Five Issues That Impact Craft Brewers

BY
MARC SORINI

Each year at the Craft Brewers Conference, I give a presentation summarizing the most important alcohol beverage law developments impacting craft brewers during the previous year. Preparing for it presents me with an opportunity to sit back and take stock of the implications of everything that has transpired in my world—the intersection of law and the brewing industry—during the past 12 months.

Here are five issues most likely to have a meaningful impact on craft brewers in the coming years.

1. CBMTRA

Excise tax reform has been a priority of the Brewers Association since the late 2000s. Since 2015, those efforts have focused on the Craft Beverage Modernization and Tax Reform Act (CBMTRA), a comprehensive excise tax reform measure affecting the entire alcohol beverage industry. The Tax Cuts and Jobs Act (Tax Act) provided the opportunity to enact CBMTRA into law in December 2017.

Of primary importance to the brewing industry is CBMTRA's new tiered rate structure:

- All brewers regardless of size will pay $16/barrel (down from $18/barrel) on their first six million barrels of production.
- After six million barrels, the rate goes to the $18/barrel rate first established in 1990.
- For domestic brewers producing less than two million barrels per year, the rate on their first 60,000 barrels produced in the year is just $3.50/barrel. Under current law, qualifying small brewers pay $7/barrel on their first 60,000 barrels.

Significantly, CBMTRA extends the benefits of most lower-rate tiers (in the case of the wine excise tax, credits) to foreign producers. Thus, a foreign brewer can assign a $16/barrel rate—the $3.50/barrel rate is reserved for domestic producers—to one or more U.S. importers. But because the Alcohol and Tobacco Tax and Trade Bureau (TTB) has not, at the time of this writing, published rules and procedures for assigning the lower rate to importers, foreign producers and their importers have only the promise of a future refund once the TTB can establish the processes for taking the reduced rate. By treating non-U.S. producers more or less equally to domestic producers, CBMTRA substantially reduces the likelihood of a World Trade Organization challenge to the U.S. excise tax system.

As the prior law did, the Tax Act includes a "controlled group" rule that aggregates the production of brewers sharing more than 50 percent common ownership. This mechanism ensures that large brewers or groups of brewers only benefit from the $16/barrel reduced rate once, and cannot qualify for the $3.50/barrel rate available to brewers under two million barrels. The Tax Act also adds a specific controlled group rule that appears to require that TTB treat a U.S. importer as a member of the same controlled group as a foreign producer if the foreign producer assigns its reduced rate to that importer. Another new provision creates a "single taxpayer rule" that appears to aggregate the marketing or production of contract brands sold under a collective "brand family" umbrella, even if the contract production occurs at an unaffiliated brewery. The TTB had yet to announce its interpretation of these provisions at the time of this writing.

Finally, the Tax Act authorizes brewers to transfer beer in bond (without tax payment) between breweries of different ownership. Under prior law, such transfers could only occur between brewers within the same controlled group. The Tax Act accordingly will facilitate the creation of true collaboration beers, where two different brewers produce and then blend their beer to create something new.

While a great achievement, the Tax Act comes with a catch—all the changes described above will end on December 31, 2019 unless Congress acts to extend the law. The Brewers Association and, indeed, all the alcohol beverage industry trade associations, have made the extension of the Tax Act a legislative priority.

2. COMMERCE CLAUSE PRINCIPLES

In February 2018, the U.S. Court of Appeals for the Sixth Circuit published an opinion in *Byrd v. Tennessee Wine and Spirits Retailers Association.* The decision affirms a Middle District of Tennessee decision finding that the "durational-residency" requirements imposed by Tennessee law for alcohol beverage retail licensees are unconstitutional under the "dormant" Commerce Clause.

Tennessee law requires an applicant for a retail license to have been a resident of Tennessee for at least the two-year period immediately preceding the submission of the license application. For corporate license applicants, the two-year requirement applies to any officer, director, or stockholder of the corporation. Moreover, to renew such a license, the law requires Tennessee residency for at least 10 consecutive years. After two prospective retail applicants that did not meet the two-year residency requirement sought licenses, the Tennessee attorney general filed a declaratory judgement action seeking to have the residency requirements declared constitutional. The U.S. District Court for the Middle District of Tennessee found them unconstitutional.

As many readers know, under the so-called "dormant" Commerce Clause, absent congressional authorization state statutes and regulations generally cannot discriminate against out-of-state interests or in favor of in-state interests. The 21st Amendment acts as a partial limitation of dormant Commerce Clause principles when the issue involves a state law regulating alcohol.

The Sixth Circuit's *Byrd* opinion stands at the cutting edge of where the Commerce Clause meets the 21st Amendment. Since the Supreme Court's *Granholm v. Heald* (2005) decision, several U.S. Circuit Courts of Appeal have struggled to reconcile the holding of *Granholm* prohibiting discrimination between in- and out-of-state wineries and the Supreme Court's statement in the *Granholm* opinion that the three-tier system is "unquestionably legitimate." Several Circuits accordingly have decided that the non-discrimination rule must only apply to products and producers, not to retailers or wholesalers. But tackling the federal courts' disagreement head-on over whether the non-discrimination Commerce Clause principles of *Granholm* and other cases apply only to producers of alcohol beverages and their products, the *Byrd* opinion emphatically disagrees.

Concluding that the 21st Amendment does not exempt laws regarding retailers and wholesalers from Commerce Clause scrutiny, the opinion next concluded that the 21st Amendment does not shield Tennessee's residency requirements from Commerce Clause scrutiny. But relying on *Cooper II*, a 2016 Court of Appeals decision out of Texas, the opinion drew an important distinction between residency requirements and location requirements:

> *[R]equiring retailer- or wholesaler-alcoholic-beverage businesses to be within the state may be essential to the three-tier system, but imposing durational-residency requirements is not, particularly when those durational-residency requirements govern owners.*

Without the 21st Amendment to shield the Tennessee residency requirements, it's no surprise that the Sixth Circuit found them unconstitutional.

In following *Cooper II* and rejecting the approach of two other U.S. Courts of Appeal—the Second Circuit in the *Arnold's Wines* decision (2009) and the Eighth Circuit in the *Southern Wine* decision (2013)—the Sixth Circuit's *Byrd* opinion highlights a growing split in the circuit courts on the interaction between the Commerce Clause and the 21st Amendment after *Granholm*. Eventually, one can expect the Supreme Court to revisit these issues to resolve the split and to provide clear guidance to the federal judiciary. Whether that happens on a (presumably likely) appeal from *Byrd* or in a future case, the Sixth Circuit's opinion makes a Supreme Court review of the issue more likely.

3. TTB TRADE PRACTICE ENFORCEMENT

In 2017, Congress appropriated $5 million for the TTB and earmarked the funds specifically for use in enforcing the trade practice provisions of the Federal Alcohol Administration (FAA) Act. Those provisions are the federal laws (fleshed out by regulation) on: (a) exclusive outlets; (b) tied house; (c) commercial bribery; and (d) consignment sales.

The TTB has moved quickly to put that money to use. Organizationally, the agency created a new unit within the TTB's Trade Investigations Division to focus on trade practice enforcement. The TTB has since announced three major investigations pursued jointly by federal and state officials in Miami, Fla., Chicago, Ill., and Napa and Sonoma Counties, Calif.

The TTB has yet to announce any enforcement actions as a result of these investigations. But several things are clear. First, by partnering with state authorities, the TTB may overcome some of the obstacles it often faces in trade practice investigations. Unlike the TTB, most state alcohol regulators possess jurisdiction over retailers and can bring the full weight of an enforcement action to bear against retail violators of state trade practice laws. Thus, while the TTB has very little ability to punish retailers for violations of its trade practice rules, its state counterparts can take action under similar state laws.

This may prove particularly helpful today because it is often the retailer, not the supplier or wholesaler, that initiates activity deemed to violate rules like the TTB's tied house regulations. Moreover, under the "penultimate clause," the TTB can take action against conduct involving "malt beverages" (the FAA Act term for beer) only if the conduct takes place in a state with a similar state law. By partnering with state regulators, the TTB can better determine that the conduct it targets would also violate state law. And although the TTB does not issue federal "basic permits" to brewers, and accordingly has fewer options to punish a violating brewer, few state authorities will have a similar problem and can take action against a brewer's state license without this procedural difficulty.

Second, the TTB's investigative techniques are far more aggressive than what the industry has seen from a federal alcohol regulator in decades. Reports from the targeted markets include instances of multiple investigators (sometimes accompanied by state officers) arriving at a business unannounced, demands for the production of documents in hours (not days or weeks), and TTB personnel showing up at the homes of employees of businesses subject to investigation. In short, these investigations look more like those of a criminal enforcement body than the familiar approach the industry has experienced in the context of TTB excise tax audits.

Third, the TTB has stated frequently and publicly that it wants to make cases, not simply accept "offer-in-compromise" settlement payments from the industry. Since the early 1990s, federal trade practice investigations generally have not resulted in the actual suspension or revocation of a permit. But the TTB's announced objective is to change that very soon.

In the short term, the industry can expect more aggressive and rigorous trade practice enforcement by the TTB, often in tandem with state authorities. Craft brewers often like to think of themselves as untainted by trade practice violations. But one need only look to the recent case involving a large craft beer wholesaler, Craft Brewers Guild of Massachusetts, to recognize that such investigations can directly impact craft brewers.

The TTB's apparent desire to litigate actual cases may lead down several paths. Most of the TTB's tied house provisions (aside from consignment sale) require a showing of "exclusion" to make a successful case, and exclusion generally requires the TTB to show that the practice in question threatened or could reasonably threaten a retailer's independence. In today's age of behemoth retailers, making this showing will likely prove a major challenge in many circumstances. Thus, the wrong case could result in a replay of 1992, when the U.S. Circuit Court for the District of Columbia's *Fedway* decision effectively stymied federal trade practice enforcement efforts for many years.

4. WHOLESALER FAIR MARKET VALUE

Many state beer "franchise" laws contain provisions that entitle a terminated wholesaler to compensation upon a termination without "cause." Many of these state laws define the compensation due in terms of "fair market value"—the theoretical value of the distribution rights in a transaction between a willing seller and a willing buyer, neither under obligation to act. This fair market value concept also appears in some provisions of state law that call for compensation of a wholesaler when it loses distribution rights to a brand due to a change in the ownership or the importer of a particular brand.

Given that fair market value should represent the price at which the wholesaler losing the brand would be willing to sell it for, a payment of fair market value should make the wholesaler whole upon the loss of a brand. After all, the valuation of any asset—such as brand distribution rights—must factor in lost goodwill and expected future profits from the brand, as qualified by the inherent uncertainties that come with any asset (e.g., will the volume of sales grow, remain even, or decline?). Economists accordingly value distribution rights by calculating the "discounted cash flow" of the asset to determine fair market value.

In September 2017, a California Court of Appeals handed down its opinion in *Mission Beverage Co. v. Pabst Brewing Co.* Recall that in 2014, Pabst Brewing was purchased from the Metropoulos family by entrepreneur Eugene Kashper and TSG Consumer Partners. In early 2015, Pabst initiated the termination of Los Angeles-area wholesaler Mission Beverage under a California statute that creates an arbitration mechanism between the terminated wholesaler and the successor(s) "to determine the fair market value of the affected distribution rights."

Mission attempted to stop the termination twice in the California courts. When those efforts failed, the court proceeding was put on hold. Mission proceeded with the arbitration and received payment from the successor wholesalers for "the fair market value of the affected distribution rights." One would then expect the matter to be closed, but Mission pressed on with its court case. Pabst sought to dismiss the case under California's anti-SLAPP (SLAPP stands for strategic lawsuit against public participation) statute and, when the trial court did not dismiss, appealed to the court of appeals.

While much of the *Mission Beverage v. Pabst* opinion concerns the application of the anti-SLAPP statute, the court's decision on the compensation issue should give every brewery pause. Pabst argued that Mission could not show that the termination of their relationship caused any damage, as Mission had already received fair market value compensation. After reviewing the various measures of damages available for breach of contract, the court found that "an existing distributor's receipt of the 'fair market value of the affected distribution rights' under [the California statute] does not necessarily make that distributor whole." As a result, the court did not dismiss the case. The court did recognize that Mission could not receive a double recovery in its breach of contract case. Whether Mission will be able to identify any damages beyond the fair market value it has already received remains to be seen. While this non-duplication relief is encouraging, it is not something that will be resolved early in the litigation process. Thus, the brewer may be stuck with the potentially substantial time and expense of litigating breach-of-contract claims.

Mission's arguments, similar to those being made in other cases around the country, should arouse great concern among brewers, large and small. In effect, the already generous protections given by the franchise laws—virtually unheard of in any other industry—are being further stretched, as some wholesalers collect their statutory damages and/or compensation under the franchise laws and then press for additional amounts.

The *Mission Beverage v. Pabst* decision, like many others over the past several years, should serve as a further wake-up call to brewers that franchise law reform is imperative.

5. FALSE ADVERTISING CLASS ACTIONS

The past five years have seen an increasing number of self-declared "class actions" alleging that the labeling and/or marketing of various beers and distilled spirits are false or misleading. While these suits are brought in the name of one or a few individual or business plaintiffs, such class action suits are largely driven by the plaintiffs' lawyers, who can receive lucrative payments upon settlement or a contingency fee award from a successful judgment.

The early suits of this type against the beer industry usually involved the labeling and/or advertising of brands of beer customarily associated with a foreign location, but now brewed in the U.S. or Canada for the North American market. Early targets included Beck's Beer and Kirin (both brewed in the U.S. by Anheuser-Busch), and such "geographic mis-description" suits have since targeted a host of other brands with varying degrees of success.

Many of the early lawsuits brought against the distilled spirits industry, in contrast, involved challenges to claims that a particular product was "handmade." Tito's Vodka, for example, has weathered lawsuits in many states alleging that its labeling (e.g., "Tito's Handmade Vodka") and advertising claims (e.g., "made in old-fashioned pot stills") are false or misleading.

Similarly, a false advertising suit in California challenged Blue Moon's claim to be "artfully crafted." The plaintiff in that case, which a federal District Court dismissed as a matter of law, sought to use the Brewers Association's definition of a craft brewer to argue that "artfully crafted" was false when applied to Blue Moon—a product of MillerCoors.

Then in January 2018, the United States District Court for the Northern District of California issued a decision in a putative class action alleging that the labeling and marketing of The 21st Amendment Brewery Café (21st Amendment), a successful California-based craft brewery, was false and deceptive. While the brand originated in the San Francisco Bay Area, 21st Amendment produces a substantial quantity of its beer under contract in Minnesota.

The federal district court ruled on the brewer's attempt to dismiss the case as a matter of law, which requires the court to assume that all facts alleged are true. In that context, the district court concluded that a map on the beer carton showing the San Francisco Bay Area, combined with the "brewed . . . by" statement on the label, could mislead a reasonable consumer. The court also rejected 21st Amendment's argument that TTB approval of its label gave it a "safe harbor" defense, finding that the TTB's regulations, even its principal place of business labeling rule, do not occupy the field, nor are they incompatible with the plaintiff's claims.

The decision serves as a clear warning to craft brewers that they cannot ignore the waves of litigation washing over the rest of the industry and, indeed, all food and beverage businesses. Among the labeling or marketing claims that merit careful attention include:

- Any use of the word "natural."
- Any reference to a geographic location if the beer is not produced in that location.
- Any claim that a beer contains "no additives" or "no artificial ingredients."

Knowing the direction the law may be taking in our litigious society can be a critical survival skill in the increasingly competitive craft beer market.

Marc E. Sorini is a partner in the law firm of McDermott Will & Emery LLP, based in the firm's Washington D.C. office. He leads the firm's Alcohol Regulatory & Distribution Group, where he concentrates his practice on regulatory and litigation issues faced by supplier-tier industry members. NB