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# **Due Diligence in Cannabis Transactions**

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## Due Diligence in Cannabis Transactions

By Marshall Custer

As the regulated cannabis markets begin to mature across the country, numerous existing operators are choosing to exit the business and cash in, rather than continue operating in an increasingly competitive industry. This circumstance presents a rare opportunity for growing cannabis businesses to add scale, enter new markets, and diversify operations via an acquisition. Given the projections for industry growth over the next decade, cutting a deal at this stage could potentially reap outsized rewards, but as ever, deals carry with them a certain element of transactional risk.

This has never been truer than in the nascent regulated cannabis market. While the basic principles of due diligence still apply, vetting an existing cannabis business presents some unique variables and risks, not least of which is the conflict between federal law and the laws of various states that have legalized cannabis for medical or adult use.

Questions of federalism aside, many target companies have grown up during a period of changing cultural attitudes regarding cannabis and have straddled the fence between legal and illegal operations. The operators of these businesses are an eclectic lot, to say the least, but generally speaking, acquirers will find that target companies frequently exhibit a lack of sophistication concerning accounting, licensing, and regulatory compliance. Customary business practices are inconsistently applied, if applied at all, with the result being that acquirers will need to devote significant time and effort to thoroughly vetting target companies.

For starters, assessing the underlying financial condition of target companies is often frustrated by sub-standard **financial statements**. Many professional and business services firms have been reticent to engage with cannabis operators, and accountants are no different in this regard. Financial statements, therefore, are highly inconsistent as to sophistication and accuracy, often prepared by the owner-operators themselves. Even more than usual, the onus falls on the buy-side to conduct a proper analysis and secure the appropriate warranties.

Cannabis operations span numerous areas, including cultivation, product manufacturing, distribution, and retail. To the extent that a target operation has developed branded products or proprietary processes, buyers will need to include **intellectual property due diligence** in its acquisition timeline. If proprietary assets form an important component of the acquisition, buyers will need to ensure the ownership and enforceability of the intellectual property rights, which, like financial statements, present a need for heightened diligence—especially in light of the rampant rip-offs that are common in the industry and lack of federal enforcement options.

All manner of **business and regulatory relationships**—property leases, vendor and supplier contracts, insurance policies, licenses—require a greater degree of scrutiny in the cannabis context. In the insurance realm alone there has been strident disagreement about what are normally quotidian and customary terms. Cannabis industry policyholders who believed they had insurance coverage for certain exigencies have been disappointed to discover that carriers—often in the face of the plain-language meaning of policies—challenge payouts, citing the illegality of cannabis operations under federal law (of course, that did not prevent the carriers from collecting their premiums).

All agreements and contracts of this sort need to be evaluated in order to assess the risk of a breach, and more importantly, **regulatory compliance**. Standard-issue contracts and agreements—that is, those that do not explicitly acknowledge and conform to the murky and unsettled legal situation of cannabis operators—will require additional documentation or follow-on agreements.

All of these reasons argue strongly for fresh eyes and a more customized approach to cannabis industry-related due diligence. Nothing can be assumed to function per the usual, because as the cannabis industry consolidates from early entrants to larger acquirers, there is no usual.

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## About Our Cannabis Practice

Since 2010, members of the Husch Blackwell team have helped clients navigate the complex and ever-changing regulations governing the state legal cultivation and sale of marijuana and industrial hemp. Additionally, the entire firm serves as a resource when the team is dealing with highly complex and novel legal issues on behalf of cannabis clients. Our team counsels clients on a variety of transactions, including mergers and acquisitions, securities offerings (public and private), debt and equity financings, corporate formation and corporate restructurings. We also provide ongoing sophisticated legal advice regarding regulatory issues, intellectual property, tax, employment and other general corporate issues.

Our representative clients in the cannabis industry include medical and adult-use marijuana stores, medical and adult-use marijuana cultivations, manufacturers of marijuana-infused products, marijuana and industrial hemp testing facilities, marijuana technology companies, industrial hemp farms and processors, landlords, private equity funds, public companies (U.S. and Canada), credit unions and security companies. We also counsel investors for these companies.

## About Our Firm

Husch Blackwell leads our clients from where they are to where they want to be. From offices in 18 U.S. cities, we deliver legal insight and business leadership that helps our clients identify smart solutions, advance their goals and move forward.