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## FINANCING THE EMERGING CANNABIS MARKETS; MANAGING RISKS AND OPPORTUNITIES

John L. Hosack, Esq., Oren Bitan, Esq., Richard Ormond, Esq., Mr. Glenn Goldan  
and Mr. Rick Rodriguez

Buchalter  
12:00 Noon PST  
September 12, 2018  
Los Angeles, California

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- The Legalization of Medicinal and Recreational Marijuana
- Risks under the Civil Asset Forfeiture Act
- Receivership Issues for Marijuana-Based Businesses
- Bankruptcy Cases Involving Marijuana-Based Businesses
- Banking Issues Arising from Legalized Marijuana
- Questions and Answers

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# The Legalization of Medicinal and Recreational Marijuana

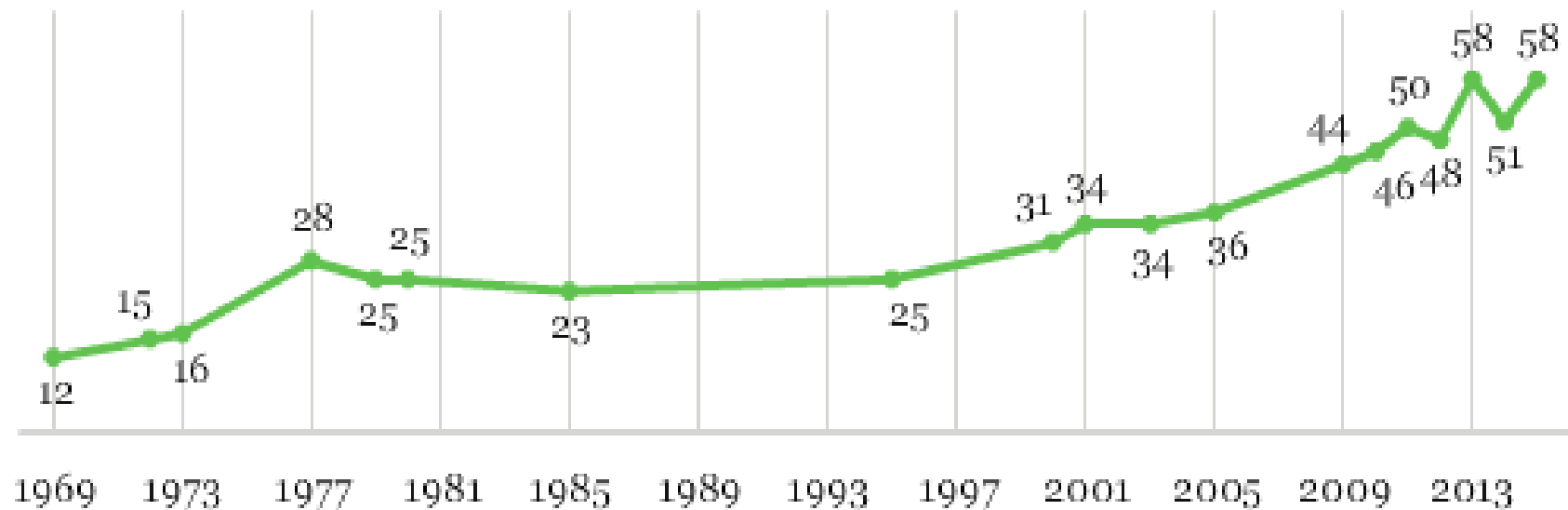


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SLIDE 3

*Do you think the use of marijuana should be made legal, or not?*

■ % Yes, legal

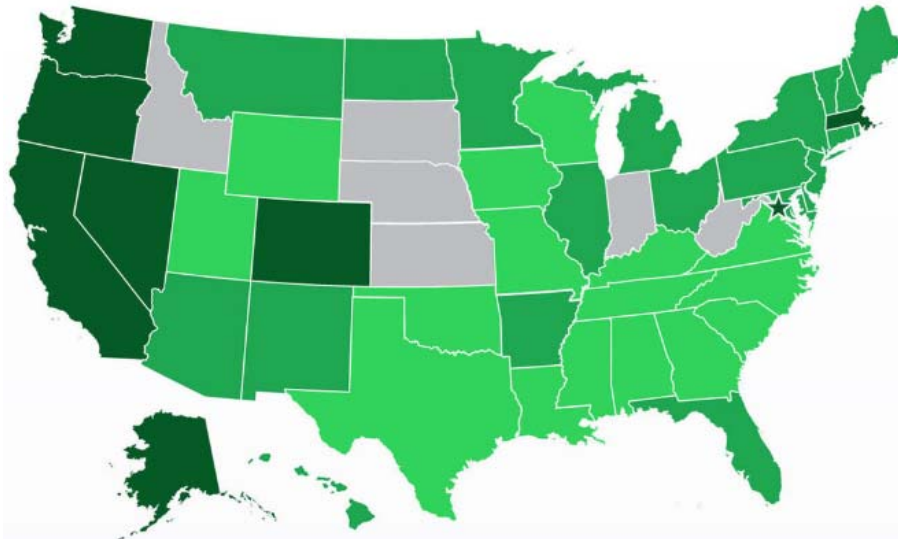


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# Marijuana Legalization by State



| Recreational Marijuana  | Medical Marijuana  | Limited Medical Marijuana*   |
|---|--|--|
| Alaska<br>California<br>Colorado<br>Massachusetts<br>Nevada<br>Oregon<br>Washington<br>Washington, D.C. | Arizona<br>Arkansas<br>Connecticut<br>Delaware<br>Florida<br>Hawaii<br>Illinois<br>Maine<br>Maryland<br>Michigan<br>Minnesota<br>Montana<br>New Hampshire<br>New Jersey<br>New Mexico<br>New York<br>North Dakota<br>Ohio<br>Pennsylvania<br>Rhode Island<br>Vermont | Alabama<br>Georgia<br>Iowa<br>Kentucky<br>Louisiana<br>Mississippi<br>Missouri<br>North Carolina<br>South Carolina<br>Tennessee<br>Texas<br>Utah<br>Virginia<br>Wisconsin<br>Wyoming |

As of November 9, 2016  
National Conference of State Legislatures  
([www.ncsl.org/research/health/state-medicalmarijuana-laws.aspx](http://www.ncsl.org/research/health/state-medicalmarijuana-laws.aspx))

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## FEDERAL LAW



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- **Controlled Substances Act (CSA), 21 U.S.C §§ 801 et seq.**
  - Establishes five classifications (“Schedules”) of regulated drugs based on potential for abuse, accepted medical use and other factors.
  - Marijuana is listed as a schedule I drug—the most dangerous category.
  - Schedule I drugs are deemed to have a high potential for abuse and no accepted medical use.
  - Schedule I drugs include heroin and LSD, but not cocaine.
  - Simple possession, manufacture, distribution and dispensing of marijuana are illegal under the CSA.
  - Criminal penalties include fines of up to \$2 million and 20 years in prison.
  - Conspiring to commit an offense under the GSA is subject to the same penalties as prescribed for the offense itself. (21 U.S.C. § 846.)

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## Department of Justice Priorities on Enforcing the Controlled Substances Act

- Preventing the distribution of marijuana to minors.
- Preventing marijuana revenue from going to criminal enterprises and cartels.
- Preventing the diversion of marijuana from states where it is legal under state law in some form to other states.
- Preventing state-authorized marijuana activity from being used as a cover for the trafficking of other illegal drugs or other illegal activity.
- Preventing violence 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 .
- Preventing marijuana possession or use on federal property.

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## *United States v. Oakland Cannabis Buyers' Cooperative*, 532 U.S. 483 (2001)

- The Supreme Court held that there is no medical necessity exception to the CSA's prohibitions on manufacturing and distributing marijuana.
  - "The statute reflects a determination that marijuana has no medical benefits worthy of an exception."
  - "medical necessity is not a defense to manufacturing and distributing marijuana."

## *Gonzales v. Raich*, 545 U.S. 1 (2005)

- The Supreme Court held that the Commerce Clause gave Congress the authority to prohibit the local cultivation and use of marijuana, despite California's state law to the contrary.

## *Conejo Wellness Center v. City of Agoura Hills*, 214 Cal. App. 4th 1534 (Cal. Ct. App. 2013)

- "We note that if either the MMPA or the CUA affirmatively authorized cultivation, possession, or distribution of medical marijuana, by individuals or collectives, it would raise serious questions of federal preemption by the Controlled Substances Act ....
- "The Controlled Substances Act defines marijuana as a schedule I drug, and prohibits any possession or use of marijuana except in the course of federally approved research projects. ...
- "A local statute that authorizes conduct prohibited by federal law is an "obstacle" to accomplishing federal objectives and is therefore preempted."

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# *United States v McIntosh*, No. 15-10117 (9th Cir. 2016) Buchalter

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- Department of Justice prosecuted the largest medical marijuana dispensary in the United States, located in Oakland, California.
- In 2014, Congress approved an amendment introduced by Reps. Sam Farr (CA-D) and Dana Rohrabacher (CA-R) that would block the DOJ from using federal funds to go after state-legal medical marijuana program. Congress reauthorized that amendment in 2015.
- The Ninth Circuit held that the amendment prohibited the Department of Justice from spending money granted by the appropriations bill to prosecute organizations or otherwise prevent certain states “from implementing their own State laws that authorize the use, distribution, possession, or cultivation of medical marijuana.”
- Holding prevents the government from spending money on prosecutions of people whose marijuana activities were legal in their states and fully complied with those laws.

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**Save The Date!**

## **Notes, Trust Deeds, and Loan Agreements: Seven Critical Issues**

John L. Hosack, Esq., Jason E. Goldstein, Esq., Mr. Joffrey Long and Mr. Rick Rodriguez

12:00 Noon PST

November 13, 2018

Webinar

Buchalter

1000 Wilshire Boulevard, Suite 1500

Los Angeles, California 90017

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# Banking Issues Arising from Legalized Marijuana



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### The Currency and Foreign Transactions Reporting Act of 1970

- The Bank Secrecy Act requires “financial institutions” to assist in detecting fraud, keep records of cash purchases and report suspicious activities (more on “SARS” later).

### Money Laundering Control Act (1986)

- Provides for criminal and monetary penalties.

### USA Patriot Act

- Must include “non-bank business” in reporting SARs.

### Fraud Enforcement And Recovery Act

- FERA included, “. . . False statements by borrowers in mortgage applications . . .” made to non-bank lending businesses.

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Financial Crimes Enforcement Network's guidance based on the 2013 "Cole" Memo provides that a financial institution should conduct customer due diligence that includes:

- Verifying with state authorities whether the business is duly licensed and registered.
- Reviewing the license application (and related documentation) submitted by the business for obtaining a state license to operate its marijuana-related business.
- Requesting from state licensing and enforcement authorities information about the business and related parties.
- Assessing the normal and expected activity for the business, including the types of products to be sold and the customers to be served (e.g., medical vs. recreational).
- Ongoing monitoring of publicly available sources for adverse information about the business and related parties.
- Ongoing monitoring for suspicious activity, including for any of the red flags described in this guidance.
- Refreshing information obtained as part of customer due diligence on a periodic basis and commensurate with the risk.

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- Formation of the Fourth Corner Credit Union
  - Following the issue of the 2013 “Cole Memo” and the 2014 FinCen guidance, Fourth Corner was formed to become the banking institution for the marijuana industry.
  - The Federal Reserve rejected their application for a master account to allow it to transact business and transfer funds through the fed wire system.
- Fourth Corner Seeks to Compel the Issuance of a Master Account
  - Fourth Corner sued and sought an injunction to force the Fed to issue a master account.
  - “Courts cannot use equitable powers to issue an order that would facilitate criminal activity.”
  - The Cole and FinCen memos “simply suggest that prosecutors and bank regulators might ‘look the other way’ if financial institutions don’t mind violating the law. **A federal court cannot look the other way.**”
  - The District Court denied the injunction and Fourth Corner appealed.
- Oral Argument was set for November 16, 2016 in the Tenth Circuit
  - Stay tuned . . .

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- In 1996, passed with 56% of the votes.
- Legalized marijuana for patients and their primary caregivers.
- Required recommendation or approval of a California licensed physician.
- In 2004, Senate Bill 420 passed, which was known as the “Medical Marijuana Program Act.”
- This allowed patients to form medical cultivation “collectives” or “cooperatives.”
- In 2015, the California Legislature enacted the Medical Marijuana Regulation and Safety Act.

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- Passed with 57% of the votes.
- Legalized marijuana use by adults 21 or older.
- Designated state agencies to license and regulate the industry.
- Imposed 15% tax on retail sales and cultivation taxes on growers.
  - Exempts medical marijuana from some taxation.
- Established packaging, labeling, advertising, and marketing standards and restrictions for marijuana products.
  - Marketing and advertising of marijuana directly to minors prohibited.
- Provides for local regulation and taxation of marijuana.
- Authorizes resentencing and destruction of records for prior marijuana convictions.

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- Enacted in anticipation of “illegality of contract” defenses to marijuana related businesses.

### § 1550.5. Lawful commercial cannabis activity

(a) The Legislature finds and declares all of the following:

(1) The Compassionate Use Act of 1996, an initiative measure enacted by the approval of Proposition 215 at the November 5, 1996, state general election, authorized the use of marijuana for medical purposes in this state.

(2) The Legislature passed the Medical Cannabis Regulation and Safety Act, formerly 3.5 (commencing with Section 19300) of Division 8 of the Business and Professions Code, to regulate and and license medical cannabis the state.

(2) The Control, Regulate and Tax Adult Use of Marijuana Act (AUMA), an initiative measure. enacted by the approval of Proposition 64 at the November 8, 2016, statewide general election, authorized the consumption of nonmedical marijuana by persons over 21 years of age and provided for the licensure and regulation of certain commercial nonmedical activities in this state.

(3) The Legislature passed the Medicinal and Adult Use Cannabis Regulation and Safety Act (Division 10 (commencing with Section 260000) of the Business and Professions: Code to consolidate the licensure and regulation of certain commercial activities with respect to medicinal cannabis and nonmedical marijuana,-now known as adult-use cannabis.

(b) Notwithstanding any law, including, but not limited to Section 1550, 1667, and 1668 and federal law, commercial activity relating to medicinal cannabis or adult-use cannabis conducted in compliance with California law and any applicable local standards, requirements, and regulations shall be deemed to be all of the following:

(1) A lawful object of a contract.

(2) Not contrary to, an express provision of law, any policy of express law or good morals.

(3) Not against public policy.

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## “Local Laws”

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- A number of cities have enacted “local laws” or ordinances which relate to cannabis related businesses.
- Don’t overlook “local laws.”

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# SUSPICIOUS ACTIVITY REPORTS



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“The obligation to file a SAR is unaffected by any state law that legalizes marijuana-related activity.”

“A financial institution is required to file a SAR if, consistent with FinCEN regulations, the financial institution knows, suspects, or has reason to suspect that a transaction conducted or attempted by, at, or through the financial institution:

- involves funds derived from illegal activity or is an attempt to disguise funds derived from illegal activity;
- is designed to evade regulations promulgated under the BSA, or
- lacks a business or apparent lawful purpose.
- Because federal law prohibits the distribution and sale of marijuana, financial transactions involving a marijuana-related business would generally involve funds derived from illegal activity.”

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## “Marijuana Limited” SAR Filing

- Used if financial institution reasonably believes, based on its customer due diligence, activities do not implicate one of the Cole Memo priorities or violate state law.

## “Marijuana Priority” SAR Filing

- Used if financial institution reasonably believes, based on its customer due diligence, activities implicates one of the Cole Memo priorities or violates state law.

## “Marijuana Termination” SAR Filing

- Used if financial institution terminates relationship with marijuana-related customer in order to maintain compliance with anti-money laundering program.

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- A bank customer appears to be using a state-licensed marijuana-related business as a front or pretext to launder money derived from other criminal activity (i.e., not related to marijuana) or derived from marijuana-related activity not permitted under state law.
- The business is unable to produce satisfactory documentation or evidence to demonstrate that it is duly licensed and operating consistently with state law.
- The business is unable to demonstrate the legitimate source of significant outside investments.
- A bank customer seeks to conceal or disguise involvement in marijuana-related business activity. For example, the customer may be using a business with a non-descript name (e.g., a “consulting,” “holding,” or “management” company) that purportedly engages in activity unrelated to marijuana.
- Review of publicly available sources and databases about the business, its owner(s), manager(s), or other related parties, reveal negative information, such as a criminal record, involvement in the illegal purchase or sale of drugs, violence, or other potential connections to illicit activity.
- The business, its owner(s), manager(s), or other related parties are, or have been, subject to an enforcement action by the state or local authorities responsible for administering or enforcing marijuana-related laws or regulations.
- A marijuana-related business engages in international or interstate activity, including by receiving cash deposits from locations outside the state in which the business operates, making or receiving frequent interstate transfers, or otherwise transacting with entities located in different states.

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## **Notes, Trust Deeds, and Loan Agreements: Seven Critical Issues**

John L. Hosack, Esq., Jason E. Goldstein, Esq., Mr. Joffrey Long and Mr. Rick Rodriguez

12:00 Noon PST

November 13, 2018

Webinar

Buchalter

1000 Wilshire Boulevard, Suite 1500

Los Angeles, California 90017

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Can only deduct costs of goods and services if business activities are illegal.

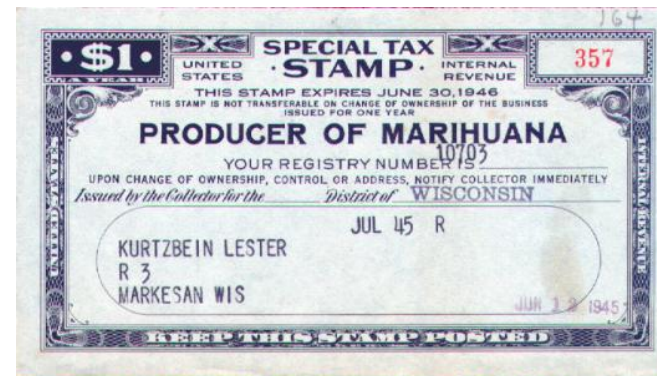
- Recommendation: have your customer's federal tax returns review by a person who is familiar with Internal Revenue Code Section 280E.

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# Bankruptcy Issues for Marijuana Based Business



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Bankruptcy courts “should not be ‘a haven for wrongdoers.’”  
*Lockyer v. Mirant Corp.*, 398 F.3d 1098, 1107 (9th Cir. 2005)

## 28 U.S.C. § 959(b):

“[A] trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager **according to the requirements of the valid laws of the State in which such property is situated**, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.”



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## *In re George and Nansee Lanning*, Case No. 2:11-bk-19760 (Bankr. C.D. Cal. 2011)

- Joint debtors owned and operated a medicinal marijuana dispensary and the real property at which the dispensary was located.
- Secured lender filed a motion to dismiss the bankruptcy case alleging that the debtors in possession could not comply with 28 U.S.C. § 958(b) due to illegality under the Controlled Substances Act.
- The court denied the motion to dismiss the bankruptcy case. The case was ultimately dismissed due to the debtors' inability to file a plan of reorganization.

## *In re McGinnis*, 453 B.R. 770, 773 (Bankr. D. Or. 2011)

- Confirmation of chapter 13 plan denied where plan payments would be funded by debtor's marijuana business in violation of the requirements of Bankruptcy Code.
- However, the court stated that it would confirm the plan if the "[d]ebtor can propose an amended Plan [that] meets the requirements of the Bankruptcy Code".

## *Northbay Wellness Group v. Beyries*, 2011 Bankr. LEXIS 4710 (Bankr. N.D. Cal. 2011)

- Adversary proceeding dismissed because the plaintiffs, a medicinal marijuana dispensary and its principal, were engaged in the unlawful sale of marijuana in violation of federal law.
- "A federal court should not lend its judicial power to a plaintiff who seeks to invoke that power for the purpose of consummating a transaction in clear violation of law."
- Even though "the conduct of the parties may have been legal under state law, in the eyes of a federal court they were conspiring to sell contraband."

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- **Appointment of a Chapter 7 or a Chapter 11 Trustee**
  - Constraints on operating or liquidating the business.
  - Asset forfeiture and money laundering risks not palatable.
  - *In re Arenas*, 514 B.R. 887 (Bankr. D. Colo. 2014) *aff'd*, 535 B.R. 845 (B.A.P. 10th Cir. 2015)
    - Chapter 7 debtor could not operate his business legally under the Controlled Substances Act even though he possessed all of the required licenses and permits necessary for producing and distributing marijuana in the State of Colorado.
    - "For the Trustee to take possession and control of the Debtors' Property and marijuana inventory would directly involve him in the commission of federal crimes."
    - The inevitable illegality of the trustee's administration of illegal estate assets constituted cause to dismiss under section 707(a).
- **Chapter 11 Practical Concerns**
  - Inability to open debtor in possession bank accounts.
  - Lack of access to DIP financing.
- **Chapter 13 Practical Concerns**
  - Distinction between how a chapter 13 trustee administers a bankruptcy case versus a chapter 7 trustee.

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## ■ Dismissal for Cause

- Lack of “Good Faith”
- *In re Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015)
  - U.S. Trustee moved to dismiss chapter 13 case of a debtor that operated a medical marijuana business under the Michigan Medical Marijuana Act.
  - “The Debtor filed his case in good faith, and it is quite obvious from his credible testimony that he is in dire need of bankruptcy relief and the court’s assistance.”
  - “To balance the court’s (and the Debtor’s) obligations under federal law . . . the Debtor’s legitimate need for relief under chapter 13, and Michigan’s policy choices reflected in the MMMA, the court will refrain from dismissing the Debtor’s case at this time, but will enjoin him from conducting his medical marijuana business (and violating the CSA) while his case is pending.”
- *In re Medpoint Mgmt.*, 528 B.R. 178, 180 (Bankr. D. Ariz. 2015)
  - Cause existed to dismiss the involuntary chapter 7 petition because the purported debtor was a medical marijuana dispensary-management entity.
  - Neither the alleged lack of enforcement funding nor the apparent lack of political will to enforce the Controlled Substance Act altered the fact that a person engaged in marijuana related business activities in Arizona was in violation of federal law.
  - The prospects of a possible forfeiture or seizure of the debtor’s assets posed an unacceptable risk to a chapter 7 estate and to a chapter 7 trustee.

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- Impediments to Plan Confirmation
  - Section 1129(a)(3) Good Faith Requirements
    - Novel Commerce Clause / Preemption Issue
  - Section 1129(a)(11) Feasibility Requirements
    - Prosecution of Principles
    - Forfeiture of Inventory
    - Unrelated Marijuana-business Income
  - *In re Rent-Rite Super Kegs West Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012)
    - Chapter 11 debtor derived roughly 25% of its revenues from leasing space to tenants who were engaged in the business of growing marijuana.
    - Whether characterized as "unclean hands" or simply as part of the totality-of-the-circumstances analysis, the debtor's activity satisfied the requirement of "cause" and required dismissal.
  - Totality of Circumstances Analysis Required

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## *Northbay Wellness Group v. Beyries*, 789 F.3d 959 (9th Cir. 2015)

- Bankruptcy Court dismissed the adversary proceeding because the plaintiffs, a medicinal marijuana dispensary and its principal, were engaged in the unlawful sale of marijuana in violation of federal law.
- The defendant was an attorney who had embezzled \$25,000 from the marijuana dispensary's client trust account.
- The Ninth Circuit reversed and remanded finding that "the bankruptcy court abused its discretion by applying the doctrine of unclean hands to bar Northbay's request for a judgment of non-dischargeability."
- The defendant "was on Northbay's board of directors and partnered in Northbay's business, so he was as responsible as Northbay for its illegal marijuana sales. That illegal activity must be attributed to both parties in the weighing of wrongdoing, so it does not tip the balance in either direction."

## *Mann v. Gullickson*, 2016 WL 6473215 (N.D. Cal. 2016)

- Court denied motion for summary judgment in breach of contract action where defendant asserted that plaintiff marijuana related business had unclean hands because engaged in violations of federal law.

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*A. Should The Non-Cannabis Lender Prohibit Its Personnel From Possessing Or using Cannabis?*

- *Thoughts and recommendations.*

*B. The Cannabis Lender's Potential Liability To Its Personnel.*

- *Thoughts and recommendations.*

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## Insurance Coverage Issues

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- What is the effect of cannabis lending – intentional or inadvertent – on insurance coverage?
- What is the effect of cannabis lending on loans secured by real property and insured by a policy of title insurance?

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## A. The Standard -- Marijuana Exception

The Standard Marijuana Exception reads as follows:

### MARIJUANA EXCEPTION

Without limiting, modifying, abridging or negating any provision of the Exclusions From Coverage stated in this Policy or any other exception included in this Schedule B, and as a supplement and addition thereto, this Policy does not insure or provide title insurance coverage for or against any and all consequences and effects, legal, equitable, practical or otherwise, civil or criminal, of any violation or alleged violation of any federal, state, county, municipal or local laws, statutes, ordinances or regulations or any actual or threatened action, court order or mandate for the enforcement thereof, relating to or governing the use, processing, manufacture, growth, possession, distribution, sale or any other activity on, about, or relating to or concerning the Land, title thereto or any interest therein, of any controlled or regulated substance, including, without limitation, marijuana, and any component, derivative or product thereof

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## **B. Exclusions from Coverage**

- *1(b) – “Governmental Police Power”.*
- *3(a) – “Created, Suffered, Assumed Or Agreed To”.*
- *3(b) – Matters Not Known To The Insurer, Not Recorded In The Public Records.*

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# Risks And Rewards Of Cannabis Lending **Buchalter**

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- A. Risks Of Being An "Inadvertent" Lender To The Cannabis Market.*
- B. Risks Of Being An "Intentional" Lender To The Cannabis Market.*
- C. Negligence "Per Se?"*

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**Save The Date!**

## **Notes, Trust Deeds, and Loan Agreements: Seven Critical Issues**

John L. Hosack, Esq., Jason E. Goldstein, Esq., Mr. Joffrey Long and Mr. Rick Rodriguez

12:00 Noon PST

November 13, 2018

Webinar

Buchalter

1000 Wilshire Boulevard, Suite 1500

Los Angeles, California 90017

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- A. Board Of Directors And Officers.*
- B. Governance.*
- C. Obtain Financial Information For Past 3 Years And Current Year.*
- D. Customers.*
- E. Tax Compliance.*
- F. Balance Sheet Verification.*
- G. Income Statement Review.*
- H. Financial Information Analysis.*
- I. Intellectual Property.*
- J. Products & Services.*
- K. Marketing & Sales.*
- L. Competition.*
- M. People.*

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- N. Systems & Processes.*
- O. Legal & Related Matters.*
- P. Articles & Publicity.*
- Q. Valuation Services.*

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## DOCUMENTING YOUR LOAN TO EITHER AVOID THE CANNABIS MARKET OR EMBRACE IT



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# Documenting Your Loan

## A. *Thoughts on documentation if you want to “avoid.”*

- *State your intention to comply with federal law.*
- *Point out if you have a federal charter.*
- *Include in your loan documents an express prohibition on participation in the cannabis industry.*

## B. *Thoughts on documentation if you want to “embrace.”*

- *Confirm cannabis is prohibited by the Federal Controlled Substances Act.*
- *State that your business relationship does not confirm the customer’s compliance with state and federal law.*
- *Obtain an opinion of counsel from the borrower that the borrower’s business is in compliance with all laws.*

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## QUESTIONS?

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