

SUPPLY CONTRACTS: COPING WITH THE THREE TIER DISTRIBUTION SYSTEM IN THE UNITED STATES

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Outline

1. What is the Three Tier System?
2. What are the contractual considerations arising from it?

Note: *There are many important considerations in a supply contract. This paper only discusses those relating to the Three Tier System.*

PART 1

DEFINING THE PROBLEM

Basic Regulatory Principle (circa 1930's)

Producers are bad, especially the big ones, and they need to be kept separated from innocent, weak and vulnerable retailers; otherwise, the producers will exercise market power, force the retailers to buy more alcohol than they need, which will in turn lead to excessive consumption by consumers.

This is an historical artifact from the United States' experiment with Prohibition (1920-1933).

Isn't This Outdated?

Of course it is. There was no US wine industry in or before the 1930's and there were no chain retailers and few wholesale distributors of alcohol.

But, even though one could argue that the retailers are now the ones with market power, the politics and money are such that the status quo is unlikely to be materially changed.

Policymakers Created a Dual Regulatory System

- Federal regulatory system primarily at the producer level
- States were allowed to control distribution within their borders (21st Amendment to the US Constitution)

There are Two General Types of Restrictions on Producer Activity

1. A distribution system that insulates retailers from producers by requiring sales through a “middle man” and that, in some States, protects distributors from producers (“Franchise Laws”).
2. Legal restrictions on the types of contacts that a producer can have with a retailer.

What is the Three Tier Distribution System?

- First Tier: Producer/Importer



- Second Tier: Wholesale Distributor



- Third Tier: Retailer (grocery, internet & restaurant)

Exceptions

- Some States act as the exclusive wholesaler/retailer within their State.
- Limited direct shipping of wine to consumers by producers or internet retailers across State lines. (Wholesalers are fighting this.)

Trade Practices Rules Further Restrict Producers

State and Federal laws further restrict the ability of producers to engage in activities with retailers.

1. No slotting/listing fees
2. Cannot move a competitor's product
3. Limitations on promotions
4. Cannot engage in conduct that influences retailers; with each State having its own rules such that what may be lawful in one may not be lawful in another.
5. Limits on ownership interests in retailers ("tied house laws.")

PART 2

THOUGHTS ON CONTRACT PROVISIONS

USA Contract Rules

- Contract law is a matter of state law but the basic principles are the same across jurisdictions (Uniform Commercial Code + English common law roots.)
- The plain language of the contract controls unless the clause is contrary to public policy or is ambiguous. “Words mean things.”
- Courts generally will not add terms to a written contract but may fill in the blanks as allowed by the UCC.
- Thus it is very important to have a clear written contract that clearly expressed the intent of the parties.

This is About Risk Management

- A contract is a kind of risk management tool and it is the client who determines the acceptable level of risk.
- As lawyers, we sometimes do not know the possible outcomes but we can and should advise the client of the risks.

What Should Your Clients Consider in a Contract?

**Suggestions and
Considerations**

1. PRICING

Because your client's wine will be going through an additional layer of distribution (the wholesaler), the FOB price is likely to be less than expected.

You must consider the appropriate retail shelf price for the wine and develop an FOB price that makes sense from a business standpoint.

2. BRAND PROTECTION

1. Clear and register the mark; license to the importer.
2. Producers are presumed to be the true owner of a mark, but that's a lawsuit.
Sengoku Works Ltd. v. RMC Intern., Ltd., 96 F. 3d 1217 (9th Cir. 1996).
3. Clarify ownership in the supply contract.
4. Makes it easier in a termination situation because the brand is clearly yours.

3. COMPLIANCE RESPONSIBILITIES

- Who handles and pays for the State and Federal Compliance work?
- Duty to inform and cooperate
- Warranty of compliance/indemnification
- Legality and cost of promotions

4. TARGETS AND GOALS

- Define expectations; performance standards by SKU by market.
- Define marketing support and investment, but consider legality in individual States.
- Annual review
- Link to termination rights.

5. EXCLUSIVE OR NON-EXCLUSIVE?

- Exclusivity agreements are lawful in the United States but in some States you may only be allowed to distribute through one distributor per territory.
- Exclusive for what? Brands, country, type of retailer, etc.

6. ESTABLISH A DISPUTE RESOLUTION MECHANISM

- Clear performance standards and grounds for termination.
- Courts will recognize arbitration clauses and these can greatly speed-up the dispute resolution process.
- Courts will recognize choice of law and venue provisions.

7. TERMINATION

- Clear standards and goals facilitate termination.
- Change of ownership, bankruptcy, etc.
- Many States have laws protecting wholesale distributors from termination (franchise laws); the impact of these can be reduced but not eliminated with a clear contract.
- Liquidated damages?

CONCLUSION

- Of course, what can be negotiated depends on your client's bargaining power.
- Several States require a form agreement that grossly favors distributors but for the most part parties can negotiate their own deals.
- Remember, this is all about the client's risk tolerance and business objectives.