

# Warehousing Risks

What you should know before storing your wine with a third party

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**THIRD PARTY WAREHOUSING** has become a common feature of the wine industry in recent times. For larger wineries it has often been part of a more extensive outsourcing program; for others it has been driven by the lack of space and/or inadequate access for delivery trucks; and for very small wineries, warehousing and fulfillment have always been a third party activity.

But, as the finished bottles of wine over which extraordinary amounts of tender loving care have been lavished are entrusted to a warehouse, how many wineries actually understand all of the attendant risks? This article will examine the nature of the legal relationship between the winery and the warehouse and what can happen if things do not go as planned, including:

- who is liable for damage to the wine;
- how best to insure against the risk; and
- what position a winery's bank will take.

## **LEGAL BASIS OF THE RELATIONSHIP**

The relationship between a winery and a warehouse is primarily governed by California Commercial Code Sections 7101ff. These sections apply irrespective of the nature of the goods stored. Of course, the storage and distribution of wine are also subject to additional regulation at both the state and federal levels. While this impacts the way the relationship works in practice, ultimately it does not fundamentally alter the nature of the relationship between the winery and the warehouse or the

risks. In addition to the statutory framework, the relationship will also be governed by any written agreement between the winery and the warehouse.

A warehouse licensed to store wine is "engaged in the business of storing goods for hire," and all of the rights and duties stem from this very basic concept. The warehouse agrees to store the winery's wine; to keep it separate from other wines so it is clearly identifiable as wine belonging to the winery; and to make it available to the winery or its designees—and the winery agrees to pay for this service. Under the general law, a warehouse is liable "for damages for loss of or injury to the goods caused by its failure to exercise care with regard to the goods that a reasonably careful person would exercise under similar circumstances." [Cal. Com.

Code § 7204(a)]. Although the warehouse is allowed in its written agreement with the winery to limit the amount of its liability in the case of loss or damage, the warehouse is not permitted to reduce the overall scope of its obligation to take good care of the goods. Thus, a provision in a storage agreement which attempts to limit the warehouse to liability only for claims arising out of "gross negligence or willful default" is not likely to be enforceable since this represents a lower standard than that of "reasonable care." On the other hand, a provision in the storage agreement limiting liability to the Free on Board (FOB) value of the wines rather than the full retail value is certainly permitted and will be enforceable (except if the warehouse misappropriates the goods for its own use).

Indeed, the warehouse is permitted to limit the amount of its liability to any amount it chooses, irrespective of the declared value of the goods.

Often a warehouse may contract to provide services other than pure storage—for example, temperature-controlled storage or “pick and pack” services. A warehouse that specifically offers these types of services is similarly liable for any losses caused by a failure to exercise reasonable care but, again, the amount of that liability may be limited.



#### RISK OF DAMAGE

The rapid expansion of the wine industry has put enormous pressure on the availability of good warehouse space. As a result, wineries that complain about terms and conditions may simply be turned away by warehouses in favor of those that are happy to sign any terms and conditions as long as the price is right. In these circumstances, any limitation of liability on the part of the warehouse results in more risk being assumed by the winery and increases the importance of insurance as discovered by many wineries that suffered loss when the Mare Island wine storage facility was destroyed by fire in 2005.

In simple terms, if the warehouse drops a pallet of wine because of the carelessness of one of its employees, it will have a liability to the winery and

the amount of the liability will depend on the terms and conditions. If there are no limits of liability, the warehouse will be liable for the damages the winery suffers as a result, namely the cost to produce the wine and the profit the winery could reasonably be expected to have earned from the sale of that wine. If the warehouse limits its liability in any way that reduces the amount of the claim, the winery will have to look to its own insurance to make good any shortfall. But if the warehouse burns down accidentally, the warehouse has no liability and the winery will have to look to its own insurance for 100 percent of its losses.

“Many wineries probably do not realize that in these circumstances their lost profit on destroyed inventory is not covered by their business interruption insurance,” said **John Sutak** of **John Sutak Insurance Brokers** in San Francisco. “The potential lost profit has to be built into the value of the inventory for insurance purposes.” According to Sutak, the failure to adequately value inventory for insurance purposes is the most common problem for wineries trying to make claims on their insurance policies. Wineries must keep careful track of the various channels to market that their wines follow. The historic performance and profitability of each channel will be the main factors that will influence how the insurance company will assess the losses attributable to the destroyed inventory, not just the cost of production.

If a winery’s business model changes significantly, then it is important to ensure that the basis of insurance is adjusted accordingly. The insurance company is calculating its risk and, therefore, the premium it will charge, based on the historic business model. If the winery wants to argue that all of the destroyed wine would have been sold at full retail through the tasting room, it needs to ensure not only that it has the data that supports that contention but also that this formed part of the assessment of the insurance risk.

#### THE BANK’S VIEW

Even if no one else is paying attention, a winery’s bank will certainly look carefully at all of the risks associated with

third party warehousing. Banks lending to the wine industry have no problem in general with wineries using third party warehouses. A decision to invest capital in wine production facilities, vineyards or sales and marketing rather than storage for cased goods certainly has merit in the bank’s eyes. The bank will want to know where the wine is to be stored and that it is properly insured (with the bank named as a loss payee). In addition, the bank will want the warehouse to agree that the bank can carry out inspections to verify inventory levels and that the warehouse will notify the bank before it takes any action to sell any of the wine to settle unpaid bills. As is the case with most businesses, there are some warehouses where record keeping is better than others. “We encourage our winery customers to keep on top of this,” said one long-time lender to the wine industry, “because, if there are significant discrepancies, this can cause problems with the borrowing base calculations.”

When things do not go well and there are outstanding warehouse bills, the warehouse is in a very strong position. Under the Commercial Code, the warehouse has a statutory lien on all goods in its possession for all unpaid charges for its services. The warehouseman’s lien can trump all comers, including the bank’s security interests and the bankruptcy court. According to **Sonoma County Vintners Co-Op** CEO **Steve Schwitalla**, “The power of the warehouseman’s lien pretty much ensures that we do not have problem customers. Customers know that if they don’t pay their bills, we will just sell their wine to cover their debt.” There are of course some regulatory issues associated with the warehouse actually selling wines, but that does not mean that the lien cannot be exercised, assuming the correct procedures are followed, including proper notice to the winery of the impending sale. It is the strength of this lien that means that banks will typically always exercise their right to pay off the warehouse debts rather than see their collateral sold. As a result, the costs of third party warehousing will be taken into account by the bank against the value of cased inventory when calculating borrowing

limits in the same way the bank deducts the amount of unpaid grower payables from bulk wine inventory values to account for the grower’s lien.

#### CONCLUSION

In short, wineries need to understand the terms and conditions that apply to the services provided by the warehouse; ensure that their insurance policies are properly underwritten; and keep their bank informed of the arrangements. Third party warehousing provides a very cost-effective solution for wineries, and so it is no surprise that there is plenty of demand for those warehouses providing good service. However, wineries need to understand that they have not outsourced all of the risks. To maximize the benefits of the arrangement, these risks need to be properly understood and managed.

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