LENDING TRENDS

Cannabis Lending: Are You Ready to Fire It Up?

BY LON M. SINGER AND LYLE P. STEIN

When Federal and State laws collide, doing business is complicated and fraught. In this article, Riemer and Braunstein LLP commercial finance attorneys Lon M. Singer and Lyle P. Stein explore the background, evolution, and emerging landscape applicable to financing the cannabis[1] industry – with practical guidance for both the lending and legal communities.

Background – Legal Conflict

In 1976, Peter Tosh sang "legalize it, and don't criticize it."[2] As of this writing, the vast majority of states allows medical and/or recreational marijuana usage. Indeed, only three states – Idaho, Kansas, and Nebraska – currently do not allow use of cannabis in any manner. At the same time, under federal law marijuana remains classified as a Schedule 1 substance under the Controlled Substance Act – the same classification applicable to heroin and LSD.[3] Not surprisingly, federally-regulated banks and financial institutions, and to a lesser extent even private debt funds, struggle to understand whether and how they can or should play a role in funding the activities of this multi-billion dollar domestic industry.[4]

Compounding the challenge, banking institutions have been loath even to accept deposits and provide customary cash management services to a business whose revenue stream flows from legally murky, brackish waters -- where state and federal regulation and jurisdiction do not smoothly blend. This has been true despite the general eagerness of banks to augment depositary holdings in the wake of post-Covid bank failures and the contemporaneous runs on several institutions other than the "too big to fail" money center banks (which benefitted from a perceived flight to safety).

Consequently, banks have been sitting on the cannabis sidelines for several years. Private debt, subject to less regulatory oversight and perhaps less fixated on reputational risk, sometimes found high-yield opportunities too good to resist. But even where private debt stepped up, the cannabis industry routinely paid more for debt capital than the application of traditional underwriting principles would have required for a different industry vertical.

This dynamic did not, however, apply uniformly throughout the often-integrated North American finance market. In Canada, marijuana use (both medical and recreational) was legalized in October of 2018[5], although laws around the lawful manufacture, distribution, and use of cannabis products vary among the several Canadian provinces. Accordingly, for several years both banks and private debt lenders have dabbled to varying degrees in the Canadian loan market in favor of licensed cannabis growers, processors, distributors, and retailers.

LON M. SINGER
Riemer & Braunstein LLP

LYLE P. STEIN
Riemer & Braunstein LLP

Experimenting, but Not Inhaling[6]

Lenders, including smaller and regional banks, have begun selectively to provide specific financing products to U.S. cannabis industry participants. Most notably, these initial forays have taken the form of real property financing, where mortgages or other security interests apply only to non cannabis related products.

As mortgage/equipment financings, these facilities are less going-concern oriented than working capital facilities and inherently are not the sort of loans that generally or even frequently include providing a range of ancillary banking products to the borrower or its affiliates. This means that, even where it obtains a mortgage or equipment financing credit extension, a domestic cannabis company often will be unable to enter into a revolving credit line with a U.S. bank or use a U.S. bank to arrange letters of credit, factor receivables from sales of cannabis products, or hedge currency or commodity risks, much less arrange for credit card usage and processing.

Moreover, Lenders need to understand that various categories of collateral, including even equipment primarily or exclusively useful in cannabis processing, may be difficult to foreclose upon and impossible to liquidate, in the absence of state licenses. In the face of these obstacles, family offices and private debt funds remain the primary participants in this delicate financing space.

While there are some pro-cannabis advocacy groups alleging that state marijuana regulation is not preempted by federal law,[7] the legal uncertainty is only likely to be fully resolved

when two things happen (i) Cannabis is reclassified under the Controlled Substances Act, and (ii) federal legislation to legalize marijuana is signed into law. In this regard, on May 1, 2024, Senators Chuck Schumer (D-NY) and Cory Booker (D-NJ), together with Finance Committee Chairperson Ron Wyden (R-OR), reintroduced the Cannabis Administration and Opportunity Act (S.4226), which would both decriminalize and reschedule cannabis. The bill is currently viewed as unlikely to become law,[8] but even if it did, the full harmonization of federal and state laws would still necessitate a protracted process of rulemaking that some commentators suggest could require a period of years, during which the regulatory landscape would continue to evolve.

An interim step that has also been floated is the Secure and Fair Enforcement Banking Act of 2023 (or the SAFE Banking Act) (H.R. 2891), which would provide cover for banks to engage with state-sanctioned cannabis businesses without fear of (i) penalties from federal banking regulators, or (ii) anti-money laundering implications of handling proceeds of unlawful activities. For the major credit card processors, it is unclear whether passage of the SAFE Banking Act would convince institutions to open their menu of financial product offerings to the marijuana industry, or if that step would still demand federal legalization or rescheduling, as mentioned above.[9]

A prospective lender also wishes to be confident that all aspects of a cannabis business are operated exclusively within a single jurisdiction that authorizes and licenses all aspects of its conduct. Accordingly, in multi-borrower facilities, each borrower will grow, process, and/or retail its product within a single state (usually the state in which it is also incorporated or organized).

For now, operators and prospective lenders alike are relying in substantial part upon the fact that as a bi-partisan matter, and for about a decade, "the federal response to states' legalizing marijuana largely has been to allow states to implement their own laws."[10] As for banking practices, "[f]ederal banking regulators have yet to issue any formal guidance in response to state and local marijuana legalization efforts; however, in February 2014 the Treasury Department's Financial Crimes Enforcement Network issued guidance on financial institutions' suspicious activity report requirements when serving marijuana businesses." [11]

This approach is reflected in specific provisions of applicable loan documents that as a global or contextual matter, as well as with respect to specific contractual provisions, embody a sophisticated understanding of the legal and commercial landscape in this specialized lending space.

Today's Leading Edge

The lenders, both private debt funds, and banks, that are funding most freely into the cannabis space, have conducted important legal and business diligence that informs the structures we are seeing in practice today.

First, the loans in each case we have encountered take the form of single or delayed draw term loans, i.e., they are not revolving facilities. Structurally, too, the corporate or limited liability organizational structure is carefully scrutinized and informs the determination as to which entities in the organizational structure can and should be loan parties, with potential covenants restricting the activities of non-loan party subsidiaries. Lenders will also need to weigh the implications of equity pledges in any subsidiaries that own state marijuana licenses, since such pledges may trigger reporting requirements (for beneficial owners of state-licensed entities) and be subject to restrictions on the transfer of state-issued marijuana licenses.[12]

A prospective lender also wishes to be confident that all aspects of a cannabis business are operated exclusively within a single jurisdiction that authorizes and licenses all aspects of its conduct. Accordingly, in multi-borrower facilities, each borrower will grow, process, and/or retail its product within a single state (usually the state in which it is also incorporated or organized). In this way, its interstate commerce activities are minimized and, instead, its business is vertically integrated within a single state that is legally favorable to its operations.

Additionally, obligors' secured structures limit the collateral

to non-cannabis related products and assets, primarily machinery and equipment, intellectual property such as federally registered trademarks, packaging materials, hemp[13] products, and CBD products (Cannabidiol, which is derived from hemp or manufactured in a laboratory and is not considered a controlled substance). Moreover, there have developed a litany of particular representations and covenants designed narrowly to: (i) define the scope of the business and assets being financed, (ii) help ensure compliance by the obligors with applicable laws to the greatest possible extent, and (iii) empower lenders to exercise rights and remedies against obligors and/or collateral when appropriate.[14]

Specifically, loan documentation will initially need to address the fact that a state-sanctioned marijuana business is, by definition, violating federal cannabis laws, including the Controlled Substances Act, (21 U.S.C. § 801 et seq.); that dilemma supports lenders requiring strict compliance with all applicable state cannabis laws. Setting aside the typical negotiations on materiality qualifiers, the ubiquitous "compliance with laws" representations and covenants will need to exempt federal cannabis laws from their scope, while avoiding overly-broad exemptions of laws and activities that may overlap with such cannabis laws.[15] For example, a recent credit agreement we prepared and negotiated for a financing transaction consummated in favor of a North American (U.S. and Canada) industry participant provides, in pertinent part, that:

The cannabis industry poses unique challenges for the banking and lending sectors. It also represents a massive opportunity, with projected growth (no pun intended) in North America alone from a $43 billion industry in 2022 to over $400 billion by 2032.[16]

> *"Agent and the Loan Parties acknowledge that although Canadian Cannabis Laws and certain State Cannabis Laws have legalized the cultivation, distribution, sale, transfer and possession of cannabis and related products, (a) the nature and scope of Federal Cannabis Laws may result in circumstances where activities permitted under Canadian Cannabis Laws and State Cannabis Laws may contravene Federal Cannabis Laws and (b) engagement in Restricted Cannabis Activities may contravene Federal Cannabis Laws. Accordingly, for the purposes of this Agreement and any other Loan Document, each representation, covenant and other provision hereof relating to compliance with Applicable Law will be subject to the following: (i) engagement in any activity that is permitted by Canadian Cannabis Laws or State Cannabis Laws but contravenes Federal Cannabis Laws, and in respect of which the general practice of the applicable Governmental Authority is, or the applicable Governmental Authority has agreed (or is bound by Applicable Law (e.g., the proposed Secure and Fair Enforcement (SAFE) Banking Act (H.R. 1595) and the proposed Clarifying Law Around Insurance of Marijuana (CLAIM) Act (H.R. 4074 and Senate Bill 2201))) to forego or have otherwise suspended prosecution and enforcement of such Federal Cannabis Laws will not, in and of itself, be deemed to be non-compliance with Applicable Law or engagement in any Restricted Cannabis Activity; (ii) engagement in any Restricted Cannabis Activity will be deemed to be non-compliance with Applicable Law; and (iii) if any Change in Cannabis Law results in the business activities of Borrowers, any other Loan Party or any of their Subsidiaries becoming Restricted Cannabis Activities, such Change in Cannabis Law will be deemed to have had a Material Adverse Effect. Nothing contained in this Agreement or in any other Loan Document shall require any Borrower, or any of the other Loan Parties or their Subsidiaries to violate any provision of the Canadian Cannabis Law or State Cannabis Law or its attendant regulations, as applicable."*

As for compliance with state cannabis laws, it is imperative that borrowers remain in strict compliance with state cannabis laws and

licensing regulations, to minimize risks of forfeiture of assets or of licenses to state authorities–and also to deny federal regulators any incentive to begin enforcing federal cannabis laws. Lenders may want access to their suite of remedies (including acceleration of loans) if there are even minor (and certainly less than MAE-triggering) violations of state cannabis laws. In furtherance of that approach, the "Events of Default" under the Credit Agreement quoted above expressly include any Loan Party engaging in any "Restricted Cannabis Activity" and any "Change in Cannabis Law" (as each such term is specifically defined). Inevitably, however, as lenders lend more regularly to the cannabis industry, increased competition may empower borrowers to insist upon relaxation of such strict covenant and default provisions.

Navigating Through the Haze

The cannabis industry poses unique challenges for the banking and lending sectors. It also represents a massive opportunity, with projected growth (no pun intended) in North America alone from a $43 billion industry in 2022 to over $400 billion by 2032.[16] Lenders, particularly federally regulated banks, undoubtedly will continue to balance in their underwriting and structuring processes, the commercial and legal risks inherent in the conflicts between federal and state laws, against the expanding economic opportunities to carve out a niche in an important commercial space—all while keeping a watchful eye on the rapidly changing regulatory landscape.

Lon M. Singer, Esq. is a senior partner and Lyle P. Stein, Esq. is a partner, in the commercial finance group of Riemer & Braunstein LLP, both based in the firm's New York office. They represent banks, hedge funds, finance companies, and other lenders in connection with secured and unsecured bilateral and syndicated credit facilities in favor of businesses in a wide range of industries, including the cannabis trade.

1 The word "cannabis" refers to all products derived from the plant Cannabis sativa. The cannabis plant contains about 540 chemical substances. The word "marijuana" refers to parts of or products from the plant Cannabis sativa that contain substantial amounts of tetrahydrocannabinol (THC).

2 Tosh, Peter. "Legalize It" ©1976.

3 21 U.S.C. 13, §§ et seq.

4 MJ Biz Factbook for FY2023 (2024).

5 The Cannabis Act, Bill C-45 (October 17, 2018).

6 Presidential candidate Bill Clinton, asked in 1992 if he had ever violated international law, famously replied "I experimented with marijuana a time or two . . . I didn't inhale . . . "

7 Marijuana Policy Project, MPP.org (2024).

8 "Senate moves to legalize pot at federal level. What are the Chances?", *The Los Angeles Times* (Sasha Hupka, July 29, 2021).

9 "From Cash-Only to Cashless: How the SAFER Banking Act Will Reshape the Cannabis Payments Industry", Business of Cannabis North America (John Yang, October 19, 2023).

10 "The Federal Status of Marijuana and the Policy Gap with States," Congressional Research Service (May 2, 2024).

11 Id.

12 For example, Colo. Rev. Stat. §44-10-312 (Transfer of Ownership).

13 Cannabis containing no more than a 0.3% concentration of the psychoactive compound delta-9-tetrahydrocannabinol [delta-9-THC].

14 One remedial point that merits underwriting attention is the potential unavailability of access to the federal bankruptcy courts. Where marijuana products are involved, bankruptcy jurisdiction has not been exercised, primarily because U.S. Trustees have highlighted their own inability to liquidate such products. It remains to be seen whether bankruptcy courts may administer cases where the debtor entity does not deal with marijuana, particularly if there is no need jointly to administer the case to include affiliates of the debtor that may do so.

15 For example, consider that manufacturing facilities of a borrower should still comply with regulations prescribed by the Occupational Safety and Health Administration (OSHA).

16 "Cannabis Market Size, Share & COVID-19 Impact Analysis, By Type (Flowers/Buds and Concentrates), By Application (Medical, Recreational (Edibles and Topicals), and Industrial Hemp) By Component (THC-Dominant, Balanced THC & CBD, and CBD Dominant), and Regional Forecast, 2023-2030" (October 7, 2024) (Source: https://www.fortunebusinessinsights.com/industry-reports/cannabis-marijuana-market-100219).