The “Legal” Marijuana Industry’s Challenge for Business Entity Law

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THE “LEGAL” MARIJUANA INDUSTRY’S CHALLENGE FOR BUSINESS ENTITY LAW

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ABSTRACT

In recent years, many states have legalized the use and sale of marijuana for medical or even recreational purposes. This has led to the booming growth of a “legal” marijuana industry. Businesses openly growing and selling marijuana products to the consuming public face some unusual legal hurdles. Significantly, although the sale of marijuana may be legal at the state level, it is still illegal under federal law. This Article explores the conflict between state and federal marijuana laws from a business entity law perspective. For example, managers owe a fiduciary duty of good faith to their businesses and equity holders. One of the ways in which managers can violate this duty is by causing their business to intentionally violate the law. This is a problem for the marijuana industry because its managers constantly and intentionally violate federal law and therefore violate their fiduciary duties by growing and selling marijuana. This Article concludes that the industry’s ability to attract professional stakeholders is harmed by marijuana business stakeholders’ inability to take advantage of key business law protections, such as limited liability. This Article proposes a state law exception that allows marijuana businesses to operate normally under state business entity law, with normal business entity law protections, despite their continuing violation of federal law.

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In light of Colorado’s laws and constitutional amendment legalizing marijuana, federal prosecutors may well choose to exercise their prosecutorial discretion and decline to seek indictments under the [Controlled Substances Act] where the activity that is illegal on the federal level is legal under Colorado state law. Be that as it may, even if the Debtor is never charged or prosecuted under the [Controlled Substances Act], it is conducting operations in the normal course of its business that violate federal criminal law.¹

INTRODUCTION

In recent decades, views on marijuana have undergone a sea change.² In 1969, only 12 percent of Americans supported the legalization of marijuana.³ That percentage climbed to 58 percent by 2013 with most of that change (27 percent) in the last decade.⁴ Reflecting this change in attitude, many states have legalized marijuana for medical⁵ or even recreational use.⁶ This has resulted in the dramatic growth of a “legal” marijuana industry.⁷ Indeed, medical marijuana sales for 2013 are currently estimated at $1.3–1.5 billion.⁸

³ Id.
⁴ Id.
⁷ The term “legal” is in quotations to reflect the fact that marijuana is illegal in many jurisdictions including at the federal level. So as not to be cumbersome, this Article will hereinafter refer to the “legal” marijuana industry simply as the marijuana industry with the intent that it not include sellers of marijuana who are not attempting to comply with state marijuana laws.
However, the industry is faced with a number of legal challenges, including the continued treatment of marijuana as a controlled substance by the federal Controlled Substances Act of 1970 (the “CSA”).9 The conflict between state and federal marijuana laws has significant implications for an industry seeking legitimacy and investors. From a business entity law perspective, whether the federal government is willing to forgo prosecuting the legal marijuana industry does not resolve the underlying conflict between state and federal law and its effects on the marijuana industry.10 This is because, even if the business’s stakeholders are never charged with a crime, the fact that they intentionally violate federal law has business entity law consequences.11 In particular, stakeholders may find themselves unable to make use of some business entity law protections.12

Although the potential criminal penalties for the sale of marijuana are well known, an emerging area of discussion is how the violation of federal law has created non-criminal legal obstacles for marijuana businesses, including tax issues13 and even complications in obtaining legal counsel.14 This

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10 See infra Part II. This Article will not address the federalism issues of whether state marijuana law can or does trump federal marijuana law. Instead, it will proceed under the reasonable assumption that the CSA trumps state attempts to legalize marijuana. See Gonzales v. Raich, 545 U.S. 1, 27, 34 (2005) (holding that the CSA’s criminalization of medical marijuana does not violate the Commerce Clause). For a discussion of the federalist issues stemming from state legalization of marijuana, see Sam Kamin, Medical Marijuana in Colorado and the Future of Marijuana Regulation in the United States, 43 MCGEORGE L. REV. 147, 151–62 (2012); Sam Kamin & Eli Wald, Marijuana Lawyers: Outlaws or Crusaders, 91 OR. L. REV. 869, 880–86 (2013); Susan R. Klein & Ingrid B. Grobey, Debunking Claims of Over-Federalization of Criminal Law, 62 EMORY L.J. 1, 5 (2012); Robert A. Mikos, Preemption Under the Controlled Substances Act, 16 J. HEALTH CARE L. & POL’Y 5, 8 (2013).
11 See infra Part II.
12 Id.
13 See Leff, supra note 5, at 526 (noting that marijuana businesses must currently pay taxes on gross rather than net profits, making it far more difficult for these businesses to be run profitably. Leff proposes a possible solution for this tax problem, forming marijuana businesses as a tax-exempt “social welfare organization.” Id. Even if the marijuana industry adopts Leff’s proposed social welfare form, it will still run into the business entity law problems raised in this Article.). Robert Wood, Harvard Law School Offers ’Tax Planning For Marijuana Dealers’—No Joke, FORBES (Apr. 25, 2013, 3:16 AM), http://www.forbes.com/sites/robertwood/2013/04/25/harvard-law-school-offers-tax-planning-for-marijuana-dealers-no-joke/?utm_campaign=forbestwitters&utm_source=twitter&utm_medium=social, archived at http://perma.cc/SNK6-PSTP (noting that of “all the federal enforcement efforts, taxes hurt most”).
14 See Kamin & Wald, supra note 10, at 869 (discussing whether lawyers providing advice on how to form marijuana businesses may violate rules of professional conduct by
Article focuses on how this jurisdictional legal conflict affects business entity law protections, and how states can minimize these effects. It concludes by proposing an exception to business entity law that would allow this industry to function as normally as possible, given the current legal conflict.

Business entity law provides many protections to business stakeholders. One of the most important protections is limited liability for equity holders. In addition, managers are generally only liable to equity holders if they breach their fiduciary duties. These protections play a number of key roles in the growth and development of a business. By limiting the personal financial risk of business stakeholders, business entity law makes stakeholders more comfortable participating in a business, whether as an investor or manager, because they know they have more control over their potential financial liability.

In the case of a marijuana business, stakeholders may be unable to make use of these business entity protections. This is because many of these protections do not apply where business stakeholders intentionally violate the law. There are obvious public policy justifications for such a limitation: it discourages businesses from breaking the law, as their stakeholders would not otherwise be shielded. In the case of marijuana businesses, equity holders risk losing limited liability because they are investing in businesses whose

assisting their clients in violating federal law. Kamin and Wald argue that while this type of representation is technically a violation of the rules of professional conduct, it may be possible to carefully give advice to marijuana businesses without running afoul of these ethical standards; see also Claire Frezza, Counseling Clients on Medical Marijuana: Ethics Caught in Smoke, 25 GEO. J. LEGAL ETHICS 537 (2012).

The principal observations and arguments made by this Article are equally applicable to all business forms that have investors and managers including partnerships, corporations, and limited liability companies. Therefore, for the sake of simplification, except where this Article specifically refers to a specific business form such as a LLC, it uses the term business entity law to refer to the various bodies of law applicable to business forms. Likewise, when this Article refers to equity holders, it refers to equity holders including shareholders, members, and partners in all of these business forms. When it refers to managers, it refers to anyone who could manage any of these businesses including directors, managers, members, or partners.

See infra Part III.


See, e.g., Robert Strassfeld, Introduction: Corporations and Their Communities, 58 CASE W. RES. L. REV. 1017, 1019 (2008) (quoting Nicholas Butler’s 1911 remarks that “the limited liability corporation is the greatest single discovery of modern times”).

See infra Part II.A.

See infra Part II.

See infra Part II.A.
very purpose is to violate the law. Likewise, managers of these businesses might be liable for violating their fiduciary duties despite taking no actions inconsistent with the intentions of the equity holders. This is because the managers intentionally cause the business to violate federal law, which, as will be discussed, is a violation of the fiduciary duty of good faith. The day-to-day management of marijuana businesses, by its very nature, causes managers to breach their fiduciary duties. The expanded liability risks for marijuana business stakeholders are further complicated by principles of equity. The unclean hands doctrine is a principle of law that can prevent parties who have participated in wrongdoing from using the court system to sue others who participated in that same wrongdoing. This may prevent the court from hearing disputes between marijuana business stakeholders.

While the Section of this Article on unclean hands and bankruptcy does not deal directly with business entity law, it is raised to show how the problems the marijuana industry causes in business entity law extend to and complicate the application of other areas of the law.

For states that have legalized marijuana, the potential loss of business entity law protections should be troubling. If officers, directors, and shareholders are unable to take advantage of standard business entity law protections, marijuana businesses will have a hard time attracting professional stakeholders, including institutional investors and professional managers who have the experience to help the industry grow professionally and legally.

23 See infra Part II.B.1.

24 This Article will focus on one particular equitable doctrine: unclean hands. See infra Part II.B.1. Additional doctrines that may affect stakeholder liability include (i) the prohibition against enforcement of a contract that violates public policy; see RESTATEMENT (SECOND) OF CONTRACTS §§ 178–85 (1981); Bovard v. Am. Horse Enters., 201 Cal. App. 3d 832, 841 (Cal. Dist. Ct. App. 1998) (refusing to enforce a contract for sale of a business that manufactured drug paraphernalia on the grounds that it was void as against public policy); and (ii) the doctrine of in pari delicto, which “is an affirmative defense which provides that when a plaintiff and defendant stand in a position of equal or mutual fault, the position of the defendant is the better one.” Christine M. Shepard, Corporate Wrongdoing and the In Pari Delicto Defense in Auditor Malpractice Cases: A New Approach, 69 WASH. & LEE L. REV. 275, 291 (2012) (internal citations omitted).

25 See infra Part II.B.1.

26 This Article will not flesh out all the complications that the marijuana industry causes for business entity law. Instead it seeks to broadly introduce some of these problems and begin the dialogue on how to solve them.

27 See infra Part II.B.1.

28 The Financial Industry Regulatory Authority has issued an investor alert warning that many marijuana stocks are simply scams and detailing how investors can protect themselves. See Marijuana Stock Scams, FINRA (last updated May 29, 2014), http://www.finra.org/Inves.
A less professional industry may in turn be less capable of, or concerned with, complying with state marijuana regulations and promote a Wild West culture of reckless business owners and operators. While this Article will not take a stance on the merits of legalizing marijuana, it accepts that states that have chosen to legalize it have done so based on numerous important public policy grounds. Further, having legalized this industry despite the CSA, states now have an incentive to minimize the effects of conflicting state and federal law, including helping businesses take advantage of standard business entity law protections. This, in turn, should help motivate states to achieve public policy goals by promoting the inclusion of professional stakeholders in marijuana businesses.

29 See Nancy Benac & Alicia Caldwell, Marijuana Legalization Gains Support, Confounding Policymakers, HUFFINGTON POST (June 29, 2014, 9:49 AM), http://www.huffingtonpost.com/2013/06/29/marijuana-legalization_n_3521547.html, archived at http://perma.cc/NGE7-25VK (noting that a recent ballot initiative had brought the number of marijuana dispensaries from 1,000 down to 135 in Los Angeles. A member of a neighborhood counsel spoke about the decision saying that the marijuana dispensaries were “just not following what small amounts of rules there are on the books ....’”); Serge F. Kovaleski, Banks Say No to Marijuana Money, Legal or Not, NY TIMES (Jan. 11, 2014), http://www.nytimes.com/2014/01/12/us/banks-say-no-to-marijuana-money-legal-or-not.html?_r=0, archived at http://perma.cc/9UZ9-6UXP (noting that since marijuana businesses cannot in many cases open bank accounts, they will often open accounts under false pretenses or store large amounts of cash in Tupperware. This in turn makes them potential targets for criminals.); infra Part II.C.

30 See Benac & Caldwell supra note 29 (noting that in California, some communities have complained that marijuana regulations are not being observed and that marijuana has become too readily available leading to problems of “unsavory characters.” This in turn has led some communities to ban outright or limit the number of dispensaries. An attorney who represents cities in Southern California with regard to dispensaries states “[w]hat we’ve learned is, it is very difficult if not impossible to regulate these facilities ....” Finally, in Colorado, the article notes that after medical marijuana was legalized there was a spike in marijuana use by school age minors attributed to “legal” marijuana dealers whose backgrounds had not been sufficiently vetted.); Kamin, supra note 10, at 149–50. Further, the inconsistency of state regulations has also had its impact. See Jose Paglieri, Don’t Expect a Marijuana Boom, Even Where It’s Legal, CNN (Nov. 8, 2012, 8:15 AM), http://money.cnn.com/2012/11/08/small business/marijuana/index.html, archived at http://perma.cc/DZ6S-3MDS (telling the story of a former technology firm executive who developed a marijuana business with $70,000 a month revenues. However, after the city where his business was located outlawed dispensaries, the business closed and he lost $300,000. While he had made an effort to comply with 165 pages of state regulations, the fact that his business was shut down anyway will probably serve to dissuade other professionals from entering the market.).

31 See infra Part I.C.
Part I of this Article reviews the current state of marijuana laws and the marijuana industry. Part II considers the conflicts between the marijuana industry and state business entity law. This Article concludes in Part III by arguing that in states where marijuana has been legalized, there should be an exception to that state’s business entity laws that allows businesses to take advantage of fundamental business concepts such as limited liability despite the fact that their businesses routinely violate the CSA.32

I. THE MARIJUANA INDUSTRY’S “LEGAL” STATUS

Most industries in the United States spend a significant amount of time and money to ensure that they comply with applicable law.33 Businesses hire lawyers, accountants, and compliance officers to advise them on the legality of their conduct. Although businesses may have occasional problems with the law, whether it is accidentally emitting pollution or failing to pay proper taxes, it is unusual to have a business organized under state law for the express purpose of engaging in illegal activity.34 Undoubtedly, part of the reason businesses do not routinely violate the law is that if a manager intentionally directs a company to violate the law, it could result in personal liability.35 In the case of the marijuana industry, law breaking permeates the entire business, from the investors who provide funding, to the managers and the employees who are engaging in an enterprise that is criminal under federal law.36 Whether or not the federal government ever enforces those laws against the business, the intentional violation of federal law has consequences under state business entity law.37

32 While the application of this Article’s proposal is currently limited to the marijuana industry, it would be equally applicable to other situations where states and the federal government are in direct legal conflict over whether a business practice should be allowed. See Jordan Shapiro, Missouri Lawmakers Plot New Strategy for Defying Gun Laws, HUFFINGTON POST (Jan. 14, 2014, 1:17 PM), http://nation.time.com/2014/01/12/mo-lawmakers-plot-new-strategy-for-defying-gun-laws/, archived at http://perma.cc/8HP-444U (discussing application of marijuana legalization strategy to gun industry).
35 See infra Part II.B.
36 See infra Part I.D.
37 In re Rent-Rite Super Kegs West Ltd., 484 B.R. 799, 805 (Bankr. D. Colo. 2012). (“Debtor points out that federal authorities have never notified it that it is in violation of the
A. The Current State of Marijuana Laws in the U.S.

The history of marijuana laws in the United States is both long and complex. In recent years, the legality of the use and sale of marijuana has changed rapidly. While the use or sale of marijuana was previously illegal across the country, in recent years, many states have legalized the medical—or in some instances, even the recreational—use of marijuana. Nevertheless, the federal government has continued to treat marijuana as a controlled substance. This jurisdictional conflict has created an unusual tension with ripple effects that can be felt in many areas of the law such as taxes, real property, and business entity law. While some states have moved towards various levels of legalization of marijuana, other states have simply changed how they enforce the laws banning it. The conflict between federal and state law has created a number of interesting legal challenges for the industry that do not have a parallel in other businesses. There is precedent for conflicting law and that it has never been charged or convicted of any federal or state crime. But the fact that a violator is never charged, tried or convicted does not change the fact that the crime has been committed.


39 See PROCON, supra note 5.


42 See, e.g., Tiago Pappas, Providing Property Owners Increased Certainty in the Conflicting Medical Marijuana Landscape, 39 REAL EST. L.J. 249 (2010); Patricia Salkin & Zachary Kansler, Medical Marijuana Zoned Out: Local Regulation Meets State Acceptance and Federal Quiet Acquiescence, 16 DRAKE J. AGRIC. L. 295, 297–98 (2011); Leff, supra note 5.


44 For example, in Nevada prostitution is legal in certain counties, but it is not explicitly illegal on a federal level. In contrast, many industries are openly known to operate in violation of federal law, but are rarely targeted. An example of this would be the farm industry’s employ of illegal workers. See Eric A. Ruark, Illegal Immigration and Agribusiness (2013): The Effect on the Agriculture Industry of Converting to a Legal Workforce, FED’N FOR AM. IMMIGR. REFORM (2013), archived at http://perma.cc/GK99-ZM56. The closest fit to be
laws between states and the federal government, such as states that legalized gay marriage and the federal Defense of Marriage Act\(^4^5\) and how that conflict created tax issues for married gay couples.\(^4^6\) However, the current marijuana situation in which states have explicitly legalized a particular business and the federal government explicitly criminalizes it, is unusual.\(^4^7\) Nevertheless, attempts to recreate the type of success achieved by the marijuana industry in the face of continued criminal treatment by the federal government will likely be tried in other areas. The cat, so to speak, is out of the bag. It is not hard to recognize that popular support, along with state unwillingness to enforce federal laws, makes it difficult to maintain a contrary federal policy. In fact, some gun rights advocates see the legal marijuana industry’s success as a potential model for states that want to defy federal attempts to impose background checks on gun buyers or ban assault rifles.\(^4^8\) Because these federal gun control laws impose limitations on gun stores, state laws that attempt


\(^{47}\) See Shelby, supra note 32.

\(^{48}\) Shapiro, *supra* note 32.
to ban federal enforcement would allow businesses to sell guns in violation of federal law. So far, this strategy has not enjoyed the success of medical marijuana, but it should be noted that this is a relatively new strategy that has not yet been attempted widely.

B. State Marijuana Laws

Currently, twenty-three states and the District of Columbia have legalized marijuana for medicinal use. Further, six states currently have pending legislation that would legalize medical marijuana. The first state to legalize marijuana was California in 1996 and the latest was Alaska, in 2014. Medical marijuana laws vary greatly between states, including who can grow marijuana, who can sell it, how much one can buy, how much one can possess, and so forth. For our purposes, it is sufficient to note that these laws have allowed for the development of a medical marijuana dispensary industry in many states. In fact, it has been a rapidly growing area of business, particularly for small businesses. Even during the recent recession, the growth of the medical marijuana dispensary industry has been dramatic. In fact, in

49 See id.
50 See id.
51 See Leff, supra note 5, at 525. In addition, a number of other states are expected to vote on the issue in 2016. Benac & Caldwell, supra note 29.
53 See PROCON, supra note 5.
54 Id.
a number of states, marijuana dispensaries now outnumber Starbucks.\footnote{Benac & Caldwell, supra note 29 (noting that while there are 112 Starbucks in Los Angeles, there had been as many as 1,000 marijuana dispensaries before a ballot measure restricted the number down to 135); Denver Pot Dispensaries, supra note 55 (noting that there was one medical marijuana dispensary per 1,535 Denver residents in 2010 and that the city was averaging 25 applications per day from prospective dispensary owners).} While most marijuana businesses are relatively small, it is important to note that at least some have grown to be worth tens or even hundreds of millions of dollars.\footnote{Infra Part II, notes 83–93.}

While many states have legalized medical marijuana, four states have recently gone further.\footnote{As this Article was going to print, Oregon and Alaska also legalized marijuana for recreational purposes. See, e.g., Matt Ferner, Alaska Becomes Fourth State to Legalize Recreational Marijuana, HUFFINGTON POST (Nov. 5, 2014, 8:59 AM), http://www.huffingtonpost.com/2014/11/05/alaska-marijuana-legalization_n_5947516.html, archived at http://perma.cc/5MQQ-8E4H. Despite the recent changes in marijuana law for these states, this Article will continue to focus on Colorado and Washington, as Alaska and Oregon’s recreational marijuana laws do not affect the content of this Article.} On November 6, 2012, voters in both Colorado and Washington approved the legalization of the sale and possession of marijuana for recreational use.\footnote{See, e.g., COLO. CONST. art. XVIII, § 16 (making it legal to produce and sell marijuana and to possess up to one ounce); Ng et al., supra note 6; Aron Smith, Marijuana Legalization Passes in Colorado, Washington, CNN MONEY (Nov. 8, 2012, 11:46 AM), http://money.cnn.com/2012/11/07/news/economy/marijuana-legalization-washington-colorado/index.html, archived at http://perma.cc/9A2S-LL55.} Because this happened so recently, and these laws have just gone into effect, there has not yet been any development of the legal recreational marijuana market in these states. However, one can expect it to eventually broaden the market for marijuana products and thus grow the industry.\footnote{See Colorado Recreational Pot Sales: Medical Marijuana Shops Get Head Start, HUFFPOST DENVER (Apr. 25, 2013, 5:10 PM), http://www.huffingtonpost.com/2013/04/25/colorado-medical-marijuana-recreational-pot-sales_n_3157647.html, archived at http://perma.cc/6BUR-MEU2 (noting that regulations allowing for the sale of recreational marijuana go into effect on January 1, 2014).} Despite legalization on a state level (whether for medicinal or recreational sale and use), federal law still makes it illegal to sell marijuana.\footnote{See supra note 9.}

\section*{C. Policy Grounds for Marijuana’s Legalization}

There have been many policy arguments advanced in favor of marijuana’s legalization. These include combating crime, creating a new source of tax revenue, failure of the war on drugs, unnecessarily high incarceration rates, disproportionate impact of criminalization on minorities, and, of course, compassionate care for sick people who would potentially benefit from the
pain-mitigating effects of the drug.\textsuperscript{63} While the values behind these policies are still hotly debated, the fact remains that in many states, elected officials and citizens have been persuaded by these arguments.\textsuperscript{64} As this Article will demonstrate, the conflict between state and federal marijuana policy negatively affects states’ ability to work towards their policy goals. Accordingly, states should do what they can to minimize the negative effects of this conflict.\textsuperscript{65} While states do not have the direct power to change the federal government’s stance on marijuana, they do, as will be discussed in Part III of this Article, have the power to minimize the effects of this legal conflict until the day when the laws are reconciled.

\textbf{D. Federal Government’s Response to Marijuana’s Legalization}

While many states have moved in the direction of decriminalizing marijuana, possession, and trafficking are still criminal under federal statutes,

\begin{itemize}
\item \textsuperscript{64} See Leff, \textit{supra} note 5, at 525 (citing Colorado Voter Guide and Washington Voter Guide).
\item \textsuperscript{65} See infra Part II.C.
\end{itemize}
specifically under the CSA, which lists marijuana as a drug with "no currently accepted medical use." 66 Aside from making it illegal to sell marijuana, the CSA, along with other federal laws such as the Racketeer Influenced and Corrupt Organizations Act or Continuing Criminal Enterprise Statute, makes it criminal to engage in a host of activities surrounding the sale of marijuana, including renting real property to a marijuana business, 67 funding the operations of a marijuana business, 68 or taking profits from a marijuana business. 69 The CSA, therefore, criminalizes not just those who directly sell marijuana, but also the stakeholders who participate in marijuana businesses, including managers, equity holders, and creditors. 70

The federal government’s response to whether it would respect state legalization of marijuana has been inconsistent. 71 On the campaign trail in 2008, President Obama said “I’m not going to be using Justice Department resources to try to circumvent state laws on this issue.” 72 Further, in 2009, Attorney General Eric Holder indicated that he would not pursue medical

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67 See Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1962 (2012); Continuing Criminal Enterprise Statute, 21 U.S.C. § 848 (2012); 21 U.S.C. § 856 (2012) (noting that under the CSA, it is a federal crime to “manage or control any place, ... as an owner, ... and knowingly and intentionally rent, lease, profit from, or make available for use, with or without compensation, the place for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance”).
69 Id. at §§ 841, 844, 846, 848; see also 18 U.S.C. § 1962 (2012); see James M. Cole, Memorandum for United States Attorneys, FREEDOMISGREEN, (last updated July 1, 2011) http://www.freedomisgreen.com/full-text-department-of-justice-memo-on-medical-marijuana/, archived at http://perma.cc/Y27F-4Z7U (“Persons 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.”).
70 Cole, supra note 69.
71 See, e.g., Dennis Romero, Marijuana: Obama Is Champion Spender on Medical Enforcement, LA WEEKLY (June 14, 2013, 10:05 AM), http://blogs.laweekly.com/informer/2013/06/half_billion_marijuana_enforcement_us.php, archived at http://perma.cc/EDW4-ATCU (noting that under Obama, the Department of Justice has spent $300 million on federal marijuana enforcement compared with a total of $500 million spent since 1996); Phillip Smith, DEA Raids Three LA Medical Marijuana Dispensaries, DAILY CHRONIC (Jan. 10, 2013, 12:31 AM), http://www.thedailychronic.net/2013/14376/dea-raids-three-la-medical-marijuana-dispensaries/, archived at http://perma.cc/93LZ-5EBJ (noting that while there was a respite from prosecution between 2009 and late 2011, the DEA and federal prosecutors have otherwise been going after medical marijuana dispensaries under both the Bush and Obama administrations).
marijuana users and businesses.\footnote{Id.} He observed that “[f]or those organizations that are doing so sanctioned by state law, and doing it in a way that is consistent with state law, and given the limited resources that we have, that will not be an emphasis for this administration.”\footnote{Id.} This liberal or libertarian attitude to enforcement of the CSA seemed to give states hope that even if medical marijuana was technically illegal on a federal level, sellers would not be prosecuted under federal law.\footnote{See John Ingold, Obama: Feds Won’t Arrest Marijuana Users in Colorado, Washington, DENVER POST (Dec. 15, 2012, 12:01 AM), http://www.denverpost.com/news/22196922/obama-feds-wont-arrest-marijuana-users-colorado-washington, archived at http://perma.cc/6BZ7-6WN3.} In late 2012, President Obama seemed to give further hope to the industry when he indicated that it would not be a federal priority under his administration to go after the medical marijuana industry, or at least users, in states where it was legal.\footnote{See Ingold, supra note 75; see also Benac & Caldwell, supra note 29 (quoting Obama as saying “‘it does not make sense, from a prioritization point of view, for us to focus on recreational drug users in a state that has already said that under state law that’s legal.’” But just a couple months later, Attorney General Holder said that “‘[w]e are certainly going to enforce federal law.’”).}

However, in a 2011 memorandum to the United States Attorneys, James Cole, the Deputy Attorney General, clarified how they should address medical marijuana.\footnote{See Cole, supra note 69.} Cole’s memorandum is less respectful of state choices related to medical marijuana, particularly with regard to dispensaries.\footnote{Id.} Cole wrote:

> The Department of Justice is committed to the enforcement of the Controlled Substances Act in all States. Congress has determined that marijuana is a dangerous drug that the illegal distribution and sale of marijuana is a serious crime that provides a significant source of revenue to large scale criminal enterprises, gangs and cartels.\footnote{id.}

The memorandum seems committed to the vigorous enforcement of the CSA’s ban on the possession or sale of marijuana. However, the next paragraph makes clear that in reality it is no longer a priority to go after at least certain classes of marijuana users, stating:

\footnote{The language of this memorandum largely tracks and quotes an earlier memorandum by Deputy Attorney General David Ogden in a 2009 memorandum on the same subject of how United States Attorneys should deal with medical marijuana. However, while David Ogden’s letter seemed to indicate that the federal government would not prioritize the marijuana industry, Cole’s letter indicates that it will. See Ciaramella, supra note 72.}
It is likely not an efficient use of federal resources to focus enforcement efforts on individuals with cancer or other serious illnesses who use marijuana as part of a recommended treatment regimen consistent with applicable state law, or their caregivers. The term “caregiver” as used in the memorandum meant just that: individuals providing care to individuals with cancer or other serious illnesses, not commercial operations cultivating, selling or distributing marijuana.80

This seems to put medical marijuana users in the clear, but not the dispensaries that provide those users with the marijuana. The memorandum states that even when the marijuana dispensary is conducted in accordance with state law, the people who facilitate this activity “are in violation of the Controlled Substances Act, regardless of state law” and are:

subject to federal enforcement action, including potential prosecution. State laws or local ordinances are not a defense to civil enforcement of federal law with respect to such conduct, including enforcement of the CSA. Those who engage in transactions involving the proceeds of such activity may also be in violation of federal money laundering statutes and other federal financing laws.81

It is clear from this memorandum that the United States Attorney’s office views the CSA as trumping state and municipal laws legalizing marijuana. However, this is not just empty rhetoric. The federal government has put this memo into practice by raiding numerous medical marijuana dispensaries in multiple states, recently raiding twenty-six medical marijuana dispensaries in Montana cities.82 These raids were not spur-of-the-moment either; they had been planned for eighteen months.83 Marijuana plants, computers, and other business items were seized, and some bank accounts were frozen.84 Along with the raids, civil seizure warrants were executed on financial institutions seeking $4 million worth of assets.85 These raids were obviously devastating for these businesses and most likely caused a total loss of investment.86
While the enforcement action above is hardly the only such incident, it serves to demonstrate the vulnerability of medical marijuana businesses. They can be, and in some cases are being, shut down at any time. In fact, hundreds of dispensaries in California have been closed due to raids, and many raids have occurred in other states such as Colorado and Montana. Nevertheless, the federal government has not taken the step of shutting down all of the thousands of still openly operating dispensaries. It either targets certain dispensaries or is simply providing a public reminder of the law through the occasional raid.

All of the federal responses discussed above have been with regard to medical marijuana laws and participants. Because Washington and Colorado’s recreational marijuana laws have just gone into effect, we have not yet seen how many enforcement actions will be brought against businesses that sell recreational marijuana. In August 2013, the Justice Department announced it would not seek to block or pre-empt these laws but that marijuana would remain illegal under the CSA. However, it is probably safe to say that if medical marijuana dispensaries are still considered illegal and an option for prosecution by the federal government exists, then a recreational marijuana dispensary would be at even more risk. In November 2013,
one month before the law went into effect, federal agents raided numerous marijuana dispensaries in Colorado in what may have been a warning to marijuana businesses set to start selling marijuana to recreational users in January 2014. 

While the overall trend seems to be towards less aggressive enforcement of federal marijuana laws, as will be discussed below, for purposes of this Article it is not crucial whether the federal government backs off from enforcement of the CSA. As long as the sale of marijuana is illegal on a federal level, according to state business law, there will be complications for businesses trying to make use of standard business entity law protections. In any case, it is clear that despite the stepped up raids on the marijuana industry by the federal government, the marijuana industry is still growing in terms of the size of these businesses, the amount of money being invested, and the total number of businesses being created and operated. Therefore, since neither the industry nor the criminalization of marijuana on the federal level are going away, there is an interest in ensuring that the industry is run professionally.

E. The Financial State of the Marijuana Industry

Because of the legal concerns related to the industry, most marijuana businesses will be relatively small, though there are some companies with

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95 See Jack Healy, Groundwork Laid, Growers Turn to Hemp in Colorado, N.Y. TIMES (last modified Aug. 8, 2013), http://www.nytimes.com/2013/08/06/us/groundwork-laid-growers-turn-to-hemp-in-colorado.html?pagewanted=all&_r=0, archived at http://perma.cc/B8J7-U558 (noting that the total number of marijuana plants seized by federal authorities has “dropped sharply in recent years. In 2012, federal officials reported that 3.9 million cannabis plants had been destroyed under DEA eradication efforts. A year earlier, officials said they had eradicated 6.7 million plants.”); Merica & Perez, supra note 43; Perez, supra note 92 (noting that the Justice Department issued new marijuana guidelines for federal prosecutors requiring them to focus on enforcement priorities such as preventing marijuana distribution to minors and drugged driving instead of broadly going after all marijuana users).

96 While enforcement policies have changed, it is unlikely that Congress will change marijuana’s status in the CSA anytime soon. See Kamin, supra note 10, at 153.

97 Kamin, supra note 10, at 155 (citing the Ogden memo); Swift, supra note 2 (noting that thirty-eight percent of Americans admit to having tried marijuana); Tim Walker, Mile High City: Inside Denver’s Billion-Dollar Marijuana Industry, THE INDEPENDENT (Aug. 3, 2013), http://www.independent.co.uk/news/world/americas/mile-high-city-inside-denvers-billion-dollar-marijuana-industry-8740525.html, archived at http://perma.cc/TJK4-T23L (noting that despite the federal prohibition on marijuana, the legal marijuana industry employed approximately 10,000 people in Colorado).
substantial assets. Currently, the largest medical marijuana industry businesses have market caps approaching $126 million. Some wealthy investors are also getting involved with this industry, potentially putting their substantial personal resources at risk. Further, if the business entity law issues (along with other legal issues such as tax problems) could be solved, numerous large companies and investors would eagerly move into this industry. One can easily understand why investors are eager to get into this industry before it is built up, when the “legal” domestic marijuana industry has been estimated to have a potential value of $100 billion. In 2005, the United Nations estimated the worldwide trade in marijuana was worth $142 billion. The legal medical marijuana industry grew at a rate of 13.8 percent from 2008 until 2013. In particular, one can expect that if the legal conflicts get worked out, the most likely companies to move into this industry would be the tobacco companies. They have the farmers, supply chains, and industry expertise to create a strongly branded product. Opening this industry would also give these deep-pocketed companies a strong new revenue source to

100 See Steve Hargreaves, Marijuana Dealers Get Slammed by Taxes, CNN (Feb. 25, 2013, 3:17 PM), http://money.cnn.com/2013/02/25/smallbusiness/marijuana-tax/index.html, archived at http://perma.cc/7GDB-U4L6 (quoting an industry expert on the marijuana industry’s inability to deduct business expenses, saying “[a]n emerging industry that can provide hundreds of thousands of jobs is being held back by these crazy tax rates.” The article cites an accountant who says this can drive the industry’s effective tax rates from fifteen to thirty percent to sixty-five to seventy-five percent.); Ritter, supra note 98.
101 Hargreaves, supra note 100.
102 2005 World Drug Report, UNITED NATIONS OFFICE ON DRUGS AND CRIME 128, archived at http://perma.cc/B2LG-2BQV [hereinafter 2005 World Drug Report]. The report notes that it is difficult to give an accurate estimate since most marijuana is sold illegally and never reported to a government. Id.
103 See Ritter, supra note 98.
105 See id.; see also Ritter, supra note 98.
supplement the slowly declining cigarette market. Another possibility would be for large pharmaceutical companies to enter the market, as they, like tobacco companies, have the experience and resources to become major players. However, as long as the current legal conflicts remain, it is unlikely that companies from these established industries would move into the marijuana industry because of the significant liability issues. According to surveys, up to half of adults have tried marijuana and 12 percent have tried it in the last year. This would be a big market for established companies to move into when you consider the amount of money tobacco companies make when less than 18.1 percent of adults currently smoke cigarettes. However, these businesses will not invest so long as investing is a federal criminal offense. They do not want to expose their main businesses to potential criminal liability. Ironically, as most marijuana businesses are small operations due to lack of investors, they are at even more risk than large companies by not receiving standard business law protections, because it is less likely that they will thoroughly vet potential sources of liability with a business attorney.

Though most marijuana businesses are small, there are still some stakeholders with significant assets. For example, there is at least one private-equity fund, Privateer Holdings, which specializes in investing in this industry, though it has a confusing policy of “don’t touch the leaf,” indicating its underlying concern with potential federal law enforcement action. Instead, the fund chooses to focus on ancillary businesses that provide services to marijuana companies without directly dealing with the drug. These high net worth investors are proceeding very cautiously, but clearly the demand for investment opportunities in this market exists.

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106 Mitchell, supra note 104; see also 2005 World Drug Report, supra note 102, at 93 (estimating that 161 million people worldwide use marijuana in various forms).
107 Ritter, supra note 98.
108 See Benac & Caldwell, supra note 29.
110 Marijuana businesses’ ability to get adequate legal counsel for their complex needs is further complicated by restrictions on an attorney’s counsel to criminal organizations. See Kamin & Wald, supra note 9, at 892–94.
111 See Kaminsky, supra note 99.
113 Id.
Finally, it should be noted that not all marijuana businesses are one-stop shops. The marijuana industry is likely to have different specialized businesses, each having a separate role in getting marijuana to the final user.\textsuperscript{114} There will be seed sellers, farmers, dispensaries, etc.\textsuperscript{115} While some dispensaries will grow their own marijuana, many of them will acquire their product from outside sources.\textsuperscript{116} No matter what size these businesses are, or how much personal wealth their investors have, there is no question that this industry would benefit from the normal protections of business entity law, which are afforded to all other businesses (such as limited liability for equity holders or the business judgment rule for managers). The next Section of the Article goes on to discuss a few examples of basic business entity law protections and how these protections might not be available to the marijuana industry.\textsuperscript{117}

II. THE MARIJUANA INDUSTRY’S TROUBLE WITH BUSINESS ENTITY LAW

Since this Article focuses on the effect that conflicting marijuana laws have on the application of business entity law, it is worth asking whether marijuana businesses are in fact being run as business entities. After all, most drug dealers are not known for complying with laws and registering their businesses with the state.\textsuperscript{118} By not registering their business formally with a state, drug dealers do not even attempt to gain protections, such as limited liability, that come with choosing an appropriate business form. In most states, if a business does not take active steps to register with the state, the business will, by default, be considered either a sole proprietorship if run and wholly owned by an individual, or a general partnership if there are at least two


\textsuperscript{115} Id.


\textsuperscript{117} There are standard business law protections that marijuana industry stakeholders will likely not have access to in addition to those addressed in this Article. For example, officers and directors might not be able to get permissive indemnification because they are violating their duty of good faith by intentionally violating federal law. \textit{See In re Landmark Land C. of Carolina}, 76 F.3d 553, 562–65 (4th Cir. 1996).

participants in the business.\(^\text{119}\) Neither of these business forms receives the benefit of limited liability for equity holders.\(^\text{120}\) As such, if a marijuana dispensary is run in either of these business forms, the owners should not expect to receive protection from creditors and therefore, some of the problems raised in this Article would not apply. However, despite the problems with business entity law in states where marijuana businesses are legal, most of these businesses will not skip the step of active formation by forming as LLCs.\(^\text{121}\) This is advisable because, if nothing else, forming an LLC and adopting an operating agreement will create default rules that will help the LLC by governing disputes between the various stakeholders of the business.\(^\text{122}\) However, in addition, many people forming marijuana businesses as LLCs may not be aware of the potential problems they might have with business entity laws. Having formed their business as an LLC, equity holders and managers most likely expect to get the same treatment under business entity law as other LLCs. Alternatively, these businesses may form as LLCs with the hope that state courts will not recognize their illegal activity when applying state business entity laws.

A. Limited Liability Protection Might Not Be Available to Marijuana Businesses

Most commonly used business entity forms get the benefit of limited liability protection for equity holders. The concept of limited liability protects


\(^{120}\) Missouri Small Business Startup Guide, supra note 119.

\(^{121}\) See State v. McQueen, 811 N.W.2d 513, 527 (Mich. Ct. App. 2011) (noting that a medical-marijuana dispensary had been formed as a LLC). While the LLC is currently the most popular business form, there are other ways in which the medical marijuana community can transact the transference of marijuana, including the use of a medical marijuana collective. A medical marijuana collective is a group of qualified patients or caregivers who share or are motivated by a common interest. Often the common interest is the production and transfer of medical marijuana amongst the group. Collectives will also democratically share and exercise political and social power between their members. Collectives differ from cooperatives in that they are not necessarily focused on the production or transfer of medical marijuana. Medical Marijuana Collective & Cooperative Attorneys, Proposition 215 Attorney (2009), http://www.prop215attorney.com/marijuana-dispensary-collective-cooperative.html, archived at http://perma.cc/VYQ5-6TLL. While these collectives may or may not have a formal structure lending itself to business entity law analysis, there are still thousands of businesses that do.

\(^{122}\) There are, of course, many other benefits to actually forming an LLC that are well addressed elsewhere. See J. William Callison & Maureen A. Sullivan, Limited Liability Companies: A State-by-State Guide to Law and Practice § 2 (2014).
equity holders against vicarious liability earned by the business or its other stakeholders.\textsuperscript{123} It is a core concept of modern business law and has been instrumental in the growth of modern business.\textsuperscript{124} It is important for businesses on two key levels.\textsuperscript{125} The first is that limited liability promotes investment in business both in terms of total dollars invested and the number of people who invest.\textsuperscript{126} This is because investors will know that the only money that is at risk is the money they invest.\textsuperscript{127} As a consequence, they can invest in businesses with a higher potential rate of return, but also a higher risk of loss.\textsuperscript{128} They know that the rest of their assets will not be at risk.\textsuperscript{129} Further, it allows investors to diversify their investment by putting money into multiple businesses without having to worry about overseeing management.\textsuperscript{130} As such, it promotes passive investing.\textsuperscript{131} The second key benefit of limited liability is the effect it has on the management of limited liability entities.\textsuperscript{132} Management knows that the only equity money that can be lost is that actively invested in the business.\textsuperscript{133} They are not risking their investors’ outside personal assets;\textsuperscript{134} therefore, the management can make business decisions without worrying about excess liabilities.\textsuperscript{135}

But without limited liability, the risk tolerance for investors and managers will change. For example, Jamen Shively, a retired Microsoft executive, has announced that he wants to launch the first national marijuana brand in the U.S.\textsuperscript{136} As part of this business plan, Shively is seeking up to $10 million worth of investment.\textsuperscript{137} While it is unclear what Shively’s total net worth is, let us assume that it is $50 million. If Shively invests $1 million in the marijuana brand company and the company is unsuccessful and closes with a

\textsuperscript{123} Douglass M. Branson et al., Business Enterprises: Legal Structures, Governance and Policy Cases, Materials and Problems 275 (LexisNexis 2d ed. 2012).
\textsuperscript{124} See Strassfeld, supra note 19, at 1019.
\textsuperscript{125} See Branson et al., supra note 123.
\textsuperscript{126} Id.
\textsuperscript{127} Id.
\textsuperscript{128} Id. For example, a normal limited liability entity funded with $50,000 in start-up capital would be able to lose only that $50,000 investment, even if the company ends up dissolving with liabilities in excess (even greatly in excess) of that $50,000. This is a major comfort for high net worth individuals who are investing only a small portion of their total assets into a business.
\textsuperscript{129} Id.
\textsuperscript{130} Id.
\textsuperscript{131} Id.
\textsuperscript{132} Id.
\textsuperscript{133} Id.
\textsuperscript{134} Id.
\textsuperscript{135} Id.
\textsuperscript{136} Kaminsky, supra note 99.
\textsuperscript{137} Id.
$20 million liability (due to a tort claim, for example), Shively would only lose $1 million and the rest of his investors’ $9 million when limited liability is applied as it would to a normal business. The company would dissolve and creditors would not see a full return on their debt. This would only be the case if marijuana businesses were able to benefit from limited liability. Without limited liability, when the business dissolves, Shively and his investors would not simply have lost their cumulative $10 million initial investment; they would also be on the hook for any unpaid liabilities that exist when the businesses dissolves. Since there is no way of predicting what the liabilities of a marijuana business will be when it closes in the future, these potential losses could be astronomical and could personally bankrupt these high net worth investors. The lack of limited liability would in fact dissuade most investors from investing at all. Therefore, the question of whether marijuana businesses get limited liability protection is crucial to the growth of this industry.

Unfortunately, there does not seem to be any case law specifically addressing whether there is limited liability for investors in marijuana businesses. In addition, there does not seem to be any scholarly or media discussion of this issue. However, an analysis of normal business entity law indicates that they should not get the benefit of limited liability protection. Courts agree that limited liability is not to be used to protect investors in businesses whose purpose is to conduct fraudulent or illegal operations. 138

138 See Laura Hunter Dietz et al., Factors Affecting Liability, 18 AM. JUR. 2d Corporations § 57 (2014) (“The corporate entity generally is disregarded where it is used as a cloak or cover for fraud or illegality ... to defend crime, or to defeat an overriding public policy .... The corporate entity may be disregarded when failure to do so would enable the corporate device to be used to circumvent a statute.”); Neil A. Helfman, Establishing Elements for Disregarding Corporate Entity and Piercing Entity’s Veil, 114 AM. JUR. 3d Proof of Facts § 3 (2013) (noting that “corporate structure is not a shield for dominant shareholders to hide behind while ... conducting illegal operations”); Peter Oh, Veil-Piercing Unbound, 93 B.U. L. REV. 89, 131 (2013) (quoting Adolf Berle, The Theory of Enterprise Entity, 47 COLUM. L. REV. 343, 354 (1947) (“Whenever ‘corporate entity’ is challenged, the court looks at the enterprise .... This is, in essence, not so much a ‘disregard of the corporate fiction’ as it is a holding that the economic enterprise ... is illegal, or criminal, or in violation of public policy, or fraudulent, or otherwise objectionable, as the case may be.”)).

139 See, e.g., B & E Gibson Enterprises Inc. v. Darnagvil Enterprises LLC, 2013 WL 1969288, at *3 (M.D. Fla. 2013) (“Piercing the corporate veil is proper if the corporation is a mere device or ... where the purpose is to evade some statute or to accomplish some fraud or illegal purpose.”) (internal citations and quotations omitted); see also Associated Vendors, Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, 840 (Cal. Ct. App. 1963) (listing “the use of a corporation as a subterfuge of illegal transactions” as one of the situations where piercing is appropriate). There is little subterfuge regarding illegal transactions for most marijuana businesses; they are open about it. The fact that a business openly violates the law might in fact impact which creditors can pierce. See MAG Portfolio Consultant, GMBH v. Merlin Biomed Group LLC, 268 F.3d 58, 63 (2d Cir. 2001); In re Checiek, 492 B.R. 918, 920
Under the alter ego doctrine, then, when the corporate form is used to perpetrate a fraud, circumvent a statute, or accomplish some other wrongful or inequitable purpose, the courts will ignore the corporate entity and deem the corporation’s acts to be those of the persons or organizations actually controlling the corporation, in most instances the equitable owners.  

Because a marijuana business’s entire purpose is to sell marijuana, a crime under federal law, this should mean that the investors in these businesses should not have limited liability and are therefore exposing their entire net worth to potential claims against the business.

One small comfort for marijuana business stakeholders is that courts might hold that there must be a nexus between the wrongful purpose of the business and the creditor’s injury. Normally this would mean that the creditor trying to pierce the corporate veil on the basis that the business was an instrument for fraud must prove that they were a victim of that fraud and not simply a normal business creditor. But what does this mean for a marijuana business’s creditors? Who are the victims of this illegal business? While illegal according to the federal government, marijuana businesses are not (at least in general) run as schemes to steal money and not pay back debts, and, for the most part, creditors will know exactly what type of business they are getting involved with. Of course one could imagine exceptions. A marijuana business that burns down because of poorly installed grow lights and damages a neighbor’s property could give rise to a wholly innocent tort

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140 Sonora Diamond Corp. v. Superior Court, 99 Cal. Rptr. 2d 1081, 1089 (2000).

141 See also State Dept. of Env. Pro. v. Ventron Corp., 468 A.2d 150, 164 (N.J. 1983) (“The purpose of the doctrine of piercing the corporate veil is to prevent an independent corporation from being used to defeat the ends of justice, to perpetrate fraud, to accomplish a crime, or otherwise to evade the law ....”) (internal citations omitted).

142 Roberts’ Fish Farm v. Spencer, 153 So. 2d 718, 721 (Fla. 1963) (“Those who utilize the laws of this state in order to do business in the corporate form have every right to rely on the rules of law which protect them against personal liability unless it be shown that the corporation is formed or used for some illegal, fraudulent or other unjust purpose which justifies piercing of the corporate veil.”).

143 See Mag Portfolio Consultant, GMBH, 268 F.3d at 62.

144 See In re Montalbano, 486 B.R. 436, 445 (Bankr. N.D. Ill. 2013) (“Where there is no evidence of any misrepresentation, no attempt to conceal any facts, and the parties possess a total understanding of all of the transactions involved, Illinois courts will not pierce the corporate veil in a breach of contract situation.”).
creditor whose injury flowed directly from illegal activity. However, this would probably be a rare case. Therefore, if courts require a nexus between the marijuana business’s illegal activity and the creditor’s harm, the equity holders might still get the benefit of limited liability against some creditors. In any case, it is at least possible that some courts that do not require a nexus, will not grant equity holders limited liability at all.

Without limited liability, marijuana dispensaries will have a hard time attracting high net worth investors and will also be more constrained in the business risks their managers can take. As long as the current jurisdictional conflict over the legality of their business continues, this industry will not be able to attract professional investors, including institutional investors such as venture capital and banks, to help set up these businesses. A recent New York Times article noted that

[b]anks handling money from state-authorized marijuana dispensaries may face a money-laundering prosecution by either the federal government or by another state if the funds cross state lines .... Shunned by banks, dispensaries have flocked to money-services businesses to obtain money orders. But that industry is not well prepared to manage the legal obligations ....

Perhaps recognizing this, the Treasury has recently changed its policy to allow marijuana businesses to open bank accounts, but the banking industry has not had the confidence to embrace this policy. This is, of course, the exact opposite of what states should want. They should want marijuana dispensaries to get the firm guidance of professional bankers and not be forced into the overwhelmed money-services industry which itself has a reputation for shadiness.

\[145\] See Kamin, supra note 10, at 188, 165; Barcott, supra note 112; Perez, supra note 92 (noting that while the federal government was easing up on prosecuting marijuana businesses, it was not changing its stance on federal money laundering rules which make it difficult for banks to do business with marijuana businesses); Tim Sprinkle, Kingpin: Marijuana Funding Model Starts to Take Shape, YAHOO FIN. (Feb. 14, 2013, 4:24 PM), http://finance.yahoo.com/news/kingpin--marijuana-funding-model-starts-to-take-shape-212346330.html?l=1&desktop_view_default=true, archived at http://perma.cc/92NN-J73P.


\[147\] Id.


\[149\] Nathalie Martin & Joshua Schwartz, The Alliance Between Payday Lenders and Tribes: Are Both Tribal Sovereignty and Consumer Protection at Risk?, 69 WASH. & LEE
Of course, even without limited liability, this does not mean the marijuana industry will not draw investors. Friends, family, and alternative investment funds will come together to provide the seed money necessary to get these businesses up and running. While this limitation on funding will likely change over time if the industry gains federal acceptance, in the meantime, the industry is largely shut out from the benefits of professional investors and the experience they can bring to a business. There has already been discussion of the big tobacco and pharmaceutical companies moving into this industry, though they are likely waiting until the federal government changes its stance on marijuana because of potential liability. Because of the lack of discussion of this issue, investors in this industry may not understand the level of risk they are currently taking.

B. Fiduciary Duties of Managers of Marijuana Dispensaries

Another key concept in business law is the fiduciary duties of management. With a normal business, management is liable to equity holders only if there is a breach of a fiduciary duty. The business judgment rule protects management from liability due to bad business decisions. This rule, like limited liability protection for investors, means that managers can take more risks in running the business than they would be comfortable doing if

L. REV. 751, 792 (2012); Carter Dougherty, U.S. Regulators Squeeze Banks to Cut Ties to Some Online Lenders, BLOOMBERG (Aug. 9, 2013, 12:01 AM), http://www.bloomberg.com/news/2013-08-08/u-s-regulators-squeeze-online-lenders-via-bank-transfer-system.html, archived at http://perma.cc/9TDL-B62J (noting that the federal government was pressuring banks to cut ties with online payday lenders “whom regulators suspect of shady business practices, as part of a broad crackdown on frauds in the payment system...”); Kovaleski, supra note 29 (noting that marijuana dispensaries have a hard time opening bank accounts and thus must operate with large amounts of cash on hand, $51,321 for one dispensary in the article).

Sprinkle, supra note 145.


See id. at 530.

Id. at 526.
they were on the hook for regular business decisions gone bad.156 This rule, limiting liability to breaches of fiduciary duties, is a standard protection afforded to business managers in all states.157 Managers of all business entities owe their businesses and investors two fiduciary duties, the duty of care and the duty of loyalty.158 In addition, managers owe their businesses and investors a duty of good faith, which some states include as a separate fiduciary duty and some include as a part of the duty of care or loyalty.159 Without going into detail on these well-discussed duties, the duty of care requires that managers keep track of their business and stay informed as to how it is being run.160 The duty of loyalty limits a manager’s ability to put their own personal interests ahead of the business.161 Finally, the duty of good faith requires that directors not intentionally harm their business.162 In addition, the duty of good faith is violated when a manager causes his or her business to intentionally violate the law.163 There is both scholarly and judicial consensus on this point.164

156 Id. at 527.
157 See CALLISON & SULLIVAN, supra note 122, § 8:7.
158 McMillan, supra note 153, at 531, 533.
161 See Guth v. Loft, Inc. 5 A.2d 503, 510 (Del. 1939).
162 See In re Walt Disney Co. Derivative Litig. 906 A.2d 27, 67 (Del. 2006).
163 See Miller v. Am. Tel. & Tel. Co. 507 F.2d 759, 762 (3d Cir. 1974) (“[E]ven though committed to benefit the corporation, illegal acts may amount to a breach of fiduciary duty ...”); Bainbridge et al., supra note 44, at 592, 594 (arguing that while under current Delaware law, intentional violations of the law breach the duty of good faith, the law should be changed so that these are not automatically breaches because of the rational business decision to break lesser laws when the potential penalty is less than the economic gain to the business. The authors give the example of the directors of a parcel delivery service company telling drivers to double park while making deliveries. Id. at 592. If the economic benefit to the company of faster deliveries is greater than the cost of the parking tickets received, then this was a good business decision and the directors should not be punished with a finding that they violated their duties of good faith. The authors would exclude more serious violations of the law from this line of reasoning. Id.).
164 See In re Landmark Land C. of Carolina, 76 F.3d 553, 565 (4th Cir. 1996) (“An agent who has intentionally participated in illegal activity or wrongful conduct against third persons cannot be said to have acted in good faith, even if the conduct benefits the corporation.”); Lisa Casey, Twenty-Eight Words: Enforcing Corporate Fiduciary Duties Through Criminal Prosecution of Honest Services Fraud, 35 DEL. J. CORP. L. 1, 15 (2010) (citing Desimone v. Barrows, 924 A.2d 908, 934–35 (Del. Ch. 2007) (“[E]xecutives breach their duty of loyalty by knowingly causing the corporation to use illegal means in the pursuit of profit, by exposing the corporation to penalties from criminal and civil regulators, or by consciously causing the corporation to act unlawfully.”)).
Most states allow businesses to limit the liability of directors in their formation documents.\textsuperscript{165} The extent to which liability may be limited varies greatly both between states and within a state according to the form of the business. In general, LLCs may limit their managers’ liabilities to a greater extent than other businesses.\textsuperscript{166} While the exact extent of the fiduciary duties may change according to the form of business and state of formation, at a minimum, states require managers to comply with the duty of good faith.\textsuperscript{167} While this can go a long way in protecting managers, no state currently allows the elimination or limitation of the duty of good faith.\textsuperscript{168} So at a minimum, managers will owe this duty to their businesses and investors.\textsuperscript{169} Normally, the breach of the duty of good faith is a difficult breach to prove.\textsuperscript{170} Ironically, for marijuana businesses, it may be the easiest.\textsuperscript{171}

It is possible to advance an argument that intentional violations of the law should not be per se violations of the duty of good faith, but these arguments

\textsuperscript{165} See, e.g., \textsc{Del. Code Ann. tit. 8, § 102(b)(7)} (2013) (allowing Delaware corporations to eliminate their directors’ duty of care).

\textsuperscript{166} \textit{Compare} \textsc{Del. Code Ann. tit. 6, § 18-1101(c)} (2013) (allowing an LLC agreement to eliminate all management duties except for the implied contractual covenant of good faith and fair dealing), \textit{with} \textsc{Del. Code Ann. tit. 8, § 102(b)(7)} (2013) (specifically proscribing provisions limiting a corporate director’s liability for any breach of the director’s duty of loyalty).

\textsuperscript{167} See, e.g., \textsc{Del. Code Ann. tit. 6, § 18-1101(c)} (2013) (allowing the elimination of fiduciary duties in an LLC, but “the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing”). This Article will refer to the fiduciary duty of good faith instead of a contractual duty of good faith. While there are differences between these duties, for our purposes, they are essentially the same.

\textsuperscript{168} See Eisenberg, \textit{supra} 159, at 6.

\textsuperscript{169} The duty of good faith is only the most obvious example of how marijuana businesses will struggle with fiduciary duty principles but there are others. For example, the duty of care requires managers to set up a compliance system within their company to ensure that employees are not violating the law. \textit{See In re Caremark Intern. Inc. Derivative Litig.} 698 A.2d 959, 970 (Del. 1996) (“[A] director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards ….”). If employees are violating the law then the managers must correct this action. \textit{See id.} at 964. Clearly, no such compliance system could function in a business whose entire purpose violates federal law. However, many states allow businesses to eliminate the duty of care for their managers, so marijuana businesses, properly formed, have a way around issues such as this. See, e.g., \textit{supra} note 166.

\textsuperscript{170} \textit{See In re Caremark Intern. Inc.}, 698 A.2d at 967 (stating that a breach of the duty of care, without allegations of self-dealing or breach of loyalty, “is possibly the most difficult theory in corporation law upon which a plaintiff might have to win a judgment”).

\textsuperscript{171} \textit{In re Walt Disney Co. Derivative Litig.}, 907 A.2d 693, 755–56 (Del. Ch. 2005) (“A failure to act in good faith may be shown, for instance … where the fiduciary acts with the intent to violate applicable positive law ….”); Miller v. Am. Tel. & Tel. Co., 507 F.2d 759, 762 (3d. Cir. 1974).
do not seem to reflect current law. For the managers of most businesses, the fiduciary duty of good faith is easy to comply with, but the marijuana industry is in constant breach of federal law since its entire purpose is openly to violate the CSA. For marijuana businesses, every act of the business is in furtherance of an illegal act, namely growing and selling marijuana. As such, any time a manager of a marijuana dispensary authorizes any act in furtherance of the business, she is intentionally authorizing the violation of the law and is therefore in breach of her duty of good faith according to state business entity law. As a consequence, the management of marijuana businesses is in constant breach of its duty of good faith to its investors. Because every act a marijuana business takes, and every decision its managers make, is in furtherance of the criminal act of selling marijuana, the managers will never get the benefit of the business judgment rule. If this industry is unable to take advantage of the business judgment rule and its management is exposed to higher than normal personal liability, then it will have a hard time attracting professional managers accustomed to running businesses in compliance (or at least as in compliance as the marijuana industry can currently be) with the law.

The results of this constant breach of good faith are themselves complicated. Normally, violations of fiduciary duties are isolated affairs and not reflective of the entire purpose of the business. When a director breaches her duty of good faith by authorizing an intentional violation of the law, the business (or possibly the equity holders through a derivative action) can normally sue the manager for any damages caused to the business as a result of this action. But can the business or equity holders sue their managers for authorizing a breaking of the law when the equity holders funded the business for

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172 One could argue that a manager that authorizes minor infractions of the law in order to experience economic gains greater than any negative effect from breaking the law is doing the business a valuable service and not acting in bad faith towards it. See Bainbridge et al., supra note 44, at 592 (noting that a delivery company that authorizes its delivery drivers to park illegally and get tickets on occasion might very well experience greater economic gain than the cost of those tickets. In fact, due to limited parking in many cities, it is possible that many delivery businesses can only operate by knowingly violating traffic laws.).

173 See Miller, 507 F.2d at 762 (Even if directors were given the benefit of the business judgment rule, it would offer them no protection: “we are convinced that the business judgment rule cannot insulate the defendant directors from liability if they did in fact breach [a federal statute], as plaintiffs have charged.”).

174 See Benac & Caldwell, supra note 29 (quoting a marijuana business representative on the impact that the federal versus state conflict on marijuana is having on marijuana businesses, “[h]aving a regulated system is the only way to ensure that we’re not ceding control of this popular substance to the criminal market and to black marketeers [sic]”).

175 See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (2013) (expressly excluding acts involving “intentional misconduct” or a “knowing violation of law” from the scope of exculpation); Miller, 507 F.2d at 762 (Shareholder plaintiffs sued the defendant directors over losses that resulted from the corporation’s failure to collect on a past-due debt.).
this very purpose? Also, what does it mean to sue management for damages for this breach of the fiduciary duty to their business when the business would not be operational without this legal violation?

1. The Duty of Good Faith and the Unclean Hands of Marijuana Stakeholders

The problems that the marijuana industry causes for business entity law extend to other areas of the law as well. The first complication in holding that managers of marijuana businesses are in constant breach of the duty of good faith, and thus potentially liable to their business or investors, arises from doctrines, such as the unclean hands doctrine, which bar recovery by individuals who participated in the illegal conduct.\(^{176}\) Specifically, this doctrine holds that a court will not participate in or give legal credence to a lawsuit between two parties who participated in a shared bad act such as a criminal enterprise.\(^{177}\) For example, if two individuals run a fraudulent business together, once that business fails, those individuals will not be able to sue each other to recover money they lost in that business.\(^{178}\) “It is a fundamental principle of equity that ‘he who comes into equity must do so with clean hands.’”\(^{179}\) A litigant’s unclean hands “in relation to the matters in controversy” forfeits his claim, regardless of merit.\(^{180}\) Intentional participation in criminal acts by a plaintiff will generally be sufficient grounds for the application of this doctrine.\(^{181}\) Based on this doctrine, equity holders who intentionally fund an illegal business should forfeit claims against management.

The application of the unclean hands doctrine to the marijuana industry both complicates the normal application of business entity laws and is likely to confuse stakeholders about their rights and responsibilities. This is because

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\(^{177}\) See \textit{In re Beyries}, 2011 WL 5975445, at *1 (noting that in a case where an attorney was accused of misappropriating a marijuana business client’s funds, “the court cannot enter a judgment for plaintiffs because they were engaged in unlawful activity. While the sale of marijuana may be legal under state law, it is a serious federal crime ....”). \textit{See also} FRANCIS C. AMENDOLA ET AL., 30A C.J.S. Equity § 109 (2013) (“[The unclean hands doctrine] means that equity refuses to lend its aid in any manner to one seeking its active interposition who has been guilty of unlawful or inequitable conduct in the matter with relation to which he or she seeks relief ....”).

\(^{178}\) See \textit{In re Beyries}, 2011 WL 5975445, at *2 (“The unclean hands doctrine closes the doors of a court to one who is tainted relative to the matter in which he seeks relief, however improper may have been the behavior of the defendant.”).


\(^{180}\) \textit{Id.} at 791 (citations omitted).

\(^{181}\) Hill v. Cross Country Settlements, LLC, 936 A.2d 343, 360 (Md. 2007).
the equity holders, management, and any creditors who knew the nature of the business all equally decided to participate in a criminal enterprise and therefore none of their hands are clean. Put differently, whereas it was noted above that marijuana business managers are in constant breach of their duty of good faith, and thus should be liable to their equity holders if the business does not succeed, in reality, those equity holders might not be able to sue management because they themselves participated in and condoned the illegal acts that gave rise to the breach. While there are no cases that have addressed this issue, at least one bankruptcy court, without explaining its basis, speculated that no court would apply the unclean hands doctrine to deny an employee’s right to sue their employer for personal injury even though the business grew marijuana.182 Presumably, the court came to this conclusion because it found that the illegal conduct of the parties was not central to the plaintiff’s claim.183 Unfortunately, no opinion directly addresses whether marijuana business stakeholders are barred from suing each other by the unclean hands doctrine, so there are a number of open questions as to how it will be applied to this novel situation.184 The unclean hands doctrine generally bars a plaintiff’s claims only when his wrongful conduct is part of the equitable claim, that he “dirties them in acquiring the right he now asserts.”185 In the marijuana industry’s case, the equity holders obtained any rights they have against management by committing the illegal act of funding the business, so it seems likely that a court would not adjudicate their dispute.

Although it is a bit speculative, on its face, the unclean hands doctrine should clearly bar plaintiffs from using federal and state courts in states where the marijuana activities being conducted are not legal. At least one court has denied a medical marijuana business the right to pursue claims in federal court because it violated 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 .... The unclean hands doctrine closes the doors of a

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184 See, e.g., Pack v. Superior Court, 132 Cal. Rptr. 3d 633 (Cal. App. 2d Dist. 2011) (noting that the court did not apply the unclean hands doctrine to bar a medical marijuana collective’s challenge of a city ordinance requiring permits for medical marijuana despite the plaintiffs’ violation of the CSA. However, the court’s opinion was based in large part on the fact that if it applied the unclean hands doctrine to the plaintiffs in this case, no one would have standing to challenge the city ordinance. Id. at 647. The court did note, however, that the plaintiffs’ hands were not unclean with regard to California law. Id.).
court to one who is tainted relative to the matter in which he seeks relief, however improper may have been the behavior of the defendant.186

But would state courts in states where marijuana has been legalized apply the unclean hands doctrine to marijuana businesses? This is a more difficult question to answer because there is little case law on this point. The answer is probably contingent upon the situation, but should not be an automatic yes for both sovereignty and policy reasons. It would seem ridiculous to allow an equity holder to sue their manager for violating the law when the equity holder invested for that very purpose. The unclean hands of the equity holder should bar this suit. However, what about other violations of fiduciary duties, for example, if the manager steals money from the business? On one hand, it seems crazy to think that a court would allow a manager to commit a crime without leaving victims an opportunity for recourse. On the other hand, the entire nature of their relationship is based upon a criminal intent, and the stolen money was the result of criminal activity. If two people rob a bank, and then one bank robber robs the other, no court would allow the wronged bank robber to sue for his portion of the stolen money. In the marijuana case, all the profits of the business are a result of the criminal sale of illegal drugs, and therefore, courts should not allow themselves to be used to apportion this money.

Does this mean that despite the managers’ constant breach of their duty of good faith that they cannot be sued for this breach because of the equity holder’s own participation in the business’s criminal activity? If the answer is yes, then management for marijuana businesses have unintentionally been given something that no other industry’s management can have, a complete lack of fiduciary liability to its equity holders. This is not a logical, or desirable, outcome for these businesses, and so the exception to business entity law proposed later in this Article will attempt to negate this legal quirk.187

However, even if equity cannot enforce a manager’s fiduciary duties because of the unclean hands doctrine, that does not necessarily mean that the management escapes entirely from the problem of being in constant breach of its duty of good faith. When a business becomes insolvent, the management’s fiduciary duties can shift from the equity holders to the creditors of the business:

It is well settled that directors owe fiduciary duties to the corporation. When a corporation is solvent, those duties may be enforced by its shareholders, who have standing to bring derivative actions on behalf of the


187 See infra Part III.
corporation because they are the ultimate beneficiaries of the corporation’s growth and increased value. When a corporation is insolvent, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value. Consequently, the creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties.188

If management is in constant breach of its duty of good faith, and the creditors are not preempted from suing by the unclean hands doctrine, then management faces the possibility of always being liable to creditors if the business becomes insolvent. This issue is a bit more complicated for LLCs, but if the company goes into a bankruptcy proceeding, the duties will also likely shift to creditors.

If a marijuana business becomes insolvent, can creditors bring claims against management for their breach of the duty of good faith or are they barred by the doctrine of unclean hands? The answer is more complicated than it is with the marijuana business’s equity holders. Though the unclean hands doctrine can apply to a creditor-management relationship, just as it can with an equity-management relationship, it will not be as obvious that the creditors have unclean hands.189 The equity holders of a marijuana business knew that they were funding a business that would violate federal law. Creditors might likewise have known. For example, a common financing structure for many start-up businesses includes the founders putting in both equity and debt.190 As such, for many small businesses, the equity holders are also creditors.191 In such a scenario, it seems obvious that when the equity and debt is owed to the same individual, the unclean hands doctrine would bar claims brought under either relationship. However, even unrelated creditors can have unclean hands. A marijuana dispensary might buy its marijuana from a farmer on credit. The farmer is equally complicit with the business’s equity holders in furthering the illegal sale of marijuana, and the unclean hands doctrine should bar his claims against management. Another creditor might be supplying a product or service to the business that is not directly marijuana related, but the creditor might still know that the business is going

191 See, e.g., Wei Jiang, Kai Li & Pei Shao, When Shareholders Are Creditors: Effects of the Simultaneous Holding of Equity and Debt by Non-commercial Banking Institutions, 23 REV. FIN. STUD. 3595, 3595–96 (2010).
to use that product or service in furtherance of selling marijuana. So a car dealer that sells a delivery van to a marijuana dispensary with full knowledge that it will be used to transport drugs should also be barred from suing management under the unclean hands doctrine. Of course, there will be innocent creditors as well; those who knew nothing of the nature of the business they were getting involved with and who as a result do not have unclean hands. A tort victim could be injured by a negligently driven marijuana delivery vehicle. That victim obviously made no contribution to the criminal activity of the business. Or a creditor could supply products or services to a marijuana business without knowing the nature of the business, such as when the business’s name does not clearly indicate the nature of the company. These innocent creditors would be owed fiduciary duties in the event that the business becomes insolvent and as a result, they could attempt to bring derivative claims against management to enforce those duties. If the business becomes insolvent at any point, even for reasons unrelated to the management’s direct breach of their fiduciary duties, there will be someone, if no one else than a bankruptcy trustee, who will come looking to collect on any money owed to the business.

Thus, the constant violation of the duty of good faith by managers could potentially lead to their personal liability, though it may take creditors working through an insolvency proceeding to get there. Fortunately, for creditors, and unfortunately, for managers, the insolvency proceeding for marijuana businesses is not the normal process. The normal response by an insolvent company unable to pay its creditors would be to file bankruptcy at which point creditors can only pursue claims through that proceeding. However, as this Article will discuss in the next Section, marijuana businesses cannot make use of the federal bankruptcy system in the way a normal business would.

2. Can Bankruptcy Trustees Pursue Fiduciary Duty Claims Against Managers in the Name of Creditors?

A standard protection in our society for businesses that have taken on too much debt and are now unable to pay their creditors is found in federal bankruptcy laws. In particular, businesses are able to file either a chapter 11 case and try and rehabilitate their business or a chapter 7 case and simply

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liquidate the business for the benefit of creditors.\textsuperscript{194} As part of the bankruptcy process, businesses will negotiate and pay off creditors, to the extent able, while collecting as much money owed to the business as possible.\textsuperscript{195} Normally, managers would not be liable during the insolvency proceeding unless there is a claim against them, such as for a breach of their fiduciary duty to their business.\textsuperscript{196}

However, because medical marijuana businesses are illegal on a federal level, it appears that these businesses will not be able to take full advantage of federal bankruptcy laws. A bankruptcy court recently applied the unclean hands doctrine and denied chapter 11 bankruptcy protections to a business that had violated the CSA by knowingly renting space to a marijuana business.\textsuperscript{197} It noted that “a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime.”\textsuperscript{198} The court concluded that it must either dismiss the case entirely or convert the case to a chapter 7 case.\textsuperscript{199} The court struggled with this decision in part because converting the case to chapter 7 would require a bankruptcy trustee to administer the debtor’s estate and therefore participate in its criminal activity, if only to wind the business down.\textsuperscript{200} Ironically, it may be better for the marijuana business’s managers if the court dismisses the case entirely instead of converting it to chapter 7. If the case is converted, a bankruptcy trustee will be appointed to go after the managers for their breaches of fiduciary duty.\textsuperscript{201} In contrast, if the court dismisses the case, the business will have to proceed with a state court insolvency proceeding if it wants relief from creditor collection efforts.\textsuperscript{202} These non-bankruptcy alternatives include assignments for the benefit of creditors and receiverships. While the nature of these proceedings varies according


\textsuperscript{195} See Bankruptcy, supra note 193.


\textsuperscript{197} In re Rent-Rite, 484 B.R. 799, 805 (Bankr. D. Colo. 2012).

\textsuperscript{198} Id.

\textsuperscript{199} Id. at 809.

\textsuperscript{200} Id. at 810.

\textsuperscript{201} Id. at 807–08.

to state law, generally, creditors or a receiver would be able to pursue the management for breaching their fiduciary duty to their business.203 From this perspective, a chapter 7 and state insolvency proceeding would have the same impact on claims against management, but state courts, as will be discussed in Part II.C, have a greater incentive not to find that management’s violation of federal law should negate a business’s ability to use the court system to litigate inter-stakeholder disputes.

Though undecided, it is probable that at the very least, creditors, a bankruptcy trustee, or a state receiver will be able to pursue claims against management for breaching their fiduciary duties. In the next Section, this Article will propose an exception to business entity law to help minimize the effects of the conflict between state and federal marijuana laws on the marijuana industry.

C. How Will Marijuana Dispensaries’ Inability to Take Advantage of Business Entity Law Protections Affect This Industry and the States in Which it Operates?

On top of the other legal challenges the marijuana industry faces, without standard business entity law protections like limited liability and the business judgment rule, marijuana businesses will have a hard time attracting professional stakeholders. Institutional and high net worth investors and professional managers will be nervous that they could be subject to unusually high liabilities if the business experiences financial problems. As a consequence, we are likely to see a different kind of entrepreneur dominating this market. Instead of professionals who are primarily motivated by profit, as we see in other industries, we are likely to see fewer professional stakeholders who do not understand the risk of investing in illegal businesses, those with no assets outside the business that are at risk, or those who are drawn to work in this industry for other reasons such as their personal experience with marijuana.204 The large businesses that would be a natural fit for moving into this market, such as tobacco or pharmaceutical companies, will probably stay out. Whereas some might be happy if the marijuana industry is not taken over by the

203 See, e.g., In re Netzel, 442 B.R. 896, 899 (Bankr. N.D. Ill. 2011) (discussing Illinois’ insolvency exception to the rule that officers and directors generally do not owe creditors a fiduciary duty).

204 See David Freed, California’s Medical Marijuana Morass, PACIFIC STANDARD (Jan. 3, 2012, 4:00 AM), http://www.psmag.com/legal-affairs/californias-medical-marijuana-morass-38772/, archived at http://perma.cc/Q2SY-PS5U (discussing a marijuana business owner’s personal use of his product and how money is not his priority in running the business, “‘[p]ot, for us, is about the values .... It’s not about the money.’”).
tobacco industry, there will be consequences for both the marijuana industry and the states in which it operates.205

The industry will likely suffer because it will attract people who are less experienced with business.206 In fact, it will primarily attract individuals who had experience dealing with marijuana before it was legalized. For these formerly criminal drug dealers, the partial legality of the industry is actually an improvement for them from a legal perspective. Unlike regular businesspeople, these individuals were used to operating in the shadows, fearing possible legal enforcement. The chance of legal enforcement has simply decreased for them because now it is only a federal and not a state criminal issue. However, these individuals will have less experience navigating the tricky regulatory rules207 for marijuana dispensaries and will be more likely to take shortcuts. In fact, it is more probable that they will intentionally skirt state regulations when they see benefit in doing so, because many have a history of avoiding the law. This in turn will give the industry a reputation for lawlessness, something we have already seen develop.208 While states set rules on who can buy marijuana and the quantity, the common belief about the industry is that sellers are obeying these limitations superficially at best.209 As a consequence, this will cause communities to clamp down on the growth of the industry where they can;210 it also likely will not help persuade the federal government that it should legalize the product. Finally, it will act as a vicious circle in the

205 Id. “The U.S. Justice Department contends that state sanctions intended to regulate the sale of medicinal marijuana have been hijacked in many cases by criminally minded profit- ers who basically turned dispensaries into convenience stores that cater to recreational users.” Id.

206 See Stephanie Simon, In Mile High City, Weed Sparks Up a Counterculture Clash, WALL ST. J. (Mar. 19, 2010, 12:01 AM), http://online.wsj.com/article/SB10001424052748704784904575111692045223482.html, archived at http://perma.cc/L6W-B646 (giving an example of a “pot expert” who was “an out-of-work handyman” who like others “found that for an investment of a couple thousand dollars, they could rent a small shop, set out a dozen strains of marijuana in glass jars and reinvent themselves as bud-tenders, ringing up $80,000 a month in sales.”).

207 See Freed, supra note 204 (citing California’s “minefield of marijuana laws that are stunningly inconsistent from one jurisdiction to the next”); see also Allison Margolin, Does Anyone Really Understand the Medical Marijuana Laws?, 33 L.A. LAWYER 76 (Apr. 2010), archived at http://perma.cc/4NWE-D8LF (arguing that “[w]hat the [medical marijuana] law is and what activity it immunizes elude not only much of the public but the legal community too.”).

208 See Freed, supra note 204; Simon, supra note 206.

209 See Freed, supra note 204 (discussing marijuana business owner’s use of gray areas in California’s medical marijuana laws to treat himself and other industry workers as “patients” and “caregivers” for each other. Freed also discusses how virtually anyone can get a medical marijuana card by simply claiming an ailment. Id.).

210 See Pagliery, supra note 30.
sense that this lack of professionalism will scare away professional stakeholders who might otherwise be tempted to move into the market.211

The unprofessionalism of the industry will also lead to problems for the states in which marijuana has been legalized. While legalizing marijuana was, in part, intended to reduce crime and drug use by minors, if the marijuana dispensaries are not run professionally, they could instead promote crime and drug use in minors.212 They could do this by dealing with questionable marijuana growers, such as Mexican cartels, who would in turn use those profits to grow their cartels’ interest in other criminal fields.213 Alternatively, the dispensaries might simply sell the drug so freely that it will be passed on to non-licensed consumers.214 For example, if a customer seeks to buy marijuana and then frequently is seen meeting underage individuals outside, a professional businessperson would stop selling to that customer. However, if the business is run by unprofessional individuals who perhaps sold to underage people themselves before marijuana was legalized, they may be more likely to look the other way in the name of short-term profits.215

211 See Barcott, supra note 112 (in which a private equity fund’s managers discuss the need to install new management in marijuana businesses they invest in because “[e]ntrusting great sums of cash to the equivalent of Harold and Kumar seemed foolhardy”); Simon, supra note 206 (detailing the struggle of some in the marijuana industry to make pot respectable despite the stoner culture which keeps dragging the industry down. The article reports complaints of marijuana breeds named “Green Crack,” “AK-47,” and “Jack the Ripper,” which do not reflect the medical purpose of the drug so much as the stoner culture from which many sellers originated. Further, “[m]any of the new dispensaries are dingy and cramped, with bars on the windows, psychedelic posters on the walls and a generally furtive feel.”); See also Sam Kamin, Lessons Learned from the Governor’s Task Force to Implement Amendment 64, 91 OR. L. REV. 1337, 1344 (2013) (noting that in order to balance federal concerns with state implementation of the amendment, Colorado is considering limiting the amount of investment in marijuana businesses that can come from out of state sources).


214 See Freed, supra note 204 (quoting an industry expert on the thousands of marijuana businesses nationwide: “[t]he untold part of the story ... is that for most of these dispensaries to actually be viable ... they have to largely tap into the so-called black market to get their cannabis”).

The argument in favor of this Article’s proposal is that various states have made the political decision that the state would benefit if marijuana were sold openly through state regulated entities rather than illegally by criminal drug dealers. Having made that decision, states that have legalized marijuana now have to make some difficult choices. Do they wait for the federal government to change the CSA and meanwhile allow the marijuana industry to stumble along in the current legal gray zone, operating openly but not able to take advantage of the standard business practices that would help professionalize them? Or do they do what they can in the meantime to help these industries? From an equitable standpoint, they have given the blessing of state legality to these businesses, and it only seems fitting that they should try to make it as easy as possible for them to operate within the law.

How serious the effect of the lack of professionalism on the marijuana industry may be is open to debate. However, states that have legalized marijuana on policy grounds have an incentive to see the industry behave in a responsible manner. Thus, they should seek to minimize the effects that the marijuana legal conflict has on this industry. Creating a business entity law exception for marijuana businesses certainly would not solve all the legal problems facing this industry or address all their liability concerns, but it will help bring this industry closer to the legal world inhabited by other industries. Until the legality of marijuana is reconciled between the states and the federal government, this industry will always be at risk of federal enforcement actions and will not be able to take advantage of many aspects of business life that other industries take for granted, such as the ability to deduct expenses from its taxes or the ability to get a loan from a bank.

As this Article was being completed, the Treasury Department changed its policy to allow marijuana businesses to open bank accounts. But the federal government did not...
decriminalize marijuana. This piecemeal approach by the federal government only underscores the need for states to do more to protect the marijuana industry by creating an exception to their own business entity laws.

III. PROPOSED BUSINESS ENTITY EXCEPTION FOR MARIJUANA BUSINESSES

As has been discussed, states that have legalized the marijuana industry now have an incentive to see them operate professionally. Part of promoting a professional marijuana industry will be to pass laws that encourage professional and responsible businesspeople to become stakeholders in the industry. To accomplish this, a state such as Colorado should create an exception to its business entity and other related laws so that the violation of the CSA by the marijuana industry will not negate the industry’s ability to take advantage of other state laws. In form, the exception would hold that a violation of another jurisdiction’s laws, which directly contradicts laws passed within Colorado, will not act as a violation of the law for purposes of establishing good faith and clean hands in a Colorado court with regard to a business operating entirely within Colorado’s borders. The court can apply this exception when it finds that state public policy outweighs the value of enforcing the foreign jurisdiction’s law.

The exception to the business entity laws being proposed by this Article has the benefit of being simple in concept, though its application would naturally be more complex. The exception would strive to make business entity rules such as limited liability and fiduciary duties function for the marijuana industry as similarly as possible to the way they work for a business that does not have the jurisdictional legal conflicts that the marijuana industry does. This in turn should promote the marijuana industry’s integration into the regular business culture of their states and help to attract professional stakeholders.

The exception could originate either from a court ruling or legislative action. A court could find that for purposes of a state’s business entity laws, the violation of the CSA by a domestic marijuana business is not a violation of the law, or a state legislature could pass a law giving courts this guidance. Whichever body created the exception, the function would be the same—state courts would allow marijuana businesses to take advantage of normal business entity law protections and regulations.

If passed by a state legislature, the law would state: “For purposes of promoting a professional (medical) marijuana industry, the violation of the Controlled Substances Act by licensed marijuana retailers operating within the bounds of (that state’s marijuana laws) will not be considered a violation of the law for purposes of applying, or taking advantage of, other state laws.” While this language would need to be tailored to fit the specifics of each state’s legal terminology, in concept it should be fairly easy to draft. Under
this proposed exception, it would be left up to the courts to determine whether the exception applies to any given state law based on whether doing so would promote the state’s public interest in having a professional marijuana industry. Essentially, a state legislature would amend its business entity laws or a court in a state where marijuana has been legalized would hold that for purposes of marijuana businesses operating within the parameters of the state’s marijuana laws, the fact that the business is operating in violation of federal laws that specifically contradict those state laws need not be taken into effect for business entity law purposes. In other words, in places where business entity law limits protections on businesses or its stakeholders to situations when the business did not intentionally violate the law, the fact that the business is in violation of the CSA would not be taken into consideration. Thus, equity holders would be given limited liability protection, and managers the benefits of fiduciary duty liability protection. In essence, the court would be holding that the state laws which have explicitly legalized this industry trump the points in business entity law that deny protections to businesses that purposely violate the CSA.

If the exception were created by the courts, the reasoning would be as follows. The state legislature passed a law specifically allowing for this industry to operate within its borders, and state laws that deny businesses protections based on violations of the law are also state creations. Therefore, the court is simply harmonizing the intent of the legislature between these two laws. Because the marijuana laws were passed after business entity laws, and were passed with the full knowledge that they were legalizing an industry in the face of continued criminal treatment by the federal government, the legislature most likely intended for the new laws to trump earlier laws that denied legal protections to business stakeholders based on a violation of the federal law.

Because the application of this exception could be accomplished by state courts, let us consider how it would change some of the scenarios this Article has discussed. First, equity holders would not lose limited liability protection simply because they funded a marijuana business. If the marijuana business becomes insolvent and is unable to pay its debts, the equity holders would not be liable to the business’s creditors automatically and simply because they funded an illegal business. This, of course, would not mean that they could not lose their limited liability in other ways, such as under a normal application of the alter ego test.\(^{219}\) The effect of this would be to promote high net worth investors coming into the industry. These investors would bring with them demands for professional management of their businesses. Likewise,

\(^{219}\) See Callison & Sullivan, supra note 122, § 5 et seq.
marijuana business managers would not be in continuous violation of their
duty of good faith simply because they are operating in violation of the CSA. 
Again, this would not mean that managers could not violate their duty of 
good faith by breaking other laws, such as state marijuana regulations. But 
because managers would not be in continuous violation of the law, now they 
would have an incentive to operate the business within all non-CSA laws 
so as to avoid personal liability. This should have the effect of giving com-
fort to investors in marijuana businesses that the business they invested in 
will be operated professionally. Hopefully, this will act as a virtuous circle 
where the investors now promote professionalism among management, and 
management gives confidence to professional investors. Finally, at least in 
state courts, courts would not find that marijuana businesses have unclean 
hands and thus are not able to take advantage of the court system to sue each 
other for violation of their rights with regard to one another. This should only 
work to further help professionalize the marijuana industry by holding stake-
holders accountable to one another.

Obviously, the exception being proposed in this Article will raise serious 
concerns and objections. First, while it is generally true that businesses should 
not be encouraged to violate the law, even another jurisdiction’s laws, the 
marijuana situation appears to be a unique one. In this case, the marijuana in-
dustry has specifically been approved by the states where these businesses 
practice. Further, business entity law is entirely a state law affair and so the 
only laws that would be modified to reconcile them would be state laws. By 
allowing these businesses to make use of normal business entity law, states 
are not encouraging the violation of law outside of their geographic borders 
or population. Although they are encouraging the violation of another juris-
diction’s laws—the federal government’s CSA—that encouragement hap-
pened when marijuana businesses were legalized in the first place. This 
proposed exception will not cause more violation of the CSA, but hopefully 
will promote a professional industry that will embody good public policy. 
Further, this exception will not protect against the federal government’s abil-
ity to enforce the CSA; it will simply help reconcile state business entity law 
with state marijuana laws so that, as long as the legal conflict exists, the con-
flict between state laws is minimized. Finally, the federal government has it-
self undercut this concern when the Treasury Department changed its own 
policy to allow marijuana businesses to open and maintain bank accounts.220

Another potential drawback to the proposed exception would be that on 
its face, it would seem to increase forum shopping. Parties who wanted to 
avoid application of this exception would try to bring or move proceedings to

220 See Weise, supra note 148.
a jurisdiction that would not apply it. In particular, it is unclear whether a federal court would apply the proposed exception on public policy grounds. However, because federal courts are likely to refuse to adjudicate disputes between marijuana business stakeholders in any situation, whether there is a proposed exception, the situation would not have changed dramatically from where it is at present. Namely, state courts will hear disputes between marijuana business parties, while federal courts will not. The incentive to forum shop already exists and will not necessarily be increased by this exception. Because of the internal affairs doctrine, which holds that the internal affairs of a business entity are governed by the laws of the state of formation, state courts would presumably only apply this exception to businesses that are both formed and operated in a state that has legalized marijuana. So, for example, if a business is formed in Texas, where marijuana is currently not legal, but operates in Colorado, where it is physically located, the exception probably should not apply. This is because Texas has no reason to create such an exception, and Colorado should simply be applying Texas business entity laws. Therefore, this exception works best if the business is both formed and operated in a state where marijuana is legal.

CONCLUSION

Until the federal government legalizes marijuana or an exception to state corporate law is created, the marijuana industry needs to operate under the assumption that its stakeholders will not receive the protections commonly afforded to businesses by state business entity law. For states that have legalized the sale of marijuana for medicinal or recreational use, the additional risks of operating in this industry can be minimized by creating a state exception allowing these businesses to take advantage of standard business entity law protections, despite the business’s violation of a federal law that conflicts with state law.

The exception to business entity law proposed in this Article certainly will not solve all the legal problems for marijuana businesses caused by the conflict between state and federal law. For example, it will not stop the risk of raids by federal authorities or the inability to take advantage of federal tax law. However, this exception will mitigate some of the disruptions to these businesses, specifically those experienced when there are conflicts between

221 See Miller v. Am. Tel. & Tel. Co. 507 F.2d 759, 762 (3d Cir. 1974) (citing Roth v. Robertson, 118 N.Y.S. 351, 353 (Sup. Ct. 1909)).
223 See supra Part II.C.
the various stakeholders of the business. 224 The proposed exception would allow these parties to operate marijuana businesses normally for business entity law purposes. 225 As such, its implementation would represent one step towards bringing the marijuana industry into a normal legal and business framework, a framework that is occupied by legal businesses. Implementing the proposed exception would promote professionalism amongst marijuana industry stakeholders and, by doing so, promote the public policy initiatives that initially motivated states to legalize the marijuana industry in the first place. 226

224 See supra Part III.
225 Id.
226 See supra Part II.C.