

Six Things to Consider Before Doing Business with Cannabis and CBD/Hemp Companies

By: Sam Fensterstock, AG Adjustments

As originally published in the Credit Research Foundation's publication, Perspective by CRF (Q1 2020)

With the legal cannabis and CBD/Hemp markets are expected to generate more than \$50 billion in revenue by 2024¹, many mainstream members of corporate America are looking to do business in this emerging market. Many of AGA's clients have told us that they have either been approached or have started do business in this market, and to that extent, I have become actively involved as a member of the National Cannabis Association's Banking & Finance Committee. At the upcoming March Credit Research Foundation Forum I will be moderating a panel discussion to address the operational and legal issues that companies face when selling into this new market, and thought that prior to the Forum I would provide some insight as to what we will be reviewing in March.

Any personal or corporate position on legalization or descheduling should be tabled; there is significant potential revenue in providing your company's goods and services to cannabis or CBD/hemp companies. But before you do, you must determine what your legal exposure is. So, here are six things every company must consider before doing business in the cannabis-related market:

1. Is the Company You're Doing Business with Plant Touching and Do They Have a State Issued License?

If the company you are looking to do business with is plant touching, then they must have a license issued by the state in which they operate in order to be a state legal cannabis business. The black market is huge, so you need to determine if your potential customer is legit. **If they do not have a state issued license, or their license is not in good standing, DO NOT do business with them.**

There are also many different types of plant touching businesses in the cannabis market and it is important to know who you're selling to. Just like in corporate America, there are different segments to the market, and the more you know about your potential customer and what they are going to be using your products and services for, the better decisions you can make to mitigate your company's risk. Here are the main segments of the cannabis market:

- a. Cannabis – is a group of 3 plants with psychoactive properties known as Cannabis sativa, Cannabis indica and Cannabis ruderalis.
- b. Marijuana – the dried leaves and flowering tops of the Cannabis sativa or indica plant that contain more than .3% THC.
- c. Hemp – is a strain of the Cannabis sativa plant that is grown specifically for industrial purposes. Hemp has lower concentrations of THC and higher concentrations of cannabidiol (CBD). Hemp can be used to make textiles, industrial products, clothing, shoes, bioplastics, insulation and much more. In 2018, all hemp with less than .3% THC became legal under The Farm Bill. The Bill allows hemp cultivation broadly, not simply pilot programs for studying market interest in hemp-derived products. It explicitly allows the transfer of hemp-derived products across state lines for commercial or other purposes. It also puts no restrictions on the sale, transport or possession of hemp-derived products, as long as those items are produced in a manner consistent with the law.
- d. CBD – or cannabidiol is a naturally occurring compound found in the resinous flower of the cannabis plant. CBD that is derived from a hemp plant with less than .3% THC is legal under federal law. If the CBD is derived from the marijuana plant (a cannabis plant with more than .3% THC) then this

¹ Forbes Magazine - <https://www.forbes.com/sites/irisdorbian/2019/05/20/cbd-market-could-reach-20-billion-by-2024-says-new-study/#17c3185249d0>

<https://www.forbes.com/sites/irisdorbian/2019/09/24/new-cannabis-report-predicts-legal-sales-to-reach-nearly-30-billion-by-2025/>

version of CBD remains classified as a schedule 1 drug on the CSA.

- e. Direct Marijuana Business – is a business that grows, produces, distributes or sells marijuana products, edibles or derivatives, regardless of the amount of such activity. This applies to both medical and recreational use no matter the laws of the state.
 - i. Cultivators – or sometimes called growers, are the companies that are growing cannabis flower.
 - ii. Processors & Manufacturers - are responsible for taking the raw cannabis plant and creating entirely new products from it including concentrates, topicals and edibles. In addition to creating these products, processors must also package them in compliance with their state’s regulations. Processors can also be referred to as manufacturers, extract technicians, extract artists or edibles chefs depending on the way their states have defined industry roles on their finished products.
 - iii. Distributors – are the liaison between a cultivator, processor and their customer – typically a retailer or dispensary. Because cultivators and processors cannot always sell directly to the retailer or be what we call “vertically integrated”, distributors connect cannabis brands with dispensaries and delivery services.
 - iv. Retailers – these are the businesses that are selling cannabis products directly to consumers and are either store fronts or delivery services.
- f. Indirect Marijuana Business – is a business that ANY of its gross revenue from the previous year was from sales to direct marijuana businesses of products or services that could be reasonably determined to aid in the use, growth or enhancement, or other development of marijuana.
 - i. Non-Plant Touching Service Providers – any type of company that provides ancillary services to the cannabis market. These are companies such as ag products, packaging, software, legal & financial services, shipping, logistics and staffing.
 - ii. Plant Touching Service Providers – these are companion companies that are used in the aid, growth or enhancement of marijuana, such as testing labs or companies that install grow lights or build grow houses.

2. Banking Considerations

If you take in money from a plant touching state legal cannabis business, can you deposit it – no matter if it is cash, check or ACH? Also, does your customer have a banking relationship where they can easily pay you?

Most cannabis related businesses deal in a lot of cash, but many have a banking relationship and can pay you by check or ACH, just as any other normal business would. The Financial Crimes Enforcement Network reported that as of September 30, 2019 there were 563 banks and 160 credit unions servicing cannabis companies. One of the key things to do when you are evaluating a credit relationship with your cannabis customer is to perform due diligence around if and where they have a banking relationship.

If your customer does not have a banking relationship, then you will probably be paid in cash or sometimes by the owner’s personal credit cards - there is risk associated with this. If you are going to be paid in cash, if the transaction is more than \$10,000, you will need to file a form 8300 with the IRS detailing where the cash came from. Also, if your bank knows that you are receiving funds from a cannabis related business, they could shut down your bank account. To avoid any problems, you should probably have a conversation with your bank before going down this path.

To help bring banking to the cannabis market while cannabis is still illegal under the CSA, the SAFE Banking Act of 2019 was passed by the House in September 2019 and now is in the Senate. The SAFE Banking Act is proposed legislation that is aimed to address the state legal cannabis industry’s lack of access to banking and financial services, but probably won’t passed until 2021. The Act prevents banking regulators from penalizing banks or their employees for providing financial services to state-legal cannabis businesses. The SAFE Banking Act is a move in the right direction, but it won’t open the flood gates for banking services for the cannabis market as many banks will still sit on the sidelines.

3. Will You Be Getting Paid in Cash, Credit Card or Electronically?

- Accepting cash – as 75% of all cannabis transactions are made in cash, it is the most widely used method of payment in the market. However, there are lots of issues with accepting cash, especially if you are accepting more than \$10,000 at a time. As we said previously, this requires you to file a form 8300 with the IRS. Once the form is received, the information is cross referenced with the Financial Crimes Enforcement Network to verify that the transaction was not part of any criminal activity.
- Accepting credit card – this is the second most popular way that cannabis companies pay their bills.
- ACH / Wire and paper check – accepting any of these payment types from state legal cannabis companies to pay for your goods and services is the same as accepting these types of payments from your other customers. However, the challenge in the cannabis industry is that your customer may not have a bank account and won't be able to pay you electronically.

Each of these payment forms still has one mitigating factor. The company you are doing business with may still be considered an illegal business by the federal government. Therefore, payments to your company may be scrutinized and should comply with state and federal law, be transparent and properly documented in order to avoid suspicion of money laundering.

4. What are the Legal/Criminal Issue Considerations of Doing Business with Both Plant Touching and Non-Plant Touching Cannabis Related Businesses?

As of 2020, cannabis remains illegal under the federal Controlled Substances Act (CSA). If you provide general business services to a cannabis company, are you breaking the law? If so, which law, state or federal? There are a few different areas to consider.

Are you an accessory to violating the federal CSA if you are doing business with a cannabis company? According to the law, anyone who aids, abets, or conspires to commit a crime is just as guilty as the individual who commits that crime. At least for now, according to the CSA, businesses that cultivate or sell marijuana are performing a criminal act. However, it is very difficult to prove that a goods/service provider to a cannabis company should be found equally liable for aiding and abetting those criminal acts. The one saving grace is the prosecution needs to prove intent - the so-called mental state requirement. To prove criminal liability, it is required that the government prove that the provider of goods/services intended to aid in the commission of a crime. In this situation it can be shown that the third-party service provider does not care what their customer's business is. Even if they know that their activity aids the selling of cannabis-based products, it doesn't mean that they intend it to be so, and in any case, you would have to prove it to a jury - a very difficult task considering the public's general feeling about the current state of cannabis legislation.

There have been several pieces of legislation that helped the cannabis industry grow. The primary one was the Cole Memorandum in August 2013. The Cole Memorandum instructed the federal government to not enforce federal cannabis prohibition in states that have legalized cannabis in some form, and to only prosecute cases that implicate a significant federal interest – primarily when a case involves violence. However, the memorandum was rescinded in January 2018 by then Attorney General Jeff Sessions. The Session Memorandum stated that the CSA was the law and cannabis continues to be illegal, and that cannabis related activities can serve as the basis for the prosecution of other crimes. The Session Memorandum directs federal prosecutors to exercise the discretion when it comes to the enforcement of the CSA.

In response, in June 2018, The STATES Act bill² was proposed in Congress and was reintroduced in April 2019. The bill would continue to protect states' rights to enact their own cannabis policies by amending the CSA to exempt cannabis-related activities that comply with state, territory or tribal laws. The legislation would also protect banks that work with cannabis businesses.

2 <https://www.congress.gov/bill/116th-congress/house-bill/3754/text?format=txt>

5. What is the Difference if the Customer is a CBD/Hemp Company, and How Does This Affect You?

The Agriculture Improvement Act of 2018 ("The Farm Bill") legalized hemp by removing the crop and its derivatives from the definition of cannabis under CSA and by providing a detailed framework for the cultivation of hemp. The Farm Bill gives the US Department of Agriculture (USDA) regulatory authority over hemp cultivation at the federal level. However, states can maintain primary regulatory authority over the crop cultivated within their borders by submitting a plan to the USDA.

However, not all CBD is the same. CBD that is derived from the cannabis plant falls under the CSA and is still considered federally illegal. CBD that is derived from the hemp plant and has less than .3% THC falls under The Farm Bill and is legal in all 50 states. However, the FDA has only approved one cannabis-derived CBD based drug, Epidiolex, and the agency is not going to grant companies the ability to add CBD to food, beverages or dietary supplements. Currently, any company that adds CBD to food, beverages or dietary supplements is in violation of FDA guidelines. So, if you're doing business with a CBD company that is infusing CBD in other food or beverage products, you need to know that as they may be violating FDA guidelines, and this could have negative ramifications on your business. Recently the FDA has cracked down on CBD companies that have made false claims about the uses of CBD for curing or preventing disease. The FDA has been clear that CBD has not yet been declared to be GRAS or generally recognized as safe.

Many states have addressed this situation by passing legislation that allows the commercial production of hemp within their borders. Moreover, many states also regulate the sale of products derived from hemp. As the laws vary from state to state, you need to review the law for each state that you will be doing business in to make sure you avoid any legal problems. Additionally, according to the USDA, for a producer to cultivate hemp, it must either have a license or other authorization from a state, Tribal or USDA hemp program. The USDA will issue licenses to producers who are operating in jurisdictions that have not submitted a plan or in jurisdictions where a plan has not been approved.

If you plan to do business with a CBD/Hemp producer, to protect yourself, make sure that they have a USDA, state or Tribal license that authorizes them to cultivate hemp.

6. Making a Credit Decision on a Cannabis Based Business

So, your new cannabis or CBD/Hemp customer wants credit terms. How do you make a credit decision on a company who might not have any traditional credit related data available on them? As we talked about in #1, the first thing you need to make sure is that your potential customer has a license issued by their state to do whatever they are doing in the market. If a company is a cultivator, extractor, retailer or any other plant touching company, as we stated earlier, if they do not have a license in good standing and registered to operate in their state, you should not do business with them. If you do, you are not only breaking federal law, but state law as well.

If you find that your potential customer is a licensed operator that you would extend credit to like any other customer, we recommend you have them fill out a credit application. The challenge you might face is that not many cannabis related businesses are used to filling out a credit application. The cannabis industry has been mostly cash based for the past 10 years and therefore you might have to do some explaining to your potential customer about why you need a credit application completed. If they won't do it – you may not want to do business with them.

While personal guarantees are commonplace in corporate America, they are not in the cannabis market. Most business owners have never been asked to sign one from a vendor. Once again, just like a credit application, your potential customer may be hesitant about signing one – another thing to consider.

As we have reviewed in previous articles, a credit application is more than just a form for requesting credit.

A credit application is a contract between the seller and the buyer. A good credit application will benefit the seller, a bad one the buyer. Therefore, it is important that your company is certain your credit application contains all the safeguards (provisions for credit applications and personal guarantees) available to reduce customer risk. Securing a credit application does not guarantee payment, but it is one of the more significant documents you can obtain to assist you in making a good credit decision. The credit application is the first step in gathering information about your potential customer. Even if your customers are paying you in cash, ask them to fill out a credit application. Collecting the necessary information will make it easier to determine exactly how much credit to extend.

While there is not much trade data on cannabis related companies that has been reported to the leading credit bureaus, as the market matures, so will the depth of trade data that will be available on cannabis related businesses that can be used in your credit decision process.

Conclusion

We are hearing from many of our clients that there are significant opportunities in the cannabis and CBD/hemp markets as they continue to grow, but there is also significant risk. Cannabis is still federally illegal under the CSA, and while the federal government is not actively enforcing the CSA in states where cannabis is legal, it still is illegal - and the risks of doing business in this market need to be considered.

We have tried to provide some basic information on the perils and pitfalls of doing business with a cannabis or CBD/hemp company. This is an ever-changing topic as the federal government and the states are currently addressing this area, and the legal ramification of doing business with cannabis and CBD/hemp companies is in a constant state of flux. There are currently bills pending in congress that could significantly change the business environment in the future. We will endeavor to help you stay current by publishing information about the state of the business when it changes.

About the Author



Sam Fensterstock is the SVP of Business Development at AG Adjustments (www.agaltd.com). AGA is one of the nation's leading providers of 3rd party commercial collection services. Sam oversees AGA's sales organization as well as corporate partnerships and marketing. He has more than 25 years of experience as a Senior Business Development Executive, Manager and Coach in the commercial credit and collections space. He is passionate about helping companies improve their order to cash process with a specific focus on credit risk and collection management. He has been a founder and played a key role in the dynamic growth of several leading niche commercial credit risk management companies and is considered an expert in the order to cash and credit and collections process. Prior to joining AG Adjustments Sam was the Director of Business Development at PredictiveMetrics, a statistical based credit and collection scoring and modeling company that he helped grow and sell to SunGard (FIS) in 2011. AG Adjustments has been a Platinum Partner of The Credit Research Foundation since 2000. Sam can be reached at samf@agaltd.com or 631-719-8096.