

LexVid | Beverage Law Series

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Overview of the **LexVid** Series

- Goal: Provide a holistic look at beverage practice across the US using beer as a lens.
  - Part 1: A. Market & Regulatory Primer
    B. Start-up and Business Counsel
  - Part 2: Intellectual Property Concerns

Part 1A: Market Introduction

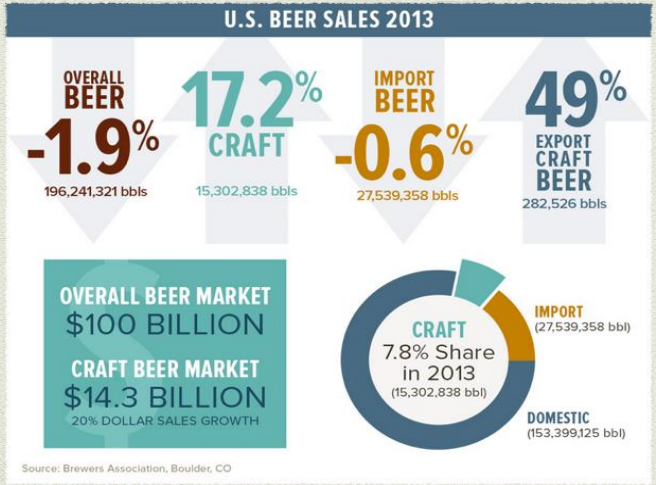


Source: Brewers Association

Breweries in 2012: 2,456
Breweries in 2013: 2,822 (+14.9%)

Part 1A: Market Introduction

- Takeaway: It's a growing industry.
- Craft is on the rise, gaining share.
- "Craft" = fewer than 6,000,000 bbl produced per year. (bbl = 31 gallons)
- Demand for US beer.



Part 1A: Market Introduction

- Hundreds of breweries in planning stages right now.
- Homebrewing at a high since legalized.
- Need for industry-savvy attorneys to help as new breweries open and established breweries grow.



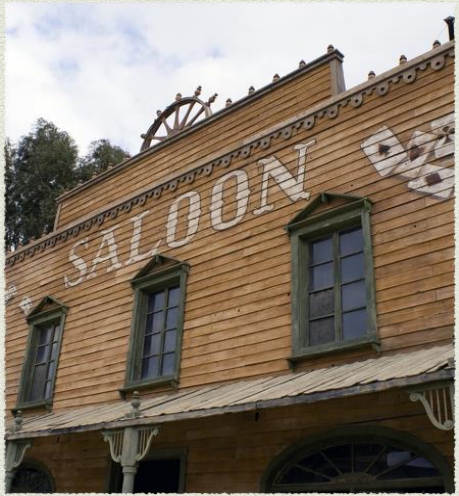
Part 1A: Regulatory Introduction

- Highly regulated industry, at the federal, state, and local levels.
- Much regulation stems from the post-Prohibition era.
- Brewers are forming guild organizations and seeking to change these burdensome laws.
- Legislators are increasingly responsive: Beer industry is creating jobs, and a lot of tax revenue, too.



Part 1A: Regulatory History

- Current regulatory climate reaches back to historic concerns.
- Understanding beverage history helps us understand why current laws are in place (and, in turn, helps fuel change).
- We will explore some of the historic ebb and flow of regulatory power:
  - States under the 10th Amendment?
  - Federal government under the Commerce Clause?
  - States under the 21st Amendment?



Part 1A: Pre-Prohibition

- Strong & Cheap Alcohol.
- Excessive drinking led to spousal abuse, unemployment, and family neglect.
- Women, not able to meaningfully enter the workforce, were leaders of the temperance movement.
- Religious/moral & health concerns with alcohol.



Source: Ohio Historical Society

Part 1A: Pre-Prohibition

- 1847: SCOTUS says alcohol is not subject to commerce clause. Under the 10th Am., states could regulate how they wanted.
- 1890: SCOTUS struck down Iowa law that banned improperly permitted beer from entering the state. Interstate commerce.
- Congress “spoke,” passing laws that gave states power to regulate (even discriminatorily) alcohol.



1917: Signing of Indiana Prohibition Act.

Part 1A: Prohibition

- January 17, 1920: Prohibition.
- Notably, under the Volstead Act, some home production of wine and cider was okay (but, sadly, not beer).
- Breweries shifted production to alcohol-free offerings to stay in business.



1919: A-B doesn't close shop, but switches to alcohol-free beverages.

Part 1A: Prohibition

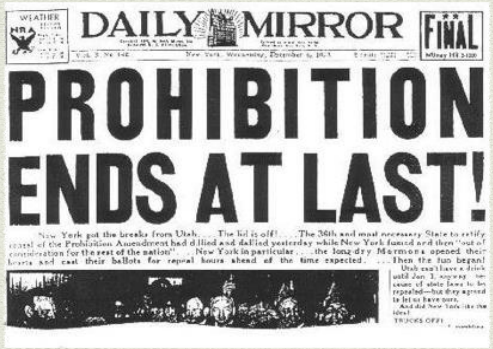
- Alcohol still produced and consumed, only this time through evasive channels.
- States struggle to combat underground crime rings that were getting wealthy.
- No way to know how much alcohol was entering the state, made within, or sold.



Public enforcement efforts.

Part 1A: Twenty-first Amendment

- Given what happened before and during Prohibition, states were concerned. Their goals:
  - Create an orderly market.
  - Ensure alcohol is taxed, no underground channels
  - Keep the now-wealthy gangsters from having too much power or influence on the public.
  - Avoid the ills that underpinned 18th Amendment.


DAILY MIRROR

FINAL

PROHIBITION ENDS AT LAST!

Ratified Dec. 5, 1933.

Part 1A: Post-Pro Solution?

- So, with these goals in mind:
  - Create an orderly market.
  - Ensure alcohol is taxed, no underground channels
  - Keep the now-wealthy gangsters from having too much power or influence on the public.
  - Avoid the ills that underpinned 18th Amendment.
- States adopted some version of a strict regulatory and permitting system called the three-tier system or the three-tier distribution system.

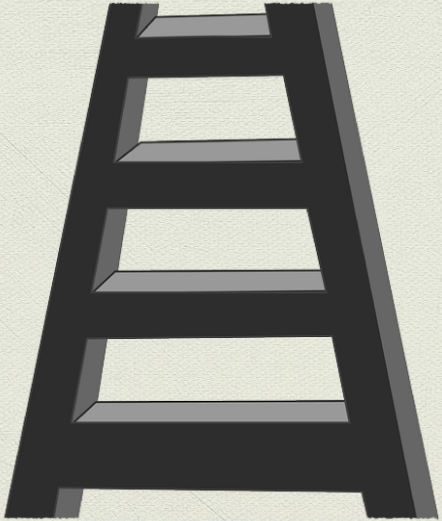
Part 1A: Three-tier System

Consumers

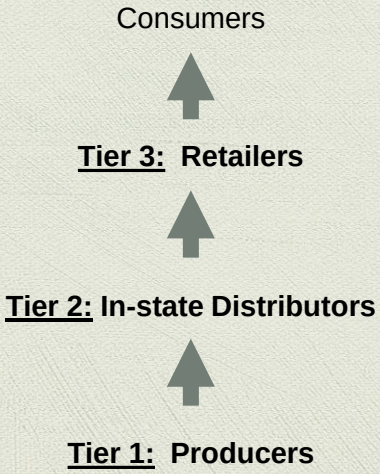
<u>Tier 3:</u> Retailers

<u>Tier 2:</u> In-state Distributors

<u>Tier 1:</u> Producers



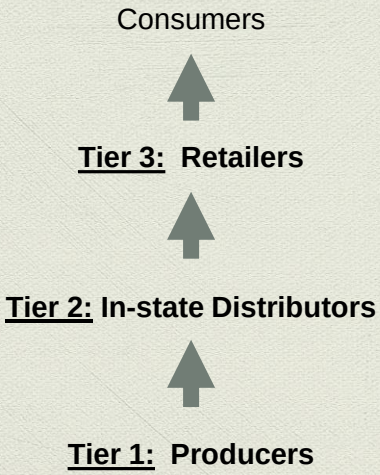
Part 1A: Three-tier System



- State permitting system.
- Regulations on who/what/where/when of sales.
- Parties can only have financial interest at one tier.
- Distributors are in-state entities.
- Restricts inter-tier relationships and promotions.

Part 1A: Three-tier System

- All alcohol, whether out of state or in state, must funnel through a state distributor.
- A producer cannot distribute.
- A producer also cannot sell products a retail. So, no taprooms, no “brewpubs,” no sampling at this time.
- Producers can't influence retailers into buying product.



Part 1A: Three-tier System

- By structuring the system this way and creating a regulatory authority in charge of reviewing applications and issuing permits, states could:
  - Control where alcohol was sold, when it was sold, and who sold it.
    - Ability to promote temperance (Sunday sales, hours of operation, ease of access).
    - Keep out those with criminal backgrounds.
  - Force alcohol to pass through regulated in-state channels.
    - Facilitates taxation and helps track quantity of alcohol flowing through the state.
  - Lock influential groups into having only financial interest at one tier.
    - Prevent market domination and also prevent persuasive advertising.

Part 1A: Three-tier System



- Still underpins the regulatory framework in most states.
- As industries organize, we're seeing change—but not evenhanded change.
- As we'll see, it sets up tension between breweries who want more freedom and distributors who like the required arrangement.

Part 1A: Lingering Questions

- What's the scope of the 21st Amendment?
  - Does it gives states only the ability to go dry if they wish, banning all alcohol?
  - How does the 21st Amendment interact with the Commerce Clause?
    - Can states, via the 21st Amendment, forbid out-of-state alcohol from entering the state while allowing in-state production?
  - Can states create favorable tax strategies for in-staters, propping up the in-state industry at the out-of-state industry's expense?
- Answer depends on when you ask. Inconsistent SCOTUS jurisprudence.

Part 1A: Painless Con Law Review

- U.S. Const. art. I, sec. 8, cl. 3.
- Interpretation has evolved over time (see recent ACA decision), but we know it gives Congress the power to regulate channels and instrumentalities of interstate commerce as well as things economic in nature that have an aggregate effect on commerce.
- "Dormant Commerce Clause"—Where Congress hasn't regulated, states can, as long as the reg doesn't discriminate against interstate commerce (unless Congress said discrimination ok).



That's my Con Law Prof., John Hill.

Part 1A: Post-Pro SCOTUS

- 1939, *Indianapolis Brewing*: “the right of a state to prohibit or regulate the importation of intoxicating liquor is not limited by the commerce clause.”
- 1984, *Bacchus Imports*: “Despite broad language in some of the opinions of this Court written shortly after ratification . . . no clear consensus . . . .”
  - Core Concerns Test:
    - Is the state acting within its core Twenty-first Amendment concerns in regulating?
    - If so, insulation from the commerce clause.



Part 1A: Granholm v. Heald (2005)

- The latest word from SCOTUS came in 2005.
- *Granholm v. Heald*, 544 U.S. 460 (2005).
  - **Michigan**: In-state producers could ship wine to in-state consumers, but out-of-state producers could not.
  - **New York**: An out-of-state producer could ship to in-state consumers if the producer had some in-state presence.

Part 1A: Granholm v. Heald (2005)

- *Granholm v. Heald*, 544 U.S. 460 (2005).
  - **Held 5-4**: These laws "discriminate against interstate commerce in violation of the Commerce Clause . . . and the discrimination is neither authorized nor permitted by the Twenty-first Amendment.**"**
  - Three-tier given the thumbs up:
    - "States can mandate a three-tier distribution scheme in the exercise of their authority under the Twenty-first Amendment."


SUPREME COURT ROOM—Capitol.

Part 1A: Granholm v. Heald (2005)

- *Granholm* Takeaways:
  - States can use the three-tier distribution system to address their 21st Amendment concerns (even if the three-tier distribution system inherently has some discrimination.)
  - States may adopt exceptions to three-tier or otherwise regulate how they wish, so long as those regulations are evenhanded.



Part 1A: Granholm v. Heald (2005)

- Note on Post-Granholm Inquiries:
  - *Granholm* created an inquiry for facially discriminatory laws.
  - Unclear how much protection for laws with discriminatory impact.


SUPREME COURT ROOM.—Capitol.

Part 1A: Note on 21st Am.

- Another Note: CC implicated only when reg puts in-state and out-of-state interests on unequal footing.
- If a reg affects in-staters differently, CC is not at issue. Equal protection argument, but R/B/R.
  - Cold Beer case—*Indiana Petroleum Marketers*, S.J. denied on June 16, 2014 in the S.D. of Ind.
    - "The State could have rationally believed that limiting the sale of immediately consumable cold beer to package liquor stores furthers its legitimate goal of curbing underage consumption of alcohol. The court's finding is supported in the record."

Part 1A: Quick Recap

- States have historic concerns about alcohol.
- Post-pro, States regulated with heavy hands, introducing strict three-tier and other restrictions.
- Many of these laws are still undisturbed, or have only recently been questioned.
  - Changes have been piecemeal and not uniform with respect to sub industries (we see lobbied-for differences in wine regs, beer regs, spirits regs, etc.)
  - Thus, regs are confusing and the regs and the statutes don't always nicely fit together.
  - With the growing industry, there is an increased need for attorneys as counselors and also legislative advocates.

Part 1A: State Representation

- In considering representation under your state's framework:
  - The state may still have strict three-tier controls. Some may have been carved out, but not necessarily evenly for everyone.
  - Your state regulatory authority is also likely the one that issues permits for bars, requires certain server training, etc.
  - Administrative code and state statutes fit together to explain what kinds of permits are possible and what producers/distributors/retailers may do under those permits.

Part 1A: Local Regs - Issues

- What can a brewery as a tier-one producer brew?
- May a brewery brew only beer or also cider/wine/spirits?
- Must a brewery add to its permit to produce those other beverages?
  - In Indiana, craft distilling was pushed for in 2013—the legislation change allowed producers to add a permit if they'd held another beer or wine production permit for at least three years.
- Can a brewery brew a beer of any alcohol content?
  - Recent change in Ohio: ABV limit increased from 12 percent to 21 percent.
  - Capped producers can't compete in out-of-state markets with like products.

Part 1A: Local Regs - Issues

- Can breweries act as distributors (tier two)?
- May a brewery self-distribute their own products, selling directly to bars, restaurants, bottle shops, etc?
- To have those self-distribution privileges, must a brewery keep production below a certain annual threshold?
- In states where self-distribution exceptions are emerging, there is significant pushback from distributors.
- Could a brewery distribute another brewer's beer? How about out-of-state or imported beers—what about wines, ciders, or spirits?

Part 1A: Local Regs - Issues

- Can breweries act as as retailers (tier three)?
- May a brewery charge for samples, or must they only give samples away? Sample size restrictions?
- May a brewery sell its own beer for off-premises consumption, by the bottle or six-pack?
- If so, may a brewery fill sanitary containers (growlers) that consumers bring in?
  - Recent legislative pushes in Florida, where 32-oz growler fills are okay, one-gallon growler fills are okay, but not the industry standard 64-oz fills.
  - Distributors used the opportunity to push back, saying they'd agree to 64-oz fills, but want to (1) ban one-gallon fills; (2) ban all other brewery carryout sales; (3) prohibit “guest taps" at a brewery; and (4) prohibit breweries from selling collaboration beers.
- May a brewery sell another brewery’s beer or another producer's wine or cider for on-premises or off-premises consumption?

Part 1A: Local Regs - Issues

- In conducting its business, are there time/place/zoning restrictions?
- Could a brewery operate its brewhouse while running an off-site taproom? What about serving beer at a farmer's market—selling growlers there?
- Could a brewery operate a restaurant while also selling beer to distributors?
  - Interestingly, some states have divided brewers into either brewpub or production brewery permits. We're seeing change, like recently in SC, to invite out-of-state investment.
- Does a brewery have minimum food requirements—would a food truck or prepackaged food meet those requirements?
- May a brewery have minors in the taproom, or in the back offices?

Part 1A: Local Regs - Issues

- How restricted are relationships between the different tiers?
- May a brewery give away beer? For example, could a brewery give away beer to potential distributors, bartenders, sales reps, chefs, etc.? Could a brewery donate beer to a charity event?
- May a brewery give away neon signs, t-shirts, offer free bar equipment, engage in promotional events with retailers? What about offering similar promotions/incentives to distributors?

Part 1A: Local Regs - Issues

- Washington:
  - "Money's Worth" approach
- Also, remember lottery laws:
  - Prize
  - Chance
  - Consideration

Not Allowed
Items that are considered to be "Money's Worth"

- Extension of credit or directly providing money
- Providing labor normally provided by retail licensee
- Liquor products or other products
- Sponsoring promotional events for a specific licensee
- Promotional gift Items i.e. vacations, vehicles etc.
- Tables, chairs, table umbrellas, equipment, custom display cabinets and mirrors
- Neon signs or permanent signs

Please note: A licensed retailer may purchase these items at fair market value from another licensee. A violation of the law may impact all licensed parties.

Allowed
Items that are not considered to be "Money's Worth"

Promotional Items: Trays, lighters, blotters, postcards, coasters, menu cards, meal checks, napkins, clocks, mugs, glasses, hats, visors, t-shirts, jackets or other clothing, display cabinets or merchandizing displays, mirrors or promotional event banners, point of sale advertising, brand signs and similar items.

Please Note: Promotional items are for use by the retail licensee. They are not to be given away to consumers. Items must bear imprinted logo of the industry member that is providing the item only; and items may not be targeted to or appeal principally to youth.

Part 1A: Changing State Regs

- As you can see, state law dictates what brewery business models are possible.
- Breweries are starting to examine laws and seek change, and sometimes quickly succeeding as big out-of-state breweries look to bring their business models into the state.
- In seeking change, however, breweries are frequently bumping up against distributors who oppose any brewery-favored exceptions.



Part 1A: State Franchise Laws

- By far, one of the hottest recent issues is the propriety of state brewery–distributor franchise laws.
- In examining franchise laws, it helps to know a bit about brewer–distributor relationships.



Part 1A: Distributor Relationships

- **The Good**:
  - Distributors help breweries get their beer into new markets, helping grow their brand.
  - Distributors are specialists at what they do. They have built-in delivery teams, ordering systems, sales relationships, and the ability to quickly bring new products to the market.
  - It's not easy for a brewery to take on large-scale distribution, and a good distributor relationship can help the brewery grow, at just the right times.



Part 1A: Distributor Relationships

- **The Bad**:
  - There are a limited number of distributors, but there are so many brands.
  - Breweries are competing for the sales team's attention.
  - In some states, a brewery simply can't self-distribute, even if the brewery only desires extremely small-scale, targeted distribution.
  - With forced third-party distribution, distributors may not have certain requirements a brewery wants to keep its product at its freshest (*e.g.*, temperature-controlled storage options within a limited temp range).
  - With so much competition and no way to distribute, breweries often see their product sit on shelves and not move as they would like.

Part 1A: Distributor Relationships

- **The Ugly**:
  - State franchise laws govern how a brewery may “break up” with its distributor.
  - Even if a brewery and a distributor negotiate the definition of "for cause termination” in the agreement, state franchise laws can trump.
  - A rock and a hard place: Spend money to litigate the contract / settle the dispute, or deal with low sales.
  - We're seeing distributors introduce legislation that would make break-ups more difficult.

Part 1A: Distributor Relationships

- **The Bottom Line**:
  - On the one hand, it could be unfair to a distributor to establish a brewery's market inroads, and then have the brewery jump to another distributor.
  - On the other hand, this is a foreseeable issue for the contract.
  - Advocates for reform are asking, why do we still have forced distribution? Won't market forces require distribution anyway?
  - In forced-distribution states, why are distributors further insulated from market forces by these distributor-leaning franchise laws?
  - Likely to see a lot more on this issue as breweries wish to "break up."

Part 1A: Quick Recap

- We've looked at why states have such stringent regulations.
- Today, less justification for some Prohibition-centric reasons.
- Regs vary a lot from state to state, based on how many incursions advocates have made into the once-predominant three-tier system.
- Breweries and distributors—who sometimes must work together—are seeking very different changes.
- Recently, change tipped in breweries' favor—job creators.

Part 1A: Federal Regulation

- Federal regulatory authority
  - Alcohol and Tobacco Tax and Trade Bureau (TTB)
  - FDA has some authority but FDA plays second fiddle to TTB.
    - Hot issue on that: FDA v. TTB regulation gaps. FDA-regulated beers may say “gluten free” but TTB-regulated ones may not, even if the TTB beers would meet FDA’s gluten-threshold requirements.



Part 1A: TTB Representation

- TTB requires that would-be brewers submit Brewer's Notice to them for federal approval of their commercial brewing aspirations.
- Issues Certificates of Label Approval (COLAs) required on beverages entering in interstate commerce (not required for solely in-state sales). Strict label image/content requirements.

Part 1A: TTB Representation

- Getting the approval is relatively easy, but ongoing compliance more difficult. Stringent record-keeping, taxation, reporting, and production standards for producers. Can conduct audit at any time.
- As soon TTB issues the Brewers Notice, you have to file quarterly Brewer's Report of Operations, even if you're not in operation.
  - Brewpub - More simple form, but for fewer producers, only for those under 500k bbls and selling only on-premise.
  - Brewery - Over 500k or the brewery distributes outside of house (even just 1 keg).

Part 1A: TTB Representation

- Taxes:
  - Monthly excise taxes $7/bbl for most microbreweries. (Also seeing similar monthly taxes on the state side).
- Bond:
  - Must be bonded right out of the gate.
  - The bond must equal the full amount of one quarter's tax payments. (E.g., 5k barrels in the quarter at $7 = $3,500 bond.)

Part 1A: TTB Representation

- Facility Itself:
  - Tanks must be inaccessible to the public, behind an 8’ wall or completely locked up (can’t turn a valve). Seeing audits with this.
  - Have to have calibrated equipment, so you are properly measuring to satisfy your tax obligations.
- Ongoing Reporting:
  - If answers on your owner/officer form change—such as holding of other alcohol permits, commission of a felony, etc.—must notify TTB and TTB can revoke your permit.

Part 1A: Regulatory Wrap-up

We've covered what the general regulatory framework looks like for beverage producers, with big differences as you dive into state regs.

Given that the industry is growing, and many homebrewers are considering the leap to commercial, we'll now apply this framework to the typical start-up scenario.



Part 1B: Start-up Counseling

But, first, a brief overview of homebrewers and the brewing process itself.



Part 1B: Homebrewing



- Homebrewing was federally legalized in 1978, with Alabama and Mississippi the last states to allow it in 2013.
- As interest in craft beer has grown in recent years, homebrewing has also grown in popularity.
- You'll find brewers in kitchens, garages, basements, and backyards, often brewing-up commercial aspirations of their own.

Part 1B: Homebrewing

- Homebrewers are DIY people. Build/modify equipment, tinker with recipes, have a lot of fun. Weekend warriors.
- Lots of husband-wife hobbyists or best friends looking to start a brewery together after brewing together for years.
- Ways to establish yourself as a homebrewer, through entering competitions, homebrew clubs, events, etc.
- Close-knit group that reflects the camaraderie still seen in the industry at large.
- As the industry has developed more beer-related jobs, many homebrewers now have some commercial brewing and/or beer business experience (or at least easier access to it).

Part 1B: Homebrewing

- Homebrewers tend to be the ones calling you for legal advice, as they debate transitioning to commercial.
- Some brewers have business experience, but many have never owned or operated a business before.
- Often, but with less frequency, unrealistic expectations of the funds needed to open a brewery at their desired size.
- The effective beer attorney needs to know the start-up costs, to counsel through selecting a solid, realistic business plan.

Part 1B: Start-up Counseling

- Consult state regulations to see if there are different levels of permits a start-up may choose, perhaps with less cumbersome facility requirements. **Contract brewing?**
- As the would-be brewer evaluates potential locations, consider whether zoning restrictions or caps on retailer permits in a given area might inhibit the brewery's options.
- Apprise the would-be brewer of needs in the commercial lease, given the nature of the brewing process.

Part 1B: Brewing Itself



- Brewing in a ~~nutshell~~ grain husk:

1. Steep a curated selection of grains in hot water.
2. After extracting sugar from the grains, boil the wort while adding hops, which provide degrees of bitterness and flavor/aroma.
3. Rapidly cool, add yeast, allow to ferment.
4. Condition and carbonate.
5. Enjoy!

Part 1B: A Brewery's Needs



- The brewing process generates a lot of heat, requires special plumbing, and involves heavy equipment, affecting commercial lease options.
- Storage of lots of grain, generation of wet "spent grain," and manufacturing needs frequently create zoning issues that would-be brewers don't realize are problematic.

Part 1B: Business Planning



- Hopefuls reach out early in the process, often before they have formed an LLC or any sort of formal business plan.
- Early intervention options:
  - Help select a defensible name (More: Part II)
  - Provide business-planning guidance.
  - Begin discussing investment structure.
  - Start with permitting applications.

Part 1B: Business Planning



- Note: brewers, by nature, are creative DIY people—else they wouldn't be brewing.
  - Collaborative, flexible approach to legal is often welcomed at this early stage.
  - Clients would like to DIY, while you review for accuracy and completeness.

Part 1B: Fundraising?

- Some personal investment, small business loans, but often fundraises.
- **Ballpark <u>minimum numbers</u> to open**:
  - Nanobrewery - $50-60k
  - 7bbl-10bbl Production Brewery - $250k
  - 10-15bbl Brewpub - $500k
  - Packaging and production - $1 million
- Breweries can start too small and underestimate taproom demand, limiting their ability to get product to a distributor.

Part 1B: The Operating Agreement

- When a brewery has its basic business plan, drafting the OA provides a good opportunity to help the client think through other needs and concerns they may not have considered.
- May require some education on why a formal OA is necessary.
- In addition to general OA considerations, there are other needs that are important to handle:
  - Address intellectual property assignments. (More: Part II)
  - Confidential information: beer recipes?
  - Non-competition: beer recipes? beer lineups?

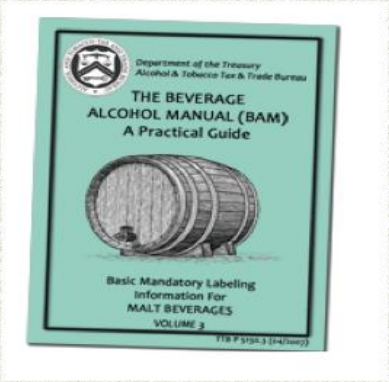
Part 1B: Licensing

- **Federal License**
  - Floor plan & detailed information about owners/investors.
  - Timeline: Varies by time of year submitted. 60-90 days minimum.
- **State License**
  - Typically needs some lease in place, also floor plan and investor info.
  - Subject to equipment inspections pre-permit and thereafter.
  - Timeline: Varies by locality. WA—30-60 min for conditional approval.
- Consider: Delays in permitting will affect business planning and costs.

Part 1B: Licensing

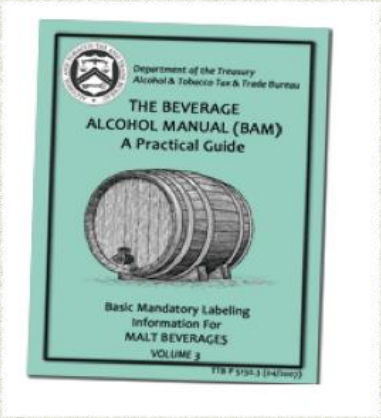
- **Licensing Updates**
  - Change in owner? Change in answers to the form?
  - Perhaps more stringent requirements at the state level.
- Consider share-transfer limitations in the OA that are subject to regulatory approval of the new member.
  - Criminal background involving fraud/tax? Potential approval issue—same goes for initial licensing process.

Part 1B: Getting Product Out



- Label Requirements.
- For bottles/cans, state regulations apply if the goods will only be sold in state.
- For interstate goods, need to obtain a COLA (Certificate of Label Approval).
  - Label information required (*e.g.*, brand name, address, type, quantity)
  - Size/lettering of warnings.

Part 1B: Getting Product Out



- COLA Continued
  - Some minor changes to the label are okay without seeking re-approval.
    - Moving graphics/info around is fine, but you can't add new graphics other than holiday graphics and minor things like TM symbols, social media icons, etc.
  - Generally, you can't confuse/mislead consumers.
  - Timeline—can be as fast as two weeks.

Part 1B: Growing the Business

- Distributor contracts—within the state, outside of it?
- Contracts for new equipment, custom designs?
- Expansion into new facilities, second taproom, restaurant?
- Increased web and print marketing, subject to regulations?
- Need for creative thinking:
  - Contract brewing as a way to expand without investment?
  - Flexible OA that allows for future growth and investment?

Part 1: Wrap-up

- It’s a growing industry, with a need for beer-savvy attorneys.
- An understanding of the unique regulatory environment within the state and outside it helps inform your business insight.
- Business and compliance assistance is a must, with increasing need for intellectual property know-how, which we’ll cover in Part II.
- Thinking outside the box:
  - As this industry grows, so do related areas. Opportunity: Homebrew shops, ingredient and equipment suppliers, “craft" distributors, web and media services catering to the industry.



LexVid | Beverage Law Series

Thank You!
See you in Part II.

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