Surviving Distributor Power Plays

Knowing your rights and protecting your brand in a franchise state

By Suzanne DeGalan

One of the most common questions I get from winery clients is: "My distributor (in a franchise state) has no incentive to sell my brands–he knows I cannot fire him. Do I have any leverage at all?"

This is a valid question: Is there anything a winery can do to encourage performance from a distributor in a franchise state? Failing that, can the winery terminate the relationship?

Written distribution agreements

I recently exchanged emails with a winery executive who was entering the market in a franchise law state and preparing to appoint a new distributor. I asked my customary threshold question: "Do you have a written agreement for the distributor?" The executive replied, "No. Isn't an agreement worthless in a franchise state?" This is a typical response from wineries experienced enough to know the nightmare that is alcoholic beverage franchise law, and the simple answer is "NO," although there is admittedly a more nuanced response, depending on the state in question.

The fact is that a written agreement, properly drafted to respond to the specifics of a particular state's franchise laws, is usually the supplier's only leverage against the distributor "deck-stacking," which occurs in states with alcoholic beverage franchise laws.

Good cause termination

Let's start with a basic premise. All franchise states allow a winery to terminate its relationship with a distributor for "cause." Some franchise states define the universe of what constitutes cause under that state's laws. Other states provide examples that are not an exhaustive list, while other states give no guidance at all. Some of the more unfriendly states have very narrow definitions of cause and even go so far as to state that cause does *not* include a distributor's failure to meet any particular goal or quota.[1]

EDITOR'S NOTE

This is the second installment in a two-part series about franchise laws by attorneys John Trinidad of Dickenson, Peatman & Fogarty and Suzanne DeGalan of Hinman & Carmichael. Trinidad's article, "Why Producers Hate Franchise Laws," appeared in the April 2016 issue of *Wines & Vines.*

KEY POINTS

A distribution agreement should track the language of that state's franchise laws and make clear that performance failures constitute good cause to the extent allowed by that state's laws.

Be aware that any agreements that violate state franchise laws are not enforceable.

Use meeting evaluation forms to track performance. Sales force training is a must.

On the positive side (for a winery), many franchise states include in their definition of "cause" or "good cause" a distributor's failure to comply with an important and reasonable requirement by a supplier.[2]

A written agreement, signed by the distributor, that defines such important and reasonable requirements will support a supplier's termination for good cause if the distributor has failed to meet one or more of these requirements.

For example, the Liquor Control Code in Michigan (a franchise law state) provides that a supplier may not terminate or fail to renew a distribution agreement unless it has good cause, including "failure by the wholesaler to comply with a provision of the agreement, which is both reasonable and of material significance to the business relationship."[3]

Without a written agreement defining the obligations that are of "reasonable and material significance," a court would likely look to Michigan's franchise law itself to determine whether a distributor's performance was so substandard as to justify termination. Here the law requires only that the distributor devote "reasonable" efforts to sales and distribution of the products and maintain "reasonable" sales levels.[4]

Most suppliers would find it difficult to prove a distributor's performance fell short of these mediocre requirements absent an egregious lapse of effort by the distributor. However, a precise definition of what constitutes reasonable performance in a written agreement will provide the winery with leverage in resolving distributor conflicts in Michigan.

As another example, Massachusetts prohibits a supplier from terminating a distributor without good cause, which includes the distributor's "failure to comply with the terms of sale agreed upon between supplier and wholesaler."[5]

Massachusetts case law, moreover, supports the finding of good cause when a distributor violates a material provision of its written distributor agreement—even if the conduct would not be considered good cause for termination in the absence of such contractual provision. In Seagram Distillers Co. v. Alcoholic Beverages Control Commission, for example, a termination was upheld when the distributor's sole shareholder sold all of his stock to another party and a clause in the distributor agreement allowed either party to cancel "upon the (s)ale or transfer of control or management of the other party."

While the court found good cause in the cancellation provision of the written agreement, the court found no good cause for termination of additional *oral* agreements between supplier and distributor, because these oral agreements lacked the express written requirement of consent to a change of control that was included in the written agreement between the parties.[6] Thus, while the distributor's change of control in and of itself would not have constituted good cause in the court's judgment, the violation of a written contractual provision forbidding such change of control was found to constitute good cause.[7]

As you can see, a written distribution agreement that defines such important and reasonable requirements as failure to meet sales goals mutually agreed upon by the winery and the distributor will support a supplier's termination for good cause when the distributor has failed to meet one or more of these requirements.

Other key provisions in distribution agreements

A written distribution agreement can provide many important terms in addition to enumerating the distributor's performance obligations. These are terms that would not automatically apply to the relationship in the absence of a written agreement specifying them. In fact, franchise state distributors frequently object to signing written distribution agreements—not because the agreement is contrary to a state's franchise laws,[8] but because the distributors know the agreement could minimize the protections afforded them by their franchise laws.

As in the Seagram Distillers case, many courts will hold the distributor to such written terms (so long as they do not violate their state's franchise laws), even if the provision would not apply absent a written agreement.

One example is a dispute-resolution provision. Binding arbitration is of much greater advantage, particularly to small suppliers, than the far more costly litigation route that a contract will default to in the absence of a dispute-resolution provision. This becomes an important protection in the event the distributor refuses to accept a supplier's notice of termination and pursues a claim.

Other key components of a written distribution agreement include:

Territory carve-outs: These make clear that the distributor's right to distribute is limited to those territories listed in the agreement and no others. Many multi-state distributors include in their agreement the right to any future territories in which the supplier sells its products. New suppliers just launching in a single state are particularly vulnerable to this provision.

Brand limitations: While a distributor's franchise rights almost always travel with the "brand" (that is, if a supplier sells a "brand," the successor-owner of that brand is bound to the same distributor in that state) most of these states have notoriously fuzzy definitions of what constitutes a "brand."

For suppliers with multiple brands that do not necessarily all carry the name of a particular winery, the distribution agreement should specifically list which brands the distributor has a right to distribute. This leaves open the option to grant future brand rights to different distributors in that state. Under Maine law,[9] for example, a supplier may not appoint more than one distributor in any territory "for its brand or label in the same territory."[10]

LET THE BUYER BEWARE

It is important to note that *any* written agreement is not necessarily superior to *no* agreement in franchise states (or any state for that matter). More often than not, distributor-drafted distribution agreements include provisions that tie up the supplier's brands (including any future brands and often future territories) in perpetuity, omit any performance requirements, deny the supplier any right to terminate—not just for a distributor's failure to perform, but often for any reason at all—and include termination penalties of multiple times the distributor's gross profit.

With these kinds of agreements, a supplier may be better off relying on the paltry protections afforded by that state's franchise law rather than giving away those meager protections under the terms of the distributor's version of a distribution agreement. This will depend on the agreement and the laws of the applicable state. We recommend wineries consult legal counsel to help them determine how to proceed under these circumstances.

PRE-SIGNED RELEASES AND WAIVERS

It is not uncommon for winery clients to come to us with the "perfect solution" to entering into a distribution relationship in a franchise state: Simply get the distributor to sign, in advance of entering into the relationship, a waiver stating the distributor agrees that supplier may terminate distributor at any time without penalty.

What many suppliers do not realize, however, is that franchise state laws prohibit the distributor from contractually waiving any of the rights it has under the franchise laws. Any sort of written waiver stating otherwise might simply be void under the applicable state's laws. In fact, in many cases the distributor is well aware of this and knows the waiver will likely be unenforceable when the supplier attempts to terminate. Thus this "perfect solution," if unenforceable, actually leaves the winery worse off than if there was a written agreement in place defining essential terms.

The Maine Act does not define the word "brand," creating ambiguity as to whether wineries may appoint different distributors in the same territory for different "brands" owned by the same winery. Happily, in this case, a federal court case has established that "brand" under the Maine Act refers to a single label, or "item," rather than a manufacturer's entire line of products.

In Briggs Inc. v. Marlet Importing Co. Inc.,[11] the court found under the Maine Act that "Molson Ice" was a separate "brand" from Molson Breweries U.S.A.'s other products, such as Molson Ale and Molson Light, thus giving Molson Breweries the right to grant distribution rights to its new product, "Molson Ice," to a new distributor in the same Maine territory where another distributor was distributing other Molson products.

Note that this is not a typical result in a franchise state—usually the brand name "Molson," as part of the name of both products, would be enough to constitute the same brand. This is why completing due diligence by reviewing the particular state's franchise laws (in this case, including case law) is always a best practice.

Exclusivity (dualing): Some franchise states allow a supplier to grant distribution rights to more than one distributor for a particular territory (which sometimes means the entire state). In some states, this law must be taken advantage of at the outset of the relationship, since any later addition of another distributor to the same territory could be interpreted by the state as a material impairment or diminishment of the existing franchise, triggering the distributor's right to compensation for its "loss" of distribution rights. In those states that allow it, therefore, the agreement should specify that the appointment is "non-exclusive" in order to leave the supplier's options open to grant future rights in the same territory to other distributors.

Liquidated damages: Yes or no? As noted above, distributors willing to enter into written agreements usually want to include a liquidated damages (or "termination fee") provision for any supplier termination without cause. Usually the fee will be expressed as a multiplier of the distributor's gross profit from sales of the brand ranging from one to as much as five times or more gross profit. A termination fee is not necessarily a bad thing, as it provides the supplier with certainty regarding the cost of exit. In fact, a termination-fee provision is often preferable to relying on the state's franchise law, which often requires suppliers to pay the terminated distributor "fair market value," a notoriously ambiguous phrase that encourages litigation.

We recommend consulting with your counsel and checking that state's franchise laws prior to agreeing to a fee. We generally insist upon no more than one times gross profit when negotiating these provisions, but the amount of a reasonable liquidated damage fee varies both state by state and by supplier volume of sales within the state (higher volumes generally translate to lower liquidated damage multiples).

Monitor relationship

Track performance: Suppose you are successful in getting a franchise state distributor to sign your agreement. The agreement tracks the language of that state's franchise statutes regarding good cause and allows for termination in the event of failure to perform. Does this guarantee you can terminate a non-performing distributor, provided you are willing to diligently follow the franchise state's requirements regarding notice, opportunity to cure and so on in the event of distributor performance failure? By no means.

The right to terminate a distributor for failure to perform is meaningless unless the winery tracks the distributor's performance. The most common mistake suppliers make regarding distributor relationships in franchise or open states is to relax their vigilance once the distributor has been appointed and fail to keep a paper trail of the distributor's performance, communications with the winery, sales and depletion efforts, promotional activities and the like.

While it is true that distributors are loathe to commit to depletion numbers and may often refuse to do so, wineries can still establish systems for tracking performance, require regular sales and depletion reports, schedule at least quarterly meetings with distributors (including at least one face-to-face meeting annually) in which both sides agree to certain sales and promotional efforts and—above all—put everything in writing. A distributor meeting evaluation form is vital for this purpose (our firm routinely provides such forms to our clients for this reason).

Emails can be critical in this regard; they can be your best friend or your worst enemy when it comes to tracking distributor performance in the event of a dispute. We have many suppliers who come to us with tales of distributors who are ignoring their brands, avoiding their phone calls and generally foreclosing any opportunity for achieving the winery's sales goals in that territory.

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But when we begin to collect the paper trail of the relationship, frequently we find emails in which the winery has complimented the distributor on its performance, failed to note distributor deficiencies and let slide opportunities for pointing out weaknesses in performance. In these cases, the email correspondence has generally weakened if not seriously undermined the winery's case for termination with cause in that territory.

Watch for termination opportunities

Certain situations or events can create "termination opportunities," even in franchise law states.

Sale of distributor: Franchise laws that address the sale of a distributor to another distributor generally state that the brands follow the sale. However there is often a window of opportunity in many franchise states, because the distributor is required by the franchise law to notify its suppliers of its impending sale and seek their approval. Suppliers in turn are usually required by this same law to grant the approval, so long as the successor distributor meets the reasonable requirements of the supplier.

While in practice this often means the supplier has no choice but to go along with the sale, a new distributor that carries many-fold more brands than the existing distributor—and in particular who carries brands that compete directly with the supplier's brands—may provide the winery with grounds to object to the sale. This justifies a request to the new distributor to furnish important basic information about its organization, other brands, financial strength and manpower.

If nothing else, the impending sale creates a moment in which the supplier has rare leverage as the new distributor seeks to woo all suppliers of the prior distributor and convince them it is dedicated to their success. We have frequently used this moment to get franchise state distributors to sign written agreements with terms as favorable to the supplier as franchise laws will allow.

Wrongful sales outside of territory: One of the few restrictions placed on distributors in many franchise states is the prohibition against selling a product outside of the territory designated to it for that particular product. Despite this, it is not unusual to hear about distributors that are selling products in counties to which they were not appointed—or even selling the product into neighboring states. The latter usually violates more than one state's alcoholic beverage laws and provides a potential opportunity for the supplier.

Sometimes the distributor's actions are so outrageous that even the franchise state's courts are appalled.

For practical purposes we often help our suppliers use this opportunity to trade out their brands with another distributor (see below) or negotiate a termination with a modest settlement fee rather than use the wrongful sales as grounds for a termination with cause action—the latter is usually costly, protracted and often unsuccessful in these states.

Egregious behavior: Sometimes the distributor's actions are so outrageous that even the franchise state's courts are appalled. If you have a distributor that is a really bad actor, it is worth consulting with your counsel before concluding it is hopeless because you are in a franchise state.

For example, there is a small winery whose wines were being distributed in a particular franchise state. One year, the winery introduced some new varieties and brands into the portfolio. But when the winery provided a presentation of the new wines to the distributor in that state, it was informed that the distributor had established its own "tasting panel" that found the winery's new wines did not pass muster under the panel's dubious criteria, and that the distributor was not willing to carry the new wines.

When the winery humbly (I know, it is galling, isn't it?) asked to take those new wines to another distributor in that state, it was told no. Because the distributor had made it legally impossible for the winery to sell its new wines in that state, the producer terminated for cause under that state's franchise law provisions.

When the distributor—as we expected—filed a complaint in state court against such termination, the judge threw the distributor out of court. The takeaway? There can be justice, even in a franchise state, although admittedly you might need to have a hair-raising tale like this one to obtain a swift verdict.

Termination

If the distributor situation in a franchise state has deteriorated to the point where you want to pursue termination despite the unfavorable odds, there are a few things to keep in mind:

- First, make sure you have solid and documented "good cause" reasons for termination, backed by documentation to support such termination.
- Any official termination for "cause" action must strictly follow the state's notice and cure requirements, including lengthy time periods for cure, certified mail instructions, proper notice enumerating the reasons justifying good cause termination and more. Even so, expect an aggressive fight from the distributor and an unsympathetic Alcohol Beverage Commission response. (In states that make no provision for a regulatory hearing process, you may simply be waiting for the distributor to file an action in state court, which they do not hesitate to do in most cases.)
- If at all possible, given the bleak prospects outlined above, contact another distributor who is willing to buy out or trade brands with the existing distributor. Even if you have to contribute to the buyout, this could be money well spent.
- In the event that the existing distributor is willing to agree to a buyout or settlement, secure a release from that distributor against any future actions under the franchise laws or any other laws. We routinely negotiate such releases, and your counsel should be instructed to draft such release in the event of impending termination.

Rethinking your franchise mentality

Managing relationships in franchise states is difficult, but not impossible. Doing it right requires discipline, experience and (more than anything else) knowledge. Distributors are business people every bit as dedicated to the success of their business as the suppliers they serve. A relationship founded on a mutual understanding of the role of each party—and recorded in a written agreement that reflects those understandings—is a relationship where the parties will both prosper. This is as true in franchise states as it is in open states.

This article is not intended to be a comprehensive review of all the necessary terms and conditions that should go into every distribution agreement in a franchise or open state. There are many other important issues that vary between individual suppliers based on their marketing strategies, routes to market, promotional policies, price points and other factors. For this reason, we encourage all wineries to consult with their counsel before undertaking initiatives that affect their brands in the many different U.S. markets.

There can be justice, even in a franchise state, although admittedly you might need to have a hair-raising tale to obtain a swift verdict.

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The references for this article are available online at winesandvines.com

FRANCHISE LAW

Monitoring a distributor's sales performance

By Paul Young

When I was the sales and marketing director for a medium-size winery in the Sonoma Valley of California, I monitored a distributor's sales performance with the BDI/CDI Index. This helped me and many sales and marketing departments in other wineries to benchmark for each state how a distributor was doing for the winery's brands in that state.

The BDI/CDI Index (BDI=Brand Development Index/CDI=Category Development Index) is available in the annual *WINE Handbook* published by Beverage Information Group of Norwalk, Conn.

The BDI number shows the percentage of a winery brand's sales compared to all wine sales in one state. For example, the Sonoma Valley winery usually performed in the 1.5%-3% range for each state. The CDI number shows the overall percentage of how the competitors (determined by case volume) should be against all wines sold in that state, usually in the 1%-4% range.

I could determine how well a distributor was doing by comparing his winery current case sales in one state (BDI number) against the other vintners' case sales in that state (CDI number), for wineries selling about 600,000 cases for the entire United States. If the BDI for my Sonoma Valley winery was 1.5% for one state, and the CDI was 3.0%, we would know that the distributor was underperforming for that state, compared to competitors.

Our winery would usually include the BDI/CDI numbers for each distributor during the winery's annual sales review and goal projections for the next year. The winery sales manager would fly to each major distributor's headquarters in January and set the goals for case sales, along with pricing, programming and incentives for the upcoming year.

For example, the sales manager would meet with Young's Market (a California distributor) and break down sales by market channel/segments, chain stores, independent retailers (of importance), restaurants and hotels. That way, when the sales manager visited during the year with each distributor on sales progress, there was a benchmark that was agreed to in January.

If the distributor fell behind their sales goals in a franchise state, a warning letter would be issued, asking how we could improve sales. If sales continued to be "substandard," a follow-up letter would be sent to warn the distributor of possible termination. These letters, along with the annual case goals and BDI/CDI numbers, form the basis for termination in a franchise state for due cause.

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