CUSTOM CONTENT

MAY 27, 2019

THE BUSINESS OF CANNABIS

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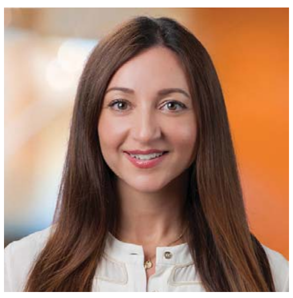

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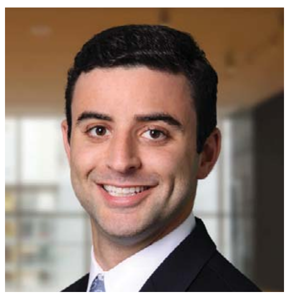

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The cannabis industry has been heating up and has clearly become one of the fastest growing business sectors in Southern California. The landscape of managing such businesses has rapidly evolved as well – with laws, regulatory protocols, best practices, consumer and business needs and industry trends seemingly changing by the day.

To take a closer look at how the cannabis industry is shaping up in 2019, we asked some of the subject's top experts in the region to share their thoughts with us. Across the next several pages, you'll find the inside story and relevant insights on topics ranging from investing and tax planning to legal, insurance and packaging needs within the rapidly evolving sector.

BUSINESS OF CANNABIS

IMAGE COURTESY OF COLORADO CULTIVARS

Cannabis Insurance - From Seed to Sale

By GREG WINER and TREY BUSCH

The level of complexity to operate a cannabis business and the myriad of federal, state and local requirements businesses face requires a diligent and thoughtful approach to bring "out of the box" results, and deliver on relevant solutions. The cannabis industry is operating in an environment where limited insurance options and solutions exist and where few insurance companies will underwrite this coverage. The current environment requires cannabis growers, operators, manufacturers, delivery services and all supporting affiliates select a broker that has an articulated path forward and the market strength and knowledge to help cannabis businesses reach their goals.

In the U.S., insurance companies have been steadily creating products to help cannabis companies mitigate risks. Below are the essential insurance coverages to consider.

CROP COVERAGE

INDOOR RISK

The good news is that the cost of coverage for growing in a controlled environment has reduced over the past couple of years. Understanding how to cover the business translates to really knowing the costs to grow and how to get the crop to each stage. These risks are broken down to living plant material, harvested plant material and finished stock. Documenting costs at each stage will need to be recorded if a claim is made.

OUTDOOR RISK

Opportunities for outdoor coverage exist for cannabis, but it is important to understand what is being asked, what is needed, and finding coverage that can truly provide the adequate protection. Growing cannabis is a major investment and covering that investment properly is good financial strategy.

PRODUCT LIABILITY INSURANCE

All companies operating in the cannabis industry regardless of being plant touching or non-plant touching face risk with regard to the products they are selling. Coverage is intended to protect the business owner against claims of property damage or personal injury caused by products sold or supplied by the business. As businesses continue to grow and expand the network of suppliers, it is important to get added as an Additional Named Insured on suppliers' policies, and collect full copies of their insurance policies to determine "IF" they have coverage for what they're supplying to the business. There are many opportunities within these policies that may list an exclusion or gap in coverage that may leave companies exposed.

MANAGEMENT LIABILITY INSURANCE

All cannabis companies should consider having Management Liability insurance due to the many unique challenges they face-- a hostile regulatory environment, limited access to bank services and a large influx of money from sophisticated investors.

The following coverages are often included in the Management Liability package.

Directors and Officers (D&O): D&O insurance is a great tool to protect a company in the event of regulatory action. Even though federal enforcement of the Controlled Substance Act cannot be covered because you cannot insure against illegal activities, coverage for state and local enforcement issues is provided.

Ignorance is not bliss! Claims may arise when a company is non-compliant with state regulations, even if a company believed they were strictly adhering to regulations. For example, California recently introduced a legislative bill, AB 1356, which if passed could require cities to permit one dispensary for every four liquor stores. Should a company not adhere to this, they and their officers would be severely fined.

Limited banking options have created unique challenges to companies in the cannabis space. Access to checking accounts is often expensive or hard to come by, which created a cash intensive environment. It's imperative to keep good records as these are needed for payroll documentation and showing investors and the IRS company profits and expenses.

Lack of traditional funding has created a number of issues and exposures from private lenders or selling shares to fund growth. The largest claims in this instance are for not returning the loan or mismanagement of funds.

In addition, D&O insurance is becoming a requirement to hire experienced executives as this industry grows. These executives want to ensure they have coverage in the event of a claim.

Understanding how to cover the business translates to really knowing the costs to grow and how to get the crop to each stage.

Employment Practices Liability Insurance (EPLI): All companies with employees should consider EPLI coverage. Improper termination and discrimination claims can be costly. Although cannabis companies face the same risks as other companies, retail stores and grow facilities are at a heightened risk for third party claims, due to the nature of the business.

ALLIANT ALTERNATIVE RISK FINANCING/CAPTIVE FORMATION

As with most emerging industries, the availability of insurance coverage and the cost of coverage is an issue for cannabis companies. A captive insurance company could provide a cannabis business the ability to create its own insurance risk financing solution by offering customized coverage, a vehicle to share risk on difficult-to-insure cannabis related exposures and cost savings. We understand the challenges in the current regulatory environment on captive formation, and our team is on the leading edge in working with insurance markets and regulators to find captive solutions.

Our history as a Specialist insurance brokerage has allowed us to strategically support and advise our clients' business operations regardless of their involvement in the marijuana and hemp industry. We work with various segments of this business including:

- Multi-state operators
- Grow/Cultivation operations
- Manufacturing and processing facilities
- Retail/Medical dispensaries
- Delivery services
- Cannabis lounges
- Ancillary/Support services

Alliant has solutions for your cannabis business. From seed to sale.

At Alliant, we understand the potential risks facing cannabis businesses every day, from seed to sale. We take a long-term, all-inclusive approach to the business, with a focus on understanding every touchpoint, so we can help anticipate what lies ahead. We're not in the business of selling a product or program. We're in the business of empowering clients to deliver the highest quality products to the market and drive the outcomes that matter to their business. Our creative solutions are structured specifically for cannabis businesses, leveraging long-term relationships with key industry specific markets to manage the risk, and protect business assets. Call us!

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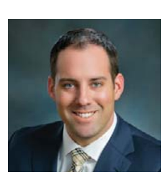

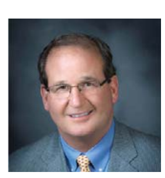

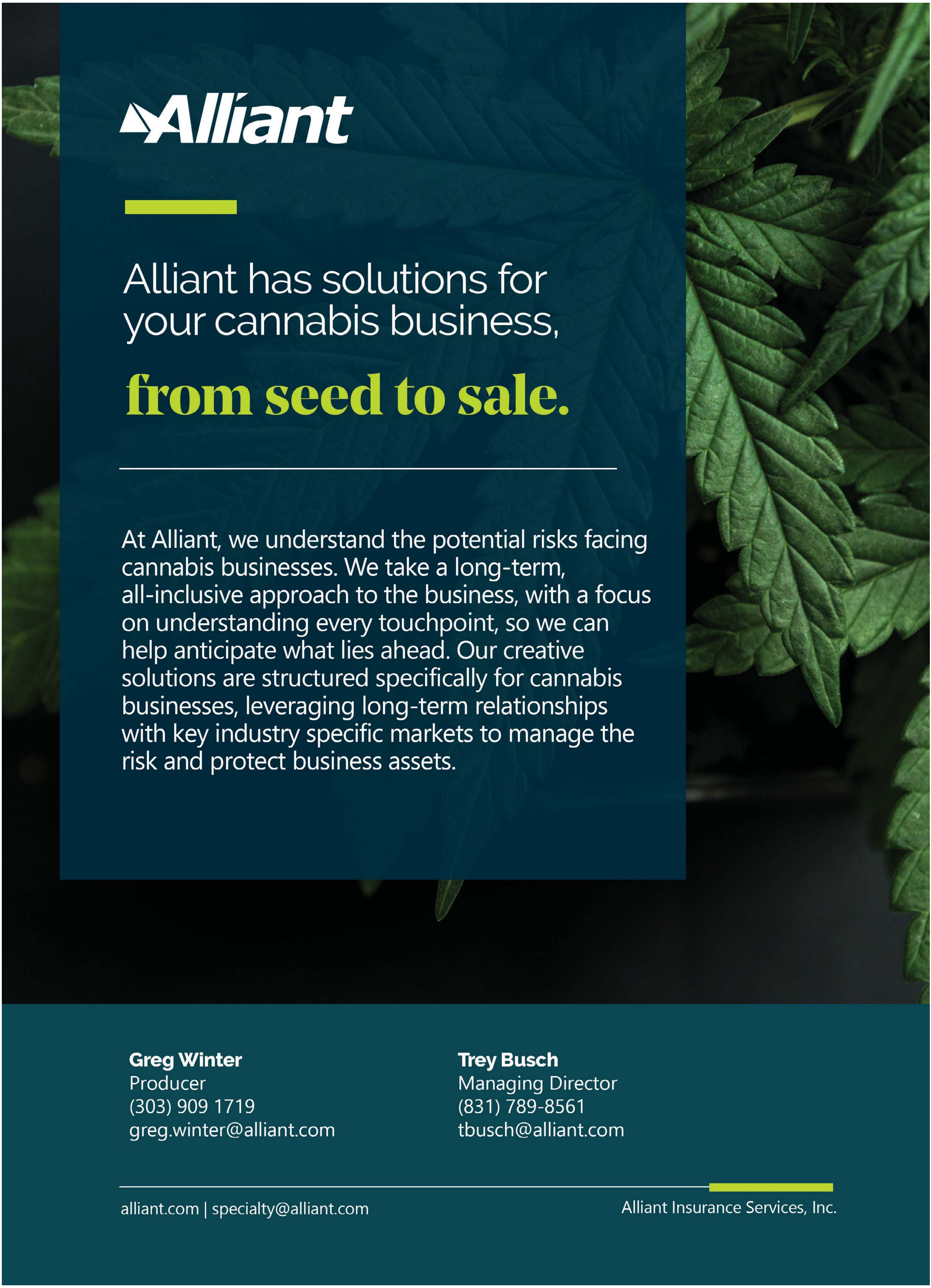
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BUSINESS OF CANNABIS

Counterfeit Cannabis: A Threat to Public Health

By PRIYA SOPORI and STEVE STEIN

Walk into a cannabis dispensary and chances are you will see on display products of some of the top brands in California, such as Heavy Hitters, Absolute Extracts, and King Pen. You will see certifications and stickers on the packaging itself, indicating that the product has passed California's stringent testing standards, clearly intended to reassure you that the cannabis is clean.

What you may not know, however, is whether what you see is genuine or not. A thriving market exists of unlicensed dispensaries selling cannabis that bears the labels and markings of legitimate product, but in fact is not.

Where profitable business goes, cheaper counterfeiters will follow. Counterfeit cannabis not only undermines the legitimate cannabis industry by hurting sales—not to mention robbing state and local governments of tax revenue—it is also a public health issue.

Just as is true for other food and drug industries, cannabis is subject to regulations that require testing. California regulates the entire chain of distribution of cannabis. From cultivators to manufacturers to distributors to retailers, everyone must be licensed. The California Bureau of Cannabis Control ("BCC") mandates that all batches of cannabis be sampled and tested by a state-licensed laboratory for an array of possible contaminates as well as for the potency of the cannabis.

These requirements increase costs. For example, the BCC has estimated that testing increases the cost of cannabis by over $400 per pound. Avoiding these costs allow counterfeiters to sell for less, but the risk to consumer health and safety is a high price to pay.

Take, for example, our client Mammoth, a licensed cannabis manufacturer. A few months ago, Mammoth—a purveyor of the hugely popular Heavy Hitters brand—took it upon themselves to randomly purchase samples of counterfeit products from unlicensed shops that were falsely labelled with its brand. When those samples were tested, the results were stunning. Nearly all of them had chemicals that far exceeded standards set by the State of California. In one case, the level of insecticide was approximately 600 times the legal limit. Since then, similar tests have been conducted by local media—all with similar results.

The cannabis industry—like other industries targeted by counterfeiters—has multiple options for dealing with fake products.

First and foremost is public education. Consumers should take steps to educate themselves and ensure that dispensaries are licensed. For example, the Los Angeles Department of Cannabis Regulation maintains a list of licensed dispensaries at https://cannabis.lacity.org/resources/authorized-retail-businesses. Likewise, Heavy Hitters has posted on its website a list and map of retailers authorized to sell its brand. Consumers should check these and other resources before purchasing products at a dispensary.

A second avenue for dealing with counterfeiters is trademark law. One of the purposes of trademark law is to protect consumers from deception; that is, from buying a product that looks as though it is made by one company when, in fact, it is a counterfeit made by a different company. Cannabis manufacturers can apply for and obtain California trademarks for their products. They can then enforce those rights with "cease and desist" letters to dispensaries selling counterfeit product, followed by lawsuits if the dispensaries do not actually cease and desist.

The California BCC mandates that all batches of cannabis be sampled and tested by a state-licensed laboratory for an array of possible contaminates as well as for the potency of the cannabis.

A third avenue is to bring a lawsuit against the popular consumer websites and platforms that advertise unlicensed dispensaries alongside licensed ones, with no distinction between the two—thereby profiting from the counterfeit cannabis market. Under state and federal law, advertising the illegal sale of controlled substances, including cannabis, is a crime.

Finally, the cannabis industry should urge the government to enforce regulations that would prevent counterfeiters from operating in this space. After all, the above-listed avenues of enforcement may be more appropriate for Louis Vuitton—because no one is ingesting a contaminated, knock-off handbag. When consumer health is at risk, however, the government arguably has an obligation to assist, and many existing criminal and civil statutes apply to counterfeit cannabis. For example, California Penal Code Section 347 makes it unlawful to mingle poison or any harmful substance with a product intended for consumption; California Health & Safety Code Sections 111445 and 111450 make it unlawful to misbrand or to deliver any misbranded drug.

While there is no quick fix to stop the proliferation of counterfeit cannabis product, by working together, the public and private sectors can make California cannabis as safe as possible for all consumers.

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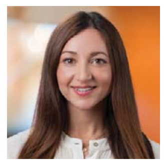

BUSINESS OF CANNABIS

Solutions for the Cannabis Industry's Packaging Needs

By BRAD DAVIS

BUSINESS OF CANNABIS **SPOTLIGHT**

Everyone in the cannabis industry has a "story." Acorn is no different. A Los Angeles based family-owned and operated business since 1946, Acorn has been dedicated to serving the packaging needs of numerous California based industries. The business strategy has included embracing California centric lifestyle industries -- such as launching a dedicated wine division serving the wine industry, where Acorn counts over 100 major vintners as clients. Last year, Acorn embraced the nascent recreational cannabis industry in California, creating a dedicated department for meeting the needs of the entire cannabis supply chain. To differentiate itself from the competitive packaging landscape, Acorn built a strategy that is based on ideals including growing brand awareness of companies involved at every stage of the cannabis supply chain, furthering sustainable solutions and keeping regulatory compliance at the forefront.

Brand building is a key success metric in establishing market share in the highly competitive cannabis space. Many companies in packaging focus on Business to Consumer packaging solutions. This component of the supply chain is critical as it is the end stage of the marketing cycle, developing the external packaging that establishes the brand awareness with consumer at the time of purchase. Acorn "plays in this space" but the differentiation is that the company is dedicated to building brand awareness at the top of the supply chain funnel for cultivators, distributors and brands that work independently or within a verticalized structure. Acorn uses a consultative sales approach to understand which of its solution sets, across Acorn owned manufacturing facilities to numerous distributor relationships with domestic and international vendors, will most appropriately meet a client's needs.

"We possess the unique capability of meeting just about any need a client may have across the packaging and logistical shipping supply chain, within the cannabis industry," according to CEO David Weissberg.

Sustainability and environmental focus are another core value proposition that Acorn has embraced. Acorn begins its focus of sustainability at the manufacturing level, where their in-house produced corrugated packaging is created from recycled pulp and constructed to be fully sustainable. Acorn is working towards becoming 100% sustainable, start to finish, soon. The Cannabis industry is facing significant issues with sustainability. Acorn is taking a leadership position in not only their own manufacturing but in developing cannabis focused vendor relationships with other companies that hold the same core value of providing sustainable solutions. In addition, each of the Acorn sales consultants have been trained and certified on the requirements of Amazon's "Frustration Free Packaging" requirements. This will be a critical component to meeting the needs of the growing CBD marketplace.

Another difference with Acorn is it keeps compliance at the forefront of all its recommended solutions. Acorn's packaging specialist makes sure that all stock product and corrugated product meet and exceed industry standards. The company is part of a nationwide network of packaging manufacturers that guarantee the highest standard in compliant production standards. The cannabis department maintains constant attention to the latest rules and regulations in California and surrounding markets. It provides expert consultation on packaging, labeling and advertising compliance at the state and local level. As acting members of ASTM (American Society of Testing and Measurements), Acorn guarantees that the company is at the forefront of industry standards and compliance including with the cannabis industry.

CERTIFIED FRUSTRATION-FREE PACKAGING

We possess the unique capability of meeting just about any need a client may have across the packaging and logistical shipping supply chain, within the cannabis industry.

Child safety is a primary concern, challenging consumer-friendly product packaging solutions in the cannabis industry. In keeping with their history of family, their focus on sustainability and compliance, and their understanding that brand building is important throughout the supply chain. Acorn will soon be rolling out its first proprietary Child Resistant Package, this solution will be 100% sustainable and recyclable. It will be child safe and senior friendly. The Child Resistant package will allow for printing customization for brand building and provide a ubiquitous design that can be used for a variety of cannabis consumer products.

Acorn has a history of deep roots in California. It continues to innovate and provide cutting edge solutions designed to meet the specific needs of companies throughout multiple California based industries, and now also within the cannabis supply chain.

Brad Davis is General Manager for Acorn Paper Cannabis Packaging. For more information on Acorn's cannabis packaging offerings or to request a free consultation, contact him at 323-980-8353, or via Bdavis@acorn-paper.com, cannabispckg.com.

BUSINESS OF CANNABIS

Tax Planning for Cannabis Companies

By DANIEL ROWE

Now legal in 33 states (as well the District of Colombia, Guam and Puerto Rico), cannabis has seen a rise in the percentage of Americans favoring legalization with a majority now in support of ending prohibition. As the tide of public opinion shifts, state legalization has opened up significant economic opportunities. Experts predict that the legal cannabis industry will create hundreds of thousands of jobs in the next few years, and it is widely recognized as the fastest-growing job market in the country.

Despite these positive trends, state-legal cannabis businesses still face many economic obstacles to success, including a high barrier to entry for small business owners due to complicated and costly licensing processes, high application fees and the need for professional advice to navigate the regulatory system.

Once established, businesses face further economic hurdles stemming from cannabis being a Schedule I controlled substance under the federal Controlled Substances Act. In addition to preventing access to traditional banking, this federal classification subjects state-legal cannabis businesses to a substantial tax burden created by Internal Revenue Code Section 280E.

SECTION 280E – AN OVERVIEW

In response to a Tax Court case involving a drug trafficker, Congress added Section 280E to the Internal Revenue Code in 1982 as a punitive measure against illegal drug dealing. This code section prohibits taxpayers from deducting ordinary and necessary business expenses if they are in the business of trafficking controlled substances. This causes state-legal cannabis businesses to potentially owe income tax on gross business income, even if they generate a net loss after paying normal business expenses such as payroll, rent and utilities.

The law does allow for the deduction of Cost of Goods Sold (certain inventory or production costs), but the inability to deduct other operating expenses can lead to a heavy tax burden. Section 280E was enacted long before states began legalizing cannabis, and before medical benefits and research had become well known, helping to shift public opinion. As long as cannabis is considered a Schedule I controlled substance, state-legal businesses must grapple with the economic impact of Section 280E.

MITIGATING SECTION 280E

Cannabis businesses may deduct Cost of Goods Sold in determining taxable income. Thus, proper accounting for inventory and production costs and proper classification between retail and production activities can enable these businesses to capture appropriate deductions and reduce taxable income.

While Section 280E applies to trafficking controlled substances, some cannabis companies may be engaged in other non-280E type activities, such as sales of non-cannabis merchandise or health services. By identifying and properly allocating business expenses to the non-280E activities, cannabis businesses can reduce their taxable income. Expenses attributable to the non-280E activities generally remain fully deductible.

Proper planning, such as utilizing separate entities for non-280E activities or maintaining separate payrolls or books and records, can mitigate the scope of Section 280E.

CHOICE OF BUSINESS ENTITY

The form of entity has tax implications well beyond the impact of Section 280E, but there are specific features that cannabis businesses should consider. While California tax law conforms to federal Section 280E for individuals, it does not do so for corporations. As a result, a cannabis company operating as a corporation under California law may still deduct its ordinary and necessary business expenses in determining its California taxable income. Cannabis companies operating in California must factor the value of this differing treatment into choosing their form of business entity.

PASSTHROUGH ENTITIES

Businesses operating in passthrough form (partnerships, S corporations and even sole proprietorships) may be able to benefit, for federal tax purposes, from the newly enacted 20-percent passthrough deduction of Section 199A.

While there may be a benefit derived from Section 199A, a business formed as an S corporation may face an increased tax burden due to the requirement that it pay reasonable compensation to its shareholder-employees. This requirement could result in taxable wages for the shareholders without a corresponding wage deduction because of the 280E limitation.

Section 280E is just one of many economic hurdles facing the rapidly expanding cannabis industry, but an awareness of and proper planning for the impact of Section 280E can go a long way in improving the profitability of a cannabis enterprise. While many bills have been introduced to legalize cannabis at the federal level, until one becomes law, businesses must contend with the tax effects of Section 280E.

Because of the various impacts, it is important for cannabis businesses to partner with tax advisors with a strong understanding of this area and an awareness of developing case law so they can help ease the tax burden on emerging cannabis businesses.

Daniel Rowe, J.D., CPA, is a partner with Green Hasson Janks. He has 17 years of public accounting experience and specializes in partnership and S corporation taxation. He provides technical and strategic advice to partnerships, S corporations and their individual owners, including tax advice on restructuring and buy/sell transactions. He has authored numerous tax articles and served as an editor or adviser on tax and legal journals.

Investment Opportunities in the Cannabis Industry

By BARRY WEISZ and MICHAEL ROSENBLUM

In 2018, global legal cannabis sales were between $18-20 billion. The booming cannabis industry offers significant opportunities for investors and private fund managers, but is also fraught with risks and legal knots. As we progress into the second half of 2019, cannabis industry investors and analysts should be aware of some of the key issues and where to look for opportunities.

SCOPE OF INVESTMENT OPPORTUNITIES

Cannabis investments can take two forms: plant-touching or ancillary. Plant-touching companies often prove more innovative and, as a result, are more efficient in allowing for arbitrage opportunities. However, these companies are disfavored by many investors because their operations directly violate the Controlled Substances Act. Unique acquisition structures are being developed to manage this risk. Most notably, Canadian-based Canopy Growth Corp recently agreed to pay $3.4 billion for the right to acquire New-York based Acreage Holdings upon a change in federal law making Acreage's operations legal.

Conversely, ancillary companies may be preferable as they are scalable, require less capital, and have less exposure to legal implications. Nevertheless, ancillary companies must also be mindful of the legal implications of doing business in the space. For example, ancillary companies may encounter issues with their insurance coverage if a claim arises in the course of servicing a plant-touching customer.

Due to their scalability, technology-based companies offer unique prospects for investors. Real estate also provides opportunities due to the rent premiums arising from the risk of federal forfeiture. Landlords with cannabis-compliant properties can often generate double (or more) the rent that would be paid by a non-cannabis client for another use.

In the capital markets, there is a preference for equity investments rather than debt. Investors seek to underwrite large returns and there are currently few debt instruments corresponding with the equity underwriting.

ANALYZING INVESTMENT OPPORTUNITIES

In evaluating financial metrics, investors should pay particular attention to free cash flow and capital expenditure requirements, as these can be more easily verifiable and are crucial for the viability of the company. To properly evaluate a cannabis company, investors should carefully consider various non-financial factors such as board composition, corporate governance, and the composition of the management team.

Another crucial factor is alignment with the investor's vision and values. Companies should be evaluated on how they fit into the investor ecosystems, whether there are shared visions for success, and whether the company's future plans align with the investor.

When evaluating a company, it is also crucial to look for red flags which may be more subtle and difficult to detect. Two of the biggest red flags are management selling their shares and acting irrationally. Such behavior is currently a regular occurrence and should be monitored closely.

PREDICTIONS

Companies will be able to differentiate themselves by developing a strong brand and relate to the consumer. As a result, more capital should be deployed into brands, particularly to develop consumer experiences and loyalty. Social equity programs will be critical, as governments are using licensing as a means to create job opportunities for individuals previously incarcerated for non-violent cannabis-related offenses.

While the industry continues to grow, we may see a looming distress cycle fueled by companies that receive funding, incur significant capital expenditures, and are unable to support their infrastructure. This could provide opportunities to investors who are looking to buy distressed assets and stabilize such businesses, and will lead to significant levels of distressed debt in the cannabis capital markets.

With multiple states having passed cannabis legislation in 2018, including Missouri and Michigan, and new states expected to enact medical and recreational cannabis programs in the coming year, there appears to be an increase in public acceptance for cannabis. This extends to medical cannabis, where consumers do not yet understand the benefits of the various products. This growing acceptance will likely result in a massive new consumer base.

Overseas, many opportunities exist for cannabis industry investors. These opportunities offer international growth for brands, particularly in Europe, where 14 countries currently permit medical cannabis. That number could increase this year and it is likely at least one European country will legalize recreational cannabis. The United Kingdom in particular could serve as a barometer for the rest of Europe and Africa, as other countries look to its approach for guidance. For the remainder of 2019, as cannabis' stigma declines, we can expect better management teams to emerge in these international regions and cannabis programs to develop throughout India, Africa and Asia.

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Michael Rosenblum represents and advises public and private companies, private equity firms and hedge funds in a variety of transactions and industries. He is an active member of Thompson Coburn's Cannabis practice.