KAUFMAN MCGOWAN PLLC
Attorneys-at Law

190 Motor Parkway, Suite 202
Hauppauge, New York 11788
(631) 972-0042
(631) 410-1007 fax
nkaufman@kaufmanmcgowan.com
www.kaufmanmcgowan.com

June 10, 2022

MERGERS & ACQUISITIONS: HOW TO BUY OR SELL A CANNABIS BUSINESS

Prepared by Neil M. Kaufman, Esq.
Managing Member
Kaufman McGowan PLLC

This outline summarizes how to approach the critical factors in merger and acquisition transactions relating to United States cannabis businesses in particular. These transactions generally are conducted in a manner very similar to the non-cannabis merger and acquisition marketplace, while also exhibiting several critical differences.

I. Evaluating Potential Buyers and Sellers.

A. Preparing for the Deal:

1. Sellers should:
   - (a) fill key positions in the management team in order to ensure an efficient process (see Section III.A.1).
   - (b) Lock in recurring high-margin revenue growth. Profitable recurring revenue from long-term customers generally will lead to higher multiples.
     - For cultivators, extractors and infusers, seek long term distribution and supply agreements
   - (c) Consider vertical integration where legally permitted
   - (d) Consider acquiring complementary business(es).
   - (e) Sellers should take into account personal financial and personal goals:
     - (i) Are you seeking to cash out?
     - (ii) Do you want to join with a larger organization?
     - (iii) Do you have a succession plan?
     - (iv) Are you planning to retire?
       - When do you want to stop working?
       - How much money will you need in order to retire?

(f) Consider separating certain assets (e.g.- real estate) from operating assets (e.g.- equipment, customers, etc.), if not already done.
- Real estate is a valuable financing asset
- Many buyers attach little value to real estate

(f) Prepare pro forma financial statements and cash flow projections (see Section I.D.)

(g) Legal Considerations:
- (i) State and local regulatory approvals/timing
- (ii) Review key contracts for change of control and assignability upon a sale of the business.
- (ii) Corporate cleanup:
  - Ensure that the corporate records of the Company have been properly maintained, and if not clean them up.
  - Review all liens or security interests encumbering the assets of the business.
  - Review intellectual property rights, including
    - State-level protections
    - Any available federal registrations, despite limitations on federal registrations for cannabis trademarks and patents
    - confidentiality/work-for-hire agreements with all employees.
  - Non-compete/non-solicitation agreements for key employees.

(h) Tax issues:
- (i) Delinquent tax returns or payments
- (ii) Good standing issues
- (iii) Assess IRC 280E exposure
- (iv) Individual tax considerations:
  - a. Estate planning and achieving the best tax basis by shifting wealth to children is more difficult where regulatory approvals of transfers is necessary.

(i) Stock Options and bonuses.

2. For Buyers preparing to embark on an acquisition program:
   (a) Assemble negotiating, due diligence and integration teams
   (b) Identify targets
   (c) Design the process you prefer
   (d) Maximize tax deductions and accretive earnings/cash flow

B. Finding the Right Buyer or Seller.

1. Sellers' Considerations.

(a) **Types of Buyers:**

(i) Financial:

- Public: many of the large MSO and other cannabis companies have gone public in Canada and implemented acquisition programs.
- Private Equity: typically, the Buyer purchases 75 – 100% of the business with institutional equity capital and debt leverage. Private equity buyers have begun to be more active in the cannabis industry.
- SPACs: There are several cash-rich public shell companies focused on the cannabis industry. They must meet certain minimum purchase price, timing and stockholder approval requirements. If they are running out of time they may be forced to liquidate if they don't close an acquisition, so they are highly motivated buyers.

(ii) Industry:

- MSOs: public and well-financed private Multi-state operators have been aggressively acquiring cannabis companies.
- Competitors: Care must be taken when selling to competitors, as you don't want them to know your business inside and out if the transaction does not close.
- Suppliers: Allows vertical integration to offer a full line of products/services, if permitted by applicable state law (not all states permit vertical integration).
- Customers: A customer may want to purchase your business in order to take the product/service you have been providing in-house or to vertically integrate.

(iii) Working executives:

- Management Buyout: This is often leveraged, like an LBO, or these buyers can work with a financial buyer.
- Family: If inter-generational, be sure to consider estate planning issues.
- Employee Stock Ownership Plan ("ESOP"): requires available borrowing capacity so the ESOP Trust can borrow to fund the ESOP, which makes this type of buyer unlikely for a cannabis company. This structure provides certain tax advantages, including tax-free payments to owner.

(b) **Price**. What is the Buyer willing to pay? What is Seller willing to accept? See Section C, Valuation Methods.

(c) **Tax and Deal Structure**.

(i) Is the Buyer proposing an asset or stock purchase?

(ii) Will the Buyer pay cash, issue notes or stock?

- If notes, need to assess credit-worthiness of Buyer
- If stock, need to assess liquidity of market and trading restrictions such as lockup agreements
  - Canadian public companies can issue free trading stock in an acquisition

(iii) Fixed or contingent purchase price?

(iv) What are the other material parts of the deal proposed by the Buyer?

(d) **Financial strength of the Buyer**.

(i) Can the Buyer close the deal?

(ii) How solid is the Buyer's financing?

(iii) Does Buyer have continuing credit availability issues, especially for the increasing number of large cannabis companies that rely on institutional secured debt financing.

(e) **Legacy**. What legacy do you want to leave and what do you want your future role to be?

(f) **Employees**. Concern for employees?

2. Buyers' Considerations.

(a) **Financial concerns**.

- Is the acquisition financeable in the current credit environment?
- What will the return on investment be?
- What form will the consideration take?

(b) **Exit Strategy**. How will the Buyer realize a return on its investment? Note the continuing lack of an IPO market in the USA for cannabis stocks due to federal illegality precluding US listings.

(c) **Efficiencies** that can be realized – overhead, sales channels, economies of scale. A Buyer may want to combine operations in order to achieve economies of scale.

(d) **Corporate culture**. Are the cultures of the Buyer's and Seller's organizations compatible?

(e) **Integration issues**. One of the primary reasons that acquisitions fail is due to the failure to integrate properly the acquired business after closing.

(f) **Why is the business for sale**? Does it have deteriorating results or prospects? Is the business too far gone? Vulture Buyers may lowball the price for a distressed business.

C. Valuation Methods.

Public/private: valuations generally are higher in public markets than in private markets.

1. Multiple of Revenues or Earnings/EBITDA/Cash Flow:
   (a) annual historical;
   (b) trailing 12 months;
   (c) annualized; or
   (d) projected

   --Cannabis deals tend to be priced based on EBITDA multiples, despite
   - the inordinate impact of 280E on actual cash flow and
   - the non-deductibility of depreciation and amortization

   --The higher the recurring revenues, margins and sustainable growth rate, the higher the multiple.
2. Comparable Companies. Research should be done to determine what comparable companies in the industry have been selling for.
3. Book Value - Stockholders' Equity on the balance sheet. This usually (but not always) produces the lowest price.
4. Other opportunities. This can be based upon, for example, the value of brands, access to distribution channels or other factors.

D. Packaging the Company.

1. A well-packaged business plan/offering document usually is necessary. Be sure to have a clear and concise executive summary or teaser that will immediately impress the reader.
   - An investment banker typically will prepare a confidential information memorandum or similar document.
2. Organize due diligence materials that will need to be provided to Buyer (see Section II.D), typically in an online data room. The sooner and more comprehensively this is completed, the fewer renegotiation opportunities will be afforded to a buyer.
3. Pro forma financials - the Seller should present pro forma and/or projected financial statements to the prospective Buyer that:
   (a) reflect increased combined revenue opportunities;
   (b) eliminate expenses that will be cut after closing, such as:
      (i) overlapping G&A;
      (ii) one-time or non-recurring expenses; and
      (iii) excess owner compensation and perks;
   (c) reflect cost-saving efficiencies; and
   (d) have a reasonable and consistent basis for all assumptions.
   (e) Investment bankers can be very helpful if your CFO is not up to the task.

4. In order to get the most value you will want to make your company look as good as possible, but be careful about puffery. False or misleading statements can provide a basis for the Buyer to attempt to renegotiate the price later, so make sure all assertions are reasonably defensible.
5. Always be organized, efficient and responsive.

E. How to find Buyers:
1. Investment banker auction.
2. Who do you and your advisors know?
3. Industry participants.
4. Insiders.

F. How to find targets:
1. Investment banker on retainer searching for potential matches.
2. Who do you and your advisors know?
3. Commercial bankers.
4. Industry trade associations
5. Referrals from customers, suppliers, competitors
6. Possible approaches:
    a. Warm introduction
    b. Letters
    c. Telephone potential targets to gauge interest – personally or through a third party.

II. **The Process**.

How to Make the Deal Work

A. Strategy & Tactics.

1. Assemble your team: Seller:
   (a) CFO: the more savvy and competent your CFO is, the lower your costs and the smoother your process.
      - Consider an interim CFO?
      - A leaderless staff of bookkeepers likely will be a problem
   (b) Other key executives: Try to limit number; lock up with employment and/or non-competition/confidentiality agreements.
   (c) Fill key positions.
   (d) Accountant: If your regular accountant is not experienced in M&A, you may need to supplement.
   (e) Lawyer: Must be experienced in M&A and be able to quarterback the deal.
   (f) M&A Advisor/Investment Banker: Indispensable for an auction and reach of contacts. Can be paid a retainer, a success fee or a combination.
2. Assemble your Team: Buyer:
   (a) CFO; supplement with accounting firm if expertise or time availability is an issue, or if a Quality of Earnings report is desired.
   (b) Due Diligence Team
   (c) Integration Planning and Execution Team
   (d) Accountant – plan your tax and earnings impact
   (e) Attorney
   (f) M&A Advisor/Investment Banker, if appropriate
3. For Seller, determine whether you would like to use one of the following processes:
   (a) auction
   (b) quasi-auction/multiple bidders
   (c) sequential negotiations: one bidder at a time/direct approach to one party.
4. For Buyer, determine your financial and timing parameters:
   (a) will you participate in an auction?
   (b) are you willing to pay a deposit to get exclusivity?
5. Set deadlines - the longer the transaction takes, the more problems can arise.
6. For Buyer, a well conceived integration strategy is necessary. A checklist should be developed by the Buyer (with the help of the Seller) as early in the process as possible. This will increase the chances of the acquisition being a success in generating value for the Buyer.

7. Especially for the Buyer, learn and understand the Seller's corporate culture.
8. Keep accountants involved for Sellers - do tax, estate and accounting planning early in the process; Buyers should focus on tax and GAAP issues.
9. Participation of the CFOs is necessary to identify, document and quantify synergies.
10. Review Seller's key contracts for assignability/change in control/termination provisions.
11. Understand regulatory approval process and timing.
12. Consider keeping employees informed of non-confidential information through e-mail and/or company newsletters to reduce employee frustration and enhance retention. But guard against over-disclosure.
13. Your corporate lawyer and/or investment banker should quarterback the deal.
14. Seller should clean up its corporate house – minutes, stock records, contracts, taxes, permits, licenses, ownership of assets, etc.

Preliminary Documents

B. Confidentiality Agreement.

1. Sign a confidentiality agreement before disclosing any information.
    - Typically after sending a teaser but before the confidential information memorandum
2. Be careful about disclosing competitive information.
3. Prohibit the solicitation of the Seller's employees, customers and suppliers during the due diligence process and thereafter until closing (and for one to two years after any cessation of negotiations).
4. If you are receiving confidential information, include customary exceptions for disclosure or use of information:
    (a) that is already in your possession;
    (b) which is or becomes generally available to the public through no wrongful act of yours;
    (c) which is or becomes available on a non-confidential basis from another source that is not subject to an obligation of confidentiality with respect thereto;
    (d) which is independently developed by you without the use of any confidential information; and
    (e) which is required to be disclosed to comply with applicable law, subpoena or court order.
5. This generally is not the place for no-shop, break fee or related terms.

C. Letter of Intent.

1. Sellers will want to avoid signing a letter of intent if they are in discussions with multiple Buyers, as they will not want to grant exclusivity to any one Buyer. Buyers will want to sign a letter of intent to gain exclusivity and to assess the seriousness of the Seller.
2. A letter of intent will usually be signed before due diligence begins, but not always. The more due diligence that is done prior to the execution of the letter of intent, the fewer grounds the Buyer should have to back out or renegotiate.
3. The letter of intent should outline the basic terms of the transaction.
4. The letter of intent may include a no-shop (exclusivity) provision, which would prohibit the Seller from soliciting, and even discussing, any other offers for the business.
    (a) The Board of Directors of a Seller should be concerned with accepting a no-shop provision, because they have a fiduciary duty to the shareholders to maximize shareholder value. If a better offer is presented for the business, the Board may have to consider it anyway, despite damages to the Buyer for breach of contract. Accordingly, a "fiduciary out" provision is typical if the Seller is publicly held and should also be considered if the Seller has unrelated third-party minority stockholders.
    (b) If a Seller accepts a no-shop provision, it should consider asking for a down payment.
    (c) In Delaware, a tight "no-shop" is probably unenforceable unless it is reasonable for the Board to conclude that it has gotten the absolute best offer available.
5. Break fees. If the Buyer asks for a no-shop provision, the Seller should ask for a down payment and/or a break fee. This would be an amount of money payable by the Buyer if it decides not to proceed with the transaction. Buyers may also ask for a break fee if a Seller's "fiduciary out" provision is exercised.
6. The letter of intent is typically non-binding, except for certain specified provisions, including clauses relating to no-shop, break fee, expenses and confidentiality, if any.
7. A letter of intent can be a binding contract if it addresses all material terms and does not have "non-binding" language. Some circumstances may make this desirable, such as when it is important to lock up a deal.

Due Diligence

Usually, the Buyer does extensive due diligence on the Seller and the Seller does only a little due diligence on the Buyer. If the Seller is taking stock or notes as part or all of the purchase price, however, the Seller should do more extensive due diligence on the Buyer.

Due diligence topics include:

1. Business:
   - (a) Interview officers and key employees.
   - (b) Detailed review and analysis of operations, cash flow and liabilities (including contingent liabilities).
   - (c) Interview major customers and suppliers, if feasible.
   - (d) Evaluate corporate culture, including "that doesn't apply in cannabis" mentality.
2. Financial:
   Review financial statements for at least three years - audited yearly, if available, and unaudited interim. At a minimum, review in detail the following:
   - (a) Revenues:
     - profitability;
     - predictability; and
     - growth.
   - (b) Collectability of accounts receivable/allowance for doubtful accounts;
   - (c) Accounts payable aging and accrued liabilities;
   - (d) Unusual expenses; and
   - (e) Contingent liabilities.
   - (f) The footnotes
3. Legal.
   - (a) Order "good standing" certificates from the state of incorporation of the target company(ies) and any other states in which the target company(ies) is qualified to do business.
   - (b) Order UCC, judgment and tax lien searches on the target company to determine if there are any outstanding liens or judgments against the company.
   - (c) Order credit report.
   - (d) Review Certificate of Incorporation and Bylaws for a corporation, Articles of Organization and Operating Agreement for an LLC.
     - Beware of preemptive rights, rights of first refusal or other possible obstacles.
   - (e) Review corporate minute and stock record books.
     - Account for all stock certificates.

- Confirm clear path in title to equity, including all necessary historical regulatory approvals.

(f) Review all material contracts, and note especially the following:

(i) "Change of control" provisions for stock/merger deals and "assignability" provisions for asset deals. A consent will be required in connection with the closing in respect of these contracts. This can be critical for any major contracts.

(ii) Termination provisions. Note whether any material contracts will be terminable by a third party as a result of the closing.

(g) Liabilities. Note any liabilities to which the business may be subject for which a Buyer would become liable (e.g. environmental, tax liens on assets, etc.).

(h) Litigation. Review the status of all current litigation to which the target company is a party, and assess the likelihood of the target company being liable to a third party. Also probe as to whether or not there is any threatened litigation or any facts that could form the basis for a lawsuit against the target company.

(i) Environmental. The environmental laws are very broad, and extend liability to successors to businesses. Review in detail all operations of the target company at any site on which it did business, whether or not it actually owned the property.

- Review cannabis-specific environmental regulations

(j) Labor and Personnel.

(i) Determine any severance obligations that will arise in connection with the sale.

(ii) Ascertain whether any employees (likely high-level employees) have golden parachutes or change in control provisions in their employment contract that would be triggered by the sale of the business.

(iii) Review all employee benefit plans. They will need to be integrated/coordinated.

(iv) If there are unions involved, review any impact that the sale will have on the collective bargaining agreement, including possible withdrawal liability for union pension plans.

- Review status of labor peace agreements commonly required by many states in cannabis regulations
    - Has requirement been triggered
    - Is this requirement being enforced?

(v) Check whether or not there are any Worker Adjustment and Retraining Notification ("WARN") statutes that apply. These would generally only be applicable to businesses within excess of 100 employees and may require advance

notice to employees (on the federal level) of the transaction. Note similar state laws.

(vi) review any withholding, sales tax or other trust fund liabilities, and state-specific exposures (e.g. California private rights of action liabilities).

(k) Intellectual Property.

(i) Confirm ownership of patents, trademarks and copyrights.

- Registered or unregistered/common law
- Federal or state

(ii) Make sure that all intellectual property was created as a "work for hire" or that proper assignments were completed to assure that the target company owns the intellectual property.

- All employees need to sign work-for-hire and assignment agreements, which can be part of an employee handbook.

(iii) Evaluate the strength and value of the intellectual property.

(l) Governmental Matters.

(i) Determine if Hart-Scott-Rodino is applicable (See IV E. below).

(ii) Check whether cannabis licenses and permits and any other governmental licenses or permits are assignable.

(iii) Determine if any other governmental consents are necessary, under contracts or otherwise.

- Many local governments use "Development Agreements" or similar contracts with cannabis companies. Consents thereunder or amendments thereof may be necessary.

III. **Structuring the Transaction**.

A. <u>Assets or Stock</u>: generally, the Seller prefers a stock sale and the Buyer prefers the purchase of assets for tax (if Seller is a C-corp) and liability purposes.

1. Cannabis Regulatory considerations:
   (a) Many states and localities prohibit the transfer of a cannabis license.
   (b) Where not prohibited, approval of a transfer is generally required. Sometimes this requires the assignee to satisfy all the requirements of the initial license, which be very burdensome.
   (c) Transfer of ownership of a licensed entity may be easier than transferring the license itself, though it still generally requires regulatory approval at the state and local levels. Some jurisdictions:
   - allow partial transfers of ownership but not 100% transfers.
   - Require continuity of equity owners and/or individual managers/officers/directors.

   (d) Accordingly, most cannabis acquisitions are structured as sales of equity, rather than assets.

2. Tax considerations are especially important given the uncertainty of exposure for 280E-driven tax underpayments.
   (a) Assets:
      (i) Double tax for C Corps - the corporation is taxed on the gain from the sale of the assets (purchase price less tax basis) <u>and</u> the shareholders are taxed when the proceeds are distributed (as a dividend);
      (ii) There may be sales tax payable on the sale of some assets (e.g., equipment, not-for-resale goods); and
      (iii) The Buyer will get a stepped-up basis in the assets.
      (iv) The parties must allocate purchase price to the various classes of assets, which can have serious tax and accounting consequences.

   (b) Stock:
      (i) No double tax for C Corps - shareholders will get capital gains treatment on the difference between the basis in their stock and the amount for which the stock was sold;
      (ii) No sales tax;
      (iii) The Buyer will get a carry-over basis in the assets;
      (iv) Internal Revenue Code Section 338(h)(10) election is available to treat stock sale as asset sale for tax purposes; and

(v) A stamp transfer tax may be payable in connection with the sale of the shares. This amount usually is relatively nominal.

(c) Generally, the purchase price will get capital gains tax treatment, while employment, consulting and non-competition payments will be treated as ordinary income for tax purposes.

(d) A merger can allow tax-free treatment of the part of the purchase price that is paid in stock even if the purchase price is paid partially in cash, subject to some limitattions. In a non-merger stock sale, the entire purchase price may be taxable if any "boot" (cash or other non-stock consideration) is paid. Tax-free treatment of the sale of LLC membership interests is also available.

3. Liabilities:

(a) Assets - Liabilities stay with selling company as primary obligor; Buyer may assume all or only specified liabilities.

(b) Stock - Liabilities of the target company remain with it post-closing. Seller is not a direct obligor with respect to liabilities of the target. Buyer will demand an indemnity, especially for any undisclosed liabilities.

4. Accounting considerations:

(a) Under purchase accounting. The goodwill of the acquired company (excess of purchase price over the fair market value of the assets acquired) must be tested for impairment at least annually.

5. Other considerations:

(a) More third-party consents are usually required in an asset transaction in order to properly assign contracts, licenses, permits, etc.

(b) A stock sale is usually simpler for liability and regulatory purposes, and is usually used in cannabis deals.

(c) In an asset sale, bulk sales laws may need to be complied with or an indemnity given by Seller, if applicable (generally if inventory is being sold, which is sometimes not possible in cannabis deals). Compliance generally requires notice to all creditors.

B. <u>Payment in Cash, Note or Stock.</u>

1. Deferred payments or notes:

(a) Installment Reporting

(i) Installment reporting is generally available for deferred purchase price paid in the form of a note, allowing tax to be

paid as payments are received. Exceptions to the ability to use installment reporting include:

- Disposition of personal property by a person who regularly sells or otherwise disposes of property of the same type of property (i.e. inventory).
- Disposition of real property that is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.
- Sales of publicly traded securities or commodities.
- Recaptured depreciation.

(ii) Installment obligations in excess of $5,000,000 (other than personal-use property, farm property, and timeshares and residential lots) will be subject to an interest charge.

(iii) If an installment obligation is transferred, gain or loss results to the extent of the difference between Seller's basis in the obligation and the amount realized.

(b) Deferred payments can be used by the Buyer as leverage in post-closing disputes, where the deferred payments can be withheld until the dispute is resolved.

(c) For Seller, the notes should be collateralized by the stock or assets of the business being sold. The regulatory implications of this need to be addressed.

(d) For Buyer, notes should include an offset right.

(e) Seller should investigate the solvency/creditworthiness of the Buyer, especially if seller notes are subordinated to a senior lender.

(f) Seller should consider getting personal guarantees from the principals of Buyer (if a private company).

2. Stock:

(a) Sellers should avoid stock in private companies other than private equity-backed or pre-IPO companies because it may never be liquid, unless the Seller gets:

(i) A put right, which would give the Seller a right to sell the stock at a certain price; or

(ii) Demand registration rights, which can force the Buyer to go public.

(b) All stock received as part of the purchase price could have registration rights if the Buyer is public in the US (not applicable to Canadian public companies, where stock issued in an acquisition can be freely tradeable); Seller may be subject to a lock-up.

(c) Consider value guaranty.

(d) If the Seller is getting stock, investigate the solvency of the Buyer.

C. Fixed or Contingent Purchase Price.

1. Earn-outs.
   (a) Useful in resolving valuation disputes - Buyer should always cap.
   (b) If Seller accepts an earnout, Seller should insist on customary earnout protective provisions:
      (i) stay on to manage;
      (ii) require proper financing and support for growth;
      (iii) maintain separate accounting;
      (iv) mechanics/details are critical;
      (v) categorize earn-out as contingent purchase price so you get capital gains tax treatment; and
      (vi) all payments should be accelerated in the event of termination without cause or if there is a breach by the Buyer.

2. Closing date audit and working capital adjustment for balance sheet deals.
   (a) Seller usually prepares baseline closing date balance sheet, subject to challenge.
   (b) Dispute resolution provisions - use accountants instead of investment bankers to save costs.

D. Employment Agreements. The following issues should be considered in connection with the execution of an Employment Agreement:
1. Who is the employer? Will Seller and/or parent entity be responsible?
2. "Cause" definition. An employee will want the definition to be as narrow as possible, while the employing company will want it to be as broad as possible. Examples are as follows:
   (a) A broad definition, which would benefit the employing company, might include language defining cause to include:
      - "any act of dishonesty,"
      - "the commission of any crime," or
      - "the failure to perform assigned duties."
   (b) A narrow definition, which would benefit the employee, might include language defining cause to include:
      - repeated material knowing dishonesty that materially harms the Company's reputation,
      - "the conviction of a felony", or
      - "the willful failure to substantially perform employee's duties after written notice and opportunity to cure."
3. Term. The term should be specified. Consider self-effectuating renewal. In at-will employment, term can be structured through severance benefits.
4. Duties. The duties of employee should be specified. The duties should be the same level duties as employee was performing previously, to avoid

being assigned lower-level duties and then being fired for cause if employee refuses to perform. Consider specifying direct report.

5. Payments received under an employment agreement will be taxed as ordinary income, as opposed to getting capital gains tax treatment on amounts paid as part of the purchase price.

E. Consulting Agreements.

1. Differs from an Employment Agreement in that you are not a full-time employee. You will receive a 1099 as opposed to a W-2.
   (a) time commitment is usually less;
   (b) chain of reporting usually is more flexible; and
   (c) can be structured to not require much or any work.
2. The payments received will be taxed as ordinary income.

F. Non-Competition Agreements.

1. The scope and duration must be reasonable and proportionate to the consideration paid for it.
2. Any amount of the purchase price that is allocated to a Non-Competition Agreement will be taxed as ordinary income. A Seller will want to avoid allocation to a non-compete, while a Buyer will argue that allocating to the non-compete makes it more enforceable. Some reasonable amount must be negotiated.

IV. **Definitive Documentation**.

- Asset Purchase Agreement
- Stock Purchase Agreement
- Merger Agreement

A. Representations and Warranties.

1. Survival - the length of time the representations and warranties will survive after closing is generally one to three years, except title to stock or assets and certain other "fundamental representations" (survives forever), tax and environmental (statute of limitations), and sometimes certain labor or ERISA matters (statute of limitations). The Buyer should insist on at least one full audit cycle.
2. Escrow part of purchase price for breaches - the Buyer may want a portion of the purchase price to be held in escrow so there will be some assets readily available if there is a breach of a representation or warranty by Seller.
    (a) Is Seller/principals able to stand behind representations? If the entity and/or persons giving the representations will not have the assets to satisfy a claim post-closing, it is more likely that the Buyer will demand an escrow.
    (b) Representations and warranties insurance is available to insure against breaches of representations and warranties, though less available in cannabis deals. If used, it should be the sole source of recourse for the Buyer.
3. Who should give the representations and warranties? A sole owner or a majority owner that operates the business should be required to give the representations in addition to the company itself. An inactive minority owner usually does not need to give the representations and warranties regarding the company, although they should represent that they own their shares if it is a stock sale.
4. Standard representations and warranties. The number of representations and warranties, as well as the specificity and detail contained therein, will vary significantly depending on the nature and complexity of the transaction. The following are some of the more customary representations and warranties:
    (a) Organization - that the party is duly organized, validly existing and in good standing.
    (b) Capitalization - that the capital structure of the company is as stated.
    (c) Authority - that the party has the corporate power and authority to enter into the various agreements to be executed in connection with

the transaction and to consummate the transactions contemplated by such agreements.

(d) Financial statements - that the financial statements were prepared in accordance with generally accepted accounting principles consistently applied and present fairly in all material respects the financial condition and results of operations of the party.

(e) Undisclosed liabilities - that the company has no liabilities other than those disclosed on the financial statements or incurred in the ordinary course of business since then.

(f) Absence of certain changes or events - that none of the specified events have occurred within a specified period of time (since the date of the financial statements). This representation is intended to assure the Buyer that the business has been run in the ordinary course.

(g) Taxes - that all required tax returns have been filed and are correct and all taxes shown thereon as payable have been paid. This requires a careful review of 280E-driven tax liability for cannabis companies.

(h) Intellectual property - that the company owns the specified intellectual property, such intellectual property does not infringe on the rights of others, and no third party is infringing on such intellectual property rights.

(i) Compliance - that the party is in compliance with all laws (with appropriate exceptions for the federal illegality of cannabis, which must be carefully drafted) and with all contracts to which it is a party.

(j) Brokers' and finders' fees - that no broker's or finder's fees are payable in connection with the transaction.

(k) Employees; employee benefits - that the employees are provided the salary and benefits indicated and that employee relations are good.

(l) Litigation - that the party is not subject to any pending or threatened litigation or similar proceedings.

(m) Environmental matters - that all environmental laws are being and have been complied with.

(n) Major customers and suppliers - who the major customers and suppliers of the business are and that they do not intend to cease doing business with the Seller.

(o) Agreements, contracts and commitments - that all of the specified agreements are in effect and will not be breached or terminated by the transaction.

(p) Change of Control payments - that no amount will be payable to anyone as a result of the sale of the business.

(q) Title to properties and related matters - that the business owns all of the property that it purports to own.

(r) Inventory - that inventory is saleable in the ordinary course of business and not obsolete.

(s) Accounts Receivable - that they were all created in the ordinary course and are not subject to set off or counterclaim; Buyers may demand a representation that they are collectible.

5. Other Representations.

(a) A Buyer may also request representations as to:

(i) Financial projections: This should be avoided by Seller if at all possible, or at least given only "to the best knowledge of Seller" and subject to disclaimers.

(ii) Information provided to Buyer. Sellers should not give any representations as to documents or information provided to Buyer during the due diligence process, unless specifically identified in the purchase agreement.

(iii) Disclosure. A Buyer will request a representation that the representations do not contain an untrue statement or omit any statement necessary to make the representations not misleading. Sellers resist this.

(b) The Seller may receive a representation from the Buyer that the Buyer does not know of any breach of any of Seller's representations and warranties. This prevents Seller from being liable for something the Buyer knows about. This representation is especially appropriate when the Buyer has done extensive due diligence, and sometimes knows the details of Seller's business better than the Seller does. Buyers generally resist this.

6. Disclosure Schedules.

(a) Set forth exceptions to representations and warranties.

(b) Must be prepared carefully by Seller and Seller's counsel after thorough internal due diligence.

B. <u>Indemnities.</u>

1. Basket - This is the amount that indemnity claims must exceed before any liability to indemnify arises. This minimizes wasted time over minor matters or small amounts (e.g. 1% of the purchase price). The amount can vary considerably. There are two types of baskets, as follows:

(a) dollar one (true basket/threshold) - If the claims for indemnification exceed the agreed-upon amount, all claims for indemnification would be paid; and

(b) excess (deductible) - If the claims for indemnification exceed the agreed-upon amount, only those claims in excess of the agreed-upon deductible amount would be paid.

2. Cap - This is the amount that the aggregate of all indemnity claims against a party cannot exceed. This amount is typically not greater than 25 – 100% of the amount of the purchase price, sometimes net of taxes.
3. Who controls litigation/settlement negotiations?
   (a) Generally the indemnifying party controls litigation/settlement negotiations.
   (b) Include a provision that no settlement shall be made to the detriment of the other party without their consent.

C. <u>Simultaneous Contract and Closing or Deferred Closing.</u>
1. Hart-Scott-Rodino (See IV E. below). If H-S-R approval is necessary, there will be a deferred closing.
   - The U.S. Department of Justice, which reviews H-S-R filings, has often been hostile to cannabis companies, and many cannabis companies seek to avoid H-S-R filings whenever possible.
2. If there is a deferred closing, there will be restrictions on what the Seller can do between the time the definitive agreement is executed and the closing. Generally, the business must be run in the ordinary course between contract and closing.
3. Any necessary consents and financing will be obtained between the signing of the contract and closing, if there is deferred closing. Otherwise, they will need to be obtained even before the contract is signed.

D. <u>Conditions to Closing</u> - In the event of a deferred closing, the following are some possible closing conditions:
   (a) Typical conditions.
      (i) The representations and warranties of each party must be true and correct as of closing.
      (ii) All covenants contained in the purchase agreement must have been complied with.
      (iii) There are no suits, proceedings or investigations pending or threatened regarding the transaction.
      (iv) There has been no material adverse change in the business.
      (v) All necessary third-party and governmental consents have been received.
   (b) Other "not-always" conditions:
      (i) Buyer has completed and is satisfied with its due diligence of Seller.
      (ii) Buyer has obtained necessary financing.
      (iii) Transaction-specific conditions.

   (c) Cannabis-specific conditions:
      (i) state and local regulatory approval
      (ii) accurate assessment of 280E liabilities

E. Hart-Scott-Rodino.

1. Generally, a pre merger notification filing is required if:
    (a) as a result of the transaction, the acquiring party will hold in excess of $403.9 million of the acquired party's stock and/or assets; or
    (b) as a result of the transaction:
        (i) the acquiring party will hold more than $101 million of the acquired party's stock and/or assets (but not in excess of $403.9 million); and
        (ii) either party to the proposed transaction has total annual net sales or total assets of at least $202 million and the other party has annual net sales or total assets of at least $20.2 million.
2. File after execution and before closing if deferred closing.
3. 30 day waiting period.
4. Can request early termination of waiting period, which generally will be granted if the proposed transaction poses no threat to competition.
5. Filing fee ranging from $45,000 to $280,000, depending on the size of the transaction.

V. Closing

A. Closing deliveries.

1. Main Agreements. These may not all be applicable, and there may be others, depending upon the nature of the transaction.
    (a) Purchase or Merger Agreement.
    (b) Escrow Agreement - in the event that the Seller will be required to leave some money in escrow to secure against breaches of representations and warranties.
    (c) Employment/Consulting Agreements - in the event that any of the principals/key employees will be staying on with the business.
    (d) Non-Competition Agreements - in the event that the Buyer wants to prevent the Seller/principals/key employees from competing with the business after closing.
2. Secretary's Certificates - the Secretary of each party will certify as to the following:
    (a) Certificate of Incorporation;
    (b) Bylaws or Operating Agreement; and
    (c) Resolutions of Board and Shareholders, if applicable.
3. Officer's Certificates - generally, each party will provide this certificate certifying that the conditions precedent to closing and the covenants of such party have all been performed or complied with.

4. Third-party and governmental consents, including any required pre-closing state and local cannabis regulatory approvals (note these are not always required pre-closing).
6. Stock and minute books if a stock transaction.
7. Representation letter if Seller receiving stock - this will be necessary in order to make sure that there is a proper exemption under the securities laws for the issuance of the shares.
8. Financial statements - recent financials will usually be delivered at the closing and may be certified as being true and correct by the Seller's CFO.
9. Good standing certificates - this confirms that the parties are duly incorporated and in good standing.
10. Assignments of copyrights, patents and trademarks - these are necessary so they may be properly transferred in the U.S. Copyright Office and, to the extent applicable, the U.S. Patent and Trademark Office and on state trademark registries.
11. Website URL assignments - there are separate forms for this.

- Note that opinions of counsel are rarely required in cannabis M&A transactions.

VI. **Post-Closing**

A. Key business/integration issues must be planned pre-closing:

1. management information/financial accounting/computer systems.
2. cultural differences.
3. coordinating sales channels.
4. cross-training sales forces.
5. restructuring offices.
6. brands.
7. lines of authority for continuing former owner(s).
8. inform customers and coordinate any necessary transitions.
9. regulatory approvals

B. Make any necessary governmental filings, including filing of copyright, patent, trademark and website assignments, and of course cannabis regulatory filings.

C. Closing date balance sheet and working capital adjustment process.

D. Payment of earnout and/or deferred payments.

E. Working for the Buyer.

Nothing contained herein constitutes legal advice.