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The Challenges of the Evolving Marijuana Industry: Reconciling State Legislation with Federal Prohibition

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Cultivation, production, distribution, or possession of marijuana is a federal criminal offense under the Controlled Substances Act (the CSA).¹ Yet, despite federal prohibition, state-sanctioned marijuana industries have emerged and are continuing to develop and expand. The question is thus raised: How do we reconcile federal prohibition with a state's legalization?

Decriminalization and the Rise of the Medical Marijuana Industry in California²

In 1996, California voters approved Proposition 215, the Compassionate Use Act, which, in pertinent part, decriminalized the cultivation and use of marijuana by seriously ill medical patients.³

In 2004, Senate Bill 420 (SB 420), the Medical Marijuana Program Act, became law. Among other things, SB 420 (1) required the California Department of Public Health to establish and maintain a statewide medical marijuana identification card program; (2) established possession and cultivation limitations and guidelines for qualified patients and their primary caregivers; and (3) extended decriminalization so qualified patients, persons with valid medical marijuana identification cards, and appropriate primary caregivers, may associate collectively or cooperatively within California on a non-profit basis only to cultivate marijuana for medical purposes.⁴

¹ 21 U.S.C. § 801 *et seq.*

² In a sense, California has not "legalized" medical marijuana. Instead, the state is exercising its reserved powers to not punish certain marijuana offenses under state law when a physician has recommended marijuana use to a qualified medical patient. *Guidelines for the Security and Non-Diversion of Marijuana Grown for Medical Use*, Edmund G. Brown, Jr., Attorney General, Department of Justice, State of California, August 2008, p. 3.

³ Cal. Health & Safety Code § 11362.5.

⁴ Cal. Health & Safety Code §§ 11362.765, 11362.775.

Following the passage of SB 420, certain local governments created ordinances authorizing medical marijuana dispensary permits. In 2007, the California Board of Equalization issued a Special Notice clarifying that medical marijuana sales were generally subject to sales tax, and businesses engaged in such transactions needed to possess a seller's permit.⁵ Then, in 2008, the California Attorney General issued guidelines for "a properly organized and operated collective or cooperative that dispenses medical marijuana through a storefront...."⁶

The Medical Marijuana Regulation and Safety Act (the MMRSA) became law January 1, 2016. The MMRSA is comprised of three pieces of legislation: Assembly Bill 243, Assembly Bill 266, and Senate Bill 643. Among other things, the MMRSA:

1. Establishes a dual licensing system in which medical marijuana enterprises will need an annual license issued by the state in addition to a local permit, license, or entitlement. Creates 12 general categories of license types for various enterprises involved in the production, distribution, testing, and sale of medical marijuana. Provides restrictions on vertical integration.
2. Establishes penalties for medical marijuana enterprises violating the MMRSA's licensing and recordkeeping requirements.
3. Creates a new Bureau of Medical Marijuana Regulation (the Bureau) within the California Department of Consumer Affairs with the sole authority to regulate licenses for the transportation, storage, distribution and sale of medical marijuana within the state and to collect fees in connection with such activities.

The Bureau and Local Jurisdiction

Before the new statewide system can operate and issue licenses, certain agencies, including the newly created Bureau, must establish rules and regulations. On February 4, 2016, Governor Jerry Brown appointed Lori Ajax, former Chief Deputy Director of the California Department of Alcoholic Beverage Control, to head the Bureau. Chief Ajax's immediate undertakings are to staff the Bureau and develop agency rules and regulations. Regarding the latter, Chief Ajax anticipates holding stakeholder meetings in the coming months for the purpose of gathering stakeholder input that the Bureau intends to use to draft its rules and regulations, which will be circulated for public comment before finalization.⁷ The Bureau and other licensing agencies, as well as industry stakeholders, are also in the unique position of designing regulations based on lessons learned from other states, such as Colorado and Washington, which have previously established their own licensing regimes. The Bureau anticipates developing regulations sometime before January 1, 2018.⁸

In the meantime, local governments are creating their own medical marijuana policies and regulations pertaining to whether and what type of commercial activities will be permitted within their jurisdictions. For the time being, local jurisdictions wield significant power over medical marijuana enterprises wishing to establish or expand their businesses. Businesses should be aware that once the various state agencies start issuing

⁵ *Important Information for Sellers of Medical Marijuana*, California State Board of Equalization, February 2007.

⁶ *Guidelines for the Security and Non-Diversion of Marijuana Grown for Medical Use*, Edmund G. Brown, Jr., Attorney General, Department of Justice, State of California, August 2008, pp. 8-11.

⁷ LA Times, Q&A (with Lori Ajax), Patrick McGreevy, April 7, 2016, available at: <http://www.latimes.com/politics/la-pol-ca-lori-ajax-marijuana-regulator-20160408-htm1story.html>.

⁸ Bureau of Medical Marijuana Regulation FAQ's, available at <http://www.dca.ca.gov/marijuanafaqs.shtml>.

licenses, licenses will be prioritized for any facility or entity that can demonstrate that it was in operation and in good standing with the local jurisdiction in which it operates before January 1, 2016.⁹

Reconciling State Approval of Marijuana with Federal Prohibition

The tension between federal prohibition and state legalization of marijuana, medical and recreational, is perhaps most paramount with regard to issues involving banking, federal taxes, and employment. For all three subject matters, the general consensus is federal prohibition trumps state legalization. With regard to banking, due to the prevailing interpretation of current federal banking laws, marijuana money transfers cannot be effectuated through credit card companies or debit networks, and most banks will not deposit funds obtained by marijuana enterprises.¹⁰ With regard to taxes, among other things, marijuana businesses cannot deduct business expenses for federal tax purposes.¹¹ And, with regard to employment, for national employers, especially those with government contracts and zero-tolerance drug policies, it appears that employers cannot be punished for enforcing their drug policies even if they prohibit state-sanctioned marijuana use.¹²

Recent developments, however, could signal a potential shift in federal marijuana policy. On April 4, 2016, the U.S. Drug Enforcement Administration released a letter addressed to lawmakers stating, among other things, that the agency is undergoing a review of a recommendation by the Food and Drug Administration to reschedule marijuana from Schedule 1 to a lower level. The DEA expects to reach its conclusion by the end of the first half of 2016. Should marijuana be rescheduled, at the very least, it would make it easier for researchers to scientifically study marijuana and its potential health benefits.

Furthermore, in a recent decision, *City of Palm Springs v. Luna Crest Inc.*,¹³ a California Court of Appeal added another piece of precedent establishing that California's medical marijuana laws do not conflict or obstruct federal law in violation of the Supremacy Clause of the U.S. Constitution. In the *Luna Crest* case, Luna Crest Inc. (Luna) opened a medical marijuana dispensary within the City limits of Palm Springs (the City). The Palm Springs Municipal Code requires, among other things, a permit to operate a marijuana dispensary within the City, which Luna did not obtain. The City subsequently brought suit seeking a preliminary injunction against Luna's continued operation of its unpermitted dispensary. In response, Luna filed a cross-complaint and a motion seeking a preliminary injunction against the City's continued enforcement of its permitting requirement.

⁹ Cal. Bus. & Prof. Code § 19321(c).

¹⁰ On February 14, 2014, the Department of Treasury Financial Crimes Enforcement Network (FinCEN) issued, *BSA Expectations Regarding Marijuana-Related Businesses*, FIN-2014-G001, providing industry guidance for how financial institutions can provide services to marijuana-related businesses consistent with their Bank Secrecy Act (BSA) obligations. FinCEN's memorandum, however, does not change the law and has not alleviated the cloud of uncertainty regarding banks transacting with marijuana related businesses. See *The Fourth Corner Credit Union v. Federal Reserve Bank of Kansas City*, U.S. District Court, Colorado No. 15-cv-01633-RBJ, order denying motion for summary judgment, *7-8 (January 5, 2016) (FinCen guidance and Cole memorandum do not authorize financial institutions to serve marijuana related businesses, but "simply suggest that prosecutors and bank regulators might 'look the other way' if financial institutions don't mind violating the law"). For these reasons, "perhaps among others, banking institutions have been reluctant to serve [marijuana related businesses]." *Id.* at *2.

¹¹ *Olive v. C.I.R.*, 792 F.3d 1146, 1151 (9th Cir. 2015) (tax court properly found that that Internal Rev. Code sec. 280E, which prohibits deductions for business expenses where the "trade or business" consists of trafficking controlled substances prohibited by federal law, applied to a California sanctioned medical marijuana business).

¹² Cal. Bus. & Prof. Code § 19330 (California's Compassionate Use Act, California's MMRSA, and relevant provisions of the Code do not, among other things, require employers to accommodate marijuana use); *Ross v. RagingWire Telecommunications, Inc.*, 42 Cal. 4th 920, 928, 930-31 (2008) (California's Compassionate Use Act does not compel employers to accommodate marijuana use); see also, *Coats v. Dish Network, LLC*, 2015 CO 44, 350 P.3d 849 (June 15, 2015) (Colorado Supreme Court held that medical marijuana use is not "lawful" activity for the purposes of a Colorado anti-discrimination statute, which makes it an unfair and a discriminatory labor practice to discharge an employee based on the employee's "lawful" outside-of-work activities; therefore, Dish Network was entitled to enforce its drug policy and had not wrongfully terminated an employee for consuming medical marijuana at home, after work, in accordance with Colorado law).

¹³ Case No. E062654, 2016 WL 1056700 (Cal. Ct. App. Mar. 17, 2016).

In its motion, Luna contended that the CSA preempts the City's permit requirement. The trial court denied the motion, and Luna appealed.

The California Court of Appeal affirmed the trial court's order, rejecting Luna's preemption argument. In relevant part, the Court held that the City's laws did not conflict or obstruct the CSA. With respect to the issue of conflict preemption, the Court concluded that the City's permitting requirements do not require anything that the CSA forbids—the City is merely exercising its regulatory, licensing, and zoning authority, regarding medical marijuana dispensaries.¹⁴ With respect to obstacle preemption, in relevant part, the Court ruled that a strong local regulatory regime governing medical marijuana related conduct is actually consistent with the purpose of the CSA, which, among other purposes, is meant to combat recreational drug abuse and drug trafficking.¹⁵

For now, *Luna Crest* maintains the status quo, at least in California, but the issue of preemption still looms. On March 21, 2016, the U.S. Supreme Court declined an opportunity to exercise its original jurisdiction and hear a lawsuit brought by Nebraska and Oklahoma against Colorado based on the harmful effects of Colorado's recreation marijuana laws, which are allegedly causing marijuana and criminal activity spill-over into Nebraska and Oklahoma. Among other things, the case would have provided the U.S. Supreme Court the opportunity to address the issue of whether Colorado law, legalizing the recreational use of marijuana, is preempted by federal law, and therefore unconstitutional and unenforceable under the Supremacy Clause.¹⁶

What Lies Ahead in California?

The upcoming November 2016 ballot presents a potential major development for California's marijuana laws. This November, Californians will likely have the opportunity to vote on whether recreational marijuana should be permitted in California.¹⁷ Although more than a dozen statewide ballot measures have been proposed to date, the one receiving the most traction is the so-called Adult Use of Marijuana Act (AUMA). The AUMA, if passed, would, among other things, permit adults 21 and older to possess and cultivate limited amounts of marijuana for recreational purposes. The law would also substantially impact the Bureau. Among other things, it would change its name to the "Bureau of Marijuana Control" and expand its powers and duties to regulate recreational marijuana.

In the meantime, it is important for California businesses to stay current with federal, state and local laws, regulations and guidance.

If you have any questions about the content of this alert please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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¹⁴ *Luna Crest*, at *7.

¹⁵ *Luna Crest*, at *8.

¹⁶ See *Nebraska and Oklahoma v. Colorado*, U.S. Supreme Court, No. 22O144 ORG, order denying motion for leave to file a bill of complaint (March 21, 2016).

¹⁷ <http://www.latimes.com/politics/la-pol-ca-marijuana-legalization-california-ballot-20160222-story.html>.

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