

Corporate Cannabis Q&A: Cannabis Loans and Investments

Thursday, March 3rd, 2022

Presented by [Hilary Bricken](#), [Vince Sliwoski](#), [Griffen Thorne](#), and [Nathalie Bougenies](#)

Hilary Bricken 00:05

Hi everybody, welcome to our webinar. It's another corporate cannabis Q&A. This time though it's about cannabis loans and investments. Last time, we talked a lot about M&A. And now we're moving more into the field of finance. My name is Hilary Bricken. I'm coming to you today from Los Angeles. I'm the partner in our LA office. And we have the same panelists as last time we have Vince Sliwoski from Portland, Griffen Thorne, who's in LA and Nathalie Bougenies, who splits time between Oregon and Washington, DC. And today we're going to cover a variety of topics when it comes to financing the cannabis industry, just like everything else, it's its own wild animal because of the federal conflict. Although it does have these basic characteristics that you see in other transactions. And we're going to go through the basics. As the webinar progresses, or over an hour, feel free to submit questions are back of webinar tech folks will submit those to us, we'll ask the ones that we think makes sense. And if we don't get to something, we will probably do a follow up blog post. So don't worry, in some form, your question probably will be answered. We also got a bunch of registrant questions before the webinar, we've basically compiled those into a very conversational outline. So we're going to try to incorporate your questions right off the bat. Anyway, with the time we have without further ado, I'd like to get started. Let's first talk about the types of investments that are in the industry. A lot of people I think are mystified by cannabis financing. They see all these headlines that cannabis companies are making insane amounts of money. But the truth is, they also require a ton of capital to get started and stay alive because it's a very volatile market with no interstate commerce. So the first question is, let's start with the basics. Debt, and equity. What are they? What are their main features and characteristics? And how are they playing in the cannabis industry? Do we see one more often than the other? Who wants to take that one?

Vince Sliwoski 02:01

I could. It's probably I mean, it's a simple question. And it's probably what a lot of people think it is, but we should talk about it at the start. So to raise capital for business needs, companies usually have two kinds of financing as an option, equity financing, and debt financing. And some companies, most companies maybe even use a combination of debt, and equity financing. But there are some distinct advantages to either the big definitional difference, I guess, is that equity financing carries no repayment obligation, right? That you give somebody a piece of your company in exchange for their money, and you never have to pay them back provides a working capital, then you that use to grow your business. debt financing, on the other hand, doesn't require you to give up a portion of ownership. So somebody gives your business money, you have to pay them back, they don't own any of your business. And that's basically the high level. I want to leave it at that.

Hilary Bricken 03:04

Okay, in between the two events between the debt financing and the equity financing, are you seeing one more than the other? Especially in Oregon, where until recently licenses were being issued left and right.

Vince Sliwoski 03:15

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Sure. Um, good question. I think with early stage businesses where you know, they're pre revenue, and there aren't assets to seize on for creditors with that, and there's no collateral, and they're in a startup phase, for lack of a better term, we see more equity financing. Usually people want a piece of the business in exchange for their contribution. And as businesses get further along, we see more debt, smart convertible debt, just because it's easier to raise at that point, because you have, you know, standard business financials and things that you can show to creditors, which they could capitalized upon in the event that you're unable to pay them back.

Hilary Bricken 03:59

And I know a question I get a lot, and this is kind of wearing the business hat, not necessarily the wear hat. But should these founders, these initial owners, be afraid to jettison some equity rather than taking on debt? Or does it really matter when it's that early in the company's lifecycle?

Vince Sliwoski 04:20

I don't think it should be afraid. I think, you know, each business is a little bit different. Each business is kind of a snowflake. I think the most important thing that people skip on is just documenting it correctly. And when I say document and document your agreement, directly your debt agreement, I mean, not by handshakes or by text messages, or simply by like a trail of bank paper. I'm talking about actually writing it out in the form of an agreement. So if it's a debt investment, it should be documented by a promissory note or a part of a greater loan agreement. I think that you know, beyond that, it's really up to the business and how the business is oriented, which kind of capital to raise and what's available to you, it may be easier. Some, you may just have one person on the line who wants to be a part of your business in one way or another. And they may say, look, I'll work with you, but I'm only gonna lend you money, I don't want to be a part of a cannabis business as an owner for a variety of reasons. Or you may have somebody on the opposite side, I'm not in this for the short term to make some amount of money on a loan, I want to be a part of this thing as it grows. So sometimes your options are sort of circumscribed by what's available to you.

Hilary Bricken 05:31

Right on, and, you know, you've given us a nice overview of loans lending debt, let's move a little bit more into equity. Because I think when people hear this word, they may not really understand what it means. And for that, I want to turn to Nathalie, about the main features and characteristics of the equity that you're seeing, and at least depending on state, some forms of equity may or may not be available to you, because the state might restrict the type of entity that could set up for example, right?

Nathalie Bougenies 06:00

Yeah, I think simply put an equity is basically another term for ownership, right. It's a financial stake that you get in the business, and a commitment to share in the profits and the losses. Equity may or may not come with a degree of control over the business in terms of voting rights

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and decision making, depending on the characteristics of the equity and how the business is set up. So but I'll you know, later on, we'll go into more of these differences between the voting rights versus distribution. But in a nutshell, that's basically what equity is.

Hilary Bricken 06:41

And then we've got the hybrid debt equity, right, convertible debt. What is that? What does it mean? What are the main features and characteristics? And I'll turn to Griffin to answer that one, because you've done a lot of convertible notes lately. In fact, I want to tell the audience that in the past couple of weeks, I think you've closed about \$15 million in debt financing on various transactions, including for real estate for cannabis. So give us your take on convertible debt.

Griffen Thorne 07:29

I mean, it's exactly what it sounds like you do that you do that the old someone and you have the option at some event, or some point in the future if you convert the debt or some portion of the debt into equity in the company. So for example, let's say you loan a million dollars to cannabis company, there may be the pot, you know, like it's either just whatever you want, depending on a deal, or after certain things happens or milestones are hit, you can convert into equity. A lot of the times these involve really complicated formulas for how debt actually converts into equity and the percentages and the value of each share or unit or the membership interest you're getting. And sometimes you actually can set it up where there's a fixed number you convert into at the end, it doesn't have to necessarily be that complicated, but it can be quite complicated. The real rationale for doing that is because if you're a debt lender, you don't have to take a lot of the risks you take with equity, like Vince said at the beginning of this, if you give somebody a million dollars for 20% stake in a company, you're not getting that money back, if the company fails, you're now sitting on 20% of failed company. And your best hope would be to try hopefully it can pay off its debts, and then you get 20% of the rest of the money once the company fails, right. It's the best case scenario. So when you're talking about a pre revenue company, some people may not want to actually loan you know, buy into it, but may want to buy it in the future. And the advantage of convertible debt is you can have the arm's length relationship of being a creditor, right. And the option in the future to convert a generally very favorable prices. So it seems like an optional most fate. Or you get conversion rates based on like the present day at the time of the loan is made present day valuation, potentially the company and all this is up for grabs in negotiation. But basically, it allows you to have sort of the best of both worlds option to convert to equity in the future with the security, so to speak of being a lender today. Right. So I'm actually working on a convertible debt deal right now. Those are still happening in the industry. Although in my experience. I think in California, at least what I'm seeing today is a whole lot more of that deals than equity deals. It's just what we're seeing down here.

Hilary Bricken 09:50

Yeah, I think that's due to the volatility of the market in California. Even though we've had legalization, live licensing since 2018, the dust really has not settled around things like competition and success. And one more thing on convertible debt? What typically, do you think? Is the investor profile there? Are they more conservative? Do they tend to be more

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entrepreneurial? When is it most appropriate for parties to examine a finance instrument like that?

Griffen Thorne 10:19

I think these days, there was a time a few years ago, and if anyone's been in the industry for a while, they'll understand I'm saying where people are pouring stupid money into the industry, right. And just like any investment that came up, they thought, we're gonna make millions of dollars by putting in. In those days we've seen enough companies, big ones, small ones, medium ones, just burn and fail, and then die off. And so people are way more skeptical and risk averse in 2022 than they were in, let's say, 2018 in California, or 2016. In Washington, Oregon, it's just the level is just different, right? I've seen sophisticated investors or lenders or whatever, the more sophisticated people are looking at that, right, and they don't want to necessarily put money into a company, especially for like the unproven companies or like the mid level companies who aren't as established and the chances that they fail, are going to be much higher than the chances that let's say, like a seven year operator who has positive cash flow, like there's a difference, right. So I think, today, there's much more reluctance to just jump in the equity front, at least in the deals I've seen. And you know, people who want equity are often opting to do convertible debt. At the beginning to the reasons I was talking about a few minutes ago.

Hilary Bricken 11:36

We just got a really good practical question about convertible debt. And I think it makes sense to answer it right now. Regarding convertible debt, terms and conditions, are they negotiated and finalized upfront? Or do they change over the life of the deal as the company grows and takes on additional investment or once those milestones are hit?

Griffen Thorne 11:58

I mean, I don't think I've seen a convertible instrument where it's been up for negotiation, because the idea is, if you're the guy putting money, or the person putting money into the company, you want to know specifically how and when the terms of conversion are going to hit. Obviously, the parties can negotiate it, but like any contract provision, it's only if both are willing to suddenly change it sometime down the road. But no, I mean, if you're both parties need certainty at the beginning that there's some formula. And if, you know, I suppose they could leave some things open to negotiation, but they would need to be very, very specific about what that is. Because, I mean, would you want to give a million dollars to a company and not be very certain about how it's going to convert? I think the answer is going to be no, right? So it's not something I've seen before.

Hilary Bricken 12:47

So the answer is the custom is to finalize in stone terms up front, they don't change. And typically, the benefit to the holder of the debt on conversion is that they get to buy into the company in a discount for basically cancelling the debt. That's the whole point. And that's why

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those formulas are somewhat complicated. Because usually a milestone or a trigger is a race and onboarding, new investment, so they get to convert at that point, there can be other conditions. And with cannabis, we haven't mentioned this yet. There can be conditions related to regulatory disclosure, we're gonna get into that. And that's not standard for convertible note in most industries. But moving on from the types of investment...

Vince Sliwoski 13:25

Let's talk about one thing that I kind of that we glossed over, I guess, because we talked a little bit about loans and then convertible debt. But one thing I should have probably mentioned, when you asked me that distinction between debt equity is the fact that loans can be secured. Right. And I just think that's important to point out. And when we say secured, we mean that, you know, collateral or something of value is pledged as surety, I guess that the loan creditor can seize on it the loans not repaid. So the classic example, there is a home mortgage, right? It's secured by the property itself. If you've stopped paying the bank, they'll eventually foreclose and they'll take ownership of the home. And that's because the home secures the loans and loans in addition to being securitized by, you know, personal property, real property, whatever. They can also be backed by personal guarantees, right? So a classic example there is somebody lending to a small business, they may say, oh, really, you're just a single member LLC, really, you're the same thing as the business. And I don't want you to tell me when you can't pay me back that the business has no money. So I'm up a creek, right? You have to sign and you have to personally guarantee my repayment of this loan. And loans also, I should add have to have certain terms, right? They just have to, for example, I'll often see people even lawyers, draw up a promissory note with no interest rate, for example, you can't have that. The IRS is going to look at that and consider an interest free loan to be a gift, which can have problematic tax consequences for the parties or it's allowed to impute interest to the loan under Treasury regulations, which is another headache so I mean, that's just one example of a required loan feature in this stuff that Griffen was describing, convertible notes or convertible debt have a lot more technicality and a lot more required features, I would say. But just kind of important to understand that loans can be I guess, buttress by security in general.

Hilary Bricken 15:20

And we do love security interests. When we're representing a lender. We try to securitize as much as we can, including ownership shares in the company or ownership interest, depending on the entity. We have another got another question. It's basic, but I think it's warranted to address it. Someone asked, what are the main differences between holding, let's say preferred stock, which is traditionally non voting, certain liquidation rights, it's in class to equity compared to let's say, common stock, and convertible debt? Now, to me, they're kind of apples and oranges regarding your position relative to the company. But does anybody want to take that question on?

Griffen Thorne 16:01

Yeah, I'll answer I mean, you can convert in the end. So this is the basic point I made last week? Well, all this is up for negotiation. Every deal is different. And you have a convertible note, that may not be you're converting into common stock, right, or just the normal membership

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interest in an LLC, you might be converted into preferred stock position, right? So once you're a preferred stockholder, you're a preferred stock holder right, and you have whatever rights are given to preferred stock in by the company. Like Hillary said, typically, they have certain rights customarily, but like you could call something preferred stock that has very similar characteristics minus a few things from common stock graded, it's really free for grabs, sitting on a corporate setup. So yeah, if you talk about convertible debt, I mean, the idea is that before you convert, you have zero equity in the company, you have zero right to tell it what to do, you have zero right, any distributions or dividends, none of that. All you get is payment of monthly or quarterly or whatever the deal is interesting, right? And your security, if you have any security, which, you know, again, Vince was talking about, never a good idea to not have security. But once you convert, it's just all about what you're converting into, it could be converted into common stock, preferred stock, right? It's just those are all upper negotiation.

Hilary Bricken 17:31

And the parties need to keep in mind that the conversion is in a different class of equity, than what's dictated by your articles of incorporation, for example, if your corporation or your operating agreement, if it's an LLC, you're going to have a problem, because that's not enforceable for that class of equity. So even that has to be addressed in quarterback from the outset, from the corporate government's perspective, that if a lender wants to convert into a special class of equity, this special class of equity has to be created, simultaneously with the drafting and the finalization of the convertible note. People kind of miss that step as a technicality, but it's a really big one. So moving on from convertible debt. And this I don't think it shocks the conscience or anything. But for the unwary, I'm not sure that they realize that it's a good idea to do due diligence into these companies before they just land. And that may be because a lot of the money in the industry was as Griffin put it stupid money, they weren't checking anything. They were just assuming the cannabis was gonna sell itself. Or it's money from friends and family, where there's not a lot of checks and balances, because there's trust there. But what kind of diligence should cannabis industry investor or lender perform before lending the cash?

Nathalie Bougenies 18:50

I can answer that. I think due diligence in cannabis companies is a pretty unique and more involved process than the typical due diligence that you would conduct in a less regulated industry. So some standard due diligence steps that investors and lenders should take are sample, ensuring that company's licenses are in good standing. That's kind of the first step. Another thing that's important to check is if the license can be sold because some states mandate that license holders be residents of that state, while other jurisdictions banned the sale of licenses to get altogether. Another license related due diligence step is to search search for business past and existing regulatory violations, because those can prevent the company from continuing its business operations. And in some instance, we have seen that violations can prevent a company from selling that license down the road. Generally, you can find that information on the state regulator's website. But other states like Oregon, for example, you'd have to submit a formal request form to obtain that information. Unfortunately, that process can be lengthy. And so if you don't have the time to wait for that information, which is often the case, then you would have to basically rely on whatever disclosures, the company you're looking at, is providing. Let's see a third standard due diligence step that I think is pretty important, especially

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when you're dealing with a company that's making finished products, is product liability. Investors and lenders, for example, each can understand the nature of that business. And whether the company is selling a category of products that puts them at risk, or the company at risk of liability. I see that a lot in my work with companies that are making Delta 8 THC products or products that are intended for inhalation, just because we have seen a lot of problems in terms of safety. So really, when investors and lenders are conducting due diligence, they should consider the company's risk of liability and look at things like as have any injuries, or death, then like the company's products, or does the company have mechanisms in place to deal with a product recall, which I think is a really strong sign of a well run company. So those are very relevant things to look at. And then let's give another example of a due diligence, it would be and I guess it's linked to product liability, is whether the company has adequate insurance coverage. And to make that determination, you as an investor or lender would have to closely review the company's policies, especially the policies, exclusion and coverage limitations, because some insurers include standard policy inclusions for let's say, schedule one substances and so that insurance coverage would be useless and would not protect the company at all. So some are, you know, there are many more due diligence steps that can be taken, and they vary across states, because every state has different regulations when it comes to cannabis. But I think those four probably are some of the standard ones that you'll see and should consider.

Griffen Thorne 22:40

To add to that, the insurance thing is really important. Like we have a guy here, who does insurance work, and I had him review policies of borrowers many times and find all kinds of crazy stuff that just the average insurance policies are like really tough to read. And even for trained lawyers who do corporate work, it's like a different language, right? So that's really key. Because as a lender, you want to make sure that if the property if you're if you're loaning and there's a security interest in property, that it's covered in the events mode burns it down, right or there's a flight or earthquake or something which, in California, it's totally possible. But also like diligence, I just cannot underestimate under emphasize this. It is so key for lenders to do this. And it is also something that is you come up with fierce resistance, a huge part of our practice over the last few years has been, even when we don't represent necessarily in the actual loan itself, and telling an investor or a lender, they'll hire us to look at a company and do diligence on them and tell them should I invest my money into these people? Or is it a risk? Or at least what are the risks? And we have heard some absolutely crazy stuff. I mean, I remember once people refuse to give us diligence because someone had loaned them a lot of money. And someone else loaned us money. So why are you guys asking these questions, there's a lot more that we're gonna learn from you. So it's stuff like that that comes up quite frequently in the industry. And you need to be aware of it upfront before you build a lot of time or waste a lot of time negotiating people. Just getting the diligence out of the way right away. Just keep in mind.

Hilary Bricken 24:23

Yeah, I would say if any prospect is telling you, well, this person lent us money. Why are you asking questions? You need to turn it? That's really great. And it's very telling of what's happening behind the scenes. But is anything off limits in the diligence process when we talk about financial diligence with these cannabis licensees ancillary businesses? Or should it just be a buffet of anything the lender wants to get comfortable?

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Vince Sliwoski 24:53

I mean, I tend to push clients toward more disclosure, it's not unreasonable for them to ask for an NDA right? I mean, if you're really going to open it up, and people want to look around inside your company, and they may not ultimately agree to do business with you, you want to be protected when they leave, I mean, people could even be pretending that they want to invest in you to gain some competitive advantage in the worst case scenario. So I don't know, I mean, certain things, you may keep off limits, like trade secrets, right? You may not explain exactly what those are, how those work to a prospective investor, other than the fact that maybe you have them, stuff like that, but standard types of company information, financial information, I think you have to put it all out there. If you were borrowing from a bank, they'd make you put it all out there. Company documents, you got to put all that stuff out there if you're an LLC, your operating agreement, other types of agreements, if you're a corporation, shareholder agreement, etc, you have to put that stuff out there, because the lender wants to see that your company makes sense that it's like well run, and that you're able to repay the loan, you know, by the terms of your agreements, or whatever it is. So all that stuff should be should be out there. And, you know, if a potential lender or a potential investor in your company wants to know all sorts of stuff about your company, but not agreed to non disclosure, that's another issue. But if they're willing to agree to non disclosure, I think you gotta err on the side of disclosure.

Hilary Bricken 26:22

Yeah, and this is the really fun part. What are some notorious red flags? Maybe the top five, right? Because there are so many, but we can't get too far afield? What are the big ones that lenders and investors should be looking for? And then maybe on the flip side, if you're the company looking for financing, what are red flags on that side of the aisle?

Griffen Thorne 26:46

I think the biggest one was the one what I said when they wouldn't give us information. I mean, like, anytime someone's not giving you information, that's a huge problem, right. And like if you offer an NDA, and they're still not willing to give you information, I would just say don't do the deal. As a lender, it's easier to walk away. We've told people to walk away many, many times. I've had prospective borrowers literally terminate negotiations, because they asked me questions and like to sort of go back to the last question for a second. You can overdo it in diligence, for sure. Right? If you're loaning \$50,000 and you're asking for diligence, it's just going way overboard. There is a balancing act, right. But like on big ticket deals, everything is fair game, right? Because you're really banking on these companies to be able to pay you back. And oftentimes cannabis interest rates, which is way higher than you normally see. So like, not giving information is just like the number one problem if the company's overly leveraged, right, so you want to find out what their other debt is. And if they have a lot of debt, where if there's provisions that would put other debt ahead of yours, make it more senior, if it's secured. And sometimes there's negotiation about that. But if you're lending to a company that's already very, very leveraged, that can be a huge problem, because if the minute they don't do well, everyone's like vultures are going to circle around them. Right? And you want to make sure you're the first vulture in line, so to speak. Yeah, like regulatory violations, just not doing things

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the right way. You know, I've seen companies say, oh, yeah, we have facilities in like X, Y, and Z city. And then we ask, oh, can we see licenses? Oh, we're applying for a license, we don't have a relationship yet. Do they? Why'd you just say to us, you have facilities that are in the cities if you don't even have a license, right. And so it's just stuff like that all the time, you need to constantly be on your feet, checking things, double checking things. I've seen many, many times we're on the eve of closing, and some massive new discovery comes out. Oh, we just figured we just found this out. By the way. We just found this out, we could not have discovered this earlier. So that's a huge shame. And then one more thing, that constantly comes up in negotiations, not just in this, but in M&A, basically, any other kind of deal. If you have a contract, purchase agreement, whatever. Oftentimes, there's representations by the borrower or seller or whatever, that's, to the best of our knowledge, X fact is or is not true, right. So like, to the best of our knowledge, you know, we're in compliance with all laws, the best of our knowledge, we paid all our taxes, when they start negotiating and saying, we don't want it to be constructive knowledge. We want to just be actual knowledge. My ears prick up a little bit, because if you're not familiar with the difference between those two, actual knowledge is, I have actual knowledge that effect has occurred. I know it, it's, you know, my walls are painted white. I have actual knowledge that they're white, right. Constructive knowledge is a legal term meaning you should know something if you acted reasonably right. So if I get a package from the IRS that's six inches thick, and I don't open it right well, I don't have actual knowledge that I, you know, maybe I getting a tax lien against this or that asset, right. But I should have opened it, it would have been a reasonable thing for me to do and open it and look at it and figure out what it says. So constructive knowledge is always key.

Hilary Bricken 30:19

I would say I'd add to that just from personal experience, get an org chart as well, before you commit, if it's a convoluted corporate structure, that's going to tell you right away, that there are probably fires elsewhere. And if you can't understand it, that's hugely problematic. Also, for personal guarantors, which we try to seek out a lot, because some people don't want to give secured interests, you need to diligence, the person providing the personal guarantee. Typically, it's going to be an individual high net worth wealthy person. And I would recommend at least three months of bank statements, six months if you can get it and at least three years of tax returns so that you know that the person is good for it. Otherwise, the guarantee is completely and totally meaningless. Now let's talk about tools to retrieve some of this information. Because we get very annoyed as attorneys, when we send out diligence lists and nothing comes back or months go by and nothing comes back. What can we avail ourselves of in the public record, to shore up some of this information about these people?

Vince Sliwoski 31:26

Sure, I could probably answer that. So I mean, you'd be surprised that what all is out there, if you kind of know how to search, the classic tool is just internet research, right? Google, if you're looking at investing in a cannabis business, you should be able to find out relatively quickly just from a Google search, whether that business is in good standing with the state that will be on the Secretary of State's website, whether it's licensed by the relevant cannabis agency, as Nathalie talked about earlier. But beyond that, you can gain access to information that may not be just published on Google by putting in a simple public records request. In most states, all states have open record laws, open government laws, and you can get a lot from the

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administrative agencies interacting with the licensee with whom you're going to invest and some of that can be pretty valuable. Here in Oregon, for example, we run one of those requests, literally every time we're helping somebody buy a business, but sometimes invest in a business. Because you want to know, are they about to lose their license? Have they had a bad compliance history, it cetera, you'd be surprised what pops up in these files, and it costs nothing, typically to ask for them. Or maybe sometimes you pay a small fee for the state making photocopies and things like that. Beyond that, there are also private tools to access public information. So by that, I mean here here, for example, at our law firm, we subscribe to this pretty powerful skip trace software, and we can type in somebody's name. And it pulls up this huge report on you know, have they ever been convicted of anything? Do they have any judgments against them to have any liens against them, etc, etc. And that's incredibly valuable for researching, say, you're going to invest, like we talked about the single member LLC, or where the business is really dependent on one key person, it's nice to know about that person. So you know, ask your law firm, if they have any sort of proprietary search tool, some of those tools are only available to say law enforcement and law firms and things like that. So sometimes working through your professional representatives office can be a good way to go on that. But those those are generally the public tools that can be used in diligence gathering. And, again, free to do for the most part, got to do it, if you skip over it, and you find out something later that you should have known you'll feel pretty stupid. So start there.

Griffen Thorne 33:41

Don't forget to add to that, UCC lien searches, ICC or lien, it's when you have a security interest in something you're permitted. Most of the time under the security agreement to file what's called a UCC-1 statement, which will be put to California they're on the Secretary of State's website, you would search a business and see if they have UCC-1 statements with your show existing security interest. A really important point, though, is that some people don't actually go and file them. So there could be security interest out there that don't show up. But like deeds of trust mortgages, the things that affect actual property, those should be available to the county until law firm can be able to find those through like a business report, property search, things like that. So you'll be able to see any sort of recorded instrument but protects property which most states they wouldn't even be effective if they're not recorded. And then UCC filings, but just what it says is like, you cannot just rely though alone on a Google search because there's just naturally going to be stuff out there that's not it. And so, I like to send a written Diligence Questionnaire that has spots for people to like literally check or write N/A or applicable with notes because if they say for example, note that there's no security interest on our on our property, right? There's no deed of trust. out there, they wrote No. And then turns out that there are, well, then you have, they can be potentially liable for fraud or violation of a representation warranty. So I like to get things in writing, if I can, and insist that people respond to the actual questionnaires. It's really helpful for later down the road. You doing your own diligence is key, and then also researching regulations, because oftentimes people tell you, oh, yeah, the structure that we want to do is totally legit. And then you go look at the regulations, and you're like, wait a second, it's not legit, or there's all these other caveats that you just glossed over, that are going to make this deal a lot more complicated.

Vince Sliwoski 35:35

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Yeah, there's sometimes they need the money really fast, because their business in a precarious place, right. And they'll be like, don't worry about the disclosure. We can do that later. I mean, a lot of states require you to disclose to them, if there's a new owner coming in, or if there's a lender up above a certain amount before that money comes across to the business. So check out the rules, like Griffen said, it's a trust but verify thing, in my opinion. So if somebody is saying yes and no, and etc, etc, on the due diligence checklist, fine, but check it out for yourself, too. And there's certain classes of diligence you can do that are more specific to certain types of lending, like real property, Griffen talked a little bit about looking up deeds, and you can get lot book reports, and you can work through title companies, etc. But yeah, I mean, you'll never be sorry, you didn't do enough diligence. I'll say that.

Hilary Bricken 36:22

Yeah, it's basically a form of leap of faith. There's only so much that you can uncover but a seasoned law firm, should have these comprehensive checklists to basically record the responses, be able to evaluate the danger in the transaction. And then it's a business decision for the lender if they're willing to proceed in the face of a certain amount of ignorance. And that's where the drafting becomes very important on the actual documents regarding things like knowledge, representations, and warranties. And just to kind of close out diligence really quickly, what are some of the specific diligence issues related to cannabis rather than what you'd see maybe in a normal arm's length financing deal that licensees have to deal with and investors and lenders should know about?

Vince Sliwoski 37:14

Well, for me, some of its on the financial side, because and a lot of that, in my experience relates to record keeping. Cannabis businesses, for a variety of reasons are often lackluster record keepers, I'd say. Some are bank, some are not. When you're dealing with a non bank business, you're dealing with a cash business, it's harder for a cash business to compile accurate financial records. And it's harder to audit those records. So you know, circling back around, ask for financial statements. As a lender, you want to see a balance sheet for sure. You want to see P&L for a year too, debt schedules as Griffen referenced, it should be in the balance sheet, but still, and hopefully you'll see a tax return or two. Things like that, and talk to the business owner, that's part of diligence to talk to people. And if it's a bigger business or a bigger loan, if you're under the seven, eight years, you're talking to the controller or the CFO of the business, you're entitled to do that, try to understand their cash management process, make sure provisions have been made to pay not just payables and invoices in the regular course, but other senior debt and obligations that could make repayment of your loan harder. And lastly, I would tell people to ask about taxes, right? Cannabis businesses pay a lot more than regular businesses impacts because of the punitive Treasury code section called 280-E. So ensure that they've been budgeting for this and quarterly reporting, because they should be making estimated payments, a lot of these businesses and make sure they're sort of factoring the full tax hit into the cash flow planning. I've seen businesses just drop the ball on that.

Hilary Bricken 38:43

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I'd add to that, just prospectively, all of these states have disclosure requirements. And then we touched on it briefly for anything from owners, which can be a statutory term, it doesn't always mean equity, to financiers due to parties of interest, depending on the level of financial interests, sometimes it can come down to the amount of the interest that's in play. And there are strict timelines around when you must report sometimes is actually before there's any kind of a closing, I can tell you where we're at in California, it's basically 10 days after you close the transaction, we will have to have disclosure. And that sometimes means that the financial interests are going to be subject to things like background checking, fingerprinting, they'll be giving over certain amounts of personal information. And they need to be prepped for that because we've had situations where the deal has been done. And then only after the fact the investor or the financier finds out that they have lo and behold, have to disclose the state. And we all know who the state shares information with that would be the federal government. So you're going on record essentially as aiding and abetting and conspiring to violate the Controlled Substances Act with drug traffickers. It's not an insignificant event. So make sure before you do the deal, after you've cleared the diligence and had your heart attack, that you understand the regulatory sphere, what's gonna be required around disclosure and timing. Let's talk a little bit more about compliance, it's kind of a nice segue is any kind of investment typically allowed universally in the cannabis industry on this crazy, crazy state by state basis?

Vince Sliwoski 40:12

Sort of, it depends and when I say it depends, I'm not really talking about, you know, equity versus debt or something like that I'm talking more about who can invest and when they can invest. A lot of states have disclosure and vetting requirements, especially at certain thresholds of business involvement. So, I mean, yeah, most states will allow you to make a million dollar loan to a cannabis business. But perhaps that may not be until you're vetted. Most states will allow you to be an investor in a cannabis business unless you've committed all these hideous crimes recently, or something. But again, you may not be able to invest exactly when the business would like you to invest, or when you'd like to invest. So a really important thing before moving money over is just understanding how the regulatory structure is with respect to what we call ownership interests, or financial interests or beneficial interests in the cannabis business. And beyond that, if you're clear on the regulatory side, typically within most states, there's no reason you can't do whatever kind of thing you want, whether it's a simple equity play a simple debt play where you get fancy with a convertible note that has all sorts of complex terms in it, like Griffin described.

Griffen Thorne 41:27

We got a question asking if California, our lenders subject to disclosure requirements, it's pretty unequivocally clear that they are in the state of California. The DCCs rules say the difference between financial interest holders and owners, the difference being that certain equity or debt positions may render someone a financial interest holder, which is like a low disclosure requirement here. And it's always after the fact at state level, but owners requirements are different and involve background checks. And so if you're like El Chapo or some really bad guy, you're probably not going to be able to loan money, especially to report or own, you know, significant amount of equity in cannabis company. So, yeah, I mean, I don't think I've ever seen a situation where someone loaned money through cannabis company, I don't think there's a good faith way to say that's not a financial interest.

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Hilary Bricken 42:25

Agreed, although we do have statutory exceptions, that don't constitute financial interests that are beyond the scope of this talk. But straight lending, it's going to land you in a financial interest holder position, unless you are a financial institution, namely a bank or credit union. But good luck trying to get a line of credit or loan from those guys. What about for hemp related investments or their investments that are kosher versus not? What's the regulatory landscape for hemp?

Nathalie Bougenies 42:52

I think that it's actually very similar to what Vince described in the cannabis marijuana space. But for him, really we're talking about key participants are basically people who have some sort of control over the company or have a certain level of ownership interest in the company they have them do a criminal background check to make sure that they don't have any felony conviction on their record. And if they do, then they can prevent them from being able to invest in the company. Also, any change of ownership or in the business structure by a licensee typically has to be pre approved by the state regulators. That's very much the case in Oregon, for example, where I practice. And then you also have some jurisdictions in the US where they put a cap on the amount of ownership interest that every investor can hold in that company. So these types of restrictions really have to be addressed with investors before they come on board and start signing documents.

Hilary Bricken 43:59

And this is a fun one. And a question that we often get. I'm smiling because it's so reminiscent of the early days and cannabis where nobody wanted to go on the record for pretty much anything but our investments in cannabis businesses, public record, can anybody find out who's financing these things at any time they want?

Vince Sliwoski 44:20

Usually, they are. I mean, it depends on the state. I don't know the rules in every state. And states are kind of thinking harder about that. Like here in Oregon, for instance, we're coming online with psilocybin business licensing and in that they wrote specifically into the measure that you don't have to disclose all the owners, which is sort of interesting, and I bet a lot of cannabis businesses wish that had been the case in the early days because I remember a lot of deals where people came to us with actually really famous people and celebrities and people wanted to pour money into these businesses but did not want to be disclosed or beyond the record. So they backed out in many cases, are they public records investments in the businesses? Kind of I mean, most states require you to disclose again, the financial interest holders and such as we just learned about. And with debt holders in California, states are different in they don't often require you to disclose the exact amount, although sometimes they do. And states are different with respect to whether they actually want to see the loan agreements themselves. And they kind of go back and forth on that. Oregon for time didn't want to see them and then for a minute,

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they did not, they never asked for them again. So the actual document itself might not be a public record. But the fact that you invested in some way might be a public record, it really depends on the state and the time.

Griffen Thorne 45:36

I want to add to that, that you're in California, for example, there's one, there's a search tool, so you can search a licensee. You can search an owner by name and or someone who owns more than 20% of the company or has a certain position in a company or in some cases can be a lender, if you qualify as an owner that their status as an owner is searchable, right. But as a lender financial interest holder, it's generally not. But any any information you give the government theoretically is public record, unless they can find a grounds not to produce it, right. So open records laws of fifth name, Brown Act or something California, whatever, you can send requests to the DCC here, and say, give me X information about a licensee in my experience, the DTC is just going to sit on that for a very long time, and then say, we can't share that with you. But theoretically, if someone sued them, they might be able to get it. The key point, though, here is even if it's not public information, that does not mean that the person who's a lender can refuse to disclose that on, say, an immigration petition, right. So this is a huge point, because we've wrecked lenders who are not US citizens, and it can totally affect your ability to come into United States, standing United States, become a citizen, all that stuff. And so, if you've asked, are you involved in any illegal businesses? You can't say no, even if you are just because it's not a, you know, easily accessible public record, right, that would be potentially fraud and all, you know, all kinds of a mess. So yeah, I mean, it may not be something you can easily find. But that doesn't, it doesn't mean you can just then go and like, lie to people essentially about it. Right? So it's a kind of a cargo careful thing to navigate for clients, which is like, hey, we don't want this to be out there. But we still have to be honest, if we're asked that question in business or government transactions, that makes sense.

Hilary Bricken 47:35

And regarding drafting these instruments, what are some of the cannabis intensive provisions that you guys usually put in there or that you see from other counsel, that should be in there really, for the protection of both sides?

Nathalie Bougenies 47:54

I can take that. I think the one provision that you see regardless of what instrument you're using, admission agreement, promissory note, is basically that the investors are obligated to comply with all applicable state and local cannabis laws. This helps ensure that the company can secure or maintain a license. So that's pretty critical. Another thing that you see for instance, with promissory notes, if you're, you know, when we draft them in the context of an acid purchase agreement, that promissory note cannot be effective until you close on the acid purchase agreement. That's because you can basically exchange money with a licensee until the state has approved that transfer. So that's pretty important to make sure that money is kept in escrow until closing and then the data point when you get all the state approvals, the money can be released. That's pretty key. Another type of provisions that we often see address the significant risks that are associated with investing in a cannabis company. For example,

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prospective investors need to understand that the company as we discussed, discussed earlier with Section 8-E, won't be able to take any tax deductions and claim business tax credits, because their business activities are deemed unlawful under federal law. So those are some of the things that they should preach before they start investing. And then when it comes to hemp derived products, for example, prospective investors should also be warned of the risks of enforcement actions under federal law. If you're at all familiar with this, any company that manufactures for example, dietary supplements, or food products and mix any medical claims, is very much susceptible to receiving a warning letter from the FDA and that can have pretty severe consequences on the company. As a publicly traded company, they can be sued by their shareholders because the value of their shares will drop. Inevitably, if they receive that kind of a letter, they can also be faced with consumer class action lawsuits, we're seeing more and more companies being sued for selling or marketing products in a way that's deceiving, and consumers are getting injured. And so all of those things should be in solid agreements that pertain to investment really.

Griffen Thorne 50:39

I have a thing to add to that too, which is that I think there's something I see all the time I work with borrowers. When you go up against a really big firm that may not have had a lot of experience doing that deals or something, but not necessarily in the cannabis space. They like to throw in things that just aren't going to work in the cannabis deal. So like one thing I see often is taking a security interest in a state license, you can't do that in California, because you can't tell them that history interest in the cannabis goods themselves. I don't think there's necessarily an interesting issue with a backup. I don't think there's necessarily an issue with taking security interest in a license or cannabis goods themselves. But once you go and try to take those things, A. you're not gonna be able to get the license and B. you might be walking yourself into criminal liability. If you take over cannabis goods, like thousands of pounds of flour, you don't have a license, right? What are you gonna do with it? So these are just considerations you need to think about and work through in erecting a bar or because for even a lender, you it's important to think about. The other thing that comes up very often that I think is the issue is that pledges, pledges, like a security interest. So if I am a lender, I want to pledge from the owners of the borrower, for example, that if they default, they'll just give me their equity interest in borrow, right? It's a different kind of security, but like, am I prepared as a lender to go in and start operating the cannabis company? Probably not, you know. And so if I'm getting a pledge, I need to be able to just need to consider that and think through it. What am I going to do with this? If I actually have to get ownership with a cannabis company, you may not know it, you can just assign this and sell off that, that right to somebody else? These are just things you think about a great cannabis deal, that may not be the case, if you're buying like a gym, right or a pizza parlor, it's just going to be very different configuration.

Hilary Bricken 52:33

And a footnote is for anybody who has forgotten or doesn't know, these companies cannot file for bankruptcy in federal court. So if it all goes to hell in a handbasket, you're not going to get relief as a creditor or secured or unsecured in a court of law when it comes to bankruptcy. So that's another issue the worst case scenario that has to be quarterbacks and the agreements, over priority of payments, potentially receivership and the agreement to appoint a receiver if there's an underlying claim regarding default. But keep that in mind, it's not going to be an easy

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exit. If these companies fail and can't pay you, restructuring them is very difficult because of the regulatory situation that they face. And bankruptcy is not available. Now. In the last, let's say, seven minutes or so that I have with our panelists. I want to do some flash round questions about loans, equity and convertible debt specifically. And I'm actually going to go back to convertible debt. Because we got this question beforehand. And we got it during the webinar. And I'm going to direct this events. What's the difference between a standard convertible note and a warrant and then a simple agreement for future equity, commonly known as a stakes agreement?

Vince Sliwoski 53:46

Okay, good. Well, in order to explain the difference, I got to talk about what a few of these things are. We talked about what a convertible note is a warrant, most people have heard of a warrant, it's a contract, essentially, just like all of these other instruments between a company and an investor. It gives the investor the right to purchase a company stock at a specific price. And at a specific date. And that specific price is often referred to as the strike price in the document in the warrant. And again, it's issued directly by a company to an investor. So pretty simple. It's different than an option, which is something that can be traded between and among investors. Stock warrants have been around forever. They weren't as popular in the US or the cannabis industry, I would say prior to the rise of Spax in the last few years, that's back to the special purpose acquisition company that's outside the scope of this presentation. I would say that investing in warrants may be a consideration if you have limited funds, but you want to have an opportunity to benefit from stock gains as an investor. People often also invest in warrants use leverage, which is just a strategy where an investor can happen to borrowed capital to potentially bolster gains from an investment. Warrant prices are also always lower than the cost of buying actual shares of stock. So it's important for both the company and the investor to sort of understand when presenting the idea in the first place, I guess. from an investor perspective, you can acquire more words for your investment than actual shares, increases the number of shares you could cash in on should the stock price go above the strike price written in your warrant. That's basics. safes are a really interesting difference between safe and a convertible note, let me explain what a safe is, I guess they're they're relatively new. People like them, because they're simple and simpler than convertible debt. And they tend to have lower transaction costs, too. So both safes and convertible notes, try to get the company investment in its initial stages, their early stage, investment vehicles, and the investment in with a safe just like with a convertible note later turns into equity in the company. But they contain a lot fewer of these lengthy clauses that you'll find in convertible notes, they're less detailed, I guess, they were actually introduced to simplify the working of convertible notes. There are a lot of differences I could go through, but I'm just going to highlight a couple of quick you know, a lot of time. One is interest rates. In contrast to notes, eighth notes don't actually require the company to pay interest, whereas convertible notes do. So the interest rate for convertible note maybe I don't know, 4% to 10%, or something in the cannabis deal safe doesn't have to have that. Companies like it for that reason. Maturity date is another big difference. Convertible notes include a clause for maturity date, not present in the safe note, founders aren't put under a schedule in a safe mode, they don't have some deadline where they have to either return the principal amount or convert it into equity. Control is another big one. So you know, the detailed nature that we've been talking about of convertible notes works as sort of a benefit. By providing the company with a larger degree of control, you have very detailed terms and conditions for everything, every procedure from a conversion all the way to the maturity date. It allows for

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more planning and more control by the company. And then the last thing is sort of the conversion, how it moves into equity. A safe is always converted, I think at the next round of financing. So if you offer a safe or you give out a safe during a seed round, you would be able to convert into equity in the next financing round. That would be the series A if you started at seed. But for convertible notes, it's what you negotiate like we've been talking about maturity could trigger at any point, it could be prior to the series A in that example or during or after, sort of depending on the design of the note. So in the cannabis industry, that's all what makes founders lean more towards safe notes. Because again, there's no additional liability of paying interest to the investors and they're simpler to set up. I don't know if we'll see that actually bear out in the next few years of practice. But that's that's my thinking on it.

Hilary Bricken 58:03

Basically, what are the considerations for repayment from these businesses, especially when we're dealing with all cash?

Vince Sliwoski 58:12

Considerations for payment? Well, one might be you know, whether you want to be repaid in cash. Some people are uncomfortable handling really large amounts of cash, both for bank depository reasons or safety reasons, or whatever. I know, I wouldn't want to get some giant suitcase full of cash for repayment of a loan. I think another one is whether your some, almost all notes have language in them which say you have to be repaid in immediately available funds, I can see somebody in the chat asking about the IK, which is payment in kind with respect to loan interest, you have to decide whether you're going to allow that kind of thing. I generally steer investors away from it. But you know, that's another consideration with respect to repayment, and then all the reporting that goes along with it. You want to make sure that what the business is booking is consistent with what you're booking, as far as transactions tax return, that kind of thing. So that's high level.

Hilary Bricken 59:09

Okay, guys, I really thank you for your input. We're at the one o'clock hour at least on the West Coast. And I want to thank our audience for being so attendant, for almost the entire time. There are about 120 of you watching us on the webinar. We always really appreciate that. And we hope that you'll join us for the next one. Thanks again for the time and attention. We appreciate it.