Counseling a Cannabis-Related Business

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The cannabis industry is intriguing and rapidly evolving. With more states and countries legalizing cannabis in varying forms, this industry will continue to expand. Many companies are moving into the cannabis business or expanding already existing businesses to meet the needs of the growing cannabis industry. For example, companies are:

- Harvesting hemp for use in health products, clothing, and numerous sustainable commercial uses
- Extracting cannabidiol (CBD), cannabinol (CBN), and cannabigerol (CBG), and studying lesser known and new cannabinoids to uncover potential new wellness benefits
- Cultivating different strains of marijuana containing tetrahydrocannabinol (THC) to make edible, vaping, and smoking products for medical or adult recreational use

There are also a multitude of ancillary cannabis-related companies, many of which need an infusion of capital from willing investors. The business opportunities in the cannabis world are vast.

However, cannabis remains an illegal drug at the federal level, presenting numerous challenges for cannabis-related companies and their counsel. This article examines the principal legal issues that practitioners must consider when counseling a cannabis-related business, including:

- Federal regulation of cannabis
- State regulation of cannabis
- Conflicts between federal and state laws in the areas of banking, tax, employment, and bankruptcy
- Challenges in the areas of real estate, intellectual property, dispute resolution, and business structuring
- Divergent state and local laws

HMB LEGAL COUNSEL

FEDERAL REGULATION OF CANNABIS

In 1937, the Marihuana Tax Act made cannabis illegal in the United States. In 1970, Congress enacted the Controlled Substances Act (CSA) (21 U.S.C. § 801), under which cannabis was codified as an illegal substance at the highest level, namely, a Schedule I drug under the CSA. Schedule I drugs are defined as those with no currently accepted medical use and a high potential for abuse.

After years of wrangling with prohibition, states slowly began to enact their own laws allowing for the growth, sale, and use of marijuana for medical purposes. The first major step toward broader change came in 2013, when US Deputy Attorney General James Cole issued a memorandum (Cole memo) stating that the Department of Justice (DOJ) did not intend to seek prosecution against any person or company that remained in compliance with existing state cannabis laws. At that time, no fewer than 17 states had laws that legalized some form of cannabis. The Cole memo further identified the eight most important areas where the DOJ intended to focus its prosecution:

- The distribution of marijuana to minors
- The funding of criminal enterprises
- The interstate transportation of marijuana
- Growing marijuana on public property
- The possession of marijuana on federal property
- Using marijuana activity as a cover for trafficking other illegal drugs
- The use of firearms with marijuana cultivation
- Drugged driving

The Cole memo was rescinded in January 2018. However, Attorney General Merrick Garland stated in his March 1, 2023 testimony before the US Senate Judiciary Committee that the DOJ's forthcoming cannabis policy will be "very close to what was done in the Cole memorandum" (C-SPAN: Attorney General Merrick Garland, Testimony Before the US Senate Judiciary Comm. (Mar. 1, 2023)).

In 2014, Congress approved the Rohrabacher-Farr budget amendment, which prohibited the use of DOJ funds to interfere with state medical cannabis laws. This budget amendment was another significant step toward legalization. It has been passed in some form every year since then. The budget amendment has not, however, prevented the DOJ from prosecuting individuals who used their state medical cannabis license as a façade to engage in "blatantly illegitimate activity" (*United States v. Bilodeau*, 24 F.4th 705, 714 (1st Cir. 2022)).

Another sign of movement toward full cannabis acceptance is the Agriculture Improvement Act of 2018 (Pub. L. 115-334) (Farm Bill), which made hemp federally legal (for more information, see Hemp and the 2018 Farm Bill: Overview on Practical Law). Every legislative session since the Farm Bill has contained renewed discussion and debate over some level of cannabis legalization, beyond hemp, at the federal level.

Similarly, there has been ongoing debate over the Secure and Fair Enforcement Banking Act (SAFE Banking Act), which is proposed legislation that would provide much needed relief to cannabis-related businesses by making banking easier and more accessible. The SAFE Banking Act passed in the US House of Representatives several times but did not pass in the Senate. The most recent version of the bill was introduced in April 2023 by a group of bipartisan lawmakers (S. 1323 and H.R. 2891). Although the SAFE Banking Act would be a small step toward full federal legalization of cannabis, most challenges to the industry discussed in this article would remain.

STATE REGULATION OF CANNABIS

States are continuing to legalize cannabis in varying degrees and methods. For example, some states:

- Have legalized marijuana for medical use only, yet other states permit both medical and adult recreational use
- Have created a regulatory scheme for CBD products and federally legalized hemp
- Only allow for the limited use of products containing lower levels of THC, while other states allow:
    - The possession of small amounts of marijuana; or
    - The growing and possession of marijuana, but prohibit or limit the selling of it
- Have legalized the cultivation, processing, and sale of cannabis for both medical and adult recreational use, but all with different regulatory frameworks

State cannabis laws vary dramatically and are continuously evolving. Counsel must stay informed on these differing laws and jurisdictions. (For more on state marijuana laws, see Medical and Recreational Marijuana State and Local Laws Chart: Overview on Practical Law.)

Any cannabis-related business operating in the current climate must ensure full compliance with state and local laws. Every state's law regarding cannabis is different. For each new state law that in some form lifts a ban on cannabis, new regulations must be drafted and implemented for both medical and adult recreational use to execute the new law. These regulations may include:

- Licensing and inspection of cultivation and processing facilities
- Licensing for retail sales
- Limitations for possession and use
- Seed-to-sale tracking systems for thorough oversight
- A framework for cannabis delivery, consumption lounges, and other commercial applications

- Collection of sales and other taxes
- Penalties for illegal conduct

With differing and changing state laws in the face of ongoing federal illegality, the margin for error is small. However, the opportunities are plentiful for diligent participants to help the industry progress. Effective legal counsel in the cannabis industry is crucial.

CONFLICT BETWEEN FEDERAL AND STATE LAWS

A primary challenge when counseling any cannabis-related business is the ongoing tension between a particular state's law, where cannabis is legal in some form, and federal law, under which cannabis remains a Schedule I illegal drug. The conflict between federal and state laws is likely to remain a high hurdle for cannabis-related businesses to overcome until either:

- Cannabis is de-scheduled from the CSA
- A new federal law is enacted that unequivocally defers to individual state laws and protects state-compliant businesses

Cannabis-related businesses of all kinds are faced with various concerns, and some are forced to test the legal waters for clarity. The current unknown legal scenarios are numerous. Some state courts have even determined that federal law preempts state medical marijuana laws. Navigating the new roads being paved in this industry is challenging for cannabis-related businesses and their counsel.

Counsel should monitor the status of pending federal bills regarding cannabis, including proposals that:

- Provide deference to state cannabis laws
- Allow financial institutions to do business with cannabis-related businesses without fear of criminal prosecution in states where cannabis is legal
- Prohibit the DOJ from interacting with a cannabis-related business if the business is in compliance with state law
- Institute some form of permissible interstate commerce between legalized states

These changes, if enacted into law, would remove many legal hurdles for cannabis-related businesses, even without a full de-scheduling of cannabis from the CSA.

BANKING ISSUES

Banking is likely the most difficult current issue emanating from the conflict between federal and state cannabis laws. Financial institutions are hesitant to open accounts and provide financial services to customers who conduct business that is illegal under federal law. As a result, companies operating a cannabis-related business face the initial struggle of finding a depository institution and the ongoing challenge of obtaining capital and debt financing.

Additionally, they face immediate and continuing issues with the handling of cash, most notably regarding paying employees, taxes, vendors, and other third parties.

Banks Are Hesitant To Do Business with Cannabis-Related Businesses

Financial institutions have mostly avoided the federally illegal cannabis industry to date for various reasons, including that:

- There is no complete assurance of protection from the federal government due to the federally illegal nature of the product, which creates ongoing potential legal exposure
- Servicing cannabis-related businesses requires significantly more administration and oversight for compliance with anti-money laundering regulations and the Bank Secrecy Act (BSA), including the required filing of Suspicious Activity Reports (SARs) for disclosure of every cannabis-related transaction

The purpose of SARs is to assist federal investigators in identifying and stopping criminal enterprises. Under the Financial Crimes Enforcement Network (FinCEN) rules, a bank must file one of three types of SARs for each cannabis-related transaction occurring at that bank. SARs reporting is required even where operations are legal in the state. SARs not only create more scrutiny by federal regulators but also significantly increase the costs for financial institutions to maintain the required due diligence and administrative burdens. These costs are most likely passed along to the bank's cannabis company customer. (For more on SARs filing requirements, see Suspicious Activity Reporting Requirements for Financial Institutions on Practical Law.)

For any financial institution undertaking the challenge of the cannabis industry, avoiding violations and the resulting penalties requires diligent focus on:

- Understanding the customer's business, including the customer's affiliates, licensing arrangements, and know-your-customer compliance (for more information, see USA PATRIOT ACT and Know Your Customer Requirements for Lenders on Practical Law)
- The completion of significantly more documentation for regulatory reporting
- Ongoing audit activity
- Compliance with the priorities listed in the Cole memo
- A review of internal policies and compliance procedures
- The hiring, training, and oversight of additional employees dedicated to cannabis-related businesses

Even a company ancillary to the cannabis industry may find that its banking relationships are hindered due to it transacting directly with a cannabis business. This depends on the bank's concerns with potential money laundering and BSA implications.

A cannabis-related business that operates completely in cash must decide, if the opportunity arises, whether to begin using a financial institution. This presents various concerns, including:

- Complete transparency of the business and all individuals involved
- Increased costs, passed down from banks, for increased compliance expenses

State-Chartered Banks and Credit Unions

Some state-chartered banks and credit unions have decided to service cannabis-related businesses. They rely on ongoing "assurance" from FinCEN and recent attorney general statements that a bank's full compliance with the BSA regulations serves as protection. Additionally, FinCEN guidance issued in 2014 supports banking for cannabis-related businesses. However, the FinCEN guidance includes extremely strict due diligence and reporting obligations to the government. Accordingly, most banks still consider the obligations too onerous and the risk too great.

All-Cash Businesses

For many current cannabis-related businesses, the only real option is an all-cash business. This unusual operational quagmire results in additional concerns unlike almost every other business, such as:

- **The need for additional security measures.** The current all-cash nature of cannabis-related businesses presents a scenario ripe for robbery. Daily cash payments from customers require on-site vaults and safes and significant full-time security of the premises
- **Cash transportation concerns.** Moving money off the premises requires additional security measures
- **Logistical issues with paying employees, taxes, vendors, and other third parties.** Paying employees and vendors in cash requires special measures for safety and recordkeeping. Even payment of taxes requires special efforts between the business and the tax collector

Addressing these additional concerns always results in greater expense for cannabis-related businesses.

Need for Capital

Whether a cannabis-related business is a start-up company (which is common in this industry) or a healthy business with a history of operations, the need for business funding is ever present. Therefore, the lack of traditional banking options is a major challenge for all cannabis-related businesses. Most options for capital are through private funding and non-traditional lending scenarios. The lack of traditional banking makes capital harder to locate and significantly more expensive than through a traditional lending relationship with a bank.

Practitioner Tips

To address banking challenges, counsel for a cannabis-related business should:

- Determine whether the client is interested in working with a bank, after analyzing the pros and cons
- Search throughout the state and neighboring states for banks or credit unions that are already working with cannabis-related businesses and start a discussion

Counsel providing legal services to a financial institution doing business with a cannabis-related business should understand the bank's concerns and identify the additional obligations that the bank has when working with the cannabis-related business.

TAX ISSUES

Cannabis-related businesses have unique challenges arising from conflicting federal and state tax laws.

Business Expense Deductions

Under the Internal Revenue Code (Code), a business is entitled to deduct ordinary and necessary business expenses for carrying on its trade or business in calculating taxable gross income (26 U.S.C. § 162). Maximizing business expense deductions is a common tax strategy.

Regardless of the industry, a company can decrease its overall federal tax liability by deducting numerous allowable business expenses, including employee compensation, rent, business interest, marketing and advertising, insurance, utilities, and other taxes. However, these deductions are not available for cannabis businesses. Under Section 280E of the Code, business expense deductions are prohibited for any trade or business that involves "trafficking in controlled substances" (26 U.S.C. § 280E). In light of the current designation of cannabis as a controlled substance under Schedule I of the CSA, cannabis businesses are included in this prohibition. Therefore, these businesses must pay taxes on all of their revenue without the benefit of deducting business expenses, other than the narrowly defined "cost of goods sold" (COGS), to reduce their taxable income (see *COGS* below).

Some cannabis companies have argued to the IRS that they should at least be allowed to deduct business expenses incurred for separate lines of business not directly related to the sale of cannabis. The IRS and various reviewing courts have consistently held that if any part of the business relates to cannabis, then Section 280E prohibits all business expense deductions, even if the trade or business also engages in other activities. Because of Section 280E, the federal tax liability for cannabis businesses is significantly higher than for other companies. The effective income tax rates for cannabis businesses can easily reach 70 to 90 percent, making it difficult for them to stay in business. To address this challenge, states with cannabis legalization are increasingly enacting laws to "de-couple" from the federal Section 280E prohibition and allow cannabis businesses to deduct business expenses for state tax purposes.

COGS

Cannabis businesses are able to take a credit for COGS, which can potentially include these important expenses:

- The cost of the product
- Storage
- Direct labor

For example, a COGS credit allows a marijuana seller or dispensary to deduct the purchase price of its inventory, which is the wholesale cost of the product. The COGS credit is most helpful as a tax deduction for cannabis cultivating facilities. These facilities can realize more benefit than most other cannabis-related businesses, because they can deduct costs for growing the product, such as:

- Electricity
- Labor
- Fertilizer
- Water

Practitioner Tips

Cannabis-related businesses and their counsel can seek to address tax-related challenges by taking steps to:

- **Minimize non-COGS expenses wherever possible.** Minimizing operating costs is essential. For example, a smaller retail space should help reduce monthly rent or mortgage payments, require fewer employees, and generate smaller utility bills
- **Separate any non-cannabis aspect of the business into a different entity.** Apportioning non-COGS expenses to a non-cannabis entity, to the extent possible, can potentially result in some tax savings. For example, a cannabis business may, if reasonable:
    - Assign part of its space to the separate line of business; or
    - Apportion part of its employee time and cost to the separate line of business
- **Keep thorough and accurate records.** Cannabis businesses should expect to be audited. The IRS has dedicated employees for Section 280E analysis and will request detailed records
- **Engage a certified public accountant (CPA) experienced with Section 280E and cannabis-related businesses early on.** A CPA can help a cannabis-related business handle its unique tax-related challenges before, during, and after any audit

EMPLOYMENT ISSUES

Workplace protections and related employment issues are directly affected by:

- The changing laws in each state regarding cannabis
- Inconsistent federal and state cannabis laws
- The changing interpretations of cannabis laws

These employment issues concern not only cannabis-related businesses but all employers in any state with statutes allowing some form of legal cannabis. For example, some courts have taken the position that off-site use of medical cannabis may be a reasonable accommodation under state law. The vast majority of states do not require accommodations for medical use, even where the medical use is legal. No state requires employee accommodations for adult recreational use, even where this use has been otherwise legalized.

Employment-Related Issues in States Allowing Medical Marijuana

The majority of states allow medical marijuana use. However, the medical conditions that qualify for this cannabis use can differ. For example, more restrictive jurisdictions such as Iowa only allow the use of CBD to treat a debilitating medical condition defined by statute (Iowa Code Ann. § 124E.2). On the other end of the spectrum, California permits the use of medical cannabis for any condition approved by a physician. Although California offers an identification card, all that is required for medical cannabis access is a written recommendation from a physician (Cal. Health & Safety Code § 11362.7(f) (defining "qualified patient")).

In states where conditions are specifically articulated and a patient qualifies under one of the identified conditions in the statute, generally both:

- A medical practitioner must provide that patient with a certification in some established form
- The patient must register with the state to become a legal medical marijuana cardholder

State Employment Protections for Medical Marijuana Cardholders

Some states have enacted a medical marijuana law that protects employees who are registered medical marijuana cardholders (employee-cardholders). Many state statutes regarding medical cannabis specifically address whether the law affects an employer's treatment of an employee-cardholder. For example, Arizona's and Illinois' medical marijuana laws contain language specifically prohibiting discrimination against employee-cardholders.

However, state medical marijuana laws that protect employee-cardholders typically contain exceptions for the employer's benefit, such as:

- Required drug testing for specific jobs under federal law (for example, the US Department of Transportation requires drug and alcohol screening for commercial vehicle drivers)
- Limited protection of employee-cardholders where non-discrimination against them may cause the employer to lose either a monetary or licensing-related benefit under federal law
- Limitations for on-the-job use, possession, or impairment so that employers can control activity in the workplace and during work hours. (However, some of these state laws also prescribe that the existence of marijuana in an employee's drug test, within limits, cannot alone be a basis for establishing on-the-job use or impairment during work hours)

Some states, such as Alabama and Ohio, expressly allow employers to provide no additional workplace protections for medical marijuana users, whether in hiring or continued employment. Employee-cardholders in these states do not have employment protections under the medical marijuana law even if they are following state law and limit their use to off-duty hours. (For more on state medical marijuana laws, see Medical and Recreational Marijuana State and Local Laws Chart: Overview on Practical Law.)

Workers' Compensation

Even in cases with very similar fact patterns, state courts have arrived at different conclusions regarding the obligation of an employer to reimburse its employees for the costs of medical marijuana treatment. For example:

- Some states, such as New Jersey, have concluded that employers have an obligation to reimburse their employees for medical marijuana under workers' compensation laws (see *Hager v. M & K Constr.*, 225 A.3d 137, 149-50 (N.J. Super. Ct. App. Div. 2020), *aff'd*, 246 N.J. 1 (2021))
- Other states, such as Maine, have determined that the conflict between the state workers' compensation law and the CSA precludes obligating an employer to pay its employees for medical marijuana (see *Bourgoin v. Twin Rivers Paper Co.*, 187 A.3d 10, 22 (Me. 2018))

Because of the largely analogous fact patterns among these cases, it is difficult to distinguish the legal conclusions. The expectation is that states will continue to disagree and render disparate rulings as long as the CSA continues to identify cannabis as federally illegal.

Practitioner Tips

Courts are increasingly issuing decisions interpreting the various state laws on workplace protections and related employment issues. Employers should carefully review all applicable state laws and interpretive case law when drafting drug-testing and substance-abuse policies.

Businesses that already have drug policies in place should review these policies for potentially necessary revisions based on changing state cannabis laws and court interpretations. While employers may not be required to accommodate on-the-job use, making reasonable accommodations for registered medical users in appropriate jurisdictions is a sound approach that would likely withstand judicial scrutiny. Further, tailored policies for employee-cardholders would decrease litigation risk more than blanket policies excluding marijuana users from employment.

BANKRUPTCY ISSUES

Cannabis-related businesses do not have access to the protections of the Bankruptcy Code because it is a federal statute. Despite the DOJ's current practice of non-prosecution, cannabis-related businesses are prohibited from obtaining bankruptcy protection until cannabis is de-scheduled from the CSA, because:

- A reorganization plan that permits or requires illegal activity (such as a violation of the CSA) cannot be confirmed (11 U.S.C. § 1129(a)(3))
- A bankruptcy trustee, as a fiduciary of the bankruptcy estate, cannot administer estate assets without violating the CSA

Potential Bankruptcy Reform

Although cannabis debtors cannot generally benefit from Bankruptcy Code protections, hope for reform may lie with the judicial branch. For example:

- The Ninth Circuit allowed a downstream cannabis business to reorganize through a Chapter 11 proceeding (even though it acknowledged that section 1129(a)(3) of the Bankruptcy Code forbids confirmation of a plan proposed in an unlawful manner) on the basis that section 1129(a)(3) does not forbid confirmation of a plan that has substantive provisions that depend on illegality (*Garvin v. Cook Invs. NW, SPNWY, LLC,* 922 F.3d 1031, 1035-36 (9th Cir. 2019))
- A bankruptcy court in California denied a Chapter 11 trustee's motion to dismiss where the petitioner, a wholesale manufacturer and packager of cannabis, stopped operations and transferred its value to a Canadian cannabis company before filing its petition, because there was no ongoing violation of the CSA (*In re Hacienda Co.,* 647 B.R. 748, 752 (Bankr. C.D. Cal. 2023)). The *Hacienda* decision could be a turning point for struggling cannabis companies, at least those that stop operations pre-petition, and may signal a greater tolerance for bankruptcy petitions filed by cannabis companies

While the bankruptcy courts are a place to monitor for cannabis-related businesses, there is little question that they have shown significantly more latitude for legal hemp companies. Following the 2018 Farm Bill, most hemp businesses do not face the same federal legality challenges that cannabis businesses continue to face under the Bankruptcy Code.

Non-Bankruptcy Alternatives

Failing cannabis companies can take advantage of non-bankruptcy alternatives, which include state-sanctioned assignments for the benefit of creditors or receiverships (for more information, see Assignments for the Benefit of Creditors: Overview and Corporate Receiverships: Overview on Practical Law). A liquidation of assets or a complete sale of the business can occur under these scenarios but without official bankruptcy protection. These non-bankruptcy alternatives help with creditor concerns and are typically a preferable process to an unstructured winding down of a company (which may leave creditors angry and in pursuit of business owners to personally satisfy any outstanding debts).

However, these non-bankruptcy alternatives lack certain benefits that are available in bankruptcy. Under the Bankruptcy Code, the debtor or trustee:

- Has the opportunity to object to certain creditors' claims (for more information, see Objections to Claims: Overview on Practical Law)
- Can avoid payments that the debtor made to third parties during the 90 days before the bankruptcy filing and further back (one year) if the payment was to a company insider (for more information, see Preferential Transfers: Overview and Strategies for Lenders and Other Creditors on Practical Law)

Cannabis companies also cannot benefit from:

- The automatic stay, which immediately stops substantially all litigation against the debtor on the filing of a bankruptcy petition, and both:
    - Gives the struggling debtor breathing room from its creditors' pursuit of payment; and
    - Is helpful to a judge or trustee gathering and evaluating a debtor's assets and liabilities (for more information, see Automatic Stay: Overview on Practical Law)
- The ability to reject burdensome executory contracts and unexpired leases and, thereby, curb ongoing contractual damages (for more information, see Executory Contracts and Leases: Overview on Practical Law)
- A bankruptcy judge and bankruptcy court rules for controlling the entire process (for more information, see State-Legalized Marijuana Businesses and Access to the Bankruptcy Code on Practical Law)

Finally, state court receiverships, while potentially the best option, pose their own challenges, including:

- Finding a receiver who is familiar with the complex cannabis regulatory framework in the relevant state

- The potential state requirement for the receiver to register with the regulatory agency to proceed
- Different state limitations on transfer or liquidation of the cannabis business assets

ADDITIONAL CHALLENGES

Cannabis-related businesses face specific challenges in the areas of real estate, intellectual property, dispute resolution, and business structuring.

Real Estate Issues

Some states, such as Arizona, Illinois, and Oklahoma, expressly prohibit landlords from discriminating against tenants for the legal use of cannabis. However, federal law prohibits knowingly opening, leasing, renting, using, or maintaining any place to permanently or temporarily manufacture, distribute, or use any controlled substance (21 U.S.C. § 856(a)(1)). Despite the DOJ's policy of non-prosecution, property owners considering leasing property to an entity engaged in a cannabis-related activity should still conduct due diligence before entering into a lease to determine whether the lease violates any state or local laws or other contractual restrictions, including:

- Zoning restrictions
- Deed covenants
- Mortgage provisions
- Financing terms

There are risks when a landlord leases its property to a tenant that sells or cultivates cannabis, including that the landlord may:

- Lose its property and the rent paid by the cannabis tenant because of forfeiture (if the federal government prosecutes the landlord for leasing its property to a tenant that sells or cultivates cannabis)
- Lose its property insurance coverage for leasing to a cannabis tenant
- Face security and financial complications due to cash payments of rent
- Be in default under its property loan documents for violating requirements in those documents to comply with applicable laws and other provisions
- Have trouble securing a purchaser of the property because of purchasers' reluctance to acquire property with a cannabis tenant
- Encounter environmental issues with the storage and disposal of cannabis and cannabis-related products
- Find that licensing a cannabis business for operation at the landlord's property is costly and time consuming

- Be in violation of private land use covenants, conditions, or restrictions
- Be unable to refinance a loan on the property

Tenants must also protect themselves against these risks. A cannabis business tenant should:

- Negotiate for a lease termination right that is triggered if the state or municipality where the property is located illegalizes the production or sale of cannabis
- Request a subordination non-disturbance and attornment (SNDA) provision in its lease to confirm that any landlord lender is aware of the cannabis business and to protect against eviction in the event the landlord defaults on its loan for any reason
- Restrict the landlord's access to sensitive areas of the premises in which cannabis is stored

Intellectual Property

Currently, US intellectual property law affecting a cannabis-related business differs depending on whether the business is seeking:

- **A trademark.** Cannabis-related businesses are not allowed to obtain a federal trademark from the US Patent and Trademark Office for goods or services that are unlawful under the CSA. Many companies are still filing trademark applications for lawful, ancillary goods and services, for example, website informational services in the cannabis field. Some are also filing applications for goods or services that violate the CSA in the hope that the law changes while their applications are pending. (The challenges to federal trademarks have been lifted for legal hemp businesses since the enactment of the 2018 Farm Bill, which de-scheduled hemp from the CSA.) (For more information, see Trademark Registration in the Cannabis Industry on Practical Law)
- **A patent.** Cannabis-related businesses are able to obtain patents, regardless of the CSA scheduling of cannabis, because there is no requirement that the underlying use be in "lawful commerce" as there is for a federal trademark. (It is still unknown how and whether federal courts may interpret applicable laws when patents are challenged or otherwise litigated while cannabis remains an illegal substance under the CSA.) Available patents include:
    - Utility patents for new formulations or use techniques (currently the most popular patent type);
    - Design patents for product design; and
    - Plant patents for specific types of marijuana plants reproduced from a specific parent (currently few of these exist)
- **Copyright protection.** Copyright protection is available from the US Copyright Office even while cannabis is illegal under the CSA. A cannabis-related business

may register its works for which it seeks copyright protection, such as brochures, artwork, and videos. To obtain a copyright, the work must be:

- Original and creative;
- Fixed in some tangible form of expression; and
- For more than just a passing duration

Unlike other forms of intellectual property, copyright protection does not necessarily require registration. However, registration for a copyright is beneficial because it provides the cannabis-related business with a basis for:

- An infringement claim
- Proof of ownership
- Statutory damages

(For more on patents, trademarks and copyrights, see Intellectual Property: Overview on Practical Law.)

Dispute Resolution

Uncertainty surrounding whether and how federal courts may address disputes involving cannabis-related businesses and cannabis issues will remain while cannabis is an illegal substance under the CSA. When counseling a cannabis-related business regarding dispute resolution, counsel should be aware of the jurisdictional options for hearing the dispute, including:

- Diversity or federal question jurisdiction for federal court
- State court
- Arbitration

When drafting and negotiating written agreements for a cannabis-related business, counsel should consider the potential for dispute resolution, including whether to include:

- A venue provision in the agreement, so that disputes are resolved exclusively in a particular jurisdiction where:
  - Cannabis is legal; and
  - The federal court has previously agreed to hear cannabis-related disputes
- A choice of law provision so that a particular state's law is followed, even if the dispute is heard in a different jurisdiction
- A designation of the state court as the exclusive forum with a waiver of the right of removal to federal court

- An arbitration provision to:
    - Avoid potential illegality defenses raised in court; and
    - Reduce costs

(For more on dispute resolution considerations, see Choice of Law and Choice of Forum: Key Issues and Arbitration vs. Litigation in the US on Practical Law.)

Because transactions concerning cannabis are illegal under the CSA, there remains a risk that courts will not enforce the parties' rights and obligations on the basis that they violate public policy. By contrast, most arbitral tribunals, applying the separability doctrine, will not decline to hear a case even where the underlying agreement may be illegal or invalid. Courts generally enforce arbitration agreements and awards despite assertions that to do so would be against public policy (for more information, see Challenges to Arbitral Awards in the US Based on Public Policy Violations on Practical Law). Parties should choose an arbitral seat in a state where transactions in cannabis are legal (for more information, see Choosing an Arbitral Seat in the US on Practical Law).

(For more on factors parties should consider when drafting an arbitration agreement, see Drafting Arbitration Agreements Calling for Arbitration in the US on Practical Law; for a model contract clause that requires parties to resolve their disputes by alternative dispute resolution, with explanatory notes and drafting tips, see General Contract Clauses: Alternative Dispute Resolution (Multi-Tiered) on Practical Law.)

Business Structuring

When forming any business, the first step is to decide on a strategic business structure. Using an entity to operate a business is desirable because, as a general rule, the equity owners of an entity are not personally liable for the entity's liabilities.

Similar to other industries, the most commonly used entity types for cannabis-related businesses are:

- A corporation, whether a C-corporation or an S-corporation (for more information, see Forming and Organizing a Corporation on Practical Law)
- A limited liability company (LLC) (for more information, see Forming an LLC Checklist on Practical Law)

Particular state cannabis law requirements, however, may drive or even dictate the decision to use another entity type, such as a non-profit or cooperative entity. (For more on the various structure, liability, tax, and management differences among C-corporations, S-corporations, LLCs, and partnerships formed in Delaware, see Choosing an Entity Comparison Chart (DE) on Practical Law.)

The analysis to determine in which jurisdiction to form a cannabis-related business generally focuses on the same considerations as those for other types of businesses, including whether a particular state:

- Is more cannabis-friendly for licensing purposes

- Has corporate statutes that tend to favor majority owners over minority owners (such as Delaware)
- Tends to favor consumer rights over corporate privacy (such as California)

Each of these considerations varies based on the specific nature of the cannabis-related business and the practical goals of the enterprise.

C-Corporation, S-Corporation, or LLC

A C-corporation is generally chosen as the entity structure if a business intends to raise funds from outside investors. Given the current difficulty of obtaining financing from banks and other traditional financial institutions, cannabis-related businesses tend to obtain capital directly from investors in exchange for equity interests in the company. Additionally, a C-corporation is a favored investment vehicle because this type of entity:

- **Can issue different classes of stock to its investors.** For example, a C-corporation can create a class of preferred stock that affords an investor attractive premiums or preferential distributions. An S-corporation, on the other hand, only allows for one class of stock
- **Can grant qualified stock options to employees.** A C-corporation can use qualified stock options as an important recruiting and retention mechanism for key employees. Similarly, an LLC can issue profits interests or non-qualified options (to acquire a membership interest) to its employees
- **Is more suitable for a potential initial public offering (IPO).** An IPO allows investors to become shareholders by purchasing stock in the C-corporation, allowing the company to amass significant capital. Contrarily, except in certain industries (such as energy), an LLC is not publicly traded and often must be converted to a corporation before an IPO. Currently, cannabis-related companies cannot be publicly traded in the US
- **Protects its shareholders from personal liability relating to the company's federal income tax.** This is an important difference when deciding between a C-corporation and either an S-corporation or LLC. For S-corporations and LLCs, the tax liability flows through to the equity owners

The primary disadvantage in choosing a C-corporation over either an S-corporation or an LLC is the double taxation of C-corporations. The income of a C-corporation is taxed both:

- **At the entity level.** A C-corporation must pay corporate income tax
- **At the shareholder level.** Shareholders must pay individual income tax on corporate income distributed by dividends

Double taxation can be enough to prevent a business from choosing to operate as a C-corporation. However, the reduction in the corporate tax rate from 35% to 21% under the Tax Cuts and Jobs Act (TCJA) has tempered this deterrent. Since the TCJA's 2017

enactment, it may be more advantageous in some cases to operate as a C-corporation, even with double taxation. The determination hinges on a variety of factors, including the projected combined entity and individual tax rates on business operations as well as other non-tax factors. (For more on the tax treatment of US business operations organized by a group of individuals in corporate versus partnership form, see C-Corporation and Partnership Tax Comparison Chart on Practical Law.)

Other disadvantages of C-corporations include the formal requirements to create and maintain a C-corporation, such as:

- Adopting bylaws
- Properly identifying officers and directors
- Maintaining detailed books and records
- Holding an annual shareholder meeting and board meetings

These corporate formalities are costly, especially compared to LLCs, which are not subject to these requirements.

The advantages of an LLC over a C-corporation include:

- **More flexible and less costly organization and management.** LLCs are governed by an operating agreement, which dictates the structure and operations of the company. The members (owners) of the LLC draft and agree to the operating agreement, and they can customize and amend it fairly easily. LLCs are not required to maintain the same strict formalities as corporations, such as having a board of directors and bookkeeping requirements. Where there are a small number of owners acting as the primary funders of the business, an LLC is often the preferred structure
- **No double taxation.** The profits and losses of an LLC flow through to its members. The entity itself is not taxed on the income of the company. Instead, each LLC member is taxed on their individual share of distributed income

An LLC is typically preferred to a C-corporation if:

- The business plan reflects a maximum distribution of funds to its investors rather than a reinvestment of those funds for growth of the business
- The business owners contemplate additional property contributions and distributions after initial entity formation
- The business owners expect the business to operate at a loss
- The business owners qualify for the 20% deduction for qualified business income earned directly or indirectly from pass-through entities (including an LLC) under Section 199A of the Code (26 U.S.C. § 199A)

- The business owners prefer the flexibility of an LLC's operating agreement and fewer corporate formalities

(For more on LLC agreements and their principal provisions, see LLC Agreement Commentary on Practical Law; for model LLC agreements, with explanatory notes and drafting and negotiating tips, see LLC Agreement (Multi-Member, Board-Managed) (Private Equity Buyout) and LLC Agreement (Single Member) on Practical Law.)

If a later analysis deems taxation as a C-corporation preferable, an LLC generally can be converted into a C-corporation (for more information, see Partnership to C-Corporation Conversion: Tax Issues on Practical Law).

S-corporations are generally not preferred over either a C-corporation or an LLC due to the substantial limitations on the availability of the S-corporation election. For example, an S-corporation must be an eligible US entity and must have:

- Only one class of stock
- No more than 100 stockholders
- With certain limited exceptions, only US individuals (citizens or residents) as stockholders. (26 U.S.C. § 1361)

(For more on the federal income tax rules for different types of business entities, see Choice of Entity: Tax Issues, Taxation of S-Corporations, and Taxation of Partnerships on Practical Law.)

Special Considerations for Cannabis-Related Businesses

Calculating business income is basically the same for C-corporations and LLCs. However, special consideration should be given to cannabis-related businesses regarding how Section 280E affects business income, because this can influence how and when distributions are to be made, if at all. Analyzing income projections and distributions may drive the decision on entity type (see *C-Corporation, S-Corporation, or LLC* above). Counsel should consider the full picture of a cannabis-related business as part of the entity choice and remember that business structuring considerations should factor in:

- Rapidly changing state laws
- Expected revisions to federal law in the near future, whether:
    - A full de-scheduling of cannabis from the CSA;
    - Allowing complete deference to state laws; or
    - A smaller fix to Section 280E

DIVERGENT STATE AND LOCAL LAWS

As discussed above, counsel for a cannabis-related company must fully understand the state and local laws where the client is located and operates. Compliance with the varying

statutory and regulatory regimes in all jurisdictions is both challenging and of paramount importance in the cannabis industry.

There is no uniformity among the states that have legalized some form of cannabis. Particular states allow for both medical and adult recreational use, while others allow legal cannabis solely for medical use (for more on the legal status of marijuana in all 50 states and the District of Columbia, see Marijuana State Legal Status Charts: Overview on Practical Law).

Among the states that allow some form of legal cannabis, each has its own regulatory scheme for licensing and cannabis-related activities. Regulations can cover not only the cultivation and selling of cannabis but also related issues such as the testing of products for quality and quantity, packaging, and product branding.

Counsel should also be aware of the ordinances of relevant local municipality and county governments. The local jurisdictions within each state (cities, counties, and villages) can have their own regulations regarding the possession, sale, and use of cannabis that are more restrictive than the particular state's laws. For example, local ordinances may restrict the location of or even completely prohibit a marijuana cultivator, dispensary, or related business, even if the state's statute allows medical or adult recreational use.

Compliance with the various laws relevant to a particular location can be challenging. Additional compliance with the diverse rules and regulations of other governing bodies is even more challenging. As a best practice, all cannabis-related businesses should have a dedicated compliance team to focus on the multitude of rules, regulations, and requirements, many of which are likely to be different from business to business, depending on the nature of the cannabis-related business and where it operates.

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We encourage you to contact David with any questions you may have about cannabis-related businesses.

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