

LESSONS LEARNED ON THE CANNABIS FRONTIER

by Robert E. Schiappacasse



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The possession and sale of cannabis remains illegal in the United States under the Controlled Substances Act of 1970.¹ However, states all over America are exploring uncharted territory by enacting laws that serve to legalize and regulate the business of selling cannabis. Twenty-nine² states and the District of Columbia have legalized the sale of cannabis to registered patients for medicinal purposes.³ Nine of those states and the District of Columbia have gone one step further to also legalize the recreational use of cannabis by adults. As the cannabis industry expands and matures, both legally and economically, so too will the market of entrepreneurial clients seeking their fortune by entering this growing economic sector.

The administration of Governor Phil Murphy is moving New Jersey toward a significant expansion of the New Jersey Compassionate Use Medical Marijuana Act⁴ and, possibly, legalization of recreational use of cannabis by adults. Clients that currently operate in the cannabis space in other states and countries, like Canada, which seek to acquire and operate additional business interests in cannabis, will certainly look toward New Jersey's newly expanding market for opportunities. Similarly, New Jersey-based business interests with resources may now seek to participate into cannabis ventures in New Jersey and other jurisdictions.

This market is also new for attorneys, who may now have the opportunity to counsel cannabis-related clients. Because the act in New Jersey was limited to six license holders and was otherwise far more restrictive than most other states, attorneys have not seen much, if any, activity in the cannabis space in New Jersey. By contrast, Alaska, California, Colorado, Maine, Nevada, Oregon and Washington had all passed ballot measures approving the legalization of medical marijuana by the year 2000. Thus, practitioners should look to the cannabis 'frontier' for valuable

guidance on key issues clients will confront in this business sector.

Know the Regulatory Framework

One must understand the regulatory framework of the jurisdiction in which the business will operate. Most states, like New Jersey and New York, have only approved medical marijuana, while some states, like Washington and Oregon, have approved both medical and recreational use. Further, some states, like Arizona, require medical marijuana license holders to be nonprofit entities. Other states, like Nevada, permit for-profit entities to own and operate the license.

New Jersey currently requires that the six holders of a medical marijuana license be nonprofit entities.⁵ However, based on the recommendations contained in the *Executive Order 6 Report* issued by the Department of Health on March 23, it is expected that legislation will eliminate the nonprofit requirement for future license holders and give the current holders of medical marijuana licenses the option to convert into for-profit entities. This is a critical initial distinction to understand in order to effectively structure a client's entry into the market of a specific jurisdiction, especially if the entry is by acquisition.

If the license must be held by a nonprofit entity, then the business itself is typically operated through a series of agreements between the nonprofit license holder and one or more for-profit affiliated entities that provide transportation, security, manufacturing and other necessary services in exchange for fees. The assets and infrastructure of the business are, therefore, spread out among a number of entities. The transaction structure must contemplate how to acquire the assets of the business from the various affiliated entities.

One must also contemplate how to acquire the rights to the license. One can seek to have the license transferred

to another nonprofit or, if the regulations permit, obtain control of the license through agreement by which the existing trustees of the nonprofit license holder resign and are simultaneously replaced with the client's nominees. In either case, one must understand what the regulations permit in order to make sure the transfer of the license is both timely and effective.

Know the Type of License the Client Seeks

Similar to a liquor license, there are different types of cannabis licenses. Some jurisdictions, like New Jersey and Florida, have a single license structure for medical marijuana licenses, whereby one license authorizes the holder to grow, manufacture and sell cannabis. These 'fully integrated' licenses permit the holder to engage in all aspects of the business. Other states, like Maryland, issue separate licenses for the distinct aspects of the business. A retail license, for example, would permit the holder to only open a dispensary and sell cannabis products that were grown and processed by others holding those types of licenses. Legislation recently introduced in New Jersey, called the Marijuana Legalization Act, would do away with the fully integrated medical marijuana license, as it contemplates four separate categories of licenses: Class 1 (grower), Class 2 (processor), Class 3 (wholesaler) and Class 4 (retailer). Being able to compare and contrast a client's business goals against the permissions and limitations afforded by a particular license will be critical in achieving the client's goals.

Know the Real Estate Issues

In any transaction involving the sale or acquisition of a business, one must always consider whether the operating locations will be transferred as part of the transaction. If the client intends to take over the operating location of an existing cannabis business that is cur-

rently under lease, the practitioner must go beyond the typical concern of whether the landlord's consent is required. One should also determine whether the location is encumbered by a mortgage and inquire into whether the lender has approved the tenancy. Given the current state of federal law, the landlord may be in breach of its representations and warranties under its loan agreement, thereby jeopardizing the client's ability to continue to operate at that location without interruption.

Regardless of whether the client is entering the cannabis space as a new entrant or the acquirer of an existing business, local zoning laws must be considered. For example, in Massachusetts the state has opened the permitting process for adult-use cannabis. However, as of May of this year, 65 counties or towns in Massachusetts have banned the industry from operating in their locality.⁶ New Jersey has already seen a number of municipalities and counties, including Ocean and Monmouth counties, pass ordinances and resolutions prohibiting the sale of cannabis.

Know Where the Money Is

If a cannabis client needs financing to pursue its venture, the practitioner may want to explore whether the need can be realistically met before proceeding. Traditional financing is typically not available for cannabis clients. Given the current state of federal law, federally chartered and insured banks will generally not do business with cannabis clients. In Feb. 2014, the United States Treasury's Financial Crimes Enforcement Network (FinCEN) provided guidelines for FDIC-insured banks to do business with state legal cannabis businesses, providing some hope that this would change. On Jan. 11 of this year, FinCEN announced that its prior cannabis-related guidance remains in place.

However, on April 3, the Small Business Administration (SBA) published a

policy notice that further chilled the relationship between banks and cannabis businesses. The policy notice expanded the existing prohibition on SBA funding of cannabis businesses to include any business that directly or indirectly derives any of its revenue from a business involving the sale of cannabis. The inconsistency of banking policy at the federal level has left most institutional lenders on the sidelines.

The result has been leaving entrepreneurs to seek financing from private sources, such as wealthy investors and private equity funds, to finance the capital-intensive industry.

Know What Is Not Known

There is an important role for the attorney if the client is applying for a cannabis license or looking to acquire an interest in a cannabis business. Appli-

cations for cannabis licenses uniformly require the applicant to provide detailed information on every aspect of the prospective business. Applications seek information ranging from a security plan, to an operational manual, to protocols for quality control.

The success of the client's application will rest squarely on whether its application demonstrates the operational competency and expertise necessary to successfully operate a cannabis business in compliance with the regulations of the applicable jurisdiction. For this reason, the attorney must be sensitive to his or her limitations with respect to the application process, and assist the client by 'quarterbacking' the development and accumulation of information necessary to complete the application through one or more consultants familiar with the application process in that jurisdiction.

Checklist

When advising a client seeking entry into the cannabis market, make sure to start by considering the following issues:

1. Regulatory framework: In what state does the client want to operate? Does it only permit medical marijuana, or is adult-use recreational marijuana also legal? Can the license be held by a for-profit entity?
2. Type of license: Is the client looking for a fully integrated license or a license to conduct only one aspect of the business? Does the regulatory framework accommodate the client's vision?
3. Location, location, location: Does the client know the locality within which it wants to operate? Does that locality permit the operation of a cannabis business and, if so, are there certain restrictions?
4. Financing: Does the client have the financing necessary to support an application to secure a license and, if successful, to invest the necessary

capital to open the business? If not, how does the client plan to obtain the necessary funds?

5. The team: Understand what needs to be done as part of the application process and make sure the client has the necessary consultants on board to handle those aspects not within the legal domain. ♪

Endnotes

1. 21 U.S.C.A. § 801 (1973) *et seq.*
2. Some references will report 30 states because they include Louisiana. Other references, such as the one cited here, address Louisiana separately because the extent of its laws are the subject of debate.
3. Should Marijuana be a Medical Option?, ProCon.org, <https://medicalmarijuana.ProCon.Org> (last updated May 27, 2018).
4. N.J. Stat. Ann. § 24:61-1, (West 2010), *et seq.*
5. N.J.S.A. 24:61-7(a).
6. *Marijuana Business Magazine*, July 2018, What's Happening.

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