

## Cannabusiness Investments: Evolving Risks And Due Diligence



**By Andrew M. Walsh**  
*Attorney, Anderson Kill*

With the legalization for medical use in 21 states, and for adult use in Colorado, Washington, Alaska and the District of Columbia (and Oregon, effective July 1, 2015), the cannabis industry is said to be the fastest growing industry in the United States. Arcview Market Research reported an increase in industry sales of 74 percent to \$2.7 billion in 2014, up from \$1.5 billion in 2013. As cultivation, distribution, medical and personal use become increasingly legal at the state level, entrepreneurs, their friends and family and other early-stage investors are starting to see pathways to harvest, following the influx of sophisticated investors from traditional private equity sources.

Over \$100 million in private equity investments have been made over the last two years in cannabis-related businesses,

according to CB Insights. The most recent sign the industry is coming of age is an investment from Peter Thiel's \$2 billion Founders Fund, which has added Privateer Holdings to its impressive list of investments in Facebook, Airbnb and Spotify. Privateer's three portfolio companies are Tilray, Leafly, and Marley Natural.

Prospective investors should be aware of the unique risks presented by cannabis-related businesses. If due diligence is conducted properly, the "risk factors" section of an offering memorandum should not be news to the investor. From the company's perspective, thorough disclosure of risk factors will help manage expectations and prevent shareholder litigation. Any company planning a private securities offering in the United States should take care in clearly setting forth these risks in their disclosure documents. To date, many issuers of publicly traded microcap "pot stocks" that trade over the counter or on the pink sheets are not heeding this advice and some have declined to disclose any risk factors whatsoever, citing the lack of requirement for smaller reporting companies. It is not surprising that the SEC and FINRA have logged numerous complaints against these issuers and have even issued "investor alerts" warning the public about potential risks due to inaccurate disclosures.

This article presents some of the various risks that companies should disclose and some of the questions that investors should ask as a part of any offering of cannabis-related securities. A company's failure to disclose such risks, on the one hand, and an investor's failure to appreciate them, on the other hand, could result in ill-will, litigation, rescission, loss of in-

vestment, and, theoretically, even criminal prosecution. For some of these questions, there are no easy answers and an enquiring potential investor will gain valuable insight into how well prepared the entrepreneur is to handle the issues and communicate realistic answers.

The following is a list of **risks that should be disclosed** to potential investors:

### 1. Strict Enforcement of Federal Law

As states continue to decriminalize cannabis in a variety of ways, cannabis remains a "Schedule 1" controlled substance under the federal Controlled Substances Act, alongside heroin and methamphetamines. Accordingly, businesses that engage in various forms of commerce in the cannabis industry and individuals who purchase and use cannabis-derived products remain subject to federal prosecution and seizure of assets. The main risk for the investor is that federal enforcement could lead to dissolution and total loss of investment.

The Federal position on cannabis is rapidly changing, however. The spending bill passed by Congress in December, 2014, included a provision that prohibits federal agents from prosecuting patients or dispensaries that are operating in accordance with state laws authorizing the cultivation and use of cannabis for medicinal purposes in certain states. This provides little certainty for the longer term, as successive spending bills are temporary in nature and the next Congress can easily reinstate previous policies through spending.

In addition, several bills have been introduced in congress. On March 10, 2015, the bipartisan "Compassionate Access,

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Research Expansion, and Respect States (CARERS) Act”, was introduced in the Senate which would classify cannabis as a Schedule II drug. This would mean that the U.S. government acknowledges that cannabis has legitimate use as a medicine. With respect to legal activities at the state level, the bill would also prevent federal law enforcement from prosecuting doctors and patients, and permit banking institutions to provide financial services to cannabis enterprises. Other pending bills include the “Marijuana Tax Revenue Act” (MTRA) and the “Regulate Marijuana Like Alcohol Act” (RMLAA). MTRA would impose a federal excise tax on retail cannabis sales, an occupational tax for cannabis businesses, and civil and criminal penalties for noncompliance. Under the RMLAA, the Bureau of Alcohol, Tobacco, Firearms and Explosives would provide oversight, and cannabis would be removed from the schedule of drugs enforced by the Drug Enforcement Agency.

Other bills being considered in congress include the “Respect State Marijuana Laws Act”, the “Ending Federal Marijuana Prohibition Act”, the “States’ Medical Marijuana Patient Protection Act”, the “Truth in Trials Act” and the “States’ Medical Marijuana Property Rights Protection Act” Entrepreneurs and investors should understand that there is no guaranty – or even discernible probability – that any of these bills will become law anytime soon, if ever.

The position of federal law enforcement is also changing. In a memorandum dated August 29, 2013, the U.S. Department of Justice released a memorandum indicating that it would not direct resources to block recreational and medical marijuana in “legal” states, relying on state enforcement for certain problem areas, such as sales to minors and driving under the influence.

The Department of Justice memorandum sets forth certain enforcement priorities that are important to the federal government, including distribution of products to children; diversion of med-

ical marijuana from states where it is legal to states where it is not; preventing driving under the influence; growing marijuana on federal property; and preventing possession or use of marijuana on federal property.

Investors should take note that the Department of Justice’s stance on this issue could change quickly with a new administration in Washington, or even sooner – during her January, 2015 confirmation hearings before the Senate Judiciary Committee, Attorney General Nominee Loretta Lynch testified that she does “not support the legalization of marijuana” and that she does not share the President’s view that it is not more dangerous than alcohol.

One issuer disclosed the following risk to its investors:

*“Further, and while we do not intend to harvest, distribute or sell cannabis, by supplying products to growers of marijuana, we could be deemed to be participating in marijuana cultivation, which remains illegal under federal law, and exposes us to potential criminal liability, with the additional risk that our business could be subject to civil forfeiture proceedings.”*

Another issuer characterized this risk as follows:

*“Growing medical marijuana is deemed to be illegal under the Federal Controlled Substances Act even though such activities may be permissible under state law. A theoretical risk exists that our activities could be deemed to be facilitating the selling or distribution of marijuana in violation of the federal Controlled Substances Act, or to constitute aiding or abetting, or being an accessory to, a violation of that Act.”*

Another issuer disclosed the following:

*“Currently, there are 23 states plus the District of Columbia that have laws and/or regulations that recognize, in one form or another, legitimate medical uses for cannabis and consumer use of cannabis in connection with medical treatment. Many other states are considering similar legis-*

*lation. Conversely, under the Controlled Substance Act (the “CSA”), the policies and regulations of the Federal government and its agencies are that cannabis has no medical benefit and a range of activities including cultivation and the personal use of cannabis is prohibited. Unless and until Congress amends the CSA with respect to medical marijuana, as to the timing or scope of any such potential amendments there can be no assurance, there is a risk that federal authorities may enforce current federal law, and we may be deemed to be producing, cultivating or dispensing marijuana in violation of federal law.”*

In December, the attorneys general of Nebraska and Oklahoma sued Colorado, seeking to strike down parts of Colorado’s legalization of cannabis for adult use. They claim that Colorado’s legal marijuana is crossing state lines and causing harm to their states where cannabis remains illegal by “placing stress on their criminal justice systems” and “draining their treasuries”.

One issuer disclosed the following related risk to its investors:

*“Our website is visible in jurisdictions where medicinal and/or recreational use of marijuana is not permitted and, as a result, we may be found to be violating the laws of those jurisdictions. We could lose potential customers as they could fear federal prosecution for growing marijuana with our equipment, reducing our revenue. In most states in which the production and sale of marijuana have been legalized, there are additional laws or licenses required and some states altogether prohibit home cultivation, all of which could make the loss of potential customers more likely.”*

Some related questions a prospective investor should ask about law enforcement:

- Has the business been contacted by any state or federal law enforcement or regulatory agencies?

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- Does the business have any contingency plans in the event of strict enforcement of federal law?
- How easily can the business pivot to another line of business?
- How many customers are from out of state? How do you ensure that they do not cross state lines with your product? Do you have an obligation to warn customers about this or take steps in prevention them from doing so?

## 2. No Adequate Banking Solution

Banking services are something that most entrepreneurs take for granted, but that is not the case for businesses that deal in cannabis products and services. Often cited as the biggest problem in the legal cannabis industry, banks are not yet willing to take deposits, issue credit cards, open checking accounts, or assist with payroll services. Banks have been reluctant to engage cannabis-related businesses out of fear of violating federal law and being accused of money laundering. One bank even reversed course after touting the FDIC's "tacit" approval. After Oregon-based Mbank community bank was contacted by "federal banking regulators", it promptly ceased welcoming customers from Colorado. This reversal did no go unnoticed on Capitol Hill, as U.S. Rep. Earl Blumenauer is seeking to uncover the FDIC's role in this matter. In November, 2014, another banking institution, Colorado-based Fourth Corner Credit Union, received its state charter from the Colorado Division of Financial Services, but it is still waiting for approval from the U.S. Federal Reserve while it seeks insurance from another department, the National Credit Union Administration.

Until the banking question is resolved, cannabis businesses are handling lots of cash, which presents numerous risks, including inability to secure and invest funds, manage cash flows, and pay taxes; safety/security risks and expenses; and crimes such as theft, assault, burglary, employee skimming, and tax evasion.

One issuer disclosed the following:

*"We may have difficulty accessing the service of banks, which may make it difficult for us to operate. Since the use of marijuana is illegal under federal law, there is a strong argument that banks cannot accept for deposit funds from businesses involved with the marijuana industry. Consequently, businesses involved in the marijuana industry often have difficulty finding a bank willing to accept their business. The inability to open bank accounts may make it difficult for us to operate our contemplated medical marijuana business in Nevada."*

Another issue disclosed:

*"[S]ince the use of marijuana is illegal under federal law, we may have difficulty acquiring or maintaining bank accounts and insurance and our shareholders may find it difficult to deposit their stock with brokerage firms."*

Some questions that a prospective investor should ask about banking:

- How does the company do its banking? How will your cash flow from investing activities be impacted if no brokerage firm will do business with you?
- Does the company pay its taxes, salaries and other operating expenses in cash?
- How does the company manage the risks presented with handling so much cash? How is cash-flow tracked and managed?
- What expenses are associated with this issue?

## 3. Compliance with State Laws and Regulations

Companies are subject to changing laws and regulations in their home states and in the states in which they do business. As the legal cannabis industry is in its infancy, participants should try to anticipate new rules and how they might affect their businesses. Rapidly changing laws can create numerous expenses for a growing business and enable "fast-followers" to

gain a competitive advantage by learning from the early entrant's mistakes. Increased regulatory compliance costs could result in lower gross margins or higher retail prices, or both, while competition from the black market looms.

Regulations also have unintended consequences that present risks to a company and its investors. For example, in Colorado "medical marijuana" is often less expensive, more potent and available to the patient in larger quantities than its recreational counterpart. Conversely, the process of obtaining recreational products in Colorado is more private as regulations do not require third parties (e.g., a doctor) and impose fewer record retention requirements. These differences may cause a patient to purchase recreational cannabis, and vice versa.

Some questions to ask about compliance:

- Does the company participate in any industry trade associations?
- Has a lobbyist been engaged?
- How will the company respond to changes in regulations or specific laws?
- Is there pending legislation that will adversely affect the business?
- How do prices compare to black market prices?

A prospective investor should understand whether the company is in compliance with state law and should ask questions about this. For example, Colorado requires a person to have been a resident of the state for two years before applying for a license, and it requires equity investors (and holders of convertible debt) to be residents. Washington state also has a residency requirement for the entrepreneur.

The penalties for violations of these regulations are unclear, and an investor should insist that the company represents in the transaction documents that it is in compliance with state laws.

## 4. Federal Tax Law Challenges

Except for "cost of goods sold," Section

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280E of the Internal Revenue Code prohibits cannabis businesses from taking tax deductions for numerous ordinary and necessary business expenses. This should not be a surprise to the cannabis entrepreneur who is seeking capital from investors. A business's inability to take advantage of deductions for ordinary business expenses significantly hurts profit margins and may cause investors to think twice about investing. A business's financial statements and projections of after-tax profits should take this into account. How the target handles this issue in its solicitation materials could help a prospective investor gauge an entrepreneur's sophistication or naïveté.

### 5. Product Liability Claims

Insurance law for cannabis related risks is not developed, and product liability lawsuits against manufacturers of cannabis products are a top concern. Accordingly, investors and companies should review their policies with counsel and understand that coverages may be limited or challenged by insurance carriers, despite what a policy might provide.

One issuer disclosed the following risk to its investors:

*"We are subject to the risk of product liability claims and the loss of any such claim in excess of our insurance coverage could have a material adverse effect on our business and financial condition."*

Some questions that should be asked about products liability risks.

- What testing has been conducted to ensure consistency?
- Have there been any complaints? Has anyone been harmed?
- What insurance is available? Is it adequate for the particular risks of this company? How much insurance has the company purchased?
- You sell lollipops infused with THC. How do you prevent the lollipops from being ingested by children? Have you received any complaints?

### 6. Background Checks

An investor should not be surprised if a cannabis entrepreneur developed his or her interest and expertise long before legalization. It is therefore wise to conduct criminal background checks on the founding team. An arrest for possession during a decade-old frat party may be overlooked, but if a member of the founding team, for example, served time in prison for numerous violations, the investor should seriously consider passing on the opportunity.

### 7. Market Acceptance

Even if a majority of voters support adult non-medical use of cannabis products, retailers and distributors may be reluctant to carry them for a variety of reasons. One common mistake that entrepreneurs make is the belief that their product is so good that it will "sell itself". Cannabis products are no exception, and have the added challenge of convincing retail partners to carry their products.

One issuer disclosed the following risk:

*"Due to the general negativity associated with the cannabis plant within the United States, we anticipate facing potential challenges getting our products into stores."*

Some related questions a potential investor should ask:

- How many retailers carry your product?
- What is your marketing strategy? / How do you market to retailers?
- What are the challenges in getting your products on store shelves?

### Conclusion

Of course, the foregoing are only some of the risks that a prospective investor should consider. Risks may also arise in connection with oversupply (which has been reported in Washington State), intellectual property (inability to register a federal trademark), lower-priced competition from the black market, labor issues, and of course, more general risks arising from agricultural, supply chain, employ-

ment, and economic/market conditions. Many more risks that prudent investors should be aware of and companies should disclose will certainly develop along with the industry and changing law. Identifying and anticipating such risks will add tremendous value to risk mitigation efforts.

**Andrew M. Walsh** is an attorney in Anderson Kill's Stamford office and a member of the firm's Corporate and Securities, Regulated Products and Captive Insurance groups. Mr. Walsh advises entrepreneurs, emerging companies and private equity investors in company formation, capitalization, mergers and acquisitions, commercial transactions and corporate governance. As a member of Anderson Kill's Regulated Products group, he counsels startups engaged in cannabis-related business. Mr. Walsh can be reached at [awalsh@andersonkill.com](mailto:awalsh@andersonkill.com) or (203) 388-7942.



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