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# Cannabis Investments and Exit Strategies: A Case Study

*By Robert C. Kern, Jr., and Marc S. Ullman\**

*It is relatively easy for investors to make investments in cannabis companies. Given the risks, however, they would be well-advised to have an exit plan in the event their investment does not live up to their expectations.*

An investor decided to make an investment in a Colorado company that was seeking to create a particular cannabidiol (“CBD”) product. The investment involved two parts. First, the investor extended a loan to the CBD company. Second, the investor purchased commercial real estate for the CBD company to use for its laboratory.

After the CBD company ran out of money, the investor retained the authors’ firm for advice on how to untangle its investment and maximize its recovery.

A decision was made to put the real estate, which the investor owned free and clear, up for sale. The property already was a permitted CBD location under Colorado law and, therefore, was a prime site for parties interested in operating a CBD business.

A bidding war among interested buyers followed, resulting in an agreement for the sale of the property to one buyer.

In discussions about the closing, the successful buyer first suggested that it would be paying a large portion of the purchase price in cash—despite the fact that the buyer was located in Colorado and the closing was scheduled to be held in New York. It was not at all clear how the buyer planned on bringing or sending such a large amount of cash to the closing.

Ultimately, though, the closing concluded with a wire transfer of the funds, and the investor was extricated from the troubled situation.

## **CANNABIS, MARIJUANA, HEMP, AND CBD**

Before going any further, it is important to understand the different products that fall under the cannabis umbrella, and the differences among marijuana, hemp, and CBD.

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\* Robert C. Kern, Jr., counsel in the New York City office of Rivkin Radler LLP, focuses his practice on corporate transactions, representing small to mid-sized private companies as well as individuals with an emphasis on the creation and governance of business entities. Marc S. Ullman, of counsel in the firm’s Long Island office, represents clients in matters relating to all aspects of Food and Drug Administration regulatory issues. The authors may be contacted at robert.kern@rivkin.com and marc.ullman@rivkin.com, respectively.

The federal Controlled Substances Act (“CSA”), which generally uses the word “marihuana” (more commonly spelled “marijuana”) to refer to the cannabis plant and its derivatives, classifies cannabis as a Schedule I drug. A Schedule I drug is deemed to have a high potential for abuse and the potential to create severe psychological and/or physical dependence.

Hemp and marijuana are both varieties of the cannabis plant. Hemp is defined by federal law as “the plant *Cannabis sativa* L. and any part of that plant . . . with a delta-9 tetrahydrocannabinol concentration [(“THC”)] of not more than 0.3 percent on a dry weight basis.” The cannabis plant and most products produced from that plant remain controlled substances subject to the CSA, unless they meet the statutory definition of hemp.

CBD is found in all varieties of the cannabis plant. CBD extracted from cannabis is a controlled substance. Since the 2018 Farm Bill became law, CBD extracted from hemp and having a THC level of not more than 0.3 percent is no longer a controlled substance. Thus, CBD with a THC concentration of not more than 0.3 percent is not of concern to the U.S. Drug Enforcement Administration (“DEA”). However, as noted in greater detail below, the U.S. Food and Drug Administration (“FDA”) has indicated that CBD is not lawful when combined with food or other consumer products.

## **THE NEED FOR AN EXIT STRATEGY**

Many investors and business people have faith that there is money to be made in the cannabis industry. That may very well be true, but as the Colorado CBD situation illustrates, it is important to understand the risks and to have an exit strategy in case the worst happens.

Ordinarily, one common exit strategy would be bankruptcy. Bankruptcy provides the opportunity for companies to hold off creditors temporarily so that they can either undergo an orderly liquidation or so they can restructure. Bankruptcy, however, is not available for cannabis companies.

As noted above, the CSA classifies cannabis as a Schedule I drug, thus making it illegal and making cannabis companies ineligible for relief under the federal bankruptcy laws. Therefore, cannabis companies cannot voluntarily enter bankruptcy and cannot be involuntarily forced into bankruptcy.

The prohibition on cannabis companies filing for bankruptcy limits the ability of business owners to reorganize, and of investors to potentially recover at least some portion of their investment in bankruptcy. The inability of cannabis companies to file for bankruptcy means that, in the event of financial distress, creditors with liens on debtors’ assets or who are the first to foreclose or win the race to the courthouse may obtain the greatest return.

Given that, it is important for investors to keep firmly in mind the following risks when considering whether to make a cannabis-related investment:

- *The U.S. Food and Drug Administration*

The FDA has approved one drug product that contains CBD: Epidiolex. This drug contains a purified form of CBD to treat seizures associated with Lennox-Gastaut syndrome or Dravet syndrome in patients two years of age and older and to treat seizures associated with tuberous sclerosis complex in patients one year of age and older.

The FDA's approval means that the agency has concluded that this particular drug product is safe and effective for its intended use.

There are no other FDA-approved drug products that contain CBD, marijuana, or other unlawful cannabis derivatives.

Moreover, the FDA is aware that some firms are marketing CBD products to treat diseases or for other therapeutic uses, and it has issued several warning letters to those firms. Under the Federal Food, Drug and Cosmetic Act, any product intended to have a therapeutic or medical use, and any product (other than a food) that is intended to affect the structure or function of the body of humans or animals, is a drug and subject to FDA regulation.

This regulatory scheme has important implications for cannabis investors as well as for business owners. For example, it is not at all certain that the FDA will ever approve creams, lotions, or other products containing CBD—which increases the risk of businesses who plan to produce, market, and sell those kinds of products.

If the FDA does not permit those uses, all parties interested in CBD products must consider their alternatives.

- *Banking*

The fact that cannabis remains unlawful under federal law is important for a variety of reasons, but none of them may be as significant as the banking implications. Federally chartered banks, and most other financial institutions, are unable or unwilling to provide banking services and products to cannabis companies—even when the cannabis companies are operating legally in a particular state. That is because banks are wary of violating anti-money laundering or other federal laws by providing banking services to an illegal operation.

Legislation known as the Secure and Fair Enforcement (“SAFE”) Banking Act has been introduced in Congress, and in fact was passed by the House of Representatives in March 2019. The SAFE Act, if enacted into law, would allow banks to serve marijuana businesses that are operating legally in their states

without fear of federal retribution. That bill remains pending in a Senate committee and its status remains unclear, although the House reiterated its support for the SAFE Banking Act by including it in the Health and Economic Recovery Omnibus Emergency Solutions Act it recently passed in connection with the COVID-19 pandemic.

The compromised nature of banking for cannabis companies yields a host of problems that investors in those businesses, and the owners themselves, may not be able to easily resolve. For one thing, money cannot be transferred between states if it comes from marijuana-related activities. As another example, cash becomes the primary source of payment for marijuana-related debts.

And, of course, the big questions for investors: How can they ensure that they will get repaid, and in what form?

## **CONCLUSION**

All of these issues lead to the inescapable conclusion that those who invest in a cannabis-related company need to have a strategy for exiting the business. Merely relying on the fiduciary duty that corporate officers and directors owe to investors may not be sufficient.

As the investor in the Colorado CBD company discovered, investors in cannabis ventures should carefully consider, at the outset, what they can do if something goes wrong and they need to terminate their connection with the cannabis company.