

# Before You Subscribe: Cannabis Investor Education

BY BRIAN B. DEFOE

**W**ITH ANY BUSINESS OPPORTUNITY COMES RISK AND THE CANNABIS industry is no different. Cannabis investors need to consider whether the potential recipient of their investment dollars has sufficient liquidity and access to capital, a thoughtful business plan, qualified management and solutions to the myriad other risks facing small businesses. But investors in this space also need to educate themselves on additional risks that are unique and arise because cannabis remains illegal under federal law. Consider the following:

**YOUR INVESTMENT MAY BE SEIZED.** Cannabis is currently a Schedule I substance under the Controlled Substances Act, meaning the federal government views it to be just as dangerous and illegal as heroin and LSD. Although the U.S. Department of Justice (DOJ) has indicated that it is unlikely to prosecute cannabis-industry businesses operating in compliance with state law so long as certain criteria are met, that could change at any time. And if a business runs afoul of these criteria, the government has the authority to seize any and all of the business' assets, and to criminally prosecute all those involved.

**YOUR INVESTMENT MAY BE FORCED TO OPERATE ENTIRELY IN CASH.** Because cannabis remains illegal under federal law, banks generally will not open accounts for cannabis businesses. Therefore, your potential investment is unlikely to get a line of credit from a bank and may even be unable to open a checking account. Without a checking account, routine business tasks become difficult. Even if the company gets comfortable with paying its bills in cash, operating entirely in cash — and having a lot of cash on hand at any given time — means the business may become a target for crime.

**YOUR INVESTMENT MAY BE UNABLE TO PROTECT ITS BRAND.** Investors typically prefer to put their money to work behind businesses that will develop value in excess of the value of their hard assets. Often, part of that value proposition lies in the business developing value in its brand. Commonly, businesses seek to protect their brands (and the value they're developing in them) by obtaining federal protection for their intellectual property, however, the U.S. Patent and Trademark Office will not register a trademark for a cannabis product. There may be state trademark filings that offer some protection, but your investment may

be unable to develop meaningful brand protection outside of its home state.

**YOUR INVESTMENT MAY PAY HEFTY TAXES.** Because deductions are not permitted for business activities that are illegal under federal law, cannabis businesses generally cannot claim most costs of doing business as deductions for federal income tax purposes and their effective federal income tax rates tend to be disproportionately high. If you're investing in a pass-through entity, your own income tax burden may be disproportionately high relative to the performance of the business. Your investment may also be subject to significant state taxes levied on cannabis products. As a result, the actual economic return on your investment may be lower than you might otherwise anticipate.

**COURTS MAY REFUSE TO BECOME INVOLVED.** One benefit of investing in the U.S. is our robust court system. While litigation is generally to be avoided, there are times when seeking redress from the courts is necessary. For example, a business in distress will often seek protection from creditors by filing for bankruptcy protection. In the context of cannabis businesses, this option may be unavailable. At least one bankruptcy court has declined to oversee a bankruptcy case involving a cannabis business, and there are good reasons to believe that any claims in which a party seeks to bring in federal court may also be unavailable to the investor in a cannabis business.

There is no question that the dynamic nature of the evolving cannabis industry presents unique investment opportunities. Investors must bear in mind that with the potential for extraordinary returns in this burgeoning industry comes the certainty of extraordinary risk. ■



It may take more than friendly business hours to make up for government constraints when investing in the cannabis industry.



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