BREWERY AND DISTILLERY FINANCING

FINANCING - IN GENERAL

There is perhaps no place where one's choice of company counsel will be more important than in the negotiation and structure of a third-party investment into a brewery or distillery. Not only should company counsel possess a sound understanding of federal and state regulatory laws, he or she should have a realistic understanding of the risks involved in a private capital investment from the investor's perspective and an understanding the motives for private equity investors.

FINANCING – IN GENERAL

There are many risks that private capital investors must assess when deciding whether to invest in a particular brewery or distillery: undetected flaws in the basic concept of the business plan; lack of the managerial skills necessary to execute the business plan; occurrence of unforeseen delays which “push out” the time horizons anticipated for the accomplishment of the objectives of the business plan; incurment of unforeseen expenses that require additional capital which may not be available, or if available, is available on terms that are substantially dilutive to current investors; management becomes “burned out” and must be replaced; and infrequently, fraud. The investor will generally seek to manage these risks through the documents and instruments which create the investment security and document the investment transaction.

Generally, the motive for private equity investing is either (a) financial, e.g. to secure substantially above average rates of return, or (b) strategic, e.g., to ensure access to markets, human capital, or other resources. Fundamentally, private capital investors make high risk investments with the expectation that over a defined investment horizon, the capital invested will be returned together with a substantial return on investment.

The investment may be made by a loan, by a purchase of equity, or by a combination of a loan and purchase of equity. The outline below highlights a few of the general considerations of the basic economic elements in a venture capital investment.

DEBT

Many options are available to structure debt instruments. Debt can provide the investor with a convenient way to reduce, over time, the risk exposure in an investment by reducing the outstanding principal balance over the life of the loan. If warrants are issued with the debt instrument, the investor may obtain repayment of principal, a current return through interest payments, and a future “equity return” in the future for a nominal additional investment. A debt instrument may have some or all of the following features: secured or unsecured; subordinated or unsubordinated; convertible or non-convertible; fixed or variable rate of interest; fully amortizing principal and interest; periodic payments of interest only; periodic payments of principal and interest; and, events of default

EQUITY

Many investors prefer to make an equity investment in a company. Depending on the stage of development of the company and the personal goals of the founders, company counsel should influence the choice of debt or equity. There are a virtually unlimited number of ways that an equity investment can be structured. The points below illustrate a number of terms the company should consider in creating the terms of an equity instrument.

PREFERRED OR COMMON STOCK

Many investors will require the company to issue preferred stock, although some investors will accept common stock. It is always a good idea for company counsel to suggest that the investor accept common stock. If the company has made an S-election, issuance of a second class of stock (except for a class of “non-voting” common stock) will terminate the company’s S-election.

VOTING RIGHTS

Preferred stock can be voting or non-voting. Voting preferred stock can vote together with common or have a separate class vote, or a combination of both. Separate class voting rights (or if multiple series of preferred stock, separate series voting rights) provide a veto right on significant corporate actions in favor of the investor. Sometimes the company is able to have holders of preferred stock vote together with holders of common stock as a single class. This offers the possibility that a coalition of holders of common stock and holders of preferred stock can jointly control important corporate decisions.

DIVIDEND RIGHTS

Preferred stock can carry a variety of dividend terms and in most cases will be entitled to a dividend preference. A dividend preference requires the company to pay all accrued and unpaid dividends on preferred stock prior to the payment or setting aside of any dividend on any junior stock.

Accruing dividends are dividends which are to be paid only at the discretion of the board of directors of the company, which in most cases is never. Investors use accruing dividends to provide a minimum rate of return in the event they exercise their liquidation preference or their right to require the company to redeem all outstanding shares of preferred stock. Occasionally, accruing dividends reduce the conversion price of convertible preferred stock, at the time conversion rights are exercised.

Cumulative dividends are cash dividends required to be paid on a periodic basis (generally quarterly). If the company fails to pay a cumulative dividend, the unpaid dividend becomes a liability of the company (an accumulated dividend) and must be paid at some future time. Generally, investors expect that accumulated dividends will reduce the conversion price of preferred stock, increase the amount of the liquidation payment due upon a liquidation of the company, and increase the put price if the investor has negotiated the right to require the company to repurchase the shares of preferred stock.

LIQUIDATION PREFERENCE

A second preference generally granted to preferred stock is a preference upon liquidation of the company. A liquidation preference provides that the holder of preferred stock has the right to receive a fixed dollar amount before any assets can be distributed to holders of common stock or other junior equity securities. The definition of a "liquidation" is generally negotiated between the company and the investor. The investor will often times want to include a merger or other corporate reorganization within the definition of a "liquidation."

In most cases, the amount of the liquidation payment will be an amount equal to the price per share paid upon issuance of the preferred stock plus accrued and unpaid dividends. There will be circumstances in which the investor will require a liquidation payment which is substantially greater than the original issue price. This is often the case in so called "cram down" financings or financings where there is a high likelihood that the company will be sold in a transaction in which the investor will not be able to retain an equity interest in the successor company and therefore must obtain his entire rate of return upon closing of the "liquidation event."

Some investors seek a "participating" liquidation preference. A participating liquidation preference gives the investor his liquidation payment (cost plus accrued and unpaid dividends), plus an amount which is equal to the amount a holder of the number of shares of common stock issuable upon conversion of the preferred would receive.

CONVERSION RIGHTS

Preferred stock may be issued as either convertible or nonconvertible. In most venture capital investments, preferred stock will be issued as convertible preferred stock. Occasionally, an investor will require that the company issue non-convertible preferred stock together with a warrant to purchase common stock. The nonconvertible preferred stock will carry a redemption obligation which requires the company to redeem the nonconvertible preferred stock at the original issue price plus all accrued and unpaid dividends thereon at some specified time in the future. The typical structure for a nonconvertible preferred stock includes cumulative dividends, and may include an option in favor of the company to issue additional shares of preferred stock in lieu of payment of a cash dividend for some period. A warrant is almost always issued in conjunction with nonconvertible preferred stock.

Convertible Preferred Stock will have two conversion features, “voluntary” or “optional” and “mandatory” or “automatic” upon the occurrence of the initial public offering. Convertible preferred stock is usually convertible into common stock at the option of the holder. Convertible preferred stock is often initially convertible on the basis of a one share of common stock for one share of convertible preferred stock. The conversion ratio is actually the quotient of the original issue price per share of convertible preferred stock divided by the conversion price. Usually the initial conversion price is equal to the original issue price.

The company should always request a provision for automatic conversion upon an initial public offering of the company’s common stock.

ANTI-DILUTION PROTECTION

Convertible preferred stock always contains provisions which protect it against dilution from stock splits and stock dividends. These are sometimes referred to as “event” or “organic change” adjustments. Usually, there will be provisions protecting the convertible preferred stock against sales or deemed sales of common stock for a consideration which is less than the conversion price in effect at the time of the issuance or deemed issuance of such common stock. These provisions are sometimes referred to as “price” adjustments, because they lower the conversion price of convertible preferred stock (and convertible debt instruments) so that more shares of common stock are issued upon conversion of the convertible preferred stock (or debt instrument).

EXIT STRATEGY

Investors generally expect that the company will either go public, sell to another company, or recapitalize through a management buy-out or other transaction in which the investor’s interest in the company is repurchased or “taken out” within a three to seven year time frame. Investors will insist that the financing documents cover all three potential exit strategies. The latter two exit strategies are handled through the “liquidation” preference in preferred stock or a “due on sale” provision in debt. The first exit strategy is handled by the grant of demand and piggy-back registration rights to the investor. Demand registration rights permit the investor to “demand” that the company file a registration statement with the Securities Exchange Commission and effect a public offering of its common stock.

INDUSTRY SPECIFIC ISSUES

In addition to these more corporate oriented issues, businesses operating in highly regulated environments, including the alcohol manufacturing industry, will need to address more specific issues. For example, the Alcohol and Tobacco Tax and Trade Bureau and various state agencies regulate the ownership and operation of breweries and distilleries. This complicated federal and state regulatory framework prohibits certain individuals from holding an ownership interest in a brewery or distillery.

Generally, federal and state law prohibits cross-tier relationships between a manufacturer, wholesaler, and retailer, commonly referred to as tied-house prohibitions. Felons are also prohibited from maintaining an ownership interest in certain entities involved in the manufacture, distribution and sale of alcohol.

Equity owners in licensed breweries and distilleries are required to go through qualification procedures at the federal and state level in order to address any potential ownership issues. Not only do these laws and qualification procedures need to be disclosed in a relevant offering document, the brewery or distillery needs to think through how to address post qualification situations where an equity owner violates the tied house prohibition or is convicted of a felony.

Failure by a brewery or distillery to address these ownership issues prior to raising equity either through traditional means or through a crowdfunding portal under the JOBS Act can lead to disastrous outcomes: an investigation by a federal or state regulatory body, being charged with a misdemeanor, having to return investment capital, or the suspension or loss of the license altogether.

Startup and early stage breweries and distilleries should consider all financing alternatives, including crowdfunding portals, when raising money. However, the relative ease in raising funds through a crowdfunding portal does not obviate the need to disclose certain industry specific laws and perform due diligence on potential investors.

Ownership in an alcohol manufacturer is highly regulated in the United States and proper counseling should be sought before raising equity regardless of the method.