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MARIJUANA STARTUPS TRADING EQUITY STAKES FOR LEGAL HELP, REAL ESTATE

EXPERTS SEE SUCH DEALS AS RISKY ON SEVERAL FRONTS

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Some cannabis business owners are signing over equity to lawyers and landlords to stay afloat in the emerging legal industry. (AP File Photo/Jae C. Hong)

Some attorneys, landlords and other service providers in California are quietly taking equity stakes in cannabis startups in lieu of cash fees — a practice that many say comes with ethical and legal risks.

Equity payouts can solve two problems at once. They can lower the initial costs and other barriers to entry for entrepreneurs struggling to join California's emerging cannabis market. They also can offer some assurance, and the potential for a big payout, to service providers who work with an industry that's legal in California but remains illegal under federal law.

It’s a practice that’s not uncommon in the tech industry. Tales of lottery-style wealth — such as the story of a graffiti artist who got rich after taking Facebook stock as payment for a mural when the burgeoning company was strapped for cash — are part of that industry’s history.
Such deals also have been common in the illicit marijuana market. And now, as operators struggle with high startup costs, lack of access to capital and a highly competitive real estate market, equity swaps are spilling over to the legal cannabis industry.

But attorneys and others say the arrangements can pose ethical and logistical problems. The risks range from conflicts of interest, to the potential that service providers will take advantage of business owners desperate to stay afloat in a new market.

“If you have a client that you believe in, that can’t afford you, taking stock or a membership interest in lieu of billable hours payments can work out on both sides if the client is successful,” said Hilary Bricken, a Los Angeles-based cannabis attorney.

“I often, though, see California attorneys using this practice in (the) cannabis (industry), not necessarily to help aching startups, but to try and get rich quick with a shotgun approach, as in ‘Let me bet on who the next Facebook of cannabis is and get a direct piece’,” Bricken added.

Further complicating such deals is the exposure that could come when the state sets final business rules for the cannabis industry. Instead of being able to issue small stakes of equity to unidentified partner providers, the rules now pending will require a cannabis company seeking a state business license to disclose all of its owners.

“The handshake deals, the idea of being able to provide service for equity and things not being put into contract form for disclosure to the state, those times are changing,” said Josh Drayton, spokesman for the California Cannabis Industry Association.

Red flags for attorneys

Equity swaps raise the biggest ethical concerns when it comes to deals with attorneys, according to many attorneys themselves.

“Lawyers are taking advantage of their own clients,” said Dana Cisneros, an Anaheim Hills-based cannabis industry attorney who has criticized such arrangements.

Cannabis industry attorney Dana Cisneros on Friday, July 20, 2018 in Costa Mesa. (Photo by Michael Fernandez, Contributing Photographer)

Bricken said she has has seen attorneys take a business interest in one cannabis client and continue to represent a competitor seeking an exclusive license in the same city.

“We know plenty of lawyers who advise doing it,” said Christopher Davis, executive director of the National Cannabis Bar Association in San Francisco. “But it really is just an area that is fraught with risk.”

For such deals to be considered “close to ethical,” Davis said, the attorney would need to set up lots of firewalls by disclosing all potential conflicts of interest, and have their client sign a waiver acknowledging they know about the issue. The lawyer also would need to encourage clients to seek independent counsel if there’s ever a question about the advice they’re getting.

New state ownership disclosure requirements should help address some of these concerns, according to Bricken.

“California will definitely make lawyers come clean with this in licensing,” she said. “And I think it will better inform clients as to whether or not they’re receiving ethical counsel and treatment.”

But Davis said that still doesn’t solve another question: What happens when a client who has issued equity to one attorney wants to ditch that lawyer for someone else?

The law says attorneys can’t charge fees after they’ve been fired. So would the lawyer have to sell their equity stake to ensure they’re no longer making money from that former client? And, if so, at what price would they sell, since most of these shares have no public market to determine fair value?

What’s clear, Bricken said, is that equity deals can put the attorney’s license and firm at risk.

“Taking a financial interest in a cannabis business without a doubt pins you down as a trafficker and expands the bullseye on your backside,” she said.

Real estate risks

The practice isn't limited to attorneys. Davis said equity payouts might be more common among landlords and their cannabis-industry tenants.

He's seen tenants sign away equity in exchange for a few months rent, or for an ongoing price break.

While Davis said landlords aren't bound by the same ethical issues as lawyers, that doesn't mean such ownership agreements don't come with their own set of problems — which is why they're not common in other industries.

Given its unique legal status and booming market, "cannabis is sparking the opportunity," said Dave Wensley, an Irvine attorney with the real estate-focused firm Cox, Castle & Nicholson.

Some property owners are getting creative, signing management agreements or forming joint ventures with their cannabis clients, Wensley said. Others are agreeing to take a direct ownership stake in the business, he said, or letting cannabis tenants pay rent that's based on a percentage of their revenue.

Such deals have long been common in California's underground market, according to Gem Montes, executive director of the Inland Empire branch of the advocacy group NORML.

One major landlord in San Bernardino would routinely ask for 10 percent of the profits from each marijuana harvest on top of monthly rent in exchange for agreeing to lease out warehouse space to unlicensed growers, Montes said. The idea was to offset the risk that a tenants' crop could be seized by authorities, or that they could leave town overnight, with little power for landlords to enforce lease terms for an unlicensed business.

On the flip side, Montes added, such leases sometimes leave cannabis tenants doing their own property repairs, or locked out of their own businesses. It's why some savvy marijuana entrepreneurs started asking for a small ownership stake in the real estate they are leasing, an arrangement that provides them some power in the relationship with their landlord.

Since much of today's licensed cannabis market is yesterday's underground market, Montes said, it's no surprise that long-time practices are carrying over to the legal industry.

But according to Wensley, nearly all major real estate brokers, investors and developers remain on the sidelines when it comes to the cannabis industry because the industry remains illegal under federal law. He said most established real estate players who are working with cannabis companies have no interest in owning a share of the marijuana businesses, citing ethical, legal or financial reasons.

Developers who also deal with affordable homes, for example, could lose federally subsidized loans if regulators learn they're making money from marijuana. Most major banks still won't serve the cannabis industry, which means developers also could get turned down for financing on other projects. And if there's a cannabis ownership agreement tied to a piece of real estate, Wensley said, it could be difficult to sell that property in the future.

"We have been offered ownership in exchange for commission, but the potential risk doesn't warrant jeopardizing our core business," said Jason Lamoreaux, a broker who has worked extensively with the cannabis industry as president of Coldwell Banker Commercial in Victorville.

If his firm took equity in any cannabis businesses, and if federal authorities began questioning that deal, Lamoreaux said authorities could hypothetically seize all company assets while they conduct an investigation.

"Meanwhile, I would be out of business while the feds determine what assets are not involved — which, from what I have read, could take many years," he said.

Wensley said many of the property owners or investors who take an equity payout seem to hope that they'll be able to take charge of the operation if the tenant goes belly up. But, he added, "the licensing process is very tight and person-specific," lowering the odds of such a takeover.

Equity payouts are messy and complex, but as long as the marijuana industry is growing — with service providers seeing dollar signs and barriers to entry for businesses still high — experts don't see them going away.

"People are being forced to fight tooth and nail to stay in this market," Drayton said. "This is a battlefield right now for the cannabis industry."