

Cannabis Cos. Must Heed Growing Federal Investigatory Risks

By **Alicia Corona and Amy Rubenstein** (March 30, 2023)

As state-regulated cannabis markets expand rapidly, so too does government oversight.

The dynamic between a largely new state-by-state legal industry and well-established federal investigatory regimes has left industry participants exposed to substantial liability risks.

Many times, when cannabis companies think about compliance, they focus on their local jurisdiction's regulatory scheme, especially the regulations to get the business set up and operating.

But cannabis companies — and ancillary businesses providing services to them — do not always appreciate the federal investigatory risks associated with the industry.

Despite cannabis remaining federally prohibited, federal regulators have not ignored areas where cannabis companies must comply, including Occupational Safety and Health Administration standards, Internal Revenue Code requirements, the U.S. Securities and Exchange Commission's regulations and rules, and the Foreign Corrupt Practices Act.

Cannabis companies should keep these additional regulatory schemes in mind as they continue to grow, both in the U.S. and abroad.

OSHA Investigations

Failure to comply with federal workplace health and safety requirements can pose significant legal challenges for cannabis companies, especially those with growing, cultivation and manufacturing operations that involve workplace exposure to ultraviolet light, pesticides, other chemicals and gases, and dust from the grinding process.

Some of the most common OSHA citations against cannabis companies stem from inadequate personal protection equipment for employees.

In particular, respiratory-related violations appear to have OSHA's attention, and the National Institute for Occupational Safety and Health issued two Health Hazard Evaluation Reports — one revised in August 2019[1] and another from February 2022[2] — that analyzed potential hazards during cannabis cultivation.

These and other reports put the cannabis industry on notice, and OSHA citations to cannabis companies can be expected to increase as employees and the government point to a connection between occupational cannabis exposure and respiratory illnesses.[3]

One August 2022 case study conducted by the Washington State Department of Labor and Industries reported a notable increase in new onset and work-aggravated asthma by industry workers directly after legalization of recreational use cannabis.[4]

Other cannabis-related workplace exposures, including potential dermal hazards, have



Alicia Corona



Amy Rubenstein

garnered regulatory attention as well.

For instance, in December 2018, the California Division of Occupational Safety and Health — California's OSHA-approved state plan — issued over \$50,000 in penalties to Future2 Labs Health Services Inc. after a worker suffered serious burns while extracting oil from cannabis with propane.[5]

The serious accident-related citations included failing to protect workers around flammable vapors and failing to provide them with protective gear.

These types of enforcement responses at both the state and federal level signal that such hazards are taken seriously, and that agencies will continue to take a close look at potential hazards affecting workers at cannabis cultivators and processors nationwide.

To avoid OSHA issues, as well as the potentially steep financial and reputational costs associated with any allegations of wrongdoing, cannabis companies should take appropriate steps to identify potential hazards with respect to each position in their workforce and conduct a thorough risk assessment.

Once the risks are known they must bring their facilities and policies into compliance with state and federal safety standards, including educating workers about potential hazards.

Additionally, companies should ensure that their employees know how to report any illnesses, accidents or workplace safety concerns to OSHA.

Section 280E of Internal Revenue Code

Because of an unusual rule limiting permissible deductions for taxpayers illegally trafficking in a Schedule I or II controlled substance, even state-legal cannabis companies face adverse tax treatment and IRS scrutiny.

Section 162(a) of the IRC allows a taxpayer to deduct ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business.

Under Section 280E, however, "[n]o deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business ... consists of trafficking in controlled substances" prohibited by federal law, which includes cannabis.

Accordingly, Section 280E prevents cannabis companies from claiming tax deductions other than the cost of goods sold.

Section 280E presents a significant financial hurdle for cannabis companies, an existential threat for competing against the illegal market,[6] and fertile ground for IRS investigations.

Normalizing the federal tax treatment of cannabis could be as simple as repealing the application of Section 280E to otherwise lawful cannabis dispensaries. But that would amount to a \$5 billion federal tax cut for cannabis businesses from 2018 to 2027, according to a 2017 estimate from the U.S. Congress' Joint Committee on Taxation.[7]

Multiple cannabis operators have discussed how Section 280E has inflated their tax bills by hundreds of millions.[8] More oppressive still is the enormous tax bill that can be levied against cannabis companies operating at a net loss.[9]

Accordingly, it is important for cannabis companies to identify whether deductions can be categorized as cost of goods sold to help minimize the tax impact of Section 280E on their business.

Given what the IRS has to gain, cannabis companies could be easy audit targets. Research suggests that cannabis companies are five times more likely to be audited than other companies.[10]

In addition to ordinary financial hygiene and proper accounting practices, cannabis companies should keep detailed and careful records so that if they are audited, the process will be less burdensome.

In the event that the IRS does engage in any sort of inquiry, cannabis companies can minimize the disruption to business operations with advanced preparation and proper tax planning.

SEC Investigations

Like any other public company, publicly listed cannabis companies must take care to ensure strict compliance with the SEC's regulatory requirements.

Some of the most common legal violations pursued by the SEC include misrepresentation or omission of material information about securities, selling unregistered securities and insider trading.[11]

While the SEC's interest in these violations is not new, public interest in the cannabis space may increasingly draw the SEC's attention.

For example, in September 2022, the SEC sued two companies and its associated officers and directors for their alleged involvement in a scheme to conceal paid promotion for securities offerings.

The complaint in SEC v. Mikula alleges that the individuals involved received millions of dollars for promoting the securities in a newsletter called Palm Beach Venture, but failed to publicly disclose these payments.

One promotion recommended investing in one of the defendant companies, Sway Energy Corp., formerly known as Elegance Brands Inc., based on allegedly false and misleading statements about the prospects of the company's CBD product, Gorilla Hemp.

In addition to the allegedly false and misleading statements, the newsletter article also allegedly falsely claimed that the publishers received no financial compensation for the promotion, and instead made their recommendation "based on our own analysis." [12]

In reality, the complaint alleges, one individual received "more than \$80,000 in entertainment, including meals, nightclubs, and first class airfare, in exchange for [promoting] Elegance." [13]

In another matter, the U.S. District Court for the Central District of California granted a default judgment in November 2022 against C3 International Inc., the maker of the cannabis pill Idrasil, arising from a suit brought by the SEC in September 2021. [14]

The court awarded \$3.1 million in civil penalties and disgorgement of \$1.9 million after C3 failed to respond to allegations that it made misrepresentations between 2014 and 2019 about Idrasil's patent status, the probability that health insurance companies would reimburse for Idrasil, and the use of investor funds for business purposes.

The SEC's recent enforcement action against C3 highlights the risks involved for ancillary businesses and professionals, too, especially under an aiding and abetting theory of liability for securities laws violations.[15]

This means that those who knowingly or recklessly provide substantial assistance to primary violators in the achievement of the primary violation — including by disseminating false statements — could face liability.

In a related complaint involving C3's Idrasil business, the SEC alleged that an unregistered broker hired by C3 knowingly disseminated misrepresentations about the company and its financial projections for revenue, profits and cash flow.[16]

The complaint, SEC v. Arkells, charges the defendant with, among other things, aiding and abetting violations of Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

In addition, the SEC's consistent attention to financial reporting underscores the need to ensure comprehensive, accurate and reliable reporting.

In October 2022, the SEC charged Cronos Group Inc., a Nasdaq-listed cannabis company from Toronto, and its former chief commercial officer, with improper accounting and other accounting misconduct during multiple reporting periods.

Mark Cave, associate director of the SEC's Enforcement Division, warned in the press release that "[i]t is critically important for issuers to have adequate controls in place before they take on the reporting obligations required of public companies." [17]

Most recently, the SEC filed a complaint on March 16 alleging that American Patriot Brands Inc. — a cannabis cultivation and distribution company incorporated in Nevada — defrauded investors of \$30 million by promoting itself as "one of the largest cannabis farms in the country," despite only producing a small amount of sellable cannabis, and by making "wildly inflated" claims about its revenue.[18]

For example, the SEC alleges that one presentation emailed to an investor falsely stated that in 2016 revenue exceeded \$3.3 million and earnings exceeded \$1 million, when the company's gross revenue was \$330,905, and it had negative earnings of over \$9.6 million.

The SEC also alleges that offering materials suggested to investors that the company was imminently poised to trade on a securities exchange when in fact the SEC registration it needed for widespread public trading was in jeopardy and was eventually revoked.

As the cannabis industry continues to rapidly expand, there is reason to expect that these types of enforcement actions by the SEC will become more commonplace.

Cannabis companies will need to implement robust internal financial controls to ensure strict SEC compliance.

Foreign Corrupt Practices Act Compliance

Major growth in the international cannabis market has created new opportunities for companies to expand their global footprint.

Germany — one of the most profitable markets for medical cannabis in Europe[19] — recently moved to decriminalize possession of cannabis by adults and permit its sale in licensed stores.[20]

Following Germany's lead, the Czech Republic also announced its intent to legalize adult-use cannabis, with a bill expected to be presented this month and potential legalization by January 2024.[21]

Last year, Thailand became the first country in Asia to decriminalize cannabis cultivation and consumption, potentially opening the door for other nations in the region to do the same.[22]

Indeed, the day the Thai legislation took effect, the country's Food and Drug Administration received over 100,000 applications to cultivate cannabis.[23]

Other countries that have also recently legalized or decriminalized recreational cannabis use include Malta in 2021; Canada in 2018; the Republic of Georgia in 2018; and South Africa in 2018.

As with any other industry looking to expand into international markets, particularly one that is newly legal and heavily regulated, cannabis companies likely will have contact with foreign officials that may subject them to scrutiny under anti-corruption laws like the FCPA.

In general, the FCPA imposes liability on companies for bribes paid to win business, which is broadly defined as any payment, offer to pay or authorization to pay a foreign official anything of value.

This is especially true in license-centered industries like cannabis, where foreign officials make licensing decisions, and in countries where the corruption risk is especially acute.

Mexico, for instance, is poised to become a new center for cannabis industry expansion given its close proximity to the U.S., favorable growing conditions, and the Mexican Supreme Court's 2021 decision invalidating a long-standing law that criminalized the possession of cannabis for recreational use.

Although Mexico has yet to pass a full legalization law providing the means to grow, possess and sell cannabis, some of the world's largest cannabis companies are keeping an eye on the market to capitalize quickly on legalization when it happens.[24]

However, Mexico ranks in the bottom third on Transparency International's Corruption Perceptions Index,[25] making it a challenging business climate for any company operating within the country, but especially those affiliated with the cannabis industry.[26]

Notably, CEND, a global provider of technological infrastructure and certification platforms for the cannabis industry and other regulated industries, facilitated its first large-scale shipment of low-THC legal cannabis — i.e., hemp — from Uruguay to the U.S last month.[27]

As cannabis companies engage in cross-border transactions, contact with foreign officials

should be carefully monitored and controlled. This includes, for instance, liaising with border officials to fast-track the exportation and importation process.[28]

But these types of contacts with government officials abroad are precisely the type to draw scrutiny from the U.S. Department of Justice, which investigates potential bribes and other FCPA violations.

Unlike established multinational companies used to complying with anti-corruption laws, many cannabis companies may be unfamiliar with these laws and how to navigate the risks of doing business abroad.

FCPA compliance for these rapidly burgeoning companies in the global market will be increasingly important as government entities place a magnifying glass on operations.

Compliance best practices include implementing a stand-alone FCPA compliance policy with firm guidelines regarding foreign payments; providing robust employee training; and conducting third-party due diligence.

Conclusion

As the legal cannabis industry grows, companies should expect investigatory scrutiny at all levels to increase. To avoid any unintended liability, planning is key.

Companies should recognize these risks as a business reality, and one for which they must prepare. Developing robust controls, thoughtful documentation and significant preventative measures may not only avoid liability but also unnecessary scrutiny from any investigatory agency with which the business intends to be compliant.

Alicia Corona is an associate and Amy Rubenstein is a partner at Dentons.

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