



# Key Influences *on the* **CANNABIS MARKET** in 2023

## Topics Covered

- [Finance](#)
- [Real Estate](#)
- [Privacy](#)
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- [Trademark](#)
- [Labor](#)
- [Benefits](#)
- [Litigation](#)
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2023 may create the harshest conditions yet for the cannabis industry. The economy was already expected to be a challenge to profitability and now turmoil in the banking sector may further distract Congress from passing meaningful marijuana banking legislation, continuing to limit access to credit.

Yet, as the market continues its inevitable march toward federal legalization, it is possible to maximize financing opportunities, manage risks and build and protect brands.

To that end, here are some of the key factors that will influence the cannabis industry in 2023 and related legal considerations.

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## The High Cost of Financing

### Limited Access to Credit

No one would have expected the biggest banking news to impact the cannabis industry would be a banking crisis, rather than the status of the Secure and Fair Enforcement (SAFE) Banking Act. The Act, which would create a safe harbor for banks to provide financing to state legal cannabis businesses, appears to have little chance of passing through Congress in 2023, despite widespread support.

Congressional efforts are continuing to help cannabis businesses gain access to banking in order to reduce large cash transactions, which increase the threat of crime. There is some hope that a new bill will make it to the banking committee and voted on by the full Senate later this year.

In any event, financing costs can be expected to grow higher as capital providers face their own challenges of increased costs and rising interest rates, and also tighten their underwriting and diligence standards.

**A Bounceback in M&A (But Unlike the Past)**

Economic conditions, including uncertainty surrounding interest rates and limited access to capital, as well as lack of clarity with respect to regulatory reform (specifically including the SAFE Banking Act) have significantly slowed the pace of deal making in the space. M&A activity in the industry reached a record high of \$10.27B in 2021; that number dropped to \$3.17B in 2022 and 2023 is off to an even slower pace. While the trend is likely to continue for a time, it will eventually become a buyer’s market and those industry participants that maintain the ability to close deals will be well positioned to capitalize.

Preserving cash for operations is a paramount concern due to the continued burdensome tax structure the industry faces and the difficult capital markets environment for the industry. In addition, many mature recreational markets are experiencing falling prices, and at the same time, newer markets are quickly becoming saturated. The result is that licensed companies across the industry must shift into cost-cutting mode in an effort to survive. While larger/multistate companies may be in better position to weather these storms, many smaller companies may not

be so successful and potentially available for purchase at bargain prices.

The result will be increased deal activity, but at much lower purchase prices than the historical norms. As deals start getting done, sellers can expect more equity consideration than in the past due to buyers’ increased leverage. Additionally, in M&A markets like this one, even after the parties agree in principle, closing certainty decreases. This effect is not unique to the cannabis space, but the regulatory complexity of these deals magnifies the effect in this industry as compared to others.

**Challenges for Startups**

The failures of Silvergate Bank, Signature Bank and Silicon Valley Bank, all of which serviced risky emerging markets and companies, may create further funding challenges for startups. As a result, investors in convertible preferred equity, any simple agreements for future equity (SAFE) or common equity, may all engage in more stringent diligence and a greater interest to compensate for their risk and leverage.

*What can be done?*

Capital providers will need to adjust underwriting and diligence to reflect the increased risk of loss that comes with higher expense. Operators will need to know how to make themselves attractive to acquirers, strategic partners and funding sources and be aware of the best structures to preserve value and flexibility to operate their businesses, as applicable.



## Local Real Estate Laws and Contractual Restrictions on Uses

As state and local laws continue to evolve, it is more important than ever for operators to understand the legal framework surrounding a property to guard against unexpected obstacles that could prohibit cannabis operations.

*For example:* Properties may be encumbered by recorded easements, covenants, conditions and/or restrictions which prevent noxious uses, or any use that emits odors that can be detected outside of the premises.

Further, zoning restrictions may also prevent cannabis businesses from operating as fully desired.

Landlords that are not licensed to operate a cannabis business must be vigilant to ensure their rights under any leases with cannabis companies do not violate applicable laws. Their leases must provide enough flexibility to adapt to changes in the regulatory framework surrounding the cannabis industry. In guarding their interests, landlords may present leases that contain restrictions on permitted uses of the premises.

### *What can be done?*

Operators can seek to negotiate for expansive permitted use clauses in leases so that their business is not inhibited by unnecessary restrictions and appropriate representations from their landlords that protect the operator from any prohibited use restrictions contained in recorded documents. As tenants, operators should consider ordering their own title and/or zoning reports to be certain that they are able to operate their business in the desired location.

Landlords can incorporate into their leases provisions intended to create clear boundaries between themselves and a cannabis tenant such as:

- making clear that they will not take possession of a tenant's inventory upon a tenant's default,
- avoiding collecting percentage rent from cannabis tenants (and instead collect fixed rent) as percentage rent could be viewed as having an ownership interest in a cannabis business, and
- negotiating a termination right in the lease, exercisable if any permitted cannabis use is later deemed to violate any applicable state or federal laws.



## Data Privacy and Compliance

Data is the gold that drives many online and offline business activities, but for highly regulated industries such as cannabis there are certainly pitfalls to avoid. An employee's right to use cannabis in a state where recreational use has been legalized has run up against corporate policies and the desire of businesses to have a drug-free environment.

Further, new consumer privacy laws in certain states treat physical or mental conditions as sensitive personal information that cannot be processed without a consumer's opt-in consent. The use of medicinal cannabis is likely linked to such conditions. Therefore, online advertisers may be hesitant to engage in certain retargeting activities if it means collecting such sensitive personal information.

### *What can be done?*

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Data can be processed and leveraged by businesses, but doing so in a compliant manner requires testing business plans against existing privacy laws.

## Restrictions on Advertising

The fractured regulatory scheme makes cannabis one of the most difficult products to advertise.

Currently, every state has different laws, rules, and regulations surrounding cannabis advertising. Of course, cannabis cannot be advertised in those states where cannabis remains illegal, and even where medicinal cannabis is legal, advertising rules are very restrictive. Plus, even in states where recreational cannabis is legal, cannabis advertising is subject to strict rules and regulations. And, while many of these rules are uniform across states – for example, the prohibition on making unsupported health claims – each state has different rules about content, targeting and disclosures.

Complicating things further, most major media organizations and virtually all social media websites have declined to accept cannabis advertising, and while Twitter recently bucked this trend by dropping its ban on cannabis advertising, the industry has not yet followed suit.

### *What can be done?*

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Marijuana can be advertised to some degree in most states where it is legal, and cannabis companies who understand the regulatory framework in each state are well positioned to maximize their advertising reach while remaining in compliance with the law.

## Trademark Protection for Cannabis Products

So long as cannabis is illegal on a federal level, federal trademark registration will be unavailable for cannabis products. This is because the Lanham Act, the federal statute that governs trademarks, dictates that federal trademark protection is only available for marks "used in commerce" and the U.S. Patent and Trademark Office's Trademark Trial and Appeal Board has held such use to exclude goods that are illegal under federal law.

The inability to obtain federal trademark registrations prevents the owners of cannabis brands from enjoying the benefits of federal registration such as exclusive ownership and the presumption of nationwide rights, as well as from certain enforcement vehicles including access to federal courts.

Although a very narrow path has been cleared under The Agricultural Improvement Act of 2018 (known as the “2018 Farm Bill”), which removed certain cannabis-derived products with less than 0.3% of the psychoactive compound THC from the Controlled Substance Act, availability of federal trademark protection for food, beverages, dietary supplements, or pet treats containing CBD, even if derived from hemp, will still be refused federal trademark registration.

### ***What can be done?***

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In states where cannabis products have been legalized, state trademark registration may be a possibility. However, state registration carries comparatively limited protection including in geographical reach.

Additional protection strategies include applying to register the mark federally for ancillary merchandise or offering products that meet the federal regulation of being hemp-derived with no more than 0.3% THC on a dry-weight basis.

## **The Push for Unionization**

As more states move to legalize cannabis, organized labor has sought to unionize the industry’s budding workforce. With public favor for unions at its highest levels in over 50 years, labor organizations such as the United Food and Commercial Workers union have been seeking to unionize employees in all sectors of the cannabis industry from cultivation to retail sales. As various unions – including grassroots labor organizations – mobilize across states, employers must carefully consider how to address any petitions for unionization and handle any campaigns in response to a union election.

Among other things, employers faced with a union petition should carefully consider the proposed bargaining unit and whether it may be appropriate to seek to challenge it. Additionally, employers may consider whether they have a jurisdictional argument before the National Labor Relations Board (Board), given that the Board exercises jurisdiction over employers whose activity in interstate commerce exceeds a minimal level and with cannabis continuing to remain illegal under federal law.

### ***What can be done?***

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Particularly given how swiftly union election campaigns may move under current Board procedural rules, employers should be prepared in advance to address any requests for recognition by labor organizations and consider best practices in handling any union campaigns. Employers may also wish to consider whether there are lawful steps to be taken to make it less likely their employees will seek out union representation as an initial matter.

## Employee Benefits and Coverage for Medical Marijuana

Novel tax and benefits issues may arise in setting up plans for cannabis companies. For example, Internal Revenue Code Section 280E, which generally prohibits businesses from deducting otherwise ordinary business expenses when associated with the “trafficking” of certain controlled substances, including cannabis, may complicate expensing employee benefits costs (ex. health insurance premiums, 401(k) employer contributions). Even with careful planning and analysis, a cannabis company may still, in certain circumstances, bear more benefits expenses than a non-cannabis company otherwise would. For qualified retirement plans (ex. 401(k) plans), concerns have been raised regarding the risk of potential tax penalties to the employer on any nondeductible contributions under Internal Revenue Code Section 4972. If an employee benefits provider is not sensitive to these issues, they may structure plans sub-optimally.

Additionally, even if technical issues can be navigated, the greatest hurdle to providing benefits may come from the benefits vendors themselves. Service providers for retirement plans and health and welfare benefits (which include financial services providers, third party administrators, insurers) may have their reasons to steer clear of cannabis, hemp and CBD companies, including risk aversion, internal protocols or state-level illegality. Any such resistance may prove challenging for an employer when setting up, administering, and managing traditional plans. For instance, young companies often set up their 401(k) plan as a volume submitter prototype plan – designed, maintained, and offered by a third party – and a cannabis operator may struggle to find a reputable company willing to provide this 401(k) service, and/or may struggle to find a financial institution for its 401(k) banking. This consideration may be especially pertinent for cannabis companies in states with state-mandated retirement benefits (ex. Oregon, California), as cannabis operators are generally not exempt from these mandates.

Further, denial of health plan coverage for medical marijuana may continue to limit industry sales (with coverage impacted by both federal legality and any future FDA approval). For example, Canada, which federally legalized cannabis in October 2018, still has many health plans that do not offer medical cannabis benefits. For an employer wishing to provide this benefit, if large enough, it may consider self-insurance, or even a self-insured health reimbursement account (HRA), which may allow it to provide a broader set of benefits, including coverage for medical cannabis.

### *What can be done?*

Early planning, ideally with an ERISA lawyer, is the most effective way to anticipate and work through benefit plan hurdles.

Also crucial is finding a knowledgeable, experienced accountant to closely advise and work with the operator, as early in the benefits planning process as possible and particularly for navigating Internal Revenue Code Section 280E.

Due to the novel challenges and complexities, cannabis companies may benefit from preparing to generally bear more employee benefits expenses than a non-cannabis company otherwise would.



## Litigation Related to the State-Federal Divide

Aside from the typical forms of commercial litigations, class actions and regulatory challenges that beset any growing, highly regulated industry, the disparate levels of legalization and decriminalization across states and tension between states' positions with illegality at the federal level will continue to drive cannabis litigation.

In particular, restrictions with respect to engaging in interstate cannabis commerce, such as, states allowing cannabis licenses only to state residents and prohibiting cannabis sales across state lines, are placing severe limitations on the viability of engaging in the cannabis business. Given the federal government's stance on cannabis, there remains a question whether a federal court can invoke the dormant commerce clause, which prohibits states from imposing undue burdens on interstate commerce, to strike down such restrictions.

Several federal courts have answered this question in the affirmative, including the Northern District of New York and the Eastern and Western Districts of Missouri, the Northern District of Illinois and the District Court of Maine. There are other courts that have abstained from ruling on this issue, including the Eastern District of California, while a minority of courts have found that the dormant commerce clause does not apply to cannabis.

### *What can be done?*

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In 2023, challenges may continue to be made to states' restrictions of interstate cannabis commerce, at least in jurisdictions that have allowed such challenges. If there continues to be a split among federal courts, this could be an issue that makes its way to the U.S. Supreme Court over time.

## The Potential for Bankruptcy Eligibility

As federal illegality continues, so does cannabis companies' ineligibility for federal bankruptcy protection, which contributes to the cost and scarcity of funding. Without access to bankruptcy courts, capital providers must rely on often cumbersome, uncertain and varying state-based debtor-creditor enforcement procedures such as assignments for the benefit of creditors and receiverships. These processes may implicate licensing issues, depending on the state.

A recent opinion from the U.S. Bankruptcy Court, Central District of California, may have cracked the seal on a cannabis-related debtor's ineligibility for bankruptcy. The decision provides a thoughtful analysis of the benefits of bankruptcy protection for both creditors and debtors. The court exposed flaws in reasoning that a debtor's violation of law per se prohibits access to bankruptcy court.

### *What can be done?*

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Recognizing the factors that could potentially support bankruptcy eligibility will help all market participants set expectations, if a deal or business is in financial distress.

## Be Prepared for Growth

Capital providers and operators will be aligned in many ways in 2023 as both sides seek to strategically identify and structure deals that maximize opportunities and minimize risks for the short-term and position themselves for growth as market conditions improve. As operators build brands and proprietary data, preserving and protecting those assets will become key success factors.

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Possessing, using, distributing, and/or selling marijuana or marijuana-based products is illegal under federal law, regardless of any state law that may legalize or decriminalize such activity under certain circumstances. Although federal enforcement policy may at times defer to states' laws and not enforce conflicting federal laws, interested businesses and individuals should be aware that compliance with state law in no way assures compliance with federal law, and there is a risk that conflicting federal laws may be enforced in the future. No legal advice we give is intended to provide any guidance or assistance in violating federal law.





# Davis+Gilbert's Cannabis Resource Library

For more information, see the articles and other content available in the links below:

## Finance/Bankruptcy

- [Cannabis-adjacent Bankruptcy Eligibility Update: Significant New Decision](#)
- [Bankruptcy Relief for Cannabis-adjacent Debtors? It Gets Hazy](#)
- [Five Things To Know About Underwriting Cannabis-related Real Estate Loans](#)
- [Cannabis Financing Market Insights](#)
- [What To Know About ESG and Cannabis](#)
- [Fortune or Forfeiture: Real Estate Lending in the Cannabis Space](#)
- [Top 5 Questions Regarding Cannabis Financing](#)
- [Key Considerations for Cannabis Borrowers](#)
- [NY Debt Enforcement Alternatives for Cannabis Lenders](#)

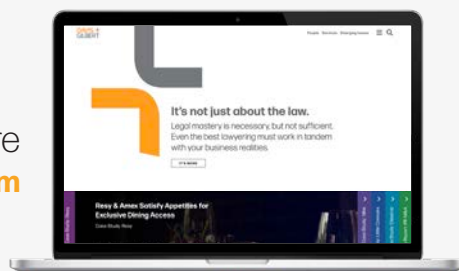
## Advertising/Marketing/Trademark

- [Twitter Goes Green: What This Means for Marijuana Advertising](#)
- [The Regulatory Outlook for THC's \(Mostly\) Legal Cousin, Ingestible CBD](#)
- [The Top 10 Advertising and Marketing Issues to Watch for in 2022](#)
- [Puff Puff Passing Off: Chronic Trademark Issues in the Growing Industry of Legal Cannabis](#)

## General

- [2023 Top Privacy Issues: New Laws & Expanded Enforcement](#)
- [State Residency Rules Up in Smoke as Cannabis Industry Grows](#)
- [Into the Weeds on Sen. Schumer's Cannabis Bill](#)
- [New California CBD Law Highlights the Federal / State Regulatory Divide](#)
- [Marijuana Legalization Has Other States Green with Envy](#)

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