Investing in Cannabis Ventures: Risk Factors and Pitfalls

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As New York has a tentative agreement in place to become the next state to pass full recreational, adult-use cannabis legislation, more and more entities and individuals are amassing capital as they consider the prospect of investing in and/or joining the management or ownership structure of a new cannabis business.

While it is no secret that the acquisition/investment flame continues to burn red hot across the cannabis industry as a whole as we continue to see tremendous upticks in special purpose acquisition company ("SPAC") deals, private placement offerings ("PPM"), simple agreements for future equity ("SAFE"), and an overall uptick in the number of licenses being granted in states with mature recreational programs, there are a number of big-ticket items prospective investors in cannabis companies should be aware of as they consider investment vehicle structures, review pitch decks, and begin hiring professional service providers to draft and review investment documents.

Federal Illegality

This is a no-brainer. Until the federal government formally removes cannabis from the list of Schedule I substances under the Controlled Substances Act ("CSA"), cannabis companies and their owners and investors theoretically remain subject to criminal liability exposure. Even ancillary service providers should discuss cannabis's illegality in any investment document's risk factors section, since these companies and any financial backers could be subject to charges of aiding and abetting or conspiring to violate federal law when providing goods and services to cannabis businesses and ultimately be forced to forfeit profits, real property, cash, equipment or other goods. Now, despite all of this, it appears the current administration plans on continuing the Department of Justice's non-enforcement policy with respect to applying federal law to cannabis companies operating in states where medical and/or recreational cannabis is legal, and will hopefully push towards full federal legality in the near future. Investment documents should continue to address federal illegality until cannabis is delisted from Schedule I.

Banking

Though more banks and financial institutions have begun providing traditional services to cannabis businesses, the vast majority of banks and financial institutions still have not warmed up to adding cannabis businesses to their customer lists, largely due to their concerns of criminal liability under the CSA, and incredibly burdensome due diligence and reporting requirements under the Bank Secrecy Act, Money Laundering Control Act, and other FinCen guidance measures.

Without access to traditional financing options, such as term loans, revolving loans, working capital lines of credit, mortgages and commercial insurance, many cannabis businesses have a difficult time managing payroll and operational expenses, hiring and retaining employees, paying taxes, etc. Naturally, a number of cannabis companies are forced to operate on an all-cash basis, resulting in both-cash flow issues and security concerns (targets or burglary and armed robbery). The number of distressed cannabis companies has grown and led to a subsequent increase in targeted acquisitions and consolidations by cannabis conglomerates. Small cannabis companies, like many small businesses affected by COVID-19, but unlike most businesses, are not able to take advantage of bankruptcy solutions. Accordingly, small cannabis companies continue to be swallowed up by larger companies, often at lower-than-anticipated valuations and distressed purchase prices.

In an effort to provide access to banking services for cannabis entrepreneurs, executives and owners, the House of Representatives passed the Secure and Fair Enforcement Banking Act ("SAFE") late in 2019; however, the bill was held up in the Senate and ultimately languished due to COVID-19 as emergency spending bills understandably took priority. The SAFE bill has once again entered the spotlight as a slate of bipartisan cosponsors reintroduced the bill to the Senate late last week. If passed, the SAFE Act aims to improve public safety by providing banks a safe harbor from regulators taking certain actions against depository institutions solely for providing services to cannabis and cannabis-related businesses.

More importantly, the SAFE Act would ensure that the proceeds of a transaction conducted between legitimate cannabis businesses, ancillary companies, and investors will not be treated as an unlawful activity and provides protection from liability under federal law for depository institutions and insurers. With the Senate and Senate Banking Committee controlled by Democrats, so long as the House can put together similar support for the bill as it did in 2019, passage of the SAFE Act, arguably singularly more important to the cannabis industry than any other factor, even removal from Schedule I of the CSA, could occur during 2021. Investment documents, including SAFE rounds, PPMs, and any related partnership, ownership, or operating agreements, should contain the necessary risk disclosures and simplified organizational charts such that regulators and investors can easily trace ownership of

cannabis businesses to natural persons and avoid additional scrutiny.

Taxes

Internal Revenue Code 280E ("280E") mandates that "no deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consist of trafficking in controlled substances (within the meaning of Schedule I and II of the CSA) which is prohibited by federal law or the law of any state in which such trade or business conducted." What does this mean? Well, it means that cannabis companies are prohibited from deducting ordinary business expenses, which forces them to contend with higher federal tax rates than other industries. The effective tax rate on a cannabis company depends on how large its ration of nondeductible expenses is to its total revenues. When attempting to project future profitability of a company, 280E should be considered. This holds true even for ancillary businesses attempting to raise money through a SAFE, PPM or otherwise given that having such an onerous tax burden significantly impacts the profitability of any plant-touching cannabis client or customer.

Operational Issues: Real Estate and Insurance

Prospective entrepreneurs and investors in the cannabis space should understand that in addition to the legal, theoretical, tax, and financial concerns discussed above, there are a number of more practical operational issues that cannabis businesses frequently face that are unique to the industry as a whole in comparison to other startup companies operating in fledgling industries. More specifically, many prospective cannabis companies and license applicants find it difficult to obtain basic lease agreements and commercial liability insurance given the relatively new status of the industry and the ability to find landlords and insurance providers that are comfortable operating in the cannabis space.

Among the myriad concerns shared by commercial landlords, secured lenders and insurance underwriters include a cannabis license applicant's ability to (1) obtain title insurance; (2) comply with "lawful purpose" provisions within lease agreements; (3) satisfy demands on leased or owned property related to power, water, and ventilation needs, as well as dangers posed by compressed gas activities related to cultivation and processing techniques; (4) address physical security concerns posed by the high street value of cannabis products and large amounts of cash on hand; and (5) ease any municipal and community concerns, including from neighboring tenants, related to moral and nuisance objections. As a result, real estate transaction documents must be thoughtfully crafted to satisfy lending and insurance needs up front, as well as to address potential liability and industry-specific risks that might occur in the future.

Accordingly, cannabis license applicants, investors and entrepreneurs should consult experienced business and legal professionals at the inception of any transaction, business plan, or license application process. The ability to address and discuss the various risk considerations and practical hurdles early on is often the difference between success and failure for businesses entering developing industries, but even more so in a regulatory-intensive industry like cannabis.

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