Craft Beer, Distillery and Liquor Law: The Ultimate Guide

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Craft Beer, Distillery and Liquor Law: The Ultimate Guide

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Presenters

MARTHA ENGEL is an intellectual property attorney with Winthrop & Weinstine PA, who advises inventors, entrepreneurs, start-ups, and companies of all sizes on protecting their intellectual property assets. She helps clients guard their competitive advantage and add value to their business by obtaining, maintaining, and enforcing intellectual property rights. Ms. Engel counsels clients on all matters related to intellectual property, including clearing trademarks; drafting and prosecuting patent applications; obtaining trademark registrations; conducting due diligence reviews regarding intellectual property in corporate transactions; enforcing trademark rights; and assisting with patent litigation. She has drafted and prosecuted patent applications on a variety of technologies, including mechanical and manufacturing devices, materials, medical devices, porting goods, packaging, electronics, and software. Ms. Engel has experience working with foreign associates to prosecute applications both in the U.S. and abroad. She also has experience preparing patent infringement options. Ms. Engel has extensive experience assisting craft breweries, wineries, and distilleries regarding the protection and enforcement of their trademark rights. She is a member of the Minnesota Intellectual Property Lawyers Association, as well as the Minnesota State and Hennepin County bar associations. Ms. Engel earned her B.S. degree from Marquette University and her J.D. degree from William Mitchell College of Law.

ADAM P. GISLASON is counsel with Fox Rothschild LLP. Mr. Gislason provides comprehensive legal services and business advice to individuals, startups, songwriters, filmmakers, recording, performance, and legacy artists and their estates. With over 15 years combined experience as a transactional lawyer, litigator, entrepreneur, and front man of a touring indie rock band, Mr. Gislason brings an empathetic, energetic, and efficient approach to help his clients achieve their dreams and business goals. On the deal-making side, he negotiates and handles transactions involving all aspects of content creation, distribution, protection and exploitation of intellectual property, including copyrights, trademarks, and trade secrets. His entertainment law practice includes music, film, reality television, internet and social media platforms, crowdfunding, e-commerce, and software as a service (SaaS). Drawing from his experience as songwriter and founder of his own firm, Mr. Gislason has a knack for building brand awareness and cutting to the chase. He also uses his extensive experience as a high-stakes, commercial and intellectual property litigator to help his clients proactively protect their businesses and improve the bottom line. Mr. Gislason is admitted to practice in Minnesota and California; and selected to the list of *Super Lawyers* in 2015 and 2016. He is the former chair of the Arts & Entertainment Section of the Minnesota State Bar Association (2015-2016), and a panelist on various intellectual property matters, including "Avoid Startup Shutdown to Raise Capital," SXSW Interactive 2016 and "Protecting Your Secret Sauce from Inside Jobs and Outside Risks" SXSW Interactive 2017. He earned his B.A. degree, cum laude, from Concordia College; and his J.D. degree, cum laude, from the University of Minnesota Law School.

BENJAMIN J. KLASSEN is an attorney with Winthrop & Weinstine PA practicing mergers & acquisitions and franchise transactions. Mr. Klassen received his B.A. degree from the University of St. Thomas, his M.B.A. degree from the University of Minnesota Carlson School of Management and his J.D. degree, magna cum laude, from the University of Minnesota Law School.

Presenters (Cont.)

JEFFREY C. O'BRIEN is a partner with Chestnut Cambronne PA and serves as general counsel to a wide variety of small and closely held businesses, as well as real estate investors and developers. He has significant experience working with craft breweries, distilleries, and wineries on an array of issues, including entity formation, financing, real estate matters, intellectual property protection, operational issues, and distribution contracts. His clients also include real estate agents, developers and investors, community banks, title companies, restaurant operators, manufacturing companies, franchised businesses, retired professional athletes, financial advisors, insurance agents, and consulting businesses. He is certified as a real property law specialist by the Minnesota State Bar Association. A frequent lecturer and writer, Mr. O'Brien has presented and written articles on a variety of business and real estate topics. He is a regular guest on several radio shows and podcasts. Mr. O'Brien has been listed as a Minnesota Super Lawyer every year since 2013. Previously he had been named a Rising Star by *Minnesota Super Lawyers* every year since 2008, a designation reserved for only 2.5 percent of all attorneys in Minnesota. He was named as one of the 40 Under Forty in 2014 by the *Minneapolis-St. Paul Business Journal.*

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Brewing Models

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Brewing Models to Be Covered:

- Production Brewery
- Brewpub
- Alternating Proprietorship
- Contract Brewing

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Production Brewery

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Brewpub

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Alternating Proprietorship

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TTB Industry Circular 2005-2

ALCOHOL AND TOBACCO TAX AND TRADE BUREAU

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Contract Brewing

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Alt Prop vs. Contract Brewing

	Alt Prop	Contract Brewing
Title Ownership	Tenant brewer holds title to its beer, including the ingredients and raw materials it uses to produce its beer, during all stages of production.	Contract brewer holds title to the beer, including the ingredients and raw materials used to brew the beer, during all stages of production.
Record Keeping	Tenant brewer and host brewer each retain their own records for production and removal of beer and each provides reports to the TTB.	Contract brewer retains all records of production and removal of beer and provides reports to the TTB.
Taxes	Tenant brewer and host brewer are individually responsible for paying their own taxes on their own beer removed from the brewery.	Contract brewer is solely responsible for paying taxes on beer removed from the brewery.
Brewer Licensure	Tenant brewer and host brewer must each qualify as a brewer and have separate licenses.	Only the contract brewer must qualify as a brewer, so the producer brewer does not need a license.
Ease of Paperwork	Requires significant paperwork for both parties.	Simple agreement; Brand is added to the contract brewer's Notice.

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Thank You!

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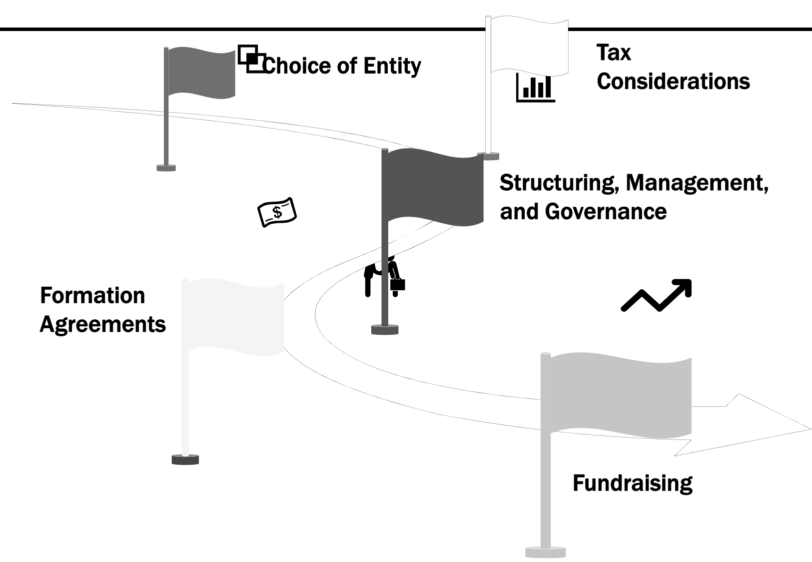
ROADMAP



CHOICE OF ENTITY

COMPARISON OF ENTITY TYPES

Entity	Advantage	Disadvantage
None	Easy	LIABILITY
LLC	Flexible	SE Tax
S-Corp	Tax Advantages	Owner Limitations
C-Corp	No Owner Limitations	Double Taxation

LIMITED LIABILITY COMPANY

> **Governing Law**: Governed by state statute.

> **Formation:** Certificate or Articles of Organization/Formation filed in state office (generally Secretary of State), sometimes county recorder's office.

> **Management:** Owners are "members." Can be member-managed, manager-managed, or board-managed. Operating Agreement (or Limited Liability Company Agreement) governs operations.

> **Pass Through Taxation**: Taxed as a pass-through entity, unless alternative tax election made.

> **Limited Personal Liability**: Entity separate from members. Members not held liable for LLC obligations and debts (if corporate formalities preserved).

> **Flexibility:** Can be tailored to meet nearly any business need.

CORPORATION: C-CORP & S-CORP

> **Formation:** Articles or Certificate of Incorporation filed in appropriate state office—usually Secretary of State.

> **Management:** Owners are called "shareholders;" directors and officers govern and manage the corporation. Bylaws and often a shareholder agreement control governance.

> **Limited Personal Liability:** Similar to LLC—shareholders are not liable for debts and obligations of corporation (if corporate formalities are observed).

> **Taxation**: S-Corporations and C-Corporations are subject to different tax rules. Corporation is taxed as a C-Corp unless it elects to be taxed as an S-Corp. S-Corps have pass-through taxation similar to an LLC. C-Corps are taxed at both the corporation level and shareholder level for distributions.

S-CORP OWNERSHIP RESTRICTIONS

> C-Corps have no restrictions on ownership, but S-Corps do. The S-Corp must meet certain characteristics such as:

- It cannot have more than 100 shareholders;
- Its shareholders must be individuals;
- Its shareholders must be citizens or residents of the United States; and
- It can only issue one class of stock (may be voting and nonvoting).

> While an S-Corp may offer tax savings in the beginning, if a corporation plans to take on investor capital, maintaining C-Corp status may be beneficial in the long run.

TAX CONSIDERATIONS

TAX CONSIDERATIONS FOR ENTITY SELECTION

> **Limited Liability Company:**

- May be considered a disregarded entity for tax purposes if it only has one member.
- Taxed as a partnership if entity has multiple members (taxed on profits whether distributions are made or not)
- May elect to be taxed as a C-Corp or, more commonly, as an S-Corp.

> **Corporation:**

- C-Corp – Double Taxation. Corporation taxed on profits; Shareholders taxed on distributions.
- S-Corp – Pass-Through Taxation. Shareholders only taxed individually.

> **LLC vs S-Corporation (Flexibility vs. Self-Employment Tax):**

- While an LLC is flexible, owners are never considered employees and those active in business pay self-employment tax on all guaranteed payments and distributive share of partnership income—regardless of whether its distributed.
- S-Corps owners can take a reasonable salary and receive all other payment as dividends (which are not hit by employment tax).

> **New Pass-Through Business Income Deduction:** Some savings may be available for pass-through entities (LLCs and S-Corps) – breweries and distilleries most likely eligible.

2017 TAX ACT

> **Lower Tax Rate for Corporations**

- The tax rate applied to earnings from corporations has been permanently reduced from 35% to 21%.
- The deduction applied to dividends received by corporations that hold equity in other corporations has been reduced (from 85% to 60% for subsidiaries and from 70% to 50% for non-subsidiary holdings).

> **Flow-through Business Income Deduction (Section 199A)**

- Owners of qualified businesses are entitled to a 20% deduction on income passed through from the company to the owner.
- Breweries and distilleries will almost certainly generate "qualified business income" eligible for the deduction. The deduction does not apply to certain services businesses in industries such as law, health care, accounting, financial services, or any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners.

> **Bonus Depreciation**

- A business may elect to depreciate, in first year, 100% of the value assets with depreciable life of 20 years or less (e.g. equipment).
- Bonus depreciation now available for used equipment.
- Special election to depreciate 50% of value in first year (rather than 100%) for first taxable year ending after 9/27/2017.

STRUCTURING, MANAGEMENT & GOVERNANCE

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LIMITED LIABILITY COMPANY & STRUCTURING/MANAGEMENT

> **Generally:** Default management structure generally specified by statute. Statutes may also require appointment of certain designated officers sometimes with specified duties. In a small company, officers and directors/governors/managers generally are (at least in part) owners, but need not be.

> **LLC:** (flexible) Default management structure generally waivable/modifiable in Operating Agreement. Agreement (and in some states, the Articles) must establish management structure (member, board, manager), how board members/managers are elected/appointed and removed, and duties and roles subject to fiduciary duties. Managers, governors, and officers subject to fiduciary duties and must act in best interests of the company.

> **Corporation:** (less flexible) Managed by a board of directors. Bylaws and/or Shareholder Agreement should establish how directors are elected/appointed and removed. Directors must be individuals. Board members and officers must serve best interests of corporation above all else, but may consider interests of employees and shareholders among other matters.

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FIDUCIARY DUTIES

> Failure to adhere to duties of loyalty, care, and good faith and fair dealing may expose individuals responsible for management and operations of LLC or corporation to liability.

> **Duty of Care:** Requires adherence to a specified standard of reasonable care while performing any acts that could foreseeably harm the company or others. If the company is insolvent or, depending on the jurisdiction, approaching insolvency, this duty may be owed to creditors of the company.

> **Duty of Loyalty:** Requires fiduciaries to put the company's interests above their own. Generally breached when controlling owners or managers/directors/governors divert corporate assets, opportunities, or information for personal gain.

> **Duty of Good Faith & Fair Dealing:** General contractual presumption requiring parties to deal with each other honestly, fairly, and in good faith.

PRESERVING LIMITED LIABILITY: OBSERVATION OF CORPORATE FORMALITIES

> **Piercing the Corporate Veil:** Operators of LLCs and corporations must treat the entity as entirely separate from their personal and other business affairs or they risk losing the limited liability protections afforded by law. Corporate formalities must be observed:

- Sufficient capitalization
- Proper documentation of all transactions and significant decisions
- Maintaining separate bank accounts; non-commingling of funds
- Obtain business EIN
- Payments to owners documented as wages, expense reimbursements with receipts, or profit distributions
- Owners working in business receive defined salary/wage
- No "Profit distributions" if entity is insolvent
- Creditors paid before distribution of profits
- Transactions with owners/management should be at commercially reasonable prices and terms, documented in formal agreement and approved by disinterested members of board/management
- Use only full legal name or authorized assumed names
- Hold meetings as required by law and/or Operating Agreement/Bylaws

NEGOTIATING FORMATION AGREEMENTS

NEGOTIATE WHEN THINGS ARE GOOD TO BE PREPARED FOR WHEN THEY'RE NOT

> **Types of Formation (Governance) Agreements:** operating agreement, partnership agreement, shareholder agreement, buy-sell agreement, and bylaws.

> **What Goes into Governance Agreements?** Company decision making process and management rules, methods of allocating profit and loss, rules regarding how business partners enter or leave the equation, establishment of clear expectations, roles, responsibilities, and rights of the owners, managers, officers, etc.

> **Brewery/Distillery Provisions:** Require proposed members/ shareholders, managers/directors/governors, and officers to represent and warrant they comply with TTB, state, and local background check criteria and other liquor-related requirements, and mandate continued compliance. Require disclosure of liquor related interests prior to involvement.

> Establish procedures to terminate relationship, including through forced buy-out, if owner fails to comply with the above.

> Check for specific state/city required language.

CORPORATE GOVERNANCE

> **Board of directors/governors:**

- Composition
  - Investor/Owner-elected directors
  - Independent directors
- Consider examples of "major decisions" requiring supermajority approval of board or shareholder/member approval:
  - Relocating the Company's main brewing/distilling facility or opening additional facilities
  - Borrowing funds from lenders in excess of $X
  - Selling substantially all of the Company's assets
  - Appointing a distributor for the Company's products
  - Issuing new equity securities in the Company
  - Increasing founder salaries beyond pre-approved ranges

FUNDRAISING

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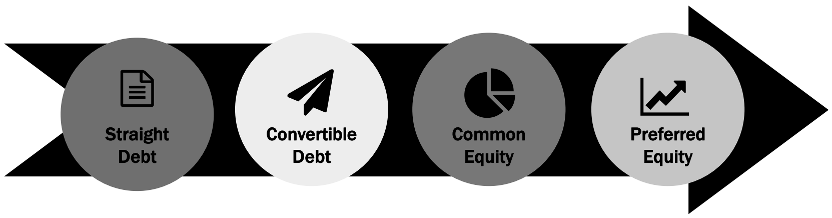
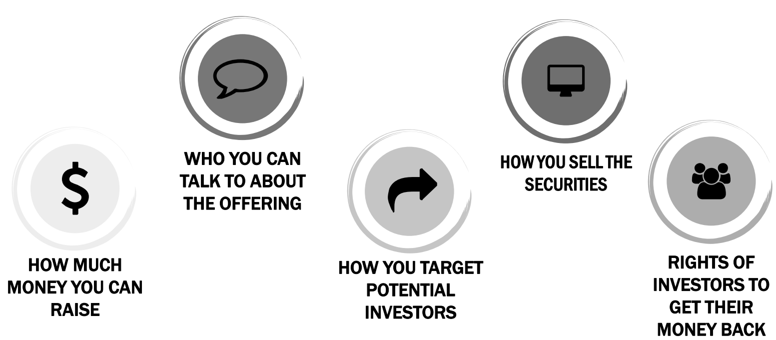
RAISING MONEY FROM INVESTORS

> What are you selling?



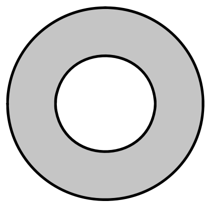
HOW DO YOU FIND INVESTORS?

- Other than donation-based crowdfunding, almost every means by which a business raises capital will be subject to securities laws.
- Securities laws regulate:

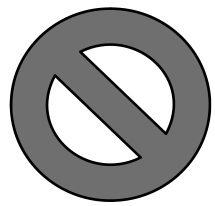


SECURITIES REGISTRATIONS VS. EXEMPTIONS

> As a general rule, in order to comply with Federal securities laws, a company offering or selling a security must either:



OR



Register the offer or sale with the SEC

Identify a specific <u>exemption</u> that allows the offer or sale to be conducted without registration.

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BLUE SKY LAWS

> In addition to complying with Federal securities laws, an issuer offering or selling securities must also adhere to blue sky laws in each state where the securities are being offered or sold, all of which vary from each other.

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PRIVATE PLACEMENT OFFERINGS

- Historically, most breweries have relied on the PRIVATE PLACEMENT federal securities law exemption.
- In order to keep the offering "private," companies have historically been required to comply with onerous requirements:

RULE 504, 506(B), 506(C)

	Rule 504	Rule 506(b)	Rule 506(c)
How much money can I raise?	Up to $5M	Unlimited	Unlimited
Can I advertise the sale of my securities?	No, unless coupled with a state exemption or registration that allows advertising.	No.	Yes.
To whom can I sell securities?	Those the Issuer has a substantial preexisting relationship with. However, counterpart state exemptions or registrations may impose additional restrictions on number of non-accredited investors.	Unlimited number of accredited investors Up to 35 non-accredited investors if you believe they are "sophisticated"	Unlimited number of accredited investors
Do I have to comply with the SEC's formal information delivery requirements?	No, but counterpart state exemption or registration may impose additional requirements.	No, if only accredited investors are included Yes, if any non-accredited investors are included	No.
Do I have to verify that any accredited investors are truly accredited?	No, accredited investors can "self-certify."	No, accredited investors can "self-certify."	Yes, you must take "reasonable steps" to verify that the investors are, in fact, accredited.

TITLE III AND REG CF

> Companies may raise up to $1M in any 12 month period.
> Individual investor limits:
  - If the investor's annual net income OR net worth is < $100k, then the investor may invest the greater of: (a) $2,000; or (b) 5% of the investor's annual income or net worth.
  - If the investor's annual net income AND net worth is > $100k, then the investor may invest 10% of the investor's annual income or net worth
  - $100k max across all CF offerings in any 12 month period.
> Financial statement requirements based on offering size:
  - < $100k → Internally prepared, certified statements
  - $100k - $500k → CPA reviewed statements
  - $500k - $1M → CPA audited financials (or CPA reviewed statements if the company is a first time user)
> Disclosure document must be filed with the SEC
> Annual SEC reporting obligations
> Offerings must be made through registered portals.
  - Registered as B-D; or
  - Registered as portal operator with SEC and member of FINRA
  - Regulatory compliance burden has largely been transferred to the crowdfunding portals

TITLE IV AND REG A+ | THE "MINI-IPO"

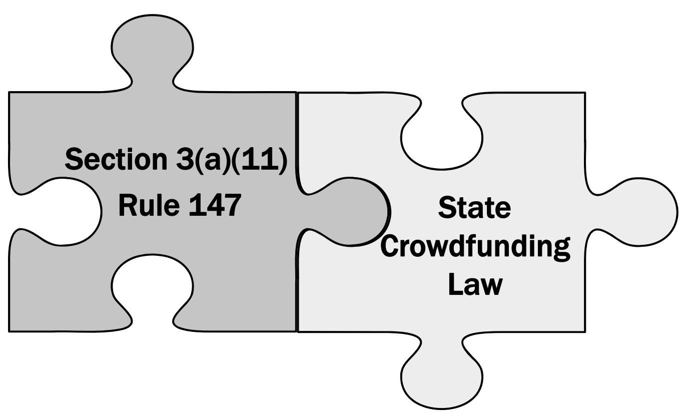
> Became effective in June 2015
> Companies able to raise up to $50M from general public
> Pros:
  - General solicitation allowed; non-accredited investors can participate
  - State preemption (under Tier 2)
> Cons:
  - Raises under $20M (Tier 1) subject to state review
  - Likely cost prohibitive for startups and earlier stage companies (filing offering circular, financial audit, and ongoing reporting under Tier 2)
> Tier 2 offerings could take up to 6 months to receive SEC approval

Conclusion: This will likely only be attractive to regional breweries wanting to involve customer base with national expansion plans

QUICK COMPARISON OF FUNDRAISING MODELS

Method	$ Limit	Advertising?	Non-Accredited Investors?
Rule 504	$5M	✗	✓
Rule 506(b)	Unlimited	✗	✗
Rule 506(c)	Unlimited	✓	✗
Federal Crowdfunding (Reg CF)	$1M	✓	✓

INTRASTATE CROWDFUNDING



INTRASTATE CROWDFUNDING

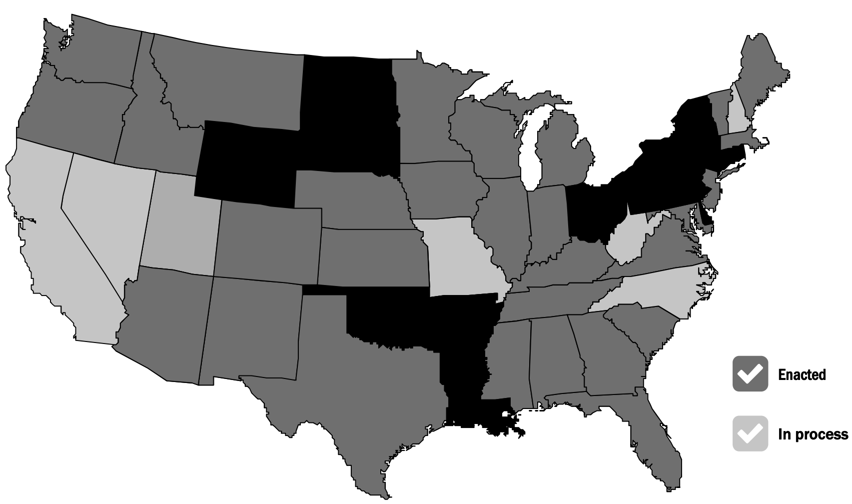
> In addition to the new Federal laws, over the past few years individual states have adopted their own crowdfunding laws.

> These state crowdfunding laws only permit intrastate offerings.

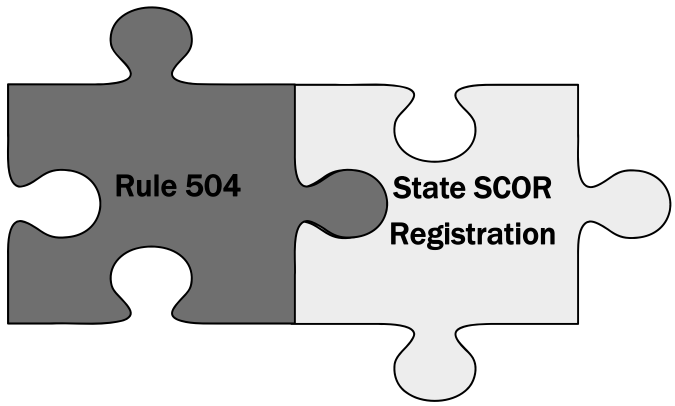
> Common Framework:

- Company can raise up to $1M with no audit or $2M with audit
- Investment cap for state residents (b/n $5-10k)
- Funds held in escrow for duration of raise
- Periodic reporting (quarterly or yearly)

STATE CROWDFUNDING LAWS (APRIL 2016)



SCOR OFFERING



TYPICAL SCOR OFFERING REQUIREMENTS

> Offerings up to $5M

> Must file Form U-7

- Requires audited or reviewed financial statements

> Nothing prohibits issuer from selling securities online (i.e., operating its own "crowdfunding portal")

> Cannot use third party portal who is not a registered B-D Coordinated review if issuer wants to sell securities in multiple states

OTHER PRACTICAL CONSIDERATIONS

> Put Rights
> Call Rights
> Preferred Distributions
> Preferential/Accelerated Distributions
> Informational Rights
> Minority Rights regarding Oppressive Conduct

PPM

> Typical outline:
- Intro / Disclaimer
- Summary of Terms
- Risk Factors
- Business Plan
- Subscription Agreement
- Operating Agreement

SOCIAL/REWARDS CROWDFUNDING

> Social or Rewards Crowdfunding refers to the online funding of a campaign or project whereby contributors receive gifts, perks, or other rewards in exchange for their contribution.

> Not a sale of securities.

> Made popular by services such as Kickstarter, which has raised over $2.3 billion since 2009.

> Example: Bauhaus Brew Labs (Minneapolis, MN)

> 369 backers pledged $42,772 in less than 24 hours.

OTHER FUNDING SOURCES

> State or Local Grants

> Tax Increment Financing

> Municipal loans

LATER STAGE GROWTH

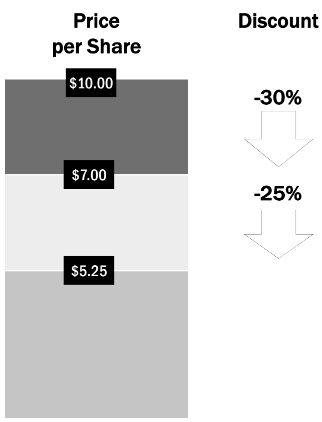
LATER STAGE GROWTH

> **Craft beer is a "hot" investment**

- Follow-on private offerings
- Private equity
- Family offices
- Strategic investors
- Mezzanine financing
- Sale of distribution rights

LEVELS OF VALUE

> Strategic investors generally pay higher valuation multiples



Investor Type	Notes
Strategic Controlling Interest	Value of strategic synergies
Financial Controlling Interest	Value of control
Financial Non-Controlling	Value to purely financial investor

RECENT M&A ACTIVITY RATIONALE

Target	Acquirer	Acquisition Rationale
Ballast Point Brewing & Spirits	Constellation Brands	▪ Leading marquee brand provides Constellation foothold in fast growing craft beer segment ▪ Opens door for additional bolt-on craft acquisitions ▪ Constellation able to leverage expansive U.S. distribution network currently serving Grupo Modelo portfolio ▪ Platform to service international markets that have a growing appetite for U.S. craft beer offerings
Abita	Enjoy Beer	▪ Recently established Enjoy Beer, LLC, is a private equity backed acquisition vehicle and craft beer consortium ▪ Led by industry veteran Richard Doyle (Harpoon Brewing), Enjoy Beer intends to become a publicly traded company with multiple craft brands under its control ▪ Abita Brewing Company is a top-25 regional brewery which found growth slowing due to capacity constraints
Lagunitas Brewing Company Petaluma Calif.	Heineken	▪ Lagunitas on pace to produce more than 800,000 barrels in 2015, led by eponymous IPA ▪ Partnership with leading craft brewer gives Heineken much-needed relevance in U.S. market ▪ Growth plans include leveraging Heineken's robust international distribution network with particular focus on Mexico and Europe

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TYPES OF INTELLECTUAL PROPERTY

> Copyrights
  - 17 U.S.C. § 101, *et seq.*

> Patents
  - 35 U.S.C. § 101, *et seq.*

> Trademarks
  - 15 U.S.C. § 101, *et seq.*

> Trade Secrets
  - 18 U.S.C. § 1836*, et seq.* and state statutes

COPYRIGHTS

> Original works of authorship fixed in a tangible medium of expression

> What copyrightable works are owned or used by breweries and distilleries?

- Advertisement
- Website content
- Recipes (only in their written form)
- Artistic works displayed in taproom / tasting room
- Performances
- Music played over sound system

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COPYRIGHT OWNERSHIP

> Ownership vests in the individual author(s) of the work.

> Ownership can vest in the company if:

- Employer/employee relationship
- For independent contractors or commissioned works, contract language must clearly state that the work was a "work made for hire."
- Otherwise assigned from author(s) to company

> May have separate rights in the same "work" owned by multiple parties

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COPYRIGHT INFRINGEMENT

> Plaintiff must prove ownership of a copyrighted work and that Defendant misappropriated the work by copying it, either by proof of:
  - Direct copying
  - Inference based on Defendant's access to the copyrighted work and the substantial similarity to the copyrighted work

> Injunction, monetary damages

COPYRIGHT FAIR USE DEFENSE

> Subjective test with several factors:
  - Purpose and Character of the use
  Is it for a commercial purpose? Or is it for commentary? Is it a parody?
  - Amount and Substantiality of the Portion Used
  How much of the work is borrowed? Some of it? All of it? How important is the portion borrowed to the overall work?
  - Nature of the Copyrighted Work
  Is it published or unpublished?
  Is it informative or entertaining?
  - Effect on the Market for the Copyrighted Work
  Does the use deprive the copyright owner of income or prevent the owner from a new market for the work?

COPYRIGHT ISSUES FOR BREWERIES / DISTILLERIES

> Any content created by a 3rd Party

- Artwork
- Label
- Website
- Images
- Songs played in a taproom or tasting room
- Video

Agreements in place that (1) assign copyrights to brewery / distillery or (2) grant permission (license) to brewery/distillery to use the work.

COPYRIGHT ISSUES FOR BREWERIES / DISTILLERIES

> What about recipes?

- Remember copyrights are limited to "<u>original</u> works of authorship <u>fixed</u> in a tangible medium of expression"
- Must be in written form – no copyright for taste
- Unlikely to reproduce a written recipe
- Other forms of IP protection are more suitable to protect these
- Can't protect against independent creation of a similar recipe - need either direct copying or an inference of access for infringement

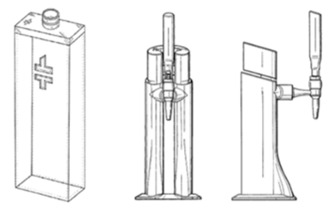
PATENTS

> "Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent." – 35 U.S.C. 101

> To be eligible for patent protection, the invention must be novel and non-obvious. 35 U.S.C. 102, 103

> Types of patents

- Utility (process, widget)
- Design (bottle)
- Plant (hops, grain)



PATENT PROCESS

> Must be filed by a registered patent attorney or *pro se* by the inventor(s)
> Can be expensive and time-intensive
> Requirements:

- Claim(s)
- Drawings
- Specification
- Oath/declaration

> Must file within one year of any public disclosure or offer for sale
> First inventor to file system

PATENT INFRINGEMENT

> Utility patents:
  - "[W]hoever without authority makes, uses, offers to sell, or sells any patented invention, within the United States or imports into the United States any patented invention during the term of the patent therefor, infringes the patent." – 35 U.S.C. 271
  - Defendant must practice each element of the claim (or an equivalent)

> Design patent: if an ordinary observer would think that the accused design is substantially the same as the patented design when they are compared

> Injunction, monetary damages

> Defenses: Non-infringement, invalidity of the patent

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PATENT ISSUES FOR BREWERIES / DISTILLERIES

> Generally rare to have patent issues

> Unlikely useful for recipes or the brewing / distilling process
  - *But* any novel and not obvious manufacturing process

> Novel bottle shapes, tap handles, flight holders

> Hops, grains, or other plants
  - *Bowman v. Monsanto Co.,* 569 U.S. ___, 133 S. Ct. 1761 (2013)

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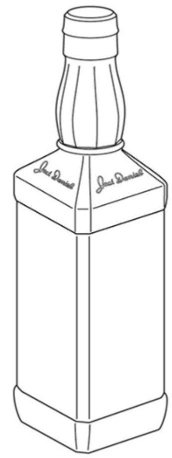
TRADEMARKS

> Trademark – JACK DANIEL'S

> Trade Dress

> Product Configuration



TRADEMARK RIGHTS

> Based upon use of the mark in commerce

- Unregistered (common law) rights
  – Only where consumers have encountered the mark
- State trademark registration
  – Statewide rights
- Federal trademark registration
  – Nationwide rights
  – If an intent-to-use based federal trademark application is filed prior to use, priority of rights in the mark goes back to the filing date of the application

TRADEMARK INFRINGEMENT

> Likelihood of consumer confusion
- Strength of Plaintiff's mark
- Similarity of the marks
- Similarity of the goods or services
- Similarity of trade channels
- Number and nature of similar marks on similar goods or services
- Length of time and conditions under which there has been concurrent use without consumer confusion
- Actual confusion
- Other factors

THE PROBLEM WITH ALCOHOL & CONFUSION

> Courts and the USPTO generally consider beer, wine, and distilled spirits to all be related when analyzing marks for a likelihood of consumer confusion
- Liquor stores traditionally sell all three
- Consumers considered to be unsophisticated purchasers
- Increasing collaboration between breweries, wineries, and distilleries
  - Barrel-aged beers
- Also have considered beer and alcohol similar to food products or restaurant / bar services

  Allagash Brewing Co. v. Cathie A. Pelletier (TTAB 2015)

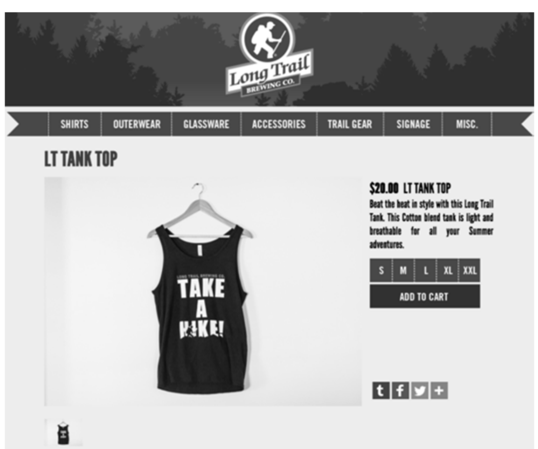
THE PROBLEM WITH ALCOHOL & CONFUSION

THE PROBLEM WITH ALCOHOL & CONFUSION

THE PROBLEM WITH ALCOHOL & CONFUSION

> *In re Reuben's Brews LLC*, Ser. No. 86/066,711 (TTAB 2015) (non-precedential)

OTHER INFRINGEMENT ISSUES



OTHER INFRINGEMENT ISSUES

OTHER INFRINGEMENT ISSUES

BUT THERE'S INCONSISTENCY

DONQ

Among other goods and services:
"providing alcoholic beverages"

Destileria Seralles, Inc. v. Kabushiki Kaisha Dong d/b/a Dong Co. Ltd., **Opposition No. 91204129 (TTAB 2017) [Non-Precedential]**

Opposer failed to prove goods & services are related by producing only third-party registrations mostly from "well recognized distillers"

BUT THERE'S INCONSISTENCY

Tao Licensing, LLC v. Bender Consulting Ltd. d/b/a Asian Pacific Beverages, **125 USPQ2d 1043 (TTAB 2017) [Precedential]**

SELECTING A TRADEMARK

- Consider strength of mark

Generic	Descriptive	Suggestive	Arbitrary or Fanciful
Aspirin	*Wisconsin Brewery*	*Lupulin*	*Apple*
Elevator	*IPA*	*Blu-Ray*	*Xerox*
Flip Phone	*Bourbon*	*Greyhound*	*Pepsi*
Thermos	*Craft Beer Attorney*	*Trek*	*Kodak*

More descriptive, Less protection ⟷ **More distinctive, More protection**

SELECTING A TRADEMARK

> At minimum, conduct a trademark search in USPTO records and on internet for similar marks

> Geographic names are often subject to a descriptiveness (or misdescriptiveness) refusal by the USPTO depending on how used

MERELY DESCRIPTIVE

WHITE SANGRIIIA

Even misspellings may not overcome a refusal based on being merely descriptive
***In re Pan American Properties Corp.*, Serial No. 86/556,214 (TTAB 2018)**

FEDERAL TRADEMARK FILING PROCESS

> Application can be use-based or an intent-to-use application

> Application is examined within 3-6 months of filing date

- Formalities
- Likelihood of confusion under Section 2(d)
- Descriptiveness under Section 2(e)
- May need disclaimer of descriptive terms such as "Brewing"

> Once approved, application is published for opposition by third parties

> If use not shown at filing, Applicant will have three years from allowance date to show use.

> Registration certificate will issue once all requirements are met.

REFUSALS TO REGISTER

> Likelihood of confusion with a previously registered mark
> Merely descriptive
> Deceptively misdescriptive
> Geographically descriptive or misdescriptive
> Primarily merely a surname
> Immoral, deceptive, scandalous, disparaging matter*
  - *Matal v. Tam* (2017) – THE SLANTS
> Flag of the United States, or of any State or municipality, or of any foreign nation, or any simulation thereof.
> Consists of or comprises a name, portrait, or signature identifying a particular living individual except by his written consent, or the name, signature, or portrait of a deceased President of the United States during the life of his widow, if any, except by the written consent of the widow.

PRINCIPAL REGISTER V. SUPPLEMENTAL REGISTER

> If rejected under 2(e) as being descriptive and use has been made, Applicant has option of amending to the Supplemental Register to obtain a registration
  - After 5 years of continuous use, brewery or distillery can then show acquired distinctiveness and overcome the descriptiveness refusal in a new filing
> Under either Register, the Registrant may use the ® symbol
  - Supplemental Register does not carry the same presumptions of validity and ownership as the Principal Register in an enforcement proceeding

MAINTAINING A FEDERAL TRADEMARK

- Federal trademark registration has a term of 10 years
- However, between the 5th and 6th anniversary of the registration date, Registrant must file a Declaration of Use affirming that the Registrant is still using the mark
  - 6-month grace period available after 6th anniversary with payment of additional fee
  - Failure to file by end of grace period will result in cancellation of the registration
- If Registrant has used the mark continuously over a period of 5 years, Registrant may file a Declaration of Incontestability along with the Declaration of Use or at anytime thereafter
- Between the 9th and 10th anniversary, Registrant must file a Renewal Application
  - Must file renewal every 10 years thereafter

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TRADEMARK ENFORCEMENT

- Staying vigilant with respect to third party uses keeps trademark rights as broad as possible.
- Formal proceeding options:
  - Opposition (TTAB) for trademark applications
  - Cancellation (TTAB) for trademark registrations
  - Infringement lawsuit (applicable federal court)

  Note: *B&B Hardware* SCOTUS decision held that when elements & facts considered by TTAB are materially the same as those before court, preclusion should apply.

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DEFENSES TO TRADEMARK INFRINGEMENT

> Mark is not confusingly similar
> Mark is merely descriptive
> Priority of use by Defendant
> Significant third party use
> Mark has been abandoned by Plaintiff
> Mark is generic for the goods or services

RESOLVING TRADEMARK DISPUTES

> Beyond ceasing use of the infringing mark altogether, parties can consider options involving:
  - Territory limitations
  - Timeframe limitations (seasonal v. flagship)
  - Types of beer sold under the mark
  - Product packaging changes
  - Cross-promotional opportunities or other collaborations
  - Transaction to assign the trademark to the other party

CONSENT AGREEMENTS

> One way to resolve some disputes, especially with respect to refusals to register at the Trademark Office over a perceived likelihood of confusion is for the parties to agree to a consent agreement

> Parties must explain why consumer confusion is unlikely

> Often accepted, but USPTO may choose to maintain refusal if there's no meaningful steps to prevent confusion included in the agreement

- *In re Bay State Brewing Co.* (TTAB 2016) (precedential opinion)

TRADEMARK ISSUES FOR BREWERIES / DISTILLERIES

> Trademarks are highly valuable assets of breweries and distilleries

> Establishing use in "interstate commerce" to support federal trademark registration

> Foreign distribution – especially as China and other Asian markets for American beer grow

> Beer with an unregistered trademark being distributed in new territories

> Marketing materials used by distributors to advertise product

LUMBEE TRIBE OF NORTH CAROLINA

WATCH OUT FOR TRADEMARK SCAMS

> Anyone filing a federal trademark application will likely receive solicitations by mail or e-mail from third parties offering services like:
  - International registration
  - Searching services
  - Filing services for maintaining U.S. registrations
  - Domain name services

> Many of these are scams and a trademark practitioner will likely be able to identify the fake ones from legitimate vendors

> Remind your clients of maintenance deadlines before the window to file the documents opens

TRADE SECRETS

> Any valuable commercial information that is not generally known and that provides an advantage to a business over competitors who do not have that information.
  - Recipes or formulas
  - Processes
  - Know-how
  - Contacts and consumer information

TRADE SECRET LAW

> Until recently, only cause of action was under state law
  - Most states have adopted the Uniform Trade Secrets Act (UTSA)
  - Exceptions are New York and Massachusetts

> On May 11, 2016, Obama signed into law the Defense of Trade Secrets Act (DTSA)
  - Provides a federal cause of action for trade secret misappropriation
  - Provides injunctive relief and opportunity for ex parte seizure under certain circumstances

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PROTECTING TRADE SECRETS

> Key to protecting a trade secret is keeping it "secret"
  - Limit the number of people with knowledge of the secret
  - Regularly identify and mark documents as "confidential" that contain trade secret material
  - Have an employee policy with respect to trade secrets and confidential information
  - Non-disclosure agreements with third parties, including contract brewers
  - Confidentiality agreements and non-compete agreements with employees

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TRADE SECRET ISSUES FOR BREWERIES / DISTILLERIES

> Recipes and manufacturing processes

> Marketing plans

> Distribution plans

> Commodity prices and packaging costs

> In contract manufacturing arrangements, ensuring trade secrets are properly “returned” or destroyed if relationship ends

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ALCOHOL BEVERAGE ADVERTISING

> “Advertisement” is essentially anything in writing that is disseminated to the public

- Print ads, television ads, mailings, videos, webpages, social media

> Do not need TTB approval, but TTB does monitor

> Distillery: 27 C.F.R. 5.61-5.66

> Brewery: 27 C.F.R. 7.50-7.55

> State regulations also apply

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MANDATORY STATEMENTS

> Name, city and state for brewery / distillery responsible for content.
> Class of product
> For distilleries, alcohol content and percentage of neutral spirits (not required if advertisement covers full brand with multiple products)
> Statements must be
  - Conspicuous & readily legible
  - Clearly part of the advertisement
  - Readily apparent to the viewer

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PROHIBITED STATEMENTS

> Statements that are false, untrue, or tend to create a misleading impression
> Statements that disparage a competitor's product
> Obscene or indecent statements or images*
> Misleading statements about testing or product guarantees
> Use of terms like "bond," "pure" or "organic"
> Statements by breweries that create false or misleading impression that product contains distilled spirits
> Health-related statements that are untrue, misleading, or not substantiated by evidence

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PROHIBITED STATEMENTS

SOCIAL MEDIA

> Social media pages are considered "advertisement" and must include mandatory statements

- Should be placed where viewer would most logically expect to find information, such as the "profile" or "About" section

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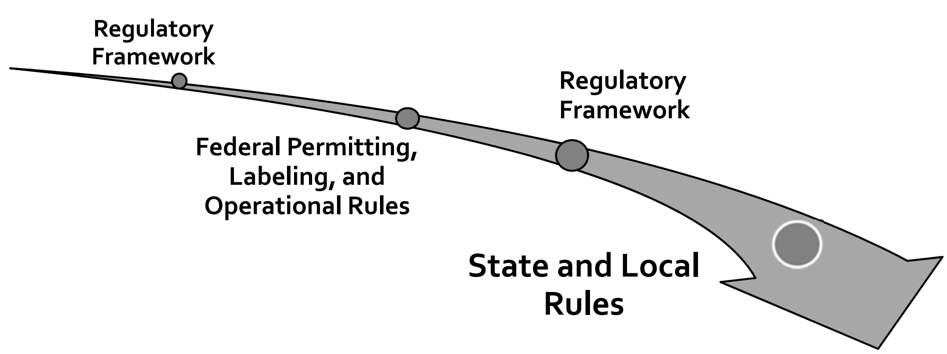
ROADMAP



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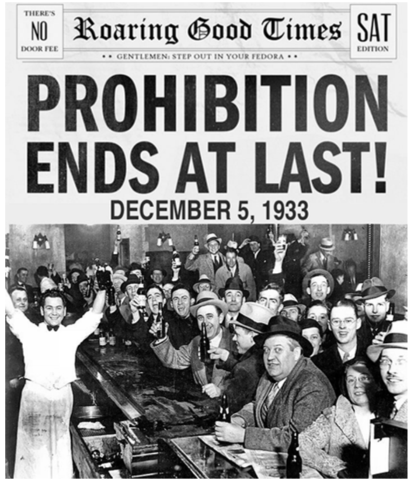
PROHIBITION AND REPEAL

> 18th Amendment
  - Prohibited the manufacture, transportation, and sale of alcohol nationwide

> Prohibition Era and Organized Crime
  - Illegal operations ran rampant during the time – bootleggers and manufacturers of moonshine kept speakeasies well stocked
  - Mobsters such as Al Capone made as much as $100 million a year (about $1.3 billion today)

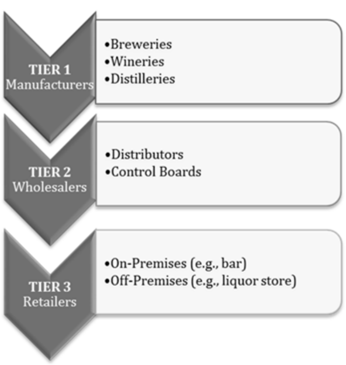
> Harm to the public and the economy
  - Thousands died and hundreds of thousands were crippled from the effects of drinking tainted liquor
  - Federal government lost about $11 billion in excise tax revenue

> 21st Amendment
  - Repealed the 18th Amendment, gave states the authority to regulate alcohol within their borders



CURRENT REGULATORY FRAMEWORK

Three-Tier System



Main Goals:
- **Ensure the safety of the product**
- **Promote orderly collection of taxes**
- **Mandate fair business practices (eliminate tied-houses)**

FEDERAL REGULATION

> Federal Alcohol Administration Act of 1935
  - 27 U.S. Code, Chapter 8 – Enforced by TTB

> Registration and Permits
  - Federal Basic Permit
  - Brewer's Notice

> Labeling
  - Certificate of Label Approval ("COLA")

> Taxation
  - TTB oversees collection of federal tax on alcohol

> Common Compliance Issues
  - Recordkeeping, inventory, reporting and tax payment, permit and registration requirements

REGISTRATION AND PERMITS

> No person may produce alcohol for *commercial* use without appropriate permit.

> Home brewing and wine making are permitted for personal consumption, but distilling spirits <u>always</u> requires a permit—even for personal use.
  - Although 8 states have home distilling laws (Fed. Supremacy)

<u>What Permits Are Required:</u>

> **Distilleries:** Fed. Basic Permit required (27 CFR 121

> **Breweries:** Fed. Brewer's Notice required (27 CFR 25.61)

APPLYING FOR A BREWER'S NOTICE OR FEDERAL BASIC PERMIT

> The application will take longer and require more information than you might expect. TTB estimates:
- Distilled Spirits Plant - 83 days
- Brewery Premises - 59 days

> Permit applications can and should be submitted using TTB's Permits Online application system.

> Application processing generally includes:
- Initial evaluation for completeness
- Background checks of owners and officers
- Legal analysis of proposed applications
- Field investigations (rare)

APPLYING FOR BASIC PERMIT OR BREWER'S NOTICE

Just *some* of the information required for an approvable application:

- Entity formation and governance documents
- Proof of ownership and/or right to use land for intended purpose, including lease to a company you wholly own.
- Legal description of property
- Bond to cover tax obligations (only if >$50,000 in annual excise taxes)
- Detailed environmental questionnaire
- Detailed owner/officer questionnaire
- Copy of drivers license/state ID
- Source of Funds documentation
  - 3 months bank records, loan records, gift records and evidence donor has no interest in business
- Scale drawing of entire premises and building, detailed with dimensions, identifying equipment, loading docs, doors, windows, etc.
- Written description of all areas of building and how security is provided.
- Power of attorney if app filed by attorney; written action or approved resolutions for entity

RESTRICTIONS ON LOCATION

Brewery

Generally cannot be located:

> In any dwelling house

> On board any vessel or boat

> In any building or on any premises where the revenue will be jeopardized or effective administration hindered

27 CFR 25.21

Distillery

Generally cannot be located:

> In any residence, shed, yard, or enclosure connected to a residence

> On any vessel or boat

> Where beer or wine is produced

> Where liquors are sold at retail

> Where any other business is conducted except with prior approval

27 CFR 19.52

LABELING (COLAS)

> Every alcohol product introduced into interstate commerce must be properly labeled and have received a Certificate of Label Approval (COLA) from the TTB

> If selling only in the state of production you may still need a COLA (due to state label requirements) and should consider seeking approval anyway to register your trademark.

> Labeling rules differ for beer and distilled spirits.

> Generally relatively quick processing times (est. 9 days for spirits & 6 days for beer, *assuming no formula approval is required).*

> Plan for the process to take longer—the TTB has up to 90 days to process label applications.

DISTILLED SPIRITS LABEL REQUIREMENTS

Brand name

Class and type

Alcohol content by volume

Net contents

Name and address of distiller/bottler (not pictured)

Neutral spirits: commodity from which distilled (e.g., corn, rye)

Statement regarding existence of sulfites (if applicable—can be on neck/strip label)

Statement of age (time whisky is stored in oak containers) (NA)

- **Name/Address of Bottler**
- **Net contents**
- **Sulfites statement**
- **Health Statement**
- **Brand name**
- **Class designation**
- **ABV (if required by state law)**

COLA APPROVAL STEP-BY-STEP

1. Must already have Basic Permit / Brewers Notice
2. Determine if formula approval (or other pre-COLA eval) is required. If so, obtain approval (Formulas Online portal)
3. File COLA application using TTB COLAs Online portal (JPG, TIFF file types. No white border or background. No printer proof info)
4. Fourth, wait. (TTB has up to 90 days to approve/reject)
5. Finally, if you do not hear from TTB within 90 days, you must appeal (*See* (27 CFR 13.21(b))

COLA APPEALS (27 CFR 13.25)

> If COLA is rejected, reasons for denial are stated in notice.

> Review decision; analyze standards and application of facts.

> If you disagree, file appeal within 45 days of notice.

- Pro Tip: Often best to contact assigned TTB officer to seek informal resolution
- Do so promptly, leaving enough time to appeal

COMMON TTB COMPLIANCE ISSUES

Compliance problems most frequently found by TTB Audits:

> Recordkeeping

> Reporting and Tax Payment

> Failure to register business changes with TTB (location, premises, ownership, COLAs)

Penalties: suspension/revocation of permits, up to a year in jailtime and/or $1,000 in fines, and 5% monthly penalty, plus interest on late tax payments.

COMPLIANCE PITFALL: *GULFCOAST MARITIME SUPPLY, INC. V. UNITED STATES*

> **Facts**: Years after seemingly inconsequential change in control from deceased spouse to other spouse via survivorship (joint tenancy), Basic Permit terminated & ordered to cease operations or face civil/criminal penalties, upon discovering failure to file new application for Basic Permit.

> Change in control of Brewery requires amendment to Brewers Notice (27 CFR 25.74)

> Change in control of Distillery requires new application for Basic Permit. (27 CFR 19.114)

> Saving clause: 27 USC 204(g) (file w/in 30 days of CIC)

STATE AND LOCAL REGULATION

Tied-House Rules

Control/License Systems

Dormant Commerce Clause

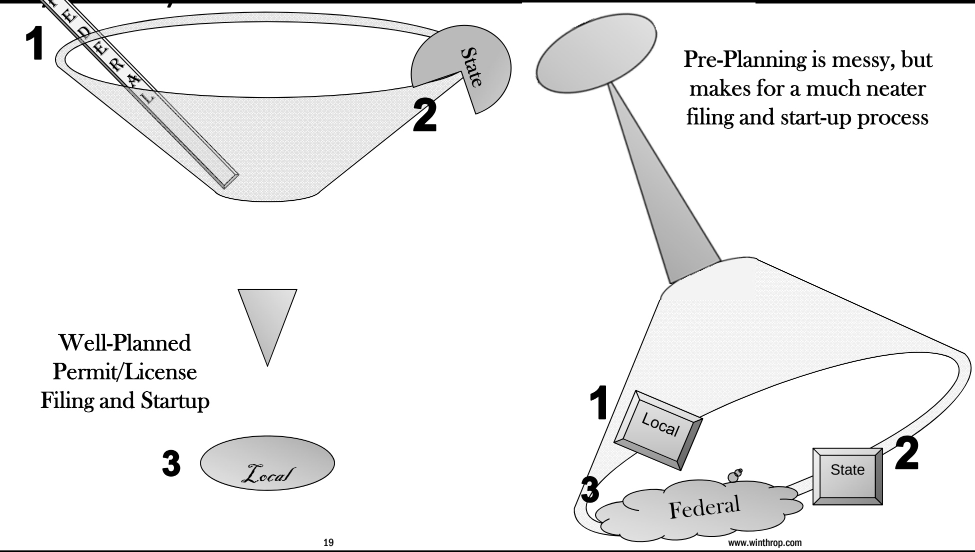
Every state is different

STARTING A BREWERY/DISTILLERY (MINNESOTA EXAMPLE)

> To get up and running you must navigate a maze of government agencies:

- TTB
- IRS
- FDA
- USPTO
- MN Secretary of State
- MN Dept. of Revenue
- MN DPS, Alcohol and Gambling Enforcement Division
- MN Dept. of Agriculture
- MN Dept. of Labor and Industry
- City Council
- Zoning Commission

PERMITTING: FEDERAL, STATE, LOCAL. EFFECTIVE PLANNING: LOCAL, STATE, FEDERAL



CASE STUDY: STARTING A BREWERY/ DISTILLERY

- Determine Intended Location
- Navigate Zoning Laws
- Develop a Business Plan
- Select and Form an Entity
- File Trademark Apps for Brand and Key Products
- File for Basic Permit/Brewers Notice
- Plan Review App. & Construction
- Apply for State Licenses (after receiving Federal)
- Production/Compliance/Distribution

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Craft Beer, Distillery and Liquor Law: Other Issues

Jeff O'Brien

Attorney

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Topics to Be Covered:

- History and Overview of the Three-Tier System
- State Distribution Laws
- Recent Exceptions to the Three-Tier System
- Sales of Distribution Rights
- Small Brewer Exemptions to State Distribution Laws
- Distribution Issues in the Wine and Spirits Industries
- Employment Issues
- Real Estate (Lease vs. Purchase)
- Insurance Matters

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History and Overview of the Three-Tier System

History and Overview of the Three-Tier System

- "Tied Houses"
- Prohibition: 18^{th} Amendment and the Volstead Act
- 21^{st} Amendment and State Regulation of the Liquor Industry

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State Distribution Laws

State Distribution Laws

- Creation of the Distribution Agreement
- Termination Restrictions
- What Constitutes "Good Cause"?
- Notice Requirement
- Reasonable Compensation

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Exceptions to the Three-Tier System

Exceptions to the Three-Tier System

- Self-Distribution Rights
- Growlers, Etc.
- Taprooms

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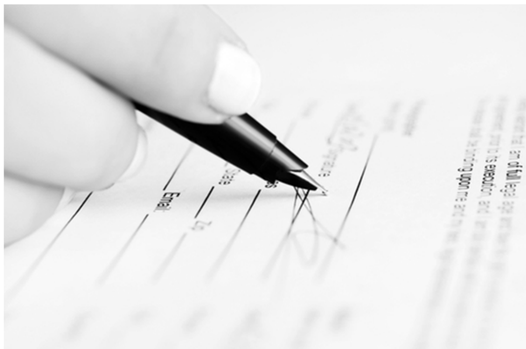
Sales of Distribution Rights



Small Brewer Exemptions to State Distribution Laws

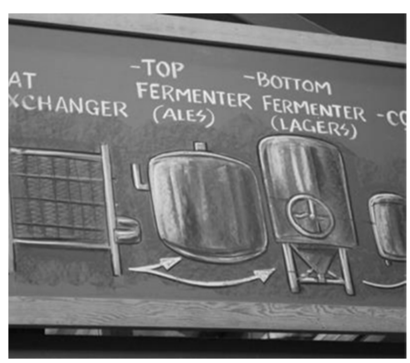
Distribution Issues in the Wine and Spirits Industries

Employment Issues

- Laws vary by state; general rule is “at will” employment
- Employment agreement for head brewer
- Trade secret issues
- Worker classification issues, especially regarding the use of volunteers

Real Estate: Lease vs. Purchase

Insurance Issues



Questions?

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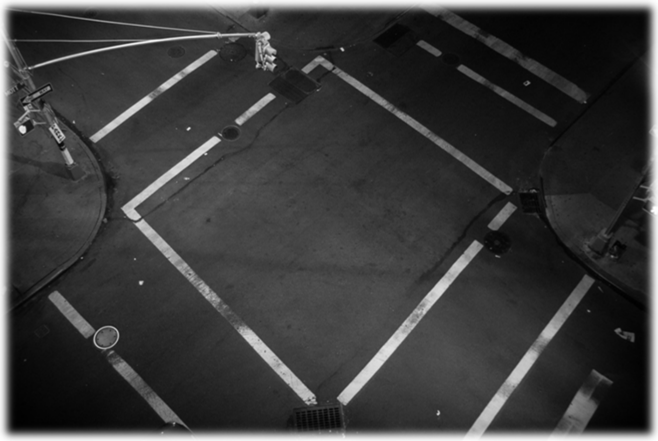
VI. COMMON ETHICAL MISTAKES ATTORNEYS MAKE



WALKING THE ETHICAL LINE

1

2

WHAT WE'LL COVER

- ETHICAL STANDARDS AND CIVIL LIABILITY
- ROLE OF ATTORNEYAS ADVISOR
- AVOIDING CONFLICTS
- THE 3 C's, FOCUSING ON CONFIDENTIALITY
- FEES
- COMMON SCENARIOS

3

BACK TO THE BASICS
ETHICAL STANDARDS AND CIVIL LIABILITY

- **Lawyer Ethics: Not an Oxymoron**
- **Model Rules of Professional Conduct**
- **States' Rules of Professional Conduct or Professional Responsibility**

4

BACK TO THE BASICS
ETHICAL STANDARDS AND CIVIL LIABILITY

- **Majority courts: violation of ethical standards is evidence of attorney malpractice.**
- **Compliance with ethical standard may be defense to attorney malpractice.**

5

THE ROLE OF ATTORNEY AS ADVISOR IN ENTITY FORMATION

- **Rule 2.1: Advisor**
- ***Who is the client?***

6

THE ROLE OF ATTORNEY AS ADVISOR IN ENTITY FORMATION

- **Advisor in Entity Formation**
- **Representation of Entity or Organization**
- **Representation of Individuals or Principals**

7

COMMON MISTAKES LAWYERS MAKE

- **Failure to identify the correct client**
- **Failure to communicate**
- **Failure to recognize a conflict of interest**

8

AVOIDING CONFLICTS OF INTEREST

- Again: Who is the client?
- What is a conflict of interest?
- Who determines whether a conflict exists?

9

AVOIDING CONFLICTS OF INTEREST

- Can the lawyer represent the client despite the conflict?
- What is concurrent representation and informed consent?

10

COMMON MISTAKES LAWYERS MAKE

- **Failure to consider potential conflicts**
- **Failure to perform conflicts check**
- **Failure to obtain informed consent conflict waiver**

11

THE THREE C's:

- **#1: COMMUNICATION**
- **#2: COMPETENCY**
- **#3: CONFIDENTIALITY**

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CONFIDENTIALITY

- What is a lawyer's duty of confidentiality?
- What is the attorney-client privilege?
- When an entity is the client?

13

COMMON MISTAKES LAWYERS MAKE

- Failure to advise client to whom duty of confidentiality is owed.
- Waiver of confidentiality.
- Failure to adequately safeguard confidential information.

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ADEQUACY OF FEES AND CHARGES

- What is a retainer agreement?
- What is a reasonable fee?
- Can lawyers take an ownership stake in exchange for services?
- What transactions are prohibited?

15

COMMON MISTAKES LAWYERS MAKE

- Failure to get fee agreement in writing.
- Failure to assess whether transaction is prohibited.
- Failure to keep client's best interests in mind.

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WHAT WOULD YOU DO?

DIFFERENT ETHICAL SCENARIOS

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Brewing Models

Submitted by Jeffrey C. O’Brien

Brewing Models

Submitted by Jeffrey C. O'Brien

A. Production Brewery

1. **Definition:** A brewery that brews its own beer onsite and packages its beer for sale largely off-premise. May have a tasting room.

2. **Examples of Large Production Breweries:** Lagunitas, Bell's, Stone, Summit, Surly, Lift Bridge.

B. Brewpub

1. **Definition:** A brewery whose beer is brewed primarily on the same site from which it is sold to the public, such as a pub or restaurant. If the amount of beer that a brewpub distributes off-site exceeds 75%, it may also be described as a craft or microbrewery. Most brewpubs must adhere to laws which limit the total ratio of beer sales to food sales. A brewpub cannot be considered a bar or beer garden which offers a limited amount of food or limits the restaurant's hours of operation. It must operate as a public restaurant which happens to offer a wide selection of micro-brewed beers.

2. **Pros of a Brewpub**

a. Brewpubs create marketing to new customers who may not be willing to go to a brewery just to taste beer, but who may be willing to try a new restaurant closer to home.

b. Brewpubs may be located in a more accessible location to attract more people because the brewery is not actually manufacturing beer onsite.

c. Brewpubs can easily develop their own identity by designing the brewpub to reflect their branding and style.

3. **Examples of National/Regional Brewpubs:** Rock Bottom Brewery, Gordon Biersch, etc.

C. Alternating Proprietorship (AP)

1. **Definition:** An "alternating proprietorship" is a term used to describe an arrangement in which two or more people take turns using the physical premises of a brewery.

Generally, the proprietor of an existing brewery, the "host brewery," agrees to rent space and equipment to a new "tenant brewer." Alternating brewery proprietorships allow existing breweries to use excess capacity and give new entrants to the beer business an opportunity to begin on a small scale, without investing in premises and equipment.

The tenant qualifies as a brewer by filing the appropriate documents with TTB. The tenant brewer:

- Produces beer
- Keeps appropriate brewery records
- Labels the beer with its own name and address
- Obtains the necessary COLAs
- Pays tax at the appropriate rate upon removal of its beer from the brewery

The tenant brewer has title to the beer at all stages of the brewing process.

2. **Operating as an Alternating Proprietorship** On August 12, 2005, TTB issued Industry Circular 2005-2 to provide guidance to brewers on how to qualify for and operate as an alternating proprietorship. This industry circular:

- Outlines what documents must be filed to qualify as a brewery alternating proprietor by both parties
- Provides guidelines for the operation of brewery alternating proprietorships by both the host and tenant breweries
- Describes the information used by TTB officials to make determinations regarding approval of alternating proprietorship arrangements

A copy of Industry Circular 2005-2 is included as Appendix A to these materials.

3. **How to Apply**

Both the tenant and host brewer must submit a series of forms and documentation to the National Revenue Center in order to qualify for an alternating brewery arrangement. Industry Circular 2005-2 sets forth a complete list of application requirements. For

4. **Pros of an Alternating Proprietorship**

a. Tenant brewers can develop a brand before they are ready to invest in their own premises and equipment.

b. Tenant brewers can begin placing their product in the stream of commerce to better preserve intellectual property rights.

c. Host breweries can offset their investment by renting out their excess capacity.

d. Host breweries often serve as a buffer to allow for easy transition into a highly-regulated industry.

e. Host breweries take on much of the physical pressure, burden and liability

of the brewing operation.

f. Tenant brewer may be eligible for a lower tax rate on beer. Where a brewer produces less than 2,000,000 barrels of beer during a calendar year, there is a reduced tax rate of $7 per barrel on the first 60,000 barrels on beer produced that is also consumed or sold in that same year.

5. **Examples of Alternating Proprietorships:** 21st Amendment Brewery in CA (Tenant Brewer) within Cold Spring Brewery in MN (Host Brewer), Avery Brewing in CO (Tenant Brewer) within New Belgium Brewing in CO (Host Brewer).

D. **Contract Brewing**

1. **Definition:** A business that hires another brewery to produce its beer. It can also be a brewery that hires another brewery to produce additional beer. The contract brewing company handles marketing, sales and distribution of its beer, while generally leaving the brewing and packaging to its producer brewery. The producer brewery provides the recipes for the beer to the contract brewer.

2. **Pros of Contract Brewing**

a. Producer breweries that cannot supply enough beer to meet demands can contract with a larger brewery to help alleviate their supply issues.

b. Producer breweries do not need to own a brewing facility, so they can avoid the costs associated with a physical brewery.

c. Producer breweries do not need a separate license.

3. **Example of Contract Brewing:** Gluek Brewing Company in MN (Producer Brewery) within Hard Energy Company in CA (Contract Brewery)

4. **Elements of the Contract Brewing Agreement:**

a. Producer brewery shall be granted a license to utilize the other party’s trademarks, recipes, etc. in the production of the beer to be brewed by the contract brewer.

b. Term of the agreement.

c. Duties of the contracting party: provide the contract brewer with recipes, etc., secure product orders and provide packaging materials.

d. Duties of the contract brewer: brew and package the product(s), label approvals, deliver products, handle all TTB reporting and tax payments (subject to reimbursement from the contracting party), etc.

e. Insurance coverage requirements.

f. Price to be paid by the contracting party to the contract brewer for the products.

E. Comparison of Alternating Proprietorship and Contract Brewing Models

Differences	Alternating Proprietorship	Contract Brewing
Title Ownership	Tenant brewer holds title to its beer, including the ingredients and raw materials it uses to produce its beer, during all stages of production.	Contract brewer holds title to the beer, including the ingredients and raw materials used to brew the beer, during all stages of production.
Record Keeping	Tenant brewer and host brewer each retain their own records for production and removal of beer and each provides reports to the Alcohol and Tobacco Tax and Trade Bureau (TTB)	Contract brewer retains all records of production and removal of beer and provides reports to the TTB.
Taxes	Tenant brewer and host brewer are individually responsible for paying their own taxes on their own beer removed from the brewery.	Contract brewer is solely responsible for paying taxes on beer removed from the brewery.
Brewer Licensure	Tenant brewer and host brewer must each qualify as a brewer and have separate licenses.	Only the contract brewer must qualify as a brewer, so the producer brewer does not need a license.
Ease of Paperwork	Requires significant paperwork for both parties.	Simple agreement; brand is added to the contract brewer’s Notice.

APPENDIX A

Industry Circular 2005-2

DEPARTMENT OF THE TREASURY
Alcohol and Tobacco Tax and Trade Bureau

Industry Circular

Number: 2005-2
Date: August 12, 2005

Alternating Proprietors at Brewery Premises

To: Brewers and Others Concerned

Purpose of this Circular

This Circular—

- Summarizes the existing policy of the Alcohol and Tobacco Tax and Trade Bureau (TTB) regarding the qualification and operation of alternating proprietors at breweries;

- Describes the differences between alternating proprietors at breweries and contract brewing arrangements;

- Outlines the procedures for brewers to follow when they apply for alternating proprietor arrangements;

- States TTB policy regarding alternating brewery proprietors that may be eligible to pay the reduced rate of tax;

- Defines the policy TTB applies regarding the continuing operation of existing alternating brewery arrangements, including instances when those arrangements are inconsistent with TTB guidelines;

- Announces that all previous approvals under 27 CFR 25.52(a) that allow operation as an alternating proprietor at a brewery no longer apply as of September 1, 2006; and

- Advises brewery proprietors who alternate premises to resubmit applications for alternate methods of operation if they intend to continue operating as an alternating brewery proprietor after August 31, 2006.

Reason for Issuance

We issue this Circular for two reasons. First, we want to provide guidance to brewers and others who wish to obtain under 27 CFR 25.52 TTB approval for a variation from existing regulatory requirements (alternate method or procedure) that would allow them to establish alternating brewery proprietorships. Regulations in 27 CFR part 25 do not expressly authorize these arrangements and provide no guidance for the establishment or operation of alternating brewery proprietorships.

Second, we want to resolve problems that we discovered through examination of applications at the National Revenue Center (NRC) and through field audits of operations. These problems relate to certain aspects of alternating brewery operations. Examples of such problems include the splitting of beer production, contractual relationships, and the blending of beer. We believe some of these problems result from Bureau failure to state clearly Bureau guidelines for the operation of alternating brewery proprietorships. In this Circular, we provide guidance regarding the standards TTB applies for the establishment and continuing operation of alternating brewery proprietorships.

Background

The Homeland Security Act of 2002 brought TTB into being and resulted in the transfer of the revenue collection function and certain other duties of the Bureau of Alcohol, Tobacco and Firearms (ATF) to TTB. In this Circular, the pronoun “we” refers to TTB. Sections 7805 and 5051, among others, of the Internal Revenue Code of 1986 (the IRC) authorize the Secretary of the Treasury to administer requirements for qualifying a brewery, operating a brewery, and for paying tax and labeling beer removed from a brewery. The Secretary has delegated such functions to TTB. Regulations in 27 CFR part 25 implement the IRC beer provisions and include requirements on brewers that cover the production, removal, and taxpayment of beer. In those regulations, TTB sets out requirements for qualifying for the reduced tax rate for small brewers for which certain alternating brewery proprietors may be eligible.

Contract brewing arrangement and alternating brewery proprietorship arrangement differences

What is a "contract brewing" arrangement?

A contract brewing arrangement is a business relationship in which one person, such as a wholesale or retail dealer or a brewer, pays a brewing company, the "contract brewer," to produce beer for him or her. The contract brewer is entirely responsible for producing the beer, keeping appropriate brewery records, labeling the beer with its name and address, obtaining necessary certificates of label approval (COLAs), and paying tax at the appropriate rate upon removal of the beer from the brewery. The contract brewer retains title to the beer at least until the beer is taxpaid or removed from the brewery. TTB considers contract brewing arrangements to be ordinary commercial arrangements.

What is an "alternating brewery proprietorship"?

An "alternating proprietorship" is a term we use to describe an arrangement in which two or more people take turns using the physical premises of a brewery. Generally, the proprietor of an existing brewery, the "host brewer," agrees to rent space and equipment to a new "tenant brewer." The tenant qualifies as a brewer under part 25 by filing the appropriate documents with TTB. The tenant produces beer, keeps appropriate brewery records, labels the beer with its own name and address, obtains the necessary COLAs, and pays tax at the appropriate rate upon removal of its beer from the brewery. The tenant brewer has title to the beer at all stages of the brewing process.

Alternating brewery proprietorships allow existing breweries to use excess capacity and give new entrants to the beer business an opportunity to begin on a small scale, without investing in premises and equipment. Regulations in part 25 do not refer to this type of arrangement. However, in the mid-1980s, ATF began approving applications for alternate methods and procedures that allow two or more brewers to alternate the use of brewery premises and equipment.

What distinguishes an alternating brewery proprietorship from a contract brewing arrangement?

Significant differences between these two types of arrangements follow.

- Title. Section 5092 of the IRC (26 U.S.C. 5092) defines a brewer as a person who brews beer or produces beer for sale. In order to brew or produce beer, a person must first have title to the ingredients or raw materials, including unfermented wort. In a contract brewing arrangement, the contract brewer has title to the ingredients and to the beer during all stages of production. Ordinarily, the title to the beer passes to the person on whose behalf the beer is brewed only after production, taxpayment, and removal from the brewery.

- In an alternating arrangement, the host and tenant brewer hold title separately to the ingredients or raw materials that they use and to the beer that they individually produce. Holding title to the ingredients or raw materials is essential in order for either the tenant or host brewer to brew or produce his or her own beer, as required by the definition of a brewer under section 5092.

- Records and reports. In a contract brewing arrangement, the contract brewer is responsible for keeping records of beer production and removal and for providing operational reports to TTB. The beer purchaser has no responsibility for records or reports under part 25, although that person may be required to maintain records as a retail or wholesale dealer in beer under 27 CFR part 31. In an alternating arrangement, the host and tenant brewer must keep separate records of their respective beer production and removals and each must provide operational reports to TTB.

- Taxpayment. In a contract brewing arrangement, the contract brewer is responsible for paying tax at the appropriate rate of tax on beer removed from the brewery. The person for whom the beer is produced has no responsibility to pay tax on the beer but may compensate the contract brewer for tax or any other expenses pursuant to the contract arrangement. In an alternating arrangement, the host and tenant brewer individually pay tax, at the rate of tax applicable to each, upon removal of their own beer from the brewery.

- Qualification and permit status. In a contract brewing arrangement, only one person, the contract brewer, must qualify as a brewer under part 25. The person on whose behalf the beer is brewed may be a wholesaler, a retailer, or another brewer. If this person on whose behalf the beer is brewed under contract resells the beer to a dealer, then that person must hold a basic permit as a wholesaler under the Federal Alcohol Administration Act, and must comply with all applicable special tax requirements. In an alternating arrangement, both the host and the tenant brewer act as brewers and each must be qualified under part 25. The tenant brewer does not need to be qualified as a wholesaler, since the beer that the tenant produces is considered his or her own production and is not sold to the tenant by the host brewer.

Alternating brewery proprietor eligibility to pay a reduced rate of tax on beer

Title 26 U.S.C. 5051(a)(2) provides for a reduced rate of tax on beer for certain qualified domestic brewers. To qualify, a brewer must not produce more than 2,000,000 barrels of beer during the calendar year. The reduced rate of tax is $7 per barrel on the first 60,000 barrels of beer that are removed for consumption or sale during the calendar year. Additional beer removed by the qualified brewer during that calendar year is taxed at the full rate of $18 per barrel up to 2,000,000 barrels. Brewers who produce more than 2,000,000 barrels of beer in a calendar year are not eligible to pay tax at the reduced rate on any beer removed that year.

Under the eligibility requirement in section 5051(a)(2), a group of brewers under common ownership (referred to as a "controlled group") are treated as a single brewer for purposes of determining eligibility to pay tax at the reduced rate. To be eligible to pay the reduced rate of tax, the controlled group cannot produce more than 2,000,000 barrels of beer collectively and must apportion the 60,000-barrel beer quantity eligible for the reduced rate of tax among the brewers who are members of the group.

Brewers who operate as tenant brewers at a host brewery may be eligible to pay tax at the reduced rate on the first 60,000 barrels of beer they remove in a calendar year if they—

- Do not produce more than 2,000,000 barrels of beer in a calendar year; and
- Are not members of a controlled group of breweries whose total production is more than 2,000,000 barrels of beer in a calendar year.

Qualification and what rate of tax is applicable to a host or tenant brewer are separate issues. However, TTB is concerned that some alternating brewery arrangements are efforts to split the production of a larger brewery into smaller businesses, in order to extend the reduced rate of tax to beer that might not otherwise be eligible for the reduced rate. TTB examines applications to establish alternating brewery proprietorships to determine if the applicant brewer is eligible to pay the reduced rate of tax on beer. Similarly, we examine existing alternating arrangements to determine if brewers who are paying the reduced rate of tax are eligible to do so. Although TTB may have approved certain alternating brewery arrangements in the past, the Bureau takes appropriate action if brewers who engage in an alternating arrangement are not entitled to pay, but are paying, tax at the reduced rate.

Alternate methods and procedures

An alternate method or procedure operates in lieu of a method or procedure specified in regulations. Authorization of alternate methods and procedures does not waive regulatory requirements. In the absence of a specific regulation, TTB has authorized alternations at brewery premises as alternate methods and procedures under 27 CFR 25.52(a). TTB may approve brewery alternations if they—

- Afford the protection to the revenue intended by the requirements of part 25;

- Do not hinder the effective administration of part 25; and

- Are not contrary to any provision of law.

Only the authorization of an alternate method or procedure in lieu of a method or procedure specified in regulations, such as recordkeeping, segregation of premises, and extension and curtailment of premises, makes an alternating brewery proprietorship arrangement possible. For example, alternating brewers do not file amended Brewer's Notices every time the premises are alternated to the use of another brewer, because records that show the status of the brewery at any time document this activity. TTB may revoke a previously granted approval, when conditions contrary to the conditions of that approval exist.

We emphasize that TTB cannot waive the statutory requirement that each alternating proprietor must actually produce beer. It is the responsibility of applicants for alternations to disclose all information necessary to determine that they will engage in bona fide beer production. Furthermore, approved alternating brewers must notify TTB if subsequent changes in their operations affect the conditions of their approval.

Qualification of an alternating brewery arrangement

In order to establish an alternating brewery proprietorship, both the host and tenant must be qualified as brewers and must file the information TTB needs to evaluate the alternating arrangement request. TTB must approve the brewers' qualifying documents and any necessary applications for alternate methods or procedures from existing regulatory requirements, in order to establish the alternating arrangement.

What documents must a host brewer file with TTB?

A host brewer must file the following documents with the NRC, in order to establish an alternating brewery arrangement.

- An amended Brewer's Notice, TTB Form 5130.10. The attachments to the Notice must describe the portion of the brewery premises and equipment to be periodically alternated and the tenant brewers with whom it will alternate. The amended Notice must include a diagram that identifies the areas that the alternating brewers plan to use. The host brewer must execute item number 14 of the Form, which includes a determination of whether the host is a member of a controlled group of brewers that includes the applicant tenant brewer.

- An attachment to the Brewer's Notice that describes security at the brewery. This attachment is not necessary if the alternation does not result in any change to existing security information.

- A Consent of Surety, TTB Form 5000.18, that conveys consent to the periodic alternation of premises with the tenant brewer. Suggested language for the consent follows.

This consent extends the terms of the bond identified above to cover the operations as an alternating proprietorship between HOST at (list the brewery location–street, city, State, and zip) and TENANT, periodically suspending and resuming operations, in accordance with the procedures described in the Brewer's Notice.

- A request for an alternate method of operation from the requirements of 27 CFR 25.23(a) to permit use of the brewery for other purposes.

- A request for an alternate method of operation from the requirements of 27 CFR 25.78 to permit the use of brewery records as the record of extension and curtailment of brewery premises, in lieu of filing an amended TTB Form 5130.10 with each alternation of the brewery premises.

What documents must the tenant brewer file with TTB?

A tenant brewer must file the following documents with the NRC to qualify as a brewer and to establish a valid alternating brewery arrangement with the host.

- A Brewer's Notice, Form 5130.10, qualifying the brewery and describing the portion of the brewery premises and equipment to be periodically alternated with the host brewer. The Notice must include all attachments and organizational documents and must include a diagram that identifies the areas that the host brewer plans to use. The tenant brewer must execute item number 14 of the Form, which includes a determination of whether the tenant brewer is a member of a controlled group of brewers that includes the host brewer.

- A Brewer's Bond, Form 5130.22.

- A Consent of Surety, Form 5000.18, consent to the periodic alternation of premises with the host brewer. Suggested language for the consent follows.

This consent extends the terms of the bond identified above to cover the operations as an alternating proprietorship between HOST at (list the brewery location–street, city, State, and zip) and TENANT, periodically suspending and resuming operations, in accordance with the procedures described in the Brewer's Notice.

- An attachment to the Brewer's Notice that describes security at the brewery. An amended copy of the host brewery's description may be sufficient.

- Environmental Information, TTB Form 5000.29, and Supplemental Information on Water Quality Considerations, TTB Form 5000.30. Amended copies of the host brewery's environmental forms may be sufficient, or the applicant may incorporate the host's environmental forms by reference in its application.

- Special Tax Registration and Return, TTB Form 5630.5.

- A request for an alternate method of operation from the requirements of 27 CFR 25.300(a), if the alternating brewer plans to prepare or store records on the premises of the host brewery.

- Power of Attorney, TTB Form 5000.8, if host brewery employees plan to prepare records or reports for the tenant brewer.

- A request for an alternate method of operation from the requirements of 27 CFR 25.78 to permit use of brewery records as the record of extension and curtailment of brewery premises in lieu of filing an amended Brewer's Notice, TTB Form 5130.10, with each alternation of the brewery premises.

- A request for an alternate method of operation to allow the establishment of an alternating proprietorship with the host brewer.

- A copy of the entire agreement between the host and tenant brewer.

- A business plan showing development plans for the brewing business.

The NRC furnishes copies of TTB forms that are necessary to qualify a brewery and can furnish sample copies of the requests for alternate methods or procedures necessary to establish an alternating brewery proprietorship.

Bureau concerns about the qualification and operation of certain alternating brewery proprietor arrangements

As noted previously, TTB has a number of concerns about the qualifications and operations of some alternating brewery proprietorships that we uncovered during field audits. These concerns include whether the—

- Tenant brewer is, in fact, acting as a brewer and producing beer.

- Tenant brewer is operating in a manner independent from the host brewer with respect to issues such as operations, production decisions, marketing, and beer produced.

- Alternating brewery proprietorship arrangement is primarily an arrangement designed to split production of the larger company into additional smaller companies, in order to improperly claim status as a small brewer and qualify for payment of the reduced rate of tax on beer or to enable the payment of the reduced rate of tax on a larger quantity of beer than would otherwise be possible.

- Tenant brewer is merely contracting the production of the beer to the host brewer or vice versa.

- Tenant brewer is in compliance with the conditions of the alternate method or procedure, including the requirements that the arrangement provide security to the revenue, be not contrary to law, and not cause an increase in cost to the Government or hinder the effective administration of part 25.

Guidelines for alternating brewery proprietorships

TTB wishes to facilitate the establishment of alternation operations at brewery premises, while at the same time protecting the revenue, ensuring that beer is properly labeled, and ensuring that proper records are kept. Therefore, the Bureau provides the following guidance regarding the standards that we apply in assessing the qualification and continuing operation of alternating brewery premises.

A discussion follows each of the guidelines to explain TTB policy. Failure by an applicant or a host or tenant brewer to adhere to one or more of these guidelines does not automatically result in the rejection of an application to alternate premises or in the revocation of an existing approved alternate method or procedure. TTB considers all relevant factors to determine whether to approve an application for an alternating brewery arrangement or whether an existing alternating brewery arrangement is consistent with TTB policy and the part 25 regulations.

1. Tenant qualification as a brewer. The tenant brewer must qualify as a brewer with the NRC. In considering the qualifications and proposed operations of the tenant brewer, TTB carefully examines the terms of the agreement between the host and tenant brewer.

A clear indicator of an alternation arrangement is when there is an agreement between a host brewer and a tenant brewer providing for the rental or lease of brewery premises and the equipment with which a tenant intends to produce beer for sale. A "brewing services agreement" may also be used in an alternation arrangement when the tenant is paying the host for certain services relating to the tenant's production of beer. A tenant may pay a host for its employees' services on a per-unit or per-time basis and a tenant may purchase raw materials from the host prior to brewing.

An agreement must not provide for pass-through payments to cover Federal excise taxes (FET). A pass-through is a payment provided in some agreements wherein one of the brewers reimburses the other brewer for the amount of the FET payment. TTB examines the agreement to determine if a host brewer is passing through FET payments to a tenant brewer or vice versa, a practice that may indicate that the host brewer is splitting production of its beer among one or more tenant brewers or that the arrangement is actually contract brewing.

2. Tenant operation as a brewer, not as a party to a contract brewing arrangement. The agreement must indicate that the tenant operates as an actual brewer, rather than engages in a contract brewing arrangement. TTB considers whether the tenant holds title to the raw materials or ingredients prior to brewing. Further, we examine these agreements to determine whether beer is being sold or purchased by either brewer at any stage. TTB may treat the sale of beer by a host brewer to a tenant (or vice versa) during or after production of beer as an indicator of a contract brewing arrangement. Among other factors, TTB considers the following.

Access to host premises. TTB has found that in some agreements for alternating brewery proprietorships, host brewers require tenant brewers to agree to exclusion from brewery premises. If a brewer has no access to the brewery premises, then that person is precluded from actually producing beer and, thus, cannot meet the statutory and regulatory definition of a brewer as a person who produces beer for sale. TTB does not approve alternating brewery arrangements that include as part of the agreement a condition that prohibits access to the brewery premises by the tenant brewer or its employees.

Business plan. In determining whether an applicant is an alternating brewer or is instead entering into a contract brewing agreement, TTB considers the tenant brewer's business history, plans for development of future brewery assets, and level of commitment to the business, that is, investment in the business. Since the applicant is expressing interest in becoming a brewer, we look more favorably toward business plans that contemplate the opening of a brewery and the production of beer than we do toward business plans that only contemplate the marketing of beer. Business plans that are wholly concerned with the marketing of beer indicate a wholesale or contract brewing arrangement and do not indicate that a person is contemplating becoming a brewer and operating a brewery.

Separation and identification of beer. Each tenant brewer's beer must be separate and identifiable from the beer of all other tenants and host brewer at all stages, including prior to fermentation, during fermentation, during cellar storage, and as finished beer after production and before removal from the brewery. TTB has discovered instances when beer produced by different brewers was not segregated at the brewery. In one example, a batch of beer was first brewed and then allocated among various tenant brewers. In a second example, the host brewed and stored beer and, only upon bottling, allocated beer to one or another of the tenant or host brewers. In a third example, beer produced by different tenant brewers was mixed or blended prior to removal from the brewery. In yet a fourth example, leftover tenant beer was returned to the host brewery.

In each of these examples, TTB could not trace in brewery records beer produced by a single brewer from raw materials, to fermentation, to removal from the brewery. Such practices hinder the effective administration of the beer regulations and increase the jeopardy to the revenue. Moreover, these practices make it impossible to distinguish between beer produced by the host and beer produced by one or more tenant brewers. Since it is not possible to segregate production of each tenant brewer, TTB considers all of the above instances as examples of contract beer production by the host brewer. If we discover instances like or similar to those cited above, we consider the beer to be made under contract by the host brewer and the host brewer to be liable for the tax at the applicable rate.

Finally, we view the blending of beer produced by different brewers as constituting the taxable removal of beer from one or more brewery premises to a different brewery. Under section 5051 of the IRC, this action triggers the immediate payment of excise tax on the beer.

Records and reports. The tenant brewer must keep records and submit operational reports, claims, and notices, as required by part 25. As a practical matter, TTB realizes that the preparation of records and reports may be contracted to host brewery employees. While this delegation is permissible pursuant to a power of attorney, TTB expects the tenant brewer to provide any requested brewery records and to be knowledgeable in discussing those records with TTB officers. Since each brewer is ultimately responsible for paying beer taxes, preparing records, and submitting operational reports, TTB believes that the actual tenant brewer must bear responsibility for his or her records and must be able to discuss those records and reports with TTB representatives. See also the paragraph titled "Representation" in item number six below.

Taxpayment of beer. The tenant brewer is responsible for taxpayment of beer at the rate applicable to that brewer. Liability for taxpayment cannot be delegated, although the preparation of tax returns may be delegated to employees of the host brewery pursuant to a power of attorney. TTB further notes that any pass-through of money provided in any agreement between a tenant and host brewer that is intended for the payment of Federal excise tax is a prima facie indication that one brewer is paying the excise tax for the other brewer. TTB considers such practice as an indication of a contract brewing arrangement, rather than an alternating brewery arrangement and assesses tax based on the rate of tax applicable to the larger brewer.

3. Tenant brewer involvement and oversight of brewery operations. The tenant brewer must be materially involved and must exercise oversight over brewery operations. TTB considers a number of factors shown below.

Product development. The tenant brewer must be involved in the development of the beer, whether by hiring a brewmaster, using its own formula, retaining a brewery consultant to develop formulas, or working with the host to develop formulas.

Records. The tenant brewer must maintain completely separate records of brewery operations from those of the host or other tenant brewers, and the records must relate only to the beer produced by the tenant brewer. Records must show the ingredients and materials purchased, the beer produced, the movement of beer throughout the brewery while it is in process, the beer removed from the brewery, the payment of taxes, inventories, and any other operations for which brewery records must be kept. The tenant may contract the preparation of these records to host brewery employees.

Quality control. TTB expects the tenant brewer to establish quality control standards and procedures that relate to the beer he or she produces at the host brewery. The tenant may—

Employ a brewmaster to supervise the production of his or her beer;

Establish procedures for overseeing the testing of the tenant's beer by the host brewer;

Receive samples regularly of his or her own beer for testing and quality control purposes;

Make regular or periodic visits to the brewery premises to oversee production, although the presence of a tenant brewer or tenant brewer representative is not required during the production of the tenant brewer's beer.

Product liability. Since the tenant brewer holds title to any ingredients prior to production and to its beer produced at the host brewery, TTB expects the tenant to be accountable for any risks or loss of beer during production. Accordingly, the tenant must be the party accountable for the actual risk of loss of beer or ingredients.

4. Independent tenant brewer operation. Except in the case of controlled groups of brewers, TTB expects the tenant brewer to operate independently from the host. If the host and tenant brewer operate in concert with each other with respect to brands, formulas, trademarks, marketing, or directed sales of beer to each other or to each other's customers, then TTB may conclude that the alternating brewery arrangement is merely a scheme to split production of beer produced by the larger brewer. In such a case, TTB considers the arrangement to be contract brewing and takes appropriate action, including assessing tax at the full rate and revoking approvals to operate under alternating brewery arrangements. TTB may take any other measure provided under the IRC and applicable regulations.

TTB carefully examines alternation agreements, business plans, formulas, labels and trademarks, and actual brewery operations to determine if the host and tenant brewers are, indeed, independent or if the alternating arrangement is merely a scheme to split the production of beer among brewers, in order to reduce the amount of tax to be paid. Among other factors, TTB considers the following.

Production. TTB expects the tenant to direct the production of beer at the host brewery. This means that the tenant should have customers or anticipate having customers to whom beer is to be sold. This also means that the tenant should receive orders from customers on which to determine the scheduling and amount of beer to be produced. This does not mean that the tenant must actually schedule beer production, but rather that the tenant provide input about the amount of beer to be produced based on orders or anticipated needs.

Marketing. TTB expects the tenant to have customers for whom the tenant is producing beer for sale and to market the beer separately and independently from the marketing of beer by the host or any other tenant brewers. We look unfavorably on applications for alternate methods of operations or procedures or on ongoing brewery alternations when the tenant brewer produces beer for a wholesaler owned or controlled by the host brewer or when the tenant produces beer for sale to a wholesaler on behalf of or at the direction of the host brewer.

Restricting production relocation. An independent brewer may produce beer at any suitable location. TTB does not approve an alternating arrangement that does not permit the tenant brewer to move production of its beer to another facility. If a tenant brewer is contractually prevented from moving production of beer to another facility, TTB considers the host and tenant brewers to be operating as a controlled group of brewers. We do not object to the contractual use of a brewery facility by a tenant brewer for a specified and limited period of time, but we do closely examine any agreement that limits or prevents the tenant from moving production to another facility.

5. Formula and label issues. TTB examines the labels, trademarks, trade names, and formulas used by tenant breweries.

Use of identical or similar labels, brand names, trademarks, or trade names. We believe the use of identical or substantially similar labels, brand names, trademarks, or trade names by a tenant brewer and a host brewer at the host brewery premises may be evidence of a contractual agreement wherein the tenant brewer is producing beer for the host brewer. If this practice results in the splitting of production of the host brewer among one or more tenant brewers, TTB views the arrangement as contract production of beer by the host brewer and determines whether the payment of tax on such beer should be at the rate applicable to the host brewer.

Sale or assignment of labels, brand names, trade names, or trademarks. Similarly, TTB examines the sale or assignment of labels, brand names, trade names, or trademarks to a tenant brewer by the host brewer. The sale or assignment of such property may indicate an attempt to move production from the host to the tenant brewer or to split production of the host brewery among one or more tenant brewers. TTB examines the use of such labels, brand names, trade names, or trademarks and takes appropriate corrective action under the IRC and applicable regulations when such action appears to be an attempt to split the production of the host brewer's beer among tenant brewers. TTB exercises great care to examine sales when the host brewer retains the right to reacquire or take back a label, brand name, trade name or trademark, since this action suggests that the tenant brewer might not be operating independently from the host brewer.

Formulas. TTB examines formulas for beer produced by tenant brewers. Our concern regarding formulas is similar to that outlined above, that is, whether the tenant is operating independently from the host or whether the host is actually engaging in contract beer production. If we determine that the formula for beer produced by the tenant brewer is identical to that for beer produced by the host brewer or by other tenant brewers, we may consider that fact to indicate contract beer production by the host. However, we take into account all factors as previously outlined. For example, although a tenant's formula for beer may be identical to that of the host, if the beer brands, labels, trademarks, and marketing plan indicate a completely separate marketing arrangement, then TTB may not consider the use of identical formulas to be indicative of a contract brewing arrangement.

Additional alternating brewery arrangement conditions

Representation. In the event that TTB conducts a conference with a tenant brewer, we require the presence of that tenant brewer. TTB does not allow the host brewer or its representative to appear at a conference on behalf of a tenant brewer. We do not object to a representative of the host brewer being present and giving advice to the tenant brewer at such a conference.

Prepayment status. Because of potential jeopardy to the revenue, TTB does not approve any new alternating brewery arrangements when the NRC has placed the host brewer in prepayment status. We do not require that existing tenant brewers terminate agreements at such host breweries.

Similarly, we do not approve the participation of a tenant brewer at any alternating brewery premises, if the prospective tenant is currently in involuntary prepayment status at another location. In the event that TTB places a tenant brewer on prepayment status at any of its locations, we revoke any approved authorizations granted to the tenant, since we consider involuntary prepayment status to jeopardize the revenue.

Limit on tenant brewers. In order to not hinder the administration of 27 CFR part 25 or jeopardize the revenue, TTB reserves the right to limit the number of tenant brewers operating at the premises of a single host brewery.

Use of host brewery employees. Host brewery employees may engage in the production of beer at the brewery on behalf of the tenant. TTB recognizes that a tenant brewer may not find it practical or desirable to provide his or her own employees or brewmaster at the host brewery and does not expect use of tenant employees for beer production when this function is part of the agreement with the host. Exact terms and compensation must be specified in the agreement. Hourly compensation or a monthly rental may be provided, or the employees' cost may be part of a broader provision in the agreement that specifies the terms between host and tenant.

TTB approval and compliance policy

We continue to evaluate each application to operate an alternating brewery premises on its individual merits, based on factors that include the physical layout of the brewery premises to be shared, the compliance and business history of each applicant, and the likelihood that the alternation will take place without administrative difficulty or jeopardy to the revenue. We continue to review alternating brewery arrangements to ensure that brewers who pay the reduced tax rate are entitled to do so. We may instruct brewers to adjust their taxes if we find the reduced tax rate was applied in error and we do enter tax assessments when necessary.

Presently the sole official authorized to approve applications for alternating proprietors is the Director, NRC. The Director, NRC, uses the guidelines set forth in this Circular and applies them uniformly in evaluating applications for alternating brewery proprietorships. The Director, NRC, uses these guidelines collectively and not individually to determine whether to approve an application for an alternative method or procedure to permit operation of an alternating brewery premises.

This Circular serves as a restatement and clarification of TTB policy with respect to qualification and operation of alternating brewery proprietorships. Because we realize that we have not always effectively communicated our policy, we provide time for existing host and tenant brewers to come into full compliance. However, we will apply this policy to new applications for alternating brewery proprietorships that are pending on or received after the date of publication of this Circular.

TTB affords existing qualified brewers who alternate premises an interim period, from the date of this Circular through August 31, 2006, to come into full compliance with TTB policy outlined in this Circular. As of September 1, 2006, TTB field personnel will apply the policies contained in this Circular when they conduct field audits and investigations. If appropriate, TTB plans to assess taxes at the full rate or to take other appropriate administrative action when we determine that:

Brewers are not operating independently;

Alternating brewery agreements are merely contract brewing arrangements; or

Brewers have engaged in other actions that do not support their claimed eligibility to pay taxes at a reduced rate.

During the interim period referred to above, TTB intends to conduct field audits and investigations of alternating brewery proprietors in accordance with policies in existence at the time that we approved the alternation arrangements and to look at the operations of host and tenant brewers as outlined in existing agreements. TTB plans no tax assessments or other administrative actions against brewers who have received authorizations to operate and are operating in accordance with those existing agreements and the provisions of part 25. TTB does plan, however, to assess taxes, rescind approved alternate methods of operations or procedures, and take necessary administrative actions under the IRC and applicable regulations, during the interim period if the existing qualification or operation of the host or tenant brewer violates the conditions of existing approved alternate methods of operations or procedures.

Rescission of existing alternate methods and resubmission of alternating brewery proprietorship applications

In order to continue to be qualified and authorized to operate as an alternating proprietor at a brewery premises, all alternating proprietors must resubmit for approval their applications for alternative methods of operation under 27 CFR 25.52(a) by September 1, 2006. These include applications under 27 CFR 25.52(a) to alternate premises, to conduct other business on brewery premises (alternating brewery proprietorship), to prepare or store records and reports for another brewer, and to conduct any other activity that allows or expedites the operation of alternating brewery premises.

We require applicants to submit along with these applications a copy of the agreement between the host and tenant brewer. We also require tenant brewers to submit copies of their brewery business plans. Host brewers and tenant brewers must submit applications and other information for all locations at which they alternate premises with other brewers. It is not necessary to resubmit brewer's notices, brewer's bonds, qualifying documents, environmental forms, or other documents if TTB already has them and the information contained in them has not changed.

We will evaluate these requests under the guidelines contained in this Circular, and we will approve requests for alternating brewery proprietorships when the qualification and operations will be in accord with these guidelines.

Alternating brewery proprietors who do not resubmit their applications under 27 CFR 25.52(a) for alternate methods of operations, or whose applications do not meet the guidelines in this Circular, will not have an approved alternate method of operation as of September 1, 2006. Although such brewers may have approved brewer's notices and bonds, as of that date they must operate according to all the regulatory requirements of 27 CFR Part 25, especially as to filing brewer's notices to alternate premises, using their own employees to prepare records and submit reports, storing records on their own portion of brewery premises, and complying with all other requirements contained in part 25.

We anticipate that the NRC will require at least one month to evaluate and approve each application, and we advise brewers to apply as early as possible in order to be assured that they will have approval to operate as of September 1, 2006. The NRC will respond to questions and inquiries concerning applications for alternating brewery proprietorships and will provide any necessary assistance in helping alternating brewery proprietors submit their applications.

Future TTB action

TTB expects to engage in future rulemaking on the subject of alternating proprietors at breweries and plans to include appropriate transition rules. Any final rule issued on this subject supersedes this Circular.

Questions

If you have questions concerning this Circular, contact the Supervisor, Brewery Applications Group, National Revenue Center, 550 Main Street Suite 8002, Cincinnati, Ohio 45202; Telephone 877-882-3277.

Signed by John Manfreda

Administrator

APPENDIX B

Sample Alternating Proprietorship Application

(Example #1) Filed by Host Brewery

Department of the Treasury
Alcohol and Tobacco Tax and Trade Bureau
8002 Federal Office Building
550 Main Street
Cincinnati, OH 45202

Re: Application to Use Brewery for Other Purposes

TTB Representative:

On behalf of __(Host Brewery)__ and pursuant to 27 CFR 25.23(c), "Restrictions on Use - Application", we respectfully submit this application to use the _(Host Brewery)_ brewery for a purpose other than those listed in Section 25.23(a) with respect to the alternating proprietorship between _(Tenant)_ and _(Host Brewery)__ at _(Host Brewery Location Address)__.

27 CFR 25.23(b) provides that a brewery may be used for other purposes that are reasonably necessary to realize the maximum benefit from the premises and equipment and reduce the overhead of the brewery. In order to utilize our brewery to its maximum benefit, we have entered into an alternating proprietorship with Applicant. In connection with the alternation, __(Tenant)__ is required to maintain its records at its premises. Consequently, __(Tenant)__ will be utilizing a location at _(Host Brewery)_ premises for retention of its records. Such location will be permanently alternated to _(Tenant)__. In addition, _(Host Brewery)_ employees will be preparing the required records for __(Tenant)__ on the premises of _(Host Brewery)_, pursuant to powers of attorney from __(Tenant)__.

We request that this alternate method of operation to use a certain portion of our premises for retention of records by _(Tenant)__ and for our employees to prepare records for __(Tenant)__ be approved. Such use by __(Tenant)__ will ensure accurate record keeping by __(Tenant)__ and _(Host Brewery)_, and will provide a centralized location for inspection of the records by TTB. Consequently, such use will not impede effective administration of regulations and will not jeopardize revenue interest.

We understand that approval of the above request for an alternate method of operation may be rescinded at any time should TTB determine that there is administrative difficulty or jeopardy to the revenue.

Sincerely,

(Example #2)

Filed by both the Tenant & Host Breweries

Department of the Treasury
Alcohol and Tobacco Tax and Trade Bureau
8002 Federal Office Building
550 Main Street
Cincinnati, OH 45202

Re: Request for Alternate Method of Operation - Change in Premises

Gentlemen:

On behalf of ____(Filing Brewery name) __ and pursuant to 27 CFR 25.52 "Variation from Requirements", we respectfully request approval of an alternate method of operation from that prescribed at 27 CFR 25.78, "Change in Premises," with respect to the alternating proprietorship between _(Tenant)_ and _(Host Brewery)_ at _(Host Brewery Location Address)_.

Specifically, the __(Filing Brewery)__ requests approval of an alternate method of operation from the requirement that an amended Form 5130.10 be filed with the Director, National Revenue Center for approval upon each alternation. Rather, __(Filing Brewery)__ requests that it be allowed to use its records of the brewing and packaging process, which will be generated upon each alternation, as notice of the alternation. The daily records generated will accurately reflect the date and time of each alternation. These records will be readily available for inspection by TTB officers.

__(Filing Brewery)__makes this request due to the on-going nature of the brewing process and the inability to determine the exact time that a specified piece of equipment or area will be alternated; it would be impracticable for __(Filing Brewery)__ to obtain prior approval for each alternation. Furthermore, the brewing process for one batch will result in a different piece of equipment or area being alternated either hourly or daily. It would be impracticable for __(Filing Brewery)__ to file an amended Form 5130.10 every hour or day during the brewing process.

We request the above alternate method of operation be approved since such approval will not impede effective administration of regulations and will not jeopardize the revenue. The Applicant's and Host records will be readily available for inspection by TTB officers. In addition, even though amended Form 5130.10 will not be filed, the daily records and monthly records will accurately reflect the amount of beer on which federal excise taxes must be paid. Finally, no provision of law will be violated by the use of the daily records as notice of alternation.

We understand that approval of the above request may be rescinded at any time should TTB judge that there is administrative difficulty or jeopardy to the revenue.

Sincerely,

(Example #3)

Filed by Tenant Brewery

Department of the Treasury
Alcohol and Tobacco Tax and Trade Bureau
8002 Federal Office Building
550 Main Street
Cincinnati, OH 45202

Re: Notice of Alternation

Gentlemen:

(Tenant Brewer) is establishing an alternating proprietorship at _(Host Brewery)_ located at _(Address/City/State)_. The Brewer's Notice and related documents, including an enforceable Bond and Consent of Surety (if required), have been submitted.

The purpose of this letter is to provide you with the following information with respect to the alternation:
•The name of the brewery is ________, a (State) corporation/LLC (as applicable). ________ has filed a qualification to do business in _(State).

•We estimate that we will brew no more than _______ barrels in the first year of alternation.
•Upon approval of the pending Brewer's Notice, we will file a certificate of label approval with TTB for any brands produced under the alternation. Prior to production, we will file a formula with TTB for any specialty products to be produced.

•The alternation will be simultaneous with __(Host Brewery)__ operations as described in the Brewer's Notice.
•All packaged products will be identified in a segregated bay at _(Host Brewery or other location)_ warehouse for pick-up by our wholesalers.

•All brewing and packaging daily records and reports will be kept at a location permanently alternated to us at _(Host Brewery)_ premises for inspection by TTB officers. We will prepare and file separate brewer's reports of operations and separate excise tax returns.

All of the above information has been incorporated into the pending Brewer's Notice.

We have received and read TTB Industry Circular 2005-2, Alternating Proprietors at Brewery Premises. Tenant certifies that (check one):
•__(Tenant Brewery)_ is not a member of a controlled group of breweries as defined in 27 CFR 25.152(b)(1) in which the host brewery, __(Host Brewery)_ is a member. The guidelines contained in Industry Circular 2005-2 apply to Tenant and are incorporated into this request for an alternate method of operation.

OR
•_(Tenant Brewery)_ is a member of a controlled group of breweries as defined in 27 CFR 25.152(b)(1) in which the host brewery _(Host Brewery)__ is a member.

We request approval to proceed with this alternation.

Sincerely,

EXAMPLE #4

Optional – Tenant will fill out only when Host will be providing recordkeeping for applicant

Department of the Treasury
Alcohol and Tobacco Tax and Trade Bureau
8002 Federal Office Building

550 Main Street
Cincinnati, OH 45202

Re: Variance Request - Recordkeeping

Gentlemen:

On behalf of __ (Tenant Brewery)__ and pursuant to 27 CFR 25.52 "Variation from Requirements", we respectfully request approval of an alternate method of operation from that prescribed at 27 CFR 25.300(a), "Retention and Preservation of Records - Place of Maintenance," with respect to the alternating proprietorship between (Tenant Brewery)_ and _(Host Brewery)_ at _(Address/City/State)_.

27 CFR 25.300(a) provides that records required under Part 25 must be prepared and kept by the brewer at the brewery where the operations or transaction occurs. In connection with the alternation, _(Host Brewery)_ employees, under power of attorney from _(Tenant Brewery)_ will be preparing records for us. It would be impracticable for us to hire new employees to prepare records for our infrequent operations at the _(Host Brewery)_ brewery. Furthermore, our records will be prepared by extracting information from the regularly kept records by _(Host Brewery)_. When such records are prepared, the _(Host Brewery)_ employees will in all likelihood be present on the _(Host Brewery)_ premises. The records will, however, be maintained and available for inspection by TTB officers at a permanent non-alternation _(Tenant Brewery)_ location.

We respectfully request the above alternate method of operation be approved since such approval will not impede effective administration of regulations as the our records will at all time be maintained and available for inspection by TTB officers at the _(Host Brewery)_ premises. In addition, because this request is sought to enhance accurate record keeping for __(Tenant Brewery)__, such approval will not jeopardize the revenue. Finally, such approval is not in violation of any provision of law.

We understand that approval of the above variance may be rescinded at any time should TTB determine that there is administrative difficulty or jeopardy to the revenue.

Sincerely,

Entity Selection, Formation and Finance Specific to Breweries and Distilleries

Submitted by Benjamin Klassen

Craft Beer, Distillery and Liquor Law: The Ultimate Guide

(Entity Selection, Taxation, Governance, and Fundraising)

Benjamin Klassen

Winthrop & Weinstine, P.A.

I. Entity Selection, Formation and Finance Specific to Breweries and Distilleries

A. LLC vs. Corporation

- A business organization is governed by both the laws of the jurisdiction in which it organizes and the laws of all jurisdictions in which it conducts business. This section is an introduction to the major concepts a brewery or distillery may face upon organization and should not be relied upon for any particular jurisdiction.
- An entrepreneur must first decide under which entity type it will operate. Most likely, the choice will come down to LLC, S-Corp, or C-Corp.
- There are many factors to consider when choosing an entity type, including liability, raising capital and control, and taxation.

1. Limited Liability Company (LLC)

a. **Governing Law**: Governed by state statute. The affairs of an LLC are governed predominantly through its various governance documents. The most prevalent governance document is the operating agreement, which defines the rights and duties of the LLC's members.

b. **Formation**: File articles of organization with the proper state office, typically the Secretary of State. The required articles typically include the name of the LLC, the LLC's in-state address, and its organizer(s).

c. **Management**: Owners are called members. An LLC can have one or more members. The LLC can be member-managed, which means that its members perform the day-to-day management of the company, or it can be manager-managed, wherein managers control the management and governance of the company. In Minnesota, the LLC can also be board-managed, where there are one or more governors who designate officers to act for the LLC who have limited authority granted by the board. This structure is similar to a corporation.

d. **Capital Contributions**: An LLC can receive capital contributions by any and all of its members, in the form of any consideration, such as money, real property, personal property, or services for the company. Members should track their contributions to establish a tax basis in their membership interest.

e. **Pass Through Taxation Benefits**: Unless it chooses otherwise, an LLC is taxed as a partnership, also referred to as a pass-through entity, which means that the taxation of income or loss passes through to the LLC members based on each member's individual ownership interest. However, the members are taxed for their share of profit or loss regardless of whether or not they received any actual cash distributions in that tax year. Note: an LLC may elect to be taxed as an S-Corporation, which may be beneficial when an owner is also an Employee of the enterprise. Technically C-Corporation taxation is also possible.

f. **Limited Personal Liability**: LLCs are entities distinct from their members. Members are not personally liability for the obligations and debts of the LLC beyond their initial capital contributions, provided that corporate formalities are observed by the members.

g. **Flexibility**: LLCs can be tailored to meet nearly any situation and are the entity type we see most commonly used by alcohol industry members in our practice.

2. **Corporation: C-Corporation and S-Corporation**

   a. **Governing Law**: C-Corporations and S-Corporations are distinct IRS tax designations; however, both are corporations formed and governed under the same state statutes. Most states have well-developed case law to interpret statutes governing corporations.

b. **Formation**: Formed by filing of Articles or Certificate of Incorporation (state dependent) with the appropriate state office, usually the Secretary of State. Bylaws and other agreements among shareholders specify the rights and duties of a corporation's shareholders and how the corporation is to be governed.

c. **Management Structure**: Corporations have shareholders, directors and officers. Shareholders are the owners of the corporation and elect the board of directors, who oversee and direct its affairs and decision-making. The board of directors elect officers who manage daily business affairs.

d. **Liability Protection**: Shareholders are not personally liable for any debts or obligations beyond the amount of capital they have contributed to the corporation, except in rare cases, usually involving fraud, when the "veil" against shareholder liability may be pierced by claimants.

e. **Corporate Formalities**: Corporations are subject to more formalities of management and governance than LLCs, such as adopting and adhering to bylaws, issuing stock, holding shareholder and director meetings, filing annual reports, paying annual fees, maintaining bank accounts and insurance separate from those of the shareholders and never commingling company funds with shareholders' personal funds.

f. **Taxation**: S-Corporations and C-Corporations are taxed quite differently.

   (1) **C-Corporations**: Separately taxable entities. C-Corporations are subject to tax at the corporate and shareholder level. Profits are taxed at a corporate rate and face the possibility of double taxation when corporate income is distributed to business owners as dividends, which are considered personal income. However, if the corporation does not distribute earnings to shareholders during a tax year, the shareholders are not taxed individually on corporate earnings.

(2) **S-Corporations**: Pass-through taxation similar to an LLC. S-Corporations do not pay income tax at the corporate level. The profits/losses of the business are instead "passed-through" the business and reported on the owners' personal tax returns. Any tax due is paid at the individual level by the owners.

g. **Corporate Ownership Restrictions**: C-Corporations have no restrictions on ownership, but S-Corporations do. The S-Corporation must meet certain characteristics such as:

(1) it cannot have more than 100 shareholders;

(2) its shareholders must be individuals;

(3) its shareholders must be citizens or residents of the United States;

(4) it must be organized in the United States; and

(5) it can only issue one class of stock.

C-Corporations therefore can provide more flexibility than S-Corporations when starting a business—especially if the business wants to raise money from investors. If the business plans to grow, expand ownership and/or eventually sell to sophisticated buyers, a C-Corporation may be preferential despite generally having higher taxation to owners (even after passage of the 2017 Tax Act).

B. Tax Considerations

1. **LLC**: May be taxed as:

a. a disregarded entity (if it has only one member). No tax return will be prepared or filed for the entity and all profit or loss will be reported as the sole member's individual return. The member experiences complete pass through taxation. The member gets taxed on all profits based on tax bracket, whether distributed or not; or

b. a partnership. While an entity level return is prepared for the company, all profit and loss is passed thru-to members. The members get taxed on all profits based on their tax bracket and ownership interest, whether distributed or not; or

c. an S-Corporation. Similarly to taxation of partnership profit and loss, an S-Corporation's profit or loss is passed through to owners, regardless of whether cash distributions have been made.

d. a C-Corporation. The company may retain earnings from year to year, and members avoid being taxed regardless of a distribution. However, profits are taxed at the entity level and again when distributed to owners.

2. **Corporation**

   a. **C-Corporation; Double Taxation**: Taxed at the entity level as well as shareholder level, who each get taxed individually for any distributions received from the corporation.

   b. **S-Corporation; Pass Through Taxation**: Shareholders are only taxed individually.

3. **LLC vs S-Corporation (Flexibility vs. Self-Employment Tax)**: Business owners need to consider that taxable income in an LLC is subject to self-employment tax for owners who work in the business.

   a. **Self-Employment Tax**: As a new business begins to generate income, owners may find tax advantages in their entity being taxed as an S-Corporation. Owners of LLCs who actively work in the business will pay self-employment tax (related to Medicare and Social Security) on all guaranteed payments and their distributive share of partnership income, regardless of whether such income is actually distributed. IRS rates on self-employment income range from approximately 15-16%.

   b. **CPA**: The above is a perfect example of why a business absolutely should utilize a good CPA from early on. A smart CPA can set a business on the right track from day one, assist in setting up payroll and other accounting mechanisms and procedures, and prepare business and personal tax filings in a manner most efficient for both the business and its owners.

4. **Changes from 2017 Tax Act.**

a. **Reduced Corporate Rate**. The federal income tax rate on corporate earnings decreased from 35% to 21% beginning with the 2018 tax years, and the corporate AMT was eliminated. The deduction applied to dividends received by a corporation was reduced (from 85% to 60% for subsidiaries and from 70% to 50% for others).

b. **Flow-Through Entities: Business Income Deduction**. Owners of certain, qualified businesses are entitled to a 20% deduction on income passed-through to the owner. Effectively (and assuming no other income) an owner will be taxed on only 80% of the income passed-through from the company to owners. Overall, tax treatment of a flow-through entity will still be most likely more favorable than tax treatment of a C-Corporation (at least for qualified businesses).

(1) Breweries and distilleries will qualify for the Section 199A Business Income Deduction.

C. **Structuring, Management and Governance**

1. **Management**

a. **LLC/Corporation**: States may require an LLC or, more often, a corporation to have certain designated officers to assist in the company's day-to-day operations. These officer positions may be held by one or more of the company's owners, but can also be held by a non-owner. Officer positions may also often have statutorily-defined duties that can be general to each officer or specific to a particular position, but can be altered with approval of the members or shareholders through the operating agreement or otherwise. The officers must carry out their duties in the best interests of the company and its owners.

(1) **LLC**: Can be managed by its members, designated managers, or board of governors. Managers and members of the board of governors can, but are not required to, be members of the LLC.

The individuals responsible for the management of the LLC may also delegate their authority to officers, such as the president, vice president, secretary, or treasurer. The operating agreement should establish how managers, governors, and officers are elected/appointed, and removed, as well as what their duties and roles are. Governors and Managers must act in the best interests of the company.

(2) **Corporation**: Management of a corporation is vested in the board of directors. The board of directors are elected/appointed by the shareholders and serve the interests of the corporation above all else, but may also consider the interests of the corporation employees and shareholders, among other matters.

- **Closely Held Corporation**: Generally, the shareholders will serve on the board, but this is not required.

2. **Fiduciary Duties**: Individuals responsible for management and operations of a company are generally required to adhere to the duty of care, duty of loyalty, and duty of good faith in discharging their duties on behalf of the company. If such individuals fail to perform these duties, they may be liable to the company and its owners.
   a. **Duty of Care**: A legal obligation which is imposed on an individual requiring adherence to a specified standard of reasonable care while performing any acts that could foreseeably harm the company.
   b. **Duty of Loyalty**: A legal obligation which requires fiduciaries to put the corporation’s interests ahead of their own. Corporate fiduciaries breach their duty of loyalty when they divert corporate assets, opportunities, or information for personal gain.
   c. **Duty of Good Faith**: A general presumption that the parties to a contract will deal with each other honestly, fairly, and in good faith, so as to not destroy the right of the other party or parties to receive the benefits of the

contract. It is implied in every contract in order to reinforce the express covenants or promises of the contract.

3. **Corporate Formalities for LLC/Corporation**: Must observe certain formalities in order to maintain the limited liability shield extended to its members/shareholders.

    a. **Piercing the Corporate Veil**: The legal standard for extending personal liability varies by state, but the following suggestions help maintain the limited liability shield after forming a limited liability entity like a LLC or corporation:

        (1) Ensure the entity is sufficiently capitalized;

        (2) Document any payments to the legal entity from the owners as either paid-in-capital or loans;

        (3) Do not commingle personal and business funds;

        (4) Do not pay owners in cash;

        (5) Owners should never use the business's cash or assets for personal use or pay personal bills with company funds;

        (6) All of the entity's taxable income should be reported on the entity's tax returns, if applicable, and tax returns should be filed promptly;

        (7) Shareholders who are actively involved in the business should receive a "reasonable" pre-determined wage or salary for their services;

        (8) All payments to shareholders should be clearly documented as being wages, expense reimbursements, or profit distributions;

        (9) All expenses paid to shareholders should be reflected in formal expense reimbursement reports, backed up by appropriate receipts and invoices;

        (10) Owners should not receive "profit distributions" if the entity is insolvent;

(11) All creditors should be paid regularly before distributing any profits;

(12) Any purchase of property, computers, equipment, etc. from shareholders should be at commercially reasonable prices and terms and documented in formal written agreement;

(13) Obtain appropriate insurance for the type of business in question;

(14) Prepare appropriate bylaws, operating agreements, etc.;

(15) Hold annual meeting of directors, shareholder, or members and prepare the minutes in a corporate minute book, which should reflect major corporate transactions;

(16) Hold elections and appoint officers and directors for the entity;

(17) Obtain federal and state tax identification numbers;

(18) Obtain sales tax exemption certificates;

(19) Issue share certificates to owners (if corporation);

(20) File annual registration statement with Secretary of State to remain in "good standing" if the state law requires it;

(21) Sign all contracts, agreements, purchases, plans, loan, investments, and accounts in the name of and on behalf of the entity;

(22) Train officers and directors how to sign contracts, purchase orders, and agreements on behalf of the entity;

(23) Register all "assumed names" being used by the entity;

(24) Use the official corporate name on all letterhead, business cards, marketing materials, coupons, websites, etc. to clearly notify third parties that the business has limited liability;

(25) If possible, run the business profitably and pay dividends/profit distributions to the owners periodically; document the same;

(26) Avoid entering into transactions or incurring debts when the company is insolvent;

(27) Avoid having the dominant owner siphon funds from the business;

(28) Ensure that all officers and directors have a meaningful voice in the business, participate in decision-making, and periodically meet and vote on major corporate decisions;

(29) Avoid using the corporation merely as a façade for individual dealings.

D. Drafting and Negotiating Formation/Governance Agreements

1. General Governance Documents

a. Drafting formation agreements is very important for memorializing the rights, responsibilities, and expectations of business owners, officers, managers, and/or board members.

b. Governance documents often dictate the decision making process, profit and loss allocations and distributions, fiduciary duties, conduct and procedures for meetings, delegation of officer positions and duties, as well as provisions restricting the transferability of interests in the business (membership interests in an LLC, or shares in a corporation).

c. A few examples of such agreements: operating agreement, partnership agreement, shareholder agreement, buy-sell agreement, and bylaws.

2. Additional Brewery/Distillery Provisions

a. Include provisions that require—or representations and warranties that express the ability of—proposed members, shareholders, directors or officers to pass and maintain compliance with the appropriate TTB background check process, state background check processes, and other requirements to obtaining or maintaining any form of liquor related license or permit (federal, state, or local) the business reasonably believes it may require.

b. If an owner does not meet any of the above standards, or fails to maintain them, the governance documents can establish procedures to terminate the relationship with the individual, including a forced buy-out of the owner's interest in the company.

E. Capital Raising, Crowdfunding, and Other Financing Methods

1. Current Regulatory Landscape and Key Definitions

a. **Generally**: Nearly every means by which a company raises capital involves securities laws. These laws regulate the manner in which securities are sold, the amount of money that may be raised, the persons to whom the securities may be offered, and the method by which investors may be solicited.

b. **Federal Registrations and Exemptions**: As a general rule, in order to comply with Federal securities laws, a person selling a security must either:

(1) "register" such sale with the Securities Exchange Commission (SEC) or

(2) identify a specific exemption that allows such sale to be conducted without registration.

- SEC registration is time consuming and expensive.
- For most small businesses, SEC registration is not a feasible option.

c. **State Blue Sky Laws**: In addition, an issuer selling securities must adhere to blue sky laws in each state where the securities are being sold, all of which vary from each other.

2. Private Placements

a. **Section 4(a)(2)**: The most common federal exemption entrepreneurs rely on is Section 4(a)(2) of the Securities Act, which exempts "transactions…not involving any public offering" - i.e., a **private placement**. A company seeking to determine whether an offering will be exempt from registration under Section 4(a)(2) will need to evaluate a number of factors which, although routinely addressed by courts, seldom lead to a definitive answer as to whether an offering is a "public offering" under Section 4(a)(2). Different courts emphasize different factors critical to the Section 4(a)(2) exemption, no single one of which necessarily controls. The factors are guidelines, and include:

(1) Offeree qualification (i.e., whether the investors are sophisticated);

(2) Manner of the offering (i.e., whether the company will engage in advertising or other promotional activities);

(3) Availability and accuracy of information given to offerees and purchasers (i.e., whether the people to whom the company proposes to sell securities have access to basic financial information about the company);

(4) The number of offerings and number of purchasers (i.e., whether the company solicited investment from a large group of people); and;

(5) Absence of intent to redistribute (i.e., whether the people to whom the company proposes to sell securities have an intention to hold the securities for investment purposes - generally for a minimum holding period of 24 months).

b. **Regulation D**: The SEC provides a clear set of "safe harbor" rules that issuers can follow to ensure that they are conducting a valid private placement under Section 4(a)(2). The most common safe harbors that small companies have customarily relied upon in conducting private placements are Rule 504 and Rule 506.

(1) **General Solicitation:** Rule 502(c) provides that "neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

(i) any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and

(ii) any seminar or meeting whose attendees have been invited by any general solicitation or advertising." In general, this means that issuers will need to have a substantial pre-existing relationship with a potential investor before making an offer of securities under Rule 504 or Rule 506(b).

(2) **Accredited investor**: Under Rule 501(a), an accredited investor is a person who meets certain qualifications and, therefore, is deemed able to protect himself or herself in making investment decisions without additional protections under the securities laws, such as those obtained through the SEC registration process and the public disclosure of information about the company that is made through the process of becoming an SEC reporting company. There are several ways to qualify as an accredited investor with the most common being:

(i) an individual with at least $200,000 (or $300,000 jointly with a spouse) in annual income over the past 2 years or at least $1 million in net worth (excluding the value of a principal residence); or

(ii) an entity in which all of the equity owners are accredited investors or the entity has at least $5 million in net assets.

3. The "Old Rules" For Raising Capital

a. Rule 504: Generally speaking, Rule 504 allows companies to raise up to $5 million from accredited and non-accredited investors (subject to counterpart state Blue Sky registrations and exemptions). Companies are not permitted to engage is general solicitation except for in states where the securities have been registered or states that provide an exemption from registration that allows the company to generally solicit.

(1) **State law counterpart - Limited Offering Exemption**: Most states have a "limited offering" exemption that is often relied on by companies who are conducting Rule 504 offerings. Normally, sales by a company to no more than 35 non-accredited investors (and an unlimited number of accredited investors) during any 12 consecutive months are exempt from registration.

b. **Rule 506**: Rule 506 is the most common "safe harbor" relied on by companies conducting private placements. Generally speaking, Rule 506 allows an issuer to raise an unlimited amount of capital from an unlimited number of accredited investors and up to 35 non-accredited investors. However, if even one non-accredited investor becomes a purchaser in the offering, then the company must provide all investors with a very detailed disclosure document that satisfies other SEC requirements, including audited financial statements. For this reason, the practical reality is that Rule 506 offerings are usually restricted to accredited investors only.

   (1) **State law counterpart**: Securities issued in reliance on Rule 506 are considered Federal "covered securities" and the offer and sale of such securities are exempt from registration as long as the issuer complies with state blue sky laws, which often includes a notice filing. Most states permit Rule 506 notice filings through NASAA's Electronic Filing Depository.

4. **The “New” Rules: Jumpstart Our Business Startups (JOBS) Act**: On April 5, 2012, Congress passed the JOBS Act in an effort to foster job growth by modernizing Federal securities laws. The JOBS Act consisted of three key parts that are relevant for securities crowdfunding:

   a. **Title II and Rule 506(c) - Advertising to Accredited Investors**: In late 2013, the SEC (pursuant to the authority granted to it under Title II of the JOBS Act), finalized new Rule 506(c) which allows companies to generally solicit (or advertise) their securities offerings so long as all of the investors who purchase securities in the offer are accredited. This means that companies may now discuss their offerings in public seminars, send out email blasts, push offering information out on social media sites, as well as run ads on TV, radio, and the internet. While companies who comply with Rule 506(c) are now free to talk about their offering to whomever they want (including non-accredited investors), companies who generally solicit under Rule 506(c) may only sell the securities to accredited investors.

(1) **Verification Steps**: Using Rule 506(c), however, comes with certain additional compliance requirements. Companies must take additional steps to verify that all purchasers are accredited. In Rule 506(c), the SEC listed several non-exclusive methods that are deemed to satisfy the verification requirements (provided that the issuer does not have knowledge that the purchaser is non-accredited). The "safe harbors" include:

(i) Income verification by checking federal tax forms, including W-2's and tax returns, and a statement by the investor that he or she expects enough income in the current year to remain accredited;

(ii) Net worth verification by checking a recent credit report (with the past 3 months) and bank or investment account statements, together with a written representation from the purchaser that he or she has disclosed all liabilities necessary to make a determination of net worth; and

(iii) Certification of accredited investor status by a registered broker-dealer, SEC-registered investment advisor, licensed attorney, or CPA who has verified the purchaser's accredited investor status.

Comparison of Rules 504, 506(b), and 506(c)

	Rule 504	Rule 506(b)	Rule 506(c)
How much money can I raise?	Up to $5M	Unlimited	Unlimited
Can I advertise the sale of my securities?	No, unless coupled with a state exemption or registration that allows advertising.	No.	Yes.
To whom can I sell securities?	Anyone However, counterpart state exemptions or registrations may impose additional restrictions on number of non-accredited investors.	Unlimited number of accredited investors Up to 35 non-accredited investors if you believe they are "sophisticated" and disclosure requirements are met.	Unlimited number of accredited investors
Do I have to comply with the SEC's formal information delivery requirements?	No, but counterpart state exemption or registration may impose additional requirements.	No, if only accredited investors are included Yes, if any non-accredited investors are included	No.
Do I have to verify that any accredited investors are truly accredited?	No, accredited investors can "self-certify."	No, accredited investors can "self-certify."	Yes, you must take "reasonable steps" to verify that the investors are, in fact, accredited.

b. **Title III "retail" crowdfunding and Regulation CF**: Title III of the JOBS Act was meant to democratize the business funding process by allowing non-accredited individuals the opportunity to participate online and invest into private companies. The SEC delayed releasing final rules for years, and the system finally went live in May 2016. Issuers must comply with multiple requirements and limitations, namely:

- Issuer may only raise up to $1M ($1,070,000) in any 12 month period.

- Individual investor limits:
    - If the investor's annual net income OR net worth is < $100k, then the investor may invest the greater of: (a) $2,000; or (b) 5% of the investor's annual income or net worth.
    - If the investor's annual net income AND net worth is > $100k, then the investor may invest 10% of the investor's annual income or net worth
- Investors are subject to a $100k max across all Reg CF offerings in any 12 month period.
- Issuer must provide financial statements based on offering size:
    - < $100k → Internally prepared, certified statements
    - $100k - $500k → CPA reviewed statements
    - $500k - $1M → CPA audited financials (or CPA reviewed statements if the issuer is a first time user of the system).
- Issuer must file a robust disclosure document with the SEC.
- Issuer is subject to annual SEC reporting obligations.
- Offerings must be made through registered portals. The portals must be either (a) registered with the SEC as a broker-dealer; or (b) registered as a portal operator with the SEC and be a member of FINRA.

c. **Title IV and Regulation A+**: Reg A+, which went into effect in June 2015, has been described as a mini-IPO or "IPO-Lite," in that it allows nearly any company with principal offices in the U.S. or Canada to use internet crowdfunding to raise up to $50 million per year from any number of both accredited and non-accredited investors under a regulatory scheme that is far less burdensome than that of a traditional IPO. There is no prohibition on general solicitation, and offering companies are not required to independently verify the sophistication (income or net worth) of their investors. Corporations, limited liability companies, and limited partnerships can take advantage of Reg A+'s two-tiered offering scheme and can sell nearly all types of securities, including equity, debt, and debt securities convertible into equity securities. Furthermore, the securities issued in Reg A+ will be unrestricted and freely transferable. One of the most exciting changes for companies seeking to raise capital under Reg A+ is that Tier 2 offerings are not subject to state Blue Sky registration and merit review (further explained below), however notice filings may be required.

(1) **Tier 1**: Tier 1 offerings are largely similar to old Regulation A offerings, but the old limit of $5 million raised in a 12-month period per issuer has now been increased to $20 million. Unlike Tier 2, there is no limit on the amount a non-accredited investor may invest in any Tier 1 offering.

(i) **State Registration**: Tier 1 still requires that offerors register under the Blue Sky laws of every state in which money is raised. However, the NASAA (North American Securities Administrators Association) recently launched a multi-state coordinated review program for Regulation A offerings that, if successful, would allow an issuer to register with multiple states by filing just one package with a relatively quick turnaround time. This could make Tier 1 much more attractive for many issuers, given its lower cost.

(ii) **Reporting**: Tier 1 is less burdensome than Tier 2 in terms of SEC requirements for initial filing and ongoing reporting. Tier 1 does not require audited financial statements nor ongoing reporting. The only requirement is that offering companies file a Form 1-Z to report the completion of their offering.

(2) **Tier 2**: Under Tier 2, companies are allowed to raise up to $50 million in a 12-month period and, most importantly, there is no requirement that the offering company register under any state

Blue Sky laws because the federal Reg A+ preempts state law. Tier 2 offerings must only be registered with and approved by the SEC. On the other hand, Tier 2 limits investment by non-accredited investors to the greater of 10% of their annual income or net worth, excluding their primary residence, per offering. Tier 2 also includes substantially more onerous reporting requirements than Tier 1.

(i) **Audited Financial Statements**: Tier 2 issuers must provide the SEC with two years of audited financial statements before approval, while Tier 1 issuers only need to provide "reviewed" statements.

(ii) **Ongoing Reporting**: After a successful Tier 2 raise, Tier 2 issuers who have 300 or more record holders of the security offered must also file the following ongoing reports:

(a) Detailed annual reports, using Form 1-K;

(b) Semiannual reports, using Form 1-SA, including unaudited interim financial statements and a management discussion; and

(c) Current event reports, using Form 1-U, reporting all fundamental changes.

Comparison of Rule 506(c), Reg CF, and Reg A+

	Title II - Rule 506(c)	Title III - Reg CF	Regulation A+ Tier 1	Regulation A+ Tier 2
Maximum Dollars Raised	No maximum	$1 million per 12 months, including affiliates	$20 million per 12 months	$50 million per 12 months
Permitted Investors	Only Accredited	Anyone	Anyone	Anyone
Per-Investor Limits	None	Yes - depends on income and net worth of investor, and applies to all Reg CF deals per year	None	For non-accredited investors, 10% of income or net worth, whichever is more, per deal
General Solicitation (Advertising) Permitted?	Yes	Yes, but only through portal	Yes	Yes
Testing the Waters Permitted?	Yes	No	Yes	Yes
Securities Sold Through Third Party Portal?	Yes (but not required)	Yes (required)	Yes (but not required)	Yes (but not required)
Can Issuer Run Its Own Portal?	Yes	No	Yes	Yes
Pre-Sale Information Required	Material information	Substantial	Very substantial, akin to a registration statement for a public company	Very substantial, akin to a registration statement for a public company
Audited/Reviewed Financial Statements Required?	No	Depends on size of offering; most first time users will have to provide *reviewed* statements	No	Yes
Pre-Sale Approval Required	No	No	Yes - submission must be approved by SEC and the states where the securities will be sold (through a coordinated review)	Yes - submission must be approved by SEC; state approval not required
Investor Verification	Verification required	Self-certification	N/A	Self-certification
Ongoing Reporting	None	Moderate	None	Substantial ongoing reporting, akin to a mini-public company, but waived depending on number of investors
Length of Process	Fast	Moderate	Very slow	Very Slow

5. **Other Crowdfunding Methods**

a. **Rule 504 + State registration**: Theoretically, a company may legally conduct a small (less than $5 million) crowdfunding campaign by combing a Federal Rule 504 exemption with state registered offering.

(1) **General Solicitation under Rule 504**: Rule 504 allows an issuer to engage in general solicitation to accredited and non-accredited investors if the issuer either:

(i) registers the offering exclusively in one or more states that require a publicly filed registration statement and delivery of a substantive disclosure document to investors; or

(ii) registers and sells the offering in a state that requires registration and disclosure delivery and also sells in a state without those requirements, so long as the company delivers the disclosure documents required by the state where the company registered the offering to all purchasers (including those in the state that has no such requirements).

(2) **SCOR Offering Option**: Some states provide a simplified process for "small corporate offering registrations" that otherwise are exempt from Federal registration under Rule 504.

b. **Federal intrastate exemption + State crowdfunding exemption**

(1) **Section 3(a)(11) and Rule 147A**: Another lesser known Federal securities exemption is the "intrastate" exemption embodied by Section 3(a)(11) of the Securities Act and Rule 147A promulgated by the SEC. Generally speaking, Section 3(a)(11) exempts from SEC registration any offering that is confined to the borders of a single state. To qualify for this exemption, the company must meet requirements of Rule 147A, which include:

(i) The company must only sell the securities to individuals residing in that state;

(ii) One of the following

(a) 80% of the company's consolidated gross revenues must be derived from the state in which the offering is conducted;

(b) 80% of the company's consolidated assets must be located within the state in which the offering is conducted; and

(c) 80% of the offering's net proceeds must be intended to be used, and actually used, in connection with the operation of a business or real property, the purchase of real property located in, or the rendering of services, within the state in which the offering is conducted; or

(d) 50% or more of the issuer's employees are located within the state.

In addition to complying with the Federal "intrastate" exemption, the issuer must also satisfy the requirements of the state crowdfunding exemption. The requirements vary on a state-by-state basis, but they often impose:

(i) Limits on the amount of money the issuer can raise;

(ii) Limits on the amount of money that investors can invest (there are usually different limits for accredited investors vs. non-accredited investors);

(iii) Disclosure requirements, including whether the issuer must provide purchasers with audited or reviewed financial statements;

(iv) Escrow requirements;

(v) Use of third party internet portal; and

(vi) Ongoing reporting requirements of the issuer.

c. **General Solicitation in Intrastate Crowdfunding Offerings**: There is no prohibition in Section 3(a)(11) or Rule 147A regarding general solicitation as long as such solicitation:

- complies with applicable state law; and
- does not result in a sale to nonresidents of such state.

6. **Capital Raising Pitfalls**

a. **Rights of Ownership**: When considering whether to engage in a private offering to raise investment capital, a company must consider that investors will be owners of the company following the offering (albeit likely constituting a minority stake in the entity) and as, such, those investors will have certain rights afforded to them by law.

b. **Limited Liability Companies**

(1) **Governance Rights**: A member's governance rights (i.e., the right to vote and control) in a limited liability company (LLC) depends upon whether the LLC is member-managed, board-managed or manager-managed. If the LLC is member-managed, each member has equal rights in the management and conduct of the company's activities. Even if the LLC is manager-managed, certain proposed actions require consent of the members. In a board-managed LLC, while the board of governors manages the LLC's affairs, the board is selected by a majority vote of the members.

(2) **Right to Profits**: Unless otherwise provided in the LLC operating agreement, each member is entitled to participate in any distribution(s) of the company's profits (although as noted herein, some additional incentives may be necessary).

(3) **Right to Information**: Members have the right to access information from the LLC that is material to the member's interest as a member.

(4) **Minority Rights Regarding Oppressive Conduct**: A member does not have the right to dissent from a proposed course of action and require the LLC to purchase his/her membership interest. However, some states provide for certain rights and remedies upon a court finding of "oppressive conduct" towards a minority member or members. Note, however, that the LLC operating agreement can limit the remedies that a court may impose, including but not limited to a court-ordered buyout.

c. Corporations

(1) **Voting Rights**: Unless otherwise provided within the corporation's articles of incorporation, a shareholder in a corporation has one vote per share. In addition, even if the articles provide that the holders of a particular class of shares are not entitled to voting rights, in some instances, these shareholders are entitled to voting rights as a matter of law.

(2) **Rights to Information**: Shareholders are entitled to inspect books and certain records of the corporation.

(3) **Dissenters Rights**: Most significantly, a shareholder of a corporation may dissent from, and obtain payment for the fair value of the shareholder's shares in the event of certain actions.

d. **Maintaining Control**: Frequently in private offerings for startup ventures, the capital contributed by investors through the offering often exceeds the amount of capital contributed by the company's founders. This can prove problematic for the founders seeking to maintain control of the entity by offering a minority ownership stake in the company through the offering. However, various incentives can be employed to make ownership of a minority interest in the business more palatable for investors.

e. **Changes to Terms of Offering; Rescission Offers**: Frequently a prospective investor will propose a counteroffer which differs from the terms outlined in the offering document. If accepted, be aware that changed terms for even a single investor will trigger an obligation to make a rescission offer to prior investors.

7. **Other Sources of Funds**

a. **Debt Financing**: Before embarking upon a private offering, it is best to consult with one or more lending institutions regarding a small business loan. Banks offer several small business loan programs, ranging from their own private loan programs to those loan programs established by the U.S. Small Business Administration (SBA). These types of programs are particularly useful when seeking financing to acquire equipment and/or real estate, given the ability to pledge these assets as collateral. Personal guaranties of those owners holding 20% or more is also generally required.

b. **"Gap" Financing**: "Gap" financing refers to state and local financing incentives that can bridge the gap between a bank loan and an equity capital investment.

(1) **State Initiatives**: Some states have financing programs available for small businesses. These initiatives provide financing to help add new workers and retain high-quality jobs on a statewide basis. The focus is usually on industrial, manufacturing, and technology-related industries to increase the local and state tax base and improve economic vitality statewide.

(2) **Local Financing Incentives**: Some cities have financing programs and incentives available for small businesses that locate within those cities. For example, some cities have a "Two-Percent Loan" program. Two-Percent Loans provide financing to small businesses (retail, service or light manufacturing) to purchase equipment and/or to make building improvements. A private lender provides half the loan at market rate and the City provides the rest, up to $50,000 at 2 percent interest (up to $75,000 in designated neighborhood commercial districts). The loan term is set by the private lender and can be for up to 10 years. Bank fees vary, but the City charges a 1 percent origination fee with a minimum of $150 due at closing.

(3) **Tax Increment Financing**: Tax increment financing, or TIF, is a public financing method that is used as a subsidy for redevelopment, infrastructure, and other community-improvement projects. Through the use of TIF, municipalities can dedicate future tax revenues of a "particular business or group of businesses toward an economic development project in the community.

c. **Kickstarter/Rewards Based Crowdfunding**: In recent years, websites such as Kickstarter.com have popularized "rewards-based" crowdfunding. Kickstarter.com is a web portal that allows individuals to make a contribution to a particular project in exchange for some reward, typically some type of tangible product. Other variations of rewards-based crowdfunding include "founders clubs" (often used by local breweries and distilleries) which offer a variety of member benefits (but not any voting rights or share of profits in the enterprise so as to steer clear of the definition of a "security") in exchange for payment of a one-time membership fee. These types of rewards-based incentives should be structured in a way that minimizes liability for the company; i.e., the terms and conditions of membership should be in writing and should specify what happens to the memberships if the company is sold or ceases to do business, that the memberships are non-transferrable and that the membership does not carry with it the rights of ownership.

8. **Practical Considerations in Structuring a Private Offering**

   a. **Put Rights**: A put or put option is a device which gives the owner of the put the right, but not the obligation, to sell his/her shares, at a specified price (the put price), by a predetermined date to a given party (typically the company).

   b. **Call Rights**: In contrast to put rights, call rights or a call option refers to the right, but not the obligation, to buy an agreed number of shares within a certain time for a certain price (the "call price"). The seller is obligated to sell his/her shares to the buyer if the buyer so decides.

   c. **Preferred Distributions**: In some instances, it may be necessary or advantageous to incentivize potential investors by including a preferred distribution for investors. Most closely held companies give their board the discretion to make (or not make) distributions of profits and the amount of such distributions. A preferred distribution constitutes the company's contractual obligation to pay a minimum amount to the holders of such preferred distribution rights ahead of making any discretionary distributions to all owners. Often times preferred distributions are "cumulative", meaning that a preferred distribution which is not made in one year cumulates and is to be paid when the company has funds available to pay it.

   d. **Preferential/Accelerated Distributions**: In regards to general distributions of profits, in order to maintain governing control of the company following a private offering, and in addition or alternative to preferred distributions it may be necessary to offer investors a distribution preference. For example, suppose the investors as a group own 40% of the company. A distribution preference would be to make 60% of the company's operating distributions to the investor class for a period of years until the investors recoup their initial investment. Upon doing so, distributions would then be made pro rata based upon ownership percentages.

   e. **Written Agreement**. All of these mechanisms should be included in a written agreement between the owners (an operating agreement for an LLC or a shareholder agreement for a corporation), and new investors should be required to execute a joinder to the agreement in order to bind themselves to the agreement.

Handling Intellectual Property Problems, Marketing and Advertising

Submitted by Martha Engel

INTELLECTUAL PROPERTY CONSIDERATIONS
FOR BREWERIES AND DISTILLERIES

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Intellectual property generally falls into 4 main categories:

1. Copyrights – any original work of authorship or other creative work;
2. Patents – any new and useful invention, visual characteristics of an original article of manufacture, or any distinct and new variety of plant;
3. Trademarks – any word, symbol or design that identifies and distinguishes the source of a good or service from those of others;
4. Trade Secrets – any information that derives its economic value from not being generally known and is the subject of reasonable efforts to maintain its secrecy

Copyrights

Copyright-eligible works are any "original works of authorship fixed in any tangible medium of expression, now known or later developed, from which they can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device." 17 U.S.C. 102(a). Importantly, the work must be (1) original and (2) fixed in a tangible medium. Copyright-eligible works fall into several categories: (1) literary works; (2) musical works, including any accompanying words; (3) dramatic works, including any accompanying music; (4) pantomimes and choreographic works; (5) pictorial, graphic, and sculptural works; (6) motion pictures and other audiovisual works; (7) sound recordings; and (8) architectural works. *Id.* Copyright protection includes protection for compilations and derivative works, but only to the extent that new material is included. 17 U.S.C. 103. Breweries and distilleries should pay attention to copyrights in advertisement, website content, artistic works displayed or performed in their taproom or tasting room, or music displayed over a sound system in a taproom or tasting room. Recipes are protectable under copyright law only to the extent that they are written down (fixed in a tangible medium) and copied.

Copyright protection extends from the moment of creation. However, a copyright must be registered with the U.S. Copyright Office in order for a copyright owner to sue for infringement and to be eligible to recover certain remedies. *See* 17 U.S.C. 412. If registration occurs within 5 years of publication, it is considered *prima facie* evidence of ownership and validity.

Copyrights are generally owned by the author or creator of the work. Where two or more authors have contributed to the work, the work may be jointly owned by the authors. Each owner has an equal right to register the copyright, enforce it, and commercially exploit it unless otherwise agreed. If the work is a commissioned work or a work made for hire, special rules apply. If an employee creates the work on behalf of the employer within the scope of his or her employment, ownership of the copyright vests in the employer. 17 U.S.C. 101. If a work is specially commissioned (e.g. photographs of the tap room, advertising material, packaging artwork, etc.), the ownership only will vest in the brewery or distillery "if the parties expressly agree in a written instrument signed by them that the work shall be considered a work made for hire." *Id.* If breweries or distilleries are utilizing a third party to develop creative works, they should ensure that any contract or purchase order specifically states that the work product "shall be considered a work made for hire" in order for ownership to vest in the brewery or distillery.

With some exceptions based on publication dates, the term of a copyright is 95 years from first publication or 120 years from creation, if a work made for hire or anonymous works. With some exceptions, the term of a copyright is otherwise the duration of the author's life plus 70 years.

For the alleged copyright owner to prevail in a copyright infringement dispute, the Plaintiff must prove ownership of a copyrighted work and that the Defendant misappropriated the work by proof of either direct copying or an inference of copying based on Defendant's access to the copyrighted work and the substantial similarity to the copyrighted work.

<u>Patents</u>

The patent system seeks to promote innovation by granting to an inventor a limited monopoly in its invention in exchange for public disclosure of the invention. There are three types of patents: utility patents, design patents, and plant patents. Patents are an exclusionary right. They permit the owner to exclude others from making, using, or selling the invention for the term of the patent. A patent does not mean the owner has the right to fully perform the invention, just to exclude others from doing so. Patent applications must be filed by an attorney or patent agent registered with the United States Patent & Trademark Office, or *pro se* by the applicant.

Ownership of a claimed invention described in a patent application is initially in the name of the inventor or inventors. Joint inventors each own a full 100% right in the claimed invention. Ownership of a claimed invention may transfer to an employer if an employee agreement

Utility patents are directed to the invention of any new and useful process, machine, manufacture, or composition of matter, or a new or useful improvement thereof. A utility patent application must include a title, a specification describing the patent, and at least one claim. Similar to real property rights, the claim describes the metes and bounds of the patented invention. The claimed invention shall be granted a patent if it is novel and not obvious. The claimed invention is novel if it was not already patented, described in a printed publication, or in public use, or on sale, or otherwise available to the public before the effective filing date, with some exceptions for the inventor's own disclosures. The claimed invention will not be granted a patent if the differences between the claimed invention and the prior art are such that the claimed invention as a whole would have been obvious to one of ordinary skill in the art to which the claimed invention pertained. For applications filed on or after June 8, 1995, any issued patent has a term of 20 years after the earliest filing date for the application. For any patents resulting from applications filed before June 8, 1995, the patent has a term of 20 years from the date of grant of the patent. Infringement of a utility patent occurs when the defendant practices each element or its equivalent.

Design patents are directed to the ornamental design of a functional item, such as a bottle design, other packaging design, or a flight design for a beer or distilled spirit. A design patent application must include drawings of the design (typically several views of the design), a description of the drawings, and a single claim. Design patents are also examined for novelty and non-obviousness. The term of a design patent is 14 years from the date of grant. Infringement of a design patent occurs if an ordinary observer would think that the accused design is the same as the patented design when they are compared.

Plant patents are directed to newly discovered and asexually reproduced plants including cultivated sports, mutants, hybrids, and newly found seedlings, other than a tuber propagated plant or a plant found in an uncultivated state, may obtain a patent therefore. 35 U.S.C. 161. The application requires a drawing, a description of the plant, and at least one claim. Like utility patents, plant patents are examined for novelty and non-obviousness. The term of a plant patent is 20 years from the filing date of the application. The most relevant application for plant patents for brewers are hop plant patents. Many hops are covered by plant patents., and brewers or hop farmers should be aware of the patent implications of re-planting patented hop seeds. In *Bowman v. Monsanto*, 569 U.S. ___, 133 S.Ct. 1761 (2013), the Supreme Court considered whether the doctrine of patent exhaustion applied to a farmer who purchases seed covered by a patent and then plants a harvested and saved seed from that crop. The Supreme Court ruled that despite the farmer initially purchasing the seed, the farmer replanting seed to harvest a second crop constituted making a copy of the patented invention and thus was an unauthorized making of the patented invention.

Trademarks

One of the most important assets of a brewery or distillery is its house brand and its product names.

A trademark is any word, phrase, symbol, design or other device that identifies or distinguishes the goods of one party from those of others. When applied to services, this often called a “service mark.” “Trade dress” covers the visual appearance of a product or its packaging that identify or distinguish the source of a product to consumers.

Rights in a trademark generally begin based on use of the mark in commerce, but filing an intent-to-use application with the U.S. Trademark Office can provide priority of right in a trademark back to the filing date of the application if use is perfected within three years of the allowance date of the application. Further, prior users (“senior users”) of a trademark may have rights that precede a junior user’s rights in a mark that may limit the junior user’s rights.

These rights can come in three forms: unregistered rights (often called “common law” trademark rights); a state trademark registration; or a federal trademark registration. Unregistered, common law rights extend only to the geographic area where consumers have encountered the mark. These rights are not believed to extend to use of a mark by homebrewers who aren’t selling the product or operating under a TTB license by virtue of their use alone. State trademark registrations cover the entire area of the state, but do not extend beyond its borders and could not be used to enforce trademarks outside of the state. Federal trademark registrations provide nationwide rights to a mark and provide the ability to enforce rights in a mark, even in areas where the owner has not used the mark. Unlike a state filing, which typically requires use at the time of filing, an applicant can file a federal application based on an “intent to use” the mark. Breweries and distilleries should consider filing a federal trademark application while in the planning stages of their brewery or distillery (as well as obtaining domain names as soon as possible).

Infringement of these rights occurs when another party uses a mark with which such use is likely to cause confusion, or to cause mistake, or to deceive. 15 U.S.C. 1114. The likelihood of confusion standard varies by circuit, but typically considers:

- the strength of Plaintiff's mark;
- the similarity of the marks;
- the similarity of the goods or services;
- the similarity of trade channels;
- the number and nature of similar marks on similar goods or services;
- length of time and conditions under which there has been concurrent use
- without consumer confusion;
- actual confusion;
- other factors pertinent to a determination of whether consumers are likely to be confused by the two marks being used in commerce.

When selecting a mark, a search should be conducted both on the USPTO's search system TESS, the TTB's website, and also on the internet to determine availability. When conducting a search, one should consider alternative spellings that may sound the same as the proposed mark and also marks in use by others in the food and beverage industry. Breweries and distilleries should also consider the strength of a mark. The strength of a mark is considered based on where it falls on the "spectrum of distinctiveness" and how many third parties use the mark on related goods or services. Arbitrary or fanciful marks are inherently more distinctive and provide more protection than those marks that are merely descriptive or generic.

Generic | **Descriptive** | **Suggestive** | **Arbitrary or Fanciful**

More descriptive,
Less protection

More descriptive,
More protection

1. Generic marks are those that the relevant consuming public understands primarily as the common name for a good or service. Examples include Beer, Vodka, Aspirin, Elevator, Flip Phone, Thermos.
2. Descriptive marks include those that describe an ingredient, quality, characteristic, function, feature, purpose, or use of the goods or services. Examples include Hoppy IPA, Brooklyn Brewery, Palms Free, Your Cloud and Oat Nut Bran Cereal. Even descriptive marks may acquire distinctiveness in the market by having been used continuously for five years or having gained significant recognition by the relevant consuming public that consumers identify that mark with a particular source.
3. Suggestive marks are marks that require imagination, thought, or perception to determine the nature of the goods or services. Examples include Chicken of the Sea, Citibank, Trek, Greyhound, Lupulin Brewing.

4. Arbitrary and fanciful marks are known words used in an unexpected or uncommon manner (e.g. Apple for computers, Tin Whiskers for beer) and those marks that are invented for the sole purpose of functioning as a trademark (e.g. Pepsi, Xerox).

When applying for federal trademark protection, applicants can file based on an intent to use the mark or based on actual use of the mark. Importantly, applicants must have actual use of the mark in interstate commerce in order to obtain a trademark registration. The application is examined by a USPTO examining attorney within about three to six months from the filing date of the application for conformance with formalities and to determine whether there is any reason that the mark should not be registered based on any requirements of 15 U.S.C. 1052. Reasons for not registering the mark include that the mark consists or comprises:

- Immoral, deceptive, or scandalous matter; or matter which may disparage or falsely suggest a connection with persons, living or dead, institutions, beliefs, or national symbols, or bring them into contempt, or disrepute;
- Importantly for distilleries, a geographical indication which, when used on or in connection with wines or spirits, identifies a place other than the origin of the goods and is first used on or in connection with wines or spirits by the applicant on or after 1996;
- Flag or coat of arms or other insignia of the United States, or of any State or municipality, or of any foreign nation, or any simulation thereof;
- Name, portrait, or signature identifying a particular living individual except by his written consent, or the name, signature, or portrait of a deceased President of the United States during the life of his widow, if any, except by the written consent of the widow;
- Resembles a mark registered in the Patent and Trademark Office, or a mark or trade name previously used in the United States by another and not abandoned, as to be likely, when used on or in connection with the goods of the applicant, to cause confusion, or to cause mistake, or to deceive;
- When used on or in connection with the goods of the applicant is merely descriptive or deceptively misdescriptive of them;
- When used on or in connection with the goods of the applicant is primarily geographically descriptive of them, except as indications of regional origin may be registrable;
- When used on or in connection with the goods of the applicant is primarily geographically deceptively misdescriptive of them;
- Primarily merely a surname;
- Generally in the case of trade dress registration or product configurations, any matter that, as a whole, is functional.

If the application fails to conform with particular formalities, or the examining attorney determines that registration must be refused based on one of the foregoing, the examining attorney will issue an office action. Applicants have six months from the date of the issuance of the office action to reply.

Trademark registrations for alcoholic beverages can be difficult to obtain because of case law, and the Trademark Office's interpretation of that case law, that suggests that beer is sufficiently related to wine and distilled spirits and vice versa. In rejecting marks on beer as being likely to be confused with similar marks registered for wine or distilled spirits, the Trademark Office generally relies on some of the following cases:

- *In re Chatam Int'l Inc*., 380 F.3d 1340, 71 USPQ2d 1944 (Fed. Cir. 2004) (holding GASPAR'S ALE for beer and ale likely to be confused with JOSE GASPAR GOLD for tequila);
- *In re Majestic Distilling Co*., 315 F.3d 1311, 65 USPQ2d 1201 (Fed. Cir. 2003) (holding RED BULL for tequila likely to be confused with RED BULL for malt liquor);
- *In re Salierbrau Franz Sailer*, 23 USPQ2d 1719 (TTAB 1992) (holding CHRISTOPHER COLUMBUS for beer likely to be confused with CRISTOBAL COLON & design for sweet wine);
- *Somerset Distilling, Inc. v. Speymalt Whiskey Distribs. Ltd.*, 14 USPQ2d 1539 (TTAB 1989) (holding JAS. GORDON and design for scotch whiskey likely to be confused with GORDON'S for distilled gin and vodka);
- *Schieffelin & Co. v. Molson Cos.*, 9 USPQ2d 2069 (TTAB 1989) (holding BRAS D'OR for brandy likely to be confused with BRADOR for beer);
- *Bureau Nat'l Interprofessionnel Du Cognac v. Int'l Better Drinks Corp.*, 6 USPQ2d 1610 (TTAB 1988) (holding trademark COLAGNAC for cola flavored liqueur likely to be confused with certification mark COGNAC for brandy).

Typically, the Trademark Office's position is that alcoholic beverages are all related because they are available within the same channels of trade (e.g. liquor stores) to the same consumers, that the conditions in which consumers encounter the marks are generally the same, and that these consumers are generally unsophisticated purchasers.

If an application is rejected as being merely descriptive, the Applicant has the option of claiming acquired distinctiveness of the mark by virtue of the Applicant using the mark continuously over a period of five years or by providing evidence of acquired distinctiveness (sales information, advertising expenditures, statements from customers). If the Applicant cannot show this, the Applicant may also amend the application from the Principal Register to the Supplemental Register, which still allows the applicant to use the ® symbol but does not carry the same presumptions of validity and ownership in an enforcement proceeding. However, in order to amend the application to the Supplemental Register, use of the mark in interstate commerce must have occurred and the Applicant must have either filed the application as a use-based application or otherwise shown use by filing an allegation of use with the Trademark Office. In five years, the Applicant can then re-apply for registration on the Principal Register when it has had sufficient use to claim acquired distinctiveness.

Once an application is approved, the application will be published for opposition by third parties. Third parties may oppose registration of an application based on their own prior rights in a similar mark and generally oppose registrations at least on the basis of a likelihood of confusion with their own mark or being merely descriptive such that registration of the mark would weaken the third party's ability to use the same term.

If the application was filed as an intent to use, applicants will need to show use before a registration certificate will be issued. Applicants have three years from the allowance date in order to show use of the mark.

Trademark protection requires staying vigilant with respect to third party uses in order to keep rights as broad as possible. Formal proceedings include opposing pending trademark applications, petitioning to cancel trademark registrations, and infringement lawsuits. Trademark disputes among breweries and distilleries are often resolved through negotiating settlement agreements. Terms of these agreements may include agreeing to cease use all together, territory limitations, duration of use limitations, types of goods sold under the mark, product packaging requirements, cross-promotion or other collaborations, or assignment or licensing of a trademark to another party.

Trade Secrets

Trade secrets can be one way for a brewery or distillery to protect confidential recipes, formulas, processes, customer information, and other important business information.

A "trade secret" is any information that derives independent economic value from not being generally known or readily ascertainable by other persons and is the subject of reasonable efforts to maintain its secrecy.

The second part of a "trade secret" definition is particularly important – breweries and distilleries must make reasonable efforts to maintain the information as a secret. In order to maintain information as a trade secret, breweries and distilleries should be counseled about employment agreements, employment handbooks, proper marking of materials as "confidential," and other steps to maintain this business information as a secret. Examples of such steps include:

- Limiting the number of people with direct knowledge of the recipe or process steps to those who must know and reminding them that the brewery or distillery considers this information to be a trade secret
- Having employees sign properly drafted confidentiality agreements and non-compete agreements in accordance with local laws
- If using a contract brewery, making sure that the contract brewery signs a non-disclosure agreement.
- Marking any documents that contain trade secret information as confidential
- Making sure confidential trade secret information is not posted on unsecured sites or databases that are not password protected

When hiring a brewer or distiller, clear expectations should be set about who owns the proprietary recipes or formulas that may be used during the course of the employment. To ensure that those recipes can continue to be used by the brewery even if it later parts ways with the brewer – particularly with respect to flagship products – companies should consider having the brewer assign the rights in those trade secrets to the brewery. Non-compete agreements are often disfavored in many states and are not as effective as an employment agreement that outlines ownership of trade secrets. Non-compete agreements are often held to be unenforceable, but limiting the duration of the agreement (often to one year or less) and the geographic reach of the agreement can help with enforcement of these types of agreements.

Misappropriation of trade secrets has traditionally been governed under individual states' trade secret laws. The trade secret laws in most states conform to the Uniform Trade Secrets Act, with the exceptions of Massachusetts' and New York's laws. Until May 11, 2016, causes of action pertaining to misappropriation of trade secrets had to be brought in state court under state law. On May 11, 2016, the Defend Trade Secrets Act became effective. The Defend Trade Secrets Act (DTSA), 18 U.S.C. 1836, provides the first federal private cause of action for misappropriation of trade secrets. It is intended to co-exist with state trade secret laws and does not preempt state trade secret laws, but it provides some remedies and whistleblower protections otherwise unavailable under the Uniform Trade Secrets Act. Generally the statute of limitations for bringing a cause of action under state law or the DTSA is three years from when the misappropriation was discovered or reasonably should have been discovered. Remedies include injunctive relief, actual damages, damages for unjust enrichment, or a reasonable royalty.

Misappropriation of trade secrets by improper means generally includes theft, bribery, misrepresentation, breach or inducement of a breach of duty to maintain a secret. It does not include independent invention, reverse engineering, discovery on one's own, observation of the item in public use or on public display, or obtaining from published materials. For instance, someone purchasing a beer can independently try to replicate the beer through experimentation, essentially reverse engineering the beer, and this is not a trade secret violation. Once a trade secret has been publicly disclosed, it cannot return to its former state as a trade secret.

Under the DTSA, additional whistleblower protections have been implemented. These protections extend to employees, which also include contractors and consultants. Employers <u>must</u> provide employees with notice of these immunity protections offered by the DTSA for disclosing a trade secret in reporting a legal violation. This notice can include simply a cross-reference to an employee handbook that describes the notice. Any employment agreement entered into, or modified, after May 11, 2016 that does not inform employees of these protections will forfeit certain rights of the employer.

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Liquor Law Issues

Submitted by Benjamin Klassen

Craft Beer, Distillery and Liquor Law: The Ultimate Guide

(Liquor Law Issues Section)

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I. Current Regulatory Framework

A. 21st Amendment: The End of Prohibition

1. Franklin D. Roosevelt campaigned on the promise to end Prohibition, and his presidential victory ensured its demise. In February 1933, Congress adopted a resolution proposing the 21st Amendment. The amendment would repeal the 18th Amendment and give states the authority to regulate the production, importation, distribution, sale, and consumption of alcohol within their borders. Unique among the 27 amendments to the U.S. Constitution, the 21st Amendment—ratified in December of 1933—is the only amendment to repeal a prior amendment and to have been ratified by state ratifying conventions as opposed to state legislatures.

2. Twenty First Amendment

a. **SECTION 1**: The eighteenth article of amendment to the Constitution of the United States is hereby repealed.

b. **SECTION 2**: The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited.

c. **SECTION 3**: This article shall be inoperative unless it shall have been ratified as an amendment to the Constitution by conventions in the several States, as provided in the Constitution, within seven years from the date of the submission hereof to the States by the Congress.

3. With the end of Prohibition came the loss of the carefree speakeasy, replaced largely by what would come to be known as the "three-tier system" of licensed barrooms stocked with liquor provided by licensed wholesalers, produced by licensed manufacturers—all subject to both heavy government regulation and taxes.

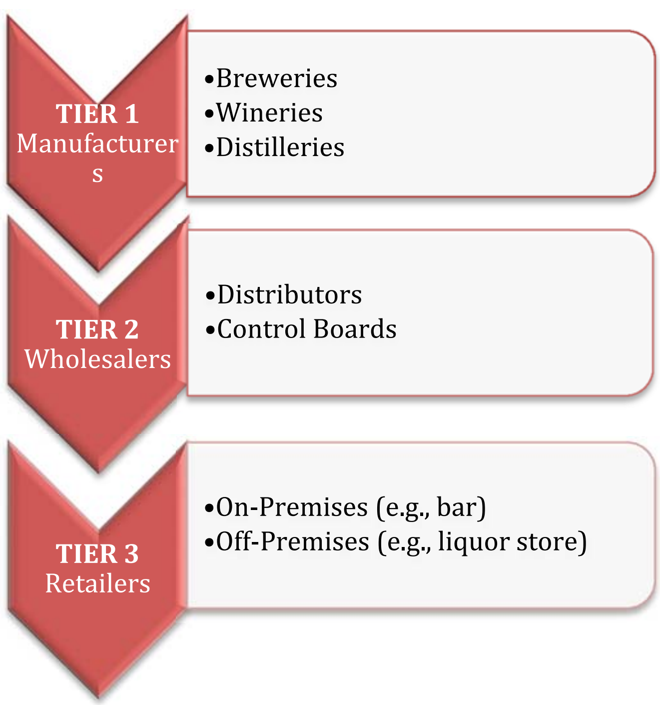
B. Three-Tier System

1. Today, the alcohol industry is regulated at the federal, state, and local levels. While the passage of the 21st Amendment did not prescribe any particular regulatory scheme, both the federal government and many of the states subsequently adopted similar regulatory regimes designed to address the main concerns surrounding the alcohol industry at the time: safety, taxation, and monopoly. First, as a result of the thousands of injuries and deaths to occur during Prohibition, an emphasis was placed on ensuring all alcohol products would be safe for consumption. Second, the framework promoted the orderly collection of revenue by the federal and state governments through liquor excise taxes. Third, in response to the prevalence of tied-houses where retailers were forced to purchase the products of particular producers or were owned outright by those producers (often tied up in organized crime), certain fair business practices were mandated and specific non-competitive activities prohibited. All of these goals were pursued through implementation of the three-tier system, which is still in place throughout most of the United States today.

2. The three-tier system requires alcohol to be sold at three separate market levels ("tiers") and prohibits certain ownership interests and business activities among the various tiers:

- Tier 1: Manufacturers/Suppliers
- Tier 2: Wholesalers
- Tier 3: Retailers

3. Most states adhere to the general framework of the three-tier system. While



specific requirements vary from state to state, businesses operating at each tier generally must be separately licensed and owned independent of one another. Restrictions often prohibit one tier from having financial interests in or influence over another tier. The separation of the tiers seeks to eliminate the "tied-house" practices that dominated the liquor industry before Prohibition, in which taverns or bars were required to purchase products from a single manufacturer. The current three-tier system creates a series of checks and balances to enforce provisions from one tier to another, and helps to manage alcohol availability, quality and safety, price, and promotional practices.

C. Federal Regulation: Permitting, Labeling, and Operational Rules

1. ***Federal Alcohol Administration Act of 1935.*** Codified in 27 U.S. Code, Chapter 8 and known more commonly as the FAA Act, the Federal Alcohol Administration Act of 1935 was signed into law by President Roosevelt to regulate the alcohol industry in the wake of the 21st Amendment. Above all, the FAA Act was designed to protect the safety of consumers, to ensure the integrity of the industry, and prevent unfair trade practices. As outlined on the website of the Alcohol and Tobacco Tax and Trade Bureau, a modern division of the Department of Treasury more commonly known as the "TTB":

a. To ensure the integrity of the industry, the FAA Act includes provisions to:

- Require a permit for those who engage in the business as a producer, importer, or wholesaler of alcohol beverages;
- Issue, suspend, and revoke such permits; and
- Prevent persons who are not likely to operate in accordance with the law from entering the trade.

b. To protect consumers, FAA Act provisions:

- Ensure that labeling and advertising of alcohol beverages provide adequate information concerning the identity and quality of the product;
- Require that alcohol beverage bottlers and importers have an approved certificate of label approval ("COLA") or an exemption certificate before any alcohol product may be sold in the United States; and
- Prevent misleading labeling or advertising that may result in consumer deception regarding the product.

c. The FAA Act's provisions crafted to preclude unfair trade practices:

- Regulate the marketing promotional practices concerning the sale of alcohol beverages; and

- Regulate practices such as exclusive outlets, tied-house arrangements, commercial bribery, and consignment sales.

2. The TTB's implementation of the FAA Act includes supervising all federal tax revenues, permits, licenses, tax audits, trade investigations, and labels related to alcohol products. The lasting effects of Prohibition continue to influence alcohol policy today, as shown by the TTB's stated mission:

a. Collect the taxes on alcohol, tobacco, firearms, and ammunition;

b. Protect the consumer by ensuring the integrity of alcohol products; and

c. Prevent unfair and unlawful market activity for alcohol and tobacco products.

D. Registration & Permits.

1. Applicants looking to operate a distillery must file for a Federal Basic Permit (27 CFR 121), while those hoping to operate a brewery must apply for a Federal Brewer's Notice (27 CFR 25.61). Note that a Permit/Notice must be obtained for each individual plant or brewery premises.

2. Both applications can be completed electronically through the TTB's "Permits Online" system, but generally take several months to fully process (currently processing estimates are 61 days for a brewery application and 86 days for a distilled spirits application. Application processing may include:

a. Initial evaluation of the application for completeness,

b. Background checks,

c. Field investigations,

d. Examination of equipment and premises,

e. Legal analysis of proposed operations.

3. While individuals of legal drinking age may produce wine or beer at home for personal or family use, federal law strictly prohibits individuals from producing distilled spirits at home (*See* 26 U.S.C. §§ 5042(a)(2), 5053(e)). Nevertheless, according to the Hobby Distillers Association (hobbydistillersassociation.org), Alaska, Arizona, Maine, Massachusetts, Michigan, Missouri, Ohio, and Rhode Island have laws on the books permitting home distilling in one form or another, meaning if federal law were ever changed, home distilling would immediately be legal there.

4. Producing distilled spirits at any place other than a TTB-qualified distilled spirits plant exposes you to federal charges for serious offenses including felonies punishable by up to 5 years in prison, a fine of up to $10,000, or both, for each offense. (*See* 26 U.S.C. § 5601).

E. Labeling (COLAs). The TTB's responsibility for the regulation and approval of labels on the packaging of alcohol products requires that every product, before it is introduced into interstate commerce, have a Certificate of Label Approval ("COLA"). COLAs, like basic permits and brewers notices, should be applied for online using the TTBs COLAs Online application tool.

1. The goal of the regulations is to ensure that consumers are provided with adequate information as to the identity and quality of the product, as well as to prevent consumer deception more generally.

2. Labeling rules differ for beer and distilled spirits, but both generally have relatively quick processing times (currently estimated at 9 days for distilled spirits and 6 days for beer, assuming no formula approval is required). Nevertheless, expect the process to take longer—the TTB has up to 90 days to process label applications.

3. Brewers must follow the labeling and advertising requirements found at 27 CFR, Chapter I, Subchapter A, Part 7 (beginning at 27 CFR 5.1), Labeling and Advertising of Malt Beverages and 27 CFR Part 16, Alcoholic Beverage Health Warning Statement. The label must include:

- Brand name
- Class designation (e.g., Stout, India Pale Ale)
- Alcohol content by volume (if required by state law)
- Health statement (surgeon general warning regarding drinking while pregnant and inability to drive a car or operate machinery, etc.)
- Name and address of bottler
- Net contents (fl. oz. or pints).
- Statement regarding existence of sulfites

***Other requirements may apply**

4. Brewers also must follow the formulation requirements found at 27 CFR Part 25 (specifically, 27 CFR 25.55 – 25.58). Generally, a brewer must obtain formula (using TTB's Formula's Online tool) for approval of any fermented product that (a) will be treated by any processing, filtration, or other method of manufacture that is not generally recognized as a traditional process in the production of a fermented beverage designated as "beer," "ale," "porter," "stout," "lager," or "malt liquor;" or (b) involves the addition of other ingredients, coloring, natural or artificial flavors, fruit, fruit juice/concentrate, herbs, spices, etc. However, the TTB has come out with a list of many ingredients and processes that are compliant as "traditional" notwithstanding the fact that they otherwise would violate this general rule.

5. Distillers must follow the labeling and advertising requirements found at 27 CFR, Chapter I, Subchapter A, Part 5 (beginning at 27 CFR 5.1), Labeling and Advertising of Distilled Spirits, and 27 CFR Part 16, Alcoholic Beverage Health Warning Statement. The label must include:

- Brand name
- Class and type
- Alcohol content by volume
- Net contents where no standard of fill is required
- Name and address of distiller/bottler (see 27 CFR 5.36)
- Statement regarding existence of sulfites
- Statement of age (time whisky is stored in oak containers)
- Percentage of neutral spirits (if applicable) and name of commodity from which distilled (e.g., corn)

***Other statements may be required.**

6. Distillers must also follow the formulation requirements found at 27 CFR 5.25-5.28. An approved formula is required to blend, mix, purify, refine, compound or treat spirits in a manner which results in a change of character, composition, class or type of the spirits. Detailed descriptions of such processes, additions, etc. that would require formula approval prior to receiving COLA approval are found at 27 CFR 5.27.

a. Sometimes a lab analysis is required along with the product evaluation. Formula evaluations that do not require sample analysis re estimated to take 4 days from submission for distilled spirits and 3 days for beer, while formula evaluation requiring sample analysis are currently estimated to take 17 days to process regardless of alcohol type.

b. Some of the most frequently cited reasons why COLA applications are returned for correction revolve around the formula requirements for certain alcohol beverages. Often industry members either are not aware that formula approval is required prior to applying for label approval, or the applicant fails to supply the correct formula approval information.

c. The TTB has added some questions and links to guidance in COLAs Online to help prevent you from submitting a COLA application if you are required to get formula approval before applying for label approval.

F. COLA APPLICATION STEP-BY-STEP GUIDE:

https://www.ttb.gov/labeling/colas-docs/create-an-application.pdf.

1. First, you must have a TTB Basic Permit or Brewers Notice before filing for COLA approval

2. Second, determine whether you need formula approval and or other pre-approval requirements before submitting a COLA application. If you are confused on these requirements (or any others, call the TTB—specifically your agent if one has been assigned).

3. Third, file the COLA application using COLAs online

a. Make sure your images and all submitted data follow the instructions on the online forms to the letter. Following these instructions is literally the law (See 27 CFR 13.20).

b. Note that, among other more technical and legal reasons for denial, labels will fail if the required images are submitted in the wrong file format (other than JPG or TIFF), or if there are other non-compliance issues like having a white border/background or printer proof information contained in the image.

4. Finally, assuming your submission went through, wait. The TTB has up to 90 days to approve or reject your application, but is allowed a one-time 90-day extension in the event of unusual circumstances requiring extra time and attention. The TTB will notify you by letter of a decision to extend, along with a brief explanation of the issues presented by the label. If you do not hear from the TTB within the stated times, you must file an appeal. (27 CFR 13.21(b)).

G. LABELING APPEALS.

1. ***General***. If your COLA application is denied, the reasons for denial will be stated in the notice of denial. If you disagree with the decision, and after reviewing the rules and applying the facts you believe you have basis for an appeal, you have up to 45 days to submit your appeal in writing. (27 CFR 13.25) Often, however, it may make sense to reach out to the assigned TTB officer directly to seek an informal resolution. If you wish to pursue this route, do so quickly after receipt of the statement of denial, leaving yourself enough time to file a formal appeal within the 45-day window if the situation is not informally resolved.

2. ***Taxation*.** The TTB also oversees collection of the appropriate federal tax revenue from alcoholic beverages. Beer, wine, and spirits are taxed at differing rates as defined by statute. Beer produced for commercial use is governed by 26 U.S.C. § 5051, which imposes a tax on all beer "brewed or produced, and removed for consumption or sale, within the United States, or imported into the United States." All wine and distilled spirits produced in or imported to the United States is taxed according to 26 U.S.C. § 5041 and 26 U.S.C. § 5001 respectively.

3. ***Common Compliance Issues.*** TTB agents will periodically perform audits of suppliers in order to ensure compliance with relevant regulations. According to the TTB, the most common audit issues found during TTB visits relate to:

   a. Recordkeeping:

   - A brewer is required to maintain daily records of operations (27 C.F.R. § 25.292), records of balling* and alcohol content (27 C.F.R. § 25.293), inventory records (27 C.F.R. § 25.294), records of unsalable beer (27 C.F.R. § 25.295), and records of beer concentrate (27 C.F.R. § 25.296) for at least three years.

     (1) *Balling means the percent by weight of dissolved solids at 60° F present in wort and beer, usually determined by a balling saccharometer.

   - Distillers must maintain records accurately reflecting operations and transactions occurring at the distilled spirits plant in three primary accounts: production, storage, and processing.

   b. Production and Inventory:

   - Suppliers must adequately track all products they handle in a detailed fashion, ensuring the proper amount of tax is paid and at the proper times.

c. Reporting and Tax Payment:

- Brewers must periodically file operational reports; the frequency of reports depends on the amount of excise tax liability.

- Reporting requirements for distillers vary according to the type of permit held by the operator.

- Frequency of excise tax payments varies from operation to operation.

d. Basic Permit/Brewer's Notice, Registration, and Bond Requirements:

- Generally speaking, all suppliers must ensure that their paperwork filed with the TTB is current and licenses are up to date.

- Many important business changes must be registered with the TTB – such as a change in location, mailing address, business name, or ownership – through either the filing of an amendment to permit or notice or the filing of an entirely new application. *See the example below of a significant penalty asserted for failure to comply with these mandatory updates:*

- Brewers must file a new brewer's bond or a continuation certificate once every four years.

e. Penalties:

- The IRS and TTB can assert a variety of penalties against non-compliant industry members, which can include suspension or revocation of permits and licenses, as well as fines and fees, and even jail time.

- Under 26 U.S.C. § 5672 a brewer's failure to maintain or disclose records requested by the TTB, can result in a fine of up to $1,000 per incident or up to a year in prison, or both.

- Under present law, if you fail to timely file your tax return you may have to pay a penalty equal to 5% of the tax not paid by the due date for each month or part of a month that the return is late. This penalty cannot be more than 25% of the tax. Additionally, interest, compounded daily, is charged on any unpaid tax or penalty as prescribed by law.

f. Penalty Example: Failure to notify of Change in Control of Permittee:

- It is absolutely critical that a brewery or distillery that undergoes a change in control of the management and/or stock ownership of its business, file either, in the case of a brewery, an amendment to its Brewers' Notice, or, in the case of a distillery, a new application for Federal Basic Permit within 30 days following the change in control. See *Gulf Coast Maritime Supply, Inc. v. United States,* No: 16-5350 (D.C. Cir. Aug. 11, 2017) where a business had its Basic Permit terminated and was ordered to cease operations or be subject to civil and criminal penalties years after undergoing a change of control from spouse to spouse upon one spouse's death and without filing a new application. These rules are provided under 27 USC 204(g); 27 CFR 1.44; and 27CFR 19.114 for distilleries and 27 CFR 25.74 for breweries. *See* 27 USC 204(g) below for an example:

    (1) "[I]f if actual or legal control of the permittee is acquired, directly or indirectly, whether by stock-ownership or in any other manner, by any person, then such permit shall be automatically terminated at the expiration of thirty days thereafter: Provided, That if within such thirty-day period application for a new basic permit is made by the transferee or permittee, respectively, then the outstanding basic permit shall continue in effect until such application is finally acted on by the Secretary of the Treasury.

H. State and Local Regulation

1. Section 2 of the 21st Amendment left to the states how each would regulate the "transportation, importation or possession" of alcohol within its borders. While all states require some form of license/permit to manufacture beer or distilled spirits, states have opted for one of three general types of regulatory schemes placing different levels and methods of control on the distribution and retail tiers of the three-tier system:

a. a "control" system for alcohol where the state itself controls the distribution and retail sale of alcohol;

b. a "license" system where the state licenses individuals to act in these capacities; or

c. a hybrid system where particular aspects of sale and distribution are controlled/operated by the state and other aspects are operated by independent companies or individuals licensed by the state.

2. Currently, seventeen states and certain counties in Maryland have opted for a "control" system over at least certain parts of the distribution and sale of alcohol in their state. This will be most readily apparent in states where consumer facing retail stores are operated by the state's alcohol beverage control ("ABC") authority. In Virginia, for instance, liquor stores are actually called "VAABC" stores and will reflect such a label on the sign above their doors.

3. The most important thing to know about state liquor law is that, before doing any business in a particular state, you must become well versed in the alcohol laws there. Although states generally share some similarities in their regulatory schemes—such as the requirement that independent producers, wholesalers, and retailers be licensed/permitted, and that certain transactions and ownership interests among the different tiers are prohibited or severely restricted—you can never assume you know how something works in one state because you have dealt with familiar concepts in another. Furthermore, don't expect state rules to seem logical or small-business friendly. Most rules date very far back and contain protections (often for wholesalers who were once considered the "the little guy" by comparison with enormous macro level liquor manufacturers) that no longer seem to make sense in today's market and the meteoric rise of craft producers. While laws in some states are far behind the times, others have been updated and are more relevant, creating a favorable climate for growth of the craft beverage industry. As the craft industry has grown in size and popularity it has earned more clout with state legislatures, catalyzing further modernization of laws and allowing for further growth of the industry and competition among states. If you see a booming craft beverage industry in a state, you can often assume its laws have been modernized to be (or were from the beginning) more flexible to allow for growth of small liquor producers.

4. ***Tied House Rules: Minnesota Example***

a. While tied-house rules vary from state to state, they often take a similar form as those provided in sections 340A.301, 325B.11, 340A.308, and 340A.309 of the Minnesota Statutes. Interestingly, some provisions apply only to beer, while others apply only to wine or distilled spirits.

5. A most basic example of a tied-house regulatory scheme is provided in Minnesota Statutes, section 340A.301, subdivision 8, which essentially says no manufacturer or wholesaler of alcohol can have an interest in a retailer and vice versa:

a. Subd. 8. **Interest in other business.** (a) Except as provided in this subdivision, a holder of a license as a manufacturer, brewer, importer, or wholesaler may not have any ownership, in whole or in part, in a business holding a retail intoxicating liquor or 3.2 percent malt liquor license. The commissioner may not issue a license under this section to a manufacturer, brewer, importer, or wholesaler if a retailer of intoxicating liquor has a direct or indirect interest in the manufacturer, brewer, importer, or wholesaler.

6. Section 340A.308 goes further than section 340A.301 in defining the restrictions on relationships between brewers and wholesalers of beer and retailers. Possibly due to Minnesota's only recent history of having numerous licensed producers of distilled spirits and wines, this section only applies to beer or other malt beverage products. The section prohibits a brewer or wholesaler of beer from directly or indirectly having a financial or managerial interest in a retail license or giving anything of value to a retailer, with some limited exceptions. Common threads among the various state laws (Minnesota included) include prohibitions or significant restrictions on the sale of liquor on credit to wholesalers from manufacturers or from wholesalers to retailers. Consignment sales are also generally prohibited.

7. Section 325B.12, is another common type of provision in three-tier regimes that prohibits a producer of alcohol (in this case beer only) from discriminating among its various wholesalers. Wholesalers are generally prohibited from discriminating against their various retail accounts as well—a practice generally prohibited by the provisions of Section 340A.308 prohibiting the giving of anything of value to a retailer.

8. Finally, a most explicit example of a legislative attempt to prohibit tied-house arrangements is provided in section 340A.309, which states, "A manufacturer, brewer, or wholesaler may not directly or indirectly make an agreement with a retailer which binds the retailer to purchase the products of one manufacturer or brewer to the exclusion of the products of other manufacturers and brewers."

I. Distribution Rules

1. Although, like all state laws related to liquor, distribution rules can vary significantly state-by-state, there are some notable common threads. First, for historical reasons that are not readily apparent, distribution of beer is often treated differently than distribution of distilled spirits and wine. Rules regarding the distribution of beer are often more heavily prescribed and a majority of states have enacted full-fledged beer franchise laws. A beer franchise law typically includes the following types of provisions:

a. Defines franchise agreements to include informal, oral arrangements, making any shipment to a wholesaler potentially the start of a franchise relationship, which may be an exclusive relationship depending on state law;

b. Requires "good cause" or "just cause" before a brewer can terminate the relationship. Good or just cause are often defined to include only certain statutorily prescribed circumstances, including in some states—if a brewer is lucky—a significant breach of a "reasonable" and "material" term in the parties' distribution agreement;

c. Provides significant remedies to wholesalers, often including a forced payment of fair market value for the distribution rights upon termination of a wholesaler without cause or without full compliance with the notice and cure provisions of the relevant statute; and

d. Makes waiver of the distribution rules ineffective.

2. In an effort to encourage the development and growth of craft breweries, many states permit breweries below a certain production threshold to distribute their products directly to retailers without engaging a distributor. While self-distribution can help breweries get their products to consumers at a more favorable price and without being stuck in complex, heavily regulated, and often exclusive franchise relationships, successful self-distribution can be quite capital intensive and a major distraction from the brewer's primary focus—producing and marketing good beer. Furthermore, once barrel limits are exceeded, the brewer is forced into the distribution system eventually anyway. Some state laws also exempt "small brewers" from the state's franchise laws. What constitutes a small brewer can vary significantly from state to state, ranging from 2,000 to 300,000 barrels produced annually.

J. A Note on The Commerce Clause:

1. While the 21st Amendment undeniably gives individual states the right to regulate the sale of alcohol within their borders, the nondiscrimination principal of the Commerce Clause prohibits the states from interfering with or burdening interstate commerce. State laws can run afoul of this rule when attempting to regulate in-state producers, distributors, or retailers differently from out-of-state parties. The Supreme Court has routinely held that "in all but the narrowest circumstances, state laws violate the Commerce Clause if they mandate 'differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter.'" *Granholm v. Heald*, 544 U.S. 460, 472 (2005) (quoting *Ore. Waste Sys., Inc. v. Dep't. of Envtl. Quality of Ore.,* 511 U.S. 93, 99 (1994)). This issue—most recently addressed by the Supreme Court in the *Granholm* case, involving disparate treatment in the ability of in-state and out-of-state wine producers to ship their products directly to consumers—is further discussed below in Section IV.

II. Case Study: So you want to be a craft beverage producer?

1. Craft brewers, home winemakers, and those who love distilled spirits (and illegal moonshiners) often dream of leaving their careers and chasing the dream of opening a small brewery, winery, or distillery. It all sounds fun and exciting, and it can be, but the liquor world is not for the faint of heart or anyone trying to simply jump in on a whim. Burdens of cost, time, and administrative headaches often exceed what most imagine. No matter how long you imagine getting up and running might take, how simple you believe the process to be, and whatever your budget, in most cases it will take longer, be more complicated, and cost far more than you plan.

2. For purposes of an example of how complex the regulations can be and what all must go into the calculation of whether the alcohol business is right for you, let's look at *what is required to open a winery in Minnesota:*

3. First, know that you will need to obtain multiple permits, licenses, and other certifications from local, state, and federal branches government. Obtaining a TTB Basic Permit for a bonded winery alone takes around 5-6 months, but the process starts much earlier than that and can stretch far beyond that time. Planning and execution strangely must be completed in practically opposite orders. Although in applying for permits and licenses you will generally start at the federal level—first seeking a federal Basic Permit to establish and operate as a bonded wine premises, and then move progressively more local, seeking your state winery permit, a retail food handler's permit from the Department of Agriculture, and potentially a retail license of some sort—the first thing you must consider in the planning stage is whether local zoning ordinances will even permit your intended production operations on the land you own or intend to lease.

B. *Will state law and local zoning laws even allow you to operate a winery on your land?*

1. In Minnesota, state law creates a distinction between farm wineries and wine manufacturers (discussed further below). Although a wine manufacturer has no state level restrictions on location, "A farm winery license must be issued for operation of a farm winery on agricultural land, operating under an agricultural classification, zone, or conditional use permit." (Minn. Stat. § 340A.315, Subd. 9)

a. Will the local zoning laws in your town, city, or county allow you to operate a winery on the land you own or lease?

b. If not, can you feasibly obtain a Conditional Use Permit or have your property rezoned?

c. Will your land and local ordinances allow for construction and operation of a proper winery building and sufficient parking without cutting into the space for your vineyards and complying with setbacks, environmental regulations, etc.?

d. Do you want to have a tasting room? Will you be holding events at your winery premises? Will local laws allow you to obtain a retail license on the same premises if you want to be able to sell alcohol products other than the wine you produce on site?

2. Many would-be wineries will have already started developing a viable and sizable vineyard on their land and should, therefore, know what local zoning allows; however, it is a critical first step to ensure you can actually do what your business model calls for on the land you own or lease.

C. *What is your business model and is it both legal and profitable?*

1. Starting a winery sounds like a dream, but you need to be confident your operation can make enough money to stay afloat. To do that, you'll need to know where you're getting your grapes, where and how you're processing them, the expense of all that, how you might be able to finance such costs, and what your realistic path to market might be. In considering these business-related decisions, you'll need to be certain your intended model is even legal under state and local laws. It's far more complicated than just obtaining a winery permit. Below are some questions you must consider before moving forward:

a. Sourcing/Production: What types of wines do you want to make, where are your grapes coming from, and who will be crushing, processing, and bottling your wine?

(1) Will you be processing only (or primarily) grapes you grow on your own Minnesota vineyard?

(2) Will you be buying grapes/grape juice/bulk wine from another Minnesota vineyard or winery?

(3) Do you desire to import grapes, grape juice, or bulk wine form another state or country?

(4) What quantity of wine will you produce?

b. Sales/Distribution: What is your target market and how does your product reach the consumer?

(1) Will you have a tasting room? Is that where you intend most of your sales to come from?

(2) Do you intend to sell your wine through retailers like liquor stores, restaurants, bars, etc.? If so, do you

intend to self-distribute or sell your products first to distributor who will then sell the products to these retailers?

(3) Do you intend to engage in direct shipping?

2. All of these questions should be answered, or at the very least seriously considered, before you begin applying for any licenses or spending any money on a winery project. Not only are they critical from a business standpoint generally, what the law allows and prohibits a winery to do can vary dramatically based on the answers to some of the above questions. Furthermore, assuming your proposed business model will even be permissible legally, which license(s)/permits you must seek from the state and/or municipality to engage in the proposed operations can also vary.

D. *Wine Manufacturer versus Farm Winery:*

1. Wine Manufacturer:

a. If you intend to operate as a large-scale production winery, you can source your grapes and bulk wine from anywhere in the country with minimal restriction as a licensed wine manufacturer (See Minn. Stat. § 340A.301, Subd. 10).

b. However, a wine manufacturer does not have the ability to self-distribute and must therefore contract with a wholesale distributor.

c. Furthermore, if the volume of wine produced annually is made with less than 51% Minnesota grown grapes, you cannot have a tasting room on site. Because of the three-tier system, a wine manufacturer cannot obtain a separate retail on-sale license to sell others' wines and cannot even sell its own wine at retail without a special statutory carve-out. The carve-out that exists only allows a wine manufacturer to sell at retail the wines it produces on site, and only if those wines are made with at least 51% Minnesota grapes.

2. If you are like most start-up wineries in Minnesota, and elsewhere, your business model will likely include retail sales on-sale and off-sale from the winery premises, meaning you'll have a tasting room, as well as sales through retail liquor stores and potentially bars/restaurants. You may also desire to have the ability to host events on your winery premises where you'll sell liquor other than wine you've produced on site. If this is the case, you must plan on obtaining a farm winery license.

a. Farm Winery:

(1) The farm winery license allows greater flexibility generally but comes with additional restrictions.

(2) "[The farm winery] license authorizes the sale, on the farm winery premises, of table, sparkling, or fortified wines produced by that farm winery[1] at on-sale or off-sale, in retail, or wholesale lots in total quantities not in excess of 75,000 gallons in a calendar year, glassware, wine literature and accessories, cheese and cheese spreads, other wine-related food items, and the dispensing of free samples of the wines offered for sale."

(3) You can self-distribute your products to retailers

(4) You may be able to obtain a separate retail on-sale license authorizing you to sell beer, wine, and/or spirits produced by others.

(5) However, you cannot produce more than 75,000 gallons of wine a year.

(6) No more than 10% of your production can be derived from use of bulk wine from other producers.

(7) Your winery must be on agriculturally zoned property (see above).

3. Once you have decided whether to seek a wine manufacturer's license or farm winery license and determined your business model will be legally compliant, you must make projections of revenues and expenses and determine whether your business will be sustainable and hopefully profitable. Many would-be winemakers fail to consider all of the costs associated with creating a winery. Although they may consider the costs of ingredients, bottles, labels, and some of their production machinery, they often overlook or underestimate the costs of:

a. Real estate rent or acquisition

b. Grape production and harvesting (unless already doing so)

c. Labor at all levels (farming, production, sales and marketing, distribution, and retail operations, etc.)

[1] Note: Bringing finished (bottled) wine to your Minnesota winery generally requires going through a distributor. Furthermore, Minnesota does not (according to local enforcement agents) recognize the concept of a contract production or custom crush arrangement. If another licensed winery (even another Minnesota winery) produces your grapes into wine—even at your direction, pursuant to a contract—enforcement claims that wine is no longer yours and you cannot bring it to your winery and sell it as your own. The only way enforcement claims you can sell this wine would be to bring it to the winery through a distributor and conduct sales through a separate retail on-sale license.

d. Environmental remediation or run-off/contamination prevention measures

e. Taxes (real estate, income, excise, FICA, etc.)

f. Marketing and distribution

g. Legal and Accounting.

E. *What type of entity or entities should you form to own and operate your winery?*

1. Rarely should any business be operated as a sole proprietorship or partnership without the liability protections of some liability limiting entity. In the alcohol industry, liability risk is very high so this goes double. Whether your winery should be organized as a limited liability company, s-corp., or limited liability partnership depends on many factors. The simplest entity to own and operate is a limited liability company, but it is not always best. Advice of counsel and an accountant should be sought to consider, among other things:

a. Tax consequences of various entity structures;

b. Compliance with state Farm Act statutes (In some states only certain entities can own/operate farmland);

c. Corporate record keeping burdens; and

d. Whether a more complex, but potentially more tax efficient and liability shielding structure is advisable, such as holding the vineyard and winery real estate in one entity and the winery operation in another.

F. *Should you seek trademark protection of your winery name and individual products/labels?*

1. Yes. One of the most important assets of a brewery, distillery, or winery is its house brand and its product names. If you ever plan on selling your products outside the state where they are made, you should seek federal trademark protection for the brand and your key products/labels. Although rights in a trademark generally begin based on use of the mark in commerce, you can protect your rights even before such use by filing an intent-to-use application with the U.S. Trademark office, which can provide priority of right in a trademark back to the filing date of the application if use is perfected within three years of the allowance date of the application. As a cautionary tale regarding the importance of registering and protecting your trademark rights early, see this article about a brewery that found out it could not operate under the name it had selected—very late in the game:

a. http://www.bizjournals.com/twincities/news/2015/11/19/bryn-mawr-brewing-utepils-name-change-winery.html.

G. *When can I start construction of the building that will house my winery operations and tasting room?*

1. Because erecting a building from the ground up can take quite a long time, many start-up wineries make the misstep of jumping into construction before ensuring their plans comply with the very particular laws related to food operations—often failing to realize wine is considered a food. Most often overlooked is compliance with the Minnesota Food Code and federal Good Manufacturing Processes, which is overseen primarily by the Minnesota Department of Agriculture. Contrary to popular understanding, the first permit/license application that should probably be filed when planning to operate a winery is a Plan Review Application submitted to the Department of Agriculture. Among other things, a completed plan review application requires:

a. Information on well (unique well number) and private septic system (certificate of compliance);

b. A copy of the zoning approval or building permit from the local unit of government;

c. Complete set of plans drawn to scale, including proposed layout, mechanical schematics and construction material;

d. Finish schedule for floors, base cove, wall and ceilings ;

e. A proposed menu that indicates the types of foods you will be selling and their methods of preparation or storage;

f. A description of the project;

g. Equipment locations on the layout;

h. Equipment specification sheets for all equipment. All food service equipment must be National Sanitation Foundation International (NSF) certified, or certified as meeting NSF International standards by a certifying agency such as Edison Testing Laboratories (ETL);

i. One complete set of elevations and drawings for all custom designed equipment; and

j. Counters and cabinetry shop drawings indicating cabinet construction and countertop finish.

2. Plumbing plans must also be submitted to the Minnesota Department of Labor and Industry.

3. Complying with these requirements and gaining plan review approval will ensure you do not need to go back and make costly construction and design changes. Furthermore, many of the above requirements, such as the diagrams and plans, zoning approval, etc., will be required for other components of license and permit applications.

4. In this pre-building stage, it is also highly recommended that a prospective winery consult with an environmental expert to determine whether any potential contamination and runoff issues must be averted before construction begins.

H. *Now can I file my license and permit applications?*

1. Not just yet. If your intended business model includes or requires obtaining a retail on-sale license in addition to your Farm Winery License and federal Basic Permit, before filing any applications, you should first consult your local city clerk or an attorney to determine whether obtaining such a license will be feasible in your municipality. If not, your model (or local law) will need to change, or you need to consider stopping altogether.

2. Federal Application for Basic Permit:

   a. Having addressed all the above, it is time to prepare your federal application to register as a winery premises and obtain a federal Basic Permit.

   b. Although applications can be made in paper and submitted by mail, the TTB much prefers that applications be submitted online using their "Permits Online" portal, located at https://www.ttb.gov/ponl/permits-online.shtml. Using Permits Online will increase the efficiency of processing your application as well, although you should plan on the process taking far longer than you may anticipate. As of November 2016, the average time to process an application for a winery was 162.89 days. This may significantly vary, and if your application is not "perfect" (which they rarely are) it will likely take longer.

   c. To complete the application, you will need documentation including, but usually not limited to, the following:

   - Lease Agreement or Proof of Property Ownership;

     (1) If you are leasing the property/premises where you will be conducting your operations, you must submit a copy of your lease agreement. This agreement must

show that the property owner knows the intended use of the proposed operations at that location and gives consent for the building/land to be leased for this purpose. Such an agreement is necessary even if the owners or officers of the company own the property and are "leasing" to the company.

(2) If you own the property/premises, provide proof of ownership.

- Bond Form – Form 5120.36 (However, generally not needed any longer for small wineries[2]);
- Copy of driver's license or official state ID Card;
- Federal Employer Identification Number (obtained from IRS);
- Diagram of Premises/Building, detailed with the dimensions, identifying equipment with size, loading docks, doors, windows, etc.;
- Detailed written description of all areas the Premises/Building;
- Description of all methods of providing security to the premises;
- Description of how to keep taxpaid and untaxpaid wine separate;
- Power of Attorney form if application being filed by your attorney;
- Environmental Questionnaire, specifying the number of employees, amounts and types of waste, disposal plans for liquid and solid waste, electric/gas provider name and sometimes HVAC equipment list

(1) Recommend speaking with an environmental consultant about these matters—not just to pass TTB review of your application, but rather to ensure compliance with local, state, and federal

[2] As a result of the Protecting Americans from Tax Hikes Act of January 2015 (PATH Act), as of January 1, 2017, if you are the proprietor of a brewery, distilled spirits plant, or winery owing not more than $50,000 in excise taxes in the previous year, and you expect to owe not more than $50,000 in excise taxes in the current year on beer, distilled spirits, or wine, you may no longer be required to hold a bond.

In addition, if you owed not more than $1,000 in excise taxes the previous year and expect to owe not more than $1,000 in the current year, you will be eligible to file your excise taxes annually, rather than semi-monthly or quarterly.

environmental protection laws. Early planning can save a lot of time, money, and hassle later on;

- Supplemental form regarding disposal of waste into navigable waters;

- Description of Property (metes and bounds is usually best);

- Sometimes description of the equipment to be used;

- Articles or Certificate of Organization/Formation (depending on entity type and state requirements);

- Operating Agreement / Bylaws and Shareholder Agreement (as applicable);

- Owner and Officer Questionnaires for each officer and each owner of 10% or more)

- Source of Funds Documentation - For each owner (whether an individual, company, or trust). You must supply documentation to support the sources of funding for the investment shown on this application. Examples of these sources of funding and details outlining what is required to be submitted are shown below:

  (1) Financial Gifts – The name of any individual making a gift, along with the amount of the gift, must be shown on the application. You must submit a statement from the individual stating that they have no interest in the business. You also must submit a financial record or bank statement showing your receipt of the gift.

  (2) Loans – You must submit a copy of the promissory note or a statement from the entity providing any loan made as part of the source of funds. You must also submit a financial record or bank statement showing your receipt of the loan amount.

  (3) Bank Account Records – If the source of funds invested in the business is from a savings account, checking account, or other source(s), you must submit a current bank statement with a balance which includes that amount present, and the bank statements for each of the three months prior to that month. If the funds have already been used, you

must submit a bank statement from the month that the funds were removed for business purposes, and the bank statements for each of the three months prior to that month. In addition, you must submit any documentation (copies of checks, details within bank statement, etc.) showing that the funds were used for business purposes.

- If the bank account is a jointly owned account (such as with a spouse), submit a signed letter from the other party stating that they have no control or ownership in the proposed business (if applicable).

- If a company has a current, official, detailed Financial Statement covering the proposed operations, it may be submitted in lieu of the above-mentioned bank account records, but often both will be required; and

d. Signing Authority Authorization - one of the following is required:

- Written action or approved resolution – required if you will be granting Signing Authority to individuals or positions through a Board action as opposed to such authority being specifically granted within the entity’s organizational documents

- OR

- Articles of Organization OR Operating Agreement– submit if you will be granting Signing Authority to individuals or positions through specific designation contained within the corporation's organizational documents

- OR

- Signing Authority For Corporate or LLC Officials Form – submit TTB Form 5100.1, completed and signed.

3. As you can see much pre-planning and legal work are required before filing your federal applications. Once you have filed all the above materials through the TTB’s Permits Online portal, you will be assigned a reviewing agent. Although the TTB says they will contact you when your application materials have been reviewed, you should reach out to this person and develop rapport. They can be your best friend or worst enemy as the application process transpires. Pro Tip: Give it at least 75 days before asking your agent about the status of your application.

I. State Application for Wine Manufacturer / Farm Winery License:

1. Now begins the waiting game. In Minnesota, Wisconsin, and many, if not all, other states, you cannot file your state application for a winery license/permit until you have received approval at the federal level.

2. In Minnesota, the primary licensing and regulatory authority for alcohol is the Department of Public Safety, Alcohol and Gambling Enforcement Division (AGED). The application materials requirements and time period for approval are generally far less excessive than those of the TTB.

3. The application for Farm Winery License is a simple two-page form and requires primarily information you will already have obtained for your TTB Application. However, the following additional documentation and information must accompany your application:

   a. A Valid Liquor Liability Insurance Certificate must be attached.

   b. You must have a Workers' Compensation policy in place because the form requires the insurance company and policy number to be listed.

   c. You must obtain a Surety Bond in the amount of $5,000 and attach a copy of the same to cover your State excise taxes. A bond like this is most easily obtainable through your insurance provider and generally only costs $100-$200 in annual premiums. You can also submit a check for $5,000 in lieu of the bond.

   d. In preservation of the three-tier system, the application requires you to answer whether any owner or officer of the winery has any interest in any other brewery, manufacturer, wholesaler, or retail alcohol beverage establishment anywhere.

   e. You must attach your valid TTB Basic Permit.

   f. You must also provide your company's organizational documents.

4. The requirements for a Wine Manufacturer are similar, but a different form must be filed called an Application for a Wholesaler's/Manufacturer's Intoxicating Liquor License. The fees are also higher ($500 as opposed to $50).

5. Along with either type of license application, you must also submit a Background Investigation Inquiry form on behalf of the prospective licensee and a Background History Statement on behalf of each person who owns more than 5% of the applying entity.

6. Pro Tip: As discussed above, be certain you understand the laws of your state regarding what wine a winery license allows you to sell at on and/or off-sale from the premises. Wineries in both Minnesota and Wisconsin, in

logical preparation for opening, have run into significant regulatory troubles in having wine prepared at an out-of-state winery during the application process so they have product available once their licenses are approved and can open for business. In Minnesota, these issues can even apply when the wine is made by another local Minnesota farm winery (discussed above in Note 1).

J. Retail On-Sale License:

1. Remember that a wine manufacturer cannot obtain a separate retail license; however, a farm winery can. Sometimes, as discussed above, this is the only way to have product available for sale when your licenses are approved and your winery opens. Such a license must be obtained from the town, city, or county where your winery is located. The requirements to issue such a license—and whether such a license can even be obtained by a particular applicant—vary greatly between municipalities. For example, in one Minnesota city, only a private club can obtain a retail liquor license.

2. State Brand Registration and COLA Approval:

a. *State Brand Registration:*

- Each brand and brand label of wine produced by a Minnesota winery must be brand registered with the state. *See* Minn. Stat. § 340A.311. Registration of each brand wine requires payment of a $40 fee; however, farm wineries are exempt from this fee. Registration must be renewed every year. To register a brand label you must have already obtained a COLA from the federal TTB.

b. *COLA Approval:*

- Generally you must only obtain label approval prior to bottling if you are shipping out of state; however, since the state of Minnesota requires you to submit your COLA with each brand registration application, you must obtain a COLA first. Obtaining label approval for a wine generally takes around 15 days, assuming the applicant uses the TTB's COLAs Online portal, located at https://www.ttbonline.gov/. Section 4.50(a)-(b) of Title 27 of the Code of Federal Regulations, which regulates wine only, provides that "[n]o person shall bottle or pack wine … or remove such wine from the plant where bottled or packed" without a certificate of label approval issued by the appropriate TTB officer, unless the bottler or packer of wine shows "that the wine to be bottled or packed is not to be sold, offered for sale, or shipped or delivered for shipment, or otherwise introduced in interstate or foreign commerce."

3. In some instances, the TTB may require a formula approval before a bottler or importer can apply for a COLA. This is typically required when flavoring or other coloring is added to a beverage. In these cases, the ingredients and production process must be evaluated in order to ensure compliance with all applicable regulations.

K. Retail or Wholesale Food Handler's License:

1. Before you can begin selling your products you must obtain approval of your operations from the Minnesota Department of Agriculture and a Retail or Wholesale Food Handler's License must be issued (*See* section 5 above for greater detail). Whether the license obtained is for wholesale or retail depends on whether the majority of your annual sales volume will come from retail or wholesale.

L. *I've received my federal and state licenses, permits, and approvals—now what?*

1. Obviously, it is time to start producing wine; however, other considerations must be addressed.

2. <u>Distribution</u>:

a. If you will be self-distributing, it's time to start contacting retailers to set up sales orders and consider obtaining a Direct Wine Shipper's permit from the State of Minnesota.

b. If you are licensed as a wine manufacturer and therefore can only distribute through a traditional third-party distribution relationship (or if you simply decide to use traditional distribution as a licensed farm winery), you must reach out to various third-party distributors and determine whether any have interest in distributing your products and, if so, which seems to be the best fit. Before reaching out to distributors, you should develop a fine-tuned presentation and pitch. Furthermore, you must make sure the distributor you choose is the right fit because termination of the distribution relationship, depending on the law of your state, can be quite difficult and/or expensive.

3. <u>Compliance</u>:

a. Once up and running, compliance is the biggest legal concern. The most common compliance issues at the federal level involve record keeping and timely/proper payment of taxes. At the state level, while record keeping and payment of excise taxes can cause alcohol producers some trouble, often compliance issues revolve around registration and updating of brand labels and adherence to state law provisions surrounding the three-tier system and prohibition of tied-house arrangements. Questions often arise as to whether donations of products can be made to certain events or organizations, whether special pricing can be given to certain retailers or distributors, whether certain partnerships or other mutually beneficial arrangements between multiple manufacturers or between manufacturers and retailers or wholesalers are allowable, and whether certain advertising and marketing initiates are permitted. These issues always come down to state law and often the answers are not entirely clear. Your best bet is to contact the state regulators and/or an experienced attorney before engaging in a new initiative of which you are not certain about the legality. Often the laws are more restrictive than one would expect.

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Other Issues

Submitted by Jeffrey C. O'Brien

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A. Distribution Agreements and the Three-Tier System

Origins

In 1933 the 21st Amendment to the United States Constitution repealed Prohibition and also gave states the authority to regulate the production, importation, distribution, sale and consumption of alcohol beverages within their own borders. A new regulatory system known as the Three-Tier System was created. This system was established to eliminate tied-house abuses. "Tied-houses" would no longer exist - instead beer would be sold through independent distributors.

While each state has its own set of laws governing the three-tier system, the separation of the three-tiers by inserting an independent distributor between the brewers and the retailers is a common thread. The three tiers (brewer, distributor, retailer) are also further separated by other laws and regulations prohibiting suppliers and distributors from having any financial interest or influence with retailers - for example, beer sales on credit are not allowed and consignment sales are banned.

State Distribution Laws

Distribution laws vary between states. See Appendix 1 for a summary of each state's law.

Franchise Laws

A majority of the states have enacted full-fledged beer franchise laws. Although it is not hard to detect a whiff of protectionism in these enactments, their stated purpose is to correct the perceived imbalance in bargaining power between brewers (who are presumed to be big and rich) and wholesalers (who are presumed to be small and local). Temperance concerns are also cited. A full-fledged beer franchise law will usually:

- Define franchise agreements to include informal, oral arrangements, making any shipment to a wholesaler the start of a franchise relationship.
- Prohibit coercive brewer practices, most often including actions in which a brewer (a) requires the wholesaler to engage in illegal acts, (b) forces acceptance of unordered beer, or (c) withholds shipments in order to impose terms on the wholesaler.
- Require “good cause” or “just cause” before a brewer can terminate a wholesaler.
    - The burden is generally on the brewer to demonstrate cause for termination.
    - “Good cause” is usually defined to include a significant breach of a “reasonable” and “material” term in the parties’ agreement.
- Dictate that a brewer give prior written notice (60 or 90 days is common) to a wholesaler before termination is effective, with the notice detailing the alleged deficiencies that justify termination.
- Grant wholesalers an opportunity to cure the deficiencies alleged in a termination notice, with termination ineffective if a wholesaler cures the defect(s) or presents a plan to cure the defect(s).
    - “Notice-and-cure” requirements usually are waived under certain circumstances. These most often include a wholesaler’s (a) insolvency, (b) conviction or guilty plea to a serious crime, or (c) loss of a license to do business. Many franchise laws also permit expedited termination where a wholesaler (d) has acted fraudulently or (e) has defaulted on a payment under the agreement despite a written demand for payment.

- Require wholesalers to provide brewers with notice of any proposed change in ownership of the wholesaler, giving the brewer an opportunity to object. The brewer's approval of an ownership change cannot be "unreasonably" withheld.
    - Brewers usually have little or no right to block a transfer to a previously designated family successor.
- Create remedies for unfair termination, generally granting wholesalers the right to receive "reasonable compensation" following termination.
    - Most beer franchise laws grant wholesalers the right to seek an injunction that, if granted, would quickly halt termination proceedings pending the resolution of wrongful termination claims. The forum for such relief can be either a state court or the state's alcohol control authorities.
    - Although arbitration of the entire dispute is not required, and sometimes prohibited, disputes over what constitutes "reasonable compensation" often must be arbitrated at the request of a party.
    - Even if the franchise law prohibits arbitration, an arbitration clause in the parties' written agreement is likely enforceable under the Federal Arbitration Act if the parties reside in different jurisdictions.
- Declare any waiver of franchise law protections void and unenforceable.
- Set a date that the law becomes effective. Some franchise agreements may predate franchise acts' effective dates, likely making the franchise law inapplicable to that agreement.

In addition to the extremely common provisions described above, other terms may:

- Require beer franchise agreements to be in writing.
- Mandate that sales territories be exclusive.
  - Wholesalers may face substantial penalties for making deliveries outside their designated territory, and such conduct may permit expedited termination by the brewer.
  - Territorial designations may need to be filed with state liquor control authorities.
- Restrict a brewer's ability to dictate prices, with restrictions that often go beyond the strictures of antitrust law. Common provisions prohibit brewer price fixing, require brewers to file and adhere to periodic price schedules, and ban price discrimination between wholesalers within the state.
- Provide that the prevailing party in a termination dispute will be compensated for its attorneys fees.
- Bind succeeding brand owners to existing franchise agreements, although some permit not-for-cause termination after a change in brand ownership, as long as compensation is paid.
- Impose a good faith obligation on both parties. Under modern contract law, this good faith obligation is already implied in all contractual relations.
- Impose specific obligations on wholesalers, occasionally specified to include a duty to properly rotate stock, maintain tap lines, and comply with other reasonable quality control instructions.

Most states have enacted at least a few laws that regulate brewer-wholesaler relations. In some, beer wholesalers are covered by a franchise law protecting all alcohol beverage wholesalers. In a few states, beer wholesalers are protected by franchise laws that apply to a variety of franchise relationships, from beer to burgers. Still others partially regulate beer franchise relationships through their alcohol control laws by, for example, requiring exclusive territories as a condition for licensing. Finally, a few states and the District of Columbia have, to date, left brewer-wholesaler relations essentially unregulated, thereby allowing the franchise relationship to be governed exclusively by the terms of the parties' agreement, to be enforced under general contract law principles.

Appendix 1 sets forth a state-by-state summary of beer distribution laws.

Self-Distribution

Many states permit breweries below a certain production threshold to distribute their product directly to retailers without the use of a distributor. While self-distribution can be a viable means around the complex and onerous franchise laws, the time and capital required to operate an effective distribution system is significant and tends to detract from other operations. Further, breweries that grow beyond the production thresholds are forced into the franchise system as they lose their rights of self-distribution.

Appendix 2 sets forth a state-by-state summary of these self-distribution laws.

Small Brewer Exemptions

In response to the continued consolidation of beer wholesalers in the U.S. and the imbalance in negotiations between larger wholesalers and small craft brewers, several states have created exemptions within their distribution laws for "small brewers" relative to the onerous termination provisions:

- Arkansas: Small brewers within the state are fully exempt from any remedies under the state's franchise act. Ark. Code Ann. §§ 3-5-1102(12)(B); 3-5-1403(13). An Arkansas statute defines a small brewery as a "licensed facility that manufactures fewer than thirty thousand (30,000) barrels of beer and malt beverages per year for sale or consumption." Ark. Code Ann. § 3-5-1403(13).
- Colorado: None of the state's franchise protections are enforceable against small manufacturers. Colo. Rev. Stat. § 12-47-406.3(8). Specifically, the applicable statute exempts manufacturers that produce "less than three hundred thousand [300,000] gallons of malt beverages per calendar year." *Id.*
- Illinois: The state's franchise provisions allow small brewers whose annual volume of beer products supplied represents 10 percent or less of the wholesaler's entire business to terminate upon payment of reasonable compensation to the wholesaler. 815 Ill. Comp. Stat. 720/7.
- Nevada: The state's good cause franchise protection against terminations is not enforceable against small suppliers in-state and out-of-state. Nev. Rev. Stat. § 597.160(2). Specifically, the statute exempts suppliers that sell "less than 2,000 barrels of malt beverages . . . in this state in any calendar year." *Id.*
- New Jersey: A brewer from within or without the state who succeeds another brewer is exempt from a rebuttable presumption that favors an injunction preventing termination of the preexisting wholesaler when the affected brands represent a small portion (*i.e.*, less than 20 percent) of the terminated wholesaler's gross sales, the terminated wholesaler

receives compensation, and the brewer assigns the brands to a wholesaler that already distributes its other brands. N.J. Rev. Stat. § 33:1-93.15(4)(d)(1).

- New York: A small brewer whose annual volume is less than 300,000 barrels produced in the state or outside of the state and who represents only a small amount (*i.e.*, no more than three percent) of a wholesaler's total annual sales volume, measured in case equivalent sales of twenty-four-twelve ounce units, may terminate a wholesaler upon payment of compensation for only the distribution rights lost or diminished by the termination. N.Y. Alco. Bev. Cont. Law § 55-c(4)(c)(i). The statute defines "annual volume" as "the aggregate number of barrels of beer" brewed by or on behalf of the brewer under trademarks owned by the brewery, or the aggregate number of barrels of beer brewed by or on behalf of any person controlled by or under common control with the brewer, "during the measuring period, on a worldwide basis." N.Y. Alco. Bev. Cont. Law § 55-c(4)(c)(iv).
- North Carolina: A small brewer may terminate a wholesaler upon payment of compensation for the distribution rights with five days' written notice without establishing good cause. N.C. Gen. Stat. § 18B-1305(a1). North Carolina's alcohol beverage statutes define a small brewer as "a brewery that sells, to consumers at the brewery, to wholesalers, to retailers, and to exporters, fewer than 25,000 barrels . . . of malt beverages produced by it per year." N.C. Gen. Stat. § 18B-1104(8).
- Pennsylvania: Although not a small brewer carve-out, the state's franchise provisions exempt in-state manufacturers whose principal place of business is in the state, "unless they name or constitute [or have named or constituted] a distributor or importing distributor as a primary or original supplier of their products." 47 Pa. Cons. Stat. §

431(d)(5). **Warning**: this provision likely violates the Commerce Clause of the U.S. Constitution.

- Rhode Island: Although not a small brewer carve-out, the state's franchise laws exempt Rhode Island-licensed manufacturers. R.I. Gen. Laws § 3-13-1(5). **Warning**: this provision likely violates the Commerce Clause of the U.S. Constitution.
- Washington: Small brewers holding certificates of approval are excluded from the state's franchise protections. Wash. Rev. Code § 19.126.020(10). Specifically Washington's franchise law excludes from the definition of "supplier" "any brewer or manufacturer of malt liquor producing less than two hundred thousand [200,000] barrels of malt liquor annually." *Id.*

Distillery Distribution Issues

Regarding distilleries, most states do not have statutory distribution provisions similar to breweries. In Minnesota, for example, a distillery can have a distribution agreement for a term certain and is not subject to the franchise-type termination provisions described hereinabove. However, distilleries typically have little to no rights of self-distribution, which again leads to unequal bargaining power in contractual negotiations.

B. Employment Issues

Dealing With Key Employees

Most states provide that employees are "at will" employees; that is, they can leave their employment whenever they wish, for any reason or no reason. If a business owner has a key employee that is integral to its success, that employee should have a written employment agreement that provides for a fixed term of employment. A covenant not to compete can be included to deter a key employee from leaving to work for a competitor. Absent this type of agreement, the key employee can leave at any time.

A written employment agreement is imperative for your head brewer who knows a brewery's formulas could do the most damage to the business working for the competition. Hence, a master brewer employment agreement should include a covenant not to compete and provisions that clearly state that the beer formulas are "trade secrets" and thus the property of the brewery.

Covenants not to compete must be narrowly tailored to balance the interests of employer and employee. The employer must show (i) the covenant not to compete was supported by consideration when it was signed (if the consideration for the covenant is the continued employment of the employee, then the covenant must be signed prior to the start of employment to be valid); (ii) the covenant protects a legitimate business interest of the employer; and (iii) the covenant is reasonable in duration and geographic scope to protect the employer without being unduly burdensome on the former employee's right to earn a living.

Use of "Volunteers"

Many breweries take advantage of the abundance of people interested in helping their business grow by allowing them to volunteer at the brewery. Depending upon the nature of the duties they are performing, classifying an individual who ought to be treated – and compensated – as an employee as a "volunteer" can lead to significant penalties under Minnesota and federal law. In the past few years as both state and federal government have tried to get more revenue, they have focused on going after employers for misclassification of workers, whether they be independent contractors, interns or the use of volunteers.

Minnesota Law:

There is a presumption anyone performing work for a “for-profit” enterprise is an employee. In Minnesota, the nature of the employment relationship is determined by using worker classification tests, similar to the manner in which employee status is determined under both workers’ compensation and unemployment insurance laws. Compensation of Minnesota employees is determined under Minn. Stat. § 181.722, Subd. 3, and the federal Fair Labor Standard Act. Correctly assessing a worker as an employee, student/intern, independent contractor, or volunteer is critical.

Minnesota Statute Section 177.23 governs the use of volunteers. Minn. Stat. §177.23, Subd. 5 states that "Employ" means “to permit to work”, and Subd. 6 states that an “Employee” means any individual employed by an employer, subject to certain enumerated exceptions. There is an exception for “any individual who renders service gratuitously for a nonprofit organization”, but there is no exception for an individual who renders service gratuitously for a for-profit organization.

Federal Law:

The Fair Labor Standards Act (FLSA) defines employment very broadly, i.e., "to suffer or permit to work." However, the Supreme Court has made it clear that the FLSA was not intended "to stamp all persons as employees who without any express or implied compensation agreement might work for their own advantage on the premises of another." In administering the FLSA, the Department of Labor follows this judicial guidance in the case of individuals serving as unpaid volunteers in various community services. Individuals who volunteer or donate their services, usually on a part-time basis, for public service, religious or humanitarian objectives, not as employees and without contemplation of pay, are not considered employees of the religious, charitable or similar non-profit organizations that receive their service. Members of civic organizations may help out in a sheltered workshop; men's or women's organizations may send members or students into hospitals or nursing homes to provide certain personal services for the sick or elderly; parents may assist in a school library or cafeteria as a public duty to maintain effective services for their children or they may volunteer to drive a school bus to carry a football team or school band on a trip. Similarly, an individual may volunteer to perform such tasks as driving vehicles or folding bandages for the Red Cross, working with disabled children or disadvantaged youth, helping in youth programs as camp counselors, scoutmasters, den mothers, providing child care assistance for needy working mothers, soliciting contributions or participating in benefit programs for such organizations and volunteering other services needed to carry out their charitable, educational, or religious programs.

Under the FLSA, employees may not volunteer services to for-profit private sector employers. On the other hand, in the vast majority of circumstances, individuals can volunteer services to public sector employers. When Congress amended the FLSA in 1985, it made clear that people are allowed to volunteer their services to public agencies and their community with but one exception - public sector employers may not allow their employees to volunteer, without compensation, additional time to do the same work for which they are employed. There is no prohibition on anyone employed in the private sector from volunteering in any capacity or line of work in the public sector.

Student/Interns:

Until recently, student/interns have not received the same close scrutiny as other groups of workers. Student/interns are <u>not</u> considered employees under both state and federal law, if their use in the workplace generally passes six tests offered by the Department of Labor. The tests are:

1. The training experience is similar to what is provided at school;
2. The training experience is for the benefit of the student/interns;
3. The student/interns do not displace regular employees;
4. The employer providing the training receives no immediate advantage from the activities of the trainees;
5. Student/interns are not necessarily entitled to a job at the conclusion of the training; and
6. The employer and the student/interns understand the work is unpaid training.

Whether an employment relationship exists is not always clear. Instead, whether an intern or trainee is entitled to such things minimum wage and overtime compensation will often depend upon whether the individual is receiving training without displacing other employees or providing any real benefit to the employer. (Note: a reasonable stipend may be permitted)

Independent Contractor:

Independent contractors are hired to perform special services of a limited scope and duration, and they typically perform the same services for a variety of businesses. The standards in Minnesota to be considered in determining whether or not an individual is an employee or an independent contractor depend upon the purpose for which such classification is to be considered but typically include factors such as:

1. The right to control the means and the manner of performance;
2. The mode of payment;
3. The furnishing of materials or tools;
4. The control of the premises where the work is done; and
5. The right of the employer to discharge the individual.

Generally, the more control, or right of control, an employer has over the individual performing the work, the work site, and the nature, quality, and manner in which work is performed, the more likely the relationship is an employer-employee relationship vs. an independent contractor arrangement.

C. Real Estate (Lease vs. Purchase)

As the old cliché goes, in real estate it's all about "location, location, location", and this is especially true for a brewery or distillery business. If you're looking to be the neighborhood hangout complete with a taproom (for breweries) or cocktail room (for distilleries), you'll need to find a suitable space close to home. Should you have larger ambitions, you may seek a more strategic location amenable to later expansion. Whatever the case may be, you'll need to have a space secured in order to complete the licensing process.

A new brewery or distillery owner will most likely lease a building at the start, and negotiating a suitable lease is a crucial step in the process.

Commercial lease agreements typically come in one of two varieties: "triple net" and "gross."

In a triple net, the tenant pays rent to the landlord, as well as a pro rated share of taxes, insurance and maintenance expenses. In the typical triple net lease, the tenant pays a fixed amount of base rent each month as well as an "additional rent" payment which constitutes 1/12 of an estimated amount for taxes, insurance and maintenance expenses (also called CAM or common area maintenance expenses). At the end of the lease year, the estimated amounts are compared to actual expenses incurred and adjusted depending upon whether the tenant paid too much or too little through its monthly payments.

In a "gross" lease, the landlord agrees to pay all expenses which are normally associated with ownership. The tenant pays a fixed amount each month, and nothing more.

D. Insurance Matters

Breweries and distilleries, like most businesses, face a myriad of insurance requirements. In addition to the surety bond required to obtain their license, breweries and distillers will need several types of coverages including:

- General liability insurance;
- Workers compensation; and
- Dram shop (if the business is serving alcohol for on-premise consumption).

With respect to general liability coverage, given the growth in breweries and distilleries and the increase in trademark and other intellectual property related disputes, it is imperative to carry coverage for these issues.

Many insurance companies now have special "craft brewery programs" which provide breweries with a package tailored to the needs of the industry.

Appendix 1

Summary of State Beer Franchise/Distribution Laws

State	**Summary of Law**	**Statutory Citation**
Alabama	• Written agreement required. • Exclusive territories. • State approval required before a brand is transferred. • Termination upon 60 days' notice, with wholesaler allowed to submit a plan for cure within 30 days and to cure defects within 120 days. • Immediate termination where wholesaler becomes insolvent, loses license for more than 61 days, or is convicted of a felony. • Termination on 15 days' notice for fraudulent conduct, sales outside territory, failure to pay after a written demand for payment, or a transfer of the business without brewer's permission. • Termination must be made in good faith and for good cause. • Good cause includes failure to comply with agreement provision that are reasonable and of material significance.	Ala. Code §§ 28-8-1 to 28-9-11
Alaska	• No beer franchise law	n/a
Arizona	• Exclusive territories are permitted, but not required. • Termination must be made in good faith and for good cause. • Good cause includes a failure to comply with a term in the franchise agreement, unless that term is unconscionable or requires an illegal act.	Ariz. Rev. Stat. §§ 44-1565 to 44-1567
Arkansas	• Exclusive territories, filed with the State. • Termination requires 30 days' notice with opportunity to cure. • No termination without good cause and good faith. • Good cause includes a wholesaler's insolvency, repeated violations of law, or failure to maintain a reasonable sales volume. • Immediate termination permitted for a number of reasons, including insolvency, license loss for more than 31 days, and sales outside of the wholesaler's territory. • Small brewery (less than 30,000 barrels a year) is not a supplier and exempted from the above provisions.	Ark. Code Ann. §§ 3-5-1101 to 3-5-1111 and § 3-5-1416.

California	• Territorial appointments must be in a written agreement, filed with the State. • Regardless of the parties' agreement, supplier may not terminate a wholesaler solely for wholesaler's "failure to meet a sales goal or quota that is not commercially reasonable under prevailing market conditions." • Some brewer-wholesaler relationships, particularly those involving large brewers, might be covered under California's general Franchise Relations Act. • A manufacturer that unreasonably withholds consent to transfer can be liable for damages. • Recent unpublished Attorney General letter suggested that manufacturer approval rights over wholesaler personnel decisions and business plans, impositions of changes to wholesaler standards or agreements, control over other manufacturers' brands, and control of wholesaler ownership changes are unlawful under the California Alcoholic Beverage Control Act. • In Crown Imp., LLC v. Classic Distrib. & Beverage Grp., Inc., to be published Cal. App. 3d (2014), the court found that even if you interpret the letter to disallow for a manufacture to unreasonably withhold consent to a sale of the distributorship, the law specifically allows for this and a specific statue controls.	Cal. Bus. & Prof. Code §§ 25000.2 to 25000.9
Colorado	• Exclusive territories in a written contract, filed with the State. • Franchise protections applicable to manufacturers producing at least 300,000 gallons of malt beverages annually. • Termination upon 60 days' notice, with wholesaler opportunity to cure during that period. • Grounds for immediate termination include failure to pay after written demand, insolvency, license loss for more than 14 days, fraud, and sales outside of the wholesaler's territory. • Not-for-cause termination permitted upon 90 days' written notice, with copies to all other wholesalers in all other states with the same agreement.	Colo. Rev. Stat. §§ 12-47-405 to 12-47-406.3
Connecticut	• Franchise protections apply following product distribution for more than six months. • Termination in writing, setting forth reasons and giving the wholesaler an opportunity to challenge. • Prior to termination, a brewer may appoint a replacement wholesaler, provided that the appointment is not effective until six months after the wholesaler receives notice of termination. • Termination for "just and sufficient cause," to be determined in a hearing before the Liquor Control Commission.	Conn. Gen. Stat. § 30-17

Delaware	• Territorial arrangements filed with the State. • Where parties have an exclusive arrangement, brewer must obtain ABCC consent before appointing a second distributor. • Termination upon 60 days' notice, with wholesaler opportunity to cure during the notice period. • Good cause is required to terminate a wholesaler without paying "reasonable compensation," which includes the laid-in cost of inventory and goodwill. • Good cause includes, among others, a wholesaler's refusal to comply with a material provision of the franchise that is essential, fair, and reasonable; failure to meet reasonable and fair performance standards; insolvency; and license loss for more than 30 consecutive business days. • Not-for-cause termination is allowed, provided the brewer receives the permission of the Commission to pay "reasonable compensation" and the termination does not violate the terms of the franchise agreement.	Del. Code Ann. tit. 6, §§ 2551 to 2556; 4 Del. Code Regs. § 46
District of Columbia	• No beer franchise law	n/a
Florida	• Exclusive sales territories, in writing, and filed with the State. • Termination upon 90 days' notice, with wholesaler permitted to cure defects within the notice period. • Termination without good cause is forbidden. • Good cause includes a violation of a reasonable and material contract term. • Termination upon 15 days' notice is allowed in certain instances such as insolvency, license loss for more than 60 days, fraud, and sales outside of the wholesaler's territory.	Fla. Stat. §§ 563.021 to 563.022
Georgia	• Exclusive sales territories, filed with the State. • Termination notice containing specific reasons for termination must be filed with the State, giving the State and wholesaler 30 days to object and request a hearing. Georgia Department of Revenue decides whether to allow a termination. • Justifications for termination include a wholesaler's financial instability, repeated violations of law, or failure to maintain sales volume that is reasonably consistent with other wholesalers of the brand.	Ga. Code Ann. §§ 3-5-29 to 3-5-34; Ga. Comp. R. & Regs. 560-2-5.10
Hawaii	• No beer franchise law	n/a
Idaho	• Territorial agreements must be filed with the State. • Termination upon 90 days' notice, with 30 days to submit a plan of corrective action and an additional 90 days to cure defects. • Termination without notice-and-cure permitted upon the wholesaler's bankruptcy, conviction of a felony, loss of license for more than 30 days, sales outside of the wholesaler's territory, transfer without consent, failure to pay within five business days of written demand for	Idaho Code Ann. §§ 23-1003; 23-1101 to 23-1113

	payment, or fraud.	
Illinois	• Written contract required. • Exclusive territories permitted. • Termination upon 90 days' notice, with opportunity for the wholesaler to cure within notice period. • Immediate termination permitted for wholesaler's insolvency, default on payments, conviction of a serious crime; attempt to transfer business without approval, permit revocation or suspension, or fraud in dealing with the brewer. • Termination must be for good cause, following good faith efforts to resolve disagreements. • Good cause includes failure to comply with essential and reasonable requirements of the franchise agreement that are consistent with the law. • A brewer may not discriminate among wholesalers when enforcing agreements with wholesalers. • Small suppliers whose annual volume of beer products supplied represents 10% or less of wholesaler's entire business have a mechanism to terminate upon payment of reasonable compensation to the wholesaler. • Compensation, if not agreed upon, subject to a potentially lengthy arbitration or litigation process. Pending bill (as of April 2014) seeks to amend to permit termination in 6 months while process proceeds.	815 Ill. Comp. Stat. 720/1 to 720/10
Indiana	• Exclusive territories permitted, not required. • Prohibits unfair terminations by suppliers or wholesalers, described as those without due regard for "the equities of the other party." • Currently pending legislation (as of April 2014) would allow a "small brewer" of less than 30,000 barrels to terminate the agreement without cause with notice and payment of a multiple of gross profit. Number is based on the timing of the termination.	Ind. Code §§ 7.1-5-5-9
Iowa	• Written agreement with exclusive territories required. • Termination upon 90 days' notice, with the wholesaler given 30 days to submit a plan to correct deficiencies within 90 days. • Immediate termination permitted upon a wholesaler's failure to pay when due after written demand, insolvency, dissolution, conviction of a crime that would adversely affect its ability to sell beer, an attempted transfer without approval, fraudulent conduct in dealing with the brewer, license loss for more than 31 days, or sales outside the territory. • Termination must be in good faith and supported by good cause. • Good cause exists if the wholesaler failed to comply with reasonable and materially significant requirements of the agreement that are legal and do not discriminate as compared with the requirements imposed on or enforced against similarly-situated wholesalers. • Good faith means honesty in fact and the observance of reasonable standards of fair dealing in	Iowa Code §§ 123A.1 to 123A.12

	the trade, as interpreted under Iowa’s Uniform Commercial Code.	
Kansas	• Agreements must be in writing. • Exclusive territories, filed with the State. • Termination must be for reasonable cause. • Must file written termination notice with the agency at least 30 days before the effective termination date.	Kan. Stat. Ann. § 41-410
Kentucky	• Written contract, designating exclusive territories, filed with the State. • Good cause and good faith required for termination • Termination upon written notice and reasonable opportunity (60 to 120 days) to cure. • Grounds for termination include insolvency, felony conviction, fraud, license loss for more than 31 days, sales outside of the wholesaler’s territory, and ownership change without consent.	Ky. Rev. Stat. Ann. §§ 244.585; 244.602 to 244.606
Louisiana	• Written agreement required. • Exclusive territories. • Termination upon 30 days’ notice, with termination ineffective if the wholesaler produces a plan for corrective action within the notice period that will cure the defect within 90 days. • Immediate termination permitted for numerous contingencies, including a wholesaler’s insolvency, loss of license, conviction of a serious crime, or fraudulent conduct towards the brewer. • Termination for good cause only. • Good cause includes wholesaler’s failure to comply with a reasonable and material term of the agreement.	La. Rev. Stat. Ann. §§ 26:801 to 812
Maine	• Exclusive territories, filed with the State. • Termination requires at least 90 days’ notice, plus a reasonable time to cure. • Immediate termination permitted upon wholesaler’s bankruptcy, loss of license, or conviction of a serious crime. • Termination must be for good cause. • Good cause does not include a change in wholesaler ownership, but includes a wholesaler’s loss of license, insolvency, or failure to substantially comply with reasonable and material terms of the agreement.	Me. Rev. Stat. Ann. tit. 28-A, §§ 1451 to 1465
Maryland	• Exclusive territories. • Termination upon 180 days’ notice, with 180 days for the wholesaler to cure any deficiency. • No notice required to terminate for a wholesaler’s insolvency. • Termination must be for good cause. • Good cause always includes a wholesaler’s loss of license.	Md. Code Ann., art. 2B, §§ 17-101 to 17-107

Massachusetts	• No refusals to sell after six months of regular sales. • Termination upon 120 days’ notice to wholesaler and the State. • Termination may be suspended upon wholesaler’s request, pending a hearing before the Alcoholic Beverage Control Commission. • Pending bill (as of April 2014) would allow for a quicker hearing by the Commission. • Termination only for good cause. • Good cause limited to wholesaler’s disparagement of the brewer’s product, unfair preference of a competing brand, failure to exercise best efforts, encouragement of improper practices, or failure to comply with contract terms.	Mass. Gen. Laws. ch. 138, § 25E
Michigan	• Written agreement with exclusive territories. • Termination upon written notice, with the wholesaler having 30 days in which to submit a plan to cure deficiencies within 90 days. • Termination upon 15 days’ notice is permitted upon a wholesaler’s fraud in dealing with the brewer, sales outside its territory, or sales of goods known to be ineligible for sale. • Immediate termination is permitted upon a wholesaler’s insolvency, loss of license for more than 60 days, or conviction of a felony. • Termination by the brewer must be in good faith and for good cause. • Good cause is established by a wholesaler’s failure to comply with reasonable and material contract terms.	Mich. Comp. Laws §§ 436.1401; 436.1403
Minnesota	• Exclusive territories. • Termination requires 90 days’ notice, during which time the wholesaler may cure deficiencies. • Termination upon 15 days’ notice permitted upon the wholesaler’s insolvency, loss of license, or violation of a significant law. • Termination must be for good cause. • Good cause does not include a change in brewery ownership, but includes a wholesaler’s loss of license, bankruptcy, or failure to substantially comply with reasonable and material terms of the franchise agreement.	Minn. Stat. §§ 325B.01 to 325B.17
Mississippi	• Written contract and exclusive territories required. • Termination upon 30 days’ notice, with the wholesaler given 30 days to submit a plan to cure deficiencies within 90 days. • Immediate termination is permitted for a variety of contingencies, including a wholesaler’s fraudulent conduct towards the brewer, insolvency, loss of license, or failure to make payments according to established credit terms. • Termination must be in good faith, for good cause. • Good cause exists when the wholesaler fails to comply with reasonable and material provisions of the agreement, the deficiency arose within the past two years, and the wholesaler failed to cure.	Miss. Code Ann. §§ 67-7-1 to 67-7-23

Missouri	• Written agreement required. • Exclusive territories presumed unless otherwise provided for by written agreement. • Community of Interest must exist for there to be a franchisor-franchisee relationship per Missouri Beverage co., Inc. v. Shelton Bros., Inc. 669 F3d 873 (2012). The court found no relationship because wholesaler's sales of importer's products never exceed 1.16% of wholesaler's annual sales, its name was not used in marketing, and it made no sizable investments particular to the importer. • Termination upon 90 days' notice. • Immediate termination upon criminal misconduct, fraud, abandonment, insolvency, or issuing an NSF check. • Termination requires good cause. • Good cause includes failure to comply substantially with essential and reasonable terms of the parties' contract, bad faith, or wholesaler's loss of license for more than 31 days.	Mo. Rev. Stat. §§ 311.181 to 311.182; 407.400 to 407.420
Montana	• Written contract, filed with the State. • Agreement must include a list of mandatory terms, and designate exclusive territories. • Termination upon 60 days' notice, with the wholesaler given a reasonable time to cure deficiencies. • Mandatory term in every contract includes a procedure for the regular review and correction of wholesaler deficiencies. • Termination must be for just cause or in accordance with brewer's contract terms, as applied equally to all wholesalers within the State.	Mont. Code Ann. §§ 16-3-217 to 16-3-226
Nebraska	• Written agreement required. • Exclusive territories, filed with the State. • Termination upon 30 days' notice, with the wholesaler given a reasonable opportunity to cure deficiencies within 90 days. • Termination upon 15 days' notice permitted in certain circumstances, including a wholesaler's fraudulent conduct towards the brewer, sales outside its territory, failure to pay according to the agreement's terms and after written demand, and intentional cessation of brand business for more than 31 days. • Immediate termination permitted upon the wholesaler's insolvency, loss of license, conviction of a felony, or an agreement to terminate. • Termination must be in good faith and for good cause. • Good cause includes a wholesaler's failure to comply with reasonable and material provisions of the contract. • Good faith means factual honesty and the "observance of reasonable commercial standards of fair dealing in the trade," as interpreted by the Uniform Commercial Code. • Wholesaler is obligated to maintain clean taps, adhere to the brewer's freshness program, and comply with other reasonable written quality control standards.	Neb. Rev. Stat. §§ 53-201 to 53-223

Nevada	• Exclusive territories presumed, but non-exclusive franchise permitted if specified in writing. • Termination upon 90 days' notice, with 60 days to cure deficiencies. • Termination upon written notice after wholesaler's loss of license for more than 31 days, insolvency, conviction of a felony, fraud toward the brewer, sale of beer to an unlicensed retailer, failure to pay according to agreement and seven days after demand for payment, attempt to transfer without notifying the brewer, or discontinuance of the brewer's brand. • Termination must be for good cause. • Good cause means either the wholesaler's failure to substantially comply with essential and reasonable requirements of the agreement or the wholesaler's bad faith acts in carrying out the agreement. • Brewers selling less than 2,500 bbls. within the State in a calendar year are exempt from the good cause termination requirement.	Nev. Rev. Stat. §§ 597.120 to 597.180
New Hampshire	• Written agreement. • Exclusive territories. • Termination upon 90 days' notice, with wholesaler given a reasonable time to cure deficiencies. • Immediate termination permitted upon the wholesaler's insolvency, loss of license, conviction of a serious crime, willful breach of a material provision of the franchise agreement; attempt to transfer business without notice to the brewer, fraud, or failure to pay account upon demand. • Termination only for good cause. • Good cause generally includes a wholesaler's loss of license, insolvency, or failure to substantially comply with the brewer's reasonable and material requirements.	N.H. Rev. Stat. Ann. §§ 180:1 to 180:12
New Jersey	• Exclusive territories required unless dualing prior to March 1, 2006. • Written agreements required. • Termination upon written notice and 120 days to cure • Immediate termination upon insolvency, felony conviction, fraud, license loss for more than 31 days, intentional sales outside of the wholesaler's territory, or transfer of business without consent. • Good cause required for termination. • Good cause means a wholesaler's failure to substantially comply with a reasonable term of the non-discriminatory franchise agreement.	N.J. Rev. Stat. §§ 33:1-93.12 to 33:1-93.20
New Mexico	• Exclusive territories permitted, and must be filed with the State. • Termination must be in good faith, for good cause. • Good faith means factual honesty and observance of reasonable commercial standards under the circumstances. • Good cause includes a wholesaler's failure to substantially comply with essential and reasonable contract provisions, or bad faith actions. • Good cause does not include wholesaler consolidation.	N.M. Stat. §§ 60-8A-1; 60-8A-2; 60-8A-7 to 60-8A-11

New York	• Written agreements required. • Termination for cause upon written notice, with wholesaler given 15 days (or more by court order) to submit a plan to cure deficiencies within 75 days. • Time for corrective action may be limited by a wholesaler’s prior failure to satisfactorily cure deficiencies, or if the brewer’s product makes up less than either 1,000 cases or 1/2 of 1% of wholesaler’s total purchases. • Wholesaler can demand that brewer supply it with a written plan for curing deficiencies. • Immediate termination permitted upon a wholesaler’s insolvency, conviction of a felony, loss of license for more than 31 days, fraudulent conduct towards the brewer, failure to pay monies due under the agreement, acts constituting grounds for termination under the agreement, or under a written agreement to terminate. • Upon 15 days’ notice, a brewer may terminate a multiple brand wholesaler within 120 days of a competing brewer’s loan to or acquisition of an interest in that wholesaler. • Termination only for good cause. • Good cause includes the brewer’s implementation of a national or regional consolidation policy (upon 90 days’ notice) that is reasonable, nondiscriminatory, essential, and disclosed in writing, or the wholesaler’s failure to comply with a material term of the franchise agreement. • Termination based upon consolidation requires payment of to wholesaler of “fair market value” of wholesaler’s lost business. • Small brewers (annual volume less than 300,000 barrels and sales to wholesaler 3% or less of wholesaler’s annual business) may terminate an agreement without good cause upon payment of fair compensation to the wholesaler.	N.Y. Alco. Bev. Cont. Law § 55-c
North Carolina	• Exclusive territories, filed with the State. • Termination upon 90 days’ notice, with wholesaler given 45 days to cure. • Immediate termination permitted upon the wholesaler’s insolvency, loss of license for more than 30 days, conviction of a serious felony, fraudulent conduct in dealing with the brewer, failure to pay for delivered beer, or transfer of the business without notice to the brewer. • Termination requires good cause. • Good cause means a wholesaler’s failure to comply with contract terms that are reasonable, material, and not unconscionable or discriminatory. • Good cause does not include a change in either brewery ownership or the right to distribute the brand, sale or transfer of brand rights to a successor supplier, a wholesaler’s failure to meet performance standards if imposed unilaterally by the supplier, a wholesaler’s establishment of a franchise agreement with another supplier, or a supplier’s desire to consolidate franchises. • Small brewery (fewer than 25,000 barrels) exception allows for termination absent good cause following the fifth business day after confirmed receipt of written notice and payment of fair market value.	N.C. Gen. Stat. §§ 18B-1300 to 18B-1308

North Dakota	• Written contract with exclusive territories required. • Termination upon 90 days' notice, with the wholesaler having 90 days to rectify deficiencies. • Immediate termination permitted upon the wholesaler's insolvency, loss of license, or significant violation of the law. • Termination must be for good cause. • Good cause does not include a change in brand ownership, but does include the wholesaler's loss of license, insolvency, or failure to comply with reasonable and material obligations of the agreement.	N.D. Cent. Code §§ 5-04-1 to 5-04-18
Ohio	• Agreement must be in writing. • Exclusive territories. • Termination upon 60 days' notice. • Termination without notice permitted upon wholesaler's insolvency or loss of license for more than 30 days. • Termination must be in good faith and for just cause. • Good faith requires fair and equitable business dealings. • Just cause cannot include the failure to perform an illegal act, the restructuring of a brewer's business, or the transfer of a brand. • A wholesaler must act in good faith, properly represent the brewer, adequately serve the public, and protect the brewer's reputation and trade name.	Ohio Rev. Code Ann. §§ 1333.82 to 1333.87
Oklahoma	• Franchise law applies to "low point beer" (not more than 3.2% ABW). • Franchise protections do not apply to suppliers producing fewer than 300,000 gallons of low point beer per calendar year. • Written agreement, designating exclusive territories. • Good cause required for termination. • Must provide written notice of termination and 60 days to cure defects. • Immediate termination upon written notice permitted if wholesaler engages in unapproved sales outside its designated territory, fails to pay upon written demand, insolvency, loss of license for more than 14 days, felony conviction, violation of a serious law, business transfer without approval, fraud, or ceases to do business for five business days.	Okla. Stat. tit. 37, §§ 163.2; 163.18A to 163.18H (for "low point beer")
Oregon	• Agreement must be in writing and filed with the State. • Exclusive territories required. • Termination upon 90 days' notice, with the wholesaler given 30 days to submit a plan that will correct any deficiency within 60 days. • Immediate termination upon written notice permitted upon the wholesaler's insolvency, loss of license for more than 31 days, conviction of a felony, fraudulent conduct towards the brewer, substantial misrepresentations to the brewer, or for certain unapproved assignments of rights under the agreement. • Termination requires good cause, with the brewer acting in good faith. • Good cause exists where the wholesaler fails to comply with a reasonable and material term of the agreement.	Or. Rev. Stat. §§ 474.005 to 474.115

Pennsylvania	• Pennsylvania brewers are exempt from the franchise law's provisions if they do not designate a distributor as a primary or original supplier and had not done so before 1980. • Written agreement, filed with the State. • Exclusive territories. • Termination upon 90 days' notice, with 90 days to cure any deficiencies. If a deficiency relates to inadequate equipment or warehousing, a wholesaler's positive action to comply with the required change satisfies the cure provision. • Immediate termination permitted upon a wholesaler's insolvency, fraudulent conduct towards the brewer, or loss of license for more than 30 days. • Termination must be for good cause.	47 Pa. Cons. Stat. §§ 4-431; 4-492; 40 Pa. Code § 9.96
Rhode Island	• Licensed Rhode Island brewers are not considered suppliers within the meaning of the franchise law, and are exempt from its requirements. • Written contract required. • Exclusive territories. • Termination upon 90 days' notice, with opportunity to cure within the time frame of the notice. • Immediate termination permitted in case of a wholesaler's insolvency, loss of license, or violation of a law significant to the business. • Termination must be for good cause. • Good cause means the failure to substantially comply with a reasonable requirement of the agreement.	R.I. Gen. Laws §§ 3-13-1 to 3-13-12
South Carolina	• Exclusive territories, in writing, filed with the State. • Termination upon 60 days' notice. • Termination by either party must be fair, and for just cause or provocation.	S.C. Code Ann. §§ 61-4-1100 to 61-4-1320
South Dakota	• Exclusive territories, in writing. • Termination upon written notice that gives wholesaler at least 30 days in which to submit a plan to correct deficiencies within 90 days. • Termination by written notice is permitted upon numerous contingencies, including a wholesaler's loss of license for more than 31 days, insolvency, conviction of a felony, or fraudulent conduct towards the brewer. • Termination must be for good cause, and in good faith. • Good faith imposes a duty on each party to act in a fair and equitable manner. • Good cause means a failure to substantially comply with terms that are reasonable, material, and are not unconscionable or discriminatory.	S.D. Codified Laws §§ 35-8A-1 to 35-8A-20

Tennessee	• Exclusive territories for each brand. • Termination upon 90 days' notice, with the wholesaler having 30 days to submit a plan to correct deficiencies within 90 days. • Termination upon 30 days' notice permitted upon a brewer's discontinuance of the brand in the State (which cannot be reintroduced for one year) or wholesaler's conviction for a significant felony. • Termination upon written notice is permitted upon a wholesaler's loss of license for more than 60 days, insolvency, fraud in dealing with the brewer, sales outside its designated territory, or failure to pay monies due under the agreement within five days of demand. • Termination must be in good faith, for good cause. • Good cause exists where the wholesaler failed to substantially comply with essential and reasonable requirements of the agreement, so long as those terms are not discriminatory.	Tenn. Code Ann. §§ 57-5-501 to 57-5-512; 57-6-104
Texas	• Written contract required. • Exclusive territories, filed with the State. • Termination upon 90 days' notice, with the wholesaler having 90 days to cure any deficiencies. • Immediate termination permitted upon a wholesaler's insolvency, conviction of a serious crime, loss of a license for 30 days or more, or failure to pay money when due, after demand. • Termination only for good cause. • Good cause means a failure to substantially comply with an essential, reasonable, and commercially acceptable term of the agreement.	Tex. Alco. Bev. Code Ann. §§ 102.51; 102.71 to 102.82
Utah	• Small brewers (manufacturers producing less than 6,000 barrels per year) exempted from franchise law. • Exclusive territories, filed with the State. • Written agreement required. • Termination upon 90 days' notice, with wholesaler given the opportunity to cure within 90-day period. • Immediate termination permitted for wholesaler's insolvency, conviction or a felony, loss of license for more than 30 days, or fraudulent conduct. • Good cause required for either brewer or wholesaler to terminate contract. • Good cause means the material failure to comply with terms that are essential, reasonable and lawful.	Utah Code Ann. §§ 32B-1-102; 32B-11-201; 32B-11-503; 32B-14-101 through 32B-14-402
Vermont	• Exclusive territories. • Termination upon 120 days' notice, with the wholesaler given 120 days to rectify any deficiency. • Immediate termination permitted upon a wholesaler's insolvency, or when the brewer shows that providing 120 days' notice would cause irreparable harm to the marketing of the brand. • Termination must be for good cause.	Vt. Stat. Ann. tit. 7, §§ 701 to 710

Virginia	• Exclusive territories (except where overlaps are caused by changes in brewer ownership), in writing and filed with the State. • Termination upon 90 days' notice and notice to the State, with a wholesaler given 60 days to provide the brewer with a plan for corrective action. • Immediate termination permitted in the case of a wholesaler's insolvency or loss of license. • Termination requires good cause. • Good cause is determined by the Virginia Department of Alcohol Beverage Control. • Good cause includes a wholesaler's loss of license, insolvency, or failure to substantially comply with reasonable and material requirements. Presumptively legitimate requirements include maintaining a brand's sales volume, providing services at a level comparable to that provided by other Virginia wholesalers, and requiring a brewer's reasonable consent to a transfer of the wholesaler's business. • Obligation of good faith is implied in every contract.	Va. Code Ann. §§ 4.1-500 to 4.1-517
Washington	• Franchise laws do not cover certain domestic suppliers producing fewer than 200,000 barrels of beer annually. • Written contract required. • Termination upon 60 days' notice, giving the wholesaler 60 days to cure any deficiency. • Immediate termination upon a wholesaler's insolvency, loss of license for more than 14 days, or fraud. • Wholesaler required to give a brewery 90 days' notice before termination.	Wash. Rev. Code §§ 19.126.010 to 19.126.901
West Virginia	• Written agreement, filed with the State. • Exclusive territories. • West Virginia must approve all new territorial appointments. • Distributor must be allowed to distribute new brands. • Termination upon 90 days' notice. • Termination must be for just cause.	W. Va. Code § 11-16-21
Wisconsin	• Parties must share a "community of interest" before "dealership" law applies. • Although the "dealership" provisions may not apply, Wisconsin law specifies the compensation due upon certain wholesaler terminations. • Written agreement required. • Exclusive territories required. • Termination upon 90 days' notice, with wholesaler given 60 days to rectify any deficiencies. • Termination upon 10 days' notice permitted where wholesaler is in default on payments under the agreement. • Immediate termination is permitted upon the wholesaler's insolvency. • Termination requires good cause. • Good cause includes the wholesaler's failure to substantially comply with essential and reasonable requirements of the agreement which are not discriminatory, or the wholesaler's bad faith acts.	Wis. Stat. §§ 125.33 to 125.34; 135.01 to 135.07

Wyoming	• Exclusive territorial agreements, filed with the State. • Termination upon 30 days' notice, during which time the wholesaler can cure with a plan to remedy deficiencies within 90 days. • Immediate termination permitted upon a wholesaler's insolvency, loss of license for 60 days or more, conviction of a felony, intentional sales outside the territory, or fraud. • Termination must be in good faith, and for good cause. • Good cause means wholesaler's insolvency, loss of license for more than 60 days, conviction of a felony, intentional sales outside its territory, or failure to comply with a reasonable and material provision of the franchise agreement. • Good faith requires honesty in fact and observance of reasonable commercial standards in the trade.	Wyo. Stat. Ann. §§ 12-9-101 to 12-9-119

Appendix 2

Summary of State Beer Self-Distribution Laws

State	**License to Self Distribute**	**Statutory Citation**
Alabama	No	Code of Ala. § 28-3A-6
Alaska	Yes	Alaska Stat. § 04.11.010
Arizona	Yes	A.R.S. § 4-205.08
Arkansas	Yes	A.C.A. § 3-5-1405
California	Yes	Cal Bus & Prof Code § 23357
Colorado	Yes	C.R.S. 12-47-402; C.R.S. 12-47-415
Connecticut	Yes	Conn. Gen. Stat. § 30-16
Delaware	No	4 Del. C. § 512C; Brewpubs at § 512B
District of Columbia	Yes	D.C. Code § 25-110
Florida	No	Fla. Stat. § 563.022
Georgia	No	O.C.G.A. § 3-5-32
Hawaii	Yes	HRS § 281-31
Idaho	Yes	Idaho Code § 23-1003
Illinois	Yes	235 ILCS 5/5-1; 235 ILCS 5/3-12

Indiana	Yes	Burns Ind. Code Ann. § 7.1-3-2-7
Iowa	Yes	Iowa Code § 123.124
Kansas	No	K.S.A. § 41-308b
Kentucky	No	KRS § 243.157
Louisiana	No	La. R.S. 26:273
Maine	Yes	28-A M.R.S. § 1355-A
Maryland	Yes	Md. Ann. Code art. 2B, § 2-208
Massachusetts	Yes	ALM GL ch. 138, § 19
Michigan	Yes	MCLS § 436.1401
Minnesota	Yes	Minn. Stat. § 340A.301
Mississippi	No	Miss. Code Ann. § 67-3-46
Missouri	No	§ 311.195 R.S.Mo.
Montana	Yes	Mont. Code Anno., § 16-3-214
Nebraska	No	R.R.S. Neb. § 53-169
Nevada	No	Nev. Rev. Stat. Ann. § 369.382
New Hampshire	Yes	RSA 178:12; RSA 178:12-a; RSA 178:13

New Jersey	Yes	N.J. Stat. § 33:1-10
New Mexico	Yes	N.M. Stat. Ann. § 60-6A-26.1
New York	Yes	NY CLS Al Bev § 51; NY CLS Al Bev § 52; NY CLS Al Bev § 64-c
North Carolina	Yes	N.C. Gen. Stat. § 18B-1104
North Dakota	Yes	N.D. Cent. Code, § 5-01-11; N.D. Cent. Code, § 5-01-14
Ohio	Yes	ORC Ann. 4303.02; ORC Ann. 4303.022; ORC Ann. 4301.24
Oklahoma	Yes	37 Okl. St. § 521
Oregon	Yes	ORS § 471.220; ORS § 471.200
Pennsylvania	Yes	47 P.S. § 4-431
Rhode Island	Yes	R.I. Gen. Laws § 3-6-1
South Carolina	No	S.C. Code Ann. § 61-4-940
South Dakota	No	S.D. Codified Laws § 35-8A-8
Tennessee	Yes	Tenn. Code Ann. § 57-5-101; Tenn. Code Ann. § 57-2-104
Texas	Yes	Tex. Alco. Bev. Code § 62.01; Tex. Alco. Bev. Code § 74.01 and 74.08
Utah	Yes	Utah Code Ann. § 32B-11-503

Vermont	Yes	7 V.S.A. § 230
Virginia	Yes	Va. Code Ann. § 4.1-208
Washington	Yes	Rev. Code Wash. (ARCW) § 66.24.244
West Virginia	Yes	W. Va. Code § 11-16-6; W. Va. Code § 60-4-3
Wisconsin	Yes	Wis. Stat. § 125.29; Wis. Stat. § 125.295
Wyoming	Yes	Wyo. Stat. § 12-2-201; Wyo. Stat. § 12-4-412; Wyo. Stat. § 12-5-401

Common Ethical Mistakes Attorneys Make

Submitted by Adam P. Gisalon

Common Ethical Mistakes Attorneys Make

Submitted by Adam P. Gislason

Virtually all difficult ethical problems arise from conflict between a lawyer's responsibilities to clients, to the legal system and to the lawyer's own interest in remaining an ethical person while earning a satisfactory living.

- American Bar Association, Preamble of the Model Rules of Professional Conduct

A. ETHICAL STANDARDS AND CIVIL LIABILITY

Contrary to public opinion, Hollywood portrayals, and popular lawyer jokes, the practice of law is heavily regulated in the U.S., and the vast majority of attorneys consider their integrity and professional ethics to be of paramount importance. In the U.S., the practice of law is regulated by the governments of the individual states. For the most part, federal law does not govern legal ethics. In order to obtain a license to practice law in any state within that state, a lawyer must pledge to abide by the rules of professional conduct or code of ethics of that specific state. Thus, all lawyers who practice law in the U.S. are governed by at least one set of rules of professional conduct or code of ethics. Lawyers licensed to practice law in multiple states are subject to the rules and discipline of each state.

Many of these rules of conduct or professional code follow or are substantially similar to the American Bar Association's Model Rules of Professional Conduct, which set forth the standards of professional conduct and legal ethics for lawyers practicing law in the U.S. As of 2015, 49 of the 50 states have adopted the Model Rules in whole or substantial part.

The "Scope and Preamble" to the Model Rules provide several general principles regarding "Lawyer Responsibility" including:

> [1] A lawyer, as a member of the legal profession, is a representative of clients, an officer of the legal system and a public citizen having special responsibility for the quality of justice.
>
> [2] As a representative of clients, a lawyer performs various functions. As advisor, a lawyer provides a client with an informed understanding of the client's legal rights and obligations and explains their practical implications. As advocate, a lawyer zealously asserts the client's position under the rules of the adversary system. As negotiator, a lawyer seeks a result advantageous to the client but consistent with requirements of honest dealings with others. As an evaluator, a lawyer acts by examining a client's legal affairs and reporting about them to the client or to others.
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>
> [4] In all professional functions a lawyer should be competent, prompt and diligent. A lawyer should maintain communication with a client concerning the

representation. A lawyer should keep in confidence information relating to representation of a client except so far as disclosure is required or permitted by the Rules of Professional Conduct or other law.

Following the Scope and Preamble, the Model Rules set forth a multitude of tenets, duties, and definitions that govern the "Client-Lawyer Relationship," including, e.g.,, the lawyer's duty of Competence (Rule 1.1), Diligence (Rule 1.3), Communications (Rule 1.4), Fees (Rule 1.5), Confidentiality (Rule 1.6) and Conflicts of Interest (Rule. 1.7, 1.8, and 1.9).

The rules or codes of ethics of the individual states are enforced by governing bodies established by the supreme courts of each individual state.

For example, in Minnesota, the Lawyers Professional Responsibility Board—which is comprised of 23 lawyers and non-lawyers appointed by the Minnesota Supreme Court for up to two 3-year terms—is responsible for the oversight and administration of the Minnesota lawyer discipline system. The Office of Lawyers Professional Responsibility (OLPR) is the agency established by the Minnesota Supreme Court to handle complaints against Minnesota lawyers for unprofessional conduct, including violations of the Rules of Professional Conduct. If the OLPR determines that a lawyer violated the Rules or acted unprofessionally, the OLPR has the authority to discipline the lawyer, including temporary suspension or permanent revocation of the lawyer's license to practice law.

For example, Minnesota Rule of Professional Conduct 1.3 provides that a lawyer must act with reasonable diligence and promptness in representing a client. A lawyer is subject to sanctions for failing to act in accordance with the diligence rule. E.g. *In re Discipline of Hartke*, 529 N.W.2d 678 (Minn. 1995). In Hartke, the Minnesota Supreme Court held that a lawyer's repeated and continued neglect of client matters warrants severe sanctions, absent mitigating circumstances. Id. at 683. In a disciplinary proceeding, a defendant lawyer's neglect of client matters involving patterns of procrastination, delay, lack of concern, and other dereliction resulting in financial loss to the clients, warranted an indefinite suspension from the practice of law. See *In re Levenstein*, 438 N.W.2d 665, 668 (Minn. 1989).

Failure to comply with the ethical standards in the Rules of Professional Conduct opens the door for imposition of liability. When considering whether a lawyer's behavior has risen to the level of professional misconduct, Minnesota courts consider the following factors:

(1) the nature of the offending lawyer's conduct;

(2) the cumulative weight of the disciplinary violation;

(3) the harm caused to the public because of the conduct; and

(4) any harm brought upon the legal profession because of the conduct.

See In re Olsen, 577 N.W.2d 218, 220-221 (Minn. 1998) (a lawyer's failure to cooperate with investigatory and disciplinary processes, misappropriation of client funds, and failure to maintain proper trust account books and records warranted disbarment); see also *In re Weiblen*, 439 N.W.2d 7, 12 (Minn. 1989) (where a pattern of misconduct, involving multiple offenses, existed, and the attorney refused to acknowledge violation of his ethical responsibility, suspension was necessary to protect the public and ensure the integrity of the judicial system itself).

Attorney discipline is different than legal malpractice. Legal malpractice occurs when an attorney mishandles a case or matter due to his or her negligence or with the intent to cause damage to his or her client. It is a tortious claim that must be adjudicated in a court of law or other legal proceeding (e.g., arbitration) against the lawyer. However, not every lawyer's mistake amounts to malpractice and it's not malpractice just because a lawyer loses a case. To the contrary, legal malpractice concerns serious and significant lawyer errors that actually caused damage.

Although the Minnesota Rules and Model Rules expressly provide that the Rules are not to be used to impose civil liability, most courts have determined that violations of the Rules may be considered to be evidence in a malpractice action. In other words, if the claimant shows that the lawyer violated a professional rule of conduct, that violation can be used to further show that the lawyer was professionally negligent, and thus should be liable for whatever damage was caused by the lawyer.

B. THE ROLE OF ATTORNEY AS ADVISOR IN ENTITY FORMATION

> *In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation.*

- "Advisor": Rule 2.1 of the Model Rules of Professional Conduct

The Model Rules define the role of the attorney as threefold: "A lawyer as a member of the legal professional, is a representative of clients, an officer of the legal system, and a public citizen having special responsibility for the quality of justice." When a lawyer is initially contacted to provide advice in connection with an emerging brewery or distillery business - for example, to establish or form an entity for that business - threshold questions arise: what will be the lawyer's role and who is the client?

1. Who is the Client?

As is the case with any business, when working with a brewery or distillery, it is crucial for the lawyer, the business, and the principals that the lawyer identify the client. For example, if the lawyer is retained to form an entity, such as a limited liability company (LLC) or corporation, the attorney must clearly identify who he or she represents: the entity, one or more of the principals, or some or all parties. Failure to do so at the outset is a common mistake lawyers make, which may have adverse consequences, not only for the lawyer, but more important, for the client(s) he or she represents.

When an entity is involved, there is a question of whether the lawyer represents the entity as a whole or one of the particular members. At first glance, rules of professional conduct appear to draw a bright line in entity representation. Rule 1.13(a) of the Model Rules, "Organization as Client" provides: "A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents." This general principle is also made clear by the courts. See, e.g., *Manion v. Nagin*, 394 F.3d 1062, 1068 (8th Cir. 2005) (corporate employee does not generally enjoy an attorney-client relationship with corporate counsel); see also *Humphrey v. McLaren*, 402 N.W.2d 535, 540 (Minn. 1987) (in representing a corporation against one of its officers or employees, corporate counsel's "allegiance is to the organization").

The Comment to Minnesota Rule 1.13 clarifies the meaning of the words "duly authorized constituents." For corporations, this term refers to "officers, directors, employees, and shareholders." For non-corporate entities, the term encompasses those individuals holding "the position equivalent to officers, directors, employees, and shareholders." In the case of an LLC, the equivalent positions are those of the employees, members, managers, and governors. Because the lawyer must consider each of these subgroups, conflicts of interest issues may arise. This is further explored in Section C.

a. Organization as the Client

A limited liability company is a creature of statute. Under the statutory laws of Minnesota, an LLC is a legal entity that is separate and distinct from its partners. *See Opus Corp. v. International Business Machines Corp.*, 956 F. Supp. 1503, 1508 (D. Minn. 1996). Thus, when a lawyer or firm represents a business entity, the client is the entity alone, and not the members, managers, partners, etc. *Id*.

When members of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. The organization must make its own decisions concerning policy and operations, including those decisions entailing serious risk. However, there are certain situations where it may be appropriate for a lawyer to take action. If a lawyer for an organization learns that an officer, employee, or other person associated with the organization is engaged in action or intends to act in a manner that is a violation of a legal obligation to the organization or a violation of law that can reasonably be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization. Minn. R. Prof. Conduct 1.13(b). In determining how to proceed, the lawyer should give due consideration to:

(1) the seriousness of the violation and its consequences;

(2) the scope and nature of the lawyer's representation;

(3) the responsibility in the organization and all the apparent motivation of the person involved;

(4) the policies of the organization concerning such matters; and

(5) any other relevant considerations.

Id. Any measures taken by an attorney must be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization, or even persons within the organization. *Id*.; *see also Opus*, 956 F. Supp. at 1508.

In addition to informing individuals of the consequences of an adverse action or potential conflicts, measures taken to dissuade a member from acting in a manner which could substantially injure the organization may include among others:

(1) asking for reconsideration of the matter;

(2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and

(3) referring the matter to a higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act on behalf of the organization as determined by applicable law.

Minn. R. Prof. Conduct 1.13(b). The higher authority referred to could be the board of directors or a similar governing body. In addition, the stated policies of an organization may define circumstances and prescribe channels for review. If it does not, a lawyer should encourage the formulation of such a policy. At some point it may be useful or essential to obtain an independent legal opinion.

The comments to Rule 1.13 indicate that clear justification should exist for seeking review over the head of the member normally responsible for the organization. Care must be taken to assure that the individual understands that when there is such adversity of interest the lawyer for the organization cannot provide legal representation for the individual. In addition, discussion between the lawyer for the organization and the individual may not be privileged. Whether the lawyer should give a warning to the organization regarding an individual may turn on the facts of each case.

A government lawyer has greater authority than a private lawyer to question a client's conduct because public business is involved. *Brainerd Daily Dispatch v. Dehen*, 693 N.W.2d 435, 443 (Minn. Ct App. 2005). Courts take very seriously the fact that attorneys working for such an entity have an ethical duty to assure that the laws are properly applied. *Id*. In the Brainerd Daily Dispatch case, a newspaper sued city council members under a state open-meeting law, when it was denied access to a meeting involving the city council members and the city's legal counsel. In the end, the Court concluded that the respondents invoked the attorney-client privilege in good faith and not to thwart the purpose of the Minnesota Open Meeting Law. *Id*. at 444. Therefore, the meeting remained closed.

b. Representation of Individuals

In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer must explain the identity of the client when it appears that the organization's interests are adverse to those of the organization's. Minn. R. Prof. Conduct 1.13(d). Nonetheless, a lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the consent provisions of Rule 1.7. If the organization's consent to dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

Issues arise when a number of individuals wish to form an entity and one of the individuals is the lawyer's original client. If the lawyer has been selected to draft the entity agreement for all the parties, it is important for the lawyer to clearly identify who is the client and for all parties to have an understanding of whether the lawyer represents the individual or the entity.

In *Opus Corp. v. International Business Machines Corp.*, 956 F. Supp. 1503 (D. Minn. 1996) a law firm represented IBM in the formation of a partnership with another company. After the partnership was formed, the firm assumed the role as the Partnership's counsel, as well as continuing to represent IBM in IBM's capacity as general partner and as an investor in the partnership. In this latter capacity, the firm represented IBM, on certain occasions, in a manner that was adverse to the interests of the other corporate partner. Difficult issues arose relating to attorney-client privilege during subsequent litigation between IBM and its corporate partner. These issues could have been avoided if the firm had been more observant about representing the partnership and one of its corporate partners.

A lawyer for an organization is not barred from accepting representation that is potentially adverse to the organization. However, attorneys have to be wary about providing advice to employees of the entities they represent. In *Manion v. Nagin*, an attorney agreed to represent an individual in creating a business. 394 F.3d 1062 (8th Cir. 2005). The individual later became a majority shareholder, and the attorney continued to represent the business. The attorney eventually provided the shareholder with advice about his personal interest in the company and its management structure. The Court indicated that this behavior was beyond the scope of the attorney's job as the company's attorney, and perhaps contrary to it. Id. at 1069.

If the attorney was truly working exclusively as the entity's lawyer, he should have responded to the shareholder's personal questions by clarifying the fact that he worked only for the company and he should have suggested that the individual seek outside counsel. Id. (citing Minn. R. Prof. Conduct 1.13(d), which requires corporate counsel who is dealing with a shareholder or employee to "explain the identity of the client when it appears that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing"). The individual advice given by the attorney was sufficient to establish that an attorney-client relationship existed. Id. at 1069. However, the shareholder was unable to state a claim for relief, or else the attorney could have been held liable for malpractice, breach of contract, or some other legal claim.

c. Representation of Affiliates (Parents or Subsidiaries)

Issues also arise when an entity is an affiliate of another entity, such as a parent or subsidiary corporation. While not common for start-up breweries, it is important to have an understanding of the ethical considerations and legal implications as part of the overall business plan and portfolio.

A lawyer who represents an organization does not necessarily represent any affiliated organization, such as a parent or subsidiary. Minn. R. Prof. Conduct 1.13(a). Indeed, the lawyer for an organization is not barred from accepting representation adverse to an affiliate in an unrelated manner, unless:

(1) the circumstances are such that the affiliates should also be considered a client of the lawyer;

(2) there is an understanding between the lawyer and the organizational client that the lawyer will avoid representation adverse to the client's affiliates; or

(3) the lawyer's obligations to either the organizational client or the new client are likely to limit materially the lawyer's representation of the other client.

In *Bieter Co. v. Blomquist*, 132 F.R.D. 220 (D. Minn. 1990), the court found that a law firm was not disqualified from representing a shopping center developer in its action for alleged interference with its relationship with a prospective tenant even though the firm represented a different joint venture in a similar matter. The defendants were constituents of the joint venture during contract negotiations with the tenant, so they requested that the firm be disqualified from representing the plaintiff. However, the court held that the constituents of the joint venture were not clients of the firm, only the joint venture was. *Id*. at 225. Therefore, disqualification was not necessary. *Id*.

Common Mistakes Summarized.

For reasons discussed above and in more detail in the next section, it is paramount for the lawyer to identify at the outset who the client is, specifically when an entity is involved. Failure to do so may result in unintended representation and expose the attorney to conflicting duties to multiple clients. This may require the lawyer to withdraw from representing all parties, which could be problematic legally and practically for all involved.

C. AVOIDING CONFLICTS OF INTEREST: WHO IS THE CLIENT?

The dreaded "conflict of interest." While it is a common phrase in the practice of law, it is also commonly misunderstood. Conflicts cannot only limit a lawyer's or law firm's ability to take on new clients, but also the prospective client's choice of counsel. And, if a conflict is not detected, determined or handled properly, it can lead to more drastic consequences, including attorney discipline and professional malpractice.

1. Conflict of Interest: What Is It?

A conflict of interest can be a serious ethical concept and dilemma for attorneys seeking to retain and advise clients. A conflict of interest occurs when an individual lawyer or law firm represents multiple clients (i.e., two or more) whose goals or requests (i.e., interests) are at-odds with each other. This is also known as "concurrent representation." The most blatant conflict of interest or obvious form of concurrent representation exists when a lawyer or law firm represents both the plaintiff and defendant in a lawsuit or both parties to a contract. Most conflicts are not so obvious.

The ABA has created, and all states have adopted, ethical rules and guidelines to help lawyers identify and prevent conflicts. For example, Minnesota Rule of Professional Conduct 1.7 states that a lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:

(1) the lawyer reasonably believes that the representation will not adversely affect the relationship with the other client; and

(2) each client consents after consultation.

In addition, a lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:

(1) the lawyer reasonably believes the representation will not be adversely affected; and

(2) the client consents after consultation.

Id. When representation of multiple clients in a single matter is undertaken, the consultation must include explanation of the implications of the common representation and the advantages and risks involved.

2. Conflicts Check: Who is the Client?

Before a lawyer and a potential client enter into an attorney-client relationship, the lawyer and his/her law firm must determine that the lawyer is not "conflicted" from representing the potential client. Typically, lawyers and law firms perform a "conflicts check," which generally involves reviewing the lawyer's and law firm's list of clients and matters to determine whether the lawyer and his/her firm represents (or represented) any party that has interests that are adverse to the potential client's interests. A conflicts check, however, is more than that and should involve a comprehensive system and database that is consistently conducted in a series of steps.

The first step in performing a conflicts check is to properly identify the potential client. As discussed in the preceding Section, if a lawyer is contacted by the organizer(s) of the business, the actual client may appropriately be the organization or entity, not the organizers or the directors, officers, or other constituents. The proper identity of the client must not only be determined by the lawyer at the outset, it must be adequately explained to the organizers. Model Rule 1.13(a) states "A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents," and "[i]n dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing."

This may be easier said than done. A lawyer does not talk to the entity, but deals with its authorized constituents (i.e., the principals, directors, officers). In addition, at the time formation is in progress, the organization or entity does not exist, and the lawyer must make its explanation specifically when the entity's interests are or may be adverse to the constituents' interests. In these situations, it is best for the lawyer to put this explanation in writing to avoid any dispute as to whether the explanation was ever provided.

Again, in performing a conflicts check, the lawyer is seeking to determine whether he or she is able to represent the potential client. If retention by the potential client would result in concurrent representation, then there is a conflict of interest that must be dealt with.

3. Conflicts Check: Identifying Sources of Conflict

The next step in guarding against conflicts of interest is to identify all potential sources of conflicts. Intake forms are useful to inquire about all parties related, including adverse parties and their counsel. Further steps are recommended to compare information on new matters with information on matters other individual attorneys, and the firm as a whole, have handled for other clients. Lawyers should perform a new conflict screen whenever additional parties join during representation.

According to the Comment to Minnesota Rule 1.7, the relevant factors in determining whether there is a potential for adverse effect include:

(1) the duration and intimacy of the lawyer's relationship with the client or clients involved;

(2) the functions being performed by the lawyer;

(3) the likelihood that actual conflict will arise; and

(4) the likely prejudice to the client from the conflict if it does arise.

Even non-direct conflicts of interest should be recognized if a lawyer's ability to consider, recommend, or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities of interest. Substantial risk that a conflict could interfere with the lawyer's independent professional judgment is the basis for this determination.

4. Concurrent Representation

If a potential concurrent conflict of interest exists, a lawyer is not automatically disqualified from representing the potential client. Model Rule 1.7(b) provides:

> b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
>
> (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
>
> (2) the representation is not prohibited by law;
>
> (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
>
> (4) each affected client gives informed consent, confirmed in writing.

In other words, a potential client has the option of consenting to the concurrent representation notwithstanding the conflict. Importantly, this consent must be confirmed in writing by <u>each client</u>. A writing by the attorney identifying the conflict does not replace the lawyer's responsibility to talk directly with the client and explain the risks and advantages to the representation in addition to the burden of the conflict on the client and available alternatives. See, e.g.,Minn. R. Prof.

Conduct 1.0. A lawyer, however, cannot ask for consent if a disinterested lawyer would conclude that the client should not agree to the representation under the circumstances. Such as situations where the clients are hostile it would then be unlikely that the lawyer could be impartial between the clients.

Common Mistakes Summarized.

Conflicts of interest are difficult dilemmas to identify and deal with. It is not uncommon for lawyers and law firms to overlook a conflict of interest prior to the formation of an attorney-client relationship. This failure commonly results from lawyers either misidentifying the appropriate client or failing to perform a systematic "conflicts check." It is also problematic when a lawyer fails to make clear to a business organization's constituents that the entity, not the constituents, is the client, and if this explanation is not provided in writing. Although concurrent representation does not automatically disqualify a lawyer from concurrently representing the clients, lawyers mistakenly fail to provide informed, written consent to all clients whose interests are presently or potentially adverse.

D. CONFIDENTIALITY: INFORMATION DERIVED FROM AN EARLIER REPRESENTATION

1. Duty of Confidentiality and Attorney-Client Privilege

Confidentiality is at the heart of the attorney-client relationship. Again, properly identifying the client is crucial to determine the duty is owed. Failure to do so may not only create an attorney-client relationship where none would otherwise exist, but may result in the waiver of confidentiality of one or more clients.

Further, lawyers and clients often confuse the doctrine of the attorney-client privilege and a lawyer's duty of confidentiality. The attorney-client privilege is an evidentiary rule that protects private information and communications from being made public or from being used in court or dispute resolution proceedings. The duty of confidentiality is a duty a lawyer or law firm owes to its clients as a matter of professional ethics to protect private information gained through representation of a client. For example, Model Rule, 1.6 provides, except when permitted, under a lawyer shall not knowingly:

(1) Reveal a confidence or secret of a client;

(2) Use a confidence or secret of a client to the disadvantage of the client;

(3) Use a confidence or secret of a client for the advantage of the lawyer or a third person, unless the client consents after consultation.

Rule 1.6(b) indicates that a lawyer may reveal:

(1) Confidences or secrets with the consent of the client or clients affected, but only after consultation with them;

(2) Confidences or secrets when permitted under the Rules of Professional Conduct or required by law or court order;

(3) The intention of a client to commit a crime and the information necessary to prevent a crime;

(4) Confidences or secrets necessary to rectify the consequences of a client's criminal or fraudulent act in the furtherance of which the lawyer's services were used;

(5) Confidences or secrets necessary to establish or collect a fee or to defend the lawyers or employees or associates against an accusation of wrongful conduct;

(6) Secrets necessary to inform the Office of Lawyers Professional Responsibility of knowledge of another lawyer's violation of the Rules of Professional Conduct that raises a substantial question as to that lawyer's honesty, trustworthiness, or fitness as a lawyer in other respects. See Minn. R. Prof. Conduct 8.3.

2. Issues Arising Solely from Possession of Confidential Information of Another Client

Unless a lawyer is able to earn a living representing one client for the duration of her/his career, a lawyer is likely to represent multiple clients, typically dozens of clients in many different matters. If the lawyer has developed a specialized practice, e.g., representing craft breweries or distilleries, she/he is likely to represent many different clients in one industry. Some of these clients may be competitors, which raises the following questions: 1) where a lawyer has acquired confidential information from one client that would be useful to another client, is the lawyer conflicted out from representing one or both clients; and 2) can a lawyer use confidential information derived from one client for the benefit of the lawyer or for the benefit another client?

The answers to these questions depend upon the particular facts and the totality of circumstances, including the content of the confidential information and whether the clients are otherwise "adverse." As previously discussed, lawyers are prohibited from "concurrent representation" unless the clients are informed by the lawyer and consent in writing. However, the mere fact that a lawyer possesses confidential information from one client that would be useful to another client is not "concurrent representation" of adverse interests.

A critical factor is the materiality of the information in the second representation: the more material the information, the more likely the lawyer cannot avoid using it or likely that the lawyer's professional judgment as to the second representation will be affected by the lawyer's knowledge of the confidential information. The test for the materiality of specific information is whether the information would have been obtained in the ordinary course of business of the second matter. If yes, then the confidential information is only material if it would be important to the second representation to have the information sooner rather than later in the ordinary course.

Similarly, a lawyer may not disclose or use information gained from a client to the advantage of the lawyer in a professional or personal setting. A lawyer may be privy to information that could potentially have adverse effects on the client, or that could provide financial benefits for the lawyer. Such information cannot be used or disclosed by the lawyer or those working with/for the lawyer. For example, an attorney was publicly reprimanded and suspended from practicing law for nine months after trading stock based on confidential information obtained through legal work being done by his law firm. *In re Petition for Disciplinary Action Against Marick*, 546 N.W.2d 299 (Minn. 1996).

There are limited occasions when an attorney can or must reveal confidential information gained from a client. In general, a lawyer has a duty to reveal information gained through a client that indicates future criminal activity or information pertaining to improper behavior by another lawyer. Additionally, a lawyer may reveal confidential information gained from a client upon court order or if the client consents after an informational consultation.

Common Mistakes Summarized.

Lawyers may at times fail to advise his/her client to whom duty of confidentiality is owed. This may result in the waiver of confidentiality, which could have drastic consequences in multiple forums. A lawyer's failure to safeguard confidential information may lead to severe discipline, including sanctions and disbarment, and professional liability, depending on the circumstances.

E. ADEQUACY OF FEES AND CHARGES

1. Permitted Fee Agreements

As discussed in previous sections, the legal issues facing emerging businesses, including craft breweries and distilleries, can vary in significance, scope and severity. A lawyer's fee and fee arrangements can similarly vary depending on the experience, skill, and specialization of the lawyer and the lawyer's practice. Typical fee arrangements include: 1) a retainer; 2) hourly rates; 3) flat or fixed fees; or 4) a contingency fee.

A retainer typically operates as an advance payment on a lawyer's hourly rate to secure that specific lawyer or law firm to handle a specific task, matter, or case. For example, the client may make an advance payment of $5,000 from which the lawyer will "bill against" when work is performed. It is, in effect, a down payment that will be applied to the total fee billed to the client. The lawyer typically puts the retainer amount into the lawyer's trust account from which the lawyer will deduct payment for services and expenses as they are incurred or accrue.

Although lawyers generally have wide discretion as to what types of fee arrangements to offer, rules of professional conduct do provide some basic limitations for clients' and consumers' protection. Under Model Rule 1.5, "[a] lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses. The factors to be considered in determining the reasonableness of a fee include the following:

(1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;

(2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;

(3) the fee customarily charged in the locality for similar legal services;

(4) the amount involved and the results obtained;

(5) the time limitations imposed by the client or by the circumstances;

(6) the nature and length of the professional relationship with the client;

(7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and

(8) whether the fee is fixed or contingent.

Model Rule 1.5(b) goes on to state that whatever the fee arrangement is, it must be communicated to the potential client within a reasonable time after commencing representation.

> "[t]he scope of the representation and the basis or rate of the fee and expenses for which the client will be responsible shall be communicated to the client, preferably in writing, before or within a reasonable time after commencing the representation, except when the lawyer will charge a regularly represented client on the same basis or rate. Any changes in the basis or rate of the fee or expenses shall also be communicated to the client.

While hourly rates, flat fees and retainer agreements are not required to be in writing, it is best practices to put the fee arrangement in writing to ensure that all parties understand the scope and terms of the attorney-client relationship.

Certain agreements, such as contingent fees, are required to be in writing. A contingent fee agreement is one where the lawyer doesn't take an upfront fee or bill on an hourly basis, but the lawyer receives a fixed percentage (typically 33% -- 40%) of any "recovery," which is the amount ultimately paid to the client, if the lawyer is successful. In other words, if the matter is successful or the client wins, the lawyer's contingent fee is paid out of the money award to the client. If the matter is not successful and the client loses, neither the client nor the attorney will get any money. Model Rule 1.5(c) provides in pertinent part:

> A fee may be contingent on the outcome of the matter for which the service is rendered, except in a matter in which a contingent fee is prohibited by paragraph (d) or other law. A contingent fee agreement shall be in a writing signed by the client and shall state the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer in the event of settlement, trial or appeal; litigation and other expenses to be deducted from the recovery; and whether such expenses are to be deducted before or after the contingent fee is calculated. The agreement must clearly notify the client of any expenses for which the client will be liable whether or not the client is the prevailing party. Upon conclusion of a contingent fee matter, the lawyer shall provide the client with a written statement stating the outcome of the matter and, if there is a recovery, showing the remittance to the client and the method of its determination.

2. Taking an Ownership Stake in Exchange for Legal Services

Emerging companies and new businesses, such as a start-up craft brewery or distillery, may propose that the lawyer provide legal services on behalf of the startup entity in exchange for an ownership stake in the company.

This sort of fee arrangement contains some inherent risks, complexities, and ethical issues of which a lawyer must be keenly aware.

The Model Rules and state rules of professional conduct provide guidance. Under Minnesota Rule 1.8, a lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security, or other pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which can be reasonably understood by the client;

(2) the client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and

(3) the client consents thereto in writing.

Minn. R. Prof. Conduct 1.8. Rule 1.8 makes it clear that a lawyer should be wary of getting involved in business deals with their clients. If such a deal is made, proper means should be used to guarantee that there is no appearance or impropriety or unfairness. A writing from the lawyer to the client is required, along with a separate writing from the client which indicates whether or not the lawyer is looking out for the client's interest in the transaction, the nature of the conflicting interest, and that any reasonably foreseeable risks for the client have been discussed. The lawyer should employ all possible safeguards to ensure that the deal is recognized as one that is fair, reasonable, and in the interests of the client. If these elements are not met or the safeguards not put in place, the transaction between the lawyer and client is strictly prohibited.

Common Mistakes Summarized.

Although lawyers are only required to put contingency fee agreements in writing, it is bad practice for a lawyer not to get all fee arrangements in writing. Much like conflicts checks, lawyers must be diligent in assessing whether fee arrangement is prohibited as a result of an ethical dilemma. In considering these issues, including the amount or type of a reasonable fee, lawyers fail when they don't keep the client's best interests in mind over their own.

CONCLUSION

Legal ethics is not an oxymoron. Lawyers promise to abide by comprehensive codes of ethics and rules of professional conduct, which serve not only as guide to the ethical practice of law, but the basis for attorney discipline, and potentially legal malpractice, if seriously (and repeatedly) violated. Most lawyers are very concerned about their reputations and integrity, and strive to be ethical and professionally responsible. Nevertheless, lawyers often encounter serious ethical dilemmas in the course of their work and throughout their careers because legal issues, controversies, and disputes--as well as the parties involved in them—can be very complex. Identifying these dilemmas and common mistakes early and often is critical to the endeavor of not only a successful, ethical practice, but happy clients who deserve nothing less.

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