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Cannabis Conundrum: Advising Clients Doing Business in the Cannabis Industry

Compliance and Ethics

The burgeoning opportunities in the cannabis industry are as tempting to the entrepreneur as they are vast. There are the principal “plant-touching” businesses like growers and dispensaries. There are also supporting businesses specifically catering to the cannabis industry such as certain

transportation firms and storage facilities. Finally, there are non-cannabis businesses that may take on cannabis industry clients like consultants, accountants, and insurers.

Although the allure of this growing industry is overpowering, aspiring entrepreneurs must remember that it is operating against a fluid legal landscape. The progression of US states legalizing cannabis and cannabis derivatives for medicinal and recreational purposes creates a challenging conflict with federal law. Despite the liberalizing trend in state law, the lack of federal prosecutions of cannabis businesses, and the recent change in federal law legalizing hemp, marijuana and its derivatives remain illegal under federal law. Indeed, not only are they illegal, but they are classified as “Schedule I” controlled substances — the same classification that is used for heroin and LSD.

Those companies interested in entering directly into the marijuana business are thus exposed to criminal liability for a violation of the Controlled Substances Act (CSA), which makes it a crime to possess, cultivate, or distribute marijuana. As a result, even those considering providing ancillary services to marijuana-related businesses (e.g., accountants, consultants, or insurers) may also be exposed to federal criminal liability for aiding and abetting a violation of the CSA or for Money Laundering Control Act violations for receiving proceeds from a crime — even if the businesses they are serving are acting legally under state law.

The conflict between state and federal cannabis law, therefore, creates a challenge for anyone considering entering, or doing business with, the cannabis industry. The state/federal conflict also creates a challenge for the lawyers who advise them. Can it really be illegal for an accountant or a consultant to provide services to growers or distributors of marijuana and marijuana-derived products who are acting legally under state law? If so, are federal prosecutors really going to go after cannabis growers and distributors, or a law firm or an accounting firm for advising them? These questions and others raise a variety of challenges for the in-house and outside lawyer advising businesses in, or those servicing, the cannabis industry.

In answering these questions, it is essential that lawyers identify for their clients all of the factors they must take into account when assessing the risk of entering into, or servicing, the cannabis industry. This article explores the factors to consider in navigating this increasingly complex and rapidly changing legal landscape.

Background and definitions

At the heart of the discussion is the cannabis sativa L. plant (cannabis). This term has no particular formal legal definition. Marijuana and hemp are two different types of the cannabis plant. Cannabis contains chemical compounds known as cannabinoids. There are more than 100 different cannabinoids contained in the cannabis plant. Two cannabinoids assume importance in the current discussions about marijuana: cannabidiol (CBD) and tetrahydrocannabinol (THC). THC is the psychoactive compound contained in cannabis — the compound that causes a user to experience a “high.” Marijuana contains more than 0.3 percent of THC. Hemp contains 0.3 percent or less of THC.

Marijuana is illegal to grow, possess, or distribute under federal law. Hemp, as explained further below, is now legal under federal law. CBD, found mostly in hemp but also in marijuana, is not psychoactive, but some studies claim that CBD can assist with a variety of ailments, from anxiety to itchy skin.

The CSA is the federal law regulating the manufacture, possession, and distribution of substances like narcotics, hallucinogens, depressants, and stimulants. The CSA categorizes these substances

into five categories, or “Schedules,” based on factors from their potential for addiction and abuse to their potential medical benefits. Drugs identified in Schedule I are considered the most harmful substances with no medical benefits. Examples of Schedule I controlled substances include heroin, LSD, ecstasy, and, surprising to many, marijuana.

For comparison, Schedule II, which balances a substance’s medicinal value with the potential for abuse and harm, includes methadone, oxycodone, morphine and amphetamines. Schedule III includes substances ranging from Tylenol with codeine to anabolic steroids. Schedule IV includes anxiety drugs like valium and xanax, and Schedule V includes drugs like cough syrup with codeine.

As of this writing, 33 states and the District of Columbia have passed laws legalizing marijuana either for medical purposes, recreational use, or both. In contrast, until recently, *all* forms of cannabis (with exceedingly limited exceptions) were illegal under federal law. That changed on December 20, 2018, when the Agricultural Improvement Act of 2018 was signed into law by US President Donald Trump. The Act, still known colloquially as the 2018 Farm Bill, exempted hemp from the definition of marijuana under the CSA.

This development means that hemp and hemp-derivatives, including the widely available hemp-derived CBD, are no longer illegal under the CSA. CBD is a non-psychoactive chemical found in both hemp and marijuana plants. CBD is marketed in a wide variety of products, from pain-relieving balms and stress-reducing cookies to face creams.

Marijuana and its derivatives remain Schedule I controlled substances. Even CBD derived from marijuana — though legal when derived from hemp — is illegal when derived from marijuana because marijuana itself is illegal. A business can possess marijuana legally under federal law only under extremely limited circumstances regardless of whether possession is legal in a particular state. Specifically, a business involved in any way with marijuana and its derivatives can operate legally in the United States only if it complies with *all* of the following requirements:

- It has permission from the US Drug Enforcement Administration to possess marijuana;
- It purchased the marijuana from a DEA authorized supplier;
- It uses the marijuana only for research into potential medicinal uses; and
- It complies with all US Food and Drug Administration (FDA) rules, regulations and authorization.

The practical effect of these requirements is that, unlike hemp, *all* parts of the marijuana plant, and *all* derivatives therefrom (including marijuana-derived CBD), remain illegal under federal law, despite the state-law trends toward legalization.

Conflicting messages and practical problems

The current state of the law presents conflicting messages to businesses and their in-house advisers. On the one hand, the state trend towards legalization of marijuana sends the message that marijuana is not a societal evil, and may even have medicinal benefits. On the other hand, as already mentioned, the federal government signals through its Schedule I classification of marijuana that marijuana is a dangerous substance on par with heroin, LSD, and ecstasy.

The federal government’s own contradictory hands-off approach to prosecuting marijuana-related businesses adds an additional layer of confusion. Specifically, between 2011 and 2014, during President Barack Obama’s era, Deputy Attorney General James Cole issued a series of

memoranda, called the Cole Memos, setting forth the federal government's stance against enforcing federal marijuana laws in states that have legalized the drug in some way. The Cole Memos emphasized the federal government's enforcement priorities with respect to marijuana. Priorities included:

1. Preventing marijuana distribution to minors or gangs;
2. Entry into states where marijuana remains illegal;
3. Using the drug as a pretext to trafficking other illegal drugs;
4. Driving under the influence; and
5. Growing on public lands or federal property.

Of particular significance is the latest Cole Memo in the series, issued in February 2014. It indicated that there are instances where a financial institution may engage in financial transactions with a marijuana-related business (MRB) without running afoul of the Money Laundering Control Act. The memo points to the Financial Crimes Enforcement Network (FinCEN) guidance (issued the same day and discussed below) as guidance complementary to the Cole Memos and critical for financial institutions to follow. Though non-binding and without the force of law, cannabis companies that complied with the government priorities as set forth in the Cole Memos reasonably viewed themselves as being shielded from federal prosecution as a result.

In tandem with the issuance of the February Cole Memo, FinCEN issued guidance clarifying Bank Secrecy Act (BSA) expectations for financial institutions seeking to provide services to MRBs (See BSA Expectations Regarding Marijuana-Related Businesses, February 14, 2014). Specifically, the guidance provides some guidelines to financial institutions with respect to the due diligence these institutions should conduct in determining whether to do business with MRBs. As part of its customer due diligence, the guidance states that a financial institution should consider whether an MRB's business implicates one of the Cole Memo priorities or violates state law. The guidance further provides that a financial institution that decides to provide financial services to a marijuana-related business would be required to file suspicious activity reports (SARs), and describe in detail the process for generating and filing these reports.

The Cole Memos were helpful to marijuana-related businesses in providing a meaningful assessment tool for understanding the risk of prosecution. However, because the Cole Memos were Executive Department directives and not federal law, they were subject to change at the whim of the Justice Department — and that is exactly what happened.

In January 2018, then-United States Attorney General Jeff Sessions rescinded the Cole Memos, in a one-page memorandum. Specifically, the memorandum directed all US Attorneys to use previously established prosecutorial principles to govern marijuana-related prosecutions, and deemed the Cole Memos' guidance unnecessary. The message many received from this move was that the risk of federal prosecution might be on the rise under Attorney General Sessions, although when and to what extent was not at all clear.

The more recent legal landscape continues to reflect the confusion and challenges created by these mixed messages. In 2018, dozens of bills were introduced in Congress addressing varying elements of the marijuana trade, including several bills seeking federal safe harbors from prosecution for specific industries (banks), or for businesses generally operating under state law. Some of these bills essentially seek to commit to legislation what many perceived to be the state of play during the Obama Administration: marijuana businesses, and those who serve them, could operate without meaningful threat of prosecution if they followed state law and their conduct did not implicate federal

enforcement priorities.

Adding more confusion to the outlook, President Trump's then-nominee for, and now current, US Attorney General, William Barr, testified before the Senate Judiciary Committee during his confirmation hearing on January 15, 2019, that he would not prosecute marijuana businesses that relied on the Cole Memos in states where marijuana is legal — nudging the federal pendulum back towards the prosecutorial priorities as set forth in the Cole Memos' guidance. Barr expressed his personal view that marijuana should remain illegal, but recognized that businesses have relied on past prosecutorial forbearance and their "settled expectations" should not be disturbed.

Getting to the nub of the conundrum, however, Barr emphasized that the issue of marijuana's legality under federal law was a matter that Congress should resolve one way or the other, stating that "the current situation is untenable." Of course, as with the Cole Memos, and former US Attorney General Sessions' rescission memorandum, Barr's whim could change without notice unless and until Congress acts. Barr was confirmed as Attorney General of the United States on February 14, 2019.

In this vein, the FinCEN guidance, which remains in effect, provides some meaningful federal guidance on mitigating the risk of CSA prosecution by devising compliance programs in line with the federal enforcement priorities set forth in the now-rescinded Cole Memos. Though the guidance relies on priorities set forth in the Cole Memos, and is intended for banks, it is a useful resource for other businesses providing ancillary services, such as insurance or consulting, to reference in assessing the risk of CSA and Money Laundering Control Act liability and in devising meaningful compliance programs.

The bottom line is that businesses in the marijuana trade, while generally low on the list of federal prosecutorial priorities, if they are operating legally under state law, still do not enjoy a true federal safe harbor from prosecution under the CSA and related laws.

Factors to consider in advising clients

In view of this difficult landscape, in-house lawyers should consider a number of factors when advising plant-touching or non-plant touching businesses. While these terms have no formal definition, legal or otherwise, they are used, respectively, to denote businesses dealing directly with the marijuana plant, and those not dealing with the plant directly but providing support (i.e., consulting, equipment sales, etc.).

Separating the analysis of criminal exposure from remoteness of prosecution

While federal criminal prosecution of plant-touching businesses as well as ancillary businesses operating legally under applicable state law seems quite remote, these businesses and their advisers need to appreciate that exercising federal prosecutorial discretion not to prosecute is not the same as federal legalization of marijuana and can change at a moment's notice. Accordingly, it is important to provide a client with sufficient information about their legal exposure for the client to assess and communicate its own risk tolerance.

Understanding the nature of the business

In addition to understanding and incorporating a client's risk tolerance into their advice, advisers can provide the best and most meaningful assistance to clients by carefully assessing the role of the

business in the cannabis industry, and what service, direct or ancillary, it provides. This careful examination, especially in the case of advising ancillary businesses, ensures that the advice considers the precise manner in which the ancillary business services a plant-touching business.

Staying apprised of current developments

The legal landscape surrounding cannabis is rapidly evolving. New bills concerning some element of the industry are frequently introduced in Congress, and other commentary from government officials sometimes sheds light on the government's prosecutorial priorities and industry initiatives. Given the plethora of information constantly circulating about these issues, advisers need to remain apprised of the ever-changing legal and regulatory landscape.

Devising tailored due diligence programs

Unlike other industries where there are robust and sometimes government-sanctioned directives relating to levels of due diligence, what constitutes meaningful due diligence for a particular cannabis business is unclear. Advisers can assist clients by continually evaluating the state of the law, the trends signaled by new bills, and other new or resurrected guidance or other national commentary. These developments can often provide insight into the questions businesses should be asking when dealing in marijuana or providing services to a marijuana-related business.

Mind the neighbors

With Canada's legalization of marijuana in October 2018 comes a new set of considerations in advising companies with some element of cross-border presence. It is important to assess whether these issues are implicated with respect to clients operating on a cross-border basis, or when advising Canadian clients whose operations might touch the United States.

Conclusion

Opportunities in the marijuana industry are growing. There are tempting possibilities for businesses of all types, including direct and ancillary players. The legal and regulatory landscape, however, is confusing, contradictory and above all, dynamic. Businesses currently in, those considering entering into, or those providing services to businesses in the marijuana industry, are well advised to consult with experienced counsel to properly assess, potentially mitigate and, above all, fully understand the scope of legal and regulatory risks involved.

** The contents of this article are those of the author and do not necessarily reflect those of Willis Towers Watson.*

Andrew Wasserman

General Counsel

Willis Towers Watson, North America

He manages the company’s North America legal team and is responsible for the broad spectrum of legal issues affecting the company’s US and Canadian operations. He joined Willis Group, a WTW predecessor, in 2004, becoming North America general counsel in 2012. Wasserman has served on his local government’s Zoning Board and currently sits on the boards of several non-profit organizations. He is a 1992 magna cum laude graduate of New York Law School.

Meghana Shah

Partner Resident

Eversheds Sutherland

Meghana Shah is a partner resident in the New York City office of Eversheds Sutherland, a global law firm with 67 offices in 34 cities worldwide. Shah has 15 years of experience handling complex, class action and large-scale multi-district litigation here at home and managing multi-lingual, international investigations around the world. Her industry experience spans multiple areas including, most recently, advising various businesses in connection with cannabis-related issues.