February 13, 2018

RISKS? WHAT RISKS?

IT'S A POT PARTY … BUT THE FEDS AREN'T COMING (OR ARE THEY?)

A. Introduction.

It's a gold rush! Cannabis business activity in California is booming! And…

All you read in the press … all you see in the media … is that you better jump in with both feet.

We're business lawyers and we represent business clients. One of our most important duties is to advise our business clients of the legal risks associated with their business ventures.

When it comes to cannabis-related business activity, there are some significant legal risks that nobody is talking about. We think you need to know what they are.

This article summarizes some of the legal risks under federal law associated with engaging in cannabis-related business activities.

B. Executive Summary.

Despite broad public support for legalization of medical and recreational marijuana, and despite state laws authorizing and regulating medical and recreational cannabis-related business activity, marijuana is not "legal." Federal law, which applies even in California and other states which have legalized medical and/or recreational marijuana, treats marijuana as a dangerous drug akin to heroin or cocaine. Engaging in, assisting, funding, serving or facilitating marijuana-related activities are fraught with risk, both criminal and civil. Those risks include possible prosecution for commission of a felony, aiding and abetting a criminal activity, conspiracy to commit a felony, and civil forfeiture of assets used in, or received from, illegal activity. In addition, participants in cannabis-related activity may not be able to enforce contract rights, seek redress from state or federal courts, or be entitled to rights afforded to "legal" business activities. In summary:

- Compliance with California marijuana laws doesn't protect you from federal prosecution.
- The U.S. Department of Justice has rescinded a key element of the prior protections against enforcement of federal marijuana laws against state-compliant medical marijuana activity. No federal protections exist for state-legal recreational marijuana activities.
- Even peripheral involvement, by serving, funding or assisting a cannabis-related activity, may subject you to criminal liability as an aider and abettor, or co-conspirator.
- Your real property and other assets can be seized in a civil forfeiture action.
- Your liability and casualty insurance may not cover you in the event of a loss.
- You may not be able to enforce your contracts in state or federal courts.
- You may not be able to deduct your business expenses on your tax returns.
- Your activity may cause you to be in default under your loan documents or other contracts.
- Your bank accounts may be closed, and you may not be able to open new accounts.
- You aren't entitled to bankruptcy protection if your business fails.

- Your conversations with your lawyers may not be privileged.
- Your lawyers may become witnesses against you in a federal enforcement action.

Each of the above risks is discussed in more detail, below.

C. State Marijuana Law.

The State of California has legalized cannabis-related activities under statutes permitting certain "medical marijuana" business activities, and as of January 1, 2018, certain recreational marijuana activities. This results in two categories of cannabis-related business activity: (1) businesses operated by Licensees; and (2) businesses operated by third parties who do business with Licensees, including by financing them, selling or leasing buildings or land to them, or providing them with services or products. Such ancillary service providers include investors, bankers, lawyers, accountants, landlords, real estate brokers and vendors.

"Legal" marijuana use in California is big business. On October 9, 2017, the Sacramento Bee published an article entitled "Pot Growers Take Over Warehouse Space in Sacramento." Among other things, that article stated that more than 100 businesses were seeking special permits from the city of Sacramento to run indoor marijuana growing operations as of July 2017, and some officials predicted that up to 200 might apply before the end of 2017. According to the article, legal pot growers are pushing prices and rents for industrial properties to unheard-of heights in some areas of the city of Sacramento. The Bureau of Cannabis Control, the agency responsible for regulating commercial cannabis Licensees, announced in early January 2018 that more than 400 licenses had been issued and more than 1,800 applications for licenses had been submitted. The legalization in California, under State law, of medical marijuana and certain recreational uses of marijuana, has engendered widespread business activity related to the cannabis industry that has been characterized by some as the "next California gold rush."

"Legal" marijuana use in California is limited in scope, complicated and fraught with traps for the unwary. Local governments can pursue illegal cannabis operators and their landlords for administrative code enforcement, civil nuisance abatement actions and criminal actions. The remedies available to local governments include recovery of attorneys' fees and costs associated with abatement, through liens and special assessments against the property of the operator and the landlord. The state can also prosecute and pursue illegal cannabis operators and pot-adjacent parties under various state criminal and civil laws.

D. Federal Marijuana Law.

1. "Legal" marijuana does not exist in the United States. Federal law still broadly criminalizes growing, distributing and/or possessing marijuana, including "medical marijuana." Knowingly or intentionally growing, distributing or possessing marijuana with the intent to manufacture, distribute or dispense is punishable by up to life imprisonment. 21 U.S.C. § 841(a). All activities involving the cultivation, distribution and/or sale of cannabis remain illegal under the United States Controlled Substances Act. Cannabis is classified as a Schedule I drug under that act, no different from heroin. The fact that a cannabis-related business activity is legal under state law and fully compliant with applicable state law does not make such activity legal under federal law. A number of bills have been introduced in the U.S. Senate and the House of Representatives, each of which addresses, in some form, the criminalization of marijuana under federal law. At present, and notwithstanding broad public support for decriminalization, no bill has the necessary support to become law.

2. On January 4, 2018, the Department of Justice took the first step in overriding guidance given under the Obama administration that limited federal enforcement of marijuana laws against "state legal" medical marijuana activities. In October 2013, the U.S. Department of Justice ("DOJ") promulgated the "Cole Memorandum," under which the DOJ outlined its marijuana enforcement priorities under the Controlled Substances Act. The Cole Memorandum did not list as an enforcement priority state-legal medical marijuana-related conduct so long as the state regulatory scheme contained "robust controls and procedures on paper" and was "effective in practice." The Cole Memorandum has been viewed in the cannabis industry as providing a "safe harbor" for medical marijuana business activity operated in strict compliance with state law.

The guidance in the Cole Memorandum was subject to change at any time. In September 2017, Deputy U.S. Attorney Rod Rosenstein signaled a change in the DOJ's enforcement priorities and has been quoted as saying, "[The Cole Memorandum has] been perceived in some places almost as if it creates a safe harbor, but it doesn't. And it's clear that it doesn't. That is, even if, under the terms of the memo you're not likely to be prosecuted, it doesn't mean that what you're doing is legal or that it's approved by the federal government or that you're protected from prosecution in the future."

On January 4, 2018, Attorney General Jeff Sessions announced the rescission of the Cole Memorandum:

> "It is the mission of the Department of Justice to enforce the laws of the United States, and the previous issuance of guidance undermines the rule of law and the ability of our local, state, tribal, and federal law enforcement partners to carry out this mission. Therefore, today's memo on federal marijuana enforcement simply directs all U.S. Attorneys to use previously established prosecutorial principles that provide them all the necessary tools to disrupt criminal organizations, tackle the growing drug crisis, and thwart violent crime across our country."

As a result of the rescission of the Cole Memorandum, federal enforcement of marijuana laws now resides in the 93 U.S. Attorneys. The recently appointed U.S. Attorney for the Eastern District of California (Sacramento and 33 other California counties) is McGregor "Greg" W. Scott, a Trump appointee who already held the position under President George W. Bush. While in office, Scott targeted large-scale cannabis operations and developed a reputation for seeking harsh sentences. On January 18, 2018, a Sacramento Bee article quoted Omar Figueroa, a Sebastopol lawyer specializing in marijuana cases: "He used to be a hardcore, anti-cannabis drug warrior. I hope he has evolved."

Public backlash against the rescission of the Cole Memorandum has been significant. On January 24, 2018, a bi-partisan group of 54 members of Congress sent a letter to President Trump encouraging reinstatement of the Cole Memorandum. Nevertheless, as of the date of this article, the White House has not issued any policy statements addressing the rescission of the Cole Memorandum.

3. Leadership at the DOJ continues to support and lobby for enforcement of federal marijuana laws and funding to do so. Under what was known as the "Rohrabacher-Farr Amendment" to the House appropriations bill of 2015 (currently known as the "Rohrabacher-Blumenauer Amendment") (the "Rohrbacher Amendment"), the DOJ is presently prohibited from using appropriated funds to enforce federal marijuana laws against "state compliant" medical (but not recreational) marijuana operations. The Rohrbacher Amendment has been extended through March 23, 2018, at which time it will expire absent renewal by Congress or further extension. While there is significant support in Congress for further extension of the Rohrbacher Amendment, the Attorney General and the House Rules Committee

have opposed its renewal. If the Rohrbacher Amendment is not renewed, the DOJ will have no restrictions on the use of federal funds for enforcement of federal marijuana laws.

4. Federal restrictions under the Cole Memorandum and the Rohrbacher Amendment applied only to state-legal medical marijuana activity, not recreational marijuana activity. Neither the Cole Memorandum nor the Rohrbacher Amendment limit federal enforcement or prosecution against state-legal recreational use of marijuana. No "safe harbor" exists to limit or prohibit DOJ funding for the enforcement of federal law against state-legal recreational marijuana cultivation, manufacturing, distribution or use. Members of Congress proposed an addition to the latest emergency appropriations bill that would have extended the Rohrbacher funding limitations to state-legal recreational marijuana use (the "McClintock-Polis Amendment"), but the McClintock-Polis Amendment did not have sufficient support for inclusion in the latest emergency funding bill.

5. Licensees are not the only parties at risk of criminal prosecution. Those who facilitate the marijuana business are also at risk of criminal prosecution. These parties include owners, operators, investors, bankers, landlords or vendors for a marijuana business. It is a separate federal crime to manage or control any place, permanently or temporarily, for the purpose of manufacturing, distributing, storing or using marijuana. 21 U.S.C. § 856. The statute is commonly used to prosecute owners and operators of marijuana-related businesses. A landlord, lender, investor or ancillary service provider (including a lawyer) to a Licensee may also be subject to prosecution under this statute as a principal, co-conspirator, or an aider and abettor. Under federal law, whoever commits an offense against the United States, or aids, abets, counsels, commands, induces, or procures its commission, is punishable as a principal. 18 U.S.C. § 2. Non-Licensee pot-adjacent parties are also at risk for money laundering, financial reporting, and facilitation crimes. For example, Licensees generally don't have access to banks and must engage in cash or barter transactions. Receipt of large amounts of cash requires financial reporting and failure to report can result in prosecution and fines. 31 U.S.C. §§ 5321, 5322. Receipt of large amounts of cash from a known marijuana business or facilitating a financing transaction to further a marijuana business are subject to prosecution, with punishments of up to 20 years imprisonment. 18 U.S.C. §§ 1956, 1957.

6. The federal government can seize your property or your assets in a civil forfeiture action. Even absent prosecution, civil forfeiture remedies are available to federal prosecutors. Civil forfeiture allows the government to seize all the assets involved in operating the marijuana business and any property traceable to the proceeds of the business. 18 U.S.C. §§ 981, 983. This includes vehicles, land used to grow marijuana, buildings used to house marijuana operations, investor capital and profits, and other assets related to the involvement in the illegal activity. Even under the more lenient Obama DOJ, U.S. Attorneys used civil forfeiture against landlords leasing to medical marijuana businesses. For example, in two 2013 forfeiture actions brought against the owner of a retail shopping center in Oakland, and the owner of a retail shopping center in San Jose, each of which housed, as one among several tenants, a medical marijuana facility, the United States sought civil forfeiture against the property owners (who had knowledge of the business of the tenant) of the entire retail project. The government's theory was premised on the knowing receipt by the landlords of rent payments (proceeds) from illegal businesses (medical marijuana clinics) situated on the landlord's property, with the landlord's permission (under a lease). The current administration views civil asset forfeiture as an important tool in combatting crime. In a July 19, 2017, DOJ press release (accompanied by new DOJ Policy Directive 17-1), Attorney General Jeff Sessions stated:

> "President Trump has directed this Department of Justice to reduce crime in this country, and we will use every lawful tool that we have to do that. We will continue to encourage

> civil asset forfeiture whenever appropriate in order to hit organized crime in the wallet. At the same time, we must protect the rights of the people we serve. Law-abiding people whose property is used without their knowledge or without their consent should not be punished because of crimes that others have committed." [1]

7. The criminal penalties are stiff. Growing, distributing and possessing marijuana is punishable by up to life imprisonment. First time offenders with 1-50 plants or under 50 kg are subject to a fine of $250,000 to $1 million and imprisonment up to 5 years (Trafficking 21 U.S.C. §§ 841, 960, 962 and 46 U.S.C. § 70506). Mandatory fines and sentences for incarceration increase when multiple offenses and/or increased numbers or weights are involved. In addition to criminal prosecution, civil monetary penalties, civil forfeitures and/or regulatory sanctions can occur without anyone being charged with a crime. For example, even without a criminal case pending, a person who manages or controls a premises for growing, distributing or selling marijuana can be fined up to $250,000 or twice the gross receipts of the business, whichever is greater (21 U.S.C. § 856(d)). Being the owner, operator, financier, banker, landlord or vendor for a marijuana business is illegal. In addition to the potential life felony for dealing marijuana, it is a separate federal crime, punishable by up to 20 years in prison, to manage or control any place for manufacturing, distributing, storing or using marijuana (21 U.S.C. § 856). The mere receipt of a payment of more than $10,000 from a known marijuana business (including payment for services rendered) may be a federal crime punishable by up to 10 years in prison (18 U.S.C. § 1957). Engaging in a financial transaction for the purpose of promoting or furthering a known marijuana business may be a federal crime punishable by up to 20 years in prison (18 U.S.C. § 1956). Aiders and abettors to the foregoing crimes, or co-conspirators in the foregoing criminal activity, are liable to the same extent as the principal.

8. Your liability and property insurance may not cover you or your activities. Insurance policies routinely contain exclusions for criminal acts. Non-Licensee pot-adjacent parties may not have liability or casualty coverage if sued for conduct related to the marijuana business. This includes malpractice insurance for doctors, lawyers and other professionals aiding marijuana businesses. Property insurance carriers may deny coverage if the premises were used for, or the loss is related to, criminal activity. A typical exclusion from coverage for commercial property insurance is:

> Dishonest or criminal act by you, any of your partners, members, officers, managers, employees (including leased employees), directors, trustees, authorized representatives or anyone to whom you entrust the property for any purpose:
>
> 1. Acting alone or in collusion with others; or
> 2. Whether or not occurring during the hours of employment.

More broadly, insurers have successfully denied claims arising from illegal activities on the basis that coverage would violate public policy. The opportunities for large casualty claims arising from a marijuana business are many – fire from excessive electrical requirements, water damage and mold damage from humidification, illness from evacuated production air into other tenant or common areas and explosions from cannabis oil distillation systems.[2]

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[1] California property owners will encounter difficulty asserting an "innocent owner" defense to federal forfeiture actions because state law requires property owners to provide written consent to cannabis activity before the tenant obtains a license. Bus. & P C §26051.5(a)(2).

[2] Such explosions are increasing in frequency, with 32 such blasts in Colorado in 2014. See, New York Times, Odd Byproduct of Legal Marijuana: Homes That Blow Up, Jack Healy, January 17, 2015.

9. You could lose your professional licenses. Many professional licenses require good conduct and may be subject to revocation if a licensed professional knowingly engages in illegal conduct. Accountants, doctors, general contractors, real estate brokers and similar licensees are at risk.

10. Accepting money from, or paying, a marijuana business could be illegal. Most banks will not accept legal marijuana businesses as clients, so these businesses operate extensively in cash. Federal law requires banks, trades, and businesses (including lawyers) to report any cash transaction, or series of transactions, that exceed $10,000. Failing to file these reports could result in monetary fines or prosecution. Federal money laundering laws also apply to certain common financial transactions with legal marijuana businesses. For example, merely receiving a cash payment of more than $10,000 from a known marijuana business may be a federal crime punishable by up to 10 years in prison. Engaging in a financial transaction for the purpose of promoting or furthering a known marijuana business may be a federal crime punishable by up to 20 years in prison. Therefore, a vendor who supplies packaging material or agricultural equipment to a legal marijuana business, knowing that those goods will be used to help the business operate, may be committing a 20-year felony by accepting payment for those goods. Similarly, an accountant who receives payment for maintaining the financial records of a legal marijuana business could be violating the federal money laundering laws.

11. Your bank may cancel your accounts and you may have difficulty finding new banking arrangements. Most financial institutions do not accept deposits representing funds generated from cannabis-related business, and will not establish banking relationships with cannabis-related businesses. According to testimony from the director of the Financial Crimes Enforcement Network (FinCEN), in August 2014 only 105 banks nationwide were accepting deposits from marijuana businesses. As of June 30, 2017, that number had risen to only 390 banks and credit unions across the country. The Recorder, a legal industry publication, reported in a December 28, 2017 article, that Umpqua Bank closed the accounts of an attorney representing state-legal cannabis businesses, after learning of the attorney's connection with cannabis-related businesses and the attorney's refusal to document for the bank specific information about his marijuana-related clients. One attorney interviewed for the article was quoted as saying "It's definitely frequent that they kick marijuana businesses out."

12. You may not be able to deduct your business expenses. Section 280E of the Internal Revenue Code prohibits businesses involved in "drug trafficking" from deducting normal business expenses from their gross income. It provides that "[n]o deduction or credit shall be allowed" for expenses related to a trade or business that consists of trafficking in Schedule I or Schedule II controlled substances in violation of state or federal law. In a 2012 case, the U.S. Tax Court denied all business deductions to a California marijuana dispensary. In July 2015, this decision was affirmed by the U.S. Court of Appeals for the Ninth Circuit. You should discuss with your accountant and tax advisors the tax and accounting implications of involvement in a transaction related to the cannabis industry.

13. A bankruptcy may not protect you if your marijuana-related business fails. The Tenth Circuit and several bankruptcy courts have ruled that a marijuana business cannot use bankruptcy for protection from creditors. The rulings are supported by the Office of the United States Trustees, a division of the DOJ with oversight responsibilities concerning bankruptcy trustees and bankruptcy administrators. So, even if the federal government does not take all assets of the business in forfeiture or taxes, its creditors might. The same limitations may exist for businesses that facilitate or serve the marijuana industry.

14. You may be in default under contracts to which you are a party or which affect your property or occupancy. If you own real property encumbered by a loan, the loan documents typically

require that you and the businesses operated on your property comply with federal and state law. Engaging in a cannabis-related business or allowing a cannabis-related business on your property may be a default under your loan. Other types of agreements under which defaults may be triggered by operation of, or in connection with, cannabis-related activity, include leases and rental agreements (and rules and regulations promulgated thereunder), agreements with vendors to your business or companies to whom your supply services or products, distribution and supply agreements, common area declarations and restrictions on use, property CC&Rs, bank or credit agreements, and any agreements providing for federal assistance, funding or support for your business or properties.

15. You may not be able to enforce your rights under contracts with marijuana-related businesses. Contracts with marijuana-related businesses may not be enforceable in state or federal courts. In a recent case of great note, Arizona private-party lenders loaned a Colorado medical marijuana dispensary $500,000. After the dispensary failed to make payments, the lenders commenced an action in state court in Arizona to collect on their promissory note. Despite both Arizona and Colorado recognizing legalized marijuana, the trial court granted the defendant's motion to dismiss because the contract was void for illegality and against public policy. After quoting from the loan agreement which stated that "Borrowers shall use the loan proceeds for a retail medical marijuana sales and grow center," the court held:

> "The explicitly stated purpose of these loan agreements was to finance the sale and distribution of marijuana. This was in clear violation of the laws of the United States. As such this contract is void and unenforceable. This Court recognizes the harsh result of this ruling. Although Plaintiffs did not plead any equitable right to recovery such as unjust enrichment, or restitution, this Court considered whether such relief may be available to these Plaintiffs. Equitable relief is not available when recovery at law is forbidden because the contract is void as against public policy….[O]ne who enters into such a contract is not only denied enforcement of his bargain, he is also denied restitution for any benefits he has conferred under the contract."

16. Your conversations with your lawyer may not be privileged. Confidential communications between a lawyer and client are generally privileged and not subject to discovery by a third party. However, what is known as the "crime-fraud" exception to confidential communications with a lawyer does not apply to communications with a lawyer in furtherance of illegal activity. Therefore, an adverse party – either the government or a third party – could assert that all attorney-client communications about the operations and transactions of the state-legal marijuana business are not privileged and are discoverable in litigation.

17. Your lawyer's advice may not provide you a criminal defense and your lawyer may be compelled to be a witness against you. One defense to state or federal criminal prosecution is that the client relied on the advice of counsel. The advice-of-counsel defense requires that before taking an action the client fully discloses its plans to its lawyer and thereafter complies with its lawyer's advice. The advice-of-counsel defense negates the element necessary to many crimes of "specific intent to commit a crime." However, the advice-of counsel defense would not protect the client from drug crimes which merely require knowledge that the client is interacting with a marijuana business, i.e., a "general intent" crime that does not require proof of willfulness. See, e.g., 18 U.S.C. § 841. In addition, the mere assertion of the advice-of-counsel defense waives the attorney-client privilege. If the client's lawyer complied with its ethical rules and advised the client that the marijuana business is illegal under federal law, the lawyer could be called as a damaging witness in a federal drug prosecution case.

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