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Blazing New Trails: Secured Transactions Involving California Cannabis Licensed Entities

As of the date of this Client Alert, the cultivation, manufacture and sale of cannabis remain illegal under the Controlled Substances Act. Prior policy statements of the Federal Government's intention to avoid enforcement of violations of federal law in this area have been rescinded and, as such, prosecution remains in the discretion of each individual United States Attorney.

Accordingly, this Client Alert is made with respect to California law and California-compliant cannabis operations.

With cannabis listed on Schedule I of the federal Controlled Substances Act (21 U.S.C. § 812 *et seq.),* federally chartered and insured banking institutions remain unwilling to provide loans to borrowers operating in California's cannabis industry. Funds and other private entities willing to blaze new territory and extend loans to California cannabis businesses are taking advantage of the significant barrier to entry created by the statutory banking prohibition and, in return, are obtaining favorable terms on these loans, including high interest rates, short maturity and liberal loan-to-value protection. Of course, lending into the California cannabis industry comes with risk. Participants in an industry that is working its way through its infancy are still proving themselves with regard to cash flow generation and the debt coverage such performance implies.

The vicissitudes of a new business – and more generally of a new industry – have compelled lenders to mitigate their risk by taking as much collateral as possible. However, this approach also presents unique challenges for a lender in the cannabis space. Not surprisingly, where a borrower owns real estate or other easier-to-value assets, lenders generally are taking first position security interests in such assets. But all too common is a circumstance wherein the locus of value in a cannabis business lies in its right to conduct the business – the cannabis licenses themselves. This underscores a threshold challenge for a lender: how does a lender take and utilize a security interest in a cannabis license where California has prohibited the alienability of the licenses?

Common Cannabis Lender Issues

California's cannabis industry is governed primarily by the California Bureau of Cannabis Control (the "BCC"), which issues regulations codified at Title 16 of the California Code of Regulations (the "BCC Regulations"). Section 5023(c) of the BCC Regulations makes clear that "[l]icenses are not transferrable or assignable to another person or owner." This prohibition on transfer creates two immediate problems for a lender: (i) how does a lender take a security interest in the licenses; and (ii) assuming a satisfactory answer to the first question, what special considerations should be made when a lender chooses to foreclose upon the license in the event of the borrower's default on the loan?

While we may not think of the transaction as a "sale," a borrower's granting to a lender of a security interest in any asset does in fact constitute a "transfer." The borrower grants to the lender a sliver of ownership in the collateral – contingent upon the borrower's default of course, but an interest in the asset nonetheless. The very granting of a security interest in the licenses, therefore, violates the BCC Regulations' prohibitions on transfer. We believe that a lender attempting to take a security interest in a borrower's cannabis license should do so by way of taking a pledge in the ownership of the *licensee* – that is, the entity holding the license – as opposed to the license itself. The BCC Regulations do not prohibit the alienability of licensees, and as such we believe this approach comports with both the letter and spirit of the BCC Regulations. Prospective lenders should take note that accepting the actual equity of an entity as collateral for a loan involves some important requirements independent of the BCC Regulations, including how a lender must perfect such a security interest (guarantee its right in the collateral versus other possible claimants) and certain corporate formalities that must be observed.

While the pledge of ownership in the licensee navigates the outright restriction on the actual grant of the license as collateral, the BCC Regulations also create significant requirements for a lender seeking to foreclose on its interest in a licensee in the event the borrower defaults on the loan. Notably, Section 5023(c)(1) of the BCC Regulations

provides that under certain circumstances the business would be required to cease operations during the foreclosure process. Section 5023(c) requires that within two weeks of a new entity meeting the definition of "owner," such new entity must submit what amounts to a new license application. Section 5023(c)(1) provides that notwithstanding the change, the "business may continue to operate under the active license while the [BCC] reviews the qualifications of the new owner(s) . . . if at least one existing owner is not transferring his or her ownership interest and will remain as an owner under the new ownership structure. If all owners will be transferring their ownership interest, the business shall not operate under the new ownership structure until a new license application has been submitted to and approved by the [BCC]."

To avoid a potentially disastrous and open-ended interruption of business, we recommend that a lender seeking to foreclose on an equity pledge do so in stages. The first stage should leave at least one existing "owner" in place so the business can operate during the pendency of the BCC's review of the lender as a new owner. Section 5003(b) of the BCC Regulations defines "owner" to include, among other things, "a person with an aggregate ownership interest of 20 percent or more in the person applying for a license or a licensee." A lender foreclosing on a pledge, therefore, should not take more than 80% of the ownership of the licensee until the BCC has approved of it as a new owner. At that point, the lender can take the remaining equity and can serve as its own legacy owner required to keep the business open. Equally important, once approved by the BCC as a new owner, the lender can assume with confidence that the removal of the remaining legacy owner will not negatively impact the license going forward.

In addition to 20% ownership, the BCC Regulations' definition of "owner" also includes entities of various forms exercising effective control over the licensee. While this clearly implies that a lender could foreclose upon more than 80% of the existing equity while leaving in place an entity that falls under one of the "control" definitions of ownership, we are aware of at least one circumstance in which the BCC required that the legacy owner be a 20% place holder.

Potential Lender Pitfalls

Finally, a lender in the cannabis space should take note of a few more issues to avoid potential pitfalls:

- Unrelated to any collateral taken, an entity making a loan to a cannabis entity is a "financial interest holder" under the BCC Regulations, and as such its identity must be disclosed to the BCC by the licensee within two weeks of the closing of the loan and on an annual basis. While the non-foreclosing lender is not required to submit the detailed information required of "owners," the BCC has taken the position that this requirement runs all the way down to the individual principals of a financial interest holder.
- A lender considering foreclosure upon the equity of multiple cannabis borrowers could find itself in purported violation of local rules limiting the number of certain types of licenses lawfully held and, potentially, California rules regarding geographic concentration (though we have not seen this provision enforced to date). A lender should consider its potentially owned portfolio and the likelihood of owning multiple retail or cultivation licenses as well as the location of borrowers in its portfolio.

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