

Doing It Right: The Right Why's and How's of Alternating Proprietorships

Part Two



By Sara Schorske
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IN OUR last column, we warned that the wine industry may be at a crucial turning point. The now-popular privilege of sharing winery premises and equipment, known in the wine regulations as the “alternation of proprietors,” is currently the focus of regulatory concern. In a worst case scenario, this invaluable option may become less common in the future, due to the imposition of far stricter requirements.

Ten years ago, alternating proprietorships saved the industry as we know it—a vital and growing industry supporting a large number of small and medium sized proprietors. Today, it's up to the industry to save this valuable privilege from reduction or extinction.

The only truly effective way to preserve the privilege is to scrupulously use it right. That means both why we

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use it and how we use it must be appropriate.

The Right “Why’s”

When TTB gets an application for a shared premises winery, the agency is now questioning whether each alternating proprietor (“AP”) needs to become a separate winery. From TTB’s perspective the only reason to be a winery is to actually engage in the production of wine. “Okay,” you may be thinking, “Approve my AP winery, and I’ll be happy to make my own wine!” But that kind of promise may not satisfy the TTB inspector handling your AP application. He or she wants to know, what is your motivation in this scene?

Think of it this way: How would you feel if a person who’s always played the field approaches you and says, “If you’ll marry me, I’ll settle down.” You wouldn’t be tempted to accept the proposal unless you felt the person was motivated to change his or her ways, for reasons that were compelling enough to justify the effort needed to make the marriage succeed. And you would be right to be disappointed if they carried on after marrying you the same way as before!

Like that marriage suitor, AP applicants have to be prepared to change their custom crusher ways, and to demonstrate that they have bona fide rea-

sons for doing so. When TTB asks why you need to qualify as a separate producer, there are many legitimate reasons you can offer. The question is, which one fits your situation—and how believable is it, in your case?

Always, the best reason to establish your own winery is to have more control over your winemaking process than you can exert under a strictly custom crush arrangement. But if that is your stated motivation to establish an AP winery, remember, it won’t be plausible unless you plan to employ your own winemaker or are capable of taking an active role in the winemaking functions yourself.

Your commitment to your goals should not be subject to question just because you haven’t raised the million or so dollars it would take to launch your own standalone production facility. To be a viable competitor in today’s “Two Buck Chuck” marketplace, you need to keep your per unit production costs and debt service in line with what your customers will pay. Allan Hemphill, when he was CEO of Vinwood Cellars, the first winery to host multiple APs, made these persuasive comments at the time:

When you look at the economics, there’s no way for the little guys to participate against the big fellows unless you develop an innovative way for them to have production cost effi-

ciency that wouldn't be available to them as a single producer in their own premise. If we can provide low costs of production, a 15,000 case brand can have the economy of scale normally only associated with a half-million or million case brand, and we have a different way of skinning the cat.

In addition to economics, shifts in local land use policies have also made establishing a new winery incredibly difficult in the last decade. Almost all of the major wine producing regions have adopted strict land use regulations requiring each winery to obtain a use permit. Unfortunately, the public process involved allows the protests of neighbors to stymie the issuance of permits, potentially for years. And even once neighbors are appeased, water, wastewater and environmental issues must still be addressed at additional costs that often make building a standalone winery out of the question. All of these factors provide significant inducements to using an AP to start a winery.

What also drives many custom crush customers to become AP's is the fact that a state winery license gives them

extensive privileges that a wholesale license does not. These additional privileges include having a tasting room, making retail sales to consumers, exercising expanded direct shipment privileges, and participating in competitions and charity tasting events.

Occasionally, we have also encountered situations in which an applicant is barred by tied house considerations from operating as a custom crush customer (under a wholesale type license), but can legally make and sell wine if they have their own winery. Winemaking diva Helen Turley was faced with this exact dilemma when she first established her own brand years ago. Her husband worked for an on-sale retailer at the time, so California law barred her from obtaining a wholesale license while allowing her to hold a winery license.

Finally, of course the tax savings of the small producer credit figure into the economics of establishing an AP winery. Keep in mind, however, that although tax reduction strategies are a well-respected part of the "American way," TTB has the legitimate right to question AP applications where the primary motivation is tax savings—you

must still have a legitimate business purpose other than tax savings.

The Right How's

We may have the best of reasons for establishing an AP winery, but if we conduct it carelessly, and thereby create administrative difficulties, we again jeopardize the privilege for ourselves and others. Once again, it's like marriage. Most divorced couples started out with great reasons to wed, and most of them still loved each other when they split up. Almost always, their problem was in how they conducted their lives together.

With alternating proprietorships, the most important aspects of how are (1) operating in a manner that is clearly different from a custom crush arrangement, and (2) operating in a manner that avoids confusion and errors in record keeping and labeling.

The Agreement Between Host Winery and Alternator

One way to demonstrate and reinforce your intention to operate differently than a custom crush customer is to draft a good written agreement. Your agreement should clarify how you and the host winery will operate as independent producers, each of which has full responsibility and control over its own operations—even when you borrow each other's spaces and each other's personnel.

Many wineries have standard custom crush or custom bottling agreements and tend to want to use these for their alternating proprietor arrangements as well. This is not appropriate, since the standard agreements generally specify that the host winery does all the processing. Therefore, we always caution clients to take care in converting any existing agreements they have used, or copies of agreements they have seen in use by other wineries.

If you are customizing an existing agreement, you should review the standard provisions and change terminology that is appropriate for custom crushing but inappropriate for alternating. Examples of such provisions would be references to production by the host winery on behalf of the customer, references to the larger winery's winemaking responsibility, etc.

In addition, we recommend adding extra provisions that:

- Clarify the relationship between the two wineries as independent producers (as opposed to the relationship of joint ventures or the relationship be-



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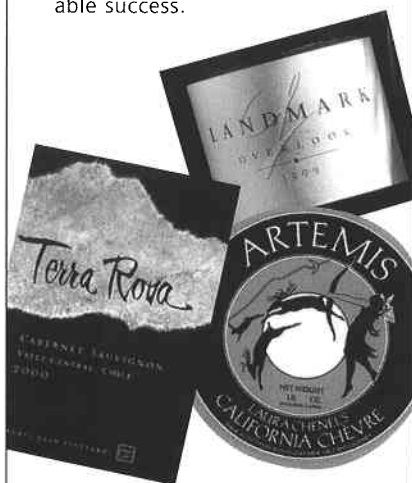
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tween custom crusher and custom crush customer).

- Confirm each party's control of its own premises, records, and wine-making activities. Emphasize that the AP has absolute control over its winemaking process and shall have access to the premises at all times. It is appropriate to have the AP rent or lease its permanent premises.

- Ensure TTB's access to the alternator's permanent premises (especially if TTB inspectors must cross property not leased to the alternator in order to get to the alternating winery).

- Require both parties' compliance with the specific regulations governing alternation of proprietors.

In terms of compensation of host wineries, fees should be assessed for the rental of space and for services contracted to alternating wineries, a piecework rate such as a fee per document for record keeping and reporting, an hourly rate for cellar work, and the like, rather than a volume rate based on tons, gallons, or cases. We do not recommend a fee structure based on a straight per case basis or other methods based on volume alone, since they are typical for custom crush arrangements, and fit best when the host winery has total control over the winemaking process.

General Recordkeeping

One of the most crucial aspects of maintaining an alternating arrangement is the need to think differently about wine movements. Cellar workers must always be mindful of which winery is controlling an alternating area. Wine movements within and between alternating proprietors can be very confusing if the situation is poorly defined.

For example, there are sometimes situations when an alternator must transfer its wine to the host winery for processing in an area that does not alternate. In this case, as strange as it sounds, transfers from tank to tank within the same building can be bond-to-bond transfers! And wine doesn't even have to move to be transferred in bond, if a tank or barrel area is full when control over the area changes to another BW!

Special care must be taken to track the changes in control of each alternating area. Each proprietor must keep records of gallons of wine received or removed while operating any alternating area, as well as the effective date and hour when it takes over and when it surrenders operation of the premise.

A physical log should be used. At wineries where cellar work orders are used to initiate and document wine movements, cellar workers should date and time stamp the cellar work order manually or using an ordinary time clock; then the time information can be entered into a log or a computer from the work orders.

There is no set format for a log. The regulations require wineries to simply record the time and date each area switches from the control of one proprietor to the control of another.

Also, be very aware of the labeling implications of how you operate. Decisions about which proprietor controls fermentation vessels and bottling lines affect production and bottling statements on the label. Estate bottling claims are especially sensitive, because estate bottled wine may not leave the premises of the bottling winery until it's bottled. Make sure that all cellar operations take place under the estate bottler's bond, and that control of any area containing wine to be estate bottled never shifts to the other proprietor.

Who is Most Likely to Succeed with Alternating Proprietorship?

Though the benefits of alternating proprietorships are many, an alternating proprietorship is no free lunch. From the start, doing business as a winery, rather than a negotiant or wholesaler, brings new responsibility for wine making and compliance: more recordkeeping, and increased scrutiny by regulators. Also, it is more complicated to license an alternating winery than a freestanding establishment. And after the licenses issue, the two wineries which alternate the use of their facilities must be well-organized, proficient at wine tracking, and very clear about their independent responsibilities in order to insure the long term success of the project.

Realistically, the obligations involved in successfully operating a winery are substantial—even after the initial investment is made affordable by sharing space and equipment. Those most likely to succeed as alternating proprietors will be the companies with a healthy respect for the regulations and a long term commitment to the wine making process. This respect and commitment can ensure that the alternation of proprietors' privilege continues to provide the wine industry with the greatest flexibility to meet the demands of the marketplace. ❁