CADWALADER

FUND FINANCE FRIDAY

Joint and Several Liability

December 7, 2018 | Issue No. 6

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Rose Capital, a Greenwich, Connecticut-based private equity firm, last week announced the closing of a $55 million fund focused on the cannabis industry. While a decision to lend to this fund would be an intended transaction, it reminded us of questions that will hit the fund finance market sooner rather than later: What if a fund borrows under a subscription line to acquire a portfolio company in the cannabis space? Or what if a fund seeks to join a cannabis-oriented portfolio company as a qualified borrower under a facility? Getting the munchies???

First, let's get into the weeds with respect to the legal aspects. Here is the state of play on the legalities of lending to the cannabis industry in the United States:

- Marijuana is illegal under federal law, regardless of varying degrees of legalization in most states.
- The Justice Department has revoked guidance protecting state marijuana laws. Conducting financial transactions with the proceeds of cannabis sales — such as repayment of loans — could violate anti-money laundering statutes.
- Lending directly to cannabis companies, or perhaps even cannabis funds, could conceivably be tantamount to aiding and abetting illegal marijuana trafficking if the government could prove that was the intent of the finance scheme.
- FinCEN has created a suspicious activity report ("SAR") regime to address banking state-legal cannabis businesses, requiring financial institutions that knowingly bank "marijuana related businesses" to file SARs for its clients' banking activities in this space.
- Yet, many banks have filed SARs and have lent money to the cannabis industry, while federal law is black and white. How it is applied and whether there is true prosecutorial and regulatory risk is a fact-specific, case by case assessment.

Fortunately, as federal law currently stands, most subscription facility documentation in the U.S. will give lenders strong protections from adding a cannabis company as a qualified borrower

based on the compliance with law and “know your customer” compliance provisions. We also believe the compliance with law sections, with particular focus on the Controlled Substances Act, would give lenders ample right to prevent a fund from using a facility to invest in a cannabis company.

Of course, the conflict between federal law and state law begs for reconciliation, and the smoke seems to be blowing in the direction of legality. Leaving, of course, franchise risk. We could see certain banks being comfortable with the franchise risk of lending to the cannabis industry, particularly indirectly under a subscription line. But others would clearly prefer to avoid the space. On the documents side, not all lender form credit agreements contain relevant use of proceeds restrictions or restrictions on qualified borrower joinders based solely on franchise risk. We have been encouraging lenders for several years to consider general consent rights around a qualified borrower (even though the underwrite is the fund) because a lender should never be obligated to lend to a company that it is not comfortable with from a franchise risk perspective. Just say no. Going forward, and not to stir the pot, but perhaps banks want to prohibit the space by contract and not just by reliance on current law. We see these issues getting more attention in the future.

If you have cannabis lending questions, we recommend talking with Cadwalader partner Jodi Avergun (Jodi.avergun@cwt.com).