

US Cannabis Cos. Must Beware Predatory Lending Practices

By **William Wolfe** (October 26, 2022)

On Oct. 6, President Joe Biden announced a federal pardon for all individuals convicted of simple cannabis possession.[1] He also announced that his administration would reform federal law to declassify marijuana as a Schedule I drug in the Controlled Substances Act, the classification reserved for the most dangerous substances.[2]



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While this news seemingly opens the door for federal legalization of cannabis, no clear timeline has been set. Biden's announcement also leaves many cannabis businesses operating in the approximately 39 states, and Washington, D.C.,[3] where cannabis use is legalized, wondering when legalization will take effect, which would likely resolve the significant challenges cannabis businesses face in seeking funding.

Presently, financial institutions providing banking services to legitimate and licensed cannabis businesses under state laws are subject to criminal prosecution under several federal statutes such as aiding and abetting, and money laundering.[4]

Therefore, businesses that legally grow, market or sell cannabis are generally locked out of the banking system, making it difficult for them to maintain a checking account, access credit, accept credit and debit cards, meet payroll or pay tax revenue.

The lack of clarity has shackled the cannabis industry's performance due to the limited ability of U.S. cannabis operators to attract capital from institutional investors. As cannabis companies desperately seek the cash they need to expand, they often feel pressured into agreements with terms heavily favoring lenders, often resulting in equity transfers in exchange for capital. This practice is known as predatory lending, and while it may not technically be illegal, it is often viewed as unethical.

There is a growing trend of U.S.-based cannabis companies tapping into the Canadian capital markets to seek needed financing, bankruptcy protection and the opportunity to list their company on the Canadian Securities Exchange.

As discussed further below *Gotham Green Partners LLC v. iAnthus Capital Holdings Inc.*, is a case that shows the potential drawbacks of U.S. cannabis companies doing business in Canada.

Predatory Lending in the Cannabis Industry

There are two types of predatory lending plaguing many companies in the cannabis industry: (1) unreasonable term loans; and (2) loan-to-own.

Unreasonable term loans often include high interest rates, short payment deadlines and a general unwillingness by the lender to negotiate. This predatory loan practice is common in the cannabis industry because cannabis businesses must usually turn to private lenders to get funding, which is much more expensive than loans provided to noncannabis businesses.

For most companies seeking financing for equipment, the interest rates range from 5%-8%; however, the rates for cannabis businesses can be as high as three times the regular rates

for financing equipment, ranging from 12-18%.^[5]

The same applies to borrowing rates for working capital, where noncannabis businesses can get bank financing for about 6%. Private lending rates for working capital for cannabis businesses range from 15%-18%.^[6] The practice of unreasonable term loans will continue until cannabis is legalized federal and cannabis business gain access to traditional funding options.

The second type of predatory lending practice is the loan-to-own model, where a deal is structured in a way where the borrower is more likely to default, giving the lender the ability to take over the company. In an attempt to avoid these predatory lending tactics, some cannabis businesses have opted not to inform investors about the nature of their business. Doing so creates its own liabilities.

For example, there is a pending class action suit against Innovative Industrial Properties Inc., one of the U.S.' leading real estate investment trusts.^[7] The IIPR class action lawsuit charges IIPR and certain top executive officers with violations of the Securities Exchange Act of 1934.

The complaint filed against IIPR alleges that the defendants made false or misleading statements and failed to disclose:

- That IIPR's focus is to be a cannabis company lender rather than a REIT;
- That the true values of IIPR's properties are significantly lower than the company represented;
- That existential issues plagued its top customers;
- That, as a result, IIPR's top customers may not be able to continue making payments to IIPR and IIPR would face significant issues replacing these customers; and
- That consequently, defendants' statements about IIPR's business, operations and prospects were materially false, misleading or lacked a reasonable basis at all relevant times.

These allegations stem from a report released by market researcher Blue Orca Capital on April 14,^[8] which described IIPR as a cannabis bank pretending to be a REIT whose model is to conduct sale-leaseback transactions with cannabis businesses because federal regulations bars those business from traditional financing options.

The report explained that IIPR's business model was to overpay for properties and fund the tenant improvement to build out the facilities for cannabis companies and IIPR would receive repayment of the loan in the form of long-term lease agreements at 11%-14% yields.[9]

According to the report, IIPR's business and valuation is contingent on high-quality tenants who are able to make timely lease payments. The report further alleged that unlike with other REITs, IIPR's will likely be unable to recover from defaulting tenants because the actual value of its properties are significantly lower than what is reflected on IIPR's balance sheet.

IIPR responded to the report in a press release stating that Blue Ocra fails to have any comprehension of all the significant improvements needed to transform standard industrial buildings to those equipped with the enhanced environmental controls and other building systems necessary for regulated cannabis cultivation and processing.[10]

Due to the illegality of cannabis, many U.S.-based cannabis companies have looked to their northern neighbor for assistance, resulting in a growing trend of established U.S. cannabis companies tapping into Canadian capital markets.

U.S. Cannabis in Canadian Markets

Canada became the first developed country — second only to Uruguay — to legalize cannabis nationwide after passing Bill C-45 in 2018, otherwise known as the Cannabis Act.[11]

The Canadian Cannabis Act permits U.S.-based companies to list cannabis-related shares publicly on the Canadian Securities Exchange. The CSE has positioned itself as one of the pillars of cannabis investment in Canada, allowing Canadian companies to seek business possibilities in the U.S. as long as they disclose risks properly to shareholders.

The cannabis market accelerated after TMX Group — the Toronto-based financial services company that operates the Toronto Stock Exchange, TSX Venture Exchange, Montreal Exchange and TSX Alpha Exchange — imposed a regulation preventing companies listed on the TSX and TSX Venture Exchange from holding U.S. assets.[12]

The CSE now offers exposure to a wide range of cannabis stocks, from those in the early stages of development to established multistate operators. Nearly 80% of the \$31.6 billion in market value hosted by the CSE is composed of U.S.-based cannabis companies with headliners including Curaleaf Holdings Inc. and Trulieve Cannabis Corp.[13] It is also home to a variety of research operations and extraction firms.

In addition, unlike in the U.S., Canada affords cannabis companies bankruptcy protection, referred to as an insolvency proceeding, under Canada's Companies' Creditors Arrangement Act.

While this protection often attracts U.S. companies to the Canadian market a dispute making its way through Canadian courts also holds its share of potential drawbacks. Gotham Green Partners LLC v. iAnthus Capital Holdings Inc.[14] in the Ontario Superior Court of Justice provides a case study example of the complications a loan-to-own predatory lending model and insolvency can present.

iAnthus Capital Holdings Inc. is a Canada-based cannabis cultivation, processing and retail

company, which currently has operations in 11 U.S. states and is listed on the CSE.[15] Gotham Green Partners LLC is a California-based private equity firm investing exclusively across the global cannabis industry.[16]

In 2018, iAnthus wanted to become a national player in the cannabis industry but lacked the capital needed to expand into other markets. iAnthus had few traditional options for securing the needed funding in the U.S. and as a result, reached out to Gotham Green for cash flow support.

Gotham Green first provided iAnthus with a \$40 million loan in 2018. In September 2019, the commitments grew, and Gotham Green agreed to a total \$100 million financing plan.

But after the execution of the plan, Gotham Green provided iAnthus with a total of only \$56 million in two separate installments. According to the plan's terms with iAnthus, Gotham Green was under no legal obligation to provide the remaining \$44 million of the \$100 million in financing.

During the start of the COVID-19 pandemic, representatives of iAnthus requested paperwork regarding the deferral of interest payments to be made on the loan. The CEO of iAnthus, Hadley Ford, alleges that Gotham Green told them not to worry about making any interest payments.[17]

Disguised as a financial lifeline, the series of iAnthus and Gotham Green deals could ultimately prove catastrophic for iAnthus shareholders, potentially wiping out hundreds of millions of dollars from investors and giving Gotham Green ownership.

According to investors, once iAnthus missed its March 2020 payment, Gotham Green took steps to seize control of iAnthus by filing a lawsuit in the Ontario courts, proposing a restructuring agreement.[18] Canadian courts have primarily ruled in Gotham Green's favor, approving the restructuring agreement that would wipe out shareholder value and extending a deadline for regulator approvals.[19]

Several U.S. states have restrictions against cross-ownership, so Gotham Green is having trouble getting operational approval in many states as it has investments in several other cannabis companies.[20] The dispute between Gotham Green and iAnthus continues to lead to investor-led lawsuits against state regulators in states that restrict the cross-ownership of cannabis licenses.

Many of the iAnthus investors feel as though iAnthus did not do its due diligence in assessing the risk when reviewing the terms of the loan agreement with Gotham Green and question why iAnthus defaulted on the interest payment despite being required by the terms of the first loan to maintain an escrow fund for it. In contrast, iAnthus executives contend that Gotham Green deceived them from the start by telling them not to make the necessary interest payments to avoid default.

The iAnthus experience shows how cannabis companies in the U.S. face stiff challenges raising money to expand their operations and other cannabis companies could potentially find themselves in the same position until there is a change in the law.

How Can Cannabis Companies Avoid Predatory Lending?

As long as cannabis continues to be illegal federally, cannabis companies will not have access to resources like the Small Business Administration's low-interest loans that are

provided to noncannabis companies. As a result, alternative lenders can leverage cannabis' classification as a Schedule I drug against cannabis companies and offer sky-high interest rates for taking the risk of lending money to a business that is operating in violation of federal law.

Unfortunately, cannabis companies looking to avoid predatory lending do not have too many options available due to this federal impediment. The best practice would be to ensure that cannabis companies do their due diligence when seeking funding and refuse any loan terms that seem unreasonable or could potentially result in the forfeiture of their company's assets upon default.

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[1] "Statement from President Biden on Marijuana Reform." The White House, The United States Government, 6 Oct. 2022, <https://www.whitehouse.gov/briefing-room/statements-releases/2022/10/06/statement-from-president-biden-on-marijuana-reform/>.

[2] Id.

[3] Approximately 18 states along with the District of Columbia have legalized recreational or adult-use of cannabis.

[4] See generally the Money Laundering Control Act, Pub. L. No. 99-570 (18 U.S.C. §§ 1956 and 1957), and the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act), Pub. L. 107-56, 115 Stat. 272.

[5] Winzelberg, David. "Putting the Green in Cannabis Businesses." Long Island Business News, 3 Aug. 2022, <https://libn.com/2022/08/03/putting-the-green-in-cannabis-businesses/>.

[6] Id.

[7] *Mallozzi v. Innovative Industrial Properties, Inc.*, No. 22-cv-02359 (D.N.J.)

[8] "Innovative Industrial Properties, Inc. Short-Seller Report on Cannabis REIT." Blue Orca Capital, 14 Apr. 2022, <https://static1.squarespace.com/static/5a81b554be42d6b09e19fc09/t/62580cb4f242a633f5c24a98/1649937590375/Blue+Orca+Short+Innovative+Industrial+Properties+Inc+%28NYSE+IIPR%29.pdf>.

[9] Id.

[10] "Innovative Industrial Properties Responds to Short-Seller Report." Business Wire, Berkshire Hathaway, 14 Apr. 2022, <https://www.businesswire.com/news/home/20220414005821/en/Innovative->

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[11] "Canada Becomes Second Country to Legalise Recreational Cannabis." BBC News, BBC, 17 Oct. 2018, <https://www.bbc.com/news/world-us-canada-45806255>.

[12] Pistilli, Melissa. "CSE Marijuana Stocks." INN, 10 Jan. 2022, <https://investingnews.com/daily/cannabis-investing/cse-marijuana-stocks/>.

[13] Kary, Tiffany. "Canadian Exchange Proposal Would Benefit U.S. Cannabis Firms." Bloomberg.com, Bloomberg, 8 Dec. 2021, <https://www.bloomberg.com/news/articles/2021-12-08/canadian-exchange-proposal-would-benefit-u-s-cannabis-firms>.

[14] Gotham Green Partners, LLC and Gotham Green Admin 1, LLC v. iAnthus Capital Holdings, Inc., et. al., Court File No. CV-21-00667501-00CL, Ontario Superior Court of Justice.

[15] "iAnthus Capital Holdings, Inc." iAnthus Capital Holdings, Inc., <https://www.ianthus.com/>.

[16] "Gotham Home." Gotham Green Partners, 3 Jan. 2022, <https://gothamgreenpartners.com/>.

[17] Zhang, Mona. "The Risky Financial Deals That Shook up One of America's Most Promising Weed Companies." POLITICO, <https://www.politico.com/news/2022/02/05/risky-financial-deal-weed-company-ianthus-00004862>.

[18] Id.

[19] Gotham Green Partners, LLC and Gotham Green Admin 1, LLC v. iAnthus Capital Holdings, Inc., et. al., Court File No. CV-21-00667501-00CL, Ontario Superior Court of Justice.

[20] Nevada and Florida state regulators have given operational approval to Gotham Green.