

## Risk-Based Compliance Improves Cannabis M&A Prospects

By **Katrina Skinner and Brion Nazzaro** (April 26, 2021, 3:42 PM EDT)

During the first quarter of 2021, as reported by U.S. News & World Report,[1] the cannabis industry raised \$2 billion for merger and acquisition activity without the assistance of banks.

The amount of capital raised indicates that the cannabis M&A deal rate that started in the end of 2020 will continue in 2021 for public and private companies both in the U.S. and in Canada. However, experts predict that M&A activity will be strategic and result in more consolidation of the industry.[2]

For licensed cannabis operators who are contemplating a sale, one way to create and increase business value is to maintain licensure and avoid regulator scrutiny. Although several factors can affect the valuation of a business, purchase prices for cannabis businesses are largely driven by the amount of revenue a company expects to earn from current and future streams of income.

In the cannabis industry, revenue is derived primarily from activities related to the type of cannabis license a business holds. This means that in order to maximize the value of a licensed cannabis entity, whether for sale or otherwise, operators must maintain their licenses unencumbered. Doing so is no easy feat but can be more easily managed if a licensee implements a well-designed risk-based compliance program.

The current commercial cannabis compliance landscape is complex because regulations, guidance and political interventions change quickly and vary from state to state.

High-risk areas of concern relate to public safety and those activities that implicate law enforcement priorities. Noncompliance in the commercial cannabis industry can result in a variety of enforcement actions and penalties.

Enforcement actions and penalties for the most severe offenses include monetary penalties and restrictions on, suspension of, or revocation of the license. Enforcement actions may affect all licenses under a current owner's control, leading to the disruption or suspension of business operations that



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impede market and product expansion strategies, which in turn results in a decreased business valuation.

Legacy compliance problems may also continue to affect a new owner's business plan if a new owner cannot demonstrate that the infractions have been remedied. Since there is no one fail-safe way to ensure compliance with cannabis rules and regulations, adopting a risk-based approach is a practical and effective way to reduce the risk of noncompliance.

### **Developing a Comprehensive Risk-Based Compliance Program**

Risk-based compliance programs help align regulator and operator interests by ensuring that a business is focusing on those areas most important to regulators.

For example, last year the U.S. Food and Drug Administration indicated that it was considering taking a risk-based approach to evaluating and regulating hemp-derived CBD and CBD-infused products.

This approach is also used in other highly regulated industries where the implementation of well designed risk-based compliance programs may be considered mitigating factors by the U.S. Department of Justice in criminal cases that involve corporations and may provide a good faith compliance defense that can be asserted by defendants.

In fact, the DOJ's Justice Manual provides an outline of factors for prosecutors to consider specifically related to evaluating compliance programs when investigating a business organization. The manual encourages prosecutors to consider whether a compliance program is well designed, being applied in good faith and working.

A well-designed, risk-based compliance program must include a risk assessment that demonstrates that risks have been identified and classified in a way that ensures appropriate controls are implemented for risk mitigation.

These controls must be documented in written policies and procedures that can be utilized by those overseeing compliance departments and the employees who perform everyday operational tasks, and they must be reviewed and updated regularly to incorporate any lessons learned from infractions and to ensure effectiveness.

Companies must also invest in compliance training throughout their operations and workforce. Doing so demonstrates that a business has a strong compliance culture, based on risk.

A strong compliance culture that understands the risks it is facing helps organizations prioritize resources and empowers stakeholders at every level to manage their risk responsibilities. It also provides management with a method to balance risk mitigation with risk appetites. This creates an environment that focuses resources on the risks most likely to jeopardize business goals while controlling the cost of compliance holistically.

### **Commitment to Continuous Improvement is Key**

Even the best designed compliance program will experience infractions and noncompliance, which by itself, does not mean that the program was ineffective at the time of the offense. It must be working as intended at the time of noncompliance by incorporating continuous improvement, investigation of

misconduct and management of issues to strengthen the program.

These factors demonstrate that the cannabis operator intends to improve and evolve. The cannabis operator should be able to identify noncompliance through timely and thorough investigations of potential noncompliance and have the ability to remediate and address identified root causes appropriately.

The top down message should be one that creates autonomy and empowers those responsible with ensuring the compliance program is effective. This approach demonstrates a strong compliance culture that adequately informs employees of their responsibilities and demonstrates the cannabis operator's commitment to compliance. Ultimately, it demonstrates whether the program is effective or a simply a paper program.

There is also a small window of opportunity to show that a compliance program can evolve and incorporate improvements that mitigate the root cause of the violation. In essence, most regulators take into consideration the licensee's ability to self-correct noncompliance.

A robust understanding of the cannabis operator's risk-based compliance program provides continuity of the program to make self-correction possible. The company must demonstrate an adequate and honest root cause analysis to understand both how the noncompliance took place and the remediation needed to prevent similar actions in the future.

One of a regulator's goals is returning a licensee back to compliance, and in many cases, correcting the noncompliance shortly after identification reduces the need for stricter regulatory enforcement action. Reducing or removing the threat of an enforcement action helps maintain a cannabis operator's ability to generate revenue through licensed activity.

### **Setting Your Company Up for M&A Success**

In a contemplated merger or acquisition context, there are many advantages for a purchaser if a selling cannabis operator can demonstrate it has implemented a risk-based compliance program. This is especially true during the due diligence period when most purchasers focus on regulatory related matters.

Prior noncompliance is more likely to be identified because the program is transparent. If noncompliance occurs in the future, a purchaser will be positioned to reduce the impact of an enforcement action.

A purchaser can also be confident that the cost of compliance will remain consistent post-purchase because a well-established culture of compliance is already in place. Incorporating these elements into a due diligence review increases the likelihood that future revenue streams of the cannabis operator will perform as expected. This in turn helps ensure that a new acquisition provides a return on the investment of its purchasers.

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[1] <https://money.usnews.com/investing/stock-market-news/articles/upcoming-mergers-in-the-cannabis-industry-to-watch>.

[2] <https://cheddar.com/media/cannabis-marijuana-industry-2021-analysis>; <https://www.fool.com/investing/2021/02/12/will-there-be-more-ma-for-the-cannabis-industry-in/>.