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Franchise States

Dealing with Under-Performing Distributors

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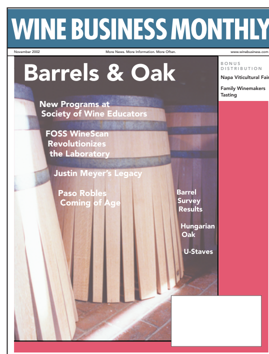
You make a great wine. Consumers love the product and your sales are booming across the country. Everywhere, that is, except for one state. In that state, sales are flat—or actually decreasing—and you're concerned. You investigate and discover that your distributor has not been promoting your brand and is not interested in doing so. So, what do you do? You terminate the distributor and offer the brand to someone who will work to increase your sales, right? The answer is, maybe. In many states that is a perfectly logical course, but in others, the terminated distributor is likely to howl, "Not so fast! This is a franchise state!"



What Are Franchise Acts?

The term "franchise" is commonly used by the wine industry to describe relationships in those states where distributors have managed to obtain for themselves a wide variety of protected rights to a supplier's product. However, these are not traditional "franchise" rights (such as those having the right to sell fast food or consumer services) as the rest of the world understands them. Rather, any state where a distributor can use state law (sometimes called a "franchise act," sometimes called something else) to shield itself from the consequences of its own actions is considered to be a franchise state.

Distribution agreements between suppliers and wholesalers are contractual relationships. This is true whether the agreements are written or oral. If the contract is oral, which is common, the supplier and distributor should abide by whatever promises have been made and otherwise act in a commercially reasonable manner (typically meaning common sense under the circumstances). If the parties have a written agreement, the terms of the contract should, and will likely spell out how long the relationship is to last, under what circumstances the supplier can terminate the distributor, how much notice is required, the obligation to buy back inventory, etc. In some states, that's the end of the issue and the parties' relationship is governed almost entirely by the promises made between them (or by the Uniform Commercial Code - another subject entirely). However, in those states that have enacted "franchise acts," it's a whole different ball game.

In order to prevent large and powerful alcoholic beverage manufacturers (mostly distillers and breweries; wineries have been an afterthought) from taking unfair advantage of the Mom & Pop distributors who dominated the beverage wholesale tier in the past, many states enacted franchise legislation aimed at leveling the playing field. The fact that most Mom & Pop distributors have long since been gobbled up by much larger distribution corporations (who now possess much greater leverage in most distribution relationships) has not led to a change in these franchise laws.

One notable exception was the Illinois Wine & Spirits Industry Fair Dealing Act of 1999, which the **Illinois District Court** has refused to enforce based on purported violations of the dormant commerce clause and contracts clause of the U.S. Constitution. However, that ruling was based on the Act's inherent protectionism of in-state wineries, rather than perceived inequity as between beverage suppliers and wholesalers.

The franchise laws vary from state to state, but most share a few fundamental attributes.

First, termination generally must be for "good cause." This typically will include a breach of, or failure to adhere to, a material and reasonable term of the parties' agreement.

Most franchise acts also prescribe a set notice period and afford the terminated party an opportunity to cure the breach. Without a written agreement, it is often difficult to determine what is, and what is not, a material and reasonable term of the agreement.

Many franchise acts also recognize a few exceptions in which the terminated party is not entitled to notice or an opportunity to cure. Typical exceptions include bankruptcy or insolvency, conviction of certain criminal acts, and suspension or revocation of permits or licenses required to perform under the parties' contract.

If the parties have a written agreement (which we recommend in every case), the terms they have agreed upon may supplement the franchise terms and enlarge upon what constitutes proper grounds for termination, and may provide that disputes get resolved in a cost effective forum (such as by mediation or arbitration, called Alternative Dispute Resolution or ADR) and in a location of the parties' choice. However, the terms of a written contract almost certainly will not be allowed to supplant or contradict a provision in a franchise act. For example, trying to vary the place where a dispute is resolved (usually the distributor's home state) and what state law applies usually do not work to remove a disputed relationship from the jurisdiction of a state's franchise act (caveat: many "franchise" states do in fact permit the parties to agree on the dispute being heard by ADR or in places other than the distributor's state; this must be evaluated on a state by state basis). Moreover, if state law requires a notice period and an opportunity to cure, and defines what "good cause" may be, the contract cannot vary those terms. Generally speaking, courts have held contract terms to be invalid when they operate to negate the intent of the franchise laws.

So, returning to our initial scenario, in which the distributor is not doing an adequate

job, can't the supplier legally terminate the distributor for cause? The answer is yes, followed by a very large however: the chances that the under-performing distributor will accept the termination gracefully and move on are slim. The reality is that - although some suppliers with the law on their sides litigate and win - it is often cost prohibitive to litigate the issue and much more economical to work out a settlement with the wholesaler who is to be terminated.

A Cautionary Note

Although this article does not focus on the mechanics of terminating a distributor, a broad cautionary note seems warranted: Suppliers will logically want to have a replacement wholesaler in mind before they terminate an existing wholesaler. It would be wise to keep such discussions highly confidential and make *no* promises during the process of selecting a replacement. The beverage distribution world is small (and getting smaller) and word travels quickly when a change is imminent. Premature disclosure of plans to change distributors may undercut a supplier's good cause argument and could expose the supplier and the new wholesaler to claims by the existing wholesaler. The supplier may even face claims by the new wholesaler if the parties have had serious discussions that do not culminate in a transfer. The industry is rife with stories of "jilted" wholesalers burying brands by dumping product below cost or trading out key accounts.

This is not to say that suppliers should always settle. The specific facts will dictate whether a supplier should dig in and hold its ground. For example, if the parties have established performance goals that have not been met, and can demonstrate (through oral testimony and prior correspondence) that the wholesaler was on notice that it was not performing, the supplier's case for termination becomes stronger. If the brand at issue normally sells well in the state, giving rise to large potential damages from the wholesaler's underperformance, this too may justify a harder stance by the supplier. Conversely, if no specific goals have been agreed upon, if the supplier has waived those goals in the past by not raising the distributor's failure to reach them, or if the underperformance is attributable to reasons arguably beyond the control of the distributor, the dispute may well be a good candidate for settlement.

Payment of Compensation and Brand Swaps

Many franchise laws provide for the payment of compensation to a wholesaler terminated without good cause, and some expressly define the required compensation as including the goodwill value of the brand that the wholesaler will lose. A few even define how the goodwill value is to be calculated. For example, the Delaware Regulations define associated good will as equal to the wholesaler's annual average gross profits on the terminated brand for the previous 3 fiscal years. (Delaware Regs, Rule 46(E) (1) (a).) In practice, the amount of compensation paid to free up a brand varies depending on such factors as brand popularity, whether the wholesaler can show significant expenditures to promote the brand, the strength of the supplier's claim that the termination is with good cause, the cost of litigating the termination, etc.

The compensation paid to the departing wholesaler is often paid in part by the successor wholesaler. Or, in a variation on that theme, the successor wholesaler may have a brand that the terminated wholesaler is interested in obtaining the rights to, and a brand swap may be arranged. Again, the parties' respective strengths in arguing that the termination will be with good cause, brand-specific value factors, whether a brand plus a cash payment will be required, etc., are all relevant to determining the outcome to the negotiations.

New Contract

In some circumstances, suppliers may find that they lack a solid good cause termination argument, and cannot (or will not) compensate the existing wholesaler to free up the brand. In those cases, the supplier is not entirely without recourse. Many supplier-distributor relationships are based on an oral agreement - distributors have been historically reluctant to commit to written agreements. Suppliers may be able to use their dissatisfaction with a wholesaler as a means of obtaining a written agreement, even if not to terminate the wholesaler. The goal is not necessarily to terminate an underperforming distributor; rather, it should be to structure a scenario where the supplier's wine is sold in amounts justified by the brand strengths, and where retail accounts are properly and consistently serviced.

As noted above, most franchise acts include in their definition of good cause to justify termination by a supplier, the wholesaler's breach of a reasonable, material provision of their agreement. A dissatisfied supplier may wish to make entering into a written agreement a condition of the parties' on-going relationship. This is usually considered to be "reasonable and material" and may have three foreseeable beneficial effects. First, if a wholesaler refuses to enter into a written agreement, the supplier could assert that the refusal to do so itself constitutes a breach supporting a termination for cause. Second, assuming the wholesaler agrees to a written agreement, this provides a new opportunity for the supplier to clarify sales and other requirements (such as account servicing, payment and quality control) and define what constitutes good cause for termination. The net effect may be that an under-performing wholesaler rededicates its efforts to the brand. Finally, with a written agreement that clarifies the wholesalers' obligations, the stage will be set for a good cause termination if the wholesaler does not step up its efforts and meet its sales and other objectives.

Winery owners often bemoan state law franchise acts and declare themselves powerless to do anything about a poor performing wholesaler because of franchise protection. Certainly, franchise laws are a major source of leverage for wholesalers, and they make termination more challenging. However, as this article illustrates, franchise acts do not necessarily require that a winery stay with a wholesaler for life. Rather, franchise acts require that suppliers clarify the wholesalers' contractual obligations, document their performance, and look for creative solutions that will work for both sides. **wbm**

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