Investor Due Diligence for "Touch the Plant" Businesses

Ted Kelleher | January 2016

As the cannabis industry began to emerge, some investors were reluctant to invest in businesses that "touch the plant," i.e., businesses that grow, sell or process marijuana, or that make cannabis-infused consumer products. Many investors preferred to focus on "ancillary" businesses, things like testing labs, software producers and social media platforms. These start-ups aimed to support the cannabis market, but didn't have the legal risks associated with a business that trafficked in a Schedule I controlled substance. However, the maturing of the cannabis industry, the growing normalization of cannabis in the public eye and the ever-increasing demand for marijuana products seems to be leading investors to re-consider their reluctance to invest in businesses that touch the plant.

Due to the complicated legal status of cannabis in America, pre-investment due diligence on a "touch the plant" business requires examination of some additional factors over and above the normal questions an early stage investor asks.

State laws and licensure

Any business that intends to grow or sell marijuana or to make or sell marijuana-infused products will be subject to some kind of state licensure. Understanding the licensing rules under which a business operates is a critical aspect of investor due diligence. While there are some emerging standard provisions among the various state licensure regimes, there are many important differences, particularly on finely grained issues like the number of licenses available, application and annual renewal fees, limitations on volume of growth and sales and so on. There is simply no substitute for actually reviewing the state laws and regulations in question, to understand the limits and requirements they impose on a business. To bring some focus to this tedious prospect, here are some questions that an investor should be asking during this review:

- Have the business owners carefully studied the state regulations, and do they thoroughly understand the regime under which they will operate?
- Does their business plan reflect an understanding of any limits imposed by state regulation?
- What are the application and licensing fees?
- How many licenses are available, and if they are limited in number, what's the process for awarding the limited number available?
- Are there limits on how much cannabis can be grown and sold by a single licensee or limits on how many locations a licensee can have?
- In medical marijuana states, how broad or restrictive is the list of conditions that entitle a patient to get medical cannabis?
- Are there limits on types of edible products, and packaging and labeling requirements?

The answers to these questions have direct bottom line consequences. And unfortunately, because the cannabis industry is sequestered into state specific silos, you'll need to conduct this examination in every state where you invest.

Tax Strategy

The infamous Section 280E of the U.S. Internal Revenue Code prohibits "touch the leaf" businesses from deducting business expenses from revenue, resulting in effective tax rates in the 50-60% range. There are strategies for mitigating the effects of this tax provision. Expenses for business operations that don't involve sale or processing of marijuana (such as sale of non-cannabis products, like apparel or paraphernalia or advising on client health issues) are deductible, and so the expenses associated with those aspects of business need be carefully tracked and segregated. Additionally, "cost of goods sold" is not included in the scope of the Section 280E deductibility exclusion. Cannabis business that grow their own inventory need to implement inventory accounting procedures that allow them to comply with the Section 280E rules, but also to maximize the amount of expenses that can legitimately be allocated to production of inventory. In short, you need to make sure that a cannabis business has tax and accounting professionals on their team that understand these issues, and that they have a plan for dealing with Section 280E. Otherwise, the U.S. government will be all too happy to take a big chunk of the business revenues that your investment helps to create.

Intellectual Property Issues

The value of consumer products (like cannabis edibles) is often tied to brand recognition. Conventional foods and beverages can use trademark laws to protect their branding; unfortunately, the United States Patent and Trademark Office won't accept trademark applications for cannabis products, since those products are illegal under federal law. Eventually this will change and there will be a mad rush at the PTO as cannabis edible companies scramble to claim trademark rights. In the meantime, it's important that any business you invest in have thought through how to protect their branding until the PTO opens to cannabis businesses. First and foremost, an investor needs to be sure that a business has actually investigated whether there are any already-operating companies using similar branding. Trademark law will eventually grant rights to the first user of a name or logo. No investor should put money into a cannabis consumer good business unless she knows that the proposed branding isn't already in use by another company, because any brand building efforts by the later entrant will likely be wasted. Once that is done, a cannabis business needs to take actions such as state law trademark filings, documenting when names and logos went into use and claiming rights using the trademark notice (™) to make the case for its ownership and priority of the names and logos comprising its brand identity. An investor needs to make sure that a potential investment target understands the importance of brand protection and is equipped to maximize its claim on the brand identity.

There are great opportunities to be had for investors in "touch the plant" enterprises, but the complex legal status of marijuana in America today means a more involved due diligence process, focusing on some novel issues. But the extra investment of time will be critical in protecting your investment in dollars.

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