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Raising Private Capital in the Cannabis Industry

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Despite its promising trajectory, raising private capital continues to be a challenge for the nascent cannabis industry. While some of the recent sluggishness can be attributed to the economic environment caused by Covid-19, much of the difficulty surrounding cannabis fundraising predates the pandemic and is rooted in the complexities of constantly fluctuating state regulatory frameworks.

Even in the face of a challenging environment, there are proactive steps cannabis companies can take to maximize the chance of a successful raise. First, they must get the basics right, as there is a smaller margin for error in this highly regulated industry. Second, they need to understand capital sources for the cannabis industry and how they differ for plant-touching versus non-plant touching businesses. Third, they need to determine the structuring and identify regulatory issues at the outset and make a game plan for how to best address them. Finally, businesses need to anticipate and prepare thorough responses to regulatory questions commonly asked by investors.

Current Environment

Cannabis sales have held up remarkably well in 2020 despite (or possibly even due to) Covid-19, with record months reported recently in several states, including California, Colorado, Illinois, and Oregon. Still, there has been a decline in private financing in the industry, which has mirrored the decrease in cannabis capital markets activity (as reflected in the falling stock prices of public cannabis companies). This shortage of capital, combined with broader economic concerns such as climbing unemployment largely due to Covid-19, has put significant pressure on private financings. While tracking private financings is difficult, especially since down rounds are rarely publicized, cannabis industry insiders report downward pressure on valuations.

The combination of these factors raises the stakes for cannabis companies seeking to raise capital, and it leaves little room for error. As investors become increasingly sophisticated and discerning, companies should anticipate difficult questions up front about all aspects of the raise, ranging from valuation and financials to regulatory and licensing compliance. They must have in-depth responses ready, and they should be prepared to address any structural or regulatory issues well in advance of a financing.

The Basics

Successful cannabis financings require the same basic approach as any other private company financing, but due to challenging market conditions they require an even greater focus on the basics. For private companies, this means making sure their corporate structure is set up correctly, their corporate governance is faultless, and that all diligence materials that savvy investors expect to review have been organized in advance—especially those related to financials and regulatory compliance.

For cannabis companies, diligence materials should include any pertinent regulatory information, including up-to-date copies of all relevant licenses and related applications, as well as any memos regarding how the company and its affiliates are structured. They should also produce cannabis-specific due diligence request lists in anticipation of the regulatory questions that experienced cannabis investors will ask.

Other traditional best practices for private financings, such as punctual and accurate Form D and Blue-Sky filings and proper disclosures, take on heightened importance in the cannabis context. The Securities and Exchange Commission and securities regulators in several states have released warnings about the risk of fraud in the cannabis industry—see Colorado and Massachusetts, for example—so cannabis companies should anticipate increased scrutiny for these filings.

Investor Identification

Unlike traditional financings, cannabis transactions need to get potential investors over the additional hurdle of investing in a federally illegal operation. Also, depending on the jurisdictions involved and the structure of the financing, there may be state or local name disclosure or background check requirements. There may be steps cannabis companies can take to reduce investor concerns in these areas, but from a securities law perspective it is not advisable to attempt to convince investors that their investments are completely legal or without risk. Instead, companies should:

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Be Mindful of Investors They Seek Out. Choosing the right type of investor will be critical to reaching closing. The best types are those who have previously made cannabis investments and are comfortable with the risks and regulatory requirements that are involved. Many traditional institutional investors will simply not invest in a U.S.-based cannabis company, whether plant-touching or ancillary, as their mandates will prohibit them from taking on the risks associated with an investment that violates federal law.

Other investors (including some institutional investors) will be comfortable with ancillary or technology investments but will draw the line at investing in license-holding entities. Traditional private equity and venture capital funds will, at most, consider technology investments, but they will not touch licensed cannabis businesses. Consequently, much of the investment into licensed cannabis companies has come from family offices and high net worth individuals.

Anticipate Investor Concerns Regarding Federal Illegality. When it comes to cannabis's illegal status under federal law, nothing short of an act of Congress can change it. But cannabis companies can provide some comfort to investors by mitigating certain risks of a specific investment. For example, finalizing the internal regulatory compliance analysis up front will demonstrate the company takes compliance seriously, and a clear pattern of stringent regulatory compliance with state laws and applicable federal cannabis guidelines will suggest to investors that, in the unlikely event of a federal crackdown, the company will be a low risk.

The federal government has long held that cannabis operators who comply with their state regulations and do not violate certain federal enforcement priorities (e.g., selling to minors) are not a prosecutorial priority. In fact, the Department of Justice has virtually halted all prosecutions of state-licensed cannabis business operators since late 2014, when Congress first approved a budget rider that prohibits the agency from using funds to prosecute state-legal medical cannabis activity.

Address Potential Hurdles at the Outset. Ensure the transaction structure will work for the investor before pouring significant time and resources into the potential transaction. Find out up front whether an investor is uncomfortable undergoing a background check or being disclosed to state or local regulators, so that you do not find out post-investment when a regulator is demanding disclosures. To be safe, cannabis companies should avoid relying on investment commitments from first-time cannabis investors until they have cleared whatever internal hurdles they may have.

Structuring the Raise

Analysis and Structure

The first step to structuring any cannabis financing is understanding the range of state and local regulators who will have jurisdiction over the raise. It is also critical that you consider any pending license applications or planned expansions that will occur during a raise. Once the company has identified all the applicable regulations and fleshed out the relevant rules, it must determine whether any regulatory approvals will be needed for the transaction and the timing.

It is important to determine if the financing will require regulators to pre-approve any new equityholders. In many states, new controlling shareholders require regulatory pre-approval. What constitutes a controlling shareholder varies among jurisdictions. Most states use both a percentage ownership amount (e.g., above 5%) or a general evaluation of whether an equityholder has control. Considering the time it can take to get regulatory approval, it may be a wise decision to limit investors' participation in a financing to an amount that will forgo the need to regulatory pre-approval.

Demands on Investors

A frequent challenge in private financings is getting investors to comply with regulatory requirements, principally disclosure requirements and background checks. Additionally, depending on the jurisdictions and license types involved, investors may be subject to residency requirements and limitations on holding interests in other cannabis licenses.

Cannabis companies can find themselves caught between regulators demanding a full accounting of all equity holders, and lenders who may not feel comfortable disclosing their investment in a cannabis operation. If regulators think a licensed business is not fully cooperating, or worse, deliberately trying to hide their funding sources, they could hold up license renewals, suspend a company's right to operate, or invalidate its licenses outright. This type of hiccup occurs frequently

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during cannabis transactions. It is far more common for a transaction to run into regulatory issues due to an investor's unwillingness to come forward than it is for a deal to fall through because of a failed background check.

The depth and intrusiveness of a background check process will depend on the jurisdictions involved in the financing. Many states have implemented special requirements related to the disclosure of shareholders of public companies. Regulators have come to understand that it is not possible to provide a list of all shareholders of a public company. As a compromise, regulators typically require the disclosure of public company shareholders over a certain materiality threshold (e.g., 5%). These thresholds do not always exist for private companies.

Two provisions can be included in transaction agreements to ensure regulatory compliance. The first is consent to full disclosure, including an obligation to provide corresponding investor information. The second is an ability to forcibly divest an equity holder if their continued ownership is no longer permitted by regulators. These provisions may be controversial among investors, but they may be the best way to ensure ongoing compliance and an understanding amongst all parties.

Restrictions on Investors

The rules governing cannabis transactions can vary significantly from one jurisdiction to another and from one license type to another. For example, some states restrict the number of licenses any one individual can control, and some restrict out-of-state ownership or outlaw it entirely.

Many states prohibit those who hold an interest in a cannabis testing lab from holding interests in other licensed cannabis businesses.

When raising capital, companies must take precautions to ensure these restrictions are not implicated, as accepting the wrong investors could result in regulatory violations or jeopardize their cannabis licenses. Obtaining appropriate representations from investors will help protect the company, and it should occur at the beginning of a fundraising process to avoid wasting time.

Unique Considerations

Non-Licensed Holding Companies

It may be advisable to not use the licensed cannabis company as the fundraising vehicle. This can be the case where adding new equity holders to a licensed company's cap table is not possible or practical. For example, if licenses are held in a state with a strict residency requirement, it may not be possible to add out of state investors as equity holders. And limiting a capital raise to only in-state investors can make it extremely difficult to fill out a financing round.

A solution can be to set up a non-licensed entity that has contractual arrangements with the licensed cannabis company. Companies need to be careful, however, to consider cannabis regulations as some provisions, or the combination of multiple agreements, may lead regulators to determine that the non-licensed entity is an owner of the licensed business. This would defeat the purpose of the structure. The contracts set up are generally some combination of the following:

> **Management Services Agreements (MSAs)**. Certain services can be outsourced to another entity in exchange for a flat fee or percentage of revenue or profit (fees based on a percentage of revenue or profit may be considered a form of ownership). Control over cannabis operations, however, cannot be outsourced to a non-licensed party.
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> **Intellectual Property Licensing Agreements.** The IP of the licensed company can be transferred to another entity, to be licensed back in exchange for a flat fee or a royalty (royalty payments can be restricted by cannabis regulations and may be considered a form of ownership).
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> **Real Estate Leases.** The real estate used by the licensed company is transferred and leased back (participation rent can be restricted by cannabis regulations and may be considered a form of ownership).
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> **Loans.** The non-licensed holding company can fund the operations of the licensed company through loans. Fixed interest rate loans on market terms usually do not create ownership implication.

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Social Equity License Holders

Social equity license holders also have additional issues to consider when raising capital. As a threshold issue, they need to consider the consequences of losing their social equity status. In some cases, this can be an existential threat; the continued validity of a license may depend on its maintenance of social equity status. In other cases, however, the license may only lose access to certain, specific benefits (e.g., discounted licensing fees or access to unique grants). If it is critical to maintain social equity status, the following issues should be considered in connection with any financing:

> **The Management Demographics Must Remain Compliant.** Cannabis companies may need to ensure their senior management team—including the board and executive officers—remains consistent with required demographics. Giving up too many board seats, or bringing in a new chief executive, can create issues with a social equity license.
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> **Ensure Social Equity Ownership Does Not Drop Below Required Thresholds.** Social equity companies are generally subject to rules which require a certain percentage of their ownership be held by qualifying persons. They may need to create a non-dilutable class of stock to avoid violating these rules.
>
> **Do Not Provide Veto or Blocking Rights if It Will Create a Regulatory Issue.** Any veto or blocking rights provided to investors need to be vetted to confirm they do not violate regulations governing who can control a social equity license.

Technology and Ancillary Companies

A growing number of technology companies are popping up in the cannabis industry, offering everything from cultivation management software to online sales gateways. Raising capital for these ancillary businesses is generally less complicated because they do not involve licenses and the regulatory change-of-control issues that accompany them.

Sophisticated investors will want to understand the relationships between these companies and any licensed businesses they interact with, and cannabis regulations will govern how these relationships can be structured. For example, an ancillary company cannot control the operations of a licensed cannabis company. Depending on the jurisdictions in question, there are also a range of regulations that govern how ancillary companies may provide services. California and Massachusetts have led the way with these regulations, with both states creating regulations that specifically address deliveries facilitated by technology platforms.

In many states, any party taking a direct cut of the revenue or profit of a licensed cannabis business is considered an owner or financial interest holder of the licensee. This may trigger various levels of regulatory disclosure, so smart investors will want to understand the terms of any economic relationship between a technology company and its clients.

Funds and SPVs

Some jurisdictions, notably Colorado, have regulations that specifically address disclosure and background check procedures for venture capital and private equity funds. Most states, however, do not specifically address these types of funds, and regulators in these states will typically approach background-checking funds the same way they would with other types of companies. This can create challenges if limited partners wish to remain anonymous. If this is a concern, then a full jurisdictional analysis of all possible investments would need to occur in advance to determine the risks of required disclosure.

Debt Financings

Debt financings in the cannabis industry come with a host of regulatory issues. As with regulatory considerations for equity transactions, it is possible to identify the common issues that need to be considered. Nailing down how these issues will impact an issuer or transaction, however, will require an in-depth analysis of the specific jurisdictions in which a company holds licenses, as state and local regulations vary. Since a sophisticated lender will ask these questions, it is advisable to perform the analysis in advance of a transaction and be able to address any regulatory concerns up front.

Approval and Disclosure. It is important to understand whether a loan will be subject to any kind of regulatory pre-approval or post-closing disclosure. Typically, loans, as opposed to changes of control, are not subject to regulatory approval and will only become disclosable later (commonly at renewal). However, there are several jurisdictions where

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clear regulatory guidance is not available and practice around disclosure of loans varies. A company seeking debt financing should understand its options in advance and be prepared to explain and defend its approach to any lenders.

Background Checks. The type of disclosure, and potential associated background check, required of lenders varies between states. Lenders, particularly those structured as funds, are generally reticent to provide lists of their limited partners to regulators. These disclosure requirements can vary considerably across the states.

Collateralization. In most jurisdictions there is no explicit regulatory basis for securing a loan with cannabis flower or products. Lenders should also consider whether they would want to be deemed in possession or the owner of cannabis flower or products in the event of default of the underlying loan. Likewise, most regulations are silent as to whether a cannabis license can be used as collateral for a loan. Though there are limited cases where use of cannabis assets as collateral is prohibited by applicable regulations, navigating a path forward for secured loans is generally unclear.

Covenants and Control. Standard affirmative and negative covenants in loan agreements may also trigger state regulatory concerns over control. This is a theme in regulatory analysis of debt financing transactions—cannabis regulations typically do not specifically address what constitutes "control." Generally, regulators have not spent much time thinking about how cannabis regulations will impact complex debt transaction.

Pledge Agreements. Cannabis regulators will typically not allow the transfer of control of a licensed business without a regulatory approval process. Pledge agreements must be drafted in a manner that ensures regulatory compliance by tying exercise of possession of the equity of a licensed business to regulatory approval. Typically, non-licensed subsidiaries of a borrower would not be subject to these constraints.

Insolvency Scenarios. Finally, companies seeking to take on debt financing should be prepared to answer a range of questions from lenders regarding what would occur in an insolvency scenario where federal bankruptcy is not an option. As with most cannabis regulatory issues, the answers will depend on the states and licenses involved. Generally, no party can control the operations of a licensed cannabis business unless that party has been approved as an owner by the applicable regulators. Control would generally pick up an effort by the lender to force the borrower to sell itself. Lenders, therefore, should want to understand the change of ownership process in the jurisdictions in which the borrower operates.

Some states take a long time to approve changes of ownership, while others have more streamlined processes. And in some jurisdictions, the local change of ownership can be as much, if not more, of a hurdle than the state procedure. In some jurisdictions, there are special procedures for the transfer of licenses in an insolvency scenario, including the appointment of a state receiver. Cannabis companies should be able to communicate how this might play out both at the state and local levels.

Conclusion

Raising capital can be challenging in any industry, and it is particularly challenging in the cannabis industry thanks to its highly regulated environment and ambiguous legal status under federal law. Many of these challenges can be mitigated, though, by identifying and understanding the unique issues that often arise in cannabis-related business transactions and either addressing or preparing for them in advance.

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