Legal Considerations in Cannabis M&A Transactions

A Practical Guidance® Practice Note by
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M&A deals in the cannabis industry present a unique set of challenges for both buyers and sellers, especially given the rapidly changing economic conditions over the past few years. Pair this with an ever-changing regulatory landscape and an onslaught of new market entrants, and you have a recipe for disaster for unwary acquirors and targets. This practice note outlines legal challenges unique to M&A deals in the cannabis industry and discusses key considerations that you should bear in mind in order to bring your client's cannabis M&A transaction to a successful close.

For general information regarding cannabis, see Cannabis Resource Kit and Cannabis Law Practice Overview.

Background

The past few years have been a wild roller-coaster ride for M&A in the cannabis industry. By all accounts, 2018 was a banner year for the North American cannabis industry. Cannabis was fully legalized in Canada. The State of California, which had previously legalized cannabis for medical use only, also authorized recreational use, creating the largest legal recreational cannabis market in the world overnight. Stock prices for publicly traded cannabis companies soared, providing some of the biggest players in the industry with significant liquidity and purchasing power. Thanks to these tailwinds—and, arguably, a significant degree of irrational exuberance—cannabis M&A boomed, with stratospheric valuations for targets.

By contrast, 2019 represented a rocky return to earth for M&A transactions in this industry. Many acquirors began to suspect that the sale prices being requested by sellers may not have been supportable by the underlying economics of the target businesses. A record number of abandoned transactions followed, leaving many sellers waiting at the altar. The broad decline of stock prices of the publicly traded cannabis companies, some of which, by the end of the year, had fallen as much as 80% from their 2018 highs, further strained M&A in the industry by leaving many of the largest acquirors with significantly weakened balance sheets.

The decline continued into March of 2020, when COVID-19 delivered a shock to the broader capital markets and deal activity in almost all industry sectors effectively ceased for a period of time. For the rest of the 2020, however, the cannabis M&A market made a steady recovery. This recovery accelerated dramatically in 2021, with an almost 350% increase in the number of cannabis M&A transactions over the prior year. This figure includes over 200 deals in the United States and accounts for transaction value in excess of $10 billion. This trend is

expected to continue in the near future, as the broader economy continues to recover and more states legalize recreational use of cannabis.

Existing Regulatory Landscape

One of the greatest challenges to getting cannabis M&A deals done is complying with applicable law. The complex and often contradictory regulatory regimes over the cannabis industry present a number of compliance issues which in turn dictate almost every other aspect of the M&A process. Cannabis operators, and by extension, potential buyers of cannabis businesses, must stay on top of these hyper-localized requirements in order to be successful, typically with the help of lawyers and other specialized compliance professionals who are familiar with existing regulations as well as ongoing developments.

Continuing Federal Illegality . . . For Now

The most obvious—and the most significant—challenge for the industry is, of course, that the production, distribution, and possession of cannabis products (other than non-psychoactive products like CBD) is illegal under federal law. So even if a target operates exclusively in states where cannabis has been fully legalized, it is by definition violating federal law. And while popular sentiment for full legalization continues to grow, Congress and the executive branch have not yet acted in a meaningful way on federal normalization. The current federal legal status of cannabis has a meaningful impact on M&A in this sector since it effectively excludes a larger number of the most active acquirors, including many publicly traded companies, private equity firms, investment funds, foreign buyers, and businesses and people who operate in other regulated industries. With fewer potential suitors, cannabis targets often need to spend more time marketing their businesses as part of a sale process and should leave sufficient lead time accordingly. Federal illegality also means cannabis businesses are subject to unique banking challenges, generally forcing them to rely on local banks, credit unions, and other alternative financing entities, rather than traditional national banks. While there has been significant legislative effort to grant cannabis-related businesses access to federally backed financial institutions, most notably by passage of the Secure and Fair Enforcement (SAFE) Banking Act of 2021 by the U.S. House of Representatives, the bill has been languishing in the Senate. Cannabis M&A is affected by these banking complications as it means that acquirors will have more difficulty doing leveraged buyouts and may not be able to fund the transaction using their existing accounts. Lawyers will often need to structure around this latter point through the use of a real estate-type escrow process to make sure the purchase price is available for payment on the day of closing.

"Legal" Regulatory Landscape Is Hyper-Localized and Inconsistent

Since the legal cannabis regime has been developed piecemeal on a state-by-state, county-by-county, and even city-by-city basis, significant legal compliance challenges are presented for operators that must be fully diligenced as part of any acquisition process. As these laws continue to evolve daily and governing bodies adopt laws and regulations that reflect their local politics, there has been little effort made to harmonize these rules across states, making this review a much more time-consuming process than presents itself in a typical M&A transaction. With states in varying stages of legalization as to permitted use (e.g., medical vs. recreational), permitted categories (e.g., THC vs. CBD only) and permitted activities (growing, transportation, and sale), this review can be particularly challenging for multistate operators. Accordingly, buyers and sellers of cannabis companies should plan ahead to leave sufficient time in their process to allow for both a complete review of, and compliance with, applicable regulatory frameworks. Given its relatively nascent nature, cannabis as a consumer product is under heavy scrutiny from governing authorities, including district attorneys and attorneys general, which can significantly delay any approval process. And while these specialized regulations generally pose the most issues, cannabis companies still remain subject to all of the other local laws and regulations affecting businesses generally, including labor and employment, zoning, business license, and tax regulations, which must also be reviewed.

For more on federal and/or state regulation of cannabis, see Cannabis Key Legal Developments Tracker, Cannabis Federal Regulatory Activity Tracker, Cannabis State Regulatory Agencies, and FDA Warning Letters Tracker; see generally Cannabis Law Practice Overview and Cannabis Resource Kit. See also U.S. House Passes the SAFE Banking Act to Increase Banking Access for Cannabis Businesses.

Structuring Cannabis M&A Transactions

Given the foregoing regulatory concerns, structuring cannabis M&A transactions is more complicated than other industries. Over the years, dealmakers have developed

compliant transaction structures that respond to a state's change of ownership and other rules. For purposes of this article, we examine certain transaction structuring concerns that present themselves in California, the largest cannabis market in the U.S. Though similar structures and concerns present themselves in many other states as well.

Cannabis Licenses Are Not Transferrable in California

First and foremost, California regulations unambiguously state that cannabis licenses are not transferrable. This means that a licensed entity cannot attempt to sell its license to another person or entity and doing so would result in immediate termination of such license. Instead, transactions are typically structured as a sale of the stock of the licensed entity or its parent holding company. Nevertheless, these transactions remain subject to a set of complex "change of ownership" rules established by the applicable California licensing authority—Bureau of Cannabis Control (BCC) with respect to distributors and retailers, CalCannabis Cultivation Licensing (CCCL) with respect to cultivators, and the California Department of Public Health (CDPH) with respect to manufacturers of cannabis products.

Change of Ownership Rules in California and Multiphase Transaction Structure

Even when an equity sale structure is used, California law generally prohibits the transfer of 100% of the ownership interest in a licensed entity in a single transaction. For example, the BCC rules provide that if there is a 100% ownership change, the target entity cannot continue to operate under the existing license, and the new owners must stop operation until their own license is approved, which could take several weeks or even months. Since ceasing operations even temporarily is not generally an acceptable outcome, buyers of cannabis distributors and retailers typically employ a multiphase transaction, whereby at least one of the "old" owners retains a part of their interest in the target entity and remains on the existing license as a responsible party following the first closing, as the BCC rules provide that if there is a partial transfer of ownership, the business can continue to operate under the existing license during a transitionary period while the acquiror applies for a new license. Once the new license is granted, the parties then complete the second closing where the remaining seller is fully divested. Similarly, CCCL requires that a designated responsible party (DRP), who must also be an owner, always remain on the cultivation license. Practically, this means that at least one old owner must retain their interest and remain on the license as a DRP while the new owner applies to become the new DRP.

"Responsible Party" Risk during Transitional Period

The multiphase transaction structure common in California cannabis M&A presents additional issues during the post-closing transitional phase that buyers need to address in the transaction documents. After the first closing occurs, the buyer is in a de facto joint venture with the remaining seller(s) until the new license is approved. As the buyer will typically own a vast majority of the economics of the target at this point and, therefore, a disproportionate amount of the risks of ownership, however, this arrangement needs to be approached carefully. If the old owner/responsible party is disqualified for any reason during the transitional phase (e.g., due to a felony conviction), that puts the target at risk of losing its license and destroying a substantial portion of its value. Although this is not a risk that can be fully mitigated, a buyer typically requires the old owner/responsible party to execute a short term consulting agreement or another similar contractual arrangement whereby they agree to comply with all applicable laws and regulations, use their best efforts to remain qualified, and refrain from actions which could put them at the risk of disqualification. This agreement will also significantly circumscribe actions the legacy owner can take with respect to the business without approval. Such contractual commitment, coupled with significant consequences in the event of a breach (e.g., full indemnification and personal liability), should provide buyers with a certain degree of comfort.

Management Entity Structure

On the reward side of the transaction, although one or more of the old owners retain a portion of their interest in the target for regulatory reasons, as a business matter, buyers often expect to take all of the profits of operations following the first closing. To address this issue, and for other business reasons including tax efficiency and licensing efficiency, a buyer may have the target entity enter into a services agreement with a management entity wholly owned by such buyer, whereby the management entity provides certain business services—consulting, financing, tax, and other administrative support—in exchange for a management fee. This structure was popularized in the medical field to allow nonphysicians to own a part of medical practices and has the effect of diverting the revenues of the licensed target to an entity wholly owned by the buyer, so it does not flow to the old owner(s). Any such arrangement should be carefully reviewed by an accountant and other tax experts to maximize tax efficiency and avoid unintended tax consequences. For more on the legal and regulatory status of marijuana in the states, with

a focus on the sales and use tax treatment of medical and recreational marijuana on a state and local level, and applicable state excise taxes on the sale and use of recreational or medical marijuana, see Sales and Excise Tax on Marijuana State Law Survey.

Stock Consideration

In part due to the lack of access to the traditional banking system, the use by buyers of stock consideration to fund an acquisition in whole or in part is more common in the cannabis space than in other industries. Due to the volatile nature of valuations for cannabis companies, however, the parties should consider whether their deal terms should be subject to adjustment if there are dramatic changes in the value of buyer's securities during the executory period. Similarly, when stock consideration is employed, the parties will often need to negotiate the terms of such equity issuance and any resulting shareholder agreement that will govern the parties' actions going forward, including the eventual sale of the acquired business.

Managing Cannabis M&A Transaction Process

Due to the number of deal process challenges which are unique to the cannabis industry, buyers and seller must carefully plan their transaction in advance in order to give them the best chances for a successful closing.

Diligence, Diligence, Diligence

Cannabis is one of the most entrepreneurial and dynamic industries in the modern economy. These companies aspire to be on the cutting edge, and they move fast and break things. They also attract owners and operators who generally have high risk tolerance. While all of these characteristics make cannabis an exciting industry, this also means that buyers should thoroughly diligence the potential targets. The most common diligence issue that buyers come across relate to the capital structure of the target. Given the limited institutional financing options available to cannabis businesses, they are often backed by equity and debt investment from a large number of individuals, including family and friends. This often means that the capitalization table is complicated and the corporate recordkeeping is less than stellar, which heightens the risk of shareholder disputes. Sometimes, promises are made verbally and are never executed in writing. Other times, preliminary documents (such as term sheets) are used as the basis of issuing equity, rather than fully negotiated definitive agreements. Buyers should carefully investigate all of these issues, and to the extent feasible, sellers should try and clean up its corporate structure and corporate records early in the transaction process to bypass the inevitable questions and requests from buyers. As previously discussed, legal compliance (including with respect to license applications) is another area where particular attention should be paid.

Limited Access to Third-Party Services

Due to its ongoing federal illegality, third-party transaction services which are normally taken for granted may not be available in a cannabis M&A transaction. For example, escrow agent services which are typically offered by big national banks are generally not available to cannabis companies. The parties have to find local financing institutions specializing in cannabis to carry out such functions or just have buyer hold back the amount rather than transmitting it to a third-party escrow agent (which is a buyer-friendly structure/outcome). Another example of this is the representations and warranties insurance (R&W insurance), which has become common place in non-cannabis M&A. R&W insurance allows sellers to shift the risk of breach of representations and warranties to an insurance company and allows them to reduce the amount being escrowed/held back at closing. Unfortunately for cannabis operators, most insurers do not offer this product for cannabis transactions due to regulatory risks which are inherent in the industry, and even if an insurer does not categorically exclude cannabis transactions, the heavy underwriting and a long list of exclusions from coverage that would inevitably result would typically mean that such policy would not be viable. For a detailed discussion on the impact of cannabis legalization on the insurance industry, including disparate state laws, federal classification issues, and evolving federal enforcement of drug laws, coverage requirements, cannabis in the workplace, drug testing, and more, see Cannabis Legalization and the Insurance Industry. For a general discussion on representations and warranties insurance, see Representations and Warranties Insurance.

Antitrust

M&A transactions of a certain size involving transaction parties of certain size are subject to federal antitrust review under the Hart-Scott-Rodino (HSR) Act. This puts the cannabis operators in an awkward position of having to disclose an M&A transaction to a federal agency despite the industry's illegal status at the federal level. In the early days of legalized cannabis, transaction parties would weigh the risk of antitrust enforcement against the risk of disclosing their federally illegal activity (and critically, the beneficial ownership information). Antitrust filings by cannabis operators, however, have become much more common and routinized over the years, and given the heavy

and punitive consequences on the buyer for failing to make HSR filings when required, buyers typically make HSR filing when necessary. To date, the Federal Trade Commission and the Department of Justice, which review HSR filings, have played along with this arrangement. Note, however, that the antitrust analysis is sometimes complicated by the fact that the buyer uses its stock as consideration for the transaction. If, for example, buyer promises to deliver a fixed number of its shares (or a fixed pro forma percentage ownership in the buyer) as consideration, and the value of those shares shift up during the executory period, a transaction which was not reportable at the time of signing the definitive agreement could become reportable (and the government does not provide a grace period for missed filings). For more information on the antitrust laws applicable to mergers, see Merger Review Antitrust Fundamentals; see also Reportability of a Merger or Acquisition under the Hart-Scott-Rodino (HSR) Act and Hart-Scott-Rodino (HSR) Act Filings. See generally Antitrust Considerations in M&A Transactions Checklist.

Timing

Given all of the process challenges highlighted above, it is critical that the parties to cannabis M&A transaction leave enough time to address all of these issues. In particular, the parties should be mindful of the tight deadline for the buyer to file licensing applications post-closing, and must prepare such applications in advance, and set clear expectations for the seller(s) who are retaining their ownership as part of the multiphase transaction structure.

Summing It All Up

Despite all of its challenges, cannabis is an exciting and dynamic industry, the size of which cannot be ignored. Accordingly, M&A transactions in the space can offer considerable rewards to the savvy dealmakers who can successfully navigate the challenges of this complicated space. An experienced deal team that has industry and local expertise, including knowledgeable legal counsel, can help parties navigate the complex and challenging transaction process and give them the best shot at a successful closing.

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- Hart-Scott-Rodino (HSR) Act Filings

State Law Surveys

- Cannabis Key Legal Developments Tracker
- Sales and Excise Tax on Marijuana State Law Survey

Resource Kit

- Cannabis Resource Kit

Checklist

- Antitrust Considerations in M&A Transactions Checklist

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Zac's practice focuses on mergers & acquisition transactions across a wide variety of industries. He works with private equity firms, public companies, family-owned business, strategics and entrepreneurs in industries such as consumer products, business services, software & technology, video games & esports, cannabis, healthcare, apparel & beauty, manufacturing, retail, food & beverage and aerospace & defense. Over his career with Sheppard Mullin, Zac has successfully closed over 200 M&A transactions, giving him deep industry expertise in a number of sectors.

He also helps clients with debt and equity financings, venture capital investments, corporate governance and joint ventures and strategic alliances.

Zac specializes in getting deals done. He is adept at making complex issues comprehensible and finding practical solutions to legal problems. He is an avid writer and speaker with respect to areas of corporate law. He holds a law degree from Harvard Law School and B.A. from Duke University. He has been recognized as a leader by Super Lawyers, the Legal 500 and the M&A Advisors.

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