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Professional Perspective

Cannabis Opportunities in Distressed Markets

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Contributed by Matthew Kittay, Fox Rothschild LLP

After several years of upward explosive growth with seemingly limitless valuations and funding opportunities, state legal cannabis companies in the U.S. are now facing a new test: surviving and thriving in distressed local, national, and global markets.

Because cannabis business are not considered legal at the federal level, they often operate using complex organizational structures. Combined with the fact that they cannot take advantage of U.S. bankruptcy protections, they operate in a more precarious position in this downturn. In addition, most cannabis and cannabis-related businesses are ineligible for the federal aid provided in recent U.S. business assistance packages, and are being hit hard by declines in mergers and acquisitions activity.

A Unique Market

The current distressed cannabis industry is defined by a one-two punch, starting with considerable contraction in Canadian capital markets in the second half of 2019. This trend affected not only Canadian public companies but also created a halo effect that depressed the private fundraising environment in the U.S. These companies were further hit by a global Covid-19 recession. The environment is testing yet again the abilities of fledging legal state or multi-state operators in the cannabis space.

Brands that, on the one hand, are beacons of entrepreneurship in states where they operate, are once again challenged by the simple fact that cultivation, sale and use of marijuana for recreational and even medicinal purposes remains illegal under the federal Controlled Substances Act, U.S. Code, 21 U.S.C. § 801 et seq and federal criminal law. Legal cannabis employed about 250,000 people nationally across U.S. states as of January 2020.

Far from academic, this "conflicts of laws" issue has resulted in sophisticated and at times overly complex corporate relationships among the U.S. market leaders, with equally complex legal documentation and corporate structures governing the industry. For example, multi-state operators typically form one or more subsidiaries in each state in which they operate, creating a sprawling matrix of companies to manage. Now that the recession shoe has dropped, American cannabis companies deemed "essential" in many cases find themselves again faced with the need to operate and grow by remaining nimble with layers of complex, unclear regulatory and legal regimes at the local, state, and national levels.

As in the past, cannabis industry leaders who are able to marry strategic execution with entrepreneurial acumen and some luck continue to exploit the current market challenges. They may emerge as the first cannabis industry unicorns—private companies in any industry that achieve a billion-dollar-plus valuation without going public.

Industry-Specific Legal Challenges

For many state legal cannabis companies and national cannabidiol (CBD) companies, disruptions in supply chains, an unexpected surge in demand for product, and the passage of time-triggering defaults on loans and other commercial instruments, led to additional distress in the cannabis industry in spring 2020.

As more cannabis and CBD companies go into distress, there is newfound attention to inability to take advantage of the normal federal bankruptcy and asset reorganization processes available to non-cannabis companies in the U.S. Again, due to the federally illicit status of cannabis, bankruptcy, which is governed by federal law, is inaccessible for cannabis businesses under present policy.

In fact, several federal courts have even extended the bar to bankruptcy access to companies with tangential ties to the cannabis industry, such as landlords that lease space to cannabis businesses or companies that produce equipment utilized in the cannabis industry. Some flexibility may be emerging for companies with tangential ties to cannabis within the Ninth Circuit, which encompasses Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, and Washington.

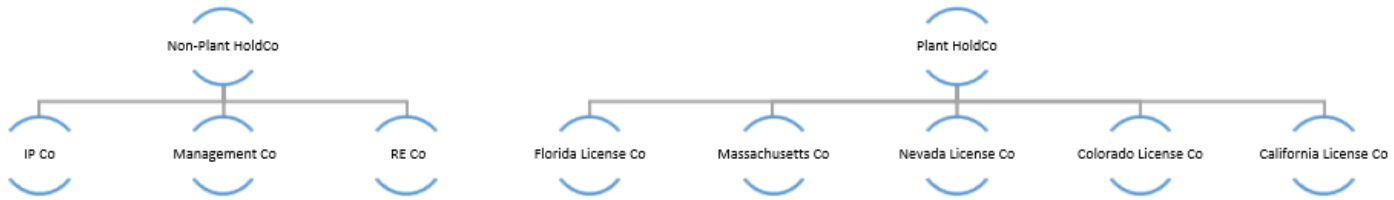
Notwithstanding the inability to go through a federal bankruptcy process, however, there are insolvency options for cannabis companies. In some states, these include processes such as:

An assignment for the benefit of creditors: Essentially a state court insolvency proceeding through which a company's assets are orderly liquidated

State receivership: A state court appointed receiver manages a company during its distressed period

Negotiated workouts: A non-judicial process through which an entity can negotiate with its creditors to restructure the amount or repayment terms of debt

Of note, however, is that the typical, complex structure of sophisticated cannabis companies is turning out to enhance the opportunity for solvent competitors with an appetite for acquisition. Cannabis companies are often structured in horizontal layers of vertical silos—with "plant touching" assets in one bucket, and non-plant touching service companies in a separate bucket. A typical, generic structure might look something like this:



Historically, this structure has afforded cannabis companies a range of benefits, including:

- Risk protection which generally accompanies captive subsidiaries
- Ability to contain "plant touching" operations within the state that has granted the licenses
- Achieving Internal Revenue Code, § 280E efficiencies
- Allowing cautious investors to invest in only portions of the operations that are not plant-touching
- Allow targeted funding to expand only within a particular state and limit equity dilution

As the distressed market plays out, however, this horizontally and vertically fragmented structure is proving to offer unexpected protections and new opportunities to existing investors/joint venture partners, as well as new distressed investors and acquisitive competitors.

For example, existing investors/joint venture partners find themselves better protected and leveraged due to the lack of bankruptcy options available to a failing partner. Joint ventures are typical in the cannabis space. Often a fledgling state licensed operator (SmallCo) will enter into a stock-for-stock deal with a larger multi-state operator (MSO) of mutual benefit to both parties.

Through this partnership, the MSO expands to a new state, and the SmallCo executes a management or consulting agreement with the MSO to leverage its experience and market know-how. If cash is involved, it is often in the form of a loan from the MSO to the SmallCo. The loan goes directly to the SmallCo. But the same loan is often guaranteed by SmallCo's ultimate corporate parent, perhaps a Delaware corporation or limited liability company, or sister operations in other states.

If SmallCo withers in the distressed environment, federal bankruptcy simply is not an option for SmallCo, the sister state companies, or the parent. SmallCo might be able to undertake one of the state or privately negotiated bankruptcy alternatives described above, but it (and more importantly, its Delaware corporate parent or sister operations in other states) cannot simply go into a standard bankruptcy process to liquidate or restructure. The result is that while the state SmallCo might melt down to no value, the MSO's corporate guaranty against the corporate parent or sister companies of SmallCo by has real value as the MSO seeks rights enforcement.

Second, the typical siloed structure makes it easier for distressed companies to dispose of certain assets, allowing the core company to survive as the distressed company divests on a state-by-state basis. As a result, many companies with sprawling operations in eight or 10 states can more quickly shirking to focus on a just a few states, while selling off distracting, non-performing or capital-intensive operations in a particular state.

Essential, but not Eligible

As the Covid-19 pandemic paralyzed large sectors of the U.S. and global economy, the designation of any industry as providing an "essential service" was key to certain businesses and markets maintaining, or even expanding, their revenues streams during state lockdowns. Cannabis is no exception. The industry benefited from an "essential service" designation in many states, in some cases allowing all licensed cannabis to remain operational (i.e., California and Colorado) while in other states only allowing licensed medical cannabis businesses to remain open (i.e., Massachusetts).

But despite some form of "essential business" designation in most states where cannabis retail is permitted, the industry was categorically denied access to related Covid-19 federal stimulus programs. While qualified hemp farmers and hemp businesses were in most cases entitled to the same relief as businesses in other industries, true cannabis businesses and businesses ancillary to cannabis were ineligible to participate in federal assistance programs due to marijuana's Schedule I status under the Controlled Substances Act.

This conflicted position—cannabis companies permitted to operate, but solely with outside capital and organic revenue and despite severe contraction in consumer spending and consumer confidence—poses unique challenges. Early indicators, however, pointed to cannabis benefiting from the circumstances. In the wake of the shutdowns in late March 2020 and April 2020 and without government assistance, California reported cannabis adult use sales more than 50% higher than the trailing four weeks, with sales of edibles in particular achieving massive gains, reported at over 100% normal volumes.

Strong product sales, however, is not enough to stop the wave of distressed cannabis assets from that came to market in spring 2020. Companies that seemed "well-diversified" with a combined business model straddling the national CBD market and while at the same time developing full spectrum cannabis assets in multiple states where it is legal, found themselves having to service massive overhead for expanded national CBD retail outlets.

Ironically, CBD is not a state licensed venture and therefore was not automatically picked up in the "essential business" designations that applied to full spectrum licensed cannabis companies. As a result, standalone CBD retail portions of cannabis companies often found themselves shuttered as non-essential, while their full spectrum counterparts continued to operate. CBD outlets went the way of general retail, losing all of their revenue streams overnight as the entire country went into economic paralysis in March 2020. Licensed cannabis companies, on the other hand, continue to sell product through delivery services or curbside pickup.

M&A Decline Hits Cannabis Industry

Far from immune, M&A activity among cannabis companies is stalling. In fact, it was recently reported that less than $300 million in global M&A deals and investments involving cannabis entities have been announced in 2020 so far, compared to 7.4 billion in global cannabis deals that were announced in 2019.

It's worth noting, however, that any measure that goes by dollars is perhaps missing at least part of the picture- with valuations on targets way down, the actual number of deals (albeit at smaller dollars) may be closer year-on-year. Second, many companies are simply bidding time to see how deep the valuations go, while shoring up their assets and even raising additional capital through up-rounds, specifically to take advantage of the buyer's bonanza market in the cannabis space.

Lastly, many believe that the sharp declines in state and federal tax revenues during the recession will speed along programs to open more medicinal and adult use in states without such programs and could perhaps also create tailwinds for pending federal banking, licensing, and de-scheduling programs such as those contained in the MORE Act.

While nothing is certain, the dynamics at play in the distressed U.S. cannabis industry, defined by macro and micro idiosyncrasies, will surely create opportunities for certain operators as this nascent industry continues to expand.