

Avoid these cannabis startup pitfalls, says top industry legal expert

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The Business Journal asked about hot-button legal issues seen these days by the key cannabis expert at one of the first U.S. law firms with a team for the growing cannabis industry.

In November, California voters approved the recreational use of cannabis for adults, starting in 2018 with new state and local governments weighing in on regulating the industry. Farella Braun + Martel partner Ryan Lowther is chair of the San Francisco-based firm's cannabis industry practice.

Will each jurisdiction be able to write their own rules for selling marijuana products or will a business just have to follow one set of state regulations?

RYAN LOWTHER: California law will require that all retail dispensaries obtain both a state and local license.

Local jurisdictions may make the decision to not permit commercial marijuana activities, including retail locations, but such jurisdictions will then be ineligible to receive any share of the revenues recouped through taxes on marijuana sales.

Local jurisdictions that do allow commercial marijuana activities may regulate the activities in accordance with local ordinances.

For example, many local jurisdictions that have already begun permitting commercial cannabis activities for



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the medicinal market have restricted such businesses to certain zones within their jurisdiction in accordance with local zoning plans.

What's the position of the companies that have contacted you — interested in getting into the market of selling recreational marijuana products in California? Wait and see, or setup to be ready to launch in 2018?

LOWTHER: We are contacted every day by people involved, or eager to be involved, in the industry.

Many of our clients — and would-be clients — have been operating in the industry for many years and are looking for us to review and structure their businesses so that they have the best chance at obtaining the necessary regulatory licenses.

Those that are just looking to enter the industry may have a tougher time obtaining such licenses given the priority scheme for license that exist under the law, but there still exists plenty of opportunity.

In our experience, it would be atypical for someone who knows they want to be involved in the industry to be taking a wait-and-see approach at this time, notwithstanding the existing legal and regulatory uncertainty that exists within the industry.

The new law prohibits smoking in public places, including bars. Given that, what is consumption of marijuana going to look like?

LOWTHER: Initially, California will probably look a lot like Colorado's market in terms of consumption. Proposition 64, like the laws in Colorado, ban the consumption of marijuana in public places. Certain premises in California may be licensed to permit

consumption.

Otherwise, consumption will be limited to locations not open or accessible to the public

Given the current federal classification of cannabis as a Schedule 1 drug, what are some of the challenges for companies in the industry?

LOWTHER: The mismatch between federal and state laws presents many unique challenges to businesses in the industry.

At the outset, owners and operators of cannabis businesses have to deal with the risk that the federal government could, at any time, shut down their business, even if their activity is 100 percent permitted by, and compliant with, state law.

In terms of specific challenges, first and foremost, many businesses in the industry have no recourse to regular banking relationships, given that banks are federally regulated and most banks are reluctant to jump through the hoops the federal government requires to have relationships with cannabis companies.

Not only does this create cash-management issues for these businesses, but it also creates a roadblock to a traditional financing source and increases the cost of debt for these businesses.

A close second in specific challenges is the tax burdens faced by businesses in the industry. Cannabis businesses pay significantly higher taxes, given that federal law prohibits them from taking standard deductions for expenses that other businesses are permitted to take,

What prohibitions are planned to keep marijuana products away from minors?

LOWTHER: The proponents of Proposition 64 drafted the initiative with the express intention of keeping marijuana products out of the hands

of minors.

As an initial matter, the initiative only permits sales to, and possession and consumption by, adults who are 21 years and older.

By creating a state-licensed market with robust regulation where adults are able to obtain marijuana products at reasonable and competitive prices, the legal market is expected to diminish black market sales which, at present, make it easy for those under the age of 21 to obtain marijuana products.

Regulations can then be crafted to protect the interest of those below the legal age of consumption such as the initiative's prohibition on any advertising and marketing containing any content elements that are known to appeal to those under the legal age, and prohibitions on advertising and retail locations being located within the immediate vicinity of schools.

As the state regulations are crafted to implement Proposition 64, additional protections will surely be considered in an effort to restrict marijuana products to those that are 21 years and older.

In what ways will marijuana laws "protect" the existing smaller companies from being overtaken by a large competitor coming into the market to capture some of the \$6 billion industry?

LOWTHER: Both California's medicinal- and adult-use laws contain certain provisions that are intended to encourage small businesses and give them a head start in the industry.

On the medicinal side, the laws currently prevent vertical integration or holding multiple types of licenses in the chain from seed to sale.

While Proposition 64 does not have the same restrictions on vertical integration, it does contain other protections like requiring that licensees be California residents as of Jan. 1, 2015, and prohibiting large scale cultivation

for the first five years, in each case for a limited initial period of time.

Even with the protections, there is no doubt there will be larger companies in the market and small businesses will need to find ways to differentiate themselves through their brands and products to remain competitive.

What are the obstacles for companies in California wishing to market their products to a larger customer base, say in nearby state, which also allows recreational use of marijuana?

LOWTHER: Given that marijuana remains illegal at the federal level, cannabis businesses are prohibited from engaging in interstate commerce. Marijuana may not be transported across state lines.

Businesses that wish to have a multistate presence need to get creative like licensing their brand to operators in other states.

What are the key considerations for financing a marijuana business?

LOWTHER: We represent many investors in the industry and their investment criteria are fundamentally the same as for businesses in other industries.

Investors are looking for innovative business plans from excellent operators with proven track records that show a meaningful and achievable return on the investment in a reasonable period of time.

What is a bit different in this industry is that many of the businesses were set up initially as nonprofits and not with the forethought as to how future investment will be structured.

Much of what we do with both our investor clients and companies is restructure companies in order to make them attractive targets for investment capital.