# Franchising a Marijuana Business: It's Not Quite Mission Impossible

*Shannon L. McCarthy and Dawn Newton*

**Authors' Note:** When we decided to write this article for the *Franchise Law Journal*, we discovered early on that there are so many topics we could discuss that we had to make some difficult choices to limit our scope. We truncated our discussion on the history of marijuana as well as the discussion on what uses have been legalized. For purposes of this article, we focus primarily on the laws in states that have legalized all uses, including smoking, of the cannabis plant by the public. Some states have legalized the use of cannabis in medical research only; use of only hemp extracts or oils; use of only cannabidiol (CBD), which is derived from cannabis but does not produce the high that comes from tetrahydrocannabinol (THC); and medical use only for epilepsy and other purposes. We limit our intellectual property discussion to trademarks because of its definitional connection to franchising, but an entire article could be written on the full panoply of the intellectual property rights related to cannabis. So, dear reader, if you find yourself questioning issues within the void, please consider how you might add to the conversation by writing on the topic or issue missed.

**Ms. McCarthy**

**Ms. Newton**

In 1996, California became the first state to legalize cannabis[1] for medical purposes and since then there has been a steady march toward legalization across the country.[2] Twenty-three states and the District of Columbia

1. Some people in the industry view the use of terms other than cannabis, including "marijuana," to be pejorative. For the purposes of this article, the authors use the terms cannabis and marijuana interchangeably, but primarily use marijuana when that is the term used by a particular statute, memorandum, or article.

2. California Ballot Proposition 215 approved Nov. 5, 1996, Alaska Ballot Measure 8 (1998), Oregon Ballot Measure 67 (1998), Washington Initiative 692 (1998), Maine Ballot Question 2

*Shannon L. McCarthy (shannon.mccarthy@millernash.com) is a partner with Miller Nash Graham & Dunn LLP in Seattle. Dawn Newton (dnewton@donahue.com) is a partner with Donahue Fitzgerald LLP in Oakland, California.*

have now legalized the use and possession of cannabis for medical purposes and four have legalized the sale, use, and possession of cannabis for recreational purposes.[3]

Over the past two years, and with increasing frequency, media and business groups have been calling cannabis "the next great American industry"[4] and America's "fastest-growing industry."[5] A cannabis research group recently estimated the value of the cannabis industry with recreational use legal in only Colorado and Washington at $2.7 billion in 2014 and that if recreational use were legalized in all fifty states, its value would exceed the organic food industry.[6] In the first half of its 2016 fiscal year, Washington state cannabis businesses reported sales of $446,366,002 (inclusive of tax); this does not include medical marijuana that will become regulated by the state later in 2016.[7] Colorado saw record sales of medical and recreational cannabis in August 2015: $100.6 million.[8]

In virtually any other industry of this magnitude, one would expect franchise activity to be well-established and highly visible, but in the cannabis industry there are no high profile franchise systems.[9] Entrepreneurs with a

(1999), Colorado Ballot Amendment 20 (2000), Hawaii S.B. 862 (2000), Nevada Ballot Question 9 (2000), Montana Initiative 148 (2004), Vermont S.B. 76 (2004), Rhode Island S.B. 0710 (2006), New Mexico S.B. 523 (2007), Michigan Proposal 1 (2008), Arizona Proposition 203 (2010), District of Columbia Amendment Act B18-622 (2010), New Jersey S.B. 199 (2010), Delaware S.B. 17 (2011), Connecticut H.B. 5389 (2012), Massachusetts Ballot Question 3 (2012), Illinois H.B. 1 (2013), New Hampshire H.B. 573 (2013), Maryland H.B. 881 (2014), Minnesota S.B. 2470 (2014), New York A.B. 6357 (2014). *Contra* Ohio Ballot Measure 3 (2015) (measure failed with 64 percent of voters voting no to legalize medical use of marijuana).

3. Colorado Amendment 64 (2012); Washington Initiative 502 (2012); Alaska Ballot Measure 2 (2014); Oregon Ballot Measure 91 (2014). *Cf.* District of Columbia Initiative 71 (2014) (voters approved recreational use but the District requires congressional approval to implement new laws).

4. Heesun Wee, *How Legal Marijuana Could Be the Next Great American Industry*, CNBC, Jan. 14, 2014, http://www.cnbc.com/2014/01/14/how-legal-marijuana-could-be-the-next-great-american-industry.html.

5. Matt Ferner, *Legal Marijuana Is the Fastest-Growing Industry in the U.S.*, HUFFINGTON POST, Jan. 26, 2015, http://www.huffingtonpost.com/2015/01/26/marijuana-industry-fastest-growing_n_6540166.html.

6. *See* Will Yankowicz, *Legal Marijuana Blooms into the Fastest-Growing Industry in America*, INC., Jan. 27, 2015, citing Arcview Mkt. Research, *The State of Legal Marijuana Markets* (3rd ed.); and The Marijuana Investment Company, *Measuring the Marijuana Market: An Introduction to the World's First Marijuana Investment Index* 3 (2015); http://marijuanaindex.com/reports/cannabisIC_special_report_012715.pdf (reporting $2.7 billion of legal cannabis sales in 2014).

7. Washington Liquor & Cannabis Bd., *Weekly Marijuana Report*, Jan. 13, 2016, http://www.liq.wa.gov/marijuana/dashboard (reporting daily average sales of over $2 million per day in August through December). Unlike Colorado, Washington's initial recreational cannabis law did not include regulation of medical marijuana. Gov. Jay Inslee signed H.B. 2136 on June 30, 2015, which will bring medical marijuana under state oversight requiring reporting and taxing. *See* H.B. 2136, 64th Leg., 2nd Special Sess. (Wash. 2015).

8. Elizabeth Hernandez, *Colorado Monthly Marijuana Sales Eclipse $100 Million Mark*, DENVER POST, Oct. 10, 2015, at 4A, *available at* http://www.denverpost.com/news/ci_28947869/colorado-monthly-pot-sales-pass-100-million-mark.

9. *See* Sean Kelly, *Growing Franchises: Pipe Dreams and Organic Sleep Sites*, FRANCHISE TIMES, Aug. 2011, at 61–62 (reporting that owners of the Colorado marijuana dispensary Cannabis Medical Technology attempted to expand through franchising in 2011). The authors are aware of a few franchise offerings in connection with cannabis, but not actual cannabis sales. *See also* Franchise

sense of adventure are trying to figure out how best to tap into this growing legal market. The decriminalization of the sale of cannabis coupled with the known demand has led some to consider the business expansion opportunities, including franchising.

Although the barriers to legal access, use, and sale of cannabis continue to fall, some significant hurdles still remain that dictate caution for franchisors. This article will explore some of the major barriers that exist for anyone who is considering creating a franchise system that touches the plant, whether it is growing, producing, or retail sales.[10] The opportunities and challenges for ancillary businesses of the marijuana industry—the sellers of picks and shovels, if you will—are beyond the scope of this article.

## I. Federal Government's Lingering Influence

To understand the delicate regulatory environment in which cannabis sales exist, some background on the applicable federal law is necessary. The Controlled Substances Act (CSA) labels "marihuana" as a Schedule I drug.[11] Under the CSA, this means that cannabis has been found to have a high potential for abuse, has "no currently accepted medical use in treatment in the United States," and "a lack of accepted safety for use of the drug or other substance under medical supervision."[12] This designation makes the use or possession of any amount of cannabis illegal.[13]

Over the past two decades, the federal government has not allocated the resources needed by law enforcement agencies to continue enforcing federal drug laws in the wake of states legalizing medical marijuana. In 2009, Deputy

Times Editorial Board, *20 to Watch: Franchise Trend-Setters in 2015*, FRANCHISE TIMES, Jan. 2015 http://www.franchisetimes.com/January-2015/20-to-Watch-franchise-trend-setters-in-2015/ (reporting that the brand Palm Beach Vapors bills itself as the first "franchisor in the marijuana business": however the franchise model is for the sale of vape systems, not marijuana products); GlobalBX, Franchised Business Listings, http://www.globalbx.com/listing.asp?bId=212086 (listing a company called Legal Cannabis Delivery that advertises franchise opportunities in California for individuals interested in delivering medical marijuana to immobile patients); Ms. Newton represented unhappy area developers in the weGrow system of hydroponics catering to the cannabis growing industry.

10. For reasons discussed in this article, the cannabis industry recognizes a stark divide between businesses that "touch" and businesses that do not touch the plant. Although some businesses that do not touch the plant, such as producers of hydroponics systems, fertilizer, or smoking devices, may be subject to additional scrutiny by various agencies, banks, or other entities simply for operating in support of the cannabis industry, the most significant problems are faced by the businesses that touch the plant such as dispensaries and manufacturers of edibles, oils, and other products containing plant extracts.

11. 21 U.S.C. § 812, Schedule I(c)(10); *see id.* § 802(16) (defining "marihuana" as all parts of the plant *Cannabis sativa L.*). The plant *Cannabis sativa L.* includes the subspecies of *stativa*, *indicia*, and *ruderalis. See* U.S. Department of Agriculture Natural Resources Conservation Service, http://plants.usda.gov/java/ClassificationServlet?source=profile&symbol=CASA3&display=31.

12. 21 U.S.C. § 812 (b)(1)(A)-(C).

13. 21 U.S.C. § 8141(a)(1) (prohibitions against the manufacture, distribution, dispensing, or possession of controlled substances). Schedule I drugs are considered the most dangerous of all drugs and include heroin, LSD, meth, ecstasy, and peyote.

Attorney General David Ogden issued a memorandum to U.S. attorneys in states where medical marijuana laws had passed (Ogden Memo).[14] The Ogden Memo instructed U.S. attorneys to focus prosecution efforts on manufacturers and distributors, including "Mexican cartels," while avoiding the spectacle of prosecuting elderly, infirm patients seeking pain relief. It stated in part:

> The prosecution of significant traffickers of illegal drugs, including marijuana, and the disruption of illegal drug manufacturing and trafficking networks continues to be a core priority in the Department's efforts against narcotics and dangerous drugs, and the Department's investigative and prosecutorial resources should be directed towards these objectives. As a general matter, pursuit of these priorities 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. On the other hand, prosecution of commercial enterprises that unlawfully market and sell marijuana for profit continues to be an enforcement priority of the Department.[15]

Despite the Department of Justice guidance, uncertainty remained high among state attorney generals about how to treat medical marijuana distributors, and many sought clarification from the Department of Justice. In 2011, Deputy Attorney General James Cole issued a memorandum for U.S. attorneys (Cole I Memo) reiterating many of the same points made in the Ogden Memo, but noting that the Ogden Memo was not intended to shield commercial marijuana cultivation, even for medicinal purposes.[16] It showed the federal alarm at the new scope of domestic growing operations. While reaffirming the Ogden Memo's declaration that in the Department's view the prosecution of individual caregivers remained an inefficient use of federal resources, the Cole I Memo noted:

> There has, however, been an increase in the scope of commercial cultivation, sale, distribution and use of marijuana for purported medical purposes. For example, within the past 12 months, several 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.[17]

The Cole I Memo went on to explain that the Ogden Memo "was never intended to shield such activities from federal enforcement action and prose-

14. Memorandum from David W. Ogden, Deputy Att'y Gen., Dep't of Justice, to Selected U.S. Att'ys, *Investigations and Prosecutions in States Authorizing the Medical Use of Marijuana* (Oct. 19, 2009), http://www.justice.gov/opa/blog/memorandum-selected-united-state-attorneys-investigations-and-prosecutions-states.

15. *Id.*

16. Memorandum from James M. Cole, Deputy Att'y Gen., Dep't of Justice, to U.S. Att'ys (June 29, 2011) http://www.justice.gov/sites/default/files/oip/legacy/2014/07/23/dag-guidance-2011-for-medical-marijuana-use.pdf.

17. *Id.* at 1–2.

cution, even where those activities purport to comply with state law." Thus, the Cole I Memo declared that "[p]ersons 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."[18]

Despite this guidance and periodic efforts in various states by federal law enforcement to shut down large scale domestic cultivation and distribution, states continued to pass laws legalizing medicinal marijuana programs. By 2013, eighteen states permitted medicinal use and Washington and Colorado had legalized recreational use.[19]

On August 29, 2013, Deputy Attorney General Cole issued a second memorandum to U.S. attorneys addressing marijuana enforcement (Cole II Memo) that signaled a dramatic shift in the federal government's position.[20] While continuing to maintain that marijuana is a dangerous drug and remains illegal under federal law, the Cole II Memo issued a list of eight federal enforcement priorities that are "particularly important" to the federal government:

- Preventing the distribution of marijuana to minors;
- Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;
- Preventing the diversion of marijuana from states where it is legal under state law in some form to other states;
- Preventing marijuana businesses from being used as a front for other illegal activity;
- Preventing violence and the use of firearms in the cultivation and distribution of marijuana;
- Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
- Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and
- Preventing marijuana possession or use on federal property.[21]

18. *Id.* at 2.

19. Asheley Southall & Jack Healy, *U.S. Won't Sue to Reverse States' Legalization of Marijuana*, N.Y. TIMES, Aug. 29, 2013, http://www.nytimes.com/2013/08/30/us/politics/us-says-it-wont-sue-to-undo-state-marijuana-laws.html.

20. Memorandum from James M. Cole, Deputy Att'y Gen., Dep't of Justice, to U.S. Att'ys, *Guidance Regarding Marijuana Enforcement* (Aug. 29, 2013), http://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf.

21. *Id.* at 1–2.

These enforcement priorities describe the Department's concerns generally and are not an exhaustive list of activities that could trigger federal investigation or prosecution.[22] The Cole II Memo explained that the Department of Justice expects states that legalized marijuana to create robust compliance systems to enforce their laws and ensure that these federal enforcement priorities are met.[23] In doing so, the Cole II Memo virtually eliminated the target that Ogden and particularly Cole I had painted on large-scale but legally compliant cultivation and distribution facilities. The Cole II Memo noted that the size of an operation might be one "relevant consideration" in determining whether it would trigger heightened scrutiny by federal law enforcement.[24]

The effect of the Cole II Memo was to provide substantially more assurance to those involved at all levels of the industry that they would not be prosecuted, provided they complied strictly with state laws and did not implicate the government's eight enforcement priorities. In the wake of this decision, the government also cleared the way for sovereign Indian Nations to legalize the cultivation and use of cannabis on reservations and tribal lands.[25]

However, because this shift in enforcement priorities occurred only in Department of Justice memoranda, it could be reversed at any time and is not binding on other federal agencies.[26] In December 2014, Congress passed and President Obama signed a spending bill containing restrictions on the Justice Department's ability to prevent states from implementing their own laws regulating the distribution, use, possession, or cultivation of medical marijuana.[27] The Justice Department maintains that the spending bill does not prohibit it from prosecuting individuals or organizations it deems in violation of federal law.[28]

22. *Id.* at 2, n.1.

23. *See id.* at 2. The Department of Justice also noted that the listed priorities are not inclusive of all activities that may trigger federal enforcement. *Id.* at n.1.

24. Cole, *supra* note 20, at 3.

25. Memorandum from Monty Wilkinson, Dir., Exec. Office for U.S. Att'ys, to U.S. Att'ys, *Policy Statement Regarding Marijuana Issues in Indian Country* (Oct. 28, 2014), http://www.justice.gov/sites/default/files/tribal/pages/attachments/2014/12/11/policystatementregarding marijuanaissuesinindiancountry2.pdf.

26. *See*, *e.g.* Rebecca Millican, Marijuana at the Border, CANNA LAW BLOG, Dec. 10, 2015, http://www.cannalawblog.com/marijuana-at-the-border-customs-and-border-protection-misses-the-cole-memo-gets-sued/ (discussing how Cole Memo II does not control U.S. Customs and Border Protection actions wholly within the United States).

27. Consolidated and Further Continuing Appropriations Act, 2015, Pub. L. No. 113-235, § 538 (2014). The spending bill specifically refers to medical marijuana laws and not recreational marijuana. *Id.*

28. Timothy M. Phelps, *Justice Department Says It Can Still Prosecute Medical Marijuana Cases*, L.A. TIMES, Apr. 2, 2015, http://www.latimes.com/nation/nationnow/la-na-nn-medical-marijuana-abusers-20150401-story.html.

## II. Marijuana Laws, Where Every State is an Island

At the time of writing this article, twenty-three states plus the District of Colombia have legalized cannabis for medical purposes, and Alaska, Colorado, Oregon, and Washington have legalized the sale to and use by adults over twenty-one for recreational purposes.[29] For prospective franchisors, it is important to note that not all statutes are equal, or even similar.[30]

California was the first state to legalize medical marijuana.[31] When California passed the Compassionate Use Act of 1996, it did not strictly enumerate the conditions for which marijuana could be dispensed.[32] The California statute recites that the purpose of the Compassionate Use Act is:

> To ensure that seriously ill Californians have the right to obtain and use marijuana for medical purposes where that medical use is deemed appropriate and has been recommended by a physician who has determined that the person's health would benefit from the use of marijuana in the treatment of cancer, anorexia, AIDS, *chronic pain*, spasticity, glaucoma, arthritis, migraine, *or any other illness for which marijuana provides relief*."[33]

The vagueness of terms like "chronic pain" and "any other illness" led to physicians providing recommendations for marijuana to patients for the treatment of dozens of common complaints including anxiety, insomnia, depression, backache, repeated headaches, menopause, osteoporosis, and obesity.[34]

States following in California's wake have been more cautious about listing the medical complaints for which marijuana could be dispensed under their medical marijuana statutes.[35] Most states adopted the requirement that a patient suffer from a "debilitating medical condition," although the definition of this term varies widely among the states.[36] In Arizona, "severe and chronic pain" is covered as long as it is caused by a chronic or debilitating disease.[37] In Maine, the statute covers severe and chronic pain, but only

29. *See supra* text accompanying notes 2–3.

30. A detailed discussion of each state's statute exceeds the scope of this article, and prospective franchisors should review and compare the requirements under each statute to determine if elements of its concept might be prohibited under the statutes of other states.

31. *See supra* text accompanying note 2.

32. CAL. HEALTH & SAFETY CODE § 11362.5, later broadened by SB420, codified as CAL. HEALTH & SAFETY CODE §§ 11362.7-.83.

33. CAL. HEALTH & SAFETY CODE § 11362.5(b)(1)(A) (emphasis added).

34. *See*, *e.g.*, United Patients Group, *How Does Cannabis Help Menopause?*, http://www.unitedpatientsgroup.com/blog/2015/10/09/how-does-cannabis-help-menopause/; United Patients Group, *Fighting Obesity and Diabetes with Cannabis*, http://www.unitedpatientsgroup.com/blog/2015/01/31/fighting-obesity-and-diabetes-with-cannabis/; California NORML, California NORML Patient's Guide to Medical Marijuana, http://www.canorml.org/medical-marijuana/patients-guide-to-California-law.

35. *See* MASS GEN. LAWS ANN. ch. 94C App. § 1–2(C) (listing a small number of qualifying conditions, but includes "any other conditions as determined in writing by a qualifying patient's physician").

36. Most states' definitions of qualifying conditions include a core group of diseases or conditions, typically including cancer, HIV, AIDS, ALS, and conditions causing bowel distress or chronic muscle spasms.

37. ARIZ. REV. STAT. ANN. § 36-2801(3)(a)–(b).

if the pain has not responded to medical or surgical measures for more than six months.[38] In Montana, in order to qualify as a debilitating medical condition, severe and chronic pain must "significantly interfere[] with daily activities as documented by the patient's treating physician" and the pain must be confirmed by both objective diagnostic tests, such as an MRI, and by confirmation through a second, independent physician.[39] The states are also split roughly equally among statutes that explicitly recognize patients from other states, those that do not, and those that are silent on the issue.

In addition, a number of other states, not included in the twenty-three that have enacted medical marijuana laws, have enacted laws permitting possession and use of cannabis products that contain very low amounts of tetrahydrocannabinol (THC), the psychoactive component in cannabis that causes a high, and correspondingly large levels of cannabidiol (CBD), which has no psychoactive effects.[40] These statutes are inconsistent with one another as to permitted levels of both THC and CBD. In Georgia, the statute permits cannabis oils with less than five percent THC and at least five percent CBD. In North Carolina, THC must be below three tenths of one percent and CBD must be at least ten percent by weight. Louisiana requires that THC "be reduced to the lowest acceptable therapeutic levels available through scientifically acceptable methods."[41]

Recreational laws are no more uniform. Although a thorough comparison of the laws exceeds the scope of this article, three differences are important to highlight. First, the states differ in how they grant permission to cultivate and sell marijuana. In Colorado, many retailers grow their own marijuana, which is legal as long as the grower holds both a retail store license and a retail cultivation license;[42] Oregon also permits the same arrangement as long as retailers hold multiple licenses.[43] By contrast, Washington based its law on the alcohol control model of tiers and prohibits retailers from growing or producing marijuana and also prohibits licensed marijuana producers and processors from having any financial interest in a licensed marijuana retailer.[44]

Second, the states differ significantly in the degree of power afforded to local municipalities when it comes to licensing retail shops within their borders. Colorado's statute allows local jurisdictions to opt out of permitting recreational cannabis dispensaries from operating in the area, either by

38. ME. REV. STAT. ANN. tit. 22, § 2422(2).

39. MONT. CODE ANN. § 50-46-302 (2)(c).

40. Alabama, Florida, Georgia, Iowa, Kentucky, Louisiana, Mississippi, Missouri, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Utah, Virginia, Wisconsin, and Wyoming. *See* Table 2, http://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx#3.

41. LA. REV. STAT. ANN. § 40:1046(K).

42. COLO. REV. STAT. § 12-43.4-402(1)(b). Individuals may also grow up to six plants at home for either medical or recreational use. COLO. REV. STAT., COLO. CONST. art. 18, § 16(3)(b).

43. OR. REV. STAT. ANN., ch. 1, § 24. Individuals may also grow up to four plants at home for recreational use.

44. WASH. REV. CODE ANN. § 69.50.328. Recreational users are not allowed to grow plants at home, although medical marijuana patients are permitted to grow up to fifteen plants.

severely limiting the number of licenses permitted within its borders or by passing laws that ban dispensaries entirely,[45] and many have done so.[46] Because the law permits each municipality to review and respond to each license application in accordance with its own local laws, even cities that do not ban retail sales may choose to permit only a single licensed location within their boundaries. Likewise, Alaska's statute permits local governments to prohibit marijuana cultivation, production, or sales.[47] Washington's approach is similar to Colorado's but with an interesting twist: local municipalities can opt-out of the state's marijuana regulatory scheme and ban marijuana businesses, but municipalities that do so will not receive any allocation of tax revenue generated from marijuana taxes.[48] Oregon's statute supersedes and repeals any municipal charter or local ordinance that is inconsistent with its retail law.[49] It provides that municipalities "may adopt reasonable time, place and manner regulations *of the nuisance aspects* of establishments that sell marijuana," provided that the municipality "makes specific findings that the establishment would cause adverse effects to occur."[50] However, the local municipality may prohibit retail marijuana sales entirely only if local voters vote in favor of a ban during a statewide general election.[51] Because Oregon's retail law went into effect on July 1, 2015, it remains to be seen whether any cities or counties will vote to prohibit marijuana licenses entirely.

Third, although each state has a minimum residence requirement for license applicants,[52] the time period differs. In Washington, the residency requirement is only six months for individuals applying as sole proprietors,[53] while Colorado and Oregon require at least two years.[54] To businesses considering whether they can relocate trained company personnel to another

45. COLO. REV. STAT. ANN. § 12-43.4-301.

46. *See Marijuana Users Beware: Colorado Cities Still Prohibiting Marijuana*, LEAFBUYER, Sept. 18, 2014, http://www.leafbuyer.com/blog/marijuana-users-beware-colorado-cities-still-prohibiting-marijuana/ (reporting that more than seventy-five cities in Colorado have either permanently or temporarily banned marijuana retail stores).

47. ALASKA STAT. ANN. § 17.38-210(a).

48. *See* 2015 Wash. Sess. Laws page nos. 1869, 1910–11 (describing allocation of marijuana tax based on amounts collected by each local jurisdiction).

49. OR. REV. STAT. ANN. ch. 1, § 58.

50. OR. REV. STAT. ANN. ch. 1, § 59 (emphasis added). This section also provides examples of what reasonable regulation includes, such as limits on hours of operation and restrictions on location. *See id.* § 59(1)(d), (g).

51. OR. REV. STAT. ANN. ch. 1, § 60(6).

52. As of the date of writing this article, Alaska's Marijuana Control Board was still in the process of finalizing its license requirements. The current draft of the marijuana regulations requires only that all license applicants who are natural persons or who have an ownership interest in the entity applicant are residents under ALASKA STAT. ANN. § 43.23, which requires physical presence in the state with an intent to remain there indefinitely. *See* 3 ALASKA ADMIN. CODE § 306.015(b) [proposed], https://www.commerce.alaska.gov/web/Portals/9/pub/Articles1-9.pdf.

53. WASH. REV. CODE ANN. § 69.50.331(1)(c)(ii).

54. COLO. REV. STAT. ANN. § 12-43.3-307(1)(m); OR. REV. STAT. ANN. ch. 1, §§ 19–23. The Oregon requirement is established as a sunrise period which expires January 1, 2020.

state in order to operate an identical business in multiple jurisdictions, the residence requirement poses a challenge.

## III. Trademark Office Says Yes to Fake Leaves, No to Real Ones

To best understand the risks associated with franchising in the marijuana industry, let's take a moment to review the basics of franchising. The FTC Rule defines a franchise as:

> any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:
>
> (1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark;
>
> (2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and
>
> (3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.[55]

The states that regulate franchising use similar definitions, but the authors' discussion is based on the broad themes of trademark, system, and money.[56]

At its essence, a franchise is the right to operate a business under someone else's trademark. Although trademark rights are created by the use of the mark in commerce, one of the first steps a franchisor takes when setting up a system is to apply for a federal trademark registration from the U.S. Patent and Trademark Office (Trademark Office).[57] Federal trademark registration confers many benefits on the trademark owner: nationwide protection; presumption of exclusive rights to use the mark; and increased remedies against counterfeiters, among others.[58] But the Trademark Office currently refuses to grant trademark registration for cannabis-related goods and services because it is illegal under federal law.

55. 16 C.F.R. § 436.1(h).

56. *See* Bruce Napell, *State Relationship Laws Are Not Uniform*, 26:1 FRANCHISE L.J. 3, 11 & 17 nn.3–5 (2006).

57. *See* Beata Krakus & Alexander Tuneski, *Caught in the Web of Federal and State Business Opportunity Laws* 19-20, A.B.A. FORUM ON FRANCHISING (2013) (explaining that federal trademark registration helps franchisors with exemption from state business opportunity laws).

58. *See* William M. Borchard, *A Trademark Is Not a Copyright or a Patent* (2014) (describing advantages of federal trademark registration). Additional benefits of federal registration are access to federal courts to enforce trademark rights against infringers, use of the registration as a basis for applying for foreign trademark registration, recording with the U.S. Customs and Border Protection to help prevent importation by foreign infringers, and state registration preemption. *Id.*

A trademark is eligible for registration on the basis that the owner has used the mark in commerce.[59] The Lanham Act defines "commerce" as "all commerce which may lawfully be regulated by Congress,"[60] and Congress regulates the manufacture, distribution, and possession of controlled substances through the CSA. Because there is no acceptable medical use for Schedule I drugs, doctors cannot prescribe them to patients.[61] When states legalized the sale of cannabis, that state action did not preempt the federal government's prohibitions of its distribution vis-à-vis the CSA.

Trademark owners that file applications for marks in connection with any type of goods or services that a trademark examiner believes may be related to cannabis use will typically be asked a series of questions about whether the applicant's goods or services comply with the CSA. These can be as broad as questions about whether the applicant's services will enable third parties to purchase, trade, or sell marijuana or marijuana-based products.[62] Attempts at subterfuge such as listing "herbal products" in lieu of marijuana or cannabis are generally not successful.[63]

Cannabis trademark owners had a spark of hope for federal registration when the Trademark Office in April 2010 added a new classification for "processed plant matter for medicinal purposes, namely medical marijuana."[64] It is estimated that the Trademark Office received over 250 applications for trademark registrations for medical marijuana-related goods after the change. The Trademark Office removed the new classification after only three-and-a-half months saying, "it was a mistake," without further elaboration.[65]

Because the owner of a federal trademark registration has priority of use from the date it files its application, some cannabis trademark owners file

59. Lanham Act § 1(a), 15 U.S.C. § 1051(a) (2015). An owner with a bona fide intent to use a mark in commerce may apply for a trademark registration on an "intent to use" basis; however registration will not issue until the owner can show evidence of the use of the mark in commerce. *Id.* § 1(b).

60. Lanham Act § 45, 15 U.S.C. § 1127 (2015). *See* Gray v. Daffy Dan's Bargaintown, 823 F.2d 522, 526 (Fed. Cir. 1987) (explaining a valid application requires the mark in "lawful use in commerce"); Clorox Company v. Armour-Dial, Inc., 214 U.S.P.Q (BNA) 850 (stating policy of the Patent and Trademark Office that "shipment of goods in violation of federal statute . . . may not be recognized as the basis for establishing trademark rights").

61. 21 U.S.C. § 812(b)(1)(b)(2015). Schedule II drugs also have a high potential for abuse but they have been determined to have acceptable medical uses and can be prescribed. *See* 21 U.S.C. § 812 (b)(2)(B). Because Schedule II and lower scheduled drugs can be prescribed, and therefore used in "commerce," the names of these drugs are registerable as trademarks with the Trademark Office. Examples of Schedule II drugs include Dilaudid, Demerol, OxyContin, Sublimaze (fentanyl), and Dolophine(methadone). Office of Diversion Control, Drug Enforcement Agency, *Controlled Substances Schedules*, http://www.deadiversion.usdoj.gov/schedules/.

62. *See* U. S. Trademark Serial No. 86/445,568, Office Action, Jan. 29, 2015.

63. *See* Trademark Manual of Examining Procedure § 907 (2015) (describing refusals based on extrinsic evidence indicated goods or services do not comply with federal law).

64. Justin Scheck, *Patent Office Raises High Hopes, Then Snuffs Them Out*, WALL ST. J., July 19, 2010, http://www.wsj.com/articles/SB10001424052748704682604575368783687129488; *cf.* Laurel Sutton, *Don't Bogart That Name: Medical Marijuana Trademarks*, FAST CO., Aug. 5, 2010, http://www.fastcompany.com/1677722/dont-bogart-name-medical-marijuana-trademarks (suggesting the change was an April Fool's joke).

65. Scheck, supra note 63.

intent-to-use applications with the hope that federal law will soon change and they will have an earlier priority date upon registration.[66] However, an intent-to-use application for a currently prohibited good or service, such as dispensary services or the manufacture of infused or edible products, cannot be maintained indefinitely, and this strategy creates a window of about twelve to eighteen months before the application is considered abandoned.[67]

Many cannabis businesses have succeeded in obtaining federal registration on the Principal Register for goods and services that do not touch the plant.[68] These include software, online discussion forums and social networking sites, electronic catalogues and directories, apparel, marketing services, and vaporizers. In some instances, these companies are using these registrations of ancillary products or services as a way to try to both announce their claim to and protect their rights in a mark they cannot yet register for core goods or services. This adds substantial complexity and art to the process of trademark clearance for businesses in this industry.

Trademark registration through state registries is not necessarily any easier. In California, despite medical marijuana's legality, trademark applications for dispensaries and products to be sold to medical marijuana patients are denied by the state's trademark office if the applicant is unable to respond that the products comply with the CSA.[69]

Registration is not the only protection for trademark owners; trademark rights exist in common law, however those rights are limited to the geographic area in which the trademark is used or could be reasonably expanded.[70] Common law allows trademark owners protections within the geographic area in which the goods or services are used, which gives some

66. *See* Kieran G. Doyle, *Trademark Strategies for Emerging Marijuana Businesses*, WESTLAW J. INTELL. PROP. 3, at 5 (May 14, 2014). A change in federal law is not the only bar to registration for cannabis-related trademarks. Owners must meet all of the other registration criteria including that the mark is not generic or merely descriptive (generic words include *sativa*, *indicia*, *cannabis*, and weed and merely descriptive words include kush, pot, ganga, schwag, dank, bud, dope, herb, blunt, Mary Jane, reefer, etc.).

67. *See generally* Trademark Manual of Examining Procedure § 705.08 (2015) (explaining that applicants generally have six months to respond to an Office action denying registration). Depending on how long the application is pending before an Office action is issued and the number of Office actions and responses are exchanged, the trademark application may be active for over a year before the application is considered abandoned.

68. *See* Miriam D. Trudell, *Marijuana in the U.S.*, INTABULLETIN, Aug. 1, 2015, http://www.inta.org/INTABulletin/Pages/Marijuana_in_the_US_7014.aspx (reporting examples of these trademarks include HIGH TIMES for books about cannabis, THE MARIJUANA COMPANY for clothing, and MISTLETOKE for decorative hanging marijuana plant leaves made of silk).

69. The California Secretary of State's Office has issued form letter rejections of trademark applications for products and services whose identification includes medical marijuana unless the applicant can declare under penalty of perjury that its activities are lawful under the CSA. California adopted the Model State Trademark Law in 2008, codified as CAL. BUS. & PROF. CODE §§ 14200 et seq. It provides in part that the intent of the law is to be consistent with the federal system of trademark registration and protection. *Id.* § 14272.

70. *See* John R.F. Baer, et al., *Franchising: Cases, Materials & Problems* 48 (Alexander M. Meiklejohn ed., 2013) (describing scope of trademark rights includes geographic use of the mark).

protections against infringers.[71] The challenge for franchising companies is that they would have to begin doing business in each state or metropolitan area in which they want to enforce trademark rights, including applying for state trademark registration because the states do not accept intent-to-use applications.[72]

Enforcing common law or state trademark registration rights against infringers may pose additional challenges for trademark owners. Most trademark infringement claims are brought in federal district court because these courts have original jurisdiction over claims brought under the Lanham Act.[73] Even the owner of common law trademarks or state trademark registrations can bring a trademark infringement claim in federal court under Section 43 of the Lanham Act:

> Any person who, on or in connection with any goods or services, or any container for goods, *uses in commerce* any word, term, name, symbol, or device, or any combination thereof, or any false designation of origin, false or misleading description of fact, or false or misleading representation of fact, which is likely to cause confusion, or to cause mistake, or to deceive as to the affiliation, connection, or association of such person with another person, or as to the origin, sponsorship, or approval of his or her goods, services, or commercial activities by another person, or in commercial advertising or promotion, misrepresents the nature, characteristics, qualities, or geographic origin of his or her or another person's goods, services, or commercial activities, shall be liable in a civil action by any person who believes that he or she is or is likely to be damaged by such act.[74]

Despite having original jurisdiction over Lanham Act claims, it is unlikely that federal courts would hear trademark infringement claims involving cannabis goods or services. The plain reading of the statute requires an infringer to use the mark in commerce for the statute to apply. As long as cannabis products are illegal under federal law, an infringer's sales would not satisfy the Lanham Act's definition of "in commerce" any more than the trademark owner who is denied federal registration on the same grounds and a federal court is likely to dismiss the claim for lack of jurisdiction.[75] Although federal district courts have original jurisdiction, it is not exclusive, which leaves cannabis trademark owners to seek remedies for infringement in state court.

71. Doyle, *supra* note 65, at 5.

72. *Id.*

73. *See* Lanham Act § 39, 15 U.S.C. § 1121(a) (2015) (noting that original jurisdiction does not require a showing of diversity or a specific amount in controversy).

74. Lanham Act § 43, 15 U.S.C. § 1125(a)(1) (emphasis added).

75. *Cf. In re* Arenas, 514 B.R. 887, 895 (Bankr. D. Colo. 2014) (dismissing debtor's bankruptcy claims because debtor's assets were used in violation of the CSA). The court in *Arenas* noted that the court could not "force the Debtor's Trustee to administer assets . . . where the mere act of estate administration would require him to commit federal crimes under the CSA." *Id. See also In re* Medpoint Management, LLC, 528 B.R. 178 (Bankr. D. Ariz. 2015) (dismissing bankruptcy claim noting it "has neither the authority nor the will to enter an order for relief or endanger a trustee who might be assigned to administer drug tainted assets . . .").

## IV. Banking—Do You Take Cash?

Even more central to the creation and expansion of a potential franchise system than a trademark registration is access to a bank account. The need for a bank account is so fundamental to the operation of a business that the authorization for corporate officers to open a bank account is typically one of the first orders of business for a new company. Unfortunately, access to banking remains one of the biggest challenges many cannabis businesses face.

In February 2014, the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) issued guidance to banks and other financial services firms[76] interested in providing financial services to cannabis-related businesses.[77] Like the Cole II Memo, the FinCEN Guidance was issued in response to recent state law legalization of the recreational use and sale of marijuana. The stated goal of the FinCEN Guidance is to "enhance the availability of financial services for . . . marijuana-related businesses."[78] The FinCEN Guidance reminds banks that the sale of cannabis remains illegal under federal law and accepting proceeds of cannabis-related activity violates the Bank Secrecy Act (BSA).[79] Violations of these laws may subject banks to loss of Federal Deposit Insurance Corporation's deposit insurance or even the criminal prosecution of individual bank employees. The FinCEN Guidance states that it was written to assist banks in complying with their BSA obligations if they decide to provide services to state-legal cannabis businesses, but most banks have opted out of offering banking services because of the compliance burden.[80]

The FinCEN Guidance recommends that banks conduct extensive due diligence on their cannabis business customers, such as (1) reviewing the customer's state cannabis-license application, (2) requesting additional information about the customer from state licensing and enforcement authorities, (3) conducting ongoing monitoring for adverse information about the customer, (4) conducting ongoing monitoring for suspicious activity by the customer, and (5) refreshing the bank's information about the customer on a periodic basis.[81]

The federally illegal nature of cannabis businesses obligates banks to submit a suspicious activity report (SAR) for transactions made by a cannabis-

76. Although the FinCEN Guidance applies to all types of financial services firms (including securities dealers, insurance companies, money transmitters, and even casinos), the focus of this paper is on banking services; therefore, we will refer to banks through the rest of this article.

77. Dep't of Treas., *BSA Expectations Regarding Marijuana-Related Businesses*, Fin-2012-G001 (Feb. 14, 2014) [hereinafter *FinCEN Guidance*].

78. *Id.* at 1.

79. *Id.* at 2. *See also* Memorandum from James M. Cole, Deputy Att'y Gen., Dep't of Justice, to U.S. Att'ys, *Guidance Regarding Marijuana Related Financial Crimes* (Feb. 14, 2014) (reminding state att'ys general that financial transactions derived from marijuana "can form the basis for prosecution under the money laundering statutes . . .").

80. *Id. See also infra* notes 80–86 and accompanying text.

81. *FinCEN Guidance*, *supra* note 76, at 2–3.

business customer in amounts over $5,000 individually or in the aggregate.[82] The legality of cannabis under state law does not relieve a bank from the obligation to file a SAR for cannabis-business transactions.[83] Banks that provide services to cannabis businesses are allowed to file "marijuana limited" SARs, which reduce the disclosure obligation to the identification of the customer and a statement that the sole basis for the SAR is the customer's cannabis-related business and that no additional suspected activity exists.[84] Banks may file "marijuana limited" SARs only if they have a reasonable belief that the cannabis-business customer is not engaged in any of the activities identified as enforcement priorities by the Cole II Memo or is or is not in violation of state law.[85]

Through the FinCEN Guidance, the Department of Treasury makes clear that any bank that wants to provide services to cannabis businesses does so at its own risk. There are no safe harbors available for the banks, including reliance on state enforcement agencies to monitor the legal activity of the cannabis-business.[86] The federal government is relying on banks to become investigative units on its behalf. The FinCEN Guidance requires bank compliance departments to look beyond the information provided by its customers and seek out and *monitor* its customer's behavior other than its banking activity.[87]

The cost of the on-going compliance, coupled with the risk of loss to the bank as a result of a shift in federal enforcement priorities, far exceeds the potential gain for a vast majority of banks in the United States. Some banks and credit unions do provide services to marijuana businesses, but the exact number is unknown.[88] FinCEN reported that from February 14, 2014, through January 26, 2015, 249 banks and 71 credit unions filed marijuana-related

82. 31 C.F.R. § 1020.320. Banks are also obligated to file SARs on customers that provide goods and services to cannabis businesses, such as a landlord that leases space to a marijuana-related business. *FinCEN Guidance*, *supra* note 76, at 6.

83. *FinCEN Guidance*, *supra* note 76, at 3 (noting "the obligation to file a SAR is unaffected by any state law that legalizes marijuana-related activity").

84. *Id.* at 4. Banks can also file a "marijuana priority" SAR if the bank suspects that the customer's activity triggers any of the enforcement priorities outlined in the Cole II Memo. *Id.* If a bank terminates a marijuana business customer, it is required to file a "marijuana termination" SAR. *Id.* at 4–5.

85. *FinCEN Guidance*, *supra* note 76, at 4.

86. *See* Cole, *supra* note 78, at 3 ("Neither the guidance herein nor any state or local law provides a legal defense to a violation of federal law, including any civil or criminal violations of the CSA, the money laundering . . . statutes, or the BSA, including the obligation of financial institutions to conduct customer due diligence.")

87. *See FinCEN Guidance*, *supra* note 76, at 6 (describing red flags that the customer's activities might trigger federal enforcement priorities such as "review of publicly available sources . . . about the business . . . reveal negative information, such as . . . potential connections to illicit activity.").

88. *See* Alison Jimenez & Steven Kemmerling, *Who is Filing Suspicious Activity Reports on the Marijuana Industry? New Data May Surprise You* (2015), http://securitiesanalytics.com/marijuana_SARs.

SARs.[89] Considering there are over 5,300 commercial bank charters (not individual branches) and over 6,100 federally insured credit unions, the number of institutions filing marijuana SARs make up a very small percentage of depository institutions.[90] What we do not know from the report is how many of those 320 banks and credit unions offer bank services to marijuana businesses as opposed to those who filed "termination" SARs as a result of learning about the source of customer deposits after the accounts were open.

Both activists in the cannabis industry and seasoned banking veterans have attempted to set up banking relationships in order to solve these problems, thus far with little success. Perhaps the most notable example is Fourth Corner Credit Union (Fourth Corner CU). In November 2014, Fourth Corner CU, operating with a mission of serving legally operating cannabis businesses, was granted an unconditional charter by the State of Colorado Department of Financial Services.[91] However, Fourth Corner CU's subsequent applications on the federal level, to the National Credit Union Administration (NCUA) and the Federal Reserve Bank of Kansas City (FRBKC), were both denied.[92] In its denial, NCUA cited findings that Fourth Corner CU could not comply with DOJ, FinCEN, or BSA requirements.[93] In turn, FRBKC used these findings as grounds for its denial of the application for a master account.[94]

Without a federal charter from NCUA, Fourth Corner CU does not qualify for FDIC insurance,[95] although the credit union could obtain private deposit insurance through a Colorado state program. More importantly, without a Federal Reserve Bank master account number, it cannot participate in electronic fund transfers, check cashing, or accept debit or credit card payments.[96] Fourth Corner CU filed suit against NCUA and the Fed-

89. *Id.* The report does not further break down how many institutions filed each type of SAR. FinCEN reports that 1,292 "termination," 313 "priority," and 1,736 "limited" SARs were filed, but it does not provide details on filings by industry. *Fin CEN*, *supra* note 76.

90. Federal Reserve Bank of St. Louis, Chart of Commercial Banks in the U.S., https://research.stlouisfed.org/fred2/series/USNUM; http://www.ncua.gov/Legal/Documents/Reports/IAG201506.pdf.

91. Missy Baxter, *Meet the Family Behind the Legal Weed Industry's First Credit Union*, ROLLING STONE, Jan. 8, 2015, http://www.rollingstone.com/politics/news/meet-the-family-behind-the-legal-weed-industrys-first-credit-union-20150108?page=2.

92. Fourth Corner Credit Union, Press Release, The Fourth Corner Credit Union Files Federal Suits (July 31, 2015), http://media.wix.com/ugd/4d9935_3849b48b32684c16954e4b972f9eca96.pdf.

93. Nat'l Ass'n of Fed. Credit Unions, Press Release, Fourth Corner Sues Fed, NCUA (Aug. 3, 2015) http://www.nafcu.org/News/2015_News/August/Fourth_Corner_CU_sues_Fed__NCUA/.

94. *Id.*

95. 12 U.S.C. § 1781(a).

96. Julie Andersen Hill, *Banks, Marijuana, and Federalism*, CASE W. RES. L. REV. 597, 627–28 (2015); *see also* 12 U.S.C. § 248a (services provided to "depository institutions"); 12 U.S.C. § 461(b)(1) (defining "depository institutions" as those eligible for federal insurance).

eral Reserve Bank in July 2015, alleging abuse of discretion and seeking to have the denials overturned.[97]

Prospective franchisors must consider whether their franchisees will have access to the banking system before launching a cannabis-related franchise. Franchisors rely on the Automated Clearing House (ACH) system to receive (or pull) their periodic royalty fees from franchisee bank accounts. If its franchisees cannot get or maintain a bank account, the franchisor must figure out how to collect royalties. The franchisor itself may have difficulty opening a bank account as well because its royalty revenues are derived from illegal activities and may trigger SAR reporting. The fact that the franchisor is not directly selling the marijuana is irrelevant to the analysis of whether the money it collects implicates BSA and anti-money laundering regulations. The franchisor's bank may refuse to accept funds from the franchisee's banking institution or refuse to open an account for the franchisor.[98]

## V. Taxation Without Representation of Your Business Expenses

It is relatively well known that many cannabis business owners end up paying their taxes in cash, literally carrying bags filled with currency to the office locations of municipal agencies because they are unable to open a bank account.[99] This is by no means the end of the tax challenges for businesses that touch the plant.

Unlike virtually any other business, cannabis businesses are prohibited from claiming any "below the line" business deduction or tax credit on their federal income tax returns. The Internal Revenue Code and regulations disallow all deductions if the business or its business activity "consists of trafficking in controlled substances (within the meaning of Schedules I and II of the Controlled Substances Act) . . ." under § 280E.[100] Although cannabis businesses are permitted to offset revenue with "above the line" expenses for cost of goods sold,[101] their other expenses, such as rent and employee salaries, which would constitute deductions for non-marijuana businesses, are not allowed as deductions.

97. Fourth Corner Credit Union v. Fed. Reserve Bank of Kansas City, No. 1:15-cv-01633-RBJ (D. Colo. filed July 30, 2015); Fourth Corner Credit Union v. Nat'l Credit Union Admin., No. 1:15-cv-01634-RM (D. Colo. filed July 30, 2015). The Federal Reserve Bank has filed a motion to dismiss, which is scheduled to be heard December 28, 2015, by Judge R. Brooke Jackson.

98. Despite the numerous challenges, some banks and credit unions do provide services to known cannabis businesses. The application process for the customer is time consuming, often requiring in-person interviews with all owners of the business, and costly. One cannabis retailer who agreed to discuss the matter disclosed that its credit union charges $5,000 per month in banking fees and makes regular compliance checks of the business.

99. *See, e.g.*, Chris Morran, *Marijuana Shop Owners Paying Taxes in Cash Because Banks Can't Take Their Money*, CONSUMERIST, May 13, 2013, http://consumerist.com/2013/05/13/marijuana-shop-owners-paying-taxes-in-cash-because-banks-cant-take-their-money/.

100. 26 U.S.C. § 280E (2015).

101. The 16th Amendment authorizes Congress to tax "income." U.S CONST. amend. XVI. Gross income is defined as gross receipts less cost of sales. Reg. 1.61-3.

Businesses that engage in a mix of cannabis-related and non-cannabis-related work are permitted to claim deductions and credits related to the portion of their business that does not violate the CSA, provided that they can satisfy Internal Revenue Code requirements for establishing that the two enterprises are "separate undertakings."[102] In *CHAMP*, the U.S. Tax Court held that a California Nonprofit Public Benefit Corporation that engaged in caregiving for members of the community with AIDS, cancer, multiple sclerosis, and other serious diseases and also dispensed cannabis in compliance with California's medical marijuana law was permitted to treat its caregiving activities as a separate business undertaking and deduct expenses related with those activities. However, in *Olive v. C.I.R.*,[103] the Ninth Circuit ruled against the Vapor Room, a medical marijuana dispensary "club" that offered its members yoga, massage services, places to watch movies, and café services with non-enhanced food items. The Ninth Circuit concluded that the additional services of the Vapor Room all supported and related to the dispensing of marijuana products and did not constitute a separate business undertaking.[104]

Section 280E creates an unusual tax posture for cannabis businesses. Unlike most businesses, entrepreneurs in this area are motivated to capitalize expenses as cost of inventory because they cannot characterize those costs as current deductions. Many cannabis businesses elected to leverage Tax Code § 263A (UNICAP), enacted several years after § 280E, which set forth items that retailers and producers are required to treat as inventory, resulting (for traditional businesses) in a broader list of capitalized items than they would prefer. To cannabis businesses, this presented leverage to deduct a larger amount of their expenses.

On January 23, 2015, however, the IRS issued a memorandum from the Office of Chief Counsel stating that taxpayers engaged in the sale of cannabis cannot use UNICAP to transform nondeductible expenses disallowed by § 280E into deductions.[105] It noted that § 263A(a)(2) includes the following language: "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."[106] This memorandum went on to note that nothing in the legislative history of § 263A suggests that Congress intended the adoption of UNICAP to repeal any part of § 280E or permit taxpayers to use the new rule to circumvent its harsh impact. It concluded, "a

102. *See Californians Helping to Alleviate Medical Problems, Inc. v. C.I.R.*, 128 T.C. 123 (T.C. 2007) (hereinafter *CHAMP*).

103. 792 F.3d 1146 (9th Cir. 2015).

104. *Id.* A detailed discussion of the Internal Revenue Code rules governing the establishment of separate business undertakings within a single company or business is beyond the scope of this article, but *see* 26 C.F.R. § 1.183-1(d).

105. W. Thomas McElroy, Jr., Office of Chief Counsel IRS Memo. No. 20150411 (Jan. 23, 2015), https://www.irs.gov/pub/irs-wd/201504011.pdf.

106. *Id.* (citing 26 C.F.R. § 1.263A-1(c)(2)(i)).

taxpayer trafficking in a Schedule I or Schedule II controlled substance is entitled to determine inventoriable costs using the applicable inventory-costing regulations under § 471 as they existed when § 280E was enacted."[107] Notably, IRS CCA guidance is not binding authority.[108] It is possible that the Tax Court will take a different approach to this question in a future ruling.

Another tax issue is less uniform. At least some unbanked businesses operating legally under Colorado's laws have been fined a 10 percent penalty for failing to pay federal employee withholding taxes electronically,[109] but many other businesses of which the authors are aware have not had such a penalty assessed.

## VI. Interstate Commerce—Do Not Pass Go

Another familiar element of franchising is reliable and uniform inventory sourcing, which is particularly important in industries with consumable products.[110] In order to ensure consistency, even the least sophisticated franchisors typically select sources for the core products offered to consumers and prohibit franchisees from purchasing from suppliers that are not preapproved or whose wares do not meet the exacting criteria established by the franchisor.

Under the CSA, transporting a Schedule I drug via interstate commerce is prohibited. As a practical matter, this means that cannabis plants, oils, extracts, and related pharmaceutical products grown or produced in one state cannot legally be transported across state lines to another state.[111] Within the cannabis industry, one consequence of this is that each state enacting a medical marijuana statute must also establish a regulatory scheme governing where cannabis can be grown, by whom, and how many plants, because the states cannot import cannabis in response to demand.

To understand the impact of this law on franchising, it is crucial to recognize that not every cannabis plant is the same. There are dozens of unique strains of cannabis, consisting of varieties of the related but not identical

107. *Id.* at 7.

108. *See* 26 C.F.R. §§ 1.6662-4(d)(3)(iii).

109. 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/irs-fines-unbanked-pot-shops-paying-federal-payroll.

110. Roger D. Blair & Francine LaFontaine, The Economics of Franchising 117 (2005); *see also* Chesley K. "Bud" Culp III & Rochelle B. Spandorf, *Sourcing Products and Services for the System: Efficiencies and Traps in Supply Chain Management*, at 22, A.B.A. Forum on Franchising (2009).

111. In *Gonzalez v. Raich*, 545 U.S. 1 (2005), the Supreme Court found that the Necessary and Proper Clause allowed the federal government to also criminalize the use of Schedule I drugs, including cannabis in intrastate commerce, which justified the Drug Enforcement Agency's seizure and destruction of cannabis plants belonging to a California resident who held a compliant referral for medical marijuana under California's law and was legally permitted to grow the seized plants. However, since the Cole II memo, the likelihood of this type of enforcement is substantially reduced.

plants: *Cannabis sativa*, *Cannabis indicia*, or hybrids.[112] One of the most famous among medical dispensaries is Charlotte's Web oil, from which Colorado manufacturers have produced a cannabis oil that some parents allege has successfully treated seizures in children for whom other drugs have not helped.[113] Unlike many other types of cannabis, this strain is high in CBD and contains almost no THC. Demand for this product is one of the significant factors behind many states' laws permitting high CBD products to be administered to minors.

For existing brands, the process of selling outside of the state where their manufacturing occurs can require identifying a licensee, sharing a recipe and exacting instructions, and letting the licensee experiment until the end result is—hopefully—identical to the original.[114] This can require the licensee to source plants and try to maintain or match the cultivation practices of the licensor so that the end product remains as uniform as possible from one state to another. The result is possibly the only medical industry in which one of the highest praises bestowed on a national brand is that its products are "consistent" and "properly dosed."[115]

## VII. Putting It All Together

The sum of all these parts is a situation in which a would-be cannabis franchisor faces a nearly insurmountable number of obstacles. It cannot obtain a federal trademark for its core services, and because it cannot easily expand its operations across the country, it is subject to a substantial risk that another entity will establish its own common law rights to the same or a similar mark in another part of the country. If it franchises, it may not be able to draw royalties, advertising fund payments, or any other amounts from franchisee bank accounts and is more likely to receive periodic payments delivered by money order or armored car. Because tax regulations prevent franchisees from deducting all of their business expenses, the net profit in such a business is uniquely reduced; an aspiring franchisor may be required to

112. Ernest Small & Arthur Cronquist, *A Practical and National Taxonomy for Cannabis*, 25(4) TAXON 405–35 (1976).

113. *"Charlotte's Web" Marijuana Supposed Cure for Kids' Seizures but Doctors Skeptical*, CBSNEWS, Feb. 18, 2014, http://www.cbsnews.com/news/charlottes-web-marijuana-a-hope-for-kids-with-seizures-despite-unproven-medical-benefits/.

114. Rob Reuteman, *Dixie Elixirs Wants to Become the First National Marijuana Brand*, ENTREPRENEUR, May 21, 2014, http://www.entrepreneur.com/article/233885; *see also* Ricardo Baca, *Dixie Elixirs Inks Infused-Product Licensing Deal to Expand Down Under*, CANNABIST, Nov. 12, 2015, http://www.thecannabist.co/2015/11/12/dixie-brands-australia-new-zealand-oregon-arizona/43807/.

115. Roni Stetter, *5 National Brands Developing Cannabis-Infused Products & Edibles*, INNOVATIVE CANNABIS PRODS., Oct. 7, 2015, https://www.cashinbis.com/cannabis-infused-products-edibles/ (noting, without sarcasm, that Bhang Chocolates is "famous for their consistent dosing" and that EdiPure "prides itself on producing accurately dosed edibles . . .").

reduce its fees well below what it could charge in any similar system, even though it may be facing more work to maintain the system than it would in a non-cannabis business.

With regard to suppliers and sourcing, a franchisor in this niche may face substantial challenges in ensuring or even offering uniformity of inventory among its franchisees. If one of its suppliers is unable to meet demand, it may face an isolated shortage that cannot be cured quickly the way a franchisor in other industries might handle it: transporting inventory from another supplier. Lack of uniformity or insufficient product may harm the brand's reputation and goodwill, and in the hands of a disgruntled franchisee it might be grounds for a claim of breach of contract or breach of duty of good faith and fair dealing on the grounds that the franchisor has failed to make its iconic products available to the franchisee. The franchisor may incur substantially higher expenses in maintaining multiple supplier relationships and ensuring that each supplier can produce goods that are uniform with all other suppliers. With regard to structuring the design of its business, a franchisor faces challenges in designing a business that can operate under the maze of state laws, many of which are revised with greater frequency than occurs in more settled areas of the law. Finally, there is a danger that a future federal administration will reverse the guidance under the Cole II Memo and make criminal prosecution of cannabis dispensers and users a priority again.

For the most daring entrepreneurs, the opportunity to be on the cutting edge of the industry, offering an opportunity to prospective franchisees that is not available from other sources, may be enough incentive to address these issues. An entrepreneur already operating in the cannabis space is itself already facing these issues, and many cannabis businesses recognize and embrace the risk to substantial financial rewards. Franchising in other heavily regulated industries such as health care may provide a roadmap for how to handle conflicting state laws and a steady stream of new and revised compliance requirements. However, once franchising in this industry inches toward the mainstream, it is likely to begin attracting less knowledgeable prospects that may have substantially less sophistication about the risks posed by this industry. Unless they have a detailed understanding of why a cannabis franchise will operate very differently from other businesses, franchisees are unlikely to have their expectations for a "business in a box" met. For franchisors, this poses a final challenge.

## VIII. The Watch List

Looking to 2016 and beyond, here are some issues to watch, which may have a substantial impact on the viability of a mainstream cannabis franchise:

- *Amending the CSA*: In 2015, serious presidential candidates from both the Republican and Democratic parties have endorsed removing

cannabis from Schedule I.[116] If cannabis were listed as a Schedule II drug under the CSA, it could be prescribed and more broadly studied and might lead to relaxed FinCEN Guidance, although some other limitations, including the lack of business deductions, apply equally to trafficking in Schedule II substances.

- *Banking options*: Efforts to expand banking options, including Fourth Corner Credit Union's suit against the Federal Reserve Bank, could have a large effect on how the industry operates. If Fourth Corner CU is successful in obtaining a master account number, it will create a meaningful banking option for cannabis businesses in Colorado at least and likely pave the way for other financial institutions to follow suit. Likewise, if other banks begin offering banking options more generally, it will have a transformative effect on the industry.

- *CARERS Act*: The CARERS Act (Compassionate Access, Research Expansion, and Respect States Act of 2015) was introduced to both the U.S. Senate and the House of Representatives in 2015.[117] As drafted, it amends the CSA to make marijuana a Schedule II drug, decriminalize conduct in compliance with state law, exclude CBD from the definition of marijuana as long as the product contains less than three tenths of one percent THC, prohibit federal banking regulators from penalizing banks for accepting accounts from marijuana-related businesses, encourage research regarding marijuana, and direct the Department of Veterans Affairs to authorize VA health care providers to recommend marijuana as appropriate.[118] Even if pared down, the passage of any significant portion of this bill would have a positive impact on the industry's viability for franchise activity.

116. Rand Paul, Hillary Clinton, Bernie Sanders, and Martin O'Malley have all publicly stated that they support reduced restrictions for marijuana. *See* Jonah Bennett, *Republican Senator Joins Rand Paul, Signs Medical Marijuana Bill*, DAILY CALLER, Mar. 12, 2015, http://dailycaller.com/2015/03/12/republican-senator-joins-rand-paul-signs-medical-marijuana-bill/; Alex Seitz-Wald, *Hillary Clinton Calls for Easing Federal Restrictions on Marijuana*, NBC NEWS, Nov. 7, 2015, http://www.nbcnews.com/politics/2016-election/hillary-clinton-calls-easing-federal-restrictions-marijuana-n459286; Rebecca Kaplan, *Bernie Sanders Introduces Bill to End Federal Ban on Pot*, CBSNEWS, Nov. 5, 2015, http://www.cbsnews.com/news/bernie-sanders-introduces-bill-to-end-federal-ban-marijuana/; Kristen Wyatt, *Martin O'Malley Vows Marijuana Change if He Becomes President*, BALT. SUN, Sept. 17, 2015, http://www.baltimoresun.com/news/maryland/politics/bs-md-omalley-marijuana-20150917-story.html.

117. S. 683, 114th Cong. (2015); H.R. 1538, 114th Cong. (2015). *See also* S. 1726, 114th Cong. (2015) (Marijuana Businesses Access to Banking Act of 2015). As of the date of writing this article, none of these bills has made it out of committee.

118. S. 683; H.R. 1538.

- *Additional legalization efforts*, particularly in the states of Arizona,[119] California,[120] Maine,[121] Massachusetts,[122] and Nevada.[123] There are likely to be several ballot measures regarding cannabis on the November 2016 ballot and with high turnout due to the presidential election, it will be instructive to see whether state populations show any trends in this area.

119. Cannabis advocates in Arizona have filed the "Regulation and Taxation of Marijuana Act" with the Arizona Secretary of State. If supporters are able to obtain enough signatures, this Act would be placed as an initiative on the November 2016 ballot. If approved, the initiative would permit adults twenty-one and older to possess up to one ounce of marijuana and grow up to six plants at home. Retails stores would be capped at 10 percent of the liquor store licenses in the state and revenue would be subject to state tax. *See* https://www.regulatemarijuanainarizona.org/initiative-text/.

120. Cannabis advocates in California have filed three different ballot initiatives for the November 2016 ballot in California. At present, it is unclear which initiative(s) will appear on the ballot and whether components of one initiative will be merged into another, but each initiative is a proposal for legalized and taxed recreational use.

121. Cannabis advocates in Maine have coalesced around efforts to promote the "Marijuana Legalization Act" as a ballot initiative for November 2016. If supporters are able to obtain enough signatures, this Act would be a ballot initiative that, if approved, would legalize possession and consumption of marijuana for adults twenty-one and older as well as cultivation of up to six flowering plants, twelve immature plants, and an unlimited number of seedlings in their home. The Act also permits licensed social clubs for consumption or purchase of cannabis and a state tax. http://legalizemaine.net/marijuana-legalization-act/.

122. Massachusetts only opened its first medical dispensary in 2015, but cannabis advocates are pushing two separate initiative proposals regarding recreational use. If supporters of either initiative obtain enough signatures, the initiative will be considered by the Massachusetts legislature. If the legislature fails to pass the act, backers can put the initiative on the November 2016 ballot if they obtain enough additional signatures.

123. Cannabis advocates have already qualified the "Initiative to Regulate and Tax Marijuana" for the November 2016 ballot in Nevada, the first state in which an initiative is guaranteed to appear on the ballot. If approved, the initiative would legalize possession of up to one ounce of cannabis by adults twenty-one and older and permit the cultivation of up to six plants at home. Sales would be subject to license requirements. Wholesale sales would be subject to a 15 percent excise tax, while retail sales would be subject to Nevada's existing state sales tax. The initiative also includes a sunrise period allowing only Nevada-licensed medical marijuana businesses to apply to licenses in the first eighteen months. *See* https://regulatemarijuanainnevada.org/about/initiative-text/.