The Law of WINE
A Guide to Business and Legal Issues

IN CALIFORNIA

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STOEL RIVES LLP
ATTORNEYS AT LAW
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## The Law of WINE

### A Guide to Business and Legal Issues in California

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Dear Member of the Wine Industry:

Thank you for your interest in our popular LAW OF WINE series. Whether you have operations in California, Idaho, Oregon, or Washington, THE LAW OF WINE is your reference manual to operating a winery or vineyard.

The Stoel Rives Wine Law Group has represented wineries and vineyards throughout the West since the 1970s. The lawyers in the group, from California, Idaho, Oregon, and Washington, understand the complex legal and business issues facing the wine industry and focus their attention on fashioning solutions that work well and are cost-effective. Our broad experience allows us to advise clients on a wide range of legal matters affecting the industry, including those listed below:

- State and Federal Beverage Licensing/Permitting
- Trademark Protection
- License Agreements
- Entity Formation
- Winery and Vineyard Acquisitions
- Vineyard Leasing
- Construction & Design
- Environmental and Endangered Species Issues
- Water Rights
- Labor and Employment; Workers’ Compensation; OSHA
- Income Taxation
- Business Succession
- Financing
- Litigation

Recognizing the business and legal challenges facing wineries, and as part of our commitment to the growth and success of the winery industry, the Stoel Rives Wine Law Group developed THE LAW OF WINE: A GUIDE TO BUSINESS AND LEGAL ISSUES. This guide contains insights we have gained during the last 40 years serving the winery industry.

This edition of THE LAW OF WINE, revised in January 2013, is an up-to-date summary of legal, business, and policy issues facing wineries today. We have not only updated the book, but have added new chapters to address emerging issues that are likely to affect our industry.

We hope that you find THE LAW OF WINE useful. We update this publication regularly, so please let us know if you have comments or suggestions for future editions. In the meantime, we will comment on important developments affecting the wine industry in our Winery Law Alerts (www.stoel.com/subscribe) and in our Alcoholic Beverages Law Blog (www.alcoholicbeverageslawblog.com).

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THE LAW OF WINE
—Wine Labeling Requirements—

A wine label serves two purposes. First, it attracts a buyer’s attention; a label designer can use whatever creative energies he or she can muster to catch a buyer’s eye. Second, the label must tell the buyer exactly what he or she is buying. The wine label has always served to inform the buyer of at least the type and producer of the wine. Current U.S. government regulations, however, require that a wine label provide a good deal more information than just the type of wine and producer. State laws often have additional requirements.

The federal government regulates wine labels through the Alcohol and Tobacco Tax and Trade Bureau (“TTB”). This agency, which is part of the Department of the Treasury, has adopted a number of regulations that govern the information that labels must, or should not, include. Most states also regulate wine labels. Some states, such as California, require only that a wine label meet the federal regulations. Other states, such as Oregon and Washington, have their own wine label requirements, which are more restrictive than the federal requirements.

A wine producer must obtain federal approval of each specific wine label before the producer can bottle that wine in the United States. To obtain federal approval, the labels must be reviewed and approved by the Advertising, Labeling and Formulation Division of the TTB. The TTB’s review ranges from checking for required information to scrutinizing the type and legibility of the labels. The process is not particularly complicated; the applicant need only submit form TTB F 5100.31 to the TTB, along with a complete set of labels to be approved. Online applications are the preferred method.

There are mandatory elements to a wine label, some of which must appear on the brand label while others may appear on any label (side, back, or neck). The brand label requirements include brand name, class and type designation, alcohol content, and, in some cases, appellation of origin. In addition to the brand label requirements, there are additional mandatory items that must be included on any label. These mandatory items include the bottler’s name and address, net contents, sulfite declaration, and health warning statement.

Every container of wine must have a brand name. The name could be virtually anything, including the owner’s name, trademark name, winery name, growing area, appellation, or grape variety. If a brand name includes a vineyard, orchard, farm, or ranch name, at least 95 percent of the contents must come from the vineyard, orchard, farm, or ranch referred to in the name. In the absence of an actual brand name, the name of the bottler or importer is deemed a brand name.

The only restrictions on brand names concern descriptive names, which must not be misleading. Brand names that describe the age (e.g., “mature”), origin (e.g., “Napa Valley”), identity (e.g., “Zinfandel” or “Retsina”), or other characteristics of the wine are prohibited unless the name accurately describes the wine and conveys no erroneous impression about the wine. For example, if the name is “Japan Gold Sake,” the TTB will require that not less than 75 percent of the volume of the wine is derived from rice grown in Japan. The TTB does not address trademark issues; it only ensures that a descriptive name is accurate.

Wine labels must also identify the contents as being either a class, type, or designation of wine. The TTB has created nine classes, including grape wine, sparkling wine, and aperitif. Types include such names as red table wine or sweet table wine. Designations may be either fanciful or varietal. If a varietal designation, such as Merlot or Pinot Noir, is used, then federal regulations require that the label provide an appellation of origin and that at least 75 percent of the grapes be of that variety. Oregon regulations increase that requirement to 90 percent.
American wine labels must include the name and address of the bottler or packer. Imported wine labels must show the name and address of the importer as well.

Wine must be bottled or packaged in a metric standard of fill. Net contents may be blown or branded into the bottle in lieu of, or in addition to, stating the net contents on the label.

Every wine label must indicate the alcohol content of the wine. Although a specific indication of alcohol content may be provided, such as alcohol 12 percent by volume, ranges may also be used. Additionally, certain types or classes of wine are permitted to contain only a certain level of alcohol concentration.

The lettering of the required information must meet minimum height requirements, generally 2 mm for containers larger than 187 ml, and 1 mm for containers of 187 ml or less. The lettering must also be legible, be set on a contrasting background, and appear separate and apart from, or be substantially more conspicuous than, other descriptive or explanatory information.

There are several optional items that winemakers may wish to include, but that are not mandatory. These optional labeling terms include varietal designation; appellation of origin; American Viticultural Area; estate bottled; vintage date; produced by or made by statements; vineyard, orchard, farm, or ranch name; and organic claim. Each of these has specific percentages and restrictions for use.

TTB has published an interim rule, effective July 26, 2006, allowing the voluntary labeling of major food allergens on the labels of wines, distilled spirits, and malt beverages.

Under the interim regulations, producers, bottlers, and importers of alcohol beverages may voluntarily declare the presence of milk, eggs, fish, Crustacean shellfish, tree nuts, wheat, peanuts, and soybeans, as well as ingredients that contain protein derived from these foods, on a product label unless an exemption applies to the product in question.

TTB has also published a notice of proposed rulemaking regarding the mandatory labeling of major food allergens used in the production of wines, distilled spirits, and malt beverages that are subject to the labeling requirements of the Federal Alcohol Administration Act.

Also, on March 10, 2006, the United States signed the Agreement between the United States and the European Community on Trade in Wine. One of the provisions of this agreement covered the use of semi-generic designations on wine produced outside of the specific European country where the wine designation originated. There are 16 designations, as well as Retsina. The list of these semi-generic designations covers Burgundy, Chablis, Champagne, Chianti, Clarer, Haute Sauterne, Hock, Madeira, Malaga, Marsala, Moselle, Port, Rhine, Sauterne, Sherry, and Tokay.

The law change disallows the use of these semi-generic designations or Retsina on any new labels. Only those that are grandfathered may continue to use these semi-generic designations on their labels.

In general, most states adopt the federal standards, or require federal approval as a prerequisite for state approval. California, for example, only requires that the label receive federal approval; there are no additional state requirements. Other states, such as Oregon, require federal approval, but also have additional regulations specific
to wines produced in that state. In Washington, for example, beginning in 2010, at least 95 percent of the grapes used must originate from Washington if Washington is used as an appellation of origin. Under the current interim policy effective August 19, 2009, the Washington State Liquor Control Board requires submittal of the approved federal COLA, and does not issue a separate approval.

Additionally, some states have regulations that restate and emphasize the basic federal requirement that wine labels may not create any erroneous impressions about the wine. Each state’s requirements are different and should be thoroughly reviewed to ensure compliance.
As any winery seeking to expand its business beyond the borders of its home state is aware, state statutes often restrict or limit a winery’s ability to ship and sell its products directly to consumers or retailers. The law surrounding direct shipping is relatively settled given the U.S. Supreme Court’s decision in *Granholm v. Heald* and subsequent cases. States have broad powers to regulate liquor, but the power does not allow states to ban or severely limit the direct shipment of out-of-state wine while simultaneously authorizing direct shipment by in-state producers. In other words, states must offer equal treatment for, and impose restrictions uniformly on, in-state and out-of-state wineries. Today, approximately 39 states allow some form of direct shipment of wine to consumers. However, caution is key in determining where you can ship directly to consumers: restrictions may be contained in state statutes, rules and regulations, or agency guidance, or within application materials that could effectively prevent direct shipments if certain requirements are not satisfied.

Although the wine industry has made great strides toward gaining better direct access to its consumers, there are additional regulatory improvements needed before it will be permissible for wineries to ship and sell directly to their customers in all 50 states. States are protective of the three-tiered system; they assert that it is easier to regulate and monitor the alcoholic beverages coming into and out of the state if all alcoholic products are funneled through a state-licensed wholesaler. As states revise and amend their wine and alcoholic beverage control laws, they likely will focus on ensuring that their statutes treat in-state and out-of-state producers equally, because (a) such restrictions have been uniformly upheld by the courts and (b) as consumer demand for wine products grows, and as more small-production wineries emerge, state statutes that deny consumers direct access to their favorite wine producers undoubtedly will be challenged in litigation.

State-specific direct ship requirements vary. Consequently, prior to beginning direct shipping as part of a winery’s business operation, a winery should assess what states it wants to ship to, evaluate each state’s direct shipping restrictions, and identify the permit that is necessary to ship to the state’s consumers. For example, some states have statutory provisions that require age verification of the person placing the order, some states have specific shipping labeling requirements, and most states require affirmation by the consumer that the purchase is for personal use.

The timing for obtaining the necessary direct ship permits can also vary from state to state, and it is important to plan ahead. For example, some state applications are straightforward, like in California, where an out-of-state winery simply needs to properly register with the California Board of Equalization and file with the California Department of Alcoholic Beverage Control a one-page application, a copy of the state license and federal basic permit, and a filing fee to obtain a permit. In contrast, some state applications are quite involved and can require a significant amount of preparation, like the new direct shipper permit application in New Jersey, which requires extensive disclosures by winery owners and officers up to a 1 percent ownership level, along with the standard

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application requirements. In addition, states vary in their processing times; Wyoming and Vermont can issue a permit in a matter of days, but Illinois can take a few months to process an application.

A winery is not authorized to ship into a state until the necessary approvals are in hand, and the compliance requirements continue after the permit is issued. Most states require periodic shipment reports and tax payments, and require notification if there is a change in a winery’s business structure or ownership. In addition, some states require product or brand registration before a product may be shipped to a consumer. Failure to comply with state direct shipping requirements can impact a winery's federal basic permit, so it is important to keep the permit in good standing and meet all related compliance obligations.
Wine production under custom crush agreements is a common trend in California. Under these agreements, existing wineries crush, ferment, age, and bottle wine for individuals who then market the wine under their own labels. Custom crushing presents an opportunity for a mutually beneficial relationship. But as more and more wineries and custom crush clients enter such arrangements, both will want to spell out clearly their agreement in order to protect their interests and preserve a good working relationship. A carefully prepared custom crush agreement should eliminate, or at least minimize, any potential problems arising from such arrangements and allow both parties to prosper.

A CHECKLIST OF THINGS TO CONSIDER

Custom crush agreements should be negotiated and drafted to accurately reflect the terms of the parties’ agreement (i.e., provide a reasonable allocation of costs, risks, and liabilities; delegate responsibilities; and address the particular requirements associated with the business). Consider including many if not all of the following terms:

- Give the name, address, and nature of each party.
- Describe the premises, facilities, and equipment that will be used.
- State the purpose of the agreement and the rights and obligations of each party.
- Describe the wine-making services to be provided, including crushing, fermenting, filtering, aging, and bottling.
- Specify the duration of the agreement.
- Specify the availability and duration of storage of bottled wine.
- Explain when and how the agreement terminates.
- State all necessary payments, what they include, and the schedule by which they are to be paid (i.e., per-case fee, deposit, cost of materials, etc.).
- Provide for payment of taxes.
- Identify whether wine produced will qualify for the small producer tax credit.
- State the number of other custom crush clients.
- Provide representations as to quality of the wine.
- Identify which party is responsible for acquiring any necessary insurance.
• Clarify which party is responsible for providing the labor and performing the activities necessary to crush, ferment, process, age, and bottle the licensee’s wine and the costs for any services to be performed by the winery owner or its agent.

• Specify whether either the winery or the custom crush client is required to indemnify the other.

• Identify which party is responsible for damages to the custom crush client’s grapes or wine incurred during processing or aging.

• Delineate available remedies (i.e., specific performance and damages).
THE LAW OF WINE
—Events at Your Winery—

Permitting the use of your facilities for various events such as weddings, parties, concerts, or festivals can be a positive experience that establishes goodwill in the community, promotes name recognition, and generates revenue. A carefully prepared license agreement reduces the risk of any problems arising from such events.

WHAT IS A LICENSE?

A license in real property is a personal, revocable, and unassignable privilege allowing one party to use the property of another for a certain purpose, such as a wedding, without having a possessory interest in the property.

A CHECKLIST OF THINGS TO CONSIDER

License agreements should be negotiated and drafted to accurately reflect the terms of your arrangement; provide a reasonable allocation of costs, risks, and liabilities; delegate responsibilities; and address any particular needs associated with the event or your facilities. Specific issues that should be addressed are:

- Identify the parties. Be sure to include name, address, and nature of each entity.
- Describe the premises and/or facilities that the licensee is authorized to use. Be particularly specific if the licensee’s use is restricted to less than the entire property.
- State the purpose of the license. A licensee’s authority is restricted to actions within the terms of the license or incidental thereto.
- Specify the duration of the license and the process and consequences of exercising the power of termination.
- State all necessary payments, what they include, and the schedule by which they are to be paid (i.e., license fee, deposit, etc.).
- Clarify which party is responsible for providing the services and amenities necessary to the licensee’s event (i.e., food, beverages, entertainment, cleanup, security, etc.).
- Require indemnification for any liability resulting from the event.
- Impose responsibility on the licensee to monitor guests’ consumption of alcohol, curtail excessive consumption, and prevent intoxicated guests from driving.
- Require reimbursement for repair of any damages to the premises incurred during the event.
THE LAW OF WINE
—Choosing the Legal Structure of Your Business—

Owners of a winery or vineyard can choose from several legal structures to operate their business. Each structure has certain advantages and disadvantages that will apply to different wineries depending on the specific attributes of each winery. Several issues should be considered when establishing a winery under a particular legal structure or changing from one type of legal structure to another. They include liability, continuity, management and control, sharing of profits and losses, taxation, transferability, and costs and expenses. Wineries should be particularly interested in the issue of liability, due to vicarious liquor liability and other liabilities of the business.

There are six legal structures most often considered: sole proprietorships, general partnerships, limited partnerships, C corporations, S corporations, and limited liability companies (“LLCs”).

Currently, an LLC is generally the recommended form of entity for a vineyard or winery, although use of a corporation might also be considered under certain circumstances, such as where the entity is considering offering equity-based compensation or accepting outside investment. The following summary describes some aspects of LLCs and considerations with respect to this form of entity.

1. LLC Overview and Terminology.

An LLC confers the benefit of liability insulation on its owners and managers. Generally, an LLC that is owned by two or more owners offers the partnership benefit of pass-through tax treatment. An LLC that has one owner is ignored for federal income tax purposes and receives branch or division treatment if the LLC’s sole owner is another entity, and sole proprietorship treatment if the LLC’s sole owner is an individual. It is also possible to elect corporate tax treatment for LLCs, but in most cases this is not desirable.

Although an LLC is sometimes referred to as a hybrid between a corporation and a partnership, it is structurally more like a partnership than a corporation. An LLC generally has advantages over either a general or limited partnership, including offering limited liability for all owners (subject in some states to certain exceptions not relevant for vineyards and wineries) and, unlike a limited partnership, not imposing restrictions on participation in management. Partnerships are creatures of contract rather than of statute. Like a partnership, an LLC offers flexibility because its governing documents can override many statutory defaults and be tailored to the specific terms of the business agreement among the parties. Corporations generally do not offer the same degree of flexibility as LLCs or partnerships and in most cases are not as advantageous tax-wise.

A number of terms are associated with LLCs:

- **Articles of Organization or Certificate of Formation.** Document filed with the office of the Secretary of State to create an LLC. Publicly available after filing and similar in content to Articles of Incorporation of a corporation.

- **Operating Agreement or Limited Liability Company Agreement.** Document governing an LLC’s operations and management and the rights and obligations of members. Internal document that is similar to a partnership agreement.

- **Member.** Owner(s) of an LLC having both economic and management rights (including voting rights). May constitute the management of an LLC. Assignees and other successors may not have management rights.
Manager. Person or entity charged with management responsibility. LLC may be either “member-managed” or “manager-managed.” Category may affect apparent authority of members and/or managers, self-employment tax treatment of members, fiduciary duty of members or managers, and other aspects of LLC.

2. Practical Tips/Considerations with Respect to LLCs.

- Many state LLC Acts initially required that an LLC have at least two members. However, all states now permit or impliedly permit one-member LLCs.

- The permissible members of an LLC include individuals and a broad range of entities, including many that are not permitted shareholders of an S corporation.

- Although state law may provide that an Operating Agreement can be oral, it should always be in writing.

- The members of a member-managed LLC act both as members and as managers and have apparent authority to bind an LLC. State law will generally address whether the members of a manager-managed LLC have or do not have apparent authority to bind the LLC.

- A manager of a manager-managed LLC may, but need not, be a member. The Articles of Organization or Certificate of Formation of an LLC may have to specify whether the LLC is member-managed or manager-managed to make this a matter of public record. Some states, such as Delaware, require no detail on this in the Certificate of Formation.

- LLC Acts may impose fiduciary duties on the members and/or managers of an LLC.

- LLC interests are generally not freely transferable under the default provisions of LLC Acts. This is because, unless the Operating Agreement otherwise provides, a transfer causes the assignee to have economic rights only and does not cause the assignee to have management rights without affirmative admission of the assignee as a member. Possible control issues should be considered when evaluating the use of an LLC and/or the drafting of provisions of the Operating Agreement governing transfer and admission of substitute members.

- Some LLC Acts give members the right to withdraw and may also entitle a withdrawing member to receive the value of the member’s interest in the LLC unless the LLC’s organizational documents provide otherwise. Withdrawal should be addressed in the Operating Agreement of an LLC. Although there are instances where permitting withdrawal may be desired, it is generally not desired because it is disruptive to the business and contrary to the expectations of the parties.
• All states and the District of Columbia have enacted LLC statutes, and the laws are similar but not uniform. Many states follow the federal income tax classification of an LLC described above in the first paragraph, but the tax treatment of LLCs in the various states is also not uniform. Be sure to review the LLC Act and other applicable laws in the proposed jurisdiction to determine tax treatment.

• There are procedures for the qualification of LLCs to do business in other states. LLC Acts, like corporate acts, generally defer to the internal laws of the state of formation with respect to governance, liability insulation, etc.

• LLC Acts do not establish elaborate governance requirements of the type applicable to corporations. For instance, LLC Acts do not require annual meetings of the members or provide for directors and officers. However, corporate governance is sometimes carried into an LLC through the provisions of the Operating Agreement. For example, a Board of Directors can be named as manager and be given the power to elect officers with corporate titles and duties. In the alternative, the members can directly appoint officers or other agents to act on behalf of the LLC. Corporate governance should not be carried too far, however, such as creating requirements for annual meetings that will probably not be held.

• Health/welfare benefit considerations and the application of self-employment taxes to the distributive share of certain LLC members may weigh in favor of a corporation (either a C or an S, depending upon the facts) rather than an LLC.

• An LLC offers advantages over an S corporation if flexibility in income and loss allocations or the ability to make disproportionate distributions is desired or if the business will finance its assets and operations with debt.
Many wineries are small family-owned and closely held businesses. Several generations may be in the running and financing of the winery. Wineries often have many issues concerning business succession and transfer of ownership that involve a number of related estate planning issues.

ISSUES TO CONSIDER IN BUSINESS SUCCESSION PLANNING

1. **Taxes.**

A necessary prerequisite to any business succession planning is a basic understanding of the structure of the federal estate tax and gift tax.

- **Estate Tax:** The federal estate tax is a tax imposed on any transfer of property at death. However, federal law allows a person to transfer a certain amount of property tax-free during life or at death. This amount is called the applicable exclusion amount. For people dying in 2011 and beyond the applicable exclusion amount is $5 million, as adjusted for inflation ($5.25 million in 2013). Therefore, generally speaking, if a person dies in 2013 with less than $5.25 million of property, including life insurance proceeds, there will be no federal estate tax imposed. Any property transferred in excess of the applicable exclusion amount is taxed at a rate of 40 percent. Some states, including Washington and Oregon, also impose an estate tax on transfers of property at death. This tax is in addition to the federal tax.

- **Gift Tax:** A federal gift tax is also imposed on the transfer of property by gift. However, as discussed above, a person can transfer an amount up to the applicable exclusion amount, either by gift or at death, tax-free.

- The application of the gift tax has many nuances, but there are two aspects of the tax that a closely held business owner should understand. First, the gift tax is not imposed on any gift of $14,000 or less per year, per person. Therefore, you can make cumulative gifts of up to $14,000 to any number of persons, per year, tax-free. For example, if in 2013 you have three children and you make no other gifts to your children during the year, you can transfer $14,000 of cash or property to each of your children tax-free. Your spouse can do the same, resulting in the transfer of $28,000 to each child. The $14,000 amount is referred to as the annual exclusion amount. The annual exclusion amount is adjusted for inflation each year.

- If an individual wants to give more than $14,000 of cash or property interest per year to the same person, then the amount in excess of $14,000 is applied against the applicable exclusion amount. When the applicable exclusion amount is exhausted the gift becomes taxable at the rate of 40 percent. For example, if in 2013 a business owner gives $5.25 million in cash or property to his child, his applicable exclusion amount will effectively be reduced to zero, and no tax will be due. If instead the business owner
gives $7 million in cash or property to his child, his applicable exclusion amount would be reduced to zero, and he would pay $700,000 in gift tax (0.40 percent x $1.75 million).

- **Tax and other considerations mean that careful business succession planning is necessary.** Consult your tax and estate planning attorney. Because the applicable exclusion amount is at its highest historical level, it may be prudent for the business owner to create a succession plan that includes lifetime gifts to avoid death-time estate tax.

- Proper valuation and proof of valuation is critical for maintaining a business succession plan that will avoid potential audits from federal or state taxing authorities.

- Proper maintenance of the business entity in which your winery is operating is also critical for maintaining a business succession plan that will be transfer tax and income tax efficient.

2. **Succession Planning.**

Many wineries are family-owned businesses that involve many different people. An extremely important part of business succession planning is determining how to keep all of the key players, both family and nonfamily, happy and working. As a winery owner, you must consider several ownership and compensation aspects before attempting to plan for your business succession.

- **Transfer During Life.** One method is to provide for a transition during life by making gradual gifts of business interests and changes in management. This means that your successor(s) would take control during your lifetime. If this is your choice, you must consider how much you want to participate in the business after the transfer, if at all. You should also consider how financing would be affected by this kind of transfer.

- **Transfer at Death.** A second method is to provide for the transition to occur after your death through your estate planning documents. If you pass the business only upon your death, you must consider how prepared your successor is to continue the business without your help.

3. **Ownership.**

Many people involve their children or other family members in the business. If this is true for you, you must consider who will take over the winery when after the business owner’s death. Some considerations include:

- **Do you want your children to eventually own and operate the winery?** If so, how can you effectively and fairly integrate them into the business? The method of succession planning (i.e., lifetime or a post-death transition) may depend upon various personal and family considerations.
• **Are some of your children more involved in the business than others?** If so, should they all share equally or do you wish to compensate the other children in other ways? You may wish to leave some of the children a bequest of other assets, instead of stock or LLC interests in the business. Alternatively, you may leave stock or LLC interests to all of your children but provide an opportunity for buyout.

• **Do you have key employees who are not family members?** If so, how do you plan to keep them happy after the business has changed hands, particularly if the transition happens after death? Do you want to sell any portion of the business to persons outside of your family? Considering this may keep the winery functioning if your family is not interested in taking over.

4. **Family Involvement.**

Some of the most important considerations in business succession planning involve managing interfamily relationships. You will have a more successful plan if the family and key players are involved in as many aspects of the planning as possible.

• It is important for family members to know and understand what will happen when the business passes.

• It is important for children to feel that they have been treated equitably.

• If a family investor wishes to give up part of the business, he or she should consider making lifetime gifts and bequests in a will or from a trust to avoid taxes.

• Consider your children. Do they wish to continue the winery? Do they need more liquid assets to continue operations?

• You may want to utilize a life insurance policy to ensure that your successors have enough cash to keep the winery functioning.

• If you plan an inter vivos transfer or sale, you will need to consider whether the business creates enough cash flow to service debt or whether your children will need to have additional sources of capital to service debt.

5. **Intestate Succession.**

Without some general business succession planning and estate planning your estate will pass according to the rules of intestate succession. This could lead to unexpected and disastrous results. Further, if you own real property in other states that is not held by a California business entity, the intestate succession laws of such other states would apply to such property.
Choice of Business Entity. The choice of the type of entity to own a winery or vineyard, whether a corporation, partnership, or limited liability company (LLC), is one of the most important considerations for any new or existing winery or vineyard business. Choosing the type of entity to use involves issues regarding transferability of ownership interests, personal liability for obligations of the entity, as well as a variety of important tax considerations. This section will focus on some of the tax considerations that a winery or vineyard owner should consider when determining the type of entity to own and operate the business.

Entity Types. There are four primary types of business entities for federal income tax purposes: C corporations, S corporations, partnerships, and disregarded entities. C corporations are separate tax-paying entities. As a result, corporate income is generally subject to two levels of tax: one at the corporate level and one at the shareholder level when distributions are made or the corporation is liquidated. S corporations are pass-through entities. The S corporation itself generally is not required to pay taxes but reports to each individual shareholder his or her allocable portion of corporate income, gain, loss and deduction, and those items are reported for tax purposes directly by the shareholders. To qualify to elect to be treated as an S corporation, a corporation generally must have no more than 100 shareholders, have only one class of stock and have only individuals or certain very limited kinds of trusts, estates or charitable organizations as shareholders. Like S corporations, partnerships are pass-through entities that are generally not subject to income tax; rather, income, gain, loss and deduction flow directly to the partners, who report these amounts on their individual returns. The operational and eligibility requirements applicable to partnerships are much more flexible than those applicable to S corporations. LLCs with two or more members are treated as partnerships for federal tax purposes, unless the LLC elects to be taxed as a corporation. Domestic single-member LLCs are disregarded as entities separate from their owner for federal tax purposes, unless the LLC elects to be treated for tax purposes as a corporation. Disregarded entities are separate entities for state law purposes, but are disregarded for federal income tax purposes. If an entity is disregarded for federal tax purposes, the entity is not required to file a separate tax return, the entity’s assets are treated for tax purposes as assets of the owner of the entity, and transactions consummated by the entity are treated for tax purposes as consummated by the owner of the entity.

Equity for Services. Generally, if a person provides services to an entity in exchange for an ownership interest, the service provider will have taxable compensation income, and the entity will be entitled to a corresponding deduction. In addition, the entity could be required to withhold income and employment taxes from the compensation.

Contributions. Contributions of property (as opposed to services) to a corporation, upon either its initial organization or its admission of additional owners, may trigger recognition of gain with respect to contributed property unless certain ownership requirements are satisfied. On the other hand, except in certain limited circumstances, contributions to partnerships or LLCs in exchange for an ownership interest are generally not taxable events.

Distributions. Generally, distributions of a C corporation’s earnings and profits to the corporation’s shareholders with respect to their stock are dividends, and shareholders recognize income upon receipt. The distributing corporation generally is not entitled to a deduction for such a distribution. Shareholders in an S corporation,
partners in a partnership or members of an LLC are generally not subject to tax on distributions from the entity unless and until the amount of the distribution exceeds the owner’s tax basis in the entity.

**Raising Capital.** A business entity can raise capital from investors by selling stock or membership interests or by borrowing. Every financing is characterized as debt, as equity, or as some combination of the two for federal income tax purposes. Although it is sometimes difficult to distinguish debt from equity, the tax consequences of debt and equity are vastly different. Interest paid with respect to indebtedness generally is deductible by the borrowing entity, whereas distributions with respect to stock or ownership (e.g., dividends) generally are not, and repayment of principal generally is not income to the lender.

**Business Operations.** Operating a winery or vineyard raises a host of tax issues, some of which were addressed in a 1995 Market Segment Specialization Program (MSSP) paper directed at the wine industry. The Internal Revenue Service (IRS) reiterated many of these principles as they relate to vineyard operations in a 2006 MSSP paper directed at farmers and grape growers. In addition, in 2011, the IRS released through the MSSP an Audit Technique Guide for the wine industry. The positions taken by the IRS in these MSSP papers are discussed below.

**Accounting Methods.** The computation of income for federal tax purposes depends in part on the taxpayer’s method of accounting. The two typical methods of accounting are the accrual method and the cash method. Under the accrual method of accounting, a seller generally recognizes income and is entitled to deductions when (i) all events have occurred causing the seller to have a right to the income or to owe the expense, and (ii) the amount of the income or expense can be determined with reasonable accuracy. Under the accrual method, income usually is recognized at the time of sale and expenses are taken into account at the time payment becomes due. Under the cash method of accounting, a seller generally recognizes income at the time of actual or constructive receipt of payment from the sale and claims a deduction for expenses as they are paid.

**Winery Operations.** Wineries are considered manufacturers for tax accounting purposes because they transform one product (grapes) into another product (wine). Manufacturers generally are required to follow the uniform capitalization (UNICAP) accounting rules. Under the UNICAP inventory method of accounting, the costs of producing, acquiring, storing and handling wine inventories generally are incorporated into the cost of goods sold (i.e., capitalized). As a result, deduction of those costs is delayed until the wine is released for sale. In accordance with the inventory method of accounting under UNICAP, all of the costs associated with manufacturing wine during the “production period” must be capitalized, and any costs incurred after the production period may be expensed. In the case of wine that is aged before it is sold, the production period begins when the grapes are crushed, continues through the aging period, and ends when the wine is released for sale.

The process of accounting for costs under the UNICAP rules begins with assigning costs to the appropriate cost center. The IRS has recognized four areas that generate costs in the wine making process: (1) grape crushing/juice fermentation, (2) wine aging and storage, (3) general and administrative, and (4) wine marketing and sales.

Recently, use by wineries of the last-in first-out (LIFO) method to value inventory has been scrutinized by the IRS in several high profile audits. In addition, the repeal of LIFO inventory accounting for all taxpayers has been proposed during recent budget negotiations between Congress and the President. The LIFO method permits the
taxpayer to treat the last units of inventory produced as the first units to be sold for purposes of measuring cost. Current costs are, therefore, charged against current revenues and, during periods of rising prices, LIFO may reduce or eliminate inventory profits that result from inflation. At issue is the wineries’ use of broad inventory items that, according to the IRS, allow product mix and other non-inflation factors to distort income in the taxpayers’ favor. In light of LIFO’s uncertain future, we recommend that wine industry taxpayers consult their tax advisors before adopting this method.

Vineyard Operations. A winery is considered a manufacturer and as such must use the accrual method of accounting. A vineyard, on the other hand, generally can use the cash method. With regard to vineyard operations, certain costs must be capitalized, including vine development costs (e.g., direct costs of vines and labor and indirect costs of planting); costs of converting vineyard production from one type of grape to another; fumigation costs; vine replacement costs (e.g., costs of new vineyard engineering and design, preparation of land for replanting, planting, installation, budding, and purchase of new vines, irrigation equipment and trellis systems); costs of acquiring, protecting, expanding, registering, or defending a trademark; and, costs of designing or developing labels and packaging designs.

Although certain expenditures must be capitalized, most of these costs may be recovered over time through depreciation. Depreciation is the decline in value of property over time due to normal wear and tear and deterioration caused by use and the passage of time. Thus, a taxpayer will generally claim depreciation deductions over a period of time determined in part by the useful life of the property. Generally, the Modified Accelerated Cost Recovery System (MACRS) applies when determining depreciation deductions. MACRS employs two depreciation systems: general and alternative. For example, depreciation deductions for the direct costs of vines and labor and indirect costs of planting begin when vines start producing grapes at a commercially harvestable level. Vines are depreciable over 10 years under the general depreciation system and over 20 years under the alternative depreciation system, and depreciation deductions must be calculated using the straight-line method.

Mixed Operations. Many wineries own or control or are otherwise related to a vineyard that produces grapes later used by the winery. If the vineyard uses the cash method of accounting and the winery pays for purchased grapes in a later year, the vineyard could have a deferral of income recognition. If the vineyard were allowed to defer the recognition of income in this way, the vineyard generally would be able to claim deductions for expenses relating to growing grapes before reporting income from the sale of those grapes. The position of the IRS with respect to a deferral of this kind continues to evolve, but it generally is permissible for a vineyard operated as a division of an operation including a winery to use the cash method—even though the winery uses the accrual method—and to achieve some deferral. Similarly, a vineyard corporation that is a member of an affiliated group of corporations filing a consolidated return can achieve deferral through the inter-company transaction rules of the consolidated return regulations. In some circumstances, the IRS may prevent deferral of income by treating the vineyard as having constructively received the proceeds of the grape sales. In addition, if promissory notes from the winery to the vineyard exist as evidence of the payment for grapes, in some circumstances, the IRS could treat the fair market value of the notes as income during the year of sale.

On-site Personal Residence. A winery owner or employee may reside on vineyard or winery property. If the entity holds title to the residence, the entity may be able to claim depreciation and other deductions with respect to the
residence, and the owner or employee may be able to live at the residence without recognizing income relating to the residence. For the entity to claim deductions and the owner or employee to live at the residence without recognizing income the following factors, among others, must be present: the residence must be located on the winery or vineyard premises; the residence must be provided for the benefit of the entity as an employer (i.e., there must be a valid business reason for requiring the employee live on the winery or vineyard premises); and, the owner or employee must be required to live at the residence as a condition of employment.

The foregoing summary describes just some of the many federal tax issues faced by wineries and vineyards. Application of these rules to your business entity and operations will depend on your specific facts and circumstances.

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THE LAW OF WINE
—Financing—

Vineyards and wineries, like any other business, need financing for the acquisition and development of their land and production facilities, and for the operation of their businesses. Financing can come from many sources, including equity financing from friends and family, venture capital and public and private capital markets, equipment lease financing, and debt financing. This chapter discusses debt financing, from conventional lending sources as well as from local governmental authorities through the issuance of bonds.

CONVENTIONAL FINANCING

Conventional debt financing, where the interest earned by the lender is taxable to the lender, is available for terms as short as a year or less, or as long as 20 or 30 years, depending on the assets and activities being financed. Long-term financing is typically used to finance the purchase of fixed assets, such as real property and improvements. Medium-term financing is available for the purchase of specific items of equipment, such as tractors, and can be arranged through the equipment seller as well as through a bank or other financial institution. Short-term financing, such as a revolving line of credit, supports the day-to-day operations of the winery, such as the annual costs of cultivation and production. Most vineyards and wineries will carry more than one type of debt to support the different aspects of their business.

1. Term Financing.

Long- and medium-term financing generally will be secured by real property, buildings, and related improvements; the grapevines and trellis and irrigation equipment; and, in some instances, fixed equipment. Term lenders generally will not seek as collateral the annual crops of grapes (although the grapevines and trellis may be part of the term security) or the proceeds of sale of grapes and wine. Term financing can be obtained from a variety of sources. Each lender will have its own criteria with respect to the loan-to-value ratio that it is willing to accept (that is, the amount that it is willing to lend, as contrasted with the value of the assets, or collateral, that secure repayment of the loan) and the level of cash flow that it will require that the business generate measured against the annual debt payments expected to be made to the lender (referred to as the debt service ratio). Generally, the better the loan-to-value and debt service ratios, the better the interest rate that is available to the borrower. Interest rates in term financings generally are set at a fixed rate. Repayment of term loans can be structured in a number of ways, from equal repayment amounts each period from the date the loan is granted until its final maturity, to a series of equal but smaller repayment amounts leading to a final significantly larger repayment amount (often referred to as a balloon payment), to interest-only payments during the loan term leading to repayment of the full principal amount of the loan on the final maturity date (often referred to as a bullet payment). An amortizing loan, in which a regular amount of the loan principal is repaid each period, is a more common structure.

2. Operating Financing.

Operating financing generally will be negotiated on a year-to-year basis and secured by the annual grape crop, inventory of wine, and accounts receivable arising from the sale of grapes or wine. Lenders providing an operating line of credit will also frequently seek a secondary security position in the collateral securing the term loan. Operating lines of credit typically are structured as revolving lines of credit, with the borrower able to borrow, repay, and reborrow a defined amount of money as the needs of the business dictate. Because of the flexibility
afforded by this structure, the interest rate applicable to these borrowings typically is a variable (or floating) rate, which is based on a defined index, the value of which can change daily (such as Prime or LIBOR).

The most common sources of agricultural financing are commercial banks, the farm credit system, and life insurance companies.

1. **Commercial Banks.**

Commercial banks make term loans either to hold in their own loan portfolios or, in many cases, for sale through the Farmer Mac program, which is a secondary market created by the federal government for first mortgage agricultural real estate loans. Banks also are a common source of short-term operating lines of credit.

2. **Farm Credit System.**

Farm Credit, a quasi-governmental lender, is a nationwide network of borrower-owned lending institutions engaged solely in the business of financing agricultural and rural enterprises. Farm Credit offers both operating and term financing, and will act as sole lender or in conjunction with commercial lenders.

3. **Life Insurance Companies.**

Many life insurance companies include agricultural loans in their investment portfolios. Several have agricultural loan representatives in the Pacific Northwest and also place loans through independent agricultural loan brokers. Life insurance companies generally will accept only the best credit risks but, as a result, frequently offer the lowest interest rates. Life insurance companies generally participate in long-term loans and do not make operating loans.

In negotiating the specific terms of any financing, care needs to be given to the following key issues:

1. **Fixed vs. Variable Rate Loans.**

As discussed, operating loans will generally be variable rate loans, with the interest rate set to equal an index rate, such as Prime or LIBOR, plus a spread or margin that reflects the amount of credit risk that the lender perceives that it is taking. The interest rate charged on term loans can be variable, but more commonly is set at a fixed rate of interest. If a fixed-rate loan structure is chosen, there usually are significant prepayment penalties imposed if the loan is paid prior to its scheduled repayment dates. Before selecting a loan rate structure, the borrower should consider the likelihood of a change in its operation that would require a refinancing or payoff of the loan.

2. **Length of Loan.**

Most operating loans are for a one-year period; however, some lenders will commit to revolving-loan periods as long as three years. Borrowers should seek, at a minimum, provisions requiring the lender to give several months’ advance notice if the lender does not intend to renew the operating loan, to enable the borrower time to obtain a new lender.
3. **Business Operating Restrictions.**

Most debt financing agreements contain restrictions, or covenants, that limit the way in which the borrower operates its business. These restrictions can be affirmative (such as the requirement to submit periodic financial reports or maintain specified levels of insurance), negative (such as restrictions on incurring additional debt, granting additional security interests in pledged collateral, or making capital expenditures), or related to financial performance (such as satisfying minimum or maximum financial ratios). Each restriction, covenant, and requirement should be carefully reviewed in the context of the borrower’s plans for its business over the medium term, and negotiated with the lender so that the lender feels that repayment of the loan is secure and the borrower feels that it has the operating flexibility to run and grow its business.

4. **Restrictions on Transfer.**

Almost all loans can be expected to provide that they are immediately due and payable upon the transfer of any significant portion of the loan collateral security, or upon transfer of the ownership interests in the borrowing entity (for example, transfers of stock in a closely held corporate borrower). Before closing the loan, the borrower should consider changes in the business or its ownership that may occur during the term of the loan and negotiate provisions setting a framework for the manner in which such changes will be addressed. Such changes could include conveyances of equity interests in the business to family members as part of business succession planning or to simplify the business’s ownership structure, changes in the form of entity (such as incorporation of a sole proprietorship), or sales or replacement of significant production facilities.

5. **Collateral.**

Care should be taken to ensure that collateral is appropriately allocated between the operating line lender and the term lender. Typically, short-term assets will secure repayment of short-term debt, and long-term or fixed assets will secure repayment of long-term debt. Even if the same lender initially provides both the term loan and the operating loan, it is preferable to allocate collateral between the term loan and the operating loan so as to not create undue difficulties in refinancing either loan separately in the future. Problems in structuring term loans can arise if an operating line lender has taken security that includes irrigation equipment, trellises, grapevines, and fixed equipment that a term lender would view as part of the real estate and other fixed collateral appropriate to secure long-term debt.

6. **Insurance Requirements.**

It is typical for loan agreements to require the borrower to carry insurance of the kind and in the amounts that the lender may require from time to time. This could include costly earthquake insurance, business interruption insurance, or flood insurance, any of which might, in the context of the particular operation, not make business sense. Borrowers should review with potential lenders the insurable risks that they consider most significant and the insurance coverage that they carry to cover those risks.

7. **Use of Insurance Proceeds.**

Loan documents frequently provide that insurance proceeds will be used, at the lender’s discretion, to either prepay indebtedness or repair improvements. The borrower should seek to include provisions giving it the right
to use the proceeds for repair. This often will depend on the magnitude of the insured loss, and the borrower should have a good understanding of, and be able to communicate to a lender, the economics of a loss scenario in the context of its operations.

**TAX-EXEMPT FINANCING**

In addition to conventional debt financing, in certain circumstances, such as the construction of a winery that will create new jobs or incorporate renewable energy, a vineyard owner may be able to borrow money from a state or local governmental authority that has raised money by issuing bonds. Because the interest paid to the holder of the bond generally is exempt from tax, the holder does not require the interest rate on the bond to be as high as a conventional lender would require with respect to a loan. As a result, the governmental authority can re-lend the money raised by issuing the bonds to qualifying projects that benefit the state or local community, and can fix or index the loan interest rate to the lower bond interest rate.

A form of tax-exempt financing is available in California for the acquisition and construction of wineries, as well as other manufacturing and processing facilities. This type of tax-exempt financing is referred to by many different names, the most common being small issue industrial development revenue bonds (“IDRBs”), small issue industrial development bonds, or small issue private activity bonds. Summarized below are some of the key guidelines applicable to financings using the proceeds of tax-exempt bonds.

1. **Determining Eligibility Requires Some Legal Analysis.**

   There are many state law and federal Internal Revenue Code restrictions on the use of tax-exempt financing. Consequently, the initial determination of whether small issue IDRBs will be available in any specific situation requires a fact-specific legal analysis. However, the effort required to complete this analysis is worthwhile because the use of this type of financing can have significant benefits for the borrower.

2. **Key Benefits: Lower Interest Rate and Longer Repayment Period.**

   An important benefit of tax-exempt financing is that it usually will reduce the borrower’s overall financing costs over the life of the loan. As discussed, this reflects the fact that the ultimate lenders (the purchasers of the bonds) do not pay federal taxes on the interest income and, for individual bond holders, typically do not pay state income tax on the interest received on bonds issued by authorized governmental issuers located within that state. Consequently, the lenders are willing to accept an interest rate on the bonds that is lower than the prevailing taxable commercial rates on similar loans. This interest cost savings starts immediately upon the creation of the loan.

   In addition to cost savings, small issue IDRBs can also produce other benefits. For example, in some instances the term of the bonds, and consequently the loan, may be longer than available for comparable commercial loans. Federal law requires that small issue IDRBs not be outstanding for longer than 120 percent of the estimated economic useful life of the assets financed. If the project is primarily a building, this would allow a theoretical loan period of over 40 years. Although the bond holders will usually not allow such a long period to pay off the bonds, it is not unusual to find small issue IDRBs with a maturity date of more than 20 years. In addition, in certain situations the bond holders will accept a bond with a bullet maturity. As discussed above, this is a
financing in which no principal payments on either the bonds or the loan must be made until the final maturity date of the bonds.

3. **What Can Be Financed?**

Small issue IDRBs are available to finance “manufacturing” and “processing” facilities. Most types of winery or other agriculture-related facilities qualify as processing facilities. The central requirement for this category is that the raw materials undergo a change in form or character. The process of crushing grapes and fermenting, aging, and bottling wine meets this requirement.

4. **Determining What Portions of a Specific Facility Might Be Financeable.**

The guidelines that have been issued by the IRS deal specifically with manufacturing facilities, not processing facilities. However, those principles are typically applied to both manufacturing and processing facilities. Under federal guidelines, the “core” portions of a facility may be financed entirely with tax-exempt funds, but no more than 25 percent of the “net proceeds” of the bond issue can be used for “directly related and ancillary” facilities. With small issue IDRBs, “net proceeds” usually equals the full principal amount of the bonds. “Core” facilities are those in which the actual manufacturing or processing occurs.

5. **How to Tell the Difference Between “Core” and “Directly Related and Ancillary” Facilities.**

- The existing guidelines are based on a fact pattern in which raw materials are stored for a period of time until used, are brought to an area where they are mixed together, are put into their initial containers, have labels affixed, and are then stored temporarily until being moved to a longer-term storage and distribution warehouse. The portion of the facility where the actual mixing, packaging, and label application activities occur is determined to be a “core” portion of the manufacturing process.

- The area where raw materials are stored before use is “ancillary,” as is the storage area where the finished product is stored temporarily until shipment to the distribution warehouse. However, if that temporary storage area is actually the final distribution point directly to customers, it will not qualify for financing as “ancillary” to the manufacturing process. In addition, equipment such as forklifts used to move raw materials and finished products around the facility is treated as “ancillary.”

6. **Application of Principles to a Winery Facility.**

Generally, the principles discussed above should apply to the financing of a typical winery as follows:

- Core:
  - Any area and equipment used to crush, de-stem, or press is a "core" part of the wine-making process;
Any area where the must is collected, fermented, or otherwise processed is part of the “core” processing;

The bottling line and facilities for affixing labels are part of the “core” processing, but areas where bottles are stored before being filled are “ancillary”; and

Areas and equipment used to put bottles into cases or other shipping containers are probably part of the “core” processing.

- Ancillary:

  Any area where grapes are delivered and sorted before the start of “wine making” is “ancillary”;

  Areas where bottles are stored before being filled are “ancillary,” but the bottling line and facilities for affixing labels are part of the “core” processing;

  Areas used primarily for storage of cases of bottled wine are probably “ancillary”; and

  Nonprocessing agricultural equipment, such as tractors, forklifts, or trucks used within or around the winery, is “ancillary.”

Tasting rooms, banquet halls, or other facilities used to entertain or market products at the winery will probably be viewed as neither core nor ancillary and cannot qualify for small issue IDRB financing at all. Administrative offices can be financed as part of a manufacturing or processing facility to the extent the offices are located on the premises and most of the functions to be performed at the offices are directly related to the day-to-day operations at the facility. For example, a general manager, a winemaker, a purchasing agent, or other personnel who oversee or are involved in day-to-day operations can have bond-financed office space. Sales personnel probably cannot.

7. Can Land Be Financed?

The acquisition of land presents unique problems under the small issue IDRB rules. The acquisition of agricultural land is generally prohibited. The general rule for nonagricultural land is that not more than 25 percent of the “net proceeds” of the bond issue can be used to acquire land. This rule must be considered when the land on which the processing or manufacturing facility is to be located is being purchased with money borrowed through the issuance of the bonds, and can cause a problem if more land is being acquired than is actually necessary for the construction of the facility, or if the facility is relatively inexpensive compared to the price of the land on which it will be located. The typical way to avoid this limitation is to finance any land with a value in excess of 25 percent of the bond proceeds from other credit sources. This rule is not triggered if the land is already owned by the borrower or will be financed by some means other than tax-exempt small issue IDRBs.
8. **How Much of the Winery Facility Can Be Financed with Tax-Exempt Bonds?**

Limits are imposed on the amount of small issue IDRB financing that can be used for any particular facility. Generally, this limit is $10 million, calculated on the basis of the borrower’s total “capital expenditures” within a specific geographic area and within a specific period of time. The geographic area is determined by the nature of the area within which the facility is located. If it is inside a city, then the city limits are the relevant area. If the facility is located within an unincorporated area of a county, then the total area of the county is the relevant area. The measuring period is a total of six years—three years before the date of the bond issuance and three years after the date the bonds are issued.

9. **Applying the $10 Million Limitation.**

The application of the limitation can be relatively simple or relatively complicated, depending on the specific facts. If the facility will be the borrower’s only operation within the relevant geographic area, the application is reasonably straightforward. You count all “capital expenditures” of the borrower within the relevant area within the three years before the date the bonds are issued (which may be zero if this is a new operation for the borrower) and add the principal amount of bonds issued. This provides the dollar amount to be applied against the $10 million limitation as of the date the bonds are issued. The difference between this amount and $10 million is the amount of “capital expenditures” that the borrower may make at the facility from sources other than bond money during the three years following the issuance of the bonds.

The application becomes more complicated if the borrower is expanding an existing operation within the same geographic area. Then the “capital expenditures” that will be considered during the three-year period before the date the bonds are issued are likely to be significant, and the requirement that the borrower stay within $10 million may be harder to accomplish since all “capital expenditures” within the geographic area count, not just those directly related to the facility. Consequently, “capital expenditures” incurred for the operation of each vineyard located within the same county as the winery will count toward the $10 million limitation even if the grapes grown at that vineyard are not processed at the winery.

10. **The Spendable Proceeds Limitation.**

Limits also are imposed on the types of capital expenditures that can be made with bond proceeds. All but 5 percent of the principal amount of the bond issue plus all investment income earned on those moneys from the time they are received until they are spent must be spent on acquisition, construction, or improvement of “qualifying capital expenditures.” “Qualifying capital expenditures” generally are defined as expenditures for land or other property that is subject to the allowance for depreciation. These “capital expenditures” must relate to a qualifying facility, either as “core” portions of the facility or as “directly related and ancillary” portions of the facility, as described above.

11. **State Volume Cap.**

Finally, before a small issue IDRB can be issued, it must receive a “volume cap allocation.” Volume cap is a dollar limit assigned by federal law to each state on an annual basis. It is determined by multiplying the population of the state by a specific dollar amount. The state is then free to decide how it will internally allocate this amount.
Most states have reserved to the state government the power to determine how the volume cap will be allocated. Since almost all types of bonds that will benefit specific private individuals or corporations require a volume cap allocation and there is a limited amount of volume cap available each year, there is some competition among qualifying projects. Generally, projects to be financed early in the calendar year have little problem receiving the necessary volume cap allocation. Some states, such as Washington, have statutory percentage allocations describing the types of projects that are supposed to have volume cap available for them each year. Other states, such as Oregon, have established certain criteria that are supposed to determine which project prevails if there is competition for volume cap.

In addition to the project-specific considerations discussed above, borrowers should be aware that the use of tax-exempt bonds involves additional costs not incurred with conventional financing. The introduction of additional parties, such as the bond holders and the party responsible for selling and administering the bonds on behalf of the issuing governmental entity, creates a more complex and costly process, which will reduce the borrower's overall cost savings. The following are some of the additional cost considerations that relate to the process of issuing tax-exempt bonds.

1. **Finding a Buyer for Your Bonds.**

Bonds can be sold several different ways. Although the issuer of the bonds will usually want to know that potential buyers have been identified, it typically does not want to become any more deeply involved in how the bonds will be sold. Often the lowest-cost means of selling the bonds is to make an arrangement directly with a single buyer. This is referred to as a “private placement.” The very lowest cost is usually a private placement to the bank with which the borrower usually does business, since this entity knows the borrower well and will view the bond as essentially a tax-exempt commercial loan to an existing customer. The bonds may also be sold in the public market to a variety of financial institutions, such as insurance or pension funds, or to wealthy individuals. An “underwriter” will usually be engaged to structure the terms of the financing and market the bonds.

2. **Credit Enhancement.**

Bonds that are going to be sold to any entity other than the borrower’s bank usually will need to have some form of credit enhancement before they are “marketable.” This typically takes the form of a letter of credit, often issued by the borrower’s existing bank if the bank does not want to own the bond. The letter of credit allows purchasers of the bonds to rely on the credit of the bank issuing the letter of credit rather than on the credit and business operations of the borrower. This structure gives the bond purchaser the security of dealing with the credit of a “known” entity and allows the purchaser to buy the bonds with relatively little credit analysis or knowledge of the borrower or its operations. The issuance of the letter of credit represents an extension of credit to the borrower by the bank issuing the letter of credit, since the letter of credit can be drawn upon by the bond holders if there is any event of default on the bonds. Consequently, the bank will charge the borrower a fee for issuing the letter of credit and will require an agreement with the borrower relating to how the bank will be repaid if the letter of credit is drawn upon, appraisals if the winery facility is included in the pool of collateral security, and other protections typical of a conventional commercial loan.
3. **Bond Counsel and Legal Counsel.**

Because of the complexity of bond transactions, independent bond counsel must be retained to review the transaction structure and documentation and give a legal opinion. Most bond counsel are lawyers that deal primarily with small issue IDRBs and other types of tax-exempt financing. Bond counsel usually is considered to represent the issuer of the bonds, not the borrower. The borrower will need its own legal counsel to assist with the complex features and documents and to give opinions to the underwriter, the bank providing the letter of credit (if one is being used), bond counsel, and possibly others.

The above discussions are not intended to present a definitive list of all issues relevant to choosing and structuring a method of financing, but instead represent an overview of some of the more significant aspects. In all cases, loan documents should be reviewed carefully by the borrower and its professional advisors with a view toward addressing, before loan closing, issues that could cause difficulties in future business operations.

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THE LAW OF WINE
—Protecting the Brand Through Litigation:
Trademark Registration Disputes in the Wine Industry—

Because a key asset for any winery is its name and associated trademark, every winery should take affirmative action to protect its brand or label from being confused with other wine products in the marketplace. This action not only includes establishing and registering trademark rights, but also requires a winery to defend its trademark if a competitor infringes upon it by using an identical or similar mark. Sometimes, this means that a winery has to seek a court order enjoining the infringing use or awarding damages caused by that unlawful use. The following is an overview of how trademark infringement lawsuits often are resolved by the courts.

1. The Legal Principles of Trademark Infringement Claims.

A trademark is a word, phrase, logo, or other graphic symbol that a manufacturer or seller uses to distinguish its product from others. Trade dress, on the other hand, includes the overall appearance and image of a product in the marketplace, including its packaging and labeling. In the wine industry, trade dress likely will consist of the wine bottle and cork.

Most trademark and trade dress infringement claims are based on Section 43(a) of the Lanham Act, which makes actionable the deceptive and misleading use in commerce of “any word, term, name, symbol, or device” on or in connection with any goods or services. In essence, this provision has been interpreted to serve as a federal law against unfair competition. To state a claim for trademark or trade dress infringement, a plaintiff must show (1) ownership of a distinctive trademark; (2) nonfunctionality; and (3) likelihood of confusion. The analysis usually is highly fact-dependent and turns on the court’s analysis and comparison of the competing marks and the marketplace in which they compete.

A trademark is distinctive if it is capable of distinguishing one person’s goods from the goods of others. Marks are generally classified in one of five categories of distinctiveness: (1) generic (i.e., the general name of the product); (2) descriptive (describes a quality or characteristic of the product in a straightforward manner); (3) suggestive (suggests the product’s features); (4) arbitrary (lacks relevance to any feature or characteristic of a product); or (5) fanciful (the most distinctive – generally a coined term). A term that is deemed “generic” can never be protected as a trademark. A descriptive mark is considered inherently nondistinctive, but it can be protected if it has acquired distinctiveness through long and exclusive use by the claimant. Suggestive, arbitrary, and fanciful marks are inherently distinctive and therefore protectable.

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3 See id. at 768-69, 780; see also Kendall-Jackson Winery, Ltd. v. E & J Gallo Winery, 150 F.3d 1042, 1046-48 (9th Cir. 1998).
4 Kendall-Jackson, 150 F.3d at 1047.
A claimed trade dress is “functional” if it is essential to the use or purpose of the product, or if it affects the cost or quality of the product. A functional feature cannot be protected as trade dress. This element of trademark law is intended to promote competition by allowing competitors to reasonably replicate important, nonreputation-related product features.

Finally, there is a likelihood of confusion if the purchasing public is likely to be deceived or confused by the similarity of the marks. Courts may consider a number of factors in determining whether the likelihood of confusion exists. The factors vary from jurisdiction to jurisdiction, but they may include (1) the strength of the plaintiff’s mark; (2) the degree of similarity between the two marks; (3) the proximity of the products; (4) evidence of actual confusion; (5) marketing channels used; (6) types of goods and degree of care likely to be exercised by the purchaser; (7) the alleged infringer’s intent in selecting the mark; and (8) likelihood of expansion of the product line.

2. Trademark Infringement Litigation in the Wine Industry.

Trademark infringement claims are not infrequent in the wine industry. In 1978, the Second Circuit resolved a trademark infringement claim brought by an established vintner against a newcomer that sought to use a similar mark on its label. The newcomer winery, Bully Hill, was owned by Walter S. Taylor, a former employee of the plaintiff winery (Taylor Wine Company) who sought to use the word “Taylor” (his surname) on his wine’s packaging. The court recognized the need for an injunction to protect against confusion of the defendant’s wine with the plaintiff’s products, but found that an injunction prohibiting the defendant from using the word “Taylor” on the label would be too broad. In that case, the court stated that to prohibit an individual from using his or her family name is akin to taking away the person’s identity. Thus, the court concluded that neither the plaintiff nor the defendant could use the name “Taylor” as a trademark, but held that the defendant could use his signature on the Bully Hill label or advertising to show his association with the winery. However, the defendant was required to include a disclaimer that he was not connected to the Taylor Wine Company.

In another family name case, in 1991, the Northern District of California granted summary judgment in favor of E & J Gallo Winery against an Italian trade association named Consorzio del Gallo Nero for the latter’s use of the name “Gallo Nero” in its promotion and distribution of wines in the United States. The court found that the

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5 Id. at 1048 (quoting Qualitex Co. v. Jacobson Prod. Co., 514 U.S. 159, 169 (1995)).
6 Id. at 733.
7 Id. at 734.
9 Id. at 735.
10 Id. at 736.
11 Id. at 734.
12 Id. at 735.
Gallo name had developed secondary meaning (aka acquired distinctiveness) in connection with wine and was therefore entitled to protection.\textsuperscript{14} The court also found that because the two companies both used similar marketing channels, there was a significant likelihood that purchasers would be confused between the two labels.\textsuperscript{15} Thus, the plaintiff was entitled to summary judgment on its claims of trademark infringement.

A few years later, E & J Gallo Winery litigated another trademark infringement dispute with Kendall-Jackson Winery over the use of a grape leaf design.\textsuperscript{16} Kendall-Jackson alleged that E & J Gallo’s use of a grape leaf design on its Turning Leaf chardonnay label infringed on the grape design found on Kendall-Jackson’s chardonnay label. The Ninth Circuit found that Kendall-Jackson’s use of the grape leaf design was not a distinctive trademark or trade dress, because grape leaf designs are so widely used in the wine industry.\textsuperscript{17} Thus, Kendall-Jackson was entitled to no relief for the alleged infringement.

Many other wineries and wine distributors have found themselves in litigation over the alleged infringement of their labels, brands, advertising, and packaging of wine products.\textsuperscript{18} The outcomes of these cases turn on all the facts and evidence established during the course of the case and on the characteristics of the labels themselves. With each new winery that enters the marketplace, there exists a greater likelihood that the newcomer’s name, label, or bottling motif will be similar to a prior existing wine label. Accordingly, the number of trademark disputes undoubtedly will increase as the industry continues to grow.

\textsuperscript{14} Id. at 462.
\textsuperscript{15} Id. at 463-65.
\textsuperscript{16} Kendall-Jackson, 150 F.3d at 1046-48.
\textsuperscript{17} Id. at 1050.
The wine industry is just like any other product industry: It includes sellers, buyers, manufacturers, distributors, and suppliers that interact based on contractual relationships. Participants in the wine industry may find themselves litigating any number of issues, including contract disputes, employment disputes, or other claims associated with the sale, manufacture, and storage of wine products or with purchasers’ use and enjoyment of the industry’s products. The issues of wine spoilage, counterfeit wine, and Internet sales of wine products are briefly overviewed here.

1. **Wine Spoilage.**

Wineries and their vendors frequently have litigated disputes regarding the spoilage of wine, a potentially costly occurrence that may threaten either consumers’ perceptions of a winery or wineries’ perceptions of a vendor—or both. The cases discussed here provide a small but representative sample of the various claims that may be asserted in this type of litigation.

As an initial matter, a winery seeking to recover damages from a vendor—particularly a foreign vendor—must choose the correct forum in which to bring suit. In a series of cases, plaintiff wineries sued a French manufacturer for “cork taint” allegedly caused by the manufacturer’s cork-based closures. A Canadian winery’s efforts to sue the manufacturer in U.S. court failed when the federal district court, reasoning that litigating the issue in France or Canada would be more appropriate, dismissed the action pursuant to the doctrine of *forum non conveniens*.¹ A California winery alleging widespread cork taint faced a similar outcome when a federal district court dismissed its complaint for lack of jurisdiction. The court lacked diversity jurisdiction because plaintiff and one defendant—the French manufacturer’s domestic subsidiary—were both citizens of California. The court further concluded that it lacked federal question jurisdiction because the treaty governing the international sales of goods—the ostensible basis for jurisdiction—did not apply where the conduct at issue occurred “largely, if not entirely” in one state.² And an Oregon winery’s claims against a California cork manufacturer stalled when the district court concluded that the contract mandated arbitration.³ By contrast, a federal district court rejected an Italian bottle manufacturer’s argument that it lacked the “minimum contacts” with California required to permit a U.S. court to assert personal jurisdiction, a ruling that allowed a wine cellar to proceed with its claims that the manufacturer’s bottles allowed wine to seep out.⁴

Parties seeking to litigate spoilage claims also must take care to bring claims within the applicable limitations period. In *Tuwe Jonge Gezellen v. Owens-Illinois*, the Northern District of Ohio addressed a claim brought by a

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¹ *Chateau des Charmes Wine, Ltd. v. Sahaté USA, Inc.*, 2003 U.S. Dist. LEXIS 20337 (N.D. Cal. Nov. 12, 2003). The district court previously had dismissed plaintiff’s claims based on a forum selection clause, but the Ninth Circuit reversed that decision. 2002 U.S. Dist. LEXIS 4406 (N.D. Cal. Mar. 14, 2002), rev’d *per curiam*, 328 F.3d 528 (9th Cir.), cert. denied, 540 U.S. 1049 (2003). On remand, the district court again dismissed plaintiff’s claims but based its decision on the doctrine of *forum non conveniens* rather than the forum selection clause. For a different result, see *Palm Bay Int’l, Inc. v. Marchesi Di Barolo S.P.A.*, 659 F. Supp. 2d 407, 413 (E.D.N.Y. 2009) (rejecting motion to dismiss on *forum non conveniens* grounds, despite parallel litigation in Italy, because "the case ha[d] a stronger connection to the United States than to Italy").


South African producer and bottler of fine wine who sought to impose liability on a U.S.-based manufacturer of glass containers for providing erroneous technical advice to Consol Glass, a bottling company that the plaintiff used for its sparkling wine. The plaintiff alleged that the defendant conducted insufficient preliminary testing and gave incomplete advice about treating bottles with gas before use, which affected nearly 30,000 bottles of its vintage sparkling wine. The plaintiff claimed that, in addition to the ruination of its wine, its reputation in the wine industry was severely damaged, its future production was disrupted, and its ability to compete in the highly competitive sparkling wine market was compromised. The court dismissed plaintiff’s claims as barred by the applicable statute of limitations.

Depending on the jurisdiction, parties may face statutory obstacles to proving that wine is “spoiled.” In Spinetta v. Complete Welders Supply, for example, a California court rejected a winemaker’s claims against a supplier of nitrogen gas cylinders for breach of contract, breach of warranty, and negligence. The winemaker sought damages for 13,548 bottles of spoiled wine, alleging that the spoilage occurred because sulfur dioxide, oxygen, and other gases from a nitrogen cylinder supplied by the defendant got into the wine during the bottling process. The appellate court affirmed the trial court’s finding that the winemaker failed to prove that the exposure of his wine to sulfur dioxide gas resulted in “adulteration” of the wine, as defined by California statute. The court expressly rejected plaintiff’s position that “equate[d] exposure with adulteration,” and held instead that statutory “adulteration” would require evidence that the “product [was] altered so that it contains poison or other deleterious substances.”

A winery litigating spoilage issues also may have to overcome the “economic loss” rule, which in some circumstances bars recovery for damages to the defective product itself (as opposed to personal injury, property damage, or damages to another product). In an older decision, the Washington Court of Appeals addressed whether a plaintiff was entitled to maintain a claim under Washington’s products liability act for defective tanks that the defendant sold to the plaintiff winery and for the winery’s loss of the wine stored in the tanks. A winery purchased five steel tanks from the defendant that it planned to use for temporary wine storage. The parties’ agreement required the defendant to sandblast the interior of the tanks and then to apply two coats of food-grade epoxy. The winery filled the tanks with 5,148 gallons of its Sauvignon Blanc wine, and when it opened the tanks approximately 10 months later, the wine’s odor and taste indicated that it had spoiled. The winery brought a claim against the defendant for breach of contract and negligence, alleging that defendant’s epoxy coating had peeled away from the tank’s interior walls, placing the wine in contact with the steel and allowing hydrocarbon

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3 2006 U.S. Dist. LEXIS 61903 (N.D. Ohio Aug. 16, 2006), aff’d, 238 F. App’x 159 (6th Cir. 2007).
7 Id. at *16-17.
8 Id.
9 See, e.g., McDowell Valley Vineyards, Inc. v. Sabaté USA, Inc., 2004 U.S. Dist. LEXIS 15797, at *12 (N.D. Cal. Aug. 6, 2004) (denying motion to dismiss based on economic loss rule because of factual issues that suggested “a ruling . . . regarding whether damage to Plaintiff’s wine constitutes ‘other property’ would be premature”).
contamination. The trial court concluded that the winery’s product liability claims for the defective storage tank and lost wine alleged only economic losses, which are specifically excluded from Washington’s products liability statute. On appeal, the court affirmed and held that the nature of the defect, the type of risk posed by the product’s defect, and the manner of injury were insufficient to allow the plaintiff to recover damages.

Winery is not the only parties that may bring claims based on spoilage. In a federal case in Pennsylvania, for example, a wine importer sued a shipping company and a freight forwarder when the Italian wine it purchased arrived in the U.S. completely frozen. The court dismissed all of the importer’s claims, finding that it had failed to demonstrate that defendants had either a contractual or statutory duty to ship the wine at a certain temperature or that defendants acted negligently in failing to do so. In a federal case in New York, an importer sued an Italian winery to recover damages incurred when a restaurant chain rejected spoiled wine it purchased from the importer. Rejecting the importer’s claims, the jury found for the winery, and the court denied the importer’s motion for judgment as a matter of law, holding that the winery was not liable, despite having breached an implied warranty of merchantability, because it had successfully attempted to “cure” the defect by offering to replace the spoiled wine.

Recent litigation concerning wine spoilage thus demonstrates the importance of choosing the appropriate forum, taking note of the applicable limitations period, and considering possible statutory bars to recovery for spoiled wine, including the economic loss rule.

2. Counterfeit Wine.

In a handful of recent, high-profile cases, wine collectors have sought to recover for their purchase of allegedly counterfeit wine. Because collectors may hold ostensibly valuable bottles for many years, statutes of limitation play a prominent role in litigation over allegedly counterfeit wine. In *Frye v. The Wine Library, Inc.*, the plaintiff, an avid collector of fine wine, brought an action against The Wine Library for allegedly selling him counterfeit wine. Between June 2000 and February 2003, the plaintiff purchased between 53 and 60 bottles of fine wine from the defendant, at an aggregated value of approximately $565,000, which plaintiff intended to sell at a Sotheby’s auction. After a Sotheby’s representative inspected the wine, the representative advised the plaintiff that Sotheby’s would not auction the wine because it questioned the wine’s authenticity. The plaintiff’s expert concluded that 34 of the bottles purchased were counterfeit and that 12 others were suspect. The plaintiff filed an action against The Wine Library for fraud, constructive fraud, negligent misrepresentation, unlawful business practice, fraudulent business practices, breach of contract, and breach of warranty. The court held that the statute

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11 *Id.* at 785.
12 *Id.* at 788-90.
15 *Id.* at 411.
of limitations precluded any of the plaintiff’s claims for damages arising out of any bottles of wine the plaintiff purchased more than four years before he filed his complaint. Similarly, a federal district court dismissed as time-barred a wine collector’s claims against Christie’s stemming from the auction of allegedly counterfeit wine.\textsuperscript{17}

In ongoing litigation in the Southern District of New York, the plaintiff, a collector of fine wine, has sought to recover for his purchase of numerous bottles of allegedly counterfeit wine consigned by the defendant to an auction house.\textsuperscript{18} The plaintiff purchased this wine after studying a catalogue in which defendant offered the wine “as is” and made no representations or warranties about the wine’s authenticity, merchantability, rarity, quality, condition, previous storage conditions, or historical relevance.\textsuperscript{19} The catalogue also invited prospective buyers to examine the wine prior to submitting bids.\textsuperscript{20}

After hiring an expert to review the wine in his cellar, plaintiff brought a claim against the defendant for fraud, negligent misrepresentation, and violations of various provisions of New York’s General Business Law. The court found that the disclaimers found in the catalogue, in conjunction with the plaintiff’s self-proclaimed expertise in purchasing fine wine and the plaintiff’s failure to inspect the wine prior to purchase despite the defendant’s invitation to do so, precluded the plaintiff’s claims for fraud and negligent misrepresentation and dismissed those claims.\textsuperscript{21} However, the court refused to dismiss the plaintiff’s claims that the defendant violated New York’s laws against deceptive business practices and false advertising. In so holding, the court found that the plaintiff sufficiently stated claims that the defendant widely disseminated a catalogue containing false statements, and that such conduct could have affected other similarly situated consumers at the defendant’s auctions and could have had a broad impact on consumers at large.\textsuperscript{22}

The same plaintiff also brought an action against Acker, Merrall & Condit Company in the New York state court, again arising out of his purchase of allegedly counterfeit wine.\textsuperscript{23} The New York appellate court dismissed the plaintiff’s claims on the grounds that no reasonable consumer would have relied on or been misled by the statements in the defendant’s auction catalogues about the vintage and provenance of the wine because the catalogues included an “as is” provision that plainly stated that the defendant made no express or implied representations or warranties regarding the origin, condition, quality, rarity, authenticity, or value of the wine and advised prospective purchasers to inspect the wine themselves.\textsuperscript{24} As demand for rare and vintage wine continues to grow, litigation relating to counterfeiting is likely to increase as well.

\begin{footnotesize}
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\item \textsuperscript{17} \textit{Koch v. Christie’s Int’l PLC,} 785 F. Supp. 2d 105 (S.D.N.Y. 2011), aff’d, 699 F.3d 141 (2d Cir. 2012).
\item \textsuperscript{18} \textit{Koch v. Greenberg,} 2008 WL 4450273, at *1 (S.D.N.Y. Sept. 30, 2008).
\item \textsuperscript{19} \textit{Id.}
\item \textsuperscript{20} \textit{Id.} at *2.
\item \textsuperscript{21} \textit{Id.} at *3-4.
\item \textsuperscript{22} \textit{Id.} at *5.
\item \textsuperscript{23} \textit{Koch v. Acker, Merrall & Condit Co.,} 901 N.Y.S.2d 271 (App. Div. 2010).
\item \textsuperscript{24} \textit{Id.} at 272.
\end{itemize}
\end{footnotesize}
3. **Internet Sales of Wine.**

A company seeking to sell wine via the Internet may face special challenges in ensuring the wine is delivered to a consumer who is at least 21 years old.\(^{25}\)

In *eVineyard Retail Sales-Massachusetts, Inc. v. Alcoholic Beverages Control Commission*, a Massachusetts case, the Internet wine seller was held liable for violating a statutory prohibition against the sale of wine to minors.\(^{26}\) The plaintiff corporation, which sold wine directly to consumers throughout the country, contracted with Federal Express for the delivery of the purchased wine, and the contract required FedEx to verify the age of the recipient. As part of the Massachusetts Attorney General’s “sting” operation, a minor opened an account with the defendant using a fictitious name and birth date and placed an online order for wine, which FedEx delivered without verifying her age. The defendant was administratively charged with violating the state statutes prohibiting the sale or delivery of alcohol to minors, and the state suspended its license to sell alcohol.

The defendant unsuccessfully asserted a number of arguments in its defense. First, the defendant argued that the suspension of its license was moot and therefore unenforceable because the license it held at the time of the violation had already expired. The court disagreed and said that the suspension could apply to the license that the defendant had subsequently obtained after the violation occurred. The court also rejected the defendant’s argument that its contract with FedEx—which obligated FedEx to verify the recipient’s age—insulated it from liability. The court held that the defendant could not “evade responsibility for making sales to minors . . . by delegating the task of delivery to a third party.”\(^{27}\) Finally, the court rejected the defendant’s claim of entrapment, finding that the Attorney General’s office was permitted by law to use decoys to misrepresent their age when ordering alcohol via the Internet.\(^{28}\)

This case demonstrates the special challenges facing any seller of wine, or any other alcoholic beverage, on the Internet. To help protect themselves from litigation, Internet wine sellers should take special precautions to ensure that their products are not delivered to minors, above and beyond mere reliance on the third-party common carrier. With growing demand to have wine delivered to consumers’ doorsteps, and with the changes in state laws regarding the direct sales and shipment of wine to consumers, more wineries and distributors will revise their business models to sell their products directly to their consumers, and this area of litigation likely will continue to grow and develop.

When faced with a potential need to pursue or defend against a suit arising out of claimed spoilage, counterfeiting, or Internet sales, an attorney familiar with the wine industry should be consulted early on to assist with evaluation of all options and potential responses.

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\(^{25}\) For further discussion of Internet sales generally, see the earlier section related to direct sales and shipment of wine to consumers.

\(^{26}\) 882 N.E.2d 334 (Mass. 2008).

\(^{27}\) *Id.* at 340

\(^{28}\) *Id.* at 341.
THE LAW OF WINE
—Retirement Plans for You and Your Employees—

GENERAL OVERVIEW

Retirement savings are important for everyone. The operation of a winery or vineyard business presents you with the opportunity to provide savings or retirement benefits for you and your employees. Some of the special tools for providing such benefits are (1) simplified employee pensions (“SEPs”), (2) simple retirement accounts (“SIMPLEs”), (3) qualified plans, and (4) nonqualified “top hat” plans. Each of these tools offers options for providing tax-deferred benefits to employees and current tax deductions for the employer.

A business can start with a simple and low-cost arrangement that does not require a fixed economic commitment. Later, the company can grow into a more sophisticated plan that offers more flexibility and greater rewards.

Retirement arrangements cover the range from very modest to substantial benefits and can be surprisingly simple or dauntingly sophisticated. Various arrangements can achieve the following:

- Allow an employer to provide retirement benefits to its regular work force while excluding casual, seasonal, or short-term employees;
- Allow the employer to control costs by increasing amounts in good years and strictly limiting or virtually eliminating costs in lean years;
- Allow employees to save with their own money while allowing the employer the option of whether or not to contribute; and
- Be limited to owners or a select group of employees rather than the core work force.

1. IRA-Based Arrangements.

The simplest arrangements allow employers to contribute amounts to IRAs of employees. Because the contributions are held in IRAs, the employer does not become involved in holding or investing the contributions. A SEP requires the employer to contribute a uniform percentage of an employee’s pay to the employee’s IRA for each employee who has worked for the employer in three out of the last five years. Under a SIMPLE, all employees who have earned at least $5,000 during any two preceding years may elect to have up to $11,500 of their pay contributed instead to an IRA. The employer must then either (1) make contributions to match the employee amounts, but not more than 3 percent of the employee’s compensation, or (2) contribute 2 percent of each eligible employee’s compensation, whether or not the employee has elected to have amounts contributed. Recordkeeping requirements are minimal, and the employer will need little or no assistance from consultants or lawyers.

2. Qualified Plans.

More sophisticated arrangements called qualified plans provide greater flexibility to satisfy an employer’s goals. Qualified plans are more often used by larger companies with numerous employees or employers of any size that

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1 After 2010, this limit may be adjusted for changes in the cost of living.
want more benefit design options or wish to provide very substantial funding. Qualified plans allow contributions up to 25 percent of pay annually or allow accrual of relatively higher benefits for the more highly compensated employees or employees who are older or have longer service. These arrangements may require significant testing and recordkeeping, and plan assets must be held in a trust or under an insurance contract. Even higher benefits can be achieved by use of a defined benefit plan. Lawyers, accountants, actuaries, or other consultants will be needed.

3. **Nonqualified Plans.**

Nonqualified “top hat” plans offer great flexibility for benefits with a few fundamental limitations. The limitations probably make top hat plans inappropriate for small wineries or sole proprietors. Top hat plans are attractive because they are not subject to the antidiscrimination rules of SEPs and qualified plans—an employer can (and must) provide benefits only to a select group of management or highly compensated employees. They are also not subject to limits on the amount of benefits. Although the benefits are tax deferred, the employer does not receive a current tax deduction and is taxed on the income on plan assets. The assets of the plan are subject to claims of the employer’s creditors, so participants risk loss of benefits in a bankruptcy. Professional help is necessary to set up and maintain a nonqualified plan.

**MOST LIKELY CANDIDATES**

Most winery businesses have characteristics that will make certain types of retirement plan design unattractive. Among the considerations that are best addressed by the arrangements described below, the following are usually of concern to wineries:

- **Variable and uncertain cash flow and profitability.** A retirement arrangement must be flexible enough to allow an employer to reduce retirement costs in lean years but still maintain a meaningful benefit for employees.

- **Reward and retention of employees.** Generally, employers prefer to reward employees who provide regular services over a longer time. Employers prefer not to spend much on benefits for irregular or short-term employees, or employees who do not appreciate the value of retirement savings. A plan that allows benefits to concentrate on the core workforce is preferable.

- **Administrative cost.** Minimizing administrative cost is always a general goal. Although participants in qualified plans can bear most of the ongoing administrative expense, an employer may wish to support the plan in order to maximize benefits to participants, especially when plans are small and administrative costs are high relative to total plan assets.

- **Employee choice.** Retirement savings are valued differently by different employees. A plan may be preferable if it allows employees a choice in determining benefits.
The following plan types are most likely to be the best fit with the needs and limitations on winery businesses. The summaries omit many details and options that are important for designing the best retirement program, including maximizing benefits for targeted employees and minimizing risks that the employer will overcommit to funding. Most dollar amounts mentioned are subject to cost-of-living adjustments.

1. **SEPs.**

A SEP may be created simply by filling out a short IRS form that explains the administration of the SEP and also serves as an explanation of the program for employees. The employer fixes a uniform percentage of pay that it will contribute to each employee’s IRA. The employer may change the percentage from year to year or may choose to make no contribution for a year. The employer also decides how long an employee must work before becoming eligible for a benefit. At a minimum, any employee who has worked three out of the last five years and receives at least $550 for the year must receive a contribution to his or her IRA. An employer may choose to have less restrictive eligibility. Apart from normal bookkeeping, very little documentation is required. The form is not filed with the IRS, and no plan tax returns are required. Because the SEP funds each employee’s IRA, the employer does not have to worry about holding or investing money for the employee. A SEP allows an annual contribution for each employee up to a maximum of 25 percent of the employee’s compensation, excluding compensation above $245,000 (as adjusted for cost of living after 2011). No employee IRA may receive more than $49,000 (as adjusted for cost of living after 2011) for a year.

2. **SIMPLEs.**

A SIMPLE also uses employee IRAs for holding contributions, which simplifies custodian and investment issues for the employer. The SIMPLE also offers the advantage that employees fund their own benefits by electing to have amounts held out of pay and contributed to their SIMPLE IRAs. The employee election feature provides choice to the employee. However, a SIMPLE requires an economic commitment from the employer. The employer must either (1) match employee-elected contributions up to 3 percent of the employee’s pay (certain temporary relief allows the matching contribution to be reduced in two years out of any five-year period) or (2) contribute 2 percent of pay to each eligible employee, whether or not the employee elects contributions in that year. The plan must cover all employees who received at least $5,000 during any two preceding years and are reasonably expected to receive at least $5,000 during the year.

3. **401(k) Plans.**

This type of plan is a qualified plan and is subject to various discrimination rules and all Employee Retirement Income Security Act (“ERISA”) provisions, including reporting and disclosure. Also, funds must be held in trust or under a group annuity contract, which creates administrative burdens and costs that are substantially greater than with SEPs and SIMPLEs. However, 401(k) plans offer various advantages. Employees may elect to have amounts up to $16,500 (as adjusted for cost of living after 2011) contributed from their pay (compare lower limits under SIMPLEs); employees 50 and older have higher limits. Eligibility can be more restrictive. The employer can limit eligibility to employees who have worked more than 1,000 hours in a year. Although SEPs and SIMPLEs can exclude short-term irregular workers, they cannot always exclude regular seasonal workers. A 401(k) plan can exclude regular seasonal workers because of the 1,000-hour requirement. A 401(k) plan offers various options for the employer to provide additional funds to all participants, including additional funds...
targeted at more highly paid employees. Those funds can be allocated in various ways, including contributions to match some or all of the employee-elected contributions, contributions to be credited proportionately based on the pay of eligible employees, and other more sophisticated methods. Also, employer amounts can be subject to vesting, which favors longer-term employees. The higher limits for employee elections and employer contributions and the additional flexibility of 401(k) plans may make them worth the additional costs.


These plans are also qualified plans, subject to discrimination testing and all ERISA requirements. However, they are generally simpler than 401(k) plans. They are similar to SEPs because they require contributions to be allocated among all eligible employees but not necessarily uniformly according to pay. Profit-sharing plans are better able to exclude irregular and seasonal employees because they may limit eligibility under the same 1,000-hour rules that apply to 401(k) plans. They may also subject benefits to vesting over a period of years. Profits are not required.

The following table offers a comparison of the design options described above. The chart omits many details and does not describe defined benefit plans.
<table>
<thead>
<tr>
<th>Plan</th>
<th>Relative Ongoing Administrative Cost</th>
<th>Flexible Employer Contribution</th>
<th>Stable Basic Benefit</th>
<th>Employee Choice or Savings</th>
<th>Concentrating Benefits on Core Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEP</td>
<td>Lowest</td>
<td>Flexible but uniform contribution rate</td>
<td>Depends on employer</td>
<td>No</td>
<td>Must cover any employee who worked three out of last five years; uniform rate for all participants</td>
</tr>
<tr>
<td>SIMPLE</td>
<td>Low</td>
<td>Almost no flexibility (some employer contribution is required)</td>
<td>Stable benefit; employee election feature is constant and employer contribution is required, with some temporary variations allowed</td>
<td>Yes, subject to applicable limit of $11,500, plus possible increases in future years</td>
<td>Must cover any employee who received at least $5,000 in any two preceding years; employer can elect to match employee savings (favors the savers)</td>
</tr>
<tr>
<td>401(k)</td>
<td>Highest</td>
<td>Flexible</td>
<td>Employee election is stable base but can limit the elections of highly compensated employees; employer contributions depend on employer and need not be uniformly allocated</td>
<td>Yes, subject to $16,500 limit, plus possible increases in future years; age 50 or older has higher limits</td>
<td>Can exclude persons who do not work at least 1,000 hours per year; can match funds for employees who save; other helpful features available, including vesting of employer funding</td>
</tr>
<tr>
<td>Profit-Sharing</td>
<td>Higher; could be much higher if extreme allocation to owners is desired</td>
<td>Determined from year to year by employer</td>
<td>No; depends on employer decisions</td>
<td>No</td>
<td>Can exclude persons who do not work at least 1,000 hours per year and can require 1,000 hours in two years before eligibility; can subject benefits to vesting; benefits not required to be uniform</td>
</tr>
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</table>
A key asset for any winery is its name and associated trademark, including its design, which distinguishes wine sold under the winery’s label from that of its competitors. As with many businesses, in the wine industry it is critical to the continued success of the venture that a product’s name and label design be protected from infringement or other unlawful use by a competitor or an unrelated business.

1. **Clearing Trademarks for Use and Registration.**

Before adopting and using a trademark, such as a winery or product name, it is advisable to conduct a search to determine whether the trademark appears to be available for use or registration. Clearance searching can take many forms, but it generally includes a check for marks at the U.S. Patent and Trademark Office (“PTO”) as well as one or more checks of industry databases and the Internet.

2. **Establishing Trademark Rights.**

Under U.S. common law, trademark rights may be established without registration by simply using the trademark. To use a trademark, it must be affixed to the product, and the product must be sold to another party. Common-law trademark rights require no filing with the PTO. However, common-law trademark rights from unregistered use are limited to the geographic region of use and a “zone of foreseeable expansion.” The ™ symbol can be used to notify others of a common-law trademark.

3. **Enforcing Trademark Rights.**

Once trademark rights are established through use, the owner is entitled to preclude any other business from using the same or similar mark in a way that is likely to cause confusion. Thus an owner can obtain a court order enjoining the use of a confusingly similar mark. However, “likelihood of confusion” is a subjective determination entailing consideration of a variety of factors, the principal of which are (a) similarity of the marks, (b) similarity of the goods or services, (c) similarity of the marketing channels, (d) sophistication of customers, and (e) intent of the junior user.

4. **Federal Registration.**

Although not required to protect a trademark, federal registration is advisable to maximize legal protection. Without registration, trademarks generally are entitled to protection only where the relevant products or services are marketed and have attained some market reputation.

The primary advantage conferred by federally registering a trademark is presumptive nationwide priority that precludes all others from using a confusingly similar mark, unless they used the mark before the registrant’s filing date or are entitled to an earlier date based on a prior filing or earlier foreign priority of a corresponding foreign application. This means, for example, that a winery that sells its product regionally and later expands to a national market will be protected in its new markets; that is, a winery with a federally registered mark could expand into other areas of the United States without risk of encountering subsequent intervening conflicting trademark rights in the new markets. Absent a federal registration, however, a trademark would not be protected against such intervening uses in markets where the relevant product or service has not been sold.
Other advantages of federal registration include a statutory presumption that the trademark is valid and the registrant is the exclusive owner of the mark, and the right to exclude infringing imports.

An application for registration must be filed with the PTO in Washington, D.C. and must follow a prescribed format. An application to register a trademark may be filed either before (in an intent-to-use application) or after (in a use-based application) the mark is used in connection with an actual sale of a product or service. If based on use, the application must be accompanied by a specimen of the mark in actual use (for example, labels or advertisements for services).

A straightforward use-based application will normally mature into a registration in 12 months or so. This assumes that no substantive issues arise while the application is pending and that no opposition is commenced by another trademark owner. If the PTO raises a question about an applicant's right to register the mark, or if the owner of a similar mark opposes the registration, the process can take significantly longer.

An intent-to-use registration can take considerably longer, depending mainly on when the applicant commences using the mark. An intent-to-use applicant must file a statement verifying use of the mark in interstate commerce within six months of receiving notice that the application has been allowed. However, the applicant may extend the period up to a maximum of three years.

Once the trademark is registered, the owner is entitled to use the symbol ® next to the mark, which designates presumptive nationwide exclusive rights. Use of this symbol before registration is prohibited.


U.S. federal registrations remain effective for 10 years. However, an affidavit of continuing use must be filed during the sixth year. Failure to file this affidavit of continuing use results in loss of the registration and associated presumptions.

Registrations can be renewed for additional 10-year periods, provided that a renewal fee is paid and a renewal application is completed and submitted. The application requires a statement that the mark is in current use in commerce and an attached specimen showing the mark in current use. If a mark is not in use in commerce, the registrant must show that nonuse was due to special circumstances and was not an intention to abandon the mark. An application for renewal can be submitted at any time within six months prior to the expiration date of the registration. For an additional fee, an application can be submitted within three months after expiration of the original registration.

6. State Trademark Registration.

Some limited advantage can also be obtained by state registration of a mark. Generally, state registration can be obtained more quickly than federal registration and may appear on databases sooner, thus providing others with notice of the trademark. In some cases, local businesses may search only the relevant state registrations to clear a mark. Furthermore, some state registrations entitle the owner to statutory or minimum damages for infringements, without necessitating that willfulness be established.
State registration is typically available very quickly and may therefore be worthwhile to a new company seeking to ensure immediate protection of its mark or design. However, although not required, federal registration of a trademark is advisable to obtain maximum legal protection.

7. Foreign Trademark Protection.

Companies doing business internationally should also evaluate whether to register their marks abroad. Unlike the United States, most countries do not provide for common-law trademark rights based on use alone. Rather, the vast majority of foreign jurisdictions condition trademark protection on registration of the mark. Thus a pirate can, by registering a mark in other countries, preclude a U.S. trademark owner from using its mark in foreign markets. The United States is a party to a convention that in most countries permits a U.S. applicant to claim the date of its U.S. application as the priority date for trademark protection, but only if the applicant files in the foreign country within six months after the date of the U.S. filing. Similarly, companies that have filed a foreign application may claim the benefit of the foreign filing date, but only if the U.S. application is filed within six months of that date.

Generally, one must file in every country where protection is desired, and this normally means having to hire local trademark counsel in each country. However, all 27 members of the European Union can be covered by a single filing with the European Union trademark office. In addition, now that the United States is a party to the Madrid Protocol, registration in the 71 countries that are members of the Protocol can be effected via a single application filed with the World Intellectual Property Organization in Geneva, Switzerland. This application, however, must be processed individually through the trademark offices of each member country designated in the international application.
The Law of Wine will be updated periodically, but to stay informed of developments in the industry before the next edition, please sign up for our alerts at www.stoel.com/subscribe. You can also visit our alcoholic industry blog at www.alcoholicbeverageslawblog.com.

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