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Wine and Beer Law

Leading Lawyers on Navigating the Three-Tier System and Other Regulations on Alcoholic Beverages

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Top Ten Pitfalls in Brewery and Winery Acquisitions

Robert Cattanach, Gabrielle Wirth,

Partners

and Kyle Leingang

Dorsey and Whitney LLP

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Introduction

As craft breweries around the United States continue to expand their market share and consumers diversify their drinking habits, rapidly expanding breweries have become targets for acquisition by private equity funds, foreign breweries, international brewing conglomerates, and, likely in the near future, even other craft breweries. Similarly, the wine industry in the United States has a wide landscape of wineries and many larger players continue to look at acquiring small producers to supplement and diversify their brand and product portfolios.

With acquisition-driven growth rising in its importance as an industry business strategy, a few common pitfalls have emerged that buyers and their advisors should focus on when conducting due diligence of potential targets. This chapter serves as a checklist for breweries and wineries of issues often overlooked when growing a business in these industries and positioning a company for a possible future transaction.

Issue One: Trademark Issues

Wineries and breweries often have a large number of products, names, and trademarks. In fact, while expenses related to equipment and manpower are the largest costs associated with building a brewery or winery from the ground up, it is the company's intellectual property (recipes, names, logos, etc., and consumer recognition of these brands and materials) and not tangible property that usually drive a third party's pursuit of an acquisition. Despite how crucial intellectual property is in the long term, it is common for most breweries and wineries to focus only on growing revenue during their start-up phase, without dedicating any time or resources to strategically create and protect their trademarks. It is not uncommon for management to have never even checked whether product names, now crucial for the business, are legally protectable at all.

While most buyers may initially value an acquisition by the existing sales, EBITDA, and projected growth, assessing the target's trademark portfolio (i.e., the ease of protecting product names and the protections currently in place in important jurisdictions) can raise red flags that should be addressed immediately. When product names are not protectable, or when correct and timely filings have not been made, post-acquisition remedies can become complicated and expensive, as those with competing claims may come out of the woodwork if it is perceived that the new owner has deep pockets. In the alternative, discovering that trademark issues have been appropriately considered and managed illustrates a management team's attention to detail and tells a story not visible solely through year-over-year revenue statistics.

Issue Two: License Transfer Process

Every alcohol acquisition involves a license transfer process both with the Alcohol and Tobacco Tax and Trade Bureau (TTB), the federal regulator of breweries and wineries in the United States, and the applicable state department of alcoholic beverage control (ABC). These regulatory authorities will need to approve the post-acquisition owners of the business, with each agency having its own process and requirements. At the state level, this process often proceeds as if the new owner had submitted a new license application, and processing the request requires the same detailed background checks, staff investigation, "three-tier" analysis, local approvals, waiting periods, and public notifications.

Approval by the applicable regulators can often take upwards of two months to complete. In light of these hurdles and delays, buyers should always investigate the steps that will be required in the applicable jurisdiction and evaluate whether the new owners will be acceptable as license holders before signing a purchase agreement. Nothing can dampen a celebration following signing more than an unexpected pre-closing waiting period or, worse yet, the denial of a license transfer.

Issue Three: Employee Issues

Employee time recording can be notoriously cavalier at breweries and wineries, but time recording rules apply to these businesses the same as any other. Failing to adhere to applicable legal requirements can result in significant penalties. While the publicity and optimism that accompany an acquisition can be euphoric, the visibility may also give a state regulator an excuse to take a careful look for potential enforcement opportunities, including imposing penalties associated with pre-acquisition business practices.

A particularly notable example of such errors made by breweries and wineries is failing to treat employees as non-exempt under the federal and state wage and hour laws. A "professional employee" is exempt from federal overtime provisions only if he or she is paid on a salary or fee basis of not less than $455 per week and has a primary duty of performing certain specialized work (i.e., work that requires knowledge of an advanced type in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction or invention, imagination, originality, or talent in a recognized field of artistic or creative endeavors). The most misunderstood exempting issue relates to the outside sales and professional exemption. Under federal law, an outside sales employee is exempt if he or she has a primary duty of (1) "making sales" or (2) obtaining orders or contracts for services and is customarily and regularly engaged away from the employee's place of business in performing such primary duty. Outside sales under federal law, however, does not include "sales made by mail, telephone, or Internet." State laws on this issue can also vary, with laws in California, Oregon, and Washington being notably more restrictive on this issue than the federal counterpart.

Federal and state occupational safety and health laws can also be difficult to navigate. Breweries and wineries must be careful to train workers on safe practices and understand the many regulations governing safe entry by employees into confined spaces (i.e., spaces where employees can enter or exit only through limited or restricted means). The use of trucks and forklifts is also highly regulated by the Occupational Safety and Health Administration, and a buyer should evaluate whether the company's business practices pose a significant risk of future penalties or other enforcement action. A buyer should also carefully review all written occupational health and safety policies as well as the historical logs of injuries, illnesses, overtime pay, and meal and rest periods.

Issue Four: Trade Secret Protection Procedures

The "secret sauce" that goes into product formulation is often the life blood for many breweries and wineries. While not patentable, this information can be protected as a trade secret with the correct procedures in place. Buyers should investigate the brewery's recipe protection procedures, such as who has access to the information and whether those individuals have signed confidentiality agreements. The law requires that the owners have taken reasonable steps to protect a trade secret, which could also include restricting access to certain areas, labeling data as confidential, keeping information under lock and key, and otherwise limiting access to such information.

With online product recipe formulation and storage software prevalent around the industry, special attention should also be given to whether recipes have been made available to the general public by the company or its employees, even unintentionally or for short periods of time. Note that, while confidentiality and non-competition covenants can often be used to help safeguard these secrets after the departure of an employee, additional care needs to be taken in states with very limited enforcement of non-competition provisions, such as California.

Issue Five: Distribution Agreements

Distribution agreements are among the most important contracts entered into by breweries and wineries, as they provide the legal framework for a significant percentage of the company's existing revenue and often dictate the form, direction, and management of the company's growth. These agreements can vary widely in terms of geographic scope, term, and the types of covenants imposed on the producer and distributor, but a producer's initial distribution agreement is very likely to be extremely distributor-favorable, especially when entered into in the early years of production, and these agreements can be notoriously difficult to terminate.

Therefore, buyers should spend significant time reviewing distribution agreements for potential problems and look beyond the price and term provisions. For example, a buyer should review distribution agreements to ensure the future growth strategy envisioned by the company (and often assumed by the projections generating the deal price) is consistent with the sales strategy contemplated by the existing distribution agreements. If not, the buyer will need to formulate a plan to amend or terminate such agreements, which can be a difficult, expensive, and even litigious process. Second, even if the company's current and future business operations are consistent with important distribution agreements, buyers should verify the terms of any change-of-control provisions that would require obtaining consent from the distributor. If those consents are required and the relationship with a distributor is not amicable, the company may, at best, lose access to many of its significant distribution accounts and, at worst, be confronted with distributor litigation post-acquisition.

Issue Six: Key Employee Relationships

As in many businesses, key employees at a winery or brewery can be the biggest difference between failure and success. If a buyer intends to continue operating the business with an existing head winemaker, brewer, cellarman, or other key employee, every effort should be made to ensure that key employees are supportive of the ownership transition. Efforts by buyers to demonstrate commitment to continue a brewery or winery's existing culture can go a long way toward building credibility. Acquisitions can also present an opportunity to implement (or clean up, as appropriate) employment agreements with key employees and an employee incentive plan, such as by offering options, profits interests, appreciation rights, or another form of phantom equity to significant members of the staff.

Issue Seven: Regulatory Compliance

Purchase agreements often will (and should) contain representations and warranties regarding a brewery or winery's prior compliance with applicable regulations, including those imposed by the TTB and applicable state ABC. However, as these regulations can be complex and easily violated inadvertently, buyers should always undertake their own investigation of potential problems, because previous violations can result in future problems for the buyer. For example, has the brewery or winery always obtained label approval prior to selling and marketing its products, including via social media? Has the company always provided the required information on advertising and avoided making prohibited statements, such as those "disparaging of a competitor's products" or that may be considered "obscene or indecent"?

While a purchase agreement may provide for indemnification for such losses, these provisions usually contain a minimum loss threshold, a maximum amount of losses that can be recovered, and require lengthy claim procedures that often result in dispute and legal challenge. Beyond the inherent imperfection of attempting to be made whole post-closing, problems involving the TTB have the potential to create serious headaches for future operations. For example, wine and beer bottle labels are highly regulated by federal and state laws, and producers must obtain federal approval of each specific label before bottling, including, in the case of wines, adhering to the appropriate viticultural area restrictions set forth in the code of Federal Regulations.

Despite giving initial consent to a label, the TTB also has the authority to revoke its approval of a label if it is discovered to be non-compliant. Should the TTB become aware of a violation that slipped by during the initial review, those labels may have to be changed and resubmitted for approval, with sales stopping in the meantime.

Issue Eight: Lease Agreements and Production Facility Expansion Limitations

Many brewery or winery acquisitions are undertaken with the goal of expanding production and increasing revenue. When such an expansion requires leasing additional space, buyers should always be ready to obtain the necessary landlord consents and undertake due diligence (to the extent possible) to explore whether expansion into an adjoining (or nearby) space is possible, given the company's existing leasing relationships. Even for businesses with adequate existing facilities, a buyer should never overlook existing lease agreements and should ensure the company is compliant with any existing restrictions or limitations, including maximum capacity, noise restrictions, parking, and even trash and waste water.

A buyer should also be aware of the term associated with such agreements and whether the company has any extension rights or rights of first refusal associated with continuing to lease in the future. Of special note for breweries or wineries with tasting rooms is that, come lease renewal, landlords often attempt to increase leasing costs if the company has a successful tasting room. This price increase is often justified on the basis that the space, previously priced at industrial rates, should now be priced closer to retail rates because of the public presence in the tasting room. Buyers evaluating long-term real estate costs or facing near-term lease expiration should be aware of this topic of negotiation and potential price increase.

Issue Nine: Stockholder Relations

If executing a stock-for-stock acquisition, or acquiring less than 100 percent of a target's stock, a buyer should be aware of any existing conflicts between management and minority stockholders. More than most industries, wineries and breweries need to establish clear corporate governance practices and effectively execute plans to take formal corporate action and communicate with stockholders. For many, owning stock in a brewery or winery is a hobby as much as an investment (sometimes even more so), and this high level of stockholder involvement can require a tremendous amount of management's time that could otherwise be spent on the company's more important business issues. It can be a unique challenge for breweries and wineries to provide its management with the flexibility and autonomy needed to effectively operate the company, while also keeping stockholders abreast of developments as legally required and pragmatically appropriate. Outside buyers coming into circumstances with complicated stockholder involvement with the business can often be surprised at the time and effort required to internally implement effective corporate governance procedures and manage difficult minority stockholders.

Issue Ten: Cybersecurity and Privacy

In today's increasingly interconnected world, protection from hackers and compliance with privacy obligations requires special attention. If the winery or brewery collects any personal or financial information, such as through website sales or personalized login accounts, special care must be taken to limit the amount of personal information collected to avoid complications when (not if) a third party improperly obtains access. While convenient and efficient in the short term, storing customer names, addresses, and most particularly credit card information should be avoided if at all possible.

Often, wineries and breweries rely on third-party vendors to perform back office functions for customer ordering, inventory tracking, loyalty programs, regular email communications, and (when allowed by the relationship) solicitations with their customers. Typically, those vendor contracts are extremely one-sided in favor of the outside vendor, and presented as a "take it or leave it" position, and concerns over cyber security and privacy often give way to longer-term vendor relationships and ease of transacting business. At a minimum, wineries and breweries should consider insisting upon some minimal level of representations and warranties from vendors dealing with personal information of customers, and some indemnification for the breach of those representations.

Vendors typically will insist on limiting any liability to the dollar value of the contract, taking the reasonable position that a modest contract for back office services should not expose the vendor to significant liabilities in the event that vendor's system is breached. Often the reasonable compromise point can be found in the vendor's cyber insurance. If, hypothetically, the vendor carries $10 million in cyber risk insurance, it is not unreasonable to request that potential future liability be satisfied through that insurance and its commensurately greater levels of protection.

Special care must be taken to determine whether the winery or brewery to be acquired has established privacy policies and procedures disclosing how it protects, and how it may use, customer and employee information. Often such policies are adopted as a matter of course, with little thought being given to whether they are actually ever enforced and verified. Simple due diligence on whether such policies exist, and what measures have been taken to determine whether they are being followed, can shed significant light not only into potential exposures in this area, but also the acquired entity's commitment to following its own established procedures.

Employee access to sensitive information presents another challenge. Good information governance requires that information collected and stored be classified in some way to reflect its sensitivity, and access limited accordingly. Simple questions on collecting, retaining, and disposing of sensitive information should be a standard component of due diligence.

Employee (or contractor) access to sensitive company information from their home computers or other mobile devices also presents challenging tradeoffs. The benefits of real-time access and convenience need to be weighed against the exponentially greater risk of inadvertent disclosure or loss of important company information. Likewise, there should be some basic policies that establish what the company's rights are to retrieve or delete information from employee devices also used for work.

While collectively protection of information from cyber theft or inadvertent disclosure may seem daunting, ultimately it can be reduced to a few basic steps that form the core of any reasonable due diligence in an acquisition.

Conclusion

Not long ago, brewery and winery acquisitions were somewhat rare. Today, these transactions occur much more frequently. Those advising investors or buyers in a beer or wine industry acquisition should pay special attention to certain business and legal issues of elevated importance in these industries. Those issues include taking steps to streamline the license transfer process, evaluating the existing intellectual property portfolio, investigating the company's regulatory compliance record, comparing the terms and restrictions in existing distribution agreements with the buyer's growth strategy, and examining the adequacy and adherence of employee and privacy policies. On the company side, many of these issues often take a back seat to ongoing operational matters, and their advisors should appropriately communicate that these issues should be prioritized and addressed before pursuing a possible change of control transaction.

Key Takeaways

- On the acquisition side, it is advisable to require targets to immediately address any red flags relating to its trademark portfolio, as post-acquisition remedies can become complicated and expensive.
- Investigate the applicable license transfer process. As approval can take upwards of two months to complete, buyers should verify the applicable process and evaluate whether the new owners will be acceptable as license holders before signing a purchase agreement. Work to prevent a long pre-closing waiting period or even the denial of a license transfer.
- As a buyer, evaluate whether the company's business practices regarding trucks and forklifts pose a significant risk of future

penalties or other enforcement action from the Occupational Safety and Health Administration. Carefully review all written occupational health and safety policies and the historical logs of injuries, illnesses, overtime pay, and meal and rest periods. Audit payroll and timekeeping practices, classification status of employees as exempt/non-exempt, and all employment policies and procedures.

- Buyers should review the procedures in place to protect trade secrets, such as recipes, and evaluate whether procedures have been followed. Reasonable steps to protect a trade secret can include executing confidentiality agreements, restricting access to certain areas, and marking information and labeling data as confidential. Additional care should be taken in states with very limited enforcement of non-competition provisions, such as California.
- Review distribution agreements beyond the price and term provisions. Ensure the future growth strategy is consistent with the sales strategy contemplated by the existing distribution agreements. Amending or terminating such agreements can be a difficult, expensive, and even litigious process.
- Make every effort to obtain support of key employees in the ownership transition. An acquisition process can also be an opportunity to implement or clean up employment agreements with key employees and adopt an employee incentive plan.
- Do not entirely depend on the seller's representations and warranties and a purchase agreement's indemnification provisions. Regulatory compliance, including prior label approval and advertising, should be reviewed. Ensure that all federal approvals have been obtained and appropriate viticultural area restrictions have been adhered to. Remember that the TTB has the authority to revoke its approval of a label if it is discovered to be non-compliant.
- If a buyer intends to expand operations, they should be prepared to obtain landlord consents and explore whether expansion into an adjoining (or nearby) space is possible given existing leasing relationships.
- If buying less than 100 percent of a target's equity, buyers should ensure that wineries and breweries have clear corporate governance practices and effectively execute plans to take formal corporate action and communicate with stockholders.

- Simple due diligence on privacy policies and procedures, including what measures have been taken to determine whether they are being followed, can shed significant light not only into potential exposures in this area, but also the acquired entity's commitment to following its own established procedures.

Robert Cattanach *is a partner at Dorsey and Whitney LLP who helps clients navigate the complexities of regulatory law, especially in the area of cybersecurity and compliance, and provides the perspective and skills of a seasoned trial lawyer to protect their interest in the courtroom. His trial experience and technical engineering background enable him to understand the complex business challenges associated with today's cyber world, and provide the strategic acumen to achieve success.*

Gabrielle Wirth *is a partner at Dorsey and Whitney LLP with successful trial experience in a broad range of employment disputes, including wage and hour, whistleblower, wrongful termination, discrimination, harassment, retaliation, breach of contract, and trade secret/noncompetition cases, and her work with the corporate team on acquisitions and startups equip her to nimbly assess and provide legally compliant options, whether in the counseling or litigation defense role. She also represents employers before a wide variety of state and federal agencies, including the EEOC, OFCCP, state human rights agencies, the Labor Commission, the Employment Development Department, and OSHA.*

Kyle Leingang *is a corporate attorney at Dorsey and Whitney LLP who regularly advises both buy-side and sell-side clients on M&A transactions and assists companies with public offerings, venture capital financings, commercial lending and corporate governance matters. Kyle has extensive knowledge and experience with clients and transactions in the craft beer industry and has represented breweries, distributors, retailers, lenders and investors on a wide variety of corporate transactions, including multiple brewery acquisitions.*

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