

Legal Considerations for Scaling in the Cannabis Business

This year's cannabis capital market activity already has exceeded that of 2020 as more institutional investors and lenders are making moves into the sector. This influx of capital provides more opportunities for cannabis companies to scale for continued growth—especially as more states approve adult-use legalization.

During this time of growth, however, cannabis companies should continue to keep in mind the unique challenges facing their industry as it continues to mature and develop.

Corporate Governance and Control

While bringing on additional investors is often necessary to grow, cannabis companies should think carefully about how the new investor will impact the management and control of the company.

Most major investors will require a seat on the company's board of directors or some kind of board observer rights, which brings more scrutiny of the corporation's governance and management. Founders might be in for a surprise when the investor that initially seemed agreeable starts questioning the company's management policies after the deal closes.

To avoid this, the company should consider establishing best practices for issues such as hiring and compensating personnel or making capital expenditures. Putting these measures in place

early helps to avoid objections by new board members or observers and also provides existing management with a foundation to make informed business decisions and demonstrate they are acting in good faith.

Getting ahead of corporate governance issues and hiring qualified professionals to lay the groundwork for the company's management and strategic vision also will help attract funding. Before committing to invest, institutional investors will want to see that the company has a sophisticated, scalable operation, which includes having solid financials, good relationships among the current owners and investors and a well-respected reputation in the industry.

Managing Reporting Requirements

Cannabis companies should also be aware of state and local reporting requirements whenever a new owner is added. In California, for example, all owners or financial-interest holders—including individuals and business entities—need to be reported to the state's Bureau of Cannabis Control.

For business entities, this might include disclosing each of the individual owners and entities in a multilayer business structure as well as those that have control of the entity. Failure to comply with these requirements could result in license and operating suspensions and an administrative headache for the company.

Real Estate and Landlord Issues

Expansion of a company's operations often means growing into new real estate as well. Although cannabis might be legal in a given state, local cities and counties often have their own operating restrictions. This is especially true in Massachusetts and California, where many local jurisdictions have put bans on cannabis businesses. Cannabis companies should be sure to familiarize themselves with the local requirements before entering into any real estate transactions.

Even if operating a cannabis business is legal on the state and local levels, landlords might still be unwilling to lease to a cannabis company—especially a plant-touching business. Landlords that do rent to cannabis companies often charge above-market rates and have additional terms and conditions designed to protect the landlord.

The cannabis company will want to review leases for early termination clauses, penalties and specific payment requirements that could allow the landlord to terminate the lease. The company should also keep in mind that if a landlord receives a share of the company's profit as part of the rent, the landlord may also be subject to reporting and disclosure requirements.

Brands and Intellectual Property

One way to scale a cannabis business is to enter interstate trademark



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licensing deals. In exchange for payment (typically a royalty), the licensor permits an out-of-state licensed operator to produce and sell cannabis products under the original business' brand name.

Cannabis companies considering such licensing arrangements should consider several issues.

First, obtaining federal registration of trademarks covering cannabis products is presently impossible, since the U.S. Patent and Trademark Office routinely rejects such applications as unlawful under the Controlled Substances Act. State trademark registrations are typically not granted until the brand owner has used the mark "in commerce"—that is, to conduct business—in that state.

Therefore, in cannabis licensing deals, parties should be mindful of the precise scope of rights that

are being licensed. Brand owners should be wary of providing robust representations and warranties regarding their trademarks since they will not have federal registrations covering cannabis products and typically will not be able to obtain a state registration in the market of interest until the deal has closed and after product launch.

Second, all trademark licenses require that the brand owner exercise quality control over the licensed products for the license agreement to be held valid and avoid abandonment of trademarks through so-called "naked" licensing. Obviously, shipping across state lines is not possible. The parties must think creatively about how to conduct inspections in compliance with applicable law.

Finally, the parties must consider how to structure payments, including

whether sales royalties payable in exchange for the trademark license might trigger disclosure requirements under state law. For example, royalties based on sales revenues might result in a brand owner becoming a financial interest holder in its licensee, triggering disclosure obligations. Because state rules vary, appropriate diligence needs to be conducted in every state in which a brand owner licenses its trademarks. **MJBiz**

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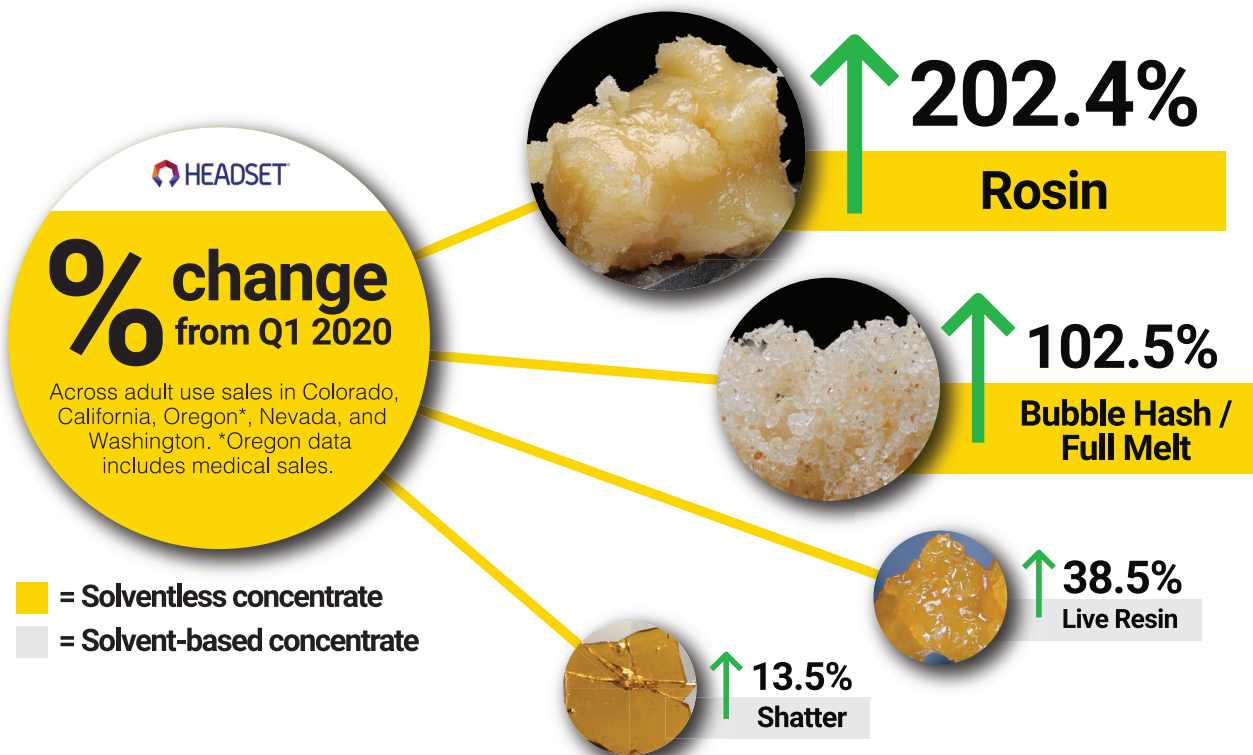
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