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Los Angeles's Social Equity Cannabis Applicants are Getting Left in the Weeds

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The passage of California Proposition 64 (Prop 64) opened the door for cities to grant licenses to businesses for the purpose of selling cannabis and to legalize personal recreational use within their own jurisdiction. The City of Los Angeles, unlike other cities, delayed the licensing of new cannabis businesses while they refined and reworked regulations to include a Social Equity Program. The City acknowledged the cannabis criminalization and enforcement had long-term and disproportionate impacts to low-income and minority communities during The War on Drugs. The Social Equity Program is designed to repair those harms by creating regulations to support and focus on the inclusion of those individuals. Although well meaning, the Social Equity Program has already been the subject of multiple lawsuits and has been deemed a failure by others. The regulations implemented by the Department of Cannabis Regulation, altruistic and aimed to promote equitable ownership in the cannabis industry, have unintended consequences for those groups they hope to assist.

The City's Program

The Los Angeles City Council created The Department of Cannabis Regulation as the City's agency in charge of commercial cannabis activity. The agency is responsible for processing cannabis applications, making licensing decisions and recommendations, and regulating commercial cannabis businesses within the City of Los Angeles.

The Social Equity Program is a three-tiered program that groups applicants meeting certain criteria and processes their application in a priority schedule created by the City. Tier 1 Social Equity Individual Applicants must be low-income, and have a prior California Cannabis Arrest or Conviction, or have a minimum cumulative residency of five years in a Disproportionately Impacted Area. A Tier 2 Social Equity Individual Applicant must be Low Income and have a minimum cumulative residency of five years in a Disproportionately Impacted Area or the individual does not meet the Low Income requirement but has a minimum cumulative residency of ten years in a Disproportionately Impacted Area. A Tier 3 Applicant is a person who applied for a non-retail cannabis license under another Section of the Code but does not meet the requirements of a Tier 1 or Tier 2 Social Equity Individual Applicant.

In order to be deemed Low Income, an individual must provide various financial disclosures to demonstrate their satisfying of the required benchmarks. Low Income individuals must earn an annual income of eighty percent or less than the Area Median Income and ensure their assets do not exceed certain levels based on household size. For applicants who have a California Cannabis Conviction or Arrest, they must have an arrest or a conviction in the State of California prior to November 8, 2016 for any crime that relates to the sale, possession, use, manufacturing, or cultivation of cannabis. A Disproportionately Impacted Area means one of the eligible zip codes the City designated after a Cannabis Social Equity Analysis Report that found certain areas in which there was a disproportionate impact by the criminalization of cannabis.

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The Department of Cannabis Regulation listened to concerns over social equity applicants entering into predatory agreements with wealthy investors because of their priority processing benefit but lack of resources to contribute to the project. To combat this, the City implemented Ownership Percentage requirements that all Social Equity Applications must satisfy. Although the City was attempting to implement safeguards to protect vulnerable communities, the Regulations inadvertently made Tier 1 Social Equity Applicants the least attractive group to partner with due to the strict definitions and requirements of the Equity Share conditions.

A Tier 1 Social Equity Applicant must own no less than a fifty-one percent Equity Share in the license. When submitting their application, parties agree to disclose all partnership agreements and acknowledge that if any provision is found to violate the Equity Share Agreements by a preponderance of the evidence the license may be suspended or revoked. The issue arises over the Equity Share percentage requirement and the practical effects it has on the parties. Under the Los Angeles Municipal Code Chapter X, Article 4, §104.20(a)(2)(ii), Equity Share means all "profits, dividends, and distributions." The Social Equity Program requires that the Tier 1 applicant receive at least their Equity Share (51%) of the profits paid to owners, 100% of the value of each share of stock or member interest, at least their Equity Share (a minimum of 51%) percentage of the retained earnings, and 100% of the unencumbered value of each share of stock, o. Lastly, the Tier 1 Social Equity Applicant must also receive at least their Equity Share percentage (a minimum of 51%) of the voting rights on all business decisions including "long-term decisions, daily business operations, retention and supervision of the executive team, managers, and management companies, and the implementation of policies.""

The Problems and Unintended Consequences for those intended to protect

By defining "Equity Share" so broadly and requiring Tier 1 Social Equity Individual Applicants to retain their Equity Share for profits and voting rights, they deter wealthy investors from partnering with them – the primary mission of the program. Either way an individual may qualify as a Social Equity Applicant, they are a low-income individual who does not, on their own, have the financial resources to start a new business. The Department of Cannabis Regulation assures these individuals do not exceed certain financial thresholds in determining if they satisfy the Low Income requirements. While trying to ensure that those who have suffered from the War on Drugs have an opportunity at equitable ownership, they are, in reality, making it more difficult for wealthy investors to partner with Tier 1 Social Equity Individual Applicants because of the high start-up costs investors have to contribute and minimal control they will retain over the investment.

Cannabis is a unique and relatively new market, with which most regulators have no experience. Because of this, regulations like the ones in place for the City of Los Angeles unintentionally discourage partnerships with the most vulnerable group of Social Equity Applicants. Most investors must be willing to contribute upwards of $500,000 if they are looking to start their own business. Investors with less than $100,000 may have an extremely hard time trying licensing their business as a sole owner because they can expect to pay between $4,000 and $120,000, based on the estimated value of the operation, for just the local licensing and permitting fees before getting into operating costs like rent for a facility, product employee wages, security, equipment, and insurance.

With so much money at stake, it is hard to see why an investor would contribute such extensive capital and then relinquish so much control and decision making authority to an individual who may not have any previous business experience– let alone experience in the nuanced legal cannabis market; especially when one considers that most investors have no relationship with the Tier 1 Social Equity Individual

Applicant Prior to beginning the licensing process.

Because of the Equity Share definition, a Tier 1 Social Equity Individual Applicant will hold a majority control which becomes more impactful as multiple investors join the project since the Social Equity Individual's ownership percentage must be a minimum of 51%. Although this was a well-intentioned requirement to safeguard Social Equity Applicants, it prevents investors from having authority on important short and long-term business decisions on their investment. If investors want to lessen their financial risk and only contribute half of the money necessary, they would need to find additional partners willing to contribute significant amounts of money for minimal equity interest and control in the project. For instance, an investor looking to partner with only one other investor who was willing to split a capital contribution of $500,000, would be prevented from owning an Equity Share percentage in excess of 24.5% and more meaningfully, only have a 24.5% Voting Share. The Tier 1 Social Equity partner who is not expected to risk any of their own money for a capital contribution due to their low income verification, now has no skin in the game and a majority say in all business decisions while the investors who risked $250,000 have a minority say in these important and business-altering decisions. While attempting to protect Social Equity Applicants, The Department of Cannabis Regulation is forcing investors who partner with a Tier 1 Social Equity Applicant, to contribute upwards of $500,000 of their own money and then hand over control of the business and decision making to this stranger. This high risk is making Tier 1 Applicants the most unattractive group to partner with and is in effect, harming their ability to find willing investors.

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By creating such strict regulations in an attempt to prevent underserved communities from falling prey to predatory partnership contracts, The Department actually made Tier 1 Social Equity Applicants the least attractive group to partner with. Their admirable attempt to bring equity into cannabis legalization was well-meaning is not working as well as they had intended. The requirements force investors to contribute large amounts of capital and lose control in business decisions, for the benefit of priority processing of the application. When the incentive of priority licensing is weighed against the burden that investors are facing, it's no surprise that they would attempt to find a different Tier to partner with, where they are able to retain more control. The Department of Cannabis Regulation and the City of Los Angeles's attempt to right the wrongs of past cannabis enforcement will unfortunately be a drawback for those individuals hoping to find an entrance into the "Green Rush".

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Kaitlin is part of the Class of 2022 at Golden Gate University School of Law. Prior to starting law school, she worked as a Compliance Consultant in Los Angeles specializing in Cannabis Compliance and Land Use Consulting. Kaitlin graduated Cum Laude from the University of Arizona with a major in Political Science and a minor in Business Administration. Kaitlin is currently the President of OUTlaw and the Communications Chair of Students for a Sensible Drug Policy.

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