

A close-up photograph of vibrant green cannabis leaves with serrated edges, set against a dark, blurred background. The leaves are the central focus of the top half of the page.

THE NEW YORK LAW JOURNAL

Joint Defense: Steps Cannabis Companies Can Take Now to Protect Themselves Against Criminal Enforcement Actions in the New York Cannabis Market

October 25, 2021

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There are a number of compliance steps that cannabis companies can take now to minimize the chances of unlawful diversion from their companies.

Continued criminal enforcement in the New York cannabis market is a virtual certainty. There will be strong financial incentives built into the legal cannabis market to divert product to the illegal market; for some market participants, that potential gain will outweigh the risk of getting caught. Cannabis companies knowingly engaged in such diversion could face prosecution not only under state law, but also federal law, including both existing statutes and major proposed reform bills. To see how criminal anti-diversion enforcement is likely to play out in their market, cannabis companies need only look to similar, highly regulated markets, such as the pharmaceutical and tobacco industries. Authorities have brought criminal charges against companies, owners and employees that have knowingly failed to live up to their compliance obligations. With that experience as a guide, there are a number of compliance steps that cannabis companies can take now to minimize the chances of unlawful diversion from their companies.

Incentives for Diversion in the New York Cannabis Market

Once the legal cannabis market is operating in New York, the illicit market still is expected to continue functioning for years, with prices well below the legal market. See Will Yakowicz, “Why New York Legalizing Recreational Cannabis Won’t Kill the Illicit Market,” *Forbes.com* (March 19, 2021); “Assessment of the Potential Impact of Regulated Marijuana in New York State,” N.Y. Dep’t of Health (July 2018) (DOH Assessment), at 16-21. This price disparity is explained, at least in part, by taxes and regulatory costs. See *id.* New York has imposed substantial taxes on cannabis, and taxes will increase if cannabis is federally legalized. There are also significant regulatory costs in the legal market. For example, New York imposes strict requirements for testing and packaging of cannabis. Marijuana Regulation and Taxation Act (MRTA) §§81-82. These taxes and regulatory costs ultimately increase the prices that consumers pay. The illicit market has no such taxes or regulation to drive up prices, so participants in the illegal market can undercut the price of cannabis in the legal market.

There lies the temptation for unlawful diversion, which for some will overcome the risk associated with violating the law. To dodge taxes or regulatory costs that eat into profits—or simply to sell excess legal supply—some

legal market participants will sell a portion of their product in the illegal market. Alternatively, in a scheme known as inversion, some may attempt to inject illegal cannabis into the legal market, fraudulently selling it as licensed cannabis and avoiding taxes and costs up the distribution chain. These are just some examples of the unlawful schemes likely to occur in New York. Cf. “Illicit Tobacco—Various Schemes are Used to Evade Taxes and Fees,” U.S. Government Accountability Office (March 2011) (GAO Report). And, some who do not directly participate in such schemes may be tempted to turn a blind eye to them if it increases their bottom line.

If cannabis is a legal substance in New York, why do authorities care about diversion? Well, to begin with, money. Part of the rationale for legalizing cannabis is the significant tax revenue expected from legal sales. See MRTA §2; DOH Assessment at 16-21. Because diverted cannabis is not taxed, diversion can lead to considerable lost tax revenue. Charged with protecting the public fisc, authorities will use the tools at their disposal, including criminal prosecution, to try to stamp out the illegal market. Authorities have also asserted other interests in preventing diversion, including preventing cannabis revenue from funding criminal organizations; keeping cannabis from minors; preventing violence and firearms use; and ensuring cannabis meets safety and quality standards. See MRTA §2; James M. Cole, “Guidance Regarding Marijuana Enforcement,” U.S. Dep’t of Justice (DOJ) (Aug. 29, 2013) (Cole Memo). The New York cannabis market is presently operating in a legal grey area, as its precise boundaries still must be defined through regulation and federal legalization still is pending. But once the market parameters are set, prosecutors will more aggressively seek to protect these governmental interests.

Criminal Anti-Diversion Enforcement in the New York Cannabis Market

Prosecutors will have a number of statutory tools available to them to combat diversion. The MRTA includes criminal penalties for diversion. Current federal law does too, as do major federal reform bills.

New York Law. The MRTA creates a comprehensive licensing scheme for New York’s legal market and contains broad prohibitions against diversion. The law specifically prohibits unlicensed distribution of cannabis, diversion of cannabis to unlicensed persons and aiding and abetting any such activity. MRTA §125. The licensee is responsible for ensuring that the licensed location conforms to the law’s requirements; licensees will be “held strictly accountable for any and all violations” that occur at the premises or by its employees. MRTA §125.8.

Any person who engages in unlicensed distribution of cannabis is subject to prosecution under N.Y. Penal Law §222. MRTA §132. That law provides for graduated criminal penalties for unlawful possession and distribution of cannabis. N.Y. Penal Law §§222.25-222.65. At the highest level, “aggravated criminal sale of cannabis” is a felony punishable by up to 15 years in prison. N.Y. Penal Law §§70.00(2)(c), 222.65. Thus, even following reform in New York, cannabis companies—as well as their owners and employees—still could face stiff penalties for illegal diversion.

Current Federal Law. The Controlled Substances Act (CSA) generally prohibits the knowing and intentional manufacture, distribution and possession of marijuana. See 21 U.S.C. §841. The CSA imposes severe penalties for violating its provisions. See *id.* But DOJ, as a matter of discretion, typically has not enforced that law against cannabis companies that comply with state law. In fact, in the August 2013 Cole Memo, DOJ enshrined that policy in a formal directive to federal prosecutors. See Cole Memo. Although DOJ rescinded that directive in 2018, it has remained influential with federal prosecutors. Additionally, since December 2014, Congress has annually passed the Rohrabacher-Farr Amendment, prohibiting DOJ from using federal funds to prosecute medical cannabis companies that comply with state law. See *United States v. Pissarski*, 965 F.3d 738, 741 (9th Cir. 2020). Importantly, though, neither the Cole Memo nor the Rohrabacher-Farr Amendment prohibit federal prosecution of cannabis companies that fail to comply with state law and engage in unlawful diversion. See *id.*; Cole Memo at 3-4. The federal government has continued to prosecute such conduct. See “The Controlled Substances Act (CSA): A Legal Overview for the 117th Congress,” Congressional Research Service (Feb. 5, 2021) (CRS Report), at 26-27.

Proposed Federal Changes. Major reform bills have not suggested eliminating federal criminal enforcement of cannabis laws. If these bills or similar versions become law, they will continue to arm prosecutors with strong weapons against unlawful diversion.

The “Marijuana 1-to-3 Act of 2021” is the least transformative of the bills, simply proposing to reschedule marijuana from Schedule I to Schedule III under the CSA. Such rescheduling would expand federally authorized distribution of marijuana. See 21 U.S.C. §§823, 829. But authorized distribution would remain subject to the CSA’s anti-diversion requirements, and unauthorized distribution still would be subject to the CSA’s present criminal penalties. 21 U.S.C. §§823, 841.

The “Marijuana Opportunity Reinvestment and Expungement Act of 2021” (MORE Act) is much more progressive. Yet, it still proposes criminal penalties for unlawful cannabis diversion, albeit far less severe penalties than the CSA. It creates a new federal licensing scheme for cannabis and removes cannabis from the CSA’s purview. MORE Act §§3, 5(b) (adding §§5922 and 5923 to Internal Revenue Code). However, it also creates a new criminal scheme, whereby those distributing untaxed cannabis, with the intent to defraud the United States, face up to five years’ imprisonment. Id. §5(b) (adding new §5942).

The “Cannabis Administration and Opportunity Act” (CAOA) likewise establishes a federal licensing scheme for certain cannabis businesses, and it retains criminal liability for diversion of 10 pounds or more of cannabis (but does not yet propose appropriate penalties). See CAO Discussion Draft §§112, 511. It also proposes transferring primary DOJ jurisdiction over cannabis enforcement from the Drug Enforcement Administration (DEA) to the Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF). See id. §102. It further creates a “federal track and trace regime” to prevent diversion and tax evasion, and it imposes affirmative reporting requirements on cannabis companies to notify DOJ if they have knowledge of diversion or tax evasion. Id. §112(b). Thus, CAO and other major reform bills lay the ground work for continued federal criminal enforcement in the New York cannabis market.

Criminal Anti-Diversion Enforcement in Similar Markets

To see how criminal enforcement may play out in New York’s cannabis market, it is useful to compare such enforcement in the pharmaceutical and tobacco industries, which also face stringent anti-diversion requirements. Participants in both industries have faced criminal prosecution for unlawful diversion.

The pharmaceutical industry, in particular, has faced significant scrutiny over the unlawful diversion of opioids. Opioids are subject to the CSA’s anti-diversion requirements, which require pharmaceutical companies to maintain effective controls against diversion, and a company’s knowing failure to meet those requirements can lead to prosecution under the CSA’s drug trafficking provisions. See 21 U.S.C. §§823, 841. The CSA also imposes affirmative reporting requirements for potential diversion. See id. §832. Additionally, the DEA has created a national database, known as “ARCOS,” to track certain controlled substances through the supply chain. Despite these anti-diversion requirements and safeguards, numerous doctors and pharmacists have faced prosecution for knowingly engaging in unlawful diversion of opioids. See CRS Report at 16-20. More recently, DOJ has prosecuted distributors for knowingly failing to implement adequate protocols to prevent such downstream diversion. In April 2019, DOJ brought criminal charges against Rochester Drug Co-Operative, a major distributor, and two of its executives for distributing to pharmacies that illegally diverted opioids. See “Manhattan U.S. Attorney and DEA Announce Charges Against Rochester Drug Co-Operative and Two Executives for Unlawfully Distributing Controlled Substances,” DOJ (April 23, 2019). Later that year, DOJ brought charges against another opioid distributor, Miami-Luken, Inc., as well as two of its employees and two customer pharmacists, for similar conduct. See “Pharmaceutical Distributor & Executives, Pharmacists Charged with Unlawfully Distributing Painkillers,” DOJ (July 18, 2019). Among the compliance failures DOJ cited in bringing charges were the companies’ knowing distribution of opioids to their customer pharmacies, despite red flags of diversion, and their failure to report customers’ suspected diversion to the DEA.

The ATF, which regulates the tobacco industry, has likewise worked with federal prosecutors to bring criminal charges against companies and persons engaged in unlawful diversion in the cigarette market. See GAO Report at 5, 19-22; “Fact Sheet—Tobacco Enforcement,” ATF (May 2018). The ATF has particularly focused on preventing the diversion of cigarettes to avoid the payment of taxes and the distribution of counterfeit cigarettes. See id. Thus, despite broad availability of legal cigarettes, federal authorities have continued to use criminal prosecution to prevent diversion.

Compliance Best Practices

Cannabis companies should expect that criminal enforcement will grow more prevalent in the New York market over time. With the above discussion in mind, there are several compliance measures they can put in place to minimize the chances of unlawful diversion. These best practices include: (1) written compliance policies and procedures, including written anti-diversion protocols; (2) employee training on those policies and procedures; (3) a dedicated compliance department, independent of the company’s sales personnel to avoid conflicts of interest; (4) know-your-customer (KYC) diligence procedures, including site visits, a customer application process and an upfront review of pertinent customer documents, such as licenses, customer lists, order history and anti-diversion protocols; (5) processes to monitor customer orders for red flags of diversion; and (6) mechanisms for quickly and fully reporting suspected diversion to authorities. By taking these steps, cannabis companies will be instituting robust compliance procedures that will reduce the chances of unlawful diversion from their companies, as well as the accompanying costly investigations and criminal penalties.

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