

**Garden State CLE Presents:**

# **In the Weeds: Legal Advice for the Marijuana Business Client**



## **Lesson Plan**

**Instructor: Larry Hardcastle, Esquire**

# **Top Seven legal issues you need to discuss with your marijuana industry clients:**

- 1) These businesses continue to operate by the grace of the Federal Government.**
- 2. The Marijuana Business Does NOT Have Access to Conveniences of Enterprises that are lawful Under Federal Law.**
- 3.) Marijuana Business Federal Income Taxes are a Nightmare!**
- 4.) In Spite of all that, Your Client has a Lot of Opportunities.**
- 5.) Your Client Can Access Private Capital.**
- 6.) Choosing a Corporate Form is an Important Decision.**
- 7.) Your Client Should Start Thinking About Where to Operate Now!**



# **1.) These businesses continue to operate by the grace of the Federal Government.**

**a) A few examples of federal laws violated by the operation of a state-sanctioned marijuana business:**

**i) Controlled Substance Act.**

**(1) Prohibits manufacture, importation, possession, use and distribution of, among other drugs, marijuana;**

**(2) Five-year *mandatory* minimum for possession of 100 KG and Ten-year *mandatory* minimum for possession of 1,000 KG;**

**(3) Conspiracies to commit offenses carry the same penalties;**

**(4) Five-year statute of limitations.**



**ii) Money Laundering Control Act.**

**(1) Prohibits a financial transaction that, among other things, uses the proceeds to promote or carry on illegal activity.**

**(2) So does that include ancillary businesses? Web designer? Construction company? Security company?**

**iii) Racketeer Influenced and Corrupt Organizations Act.**

**(1) Prohibits the operation of, among other things, a drug trafficking operation.**

**(2) This makes all participants, including passive investors, part of the conspiracy.**

**iv) Civil, criminal, and administrative forfeiture.**

**(1) Forfeit the proceeds of the trafficking activity, property purchased with the proceeds of trafficking activity, and property used in connection with the trafficking activity.**



## **b) August 29, 2013 *Cole Memorandum* Priorities:**



### **i) Preventing the distribution of marijuana to minors;**

**(1) In 2012, Colorado U.S. Attorney ordered a number of medical marijuana dispensaries located within 1,000 feet of schools to close.**

**(2) Notified the land owners that forfeiture proceedings would be initiated if the dispensaries did not close.**

### **ii) Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;**

**iii) Preventing the diversion of marijuana from states where it is legal under state law in some form to other states;**

**iv) Preventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;**

**v) Preventing violence and the use of firearms in the cultivation and distribution of marijuana;**

**vi) Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;**

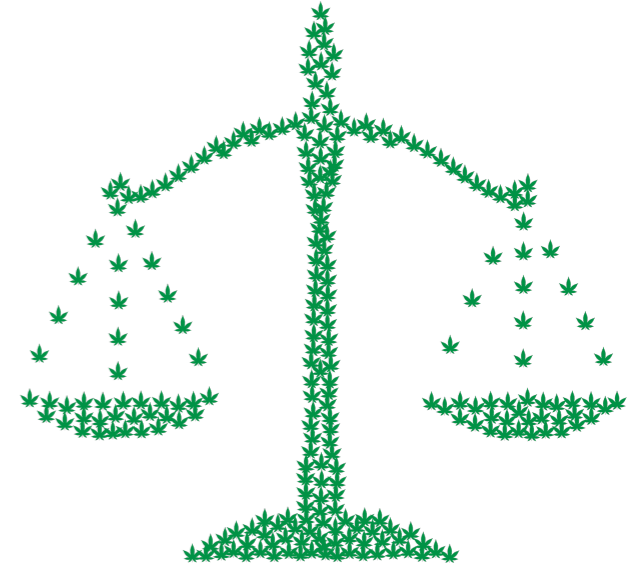
**vii) Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands;  
and**

**viii) Preventing marijuana possession or use on federal property.**



## **c) Consequence of Attorney General Jeff Sessions' Appointment:**

- i) Increased hostility towards marijuana.**
- ii) Looking at the *Cole Memorandum*<sup>1</sup> “very hard”.**
- iii) Expressly asked<sup>2</sup> congress to exclude from DOJ.**
- iv) Some appropriation legislation language Rohrabacher Amendment prohibits the DOJ from expending funds to prosecute state-licensed medical marijuana facilities.**



**d) The only way to create a stable, predictable market is a federal law that either decriminalized marijuana or permits its operation in states that legalize it.**

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<sup>1</sup> <https://www.usnews.com/news/national-news/articles/2017-11-29/jeff-sessions-hints-at-shift-in-federal-marijuana-enforcement>

<sup>2</sup> <https://www.scribd.com/document/351079834/Sessions-Asks-Congress-To-Undo-Medical-Marijuana-Protections>

## **2.) The Marijuana Business Does NOT Have Access to Conveniences of Enterprises that are Lawful under Federal Law.**

### **e) Banking:<sup>3</sup>**

#### **i) February 14, 2014 FinCEN guidance:**

**(1) Concerns banks' Bank Secrecy Act obligations for banks seeking to serve marijuana related businesses.**

**(2) Issued in order to “enhance the availability of financial services” for marijuana-related businesses.**

**(3) Was issued as a result of the Cole Memo and incorporates that Memo's priorities.**

**(4) Obligates the financial institutions to:**



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<sup>3</sup> Ex. A ~ Fin 2014-G001

- (a) verifying with the appropriate state authorities whether the business is duly licensed and registered;**
  
- (b) reviewing the license application (and related documentation) submitted by the business for obtaining a state license to operate its marijuana-related business;**
  
- (c) requesting from state licensing and enforcement authorities available information about the business and related parties;**
  
- (d) developing an understanding of the normal and expected activity for the business, including the types of products to be sold and the type of customers to be served (e.g., medical versus recreational customers);**
  
- (e) ongoing monitoring of publicly available sources for adverse information about the business and related parties;**
  
- (f) ongoing monitoring for suspicious activity, including for any of the red flags described in this guidance; and**
  
- (g) Obtain refreshing information obtained as part of customer due diligence on a periodic basis and commensurate with the risk.**

**(5) The Banking institutions must file specific Suspicious Activity Reports (SAR's) related to marijuana business.**

**(a) SARs are required when the institution (i) involves funds derived from illegal activity or is an attempt to disguise funds derived from illegal activity; (ii) is designed to evade regulations promulgated under the BSA, or (iii) lacks a business or apparent lawful purpose. Because every marijuana business is illegal under federal law, the report is required.**

**(b) Three types of marijuana related SAR:**

**(i) Marijuana Limited - marijuana-related business that it reasonably believes, based on its customer due diligence, does not implicate one of the Cole Memo priorities or violate state law. That requires the institution to include in the SAR:**

- 1. identifying information of the subject and related parties;**
- 2. addresses of the subject and related parties;**
- 3. the fact that the filing institution is filing the SAR solely because the subject is engaged in a marijuana-related business; and**
- 4. the fact that no additional suspicious activity has been identified.**



**(ii) Marijuana Priority - marijuana-related business that it reasonably believes, based on its customer due diligence, implicates one of the Cole Memo priorities or violates state law. that requires to institution to include in the SAR:**

- 1. identifying information of the subject and related parties;**
- 2. addresses of the subject and related parties;**
- 3. details regarding the enforcement priorities the financial institution believes have been implicated; and**
- 4. dates, amounts, and other relevant details of financial transactions involved in the suspicious activity**



**(iii) Marijuana Termination – Financial institution deems it necessary to terminate the relationship with the marijuana-related business. Must provide a narrative of the basis for termination and inform known subsequent financial institutions of the potential for illegal activity.**

**(iv) As of June 30, 2017, FinCEN received a total of 33,692 marijuana-related business SARs, of which 24,101 were Marijuana Limited**

**(c) The memo goes on to discuss “red flags” that financial institutions should be aware of:**

**(i) A customer appears to be using a state-licensed marijuana-related business as a front or pretext to launder money derived from other criminal activity (i.e., not related to marijuana) or derived from marijuana-related activity not permitted under state law. Relevant indicia could include:**

**1. The business receives substantially more revenue than may reasonably be expected given the relevant limitations imposed by the state in which it operates.**

**2. The business receives substantially more revenue than its local competitors or than might be expected given the population demographics.**

**3. The business is depositing more cash than is commensurate with the amount of marijuana-related revenue it is reporting for federal and state tax purposes.**



**4. The business is unable to demonstrate that its revenue is derived exclusively from the sale of marijuana in compliance with state law, as opposed to revenue derived from (i) the sale of other illicit drugs, (ii) the sale of marijuana not in compliance with state law, or (iii) other illegal activity.**

**5. The business makes cash deposits or withdrawals over a short period of time that are excessive relative to local competitors or the expected activity of the business**

**6. Deposits apparently structured to avoid Currency Transaction Report (“CTR”) requirements.**

**7. Rapid movement of funds, such as cash deposits followed by immediate cash withdrawals.**

**8. Deposits by third parties with no apparent connection to the accountholder.**

**9. Excessive commingling of funds with the personal account of the business’s owner(s) or manager(s), or with accounts of seemingly unrelated businesses.**



**10. Individuals conducting transactions for the business appear to be acting on behalf of other, undisclosed parties of interest.**

**11. Financial statements provided by the business to the financial institution are inconsistent with actual account activity.**

**12. A surge in activity by third parties offering goods or services to marijuana-related businesses, such as equipment suppliers or shipping servicers.**

**(ii) The business is unable to produce satisfactory documentation or evidence to demonstrate that it is duly licensed and operating consistently with state law.**

**(iii) The business is unable to demonstrate the legitimate source of significant outside investments.**



**(iv) A customer seeks to conceal or disguise involvement in marijuana-related business activity. For example, the customer may be using a business with a non-descript name (e.g., a “consulting,” “holding,” or “management” company) that purports to engage in commercial activity unrelated to marijuana, but is depositing cash that smells like marijuana.**

**(v) Review of publicly available sources and databases about the business, its owner(s), manager(s), or other related parties, reveal negative information, such as a criminal record, involvement in the illegal purchase or sale of drugs, violence, or other potential connections to illicit activity.**

**(vi) The business, its owner(s), manager(s), or other related parties are, or have been, subject to an enforcement action by the state or local authorities responsible for administering or enforcing marijuana-related laws or regulations.**

**(vii) A marijuana-related business engages in international or interstate activity, including by receiving cash deposits from locations outside the state in which the business operates, making or receiving frequent or large interstate transfers, or otherwise transacting with persons or entities located in different states or countries.**

**(viii) The owner(s) or manager(s) of a marijuana-related business reside outside the state in which the business is located.**

**(ix) A marijuana-related business is located on federal property or the marijuana sold by the business was grown on federal property.**

**(x) A marijuana-related business's proximity to a school is not compliant with state law.**

**(xi) A marijuana-related business purporting to be a "non-profit" is engaged in commercial activity inconsistent with that classification, or is making excessive payments to its manager(s) or employee(s).**

**ii) Despite the onerous regulation, the number of depository institutions providing banking services to marijuana-related business is steadily increasing. As of July 2017, 400 institutions are providing services to marijuana-related businesses.<sup>4</sup>**

**iii) All that regulation comes at a cost: anecdotal evidence suggests the depository institutions that will work with marijuana related business charge between \$400 and \$1,000 per month.<sup>5</sup>**

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<sup>4</sup> Ex. B ~ 3<sup>rd</sup> Q MJ Banking Update. July 2017

<sup>5</sup> <https://www.leafly.com/news/politics/shh-heres-how-cannabis-companies-are-banking-legally-on-the-down>

**iv) Fourth Corner Credit Union v. Fed. Reserve Bank of Kansas City, 861 F.3d 1052, 1053 (10th Cir. 2017), represents the most high profile attempt to force access to the broader financial structure.**

**(1) Suit sought and order compelling the Federal Reserve to issue to a marijuana focused credit union a “master account” which would have permitted it to participate more fully in the integrated financial system... it did not work. The 10 Circuit could not reconcile ordering the Fed to issue a charter to an institution with a stated purpose of violating federal law.**

**f) Postal services**

**i) Cannot use the mails to send marijuana-related proceeds!**

**(1) A business called Rainforest Farms in Alaska attempted to use the U.S. Postal Service to send a box full of cash to pay its taxes, the postal service refused delivery.<sup>6</sup>**

**ii) USPS issued a 2015 memo stating that using the mails to send marijuana advertisements is illegal.**

**(1) Apparently, the postal service cannot refuse delivery of the material, as they did with the cash, but they will report such advertisements to authorities.**

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<sup>6</sup> <http://www.thecannabist.co/2017/04/27/post-office-marijuana-tax-cash-alaska/78510/>



## **g) Federal Courts**

### **i) Bankruptcy**

**(1) Debtors directly or indirectly related to the marijuana business cannot get relief**

**(a) In re Rent-Rite Super Kegs West Ltd., 484 B.R. 799 (Bankr. D. Colo. 2012)**

**(i) Warehouse owner filed a chapter 11 case**

**(ii) Creditor moved to dismiss or convert case owing to “gross mismanagement of the estate” because the warehouse derived approximately 25% of its revenue from leasing space to a marijuana grower**

**(iii) Court found that receiving funds in violation of the CSA constituted cause for conversion or dismissal of case**



**(b) In re Arenas, 535 B.R. 845, 847 (10th Cir. BAP (Colo.) 2015)**

**(i) The opening sentence of the case says it all: “Can a debtor in the marijuana business obtain relief in the federal bankruptcy court? No!!!!!!”**

**(c) In re Johnson, 532 B.R. 53 (Bankr. W.D. Mich. 2015).**

**(i) Post-petition medical marijuana business violated federal law, rendering the debtor ineligible for relief under the Bankruptcy Code while conducting his business.**

**(2) Creditors cannot get relief against debtors from bankruptcy court.**

**(a) Creditors of marijuana businesses can have difficulty filing an involuntary bankruptcy against marijuana business debtors.**

**(i) In re Medpoint Management, LLC, 528 B.R. 178 (Bankr. D. Ariz. 2015).**

- 1. The court dismissed a creditor's involuntary bankruptcy because the creditor knew the debtor was engaged in the marijuana business, so the creditor came before the court with unclean hands and therefore could not obtain relief.**

**(b) Marijuana business creditors can have difficulty pursuing an adversary proceeding against non-marijuana business debtors.**



**1. Northbay Wellness Group, Inc. v. Beyries, 789 F.3d 956 (9th Cir. 2015).**

**a. A lawyer stole trust funds from a marijuana business client and later filed for bankruptcy. The client sued for a determination that the debt was non-dischargeable. The bankruptcy court dismissed the claim because the client came before the court with unclean hands by virtue of being engaged in the marijuana business.**

**b. Although the 9<sup>th</sup> Circuit ultimately reversed the ruling, its analysis focused on the fact that the lawyer was also a partner and board member of the client. Thus, he shared in the wrongful conduct of the client. So his additional wrongful conduct of an attorney stealing trust funds tipped the balance in favor of finding non-dischargeability because not doing so would undermine the public interest in holding attorneys to a high ethical standard.**

**c. While the attorney being a partner in the marijuana business and stealing trust funds was sufficient to permit the non-dischargeability suit to proceed, it would be easy to imagine a circumstance where the public interest was not sufficient to overcome the wrongful conduct of marijuana business and so an otherwise meritorious non-dischargeability suit would be barred.**



**ii) Civil**

**(1) Kinetic Dev. LLC v. Sky Unlimited LLC, 17-CV-0562-WJM-MLC, 2017 WL 5623512, at \*1 (D. Colo. Nov. 22, 2017).**

**(a) Parties entered into a real estate purchase contract contingent on Sky receiving a recreational retail marijuana store license.**

**(b) Sky sought to terminate the contract based upon the fact that the distribution of marijuana violates the CSA.**

**(c) Kinetic sued in state court, but Sky removed to federal court on the theory that case arises under federal law because the contingency would require Sky to violate the CSA.**

**(d) The district court remanded to state court finding that the CSA confers no private right of action. This is a positive because it is less clear how a federal court would resolve a dispute properly before it between parties involved in the marijuana business.**

**(2) Ginsburg v. ICC Holdings, LLC, 3:16-CV-2311-D, 2017 WL 5467688 (N.D. Tex. Nov. 13, 2017)**

**(a) Ginsburg loaned millions of dollars in ICC. He alleged ICC breached the promissory notes and sued in federal court.**

**(b) ICC moved to dismiss under 12(b)(6) stating the contracts are unenforceable.**



**(c) The Court denied the motion stating that: “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.”**

**(d) Interestingly, the defendant attached to its motion an Arizona and a Colorado case in which state courts dismissed on illegality grounds breaches of contract claims related to medical marijuana business, despite medical marijuana being legal in both states.**

**iii) The lesson is that it’s hard to get into federal court, and you may not want to be there anyway.**

### **3.) Marijuana Business Federal Income Taxes are a Nightmare!**

**h) They cannot deduct ordinary and necessary business expenses. Full stop.**

**i) Under 28 U.S.C. § 280E, “No deduction or credit shall be allowed for any amount paid or incurred during the 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 Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.”**

**ii) Regularly selling marijuana is traffic in a schedule I substance.**

**iii) So your client cannot deduct employee’ pay, retirement plans, rent expenses, interest paid, insurance.**

- i) Your client cannot deduct cash or inventory seized, lost or stolen.**
- j) Your client can reduce its income realized by state excise tax paid because it is not a deduction, but a reduction in amount realized.**
- k) Your client can reduce its gross income by the cost of goods sold because that is not a deduction. But record keeping—including receipts from licensed manufacturers—is required. Simply keeping a ledger is not enough!**
- l) Paying taxes in cash incurs a 10% penalty**



## **4.) In Spite of All that, Your Client has A Lot of Opportunities.**



### **a.) Actual Marijuana Operations.**

#### **i) Types of operations:**

**(1) Marijuana Cultivation Facility Does the actual growing of the marijuana.**

**(a) Requires a Class 1 Marijuana Cultivation Facility License.**

**(b) Regulations will establish how large the grow operation can be and permits an expansion of the operation at renewal, but not if the cultivator has been disciplined in the preceding year for a violation of the marijuana law.**

**(c) Size of the application fee increases depending on the square footage of the facility.**

**(d) Marijuana must be tested by a testing facility.**

**(e) Can sell to marijuana producers, to marijuana product manufacturing facilities, and to other marijuana cultivation facilities.**



**(2) Marijuana product manufacturing facility:**

**(a) Purchases marijuana and manufacture, prepare, and package products.**

**(b) Requires a Class 1 Marijuana Product Manufacturing Facility license.**

**(c) Size of the application fee increases depending on the square footage of the facility.**

**(d) Can sell to sell items to other marijuana product manufacturing facilities and to marijuana retailers, but not to consumers.**

**(3) Marijuana wholesaler**

**(a) Not clear whether wholesaler can purchase from a manufacturing or cultivation facility.**

**(b) Requires a Class 2 marijuana wholesaler license.**

**(c) Marijuana must be tested by a testing facility.**

**(d) Size of the application fee increases depending on the square footage of the facility.**

**(e) Sells marijuana items or marijuana paraphernalia for the purpose of resale either to a licensed marijuana wholesaler or to a licensed marijuana retailer.**



**(4) Marijuana retailer:**

**(a) Can purchase marijuana from marijuana cultivation facilities and marijuana items from marijuana product manufacturing facilities or marijuana wholesalers.**

**(b) Requires a class 3 marijuana retailer license issued for the premise.**

**(c) Size of the application fee increases depending on the square footage of the facility.**

**(d) Cannot have any overlapping ownership with a cultivation facility, manufacturer, or wholesaler.**

**(e) Can sell to the public.**

**(5) For all Ineligible if convicted under state or federal CDS law, unless conviction was for possession of marijuana under 50 grams of marijuana or 5 grams of hashish:**

**(6) Two-year NJ residency requirement.**

**(7) Retailer cannot have overlapping ownership with any other licensee enterprise.**

**ii) Each of the foregoing is a “marijuana establishment” and no person, partnership, employee cooperative, association, nonprofit corporation, corporation, or the agents thereof, shall hold more than three marijuana establishment licenses at any time.**

**iii) Locality may prohibit any of the marijuana operations via ordinance. Failure to enact an ordinance permits the operation of a retail location for a period of five years.**

**m) Marijuana testing facility:**



- i) Receive representative samples of marijuana and marijuana products from Marijuana Cultivation Facility and Marijuana Product Manufacturing Facilities.**
- ii) Independent, third-party entity meeting accreditation requirements established by the Division that is licensed to analyze and certify the safety and potency of marijuana items.**
- iii) Locality may prohibit any of the marijuana testing facility via ordinance. Failure to enact an ordinance permits the operation of a retail location for a period of five years.**
- iv) Also defined as a “marijuana establishment” and therefore, cannot have ownership in a retailer**

**n) Marijuana transporter:**

- i) An entity licensed to transport marijuana through and within the State of New Jersey and to maintain a warehouse.**
- ii) Requires a Class 4 Marijuana Transporter License.**
- iii) Ineligible if convicted under state or federal CDS law, unless conviction was for possession of marijuana under 50 grams of marijuana or 5 grams of hashish.**
- iv) Two-year NJ residency requirement.**

**o) Marijuana Handlers:**

- i) An individual who performs work on behalf of a person who holds license under the act requires a permit.**
- ii) There is a requirement of continuing education.**



## **p) Ancillary Services:**



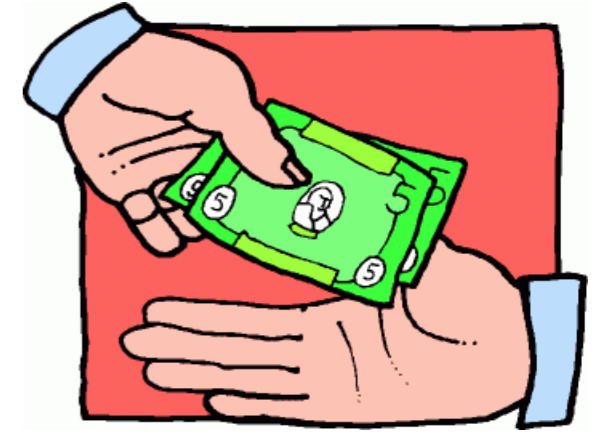
### **i) Security:**

- (1) The statute places a great deal of emphasis on marijuana establishments' security requirements.**
  
- (2) Given the likely cash-intensive nature of the operations, the marijuana establishments will likely have a great incentive to implement rigorous security protocols, including limiting hours of operations, escorts, and building security features.**

### **ii) Seed-to-User Inventory Control**

- (1) The statute requires what amounts to seed-to-user inventory tracking. Innovation in this area that allows integration between cultivators and producers to wholesalers and retailers would be incredibly valuable to compliance efforts. Also, such rigorous controls will help ensure that none of the Cole Memo priorities are implicated.**

## **5.) Your Client Can Access Private Capital**



### **q) Equity investments:**

- i) All owners of the businesses must be New Jersey residents.**
- ii) The sale of the securities implicates federal security law, so any investment memos must disclose risks including the ongoing federal prohibition, tax issues, risk of forfeiture, etc.**
- iii) Additionally, there must be an exception, such as the intrastate or private placement offering, to avoid federal security law registration requirements.**
- iv) As with all unregistered securities, they are less liquid.**
- v) Large private equity proponents of the marijuana industry include George Soros, John Sperling, and Peter Lewis**
- vi) Need to make sure that none of the equity investors violate the ownership restrictions previously discussed.**

## **r) Loans:**

- i) Need not be a New Jersey resident, BUT be highly suspicious of such investments because they implicate interstate commerce!**
  
- ii) The movement of marijuana proceeds to non-marijuana permissive states directly implicates a Cole Memo priority.**
  
- iii) Can use convertible notes that have as a triggering event the lender satisfying residency requirements.**



## **6.) Choosing a Corporate Form is an Important Decision**

### **s) C corporations:**

- i) The corporation cannot deduct business expenses if it is a marijuana trafficker, so the gross receipts minus cost of goods sold will be taxed once at the corporate rate and then dividends will be taxed at taxpayers' applicable rate**
  
- ii) But, the c-corp files its own tax return, so the individual taxpayer does not include details of the operation on his or her personal return, which can avoid self-incrimination or the "creative accounting" issues that could arise from the punitive tax regime.**
  
- iii) Dividing the business so that entity buying and selling the marijuana will help reduce the effects of double taxation.**
  
- iv) Obligation to follow corporate formalities may prove burdensome.**

**t) Pass-through Entities:**

**i) S-Corp**

**ii) LLCs**



## **7.) Your Client Should Start Thinking About Where to Operate Now!**

**u) Local control is preserved.**

**v) The law does not go into effect until one year after the passage.**

**i) Start identifying now localities that are receptive.**

**ii) Start identifying properties within those areas that seem viable.**

**iii) Play nice with your neighbors.**

**(1) Colorado RICO suits.**



## 8.) Questions:

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