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Pitfalls To Avoid As Cannabis M&A Takes Off

By **John Bessonette** (May 8, 2019, 1:58 PM EDT)

As widely predicted, 2019 is shaping up to be a banner year for cannabis M&A activity. Valuations are soaring, regulatory regimes are liberalizing, public perception continues to improve and the industry is rapidly consolidating in a land grab for licenses and other scarce assets. But while the business environment is dynamic, buyers and sellers must be aware of the particular challenges of bringing these deals to successful completion.

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In part, the challenges result from the constantly evolving and often contradictory regimes for the regulation of cannabis products in the United States. They are also attributable to the significant stock price volatility and inflated valuation metrics often found in emerging industries, where profit expectations and retail investment are at high levels.

Regulatory Considerations

Regulatory matters are, of course, a principal consideration in any cannabis transaction. The impact of regulation on the deal process will turn in significant measure on whether the parties are “federally legal,” or in compliance with all federal, state and local laws regarding cannabis, or “state legal,” meaning in compliance with state and local law but not federal law.

Companies that are federally legal are operating and investing in cannabis businesses outside the U.S., operating in hemp businesses inside the U.S. or a combination of both. This category includes well-known mid-cap firms listed on the New York Stock Exchange, Nasdaq and Toronto Stock Exchange, with valuations stretching well into the billions, and many smaller and privately held companies.

Although their businesses vary, these companies all have made the conscious decision to forgo the state-legal U.S. marijuana market. They have done so not only to avoid the potential risk of federal prosecution, widely regarded as being very low, but also to remain in compliance with listing standards of the major securities exchanges. These exchanges require listed companies to be in compliance with applicable laws.

A listing on one of these exchanges in turn permits a company to have more ready access than their state-legal counterparts to capital markets and strategic investments. And for private companies, the choice to be federally legal can provide them with a greater range of sale or other transactional opportunities.

From a process perspective, listed companies need to be in touch with their exchanges early in the transaction to ensure approvals can be obtained in a timely manner. In addition, there may be regulatory requirements at the state and local levels, depending on the particular business and the states in which it operates.

State-legal companies are engaged more directly in the marijuana business in the U.S. — growing, distributing and selling marijuana for medical or recreational purposes that may conflict with the Controlled Substances Act but are in compliance with state and local laws. This group includes well-known U.S. multistate operators and a wide range of other companies. The shares of these entities may be listed on the Canadian Stock Exchange, formerly known for hosting many mining companies but now dominated by cannabis companies.

On the regulatory front, these companies have the same state and local considerations that their federally legal counterparts do. However, especially when multistate operators are involved, there may be multiple state licensing bodies with which to coordinate, especially in larger transactions. In many cases, affirmative approvals must be granted. Therefore, even if they are comfortable with the regulatory process in general, parties need to factor in time and potential deal risk associated with obtaining the requisite approvals, taking into account a possible backlog at the state level, issues with the seller or its operations and other matters.

The most distinctive aspect of the cannabis regulatory scheme, however, is the widely held expectation that its liberalization is inevitable. As a consequence, both state-legal and federal-legal companies are entering into transaction agreements with closing contingent upon either federal legalization, state legalization or another change in state laws, such as a move from a nonprofit to a for-profit regime. This trend is gaining momentum and contingent deals are increasingly larger and more complex.

Third-Party Service Providers

Buyers and sellers will need to allow additional time and effort to obtain third-party services, such as paying agents and escrow agents. These services are routine for transactions in most industries, but the dominant firms tend to be large institutions such as national banks and stock transfer agents. Even for federally legal transactions, their risk appetite has traditionally been low, and they must perform due diligence and assess their institutional comfort level with any transaction.

Changes to the federal banking regime are gaining headway in Congress as the SAFE Banking Act makes its way through the legislative process. However, in the meantime, the challenges facing the major institutions have created opportunities for local banks and other firms less burdened by the federal regulatory structure. These institutions are taking advantage of the absence of their larger competitors to gain market share and better economics.

Capital Structure and Due Diligence

Many transactions involving cannabis companies have taken a corporate development path that requires additional due diligence and cleanup prior to closing.

Like most emerging growth companies, cannabis companies tend to fund their growth through equity or equity-linked capital out of necessity. However, due to the regulatory issues, many cannabis companies have not had a traditional institutional investor playing the lead role in an investment round. As a result, a cannabis company can go through numerous rounds of raising capital without undergoing a significant due diligence review. And even companies with relatively small actual business operations can have many shareholders, sometimes numbering into the hundreds.

Further, the lack of institutional documentation can lead to disputes with shareholders and contractual counterparties over consent rights, rights of first refusal and other terms. This is especially the case in the current deal-making atmosphere, where large amounts of money or control of significant assets are at stake.

In addition, state licensing requirements have led some companies to raise capital in more complicated ways than they otherwise would. For instance, companies may have issued a large amount of convertible debt or other securities, which inherently have more deal-related triggers than plain common stock does.

As a result of these factors, a cannabis target may have a more complicated capital structure and documentation than a company in a less regulated environment whose financings were led by an experienced institutional investor. In turn, a greater degree of cleanup may be required prior to signing or closing.

Representations and Warranties Insurance

While representations and warranties insurance, or RWI, has become market standard for transactions in excess of $50 million and is increasingly common in even smaller deals, it has not yet spread to cannabis transactions. Accordingly, target companies should expect for the time being to see more traditional mechanisms when it comes to security for indemnification obligations.

Further, as noted above, national banks are generally not yet eager to maintain escrow accounts for cannabis transactions. While state and local banks may be willing to perform the function, a pure hold-back may also be utilized by a buyer. As a result, instead of the 1%-2% escrow common in deals outside the cannabis space in which RWI is used, cannabis targets may see a more significant reduction in upfront closing proceeds.

Volatile Stock Prices, High Valuations

Yet another set of issues that cannabis companies face is related to valuations ranging high above traditional metrics used in other industries. These are not unique to cannabis companies but contribute to the need for active advance planning.

In light of high stock prices, driven by retail investors to a level last seen in the dot-com era, acquirer stock frequently comprises all or a significant part of the purchase price consideration. The customary issues associated with stock consideration are heightened by the volatility of publicly traded cannabis acquirers.

Securities Laws

The parties will need to review the target’s investor base to assess the extent to which its shareholders are accredited investors. Unaccredited investors will need to be paid cash.

In addition, target shareholders will be unable to sell their shares in the U.S. public markets for at least six months, until Rule 144 becomes available. Further, many public buyers are shell companies for securities laws purposes. Even after 12 months, shell companies are required to have current public information in order for Rule 144 to be available. Accordingly, shareholders may be unable to remove the restrictive legends in the absence of a sale even after 12 months.

In all cases, given the lack of institutional investment and the corresponding overweight of high net worth individuals, smaller family offices and friends and family investors, a meaningful amount of time can be expended in analyzing and explaining these issues.

Antitrust

Depending on the size of the transaction and the parties involved, there may be antitrust considerations. Antitrust analysis typically depends on the values of the companies involved, in the U.S. and abroad. Fluctuations in an acquirer's stock price will have an impact on that analysis. Transaction values can dramatically shift during the course of negotiations, and the analysis of whether a Hart-Scott-Rodino Act filing or other filing is required may change over the course of a transaction.

Deal Terms

From the business perspective, the parties should consider whether any deal terms may be subject to change depending on dramatic increases or decreases in the acquirer's stock price. The answer will often be no, but in any event, each party should manage the expectations of its board, investors and other constituents.

Tax

From a tax perspective, whether the equity portion of the consideration could be received tax-free depends on several factors. These include the percentage of the overall consideration that consists of equity, the structure of the transaction, the nature of any earnouts or deferred purchase price and the target's historical tax organizational structure. Cross-border deals raise additional barriers to tax-free treatment. The parties need to focus on these issues upfront in order to structure the transaction in a manner that achieves the desired tax consequences.

Assets or Stock

Structuring considerations are present in all M&A transactions but can be exacerbated when dealing with cannabis companies. For instance, a transaction in which a U.S. company acquires another U.S. company will often be structured as a reverse triangular merger. However, there can be regulatory or other considerations that lead the parties to structure a transaction as an asset sale. An asset sale can raise significant tax issues for the target and its shareholders, which can be further complicated if the acquirer is Canadian.

It is an exciting and critical time for buyers and sellers in the cannabis industry. Buyers are vigorously competing for licenses, intellectual property and other assets, and their stock valuations, public or private, allow them to pay a premium to traditional valuation metrics. At the same time, potential sellers are weighing the options of going it alone or taking advantage of the competition generated in a rapidly consolidating market. And all of this is against a dynamic and unique regulatory backdrop. The process can be smoother for all parties if they and their advisers take the time to identify and start working through issues as early in the deal process as practicable.

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