



# Western Bankers Association 2021 Regulatory Compliance & Cannabis Forum Banking Cannabis—An Introduction

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# Introduction

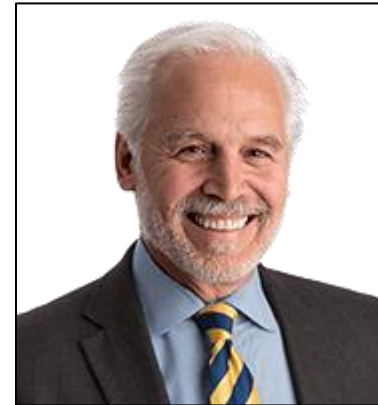
- **This presentation provides an introduction to the legal issues related to a bank's decision to provide banking services to participants in the cannabis industry**
- **Note: this is an introduction to the legal issues and is not intended to provide a comprehensive discussion of legal advice or risk considerations**
- **The issue of providing banking services is complex-the use of experienced legal counsel is strongly recommended**
- **This introduction excludes issues regarding hemp—which has now been excluded from the definition of cannabis—meaning it is now essentially deemed to be an agricultural product**

# Dorsey Speakers



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# Some Helpful Terminology

## 1. What is cannabis?

- A plant genus within the Cannabaceae family that includes multiple species, including *Cannabis sativa L.*, *Cannabis indica*, and *Cannabis ruderalis*.
- Think of “Cannabis” as an umbrella term encompassing both “marijuana” and “hemp”

## 2. What is marijuana?

- Schedule I narcotic under the Controlled Substances Act (“CSA”), meaning there is no currently accepted medical use and high potential for abuse
- Under the CSA, *Cannabis sativa L.* and any compounds
  - Does NOT include “hemp” after passage of the 2018 Farm Bill

## 3. What is “hemp”?

- “*Cannabis sativa L.* and any part of that plant, including the seeds thereof and all derivatives, extracts, cannabinoids, isomers, acids, salts, and salts of isomers, whether growing or not, with a delta-9 tetrahydrocannabinol concentration of not more than 0.3 percent on a dry weight basis”

# Some Helpful Terminology

## 4. What are cannabinoids?

- Naturally occurring compounds found in the cannabis plant
- Interact with receptors in our body's endocannabinoid system
- Over 60 known cannabinoids

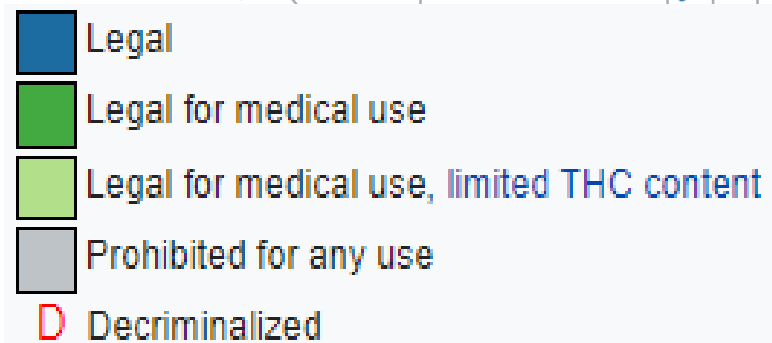
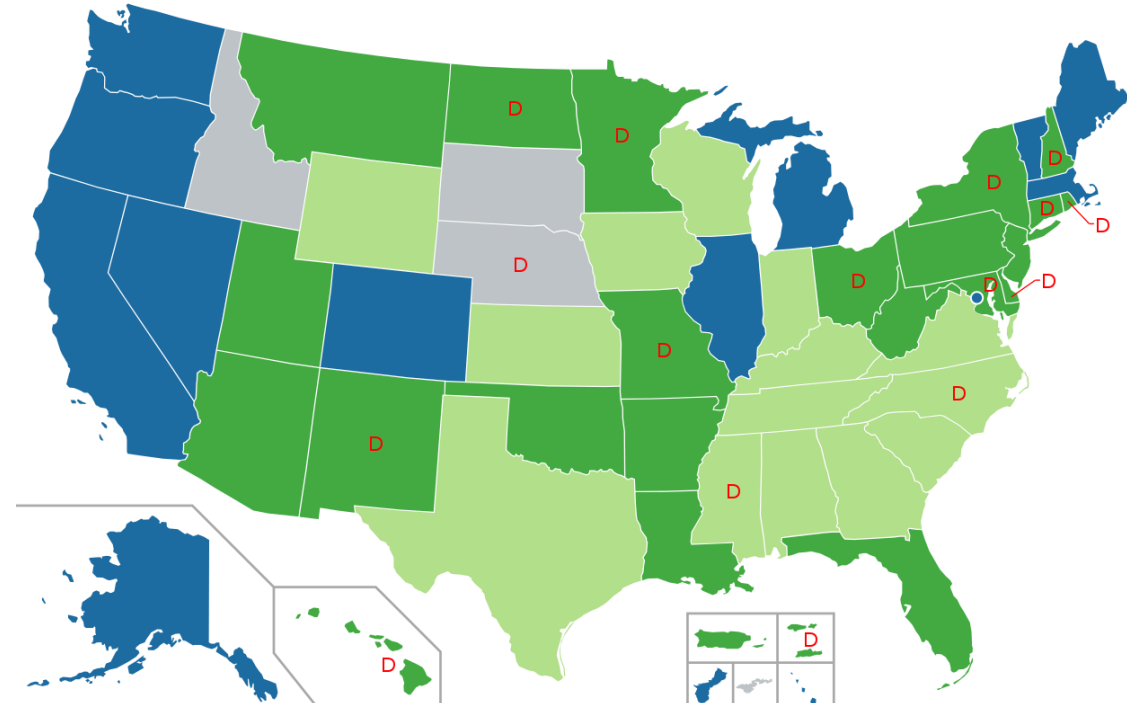
## 5. What is CBD?

- One of the most well known cannabinoids found in the cannabis plant
  - Occurs in both marijuana and hemp
  - No psychoactive effect

# Current Legal Status of Marijuana—

## State Laws

- Recreational: 18 states + D.C.
- Medicinal: 36 states
  - Including recreational states



Map from Wikipedia

# Banking Cannabis—The Continuing Federal Criminal Law Quandary

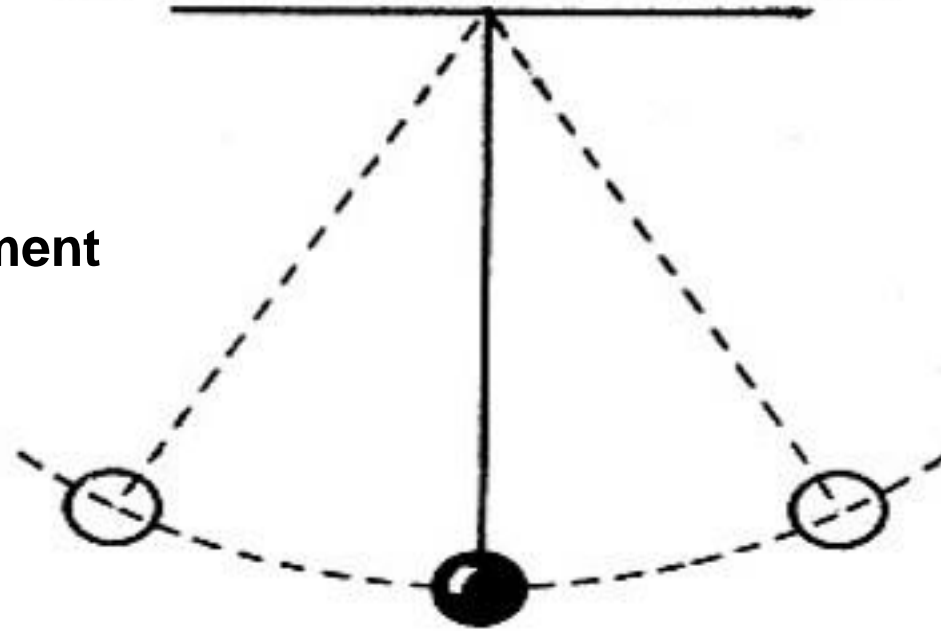
# The Banking Quandary

There continue to exist federal roadblocks to state-licensed cannabis businesses—both medical and recreational

## Pendulum

Risk Management

Jail Time





# Cannabis Legal Background

- **Legal or not under state law—the cultivation, distribution and sale of cannabis remains illegal under federal law**
- **Federal anti-money laundering laws apply to violations of federal drug laws**
- **Potential asset forfeiture and aiding and abetting liability for federal drug violations**
  - **Criminal penalties and fines**
  - **Conspiracy liability**
  - **Accessory after the fact liability**
- **Supremacy Clause of U.S. Constitution**
  - **Federal criminal law applies regardless whether state law is silent or specifically permits activity**
  - ***Intrastate* activity an irrelevancy**
    - **But may diminish intent to violate the law....**

# The Cole Memorandum—RIP—Maybe...

- **The Cole Memorandum—August 29, 2013**
  - Provided list of CSA cannabis enforcement priorities for Department of Justice attorneys and law enforcement
  - Bad v. really, really bad activity dichotomy
  - Rescinded by the former Attorney General on January 4, 2018
  - Current status is that traditional DOJ prosecutorial guidelines arguably continue to apply



# The Cole Memo Priorities

- **Preventing—**
  - **The distribution of cannabis to minors**
  - **Cannabis revenue from going to criminal enterprises and cartels**
  - **The diversion of cannabis from states where it is legal under state law in some form to other states**
  - **State-authorized marijuana activity from being used as a cover for the trafficking of other illegal drugs or other illegal activity**
  - **Violence in the cultivation and distribution of marijuana**
  - **Drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use**
  - **The growing of marijuana on public lands and the attendant public safety and environmental dangers**
  - **Cannabis possession or use on federal property**

# The Cole Memo Priorities



**Anything Tony Would  
Approve of—  
Probably Violates the  
Cole Memo...**

# FinCEN-2014-G001

## BSA Expectations Regarding Cannabis-Related Businesses

- Clarifies how financial institutions can provide services to cannabis-related businesses consistent with their BSA obligations
- Reiterates Cole Memo priorities (which has been rescinded)
  - Imposes on-going **enhanced** due diligence on banks electing to bank cannabis businesses
  - Expands the Cole Memo list of **red-flags** to 22
- Creates three new types of SARs

# FinCEN-2014-G001

## Types of Marijuana SARs



- **Marijuana Limited – no Cole memo implications, no state law violations**
  - Identify subject and related parties
  - Provide addresses
  - The filing is derived solely from marijuana-related business activities
  - No additional suspicious activity has been identified
  - Narrative section – “MARIJUANA LIMITED”

# FinCEN-2014-G001

## Types of Marijuana SARS



- **Marijuana Priority – implicates Cole Memo or violates state law**
  - Needs all information required in limited filing
  - Details on the enforcement priorities are implicated
  - Dates, amounts, and other relevant details of financial transaction(s)
  - Narrative section – “MARIJUANA PRIORITY”

# FinCEN-2014-G001

## Types of SARS Marijuana SARs



- **Marijuana Termination – If a bank deems it necessary to close an account of a marijuana-related business for compliance purposes**
  - Include the basis for termination
  - Narrative section – “MARIJUANA TERMINATION”
  - If a bank is aware that a cannabis business is moving accounts to a specific alternative institution then the bank is “urged” to alert the other institution
- **Section 314(b) authority to voluntarily disclose to other banks**



# FinCEN Due Diligence Requirements

- **Verify whether the business is duly licensed and registered**
- **Review the license application (and related documentation) submitted by the business for obtaining a state license to operate its cannabis-related business**
- **Request from state licensing and enforcement authorities information about the business and related parties**
- **Assess the normal and expected activity for the business, including the types of products to be sold and the customers to be served (e.g., dispensing medical or recreational cannabis)**
- **Monitor publicly available sources for adverse information about the business and related parties**
- **Monitor for red flags, including red flags identified by FinCEN**
- **Refresh information obtained as part of customer due diligence on a periodic basis and commensurate with the risk**
  - **At least every 90 days**

# On-Going Due Diligence

- **The FinCEN Guidance requires that a Limited Marijuana SARs must be updated every 90 days**
- **FinCEN has clarified this guidance by indicating that banks with on-going SAR requirements must file an updated SAR for continuing activity after a 90-day review—with the filing deadline being 120 days after the date of the previously related Limited Marijuana SAR**
- **This means that a minimum of 4 SAR updates are required in a calendar year**
- **The complicated nature of many state laws present significant compliance challenges—**
  - **Which explains why many banks avoid companies that “touch the plant”**

# FinCEN's Policy Position

- FinCEN has consistently indicated that FinCEN-2014-G001 was intended to authorize and encourage banks to open accounts for “lawful” cannabis entities
- FinCEN has indicated that it views the Cole Memo to remain effective
  - FinCEN has announced that its guidance *continues* to apply
  - No DOJ enforcement action to date except for traditional cannabis criminal activity



## But FinCEN's Guidance Goes So Far...

**“The SAR reporting structure laid out in FinCEN’s February 14, 2014 Guidance “BSA Expectations Regarding Marijuana-Related Business” remains in place, and that SAR reporting guidance with regard to financial institutions seeking to provide services to marijuana-related businesses applies to the specific facts and circumstance set forth in that document. Situations not specifically addressed in that guidance should be treated under standard SAR reporting rules and related guidance. The manufacture, distribution, and dispensing of marijuana is an illegal act in violation of federal law. FinCEN will continue to work closely with law enforcement and the financial sector to combat illicit finance. We will notify the financial sector of any changes to FinCEN’s SAR reporting expectations.”**

# Secured Lending:

**Evolving Lending Norms and Practices**

**Non-bank lenders**

**Threshold/Early Considerations**

**Due Diligence on Borrower Entities- General Topics**

- **Credit underwriting**
  - Customary credit underwriting exercises
  - Cannabis revenue analysis
  - Tax considerations - IRC Section 280E

# Secured Lending:

- **Licenses:**
  - Obtain copies of all licenses or on-line view access
  - Identify applicable jurisdictions
  - Which licenses are required and what regulatory authorities grant them?
  - Do the entities have the appropriate licenses to conduct the underlying operations?
  - Are the licenses in good standing?
  - When is the next renewal date?
  - Can a security interest be granted in the license?
  - Are regulatory approvals required?
- **Inventory Control:**
  - Do the entities have adequate inventory control policies and procedures?
  - Does the system record all cannabis sales, waste, and acquisitions?
  - How frequently is cannabis stock inventoried?

# Secured Lending:

## Due Diligence on Borrower Entities- General Topics

- **Security Measures:**
  - Do physical locations have adequate security measures to deter and prevent entry into/theft from restricted access areas containing either cannabis or currency?
  - Do physical locations have a security alarm system? Monitoring? Recording?
- **Organizational Review:**
  - Request an organizational chart
  - Analyze assets, cash flow, and joint ventures
  - How the Loan Parties will be obligated
  - Evaluate organizational structure from a regulatory and FinCEN compliance perspective
  - Consider whether non-subsubsidiary entities need to be within the collateral package or obligated group
  - Consider need for management agreements

# Secured Lending:

- **Threshold/Early Considerations**
- **Deposit Accounts**
  - **Concentration**
  - **Sticky deposit analysis**
- **Interstate and cross-border movement of cannabis-related products and revenues**
- **Profitability – high risk loans/higher interest rate**
- **Bank regulatory agency examinations**
- **Opinions (regulatory, security interests, enforceability - identify which firms, if any, can provide the necessary opinions)**



# Secured Lending:

## Threshold/Early Considerations

- Fees and charges
- Investment and securities law considerations
- Insurance
  - Insurable
  - D&O coverage
  - Fidelity bonds
  - Defense costs
- Employment issues
- Internal policy guidance
- Let's Chat! – Other threshold issues/considering you've encountered?

# Secured Lending:

## Documenting the Transaction

### Loan documentation:

- **“Market”**
- **Reps and warranties re licenses, permits and operations**
  - **Growers/Cultivators**
  - **Processing**
  - **Distribution/Dispensary**
- **Operational covenants**
  - **Licenses**
  - **Management agreements**

# Secured Lending:

## Documenting the Transaction

### Loan documentation:

- **Financial covenants**
- **Change of Control**
- **Collateral access agreements**
- **Assignability issues**

# Secured Lending:

## Documenting the Transaction

### Assets:

- **Personal property**
  - Cannabis inventory assets vs. other personal property – excluded property carve outs
  - Transferability issues re: licenses
  - Equity pledges (third-party equity holder consents, state law restrictions on grant of equity in cannabis license holder, enforcement)
  - Perfection vs. collection
  - Control agreements on bank accounts
- **Real property**
  - Leasehold vs. owned real property
  - Mortgages, third party consents, title work
  - Grower operations, manufacturing and processing facilities and retail

# Secured Lending:

## Documenting the Transaction

### Legal Opinions:

- **Valid and enforceable licenses and permits**
  - State by state analysis
- **Perfection opinions**
  - Does granting a security interest cause a violation of the license/state law
  - Are secured lenders required to disclose the security interest to licensing authorities
  - Limitations on enforcement of remedies
  - Bankruptcy carve-outs
  - Often reasoned opinions – very limited case law and real-world experience foreclosing on cannabis operations or assets
- **Let's chat – other documentation issues of concern?**

# Default and Enforcement:

## Initial Questions

- **Governing Law and Venue**
  - Will loan documents be governed by just applicable state law or both state and federal law with a carve out?
- **Which enforcement mechanisms are available under the loan documents, e.g. receivers?**
- **Does state or local law limit a lender's ability to:**
  - Enter the borrower's facilities?
  - Enforce against or transfer the borrower's licenses?
  - Enforce against the equity interests of an entity holding a cannabis license?
  - Take possession of inventory?
- **Is there a market for the collateral? Can the collateral be repurposed for a non-cannabis business purpose?**

# Default and Enforcement:

## Bankruptcy

- Canadian bankruptcy → YES
- U.S. bankruptcy → NO

- U.S. Trustee statement:

**“The USTP’s response to marijuana-related bankruptcy filings is guided by two straightforward and uncontroversial principles. First, the bankruptcy system may not be used as an instrument in the ongoing commission of a crime and reorganization plans that permit or require continued illegal activity may not be confirmed. Second, bankruptcy trustees and other estate fiduciaries should not be required to administer assets if doing so would cause them to violate federal criminal law.”**

*Source:* Statement of Clifford J. White III, Director of the United States Trustee Program before the House Judiciary Committee’s Subcommittee on Regulatory Reform, Commercial and Antitrust Law on June 8, 2017. <https://www.justice.gov/ust/file/testimony06082017.pdf/download>

- **Cases: *In re Way to Grow, Inc.*, 2019 U.S. Dist. LEXIS 207846 (D. Colo. Sept. 18, 2019); *In re Basrah Custom Design, Inc.*, 600 B.R. 368 (Bankr. E.D. Mich. 2019); *Garvin v. Cook Investments, NW, SPNYW, LLC*, 922 F.3d 1031 (9th Cir. 2019); *Dep’t of Revenue v. Kurth Ranch*, 511 U.S. 767 (1994); *In re Chapman*, 264 B.R. 565 (B.A.P. 2001).**

# Default and Enforcement:

## Receiverships

- A neutral third party is appointed to operate a business, preserve value for stakeholders, and liquidate some or all of the business's assets
- **Threshold Question: May the receiver be a transferee of a cannabis license?**
- **Federal:**
  - The legality of federal receiverships has not been determined
  - **Linx Card Inc.:** In February, 2020, a federal judge in Arizona was presented with the question, but did not reach the issue because it found that the party seeking the appointment had not met its burden of proof. *Tryke Management Services LLC v. Linx Card Inc. et al.*, Case No. 2:19-cv-05234 (D. Ariz.)



# Default and Enforcement:

## Receiverships

- **State:**
  - **Depending on the state, receiver may be able to:**
    - **Conduct sales free and clear of liens (sometimes outside of foreclosure process)**
    - **Recover fraudulent transfers**
    - **Obtain a stay of litigation**
    - **Assume, reject or assign executory contracts**

# Default and Enforcement:

## ABCs

- **State law process to liquidate a company's assets and satisfy creditors' claims**
- **The company (not a court) appoints an assignee who oversees liquidation of assets and satisfaction of creditor claims**
- **Cannot sell property free and clear of liens**
- **Process can be more efficient than bankruptcy, but there is no stay against creditors' claims**

# Default and Enforcement:

## UCC Foreclosure/Article 9 Sale

- **Sales may need to comply with state licensure requirements → suitable for sale to pre-approved license holder**
- **Going concern sale will require considerable Borrower/Management cooperation or appointment of a CRO**
- **Let's chat – other Default and Enforcement issues?**

# The Best Practices Goal—The Gold Standard

- **The U.S. Sentencing Commission (an independent agency in the judicial branch) has promulgated a series of guidelines to determine whether an effective compliance and ethics program is operating for potential corporate offenders**
  - <https://www.ussc.gov/guidelines/2015-guidelines-manual/2015-chapter-8>
  - **The Commission Guidelines have become the “gold standard” for evaluating the effectiveness of a corporate compliance and ethics program—compliance with which evidence an intent not to violate the law**
  - **We suggest that a bank should regularly evaluate its cannabis policies and procedures to determine whether its compliance program meets the Commission Guidelines’ standards**
- **To meet the Commission Guidelines for an effective compliance and ethics program, a bank must:**
  - **Exercise due diligence to prevent and detect criminal conduct, and**
  - **Otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law**

# The Best Practices Goal—The Gold Standard

- **The Commission Guidelines identify seven factors to be considered:**
  - (a) The bank must establish standards and procedures to prevent and detect criminal conduct**
  - (b) The bank’s senior management and Board of Directors must be knowledgeable about the content and operation of the compliance and ethics program and must exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program**
    - Specific high-level personnel within the bank should be assigned overall responsibility for the compliance and ethics program**
  - (c) Employees known to have engaged in illegal conduct cannot participate in the compliance program**

# The Best Practices Goal—The Gold Standard

**(d) The bank must conduct training for all levels of its personnel regarding the components of the compliance and ethics program**

**(e) The bank must take reasonable steps—**

- To ensure that the bank’s compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct**
- To periodically evaluate the effectiveness of the bank’s compliance program organization's compliance and ethics program, and**
- To create and to publicize a system whereby the bank’s employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation**

**(f) The bank’s compliance and ethics program should be promoted and enforced consistently throughout the organization through both appropriate incentives and appropriate disciplinary measures to ensure compliance**

**(g) After criminal conduct has been detected, the bank must take reasonable steps to respond appropriately to the criminal conduct and to prevent further similar criminal conduct, including making any necessary modifications to correct any identified deficiencies**

# Recent Federal Developments

- **Congressional legislation is now off the table until 2022**
  - **The SAFE Banking Act**
    - <https://www.congress.gov/116/crpt/hrpt104/CRPT-116hrpt104.pdf>
    - Only clarifies authority to bank cannabis entities but does not decriminalize cannabis
  - **Cannabis Administration and Opportunity Act**
    - Discussion draft introduced by Senators Booker, Schumer and Wyden
    - This expanded approach has encountered significant criticism
- **In other words—the federal quandary remains....**

# Questions?



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