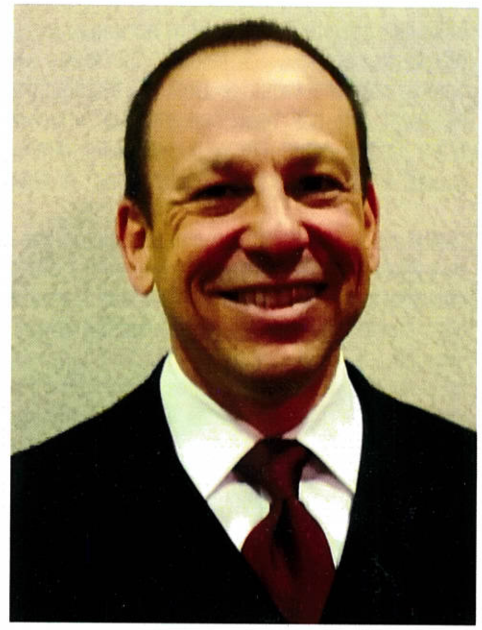
Financing Alternatives for Cannabis Companies



By Neil Kaufman, Esq.

Obtaining financing is a challenge for many high-growth companies, especially in the cannabis industry. Since bank debt often is unavailable to cannabis companies, they tend focus primarily on equity or private equity-linked debt (e.g. convertible notes). The options available depend on each company's particular prospects and the state of the markets.

The Basics: Some basic considerations generally apply:

- First, you must have a compelling business in a thriving industry which can be readily scalable. Cannabis industry companies often fit the bill.
- Your business and its prospects should be described in a clear and concise business plan with an attention-grabbing executive summary. The first paragraph of the executive summary must powerfully explain your business, the market you are going to exploit and why you will be successful doing so.
- The introduction to a prospective financing source is critical. Potential investors receive many business plans every day, often discarding ones that arrive without an introduction. If you know somebody (e.g. an accountant, lawyer or business contact) who can introduce you to the potential financing source and vouch for you and your company, it is far more likely that you will get an opportunity to pitch at an in-person meeting.
- Organization is very important. Any corporate clean-up that is needed should be done prior to serious discussions and the due diligence that any serious investor will conduct. All due diligence requests from potential investors should be responded to quickly and in an organized fashion.

The Process: The process to accomplish a financing will vary. However, most financings will follow a similar fundamental pattern:

- introduction to a financing source
- due diligence and negotiation of terms (in either order, but often simultaneously)
- drafting disclosure documentation, if applicable; and
- execution of documentation and funding.

Types of Financing Transactions

Personal Sources: The fastest way to raise money quickly and easily is from personal sources. Deploying personal savings, credit cards and home equity lines of credit avoids bringing outside ownership into the company. Of course, you risk personal financial ruin (loss of savings, damaged credit, unfavorable interest rates) and you may not be able to raise enough money in this way to fund your business. However, if you truly believe in your business, this will most likely be your first source of funding. Future financing sources generally will how much you have invested in your own business; beyond sweat equity. If you have not, then why should they?

Friends and Family: After exhausting your personal resources, the next step often is your friends and family who are accredited investors. Because these investors know you personally, you will likely get more favorable terms then from strangers. You can structure this as debt, equity or some combination (e.g., convertible notes or warrants). Depending on the amount being raised, the nature of your investors, the business's complexity and other factors, offering documents may range from a business plan with a term sheet and risk factors to a full-blown private placement memorandum. There can be a downside in the potential emotional consequences of having business dealings with your friends and family. Depending on who your friends and family are, you may not be able to raise all of the necessary capital.

Angel Investors: Angel investors are wealthy experienced business people, professional networks or other groups of accredited investors. In many cases, an angel investor will have knowledge of your industry and can provide you with business advice and contacts. Angel investors can be a great asset in this regard, but can also be a problem if they are insistent on providing unwanted or incompatible business advice. Funding from an angel can take many forms, from simple to complex. Traditionally, the terms are not as onerous as a venture capitalist would request and the documentation can be simpler. However, this has been changing, as angel investors have become more sophisticated. Often, there is little difference between an "angel round" and a "friends and family round" of financing.

Venture Capital: Venture Capital financing can provide large amounts of capital. Increasingly, these financings are documented with fairly standardized documents which can streamline the process, but also contain among the most onerous terms of any financing type. Typically, a venture capital firm will take substantial equity, board representation and sometimes even control of the company, either initially or if projected results are not achieved. The transaction costs can be fairly high if the due diligence process is extensive. Venture capitalists can provide useful business advice, access to their large network of contacts (which sometimes include IPO underwriters) and even send you customers and suppliers. A good venture capitalist can be a tremendous help to a growing company, and the availability of cannabis-focused venture capital has been increasing.

Issuers should keep in mind that venture capital funds have limited time horizons to achieve their targeted investment returns. To remain attractive to their own investors ("limited partners") so they can raise capital for their next fund, they need to achieve a sufficient return on their investments As a result, you should be careful to ensure that your interests are aligned with those of your venture capitalist.

Retail or Institutional Private Placement:
A private placement can be conducted either through a placement agent (a registered broker-dealer) or directly by the company to investors. If the former, the offering will usually be targeted to either retail or institutional investors. The private placement can be done on a "mini-max," "best efforts" or "all-or-none" basis. Typically, a private placement memorandum will be prepared and delivered to investors. Institutional private placements to one or only a few institutional investors tend to resemble venture capital transactions. Private offerings led by placement agents have the potential to raise large amounts of money and have the added advantage of inducing a broker-dealer to become interested in underwriting an initial public offering ("IPO") for the issuer at some future point. The downside to a private placement is that it can be a lengthy, expensive and cumbersome process, and you may end up raising little or no money despite incurring expenses.

Many companies have preferred the private placement offering structures available under Regulation D. In particular, Rules 506(b) and 506(c) both allow an unlimited amount of capital to be raised to an unlimited number of accredited investors. Rule 506(c) permits advertising, subject to the company reasonably verifying the accredited status of each investor.

Regulation A and Regulation A+:
Regulation A (Tier 1) and Regulation A+ (Tier 2) financings have become increasingly popular. In contrast to Regulation D offerings, both Regulation A and Regulation A+ allow "testing the waters" solicitation and an unlimited number of investors—whether accredited or non-accredited—to participate, subject to certain maximum offering size limitations (i.e., for Tier 1 limits offerings, up to $12 million, for Tier 2, up to $50 million, both in a 12-month period). Furthermore, securities issued under Regulation A and Regulation A+ are unrestricted and freely tradable, allowing for the creation of a public trading market. Companies must file with the SEC and provide to investors an offering circular that is less comprehensive than what is required for an IPO, so the transaction costs are lower than an IPO.

Crowdfunding: A company using crowdfunding can develop a high profile and seeks small amounts of capital from a large number of individuals. Generally speaking, companies conduct two types of crowdfunding transactions:

- "equity crowdfunding," where the issuer offers stock or other securities; or
- "rewards-based" or "contribution" offerings, where companies receive contributions in exchange for nothing or for a perk, such as a pre-order of a product, but contributors do not receive any ownership in the company.

While crowdfunding has several benefits such as exposure and a large number of potential investors, there are also downsides. Since contribution crowdfunding does not offer any ownership, individuals have no economic incentive to contribute. In equity crowdfunding, investors get ownership, and the issuer must comply with federal and state securities laws, which require initial and ongoing filing and disclosure requirements.

Initial Public Offering ("IPO")
An IPO is usually done with an underwriter and also can be done directly by the company. Among an IPO's many benefits, a company can raise an unlimited amount of money and create a high profile. It also provides liquidity in the company's stock by creating a public trading market, which then allows stock to be used for future acquisitions and to attract and incentivize employees. An IPO generally is the lengthiest, most expensive, and riskiest route, with extensive initial and ongoing SEC disclosure requirements (including audited financial statements. There usually will be no liquidity for the principals for at least six months. Closing an IPO dependsthe vagaries of the public markets. If a company's IPO does not close, it is left with large transaction expenses, often with little money to pay them. To date, only one cannabis company has succeeded in completing an IPO and getting listed on a national securities exchange.

Reverse Merger
Many companies "go public" by merging with an existing public company that has little or no other business, thus taking over the "public shell" and its stock market listing. By merging into the public company and taking control, the company effectively has raised capital and become a public company. The reverse merger can be made conditioned on raising capital, thus allowing the company to tap into the large pool of investors who are limited to investing in public company stocks. Usually, these transactions require the surviving company of the reverse merger to register the investors' shares with the SEC.

While the above-described financing methods are not exhaustive, they are the most common methods that most companies will encounter. For an outline of these financing methods, along with some related pros/cons and practical tips, please directly contact the author:
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