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PERSPECTIVE

Carving out a craft brew exception

By Barry Kurtz & Bryan H. Clements

Pursuant to the 21st Amendment to the U.S. Constitution, states have primary authority to regulate the distribution of alcoholic beverages and rely on the three-tier system to regulate the distribution of beer. Under the three-tier system, brewers produce beer and sell it to distributors; distributors, in turn, sell the product to retailers (retail stores, taverns, etc.), who sell it to consumers.

When craft brewers begin negotiating beer distribution agreements with distributors, they discover that the three-tier system is designed to protect distributors, regardless of whether the distributor is a much bigger, more powerful entity. When the craft brewer wishes to terminate a beer distribution agreement with a distributor, this fact becomes vividly clear. Why? Because states generally require all brewers to have "good cause," narrowly defined by statute, to terminate a beer distribution contract, even when the brewer's brands represent only a small percentage of the distributor's total business or the distributor is not putting forth its best, or even reasonable, efforts to promote or support the brewer's brands.

Even when good cause exists, brewers must provide distributors considerable notice and an opportunity to cure any violations prior to terminating. Considering the good faith and fair dealing provisions found in most state statutes, a brewer that terminates a distributor without good cause risks severe penalties, including exemplary and punitive damage awards. Compounding the problem, brewers must also comply with extensive procedural requirements or face crippling penalties. The time, cost, frustration and other risks associated with litigating a wrongful termination case often force craft brewers to settle for the status quo. So in practical terms, the termination restrictions placed on craft brewers can translate to contracts with virtually perpetual terms.

To further protect distributors, states require brewers to provide them with exclusive distribution territories. But surprisingly, most distributors dwarf the craft brewers with whom they contract. No doubt, when the brewer is a giant conglomerate, its distributors need termination protections to ensure the ongoing viability of the three-tier system. But stacking the deck in favor of much larger, more powerful distributors by subjecting craft brewers, brewing only a few thousand barrels a year, to the same termination restrictions, designed, ironically enough, to protect the public against anticompetitive practices, makes little sense.

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Aiming to rebalance the scales, promote small business, put the interests of consumers first and restore the credibility of the three-tier system, some states are considering "carve out" legislation. Carve outs allow small brewers to terminate distributors without good cause, provided the terminated distributor receives reasonable notice and is paid the fair market value of the terminated brands. New York led the way last year by passing the Small Brewer's Bill, allowing small brewers producing less than 300,000 barrels of beer annually, or whose brands account for less than 3 percent of the distributor's sales, to terminate the distributor without good cause and pay it the fair market value of the terminated distribution rights. Several states, including Massachusetts and Pennsylvania, are considering similar legislation this year, and most craft brewers support such change. However, powerful interest groups representing beer distributors and large brewers preferring to keep the pressure on small brewers, oppose it.

A review of traditional franchise law helps us see why carve out exemptions make sense. Traditional franchise relationships, like beer distribution relationships, are characterized by an inherent imbalance of power — one contracting party holds significantly more bargaining power than the other in the relationship. Many believe that in franchise relationships, as in beer distribution relationships involving large, consolidated brewers, franchisees need protection against unreasonable termination to prevent them from unfairly losing their investments. To that end, traditional franchises are heavily regulated at both the federal and state levels. But the primary protections afforded franchisees come from disclosure laws — laws specifying what investment-related disclosures franchisors must make to potential franchisees prior to signing franchise agreements.

Federal law does not govern franchise relationships or provide specific protections to franchisees once parties enter franchise agreements. 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, two of the 17 (Mississippi and Missouri), do not have a good cause requirement, but merely require the franchisee receive notice. Virginia only requires "reasonable cause." The other 14 do require that

Carving out an exception for craft brewers

franchisors have good cause to terminate.

At first blush, one might say: "Good cause' is 'good cause.'" 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 the franchisor's requirements — a much broader interpretation than what is given to the same term in the beer distribution context. There is some cross-over, 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 typically may terminate franchisees that, in the franchisor's opinion, have failed to meet their tough standards of cleanliness, quality, or service- or 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 may contain terms substantially different than 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 without compensation. In sum, what is considered good cause to terminate by all states is substantially broader in the franchise context than in the beer distribution context, despite the widely accepted view that a similar imbalance of bargaining power exists in both.

Also, procedural requirements tend to be much more reasonable in the franchise context, even in states that have franchise relationship laws. For example, California requires that franchisees be given 30 days' notice and an opportunity to cure, but permits a franchisor to terminate a franchisee immediately 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 exists. Alabama, for instance, prohibits a brewer from terminating a distributor, even when good cause exists, without notifying the distributor of its violation, affording the distributor 30 days to submit a plan of corrective action, and providing the distributor an additional 120 days to cure any violation (and an additional 60-day notice before terminating if the distributor fails to cure any violations during the cure period). Theoretically, the distributor could breach the agreement and sit on a craft brewer's brands for seven months before being terminated! In light of this, and Alabama's exclusive sales territory requirement, who can argue that this is fair to craft brewers contracting with bigger, more powerful distributors?

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When craft brewers begin negotiating distribution agreements, they discover that the system is designed to protect distributors.

The three-tier system protects distributors and the public from abuses they might otherwise face from mega-brewers and should be preserved. But the three-tier system should grow and adapt to the changing needs of society. Carve-outs represent a natural evolution of beer distribution law and should be embraced to preserve the three-tier system, promote small business and ensure consumer choice. Traditional franchise law can guide state legislatures as they consider carve out legislation. After all, most states have found that basic contract statutes and common law remedies sufficiently protect franchisees from arbitrary or bad faith terminations. Even those that have passed franchise relationship laws reject the need for overly narrow good faith restrictions or lengthy, unreasonable notice and cure requirements. Considering the similarities between franchise relationships and beer distribution relationships, and the fact that most distributors do not suffer from an imbalance of bargaining power in their relationships with smaller brewers, states should move forward and pass carve out legislation now.

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