

TYPES NOT MAPPED YET November 13, 2018 | TTR not mapped yet | Kevin J. Young

California's proposed cannabis regulations seek to restrict 'white labeling'

On November 5, 2018, the notice and comment period relating to the California Bureau of Cannabis Control's ("BCC") proposed regulations came to a close. One of the most controversial changes in the new regulations, which are expected to be promulgated in early 2019, is the modification of Section 5032 of the Readopted Emergency Regulations, which would read, in part:

(a) All commercial cannabis activity shall be conducted between licensees. Retail licensees, licensed retailers and licensed microbusinesses authorized to engage in retail sales may conduct commercial cannabis activity with customers in accordance with Chapter 3 of this division.

(b) Licensees shall not conduct commercial cannabis activities on behalf of, at the request of, or pursuant to a contract with any person that is not licensed under the Act. Such prohibited commercial cannabis activities include, but are not limited to, the following:

(1) Procuring or purchasing cannabis goods from a licensed cultivator or licensed manufacturer.

(2) Manufacturing cannabis goods according to the specifications of a non-licensee.

(3) Packaging and labeling cannabis goods under a non-licensee's brand or according to the specifications of a non-licensee.

(4) Distributing cannabis goods for a non-licensee.

In the past year, many cannabis manufacturers who, for a variety of reasons, have not obtained (or in some cases are in the process of obtaining) manufacturing licenses from the state of California, have entered into licensing agreements with licensed manufacturers. These agreements provide non-licensed manufacturers the ability to retain ownership of their intellectual property (recipes, websites and brands) while transferring the manufacture of cannabis products to licensed manufacturers. This practice, traditionally termed "white labeling," not only permits non-licensees an entry point into the legal California market, but also enables small and medium sized brands an opportunity to benefit from economies of scale in production, thus cutting manufacturing costs and promoting competition with companies with greater market share.

Subsection (b)(3) of the text would, in effect, extinguish white labeling, making it illegal for licensed manufacturers to conduct "commercial cannabis activities" with unlicensed brands. The BCC has not explained its rationale for the proposed regulation, but it is clear the outcome of this proposal would limit the number of players in the market.

Many industry experts take issue with the proposed modification because they believe it does little to promote the state's goal of regulating and promoting safety in the cannabis market. If the BCC is concerned cannabis products are produced in accordance with state regulations, then it retains the ability to take enforcement action against a licensed manufacturer, irrespective of whether that manufacturer has entered into a licensing agreement with a non-licensed brand. Moreover, as many have noted, white labeling is not unique to cannabis, and is widely found in a variety of industries as a means for smaller brands to gain entry into a competitive marketplace.

Industry experts also believe the proposal—which favors larger companies to the detriment of startups and small brands—will shrink California's nascent cannabis market. The ecosystem of brands and products will be culled, not due to natural market forces, but due of government intervention. This is in part because white label brands will either lose their entry point to the market or will be required to expend substantial capital to obtain manufacturing licenses. As a result, a fair number will likely sell their intellectual property and exit the industry, thus handing larger manufacturers even greater market share and increasing the barriers to entry for startups.

Some companies are already beginning to consider alternatives to the existing licensing agreement model. One proposal under consideration by non-licensees is to sell their intellectual property to licensed manufacturers under a purchase agreement with purchase price adjustments that will provide payments tied to annual sales of the brand over multiple years. Unfortunately, under this proposal the white label brand relinquishes ownership of its intellectual property, and is forced into a fire sale of sorts, since acquirers will know that the white label brand must sell quickly or risk obsolescence in a rapidly evolving market.

It is not yet certain whether the BCC's proposed elimination of white labeling will ultimately be promulgated, but if it is, it has the potential to radically alter California's cannabis market. Should the new regulations be promulgated, manufacturers should be ready to deal with whatever future the BCC creates.

The content of this article is for general informational purposes only. Readers are advised to consult tax counsel for matters related to installment sales.

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kevin

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