

International Franchise Association  
52<sup>nd</sup> Annual Legal Symposium  
May 5-7, 2019  
Washington, DC

---

# The Distribution of Legal Cannabis: Impact and Opportunities for Franchising

*A Comparison of the Canadian and American Cannabis Retail Regimes*

---

**David Koch**  
Plave Koch PLC  
Reston, VA

**Dawn Newton**  
Donahue Fitzgerald LLP  
Oakland, CA

**Frank Robinson**  
Cassels Brock & Blackwell LLP  
Toronto, ON

## TABLE OF CONTENTS

	<b>Page</b>
I. INTRODUCTION .....	1
II. CANADA .....	1
A. The Laws of Cannabis.....	1
1. Licensed Producers .....	2
2. Federal.....	2
3. Provincial and Municipal .....	3
B. Cannabis Retail in Ontario.....	3
1. Ontario Municipalities.....	6
C. Cannabis Retail in Alberta .....	6
1. Municipalities in Alberta .....	8
D. Cannabis Retail in British Columbia .....	8
E. Cannabis Retail in other Canadian Provinces .....	10
F. The Role of Franchising Role and the Impact of Franchise Legislation.....	11
1. Franchising Issues .....	12
2. The Branding Experience.....	16
3. Trademark Protection.....	19
III. THE UNITED STATES .....	21
A. Laws Impacting Businesses in the Cannabis Industry.....	21
1. “Touching the Plant” or Not .....	21
B. Legality.....	22
1. Federal Prohibition .....	22
2. State Laws .....	25
3. Municipal Oversight.....	25
4. Licensing.....	26
5. Vertical and Horizontal Integration .....	28
C. Laws Affecting Operations.....	29
1. Banking .....	29
2. Taxation .....	31
3. Interstate Commerce.....	32
4. Formulation, Labeling and Packaging .....	32
5. Trademarks .....	33
6. Traceability.....	34

7. No Bankruptcy Protection.....	34
8. The Role of Real Estate .....	35
D. Opportunities and Risks for Franchising.....	36
1. Market Demand.....	36
2. Franchising Challenges.....	37
3. Disclosure, Registration and Franchise Operation .....	43
IV. CONCLUSION .....	44

## I. INTRODUCTION

In both Canada and the United States, one of the largest markets for cannabis consumption—retail brick and mortar—still has many unknowns. In Canada, what has been clear from the birth of the industry is that franchising has the ability to offer a conducive and established business model to help launch and develop the retail market for recreational cannabis across the country, and beyond. In the United States, the picture is fuzzier, with many more regulatory hurdles for prospective franchisors to clear. However, with the ability to move product efficiently, to maintain consistency in consumer experience, and to build and establish brand presence, franchising has the potential to offer the cannabis industry a compelling distribution and retail option in the U.S. as well. This paper will explore some the key differences between the Canadian and American retail regimes and the significant effect Canadian and particularly American cannabis laws will have on potential cannabis franchise systems.

## II. CANADA

To better understand the role of franchising in the Canadian cannabis sector, this paper presents the following: (a) a high level overview of the cannabis laws, with a breakdown of the laws federally, provincially and municipally, including how the rules impact franchising by federally licensed cannabis producers; and (b) an analysis of the role of franchising in this evolving industry, with a specific focus on production, licensing, distribution, branding, and trademark protection.

### A. The Laws of Cannabis

The *Cannabis Act*, originally introduced as Bill C-45, aims to create a strict legal framework for controlling the production, distribution, sale, and possession of cannabis across Canada.<sup>1</sup> The purpose of the *Cannabis Act* is to protect public health and public safety and, in particular, to (a) protect the health of young persons by restricting their access to cannabis; (b) protect young persons and others from inducements to use cannabis; (c) provide for the licit production of cannabis to reduce illicit activities in relation to cannabis; (d) deter illicit activities in relation to cannabis through appropriate sanctions and enforcement measures; (e) reduce the burden on the criminal justice system in relation to cannabis; (f) provide access to a quality-controlled supply of cannabis; and (g) enhance public awareness of the health risks associated with cannabis use.<sup>2</sup>

The provinces are responsible for creating and enforcing regulations related to the distribution and sale of cannabis. Each province has done so, creating rules particular to that province which impact and direct the development of the retail landscape within its borders.<sup>3</sup>

---

<sup>1</sup> S.C. 2018, c 16.

<sup>2</sup> *Id.*

<sup>3</sup> *Cannabis in the provinces and territories*, February 4, 2019, available at <https://www.canada.ca/en/health-canada/services/drugs-medication/cannabis/laws-regulations/provinces-territories.html>

## 1. Licensed Producers

As the source of legal medical and recreational cannabis in the country, licensed producers (the “LP”) are one of the key stakeholders in Canada’s cannabis industry.<sup>4</sup> Many LPs, having focused their efforts and resources on production in the first few years before federal legalization of cannabis, have now turned attention to retail opportunities and have sought out various methods to get their wares to market. Franchising, in particular, for the reasons outlined in this paper, has proven to be one of the attractive options in this regard.<sup>5</sup> As a result, this paper will examine the role of the LP in helping to develop and to participate in franchising activities related to cannabis retailing.<sup>6</sup>

An LP is the holder of a producer’s license that is issued by Health Canada under the Access to Cannabis for Medical Purposes Regulations (“ACMPR”) to produce quality-controlled cannabis under secure and sanitary conditions.<sup>7</sup> They can be authorized to produce and sell dried and fresh cannabis, seeds and plants, and cannabis oil. As of the date of writing, there are 102 LPs of cannabis for medical purposes. The process of becoming a LP is comprehensive and highly regulated. Licences for LPs are only issued once it has been determined that all information submitted demonstrates compliance with the ACMPR and the facility has been built. Each application undergoes a detailed assessment and review, including in-depth security checks undertaken by the Canadian government.<sup>8</sup>

## 2. Federal

Under the *Cannabis Act*, the Canadian government has established federal restrictions on possession and consumption, while the provinces are able to establish their own sets of rules, such as restrictions on the minimum legal age of consumption, possession limits, and where cannabis can be consumed.<sup>9</sup> Regulation of the production, sale, and consumption of medical cannabis is entirely different from recreational cannabis and falls exclusively under federal powers. Cannabis production, home cultivation, medical cannabis, trafficking laws, advertising and packaging, impaired driving laws, cannabis education, and taxation all fall exclusively under federal jurisdiction.<sup>10</sup>

Subject to provincial or municipal restrictions, adults who are 18 years of age or older are able to possess up to 30 grams of legal cannabis, dried or equivalent in non-dried form in public; share up to 30 grams of legal cannabis with other adults; buy dried or fresh cannabis and cannabis oil from a provincially-licensed retailer; in certain provinces and territories, purchase cannabis online from LPs; grow, from licensed seed or seedlings, up to 4 cannabis plants per residence for personal use; and make

---

<sup>4</sup> *Licensed cultivators, processors, and sellers of cannabis under the Cannabis Act*, March 15, 2019, available at <https://www.canada.ca/en/health-canada/services/drugs-medication/cannabis/industry-licensees-applicants/licensed-cultivators-processors-sellers.html>

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> S.C. 2018, c 16.

<sup>10</sup> *Id.*

cannabis products, such as food and drinks, at home as long as organic solvents are not used to create concentrated products.<sup>11</sup>

### **3. Provincial and Municipal**

The provinces and the municipalities within them have a key role in both the administration and development of the cannabis retail regime. Each of the provinces of Canada has established a framework for cannabis retailing within its borders, generally divided between private, public and hybrid models of ownership. As the laws and their application vary between provinces, in some cases significantly, a general understanding of the laws in each province is essential to determining whether and to what extent retail cannabis franchising models can be used in various parts of the country.

Overlaid provincial cannabis legislation are laws which regulate franchising generally in 6 of the ten provinces in the country<sup>12</sup> and which necessarily require consideration to understand whether and in what manner franchising can be used as a business model in Canada.

#### **B. Cannabis Retail in Ontario**

In November 2017, under the previous Ontario Liberal government, Ontario introduced cannabis legislation (*Cannabis, Smoke-Free Ontario, and Road Safety Statute Law Amendment Act, 2017*), which detailed a public distribution model for all brick-and-mortar and online cannabis stores.<sup>13</sup> The original legislation included a proposal to establish a new provincial retailer that would operate 150 standalone stores, administer all online sales, and be overseen by the province's Liquor Control Board ("LCBO").<sup>14</sup> The proposed legislation was passed in December 2017, to be effective October 17<sup>th</sup>, 2018 (federal legalization day) followed by the establishment of the Ontario Cannabis Store ("OCS") banner.

Following the election of the Conservative government in June 2018, Ontario completely reversed its decision to pursue a public retail monopoly through the OCS. Instead of a public model, the Conservative government established a new private model in favour of brick-and-mortar retail to be facilitated by the Alcohol and Gaming Commission of Ontario ("AGCO"), while keeping online sales with the OCS. Due to the immediate policy shift and the critical time required to properly develop a private retail regime, it was announced that retail recreational cannabis sales in Ontario would be delayed until April 1, 2019.<sup>15</sup>

---

<sup>11</sup> *Id.*

<sup>12</sup> Alberta- *Franchises Act*, R.S.A. 2000, c. F-23.

British Columbia- *Franchises Act*, S.B.C. 2015, c. 35.

Manitoba- *The Franchises Act*, C.C.S.M. c. F156.

New Brunswick- *Franchises Act*, 2014, c.111.

Ontario- *Arthur Wishart Act (Franchise Disclosure)*, 2000, S.O. 2000, c. 3.

Prince Edward Island- *The Franchises Act*, RSPEI 1988, c F-14.1.

<sup>13</sup> S.O. 2017, c. 26 - Bill 174.

<sup>14</sup> *Id.*

<sup>15</sup> *Ontario Government Will Turn to Private Retailers to Sell Marijuana*, The Globe and Mail, July 27, 2018, available at <https://www.theglobeandmail.com/politics/article-ontario-government-will-turn-to-private-retailers-to-sell-marijuana/>

As at the time of writing, cannabis sales in Ontario are limited to purchases placed through the OCS website, until retail shops begin operation on or around April 1, 2019. While the OCS will only control online sales as of April 1, 2019, it will continue to oversee the supply chain of cannabis in the province. Notably, it will be responsible for determining supplier eligibility requirements and acting as the wholesale entity from which all retailers in the province must purchase cannabis product for resale.<sup>16</sup> The holder of a retail store license cannot enter into contracts or agreements with any person or entity for the provision of cannabis distribution services other than with the OCS. On August 22, 2018, the OCS announced that it had entered into supply agreements with 26 LPs. On September 5, 2018, the OCS entered into an additional 6 supply agreements, bringing the total number to 32. On February 7, 2019, the OCS announced that it had entered into supply agreements with 6 additional LPs and 11 new providers of cannabis accessories.<sup>17</sup>

The initial announcement of the private retail framework indicated a few important implications for franchising.

There would be no limit on the number of retail stores allowed in the province; however, additional restrictions imposed by individual municipalities could potentially lead to a cap on the number of retail stores in a specific region.<sup>18</sup> Notably, and as further discussed below, the initial plan to allow for an unlimited number of retail licenses in the province was also reversed in the months following the announcement of the Ontario government's amended retail plan, citing product supply concerns. Nevertheless, it is anticipated that, as of December 31, 2019, there will be a loosening of the restrictions on licenses and that Ontario will (at some point) revert to an environment where there is no legislated cap on the number of licenses (and stores) permitted in the province. That alone creates an exciting opportunity for retail and franchise development.<sup>19</sup>

Included in the revised plan rolled out by the Conservative government was a restriction that LPs and their "affiliates" would be limited to one cannabis retail license in the province, as a limitation on vertical integration and market dominance by a select number of cannabis growers.<sup>20</sup> For LPs that were until that point planning to develop robust retail plans across the province, this rule was surprising and particularly troubling, stopping their plans in their tracks and leaving many exposed and committed to arrangements (leases, supply agreements, franchise agreements, licenses agreements, etc.) that they could not exploit.<sup>21</sup> As a result of these rules, any LP that wishes to establish and grow a branded retail presence in Ontario will not be able to do

---

<sup>16</sup> *Id.*

<sup>17</sup> *Ontario Cannabis Store Secures Additional Supply Agreements with Licensed Producers*, Ontario Cannabis Store, February 7, 2019, available at <https://ocs.ca/blogs/news/ocs-supply-agreements-additional-licensed-producers>

<sup>18</sup> *Ontario Won't Cap the Number of Cannabis Retail Licenses*, The Financial Post, September 26, 2018, available at <https://business.financialpost.com/cannabis/ontario-wont-cap-the-number-of-cannabis-retail-licences>

<sup>19</sup> *Cannabis: Retail Regulation Facts*, March 22, 2019 available at <https://www.agco.ca/cannabis/regulation/cannabis-retail-regulation-facts>

<sup>20</sup> According to Ontario Regulation 468/18, the definition of affiliate includes: Any corporation in which the LP, directly or indirectly, owns (or has a right to acquire) 9.9% or more of such corporation's securities; Parent companies, sister companies and subsidiaries as well as typical (and atypical) structures that might otherwise have been used to involve LPs in recreational cannabis retail, such as partnerships and trusts; Any corporation in which the LP has either legal / voting control or a majority of the economic interest – whether directly or indirectly; Any member of the same joint venture. (Not only does the phrase "joint venture" have no single meaning at law, but this would catch joint venturers working together on a project unrelated to recreational cannabis retail.); Entities or individuals that have any "direct or indirect influence that, if exercised, would result in control in fact of that person".

<sup>21</sup> *Cannabis Licence Act*, 2018, S.O. 2018, c.12, Sch.2.1

so by owning or controlling retail businesses. Franchising has therefore become a strategically important manner in which an LP may be able to permit a third party to own and control retail businesses operating under the LP's brand.

As mentioned above, the original proposals by the Ontario government suggested that there would be no cap on the number of retail stores in the province. In December 2018, the Ontario government amended its original plan, limiting the amount of retail licenses to 25 until at least December 13, 2019.<sup>22</sup> On January 11, 2019, after a lottery process which allowed submissions by any individual who wished to apply, the government announced the first 25 parties that were eligible to apply for cannabis retail licenses, many of whom were sole proprietors without retail or cannabis experience. Those selected had 5 business days to submit applications along with a \$6,000 non-refundable fee and a \$50,000 letter of credit. The licenses were divided regionally, with five going to the east of the province, seven in the west, two in the north, six in the Greater Toronto Area and five in Toronto itself.<sup>23</sup> LPs were barred from the lottery process, although in the days which followed the announcement of the lottery winners, many LPs sought to strike brand-licensing and franchise-like arrangements with those lottery winners in order to have their branded outlets included in the first wave of store openings.<sup>24</sup>

Ontario's lottery process was different from other Canadian provinces because unsophisticated businesspersons were given an opportunity to apply by simply submitting an application and \$75. Other Canadian provinces have conducted lotteries to determine their cannabis retailers, but the applicants were pre-vetted, such as by way of a Request for Proposal. Unlike certain other provinces, where the cannabis regulators made decisions based on business cases, Ontario welcomed any applicant as long as they could afford the application fee.<sup>25</sup>

The vast majority of lottery winners, most of whom are sole proprietors with limited business or retail experience, were put in a unique position. Under AGCO regulations, the LPs were barred from participating in the retail system by owning retail stores; however, the current legislation, including the rules which were passed to support the lottery process, appeared to make brand-licensing and franchising a possibility so long as the lottery winner did not "change control" after having won the right to apply for a license.<sup>26</sup> As at the time of writing, although it is not settled how the AGCO will respond to different business arrangements made between LPs and lottery winners, it is a likely possibility that franchising will enable lottery winners to take advantage of the resources and assistance of an LP by operating under a franchise (or similar arrangement) granted by an LP, while remaining compliant with the rules which prohibit both the lottery winner from changing control, and the LP from owning its own store, or owning or controlling the lottery winner.<sup>27</sup>

---

<sup>22</sup> *Expression of Interest Lottery- FAQs*, January 4, 2019, available at <https://www.agco.ca/cannabis/expression-interest-lottery-faqs>

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> Finkelstein, Chad, *Why Franchising Cannabis Stores in Ontario is Legal*, The Report on Business, November 28, 2018, available at <https://www.theglobeandmail.com/cannabis/article-why-franchising-cannabis-stores-in-ontario-is-legal/>

<sup>27</sup> *Id.*



Since the release of the legislation in Ontario, many have questioned whether there is a place for franchising by LPs once the lottery period ceases in December, 2019, particularly because the cannabis rules would restrict an LP from franchising if the LP was seen to “control in fact” the franchisee.<sup>28</sup> While franchising certainly does include a level of control, it has been argued that this level of control by an LP does not rise to the level of “control in fact” over the franchisee, since the legal definition of a franchise (and the practical reality) is that a franchisor controls methods of operation and standards and not the day to day administration of the franchised business. Between those two standards of control, and so long as franchise agreements and related support and relationship realities are structured properly, it has been argued, should be a safe harbor for LP franchising in the province.<sup>29</sup>

## **1. Ontario Municipalities**

Municipalities in Ontario play an integral role in the province’s retail regime since they have had the authority to opt out of permitting cannabis retail stores within their boundaries. The province gave municipalities until January 22, 2019 to opt out of permitting private cannabis storefronts to operate.<sup>30</sup> If the AGCO did not receive written notification from a municipality by the deadline, private cannabis retail stores would be allowed within the jurisdiction by default. According to AGCO regulations, if a municipality chose to opt out, it would be given an opportunity to opt back in at any time; however, once a municipality opted in, it would no longer be able to opt out. Moreover, if a municipality chose to opt in, it would be unable to control where a retail store would be located. Authority for site approval rests with AGCO, who is responsible for approving or denying site applications for retail cannabis stores.<sup>31</sup>

While some municipalities simply chose to abstain from voting, thereby tacitly accepting the stores under Ontario law, many municipalities that chose to opt out cited a “wait and see approach” for their reason not to accept cannabis stores in their communities. Other municipalities have expressed concerns about the lack of municipal control when it comes to cannabis retail locations, in particular, the amount of uncertainty related to bylaw and city planning initiatives.<sup>32</sup>

## **C. Cannabis Retail in Alberta**

Alberta has developed a private system; however, online sales of cannabis operate through the provincial government. Relative to other provinces, Alberta has made significant progress towards implementing its cannabis retail framework. On February 15, 2018, Alberta laid out its framework for a private cannabis retailing system in an amendment to the *Gaming and Liquor Act* (now the *Gaming, Liquor, and Cannabis Act*). The *Gaming, Liquor, and Cannabis Act* also establishes the regulations related to

---

<sup>28</sup> Robinson, Frank, *Why Franchising Could Be the Answer to Retailing Cannabis in Ontario*, October 18, 2018, available at <https://www.retail-insider.com/retail-insider/2018/10/why-franchising-could-be-the-answer-to-retailing-cannabis-in-ontario>

<sup>29</sup> O.Reg. 468/18

<sup>30</sup> As of January 22, 2019, 77 out of 414 Ontario municipalities opted out of retail cannabis stores. Some of the larger municipalities that opted out include: Markham, Oakville, Pickering, Richmond Hill, and Vaughan.

<sup>31</sup> Hall, Joseph, *The Cannabis Tally: 77 Municipalities Across Ontario Opt Out, 337 Opt In*, The Toronto Star, January 22, 2019, available at <https://www.thestar.com/news/cannabis/2019/01/22/at-least-65-municipalities-across-ontario-say-no-to-cannabis-retail.html>

<sup>32</sup> *Id.*

purchase, possession, and consumption laws for cannabis in the province. Moreover, the Alberta Gaming and Liquor Commission (“AGLC”) serves as the provincial cannabis regulator and administers retail cannabis licenses in the province.<sup>33</sup>

Similar to Alberta’s privatized alcohol retail system, the cannabis distribution and wholesaling framework in the province is regulated by the AGLC. The AGLC is the sole wholesaler of cannabis in the province. Albertans can legally purchase cannabis for recreational use through two channels; either a privately-owned brick-and-mortar store or online through a government-operated website.<sup>34</sup> In the end of 2018, the AGLC set a limit on the total number of cannabis retail licenses because of supply shortages. While the intention was to grant 250 licenses, the province has only issued a total of 75 licenses as of January 2019.<sup>35</sup>

The Alberta regime permits multiple licenses to be issued to a single applicant, but establishes that a maximum of 15% of all provincial licenses can be held by a single person or “groups of persons”<sup>36</sup> at once. A “group of persons” is defined in Alberta’s regulations as any group of individuals or companies subject to “common control in any material respect.”<sup>37</sup> The phrase “control in any material respect”<sup>38</sup> appears to have occurred for the first time in this regulation, has never been judicially interpreted and remains unclear in regard to its application.<sup>39</sup> Control typically refers to board or shareholder control, or other forms of *de jure* or legal control. As such, this restriction may not necessarily inhibit the development of a franchise network in which the franchisor does not have adequate ownership in its franchisees to exercise control. There is, however, a possibility that a regulator or a court will interpret the term “control” to mean *de facto* control, such that control could be found to exist where a franchisor is able to dictate the activities of a corporation through other means, such as through a franchise agreement.<sup>40</sup>

Furthermore, Alberta’s regime includes a prohibition on LPs providing “any thing of value” to a retailer, and restricts retailers from buying or receiving “any thing of value” from a LP.<sup>41</sup> Alberta also prohibits LPs from providing, or retailers seeking, any benefits in the form of inducements for any consideration, including stocking or otherwise preferring their products. LPs also cannot generally offer, provide, or pay any monies or deposits, free products or accessories, or compensation for infrastructure, training or travel to a retailer. In the most general sense, assuming that the offering of a franchise opportunity and the support and assistance that sustains that system is a “thing of value” and that an LP would want franchisees to stock its products, taken together, these concepts have the potential to prohibit or restrict an LP from developing and maintaining a franchise system in the province of Alberta, without proper modifications to address these rules.<sup>42</sup> On the other hand, the regulators in Alberta, in certain cases,

---

<sup>33</sup> *Gaming, Liquor and Cannabis Act*, R.S.A. 2000, c. G-1 (as amended) (“Alberta Regulation”).

<sup>34</sup> *AGLC’s Role in Legalization*, March 5, 2019, available at <https://aglc.ca/cannabis/aglcs-role-legalization>

<sup>35</sup> *Retail Cannabis*, March 5, 2019, available at <https://aglc.ca/cannabis/retail-cannabis>

<sup>36</sup> Alberta Regulation, s.106.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> Alberta Regulation, s.118.

<sup>42</sup> *Id.*, s.119.

have appeared to have applied a less rigid standard to the enforcement of these rules, allowing a number of franchised relationships in the province to pass preliminary regulatory muster.

## **1. Municipalities in Alberta**

To legally sell cannabis in Alberta, a retailer must receive a cannabis license from the AGLC as well as a development permit and business license from the relevant municipality. In the City of Calgary, for example, business licenses and cannabis development permits are being distributed through an open application process that divided the licenses into three categories: (1) cannabis stores (retailers); (2) cannabis facilities (LPs located within the city); and (3) cannabis counselors (non-medical cannabis-use advisors). In Alberta, municipalities are allowed to levy additional taxes and enact bylaws relating to retail licensing, storefront placement, and public consumption.<sup>43</sup>

### **D. Cannabis Retail in British Columbia**

In December 2017, British Columbia announced that it would establish a hybrid public and private cannabis retail framework. The province's framework became law on May 17, 2018 with the *Cannabis Control and Licensing Act* (Bill 30-2018) and the *Cannabis Distribution Act* (Bill 31-2018).<sup>44</sup> Similar to all provinces listed above, the legislation provides rules related to purchase, possession, and consumption laws for cannabis in the province. The British Columbia Liquor and Cannabis Distribution Branch ("LCRB") is responsible for licensing and overseeing the retail recreational cannabis sector. The LCRB is the sole entity managing sourcing, warehousing, and distribution of cannabis products to retailers in this province. Government-owned stores are operated by the LCRB under the B.C. Cannabis Store banner and the first public store opened on October 17, 2018.<sup>45</sup>

There are two forms of licenses offered by the LCRB to retailers: (1) Retail Store License; and (2) Rural Retail Store License. In addition to private retail store licenses, British Columbia has introduced two other classes of license unique to the province. First, British Columbia will offer a cannabis marketing license which allows third parties to market cannabis products to retail store owners. Second, the province has proposed to introduce a special retail license specifically for licensed micro-processors of cannabis. While no details on the license have been released, cannabis industry stakeholders believe that it will allow standard and micro-processors to sell their own products directly to consumers.<sup>46</sup>

A regulation that is unfavourable to both corporate retail owners and franchisors is the limit the province of British Columbia places on the number of retail outlets permitted by a single applicant or group. According to the current regulations, no single applicant or group of "related persons" is permitted to hold more than 8 retail store

---

<sup>43</sup> *Cannabis Legalization in Alberta Municipalities*, February 2018, available at <https://rimalberta.com/wp-content/uploads/2018/03/Cannabis-Legalization-in-Alberta-Municipalities.pdf>

<sup>44</sup> S.B.C. 2018, c.29.

<sup>45</sup> *Cannabis Licensing, British Columbia*, March 27, 2019, available at <https://justice.gov.bc.ca/cannabislicensing/>

<sup>46</sup> *Id.*

licenses in the province.<sup>47</sup> This restriction likely means that no network of stores can have more than 8 locations in the province, effectively making British Columbia a limited opportunity for comprehensive retail and franchising. Furthermore, LPs are not permitted to own private retail stores directly; however, they may have a financial or ownership interest in other entities that hold retail store licenses.<sup>48</sup>

The British Columbia regulations grant a regulatory authority known as the “general manager” broad discretion to determine the extent to which a group of persons exists for purposes of applying the 8 store limit upon them.<sup>49</sup> Such a finding can be made if, in the general manager’s opinion, a corporation has “direct or indirect influence” or the “ability to affect, directly, or indirectly, the activities carried out under” another party. If one takes the position that a franchisor has the right to direct or influence its franchisees, or the ability to affect the activities of its franchisees, then these rules will operate to effectively limit a franchised network operating in British Columbia to no more than 8 stores.<sup>50</sup>

In addition to the 8-store maximum, the province has enacted legislation which places limits on inducements and “tied houses.” For instance, the rules prohibit a person from arranging, or agreeing to arrange, with another person, to sell the cannabis of a federal producer to the exclusion of the cannabis of another federal producer, and prohibit a licensee from requesting or accepting or agreeing to accept money, gifts, a reward or remuneration, directly or indirectly, to promote, induce or further the sale of a particular class or brand of cannabis. These rules are particularly noteworthy where the franchisor is an LP, and the franchisor expects the franchisee to stock and resell that LP’s cannabis products in the franchised business.<sup>51</sup>

Where there is an association, connection, or financial interest between an applicant and a LP or the licensee’s agent, the general manager may determine that there is a risk that, if licensed, the retailer would promote the LP’s products. The general manager may determine that the risk can only be eliminated if the license contains a condition prohibiting the retailer from selling any products of the associated LP. In such a situation, the general manager may not issue or renew a license with such a condition.<sup>52</sup>

While tied house connections are not completely banned, the licence can be denied, if the general manager of the LCRB expects the retailer may promote or purchase one LP’s cannabis over others. If the general manager determines that the franchisor-franchisee relationship offends the regulations, he or she will have the discretion to require a franchisor to arrange its franchise network in a way that ensures the franchisee will not be “likely to promote” the sale of a specific LPs cannabis. Moreover, in the event that the general manager does not believe any steps will be

---

<sup>47</sup> Cannabis Licensing Regulation, B.C. Reg 202/2018, s.6.

<sup>48</sup> *Id.*

<sup>49</sup> *Cannabis Retail Store Terms and Condition, A Handbook for the Sale of Non-Medical Cannabis in British Columbia*, February 2019, available at <https://www2.gov.bc.ca/assets/gov/employment-business-and-economic-development/business-management/liquor-regulation-licensing/guides-and-manuals/cannabis-retail-store-licence-handbook.pdf>

<sup>50</sup> Cannabis Licensing Regulation, B.C. Reg 202/2018, s.6.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

adequate to guarantee that assurance, it may fully deny or revoke retail licenses to specific franchisees.<sup>53</sup>

### **E. Cannabis Retail in other Canadian Provinces**

The provinces of Manitoba, Newfoundland, and Saskatchewan have also adopted hybrid or privatized cannabis retail models.

In Manitoba, the province ran a Request for Proposal process that granted four groups the initial opportunity to operate retail stores. As of the time of writing, four licenses have been provisionally granted in the province. The province released a Request for Pre-Qualification on July 23, 2018 seeking retailers interested in pre-qualifying for opportunities to operate new stores in Manitoba. These pre-qualified retailers will eventually be selected through a lottery process based on geographic preference. As part of its hybrid retail model, regulation is overseen by the Manitoba Liquor, Gaming, and Cannabis Authority (“LGCA”) and wholesale distribution is managed through the Manitoba Liquor and Lotteries Corporation.<sup>54</sup>

The province of Saskatchewan has adopted a private model with regulation being overseen by the Saskatchewan Liquor and Gaming Authority (“SLGA”). Two forms of licenses exist in the province: a (i) Cannabis Retail Permit and (ii) Cannabis Wholesale Permit.<sup>55</sup> As of the time of writing, all 51 of the initial Cannabis Retail Permits have been granted in the province; however, the government is considering whether to make additional opportunities available approximately 18 months after legalization. While this will be discussed in more detail below, Saskatchewan is the only province in which a government distributor is not responsible for purchasing cannabis from LPs and reselling to retailers; instead retailers will purchase cannabis supply from holders of the Cannabis Wholesale Permit.<sup>56</sup> The regulations allow licensed cannabis retail store owners to purchase cannabis for their stores from licensed cannabis wholesalers, federally LPs, and other cannabis retailers in the province. The distribution and supply channel in the province is evidently much more flexible, which can create unique growth opportunities for franchise systems, especially since Saskatchewan does not have franchise legislation.<sup>57</sup>

Similar to Manitoba, Newfoundland awarded opportunities to apply for the first retail cannabis licenses via a “Phase 1” Request for Proposal process. Private retail store licenses are issued by the Newfoundland and Labrador Liquor Corporation (“NLC”) following a detailed application process. The province proposed four tiers of cannabis retail stores for assessment in the RFP, with preference given to stand-alone stores handling only cannabis and cannabis accessories.<sup>58</sup> The four tiers of store application are: (1) Stand Alone Cannabis Retail Only (a stand-alone store carrying only cannabis and cannabis accessories); (2) Store-Within-a-Store (a completely enclosed area selling only cannabis and cannabis accessories within an existing retail store); (3)

---

<sup>53</sup> *Id.*

<sup>54</sup> *Cannabis Retail Framework Frequently Asked Questions*, January 2019, available at <https://www.gov.mb.ca/jec/cannabis/faq.html>

<sup>55</sup> Cannabis Control (Saskatchewan) Regulation, c.2-111 Reg 1, s.3-18.

<sup>56</sup> Cannabis Regulatory Policy Manual (Saskatchewan Liquor and Gaming Authority, 2019), October 17, 2018

<sup>57</sup> *Id.*

<sup>58</sup> Brown, Drew, *Everything You Need to Know About Newfoundland’s Legal Weed Plans*, Vice Media, February 21, 2018, available at [https://www.vice.com/en\\_ca/article/bj5yww/everything-you-need-to-know-about-newfoundlands-legal-weed-plans](https://www.vice.com/en_ca/article/bj5yww/everything-you-need-to-know-about-newfoundlands-legal-weed-plans)

Dedicated Service Desk and Cash-Counter (discrete location within an existing retail store that is separate from the main cash counter); and (4) Behind-the-Counter (shared space at an existing cash counter). As of February 2019, there were only 24 stores that became licensed under Phase 1 of the Newfoundland RFP process.<sup>59</sup>

#### **F. The Role of Franchising Role and the Impact of Franchise Legislation**

For decades, franchising has been used as a product distribution model to bring hamburgers, pizza, and coffee to the masses during which time the consistent and ongoing legitimization of the model has moved it out of foodservice and into an ever-growing list of other industries, including hotels, vehicle dealerships, fuelling stations, and even into public services such as healthcare, childcare, and education. As the cannabis industry emerges across North America, and itself becomes legitimized through shifting cultural and commercial preference, it is likely to become one of the next big industries to ride the franchising wave.

Indeed, retail growth through franchise development can bring particular benefits to cannabis growers, who may not necessarily be adept at retail operation, but have developed a demand for products and seek to capture market share by creating branded distribution networks to sell those products. On the flip side, franchising will allow more aspiring small businesspeople to own a stake in cannabis sales and distribution, granting access to an emerging and lucrative opportunity that might have otherwise been reserved for government or big business. Wanting to maximize that opportunity and protect their investments, independent franchise operators should be more inclined to operate good businesses and respect the rules. Together, these factors combine to create a compelling and exciting opportunity for the development and growth of cannabis retail franchising.

As noted above, 6 of the ten provinces in Canada have pre-sale franchise disclosure statutes which further impact the design and implementation of cannabis retail franchising in the country.

By its nature, any cannabis franchise offering will have a limited track record to support sustained unit economic performance, many of the basic “systems” associated with those franchise offerings are under-developed or are subject ongoing change, and costs to build retail premises are variable and unsettled due to dynamic market forces and inexperience. Other unknown or variable factors make the job of preparing a compliant franchise disclosure document even more challenging than in standard cases, increasing the risks a franchisor will need to assume to offer cannabis franchises.

Franchise agreements for cannabis retail stores are not like those used to offer franchises for hamburgers, pizza and coffee, and particularly so when the franchisor is an LP and has additional regulatory limitations (including diminished ability to impose certain “normal” franchise controls) to consider. Care must be taken to prepare franchise agreements which are uniquely tailored to address the interaction between

---

<sup>59</sup> *Retail Licensing- Newfoundland and Labrador*, January 2019, available at <https://www.cannabiscomplianceinc.com/licensing/retail-licensing/newfoundland/>

franchise and cannabis laws, provide the appropriate levels of control, and still allow a franchisor to manage and grow a system through the initial stages of a quickly changing market. In cases where the franchise agreement necessarily provides for reduced controls, but where those controls may be required in practice, questions of the extent of enforcement and implementation of those franchise agreements will arise and will require careful consideration in light of provincial franchise laws which require the parties to a franchise agreement to act in accordance with a duty of good faith and fair dealing.

## 1. **Franchising Issues**

Due to, amongst other things, restrictive rules impacting product promotion and marketing, and centralized and government-run supply chains which reduce product and price variability within provincial markets, it has become a well-accepted notion that differentiation between retail offerings in Canada will largely be dictated by the particularities of the in-store customer experience. Assuring product and service consistency, which is always a concern in the franchise context, is therefore a heightened concern for networks of cannabis stores operating in Canada. So, while franchising may seem like an attractive answer for a nascent and competitive marketplace for cannabis retailing, there are specific issues unique to cannabis retailing that will impact the implementation of franchising in this space and require further exploration and understanding.<sup>60</sup>

### a. **Product**

Canada has been grappling with a legal cannabis shortage ever since recreational consumption became legal in October 2018. Provinces point blame at the LPs, citing disappointing production volumes insufficient to meet immediate or mid-term consumer demand.<sup>61</sup> The LPs, in response, tie reduced production volumes to a complicated and time-consuming federal licensing process and supply chain limitations. Whatever the reason, a franchise system is bound to suffer when retailers are required to purchase product directly from under-supplied centralized sources, and not directly from a competitive market comprised of various LPs.<sup>62</sup>

While the lack of product supply has been detrimental to the overall business of retail stores, and has caused provinces to halt the issuing of new licenses altogether, initial product shortages created an artificially lop-sided cannabis market where the most prepared and well-stocked LPs were able to capture a larger market share.<sup>63</sup> At the same time, the lack of legal cannabis in the market has slowed (and in

---

<sup>60</sup> Robinson, Frank, *Why Franchising Could Be the Answer to Cannabis Retail in Ontario*, October 2018, available at <https://www.bnnbloomberg.ca/bloomberg-markets/why-franchising-could-be-the-answer-to-cannabis-retail-in-ontario~1546797>

<sup>61</sup> Subramaniam, Vanmala, *Canada's Cannabis Shortage Could Be Over Quicker Than We Thought, Researcher Says*, The Financial Post, February 1, 2019, available at <https://business.financialpost.com/cannabis/canadas-cannabis-shortage-could-be-over-quicker-than-we-thought-researcher-says>

<sup>62</sup> *Id.*

<sup>63</sup> Cherney, Max, *Canada's Struggle to Supply Legal Weed Described as 'National Shortage' that could Last Months*, Market Watch, November 28, 2018, available at <https://www.marketwatch.com/story/canadas-struggle-to-supply-legal-weed-described-as-national-shortage-that-could-last-months-2018-11-26>

some cases prevented entirely) what was expected to be a rush of retail development and caused a genuine lag on business expansion.<sup>64</sup>

There are two facets to cannabis supply—cultivator capacity and provincial supply-chain dynamics. Both facets impact the franchising system. Supply and demand dynamics since legalization day point towards a moderately volatile first year (or so) of legal sales. According to an RBC Capital Markets report from December 2018, recreational markets will face supply shortages until mid-2019.<sup>65</sup> Following this initial period, analysts predict that the market will be oversupplied, especially by the end of 2020. Of the LPs that have entered into supply agreements with provinces and territories, there are only a few who can consistently meet and exceed their purchase orders.<sup>66</sup>

#### **b. Licensing**

The old adage in franchising makes reference to the “chicken or egg” scenario in which franchisors and franchisees ponder the appropriate sequence and timing of forming their relationship, while the franchisee forms relationships with third parties.

More specifically, the order of the franchisee signing a franchise agreement and securing real estate and financing is often complicated in cases where a franchisee does not wish to execute a franchise agreement before securing a lease and a landlord or lender does not want to sign a lease or provide capital to a franchisee until it has seen that a franchise agreement has been executed and the franchisee has rights to operate. Complicating that dynamic further in the cannabis context is the requirement that each franchisee seek and obtain and thereafter maintain all required licenses to operate the franchised business at the same time as these other dynamics are being managed and resolved. Consideration needs to be made to address possible contingencies or outcomes in which one or more of those essential pieces of the puzzle are not obtained or are lost at any time during the franchise lifecycle, and in particular, what outcomes the franchisor wishes to address in the event a franchisee suffers a loss of a license during the term of the franchise agreement, having regard to the fact that a LP franchisor in many cases, as a result of the cannabis legislation, will have reduced options to step-in and assume operation of the business without significant regulatory restriction. While these dynamics exist in other regulated industries which use franchising as a business model, the cannabis environment poses additional complications as a result of uncertainty caused by the novelty and untested nature of the regulatory environment.

Establishing the franchise system can be complicated because a significant financial investment of both cash and time needs to be made before a license is issued. While this is true for all provinces involved in the retail regime, Ontario’s

---

<sup>64</sup> *Id*

<sup>65</sup> *RBC Capital Markets Will Start Doing Marijuana Deals*, Business Insider, December 18, 2018, available at <https://www.businessinsider.com/rbc-capital-markets-will-start-doing-marijuana-deals-head-says-2018-12>

<sup>66</sup> Thomson, Aly, *Expect No Quick End to Canada-Wide Cannabis Shortages, Producers Warn*, The Financial Post, November 14, 2018, available at <https://business.financialpost.com/pmn/business-pmn/expect-no-quick-end-to-canada-wide-cannabis-shortages-producers-warn>



licensing process, as an example, demonstrates the layers involved in securing regulatory approvals necessary to open and operate a cannabis retail location. In order to become licensed, applicants must obtain a retail operator licence and a retail store authorization, while a third license, a cannabis retail manager licence, is required for functional personnel in the store.<sup>67</sup>

**(i) Retail Operator Licence**

To be able to legally open a retail store to sell recreational cannabis, a franchisee must get a Retail Operator Licence. To get this licence, the franchisee must meet all of the eligibility criteria set out in the *Cannabis Licence Act* and its regulations. A Retail Operator Licence allows one to operate one or more retail stores in Ontario. However, one must have a separate Retail Store Authorization for every store a franchisee wishes to operate.<sup>68</sup>

**(ii) Retail Store Authorization**

A franchisee must have a Retail Store Authorization for each one of its stores because the *Cannabis Licence Act* and its regulations require that each store meet certain requirements.<sup>69</sup> Requirements relate to such matters as the store layout and design, location, reporting obligations, security, and others.<sup>70</sup>

**(iii) Cannabis Retail Manager Licence**

In order to ensure the responsible sale of cannabis, there must be at least one licensed manager for each authorized store location. The *Cannabis Licence Act* and its regulations set out eligibility criteria for the person who will have management responsibilities in authorized stores. This includes having responsibility for the cannabis inventory, for hiring and managing employees, and for ensuring the store operates with honesty and integrity at all times.

Although the above licensing process is specific to Ontario, other provinces have adopted licensing processes that are similarly comprehensive, detailed and require significant amounts of disclosure to regulators.<sup>71</sup>

**c. Distribution**

If one of the purposes of franchising is to efficiently distribute product through to retail or other end-consumer channels, then a key area of consideration in determining the suitability of the franchise model for cannabis retailing in Canada must include the opportunities and limitations in respect of cannabis distribution within provincial markets.

These opportunities and limitations are created, in large part, by the extent to which the distribution models in each province allow a franchisor to dictate

---

<sup>67</sup> 2018, S.O. 2018, c.12, Sch.2, ss.3 and 4.

<sup>68</sup> *Id.*

<sup>69</sup> This includes paying an upfront fee of \$4,000 to secure a 2-year term; the proposed retail store location must also meet the school distance requirements (150 meters) set out in the Regulation (See Section 11).

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

sources of supply and product selection, a common and indeed often essential control which is tightly managed by franchisors in other sectors. In cases where distribution is centralized through a single provincial body, product differentiation (which is often a key driver of brand identity) between retailers in the province becomes less likely, as every retailer across the market is required to select and manage product mix from a singular supplier. The same dynamic results in those same retailers being sold product at the same wholesale price, allowing less room for retail pricing flexibility at the store level. All of these factors, which are in part designed to level the playing field for retailers, tend to diminish the ability a franchisor has to control and differentiate its product offering and consequentially its brand identity.

For instance, in British Columbia, Alberta and Ontario, arguably the most important markets for cannabis in the country, the respective provincial supply chains are not designed as a direct produce-process-distribute-sell system.<sup>72</sup> Instead, the regulatory regime in British Columbia introduces a mandatory government entity into the supply chain, the Liquor Distribution Branch, as the wholesale distributor of non-medical cannabis for both public and private stores. In Alberta, the regime interposes the AGLC as the government wholesale entity within the supply chain. And in Ontario, cannabis supply is managed and administered through the OCS so that retailers may only purchase cannabis from that entity.<sup>73</sup>

Saskatchewan, on the other hand, is the only province in which producers can sell directly to retailers. There is no provincial distributor responsible for purchasing cannabis from an LP and distributing it to retail owners.<sup>74</sup> LPs are allowed to supply cannabis to any person with a valid retail permit, and importantly, there is no restriction on significant control over supply. Unlike the provinces discussed above, Saskatchewan retailers can take orders online and deliver product to consumers through common carriers.<sup>75</sup> LPs are given the flexibility and opportunity to manage the product all the way from growth stages to delivery to the consumer.

These distribution channels, particularly in Alberta, British Columbia and Ontario, provide unique challenges to a franchise network. Whereas a franchisor might otherwise be entitled to dictate sources of supply, including requiring franchisees to purchase from the franchisor itself, or require franchisees to purchase from other approved or designated sources, the franchisor in these provinces cannot exercise those rights and does not enjoy nearly as much autonomy and control over supply arrangements in general. On the one hand, that tends to diminish brand differentiation and product mix, and on the other, the franchisor loses out on the benefit of profiting or obtaining rebates or other consideration that would have otherwise been available through a franchisor-administered supply infrastructure. On a practical basis, because of the absence of competition at the wholesale level, it also means less leverage for franchisors and retailers to negotiate or manage through relationship dynamics with their supplier.

---

<sup>72</sup> B.C. Reg 202/2018, s.6.

<sup>73</sup> Alberta Regulation, s. 105.

<sup>74</sup> *Saskatchewan's Cannabis Framework*, available at <http://publications.gov.sk.ca/documents/13/106026-SK-Cannabis-Framework.pdf>

<sup>75</sup> *Id.*

To the extent supply can be controlled, an LP who directs its franchisees to purchase that LP's products, either directly, or through a provincial supplier, ought to be concerned with various rules which are intended to restrict a retailer from preferring certain products to the exclusion of others or to prohibit that retailer from being induced to purchase those products in the first place.<sup>76</sup> By definition, an inducement is a promise or undertaking that causes another person to enter into a contract or commitment.<sup>77</sup> In practice, this might occur in cases where a supplier grants a retailer support, merchandise or other things of value in exchange for the retailer agreeing to make ongoing purchases of the supplier's goods. In the cannabis context, certain federal and provincial laws prohibit an LP from inducing a retailer into purchasing that LP's products. For instance, inducing a retailer into purchasing cannabis from an LP is a contravention of the *Cannabis Act*, and it also triggers similar prohibitions under provincial law in Ontario, Alberta, and elsewhere.<sup>78</sup>

These rules have an interesting application in the franchise context in cases where an LP requires a franchisee, as part of the broader franchise arrangement, to purchase a certain level of inventory of that LP's product. On its face, a term of this kind appears to be a regular and expected obligation in a franchise agreement. But, under the lens of cannabis legislation, that same obligation might, under a certain interpretation, be viewed as a franchisee being induced to purchase cannabis product in exchange for the franchisor's obligations under the franchise agreement or the provision of the franchise system in general. However, while that is a possible interpretation of the rule, this is far too simplistic a view of the franchise relationship, which is otherwise far more multi-faceted than simply the franchisor giving away a benefit to a franchisee in order to receive a purchase commitment in return. Rather, the franchisee will pay real consideration (in the form of money) for the franchise platform in the form of an initial franchise fee and a royalty. Additionally, the franchisee will get a myriad of other benefits, such as service and support for those payments. In light of those realities, so long as the LP has a bona fide franchise program that offers consideration to the franchisee in exchange for fees, the inclusion of some form of purchase commitment within that larger franchise relationship should not be viewed as an inducement.

## **2. The Branding Experience**

The significant restrictions on packaging and labelling set out in the *Cannabis Act* will make it challenging for the industry to create distinguishable brands and to stand out on the shelves. As franchising relies heavily on branding and

---

<sup>76</sup> In Alberta, for example, a cannabis supplier or representative is prohibited from directing any services, items or activities to a licensee that could directly benefit the licensee or their staff, and a licensee may not request or accept any such inducements. Licensees are prohibited from asking for or receiving items of value from a cannabis supplier or representative as an inducement to stock a product in return for improved display case positioning or for any other consideration. A cannabis supplier or representative may not offer, provide or pay for the following on behalf of a licensee: cash, rebates, coupons, or credits of any monetary value; compensation for expenses related to but not limited to: 1. construction, interior decorating (e.g. painting, window coverings, flooring, décor etc.), renovations or maintenance to a licensed premises, or any other property owned, rented or leased by a licensee or anyone directly or indirectly involved with the licensee; 2. furniture, equipment, display cases, sensory display containers or fixtures; 3. physical security equipment, construction, installation or services; 4. product price displays, electronic devices (e.g. television screens, computer monitors, tablets, etc.); 5. point of sale systems; or 6. other items considered essential to operating a licensed premises.

<sup>77</sup>S.C. 2018, c.16.

<sup>78</sup> *Id.*

promotion to move product off the shelves, and also to sell franchises themselves, these rules have direct impact on the possible success of franchising in this area.<sup>79</sup>

Only certain elements, in determined size, fonts and colour can appear on cannabis packaging. Colour must be uniform, the finish must be matte, the packaging should have no hidden feature, scent, sound, cut-out window, or special covering.<sup>80</sup> As a result, brand owners and franchise systems which rely on those brands will have to be very innovative if they wish to create strong brand identity. According to Health Canada's regulations, "unless authorized under the *Cannabis Act*, it is prohibited to promote cannabis or a cannabis accessory or any service related to cannabis."<sup>81</sup> These prohibitions include advertising cannabis through testimonials, endorsements, or portraying marijuana as if it's linked to "a way of life such as one that includes glamour, recreation, excitement, vitality, risk or daring."<sup>82</sup>

However, cannabis companies are finding work-arounds to the regulations that make room for creative marketing tactics. Brand-preference promotion is allowed, meaning that companies distinguish themselves not by their cannabis products but their brand expressions. For example, some cannabis companies are investing in augmented reality technology. To the naked eye, a retailer's packaging could have only a logo and a standard warning, which is not in contravention of the cannabis marketing laws. However, when viewed through the lens of a smartphone, and where properly aggregated, a consumer may be able to click on different elements of the package and access brand information through pictures or video.<sup>83</sup>

Social media allows cannabis companies to connect the consumer with a lifestyle, even without specifically advertising cannabis itself. It is still unknown whether an Instagram or Facebook photograph promoting a cannabis lifestyle is off limits. While Health Canada has not confirmed whether attributes of "glamour, recreation, excitement, vitality, risk, or daring" can be drawn from perfectly captured Instagram photos that do not directly associate with cannabis, the indirect association is likely open to scrutiny by regulators. Retailers need to be very cautious of the regulations as Health Canada has announced its intentions to take extra measures to monitor cannabis marketing activities. As of January 2019, it was reported that 5 LPs had already received Health Canada warnings regarding their advertising and promotional activities.<sup>84</sup>

Marijuana can also be used in artistic productions and performances, but only if "no consideration is given, directly or indirectly, to that use."<sup>85</sup> Prior to legalization, a number of cannabis firms entered into endorsement agreements with celebrities and artists. Given the lack of interpretive guidance from Health Canada or binding statutory

---

<sup>79</sup> *Id.*, s.16.

<sup>80</sup> *Id.*, s.17

<sup>81</sup> *Id.*, s.17(1)

<sup>82</sup> *Id.*, s.17(e).

<sup>83</sup> Ligaya, Armina, *Marijuana Firms Use Creative Marketing Tactics to Skirt Strict Regulations*, The Report on Business, April 18, 2018, available at <https://www.theglobeandmail.com/business/article-marijuana-firms-use-creative-marketing-tactics-to-skirt-strict/>

<sup>84</sup> *Id.*

<sup>85</sup> S.C. 2018, c.16., s.16(a).

interpretation, franchisors should proceed with caution before entering into a business relationship that might associate an “influencer” with a cannabis company.<sup>86</sup>

From a business perspective, retailers will need to develop an array of creative marketing techniques to ensure compliance with the promotion and branding regulations. Examples of strong marketing tactics might include: billboards or mass media which deal with product education, photos with no direct association with cannabis, or sponsorships and partnerships where marijuana products or accessories are not sold or distributed. While these unique tactics utilized may aim to skirt the regulations, caution must be exercised as there is a price to pay if the regulations are not followed, including fines up to \$5 million and imprisonment of up to two years.<sup>87</sup>

Franchisees rely on the strength of a brand when making an initial investment in a franchise system. The rigid regulations for labelling, packaging, advertising, and marketing cannabis will require that franchisors provide narrow parameters in which franchisees are able to market their stores and products and otherwise reserve marketing and promotion to the control of the franchisor. Moreover, retailers will be required to create retail experiences that drive consumer dedication. If product cannot be distinguished by its packaging or labelling and retailers cannot promote the cannabis product itself, retail experiences will be largely supported by things that are not related to cannabis.

For example, one retailer has coffee shops in Toronto and Calgary. The coffee emporiums essentially serve as placeholders, established for the purpose of introducing the brand to consumers in markets where the company either does not have a license or is gearing up to launch a strong retail presence. The shops sell coffee and company branded clothing and accessories, but do not sell cannabis. The goal is to convert the stores into dispensing cannabis retail stores once licenses become available.<sup>88</sup> In the meantime, the companies cultivate strong brand presence by legally advertising and marketing its brand. Although very little is known about the Cannabis Marketing License in British Columbia, it is evident that the license will allow marketers to promote the products of LPs to licensed cannabis retail stores. This promises some opportunity to franchisors in British Columbia who want to increase brand identity and awareness within that specific province.<sup>89</sup>

On a different note, consumers appear to be expressing concern about cannabis pricing within the retail space. The lack of price transparency from cannabis retailers is a result of the federal government making it illegal for retailers to advertise information regarding price. The only exception to this rule is that retailers are allowed to advertise price and availability at the point of sale, meaning once consumers have

---

<sup>86</sup> *Id.*

<sup>87</sup> George-Cosh, David, *Seven Pot Producers Run Afoul of Health Canada Amid Legalization Growing Pains*, BNN Bloomberg, October 29, 2018, available at <https://www.bnnbloomberg.ca/seven-pot-producers-run-afoul-of-health-canada-amid-legalization-growing-pains-1.1159678>

<sup>88</sup> Edmiston, Jake, *Cannabis Café a Hazy Relic as Marijuana's New Retail Paradigm Takes Over*, The Financial Post, March 19, 2019, available at <https://business.financialpost.com/cannabis/cannabis-cafe-a-hazy-relic-as-marijuanas-new-retail-paradigm-takes-over>

<sup>89</sup> *Retail Licensing, British Columbia*, available at <https://www.cannabiscomplianceinc.com/licensing/retail-licensing/british-columbia/>

actually entered the store.<sup>90</sup> Thus, the federal government has actually mandated that retailers be less transparent in their advertising, which can impede consumer choice.

### **3. Trademark Protection**

As mentioned above, LPs, franchisors, and retailers alike should consider ways to distinguish their business, products, and services from others. Trademark rights and the protection available under Canadian trademark law can serve as an effective business strategy for most competitive cannabis brands and retailers. At the time of writing, there are over 2,000 active trademark applications and registrations on record with CIPO for trademarks covering cannabis and cannabis-related goods and services.<sup>91</sup>

Trademark registrations may be used as both a sword and a shield, granting the trademark owner the exclusive right to use the trademark, or any confusingly similar trademark, in Canada, and also acting as an affirmative defence against a claim of infringement by a third party, and preventing competitors from adopting confusingly similar names or marks.<sup>92</sup> Given the national scope of protection of a registered trademark, the owner of a trademark registration is entitled to seek injunctive relief against the use of a confusingly similar trademark, even in areas where the trademark owner is not selling its goods and/or offering its services.<sup>93</sup>

To obtain a registered trademark in Canada, an applicant must file a trademark application with the Canadian Intellectual Property Office (“CIPO”). Among other things, the application must include a description in “ordinary commercial terms” of the goods and/or services with which the trademark is or will be used. CIPO’s Goods and Services Manual lists a variety of acceptable cannabis and marijuana-related goods including “dried cannabis”, “live cannabis plants”, “cannabis oil for oral vaporizers for smoking” and “medicinal marijuana for temporary relief of seizures”. Additionally, applications may cover a variety of goods ranging from dried cannabis, cannabis plants, and specific types of oils, hashes, and/or resins to goods that are not currently permitted under the *Cannabis Act* such as edible or topical cannabis products, and retail services, which are permitted in only some Canadian provinces. Since a trademark application may be filed on the basis of proposed use, applications covering edible and topical cannabis goods are being considered in the application process as it is presumed they will become legal in the near future.<sup>94</sup>

Cannabis brand owners may seek to protect trademarks that they intend to use, even if the goods and/or services associated with those trademarks do not currently comply with Canadian cannabis law, including edible cannabis goods, and packaging, labelling and advertising laws. Because CIPO only examines trademark applications to determine compliance with the *Trade-marks Act*, any alleged non-compliance with other federal or provincial legislation cannot be raised in examination.

---

<sup>90</sup> S.C. 2018, c.16., s.17(1)(a).

<sup>91</sup> Hayman, Allison and Purow, Jonathan, *Determining How To Best Protect Intellectual Property Essential for Players in Canadian, U.S. Cannabis Space*, The Growth Op, March 13, 2019, available at <https://www.thegrowthop.com/cannabis-business/cannabis-experts/determining-how-best-to-protect-intellectual-property-essential-for-players-in-canadian-u-s-cannabis-space>

<sup>92</sup> *Id.*

<sup>93</sup> *Trade-marks Act*, RSC 1985, c T-13

<sup>94</sup> *Id.*

At the time of writing, CIPO has not objected to the registration of trademarks covering cannabis-related goods and/or services on the basis of non-compliance with the *Cannabis Act* and the *Cannabis Regulations*. However, non-compliance with federal legislation such as the *Tobacco Products Control Act*, the *Canadian Cooperative Associations Act*, the *Canadian Red Cross Society Act*, and the *Canada Post Corporations Act* has been successfully raised to support grounds of opposition under s. 30(i) (non-entitlement) of the *Trade-marks Act*, and, in the author's view, non-compliance with the *Cannabis Act* could similarly form the basis of a 30(i) ground of opposition.<sup>95</sup>

Despite the availability of trademark protection for a variety of marks, including marks consisting of texture, scents, sounds and taste, the statutory and regulatory limitations on the packaging, labeling and marketing of cannabis set out in the *Cannabis Act* and underlying regulations may limit the ability to use such trademarks for cannabis-related goods and services. For instance, upon proof of distinctiveness, scents, sounds and taste could be registrable under the amended *Trademarks Act*, but may not be used on cannabis packaging if they offend cannabis laws, such as if they appeal to young persons. This will make it virtually impossible to acquire the necessary distinctiveness necessary to obtain a registration for scents, sounds and/or taste as applied to cannabis-related goods.<sup>96</sup> Similarly, by way of example, the *Trademarks Act* also contemplates extending registration protection to texture, but the *Cannabis Regulations* prohibit embossing on labels. These limitations will be a challenge for brand owners and franchisors attempting to establish brand identity through trademarks.<sup>97</sup>

Many of the recent amendments to the *Trade-marks Act* will come into force on June 19, 2019, when the Act will undergo its most significant revision in over 50 years. Among the most significant changes is the repeal of the use requirement as a pre-requisite to registration. Under the current Act, a trademark cannot be registered until it is used in Canada, or used and registered in the Applicant's home country. Once the amendments to the *Trademarks Act* come into force, trademark applicants are no longer required to specify a filing basis in their applications, such as prior use of a mark in Canada, proposed use, or use and registration abroad, and a trademark applicant may file extremely broad trademark applications covering goods and/or services that the applicant does not use and may not use at the time of registration.<sup>98</sup>

To guard against the potential for trademark squatting (i.e. registrations covering broad goods and services which the owner does not use or intend to use) and filing overly broad applications, the amendments contain new opposition and invalidation grounds, and require that any trademark owner attempting to enforce its

---

<sup>95</sup> Spicer, W. Joshua, *IP Litigation in the Cannabis Industry: A Review of the Limited Authority in Canada Thus Far*, October 1, 2018, available at

<http://www.mondaq.com/canada/x/740836/Trademark/IP+Litigation+in+the+Cannabis+Industry+A+Review+of+the+Limited+Authority+in+Canada+Thus+Far>

<sup>96</sup> *Id.*

<sup>97</sup> RSC 1985, c T-13

<sup>98</sup> Chummar, Noble, *Amendments to Canada's Trademarks Act to Come into Force June 2019*, December 12, 2018, available at [https://www.casselsbrock.com/CBNNewsletter/Amendments\\_to\\_Canada\\_s\\_i\\_Trademarks\\_Act\\_i\\_to\\_Come\\_Into\\_Force\\_June\\_2019](https://www.casselsbrock.com/CBNNewsletter/Amendments_to_Canada_s_i_Trademarks_Act_i_to_Come_Into_Force_June_2019)

registration within the first three years from the date of registration demonstrate use of the trademark allegedly infringed.<sup>99</sup>

From a cannabis perspective, while some trademark owners may view the removal of the use requirement as an invitation to file applications covering goods and/or services that are not currently permitted under the *Cannabis Act* and related regulations, such applications may be vulnerable to challenge through opposition, and the registrations covering such goods and/or services could not be enforced without showing use of the trademark. If registered for more than three years, these registrations could also be vulnerable to challenge through Section 45 proceedings, which require the registered owner to demonstrate use of the registered trademark in association with each of the registered goods and/or services in the preceding three years. If such use is not shown, the registration can be struck as a whole, or amended to delete those goods and/or services which have not been used.<sup>100</sup>

Many trademark practitioners anticipate that with the repeal of the use requirement, opposition proceedings will become more widely used to protect the Register of Trademarks and prevent registration of trademarks that are not, do not intend to be, or cannot (under existing legislation) be used. Given the rapidly changing legal landscape for cannabis as well as the amendments to the *Trademarks Act*, the interrelationship between trademark and cannabis remains a developing area of law in Canada.

### III. THE UNITED STATES

At present, cannabis franchising in the United States will work very differently from its counterpart in Canada, due to the lingering prohibition of cannabis under U.S. federal law. Canadian franchises in the cannabis industry are likely to provide valuable data regarding demand and trends, but they are unlikely to serve as an exact template for U.S. franchising efforts in the absence of significant changes to federal law.

#### A. Laws Impacting Businesses in the Cannabis Industry

##### 1. “Touching the Plant” or Not

A threshold question for discussing U.S. cannabis businesses is how to define what it means to be in the cannabis industry. There are both broad and narrow definitions. The easiest way to talk about the division between the two definitions is to understand whether or not a business “touches the plant.” This is a critical distinction because of the degree to which this fact impacts the legality of the businesses’ operation and the number of hurdles it must clear in order to operate at all.

A business which “touches the plant” is one which in any way interacts with cannabis material. For example, businesses which grow cannabis, transport it, extract oils, manufacture cannabis products, test the content of cannabis products, or sell cannabis products, are all businesses which “touch the plant.” These include dispensaries, distributors, manufacturers of everything from edible candy bars to filled

---

<sup>99</sup> *Id.*

<sup>100</sup> RSC 1985, c T-13, s. 45.



vape cartridges, testing facilities, and all cultivators.

On the other side of the proverbial fence, and sometimes excluded from the definition of “cannabis business,” are vendors who support these enterprises and supply them with non-cannabis goods and services. These are ancillary businesses which do not “touch the plant” but are nevertheless critical to the success of the cannabis industry. This category includes companies which sell hydroponics systems, grow lights, soil mixtures and fertilizers, seed-to-sale track and trace software, all types of packaging from odor-proof bags and child-proof bottles to printed boxes, professional services, and the like. Landlords who lease commercial space to cannabis facilities are also entities which do not touch the plant. Some of these businesses focus exclusively on the cannabis industry, while others are industry agnostic.

In general, a business which does not “touch the plant” is considered a legal business under federal law and will not be impacted by the variety of federal rules which apply to business operations which work directly with cannabis. In addition, these entities are not required to obtain cannabis-specific business licenses under state or local laws. In most ways, these businesses are substantially easier to run because they are less burdened by regulatory oversight and legal risk than a business which “touches the plant.” However, as discussed in Section III.C.1, banking can sometimes be a challenge for these businesses despite their legal operation, and managing banking issues can be a critical component in the success of such a business.

The vast majority of the laws discussed in the following sections of this paper apply only to businesses within the more narrow definition of a cannabis business, which directly interact with the plant. Unless otherwise noted, the laws discussed in the following sections impact only cannabis businesses which work directly with the plant.

## **B. Legality**

Since the State of California first legalized the sale of medicinal marijuana in 1996, there has been tension between federal and state laws on this subject. A detailed exploration of the long history of actions by the federal government and individual states exceeds the scope of this paper, as does a state-by-state summary of cannabis laws.<sup>101</sup> Instead, the authors have focused on the current state of the laws which impact cannabis businesses, and on discussions of trends between laws or tension from state to state which may create challenges or opportunities for the franchise industry. The authors have also focused primarily on jurisdictions in which cannabis is legal recreationally, rather than only medicinally or in a more limited manner.

### **1. Federal Prohibition**

#### **a. The Controlled Substances Act and Federal Prosecutions**

The Controlled Substances Act (the “CSA”) categorizes

---

<sup>101</sup> See Shannon L. McCarthy and Dawn Newton, *Franchising a Marijuana Business: It's Not Quite Mission Impossible*, 35 Fran. L. J. 357 (Winter 2016) for a more detailed discussion of some of the history.

“marihuana” as a Schedule I drug. This classification is reserved for the most hazardous drugs, which have “high abuse potential with no acceptable medical use.”<sup>102</sup> The CSA prohibits medical drug testing of Schedule I drugs, which has historically made it illegal for cannabis supporters to conduct formalized drug experiments which could challenge the conclusion that it has no medical utility. The Supremacy Clause in the United States Constitution allows the CSA’s prohibition of cannabis to take precedence over state laws. It allows the federal government to enforce its drug laws in any state, county, city or other municipality, without restriction.<sup>103</sup>

The long history of federal pushback against state efforts to legalize cannabis and resulting business operations exceeds the scope of this paper. It must suffice to simply state that the number and volume of cannabis entrepreneurs have grossly exceeded the government’s capacity to enforce the CSA, and each year has brought further state legalization efforts which compounds that situation. With the scale of state-legal operations in place today, it appears unlikely that the federal government could realistically stamp out state-legal cannabis sales, although its enforcement actions continue.

In 2013, recognizing the scope of the problem and the impossibility of fully combating the problem, the then-Attorney General of the United States issued a memorandum (the “Cole II Memo”) which essentially outlined a new federal government approach to the problem. The Cole II Memo listed eight key federal enforcement priorities. It indicated that businesses strictly complying with state laws and not engaging in any of these eight types of behavior were more likely to be insulated from enforcement actions. The eight enforcement priorities were as follows:

- Preventing the distribution of marijuana to minors;
- Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs and cartels;
- Preventing the diversion of marijuana from states where it is legal under state law in some form to other states;
- Preventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;
- Preventing violence and the use of firearms in the cultivation and distribution of marijuana;
- Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
- Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and
- Preventing marijuana possession or use on federal property.<sup>104</sup>

---

<sup>102</sup> 21 U.S.C. § 812(b)(1)(A)-(C).

<sup>103</sup> U.S. Const., Art. IV, Clause 2.

<sup>104</sup> Memorandum from James M. Cole, Deputy Att’y Gen., Dep’t of Justice, to U.S. Att’ys, *Guidance Regarding Marijuana Enforcement* (Aug. 29, 2013), p. 12, <http://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf>.

The effect of this memorandum, although it did not amend the CSA, was to reassure investors and entrepreneurs that the space could be relatively safe and stable for development, as long as their businesses carefully complied with state and local regulations. In the wake of this memo, investment in cannabis businesses expanded substantially.

On January 4, 2018, Attorney General Jeff Sessions rescinded the Cole II Memo via a new memorandum which provided in part that, “in deciding which marijuana activities to prosecute under these laws with the Department’s finite resources, prosecutors should follow the well-established principles that govern all federal prosecutions.”<sup>105</sup> The phrase “these laws” referenced an earlier reference to the CSA, money laundering statutes, the unlicensed money transmitter statute, and the Bank Secrecy Act.<sup>106</sup> While the rescission of the Cole II Memo worried many industry insiders, the general consensus of industry insiders seemed to be that this might finally force Congress to create legislation on the issue, as the industry is far too mature to be shut down by federal prosecutors.<sup>107</sup>

In 2019, William Barr replaced Jeff Sessions as Attorney General. During Barr’s confirmation hearing, in written comments he submitted to the Senate, he stated, “...I do not support the wholesale legalization of marijuana.” At the same time, however, he also stated that, “...I do not intend to go after parties who have complied with state law in reliance on the Cole Memorandum.”<sup>108</sup> While Barr’s lack of support for a complete end to prohibition is sobering to cannabis proponents, his apparent willingness not to actively prosecute those complying with the Cole II Memo was encouraging, as were his comments that Congress ought to legislate a solution to the issue so that the matter does not continue to be governed by conflicting federal and state laws.

## **b. The 2018 Farm Bill**

In 2018, Congress passed and the President signed the Agricultural Improvement Act of 2018 (colloquially referred to as the “Farm Bill”)<sup>109</sup>, which legalized industrial hemp. Hemp is a plant in the cannabis family which is easier to grow than the cannabis plants from which marijuana is derived. Industrial hemp is low in Tetrahydrocannabinol (“THC”) and therefore not psychoactive. The Farm Bill explicitly excludes hemp from the definition of “marihuana” in the CSA. Thus, businesses dealing exclusively with hemp should not be subject to banking restrictions, certain tax issues, interstate commerce prohibitions, refusal to register trademarks, and related challenges. The Farm Bill specifically prohibits states from interfering with the production or transportation of hemp.

---

<sup>105</sup> Memorandum from Jefferson B. Sessions, III, Att’y Gen., Dep’t of Justice, to All U.S. Att’ys, *Marijuana Enforcement* (Jan. 4, 2018), <https://www.justice.gov/opa/press-release/file/1022196/download...>

<sup>106</sup> *Id.*, citing 21 U.S.C. § 801 et seq.; 18 U.S.C. §§1956-57 and 1960; and 31 U.S.C. §5318.

<sup>107</sup> See, e.g., <https://www.forbes.com/sites/bradauerbach/2018/03/03/how-cannabis-entrepreneurs-feel-about-sessions-reversal-of-the-cole-memo/#598a04bdc4ae>

<sup>108</sup> Tom Angell, *Trump Attorney General Pick Puts Marijuana Enforcement Pledge in Writing*, *Forbes*, Jan. 28, 2019, <https://www.forbes.com/sites/tomangell/2019/01/28/trump-attorney-general-pick-puts-marijuana-enforcement-pledge-in-writing/#2afa4f2f5435>.

<sup>109</sup> Agricultural Improvement Act of 2018, H.R. 2, 115<sup>th</sup> Cong. (2017-2018).

The passage of the Farm Bill, and the fact that it had bipartisan support, unquestionably represents another step forward for cannabis advocates. Cannabidiol (“CBD”) can be derived from industrial hemp, and the removal of hemp from the CSA means that industrial hemp-derived CBD products can be openly produced, tested, transported and sold across the country. At the same time, many cannabis experts note that industrial hemp is not rich in CBD. It takes a large volume of hemp to produce the amount of CBD which can be extracted from a much smaller volume of other cannabis plants, and there is some dispute as to the quality of hemp-derived CBD. Finally, much of the medicinal effects of cannabis require a higher amount of THC than is present in hemp. The legalization of industrial hemp has not cured the challenges faced by the industry.

## **2. State Laws**

As of early 2019, cannabis is legal to use recreationally in 10 states, permissible to use for medicinal purposes in an additional 23 states; permissible in limited medicinal ways in 13 states, and prohibited in four<sup>110</sup> states. The chart in Exhibit A shows the breakdown as of April 2019.

The majority of the 13 states which permit limited medicinal use have legalized the sale of low-THC, high-CBD oil which generally does not give the user a high, but may relieve pain or address other physical symptoms. A commonly cited example is Charlotte’s Web oil, which is a cannabis extract with very low THC which has shown promise in reducing a specific type of epileptic seizures in children.<sup>111</sup>

The phrase “state-legal” has been widely adopted in the industry to refer to activities which strictly follow the regulations and requirements of state and local laws, even though they violate federal laws. The parties to a contract might agree that a cannabis business will operate in a state-legal manner with respect to its cannabis business operations, for example. As with many other portions of this paper, a detailed exploration of different state laws exceeds the scope. The shorter summary is that state laws differ to some extent from one another with respect to what they permit, mandate, or prohibit. Many of the differences between state laws are summarized in the following sections.

## **3. Municipal Oversight**

In all of the 33 states which have legalized the sale of cannabis either for medicinal purposes or for all adult use, the states have created a strict regulatory scheme. Under many of these laws, cities and counties are permitted to make additional laws at the local level governing cannabis. Thus, it is not uncommon for cannabis to be legal within a state but subject to additional rules or prohibitions which vary within that state. In Colorado, for example, when recreational cannabis sales were first approved, each city had the right to determine whether it would permit dispensaries within the city limits. Denver promptly agreed to allow dispensaries, but most other cities

---

<sup>110</sup> Those four states are Idaho, Kansas, Nebraska and South Dakota. In November 2018, Wisconsin voters approved an advisory referendum supporting medicinal marijuana, but at present it has only permitted limited CBD use.

<sup>111</sup> “Charlotte’s Web” Marijuana Supposed Cure for Kids’ Seizures but Doctors Skeptical, CBSNews, Feb. 18, 2014, at <http://www.cbsnews.com/news/charlottes-web-marijuana-a-hope-for-kids-with-seizures-despite-unproven-medical-benefits/>

did not.<sup>112</sup> Over time, cities which had initially refused to allow dispensaries to operate began to conclude that they were losing tax revenue and their residents were simply going elsewhere to purchase cannabis products, so many municipalities have become more open to welcoming (and taxing) these businesses.<sup>113</sup> Nevertheless, many communities remain opposed to large-scale or numerous cannabis activities in their backyard.

#### **4. Licensing**

All states now require a license from a state/local agency in order to operate a business which touches the plant. A thorough discussion of the licensing laws of every state exceeds the scope of this paper, but the authors can provide a few examples to illustrate the complexity of these laws and the lack of uniformity between states, which is a complicating factor for any business trying to embrace franchising, a business model in which uniformity and equal treatment of franchisees is prized. The types of licenses and related issues are discussed in greater detail below.

##### **a. Types of Licensed Operations**

As discussed above, businesses which do not touch the plant are treated very differently from those that do. A business specializing in lights or fertilizer does not require a license and operates largely like any other business in its category. The entities discussed below are the most common types of businesses which do require a license.

##### **(i) Cultivation**

Cultivation licenses cover growers. Cultivation licenses can be very specific, allowing the licensed party to grow only a particular canopy size (measured in square feet or number of plants), and restricting the operation to grow only indoors or only outdoors, for example. Licenses often include highly specific requirements for how the space must be set up and operated. A grower who exceeds their permitted size is operating illegally.

##### **(ii) Distribution**

Distributors operate as the middle men between cultivators and retailers. Distributors are often responsible for storage, testing and quality assurance, and they transport cannabis products between the other parties in the chain.

##### **(iii) Manufacturing**

Manufacturing licenses are required for all businesses creating edibles, oils, tinctures, and similar products. License types can include medicinal manufacturing, manufacturing using volatile solvents, manufacturing or extraction using

---

<sup>112</sup> Sullum, Jacob, *So Far Colorado's Cities Overwhelmingly Prefer Banning Pot Shops to Regulating Them*, available at <https://www.forbes.com/sites/jacobsullum/2013/10/04/so-far-colorados-cities-overwhelmingly-prefer-banning-pot-shops-to-regulating-them/#47c6bbbb3e5b>

<sup>113</sup> *Longmont City Council votes to lift ban on marijuana dispensaries*, Sept. 26, 2017, <https://kdvr.com/2017/09/26/longmont-city-council-to-vote-on-lifting-ban-on-marijuana-dispensaries/>

nonvolatile solvents, packaging and labeling, and more.

#### **(iv) Dispensary / Retail Storefront or Delivery**

The “retail storefront” dispensary license covers the business activities of one of the types of business which most people think of when they imagine a cannabis business. This is a brick-and-mortar business which typically offers a variety of different cannabis strains, rolling or smoking supplies and accessories, and often edibles, tinctures or other items. Medicinal sales and recreational sales may be different licenses. In areas in which only medicinal use is legal, buyers are required to produce their card or other proof that they qualify to make purchases.

A license to operate a delivery-based dispensary covers businesses which bring cannabis products to a user. These businesses have a licensed premises at which they package their goods, but it is not open to the public.

#### **(v) Testing**

Testing laboratories are critical to the success of cannabis sales. State laws require cannabis and cannabis products to be tested for various things including THC or CBD content, moisture content, residual pesticides, residual solvents, heavy metals, foreign materials, mycotoxins and terpenoids. Only products which pass testing protocols may be sold to consumers.

In order to qualify for a testing license, labs must satisfy the licensing authority that they have adequate expertise, equipment, safety protocols and processes to be approved. Unlike most other types of licenses, a testing license may not be owned by anyone who owns another type of license. This reduces bias and helps ensure safety.

Because of the expense in starting a laboratory and difficulty in getting licensed and approved to open a laboratory, in some areas there are weeks-long waits for product testing. This can impact the freshness of products like edibles, as well as the timeline to get batches of product to market.

#### **b. Getting Licensed**

Each state has its own license approval process, but the process to obtain a license is selective. As a generality, it is safe to say that the process of applying for a license requires substantial disclosure of the individuals involved in the business, others who may hold a financial interest in the business, background checks and fingerprinting, business plans, and payment of non-refundable application fees. It is generally not possible to maintain anonymity as a silent partner. Applications require detailed information about the natural persons who are funding the applicant or may receive money or profits from the business.<sup>114</sup> These disclosure obligations often extend to any person or entity receiving profit-sharing or ongoing revenue from the business,<sup>115</sup> which

---

<sup>114</sup> See, e.g., Colorado Department of Revenue Retail Marijuana Business License Application, <https://www.colorado.gov/pacific/sites/default/files/DR%208548e%20Retail%20App%2012192018.pdf>

<sup>115</sup> See, e.g., Washington cannabis licensing regulations at WAC 314-55-035 defining a “true party in interest” as any person expecting a percentage of profits in exchange for expertise.

ostensibly would include the franchisor and potentially any parties the franchisor shares revenue with, including franchise brokers, area representatives, and affiliate companies.

Most state applications also require the applicant to demonstrate that it has already obtained local approval or consent for the area in which it intends to operate. This can turn licensing into a two-step process at minimum. In Oakland, California, for example, local ordinance requires that at least 50% of all cannabis approvals include an “equity applicant” and those applications are given priority.<sup>116</sup> An equity applicant is a low income applicant who resides in an economically disadvantaged area, or who has a past criminal conviction for cannabis. An equity incubator application involves a wealthier applicant who agrees to provide the equity applicant with at least 1,000 square feet of space for business operations, for free, for a minimum of three years.<sup>117</sup>

## **5. Vertical and Horizontal Integration**

A vertically integrated cannabis business is one which operates multiple stages of the business from growing the plants through manufacturing and retail sales (testing is excluded; vertically integrated businesses must have an independent entity provide testing to ensure accuracy and avoid self-dealing). Vertically integrated businesses control multiple elements (or in some cases every element) of the business and can ensure the quality of the products they sell. On the other hand, vertical integration is extremely expensive; the cost to manage all aspects of the business from growth through sale is daunting, and it requires the business to employ a group of individuals whose knowledge collectively covers every aspect of the life-cycle of cannabis.

Vertical integration is required in Florida and several other states, primarily northeast states: Connecticut, Delaware, Maine, Massachusetts, Minnesota, New Hampshire, New Jersey, New Mexico and New York.<sup>118</sup> As a direct result, the entities engaged in the cannabis industry in these states tend to be very large entities, sophisticated and well-funded. In vertically integrated markets, there are also often strict caps on the number of cannabis licenses which will be issued, with competition for each one. This further restricts the market.<sup>119</sup>

In contrast, primarily in the west, states have either prohibited vertical integration (California, Illinois and Washington), or permitted it without requiring it (Alaska, Arizona, Colorado, Maryland, Nevada, Oregon and Washington D.C.). This has allowed a proliferation of many smaller businesses, and dispensaries which carry a wide variety of products which they could not possibly have produced themselves. While this has expanded the creativity and variety of products in these states, it has also contributed to substantial competition and questions about whether particular areas have too many dispensaries.

---

<sup>116</sup> This program will phase out once the city has collected \$3.4 million in tax revenue from cannabis.

<sup>117</sup> City of Oakland, Cannabis Ordinances.

<sup>118</sup> Jason Perlow, “How the marijuana industry is organized in legal states” Nov. 16, 2018, <https://www.zdnet.com/article/how-the-marijuana-industry-is-organized-in-legal-states/>

<sup>119</sup> *Id.*

## C. Laws Affecting Operations

The laws outlined above address the question of whether the business can be operated at all. A cannabis business which is permitted (under state law) to operate in a particular area must also contend with a number of laws specifically targeting the cannabis industry. The most notable of these laws are discussed below.

### 1. Banking

Banking presents a tremendous challenge for cannabis-related businesses in the United States. Technically, federal law does not prohibit banks from allowing cannabis businesses to have bank accounts. However, the Department of the Treasury's Financial Crimes Enforcement Network's ("FinCEN") guidance to banks and financial institutions about cannabis has had a chilling effect on the number of banking institutions willing to open or maintain a bank account for such a business.

FinCEN guidance issued February 14, 2014 provides that a financial institution considering allowing a cannabis business to access banking services should conduct due diligence on a wide variety of topics including verifying the entity's license, reviewing the license application, requesting additional information about all of the related parties, "developing an understanding of the normal and expected activity for the business..."<sup>120</sup> "ongoing monitoring of publicly available sources for adverse information about the business and related parties",<sup>121</sup> and ongoing and continuous monitoring for red flags and continuing due diligence efforts.<sup>122</sup>

The FinCEN guidance also states that the financial institution should "consider whether a marijuana-related business implicates one of the Cole Memo priorities or violates state law," and must file suspicious activity reports ("SARs").<sup>123</sup> The FinCEN guidance outlines three types of SARs, ranging from (1) reports that the financial institution believes a marijuana-related business is generally complying with state law and does not implicate any Cole Memo priorities (a "Marijuana Limited" SAR); (2) reports that the financial institution believes the business may be implicating a Cole Memo priority or violating state law (a "Marijuana Priority" SAR); to (3) a report that the financial institution is terminating its relationship with a marijuana-related business in order to comply with anti-money laundering laws (a "Marijuana Termination" SAR).<sup>124</sup>

Unsurprisingly, the vast majority of financial institutions in the U.S. have concluded that the combined burden of risk and compliance effort exceeds the reward of banking cannabis companies. Financial institutions which violate the *Bank Secrecy Act* may lose their Federal Deposit Insurance Corporation ("FDIC") deposit insurance, or even have personnel subject to criminal penalties. And the level of investigation and ongoing monitoring of the business far exceeds what is required of banks for any other industry niche. No bank is required to engage in ongoing monitoring of the product lines, related business entities, or accuracy of license information for a restaurant or a hotel.

---

<sup>120</sup> Dep't of Treas., *BSA Expectations Regarding Marijuana-Related Businesses*, Fin-2012-G001 (Feb. 14, 2014).

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*



In 2018, FinCEN issued a Marijuana Banking Update<sup>125</sup> showing data from 2014 through September 30, 2018, which showed 486 depository institutions “actively banking marijuana businesses,” up from 318 such institutions in October 2016.<sup>126</sup> The Update also noted that as of April 12, 2018, FinCEN had received a total of 37,885 Marijuana Limited SARs and 12,331 Marijuana Termination SARs.<sup>127</sup>

Many people are surprised to learn that banking issues affect not only businesses which “touch the plant” but also many ancillary businesses which do not. It is not uncommon for landlords and vendors to businesses in the cannabis industry to have their bank accounts suspended upon their bank’s discovery that the business is connected in some way with cannabis. This discovery could occur in many ways, but two common causes are large or repeated cash deposits, or a business which forms a subsidiary or division to specialize in cannabis, markets that niche, and their marketing draws the attention of a disapproving banker. In some instances, the bank may simply notify the account holder that the bank can no longer accept their business and they have a limited window of time before the account is closed, leaving the entity scrambling to find a new banking relationship in a few days. In 2018, the CEO of a cannabis company with licenses in Nevada and California had her *personal* bank accounts closed after the bank saw her on television advocating for the industry and the bank allegedly concluded that she was a “high risk” customer.<sup>128</sup>

It is critical to understand financial institutions’ sensitivity to accounts which may only be tangentially related to the industry, not only because it signals that there is risk for individuals and legal businesses which interact with the cannabis industry, but also because it illustrates that some of the Marijuana Limited SARs may be coming from financial institutions which are filing them only in relation to ancillary businesses which interact with the cannabis industry. In other words, not all 486 financial institutions which “actively bank marijuana businesses” according to FinCEN information may be actively banking a business which touches the plant. It remains extremely challenging for many businesses to obtain and maintain bank accounts.

In 2017, the Secure and Fair Enforcement (SAFE) Banking Act was introduced in the House, and it was amended in 2019, receiving bipartisan support.<sup>129</sup> It is designed to prevent banks from losing their charter or otherwise being penalized if they work with state-legal cannabis businesses. While the bill has substantial support, there is no guarantee of passage.

---

<sup>125</sup> Dep’t of Treas., *Marijuana Banking Update*, Sep. 2018,

[https://www.fincen.gov/sites/default/files/shared/277157%20EA%202nd%20Q%20MJ%20Stats\\_Public.pdf](https://www.fincen.gov/sites/default/files/shared/277157%20EA%202nd%20Q%20MJ%20Stats_Public.pdf)

<sup>126</sup> With an estimated 13,000 financial institutions in the U.S., per FIC and Credit Union National Association statistics, this means only about 3% of the financial institutions in the U.S. are banking cannabis businesses.

<sup>127</sup> *Id.*

<sup>128</sup> Patrick Walker, *Banks closes marijuana CEO’s accounts*, [sic] Las Vegas Now, Aug. 29, 2018,

<https://www.lasvegasnow.com/news/local-news/banks-closes-marijuana-ceo-s-accounts/1405771032>

<sup>129</sup> H.R. 1595, 116<sup>th</sup> Cong., SAFE Banking Act of 2019, showing 166 cosponsors (149D, 17R), <https://www.govtrack.us/congress/bills/116/hr1595/details>

## **2. Taxation**

### **a. Federal Income Tax**

The Internal Revenue Code contains a unique provision which targets cannabis businesses. Section 280E prohibits businesses which “traffic in controlled substances (within the meaning of Schedules I and II of the Controlled Substances Act)” from deducting “below the line” business deductions or tax credits on their federal income tax returns.<sup>130</sup> While businesses are still permitted to deduct “above the line” expenses for cost of goods sold, they are not permitted to treat overhead expenses such as rent or payroll as deductions.<sup>131</sup>

Additionally, cannabis businesses are not allowed to use other tax code sections to characterize their overhead as costs of inventory. Code Section 263A (“UNICAP”) forces many other businesses to treat many “below the line” expenses as capitalized expenses of inventory.<sup>132</sup> However, when cannabis businesses attempted to utilize this section to characterize their expenses as deductible, the Office of Chief Counsel of the IRS issued a memorandum prohibiting this and referencing section 263A(a)(2) which provides that “Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.”<sup>133</sup>

As a consequence, cannabis businesses have far fewer deductions and correspondingly higher federal income tax obligations than comparable businesses.<sup>134</sup> Further, because section 280E applies to both Schedule I and Schedule II of the CSA, amending the CSA to move “marihuana” into Schedule II, as some legislators have suggested, will not cure this issue.

### **b. Sales and Excise Taxes**

Cannabis sales are subject to specific taxes, similar to product-specific taxes which sometimes apply to alcohol, tobacco or gasoline. It is not unusual for these taxes to be set by both the state and the local municipality, resulting in different tax rates in different cities. The State of Colorado, for example, taxes cannabis purchases 15%, and all municipalities have their own taxes, resulting in a 19% total tax rate in the least expensive city, and a 24% tax rate in the most expensive area.

In California, retail cannabis sales are subject to a 15% excise tax, on top of which the state’s sales tax is also imposed. Wholesale sales are also subject to a 15% excise tax after a 60% markup is applied, with sales tax also applied on top of that figure. The transaction of a wholesaler selling \$75 worth of cannabis to a retailer who resells the cannabis for \$150 to end consumers will generate \$56.89 in taxes, comprised of \$40.50 in excise taxes and \$16.39 in sales taxes in Los Angeles

---

<sup>130</sup> 26 U.S.C. § 280E.

<sup>131</sup> The Constitution permits Congress to tax “income” and the Internal Revenue Code defines “income” as gross receipts less the cost of sales.

<sup>132</sup> 26 U.S.C. § 1.263A-1.

<sup>133</sup> 26 C.F.R. § 1.263A-1(c)(2)(i).

<sup>134</sup> See McCarthy and Newton, *supra*, at p. 374 for a discussion of tax consequences for businesses involved in both federally legal and illegal activities.

County.<sup>135</sup> In this transaction, the retailer earns \$57, before accounting for any of its costs in transporting, displaying or selling the cannabis.<sup>136</sup>

### **3. Interstate Commerce**

Because the CSA makes cannabis illegal, it is also illegal to transport it in interstate commerce. This means that manufacturers, distributors and retailers cannot legally transport plants, flowers, or manufactured products containing plant extracts across state lines. For businesses seeking both uniformity and centralized supply chains, this poses a substantial hurdle in establishing business operations in multiple states.

### **4. Formulation, Labeling and Packaging**

States which have legalized cannabis have required sellers to ensure that it is carefully packaged and marked in order to avoid situations in which a consumer does not know what they are buying or using. These rules vary by state, but can include restrictions or requirements on the following:

- Mandatory information about the contents of the package, including cannabis strain and THC and CBD percentages
- Information about where the product was grown, the seller and any manufacturers
- Statements about how the product was tested and whether the testing revealed certain contaminants
- Font size requirements and requirements to ensure legibility
- Prohibitions on packaging which might appeal to children, including prohibitions on cartoons, references to candy or toys, and certain package styles
- Restrictions on color or images on packaging<sup>137</sup>
- Restrictions on making edibles resemble known candy, or making it attractive to children
- Mandatory child-proof packaging
- Requirements to stamp cannabis symbols onto some edibles (e.g., chocolate bars)
- Prohibition on infusing cannabis into alcohol
- Restrictions on where billboards or other advertising can be placed, including requirements that advertisements are not near daycares,

---

<sup>135</sup> California's state sales tax is 7.25% but many municipalities add an additional sales tax. In Los Angeles, the sales tax is 9.5% total.

<sup>136</sup> See report by Marijuana Policy Group, *Los Angeles County Cannabis Tax Considerations*, May 1, 2018, <http://cannabis.lacounty.gov/wp-content/uploads/2018/06/2018-06-19-Attachment-IV.pdf>

<sup>137</sup> The State of Washington has rolled out Interim Policy BIP-10-2018 which requires edibles to be in packaging which must have one of only three acceptable background colors (white/cream, grey/black or tan/brown), each of which corresponds to a required text color, and only three other colors may be used on the packaging, from a list of 16 acceptable colors. Any other color combinations are prohibited. The policy also prohibits formulating edibles into shapes other than those approved by the Washington State Liquor and Cannabis Board. Approved shapes are reminiscent of pharmaceutical pills: round and multi-sided shapes like triangles, ovals, squares, and octagons. Under this rule, edibles could not be shaped into stars, hearts, flowers, trees, cannabis leaves, or any freeform shape.

[https://lcb.wa.gov/sites/default/files/publications/rules/2018%20Proposed%20Rules/BIP\\_10\\_2018\\_MJ\\_Labeling\\_MIE\\_Colors\\_REVI\\_SED\\_FINAL\\_Signed.pdf](https://lcb.wa.gov/sites/default/files/publications/rules/2018%20Proposed%20Rules/BIP_10_2018_MJ_Labeling_MIE_Colors_REVI_SED_FINAL_Signed.pdf)

schools, public event centers where children might be, on mobile billboards placed on vehicles, and related restrictions

Most of these rules have emerged in response to two overarching concerns. First, consumers should know what they are purchasing and have the ability to conduct a side-by-side comparison of products and understand the potency of each product. Second, prior to mainstream state legalization, cannabis was often sold under names like Candyland or Girl Scout Cookies,<sup>138</sup> and sometimes in packaging made to look like a play on famous brands. Sellers were already risking criminal prosecution by selling marijuana, so the threat of a trademark infringement claim was not high on their list of concerns. Today, state regulators are intent on avoiding the sale of cannabis to children and focused on reducing the appearance that cannabis products are being marketed to people under age 21.

Many of the strict requirements around labeling and packaging will impact the uniformity of branding between states. A brand's signature packaging in one state, or even its core color scheme, might be prohibited by packaging rules in another state.

## **5. Trademarks**

### **a. No Federal Registration**

For owners of cannabis businesses which interact directly with plant material, a federal registration for core services or products is not currently available.

The United States Patent & Trademark Office (the "USPTO") only allows the registration of trademarks which are used in commerce. Commerce is defined as "all commerce which may lawfully be regulated by Congress."<sup>139</sup> Because Congress regulates drugs and has used the CSA to prohibit marijuana, it cannot lawfully be used "in commerce" and on this basis the USPTO refuses to register these marks.<sup>140</sup>

While some cannabis companies register their marks for legal goods or services which feature pictures or information about cannabis, such as clothing, software, marketing services, books or blogs, under the trademark class system these marks are unlikely to block the later registration of a mark for actual cannabis products or for dispensary, cultivation or manufacturing services.

Trademarks are also protected to some extent by common law. However, common law protections are limited to the geographic area in which the mark's owner used the mark. Common law offers little or no protection for a business whose operations are limited to one geographic area, if another party in a different area begins using the same mark, particularly if the original user cannot demonstrate that it was in the process of expanding into the latter territory. Moreover, federal courts have

---

<sup>138</sup> Both these names and several others were explicitly banned by the Oregon Liquor Control Commission as part of efforts to avoid making cannabis products attractive to children.

[https://www.oregon.gov/olcc/marijuana/Documents/Packaging\\_Labeling/Strain\\_Name\\_Attractiveness\\_Children.pdf](https://www.oregon.gov/olcc/marijuana/Documents/Packaging_Labeling/Strain_Name_Attractiveness_Children.pdf)

<sup>139</sup> *Lanham Act*, section 45, 15 USC 1127.

<sup>140</sup> *Id.*

original jurisdiction over trademark claims under the *Lanham Act*.<sup>141</sup> A federal court might refuse to hear such a claim on the grounds that the business at issue is illegal, or that the mark has not been used “in commerce” and therefore does not constitute trademark use.<sup>142</sup>

## **b. State Registrations**

Trademark registration is more widely available at the state level, in state-legal jurisdictions. However, state registration provides little protection against the prospect of separate businesses in many different states each independently adopting the same or similar names. Under common law trademark rights, unregistered (or state registered) marks do not protect the user from third parties in geographically remote areas developing identical marks.<sup>143</sup>

In addition, even this level of registration is not fully available to all the same parties who would ordinarily register marks. In California, for example, registration for a cannabis product is only available to a company which holds a cannabis license and which uses the mark in question in connection with its license.<sup>144</sup> The licensed entity must be the mark owner. Thus, a celebrity who allows a licensed manufacturer to produce cannabis products under their famous name cannot own their name as a trademark in connection with the co-branded or white labeled products.

## **6. Traceability**

State laws require seed-to-sale tracking of cannabis in order to ensure that it is not being diverted into the black market or otherwise used in an illegal manner. California, for example, has a statewide system which records inventory and movement of cannabis and cannabis products throughout the commercial supply chain. Use of this system is mandatory. Licensees request codes called unique identifiers which are radio-frequency identification tags assigned to individual plants or packages and used to track their movement, sale or destruction. Other states use private software systems which provide regulators with access to the information entered by users.

A critique of the tracking process is that it is time consuming and therefore adds expense for all parties involved in the chain of custody of cannabis products. For the sake of comparison, when the European Union proposed track and trace systems for tobacco products in the EU, the EU distributors’ union wrote a letter protesting the proposal and calling the system, “extremely cumbersome and costly...”<sup>145</sup>

## **7. No Bankruptcy Protection**

Finally, most courts which have considered the question of whether cannabis businesses may avail themselves of federal bankruptcy protections have

---

<sup>141</sup> *Id.*, section 43, 15 U.S.C. section 1125(a)(1).

<sup>142</sup> Compare bankruptcy courts’ rulings on cannabis decisions, described in Section III(C)(7), below.

<sup>143</sup> John R.F. Baer, et al., *Franchising: Cases, Materials & Problems* 48 (Alexander M. Meiklejohn ed., 2013) (describing scope of trademark rights includes geographic use of mark).

<sup>144</sup> The California Secretary of State’s FAQ on registering a cannabis-related service mark or trademark states only that the mark must be “lawfully in use in commerce within California” and match the USPTO’s classification for goods. However, in order to lawfully use the mark in commerce, it must be in association with a license.

<sup>145</sup> <https://www.euractiv.com/section/economy-jobs/news/commission-hits-back-at-criticism-over-tobacco-track-and-trace-proposal/>

declined to permit it, or have required the debtors to stop operating their business in order to maintain their bankruptcy petition.<sup>146</sup> In 2017, the Department of Justice published a paper titled “Why Marijuana Assets May Not Be Administered in Bankruptcy,” noting in part that the bankruptcy system “may not be used as an instrument in the ongoing commission of a crime,” and that trustees and fiduciaries should be compelled to violate federal criminal law in order to administer assets of an estate.<sup>147</sup> The authors, a Director and a trial attorney at the Executive Office for U.S. Trustees, noted that the United States Trustee Program, a division of the Justice Department, would move to dismiss bankruptcy cases “in its role as the watchdog of the bankruptcy system,” where the debtor was engaged in federally criminal behavior involving cannabis.

In general, courts have concluded that bankruptcy protections exist for legal businesses under federal law. Bankruptcy courts “should not be ‘a haven for wrongdoers.’<sup>148</sup> In at least one case, even a landlord who knowingly leased space to a cannabis tenant was denied protection.<sup>149</sup> Consequently, cannabis businesses, and their owners, must evaluate the risk of operating their businesses mindful of the possibility that bankruptcy protections may be unavailable to them.

## **8. The Role of Real Estate**

Real estate plays a critical role in the establishment of any franchised business which relies on a brick-and-mortar model. Restaurants, hotels and retail businesses of all types rely on having the “right” location. In the cannabis industry, real estate is of equal, if not more, importance.

As discussed above, having a lease is often a requirement in order to obtain a license to operate the business, and the license may be refused if the leased property is not properly zoned to house a cannabis business. Under many states’ laws, a cannabis business may not be operated within a certain distance of schools, children’s play spaces, and even daycare facilities. In many municipalities, cannabis businesses are restricted to certain areas, sometimes known as “green zones,” and prohibited from operating in other areas zoned for commercial use.<sup>150</sup> In some instances, those who oppose the establishment or expansion of cannabis operations in their areas have sought to influence zoning decisions in order to regulate or prohibit cannabis operations in their area.

---

<sup>146</sup> See *In re McGinnis*, 453 B.R. 770 (Bankr. D. Or. 2011) (Chapter 13 plan denied); *In re Arenas*, 514 B.R. 887 (Bankr. D. Colo. 2014), *aff’d* 535 B.R. 845 (B.A.P. 10<sup>th</sup> Cir. 2015) (grounds to dismiss were that the plan would have required the trustee’s administration of illegal assets); *In re Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015) (debtor enjoined from operating his medical marijuana business during pendency of matter); *In re Medpoint Mgmt.*, 528 B.R. 178, 180 (Bankr. D. Ariz. 2015).

<sup>147</sup> Clifford J. White III, Director, Exec. Off. For U.S. Trustees, and John Sheahan, Exec. Off. For U.S. Trustees, *Why Marijuana Assets May Not Be Administered in Bankruptcy*, [https://www.justice.gov/ust/file/abi\\_201712.pdf/download](https://www.justice.gov/ust/file/abi_201712.pdf/download).

<sup>148</sup> *Lockyer v. Mirant Corp.*, 398 F.3d 1098, 1107 (9<sup>th</sup> Cir. 2005).

<sup>149</sup> *In re Rent-Ride Super Kegs West Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012).

<sup>150</sup> Denver, for example, maintains a list of active childcare facilities in Denver and all licensed childcare facilities in Colorado and provides links to these on its webpage for retail marijuana licenses; see also, e.g., San Francisco Planning Department map of permitted zones, <https://sfplanninggis.org/cannabisretail/>

## D. Opportunities and Risks for Franchising

The market opportunity for franchising in the United States cannabis industry is vast, if the challenges can be overcome. There is no doubt about the swift growth of the industry to date. *Marijuana Business Daily*, a trade publication, publishes an annual *Marijuana Business Factbook* based on a survey of hundreds of cannabis professionals and on data-sharing partnerships with market research firms. According to the 2018 *Factbook*, retail sales of cannabis in the U.S. were in the range of \$5.8-\$6.6 billion in 2017 and were projected to grow by 35% in 2018 – matching McDonald’s revenue by the end of the year. The *Factbook* projected retail sales to top \$22 billion in the U.S by 2022.<sup>151</sup>

Similar figures are reported by another industry-sponsored annual report, *The State of Legal Marijuana Markets, 6th Edition*, by Arcview Market Research and BDS Analytics.<sup>152</sup> The data for this report come from BDS Analytics’ panel of participating cannabis dispensaries, which contribute daily point of sales data. Dispensary panels are recruited to be both statistically significant as well as representative of the makeup of dispensaries in the market. In a 2019 update, Arcview/BDS Analytics reported that the worldwide market for legal cannabis grew by 28.2% in 2018, to \$12.2 billion, and forecast the market to grow by another 39.1% in 2019, to \$17 billion, and beyond that to \$31.6 billion in 2022, averaging a 26% compound annual growth rate (“CAGR”) during the five-year period from 2017 to 2022.<sup>153</sup>

Independent sources largely agree with these industry sources. In April 2018, market research firm Grand View Research, Inc. released a report projecting that the global legal marijuana market will grow to \$146.4 billion by the end of 2025.<sup>154</sup> The Grand View Research report breaks down the market by medical vs. recreational, by product type (buds, oil, tinctures), by medical application, and by geographic regions. For the US legal marijuana market, the GVR report projected a 24.9% CAGR from 2017 to 2025. Separately, a Wall Street analyst, Nik Modi of RBC Capital Markets, has projected a 17% CAGR for legal cannabis sales in the US over the next decade.<sup>155</sup>

### 1. Market Demand

The 2018 *Marijuana Business Factbook* estimated total current demand for marijuana in the United States, including the black market, at \$52.5 billion. With federal legalization, sales “would likely rise [from that level] as cannabis gained mainstream acceptance and the market evolved.” Eventually, the *Factbook* speculates,

---

<sup>151</sup> *Marijuana Business Daily, Annual Marijuana Business Factbook*, 2018 6<sup>th</sup> ed., available at [MJBizFactbook.com](http://MJBizFactbook.com).

<sup>152</sup> *2019 Update to The State of Legal Marijuana Markets*, 6<sup>th</sup> Edition, March 4, 2016, available at <https://arcviewgroup.com/research/free-executive-summary/>

<sup>153</sup> *Id.*

<sup>154</sup> *Legal Marijuana Market Worth \$146.4 Billion by 2025*, April 2018, available at <https://www.grandviewresearch.com/press-release/global-legal-marijuana-market>

<sup>155</sup> Corbett, Erin, *The Legal Marijuana Market is Catching Up to Beer and Wine*, *Fortune*, August 22, 2018, available at <http://fortune.com/2018/08/22/legal-marijuana-market-size/>; Rapier, Graham, *Legal Marijuana Could Be Worth \$47 Billion in the US Alone, According to a Wall Street Analyst*, August 22, 2018 available at <https://markets.businessinsider.com/news/stocks/marijuana-cannabis-us-legal-market-could-be-worth-47-billion-2018-8-1027477326>)

marijuana could surpass cigarette sales (\$80.3 billion in 2017) and even challenge beer sales (\$111 billion in 2017).<sup>156</sup>

According to a 2018 *Forbes* contributor, “today, the U.S. is the epicenter of the legal cannabis market and it appears it will hold that position for the foreseeable future.”<sup>157</sup> Citing *The State of Legal Marijuana Markets, 6th Edition*, the article reported that the U.S. market accounted for 90% of the worldwide legal marijuana trade in 2017.<sup>158</sup> It further reported that, by 2022, legal cannabis revenue in the U.S. market would hit \$23.4 billion, or 73% of the worldwide market, while during the same period, Canada would reach \$5.5 billion (17%) and the rest of the world would be at \$3.1 billion, accounting for just under 10% of the legal cannabis market.<sup>159</sup>

Not surprisingly, the biggest boom factor is the prospect for further legalization of adult recreational use. *The State of Legal Marijuana Markets, 6th Edition* notes that adult-use legalization “creates an opportunity for a 10-fold increase in the number of potential customers a legal cannabis market can address. For example, the US had 1.9 million medical patients in 2017 but 21 million monthly cannabis consumers overall.”<sup>160</sup> A recent study commissioned by Illinois state legislators concluded that legalizing recreational marijuana in Illinois could drive demand as high as 550,000 pounds a year, far exceeding the production capacity of the state’s 16 licensed growers for medical use.<sup>161</sup>

## 2. Franchising Challenges

Despite this overall rosy demand picture, “the industry has been whipsawed by developments with conflicting implications for its future.”<sup>162</sup> For example, one surprising development is that California became “the first market in the world to transition from medical use to adult use and see the size of its legal market shrink,” with a projected decline from \$3 billion to \$2.5 billion in its first year of adult-use legality.<sup>163</sup> Why did this happen? One industry source cites an “expensive legal regime . . . that handicapped the legal business with a 77% price disadvantage against a robust illicit market.”<sup>164</sup> In addition, as discussed above in Section III.B.3, California’s state-wide licensing system for cannabis businesses permits municipalities to ban or restrict

---

<sup>156</sup> *Annual Marijuana Business Factbook*, *supra*, at 11.

<sup>157</sup> Pellechia, Thomas, *In 2017 and Beyond, U.S. Enjoys the Highest Legal Cannabis Market Share Worldwide*, *Forbes*, June 26, 2018 available at <https://www.forbes.com/sites/thomaspellechia/2018/06/26/in-2017-beyond-u-s-enjoys-the-highest-legal-cannabis-market-share-worldwide/#3a4ab21b2d20>

<sup>158</sup> *Id.*

<sup>159</sup> *Id.*

<sup>160</sup> *2019 Update to The State of Legal Marijuana Markets, 6th Edition*, *supra*, at 6.

<sup>161</sup> Keilman, John, *Demand for Legal Marijuana in Illinois Would Far Exceed Licensed Growers’ Ability to Supply It, Study Shows*, *The Chicago Tribune*, March 1, 2019, available at <https://www.chicagotribune.com/news/local/breaking/ct-met-illinois-legalized-marijuana-study-20190228-story.html>)

<sup>162</sup> *2019 Update to The State of Legal Marijuana Markets, 6th Edition*, *supra*, at 5.

<sup>163</sup> *Id.*

<sup>164</sup> *Id.* at 3. The same source cites as a contrary example the State of Nevada, which “put reasonable regulations in place quickly, opened stores apace in July 2017, and is now seeing a shrinking illicit market and the jobs, tax revenue and economic benefits that flow from legal spending growing from \$117 million in 2016 to an estimated \$574 million in 2018.” Another observer of the California market notes that “the high barriers to entry for many small businesses hoping to enter the legal market will likely serve to keep th[e] black market alive for many years to come.” Malsbury, Alison, *ICYMI: Governor Newsom Will Send National Guard to Fight Illegal California Cannabis Grows*, *Harris Bricken Canna Law Blog*, March 3, 2019, available at <https://www.cannalawblog.com/icymi-governor-newsom-will-send-national-guard-to-fight-illegal-california-cannabis-grows/>



commercial cannabis activity, and as of November 2018 – two years after California voters legalized recreational cannabis – over 80% of municipalities continue to ban it.<sup>165</sup>

California is not unusual in this regard. Although according to *Forbes* “the clear winner in the [2018] midterm elections was marijuana,”<sup>166</sup> there is often a sizeable gap in time between authorization and implementation. For example, in Massachusetts, voters approved recreational marijuana sales in 2016, but only in November 2018 were the first retail stores approved to begin operating.<sup>167</sup> In some cases, political leaders have actively resisted implementation despite voter approval. The Utah legislature, for instance, passed a law that undermines the cannabis plan approved by Utah voters in a ballot initiative, according to a lawsuit filed by supporters of the ballot initiative.<sup>168</sup>

Another challenge for new cannabis regulatory regimes is getting the balance right between supply and demand. Contrary to the Illinois example above – too few licensed producers for an adult-use market – Oregon, which does not limit the number of applicants, has wound up with too many. The Oregon Liquor Control Commission (“OLCC”), which licenses producers in that state, recently advised the state legislature of a huge excess of supply over recreational demand – to the tune of 6.5 years’ worth of inventory in the OLCC’s tracking system.<sup>169</sup> Now the state is considering legislation that would allow the OLCC to refuse marijuana production licenses based on market demand.<sup>170</sup>

#### a. Shifting State Regulations

As the Oregon example demonstrates, state cannabis regulations are in a constant state of re-evaluation and change as industry issues arise. This is hardly surprising for an emerging market, but it presents an extra challenge for a potential franchise program.

For example, California packaging and labeling requirements have gone from “emergency regulations” to “readopted emergency regulations” to “final regulations.”<sup>171</sup> The final regulations, despite making significant changes from the readopted emergency regulations, were issued without a transition period for compliance.<sup>172</sup> Perhaps detecting this flaw, the California Department of Public Health on March 7, 2019 issued checklists and Frequently Asked Questions to help with compliance, along with a statement about its “expectations” for compliance – effectively

---

<sup>165</sup> Thompson Coburn LLP, *An Inside Look into the Latest State to Legalize Recreational Cannabis: Michigan*, Lexology, November 8, 2018, available at <https://www.lexology.com/library/detail.aspx?g=0e56bfb5-37ff-4b9a-82e6-b464b247f950>

<sup>166</sup> Angell, Tom, *Marijuana Won the Midterm Elections*, *Forbes*, November 7, 2018, available at <https://www.forbes.com/sites/tomangell/2018/11/07/marijuana>

<sup>167</sup> Bowden, John, *Recreational Marijuana Stores to Open in Massachusetts*, *The Hill*, November 17, 2018.

<sup>168</sup> Alberty, Erin and Rodgers, Bethany, *Lawsuit Claims Medical Marijuana Law Was Weakened by Unconstitutional ‘Domination and Interference’ by Mormon Church*, *The Salt Lake Tribune*, December 5, 2018, available at <https://www.sltrib.com/news/politics/2018/12/06/lawsuit-claims>

<sup>169</sup> Sliwoski, Vince, *Is Six Years of Oregon Cannabis Supply Enough Already? OLCC Weighs In*, *Harris Bricken Canna Law Blog*, February 21, 2019, available at <https://www.cannalawblog.com/is-6-5-years-of-oregon-cannabis-supply-enough-already-olcc-weighs-in/>

<sup>170</sup> *Id.*

<sup>171</sup> Thorne, Griffen, *The California Cannabis Packaging and Labeling Mess Will Soon Begin*, *Harris Bricken Canna Law Blog*, January 3, 2019, available <https://www.cannalawblog.com/the-california-cannabis-packaging-and-labeling-mess-will-soon-begin/>

<sup>172</sup> *Id.*

relaxing requirements that had just come into effect with the final regulations.<sup>173</sup> A prospective franchisor could be forgiven for feeling that he or she is watching a tennis match.

Multiply the California experience by numerous states, and it becomes clear that only loose guidelines would be possible for a franchise system that intends to operate in multiple states. Either the franchisor would have to separately design packaging for each state, or it would have to trust each franchisee to create compliant packaging in their respective jurisdictions. Multiply the packaging and labeling challenge by the numerous other state regulatory issues in flux – e.g., the scope of licensing of market participants, whether to cap the number of licenses, prohibited products lists, advertising, marketing, and quality assurance testing – and the variations become truly daunting.

#### **b. Unaccommodating Federal Law**

While the state cannabis laws present challenges, the federal laws affecting cannabis operations, as discussed in Section III.C above, remain the bigger obstacle to viable franchising. The obstacles are both direct, as in the case of trademark protection, and indirect, as in the case of banking:

##### **(i) Trademarks**

The core of any franchise program is, of course, the brand – and protection of the brand is therefore a top priority for the franchisor. Most franchise systems have federally registered trademarks. This is such a common expectation that the Federal Trade Commission (the “FTC”) Franchise Rule requires an explicit statement of risk in Item 13 if the franchisor does not have a federal registration. But under current law, the franchisor of a cannabis business could not obtain federal registration of its marijuana-related mark. Registration at the state level may be possible, but the cost of registering separately in multiple states will be higher, the degree of protection will vary, and protection will be difficult to extend across state lines.<sup>174</sup> These limitations could leave cracks in the foundation when attempting to build a consistent, protectable franchise brand.

##### **(ii) Cash Business**

The lack of banking services for cannabis businesses would force franchisors and their franchised operators to operate in cash, as many cannabis businesses do today. Operating in cash raises both the costs and the legal risks of conducting business – for example, by making both the business and its employees

---

<sup>173</sup> Thorne, Griffen, *California Cannabis Agencies Drop New Packaging and Labeling Guidance*, Harris Bricken Canna Law Blog, March 10, 2019, available at <https://www.cannalawblog.com/california-cannabis-agencies-drop-new-packaging-and-labeling-guidance/>

<sup>174</sup> In *Headspace International LLC v. Podworks Corp.*, 5 Wash.App.2d 883, 428 P.3d 1260 (Ct. App. Wash. 2018), review denied, 192 Wash.2d 1027 (S. Ct. Wash. 2019), a California cannabis company sued a Washington cannabis company for trademark infringement. The trial court dismissed the claim on the basis that Headspace had not established trademark rights in Washington, though Headspace had licensed the mark to another company in Washington in association with the lawful sale of marijuana products in the state. On appeal, Podworks argued that either the license was not sufficient “use” to establish trademark rights or, if it was sufficient, then Headspace must exercise control over the goods sold under the mark, which in turn would require Headspace to be licensed in Washington to sell cannabis. The Court of Appeals disagreed with Podworks and reversed the trial court, holding that the licensing of the mark was sufficient to establish trademark rights for Headspace without stepping over the licensure line.

targets for robberies. At a United States House subcommittee hearing in February, witnesses highlighted crimes such as the 2016 killing of a Colorado pot dispensary's security guard during an attempted robbery.<sup>175</sup> And Fiona Ma, California's state treasurer, testified that California cannabis dispensaries have had to drop off duffel bags and suitcases full of cash to pay their taxes – some driving hundreds of miles to do so.<sup>176</sup> Cash operations also complicate compliance with wages-and-hours laws, increase the risk of skimming from customer payments, etc. There is hope for this situation to change, with legislation re-introduced in Congress to give banks a safe harbor to provide services.<sup>177</sup> The American Bankers Association has expressed its support for the proposed SAFE Banking Act,<sup>178</sup> and the Independent Community Bankers of America and the Credit Union National Association also recently endorsed similar proposals.<sup>179</sup>

### **c. Supply Chain Issues**

The inability to sell and transport cannabis across state lines would severely limit a franchisor's ability to manage its supply chain. For example, if outlets in Illinois faced a supply shortage, the franchisor would be powerless to tap into the oversupply in Oregon.<sup>180</sup> These imbalances between states could produce major price differences, which in turn could disrupt the products available in stores and the prices charged to consumers. Without stable and predictable sourcing, the franchisor would struggle to maintain consistent brand standards and customer experience across state lines.

State laws requiring traceability of cannabis products “from seed to sale” would add to the supply chain challenge. Whether franchisors acted as suppliers or franchisees sourced on their own, they would be subject to tracking and reporting requirements that vary from state to state, with corresponding variation in compliance costs.

### **d. Vendor Issues**

Franchisors and franchisees in the cannabis business could find it difficult to find accountants, insurance companies, etc., willing to work with them. Potential vendors not only may have concerns about their legal liability for associating with cannabis, but also may fear the impact that it would have on their business operations. According to an op-ed by the president of the American Bankers Association, a fencing company hired to build a fence around a marijuana growing facility was turned down for a loan by a bank in Ohio, and a law firm that took on a

---

<sup>175</sup> Reklaitis, Victor, *Washington Moves Closer to Delivering Protections for Banks that Work with the Pot Industry*, MarketWatch, February 14, 2019 available at <https://www.marketwatch.com/story/washington-could-deliver-protections-for-banks-that-finance-the-pot-industry-2019-02-13>

<sup>176</sup> Merle, Renae, *Banks Want a Hit of the Marijuana Business. Will They Get to Partake?*, The Washington Post, February 13, 2019, available at [https://www.washingtonpost.com/business/2019/02/13/banks-want-hit-marijuana-business-will-they-get-partake/?utm\\_term=.4567931d2d06](https://www.washingtonpost.com/business/2019/02/13/banks-want-hit-marijuana-business-will-they-get-partake/?utm_term=.4567931d2d06)

<sup>177</sup> *Bipartisan Cannabis Banking Bill Introduced*, ABA Banking Journal, March 7, 2019, available at [https://bankingjournal.aba.com/2019/03/bipartisan-cannabis-banking-bill-introduced/#\\_ga=2.180244580.1518994251.1552243262-1354987149.1552243262](https://bankingjournal.aba.com/2019/03/bipartisan-cannabis-banking-bill-introduced/#_ga=2.180244580.1518994251.1552243262-1354987149.1552243262) )

<sup>178</sup> *Id.*

<sup>179</sup> Warmbrodt, Zachary, *Bankers' Pot Push Gets Boost from Blue Wave, Sessions Ouster*, Politico, November 27, 2018

<sup>180</sup> See text at n.161 and n.169, *supra*.

marijuana business as a client had its account closed by a bank in Washington. He cited an industry survey finding that 75 percent of banks have had to close an account, terminate a client relationship, or turn away a customer because there was some connection to cannabis.<sup>181</sup> But even if banking relationships were not jeopardized, vendors would be at risk, because while “the money from cannabis businesses often goes to vendors, landlords, and employees . . . the federal criminal association follows that cash.”<sup>182</sup>

**e. Financial Restructuring Issues**

An emerging and swiftly changing market will have winners and losers in the competitive battle. In other industries, those who suffer financial failures can seek protection from creditors under federal bankruptcy law and either reorganize the business or liquidate its assets. This is not the case in the cannabis industry. Because marijuana remains illegal under federal law, federal bankruptcy courts have dismissed filings by cannabis businesses on the basis that they are ineligible to take advantage of federal bankruptcy law.<sup>183</sup> Accordingly, the franchisor of a cannabis business and its franchisees would lack a critical tool to manage the ups and downs of the business.

**f. Market Disruption**

Franchising may also have trouble gaining traction in the cannabis business if major companies occupy the field. There are already several notable examples:

- Constellation Brands, Inc., a Fortune 500 producer and marketer of beer, wine, and spirits, invested \$3.8 billion in Canopy Growth Corp., now the world’s most valuable cannabis company, in August 2018.<sup>184</sup> Molson Coors Brewing Co. has also invested in the industry.<sup>185</sup>
- Diageo plc is in the market for a cannabis partner, according to multiple reports in the business press.<sup>186</sup>
- Sandoz, the Canadian division of Novartis International AG of Switzerland, has an agreement with British Columbia-based producer Tilray Inc. to develop products and delivery systems.<sup>187</sup>
- Alimentation Couche-Tard Inc., owner of the Circle K convenience store brand, has entered into a multi-year

---

<sup>181</sup> Nichols, Rob, *End the Cannabis Banking Problem*, The Hill, February 18, 2019, available at <https://thehill.com/opinion/finance/430463-end-the-cannabis-banking-problem>

<sup>182</sup> *Id.*

<sup>183</sup> See Section III.C.7, *supra*.

<sup>184</sup> *Here Comes Weed Beer*, Bloomberg Businessweek, October 15, 2018, at p. 18.

<sup>185</sup> *Id.*

<sup>186</sup> *Id.*; see also Heglin, Joseph, *Diageo Streamlines Products*, Seeking Alpha, December 6, 2018, available at <https://seekingalpha.com/paper/4226685-diageo-streamlines-products>.

<sup>187</sup> *Prescription for Profit*, Bloomberg Businessweek, October 15, 2018, at p. 17.

agreement with Canopy Growth to sell recreational marijuana in Ontario.<sup>188</sup>

- A report that tobacco giant Altria Group Inc. was interested in buying a stake in Canadian producer Aphria Inc. caused the latter's stock to jump 17% amid a stock market rout on October 10, 2018.<sup>189</sup>
- Even lifestyle guru Martha Stewart is getting into the act, signing on as an adviser to Canopy Growth.<sup>190</sup>

Though these initial investments have been made in Canada, large companies are positioning themselves to move quickly if federal legalization occurs in the US. In some cases, they are seeking to diversify out of industries that are mature or already in decline. The validation they bring to the cannabis industry is evident in the now-daily parade of business, legal, and investing conferences focused on cannabis.<sup>191</sup>

If more large companies (like Hershey, Mars, Philip Morris, Unilever, etc.) become competitors, they will likely disrupt existing cannabis businesses. As one of its "5 Key Takeaways," the 2018 *Marijuana Business Factbook* noted that "with tight control over their own supply chains and the ability to leverage economies of scale . . . [vertically integrated companies] can profitably sell products at lower prices than smaller, independent competitors."<sup>192</sup> These companies "have implemented standard operating procedures around opening new stores and have team members devoted to the licensing and application process."<sup>193</sup> Franchisors, of course, also develop standard operating procedures and centralized support for key functions, but a new franchisor in the cannabis industry would be hard-pressed to match the clout of the multinationals.

Franchising could also be hampered by scammers and frauds at the less prestigious end of the market spectrum. The Gold Rush mentality surrounding cannabis makes it ripe for false promises of riches.<sup>194</sup> In September 2018, the US Securities and Exchange Commission felt it necessary to issue an alert to retail investors in the cannabis industry, following a 2-year string of enforcement actions.<sup>195</sup> The prevalence of get-rich-quick schemes could cast a cloud of suspicion over legitimate offers of franchise investment opportunities in the cannabis industry.

---

<sup>188</sup> Dworski, Brett and Lindenberg, Gregg, *Couche-Tard to Sell Marijuana*, Convenience Store Products, February 22, 2019 (<https://www.cspdailynews.com/cannabis/couche-tard-sell-marijuana>) (accessed March 11, 2019).

<sup>189</sup> *Investing in the Boom*, Bloomberg Businessweek, October 15, 2018, at p. 14.

<sup>190</sup> Giammona, Craig and Owaram, Kristine, *Martha Dishes Up Pot as Democrats, Burnish Cred: Cannabis Weekly*, Bloomberg, March 3, 2019, available at <https://www.bloomberg.com/news/papers/2019-03-03/martha-dishes-up-pot-as-democrats-burnish-cred-cannabis-weekly>

<sup>191</sup> As just one example, The Capital Roundtable, a New York conference company for the middle-market private equity community, held a program on March 7, 2019 entitled "Private Equity Investing in Cannabis Companies."

<sup>192</sup> *Annual Marijuana Business Factbook*, *supra*, at 13.

<sup>193</sup> *Id.*

<sup>194</sup> See Bricken, Hilary, *Don't Be a Marijuana Mooch!*, Harris Bricken Canna Law Blog, November 14, 2018, available at <https://www.cannalawblog.com/2018/11/page/2/>

<sup>195</sup> Thompson Coburn LLP, *Top 5 Warning Signs for Cannabis Investors*, Lexology, September 11, 2018, available at <https://www.lexology.com/library/detail.aspx?g=b59b595e-7bdd-40e8-89ed-610d5fa8f9d5> (accessed March 11, 2019)

### **3. Disclosure, Registration and Franchise Operation**

More than one cannabis company in the U.S. is advertising that it is offering franchises, and the authors have seen one FDD produced for a cannabis dispensary business. At the same time, franchising in the cannabis industry is far from mainstream and best practices are still emerging. It is interesting to consider what issues arise in the U.S. in connection with cannabis franchising under the FTC Franchise Rule and state registration laws, as well as the relationship between the parties. For example:

- Is the franchisor sufficiently banked so it can obtain audited financials? Can it find qualified auditors able and willing to perform the audit?
- By engaging in franchise sales activity, franchisors and their sales agents seek to induce prospective franchisees to engage in federally-illegal activity. Will experienced franchise executives agree to perform such a job, and what liability might they face?
- State regulators are responsible for imposing risk factors. Is a risk factor enough to warn a prospective franchisee that it is investing in a business which constitutes a federally criminal act, and that it may have limited or no access to bankruptcy protection? Alternatively, is something more than a risk factor required to ensure that an FDD is not misleading?<sup>196</sup> Might some states take the position that the risk to prospective franchisees is simply too great to permit franchise sales?
- A purchasing franchisee may sign an agreement promising to engage in federally-illegal activity for a period of, e.g., 10 years. If the franchisee abandons its business partway through the term, can the franchisor seek damages? Can it enforce its non-competition provisions?

These issues, and doubtless many more, remain challenges which prospective franchisors and their counsel will need to address in order to bring franchising of cannabis businesses into the mainstream.

At a minimum, it is advisable that businesses and their counsel who are willing to launch into franchising in the U.S. consider several key issues. First, standard franchise agreements require parties to follow “all federal, state and local laws.” In connection with cannabis deals, a blanket requirement to comply with federal law puts the franchisee in the impossible position of being required not to operate its business. Careful drafting is required to carve out the CSA from the scope of laws the franchisee must follow.

Second, under current law, a franchisor should plan for the possibility that at any given time during the term of the agreement, one or both parties will be unbanked. Provisions related to payments, accounting, reporting and franchisor

---

<sup>196</sup> See, e.g., Washington Franchise Investment Protection Act § 19.100.120(1), stating that the director may issue a stop order or revoke a registration if the FDD is incomplete or contains a statement which is “false or misleading with respect to any material fact.”

inspections and audits of books should all be revised in anticipation that at any time and potentially with little prior notice one or both parties may need to transact business with cash. Conditions such as additional accounting safeguards during a time the franchisee has no bank account, immediate notification of bank account closures, multiple alternate payment methods which may be selected at the franchisor's option, accrual of royalties in lieu of large cash payments, more frequent payment of cash royalties to avoid large lump sum cash deposits, mandatory security for significant cash deliveries and similar steps might be appropriate.

Third, under a number of licensing laws, the franchisor and/or its franchise brokers or other agents may be disclosable as parties with a financial or other material interest in the franchised business. Franchisors should anticipate being required to disclose all parties with a profit-sharing interest in the franchisee's business, and specific details of the financial arrangements. Franchisors should be mindful of the backgrounds of persons who may need to be disclosed and the potential impact on franchisee license applications, and should also consider release or waiver language in franchise agreements providing that the franchisor cannot be liable if the franchisee does not obtain a license, even if due to such arrangements.

Finally, laws are changing rapidly in this industry. Nearly universally, the laws trend toward allowing more sales, such as states transitioning from allowing medicinal marijuana to permitting recreational use as well, but this is not guaranteed. FDDs should convey, and franchise agreements must require, that the franchisee will be required to comply with applicable state law at all times, even if that substantially alters its business, terminates lucrative product or services lines, or imposes new costs. While this is an implied course of dealing in every franchise system, a cannabis franchisor is substantially more likely to need to show that the franchisee bargained for this outcome.

#### **IV. CONCLUSION**

The future of cannabis franchising in both Canada and the United States is exciting but also unclear. From a Canadian perspective, the legalization of marijuana federally has franchisors very eager to enter the retail market, especially the LPs who can provide franchisees with the resources to launch and develop successful franchise systems. At the same time however, the complexities and nuances to the all of the provincial retail regulations presents a great deal of challenges for Canadian franchisors looking to create a uniform franchise system. The laws in each province are continuing to be understood by cannabis stakeholders and will likely evolve overtime. Simply put, the roll out of cannabis franchises in Canada will take time, require a great deal of diligence, and will need to be appropriately tailored to each province's regulations to ensure compliance with both federal and provincial laws.

From an American perspective, the continued illegality of cannabis operations under federal law presents a very challenging hurdle to embracing franchising. Despite immense financial incentives, it is hard to ignore the problems inherent in selling prospective franchisees a business which is illegal under federal law. For systems which move too quickly and ignore or gloss over the substantial number of challenges in

banking, brand protection, supply chain issues, tax considerations, and rapidly changing compliance issues, disaster may await. On the other hand, many cannabis businesses have been carefully and deliberately establishing their brands, studying consumer demands, and refining their approaches for many years. For these mature companies, willing to proceed thoughtfully and not oversell the opportunity, franchising may be a foothold to substantial rewards. Furthermore, if the federal government continues to make strides toward ending prohibition, as it has begun to do with the legalization of hemp, it may be that many of the most serious concerns expressed in this paper will be moot. In that instance, practitioners should expect a metaphorical avalanche of franchise activity.

There is reason to believe that franchising could be a force in the cannabis industry, if the hurdles fall. If and when they do, a future IFA Legal Symposium breakout session will certainly be revisiting this topic.



# EXHIBIT A

