Expert Q&A on Cannabis Financing

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An expert Q&A with Matthew Kittay, Fox Rothschild LLP, on the challenges and opportunities for cannabis financiers.

Financing for cannabis companies is evolving to meet an expanding list of market challenges. It is reactive to the pressures in the cannabis and general markets and proactive in driving the opportunities and structures to give investors the best chance of making successful investments in a sector that some describe as at times dynamic and other times overly obtuse.

WHAT ARE THE CHALLENGES CURRENTLY DEFINING THE "OPPORTUNITY" IN CANNABIS INVESTMENTS?

The current environment is defined by investors trying to deploy their disciplined playbook, informed by the failures that precede them, and using entrepreneurial innovation to find new financial products and formats that reflect the unique challenges of financing the cannabis sector. These challenges are presently defined by the following issues:

- A sector-specific capital crunch which started in the second half of 2019 for cannabis companies coupled with a global recession which began in February 2020 creating retail headwinds from decreased consumer spending, record unemployment and broken supply chains.
- A labyrinth of unclear, multinational bankruptcy enforcement regulations for which there is no legal precedent as formerly "too big to fail" cannabis companies melt down.
- The Covid-19 global health crisis combined with social unrest, both uniquely impacting the cannabis industry.
- An election year that is likely to stymy the momentum behind cannabis banking and other Federal legalization initiatives.

These challenges still create investment opportunities along with potential for complete failure. The "green rush" buzz persists around the cannabis sector, with plenty of angel investors, venture capitalists, fund sponsors, and alternative financing products still interested in either making their first forays into this market or doubling down on their current exposure. This article details legal issues as well as developments and challenges in financing cannabis companies against this current landscape.

WHAT KIND OF DUE DILIGENCE IS REQUIRED BY LENDERS IN CONNECTION WITH A CANNABIS FINANCING?

Although the laws governing cannabis companies vary state to state, financiers have generally been able to rely on a few foundational points in evaluating capital deployment, such as proof of:

- Adequate financing during their license application process.
- Access to the real estate required to operate the cultivation or retail facilities (or both) that are the subject of the license applications.

However, as investors and lenders deploy either passive capital or invest in active management opportunities, there are many aspects of US cannabis companies that are unique to the industry, impact financiers, and complicate due diligence and capital deployment. They include:

- Complex structures. Cannabis companies that are multi-state operators (MSOs) are often structured with multiple horizontal layers and vertical silos. They may have "plant-touching" assets in a vertical silo, and non-plant touching service companies in a separate vertical silo. This seeks to afford cannabis companies a range of benefits, including:
  - risk protection which generally accompanies captive subsidiaries;
  - containing "plant-touching" operations within the state that has granted the licenses, in order to reduce federal enforcement exposure;
  - achieving Internal Revenue Code § 280E efficiencies;
  - allowing parties to finance in only portions of the operations that are not plant-touching; and
  - allowing targeted funding to limit equity dilution to state level operations.

  While often effective for the above issues, this structuring compounds the challenges in diligence. For cannabis companies trying to build a national presence, a challenge for both the

operating company as well as a potential lender or investor diligencing the enterprise.

- A sprawling web of entities. Many entities means more secretary of state and tax filings, more corporate governance documents (an operating agreement in each state for each entity), and complex capitalization tables.
- Strict, industry-specific compliance. Regulatory compliance is crucial to operations for cannabis companies and every US state with a medical or adult use program, or both, has an idiosyncratic set of regulations to navigate. As a result, maintaining relationships with regulators, lawmakers and lobbyists is essential to maintain licenses. Corporate governance documents typically contain complex provisions controlling against "bad actor" equity holders and executives using features like mandatory background checks and draconian buyout rights. Digesting the licensure and governance documentation is challenging, even for sophisticated financial and legal teams.
- Difficult asset classes. For lenders in the industry (which can include operating companies acting as business combination partners because parties sometimes negotiate loans as cash advances into their plans for future merger), options on which assets to file UCC-1s and secure against are limited because the inventory is federally illegal, licenses are generally non-transferable and state foreclosure processes are untested.
- Do not bank on banking. Banking relationships are hard to initiate and maintain and it is hard to transact at every stage, from initial investment wires to ultimate proceeds distributions. These challenges and the current legislative initiatives which seek to address them are discussed in detail in Article, Financial Services and the US Cannabis Sector (W-019-8346).
- Building IP bridges to nowhere. Notwithstanding brand building as the billion dollar opportunity, federal trademark protection for cannabis companies is limited to CBD products. As a result, the best that full spectrum/THC- companies can do is attempt to "ring fence" their brands with federal trademarks on things like apparel (and even then, limited to use to promote non-Schedule 1 products), and additionally seek limited state recognition for their trademarks.
- Weak data. Because state and national markets have not been operating for a long time, there are relatively few comps and only a short track records available for critical transaction components like company valuations and fairness opinions.

WHAT IS THE IMPACT OF STRESS-TESTING CANNABIS COMPANIES IN DISTRESS?

Starting in fall 2019 with an industry-specific capital crunch and continuing through the spring 2020 global recession, capital exposure expanded beyond known risks to those of holding positions in and potentially making additional investments in the distressed cannabis industry.

The constriction in growth capital tunnel narrowed along with the exit pipeline, as the number of RTOs (the standard method for "going public" in Canada) or major acquisition/exits dwindled. In 2019, cannabis-linked companies backed out of 95 deals valued at a combined $2.46 billion, up from 48 terminated cannabis deals valued at $946.7 million in 2018 (S&P Global Market Intelligence).

In the first half of 2020, less than $300 million in global M&A deals and investments involving cannabis entities have been announced, compared to $7.4 billion in global cannabis deals that were announced in 2019. Despite including many concepts from other venture-backed industries in their DNA, many companies were not structured for and did not have upfront controls like down-round or anti-dilution protections in their governance documents, leaving investors and lenders with no growth momentum and little protection from the brewing storm.

Investors and lenders, however, are leveraging the opportunities. On the front end, the complex corporate structures described above have afforded options in placing their capital. The web of corporate entities and assets in a typical MSO structure allows financiers to include or exclude an array of entities and assets from financings, using the corporate structure to customize their financial and operational risk by partnering, investing or lending with only one specific state's operations or alternatively only with the "non-plant touching" side of the structure.

As the market has entered its first distressed phase, these structures have unique and unexpected benefits in protecting capital and enforcing rights against companies which default. Lenders initially were viewed as exposed because the traditional protections, such as asset securitization and guaranties, were untested and considered to be difficult, if not impossible, to actually enforce. Lenders seemed doomed by:

- State patchworks of laws that a rights holder would have to navigate instead of enforcing through a consolidated federal bankruptcy action.
- Inability to ultimately take possession of critical assets, such as inventory, licenses, or even cash proceeds, accounts receivables, and bank accounts, even if secured.

As things played out, however, these circumstances are at least in some cases giving investors and lenders traction to enforce their rights.

If a lender, for example, has a loan to a MSO with a Florida OpCo guaranteed by the Delaware TopCo, neither the TopCo nor the OpCo can simply avail itself to the protections of federal bankruptcy when the OpCo goes into distress, buckling from market downturn or overheated capital expenditure. As the OpCo goes into a state workout process (such as an assignment for the benefit of creditors or state receivership), the TopCo survives as guarantor, backstopping the obligation and giving the lender nexus to other StateCos in the MSO structure.

WHAT ARE THE FUTURE OPPORTUNITIES IN CANNABIS FINANCING?

Whatever issues face the industry generally, industry insiders and financial backers seem bullish on the industry's prospects. In a survey published in April 2020, a majority (58%) felt that the legal cannabis industry would be impacted less severely than other economic sectors. Likewise, turbulence in the industry was not deterring investors. On average, eight among 10 reported that their industry-related investments would either increase (59%) or stay the same (21%) ("COVID-19's Impact on the Cannabis Industry: Industry Leader Outlook," New Frontier Data, April 12, 2020).

This, combined with the fact a majority of states which have a cannabis program deem at least the medical dispensaries to be "essential" and therefore allow them to operate in some form, provides hope for the industry during what is likely to a be a slow recovery from a global 2020 recession. A useful list of essential determinations by state is available of our website at: https://www.foxrothschild.com/publications/cannabis-companies-deemed-essential-businesses-in-some-states-but-not-all/.

In June 2020, David Klein, Canopy Growth's chief executive officer (CEO), boldly stated that "2022, for me, is the magic number," when asked when he expects marijuana will be legalized federally in the US ("Canopy Growth CEO expects weed will be legalized federally by 2022," CNBC, June 16, 2020).

However, it's unclear that even federal legalization in the US will be the tipping point for US national market expansion. To the contrary, although Canada instituted a federally legal adult market more than a year ago, the Canadian recreational market has developed slower than anticipated, creating working capital and profitability challenges across the industry ("Canopy Growth is closing down greenhouses and laying off hundreds," CNN, March 5, 2020).

Likewise, the US election year holds promise to make federal legalization a presidential platform point. Advocates promoting economic opportunity for those targeted by the War on Drugs and fueled by the explosion of social unrest focusing on the Black Lives Matter civil rights movement in the US in May 2020, however, are putting more pressure on states like New York, as well as the federal legislature, to create meaningful and lasting roles for BIPOC in the industry, presenting new challenges for investors and lenders alike as we turn the corner into the third quarter of 2020.

07-20