Carve Outs

Looking to Traditional Franchising for Guidance

By Barry Kurtz and Bryan H. Clements of the Kurtz Law Group

Terminating beer distribution agreements continues to be a hot topic in the beer distribution industry. One of the first things craft brewers discover when they begin negotiating a beer distribution agreement with a beer distributor is that the three-tier system is designed to protect beer distributors, regardless of whether the distributor is a much bigger, more powerful entity. This tenet becomes abundantly clear when the craft brewer realizes the burden it will face if it wishes to terminate or not renew a beer distribution agreement with one of its beer distributors. To the craft brewer's chagrin, it will learn that states generally require all brewers to have "good cause", as that term is narrowly defined by statute, to terminate a distribution contract with a beer distributor. This is true regardless of whether the brewer's brands represent only a small percentage of the distributor's total business and even if the brewer feels the distributor is not performing—meaning the distributor is not putting forth its best, or even reasonable efforts to promote or support the brewer's brands.

To further complicate the issue, the craft brewer will further learn that even when "good cause" does exist, brewers usually must provide the distributor considerable advance notice and an opportunity to cure any contractual violations prior to terminating the distributor. Considering the "good faith" and fair dealing provisions found in the beer statutes of most states, a brewer that terminates a distributor without being able to prove "good cause" risks hefty damage awards, including the award of exemplary and punitive damages. Compounding the problem, brewers must also comply with a plethora of other procedural requirements imposed by state statute or face crippling penalties.

Notwithstanding the one-sided termination protections afforded distributors under the current three-tier system, some distributor biased advocates describe the beer distribution relationship as a partnership or a "marriage". This may be true during the "honeymoon period"—the period early in the distribution relationship during which the distributor works diligently to support the brewer's brands, aggressively communicating with retailers of all sorts to get the brewer's products on tap, in stores and in front of consumers through floor displays and other marketing efforts designed to maximize visibility. But considering the difficulty craft brewers face in terminating under performing or non-performing distributors as the relationship matures, many craft brewers find themselves drawing parallels between the beer distribution relationship and serfdom (bondage). Face it: this may not be too far fetched, because, in practical terms, the termination restrictions placed on craft brewers can translate to beer distribution agreements that have virtually perpetual terms. Moreover, despite the exclusive territory and termination protections afforded distributors under the three-tier system, many distributors operating today dwarf the craft brewers with whom they contract. And, considering the effort, time, cost, frustration and other risks associated with litigating a wrongful termination case, craft brewers are often forced to settle for the status quo.

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No doubt, when a giant conglomerate is the brewer involved, its distributors need to be protected to ensure the ongoing viability of the three-tier system (few except the lobbyists for such behemoths would disagree). But stacking the deck in favor of much larger, more powerful distributors, by subjecting craft brewers, brewing only a few thousand barrels a year (the quintessential American small businesses), to the same termination restrictions that were originally put in place as a part of the three-tier system and designed, ironically enough, to protect the public against anticompetitive practices, makes little sense.

With the goal of rebalancing the scales, promoting business, putting the interests of consumers first and restoring the credibility of the three-tier system, some states are grappling with the idea of passing "carve out" legislation.

"Carve outs" are designed to allow brewers that represent less than a certain percentage of a distributor's business to terminate a distributor without "good cause", provided the distributor receives reasonable notice and is paid the fair market value for loss of the brands. As most who do business in the industry know, New York led the way last year by passing the Small Brewer's Bill, which allows small brewers that contract with distributors in New York

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and that produce less than 300,000 barrels of beer annually, or whose brands account for less than 3% of the distributor's sales, to terminate the distributor without good cause if the distributor is paid the fair market value of the terminated distribution rights. Similar legislation is being considered this year by several state legislatures including H. 267, "An Act Relative to Small Brewers", which is being consider by the Massachusetts House of Representatives, and Senate Bill 1088 and House Bill 1666, which are working their ways through the Pennsylvania legislature. The future of this pending legislation is, however, less than certain.

Obviously, most craft brewers support the passage of "carve out" legislation. But in the face of substantial opposition to such change mounted by powerful interest groups representing beer distributors, as well as groups representing large brewers that prefer to keep the pressure on small brewers as a means of suppressing competition, craft brewers need to hone their arguments in support of "carve outs" to help clarify for state legislators why small brewers should be afforded an exemption from the stringent termination restrictions they are subjected to under the three-tier system. Examining the way terminations are handled in the traditional franchising context may yield some insight.

Why look to traditional franchises? How is such a discussion relevant? The answer is simple. Both relationships are characterized by an inherent imbalance of power—a circumstance in which one contracting party holds significantly more bargaining power in the relationship than does the other party. It is widely held belief that in traditional franchise relationships, not unlike beer distribution relationships that involve large, consolidated brewers, franchisees need protection against unreasonable termination to protect them from losing the substantial investments they have made in their franchises.

Traditional franchises are heavily regulated at both the federal and state levels. The primary protections afforded franchisees, though, come from disclosure law—laws that specify what investment related disclosures the franchisor must make to a potential franchisee prior to selling it a franchise

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and entering a franchise agreement. Federal law does not govern the franchise relationship or provide specific protections to franchisees once the franchise agreement has been signed. Twenty three states, though, have laws addressing the franchise relationship once it is formed, known as franchise relationship laws. But, only 17 of those 23 states have specific franchise relationship statutes. Viewed another way, 33 states do not have any laws specifically governing the termination of a franchisee's franchise by the franchisor. These states are satisfied that traditional contract remedies and common law protections adequately protect franchisees against unfair and unreasonable termination.

In general, the states that have passed franchise relationship laws did so intending to protect franchisees from having their franchise agreements terminated without "good cause". That said, 2 of the 17 states that have passed franchise relationship laws (Mississippi and Missouri), do not have a "good cause" requirement and only require that the franchisor comply with certain notice requirements before terminating a franchisee. Another, Virginia, only requires "reasonable cause". The other 14 states do require franchisors to have "good cause" to terminate.

At first blush one might muse: "Good cause" is "good cause"—it sounds the same as the protection states afford to beer distributors." But, there is a difference, and the difference can be boiled down to what is meant by "good cause". In the traditional franchise context, the term "good cause" generally means any failure of the franchisee to substantially comply with requirements imposed on it by the franchisor, which is a much broader interpretation than what is given to the same term in the beer distribution context. There is some crossover, of course, as "good cause" to terminate would likely exist in either context upon the conviction of a felony, fraud, a bankruptcy filing, territorial violations, etc. Nevertheless, franchisors enjoy much greater leeway to determine whether "good cause" to terminate exists. For example, franchisors generally may terminate franchisees that, in the franchisor's opinion, have failed to meet the franchisor's tough standards-such as cleanliness, quality, service, and sales or performance related targets, just to name a few. Further, a franchisor may require a franchisee to sign its then current form of franchise agreement at renewal, which is likely to have terms substantially different than the terms of the franchisee's expiring agreement. If the franchisee refuses, the franchisor may terminate the franchisee's right to use its trademarks and system on the expiration date. In sum, what is considered "good cause" to terminate by all states is substantially broader in the traditional franchise context than in the beer distribution context, despite the widely accepted view that a similar imbalance of bargaining power exists and that franchisees need to be protected.

In addition, the procedural requirements franchisors much comply with to terminate franchisees tend to be much more reasonable, even in states that do have franchise relationship laws. For example, California, the state that passed the first franchise relationship law in 1970, requires that a

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franchisee be given notice and a 30 day opportunity to cure, but allows a franchisor to immediately terminate a franchisee without any opportunity to cure if it has repeatedly breached the franchise agreement, regardless of whether the prior breaches were cured. In contrast, states tend to require brewers to comply with lengthy notice and cure period requirements, even when "good cause" to terminate exists. Alabama, for example, prohibits a brewer from terminating a distributor, even when "good cause" exists, without notifying the distributor of its violation, affording the distributor 30 days in which to submit a plan of corrective action, and providing the distributor an additional 120 days to cure such violation (the brewer must also provide an additional 60 day notice before terminating in the event the distributor fails to cure the violation during the cure period). Did you catch that? That means the distributor could, theoretically, breach the agreement and potentially sit on a brand for as long as 7 months before being terminated! Considering that state's exclusive sales territory requirement, who could argue that this is reasonable, at least with regard to a relationship between a craft brewers and a bigger, more powerful distributor?

The three-tier system protects distributors and the public from abuses they would otherwise face from mega-brewers, and it should be preserved and protected. However, the three-tier system should live, breathe, grow and adapt to the changing needs of society. After all, the three-tier system has not changed much since the prohibition era.

"Carve-outs" are a necessary and natural evolution of beer distribution law and should be embraced as a way to preserve the three-tier system, as well as a way to promote small business and consumer choice. This argument is supported by the fact that most small brewers have considerably less bargaining power than the distributors with whom they contract. Further, the position the states have taken with regard to protecting franchisees in traditional franchise relationships should help to guide the legislatures as they consider exempting small brewers from the "good faith" requirement. Franchisees, like distributors contracting with large brewers, need certain protections due to the imbalance in bargaining power they face in the franchise relationship. But the majority of states have found franchisees in their states to be adequately protected by basic contract statutes and by common law. Those states that have passed franchise relationship laws have successfully protected franchisees from bad faith or otherwise arbitrary and unreasonable terminations without the need for overly narrow "good faith" restrictions or lengthy, unreasonable notice and cure requirements.

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In a nutshell, franchising continues to work for all parties without such onerous protections. Considering that, and the fact that most distributors simply do not suffer from an imbalance of bargaining power in the distribution agreements they enter with smaller brewers—particularly those marketing a small amount of beer each year, or whose sales make up a fraction of a distributor's sales-now is the time for states to move forward and pass "carve out" legislation.

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Saranac to offer Legacy IPA in 16-oz. Four-Packs

F.X. Matt Brewing Company has announced that the company's new Legacy IPA will soon be sold in 16-oz. can four-packs.

Originally only available on tap or as a free bonus pint in specially marked, limited time variety 12-packs, the assertively-hopped Legacy IPA proved a consumer favorite.

“We've been overwhelmed with requests for more ways to get Legacy IPA,” said company President Fred Matt. “Who are we to argue with the masses? Our customers know what they want so we're going to give it to them.”

Mr. Matt said Legacy IPA was developed from a recently re-discovered original IPA recipe by company founder F.X. Matt.

“That original IPA recipe used the most innovative ingredients available at the time, and inspired current brewers to adapt it in homage to the company's history,” Mr. Matt said. “The current Legacy IPA features a blend of historic, traditional and innovative hops for a great aroma and full-bodied flavor.”

The new Legacy IPA four-packs will be hitting store shelves in late November.

“Who knew one of Saranac's newest beers would be from a recipe so old,” said Saranac fan Donald Lindhuber of Liverpool, N.Y. “When I found the Legacy IPA in my 12-pack, I knew this was going to be good. The inviting aroma of hops with a taste to match...This beer needs a pack of its own!”