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Despite the Trend Towards Legalization, Challenges Remain for Investors Considering Investment in State-Legal Cannabis Industries

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Client Advisory
March 26, 2019 by Alexander G. Malyshev

As any casual observer of the cannabis industry knows, there appears to be an unmistakable trend of state-by-state legalization. It started with the medical cannabis industry in the West, and has slowly moved East, with a second wave of adult-use (or recreational) cannabis legalization now in the works. With several years of data now available from states such as California, Colorado, and Arizona, states like New York, New Jersey, and Pennsylvania, are at various stages of considering the legalization of adult-use, and expansion of their existing medical marijuana programs.[1]

Investor appetite for the industry is unmistakable, with some projections pegging the industry at over $20 Billion by 2021 (and some recent projections nearly doubling that number). Canada, which has recently rolled out nation-wide legalization, has a fairly robust publicly traded market in cannabis stocks. Even the United States, where cannabis production and distribution remains illegal at the Federal level, has a sort of proxy for the market.[2] For investors with assets to deploy, investment in a hot, up-and-coming industry can seem very appealing. With that in mind, it makes sense to look at potential cautionary signs which, in turn, may help those investors decipher some of the "Risk Factors" they may run across in various disclosure documents.

I. Cannabis Remains Illegal At The Federal Level

This is the 800 pound gorilla in the room. The very first piece of advice prospective investors will receive from their attorney is that, as far as the official stance of the Federal government goes, cultivating marijuana is no different than producing any other Schedule I drug (like heroin, LSD, GHB or MDMA). The second piece of advice they will receive from that attorney is that the attorney cannot, ethically or legally, advise them on how to try and avoid those federal laws. In accordance with various ethics opinions an attorney can, however, advise them about what those laws are, and also about how to comply with state laws in effect.[3] This article is not legal advice, but it can serve as a baseline for an investor to discuss with their attorneys.

Thus, notwithstanding the prevailing consensus of the medical community, as far as U.S. federal law is concerned, as a Schedule I drug, marijuana (a) has a high potential for abuse, (b) has no currently accepted medical use in treatment in the United States, and (c) lacks safety in use under medical supervision (unlike cocaine, which is listed as a Schedule II drug because it has accepted medical uses).[4] Obviously this classification is, by definition, at odds with the various medical cannabis regimes in the majority of U.S. states. Simplifying greatly, under the U.S. system of dual sovereignty, for something to be "legal" it must be legal at both the federal and state levels. With some exceptions, one can think of the federal government as setting a baseline of what is illegal, while the states can add additional requirements. Generally speaking, more permissive state laws have no bearing on what remains illegal under federal law.

Because federal criminal law forbids the possession, distribution, sale or use of marijuana – and provides no exception for medical uses – a potential investor must consider the risks of potential liability under federal law for: (i) conspiring to manufacture and distribute marijuana, (ii) aiding and abetting the manufacture and distribution of marijuana, and (iii) acting as an accessory after the fact for the manufacture and distribution of marijuana.[5] The government may also choose to target the source of the funds using criminal and civil forfeiture laws which allow federal officials to seize marijuana-related property, including bank accounts.[6] Finally, non-US citizens who invest (or participate) in the cannabis industry, even in states or foreign countries where cannabis has been legalized, may be permanently barred from entry into the United States by the U.S. Customs and Border Protection Agency (CBP).[7] There have been reports of foreign investors being detained at a border crossing (meaning an airport) when flying to industry conferences in the U.S..

Investors must keep these things in mind as they consider their risk appetite with respect to cannabis cultivators and cannabis related businesses. Although the prevailing wisdom appears to be that the further one gets away from the "bud," by for instance providing equipment or logistics products, the less likely they are to be in the cross-hairs of federal prosecutors, a zealous prosecutor may disagree.

II. Protections From Federal Law Are Limited, And Sometimes Overstated

Potential investors should be aware generally of two terms that are often thrown around in any conversation regarding the Federal government's enforcement of its laws with respect to cannabis. The first is the "Cole Memo," which refers to a now withdrawn August 29, 2013 memorandum from then Deputy Attorney General James M. Cole to prosecutors in the U.S. Department of Justice (DOJ) outlining enforcement priorities. The second is the colloquially known "Rohrabacher Amendment,"[8] which refers to a congressional appropriations bill rider that prohibits the DOJ from using any of the funds appropriated by Congress to prevent states with medical marijuana regimes "from implementing their own State laws that authorize the use, distribution, possession, or cultivation of medical marijuana."

The Cole Memo, unlike the Rohrabacher Amendment, applied to both medical and adult-use cannabis businesses. It was non-binding, though generally followed, guidance from DOJ senior staff to local DOJ prosecutors on how to use their "limited resources" in enforcing U.S. laws.[9] It outlined the following enforcement priorities:

- Preventing the distribution of marijuana to minors;
- Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;
- Preventing the diversion of marijuana from states where it is legal under state law in some form to other states;
- Preventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;
- Preventing violence and the use of firearms in the cultivation and distribution of marijuana;
- Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
- Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and
- Preventing marijuana possession or use on federal property.

Enforcement was viewed as less of a priority (i.e. less likely) in "jurisdictions that have enacted laws legalizing marijuana in some form *and that have also implemented strong and effective regulatory and enforcement systems to control the cultivation, distribution, sale and possession of*

marijuana." (Emphasis added).[10] The memorandum reiterated that it was only intended as a guide to the exercise of investigative and prosecutorial discretion, and in no way curbed the DOJ's authority to enforce federal law in a way that is contrary to the guidance. It could not be used as a defense in the event of prosecution.[11] Nevertheless, it was viewed as an important guidepost for potential investors, in the absence of any other guidance from the U.S. government.

The Cole Memo was rescinded by former Attorney General Jeff Sessions on January 4, 2018. Mr. Sessions was an opponent of cannabis legalization, though it is not clear (one way or the other) that President Donald J. Trump shares his view. In rescinding the Cole Memo, Mr. Sessions "returned" full discretion to individual prosecutors, though there is no indication that this changed actual enforcement in any way.[12] Mr. Sessions resigned as United States Attorney General on November 7, 2018 and his successor, William Barr, stated during his confirmation hearing that he would not target state legal marijuana businesses. Nevertheless, as Mr. Barr correctly pointed out, it is ultimately up to Congress to act.

One way in which Congress has acted is through the continual adoption of the Rohrabacher Amendment. The amendment was first proposed in 2003, and was adopted for the first time in 2014 (for the 2015 fiscal year). It prohibits the DOJ from using any of the funds appropriated by Congress to prevent states with medical marijuana regimes "from implementing their own State laws that authorize the use, distribution, possession, or cultivation of medical marijuana." The amendment was the basis of a ruling by the 9th Circuit Court of Appeals in *United States v McIntosh*,[13] which prohibited the Department of Justice from continuing to prosecute several defendants who complied with their respective states' medical marijuana laws, expanding the application beyond the states themselves. The viability of that ruling, which is not binding in any other circuit, depends on the continuing renewal of the Rohrabacher Amendment.

It was last renewed in February of 2019 as part of the spending bill signed by President Trump, and will remain valid through September 30, 2019. It is noteworthy that President Trump's signing statement reads as follows: "Division C, section 537, provides that the Department of Justice may not use any funds to prevent implementation of medical marijuana laws by various States and territories. I will treat this provision consistent with the President's constitutional responsibility to faithfully execute the laws of the United States."[14] The statement is, to say the least, opaque, but suggests that the administration is keeping its options open. It is important to reiterate that the Rohrabacher Amendment applies solely to medical marijuana, and has no application whatsoever to recreational use in those states that have legalized it.

III. An Investor Must Consider The Various State Laws When Investing

All state laws are not the same when it comes to their medical and recreational use regimes. When reviewing an investment proposal, an investor must pay close attention to the state in which the proposed venture will operate. State and local laws (and regulations) may vary with respect to things like:

- Whether the state allows common ownership of the production and distribution of medical or adult-use cannabis;
- Whether the state has any restrictions on who may own a production facility or dispensary, and what procedures are in place to regulate ownership (including things such as background checks, residency, and liquid asset requirements);
- What regulations are in place at the state level with respect to the location of production facilities and dispensaries;
- Whether state law allow localities to set their own exclusionary NIMBY ordinances, and what challenges does that present to cultivation or distribution in the state;
- Whether the state in question has its own rules for transporting cannabis within the state (remembering that it is a separate violation of the CSA to transport cannabis between states);

- Whether banking services are available to the cannabis industry in the state, and if not, how are payments of taxes to the state handled;
- What amount of marijuana is an individual allowed to possess;
- Whether the state allows the production and sale of edibles or extracts, or does it limit cannabis to its plant form; and
- Whether any of the above rules vary for consumers and businesses.

A now slightly out of date, but still valuable, summary of some of these differences can be found in the August 2015 study of the National Alliance for Model State Drug Laws, titled "Marijuana: Summary of Laws Allowing Use of Marijuana for Medicinal Purposes."[15]

Because state laws vary so widely, it takes a fair amount of due diligence to understand whether a proposed venture considered these issues, and is in fact viable once the costs of compliance are factored in. An investor must also consider what would happen if a venture burns through cash as the costs of compliance become too great, while non-compliance could leave the venture open to liability under state aiding-and-abetting laws.

Finally, investors need to consider the desired balance between too much regulation, which might render a venture unprofitable, and too little regulation, which might take the venture outside of whatever safety prosecutorial discretion (that used to be embodied in the Cole Memo) provides.

IV. The Profitability of Cannabis Businesses May Be Difficult To Evaluate Long Term

Due to the fact that cannabis businesses operate in what can be best described as a "grey" area, potential investors should closely evaluate the management teams and financial projections of businesses in which they invest. It stands to reason that an industry that, until fairly recently, was illegal both at the state and federal level (and continues to be illegal federally) may have material weaknesses in those areas. The production side of the market has a higher concentration of "artisans" (rather than business professionals) than one would find in a different industry. Those producers also remain subject to Not In My Back Yard (NIMBY) pressure in certain markets. Because the transportation of cannabis across state lines is illegal (and is in fact an exception to the enforcement priorities under the Cole Memo), this is not necessarily a problem that can be easily solved by moving production to more favorable locales.

Access to banking is also a major problem. The Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN"), which monitors compliance with the Bank Secrecy Act ("BSA") through the various banks' filing of suspicious activity reports ("SARs"), has incorporated the enforcement priorities outlined in the Cole Memo into its own guidance to banks who do business with cannabis-related businesses. Although the Cole Memo has been rescinded, the FinCEN Guidance, issued on February 14, 2014,[16] remains in place and tracks the Memo's priorities, providing guidance on how financial institutions can provide services to marijuana related businesses consistent with their BSA obligations. This generally involves heightened and ongoing due diligence surveillance obligations, paired with higher banking fees, and has resulted in a limited number of institutions willing to provide banking services to cannabis related businesses. As a result the cannabis business remains mostly a cash one. This makes it more difficult to evaluate a company's finances, unless it works with an accounting firm that is familiar with the industry to produce financials.

Moreover, notwithstanding the expansion of regulated adult-use cannabis programs, illegal (or black market) cannabis remains as a competitor to adult-use and medical cannabis businesses. Such enterprises can operate less expensively because, among other things, they are not as concerned with complying various state and federal laws, including Section 208E of the Internal Revenue Code of 1986, which disallows the deductions of expenses incurred during a taxable year "in carrying on any trade or business if such trade or business (or the activities which

comprise such trade or business) consists of trafficking in controlled substances (within the meaning of Schedule I and II of the CSA) which is prohibited by federal law or the law of any state in which such trade or business is conducted."

Finally, even if one believes that Federal legalization is on the horizon, an investor should evaluate the likely impact of the regulations such legalization would bring. This means compliance with the Health Insurance Portability and Accountability Act of 1996 (HIPAA), various cybersecurity regulations, as well as likely oversight of various segments of the industry by the U.S. Food and Drug Administration (FDA).

V. Enforcing Rights May Be Difficult

Many cannabis related companies in the U.S. derive some of their value from the ownership of certain intellectual property. However, generally speaking, U.S. Federal trademark protection is only available for goods and services that can be lawfully used in commerce.[17] As the Trademark Manual of Examining Procedure (TMEP) used by the U.S. Patent and Trademark Office (USPTO) explains, an application cannot relate to the shipment or production of an illegal drug.[18] Although the USPTO experimented with a medical cannabis category a decade ago, it reversed course, and as it stands today a federal trademark remains out of reach so long as cannabis remains a Schedule I controlled substance. Therefore, at least for now, state level trademark protection remains the best available solution.

While the USPTO may issue patents for cannabis related products, practicing (or enforcing) those patents is generally difficult, if not impossible, while cannabis remains a Schedule I drug. In 2018 the District of Colorado saw what appears to be the first action trying to enforce a cannabis related patent, *United Cannabis Corporation v. Pure Hemp Collective Inc.*, No., 1:18-cv-01922 (Dist. Colo. July 30, 2018). The case concerns a product that is 95% CBD. No decision has been rendered in this case, but industry observers believe it could be a bellwether for whether federal litigation is viable for enforcement of patent rights in the cannabis area.

Similarly, there is an added layer of complexity when trying to enforce rights for contracts that involve something that remains illegal under federal law. Federal courts have attempted to strike a balance in this area, but the law is not well developed. The recent decision by the Northern District of Texas in *Ginsburg v. ICC Holdings, LLC* is instructive of the difficult analysis. The case concerned an investment by the plaintiff in a cannabis business that went sour, and resulted in well familiar claims of breach of contract and fraud in connection with the notes purchased by plaintiff.[19] Among other things, defendants moved to dismiss the complaint on the grounds of illegality (meaning that the subject matter of the contract was an illegal enterprise).[20] Although the Court found that, as a general matter, "a contract entered into in violation of federal law or public policy is unenforceable" it found that, in practice, "federal courts have taken a more flexible approach to the question of enforceability" turning to such concepts as equity in trying to invalidate only so much of the contract as necessary.[21] The court reasoned that "the defense of illegality, being in character if not origins an equitable and remedial doctrine, is not automatic but requires . . . a comparison of the pros and cons of enforcement[.]"[22] The court also determined that an affirmative defense (such as one of illegality) may only be determined at the pleading stage if the defense appears clearly on the fact of the complaint and, because it found that the standard was not satisfied here, it allowed the complaint to survive at the motion to dismiss stage (because, among other things, the notes in question did not explicitly mention marijuana).[23] The court found that on the facts it is possible that plaintiff could conceivably show that the relief requested would not require ICC (the company in which he invested) to "manufacture, distribute, dispense, or possess marijuana" and that, even if the notes concerned an "illegal object (i.e. a violation of the CSA), it [was] possible for the court to enforce the Notes in a way that does not require any party to engage in illegal conduct."[24] The exercise illustrates an added level of complexity to what would otherwise be a straightforward breach of contract or business tort case.

VI. Conclusion

While the opportunities to invest in cannabis and cannabis adjacent industries may be exciting, potential investors should take additional precautions to make sure they are comfortable with the level of risk, legal and commercial, involved.

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For more information concerning the matters discussed in this publication, please contact the author **Alexander G. Malyshev** (212-238-8618, malyshev@clm.com), or your regular Carter Ledyard attorney.

[1] As of the writing of this article, 33 states and Washington D.C. have legalized medical cannabis, while 10 states and Washington D.C. have also legalized adult-use cannabis. *See*, *generally*, https://en.wikipedia.org/wiki/Legality_of_cannabis_by_U.S._jurisdiction.

[2] This comes in two varieties. First, through Canadian companies cross-listed on U.S. exchanges, which have performed quite well in the first quarter of 2019. *See* "These Marijuana Stocks Have Doubled So Far in 2019," *The Motley Fool* (March 20, 2019) *available at* https://www.fool.com/investing/2019/03/20/these-marijuana-stocks-have-doubled-so-far-in-2019.aspx. Second, through companies that are adjacent to the cannabis industry, either through products made from the now legal Hemp (or Cannabis sativa L) plant , or through various service providers to the industry. Hemp which, among other things can be used to produce the non-intoxicating extract Cannabidiol (CBD), became federally legal nationwide with the passage of the Farming Bill signed into law on December 20, 2018. *See* Pub. L. 115-334, §§ 7129, 7605, 10113. *Available at* https://www.congress.gov/bill/115th-congress/house-bill/2/text. Discussion of the various issues surrounding legalization (including the ability to transport hemp-derived products across state lines, and certain changes to the Controlled Substances Acts (CSA)) are beyond the scope of this particular article.

[3] *See* New York State Bar, Ethics Opinion 1024 (Counseling clients in illegal conduct; medical marijuana law) (September 29, 2014) *available at* http://www.nysba.org/CustomTemplates/Content.aspx?id=52179.

[4] Controlled Substances Act ("CSA") of 1970, 21 U.S.C.A. § 812(b)(1).

[5] *See* 18 U.S.C. § 2 ("Whoever . . . aids, abets, counsels, commands, induces or procures" a federal crime, or "causes" a federal criminal act to be done, "is punishable as a principal."); 18 U.S.C. § 3 ("Whoever, knowing that an offense against the United States has been committed, receives, relieves, comforts or assists the offender in order to hinder or prevent his apprehension, trial or punishment, is an accessory after the fact.") ; 18 U.S.C. § 371 ("If two or more persons conspire either to commit any offense against the United States ... and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined under this title or imprisoned not more than five years, or both.")

[6] *See* 21 U.S.C. §§ 853, 881(a)(6).

[7] Legislation, clearly targeted at Canadian investors, was introduced in the final days of the 115th Congress to change this. *See* Maintaining Appropriate Protection for Legal Entry of 2018 ("MAPLE Act of 2018"), H.R. 7275 (115th Congress). It died in committee, but it may be re-introduced at a later date.

[8] Congressman Dana Rohrabacher was one of the two original lead co-sponsors of the bill, together with Congressman Sam Farr (thus older references are to the Rohrabacher-Farr amendment). Because the bill must be re-authorized in every Congress, the actual name of the amendment has changed over time, and it was most recently known as the Rohrabacher-Blumenauer amendment (with Congressman Earl Blumenauer taking over as lead co-sponsor after Congressman Farr retired). With the retirement of Congressman Rohrabacher, it is likely that Congressman Blumenauer will be the lead sponsor in the next Congress.

[9] *Available at* https://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf

[10] *See* Cole Memo at 3.

[11] *Id*. at 4.

[12] This is likely because the Cole Memo was not binding in the first place, and generally tracked the enforcement priorities outlined in the U.S. Attorney's Manual, which take into account the federal government's limited resources, "law enforcement priorities set by the Attorney General," the "seriousness" of the alleged crimes, the "deterrent effect of criminal prosecution," and "the cumulative impact of particular crimes on the community." *See* USAM § 9-27.230 *available at* https://www.justice.gov/archives/usam/archives/usam-9-27000-principles-federal-prosecution.

[13] 833 F.3d 1163 (9th Cir 2016)

[14] *See* https://www.whitehouse.gov/briefings-statements/statement-by-the-president-28/

[15] *Available at* http://www.namsdl.org/IssuesandEvents/Comparison%20of%20marijuana%20laws%20-%20medicinal%20use%20-%20full%20laws%20-%20FINAL%20-%208_24_2015.pdf

[16] *See* FIN-2014-G001, *available at* https://www.fincen.gov/sites/default/files/shared/FIN-2014-G001.pdf

[17] *See* 15 U.S.C. § 1051; 15 U.S.C. § 1127.

[18] See TMEP Section 907 (Use of a mark in commerce must be lawful use to be the basis for federal registration of the mark. *Gray v. Daffy Dan's Bargaintown*, 823 F.2d 522, 526, 3 USPQ2d 1306, 1308 (Fed. Cir. 1987); *see* 15 U.S.C. §§1051, 1127; 37 C.F.R. §2.69; *In re Midwest Tennis & Track Co*., 29 USPQ2d 1386, 1386 n.2 (TTAB 1993); *In re Stellar Int'l, Inc*., 159 USPQ 48, 50-51 (TTAB 1968) . Thus, the goods or services to which the mark is applied, and the mark itself, must comply with all applicable federal laws. *See In re Pepcom Indus., Inc*., 192 USPQ 400, 401 (TTAB 1976) ("In order for [an] application to have a valid basis that could properly result in a registration, the use of the mark [has] to be lawful, i.e., the sale or shipment of the product under the mark [has] to comply with all applicable laws and regulations. If this test is not met, the use of the mark fails to create any rights that can be recognized by a Federal registration."). In addition, "the fact that the provision of a product or service may be lawful within a state is irrelevant to the question of federal registration when it is unlawful under federal law." *In re Brown*, 119 USPQ2d 1350, 1351 (TTAB 2016)). *Available at* https://tmep.uspto.gov/RDMS/TMEP/current#/current/TMEP-900d1e1.html

[19] Specifically, plaintiff sued "McGraw and ICC alleging claims for breach of contract based on ICC's alleged default on the Notes; common law fraud, violation of Tex. Bus. & Com. Code Ann. § 27.01; violation of § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), and Securities [*9] and Exchange Commission ("SEC") Rule 10b-5; violation of § 20 of the Exchange Act, 15 U.S.C. § 78t (as to McGraw only); violation of Tex. Rev. Civ. Stat. Ann. Art. 581-33(A)(2); violation of Tex. Rev. Civ. Stat. Ann. Art. 581-33(F) (as to McGraw only); violation of the Illinois Securities Law of 1953, 815 ILCS 5/12(F), and violation of the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. § 1962(c)." *Ginsburg v. ICC Holdings, LLC*, Civil Action No. 3:16-CV-2311-D, 2017 U.S. Dist. LEXIS 187391, at *8-9 (N.D. Tex. Nov. 13, 2017).

[20] Specifically, defendants argued that "the Notes are void and unenforceable because their illegal purpose contravenes public policy. They maintain that, under the Federal Controlled Substances Act ("CSA"), marijuana is a Schedule I controlled substance, the use of which is prohibited under any circumstance; that the CSA makes it unlawful to manufacture, distribute, dispense, or possess any controlled substance; that the CSA also makes it illegal to profit from the manufacture or sale of marijuana; that loaning money to support a business cultivating, selling, or distributing marijuana exposes individuals to other federal laws that criminalize aspects of the marijuana business; that Ginsburg has admitted to this court that he invested $10.6 million to support a business that cultivates, sells, and distributes marijuana; and that by investing in ICC to finance the cultivation, possession, and sale of marijuana, Ginsburg has knowingly violated countless Texas and federal drug laws." *Ginsburg*, 2017 U.S. Dist. LEXIS 187391, at *12-13.

[21] *Ginsburg*, 2017 U.S. Dist. LEXIS 187391, at *22-23.

[22] *Ginsburg*, 2017 U.S. Dist. LEXIS 187391, at *25 ('Although the court does not suggest that a contract with the purpose of funding an organization that is violating or intends to violate federal law is necessarily enforceable, or that, in this case, the Notes are themselves enforceable, it concludes at the Rule 12(b)(6) stage that defendants have not established from the face of the fourth amended complaint that the Notes are void and unenforceable.")

[23] *Ginsburg*, 2017 U.S. Dist. LEXIS 187391, at *19-20 (finding that "[o]n their faces, the Notes do not violate the CSA. Nothing contained in the Notes requires Ginsburg or ICC to manufacture, distribute, dispense, or possess marijuana. In fact, the Notes do not mention marijuana, ICC's business, or how ICC is to obtain the funds to repay its loan obligations. Instead, the Notes simply set forth the terms of Ginsburg's loans to ICC and provide for the repayment of the loans at a certain rate of interest.").

[24] *Id.* at *20-22.

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