

# Acquiring a Cannabis Business

by [Jonathan Bench](#) and [Hilary Bricken](#), Harris Bricken with Practical Law Corporate and M&A

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*A Practice Note highlighting issues to consider when counseling a prospective buyer of a licensed marijuana business. The Note discusses the regulatory environment, structuring the transaction, conducting due diligence, and drafting the transaction documents. In this Note, unless the context requires otherwise, the term cannabis business refers to a licensed marijuana business.*

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Cannabis businesses are unlike other businesses in large part due to the significant tension between federal and state laws and regulations. This tension creates some uncertainty for licensed cannabis businesses and other individual and businesses involved in the marketplace, including owners, financiers, employees, ancillary service providers, accountants, attorneys, and potential buyers (see [Practice Note, Counseling a Cannabis-Related Business: Overview: Conflict Between Federal and State Laws](#)).

This Note focuses primarily on the acquisition of a licensed **marijuana** business, which is one type of cannabis business (see [Understanding the Regulatory Environment](#)). Unless otherwise specified by the context, the terms cannabis and cannabis business as used throughout this Note refer to marijuana and a licensed marijuana business. While this Note discusses the acquisitions process generally and not for a specific jurisdiction, in some instances for illustrative purposes only it does provide examples of state laws or regulations for California, Oregon, and Washington, which have relatively mature cannabis legal frameworks.

This Note covers the following topics to assist counsel representing the buyer, as follows:

- [Understanding the Regulatory Environment.](#)
- [Transaction Advisors.](#)
- [Structuring the Transaction.](#)
- [Conducting Due Diligence.](#)
- [Drafting the Transaction Documents.](#)

This Note is limited to discussing an acquisition of a marijuana business and does not address:

- Considerations when counseling a client that is investing in a marijuana business as an active participant or as a passive investor. States vary in their treatment of when investment transactions need to be approved. For instance:
  - California's approval requirement is triggered at a 20% actual or beneficial ownership threshold or if an individual will have any management, direction, or control over the licensed cannabis business (see [Cal. Code Regs. tit. 16, § 5003\(b\)](#));
  - Washington requires approval for any purchase of an actual or beneficial ownership interest regardless of the size of the investment or formality of the investment relationship (see [Wash. Admin. Code 314-55-035](#)); and
  - Oregon, like California, uses a 20% threshold of direct or indirect ownership (like a landlord taking 20% or more in profits under a rental agreement) (see [OAR 845-025-1045\(3\)\(a\), \(b\)](#)).
- Concerns regarding acquisitions by an international buyer (non-US entity or individual), acquisitions using non-US funds, or the acquisition of a cannabis business that engages in international trade, either by sourcing inputs or selling products internationally.

## Understanding the Regulatory Environment

Before agreeing to represent a client in a cannabis business acquisition, counsel should clearly understand the federal and state regulatory status of the target company and its business. Because the term cannabis can refer to both marijuana and **hemp**, it is important to determine whether the acquisition target deals with marijuana or hemp, or both (for more information on cannabis classifications, see [Practice Note, Hemp and the 2018 Farm Bill: Overview: The Cannabis Plant and CBD Extract](#)). A target company's business typically specializes in one product or the other.

While many states have enacted legislation and created regulatory frameworks that permit the cultivation, processing, manufacturing, and retail sale of marijuana within their borders, marijuana remains a Schedule I controlled substance under the **Controlled Substances Act** (21 U.S.C. § 802(16)(a)). The acquisition agreements and counsel's engagement letter should clearly acknowledge the illegality of marijuana according to federal law (see [Legal Counsel in Cannabis Deals](#)).

The Agricultural Improvement Act of 2018, commonly referred to as the 2018 Farm Bill ([Pub. L. 115-334](#)), removed hemp from the definition of marijuana and now hemp is generally considered a commodity much like any other agricultural crop (for more

information, see [Practice Note, Hemp and the 2018 Farm Bill: Overview](#)). Although following the 2018 Farm Bill a hemp acquisition is significantly less problematic than a marijuana acquisition from a regulatory standpoint, many of the considerations in this Note should be reviewed in a hemp acquisition to ensure that the target company's lines of business are clearly delineated and adhered to, which is usually addressed during the due diligence process and in the representations and warranties made by the seller in the transaction documents. Many of the best practices in this Note are also useful in a hemp acquisition, if only to confirm that a buyer does not inadvertently purchase marijuana-related assets.

The buyer also needs to be aware of the type of cannabis licensure being acquired. Generally, the types of licensure include:

- Producer (grower).
- Processor (manufacturer).
- Retail.
- Testing laboratory.
- Distributor (also referred to as a transporter or transportation license in some states).

Some states, like California, also require licensing for a microbusiness and a cannabis event organizer (see [Cal. Bus. & Prof. Code § 26050](#) and [California Bureau of Cannabis Control: Cannabis Event Organizers](#)), while local municipalities and other states may require licenses for social consumption establishments like cannabis cafes or hospitality businesses (see [City of West Hollywood: Cannabis Consumption Area Business License Application](#)). Some states permit vertical integration within the industry, from plant genetics through to retail sales, while other states, like Washington, prohibit some or all vertical integration (see [Cal. Bus. & Prof Code § 26053](#) and [Wash. Admin. Code 314-55-035\(2\)](#)).

Other states may, for the purposes of promoting social equity or avoiding market dominance, have limits on the number of licenses that can be owned and the types of contracts that can be entered into among licensed companies. Washington utilizes both categories ([Wash. Admin. Code 314-55-035\(2\)](#), [\(6\)\(b\)](#) and [RCW 69.50.395](#)). Buyers from a different jurisdiction may not be aware of these regulatory limitations, which are generally only present in the marijuana industry.

With the high levels of regulation of cannabis businesses by both state and local governments, counsel should either be well-versed in these regulatory frameworks and their impact on the acquisition of a cannabis business, or they should engage local counsel familiar with them. Initial licensure is often subject to local approvals, including zoning, proximity to schools, daycares, and youth centers, necessitating lengthy review processes (see [Cal. Bus. & Prof. Code §26054\(b\)](#) and [RCW 69.50.331\(8\)](#), [\(9\)](#)). Municipalities may prevent one or more license classes from locating or operating in their city or town. Acquisitions and changes of the approved licensed location can sometimes be subject to scrutiny on par with initial licensure review. For summary information on how marijuana is regulated in various states, including links to the relevant regulations, see [Practice Note, Marijuana State Legal Status Charts: Overview](#).

## Transaction Advisors

### Brokers

Cannabis business brokers are brokers that provide general brokerage services connecting buyers and sellers and are common in the cannabis industry. In many transactions, one or more brokers are involved before either party engages counsel. As in most industries, broker competence and experience vary significantly. For instance, there are specialized cannabis business brokerage firms, some of which also provide valuation services. Others, like real estate and non-cannabis business brokers, possess poor industry knowledge and contribute little to the transaction process other than pushing for quick closings. Parties to a cannabis deal are most likely to encounter non-specialized real estate brokers because even developed cannabis markets like Washington, Oregon, and California do not have licensed cannabis brokers.

As in the real estate market, cannabis business brokers can represent a buyer, a seller, or act as a dual agent with written consent from both parties. The fee arrangement typically mirrors the assets being sold. For example, brokers in a real estate-focused cannabis deal (where real estate is the most valuable asset) often charge a total commission in the 6% range, with payment split between the parties. A business broker, however, typically requires a 10% commission, paid entirely by the seller, unless the fee is otherwise negotiated.

After a buyer engages counsel, if a broker is involved in the transaction, the buyer's counsel must evaluate the broker's competence and qualifications before allowing the broker to initiate the due diligence process or any part of the transaction. If the broker is not competent, counsel should advise the buyer that the transaction can proceed more efficiently without the broker's material involvement in the due diligence, though counsel should never advise the buyer to circumvent the buyer's contractual obligations to the broker.

Almost as a rule, counsel should seek to modify or entirely replace existing broker-initiated transaction contracts with counsel's own contracts as soon as possible even in a real estate-centric transaction. Few broker-preferred contracts contain the level of detail and protection counsel wants in the transaction documents from a general legal perspective. This is especially true in cannabis transactions, even where the broker indicates some fluency with the regulatory approval process.

## Legal Counsel in Cannabis Deals

Before agreeing to represent a cannabis client, counsel should ensure that their engagement letters protect their firms to the greatest extent possible. All cannabis engagement letters should contain additional disclaimer language to both protect counsel and the firm from future malpractice claims and ensure that the client has reasonable expectations, such as:

WE CANNOT GUARANTEE YOUR ABILITY TO RECEIVE A MARIJUANA-RELATED BUSINESS LICENSE IN ANY WAY.

POSSESSING, USING, CULTIVATING, MANUFACTURING, PROCESSING, DISTRIBUTING, AND SELLING MARIJUANA ARE ALL FEDERAL CRIMES. NO LEGAL ADVICE WE GIVE YOU IS INTENDED TO ASSIST YOU IN VIOLATING ANY LAW OR AVOIDING DETECTION OR PROSECUTION OF SUCH VIOLATIONS.

OUR ADVICE IS INTENDED SOLELY TO ASSIST YOU IN COMPLYING WITH STATE CANNABIS LAWS. THE ILLEGAL STATUS OF MARIJUANA UNDER FEDERAL LAW MAY IMPACT THE ATTORNEY-CLIENT

## RELATIONSHIP, THE ATTORNEY-CLIENT PRIVILEGE, AND THE CONFIDENTIALITY OF INFORMATION PROVIDED.

As with all transactions, counsel should consider their ethical obligations in advising their clients to comply with applicable laws and regulations. The buyer's counsel must be familiar with the applicable regulatory structure and should consider documenting any guidance provided to the buyer regarding the regulatory environment, either using regular memos to the client or to counsel's own files.

Some cannabis company owners are inherently suspicious of legal counsel, so it is not uncommon for the buyer to be the only party engaging counsel in the transaction. The buyer's counsel should confirm that the buyer is prepared to pay additional legal costs associated with its counsel performing all of the transactional work without the seller's counsel involved. This may include explaining contract provisions generally to the seller if the buyer requests that the buyer's counsel do so.

In this circumstance, the buyer's counsel should clarify to the seller that they do not intend to provide the seller with legal advice when reviewing contract provisions and ensure that they do not provide any advice. When the seller does not engage counsel, the transaction often moves forward faster, with the initial closing occurring quickly after the initial drafts are provided to the seller. Counsel should ensure that the transaction documents include representations by the seller that the seller has had an opportunity to engage counsel and, if they have not, that they have declined to do so.

## Structuring the Transaction

Acquisitions of cannabis businesses are typically structured as either a purchase of either:

- Assets.
- Equity interests (including a merger).
- Cannabis deals also often have:
  - An initial closing; and
  - A final closing.

Unless a cannabis license is not permitted to be assigned or assumed by a buyer, cannabis acquisitions are often structured as asset purchases because this structure allows the buyer to leave behind any potentially extensive known and unknown liabilities in the target company. Buyers purchasing a California cannabis business, however, must acquire the equity interests of the business because under California law these licenses are nontransferable (see [California Bureau of Cannabis Control \(BCC\): Your Questions Answered: Can a license be transferred to a new person?](#)).

## Length of Transaction

The highly regulated nature of the cannabis marketplace creates an often slow-moving environment for transactions, which first-time buyers and their counsel may not expect. Depending on the state, a typical acquisition timeline may range from as few as three months to as many as twelve months after the buyer and seller are prepared to close the transaction.

An acquisition can close on the shorter end of the time range if the buyer already owns a license in the target market and is merely expanding its market presence by acquiring another license. Transactions that stretch to a year and beyond often involve one or more of the following:

- Significant undisclosed regulatory violations in the target company.
- A pattern of regulatory violations in the target company.
- A pattern of regulatory violations in the buyer company or its key personnel.
- The buyer's inability to satisfy the state's licensing requirements, including providing satisfactory proof of funds from legal or permitted sources.

### **Staggered Transaction Closings**

A cannabis transaction also often has two closings for regulatory reasons. Although some parties may prefer to wait until the entire transaction has been approved by the state regulatory body to close a deal, most buyers and sellers are anxious to complete as much of the transaction as they can as soon as possible.

Where the closing of the acquisition is to be split into two components, the first closing occurs after:

- Due diligence is completed.
- The transaction documents are fully negotiated and drafted.
- The buyer's financing is arranged.

In the initial closing, the seller transfers as many of its business assets as permitted without regulatory approval, generally leaving only the license or the licensed entity to be transferred at the second closing. The purpose of this structure is to provide the buyer all of the financial benefit and a significant level of the responsibility for operating the business from the initial closing. Once the second and final closing occurs, often months after the initial closing, the buyer obtains all the benefits and responsibilities of owning the acquired business retroactive to the date of the initial closing.

This uncertainty regarding the closing timeline, however, rarely slows down a motivated buyer, and the industry players and their counsel routinely adapt transactions to fit the facts of a particular acquisition.

## **Choice of Transaction Structure Fundamentals**

### **Timing of License Transfer**

Generally, in an asset purchase:

- At initial closing, the buyer takes immediate possession of all business assets except the license (and any real property, if relevant), which is retained by the seller.
- Once the governing regulatory body has approved the license transfer, the seller transfers the license (and any real property, if relevant) to the buyer at the final closing.

In an equity interest purchase structure:

- Before (or as the first step of) the initial closing, all assets other than the license are transferred from the seller to a seller-owned entity (non-licensed entity). The cannabis license remains in a seller-owned entity (licensed entity).
- At the initial closing, the buyer acquires the ownership interests of the non-licensed entity.
- Following regulatory approval of the license transfer, at the final closing the buyer acquires the equity interests of the licensed entity.

A buyer may ultimately be better off structuring the acquisition of a cannabis business as an asset acquisition to avoid potential liabilities that are undisclosed or understated (see [Conducting Due Diligence](#)). These cannot be avoided using an ownership interest purchase. Moreover, the advantages that often drive buyers to use equity purchase structures when acquiring other businesses, such as long-term supply or sales contracts with favorable terms, easily transferable licenses, and tax advantages (like net operating losses (NOLs)), are not always present in a cannabis business or do not outweigh the potential negatives that flow from an equity purchase.

### Business Considerations in Choosing Deal Structure

The buyer's counsel helps the buyer determine how to structure the proposed acquisition based on various factors, including:

- **Is the buyer qualified to purchase the cannabis business?** A buyer may not be aware of state regulations governing ownership restrictions. Some states, like Washington, employ a state residency requirement to limit who can purchase a cannabis business (see [RCW 69.50.331\(b\)](#)). Many states and local municipalities are also employing social equity programs as part of their cannabis licensing regimes, which limit certain cannabis licenses (by number, geography, socioeconomic status, or all of these) to buyers that qualify based on the state's social equity parameters (see [RCW 69.50.335](#) and [California BCC: Social Equity Information](#) and [City of Portland: Social Equity Program Details](#)). Counsel should be familiar with the details of these restrictions when structuring a deal because, for example, some states require that only a buyer purchasing a majority of a cannabis business' ownership interests meet the requirements. This flexibility may give buyers an opportunity to partner with otherwise unqualified investors.
- **What is being purchased: a license or a right to a license transfer?** This determines whether the license is to be transferred by a bill of sale or by an assignment and assumption agreement (as in an asset sale) or if a different purchase structure is needed (an equity sale). For example, in California, licenses and rights to licenses cannot be purchased because those rights remain with the licensed entity. To acquire a license or right to it, the buyer must purchase the business entity holding the license if at least 20% of the original owners remain owners post-closing or an original owner remains with the entity in an executive capacity. If more than 80% of the ownership interest is being

purchased and an original owner is no longer to be involved in the business, the buyer entity must secure a new license. See [California BCC: Your Questions Answered: Can the ownership structure on a license change?](#)

- **What is the value of the assets being purchased?** License valuations generally range from processor, which is least valuable, to producer (grower) to retail, which is most valuable. Depending on the market, a single license may sell for tens of thousands up to millions of dollars. Some markets may have a distressed seller happy to transfer a license in exchange for a buyer assuming that seller's trade debt and providing a relatively easy exit to a seller unable to reach profitability or holding onto an unused license.
- **What roles must the seller owner play post-closing?** (See [Initial Closing Documents](#) and [Final Closing Documents](#).) Where the buyer wants to assume management of the target business before receiving regulatory approval, a seller often must remain involved in the business on a day-to-day basis until the license is transferred to the buyer, even if the buyer has all of the industry expertise needed to run the business post-closing (see, for example, [California BCC: Your Questions Answered: Can a business continue to operate under a license before the Bureau approves new owner\(s\)?](#)).
- **What additional role is a seller owner intending to play post-closing?** Depending on the client's familiarity with the target business, a buyer may want a seller owner involved in the business to remain for several weeks or months post-closing to assist with customer continuity and business training.
- **Does the buyer intend to replicate the seller's business entity structure?** Due to both state and federal (particularly tax) considerations, many cannabis ventures consist of a network of companies, each providing various goods and services to a licensed business, even if they all are owned by the same parent company. The buyer should consult a tax advisor to determine the ideal structure for its cannabis business post-closing and ensure that its proposed acquisition structure captures all potential tax efficiencies available to the buyer.
- **How are the real estate relationships structured (for example landlord, sub-landlord, and so on) and should they be replicated or assumed by the buyer?** Due to the ongoing uncertainty in the cannabis industry, market rent charged to a cannabis business under a lease can be two to three times (or more) above market rents charged to non-cannabis commercial tenants. As a result, many licensed cannabis entities seek to purchase real estate for their businesses as soon as possible. Alternatively, they may enter into leases with landowners at standard market rates which then allows the licensed entities to sublease space to their licensed affiliate entities at above-market rates. The buyer should consult a tax advisor to ensure most favorable tax treatment under its post-closing real estate relationships.
- **Is the seller's intellectual property integral to the buyer's post-closing operations? If so, does the seller own or license some or all of its intellectual property from an affiliated entity or a third party?** The desirability of the target company's [intellectual property](#) (IP) (usually primarily its branding) often depends on whether the buyer is an existing multi-state operator (MSO) that is increasing the geographic spread of its business. Buyer MSOs may be more interested in replicating their own brand into a new market unless the target company also has a strong market presence or the buyer is entering a market where state cannabis regulators promote brand diversity. Sophisticated buyers, however, often acquire the target company's IP, if only to retain ultimate control over whether to employ or take the seller's branding off the market. If the buyer does not intend to use the seller's branding, owning the branding provides the buyer an opportunity to sell it to a market competitor in a future transaction (for further discussion of intellectual property considerations see [Due Diligence Categories](#)).
- **How will the seller owners be paid?** Seller earn-outs are generally paid under management or consulting agreements. Often the seller or an owner must remain as a registered affiliate with the licensed buyer post-closing if the seller or owner is to receive an earn-out based on the profitability of the licensed business. This entanglement can usually be avoided by structuring the earn-out payments as flat fees that are not tied to gross sales or net income. Some states'

regulations are complex regarding what types of payments are permitted and how those are calculated (see [RCW 69.50.395\(2\)\(a\)](#)). The buyer should retain appropriate advisors familiar with these regulations to properly structure these payments.

- **What is the source of purchase funds and is that source permitted?** In some markets, like Washington, funds used to purchase a licensed owner or its license (including earnest money) must be vetted by the governing regulatory body **before** any funds changing hands (see [Wash. Admin. Code 314-55-020\(8\)](#)). Certain markets permit funds from only US residents, although the level of scrutiny often varies depending on whether the funds are to be used for equity or debt financing ([Wash. Admin. Code 314-55-035\(5\), \(7\)](#)). The laws and regulations surrounding purchase funds continue to shift, especially regarding the permissibility, source, and amount of earnest money or similar pre-closing funds. For instance, Oregon's Liquor Control Commission previously established a \$100,000 threshold on disclosure of pre-closing funding relationships. The amount was never included in [OAR 845-025-1030](#) but was included in a guidance document that has since been modified to remove the threshold. The buyer should engage counsel familiar with these sources of guidance and funding regulations to ensure compliance with local practice and applicable law, including tax law and transactional review bodies, such as the Committee on Foreign Investment in the United States (CFIUS). To date, CFIUS has not turned its attention to any cannabis transactions.
- **What is the timing of payments to the seller?** As described above, some states prohibit arrangements that are otherwise considered standard in an acquisition context. For instance, Washington prohibits any advance payment to a licensed seller in conjunction with any acquisition until the relevant regulatory body has approved the acquisition ([Wash. Admin. Code 314-55-035\(4\)\(e\)](#)). This means that in Washington, a buyer may only deposit earnest money into an escrow account controlled by the buyer or a neutral third party, regardless of whether the buyer is acquiring a business or an option to acquire the business sometime in the future if and when federal prohibitions against cannabis are lifted and state laws and regulations are modified. Counsel must ensure careful compliance with applicable laws and regulations regarding advance payments before structuring any payments to sellers who, familiar with this regulatory framework, may seek to circumvent it.

## Drafting the Letter of Intent

A cannabis letter of intent, usually referred to as an LOI, is similar in many ways to a typical term sheet or LOI for a non-cannabis acquisition, containing binding and nonbinding provisions. But because a cannabis acquisition is more complicated than a typical non-cannabis acquisition transaction, a cannabis deal LOI often provides as much detail as possible on the proposed transaction steps, the order of those steps and their potential permutations, to ensure that the buyer, seller, and counsel can track the stages of the transaction. While providing detailed steps, however, counsel should still ensure that the LOI does not lock the transaction into an aggressive closing timeline that does not account for regulatory delays. State regulatory bodies generally take their gatekeeping functions seriously, which may slow down the transaction timing. Even nonbinding portions of the LOI should also not contain any proposed transaction structure that can be construed by a regulatory body as illegal or potentially illegal.

## Conducting Due Diligence

For a variety of reasons, including perceived deal urgency, misplaced trust in a seller, and buyer naivete, many buyers do not spend enough time in the due diligence phase of their transaction as necessary for prudent deal-making. Because many cannabis operators worked in the industry before the enactment of state-legal regimes, counsel should expect to see a wide range of deficiencies, described more fully below, when conducting due diligence. Counsel should seek to unearth these potential issues early in the due diligence process to avoid unnecessary delays later or to support considered decision-making about whether to proceed with or abandon a particular cannabis deal.

## **Diligence Risks Associated with Unsophisticated Sellers**

The unsophisticated nature of many operators means that handshake deals and bare bones contracts, which may not be properly executed, are common. Many cannabis businesses also carry legacy issues, particularly regarding unresolved ownership disputes and possibly illegal financing arrangements. Ultimately these issues can and should be resolved through either closing conditions or comprehensive seller representations and warranties, or both. Certain deficiencies may be fatal to the transaction if they cannot be resolved before closing. For instance, if a transaction requires supermajority or unanimous owner approval and the early ownership arrangements are not clearly documented, it may be impossible to determine with certainty the approvals required for the acquisition to proceed.

## **Due Diligence Categories**

A due diligence request list for a cannabis transaction should include all of the typical due diligence categories, along with certain regulatory-focused requests. The following categories of information are typically included in a cannabis due diligence request.

### **Organizational Documents**

As discussed above, these may often be deficient due to undisclosed or unwritten agreements among owners, consultants, investors, and other financiers. Counsel should ensure that licensed entities are registered and in good standing with no obvious regulatory issues, such as unexpired licenses, unpaid fees or penalties, or ongoing regulatory compliance flags. In some states these can be easily viewed on the secretary of state's website alongside an entity's general business status.

### **Ownership**

In some states with restrictive regulatory regimes regarding ownership and financing relationships, such as Washington, purchase options are often granted to friends, family, employees, and consultants at early stages of the company's existence. Carefully read these early agreements, especially consulting agreements, for potential ownership claims that have not yet been exercised. It is common for potential sellers to try to dismiss the relevance or significance of these early relationships, which may not have been formally or properly documented or resolved but may present difficulty when the owner is trying to sell their business.

### **Organizational Structure Chart**

Counsel should push the seller to ensure the organizational chart reveals all of the affiliated companies that derive income from the cannabis business, especially those that the seller may retain post-closing and those retaining a contractual relationship with the buyer post-closing. Often this includes affiliates like packaging companies that may not be a part of the acquisition target entities but that can be significant in terms of the revenue they receive from the licensed seller. Counsel should ensure that each affiliated seller entity in the organizational chart is also contractually bound to the seller entity and that all revenue in those contracts is correctly represented in the seller's financial statements. The organizational chart should include all key executives, including owners who have a role in operating the business.

### **Contracts with Owners**

It is not uncommon for seller owners to have extensive (written or unwritten) agreements with the seller licensed entity describing payments to the owners that may (or may not) be disclosed in the seller's financials. Counsel should be vigilant in researching unwritten arrangements to ensure that all seller cash outflows are in compliance with applicable laws and regulations.

## Banking

Although cannabis companies are increasingly able to use banking services offered by state-chartered banks and credit unions, most larger, multi-state banks eschew cannabis companies due to the federal cannabis prohibition and heightened ongoing compliance requirements for which financial institutions are responsible. Due to these difficulties establishing and maintaining beneficial banking relationships, many cannabis companies are cash-only businesses that have large amounts of cash that need to be stored, protected, and moved. These cannabis businesses will even pay their state and federal tax obligations using cash (see [IRS: Pay with Cash at a Retail Partner](#)).

For a buyer, maintaining reliable banking services post-closing may be one of the most difficult issues. Where relationships exist, the buyer may want to continue a banking arrangement with the seller's institution and use the seller's cash transportation service as well. Available banking services generally do not extend to loans, other than commercial credit cards, which means that affiliated-company and third-party lending relationships are often also examined as part of due diligence.

## Financing Arrangements

Counsel should be vigilant in researching written and unwritten financing agreements to ensure that all previous seller cash inflows are in compliance with applicable laws and regulations regarding non-owners and non-disclosed financiers. As discussed previously, some states impose financing restrictions on sources of funds and many regulatory bodies that do not have these restrictions may require ongoing disclosure regarding a licensed company's sources of funds. These restrictions can and often do include restrictions on gifts, grants, and exchanges of assets for services. With the exception of real estate, debt financing relationships are rarely documented by **UCC financing statements** or other public liens. The buyer's counsel must diligently investigate all the seller's debt.

## Employee Matters

Due to the highly regulated nature of the cannabis industry, especially the ongoing disclosure requirements with state regulatory oversight bodies, many sellers keep well-maintained records relating to employees, including employee handbooks, employee files, and employment agreements.

However, counsel should ensure that the seller discloses all employee relationships, including those from the earliest days of the seller's business. Counsel should pay close attention to employee benefits, including equity and quasi-equity grants to employees and vesting schedules, and termination-related correspondence, agreements, and settlements regarding employee workplace injuries.

Counsel should also review employee files for employees that are to remain employed post-closing to ensure that statutory requirements, such as criminal background checks, have been completed and that employees have mandatory continuing reporting requirements regarding criminal matters.

## Financial Statements

Due to the nature of the cannabis industry, the buyer's counsel should assume that the seller's financial statements rarely reflect the full scope of business operations. A buyer familiar with the industry is likely to be aware of this. The buyer's counsel often works with the buyer and the buyer's accountant or valuation team to discover all of the streams of income and cash outflows. Counsel should ensure the buyer understands its potential liability for the seller's unreported, underreported, or underpaid tax obligations, which depends on the transaction structure, the comprehensiveness of the seller's representations and warranties, and the seller's indemnity obligations.

### Asset Lists

Asset lists are often deficient because they tend to be outdated and lacking in detail. Assets that appear to be owned by a licensed seller may actually be owned by the seller's affiliate or an unaffiliated financier. Counsel should ensure that the buyer understands which seller entities own which assets and that any assets to be purchased are in operational order. Because debt financing relationships are rarely documented by UCC financing statements or other public liens, counsel should make detailed and repeated inquiries into third-party financing relationships to ensure they are either fully discharged at closing or addressed under interparty lending agreements post-closing.

### Sales and Marketing Materials

Counsel should review the seller's prior marketing materials to discern compliance with the state's laws and regulations. Counsel can then advise the buyer regarding the buyer's ability to continue to use the seller's prior marketing materials or the need to revise them for use post-closing. For some general information relating to the online advertising and marketing of marijuana, see [Practice Note, Online Advertising and Marketing: Marijuana](#).

### Real Property

Leasing relationships in cannabis businesses often contain at least one sublease, especially where a third-party landlord owns the underlying property. A seller's affiliate entity often leases from the landlord and then subleases to the licensed entity, allowing the seller's owners to receive above-market rent from the licensed entity. The prime lease should be carefully reviewed to determine how to obtain the landlord's timely consent for assignment and assumption of the lease, if assignment and assumption is permitted.

Landlords leasing to cannabis companies typically prefer to negotiate a new lease with the buyer so that they can increase the (commonly above-market) security deposit and rent and obtain personal guarantees from the buyer's owners. In some markets, a buyer must receive local-level government approval even though the seller has already been approved to operate a cannabis business on the premises.

If a buyer intends to purchase a licensed business and relocate it to other premises or another city or county, counsel must ensure that the buyer is taking all necessary steps to receive any required approvals. The lease and all subleases should contain provisions specific to the cannabis industry, recognizing federal law illegality and how the volatility of state and local licensing requirements and processes may impact the leasing relationship.

### IP

Cannabis IP can be divided into IP that can be federally protected and IP that cannot. Federally protected IP includes **patents** and **copyrights**. It also includes **trademarks** that are not explicitly used with cannabis products. Many cannabis companies use their cannabis brand or **trade name** to obtain federal trademark protection for ancillary products, such as clothing, that is sold to

customers to spread brand awareness. At the same time, cannabis companies file state-level trademark applications explicitly for cannabis-related trademark categories in all states where they intend to operate.

Counsel should be prepared to request and review all state and federal filings, as well as all unregistered IP rights. Trademark licensing agreements are common, especially in markets that prohibit vertical integration and franchising in the cannabis industry. Sometimes intellectual property licensing agreements are split between trademarks and other IP, such as standard operating procedures (SOP) manuals. Because trademark infringement is extremely common in the cannabis industry, counsel should be prepared to have candid conversations with the buyer regarding the value of any IP that will be purchased.

### **State Reporting**

Most states use a state-mandated track and trace system for all cannabis products from seed to sale (for examples, see [California Cannabis Portal: California Cannabis Track-and-Trace \(CCTT\)](#), [Washington State Liquor and Cannabis Board: Leaf Data Systems](#), and [Oregon Liquor Control Commission: Cannabis Tracking System](#)). The publicly available information from each state's database should be carefully compared to the seller's internal records to discover any discrepancies.

In some markets, a buyer continues to use a seller's login credentials for this system. Counsel should confirm that the system's records are accurate before closing so that no improper seller actions are imputed to the buyer. These can include intentional and unintentional reporting errors in product tracking and sales tax reporting and submission.

### **Software**

Cannabis businesses often use third-party software for website, sales, and marketing purposes. While these agreements are generally loose, month-to-month commitments, counsel should review them to ensure that those services remain uninterrupted post-closing. Marketing-related contracts should be reviewed carefully to verify that the frequency and content of customer-facing communications comply with all relevant state and federal laws regarding electronic communications and advertising, both generally and as specifically related to cannabis advertisements (see, for example, [Cal. Bus. & Prof. Code §§ 26150 et seq.](#) and [Wash. Admin. Code 314-55-155](#) and [RCW 69.50.369](#)).

### **Social Media Accounts**

As with many businesses, social media is a key component to a cannabis company's business model. Cannabis companies involved in retail sales are particularly focused on the social media aspect of their marketing strategy. Counsel should review the seller's prior social media posts and text message marketing campaigns for potential regulatory violations and ensure that all social media accounts are explicitly included in the purchase agreements, including a condition to share all login credentials at the applicable closing.

### **Insurance Matters**

Many markets require cannabis companies to carry insurance under state laws and regulations (see [Cal. Code Regs. Tit. 16, § 5308](#) (relating to distributors) and [Wash. Admin. Code 314-55-082](#)). Counsel should review the state's requirements and compare the seller's schedule of all policies or binders of insurance or self-insurance arrangements, including medical, workers compensation, disability, automobile, general liability, fire and casualty, products liability, professional liability, business interruption, officers' and directors' liability, and key-person life insurance, with deductibles, coverage limits, and other significant terms.

Many insurance companies do not have cannabis-specific policy offerings. To comply with insurance requirements, cannabis businesses purchase standard business policies with cannabis-focused riders (amendments). Counsel should review these riders carefully to understand what types of claims have been categorically excluded from coverage. These exclusions can include potential claims relating to:

- Seeds, seedlings, vegetative plants, flowering plants, or harvested material that is not yet finished stock.
- Bodily injury and property damage arising directly or indirectly from alcoholic beverages or other substances (here, marijuana).
- Volunteers and employment practices liability.
- Business owners who are not employees.
- The inclusion of nutraceutical substances, such as essential oils in finished products.
- Vaporizing devices.

### Sales Tax

Cannabis retailers act as agents for the state in collecting sales tax and marijuana excise tax (for instance, 37% in Washington and up to 20% in Oregon) from their customers and remitting those taxes to the state taxation authority (see [Cal. Rev. & Tax Code §§ 34010 et seq.](#), [Wash. Admin. Code 314-55-089\(8\)\(b\)](#), and [Or. Rev. Stat. § 475B.705\(2\)](#)).

Counsel should ensure that all taxes have been remitted as of the closing and that the seller indemnifies the buyer for all pre-closing tax matters. Some states, such as Washington, have a long-arm statute that requires the buyer to notify the taxing authority regarding an acquisition transaction to cut short the taxing authority's ability to pursue the buyer for any seller tax deficiencies, which can be applied even in asset sales (see [Wash. Admin. Code 458-20-216\(6\)](#)).

### Income Tax

[Section 280E of the Internal Revenue Code](#) is important in the marijuana industry because it explicitly prohibits tax deductions and credits in any marijuana business except for cost of goods sold (COGS). Counsel should ensure that the buyer's accountant reviews the seller's prior tax returns, especially in a stock or ownership interest purchase scenario, for prior compliance with this significant limitation on deductions and credits. For more information on [Section 280E](#), see [Practice Note, Counseling a Cannabis-Related Business: Overview: Conflict Between Federal and State Laws: Tax](#).

### Governmental Oversight

Depending on the state and the segment of the cannabis industry in which the seller is involved (that is, cultivation, manufacturing, retail, wholesale, testing, events, or transportation), one or more state departments or agencies may have oversight, in addition to standard state agencies. Many states have a specific cannabis department (for example, [California's Bureau of Cannabis Control](#)) while other states combine cannabis with other similarly regulated industries (for example, [Oregon's Liquor Control Commission](#) and [Washington State Liquor and Cannabis Board](#)).

A state's department of public health and its food and agriculture department may have jurisdictional oversight as well, particularly related to cannabis businesses with processor or manufacturer licenses. Counsel should review all publicly-available government databases to confirm the seller's compliance status with each of the applicable regulatory bodies. The transaction may need to be reported to one or all of these regulatory bodies. In Washington, for instance, the sale transaction is first reported to the Department of Revenue, which then notifies and delegates the responsibility of transaction oversight to the Washington State Liquor and Cannabis Board.

The buyer's counsel also should pay close attention to the seller's regulatory and potential litigation-related disclosures, including those relating to:

- **Environmental liabilities.** Cannabis businesses, especially producers (growers) and processors, often use fertilizers, solvents, and other chemicals in their operations. These can lead to environmental liabilities if they are not properly dealt with. **Phase I environmental site assessments** are not often performed, but experienced buyers require an assessment unless the transaction is on an accelerated closing schedule. The purchase agreements should still contain robust representations, warranties, and indemnity regarding environmental liabilities and counsel should ensure the seller's due diligence materials include a complete list of all chemicals used in the seller's operations.
- **Undisclosed contracts and liens.** As discussed above, undocumented verbal contracts are common in the cannabis industry. Counsel's due diligence should include candid conversations with the seller and seller's counsel, if any, to discover these agreements, which may result in a lien or a claim being asserted against seller or its assets. The purchase agreements should contain thorough representations, warranties, and indemnity regarding any existing contracts and liens.
- **Product warranty and return policies for consumer goods.** The cannabis industry is experiencing a more robust products liability litigation environment. With exploding vape cartridges, new health concerns, and companies using new, unregulated solvents and ingredients, the potential for individual consumer-related litigation and class action litigation is significant. Counsel should ensure that the seller's indemnity obligations in the purchase agreement regarding product warranties are strong and that the buyer's post-closing business plan includes full policies and contractual terms relating to potential future product liabilities. Counsel should advise the buyer to strictly adhere to all applicable state laws and regulations regarding approved ingredients and industrial-use products, which typically change as the pace of regulation lags the pace of industry innovation. These internal company obligations should be memorialized in its SOP manual. All of the buyer's supply and sale contracts should contain strong representations and warranties to ensure the buyer is only responsible for its own actions and that its upstream and downstream business partners indemnify the buyer for their own negligence and bad acts.
- **Governmental correspondence.** Counsel should obtain all correspondence from state and federal regulatory bodies regarding the seller's business operations, including previously settled matters for which the seller is no longer under government scrutiny. This correspondence should be compared to public records regarding the seller's license status and outstanding tax obligations. Counsel should ensure that the seller is in good standing and actually owns its assets. In California, for example, there are hundreds of regulations governing cannabis businesses. Buyers failing to conduct proper due diligence can believe they are buying a licensed cannabis business only to discover that the license is merely pending, the business has violated rules and faces license revocation, or, following a change in the municipal law where the business is located, it must relocate or update its operational plans or permits to continue operating. It is important for counsel to understand whether potential cannabis license violations attach to the license itself, to the entity that owns the license, or to the individuals listed as responsible on the license. States vary in their treatment of this issue. Counsel should also inquire about verbal warnings and inquiries from governmental authorities and verify that these have been properly addressed.

- **Litigation and contingent liabilities.** Counsel should be particularly aware of potential and prior claims regarding employee wages and injuries, theft, and customer interactions (including, for example, altercations) with staff or other customers. If the seller's business model includes employees driving company vehicles, any vehicle incidents should also be investigated by counsel.
- **Additional relevant categories.** Depending on the scope of the seller's business, counsel should determine whether any of the following information may be relevant or helpful to request and review:
  - agreements with localities;
  - testing and purchase records for products (regarding pesticides, solvents, and other product components) (see [California BCC: Required Testing Chart](#), [Washington State Department of Health: Pesticide Testing](#), and [Oregon Health Authority: Marijuana Testing Requirements](#));
  - food safety compliance for consumable products (for manufacturer or processors), including state and local food safety permits (see [County of Sonoma: Health Permit for Cannabis Dispensary](#), [Washington State Department of Agriculture: Marijuana-Infused Edibles Processors](#), and [Oregon Department of Agriculture: Cannabis and Food Safety](#));
  - records of pre-approval of product packaging and labeling (see [Wash. Admin. Code 16-131-060](#) and [OAR 845-025-7160](#)); and
  - mandatory written policies, such as those relating to security, destruction of damaged products, and quality control.

### Obstacles to Comprehensive Due Diligence

Some sellers are inherently suspicious of any legal authority, including the buyer's counsel, and may not respond to an initial due diligence request list or may provide documents that represent only a small fraction of relevant agreements and information. This may require the buyer's counsel to be persistent in dealing with the seller's owners and managers, opting for face-to-face due diligence discussions with key personnel. Counsel should also encourage the buyer to engage in deep onsite due diligence to identify any significant business and regulatory problems.

Regardless of whether there are potentially undisclosed or partially disclosed liabilities, certain buyers may be willing to proceed with a transaction following due diligence if they are familiar with the industry, the seller, the seller's business model, and the seller's upstream and downstream business partners. Counsel should document its communications with the buyer regarding these matters to avoid or assist in later disputes resulting from a transaction under these circumstances.

### Drafting the Transaction Documents

A cannabis acquisition that is closing entirely after regulatory approval and without the buyer running the business pre-closing can be treated similarly to most acquisitions in a regulated industry. After the LOI is drafted and signed, the parties negotiate and finalize either an asset purchase agreement or an ownership purchase agreement, together with the instruments that transfers the purchased assets or ownership interests, as required based on the transaction structure:

- License application.
- For asset transactions:
  - assignment and assumption agreement, and
  - bill of sale.
- Seller financing documents.
- Management and related service agreements.
- Licensing agreement.
- Real estate documents.

An acquisition closing in two parts requires more agreements to accomplish the parties' goals. The following transaction documents are generally required, more often in an asset purchase structure rather than an ownership purchase structure.

## Initial Closing Agreements

### License Application

License applications vary significantly across jurisdictions. Some states permit license assumptions, while others only permit the buyer's new license to be issued in exchange for the simultaneous cancellation of the seller's corresponding license (see [Cal. Code Regs. Tit. 16, § 5023](#), [Wash. Admin. Code 314-55-020\(12\)\(b\)](#), [13\(b\)\(iii\)](#), and [OAR 845-025-1160\(4\), \(5\)](#)).

Generally, both the applicant entity and the underlying owners need to be disclosed and vetted to the same degree as the seller's owners, including individuals and entities with a deemed ownership interest through control or right to profits. In Washington, even spouses of owners must be disclosed on the license application and vetted to the same degree as the buyer's owners ([Washington State Department of Revenue: Business License Application](#)). Depending on the jurisdiction, license applications can be submitted at the LOI phase of the transaction alongside draft transaction documents or only after all transaction agreements have been executed in escrow.

### Purchase Agreement

The purchase agreement provides the roadmap for the entire transaction, including whether one or more closings are to be used, and may depart significantly from the terms of the LOI. The buyer's counsel should ensure that all seller entity parties are included in the purchase agreement, which is especially important where the seller comprises a network of entities and individuals. If two closings are contemplated, the purchase agreement should clearly delineate which assets or equity interests must be transferred only after regulatory approval and which only relate tangentially to the seller's marijuana business.

For instance, marijuana inventory, the license or the rights to the license, and certain service contracts and the equity interests in a licensed entity can and should only be acquired after regulatory approval. All other assets and equity interests can and generally are acquired as soon as possible to provide the buyer the maximum benefit of purchasing the business from the initial closing date. This is why a management agreement and an intellectual property licensing agreement are often used in the initial closing stage. The buyer's counsel should pay particularly close attention to the following purchase agreement provisions:

- Representations and warranties.
- Regulatory compliance covenants in effect from the initial closing through the final closing.
- Indemnification (as broad and for as long a time frame as possible).
- Employment matters (including which seller entity employs the remaining employees).
- Clawback from the sale price in the case of non-regulatory approval.
- Taxes.

For examples of clauses that parties in a cannabis-related transaction may use in a purchase agreement, see Standard Clauses:

- [Cannabis Contract Clauses: Enforceability Representation and Warranty.](#)
- [Cannabis Contract Clauses: Compliance with Laws.](#)
- [Cannabis Contract Clauses: Waiver of Illegality Defense.](#)
- [Cannabis Contract Clauses: Severability.](#)

### **Assignment and Assumption Agreement (Non-Marijuana Assets)**

This agreement assigns all non-tangible assets to the buyer, including all non-marijuana contracts and IP. This is only used in an asset purchase scenario.

### **Bill of Sale (Non-Marijuana Assets)**

This document transfers all tangible assets to the buyer except inventory constituting or containing marijuana. Depending on the seller's line of business, these assets may include vehicles, fixtures, furniture, equipment, or packaging materials. It should explicitly exclude raw marijuana, including seeds, seedlings, cuttings, and harvested materials in their various stages of processing, as well as products containing any marijuana or marijuana-derived substances. This is only used in an asset purchase scenario.

### **Seller's Unsecured Promissory Note**

When a buyer intends to take significant control of the business at the initial closing, many sellers want to stop investing any additional capital into the business. To avoid this difficulty, at the initial closing the buyer typically lends the seller funds for ongoing operations. The seller then uses these funds to make payments to the buyer under a management agreement and intellectual property license agreement, from the initial closing through the final closing. At the final closing, this loan is forgiven and any loan funds retained by the seller that were not paid under the management or other interim agreement may be offset against the balance of the purchase price due at that time. Counsel should confirm that any buyer financing arrangements comply with applicable law.

Some states like Washington prohibit any licensed marijuana company from receiving any financing from an undisclosed or unapproved financier (see [Wash. Admin. Code 314-55-035\(5\), \(7\)](#)). Other states like Oregon permit pre-closing financing by a buyer without advance regulatory approval, stating that it typically does not require information about non-applicant persons or entities having a financial interest in the seller (see [OAR 845-025-1030](#) and [845-025-1045](#) and [Guidance on Disclosing Interests in a Recreational Marijuana Business](#)). This financing may be a term note, a line of credit note, or a revolving line of credit note.

### **Intellectual Property License Agreement**

In situations where the buyer intends to operate the seller's business between the initial closing and the final closing, the buyer wants to pull as much revenue as possible out of the seller's licensed entity because all cannabis-derived revenue must continue to originate from the seller's licensed entity until the final closing. After the initial closing the buyer owns all of the seller's IP. An IP license agreement can help provide an avenue for revenue transfer. Under this agreement, the seller's licensed entity pays a license fee to use the IP transferred to the buyer in the initial closing until the final closing occurs. This licensing agreement, like the management agreement, is designed to pull revenue out of the target company and provide the buyer the benefit of every business asset, except the license, from the initial closing onward.

### **Management Agreement and Related Service Agreements**

The buyer enters into this agreement to provide a range of management services to the seller to further the goal of pulling as much revenue out of the licensed entity as possible. Management services may include, among others, management consulting, industry intelligence consulting, accounting and financial services, human resources, IT services, packaging, and sales and marketing.

At the final closing, the buyer may elect to terminate any intellectual property license and management agreements entered into as part of the initial closing because those agreements are then effective among the buyer's affiliated entities. These agreements, however, often remain in place due to tax and liability reasons. The buyer should engage a tax professional familiar with cannabis operations to determine a post-closing structure to optimize tax efficiencies. The buyer may desire to keep the license, intellectual property, and management operations in separate entities to keep liability shields in place. This is especially true in a cannabis company that has different business operations with disparate potential liabilities (like growing and retail).

### **Final Closing Agreements**

After the transaction receives final regulatory approval, the following agreements complete the transfer of the licensed portions of the cannabis business that could not be transferred at the initial closing.

### **Assignment and Assumption Agreement (Marijuana Contracts and License Rights)**

This agreement parallels the prior assignment and assumption agreement and transfer all remaining intangible assets related to the marijuana business, including the contracts, intellectual property, and the seller's rights to the license or the actual license itself.

### Bill of Sale (Inventory Assets)

This bill of sale parallels the prior bill of sale and transfers any marijuana inventory. Some states prohibit the transfer of marijuana inventory for less than its fair market value. Any non-saleable product and product not purchased by the buyer generally must be destroyed by the seller, sold to another license holder, or turned over to law enforcement for destruction. These constraints are generally consistent across jurisdictions.

### Real Estate Acquisition Closing Documents

When real estate is being acquired alongside the licensed cannabis business, the seller typically prefers to close on the accompanying real estate transaction as part of the final closing after the license transfer has been approved by the state regulator. This is because unwinding a real estate sale after encountering insurmountable regulatory issues is more difficult than unwinding an asset sale.

### Closing Agreement

This brief agreement addresses any remaining transaction deliverables or issues, which is often necessary for deals that stretch across many months. A closing agreement typically sets out:

- What occurred between the initial closing and the final closing, particularly regarding the buyer managing or operating the seller's business during that period.
- Which agreements have been fulfilled or need to be terminated as of the final closing.

For equity interest purchase transactions, the purchase agreement executed at the initial closing details the terms of the transfer of ownership of the equity interests of the licensed entity that occurs during the final closing and any related closing deliverables. Before the final closing, the parties should review the purchase agreement to ensure they comply with any requirements and take any actions relating to that closing contemplated in the agreement.

If the transaction also involves seller financing after the final closing, then the following agreements are used:

- **Seller financing promissory note.** Depending on the state in which the transaction takes place, the seller may need to remain affiliated with the buyer's license or licensed entity until seller financing reaches a certain threshold or is entirely extinguished.
- **Seller financing security agreement.** Although a buyer does not typically offer to provide security for seller financing, the seller or its counsel are likely to require it. The parties must negotiate whether the security agreement involves a pledge of the buyer's ownership interests in the newly acquired cannabis business, all assets the buyer purchased from the seller (including cannabis assets if they can be pledged as collateral), or only certain assets (for example, only cannabis-affiliated assets if they can be pledged as collateral).

Whether seller financing is a part of the acquisition generally depends on standard transaction factors, such as:

- The portion of the purchase price the buyer can pay at closing.
- How much of the purchase price the seller will receive at closing.
- The seller's confidence in the buyer's ability to continue running the business profitably post-closing.

In a cannabis transaction, a financier often needs to be disclosed to the applicable regulatory authority. Therefore, many sellers looking for a clean break from being regulated do not want to provide seller financing.