



## ADVISING THE CANNABIS CLIENT

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In his State of the State address, on January 8, 2020, New York State Governor, Andrew M. Cuomo vowed to work with the legislature to legalize the sale and use of recreational marijuana in New York. If Governor Cuomo follows through on his promise, New York will be the twelfth state to legalize recreational cannabis, following Colorado which was the first.<sup>1</sup> With several other states moving in the same direction and with heavy regulation existing in the states that have already legalized the substance, there is significant need and opportunity for attorneys to enter the cannabis industry. There are very good reasons for states to consider legalizing marijuana – In Colorado, alone, tax money received from the state-legal sale of retail and medical marijuana from February 2014 through December 2019 exceeded \$1.2 billion – exceeding \$300,000 in 2019.<sup>2</sup>

Nonetheless, while cannabis remains a schedule I drug under the Controlled Substances Act (“CSA”), any practitioners wishing to take advantage of such opportunities must be keenly aware of the associated risks.

### ***Brief Overview of the Current Status of Cannabis Law***

Since the enactment of the CSA in 1970, cannabis has been considered a schedule I drug, and the use, possession or distribution of cannabis remains subject to criminal penalties.<sup>3</sup> While the federal law itself hasn’t changed, the federal government’s stance on enforcement has taken many turns. In the most recent turn, Jeff Sessions, then acting as Attorney General, released a memo rescinding the Obama-era “Cole Memo” which had previously limited federal intervention in state-authorized cannabis activities. The Sessions Memo decentralized federal marijuana prosecution by giving greater flexibility to each individual prosecutor.

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<sup>1</sup> See Jeremy Berke and Sky Gould, *Legal marijuana just went on sale in Illinois. Here are all the states where cannabis is legal*, BUSINESS INSIDER (Jan. 1, 2020, 6:41 AM), <https://www.businessinsider.com/author/jeremy-berke>.

<sup>2</sup> <https://www.colorado.gov/pacific/revenue/colorado-marijuana-tax-data>. Under H.B. 2018-1070, the greater of \$40 million or 90 percent of the marijuana excise tax revenue will be credited to Colorado’s Public School Capital Construction Assistance Fund. <https://www.colorado.gov/pacific/revenue/disposition-marijuana-tax-revenue>.

<sup>3</sup> Prevention and Control Act of 1970, 21 U.S.C. §§ 801-889 (2019).

Even in the face of unfavorable federal policies, the number of states legalizing cannabis continues to grow. According to Business Insider, as of January 2020 thirty-two states have legalized medical marijuana, 11 states have legalized recreational marijuana, and several other states are expected to vote on legalization in 2020. With the states and the federal government at odds with one another, serious uncertainty looms over the cannabis industry and everyone involved in it.

So what does this uncertainty mean for attorneys wishing to enter this space and represent businesses in a state-legal but federally-illegal industry? It means that an in depth look at the rules of professional conduct and other rules is not only prudent but necessary.

### *The Professional Ethics of Advising a Cannabis Client*

While no two states' rules of professional conduct are exactly alike, almost all have a rule similar to Rule 1.2 of the ABA's Model Rules of Professional Conduct. Rule 1.2 provides in relevant part that a lawyer shall not counsel a client to engage, or assist a client, in any conduct that the lawyer knows to be criminal or fraudulent. Rule 1.2, when read in isolation, seems to preclude attorneys from assisting cannabis clients while the substance remains illegal under federal law. Recognizing the conflict, some states have started to modify their professional rules by adding official commentary, issuing binding ethics opinions, or by announcing a policy to permit counseling a cannabis client.

- For example, the Colorado Supreme Court provided comment [14] to Rule 1.2 which permits Colorado lawyers to counsel and advise clients participating in legal cannabis business operations provided that the lawyers also advise the clients of the risks under federal law.
- As of this writing, 23 of the 32 other states which have legalized some aspect of marijuana consumption have provided guidance – either in the form of an ethics opinion or a rule change – on the professional ethics of advising a cannabis client.<sup>4</sup>

As in Colorado, such guidance generally provides that attorneys may counsel or assist a client in conduct expressly permitted under the state law even where illegal under federal law, but the attorney must also advise the client about federal and other law and its potential consequences.

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<sup>4</sup> These states include Alaska, Arizona, California, Colorado, Connecticut, Hawaii, Illinois, Maine, Maryland, Minnesota, Missouri, Nevada, New Hampshire, New Jersey, New Mexico, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, Texas, Washington, and West Virginia.

Still, a startling number of states that have legalized cannabis do not provide any guidance on the ethics of advising cannabis clients. This leaves attorneys in those states where cannabis is legal searching for justification for their work with clients in an otherwise state-legal business.

With all the risks and uncertainties in mind, below are a few suggestions for any attorneys looking to represent clients involved in the cannabis industry in the near future.<sup>5</sup>

***1. Limit the scope of your engagement to specific state law.***

For example, if a client comes to you seeking your help with issues related to his Colorado-licensed dispensary, you should state in your engagement letter, in no uncertain terms, that you will provide advice on the lawful sale of cannabis only in *Colorado* (or other state where you are licensed and cannabis is legal). Failure to make this clarification could cause many issues, as “lawful sale of cannabis” may not exist under other law.

This consideration is also specifically relevant when rendering legal opinions regarding a Company’s valid existence and good standing. Under various state’s laws, including Delaware, entities may be formed for “any lawful purpose.”<sup>6</sup> While cannabis is legal under the laws of 32 states, it is *not* lawful under Delaware law, a popular jurisdiction for forming entities. Thus, using a Delaware entity for the operation of a cannabis business would likely be understood to violate the entity’s Delaware charter, and therefore, no legal opinion could be given as to the valid existence and good standing of such entity. In order to avoid pitfalls like this down the road, specific attention must be given to the state law of the organizational jurisdiction.

Moreover, even for a business formed in an appropriate organizational jurisdiction, there may still be issues regarding the enforceability of contracts and the authority of a business to operate in a manner that remains illegal under federal law. Fortunately, as stated in § 1.2(a) of the TriBar report on “*Third-Party ‘Closing’ Opinions*,” 53 *THE BUSINESS LAWYER* (ABA) 592 (1998):

An opinion on a legal issue provides the opinion recipient with the opinion giver’s professional judgment about how the highest court of the jurisdiction whose law is being addressed would appropriately resolve the issues covered by the opinion on the date of the opinion letter.

As set forth in § 4.1 of the *Statement of Opinion Practices*, 74 *THE BUSINESS LAWYER* (ABA) 801 (2019) “An opinion expresses the professional judgment of the opinion giver regarding the legal issues the opinion addresses. It is not a guarantee that a court will reach any particular result.”

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<sup>5</sup> See Daniel Shortt, *The Ethical Marijuana Lawyer*, HARRIS | BRICKEN, CANNA LAW BLOG (OCT. 3, 2019), <https://www.cannalawblog.com/the-ethical-marijuana-lawyer/>.

<sup>6</sup> See C.R.S § 7-80-103 for Colorado LLCs and § 7-103-101(1) for Colorado corporations. See also DGL § 8-101 for Delaware corporations and § 18-106 for Delaware LLCs.

For example, when offering an opinion letter under Colorado law about a Colorado entity involved in the cannabis business, one can reasonably expect the Colorado Supreme Court to conclude that it is a lawful business activity. Based on that, a due authorization and enforceability of contract opinion would likely be given by the Colorado Supreme Court.

Federal courts in the relevant state may disagree, but that is not the point of an opinion addressing a specific state's laws. For the sake of clarity and to ensure that an opinion does not overstep or mislead, however, the opinion should contain a reference to the issues that may arise under federal law.

***2. Make sure the client fully understands (1) that cannabis is illegal under federal law and (2) all the related consequences.***

In a perfect world all clients seeking to enter this industry would have done their research and know all about the status of cannabis law. Unfortunately, in reality many may not fully grasp the law or the consequences at issue. We suggest conveying this information to the client as early as possible by including a disclaimer in your engagement letter that provides "acts of possessing, using, distributing and selling cannabis are federal crimes and punishable as such."

An attorney should expand this disclosure where the cannabis client is seeking to raise capital in private placements. Risk factors to consider include not only the normal business risk factors, but also risk factors relating to the status of cannabis under federal law, the risk posed by other states where cannabis is not legal, the existing banking issues because many banks will not handle funds derived from cannabis, and other issues unique to the cannabis industry.

Additionally, cannabis clients and their counsel should be aware that any person engaged in the business of effecting transactions in securities for the benefit of others is likely considered a broker-dealer and is subject to strict federal and state registration and licensing requirements. This includes any individual who helps find investors for businesses. There are many people out there who will happily charge a fee to help cannabis businesses raise money in violation of state and federal broker-dealer registration and licensing requirements, and as such, cannabis clients and their counsel should rigorously research any person who claims they can assist in raising funds for the company.

***3. Know your client before taking the risk.***

Before agreeing to assist a client in a potentially risky area of law, make sure you really know the client. Ask yourself, "is this client worth the risks I am taking or is this client trying to use the legal system to commit improper acts?" Be very wary of the unworthy client, for the unworthy client is a significant risk to us all.

**4. Be prepared for surprises.**

**Federal Tax Law Must Be Considered.** Notwithstanding its illegality under federal law, businesses engaged in cannabis are subject to other federal laws, including federal tax law. Section 280G of the Internal Revenue Code, however, eliminates many deductions for businesses engaged in cannabis resulting in taxation of 80 percent or more of the business' revenues.

**Federal Employment Law Is Relevant.** Also, in a recent ruling, the Tenth Circuit Court of Appeals held that, even though cannabis is illegal under federal law, the federal Fair Labor Standards Act applies to businesses engaged in cannabis operations. In *Kenney v. Helix TCS, Inc.*, 939 F.3d 1106 (10<sup>th</sup> Cir. 2019), a security guard for a cannabis business sued alleging that the business had misclassified him as being exempt from the FLSA's overtime requirements. The 10<sup>th</sup> Circuit found the FLSA applicable – and other courts will likely find other federal employment laws applicable to cannabis businesses.

**Be Cautious In Advice About Capital Raising.** When advising cannabis clients about raising capital, attorneys must be cognizant that, at the present time, a cannabis business is not like any other business. Many state laws identify who can be an owner of a cannabis business – in some cases limiting ownership to in-state residents and requiring regulatory approval where ownership exceeds certain levels. Where there are out-of-state investors (through equity or debt), the investor must be warned about the possible scrutiny that may be given by the investor's home state – especially where cannabis remains illegal in that home state. Federal and state securities regulatory authorities are paying closer attention to cannabis businesses seeking to comply with the securities laws (as they must). This scrutiny includes compliance with federal and state:

- Securities registration requirements (including the availability of an exemption from registration and the qualification of the investors);
- Broker-dealer and investment advisor registration and licensing requirements, and the licensing requirements for their representatives.

Given the current state of the law, capital formation activities should only be directed toward specialized venture capital companies and accredited investors, and the payment of commissions or finders fees should be avoided. Attorneys advising cannabis businesses in capital-raising activities must not only pay attention to federal and state securities requirements, but also to the enhanced scrutiny from the cannabis enforcement regulators.

**It Is A Cash Business.** Because marijuana remains a controlled substance under federal law, Colorado's dispensaries, cultivation facilities, and other businesses have been prohibited from obtaining conventional financial services, such as lines of credits or loans, and the ability to accept

credit cards. Burglary is the most common crime at marijuana dispensaries and cultivation facilities. Experts say this is the case because they are forced to deal in cash.<sup>7</sup>

Federally, the Secure and Fair Enforcement (SAFE) Banking Act aims to open up those opportunities for legal businesses in states where medical and recreational marijuana is available.<sup>8</sup> The SAFE Banking Act passed the House of Representatives in September 2019 and is currently being discussed by a Senate committee.

In the meantime and with the encouragement of Colorado Governor Jared Polis, the Colorado General Assembly is addressing the issue. Currently, few state-chartered financial institutions work with the Colorado marijuana businesses – likely do to the significant federal regulations in place. Governor Polis hopes to increase the number of state-chartered institutions who are willing to work with marijuana businesses by identifying the hurdles that discourage state-chartered institutions from entering this facet of the industry, providing guidance to the state-chartered institutions on how to deal with the regulations in place – such as reporting suspicious activity, and developing innovative policies to encourage state-chartered financial institutions to participate in the marijuana business sector.<sup>9</sup>

### ***Conclusion***

Needless to say, the discrepancies between state and federal law need to be resolved. Until then, however, a good understanding of your client, your client's business, and your state's professional code of conduct, and the statutes and regulations surrounding the cannabis business is essential for all attorneys when advising clients in, or who want to become involved in, the cannabis industry.

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<sup>7</sup> *Colorado unveils plan to help bring banking to state's cannabis industry*, The Denver Post, February 3, 2020, <https://www.denverpost.com/2020/02/03/colorado-cannabis-industry-banking/>.

<sup>8</sup> *Perlmutter, House co-sponsors push Senate for swift action on marijuana banking bill*, The Denver Post, January 23, 2020, <https://www.denverpost.com/2020/01/22/safe-banking-act-representatives-letter/>.

<sup>9</sup> *Colorado unveils plan to help bring banking to state's cannabis industry*, The Denver Post, February 3, 2020, <https://www.denverpost.com/2020/02/03/colorado-cannabis-industry-banking/>.