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by Michael R. Diliberto

Practice Tips

Social Equity, Cannabis, and LACBA's Pro Bono Program

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Cannabis has had a long love-hate relationship with regulatory agencies. The federal government still hates it and deems it a Schedule 1 controlled substance, sharing the same category as heroin.¹ Does that seem right, given that the plant arguably offers valid medical uses? California was the first state to legalize medical marijuana in 1996.² Since then, the medical use of cannabis has been legalized in 39 states and the District of Columbia. The recreational or adult use of cannabis has been approved in 21 states and the District of Columbia.³ People with qualifying conditions ranging from epilepsy to social anxiety may, with physician referral, receive cannabis to treat or manage their conditions. Today, the use and general acceptance of medical cannabis continues to evolve in favor of medical programs.⁴

Cannabis has been legal in California for recreational use since 2016.⁵ Cannabis sales provide generous tax revenue for state and local coffers. In 2022, California collected \$1,085,931,941 in cannabis tax revenues from retailers⁶ and cultivators⁷ based on tax-

able sales exceeding \$5.3 billion that year.⁸ Critics say cannabis products are over-taxed, which drives many consumers to the unregulated cannabis market that thrives to the detriment of legitimate retail stores. Regulated cannabis is a multibillion dollar business in the United States that continues to grow.⁹ The legalization and sale of cannabis is advancing rapidly, not only in the United States but also globally. Global cannabis sales are expected to increase from \$25.7 billion in 2021 to \$148.9 billion by 2031.¹⁰

Cannabis has moved from the black market to the stock market, and the United States represents the largest cannabis market in the world. No less than 182 public cannabis companies are listed on the over-the-counter (OTC), New York Stock Ex-

change, NASDAQ, and the Chicago Board Options Exchange.¹¹ The industry divides cannabis companies into two main groups. Plant-touching companies "touch" the marijuana plant or some form of THC, the active ingredient in the pot plant. These are cultivators, distributors, producers of concentrates, or any company that touches the plant in some way.

No-touch companies generally provide a product or service to the cannabis industry but do not touch the plant or any form of THC. These include suppliers of cannabis-growing products, packaging, marketing, providers of real estate, consulting and legal services.¹² For example, Innovative Industrial Properties, Inc. (NYSE: IIPR) is a real estate investment trust (REIT) focused on



the U.S. cannabis industry, which provides sale-leasebacks to cannabis companies.¹³ For investors who seek diversification in the cannabis market, the AdvisorShares Pure US Cannabis ETF (NYSE: MSOS) bills itself as the first actively managed U.S.-listed exchange-traded fund (ETF) with dedicated exposure to U.S. cannabis companies.¹⁴ Approximately 11 cannabis ETFs trade on the U.S. stock exchanges.¹⁵

Furthermore, California sees the business of cannabis as a means to achieve social equity.¹⁶ The California Cannabis Equity Act of 2018 and the Budget Act of 2019 appropriated state funding to local jurisdictions to develop and operate local cannabis equity programs. The focus is inclusion and support of individuals in California's legal cannabis marketplace who are from communities negatively or disproportionately impacted by cannabis criminalization. In the City of Los Angeles, the Department of Cannabis Regulation (DCR) is responsible for administering the commercial cannabis licensing and regulatory program established by the Los Angeles City Council.

Social Equity Program

The City of Los Angeles created the cannabis Social Equity Program “to promote equitable ownership and employment opportunities in the cannabis industry in order to decrease disparities in life outcomes for marginalized communities, and to address the disproportionate impacts of the War on Drugs in those communities.”¹⁷ The ultimate goal is to help people who were harmed by cannabis criminalization build generational wealth, which will benefit impacted individuals, their families, and communities.

The cannabis Social Equity Program is embodied in the City of Los Angeles Municipal Code Section 104.20, which provides three separate tiers under which a social equity individual applicant may qualify. A “Tier 1 Social Equity Individual Applicant” must be “Low-Income” and have a prior “California Cannabis Arrest or Conviction;” or be “Low-Income” with a minimum of five years’ cumulative residency in a “Disproportionately Impacted Area.” A “Tier 2 Social Equity Individual Applicant” must be “Low-Income” with a minimum of five years’ cumulative residency in a “Disproportionately Impacted Area,” or a minimum of 10 years’ cumulative residency in a “Disproportionately Impacted Area.” A “Tier 3 Applicant” is a person

who applied for a “Non-Retailer Commercial Cannabis Activity” license prior to January 1, 2016 and does not meet the criteria of a Tier 1 Social Equity Individual Applicant or Tier 2 Social Equity Individual Applicant.¹⁸

Under the Los Angeles Municipal Code, “California Cannabis Arrest or Conviction” means an arrest or conviction in California for any crime under the laws of the State of California or the United States relating to the sale, possession, use, manufacture, or cultivation of Cannabis that occurred prior to November 8, 2016. “Disproportionately Impacted Area” means eligible zip codes based on the “More Inclusive Option” as described on page 23 of the *Cannabis Social Equity Analysis Report* commissioned by the City in 2017, and referenced in Regulation No. 13 of the Rules and Regulations, or as established using the same methodology and criteria in a similar analysis provided by an applicant for an area outside the City. “Low-Income” means 80 percent or below of Area Median Income for the city based on the 2016 American Community Survey and updated with each decennial census.¹⁹

Currently, and until January 1, 2025, the City will only grant cannabis cultivation, delivery, and retail licenses to businesses who partner with Social Equity Applicants.²⁰ Social equity is also reflected in the percentage of ownership that Los Angeles Municipal Code Section 104.20 bestows upon the social equity owners. Ownership Tier 1 provides that a “Social Equity Individual Applicant shall own no less than a 51 percent Equity Share in the Person to whom the License is issued.” The remaining 49 percent is typically owned by the investor. Ownership Tier 2 provides that a “Social Equity Individual Applicant shall own no less than a 33 1/3 percent Equity Share in the Person to whom the License is issued.”²¹

Michelle Mabus and Alexa Steinberg of the law firm Greenberg Glusker Fields Claman & Machtinger, LLP are corporate and transactional attorneys specializing in cannabis licensing and corporate matters. They note that the updated social equity rules did away with the equity tier system. The DCR now refers to this “tier” system as the “Original Eligibility Verification.” The tier system is still valid for those who applied by September 13, 2018, under the application requirements of Los Angeles Municipal Code Section 104.08 for “Non-Retailer Commercial Cannabis Activity”

conducted prior to the January 1, 2016, application processing window or who submitted an application for DCR vetting during the verification period between May 28, 2019, and July 29, 2019.

To participate in future social equity licensing rounds, a Social Equity Individual Applicant (SEIA) must be vetted under the requirements of Los Angeles Municipal Code Section 104.20, subdivision (b)1. Under Los Angeles Municipal Code Section 104.20, subdivision (b)2(i), the SEIA shall own no less than a 51 percent Equity Share in the licensed cannabis business. However, the SEIA’s 33 1/3 percent Equity Share under Tier 2 remains valid for SEIAs who applied during the Non-Retailer Commercial Cannabis Activity prior to January 1, 2016, processing under Los Angeles Municipal Code Section 104.08, and the Social Equity Program Commercial Cannabis Activity Application Processing Type 10 Application Processing - Round 1 under Los Angeles Municipal Code Section 104.06, subdivision 1(b).

Thus, the Social Equity Program mandates pairing qualified SEIAs with investors. The SEIAs need the capital and business acumen the investors provide, and the investors need the SEIAs on their team to “plant the seeds” for a licensed commercial cannabis business. When the smoke clears, however, some problems have emerged. Yvette McDowell is the chair of the Los Angeles County Bar Association’s Cannabis Section, which was founded in late 2018.²² A former firefighter and assistant City of Pasadena prosecutor, she now represents SEIAs. McDowell has seen certain conflicts arise between SEIAs and investors.

LACBA Cannabis Section Participation

At the start of the relationship, SEIAs are presented with legal documents such as an operating agreement and other documents which govern the parties’ relationship. Many SEIAs do not understand the legal ramifications of the documents, and they lack the means to hire an attorney. Fortunately, the Los Angeles County Bar Association’s Cannabis Section, in partnership with DCR, has created a Pro Bono/Low Bono Legal Assistance program that will operate through LACBA’s Smart Law Referral Service for Social Equity applicants.²³ Unfortunately, not all qualified SEIAs utilize this resource.

McDowell has seen investors attempt to dilute the SEIA’s 51 percent ownership

interest to wrestle majority control of the operation, leaving the SEIA relegated to no more than a figurehead who has no say in running the business. McDowell recalls a case in which the investor had the SEIA sign a management agreement, an intellectual property license agreement, and a shared services agreement, each of which charged the business a percentage of gross revenue, rather than net profits. Such an arrangement can skew the ownership percentage to 70 percent or greater in favor of the investor.

Mabugat and Steinberg represent SEIAs and investors. They note that investors can spend between \$500,000 to \$3 million to start a cannabis business, before a license is approved. Moreover, it can take up to four years to turn a profit, depending on the retail location and other factors. They believe that debt expressed in percentages can be code-compliant. For example, a license agreement with a known cannabis brand that requires 10 percent of net revenue for the right to use the brand's trademark on the retail store's awning would be legitimate. To help investors avoid a percentage-of-costs dispute with SEIAs, Mabugat and Steinberg also suggest using a fixed monthly dollar amount for normal operational expenses such as management fees. The net proceeds are then divided under the Equity Share profits structure of 51 percent to the SEIA and 49 percent to the investor.

McDowell has also seen investors offer to pay SEIAs an enticing annual salary to essentially stay home and provide no input in the business. If the SEIA complains, the investor may offer the SEIA a lump sum payment to buy out and replace the SEIA. The code provides that SEIAs shall have unconditional ownership of Equity Share and states that "[t]he Equity Share shall not be subject to conditions precedent, conditions subsequent, executory agreements, voting trusts, restrictions on or assignments of voting."²⁴ "Social Equity Applicants may only transfer control or ownership to Persons who meet the same Equity Share requirements, and only upon the prior written approval of DCR."²⁵

Forced-sale clauses, which are triggered if the SEIA violates certain conditions, are not valid. SEIAs cannot be forced to sell, and an investor who causes a forced sale puts the cannabis license in jeopardy. Another issue is voting rights. The code provides that SEIAs shall receive "[a]t least their Equity Share percent of the voting rights on all business

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decisions....”²⁶ SEIAs shall also receive at all times the highest officer position, such as chief executive officer, unless the parties mutually agree to appoint another natural person to that position.²⁷ However, McDowell has seen investor language that empowers the majority of the board to make business decisions, which she believes is contrary to the Code because it does not recognize the SEIA’s 51 percent Equity Share of voting rights. Mabugat and Steinberg believe that fairness and proficiency should govern voting rights and that allowing board members with business experience to make decisions benefits all parties.

The nature of disputes in the cannabis industry are wide-ranging and arise out of a variety of activities that involve different participants. The Los Angeles County Bar Association’s ADR Section is in discussions with the Cannabis Section to mediate disputes between SEIAs and investors, especially at the early stage when the agreements are negotiated and the relationship is formed. Mabugat and Steinberg warn that the cannabis licensing process has unforgiving deadlines. If conflicts about deal points and management disputes drag on, the parties risk missing critical deadlines and the oppor-

tunity to obtain a coveted commercial cannabis license. A skilled mediator may help the parties overcome their obstacles and forge a durable, profitable, and equitable relationship. ■

¹ 21 U.S.C. §812.

² The Compassionate Use Act of 1996, HEALTH & SAFETY CODE §11362.5 (added Nov. 5, 1996, by initiative Prop. 215, Sec. 1).

³ MJBizDaily, Where marijuana is legal in the United States, <https://mjbizdaily.com/map-of-us-marijuana-legalization-by-state/> (last accessed Mar. 7, 2023).

⁴ Ted Green, *Americans overwhelmingly say marijuana should be legal for medical or recreational use*, Pew Research Ctr. (Nov. 22, 2022), <https://www.pewresearch.org/fact-tank/2021/04/16/americans-overwhelmingly-say-marijuana-should-be-legal-for-recreational-or-medical-use>. According to a recent survey conducted by Pew Research Center, 91 percent of Americans believe medical cannabis should be legal, and Americans overwhelmingly say marijuana should be legal for recreational or medical use.

⁵ Proposition 64: The Control, Regulate and Tax Adult Use of Marijuana Act (effective Nov. 9, 2016); HEALTH & SAFETY CODE §11357 (am. Nov. 4, 2014, by initiative Prop. 47, and on Nov. 8, 2016, by initiative Prop. 64).

⁶ Effective January 1, 2023, the cannabis excise tax on purchasers of cannabis or cannabis products sold in California is 15 percent of the gross receipts of any retail sale by a cannabis retailer. Assembly Bill 195, Ch. 56 (June 30, 2022), *available at* https://leginfo.ca.gov/faces/billNavClient.xhtml?bill_id=202120220AB195.

⁷ Beginning July 1, 2022, the cultivation tax no longer applies to harvested cannabis entering the commercial market. Cal. Dep’t Tax & Fee Admin., Revised Cannabis Tax Return Beginning with the July 2022 and Third Quarter 2022 Filing Periods, <https://www.cdtfa.ca.gov/formspubs/L864.pdf> (last accessed Mar. 7, 2023).

⁸ Cal. Dep’t Tax & Fee Admin., Cannabis Tax Revenues, <https://www.cdtfa.ca.gov/dataportal/dataset.htm?url=CannabisTaxRevenues> (last accessed Mar. 7, 2023).

⁹ According to Brightfield Group, the “total U.S. hemp-derived CBD [Cannabidiol] market is expected to reach \$11 billion by 2027, up from about \$5.0 billion in retail sales in 2022. Currently, CBD is not formally permitted as a dietary supplement and food additive. If federal reforms are implemented by 2024, sales are estimated to reach \$11.0 billion by 2027 due to accelerated growth of ingestible product categories, including capsules and gummies and increased acceptance by mainstream retailers.” CFRA INDUSTRY SURVEYS, U.S. FOOD & STAPLES RETAILING 23 (Dec. 2022). In the cannabis market, CBD is only one product type.

¹⁰ Allied Market Research, *Global Cannabis Market to Reach \$148.9 Billion by 2031: Allied Market Research* (Sept. 7, 2022), <https://www.globenewswire.com/news-release/2022/09/07/2511824/0/en/Global-Cannabis-Market-to-Reach-148-9-Billion-by-2031-Allied-Market-Research.html>.

¹¹ Green Stock News, Cannabis Stocks, <https://greenstocknews.com/stocks/cannabis-stocks> (last accessed Mar. 7, 2023).

¹² Luke Bergess, *Touch vs. No Touch Cannabis Companies Rocky Mountain High Part I*, Energy & Capital (Feb. 1, 2016), <https://www.energyandcapital.com>.

¹³ Yahoo! finance, Innovative Ind. Props., Inc., <https://finance.yahoo.com/quote/IIPR/profile?p=IIPR> (last accessed Mar. 7, 2023).

¹⁴ AdvisorShares®, MSOS - AdvisorShares Pure US Cannabis ETF, <https://advisorshares.com/etfs/msos> (last accessed Mar. 7, 2023). A “Multi-State Operator” is a cannabis company that has storefronts or businesses in multiple states.

¹⁵ VettaFi, Marijuana ETF List, <https://etfdb.com/themes/marijuana-etfs/> (last accessed Mar. 7, 2023).

¹⁶ California and 12 other states have implemented adult-use social equity programs. MCBA NATIONAL CANNABIS EQUITY REPORT 7 (2022), *available at* <https://mjbizdaily.com/wp-content/uploads/2022/02/National-Cannabis-Equity-Report-1.pdf>.

¹⁷ City of Los Angeles Dep’t of Cannabis Reg., About the Program, <https://cannabis.lacity.org/social-equity-program/about-program/about-program> (last accessed Mar. 7, 2023).

¹⁸ L.A. MUN. CODE §104.20(a)1(i)(4-6).

¹⁹ L.A. MUN. CODE §104.20(a)1(i)(1-3).

²⁰ City of Los Angeles Dep’t of Cannabis Reg., General Overview, <https://cannabis.lacity.org/licensing/licensing-information/general-overview> (last accessed Mar. 7, 2023).

²¹ L.A. MUN. CODE §104.20(a)2(i).

²² Los Angeles County Bar Ass’n, Cannabis Section, “Raising the Bar Higher,” <https://lacba.org/?pg=cannabis-section-home-page> (last accessed Mar. 7, 2023).

²³ City of Los Angeles Dep’t of Cannabis Reg., Pro Bono/Low Bono Legal Servs., <https://cannabis.lacity.org/social-equity-program/applicant-and-licensee-benefits/pro-bonolow-bono-legal-services> (last accessed Mar. 7, 2023).

²⁴ L.A. MUN. CODE §104.20(a)2(ii)(1).

²⁵ L.A. MUN. CODE §104.20(c)1(i).

²⁶ L.A. MUN. CODE §104.20(a)2(ii)(3)(A).

²⁷ L.A. MUN. CODE §104.20(a)2(ii)(3)(B).

