Going Green: Legal Considerations For Marijuana Investors And Entrepreneurs

Frank Robison
University of Colorado

Follow this and additional works at: http://digitalcommons.wcl.american.edu/aublr

Part of the Banking and Finance Law Commons, Constitutional Law Commons, and the Tax Law Commons

Recommended Citation
Available at: http://digitalcommons.wcl.american.edu/aublr/vol6/iss1/6

This Article is brought to you for free and open access by the Washington College of Law Journals & Law Reviews at Digital Commons @ American University Washington College of Law. It has been accepted for inclusion in American University Business Law Review by an authorized editor of Digital Commons @ American University Washington College of Law. For more information, please contact kclay@wcl.american.edu.
GOING GREEN: LEGAL CONSIDERATIONS FOR MARIJUANA INVESTORS AND ENTREPRENEURS

FRANK ROBISON*

This article discusses legal considerations for the private equity industry interested in investing in businesses that directly handle marijuana. This article will include two parts. Part I, discusses the legal and regulatory considerations connected to deploying private equity to the marijuana industry. It focuses on private equity funds and private placements.

The total, legal and illegal, U.S. marijuana market is estimated to be fourteen billion to sixty billion dollars. The legal U.S. marijuana market is estimated to be $1.5 to $2.5 billion. Colorado alone estimates that its marijuana businesses will legally sell 100 metric tons in 2014. That is a lot of green!

In this space, business dealings and crime have been intertwined since the possession of marijuana was criminalized in the 1930s and this will likely continue to be so as long as marijuana remains illegal under federal law. Notwithstanding decriminalization and legalization trends at the state level, cultivating, distributing, or possessing marijuana is unlawful under the Controlled Substances Act. Federal money laundering statutes and the Bank Secrecy Act remain in effect with respect to marijuana related financial transactions. Aiding and abetting, accessory after the fact, and conspiracy are also federal crimes. Yet capital is being deployed in the marijuana industry.

* Frank Robison serves as a Senior Associate at Vicente Sederberg LLC, a law firm dedicated to the responsible regulation of cannabis. When Mr. Robison wrote this article, in 2015, he served as Assistant University Counsel at the University of Colorado, Boulder Office of University Counsel. Mr. Robison has seventeen years of experience at various high-tech companies as a business manager and entrepreneur. Mr. Robison holds a B.A. from Colby College, an M.A. from the University of California San Diego, a J.D. from Vermont Law School, an LL.M. in Constitutional Law from the University of Seville, Spain and an LL.M. in Entrepreneurial Law from the University of Colorado Boulder. Mr. Robison is also a licensed U.S. Customs Broker. Mr. Robison is currently pursuing an LL.M. in Taxation at Georgetown University Law Center. He also finds time to be a dad and husband, enjoying family friendly Colorful Colorado.
In spite of the inherent risk, as long as returns are high, people will exploit these markets. Prior to putting capital in play, individuals and businesses seeking investments and investors should understand the inherent risks.

Part II, which is under development, will discuss two issues: first, developments in state laws, as examples, the residency requirements for investors and proposed retail marijuana legislation in various states as well as address other salient legal developments on the state and federal levels to deploying capital to the marijuana industry; and, second, the trend of "rolling up marijuana" businesses and the respective legal implications. A roll up is a technique used to increase the value of small companies in the same market by acquiring and merging them. In many states, regulations require marijuana businesses to reserve large amounts of cash before even applying for a license; like in many industries, this favors businesspeople with cash and other capital. In addition, economies of scale significantly affect cost per unit output and margins allowing efficiently managed large operations to dominate. These issues have caused roll ups to be a popular strategy in Colorado and other marijuana states where marijuana businesses may desire to consolidate vertical and horizontal operations in order to promote growth and improve the internal rate of return. Whether this will lead to "Big Marijuana," analogous to "Big Pharma" or the tobacco industry, is a question on industry participants' minds as well as those individuals sitting on the sideline waiting on further legal developments prior to risking capital.

Part I: Touch and Grow — Deploying Private Equity to Businesses that Handle Marijuana —
INTRODUCTION

The marijuana industry is awash in green. While marijuana remains classified as a Schedule I controlled substance under the Controlled Substances Act ("CSA") — marijuana along with ecstasy, heroin, LSD, and hallucinogenic mushrooms, but curiously not pure cocaine or crystal meth, is a Schedule I controlled substance, the most restrictive status under federal law — paradoxically, it also drives entrepreneurial activities and generates deals, revenues, and jobs in the states that have legalized it.\(^1\) This intersection of the legal, under state law, with the illegal, under federal law, has created interesting business, financial, legal, and regulatory issues. The issues range from preemption to privacy, to drug use in the workplace, to conducting research with marijuana as well as the use of the federal banking system. Controversies and uncertainties appear limitless; the appetite for legislation as well as litigation is far from satiated.

This article is a legal–issue playbook for deploying private equity\(^2\) in the marijuana industry.\(^3\) It addresses whether a private equity fund may legally raise money, invest these funds in businesses that actually touch marijuana and, subsequently, distribute proceeds to investors. It also addresses whether marijuana businesses may legally solicit investors through private placements or intrastate offerings. Given marijuana’s status under the

---

1. 21 U.S.C. §§ 812(b)(1), (c)(10) (2016). The CSA classifies marijuana as a Schedule I controlled substance because of the determination that marijuana has a high potential for abuse and has no accepted medical utility. The CSA also prohibits the cultivation, sale, distribution, and use of marijuana.

2. In this article, private equity refers to the financing of high risk, potentially high reward projects.

3. While the marijuana industry includes retail stores, growing operations, and infused–products manufacturers as well as ancillary businesses like growing equipment, enterprise software, and child resistant containers In this paper the marijuana industry means the former group, the businesses that actually touch and directly handle marijuana.
CSA, the legality of working directly with these businesses is uncertain. In all jurisdictions, providing legal assistance about conduct, criminal or civil, that happened in the past is compliant with ethical rules. However, in certain jurisdictions, a lawyer may not assist a client in conduct that is criminal under federal law, structuring marijuana business deals creeps into this gray area. In spite of the challenges, investors are seeking to deploy capital in this industry.

The state–federal interplay of four issues — banking, finance, taxation, and securities — directly impacts an investor’s ability to deploy capital in and conduct business with the marijuana industry. This article analyzes these issues and other barriers created by federal law as well as discusses whether it is legally possible to construct solutions to these challenges.

Under the federal law, cultivating, manufacturing, distributing or

4. Compare Colo. Bar Ass’n Ethics Comm., Op. 125 (2013) [hereinafter Colo. Ethics Op. 125] (providing advice on past conduct acceptable but structuring deals, e.g. a lease, is unlawful) and Me. Prof’l Ethics Comm’n, Op. 199 (2010) (representing or advising clients would “involv[e] a significant degree of risk which needs to be carefully evaluated” requiring Maine attorneys to determine “whether the particular legal service being requested rises to the level of assistance in violating federal law”) and Conn. Bar Ass’n Prof’l Ethics Comm., Informal Op. 2013–02 (2013) (indicating that individual lawyers must draw the line between permissible advice to clients on the requirements of the Connecticut Palliative Use of Marijuana Act and impermissible assistance to clients in conduct that violates federal law but “[w]hether or not the CSA is enforced, violation of it is still criminal in nature. . . . Lawyers may not assist clients in conduct that is in violation of federal criminal law.”) with Ariz. Ethics Op. 11-01 (2011) (advising that to forbid attorney assistance regarding conduct prohibited by federal law yet compliant with state law would “depriv[e] clients of the very legal advice and assistance that is needed to engage in the conduct that the state law expressly permits”). See also Internal Revenue Advisory Council, 2014 Pub. Rep 25 (Nov. 19, 2014) (“Tax assistance to marijuana businesses . . . Marijuana businesses that are now legal in some states but still illegal under federal law need ethical and competent professional tax advice. Tax professionals who give that advice need assurance that they will not be adversely affected by the fact that the business is illegal under federal law.”).


6. This article is an intellectual exercise designed to explore salient legal issues connected to investing in marijuana businesses. It outlines the legal landscape and highlights risks associated with deploying capital into the marijuana industry. The article is not intended to provide any particular person legal advice. If a person or entity requires legal advice on these matters, this person should retain his, her, or its own lawyer.
possessing marijuana is illegal. Depending on whether the quantity is substantial, the offense is punishable with a mandatory minimum sentence of ten years in prison. In addition, federal money laundering statutes and the Bank Secrecy Act ("BSA") remain in effect with respect to marijuana related activities. Aiding and abetting, accessory after the fact, and conspiracy are all federal crimes. The risk of forfeiture is also

7. 21 U.S.C. § 841(a)(1) (2014) (Punishment for 1,000 kilograms or 1,000 plants includes "a term of imprisonment which may not be less than 10 years ... or a fine not to exceed the greater of ... $10,000,000 if the defendant is an individual or $50,000,000 if the defendant is other than an individual, or both"); § 856(a)(1)–(2) (2016) (providing that it shall be unlawful to:

1. knowingly open, lease, rent, use, or maintain any place, whether permanently or temporarily, for the purpose of manufacturing, distributing, or using any controlled substance;
2. manage or control any place, whether permanently or temporarily, either as an owner, lessee, agent, employee, occupant, or mortgagee, and knowingly and intentionally rent, lease, profit from, or make available for use, with or without compensation, the place for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance).

8. See generally 18 U.S.C. §§ 1956, 1957 (1986) (providing federal anti-money laundering statutes); see also § 1956(b) (stating that a person who conducts a financial transaction "knowing that the property involved ... represents the proceeds of some form of unlawful activity," may be imprisoned and fined the greater of $500,000 or twice the value of the property involved).

9. The Bank Secrecy Act ("BSA") is the common name for the statutes and regulations dealing with money laundering and counter terrorism. The BSA is intended to protect the integrity of the U.S. financial system. The BSA is central to all transactions connected to any subject matter that is or may be illegal. Accordingly, a basic understanding is fundamental to investors in the marijuana industry. See 31 U.S.C. § 310; Pub. L. No. 91-508, 84 Stat. 1114 (1970); See also FAQ: Marijuana and Banking, AM. BANK. ASS’N (Feb. 2014), https://www.aba.com/Tools/Comm-Tools/Documents/ABAMarijuanaAndBankingFAQFeb2014.pdf:

All banks are subject to federal law, whether the bank is a national bank or state-chartered bank. At a minimum, all banks maintain federal deposit insurance which requires adherence to federal law. Violation of federal law could subject a bank to loss of its charter. All banks are subject to the requirements of the BSA. Under the BSA, banks must report to the federal government any suspected illegal activity which would include any transaction associated with a marijuana business.


11. See 18 U.S.C. § 2 (2016) (providing that a person who "aids, abets, counsels, commands, induces or procures" any federal crime "is punishable as a principal" giving rise to the same consequences as the underlying crime).

12. See 18 U.S.C. § 3 (2016) (establishing that a person who knows "that an offense against the United States has been committed, receives, relieves, comforts or assists the offender in order to hinder or prevent his apprehension, trial or punishment, is an accessory after the fact.").

13. 18 U.S.C. § 371 (2016) ("If two or more persons conspire either to commit any offense against the United States ... and one or more of such persons do any act to
effect the object of the conspiracy, each shall be fined under this title or imprisoned not more than five years, or both.

14. See 21 U.S.C. § 881(a)(2) (2016) (providing that there are no property rights and the following are subject to forfeiture: property, products, and equipment used or intended to be used in violation of the CSA or other federal crimes); § 881(a)(6) (conveying that nobody has a property right to proceeds of illegal activities used in connection to a violation of the CSA or other federal crimes); § 881(a)(7) (stating that all real property, including leases, which is used, or intended to be used, to commit, or to facilitate the commission of a felony is subject to forfeiture).

15. 26 U.S.C. § 7201 (2016) ("any willful attempts to evade any tax is guilty of a felony and, upon conviction, "shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution").

16. E.g., Gene Marks, If You’re a Small Business Dealing in Marijuana, You’re Still Breaking the Law, WASH. POST (Aug. 12), https://www.washingtonpost.com/news/on-small-business/wp/2016/08/12/gene-marks-if-youre-a-small-business-dealing-in-marijuana-youre-still-breaking-the-law/ (describing one marijuana business owner that had a “tough time” even keeping a bank account for his business; his company’s account was with a credit union that only allowed him to conduct basic services such as direct deposits); see 34 CFR § 84 (2016) (requiring compliance with the Drug Free Workplace Act as a condition of receiving federal funds); see also Pub. L. No. 100–690 § 513 (1988); 34 CFR § 84 (2106); 20 USC § 1145g; 34 CFR § 86.1 (2016) (mandating that certain recipients of federal funds put into place “standards of conduct that clearly prohibit, at a minimum, the unlawful possession, use, or distribution of illicit drugs and alcohol by students and employees on its property or as part of its activities").
to raise funds.

To a certain extent, the innovation requirement falls on the business planners. This is not to say that the marijuana entrepreneur lacks innovative drive. From nutraceuticals and pharmaceuticals to cultivating strains rich in certain chemical compounds, the marijuana industry will innovate, but sophisticated business service providers are critical.

Both entrepreneurs and business managers play critical roles in a businesses’ internal rate of return. Likewise, both are exposed to similar legal risks; being cognizant of the challenges and minimizing legal exposure is critical to anyone seeking or deploying capital. Because the marijuana industry does not have access to traditional capital markets, the industry has to be creative in order to obtain the capital funding required to develop and grow.

II. BACKGROUND

Prior to discussing legal considerations and deploying capital, an analysis of the market dynamics and, significantly, the Department of Justice’s (“DOJ’s”) position on the state, legal, and regulatory regimes provides context to assess the risks connected to deploying capital. Sections II(A) and (B) provide a brief analysis of the U.S. marijuana market. Section II (C) discusses critical information about the DOJ’s approach to dealing with state conduct while understanding federal enforcement priorities are critical for anyone participating in this industry.

A. Market Potential

There are reports and stories about sacks of cash that abound in the retail marijuana states.17 While estimates vary greatly between marketing groups, economists, and state and federal agencies, the legal marijuana market is reported to be over one billion dollars.18 Harvard economist, Jeffrey Miron, estimates the total market, legal and illegal markets, to be

17. In this article, the terms “retail” and “recreational” are used interchangeably; the terms indicate a state with a regulatory scheme to control, license, and tax the cultivation, distribution, and use of marijuana for personal non-medical purposes.

18. Tom Huddleston, Jr., Legal Marijuana Sales Could Hit $6.7 Billion in 2016, FORTUNE (Feb. 1, 2016, 6:00 AM), http://fortune.com/2016/02/01/marijuana-sales-legal/ (estimating that the current United States’ legalized cannabis market was valued at $2.7 billion in 2014 and poised to grow to $10.8 billion in 2018); B. Kilmer ET. AL., What America's Users Spend on Illegal Drugs: 2000–2010 RAND CORP. (Feb. 2014), http://www.whitehouse.gov/sites/default/files/ondcp/policy-and-research/wausid_results_report.pdf (estimating the recreational, legal and illegal, marijuana market to be $30 to $60 billion); Bruce Barcott, How to Invest in Dope, N.Y. TIMES (June 25, 2013),http://www.nytimes.com/2013/06/30/magazine/how-to-succeed-in-the-legal-pot-business.html?pagewanted=all&_r=0 (“Medical marijuana is now a $1.5 billion industry.”).
currently fourteen billion dollars.\textsuperscript{19} The U.S. Government recognizes that the total may be as large as sixty billion dollars.\textsuperscript{20} Others assert the market could eventually rival the NFL’s market value.\textsuperscript{21} It also draws natural comparisons to other vice markets, such as tobacco and alcohol.\textsuperscript{22}

Because of their statuses as recreational marijuana states with operating regulatory frameworks, this paper draws upon the Colorado and Washington experiences to illustrate the challenges in legally deploying capital in legal under state law markets.\textsuperscript{23} Colorado and Washington charge sales and excise taxes to collect tax revenue.\textsuperscript{24}

Colorado and to a limited extent West Virginia are the only states with

---


\textsuperscript{20} Kilmer, \textit{supra} note 18.


\textsuperscript{22} See generally Ariel Nelson, \textit{How Big Is The Marijuana Market?}, CNBC (Apr. 2010, 12:04 AM), http://www.cnbc.com/id/36179677 (noting that the combined revenue of tobacco and alcohol was $263 billion in 2008).

\textsuperscript{23} See Colo. Const. Art. XVIII, § 16 (Effective December 10, 2012, by passing Amendment 64, Colorado amended its constitution to permit and regulate the personal use of marijuana in the same way that alcohol is permitted and regulated); WASH. REV. CODE § 69.51A.040 (2014) (medical); WASH. REV. CODE § 69.50-401 (3) (2014) (recreational); see also WASH. INITIATIVE MEASURE No. 502, (July 8, 2011), http://sos.wa.gov/_assets/elections/initiatives/i502.pdf.

meaningful revenue numbers. While marijuana sales tax revenues fell short of the sixty million dollar estimate in 2013, the state collected $33.5 million.\textsuperscript{25} Of course, the total sales tax does not account for income subject to state income taxes as these are two completely distinct tax concepts. In Washington, the Washington State Liquor Control Board oversees the marijuana program. It aggressively estimates two-year marijuana tax revenue for the 2015–17 biennium to be $120 million and for the 2017–19 biennium will be $336 million.\textsuperscript{26}

Through most lenses, these markets are large and, unless federal priorities change or the Supreme Court deems state based regulation schemes unconstitutional, the recreational and medical markets will continue to grow.\textsuperscript{27} While many investors will avoid investments tainted with even the hint of illegality altogether; other investors and entrepreneurs believe the risk is worth the potential return.

\textbf{B. Novel Social and Economic Experiments}

Entrepreneurial drive and spirit are ingrained in the United States’ social and political structure. In the United States, “a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.”\textsuperscript{28} Foreseeably, enthusiasts invoke Thomas Jefferson, offering partial quotations in the process.\textsuperscript{29} The Bill of Rights provides the foundation for federalist thinking — “[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.”\textsuperscript{30} This linchpin of federalism sets the backdrop for a fluid and growing marijuana legalization and decriminalization movement.


\textsuperscript{28} New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

\textsuperscript{29} THOMAS JEFFERSON, THE WRITING OF THOMAS JEFFERSON: VOL. II 164 (H.A. Washington Ed., 1861) (“It is vastly desirable to be getting underway with our domestic cultivation and manufacture of hemp, flax, cotton, and wool.”); Thomas Jefferson, THE THOMAS JEFFERSON PAPERS SERIES 1: GENERAL CORRESPONDENCE 1651–1827, MEMORANDUM OF SERVICES (1800), http://hdl.loc.gov/loc.mss/mjt.mjtbib009438 (“The greatest service that can be rendered to any country is to add a useful plant to its culture.”).

\textsuperscript{30} U.S. CONST. AMEND. X.
Twenty-seven states, the District of Colombia, and various territories, have passed laws that allow marijuana use for therapeutic or medicinal purposes. Over 1.5 million Americans have received recommendations from medical doctors to use marijuana. In 2014, Colorado became the first U.S. state to legalize and regulate recreational use and sale of marijuana, followed closely by Washington and later by Alaska, and Oregon. Not surprisingly, marijuana is cocktail party fodder as being the next big thing; in turn, inspiring comments that an investment bubble is already forming.

The states are indeed experimenting; no approach is alike. Some states have merely eliminated punishment and penalties relating to certain marijuana-related activities. Others have implemented comprehensive regulatory and licensing regimes to control the cultivation, distribution, and sale of marijuana.

---


36. A Comparison of the World’s First Three Jurisdictions to Legally Regulate Marijuana: Colorado, Washington and Uruguay, DRUG POL’Y ALLIANCE (May 15,
In spite of continued state decriminalization and legalization coupled with regulatory control and licensing, under the CSA, the cultivation, distribution, and possession of marijuana is illegal under federal law, except for a limited federally approved carve-out for research.

A change in executive branch administration could change federal attitudes towards the burgeoning state marijuana industry, particularly in the recreational space. Further, unless the federal government de-schedules or reschedules marijuana, courts may find state laws permitting the licensing and taxation of a Schedule I controlled substance to be unconstitutional.

On December 18, 2014, Nebraska and Oklahoma petitioned the Supreme Court to declare Colorado’s recreational marijuana laws to be in violation of the U.S. Constitution’s Supremacy Clause, claiming that such laws constitute “a patchwork of state and local pro–drug policies and licensed distribution schemes throughout the country which conflict with federal laws.” These states argue that a “positive conflict” exists between the CSA and other federal laws and international treaties and Colorado’s recreational marijuana laws to the extent that the conflicting schemes “cannot consistently coexist.” On March 21, in a six–two decision, the Supreme Court denied Oklahoma and Nebraska’s motion for leave to file a bill of complaint. Nevertheless, while less and less likely, future challenges could ultimately render state–based marijuana licensing and tax regulatory schemes unconstitutional, but the Supreme Court does not have the power to force Colorado and other legal marijuana states to

37. See United States v. Oakland Cannabis Buyers’ Coop., 532 U.S. 483, 495, 499 (2001) (holding that Congress has the right to regulate marijuana and may criminalize the production and use of cannabis even where states approve its use for medicinal purposes); Gonzales v. Raich, 545 U.S. 1, 32 (2005) (holding that the commerce clause gave Congress authority to prohibit the local cultivation and use of marijuana, despite state law to the contrary, and that local use affects supply and demand in the national marijuana market); see generally Frank Robison & Elvira Strehle-Henson, Cannabis Laws and Research at Colorado Institutions of Higher Education, Colo. Law. (Oct. 2015).

38. Oakland Cannabis Buyers’ Coop., 532 U.S. at 490 (holding that under the federal law using, possessing or manufacturing “marijuana (and other drugs that have been classified as ‘Schedule I’ controlled substances), [is illegal and] there is but one express exception, and it is available only for Government–approved research projects, § 823(f)’); see generally Frank Robison & Elvira Streble-Henson, Cannabis Laws and Research at Colorado Institutions of Higher Education, Colo. Law. (Oct. 2015).


recriminalize the cultivation, manufacture, distribution, and possession of marijuana.

In spite of the threats to state based regulatory regimes, certain entrepreneurs feel insulated from any future federal interference and disruptions, arguing that the genie is out of the bottle. Other entrepreneurs understand the stark risks. One industry professional stated, "[t]he next administration could be the difference between taking back flips off a boat in the Gulf of Mexico for the rest of my life after Phillip Morris buys me out versus finding something else to do."

C. Federal Evolution: From Reefer Madness to Enforcement Priorities

The origin of the federal controlled substance regime relates back to the Marijuana Tax Act and the Uniform State Narcotic Act. Driven by the Federal Bureau of Narcotics, led by the now infamous in the marijuana industry, Harry Jacob Anslinger, propaganda and anti-marijuana sentiments, exemplified by the documentary "Reefer Madness," led to the passage of the CSA in 1970 and several international treaties. This paradigm is in place today and set the backdrop for the forty-five year long war on drugs, including enforcement at the local, state, and federal levels.

Despite the federal specters, where there is innovation and market growth, investors tend to find a way to deploy capital. In addition to the massive amounts of cash, which inherently tends to spark interest, the current federal overtures have a net effect of precipitating entrepreneurial and investor interest in this market.

Over the past seven years, the federal government has overtly adjusted

42. DOUG FINE, TOO HIGH TO FAIL 288–99 (2012).
43. Interview with anonymous source Denver, Colorado (2014).
45. E.g., Economic and Social Council Res. 1196 (XLII), Single Convention on Narcotic Drugs of 1961 (May 16, 1967) (restricting legal marijuana uses to medical and scientific purposes, and requiring international cooperation and enforcement).
its enforcement priorities three times. First, in 2009, the DOJ issued guidance (Ogden Memo) stating that medical marijuana operations in medical marijuana states are not a prosecutorial priority.\textsuperscript{46} The Ogden Memo makes clear that retail marijuana operations remain an enforcement priority and it outlines other activities that would trigger federal action.\textsuperscript{47} The Ogden Memo triggered the first major wave of capital deployment in this market because entrepreneurs liberally interpreted the guidance to mean that large-scale marijuana operations, designed to furnish the medical marijuana industry, did not concern the federal government.\textsuperscript{48}

Second, in 2012, DOJ responded releasing another memorandum (Cole Memo I) establishing that large scale commercial grow operations are an enforcement priority even if the marijuana is purportedly for state medical marijuana users.\textsuperscript{49}

\begin{quote}
[S]everal jurisdictions have considered or enacted legislation to authorize multiple large-scale, privately operated industrial marijuana cultivation centers. Some of these planned facilities have revenue projections of millions of dollars based on the planned cultivation of tens of thousands of cannabis plants.

The Ogden Memorandum was never intended to shield such activities from federal enforcement action and prosecution, even where those activities purport to comply with state law. \textit{Persons who are in the business of cultivating, selling or distributing marijuana, and those who knowingly facilitate such activities, are in violation of the Controlled Substances Act, regardless of state law.}\textsuperscript{50}
\end{quote}

\textsuperscript{46} Memorandum from David W. Ogden, Deputy Att’y Gen., U.S. Dep’t of Justice, for Selected U.S. Atty’s, Investigations and Prosecutions in States Authorizing the Medical Use of Marijuana (Oct. 19, 2009) [hereinafter Ogden Memo] (“[P]riorities should not focus federal resources in your States on individuals whose actions are in clear and unambiguous compliance with existing state laws providing for the medical use of marijuana. For example, prosecution of individuals with cancer or other serious illnesses who use marijuana as part of a recommended treatment regimen consistent with applicable state law, or those caregivers in clear and unambiguous compliance with existing state law who provide such individuals with marijuana, is unlikely to be an efficient use of limited federal resources.”).

\textsuperscript{47} Id. (“[U]nlawful possession or unlawful use of firearms; violence; sales to minors; financial crimes and marketing activities inconsistent with state marijuana medical laws; amounts of marijuana inconsistent with compliance with state law; illegal possession or sale of other controlled substances; or ties to other criminal enterprises.”)


\textsuperscript{49} Memorandum from James M. Cole, Deputy Att’y Gen., U.S. Dep’t of Justice, for all U.S. Atty’s, Guidance Regarding the Ogden Memo in Jurisdictions Seeking to Authorize Marijuana for Medical Use (June 29, 2011) [hereinafter Cole Memo I].

\textsuperscript{50} Id.
At this juncture, capital deployment to this market may have slowed but in no event did it dry up. Investors should not overlook the importance of the Cole Memo I. The DOJ corrected any misunderstandings it perceived by directing the Drug Enforcement Administration ("DEA") to shut marijuana businesses down and initiating prosecution under the CSA, tagging on aiding and abetting and money laundering charges as well as initiating forfeiture proceedings.

It also warns individuals doing business with marijuana that the industry is still illegal and the DOJ maintains prosecutorial discretion.

Legal state activities, medical and recreational, do not shield such activities from federal enforcement action and prosecution, even where those activities purport to comply with state law. Persons who are in the business of cultivating, selling or distributing marijuana, and those who knowingly facilitate such activities, are in violation of the Controlled Substances Act, regardless of state law. Consistent with resource


constraints and the discretion you may exercise in your district, such persons are subject to federal enforcement action, including potential prosecution. State laws or local ordinances are not a defense to civil or criminal enforcement of federal law with respect to such conduct, including enforcement of the CSA.\textsuperscript{53}

Third, in 2013, as medical marijuana legalization expanded and Colorado and Washington passed retail laws, the DOJ updated the guidance establishing the current federal enforcement priorities connected to marijuana — distribution to minors, sales involving gangs, diversion, violence, drugged driving, and use or possession on federal land or property.\textsuperscript{54}

In spite of the Cole Memo I and Cole Memo II’s warnings, DOJ simultaneously indicates that states such as Colorado and Washington that have decriminalized and legalized marijuana “and that have also implemented strong regulatory and enforcement systems . . . are unlikely to threaten the federal priorities.”\textsuperscript{55} This has allowed the avalanche of growth and interest in this space to continue.\textsuperscript{56} Even though Cole Memo II directly contributes to the massive growth in marijuana industry, the conduct is merely not an enforcement priority — even though it remains illegal at the federal level.

In February 2014, the Department of Treasury (“Treasury”), through its Financial Crimes Enforcement Network (“FinCEN”) and DOJ, realized a panoply of risks associated with this business — robbery, unreported income, questionable accounting practices among others and issued guidance to enable banks to have commercial relationships with marijuana businesses, even recreational marijuana businesses.\textsuperscript{57} The guidance addresses specific issues related to the BSA where marijuana has been legalized within the state.

To close out 2014, Congress’s federal spending law contains a provision that prohibits the DEA and DOJ from preventing implementation of state medical marijuana laws, signaling yet another shift in enforcement policy

\textsuperscript{53} Cole Memo I, supra note 49.

\textsuperscript{54} Memorandum from James M. Cole, Deputy Att’y Gen., U.S. Dep’t of Justice, for all U.S. Atty’s, Guidance Regarding Marijuana Enforcement (Aug. 29, 2013) [hereinafter Cole Memo I].

\textsuperscript{55} Id.


\textsuperscript{57} FinCEN Guidance, supra note 10.
to businesses and investors.\textsuperscript{58}

These developments are important for investors because it sets a backdrop that while not ceding any ground on marijuana's legality under federal law, the federal government presumptively is uninterested in the commercial activities of these businesses as long as the Cole Memo II enforcement priorities are not implicated. In certain respects, this government action is accentuating the meaning of \textit{caveat emptor}. On one hand, the guidance establishes that marijuana businesses operating in states with robust regulatory regimes are unlikely to implicate the federal enforcement priorities.\textsuperscript{59} On the other hand, the FinCEN Guidance has discouraged banks from offering banking services.\textsuperscript{60}

Even though the banking industry's willingness to implement the nuanced compliance requirements may be evolving, as discussed below, the marijuana industry remains under–banked and cash–based because banks generally do not offer general banking services, checking accounts, loans, credit, or credit cards to any entity that directly works with marijuana. Unless marijuana is rescheduled and is uniquely scheduled so that state laws do not conflict with the CSA or is de–scheduled altogether, any capital deployed to the marijuana industry puts individuals involved at risk of criminal prosecution and subjects their assets and proceeds to potential forfeiture. How to reconcile conflicting federal and state laws regarding the cultivation, manufacture, distribution, or possession of marijuana remains a challenge. Individuals operating in this space should ask two questions: foremost, are the risks worth it? Second, assuming they are, how do you reduce them?

III. LEGAL CONSIDERATIONS FOR PRIVATE EQUITY DEPLOYMENT

From landlord–tenant matters to employment law, marijuana businesses face a broad range of legal issues. Section III provides an overview of key

\textsuperscript{58} Pub. L. No. 113–235. § 538, 128 Stat. 2129, 2217 (2014) ("None of the funds made available in this Act to the Department of Justice may be used, with respect to the States of Alabama, Alaska, Arizona, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, Oregon, Rhode Island, South Carolina, Tennessee, Utah, Vermont, Washington, and Wisconsin, to prevent such States from implementing their own State laws that authorize the use, distribution, possession, or cultivation of medical marijuana.").

\textsuperscript{59} Cole Memo II, supra note 54.

\textsuperscript{60} FinCEN Guidance, supra note 10 ("Because federal law prohibits the distribution and sale of marijuana, financial transactions involving a marijuana related business would generally involve funds derived from illegal activity.").
legal considerations for anyone seeking or providing financing to this industry.

An understanding of banking and finance, taxation, and securities is fundamental for any person or business seeking to deploy capital in these markets. Underlining these four issues is legal enforceability of basic contracts connected to a transaction where the underlying subject matter violates federal law. Even though these four issues coupled with contractual enforceability uncertainty are certainly not an exhaustive list of issues that impact the marijuana industry, they illustrate the challenges marijuana businesses face in obtaining and effectively deploying capital.

A bedrock principle of contract law is that contracts in contravention of public policy are void and unenforceable. Colorado and Arizona court cases have affirmed this principle holding that the subject matter of a contract involving a marijuana business is illegal and therefore, unenforceable. The CSA does not contain an exception covering state laws; therefore, state laws provide no protection from the federal laws. Thus, contracts for the sale of marijuana are void because they are against public policy.

These cases inject uncertainty as to whether an investment contract with a nexus to a marijuana business that manufactures, distributes, or dispenses marijuana in violation of the federal controlled substances legal regime is enforceable as a matter of law. This question raises significant business and legal issues for any investor, fund, or wealthy individual regarding structuring a deal and, ultimately, the deal’s legitimacy. To be sure, investors should only invest what they can afford to lose because any marijuana business deal that involves a CSA violation cannot be completely legal.

Since contracts play a critical role in most investments, stakeholders should structure them so that criminal and civil legal exposure is minimized. This section further discusses major risks and respective strategies to minimize exposure through diversification of investments, limited liability business structures, tax planning, and adhering to the principles of Cole Memo II. Furthermore, certain issues relating to federal and state security laws are considered.

A critical legal barrier to obtaining financing is certain marijuana states’ residency requirements for license holders and equity investors. To

61. See generally 5 WILLISTON ON CONTRACTS § 12:1 (4th ed.).
63. Id.
participate in equity financing deals with marijuana businesses in Colorado and Washington, the regulations require that an individual or entity with an ownership interest must be a state resident.\(^{64}\) This means that, in these states, out-of-state investors interested in investing in marijuana businesses are limited to loaning money. Convertible loans may be an investment option for out of state investors as long as the loans are convertible conditional on certain changes in state and federal law.\(^{65}\) Colorado has a legal mechanism to allow persons who are residents of the United States, but not Colorado, to have an interest in the Colorado marijuana business — dubbed a “permitted economic interest.”\(^{66}\) The conversion or transfer of such interest is contingent on the holder of the interest as qualifying as an owner, by meeting Colorado’s two-year residency requirement or a change in applicable law.\(^{67}\) In fact, with the passage of Senate Bill 040, the Colorado residency requirements are set to change January 1, 2017, facilitating out of state investment and, theoretically, precipitating an influx

---

64. Compare COLO. REV. STAT. § 12-43.3-307 (2016) (“An owner, as defined by rule of the state licensing authority, who has not been a resident of Colorado for at least two years prior to the date of the owner’s application.”) and WASH. REV. CODE ANN. § 69.50.331 (2014) (“(i) A person doing business as a sole proprietor who has not lawfully resided in the state for at least three months prior to applying to receive a license; (ii) A partnership, employee cooperative, association, nonprofit corporation, or corporation unless formed under the laws of this state, and unless all of the members thereof are qualified to obtain a license.”) with Oregon Legalized Marijuana Initiative, Measure 91 (2014) (allowing “possession, manufacture, sale of marijuana by/to adults, subject to state licensing, regulation, taxation.”) and California’s Compassionate Use Act of 1996 collective or cooperative based regime. See also Frequently Asked Questions, OREGON.GOV (last visited Sept. 8, 2016), https://www.oregon.gov/olcc/marijuana/Pages/Frequently-Asked-Questions.aspx (Commission stating that Measure 91 “does not specifically address [the residency] question”); CAL. HEALTH AND SAFETY CODE 11362.775 (2016) (California’s regulatory scheme has a not-for-profit foundation, providing that medical marijuana patients and primary caregivers may “associate within the State of California in order collectively or cooperatively to cultivate marijuana for medical purposes”).

65. Colo. Rev. Stat. § 12-43.3-104 (12.4)(2016) (“Permitted economic interest” means any unsecured convertible debt instrument, option agreement, warrant, or any other right to obtain an ownership interest when the holder of such interest is a natural person who is a lawful United States resident and whose right to convert into an ownership interest is contingent on the holder qualifying and obtaining a license as an owner under this article; or such other agreements as may be permitted by rule of the state licensing authority”); Marijuana Enforcement Division, Form, DR 8555, https://www.colorado.gov/pacific/sites/default/files/DR%208555e%20PEI%202016_2.pdf.

66. See 1 Colo. Code Regs. § 212–1:1.204 (outlining factors that Colorado’s Marijuana Enforcement Division uses to evaluate whether a person has an ownership interest in a licensed retail marijuana business); 1 Colo. Code Regs. § 212–2.204 (outlining factors that Colorado’s Marijuana Enforcement Division uses to evaluate whether a person has an ownership interest in a licensed medical marijuana business).

This change in Colorado law will be addressed in the Part II of this Article.

Irrespective of the residency requirements, structuring wholly intrastate deals reduces risks of triggering Cole Memo II enforcement priorities — not diverting marijuana proceeds from marijuana states to non-marijuana states — and simplifies inherently complex securities law compliance matters.

A. Banking

The elephant in the private equity room is the well-documented difficulty that marijuana businesses have in obtaining basic banking services and, in turn, capital. This subsection first synthesizes banking challenges related to financing businesses that directly handle marijuana. Second, it explores salient financing issues and offers suggestions for approaches to reduce risks connected to the problematic areas.

Under the BSA, if the financial institution knows that the property constitutes proceeds from an unlawful activity, accepting a marijuana business customer is a criminal act. Under the BSA, for a financial institution or bank to accept a marijuana business customer is a crime, if the financial institution is aware that the customer directly handles marijuana. If the bank conducts transactions “knowing that the property involved... represents the proceeds of some form of unlawful activity,” with the intent to promote the unlawful activity, the bank officials can be imprisoned and fined the greater of $500,000 or twice the value of the property involved.

In an attempt to explain how banks can serve legal marijuana businesses while remaining compliant with the BSA, FinCEN issued the FinCEN Guidance in an attempt to assist the banking and marijuana industries with compliance. Banks serving marijuana businesses must comply with ambiguously defined guidance, including the performance of due diligence requirements, which amount to a fusion of customer policing and novel banking institution compliance requirements. The FinCEN Guidance requires the banks to assess the risks of providing services to a marijuana related business through customer due diligence. This diligence includes: verifying that the business is licensed and registered; reviewing the license application (and related documentation); requesting information about the business and related parties from the state; developing an understanding of

70. 18 U.S.C. § 1956(a).
normal business activities; ongoing monitoring of information about the business and related parties and any respective suspicious activity; and re-performing this due diligence on a periodic basis. The compliance requirements are ambiguously defined and foreign to banking operations. As an example, banks, and likely bank regulators, for that matter, do not understand what normal business activities and monitoring information as well as activities means.

In order to offer bank accounts to the marijuana businesses, the federal government, in effect, requires banks to police their customers’ businesses. Compounding the risks of being client cops, DOJ maintains that “[t]he provisions of the money laundering statutes, the unlicensed money remitter statute, and the . . . BSA remain in effect with respect to marijuana–related conduct” and can form the basis for prosecution under those statutes. In light of the risks, banks are not willing to implement compliance programs that adhere to the FinCEN guidance because the framework is unclear and the risk of liability is pervasive.

In addition, banks must file one of three specialized categories of suspicious–activity reports (“SARs”). The “marijuana–limited” SAR is used to notify FinCEN that the financial institution’s customer operates in compliance with state laws and no additional suspicious illegal activity is suspected. The other SARs notify FinCEN of additional illegal activities. Seemingly simple workarounds, like forming management companies or

72. Id. (“In assessing the risk of providing services to a marijuana related business, a financial institution should conduct customer due diligence that includes: (i) verifying with the appropriate state authorities whether the business is duly licensed and registered; (ii) reviewing the license application (and related documentation) submitted by the business for obtaining a state license to operate its marijuana related business; (iii) requesting from state licensing and enforcement authorities available information about the business and related parties; (iv) developing an understanding of the normal and expected activity for the business, including the types of products to be sold and the type of customers to be served (e.g., medical versus recreational customers); (v) ongoing monitoring of publicly available sources for adverse information about the business and related parties; (vi) ongoing monitoring for suspicious activity, including for any of the red flags described in this guidance; and (vii) refreshing information obtained as part of customer due diligence on a periodic basis and commensurate with the risk.”).

73. Memorandum from James M. Cole, U.S. Dep’t of Justice, for All U.S. Atty’s, Guidance Regarding Marijuana Related Financial Crimes (2014) [hereinafter Financial Crimes Memo],

74. See FinCEN Guidance, supra note 10 (indicating that the: SAR should be limited to the following information: (i) identifying information of the subject and related parties; (ii) addresses of the subject and related parties; (iii) the fact that the filing institution is filing the SAR solely because the subject is engaged in a marijuana–related business; and (iv) the fact that no additional suspicious activity has been identified. Financial institutions should use the term “MARIJUANA LIMITED” in the narrative section).
a holding company that conduct marijuana and non–marijuana business, would likely give rise to illegal conduct. A third party doing the banking on behalf of an entity, fund, or marijuana business, likely would be tantamount to money laundering and aiding and abetting among other federal crimes subjecting the entity to criminal prosecution and asset forfeiture.

The net result of federal guidance, cynically a prosecutorial hedge, and the possibility of penalties that flow from the failure to comply with the due diligence requirements is that banks are unwilling to assume the risks of conducting business with the marijuana industry. Bank regulators permit banking, but regulators are forcing banks to manage ongoing compliance in a way that is foreign to a bank’s standard operations. In addition to the civil and criminal risks and consequences, bankers logically would like to avoid costs connected to additional regulatory scrutiny. In sum, the environment translates to banks not offering banking services to the marijuana industry, in spite of the FinCEN guidance. Colorado Bankers Association stated the following about the guidance, “[a]t best, this amounts to ‘serve these customers at your own risk’ and it emphasizes all of the risks. This light is red.”

By contrast, FinCEN is publically expressing optimism. FinCEN’s Director, Jennifer Calvary insisted that,

[T]he guidance is having the intended effect. It is facilitating access to financial services, while ensuring that this activity is transparent and the funds are going into regulated financial institutions responsible for implementing appropriate AML [anti-money laundering] safeguards.

Taken together, the DOJ and FinCEN Guidance indicate that these agencies are unlikely to sanction or otherwise take action against the banks or their


76. See, e.g., Jacob Sullum, Marijuana Money Is Still a Pot of Trouble for Banks, FORBES (Sept. 18, 2014, 5:42 PM), http://www.forbes.com/sites/jacobsullum/2014/09/18/local-banks-terrified-by-friendly-neighborhood-marijuana-merchants/ (following the FinCen guidance does not make marijuana banking legal, but rather the federal government does not view it as an enforcement priority as long as the banking participants, bank and client, follow the guidance).


customers for conducting banking operations pursuant to the guidance. Further, the Cole Memo II, coupled with the FinCEN guidance, is indicative that the federal government is unlikely to target individuals who invest in businesses that are legal at the state level as long as the Cole Memo II’s priorities are not implicated.

Regardless of whether banks readily offer services to businesses that handle marijuana, investors and banks must have a high-risk tolerance to do business in this space. The FinCEN Guidance reinforces that DOJ may prosecute banks serving marijuana businesses. The DOJ, Treasury, and banking regulators reserve the right to penalize and prosecute as well as simultaneously impose amorphously defined risk management and compliance requirements on banks. FinCEN has authority to impose civil penalties on businesses and banks that violate the BSA. Against this backdrop, investors and banks must have a high-risk tolerance to manage capital in this field.

The attitudes of bank regulatory agencies may be changing, despite the regulatory uncertainty. While examples are difficult to identify, a number of banks anecdotally appear to have decided to work with the marijuana industry. For example, the First Security Bank of Nevada has stated its intention to provide banking services to medical marijuana businesses. Colorado marijuana businesses report that at least one Colorado bank is adhering to the FinCEN guidelines allowing the businesses that actually touch marijuana to bank. Washington banks, Salal Credit Union, and Numerica Credit Union, appear to be servicing the Washington marijuana

---

79. See 31 U.S.C. § 5321 (2016) (granting significant authority to Treasury to initiate civil actions and impose civil fines for failing to comply with the BSA); 31 C.F.R § 1010.810 (2016) (delegating enforcement and compliance authority to FinCEN).

80. As an aside, Colorado enacted a law that authorizes the formation of a credit union, Fourth Corner Credit Union, to service the marijuana industry. Keith Coffman, Colorado Governor Signs Law Creating State–Run Marijuana Banking Co-ops, REUTERS (June 6, 2014, 7:43 p.m.), http://www.reuters.com/article/us-usa-colorado-marijuana-idUSKBN0EH2HH20140606; see also Sophie Quinton, Why Marijuana Businesses Still Can’t Get Bank Accounts, STATELINE (Mar. 22, 2016), http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2016/03/22/why-marijuana-businesses-still-cant-get-bank-accounts (“About 40 percent of Colorado cannabis businesses lack bank accounts altogether, according to the office of U.S. Rep. Ed Perlmutter, a Democrat who has pushed to improve banking for the cannabis industry. State officials would not comment on that number.”). It still requires approval and insurance from the National Credit Union Administration. Additionally, the credit union still must obtain a master account from the Federal Reserve System as well as share deposit approval and insurance from the National Credit Union Administration.

industry.\textsuperscript{82} In total, according to FinCEN, based on marijuana limited SAR reporting, there are currently 105 individual financial institutions from states in more than one third of the country engaged in banking relationships with marijuana related businesses.\textsuperscript{83}

Yet, given the compliance requirements, doing business with the marijuana industry arguably lacks economic significance for banks. The industry is currently a $1.5 to $2.5 billion industry.\textsuperscript{84} Assuming\textit{ arguendo} that every legal marijuana business is following the FinCEN guidance, on average, each of the 105 financial institutions willing to do business is doing approximately nineteen million dollars annually with the industry (that is, two billion/105). Unquestionably, a significant portion of the legal market is not being processed as required by FinCEN. This implies that the industry's primary problem may be lack of economic significance to the banks.

If these banks are successful, expect others to follow the lead.

\textbf{B. Finance}

A successful marijuana startup, like many startups, is characterized by two attributes: high growth potential and innovation. As long as there is growth and innovation, there will be funding. As long as there are above average returns, information asymmetries, and business and market uncertainties there are dynamic capital markets. Overlaying the federal laws and regulations on states regulatory regimes calls this traditional financial paradigm into question.

While cash rich, marijuana businesses lack access to traditional sources of capital. Without normal banking operations, any semblance of traditional financing is challenging, at best. The limited ability to bank translates to difficulties in accessing capital markets. Further, as indicated, marijuana businesses operate on a cash-only basis, which raises direct and indirect costs, increases the risk of crime, and impedes a state’s ability to account for the revenues.

Startup costs and the cost of capital in the marijuana industries are high.\textsuperscript{85} Costs, including indoor gardening capital equipment, security, and state required tracking systems are relatively high for a stereotypical marijuana entrepreneur. Since obtaining funds remains difficult, willing

\begin{footnotesize}
\textsuperscript{82.} See \textit{e.g.}, Sala Credit Union Services, https://www.salalcu.org/business/ (last visited Sept. 14, 2016).

\textsuperscript{83.} Calvery, \textit{supra} note 78.

\textsuperscript{84.} See Huddleston, \textit{supra} note 18.

\textsuperscript{85.} Eleazar David Melendez, \textit{Marijuana Dispensaries Becoming Exclusive Domain of The 1 Percent}, HUFFINGTON POST (June 25 2013), www.huffingtonpost.com /2013/06/25/marijuana-dispensaries_n_3496588.html.
\end{footnotesize}
investors expect a rate of return proportionate with the risk.  

While deploying capital inherently requires a bank, creative business planners are finding ways to distribute and access capital, perhaps in violation of the bevy of applicable federal laws. Studying available sources of the funds is challenging, as business owners tend to maintain scarce sources of capital as privately as possible. Presumably, bootstrapping as well as friends and family are the largest source of funds but certainly not the only source. Other sources include private equity, including niche firms (i.e. VCs, micro-VC) and wealthy individuals.

Although, the marijuana industry's best, perhaps only, hope to achieve commercial parity with other industries is for the federal government to eliminate marijuana as a Schedule I controlled substance. This, however, will alter the legal and commercial landscape altogether; it will decrease or eliminate the criminal risks with doing business in this industry, paving the way for tobacco and alcohol, among other industries that have access to capital and are familiar with highly regulated businesses.

In the meantime, other options for changing the legal landscape may prove easier to accomplish. First, the marijuana industry should focus on those banks that are willing to engage with the industry. This will demonstrate to other banks that they will lose potentially profitable and valuable banking customers if they shun marijuana businesses. Second, marijuana businesses should assist the banking industry by assisting to compile the information required to complete the FinCEN due diligence and information reporting requirements, thereby reducing a substantial practice impediment to the banks. Third, the marijuana industry should continue various lobbying efforts; including, (1) encouraging state banking associations to lobby on their behalf; (2) requesting that federal officials include guidance assurances that the federal government will not prosecute banking officers or banks; (3) promoting that federal officials reduce reporting requirements including further simplifying the SAR mechanisms;

86. E.g., Tom Huddleston, Investors Buzz for Marijuana–Related Businesses, FORTUNE (Nov. 11, 2014), http://fortune.com/2014/11/11/medmen-private-equity-funding-marijuana/ (discussing the scarcity of venture capital); Full Circle Capital Corp., Annual Report (Form N–2/A), 55 (Dec. 16, 2014) (explaining that Full Circle Capital [1]Invested $500,000 in a warrant as part of a $30 million senior secured convertible note purchase agreement with Advanced Cannabis Solutions, Inc. (ACS), a non–residential property owner. The agreement to purchase convertible notes is contingent upon ACS’ satisfaction of certain requirements. The convertible notes will bear interest at a fixed rate of 12.00% per annum and have a final maturity of January 21, 2020. ACS Leases lease growing space and related facilities, commercial real estate, and equipment, to licensed marijuana business operators for their production needs, arguably not an ancillary marijuana business but rather a business that directly handles marijuana).
(4) enlisting in state banking association to lobby; and (5) empowering Congress to pass laws exempting banks from certain compliance and policing issues.

C. Taxation

Whether entrepreneurs or investors are using financial institutions or dealing with sacks of cash, so long as they are complying with the federal tax laws, taxation issues directly affect the internal rate of return on invested capital. Three major tax issues affect a marijuana business and attracting investors: first, Internal Revenue Code ("IRC"\(^\text{87}\)) \(\S\) 280E deduction limitation, which in effect forces marijuana businesses to pay tax on gross revenues, minus cost of goods sold; second, the issue of self-incrimination based on filing a tax return on a business that is engaged in illegal federal activity; and, third, tax penalties imposed on taxpayers paying taxes in cash. These issues play a direct role in determining the optimal organizational structure of the operating entity, that is the marijuana business, as well as any entity that may invest in an operating entity.

First, federal income taxes are based on "gains or profits and income derived from any source whatsoever," unless the source is specifically exempted.\(^\text{88}\) Since there is no IRC exemption for illegal income, the IRS requires taxpayers to report and pay taxes on illegal income.

While marijuana income is subject to federal taxation, a business’ ability to deduct expenses and capitalize depreciable assets is limited. IRC \(\S\) 263A states that any cost that is prohibited from being be taken into account in computing taxable income for any taxable year may not be capitalized and expensed.\(^\text{89}\) Section 280E prohibits tax deductions or credits for marijuana business expenses.\(^\text{90}\) Together these IRC sections prohibit marijuana businesses from deducting indirect costs and capitalizing depreciable or amortizable assets. In sum, even if marijuana is legal at the state level, the IRC limits the taxpayer’s ability to account for direct and indirect costs as well as capitalized property, such as plants and

\(^{87}\) IRC means the Internal Revenue Code of 1986, 26 U.S.C, as amended.  
\(^{89}\) 26 U.S.C. \(\S\) 263A9(a)(2)(B) (2012) ("Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.").  
\(^{90}\) 26 U.S.C. \(\S\) 280E (2012) ("No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.") (emphasis added).
equipment. Indeed, the IRS has used § 280E to collect additional tax revenues in connection to marijuana businesses that report income. 91

The IRS regulations provide examples of where capitalization of the deduction is prohibited.92 Although the examples do not address IRC § 280E, they specifically state that any item not allowed to be deducted under another section of the IRC is not eligible for capitalization.93 Therefore, a business is likely prohibited from using the benefits of IRC § 263A because of IRC § 280E.

Certain tax professionals argue that the capitalization rules should apply to certain expenses excluded by IRC § 280E asserting that businesses may use the absorption and capitalization rules established by IRC § 263A to limit the IRC § 280E effect.94 As indicated, IRC § 263A allows businesses to capitalize certain direct and indirect expenses. These professionals supposedly advise the marijuana industry to reduce gross revenues by increasing cost of goods sold using the absorption and uniform capitalization rules to capitalize and deduct certain direct costs and indirect expenses. Again, such expenses would, if deducted currently rather than capitalized, be prohibited.

Other tax professionals take the questionable position that expenses in producing marijuana are deductible and expenses connected to selling are not.95 Perhaps these professionals place emphasis on the “trafficking in controlled substances” language of IRC § 280E. Surely, production is a component of trafficking and, even if it is not, production likely is aiding and abetting trafficking. If a tax professional takes a questionable position, he or she must report these practices and positions to IRS. In reviewing these approaches, the IRS ultimately may not allow the taxpayer to use the expense and capitalization rules in this manner.96

93. 26 U.S.C. § 263A.
94. Eric D. Budreau, CPA Perspective on Marijuana Business in Colorado, CLE Presentation at Colorado Bar Association, Nov. 19, 2014 (stating that he does not endorse this approach but certain tax professional may be advising clients using this rationale).
95. Todd Arkley, Financial Pages: Account Management for Tax Purposes, MARIJUANA VENTURES (Sept. 2014) (“If it is a cost related to acquiring/creating your product, then it will likely be an allowable deduction on your federal tax return. If it is a cost related to selling your product, it will likely not be allowed on your federal tax return.”).
96. APB Opinion No. 28; FASB Statement 109, Accounting for Income Taxes; ASC 740-10; FIN 48 (requiring businesses to analyze and disclose income tax risks); see generally FINANCIAL ACCOUNTING STANDARDS BOARD, FASB INTERPRETATION NO. 48, ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES AN INTERPRETATION OF
Returns on invested capital and taxation are intertwined. The overlap between the financing efficacy and tax planning is fundamental to making good investment decisions. Of course, relaxing § 280E would reduce yet another barrier to obtaining capital in this industry. Furthermore, the disallowance of expenses provides an incentive to those engaged in marijuana businesses in states permitting such businesses to understate the reported income.

Two Tax Court cases illustrate the challenges faced by marijuana businesses in taking advantage of fundamental tax practices. A 2007 Tax Court case provided many marijuana businesses hope that by engaging in health care activities they could deduct their expenses as a health care business. In 2012, the Tax Court substantially narrowed this position by limiting what constitutes health care to more traditional health care activities that do not include dispensing marijuana or other caregiving services. As a result, tax planning by deducting businesses expenses with a nexus to marijuana appears to have been eliminated; however, an ancillary business, with actual and distinct revenues, as an example a business that sells marijuana paraphernalia (if such goods are not marketed as or intended to be controlled substance paraphernalia), may be permitted to deduct some expenses against the operations of the ancillary business. As a second example, a parent or holding company could provide services, such as those provided by an intellectual property holding company.

Second, businesses operating legally under state law assert that filing a federal tax return connected to an illegal activity under federal law constitutes self-incrimination (that is paying tax on the illegal business is a confession of a crime). Courts have held that engaging in illegal


99. See Int. Rev. Code of 1954, § 4744 (stating that the Fifth Amendment protects individuals from such compulsory, incriminating disclosures and provides a complete defense to prosecution); see also Leary v. United States, 395 U.S. 6, 28–29 (1969); People v. Duleff, 515 P.2d 1239, 1240 (Colo. 1973) ("[T]he Fifth Amendment prohibits licensing requirements from being used as a means of discovering past or present criminal activity which is subject to prosecution by calling attention to the licensee and his activities....There is no doubt that the information which Duleff would have been required to disclose would have been useful to the investigation of his activities, would have substantially increased the risk of prosecution, and may well have been a direct admission of guilt under federal law."). See generally Leary, 395 U.S. 6; Haynes v. United States, 390 U.S. 85 (1968); Grosso v. United States, 390 U.S. 62 (1968); Marchetti v. United States, 390 U.S. 39 (1968). John Ingold, Marijuana Activists Lose Initial Challenge to Colorado Marijuana Taxes, DENVER POST (Aug. 22, 2014, 1:14 PM), http://www.denverpost.com/news/ci_26387324/marijuana-activists-argue-pot-taxes-violate-self-incrimination.
activities is not an excuse or justification for the failure to file a federal income tax return.\footnote{United States v. Sullivan, 274 U.S. 259, 264 (1927).}

To be sure, when a marijuana business files a federal tax return and pays federal income taxes, the taxpayer is documenting violations of federal crimes included in the CSA. Marijuana businesses that are legal under state law must file state tax returns in order to maintain their status as legal entities.\footnote{See, e.g., COLO. REV. STAT. § 39–28.8–304(1)–(2) (requiring Colorado marijuana businesses to pay taxes); COLO. REV. STAT. § 39–28.8–306 (providing penalties for marijuana tax evasion).} While filing a state return in those states in which marijuana businesses are legal would not result in self-incrimination for state law purposes, how the federal government will use the tax returns is uncertain.\footnote{Sarah Ferris, Colorado Judge Will Not Strike Down ‘Self-incriminating’ Marijuana Taxes, WASH. POST (Aug. 25, 2014), http://www.washingtonpost.com/blogs/govbeat/wp/2014/08/25/colorado-judge-will-not-strike-down-self-incriminating-marijuana-taxes/ (rejecting claims that paying federal income taxes are a violation of the a person’s right against self-incrimination); see also Ariel Shearer, IRS Targets Medical Marijuana Businesses In Government’s Ongoing War On Pot, HUFFINGTON POST (May 29, 2013), http://www.huffingtonpost.com/2013/05/29/irs-medical-marijuana_n_3346801.html.} Indeed, under the Federal/State Tax Information Exchange Program, the IRS, and the relevant state department of revenue have the right to view the others’ tax returns and audit information.\footnote{26 U.S.C. § 6103(d) (2016).}

Investors should evaluate the consequences of reporting income or failing to report income from marijuana business investments. States permitting legal marijuana businesses would likely lose substantial revenue if the federal government began to use tax returns as a method of enforcing the federal criminal law against marijuana businesses.

Third, many marijuana businesses, which are legal under state law, strive to operate legitimately. Because of the lack of available banking services, many businesses find it necessary to pay quarterly federal and state withholding taxes in cash. The IRS imposes a ten percent penalty tax on businesses, which pay such amounts in cash, creating yet another impediment to a favorable internal rate of return.\footnote{See 26 U.S.C. § 6302(h) (2016) (requiring Treasury to implement regulations for the electronic funds transfer system); 26 C.F.R. § 31.6302–1 (2016) (a taxpayer that is required to withhold payroll taxes under 26 C.F.R. § 31.6302–3 (2016), Treas. Reg. § 31.6302–3 must use the electronic funds transfer system to make all deposits of those taxes); 26 U.S.C. § 6656(b)(2) (2016) (imposing penalties for failing to use electronic funds transfer system); Rev. Rul. 95–68, 1995–2 C.B. 272 (1995) (requiring use of electronic funds transfer system and affirming penalties for failing to use electronic funds transfer system); see also David Migoya, IRS Fines Unbanked Pot Shops for Paying Federal Payroll Tax in Cash, DENVER POST (July 2, 2014), http://www.denverpost.com/business/ci_26075425/undefined?source=infinite; Trevor Hughes, Pots of
The seemingly obvious solution of using a payroll company may implicate the federal crimes of aiding and abetting and money laundering.\textsuperscript{105} Many payroll companies and, likewise, many banks are avoiding relationships with such businesses.

Tax planning drives many private equity investment decisions. In this industry, incentives are high to underreport income, particularly when deductions are not allowed. Investors seeking to deploy capital should consult with a certified tax professional or attorney who specializes in tax matters and carefully choose businesses in which they invest. Each issue affects the organizational structure of both the investing fund and the business, requiring careful evaluation.

The federal government has a financial incentive to equalize the tax consequences for marijuana businesses with other businesses such as alcohol and tobacco in order to facilitate industry growth and, in turn, increase tax revenues. As in the financing area, the tax arena provides many areas in which lobbying may have the consequence of reducing the risks associated with deploying capital in this market; as examples: (1) lobbying Congress to eliminate the IRC § 280E expense rule in states where certain marijuana businesses have been legalized; (2) lobbying federal officials to agree not to use the state or federal tax return in order to impose criminal liability on those engaged in the space and not violating state law and in the case of Washington and Colorado, state regulated businesses; and, (3) lobbying the Treasury to issue a ruling that the capitalization rules do not exclude business which can not avail themselves of IRC § 280E.

\textbf{D. Securities and Registration Exemptions}

Many investments in marijuana businesses involve the sale and purchase of securities. The primary purpose of securities laws is to inform and

\begin{itemize}
  \item \textsuperscript{105} 18 U.S.C. § 1956(a)(1)(B); see also U.S. v. Fishman, 645 F.3d 1175, 1187 (10th Cir. 2011) (explaining that the crime of money laundering requires the following elements: (1) knowingly conducting a financial transaction; (2) the funds are proceeds of a specific unlawful activity; (3) the defendant knows the funds involved are proceeds of that unlawful activity; and (4) the transaction is designed to conceal the nature, location, source, ownership, or control of the proceeds.); U.S. v. Sherman, 262 F.3d 784, 794 (8th Cir. 2001) (explaining that a person or organization “who aids and abets money laundering is criminally liable as a principal, and the government’s burden to show aiding and abetting requires that the defendants ‘associated themselves with the venture, participated in it as in something they wished to bring about, and sought by their actions to make it succeed.’”) (quoting U.S. v. Alvarez, 987 F.2d 77, 83 (1st Cir. 1993)).
\end{itemize}
protect investors from information asymmetries.

Against the backdrop of the green rush, the Securities and Exchange Commission ("SEC") warned investors about risks connected to marijuana related investments. Illicit marijuana–related investments have been sold in registered and unregistered offerings alike taking many forms. The examples provided by the SEC indicate that fraudsters, scam artists, and general crooks are trying to take advantage of the buzz, pun intended, surrounding this marijuana industry.

In spite of this development, many business people in this industry are seeking to structure legitimate business deals. The structure of private equity investment contracts varies greatly. As previously mentioned, private equity means the financing of potentially high risk and high reward projects. When a person invests in a common enterprise expecting profits predominately from the efforts of others the underlying "investment contract" is a security.

Securities laws apply broadly. While there are two basic types of securities — debt securities and equity securities — a security is a term used for many kinds of investment contracts including stocks, bonds, and mutual funds, among many others.

Marijuana companies and managers of other peoples’ wealth must consider securities laws. The civil and criminal consequences of not doing so are severe. The Securities Act requires issuers of securities to issue a prospectus, comply with gun jumping rules, and to face heightened liability under §§ 11 and 12. Issuers include a marijuana business, raising money through a private placement, or venture capital firms, where


108. Supra note 2 and accompanying text.


110. The Securities Act of 1933 § 11, 15 U.S.C. § 77k (2016) (material misrepresentation or omission of fact in the registration statement); § 12(a)(1) (contract rescission for sale or offer of unregistered securities or gun jumping violation); § 12(a)(2) (contract rescission for a prospectus or oral communication containing materially false and misleading statement); § 24, 15 U.S.C. § 77x (criminalizing willful false or misleading statements in registration statements); 15 U.S.C. § 78ff(a) (criminalizing willful false or misleading statements in 18 U.S.C. § 1348 (fraud)).

111. See Securities Exchange Act of 1933 § 5 (explaining that gun jumping is the concept of stimulating interest in a security prior to the filing of a registration statement).

the firms invest in portfolios of private companies.

Issuers or sellers of securities must file a registration statement or find and rely upon an available exemption.113 Structuring marijuana industry investment vehicles so that they are exempt from the registration requirements and public disclosure requirements of the federal securities laws will reduce costs, decrease regulatory scrutiny in an already highly scrutinized industry and, under certain exemptions, conveniently facilitates compliance requirements with the instate residency requirements, like in Colorado and Washington.

Residency requirements complicate the deployment of capital and providing financing to these businesses.114 For example, in Colorado, investors have two-year residence requirements (which are set to change in 2017) because Colorado Marijuana Enforcement Division considers the source of funds and financial review as principle compliance areas, subjecting applicants to thorough background checks.115 In Washington, the residency requirement is three–months.116 In both states, equity owners of businesses that touch marijuana must be residents of the state in question.

Two types of transaction exemptions are important in the marijuana space: intrastate offerings and private placements. Anyone seeking to rely upon these exemptions should seek the advice of a lawyer, keeping in mind a lawyer may be confronted with ethical challenges related to providing legal advice connected to structuring deals in this space.117

The sale of registration exempt securities will differ from state to state according to any given state’s marijuana and blue–sky laws.118 Of course,

113. The Securities Act of 1933 § 5(a), 15 U.S.C. § 77e (2016) (providing that “[u]nless a registration statement is in effect as to a security, it shall be unlawful for any person,” to use any means of interstate commerce in connection to security).


117. Supra note 5 and accompanying text.

118. See, e.g., CAL. CORP. CODE § 25102 (f), (n) (2014) (California intrastate exemptions); COLO. REV. STAT. § 11–51–308 (2016) (private placement exemptions including Section 4(2) under the Securities and Exchange Act of 1933 as well as offers
the issuer or seller of the investment interests should contact the state regulators to confirm that the offering has been cleared for sale in the state.119

Useful exemptions are highlighted below. Section 3(a)(11) including Rule 147 is used in connection with intrastate exemptions. Many intrastate investment contracts do not need to be registered under the Securities Act of 1933 or any state securities law.120 Section 4(a)(2) including Regulation D is used in connection with private placements. Relying on exemptions has advantages and disadvantages.

1. Interstate Offerings

Section 3(a)(11)121 exempts securities offered and sold only to persons resident in a single state by an issuer incorporated in and doing business in that state. While less relied upon than other federal exemptions, Section 3(a)(11) provides the basis for an intrastate fund.

The legislative history . . . suggests that the exemption was intended to apply only to issues genuinely local in character, which in reality represent local financing by local industries, carried out through local investment. Rule 147 is intended to provide more objective standards upon which responsible local businessmen intending to raise capital from local sources may rely in claiming the section 3(a)(11) exemption.122 The specific advantage of the Section 3(a)(11) exemption includes a requirement to restrict eligible investors to a single marijuana friendly state. A Cole Memo II priority is preventing diversion of marijuana. While the guidance is limited to diversion of marijuana, likewise the distribution or diversion of proceeds that have a nexus to marijuana business securities may trigger increased federal scrutiny.123 Relying on this exemption,

to no more than twenty persons in Colorado and ten purchasers); WASH. REV. CODE § 21.20.320 (2014).
121. The Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c (2012) (“Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.”).
122. 17 C.F.R. § 230.147 (2016) (“Part of an issue”, “person resident”, and “doing business within” for purposes of section 3(a)(11)).
informs federal authorities that investors are not directly diverting proceeds to other states; in fact, the explicit message is that capital is being deployed and proceeds are being distributed within the marijuana friendly state. The disadvantages include the burden being on the issuer to establish that conditions of exemption have been met.

In the marijuana space, restrictive contractual covenants are important. Colorado and Washington marijuana businesses could take advantage of Section 3 (a)(11) and Rule 147 as long as investment contracts contain covenants requiring ownership transfers to comply with state regulations including restricting investors from reselling to out of state residents. Likewise, fund managers could form intrastate funds relying upon these exemptions as long as the investors and portfolio companies are intrastate.

Rule 147 is a safe harbor to Section 3(a)(11). Rule 147 typically applies to small business entities that would like to raise limited amounts of money, without incurring the expensive fees associated with registering with the SEC. Rule 147 requires that all purchasers must be residents of the state, eighty percent of the business’s gross revenues, assets, and use of offering proceeds must be within the state, and resales are limited to state residents. Rule 147 also has practical limitations, including a strict advertisement compliance requirement. Even though this exemption presents challenges for marijuana businesses with multistate operations, it provides additional flexibility for businesses with limited out of state assets and operations.

2. Private Placements

Regulation D is relied upon heavily for private placements. A private placement is the sale of interests in a business (securities) to a limited number of qualified private investors, typically taking the form of a private placement memorandum (“PPM”) for one of the following: a subscription agreement for preferred stock, limited partner interest in a limited partnership, or membership interest in a limited liability company (“LLC”). In fact, ownership interests in limited liability organizations are broadly considered securities under state and federal securities laws. The contractual vehicle between venture capital fund managers and portfolio companies typically takes the form of a stock purchase agreement, also, for preferred stock.

Rule 506 of Regulation D is considered a “safe harbor” for the private residents from moving to Colorado expressly to establish an adult-use marijuana business.”).

125. Id.
offering exemption of Section 4(a)(2) of the Securities Act.\textsuperscript{126} It allows an unlimited amount of money to be raised, an unlimited number of accredited investors, up to thirty-five non-accredited investors, and is subject to certain restrictions on public advertising.\textsuperscript{127}

Even though Regulation D exemptions are relied upon in unregistered security transactions, they may not be ideal in the marijuana industry context because the distribution of proceeds from the sale of marijuana across state lines is, on many levels, analogous to the actual diversion of marijuana. Consequently, the Cole Memo II’s diversion—control prevention enforcement priority may be triggered. Further, recall in 2005, the U.S. Supreme Court held that Congress had the power to and did prohibit purely intrastate cultivation and possession of marijuana.\textsuperscript{128} To avoid the diversion inference, investors should be limited to the same state or marijuana states with similar regulations (that is, only investors from retail marijuana states or only investors from medical marijuana states).

The advantage of the Regulation D Rule 506 lies in the requirement for investors to be sophisticated or accredited.\textsuperscript{129} Due to the high-risk nature of the marijuana industry, entities seeking investments should only deal with persons that have sufficient knowledge and finance experience so that they can evaluate the risk as well as afford the risks. Therefore, Rule 506 requires what good businesses sense dictates — sophistication and accreditation. As an aside, if an issuer (again a business seeking capital or fund) relies on any of the Regulation D exemptions, it is required to file notice with SEC after the first sale.\textsuperscript{130}

To summarize, on the one hand, the use of unregistered securities reduces costs and decreases regulatory scrutiny in an already highly scrutinized industry. In addition, under certain exemptions, in state residency requirements are aligned with the federal government’s diversion control concerns. On the other, unregistered securities tend to be less liquid. While illiquidity based on the unregistered status of the security is a risk, prudent investors will put significant weight on the DOJ’s diversion—control enforcement priority when evaluating investment opportunities.

\textsuperscript{126} Id. § 230.506 (exemption for limited offers and sales without offering limitation).
\textsuperscript{127} Id.
\textsuperscript{128} Gonzales v. Raich, 545 U.S. 1, 1–3 (2005).
\textsuperscript{130} 17 C.F.R. § 239.500, Rule 503(a) (Form D).
IV. PLAYBOOK FOR PRIVATE EQUITY DEPLOYMENT

The private equity business is enormously complex. Typically, private equity firms invest money from pension funds, institutions, and high net worth individuals with an exit strategy of either an initial public offering or sale to another company. Private equity takes many forms like hedge funds, leveraged buyouts, and venture capital, but typically, venture funds invest in portfolio companies in exchange for preferred equity stock or debt, which is convertible into equity upon a subsequent event or milestone. Pending the investment vehicle, investments can be locked up for years, a decade, or longer. Other investment vehicles are debt focused with an option to convert to equity based on certain events, as an example, rescheduling of marijuana under federal law.

A nuanced private equity industry is emerging to serve marijuana businesses. Noted wealthy individuals support the marijuana industry. George Soros, John Sperling, and Peter Lewis have spent millions supporting the cannabis industry. In spite of this support, large, from the need to understand business management to the highly technical products and services that characterize specific markets, understanding private equity is challenging. Many private equity funds are structured as limited partnerships (“LPs”) and, accordingly, limited partnership agreements govern the terms of the agreements. Others are limited liability companies or corporations. In any case, the organization would be one in the state that permits marijuana cultivation, distribution and use for medical or recreational purposes.

In the LP rubric, general partners (“GPs”) raise capital, make investment decisions and, at least the good ones, provide valuable management services. LPs include pension plans, university foundations, endowments, and high net worth individuals; they make the investments. LPs lack expertise in management and markets. GPs (fund managers) pool portfolio companies in order to mitigate risk. See generally JOSH LERNER ET. AL., VENTURE CAPITAL & PRIVATE EQUITY, (5th ed., 2012); JOSH LERNER ET. AL., VENTURE CAPITAL, PRIVATE EQUITY, AND THE FINANCING OF ENTREPRENEURSHIP (2012).


institutional funds and investors are unlikely to invest in companies that actually touch marijuana until these businesses are able to do public offerings, and, in turn, list and sell shares publicly; which requires the federal government to de-schedule marijuana altogether. Recently, Pay Pal co-Founder Peter Thiel’s venture fund, Founders Fund, invested in Privateer Holdings, a venture firm that invests marijuana businesses. In spite of this development, investments in companies that actually touch marijuana remain largely reserved for friends, families, and wealthy individuals. All investors are confronted with similar legal risks.

This section of the article addresses two facets of this industry: private equity funds and private placements. In both cases, the surrounding illegalities make linking incentives of all the parties, the entrepreneur as well as the general and limited partners, challenging. Obviously, businesses and investors want to make money, not a stint in the federal penitentiary. Investors face a range of risks from inherent reputational considerations to underlying investment risks caused by short-term cash flow issues resulting from the portfolio company’s inability to secure a loan or obtain credit cards. Many investors, regardless of residency, will hesitate to put money into an industry that is illegal on the federal level. Similar to other industries that rely on private equity, linking incentives is critical to the success of the fund for the underlying portfolio companies or anyone else to be willing to invest directly into a marijuana business.

In the marijuana industry, investors are limited. Investors fall into four generalized categories. First, family and friends appear to be one of the largest sources of funds. Second, a common dominator for many investors is that they think marijuana should be legal. The rationale for legalizing marijuana ranges from patients having access to medicine, reducing violence in Latin America, and states’ rights. Third, other investors are enticed by the high returns associated with the next big thing; stories abound of people wanting to throw money at marijuana. Fourth,
others want highly diversified portfolios.

Funds are poised to invest and angels are investing because of the anticipation that the internal rate of return will be high. Of course, if the banking and tax issues are not addressed, the bottom line rate of return will be reduced significantly.

A. Investment Agreements

A key component to private equity is the incentive alignment driven structure of the markets; the core, perhaps the entire purpose, of this structure is to align incentives of the stakeholders (investors, fund managers and entrepreneurs). Inherent in financing businesses are problems of uncertainty, information asymmetries, and agency costs. In the marijuana industry, as discussed above, these issues are magnified because of the uncertainties connected to the federal law including taxation, money laundering, securities, and dealing in controlled substances. Individuals that work with private equity (funds and private placements) must understand, manage, and disclose these complications.

In the venture capital context, general characteristics of limited partners include a readiness to trade anticipated above–market gains in exchange for illiquid investments. An entrepreneur has limited access to capital and a requirement for management expertise. Private equity managers are investment professionals and bridge these worlds by identifying businesses with latent value, investing capital, and providing the business with valuable management services. While seasoned private equity managers think they understand the marijuana market, perhaps with the exception of cannabis based pharmaceuticals, understanding the capital deployment challenges is generally distinct from understanding the business of cultivation, distribution, and sale of marijuana and its compounds.

While managers are not typically involved in day-to-day operations, an understanding of the market sector is critical. To illustrate, entrepreneurs and industry insiders possess significant amounts of information on a wide range of issues, ranging from strains with recreational, scientific, or medicinal merit to knowledge of the business’s prospects compared to peers. Invariably one party has more information than the other. Further, the surrounding federal illegality gives rise to unique uncertainties. These

public vehicle and bring business professionalism to the sector. Mentor attempted to execute this strategy with a business, Bhang Chocolates, which actually handles marijuana.; see also Robert Sanchez, The Money Tree, 5280 THE DENVER MAG. (Nov. 2014) (reporting the interactions between Colorado Harvest Company and a potential investor.).

137. The author does not have enough information to evaluate internal rates of return, pre–post money valuations, and other basic financial metrics.
challenges make modeling outcomes and drafting respective contractual contingencies based on any events that may occur (as an example, unable to meet milestones because changes in state or federal law) challenging.138

Terms of the investment contract revolve around aligning financial interests. Typically, the fund agreements (limited partnership and subscription) provide the representations, warranties, covenants, and other contractual provisions of investors and managers to address issues inherent to private equity financing.139 Funds agreements often require investments in or restrict investments from certain markets. Funds include cross fund investment restrictions, that is when a fund manager may not invest money from a later fund into a company the firm invested in an earlier fund; restrictive covenants involving debt and raising new funds are common. Further, subscription agreements are typically and expressly by contract subject to anti-money laundering regulations compounding risks the managers may breach. In this space, as others, agreements should maintain “key-person” clauses. In the marijuana industry, a key-person clause is critical as many purport to have business acumen, but few actually do.

Similarly, the portfolio company contracts should focus on staged financing and control to align incentives. For these reasons, marijuana businesses may not capitalize via traditional methods and institutional investors may not participate in this market for the time being.

In the private placement context, concerns are distinct. Unlike the venture capital model, while an investor may gain a certain level of control over the issuer’s business, the private offering typically does not involve complex maneuvering to balance interests. The core issues are ensuring that securities exemptions are properly relied upon as well as requesting and securing sufficient financing. Going back to the well for money in exchange for preferred, much less common stock, becomes progressively more challenging.

Compounding the challenges related to financial contracts, certain state lawyers may not be able to comply with their rules of professional conduct and simultaneously draft or negotiate contracts, including leases.140 If a

---

139. Numerous formulaic documents are required including IRS Form SS–4, U–2, and SEC Form D, application for EDGAR Codes, among others.
140. See Colorado Ethics Option 125 (“A lawyer cannot comply with Colo. RPC 1.2(d) and, for example, draft or negotiate... leases for properties or facilities, or contracts for resources or supplies, that clients intend to use to cultivate, manufacture, distribute, or sell marijuana, even though such transactions comply with Colorado law, and even though the law or the transaction may be so complex that a lawyer’s assistance would be useful, because the lawyer would be assisting the client in conduct that the lawyer knows is criminal under federal law.”); see also Colo. Rules of Professional Conduct 1.2(d) (“a lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal...”); ABA Model Rules or Prof'l
lawyer cannot assist a client with a lease, structuring an interstate PPM for a marijuana business could be a violation of the CSA as well as aiding and abetting the cultivation, distribution, and possession of marijuana among other federal crimes. To address this ethical quandary, the Colorado Supreme Court adopted a comment so Colorado attorneys may counsel and advise on Colorado’s marijuana laws.\(^\text{141}\)

### B. Business Structures

Both the business operating entity and the investment fund–focused entities (whether a fund, an angel, or a group of angel investors) have an interest in setting up the appropriate business organizations. Because of the conflict between federal and state law and the banking, tax, and contractual issues, an entity organization is particularly important in achieving business planning goals, minimizing legal risk, and maximizing returns. Appendix III is an overview of various business structures. Appendix III is not intended to provide guidance, but it merely presents a summary of the alternative vehicles in which marijuana businesses and the investor relation may be formed. Undeniably, the services of lawyers and other business–planning professionals are required to effectively make these decisions to address the present ethical challenges discussed above.

Using these entities is driven by a desire to reduce personal liability as well as facilitate investment and business development. Investment entities and as with all operating businesses, marijuana businesses should consider the following factors: (1) limited liability; (2) centralized management and control; (3) liquidity of ownership interest; (4) distribution of proceeds; (5) pass-through taxation; and, (6) continuity of business life.

Reducing this section to the salient points is a challenge. In respect to funds, at least two organizational entities merit consideration: (1) the actual fund and (2) the entity the private equity professionals form to manage the fund.

Typically, the fund is structured as a limited partnership. The limited partners are investors and the general partners are the managers. In turn, the general partner forms a management services entity, typically structured as an LLC for tax and flexibility purposes.

Notwithstanding the traditional structure, private equity professionals

---
\(^{141}\) Colo. RPC 1.2(d) cmt. 14 ("A lawyer may counsel a client regarding the validity, scope, and meaning of Colorado constitution article XVIII, §§ 14 & 16, and may assist a client in conduct that the lawyer reasonably believes is permitted by these constitutional provisions and the statutes, regulations, orders, and other state or local provisions implementing them. In these circumstances, the lawyer shall also advise the client regarding related federal law and policy.").
should consider forming C-Corporations ("C Corp") in the marijuana space. First, with or without tax losses, the tax information would not be included on the investor’s federal income tax return since the C Corp is not a pass-thru entity. Second, since the investor generally holds a preferred class of stock, the investor’s rights could be structured so that voting rights are prohibited in all matters relating to handling marijuana with the only rights being the organizational structure and additional investment matters. Third, it is generally easier to transfer stock interests to a subsequent or replacement investor. Fourth, the investors and manager–investors (who may receive salaries and commissions as compensation) would not show the source of income on their returns except as a dividend or salary from such company. Although the dividend and compensation would be taxed at the investor or employee level, the business income and deductions would be reported only at the corporate level, potentially providing some insulation from self-incrimination as well as civil and criminal liability.142

Since IRC Section 280E prevents investors from deducting expenses from federal income tax obligations, a pass-thru business structure may not be the optimal vehicle for the management service entity.143 An LLC, electing to be taxed as a corporation, is a practical option.

If the management services entity is formed as an LLC, as is typical, it is governed by an operating agreement. The managers may structure the operating agreement to provide flexibility to adapt to changing needs and circumstances that are subject to the terms of the subscription agreement.

Electing to be taxed as a C Corp is not typical. An LLC may elect to be taxed as a partnership (that is, a pass–thru entity) or as a corporation merely by checking the appropriate box on the federal income tax forms. In either case, whether taxed as C Corp or partnership the LLC maintains significant operating flexibility. However, if pass–thru is not elected the managing member would show the source of income as a return or dividend allowing the members more discretion. By contrast, if pass–thru is elected, the managing member would likely be required to show income, expenses, and deductions from the marijuana business.144

Turning from funds to the operating business, while the six factors above


144. 26 U.S.C. § 706(b)(4)(B) ("A partnership as such shall not be subject to income tax imposed by this chapter. Persons carrying on business as partnership shall be liable for income tax only in the separate and individual capacities."); §702(a)(1)–(7) (elaborating that each partner must accounting separated for his or her share of capital gains, losses as well as bottom line income and losses); see also IRS Form K1, http://www.irs.gov/pub/irs-pdf/f1041sk1.pdf.
should be evaluated, marijuana businesses should consider LLCs as the primary option because of the contractual flexibility for determining the rights of the members and structure of the organization. Certainly, limited liability is important, but flexibility in structuring the ownership interests and distribution of proceeds are equally necessary. Again, an LLC electing to be taxed as a corporation provides this flexibility. As a secondary option, since business deductions for a marijuana business are unlikely to be allowed because of IRC Section 280E, C Corps which offer all six of the characteristics above should be considered for the operating business.

Because ownership interests are treated as securities under state and federal securities laws and many states regulations have license assignment restrictions, investors should not be able to resell their interest without approval. To be sure, reselling the interests to the public may not only be prohibited under state law but also it may destroy the applicable exemption. Improper reliance on securities law exemptions may result in the applicability of heightened fraud provisions as well as give rise to the possibility of administrative and civil liability. 145

C. Raising Money, Deploying Capital and Distributing Proceeds

A core purpose of this article is to discuss whether and how managers of private capital may invest in businesses that actually touch marijuana and, subsequently, how proceeds may be distributed back to the investors. Perhaps nothing, besides federal rescheduling or descheduling of marijuana, will make investing in this industry ostensibly legal because a direct investment in a business that handles marijuana likely is a direct violation of the CSA. Likewise, the activities amount to aiding and abetting to or conspiring with someone to cultivate, distribute, and possess marijuana, even though the federal government has indicated that it does not intend to enforce federal laws in this area. 146

Despite the challenges in finding investors, businesses that exhibit growth attributes seek and find capital. 147 Institutional and other investors have explored ancillary markets and, recently, direct investments in the retail marijuana industry. Generally, investors are intrigued by this market because of the perceived dynamic growth. Structuring an investment so that it does not implicate the Cole Memo II’s enforcement priorities, adheres to DOJ requirements, and abides by the Treasury’s financial

146. 18 U.S.C. § 2 (aiding and abetting); § 371 (conspiracy); §§ 1961–68 (racketeering).
guidance is feasible.

Assuming that investments do not implicate the Cole Memo II’s enforcement priorities and the investors follow the FinCEN Guidance, even though federal authorities could enforce federal laws, federal authorities (such as the DOJ and the DEA) should not do so in the retail and medical marijuana states with robust regulatory frameworks. If marijuana businesses that directly handle marijuana and the respective investors adhere to the principles that follow, they will reduce the inherent risks associated with deploying capital in this industry.

Foremost, the marijuana businesses and investment entities alike must be professionally operated, comply with business and accounting standards, and, of course, understand and adhere to the federal guidance.

Second, prior to issuing or selling securities, interested parties should attempt to resolve the banking conundrum by collaborating with a bank that is willing to implement a robust compliance program. Banking relationships will facilitate the deployment of capital. Fund managers and marijuana business leaders need to work with the bank’s risk managers as well as the federal regulators to establish mutually beneficial compliance programs. In turn, the bank must maintain an active compliance program, including a risk management component that actively conducts and works with clients to accomplish the required due diligence.

A fundamental component of this collaborative compliance is filing a Marijuana Limited SAR for every transaction. Using the marijuana limited SAR mechanism for every transaction is the foundation for a working business relationship between a bank and a business that directly handles marijuana. In short, the marijuana businesses and the banks should collaborate to comply with FinCEN guidance.

Third, using a PPM or other prospectus, individuals soliciting the investment should disclose all available information to the investors — the fund should be above board and over-disclose. The purpose of the investment should be outlined in the PPM and defined in the fund agreement highlighting the high degree of risk and illiquidity. Many investors are aware of the surreal dichotomies (illegal but won’t prosecute; conduct commerce without access to banks). In spite of the general understanding, in the context of soliciting other people’s money, the issuer or solicitor should be above board. The solicitor, in the interest of full disclosure and mitigating the risks associated with securities regulatory compliance, should inform all investors, including friends and family, angels, and other entities with wealth, of the criminal and civil risks, particularly forfeiture.

Fourth, continuing with critical legal compliance matters, all investors should understand and comply with state regulatory requirements (e.g. in
state residency, background checks, over 21 years old). In Colorado, for example, the prospectus should address the Colorado residency and the good moral character requirements. All investors should be accredited and sophisticated; likewise, issuers should take active steps to verify that investors meet these criteria.

Fifth, specifically evaluate securities laws and regulations. Creating a wholly intrastate fund has advantages. The issuer (that is, the angel, fund managers or business) of an investment contract must be aware of the Blue Sky laws. In Colorado, the issuer should contact the Division of Securities regarding his or her intent to sell unregistered securities. Likewise, in Washington, the issuer or seller should communicate with the Washington State Department of Financial Institutions.

Sixth, the prospectus should provide an overview of the CSA, the BSA, the tax code, and the respective DOJ and FinCEN Guidance. The investment solicitor should (1) disclose the difficulties and risks associated with distributing proceeds and (2) acknowledge that the FinCEN Guidance affirms that, unless the FinCEN guidance is followed, doing business with marijuana businesses could be construed as money laundering and other violations of the BSA.

Seventh, as in most circumstances, business owners and fund managers should incorporate or form limited liability business organizations. Forming the entity in a limited liability structure does not assure insulation from liability, but certainly provides for less exposure. Because certain underlying activities are illegal under federal law, individuals may not be protected from federal actions by a state business organization, even if formed in a state permitting the activity. The potential to reach assets exists as well as federal enforcement, particularly if the climate in Washington, D.C. changes.

Finally distributing proceeds has risks. In addition, to the omnipresent threat of money laundering statutes and the BSA, investing proceeds from a business that directly handles marijuana is a federal crime.

148. See Colo. Sess. Laws § 12–43.4–306 (persons prohibited as licensees); COLO. CODE REGS. § 212–2.204 (2016) (factors considered when evaluating ownership of a license for retail marijuana establishments); COLO. CODE REGS. § 212–2.201 (2016) (complete applications requirement); COLO. CODE REGS. § 212–1:1.232 (2016) (factors considered when determining residency).


151. 21 U.S.C. § 854(a) (2016) (**It shall be unlawful for any person who has received any income derived, directly or indirectly, from a violation of [the CSA] punishable by imprisonment for more than one year in which such person has
Whether adhering to these guidelines provides investors sufficient comfort to risk exposure to activities that are illegal on the federal level is another question altogether, but some investors may find these risks acceptable.

V. CURRENT PRIVATE EQUITY EFFORTS

For some investors the rewards outweigh the risks. Unusual complexity and risk coupled with upside characterizes the cannabis market. Many businesses are thinly capitalized, highly speculative, and merely trying to benefit from the market buzz.

Aligning the incentives of the investors is an important concern in most private equity transactions for both the private equity managers and entrepreneurs. Typically, fund managers begin the process of aligning incentives by focusing on certain markets or market segments. Funds and investments directed to businesses that actually touch marijuana, regardless of recreational or medicinal use, inherently give rise to the risks discussed in this article. Of course, the fund must find a bank willing to conduct business with it in the first place.

Although these risks are great, there are now more than seventy–five public cannabis companies in the U.S., up from thirteen at the end of 2012. Investors have deployed $100 million into the general marijuana industry in the last two years. In 2014, investments in the general industry grew 941.5%. Niche investors are active.

155. Id.
156. Id. According to CB insights the listed investors (ArcView Group, PharmaCan Capital, Broadband Capital, Adam Wiggins, Delavaco Group, Broadband Capital, Dutchess Capital Management, Delavaco Group, FastFunds Financial Corporation, Dutchess Capital Management, Founders Fund, FastFunds Financial Corporation,
Investment managers seeking niche specialties may target five market segments. First, funds could target their investments in legal ancillary businesses that support the marijuana industry. Many businesses are integral to the marijuana industry, such as childproof bags to indoor growing industry products, which are potentially ripe for investment consideration. Generally, these licensing, real estate, compliance, and technology businesses are limited to over-the-counter markets.

Ancillary business segments include biotechnology, consulting services, consumption devices, cultivation, hemp based products and extracts, investment and M&A, physical security, real estate, and software. A number of examples of firms that services these sub-segments exist. Perhaps most well-known is Privateer Holdings; a private equity firm that invests, incubates, and acquires companies in the marijuana and the medical industry. Until recently, Privateer had disavowed investing in companies that actually handle marijuana in U.S. markets. Departing from this stance, in November 2014, it announced the creation of Marley Natural, a marijuana brand. Purportedly, the Marley Natural will have a suite of products that include heirloom Jamaican cannabis strains said to be similar to the ones Bob Marley consumed. This is a radical change in stance; it appears Privateer has researched the speculative conclusion that the U.S. market has reached a tipping point.

Similarly, Fresh VC claims to have deployed capital in the medical marijuana–mobile app space. While certain ancillary businesses are performing well, others have difficulties raising money and obtaining capital because they still have reputational considerations without the perceived economic upsides connected to businesses that actually manage marijuana cultivation, distribution, or sales.

Second, a fund could structure itself around the pharmaceutical or nutraceutical markets. While the underlying compliance matters should be evaluated, pharmaceuticals businesses may conduct business legally as long as the business has its licenses and approvals in place from the DEA.

158. Id.
and the Food and Drug Administration ("FDA").

Nuvilex, is developing cancer treatments based upon chemical constituents of marijuana, cannabinoids. Nuvilex Inc.'s subsidiary, Medical Marijuana Sciences, Inc. is conducting research involving pancreatic and brain cancer focusing "on ways to exploit the benefits of the live cell encapsulation technology in optimizing the anti-cancer effectiveness of constituents of cannabis, known as cannabinoids, against cancers while minimizing or outright eliminating the debilitating side effects usually associated with cancer treatments."

GW Pharma grows cannabis in the UK and legally imports compounds into the United States. It has a cannabis focused IP portfolio; Sativex has FDA Fast Track status and is currently collaborating with major global pharmaceuticals to commercialize the drug. Novartis, a global pharmaceutical giant, acquired five percent stake in the company with an option to acquire an additional five percent.

As others do, these businesses operate legally at the federal and state levels; individuals interested in investing in this industry should evaluate this segment to better understand how to legally work with cannabis at the federal level. In any event, in the long term, pharmaceuticals may be one of the more profitable segments because of its market potential.

Third, internationally focused funds may not be hindered by the same barriers to entry, in particular banking and tax, as in the U.S. market. The international markets also present the opportunity for high rewards albeit coupled with high risk. Uruguay, Israel, Spain, and Holland have cannabis markets meritorious of consideration.

Fourth, a number of highly publicized enigmatic funds that work in a grey area exist — they appear to work with businesses that actually directly manage marijuana, but tend to promote their relationships with the ancillary ones. In this vein, the High Times Growth Fund and the Arc View fund merit mention. Arc View is California based and claims to manage a fund and various portfolio companies. Based on Arc View's website, it actively solicits "accredited investors" from apparently any state. It also advertises that it has funded twenty-eight businesses with fourteen million dollars invested. By contrast, the High Times Fund has a meager web presence and, at some point in 2016, the web presence

Finally, companies that actually touch cannabis: certain funds are supposedly deploying capital to companies that directly handle marijuana. Remarkably, a handful of over the counter companies are dealing directly with marijuana.

The game is changing rapidly on many levels. Notably, tobacco and alcohol companies as well as private equity firms that focus on tobacco, alcohol, and drug markets are evaluating the marijuana industry. These companies and firms have a keen understanding of regulated vice markets. Whether individuals that manage this money will embrace risks of working with businesses that actually handle marijuana, while it remains illegal on the federal level, remains unknown. If, or perhaps when, they enter, the private equity industry will certainly look different than it does today; for one, marijuana may become commoditized where branding and marketing are critical.

VI. CONCLUSION

The green rush is on. Yet again, Colorado, along with other states, are redefining what Wild West means. Entrepreneurs, once again, are lured to marijuana states, particularly, Colorado, Nevada, Arizona, Oregon, Washington and California, with thoughts of easy money.

Notwithstanding state decisions to exempt the cultivation, sale, distribution, or use of marijuana for medical and recreational purposes, this


conduct continues to be a violation of federal criminal law and may be
prosecuted by federal authorities. The limits of state legalization and
regulation of the sale of marijuana are evident in the private equity
industry. Structuring and participating in deals that violate federal laws
could give rise to harsh penalties and punishments. Convincing investors
to invest into a business that may implicate the investors in a criminal
activity or enterprise or, more likely, that could have its assets seized by the
federal government is challenging. Logically, business owners turn to
family and friends, because who better to share fortune or misfortune
than someone you know or love?

While overcoming the CSA altogether, that is making the transaction
legal under federal law is challenging to say the least, an investors can take
steps to mitigate risk exposure. On many levels, the definition of a
successful exit is limited. Of course, not going to jail is a condition
precedent for a successful exit. After avoiding criminal punishment, not
having assets seized is also a threshold matter. Taxation on gross revenues
and limited ability to bank are massive hurdles. After getting by these
obvious risks, as many entrepreneurs appear to have done, the market is
growing and dynamic; entrepreneurs who take risks may reap impressive
returns.

Unlike any other industry, because of the inherent risks presented by the
specter of the federal laws and regulations these businesses do not have
access to traditional capital markets. Private placements are a potential
option for marijuana companies that need to generate capital.

Particularly concerning to the private equity industry is the inability to
conduct normal banking operations. Providing a solution to the banking
issue is fundamental to effectively deploying private equity. Banks and the
FDIC–insured local lenders typically will not work with marijuana
businesses. Providing banking services to marijuana businesses could be
construed as money laundering, conspiracy to violate the CSA, or
racketeering. To be sure, these are atypical and significant risks for any
investor. Although certain federal overtures provide assurances that
individuals who adhere to the state statutes and regulations will not be
prosecuted under federal laws, the assurances are not law.

With a change in federal priorities, the enforcement paradigm may
change as well. The value of a business could vary significantly with a
change in political parties in Washington D.C., a Supreme Court decision
or a minor modification to Congress’s appropriations acts. Until the

168. Consolidated and Further Continuing Appropriations Act, 2015, Sec. 538;
Consolidated Appropriations Act, 2016, Sec. 763 (while these legislative acts pertains
to industrial hemp and medical marijuana it demonstrates how Congress may adjust
enforcement priorities in the cannabis space from year to year).
federal government embraces the open and regulated market, investors should take steps to reduce inherent risks.

Against this backdrop, the money tree is blooming. While some dreams have been and will continue to be fulfilled, those who understand capital considerations and risks will fare better. Until the federal government, de-schedules marijuana there will be no legal certainty in this space. Uncertainty gives rise to high risks. High risk gives rise to high returns. How much risk is an investor willing to carry? Under the “it’s legal,” but it’s really not dichotomy–paradigm entrepreneurs and investors should do their due diligence and they should conduct it on a regular basis because the times are changing quickly.

---

APPENDIX I: A BRIEF HISTORY OF MARIJUANA

The history of marijuana and the respective laws are complex, well-cited accounts often conflict. A basic understanding is necessary to understanding conflicting interests driving issues effecting marijuana businesses today.

In ancient China, people used it as a general analgesic and for migraines and nervous system disorders. The Babylonians used it for textiles. The Egyptians and Greeks used it for recreation, textile and medicine. Sorting through the fact and fiction is difficult but marijuana was an important crop with many uses, industrial and medical, for thousands of years.

Fast-forwarding a few thousand years, King James required early American colonists to plant a minimum of 100 hemp plants for rope manufacturing. In 1839, William O’Shaughnessy introduced marijuana to Western medicine. Eventually, marijuana was readily available in the 1850s. From 1854–1941 U.S. Pharmacopeia listed marijuana as a medical drug and, accordingly, it was available in U.S. pharmacies. Through the 1920s, physicians prescribed marijuana for many medical issues (analgesic, cramping, and nervous systems disorders among others).

Beginning in the early 1920s, certain states began to categorize marijuana as a poison. The early regulation of the growing of “hemp” culminated in the enactment of the Marijuana Tax Act of 1937, which imposed an excise tax on all sales of marijuana including marijuana and industrial hemp. The American Medical Association opposed the Marijuana Tax because it taxed physicians and pharmacists.


175. California Poison Act, 1880 Cal. Stat. 102 (“extracts, tinctures, or other narcotic preparations of hemp, or loco–weed, their preparations or compounds”).

By the 1930s, marijuana was a controlled drug in every state. While theories connected to the origins of the anti-cannabis/marijuana movement abound, ranging from Hearst’s racial prejudices to DuPont’s monopolistic chemical–market driven incentives, there is ample evidence that marijuana was used for centuries to treat medical issues and its industrial utility is unquestioned.

## APPENDIX II: EXAMPLES OF PUBLICLY TRADED CANNABIS COMPANIES IN 2015

<table>
<thead>
<tr>
<th>Ancillary Cultivation &amp; Retail</th>
<th>OTCQB/America, OTCPink/America, OTCQX/America</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aerogrow International</td>
<td>OTCQB:AERO</td>
</tr>
<tr>
<td>American Green, Inc.</td>
<td>OTCPink:ERBB</td>
</tr>
<tr>
<td>AVT, Inc.</td>
<td>OTCPink:AVTC</td>
</tr>
<tr>
<td>GreenGro Technologies</td>
<td>OTCPink:GRNH</td>
</tr>
<tr>
<td>Growlife Inc.</td>
<td>OTCQBO:PHOT</td>
</tr>
<tr>
<td>IMD Companies</td>
<td>OTCPink:ICBU</td>
</tr>
<tr>
<td>Neutra Corp</td>
<td>OTCQB:NTRR</td>
</tr>
<tr>
<td>Quasar Aerospace Industries</td>
<td>OTCPink:QASP</td>
</tr>
<tr>
<td>The MaryJane Group, Inc.</td>
<td>OTCQB:MJMJ</td>
</tr>
<tr>
<td>Two Rivers Water &amp; Farming Company</td>
<td>OTCQB:TURV</td>
</tr>
<tr>
<td>Verde Science, Inc.</td>
<td>OTCQB:VRCI</td>
</tr>
<tr>
<td>Nhale, Inc.</td>
<td>OTCQB:NHLE</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Biotechnology</th>
<th>OTCQX/America, OTCQB/America, OTCQX/America</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abattis Biocenticals Corp.</td>
<td>OTCQX:ATTBF</td>
</tr>
<tr>
<td>Cannabis Pharmaceuticals, Inc.</td>
<td>OTCQB:CNBX</td>
</tr>
<tr>
<td>Cannabis Science, Inc.</td>
<td>OTCQB:CBIS</td>
</tr>
<tr>
<td>Business Name</td>
<td>Stock Symbol/Exchange</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>-----------------------</td>
</tr>
<tr>
<td>Creative Edge Nutrition</td>
<td>OTCPink:FITX</td>
</tr>
<tr>
<td>Easton Pharmaceuticals</td>
<td>OTCPink:EAPH</td>
</tr>
<tr>
<td>Growblox Sciences</td>
<td>OTCQB:GBLX</td>
</tr>
<tr>
<td>GW Pharmaceuticals</td>
<td>NasdaqGM:GWP</td>
</tr>
<tr>
<td>Medican Enterprises</td>
<td>OTCQB:MDCN</td>
</tr>
<tr>
<td>Medical Marijuana, Inc.</td>
<td>OTCPink:MMI</td>
</tr>
<tr>
<td>Nuvilex, Inc.</td>
<td>OTCQB:NVLX</td>
</tr>
<tr>
<td>Consulting Services</td>
<td></td>
</tr>
<tr>
<td>Advanced Cannabis Solutions</td>
<td>OTCQB:CANN</td>
</tr>
<tr>
<td>American Cannabis Company</td>
<td>OTCQB:BIMI</td>
</tr>
<tr>
<td>CannLabs, Inc.</td>
<td>OTCQB:CANL</td>
</tr>
<tr>
<td>Chuma Holdings, Inc.</td>
<td>OTCQB:CHUM</td>
</tr>
<tr>
<td>Medbox, Inc.</td>
<td>OTCQB:MDBX</td>
</tr>
<tr>
<td>Novus Acquisition &amp; Dev.</td>
<td>OTCPink:NDEV</td>
</tr>
<tr>
<td>United Cannabis Corp.*</td>
<td>OTCQB:CNAB</td>
</tr>
<tr>
<td><strong>Consumption Devices</strong></td>
<td><strong>Company</strong></td>
</tr>
<tr>
<td>------------------------</td>
<td>-------------</td>
</tr>
<tr>
<td>mCig, Inc.</td>
<td>OTCQB:MCIG</td>
</tr>
<tr>
<td>RapidFire Marketing</td>
<td>OTCPink:RFMK</td>
</tr>
<tr>
<td>Vapor Group, Inc.</td>
<td>OTCQB:VPOR</td>
</tr>
<tr>
<td><strong>Cultivation &amp; Retail</strong></td>
<td></td>
</tr>
<tr>
<td>Terra Tech Corp.</td>
<td>OTCQB:TRTC</td>
</tr>
<tr>
<td>-----------------</td>
<td>------------</td>
</tr>
<tr>
<td>Cannabis-based Products &amp; Extracts</td>
<td></td>
</tr>
<tr>
<td>Alternaturals</td>
<td>OTCPink:ANAS</td>
</tr>
<tr>
<td>Cannabis Sativa, Inc.*</td>
<td>OTCQB:CBDS</td>
</tr>
<tr>
<td>CannaVest Corp.*</td>
<td>OTCQB:CA NV</td>
</tr>
<tr>
<td>Global Hemp Group</td>
<td>OTCQB:GBHPF</td>
</tr>
<tr>
<td>Latteno Food Corp.</td>
<td>OTCPink:LA TF</td>
</tr>
<tr>
<td>MediJane Holdings, Inc.</td>
<td>OTCQB:MD</td>
</tr>
<tr>
<td>Hemp</td>
<td></td>
</tr>
<tr>
<td>Hemp Inc.</td>
<td>OTCPink:Hemp</td>
</tr>
<tr>
<td>Investment and M&amp;A</td>
<td></td>
</tr>
<tr>
<td>FastFunds Financial Corp</td>
<td>OTCPink:FFFC</td>
</tr>
<tr>
<td>FutureWorld Corp</td>
<td>OTCPink:FWDG</td>
</tr>
<tr>
<td>Hemp, Inc.</td>
<td>OTCPink:HEMP</td>
</tr>
<tr>
<td>Medical Marijuana, Inc.</td>
<td>OTCPink:JNA</td>
</tr>
<tr>
<td>Mentor Capital</td>
<td>OTCPink:MNTR</td>
</tr>
<tr>
<td>Surna Inc.</td>
<td>OTCQB:SRNA</td>
</tr>
<tr>
<td>TumbleWeed</td>
<td>OTCQB:DC</td>
</tr>
<tr>
<td>Holdings</td>
<td>DC</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>----------</td>
</tr>
</tbody>
</table>

**Physical Security**

| Blue Line Protection        | OTCQB:BL PG | http://www.bluelineprotectiongroup.com/ |
| DirectView Holdings, Inc.   | OTCPink:DI RV | http://directview.com/ |

**Real Estate**

| Agritek Holdings, Inc.      | OTCQB:AG TK  | http://agritekholdings.com/ |
| CannabisRX                  | OTCPQB:CA NA | http://www.cannabis-rx.co/ |
| The CannaBusiness Group*    | OTCPQB:CB GI | http://www.cashinbis.com/ |
| Mountain High Acquisition   | OTCPQB:MY HI | http://www.mountainhighacg.com/ |

**Software**

| AnythingIT                  | OTCQB:ANYI | http://www.anythingit.com/ |
| BreedIT Corp.               | OTCQB:BR DT | http://ibreedit.com/ |
| ENDEXX Corp.                | OTCQB:ED XC | http://www.endexx.com/ |
| Medical Cannabis Payment Solutions | OTCQB:REFG | http://medicalcannabispaymentsolutions.com/ |
| Singlepoint, Inc.           | OTCPink:SI NG | http://www.singlepointinc.com/ |

**Dispensary**

| Terra Tech Corp.*           | TRTC      | www.terratechcorp.com |

**Notes**

* indicates a business that appears to directly handle marijuana
APPENDIX III: BUSINESS STRUCTURES

There are three primary business structures (not including a sole proprietorship) and several variations.

**Partnership:** There are three types of partnerships:

1. **General Partnership:** In a general partnership, the percentage of ownership may vary but each partner is responsible for reporting and paying his or her percentage share of tax on the income or losses of the partnership and has an unlimited share in the debt and obligations of the partnership. The partnership must still file a tax return but it does not pay the tax liability. Due to the risks involved, individuals generally should not willing to invest in a marijuana business as a general partner.

2. **Limited Partnership:** In a limited partnership, the investors are generally limited partners and the manager/operator of the business is the general partner. For tax purposes, the income and losses flow through to the partners according to their interest. Limited partners' rights are generally set out in the Limited Partnership agreement and must comply with state law and federal tax rules. Limited partners are not liable for the debts and obligations of the limited partnership and do not participate in making managerial decisions for the business. The general partner is liable and makes all managerial decisions.

3. **Limited Liability Partnership:** Limited Liability Partnerships insulate the other partners from debts and obligations incurred by another partner. In many states, these are limited to professional organizations such as doctors, lawyers and architects and like the sole proprietorship are not a viable investment vehicle.

**Corporations:** Corporations are incorporated under state law by filing incorporation documents with the Secretary of State. The primary advantage of the corporate structure is to limit liability of both investors and manager/owners. Personal assets are protected from lawsuits and other business issues that can arise. For tax purposes, the corporation may be either a C corporation or an S corporation. It is generally easier to sell or merge a corporation than another type of entity because it is a simple matter of changing shareholders rather than establishing a new entity.

1. **C Corporation:** Unless a corporation makes an S election, it will be taxed as a separate entity from its investors (shareholders). This runs a risk of double taxation and does not provide the shareholders with any tax losses.

2. **S Corporation:** The S corporation is not a separate legal business
form. To become an S corporation and receive a tax pass through of income and losses, the corporation must make an S election. There are a number of requirements to be eligible for an S election including the number and type of shareholders. Because of these restrictions, it is generally not a good vehicle for investment except for some small and medium sized closely owned and domestic businesses. Like any other form of pass–thru entity, (LLC, Limited Partnership, and LLP) more income may be allocated to the investor/shareholder on which taxes are owed individually, without cash going to the investor/shareholder.

**Limited Liability Companies:** The LLC has attributes of both the corporate and partnership structures. Except for provisions required under state law, the LLC is primarily governed by the Operating Agreement agreed upon with the members. As such, it is a contract amongst the members. Flexibility in terms of operation is generally much simpler than in a corporation. There are no limitations on the number or type of investors as in a corporation electing S treatment. For tax purposes, the LLC may elect to be treated as a corporation with a tax at the corporate and member level or as a pass–thru entity like a partnership.