# Key Considerations for Alcohol Suppliers in M&A Transactions

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As one of the most heavily regulated sectors in the United States, almost no aspect of the alcohol industry is untouched by regulatory considerations, including mergers and acquisitions (M&A). Whether it is a venture investment, partial- to full-ownership acquisition of an alcohol beverage company, or a divestiture, all are subject to rigorous regulatory scrutiny and requirements that need to be considered alongside traditional corporate and tax considerations.

In this client alert, McDermott's alcohol team provides a roadmap for M&A activity in the alcohol industry, whether businesses and investors are buying or selling alcohol companies or brands, or alcohol beverage companies are expanding into newer innovations in the non-alcoholic and never-alcoholic space.

**In Depth**

**The Basics**

In our experience, many lawyers struggle to appreciate the host of regulatory obligations inherent to an alcohol beverage business – obligations that can make it challenging, if not impossible, for certain parties to achieve their original intentions. Below are recurring considerations to keep top of mind when buying and selling alcohol beverage companies.

**Where Is the Company Licensed?**

One of the first considerations in understanding the regulatory environment for any alcohol industry M&A transaction is the location of the company. Each state, as well as the federal government, has its own rules and regulations regarding who must be qualified and vetted as a new owner or investor of an alcohol company, and how far their regulatory requirements, such as "tied house" laws, extend.

For example, certain states require onerous and extensive background checks for any company and/or individual who holds any (yes, *any*) indirect interest in an alcohol beverage company. Other states may only vet those persons more directly involved in the direct ownership of the licensed entity or who serve as the alcohol beverage company's officers or directors.

**What Is Happening to the Original Licensed Entity?**

While there may be a host of primarily corporate and tax considerations for fashioning a deal as an asset versus a stock purchase or – as a second example – changing the corporate form of certain of the preexisting entities from S corporations to limited liability companies (LLCs), any changes to the alcohol licensed entity and/or its direct ownership can have additional, significant consequences for the ongoing operations of the company.

Among other potential issues, under federal law, the Alcohol and Tobacco Tax and Trade Bureau (TTB) distinguishes between a "change of control" and a "change of proprietorship," explaining that "a change of proprietorship occurs when there is a change in the entity which owns and operates the business," including "a change of entity type." This is a significant distinction because, while a change in ownership allows operations to continue post-closing so long as the TTB is notified within 30 days, a change in proprietorship must be approved in advance of any close. Similar requirements and distinctions exist at the state level, with their own nuances.

Further, because in some states it can take months to obtain approval of the new licenses, many clients need to work through interim agreements, such as transitional services agreements, to allow operations to continue in the interviewing period. The extent, availability, and structure of these agreements is important, especially since one universal principal of alcohol beverage law is that no entity other than the licensed entity may benefit from the sale of alcoholic beverages and other privileges associated with holding an alcohol license.

**How Compliant Is the Target?**

Ensuring that the seller's "housekeeping" is in order early in the diligence process is critical to avoiding hidden financial penalties and costly administrative actions that could either put the deal in jeopardy or create significant financial burdens post-closing.

For example, one of the most common issues we find in conducting diligence is a target's failure to pay excise taxes in a timely manner and/or at the appropriate tax rate. Each year, the TTB's Tax Audit Division issues a number of tax-related citations for failure to timely file and/or pay taxes (which account for nearly 70% of violations) and for the use of inappropriate tax rates. The latter stem largely from the improper use of reduced tax rates under the Craft Beverage Modernization Act, among other violations.

Another common issue involves ownership changes that are not reported to the TTB and/or various state agencies. The company's current organizational chart should match what is on file with the TTB or the state agency. If an unreported change of control is discovered early in the diligence process, it can be remedied. Discovered afterward, it can cause significant hurdles in identifying, for the regulatory agencies, which changes were missed along the way and preclude proceeding with the most recent ownership updates.

**Do You Know What You Are Buying?**

Most sellers are naturally reluctant to turn over certain personal information or trade secrets until closer to closing. However, obtaining certain pieces of information early in the diligence process and understanding where there may be pitfalls can help the parties determine potential dealbreakers and whether any such issues can be resolved before or after closing. Nowhere is this more important than while conducting a thorough assessment of a target's labels, formulas, and ingredients. In most instances, these are the crown jewels of any deal, so confirming – as early in the process as possible – that what you are actually buying aligns with what you believe you are buying is critical.

**Beyond the Basics**

Preparing for an alcohol industry M&A transaction requires more than just financial due diligence and preparing for leadership changes; it demands a strategic approach to the entire business operation.

**Issues Involving Potential Distributor Changes**

First, can you make a change?

Under ordinary commercial law principles, an asset purchase would impose no obligations (other than those assumed) on the buyer to continue doing business with the seller's distributors. A stock/equity purchase would not alter the preexisting obligations between the target company and its distributors (of course, preexisting agreements can create additional rights and obligations between the parties). However, alcohol franchise laws alter these normal commercial principles and often contain "successorship" provisions. In general, these may bind the acquirer of a brand to continue selling the newly acquired business (often on an exclusive basis) to the brand's prior distributors.

Franchise states can be divided into three rough categories:

1. Those that do not impose any obligations on brand successors;
2. Those that impose successor obligations on successors with no further provisions on successorship; and
3. Those that impose successor obligations but provide a mechanism for changes, with compensation.

In certain jurisdictions, a requirement of exclusivity makes for a materially different business calculus than in a jurisdiction where the supplier can "dual." Some statutes – mostly (but not always) confined to those pertaining to beer – include a transfer mechanism. These transfer mechanisms usually permit not-for-cause termination, but also require a "fair market value" (the term used in most statutes) payment to the distributor(s) losing the brand.

A key issue to consider is knowing which party (the new brand owner or new distributor) is made responsible, by statute, for the payment. While indemnification arrangements are common, other issues may also arise, including whether the statute requires continued distribution during the process to calculate fair market value and whether fair market value compensation is the exclusive remedy.

**Issues Involving Inventory**

Alcohol companies, particularly wine and spirits manufacturers, often have inventory in aging barrels or as finished goods. Understanding the value, shelf life, and supply chain dependencies of the inventory will be critical for determining an accurate valuation. Robust representations and warranties about aging products (such as how far back is the look-back, how the product is being aged, where it is being aged, etc.) should be addressed in the agreement.

**Looking Ahead: Considerations for 2025**

**Non-Alcoholic Products**

The market for non-alcoholic (NA) brands has been a standout growth segment for a few years. NA beer is expected to build to at least 5% share of the beer category in the United States. In terms of M&A, well-known international companies (*e.g.*, Anheuser-Busch InBev, Tilray, and Asahi) continue to acquire local breweries – or entire brand portfolios – to bolster innovation pipelines and local market share in this segment.

However, understanding the regulatory landscape for these companies and brands is critical, as many of these products – particularly NA beer – still bear certain hallmarks and limitations inherent in their more potent counterparts. For example, NA beverages that were originally created in their alcoholic form and then dealcoholized still require all the licenses and related ownership disclosures as any other alcoholic beverage. Similarly, certain states still treat NA products in the same manner as their more potent cousins, with particular respect to sales outlets, opportunities for shipping direct to consumers, age restrictions, and other issues.

**Alcohol-Free Products**

As consumer preferences continually develop and change, we are seeing more alcohol industry members are expanding their portfolios to include new alcohol-free products (*e.g.*, tea, energy drinks, water) to diversify their overall offerings. However, housing both NA and alcoholic products under one overall company structure does not come without its complications.

For example, many state regulators have expressed their concerns that an alcohol company would leverage the opportunities available in the non-alcohol space (such as slotting fee payments) for the inappropriate benefit of their alcohol brands. In fact, many alcohol state regulations apply their trade practice restrictions to industry members, regardless of whether the product in question is in fact alcoholic or NA. For this reason, we suggest that industry members considering bringing these products into their portfolios try to maintain, as much as practically possible, operational, sales, and financial separation to help mitigate regulators' concerns of leveraging one side of the business against the other.

Other questions that could also come into play in this space and should be considered in the context of an M&A transaction include:

1. Would the new brands be covered under the current distribution agreement or subject to franchise law?
2. Must the products be registered with the state?
3. What are the reporting and compliance requirements for these products?

**"Ready-to-Drink" and Low-Alcohol Products**

Another industry trend to watch, with respect to M&A activity in 2025, is the continued growth of products containing lower amounts of alcohol. This includes canned cocktails or "ready-to-drink" beverages that tend to be spirits-based but have lower alcohol by volume (ABV) than their traditional counterparts. As noted with the products listed above, these products have their own unique regulatory considerations, including:

1. Whether the product is governed chiefly by the TTB or the US Food and Drug Administration (as in the case of wines below 7% ABV).
2. Whether state laws provide for unique differences for these products' route-to-market and distribution partners, given their lower ABV.
3. Which type of distributor – *i.e.*, a primarily spirits or beer distributor – is best suited to support these brands, and which principles of franchise law and/or contract terms apply.

**Hemp and Low-Dose Tetrahydrocannabinol (THC) Beverages**

Finally, while technically not alcoholic beverages, it appears that hemp and low-dose THC beverages are here to stay. Federally, the 2018 Farm Bill has been extended through 2025, which means that manufacturers have another year to gain access to the hemp and intoxicating hemp beverage market before Congress potentially acts.

For alcohol beverage companies looking to diversify into this rapidly growing – but equally rapidly shifting – market, several key considerations will be critical, including a company's risk tolerance for products that may or may not be legal at the state level, but remain (at least on the books) illegal under federal law. Other considerations to note include:

1. Whether you are planning to manufacture the product yourself.
2. Whether you are you engaging a contract manufacturer.
3. The flow of the product.
4. The physical location where infusion of the cannabis will take place.
5. Any potential impacts to existing alcohol licenses
6. Plans for distribution.
7. Plans for addressing multiples in distribution agreements.

**Conclusion**

While M&A activity in the alcohol space may continue to shift throughout 2025 and beyond as companies look to chase new opportunities and market share, consideration should always be given to the regulatory environment and its impact on realizing these new expanded opportunities and balancing the restrictions inherent of this market.

This article was originally published by Alva Mather and Christine Dower of McDermott Will & Schulte

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