day in Court Act

The Automobile Dealers' Day in Court Act (DDCA)[8] was enacted by Congress in 1956 to rebalance power in auto manufacturer/auto dealer relationships, which are, in general, weighted in favor of automobile manufacturers.[9] The DDCA enables a franchised automobile dealer to bring suit to recover damages it has sustained from an automobile manufacturer's failure to act in good faith in complying with the terms of the automobile franchise or unreasonable termination or refusal to renew the dealer's franchise. Under the DDCA, the term "automobile manufacturer" means any business enterprise engaged in the manufacture or assembly of passenger cars, trucks, or station wagons,[10] and "franchise" means the written contract between an automobile manufacturer engaged in commerce and an automobile dealer that purports to fix the legal rights and liabilities of the parties.[11] "Automobile dealer" means any business engaged in the sale or distribution of passenger cars, trucks, or station wagons and operating under the terms of an automobile franchise contract.[12]

Beer Distribution

Unlike the case with petroleum products and automobiles, states take the primary role in regulating the distribution of beer, and 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, and 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. To combat that problem, the states ratified the 18th Amendment, outlawing the manufacture, distribution, and sale of alcoholic beverages and ushering in Prohibition. 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.[13] 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.[14] In a decision handed down in May 2005, the U.S. Supreme Court found the three-tier distribution system to be "unquestionably legitimate."[15]

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 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, a brewer who brews beer in another state, but who wishes 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.[16] Beer distributors/wholesalers are required to purchase a beer wholesaler's license, which allows for the distribution of beer only, and must purchase an additional license to distribute distilled spirits or wine.[17] There are usually numerous types of retail licenses, as well as separate licenses for craft brewers and special events.[18]

Eighteen states operate as control states. Although control states also have licensing requirements, the primary 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, which resembles the imbalance of power that exists in franchising relationships. To address this problem, many states have passed legislation aimed at balancing power in favor of distributors by requiring good faith dealings between the parties to beer distribution agreements. Not unlike franchising, which requires franchisees to make substantial initial investments to get their franchised businesses up and running, distributing beer requires beer distributors to make substantial investments in infrastructure, which is one of many reasons why states have an array of statutes, rules, and regulations aimed at balancing power in favor of beer distributors.[19] These balancing protections may, in general, be boiled down to four categories: 1) territorial protections, 2) transfer protections, 3) termination protections, and 4) dispute resolution protections/remedies.

Territorial Protections

To begin with, nearly all states protect beer distributors by allowing brewers to grant beer distributors exclusive sales territories for their brands. In fact, most states require brewers to grant distributors an exclusive sales territory for their brands.[20] This differs substantially from franchising, however. In all states, franchisors *may* grant exclusive territories to their franchisees, but they rarely do. The fact that states generally require brewers to provide distributors with exclusive territories in which no competitors may distribute the brewer's beer, but do not require franchisors to provide exclusive territories to their franchisees, demonstrates the degree to which beer distributors enjoy even greater territorial 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 their 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, that are nondiscriminatory and are applied uniformly to all similarly situated distributors. For example, the California Alcoholic Beverage Control Act (the "ABC Act") 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]."[21] In addition, most state beer distribution

statutes allow distributors and their owners to 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.[22]

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.[23] Interestingly, though, in the authors' experience, 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 distributer has committed fraud, been convicted of a felony, filed for bankruptcy, or knowingly distributed the brewer's products outside of its exclusive territory.[24] Most states' statutes bar brewers from modifying, not renewing or terminating any beer distribution agreement unless the brewer acts in good faith.[25] In the authors' experience, 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 of those that do require the franchisor to have good cause to terminate the franchise agreement before its expiration.[26] 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.[27] Filing for bankruptcy, failing to comply with the franchisor's "system" in a way that may damage the franchisor's reputation, under reporting sales, and selling unauthorized products are just a few additional examples of acts that may constitute good cause for a franchisor to terminate a franchise agreement.[28]

Although the ABC Act contains some protections for beer distributors, California's statutes designed to protect beer distributors against unreasonable termination are noticeably less comprehensive than those in most other states. As stated above, most states require that a brewer have "good cause" to terminate the distribution agreement. California, however, is one of five states whose beer statutes do not have such a requirement.[29] The ABC Act merely provides that "[N]o 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."[30]

Dispute Resolution Protections/Remedies

Many states have statutes providing distributors with the right to recover damages from brewers that have terminated, not renewed, or refused to consent to the transfer of a distribution agreement without good cause.[31] In addition, states generally impose mandatory venue requirements, demanding that any disputes between a brewer and a distributor be brought in the jurisdiction in which the distributor has its primary place of business,[32] and most void all choice of law provisions in distribution agreements that specify that any law other than that state's laws shall govern the beer distribution agreement.[33] Additionally, all states have anti-waiver provisions that require their own laws to govern any beer distribution agreement relating to the distribution of beer within their own borders.[34]

However, 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.[35] 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.[36] 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 [the brewer's] products" and the goodwill of the distributor's business.[37] 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. Only some states provide anti-waiver and venue protections relating to franchise agreements to franchisees. While California Business and Professions Code section 20040.5[38] voids any agreement in a franchise relationship that restricts venue to a forum outside California, conflicting case law has created uncertainty regarding the enforcement of the statute.[39] 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 law governing the franchise agreement.[40] 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, "[T]he 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."[41] 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, there are certain commonalities. Although the three-tier system of beer distribution can trace its origins to the Prohibition era and the 21st Amendment, modern beer laws governing beer distribution relationships between brewers and distributors have been patterned after franchise relationships laws. Why not, after all, since brewers resemble franchisors in that they tend to hold the lion's share of power in the beer distribution business relationship? Considering the complexity of and differences among the various state statutes in both contexts, it is easy to see why expert legal advice from an attorney specializing in franchising and beer distribution law is essential at every step for those doing business in either franchising or the beer distribution industry.

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1 CAL. BUS. & PROF. CODE § 31005.

2 *See* 16 C.F.R. pt. 436; Under federal law, a franchise is defined as a continuing commercial relationship in which the franchisee obtains the right to operate a business or to offer or distribute goods identified or associated with the franchisor's trademark, the franchisor has the authority to exert significant control over or provide significant assistance in the franchisee's method of operation, and as a condition of obtaining or commencing operations of the franchise the franchisee makes or commits to make a required payment to the franchisor or its affiliate. 16 C.F.R. § 436.1(h).

3 *Franchise Registration States*, FRANDOCS, http://www.frandocs.com/franchise-registration-states.htm (last visited Nov. 23, 2014); the registration states include California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, North Dakota, New York, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.

4 Herman Mario, *Protection After the Purchase, State Franchise Relationship Laws*, BLUE MAUMAU (May 23, 2011, 1:16 PM), http://www.bluemaumau.org/protection_after_purchase_state_franchise_relationship_laws. *See also* ABA, FUNDAMENTALS OF FRANCHISING 190 (Rupert M. Barkoff & Andrew C. Selden eds., 3d ed. 2008) (stating that 22 states and territories have laws governing the franchise relationship, including Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Puerto Rico, Rhode Island, South Dakota, U.S. Virgin Islands, Virginia, Washington, and Wisconsin. Ohio should now be included as the 23rd state, after its passage of additional franchise protection laws in February 2013).

5 15 U.S.C. §§ 2801-2806.

6 15 U.S.C. § 2801(1)(A)-(B).

7 15 U.S.C. §§ 2802, 2804.

8 15 U.S.C. §§ 1221-1225.

9 *See* Gene J. Brockland, *The Long and Winding Road: Automobile Dealers' Day in Court Act Turns* 50, http://www.herzogcrebs.com/News-Information/2007-Articles/The-Long-and-Winding-Road-Journal-of-Missouri-Bar-May-June-2007.pdf (last visited Dec 5, 2014) (citing the legislative history during Congressional debate: S. Rep. No. 2073, 84th Congress, 2nd Sess. 2 (1956)).

10 15 U.S.C. § 1221(a).

11 15 U.S.C. § 1221(b).

12 15 U.S.C. § 1221(c).

13 *See e.g. Arnold's Wines, Inc. v. Boyle*, 571 F.3d 185, 187 (2d Cir. 2009) (in dicta, the court discussing the background of the three-tier system and its purpose).

14 Charlie Papazi, *The Future of Beer Distribution in America,* THE FULL PINT, http://thefullpint.com/beer-news/future-of-beer-distribution/ (last visited Jan. 18, 2015) (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).

15 *Granholm v. Heald,* 544 U.S. 460, 476 (2005) (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, violated the Commerce Clause of the Constitution).

16 *See* CAL. DEP'T OF ALCOHOLIC BEVERAGE CONTROL, LIST OF LICENSES, http://www.abc.ca.gov/permits/licensetypes.html (last visited Jan. 18, 2015) (website listing all of the various licenses required in California).

17 *Id.*

18 *Id.*

19 *See* W. Michael Garner, *Franchise and Distribution Law and Practice,* 3 FRANCH. & DISTR. L.& PRAC. § 16:43; FRANCH. & DISTR. L. & PRAC. § 16:4 (a summary of beer, wine and liquor statutes).

20 CAL. BUS. & PROF. CODE § 25000.5(a).

21 CAL. BUS. & PROF. CODE § 25000.9.

22 *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.").

23 *See* IOWA CODE ANN. § 523H.5.12.12(a-f) (exempting certain occurrences from the definition of a transfer requiring the franchisor's consent and denying franchisors the right to impose a penalty upon the franchisee or to exercise a right of first refusal in the event of such occurrences; such occurrences including, among others, the succession of ownership of a surviving spouse, heir, or partner upon the death of a franchisee.

24 WIS. STAT. ANN. § 125.33(10)(b-c).

25 *See e.g.* IDAHO CODE ANN. § 23-1107(2).

26 *See e.g.* CAL. BUS. & PROF. CODE § 20020 ("Good cause shall include, but not be limited to, the failure of the franchisee to comply with any lawful requirement of the franchise agreement after being given notice thereof and a reasonable opportunity, which in no event shall be more than 30 days, to cure the failure.").

27 *See e.g., id.*

28 *See* CAL. BUS. & PROF. CODE § 20021; *see also* 815 ILL COMP. STAT. 705/19 (a-c).

29 The five states are California, Kansas, Missouri, Oklahoma, and Wisconsin. 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.

30 CAL. BUS. & PROF. CODE § 25000.7.

31 *See* KY. REV. STAT. ANN. § 244.606.

32 *See* ALA. CODE § 28-9-11.

33 *See* N.H. REV. STAT. ANN. § 180:6(I)

34 *See id.*

35 IDAHO CODE ANN. § 23-1110(1-4) .

36 *See id.*

37 IDAHO CODE ANN. § 23-1110(2).

38 California Business and Professions Code section 20040.5 voids any agreement in a franchise relationship that restricts venue to a forum outside California.

39 *Compare Atlantic Marine Constr. Co. v. U.S. Dist. Court,* 134 S. Ct. 568 (2013), which held that "enforcement of valid forum-selection clauses, bargained for by the parties, protects their legitimate expectations and furthers vital interests of the justice system" and "a valid forum-selection clause should be given controlling weight in all but the most exceptional cases," *with Frango Grille USA, Inc. v. Pepe's Franchising Ltd.,* No. CV 14-2086 DSF, 2014 WL 5411480 (C.D. Cal. July 21, 2014), which held that the application of California Business and Professions Code section 20040.5 rendered a venue provision in a franchise agreement between a U. K. franchisor and a California franchisee setting venue in London invalid because the *Atlantic Marine* decision enforces *valid* agreements on venue and the application of section 20040.5 rendered the contractual provision invalid, *and TGI Friday's Inc. v. Great Nw. Rests. Inc.,* 652 F. Supp. 2d 750, 760 (N.D. Tx. 2009), in which a U.S. district court enforced an agreement setting venue in Texas over a California franchisee's section 20040.5 objection, noting that "Defendants do not explain . . . why this court should apply California law to void a franchise agreement that provides that Texas law applies to all matters relating to the agreement, and that Texas is the forum for any disputes relating to the agreement."

40 *See, e.g., To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc.*, 953 F. Supp. 987, 1000 (N.D. Ill. 1997), *aff'd,* 152 F.3d 658 (7th Cir. 1998) (court awarded lost profits and attorneys' fees to a plaintiff wrongfully terminated under the Illinois Franchise Disclosure Act).

41 CAL. BUS. & PROF. CODE § 20035.