

High Stakes: Investing in a Legal Marijuana Business

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Considering diversifying with a high-risk investment? Heard the lure of the “green rush” toward a possible \$100 billion legal marijuana industry?

Before you write that check:

- First, research the company, related persons, and the business, industry and legal risks.
- Next, *if* you decide to make the leap, consider having legal counsel assist you in documenting your equity position.

Pressing escape or reboot can be difficult, after you have already signed documents. If you’re investing in a partnership or limited liability company, state law imposes default rules, unless you have an agreement modifying them. If the business — or you — fail to comply with the state’s rules on ownership and investors, the state regulator may impose penalties including cancellation or suspension of license and fines.

Have You Heard the Warnings From Regulators?

Be cautious. Do your own research. Consider the industry, company and business specific risks. Spot the scam red flags like rosy and frequent press releases setting up a pump-and-dump scheme.

The U.S. Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) warned investors about marijuana-related businesses in May 2014.¹ The SEC later sued several promoters leading to criminal sentences and the disgorgement of profits.² The Colorado and Washington state regulators published a warning to “Be Aware in the Next Big Investment” in November 2015.³ In May 2016, the SEC brought charges for a scheme to misappropriate investor funds and conceal ownership and control involving a medical marijuana

¹ SEC Office of Investor Education and Advocacy, Investor Alert: Marijuana-Related Investments (May 16, 2014) (announcing trading suspensions of common stock of five companies) at https://www.sec.gov/oiea/investor-alerts-bulletins/ia_marijuana.html.

FINRA, Investor Alerts, Marijuana Stock Scams (May 29, 2014) at <http://www.finra.org/investors/alerts/marijuana-stock-scams>.

² *U.S. Sec. and Exch. Comm’n v. Galas*, No. 3:14-cv-05621 (W.D. Wash.); *United States v. Mrowca*, No. 3:14-mj-05172-DWC (W.D. Wash. 2014-15).

³ Wash. St. Dep’t of Fin. Institutions, Beware of the Next Big Investment (Nov. 10, 2015) at <http://www.dfi.wa.gov/consumer/alerts/beware-next-big-investment>.

company known as Cannabis Mobile, Inc.⁴ In late June, the SEC sued HEMP, Inc. and others for a fraudulent scheme to sell to the public millions of restricted shares as unrestricted in the so-called pot penny stock bubble of 2014.⁵

What Are Some Risk Categories for Marijuana Businesses?

- Loss of investment from illegality, reclassification and changes in law;
- Emerging market lacking specific data on historic trends and profits;
- High-tax burdens on licensed businesses;
- Checkerboard of compliance with shifting state laws;
- State geographic markets impeding efficiencies;
- Restrictions on consumption, transportation, labeling, marketing, and advertising;
- Obstacles to developing intellectual property (IP);
- Obstacles to enforcement of agreements remedies in court;
- Investor, lending, and banking compliance requirements;
- Additional scrutiny for source of funds and criminal history;
- Limited investor and business information; and
- Limited exit strategies and secondary market.

Some of those risks are described in further detail below.

- ***Illegality and Uncertainty Under Federal Law.*** Cannabis is a Schedule I substance under the Controlled Substances Act. But the present administration has exercised the prosecutorial discretion not to prosecute marijuana businesses consistent with the enforcement priorities in the Cole Memorandum available [here](#).
 - A change of criminal prosecutorial policy enhances the possibility of asset forfeiture (including investor funds) and criminal prosecution.
 - Even without a change in prosecutorial discretion, some courts may not enforce agreements. The preferred remedy may be arbitration.
 - Reclassification or declassification of marijuana would affect most business plans for licensed marijuana businesses.
 - There is no definitive decision from the Supreme Court applying the Controlled Substance Act's positive-conflict test to recent state laws regulating and licensing marijuana.⁶
- ***State Restrictions.*** Marijuana is currently permitted for medicinal use in many states. Marijuana is permitted for recreational use in only four states. Transportation between

⁴ U.S. Sec. and Exch. Comm'n, Litigation Release, No. 23545, May 26, 2016 (*SEC v. Christopher R. Esposito*, No. 16-CV-10960 (D. Mass. May 26, 2016)).

⁵ U.S. Sec. and Exch. Comm'n, Litigation Release No. 23575, June 21, 2016 (*SEC v. Hemp, Inc.*, No. 2:16-cv-1413 (D. Nev. June 20, 2016)).

⁶ Todd Garvey and Brian T. Yeh, U.S. Congressional Research Serv., R43034, *State Legalization of Recreational Marijuana: Selected Legal Issues* (Jan. 13, 2014) at <https://www.fas.org/sgp/crs/misc/R43034.pdf>.

states remains illegal even between contiguous legalizing states. Even in the states where it is legalized there are restrictions on consumption, transportation and marketing.

- **Banking Challenges.** It is extremely difficult for businesses operating in this space to obtain and maintain banking relationships. National banks won't take their business, though some state banks and credit unions will accept marijuana businesses as clients so long as the credit union is satisfied that the business is operating in compliance with state law and consistent with the enforcement priorities described in the Cole Memorandum. The guidance provided by the Department of the Treasury Financial Crimes Enforcement Network to financial institutions can be viewed [here](#).
- **Higher Tax Burden.** Marijuana businesses typically cannot claim their costs of doing business as deductions for federal income tax purposes. They can claim merely the cost of goods sold. The result is the effective income tax rate of a marijuana business is significantly higher than the effective tax rate of a similarly situated business that is operating in an industry that is legal under federal law. In addition, many states impose material excise taxes on marijuana operations.
- **Obstacles to Intellectual Property Development and Enforcement.** Marijuana businesses face obstacles in developing and enforcing intellectual property (IP). For example, the U.S. Patent and Trademark Office will not issue a registered trademark for an illegal marijuana product. As a result, marijuana businesses must adopt a variety of strategies to handle their IP needs.
- **Securities Considerations.** Early-stage businesses looking for funding will often seek to source capital in a transaction exempt from state and federal securities registration. Such an exemption is likely available for a cannabis-based business, assuming compliance with applicable regulations. If an investor feels that he or she was misled in the offering, and the investor does not reside in a state in which cannabis is legal, then the investor may bring suit in a state where cannabis is legal. Even then, there are questions about how particular state courts will respond in view of the federal law.
- **Restrictions on Ownership.** Many of the states that permit cannabis businesses require equity owners of the businesses to be state residents, though it is unclear whether residency requirements would sustain a challenge under the dormant commerce clause. Further, most states also impose background checks similar to what might be expected in the context of application for a liquor license.
- **Restrictions on Bankruptcy.** Federal bankruptcy courts have declined to entertain any cases involving cannabis businesses. See *In re Aranas*, 535 B.R. 45 (BAP 10th Cir. 2015). Any business seeking to restructure will likely be forced to use the receivership statute in its home state and there are risks regarding how state judges construe the supremacy clause.



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