

*All That Glitters Green in Colorado Is Not Pot Gold**By Tom Downey*

While nearly half the states in the country have legalized marijuana in some form, and others are moving in that direction, many entrepreneurs-to-be have false visions of easy money. Despite common lore and portrayals in the media, few Colorado marijuana businesses have made a great deal of money, and many more than expected have failed. There have been Three Waves so far in Colorado's legal pot trade.

The medical marijuana industry in Colorado started five years ago, almost exclusively by former illegal pot growers. Many had passion for the marijuana movement or a genuine desire to help people in pain. A great number, however, were looking to make a quick buck. The recession was in full bloom, and they were able to find cheap space from desperate landlords. They also faced little regulatory scrutiny beyond zoning compliance and avoiding criminal violations. They relied upon word of mouth for guidance, supplemented by criminal defense attorneys, without experience in regulatory or transactional law practice.

Colorado voters passed the medical marijuana constitutional amendment in 2000, but the General Assembly did not agree on enabling legislation until 10 years later. Frustrated with the lack of action, proponents started opening up cultivation centers and dispensaries in 2009. State and local governments played catch-up, imposing regulations and licensing structures, but the existing First Wave was grandfathered in.

The Second Wave started in late 2010, made up of non-marijuana business people stepping into the industry. Typically, a real estate developer leased warehouse space to a medical marijuana grower, saw poor business practices and great opportunity, and bought out the tenants. They succeeded, but not as conventional wisdom has assumed. They worked tremendously hard, bringing legitimate business practices to an incipient industry. They weathered extreme changes in both the pot market and regulatory requirements.

When legal medical marijuana sales increased dramatically from 2010 through 2013, the industry started shaking out into an oligopoly. A small business savvy minority of the First Wave combined with the Second Wave to represent the lion's share of the expanding market. Their success has been measured in the media coverage and the tax revenues. While the total profits have been significant, few pot businesses have experienced the successes portrayed in the press. Some were forced out by regulators for illegal activity. Some could not withstand their competition or simply exercised poor business practices. A handful of unsophisticated owners even collapsed under the weight of IRS audits, just the audit process itself, not resulting fines. Regardless, many businesses went under or sold to the bigger operators. Although the State has issued hundreds of marijuana licenses in the past four years, it is reasonable to estimate that the top five operations control at least one-third of Colorado's legal marijuana market.

The marijuana facilities of 2014 are unrecognizable from their ancestors. The dank basement grows have given way to massive and highly technical cultivation centers. Those who have succeeded are not sitting on piles of profits, as they have continually re-invested in their operations. Those without state-of-the-art functionality need money to upgrade, or they will be unable to compete. Those who have invested in the best and latest operations are property-and-equipment-rich, but cash-poor.

This capital demand has created the Third Wave. Starting in the last year, with legalized recreational marijuana coming on line, new money is coming into Colorado's marijuana industry. They are sophisticated investors with reasonably deep pockets. Their goal is not just to make pot money in Colorado, but to hone their systems, processes and brands before replicating their efforts in other states. As one client regularly reminds me, "There are five times more potential customers in Chicago, than all of Colorado."

They must be wary, however, of the potential pitfalls. The most common mistake is to rely too heavily upon the representations of the sellers. While most Colorado marijuana businesses have trustworthy owners and great potential for real returns on investment, others are desperate to sell and have a history of illegal activity. They may misstate Colorado's strict rules and regulations, such as glossing over the requirement that an owner of any portion of a marijuana business must have been a Colorado resident for two years. If a transaction is not fully compliant, the State Marijuana Enforcement Division will reject the transfer, and the deal will collapse. A short-sighted investor may end up with expensive property, but no marijuana license.

The next warning is that the short-term profits will not sustain their earlier growth. A mistaken assumption has been that recreational marijuana sales would dwarf those for medical marijuana. In fact, medical marijuana far surpassed recreational in the beginning, and the number of registered medical marijuana patients has increased since recreational marijuana became legal. The heavy consumers were already registered as medical patients.

A supply/demand clash is also on the horizon. As bigger, more efficient grow facilities are coming on line, the amount of available legal marijuana will increase. This higher supply will outpace the growth in demand. The resulting glut of product will likely trigger two outcomes: Collapsing prices and production caps. This will force more operators out of business and accelerate the industry hegemony by a few. State regulators take these matters very seriously, and in the end, that is good for the marijuana industry.

Two years from now, Colorado's marijuana trade will be strong and quite successful. There will be many short-term casualties along the way, along with plenty of lessons for other states.

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This article is intended to provide general information and is not to be construed as legal advice. If legal advice is needed you should consult an attorney. The Colorado Supreme Court has provided some guidance to Colorado attorneys who represent clients in matters directly or indirectly related to the sale, use or cultivation of marijuana. However, these activities remain illegal under federal law. The views expressed in this article are the author's own thoughts and opinions and do not necessarily represent the views of Ireland Stapleton Pryor & Pascoe, or its officers and directors.