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The following article will be featured in an upcoming edition of the [TIPS Business Litigation Committee](#) Newsletter.

**MARIJUANA BUSINESS LITIGATION - SPECIAL CONSIDERATIONS**

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As of the date of this article, twenty-five states and the District of Columbia have legalized marijuana in some form, with four states having legalized marijuana recreationally. In November 2016, eleven more states will have various marijuana-based referendums on the ballots. The states with medical marijuana programs include Alaska, Oregon, Washington, California, Colorado, Nevada, Arizona, New Mexico, Montana, Minnesota, Michigan, Illinois, Louisiana, Delaware, Maryland, Pennsylvania, New York, Vermont, New Hampshire, Massachusetts, Connecticut, and Rhode Island. The four states with recreational programs are: Alaska, Oregon, Washington, and Colorado. California, Arizona, Nevada, Massachusetts, and Maine are slated to consider adult use marijuana on November 8, 2016. Legalization in California alone is expected to be a heavy domino in the creation of a new industry.

With legal marijuana rolling out across the country, the businesses supporting it are already developing. This new industry is comprised of business dealings and investor relationships that are vulnerable for controversy just as in any other industry--in fact, many of the business disputes which arise are the same as in any other industry, just with added rules and regulations with which to adhere. However, unlike other industries, marijuana remains illegal at the federal level. Because of its federal illegality, complications exist with banking, forcing more reliance upon private investors and creative partnership agreements. Taxes are extremely high because marijuana businesses cannot deduct ordinary business expenses, inevitably creating a strain on underlying business relationships. When those relationships break down, enforcement of contractual obligations can be tricky, again, due to the illegal status of marijuana at the federal level, and due to compliance issues at the state level. Two Business Litigation Committee Vice-Chairs, Lisa Dickinson and Lisa Pittman, are well versed in these disputes and relay the following tales from the trenches.

One issue is whether to file a lawsuit in federal court. Often, the funding of businesses depends upon investors located in different states. When a dispute among the parties arises, federal diversity jurisdiction is implicated. However, proceeding in federal court is not desirable, even when the underlying subject matter is something as seemingly innocuous as purchasing security cameras from an out-of-state vendor. The backdrop of these business activities at the federal level is that the activity is inherently illegal for pertaining to a Schedule I illegal substance, and particularly so if the business involves transport through the U.S. Mail for any supplies. When

forming entities to own and operate marijuana companies, consideration should be given to dispute resolution provisions requiring arbitration instead of court to sidestep the litigation complications that arise from the nature of the business activity. The use of arbitration can keep the facts developed about the underlying transaction in dispute confidential.

There are currently very few litigators who have handled a business dispute over a legal recreational marijuana business. In Washington State, marijuana is legal for recreational purchase and use under Initiative 502 (I-502), and more recently, retail stores may be licensed to sell medical marijuana. When this started, as the licensing process was completely new, many persons entered the “lottery,” where one could obtain a marijuana license by passing a background check, paying a fee, and getting a “winning ticket” in the lottery. More requirements were added to open a marijuana business, but the first test was to apply and “win” the lottery. This led to many persons forming entities with other persons to acquire funding without doing their due diligence on their partner and on what it would take to run a business. In order to get an application in by the deadline, and without risking more capital, many people formed entities to enter into the marijuana business without the advice of attorneys.

Lisa Dickinson tells about one of her cases: “One of the cases that I had involved a 50/50% member-managed LLC. There were two owners, and no real operating agreement. One of the members did not do any work, and did not put in any initial capital contribution other than ‘labor,’ which was really unspecified, but enough for an adequate ‘buy in.’ That member eventually wanted a distribution, as he felt that a multi-million dollar business should pay him distributions on a regular basis. Without going into why a party may have no right to force a distribution, litigating this matter in court was another matter. At the time, banks and credit unions would not allow these businesses to open accounts. Therefore, the business proceeds were held in a safe, or in cash, or in personal accounts. This is an obvious litigation issue to prove where the money is being held. Accusations of co-mingling or misappropriation of funds or embezzlement were ripe. The unanticipated problems were how does one prove or disprove the ‘cash on hand’ for a business? This resulted in ‘Exhibit A’ being a photograph of \$400,000.00 in cash being taken on a conference room table. Practice tip: no one wants this in their office. No one wants ‘Exhibit A’ being filed as public record. The other party chose to do so, resulting in requests for protection orders. Admissions in declarations as to where marijuana funds are being held could cause potential federal issues. A drafting tip would be to force arbitration to avoid embarrassing public filings and potentially opening up federal asset seizure from your clients.”

Ms. Dickinson has also handled collection issues. She asks, “as previously mentioned, if one gets a judgment against a business, are there liquid assets? As there are many taxation issues also involved because of I.R.S.C. 280E and the inability to write off many usual business expenses, most of the funds are used to pay tax liabilities. If assets are held in personal accounts or cash, how are these funds seized? You should allege piercing the veil early on in the litigation if your client is unsure of where the money is held. Second, you will want an attorney well-versed in collections, charging orders, and garnishments to assist in the collection.”

Lisa Pittman has refocused her career this year to specialize in the representation of businesses involved in the marijuana industry, both directly and indirectly, in various states. In Texas, for example, she has been counseling clients who seek to harness new revenue opportunities from products being used by marijuana businesses, even though many of the products do not “touch the plant,” as they say in the parlance, at all. Think credit card processing machines, irrigation systems, testing devices, and inventory tracking software. Still, if the product is used in a marijuana dispensary or cultivation or distribution facility, the federal and applicable state Controlled Substances Act can be implicated, particularly if the product falls under the very broad definition of paraphernalia, and the businesses must take all reasonable precautions to avoid the perception of aiding and abetting the manufacture or distribution of marijuana, despite not being active participants themselves. This is particularly true if the mail or internet is used to create an interstate commerce transaction, and if employees are used as customer service agents to give advice about the products or are otherwise involved in their sale. The businesses participating in this trade are risking criminal enforcement by the Drug

Enforcement Agency of violating the Controlled Substances Act. But the more mitigating steps the businesses take to refute the notion that their product is designed for marijuana businesses, the less likely they will be considered to run afoul of the U.S. Department of Justice's current list of enforcement priorities as it pertains to marijuana.

In Colorado, the residency requirements are about to change on January 1, 2017, to allow nonresidents of Colorado to invest in and have ownership interests in Colorado marijuana businesses. Similar to Washington, and unlike New York, Minnesota, and Illinois, for example, which very restrictively only allowed a small number of licenses, Colorado is a very competitive market which includes both people who have been involved in the marijuana business for some time (Colorado has had a medical program for years), and those who merely want to enter the industry with a financial motivation. Currently, many investors are looking for opportunities to jump into the Colorado market, and many businesses, distressed by the tax burdens and competition driving down profit, are eager to seek out infusions of capital from outsiders. Business marriages are likely to be formed, and the likelihood that there will eventually be a business divorce or exit of a party is highly likely. Careful attention must be paid to the disclosures contained in the investment documents, corporate formation and operating agreements, and other governing documents for transactions and alliances conducted in this industry in light of the federally illegal landscape. Solicitation of investment is also fraught with peril to avoid securities and regulation D violations and fraud allegations. If an investment goes awry, expect to confront very serious allegations as a result.

Sometimes, the contrasting motivations and expectations between the investors and operators leads to impasses that involve fierce disputes between the parties, and these disputes can become exacerbated at the administrative level. For example, it is not uncommon for a license holder/grower to pursue a joint venture with a landlord investor/owner of a building for the cultivation of marijuana. In a recent case, a disagreement arose as to the terms of occupancy and payment of rent, as the terms of the overall business venture evolved. Unusual arrangements are often entered to facilitate the financing of a cultivation facility, but if the relationship between the parties sours, not only can a court battle be initiated and become heated quickly, but the governing administrative agencies which preside over marijuana businesses also play a role in who has access to the premises and the product, the destruction and transport of product, and use of the license according to rules and regulations. Both parties can sabotage the other through the use of administrative enforcement, and then try to create a misleading evidentiary record for a civil trial. Sometimes, this administrative layer can be a frustrating logjam for the parties involved, and determinations by the agencies can change the power dynamics in a given transaction. In the example given, for instance, the commercial landlord was unable to enter and inspect the leased premises because it was not a license holder designated by Colorado's Marijuana Enforcement Division. The tenant was the license holder and thus was able to maintain control of the premises, potentially destroying fixtures while present, until the administrative officials conducted their procedural inspections and made their administrative rulings on the status of the license.

And while Ms. Dickinson notes that collecting against a marijuana business can be difficult, Ms. Pittman agrees and highlights that collecting your legal fees from marijuana businesses can be difficult as well. While allowances are made in budgets for capital expenditures and taxes, often insufficient allocations are made for legal and accounting services, which inevitably become necessary when a dispute arises in these highly leveraged and risky investment deals that require absolute compliance with administrative and state regulations. Practice Tip: Work under retainers or advance of fee arrangements only!

In conclusion, practicing in the marijuana industry requires attention to federal laws at issue, state laws, as well as administrative regulations. While many business disputes are often traditional ones, resolving the disputes requires sensitivity to these various regimes, understanding of the context of the marijuana industry, and finessing the use of the court system or preferably, alternative dispute resolution. This is just a small sampling of considerations in marijuana business litigation. TIPS BLC hopes to be on the cutting edge of relaying

marijuana litigation practice tips to you in future articles. Feel free to contact us with any questions that you may have!

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