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5-15-2019

## Marijuana's Continuing Illegality and Investors' Securities Fraud Problem: The Doctrines of Unclean Hands and In Pari Delicto

Casey W. Baker

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### Recommended Citation

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# **Marijuana’s Continuing Illegality and Investors’ Securities Fraud Problem: The Doctrines of Unclean Hands and *In Pari Delicto***

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## ABSTRACT

Marijuana-related businesses have blossomed into an industry with an estimated total market value of \$7.2 billion in 2016, with annual growth projected at 17%. Industry surveys report that 62% of marijuana-related businesses have offered equity stakes to investors and approximately one-half of marijuana-related businesses planned to actively seek investment funding in 2017.

Along with the investment opportunity comes heightened fraud risk, with regulators cautioning investors against investment due to the lack of accurate and publicly-available information. Also, despite state-

level decriminalization, marijuana possession, sale, and distribution continues to be a crime under federal law. The criminal nature of the marijuana industry can have ripple effects on investors, even if never prosecuted.

This paper explores the risks to investors presented by the similar but distinct doctrines of unclean hands and *in pari delicto*, both of which provide that a court should not allow a person engaged in wrongful conduct to profit therefrom. Because marijuana-related businesses are criminal enterprises, the doctrines may bar investors from pursuing civil actions for securities fraud or other misconduct.

Existing case law does not provide sufficient guidance to courts in resolving the potentially competing policies of securities law enforcement and controlled substance enforcement. This article therefore proposes a two-step analysis for courts that would encourage courts to ascertain whether lawmakers have articulated a clear legislative policy preference when applying unclean hands and *in pari delicto* to criminal conduct. If there is not a clear policy preference, courts should allow the fraud suit to proceed.

## INTRODUCTION

Marijuana-related businesses have blossomed into a market worth \$7.2 billion as of the end of 2016 and projected to grow at an annual compound rate of 17%,<sup>1</sup> despite the fact that marijuana cultivation, possession, and sale continues to be a crime under the federal Controlled Substances Act.<sup>2</sup> Federal law enforcement has essentially turned a blind eye as states have decriminalized and instituted marijuana cultivation, processing, and sale regulatory systems. As of 2017, twenty-one states have instituted medical-marijuana programs, with another eight states and the District of Columbia allowing recreational-marijuana sales in addition to medical sales.<sup>3</sup>

The phenomenal growth of the marijuana industry represents an enticing opportunity for prospective investors and an equally enticing

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<sup>1</sup> Debra Borchartdt, *Marijuana Industry Projected to Create More Jobs than Manufacturing by 2020*, FORBES (Feb. 22, 2017), <https://www.forbes.com/sites/debraborchartdt/2017/02/22/marijuana-industry-projected-to-create-more-jobs-than-manufacturing-by-2020/#3b2d0a163fa9>.

<sup>2</sup> 21 U.S.C. §§ 812, 841 (2018).

<sup>3</sup> Brad Finkelstein, *Cash Crop; 29 States. 283,000 New Jobs. \$50 billion in Annual Revenue. What will it take for the Mortgage Industry to Capitalize on this Opportunity?*, NAT'L MORTGAGE NEWS (Oct. 22, 2017), <https://www.pressreader.com/usa/national-mortgagenews/20171022/281483571607729>.

opportunity for securities fraud. While federal securities fraud statutes typically offer protection to defrauded investors, it is a fundamental principle of equity that a court will not provide a safe-haven to a person engaged in criminal conduct. Therefore, investors should recognize that the criminal nature of marijuana-related businesses—even if criminal prosecution is unlikely—represents a major risk to an investor’s right to recover for securities fraud committed by the promoters, officers, or other persons in control of a marijuana-related business.

This article will explore the related but distinct defenses of unclean hands and *in pari delicto*, each of which may bar an investor’s ability to pursue a civil action against officers and directors of the marijuana-related business for fraud or some other breach of duty. Because courts are not consistent in applying the defenses,<sup>4</sup> investors should be cautious with regards to investment in marijuana-related businesses until federal law changes to decriminalize marijuana. Existing law should be clarified so that investors have a better understanding of when a fraud action may be barred. The article concludes that when unclean hands or *in pari delicto* is raised in a securities fraud action in which criminal business activities are implicated, courts should bar the action only where lawmakers have articulated a clear policy with regards to the criminal activities.

## I. INVESTMENT IN MARIJUANA-RELATED BUSINESSES: A SUMMARY OF REGULATORY CONCERNS AND EXISTING SCHOLARSHIP

The growth of the marijuana industry has spurred an increased demand for investors’ capital. Globally, equity investment in marijuana-related businesses topped \$1 billion in 2016.<sup>5</sup> According to one industry survey, within the United States, approximately one-half of operational marijuana-related businesses either actively sought or planned to actively seek investment funding in 2017.<sup>6</sup> Sixty-two percent of operational marijuana-related businesses offered equity to investors.<sup>7</sup> Investors, on average, have taken a 15% equity position in marijuana-related businesses.<sup>8</sup>

Investors in marijuana have been relatively inexperienced, however. Less than one-fourth percent reported having been a marijuana

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<sup>4</sup> T. Leigh Anenson, *Limiting Legal Remedies: An Analysis of Unclean Hands*, 99 KY. L.J. 62, 68–73 (2010).

<sup>5</sup> MARIJUANA BUS. DAILY, MARIJUANA BUSINESS FACTBOOK 2017, 272 (Chris Walsh ed., 5th ed. 2017).

<sup>6</sup> *Id.* at 275.

<sup>7</sup> *Id.* at 280.

<sup>8</sup> *Id.* at 282.

investor for less than one year; more than three-fourths reported having fewer than three years of marijuana-related investment experience.<sup>9</sup> As one industry trade group reported in 2017, “[a]lthough investment activity in the cannabis industry is increasing, big investment firms, venture capitalists and institutional investors largely remain on the sidelines, wary of getting involved in an industry that revolves around a federally illegal substance.”<sup>10</sup> Nearly half of investors reported learning about marijuana investment opportunities online, despite the fact that the marijuana industry remains largely a collection of “small, privately run businesses for which little reliable data regarding financial fundamentals is available.”<sup>11</sup> Indeed, investors reported that the baseless financials were their primary reason for not investing in a marijuana-related business.<sup>12</sup>

Accordingly, the Securities and Exchange Commission<sup>13</sup> (“SEC”) and Financial Industry Regulatory Authority<sup>14</sup> (“FINRA”) have each issued investor alerts cautioning investors against investment in marijuana-related businesses due to fraud risks. According to the SEC:

Fraudsters often exploit the latest innovation, technology, product, or growth industry – in this case, marijuana—to lure investors with the promise of high returns. Also, for marijuana-related companies that are not required to report with the SEC, investors may have limited information about the company’s management, products, services, and finances. When publicly-available information is scarce, fraudsters can more easily spread false information about a company, making profits for themselves while creating losses for unsuspecting investors.<sup>15</sup>

FINRA cautions specifically about “pump-and-dump” schemes:

Like many investment scams, pitches to invest in potentially fraudulent marijuana-related companies may arrive in a variety of ways—faxes, email or text message invitations to webinars, infomercials, tweets or blog posts. Regardless of how you first hear about them, the offers almost always contain hallmarks of “pump and dump” ploys. Specifically, fraudsters lure investors with aggressive, optimistic—and potentially false and

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<sup>9</sup> *Id.* at 283.

<sup>10</sup> *Id.* at 272.

<sup>11</sup> *Id.* at 292.

<sup>12</sup> *Id.* at 294.

<sup>13</sup> *Investor Alert: Marijuana Related Investments*, U.S. SEC. & EXCHANGE COMMISSION (May 16, 2014), [https://www.sec.gov/oiea/investor-alerts-bulletins/ia\\_marijuana.html](https://www.sec.gov/oiea/investor-alerts-bulletins/ia_marijuana.html).

<sup>14</sup> *Marijuana Stock Scams*, FINRA, <http://www.finra.org/investors/alerts/updated-marijuana-stock-scams> (last updated May 24, 2014).

<sup>15</sup> *Investor Alert: Marijuana Related Investments*, *supra* note 13.

misleading—statements or information designed to create unwarranted demand for shares of a small, thinly traded company with little or no history of financial success (the pump). Once share prices and volumes reach a peak, the cons behind the scam sell off their shares at a profit, leaving investors with worthless stock (the dump).<sup>16</sup>

Since 2014, the SEC suspended the trading of securities or began enforcement actions against several marijuana-related businesses over concerns about misrepresentations of financial and operational information.<sup>17</sup>

Despite the growing number of investors and regulatory concerns about misleading information, there is very little scholarship addressing the rights of investors who are defrauded by promoters or persons in control of marijuana-related businesses. Current marijuana legal research largely focuses on the tension between federal regulation and state legalization efforts.<sup>18</sup> Scholarship on the legality of marijuana-related businesses tends to focus on the businesses themselves and their right to enforce contracts, as well as the ability to assert other rights given the illegality of marijuana under federal law.<sup>19</sup> Luke Scheuer addressed the potential that marijuana contracts are unenforceable illegal contracts,<sup>20</sup> as well as managers' ability to fulfill fiduciary duties and the availability of limited liability protection.<sup>21</sup> Lauren A. Newell examined whether Colorado's Retail Marijuana Amendment implicitly permits a marijuana-related business to form as a partnership, despite the general rule that a partnership may not be formed for an illegal purpose.<sup>22</sup>

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<sup>16</sup> *Marijuana Stock Scams*, *supra* note 14.

<sup>17</sup> *See, e.g.*, Trading Suspension, Exchange Act Release No. 71,723, 79 Fed. Reg. 15,201 (March 14, 2014), <https://www.sec.gov/litigation/suspensions/2014/34-71723.pdf>; Trading Suspension, Exchange Act Release No. 72,337, 79 Fed. Reg. 33,254 (June 6, 2014), <https://www.sec.gov/litigation/suspensions/2014/34-72337.pdf>; Securities and Exchange Commission v. Fortitude Group, Inc., *et al.*, Civil Action No. 1:16-cv-00050-SPB (W.D. Pa. filed Feb. 29, 2016); Securities and Exchange Commission v. Strategic Global Investments, Inc., *et al.*, Civil Action No. 3:16-cv-00514-H-JLB (S.D. Ca. filed Feb. 29, 2016); Securities and Exchange Commission v. Hemp, Inc., *et al.*, No. 2:16-cv-1413 (D. Nev. Filed June 20, 2016); Securities and Exchange Commission v. Notis Global, Inc. (f/k/a Medbox, Inc.), *et al.*, Civil Action No. 2:17-cv-01905 (C.D. Cal. filed March 9, 2017).

<sup>18</sup> *See, e.g.*, Sam Kamin, *Legal Cannabis in the U.S.: Not Whether but How?*, 50 U.C. DAVIS L. REV. 617 (2016).

<sup>19</sup> *See, e.g.*, Steven Mare, *He Who Comes into Court Must not Come with Green Hands: The Marijuana Industry's Ongoing Struggle with the Illegality and Unclean Hands Doctrines*, 44 HOFSTRA L. REV. 1351 (2016).

<sup>20</sup> Luke Scheuer, *Are "Legal" Marijuana Contracts "Illegal"?*, 16 U.C. DAVIS BUS. L.J. 31 (2015) [hereinafter Scheuer, *"Legal" Marijuana Contracts "Illegal"?*].

<sup>21</sup> Luke Scheuer, *The "Legal" Marijuana Industry's Challenge for Business Entity Law*, 6 WM. & MARY BUS. L. REV. 511 (2015) [hereinafter Scheuer, *Marijuana Industry's Challenge*].

<sup>22</sup> Lauren A. Newell, *Up in Smoke? Unintended Consequences of Retail Marijuana Laws for Partnerships*, 38 CARDOZO L. REV. 1343 (2017).

These scholarly works identify the unclean hands doctrine as a significant hurdle for marijuana-related businesses. Likewise, this article will explore the impact of the unclean hands doctrine and the related *in pari delicto* doctrine in the marijuana industry. However, this article distinguishes itself from previous research by focusing on the rights of the investors when investing in a business that is prohibited by federal law, such as a marijuana-related business.

## II. DESPITE STATE-LEVEL EFFORTS TO ALLOW MARIJUANA SALES, FEDERAL LAW CRIMINALIZES ALL MARIJUANA-RELATED BUSINESSES

While the focus of this article is on the private securities law implications for investors in the marijuana industry, it is first necessary to describe the recent—and convoluted—criminal regulation of marijuana. The word “legalized” is commonly used to describe marijuana-related businesses operating in compliance with state law, but those businesses can hardly be said to be in compliance with marijuana regulation as a whole.<sup>23</sup> Marijuana remains illegal—criminally illegal—in all states as a result of federal law.<sup>24</sup>

The Controlled Substances Act,<sup>25</sup> codified at 21 U.S.C. § 801, *et seq.*, specifies that “any material, compound, mixture, or preparation, which contains any quantity of” marijuana or tetrahydrocannabinols (“THC”), the psychoactive substance in marijuana,<sup>26</sup> is a Schedule I controlled substance.<sup>27</sup> By deeming marijuana and THC as Schedule I controlled substances, Congress determined that the substances (i) have a high potential for abuse, (ii) have no currently accepted medical use in the United States, and (iii) have no accepted safety for use under medical supervision.<sup>28</sup>

The Controlled Substances Act likewise deems it unlawful “to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance.”<sup>29</sup> Penalties for violation

<sup>23</sup> See, e.g., 21 U.S.C. § 801.

<sup>24</sup> Federal Marijuana Law, AM. FOR SAFE ACCESS, [https://www.safeaccessnow.org/federal\\_marijuana\\_law](https://www.safeaccessnow.org/federal_marijuana_law) (last visited Oct. 21, 2018).

<sup>25</sup> The Controlled Substance Act, Pub. L. 91-513, Title II, 84 Stat. 1236, 1242–84 (1970).

<sup>26</sup> *Drugs of Abuse* (2017), U.S. DEP’T OF JUSTICE DRUG ENFORCEMENT ADMIN., [https://www.dea.gov/sites/default/files/2018-06/drug\\_of\\_abuse.pdf](https://www.dea.gov/sites/default/files/2018-06/drug_of_abuse.pdf) (last accessed Oct. 22, 2018).

<sup>27</sup> 21 U.S.C. § 812(c) (2018). *But see* *Hemp Indus. Ass’n v. DEA*, 357 F.3d 1012 (9th Cir. 2004) (holding that the inclusion of THC in the Controlled Substances Act refers only to synthetic THC and not THC naturally occurring in marijuana).

<sup>28</sup> 21 U.S.C. § 812(b)(1) (2018).

<sup>29</sup> 21 U.S.C. § 841(a) (2018).

range from a \$1,000 fine<sup>30</sup> to life in prison,<sup>31</sup> depending on the amount of marijuana involved, the violator's intent, and the criminal history of the violator.<sup>32</sup> In addition, civil penalties up to \$10,000 per violation are possible.<sup>33</sup>

Obviously, no marijuana grower, processor, or retailer—even in those states that have authorized marijuana businesses—could openly operate if such federal prohibitions were actively enforced. Thus, the growth of the “legal” marijuana industry has been facilitated by two federal law enforcement-related items: the so-called “Cole Memos,” and the “Rohrabacher-Farr” appropriations amendment.

The Cole Memos have received much of the media attention with regards to federal law enforcement's inaction with regards to marijuana laws. On August 29, 2013, then-Deputy Attorney General James M. Cole issued a memorandum (the “2013 Cole Memo”) to all United States Attorneys offering guidance on the use of resources relating to civil and criminal marijuana law enforcement and prosecutions under the Controlled Substances Act.<sup>34</sup> The 2013 Cole Memo stressed that, although Congress had determined that marijuana is a dangerous drug, the Justice Department was focusing its marijuana-related law enforcement efforts on eight specific priorities:

1. Preventing the distribution of marijuana to minors;
2. Preventing the revenue of marijuana sales from funding criminal enterprises, gangs, and cartels;
3. Preventing the distribution or diversion of marijuana from states that have decriminalized marijuana to states that have not;
4. Preventing state-authorized marijuana operations from serving as a cover or pretext for other drug trafficking or illegal activities;
5. Preventing violence and the use of firearms in the cultivation and distribution of marijuana;
6. Preventing driving under the influence of drugs and the exacerbation of other adverse public health consequences;
7. Preventing growth of marijuana on public lands, and attending to public safety and environmental concerns related to marijuana production on public lands; and

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<sup>30</sup> A first-time conviction of possession of a controlled substance, without intent to distribute, or distribution of a small amount of marijuana for no remuneration, is punishable by a minimum fine of \$1,000 and up to one year in prison. 21 U.S.C. § 841(b)(4) (2018); 21 U.S.C. § 844(a) (2018).

<sup>31</sup> Possession of 1,000 kilograms or more of a substance containing a detectable amount of marijuana, or 1,000 or more marijuana plants, is punishable by not less than ten years and up to life in prison. 21 U.S.C. § 841(b)(1)(A)(vii) (2018).

<sup>32</sup> *Id.*

<sup>33</sup> 21 U.S.C. § 844a (2018).

<sup>34</sup> Memorandum from James M. Cole, Deputy Att’y Gen., to all U.S. Att’y’s (Aug. 29, 2013) (on file with the Department of Justice).

8. Preventing marijuana possession or use on federal property.<sup>35</sup>

According to the 2013 Cole Memo, besides these eight priorities, federal law enforcement had traditionally relied upon—and would expect to continue to rely upon—state and local law enforcements to address marijuana through their own drug laws.<sup>36</sup> The 2013 Cole Memo advised that so long as a state marijuana regulatory system is robustly designed and enforced in accordance with the eight highlighted priorities, federal law enforcement should focus its resources on whether an operation complies with such state regulations.<sup>37</sup> If federal law enforcement is concerned about the design and enforcement of the state systems with regards to the eight priorities, then the 2013 Cole Memo instructs district attorneys to both challenge the state regulatory systems directly and pursue actions against individual marijuana violators.<sup>38</sup>

In sum, the 2013 Cole Memo advises federal district attorneys to allocate resources to the areas identified by the aforementioned eight law enforcement priorities, as well as to rely upon local law enforcement for other marijuana-related matters.<sup>39</sup> If local law enforcement’s actions are inconsistent with the eight priorities, then federal law enforcement could appropriately direct resources to rectify the situation.<sup>40</sup>

On February 14, 2014, Deputy Attorney General Cole issued another memorandum (the “2014 Cole Memo”) that offered guidance to all United States Attorneys on the 2013 Cole Memo’s delineation of federal law enforcement efforts concerning marijuana-related business transactions under the Bank Secrecy Act and other financial crime statutes.<sup>41</sup> The Bank Secrecy Act<sup>42</sup> and the regulations developed thereunder required most financial institutions to file a report with the Treasury Department regarding any “suspicious transaction relevant to a possible violation of law or regulation.”<sup>43</sup>

The 2014 Cole Memo stressed the importance of the eight federal law enforcement priorities outlined in the 2013 Cole Memo, by instructing

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<sup>35</sup> *Id.* at 1–2.

<sup>36</sup> *Id.* at 2.

<sup>37</sup> *Id.* at 2–3.

<sup>38</sup> *Id.* at 3.

<sup>39</sup> *Id.* at 2.

<sup>40</sup> *Id.* at 2–3.

<sup>41</sup> Memorandum from James M. Cole, Deputy Att’y Gen., to all U.S. Att’ys (Feb. 14, 2014) (on file with the Department of Justice).

<sup>42</sup> Bank Secrecy Act, Pub. L. 91-508, Title II, 84 Stat. 1236, 1242–84 (1970).

<sup>43</sup> 31 C.F.R. § 1020.320 (2018). Note that although § 1020.320 uses the word “bank,” that term is defined to include other financial organizations, including savings and loan associations and credit unions chartered under the laws of any state or the United States, or any bank organized under foreign law. 31 C.F.R. § 1010.100.

law enforcement agencies to review possible marijuana-related financial crimes with the eight priorities in mind.<sup>44</sup> In addition, the 2014 Cole Memo referred financial institutions to guidance issued by the Department of Treasury’s Financial Crimes Enforcement Network (“FinCEN”).<sup>45</sup> This FinCEN guidance is discussed later in this article.<sup>46</sup>

Opponents have criticized the Cole Memos for the memos’ lack of clarity as to federal law enforcement’s position on state marijuana regulatory schemes.<sup>47</sup> What is clear, however, is that the Cole Memos were not binding law—they merely served as guides to best practices for federal law enforcement agencies.<sup>48</sup> Nevertheless, marijuana-related businesses, their investors, and their state regulators viewed the Cole Memos as a roadmap to legal compliance.<sup>49</sup>

Thus, the presidential administration change in 2017 caused significant concern in the cannabis industry, as a December 2016 industry survey had revealed that a federal crackdown would be the primary factor to cause investors to cease investing in marijuana-related businesses.<sup>50</sup> Roughly one-third of marijuana investors reported that Donald Trump’s election caused them to change their company’s growth plans, while another third were still considering revisions to their plans.<sup>51</sup>

Indeed, in January 2018, Attorney General Jeff Sessions rescinded the Cole Memos’ guidance as unnecessary, for Justice Department policies have always required law enforcement to weigh all relevant factors, including enforcement priorities, when allocating resources to prosecutorial efforts.<sup>52</sup> However, the Sessions guidance is no clearer than the Cole Memos—there is no directive to law enforcement agencies to take any action with regards to marijuana. Thus, the Cole Memos may nevertheless serve as loose guidance with regards to law enforcement priorities.

The other significant limitation on federal law enforcement of the marijuana industry does have the force of law: the Rohrabacher-Farr appropriations amendment. Introduced by a bipartisan group led by Rep.

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<sup>44</sup> Cole, *supra* note 41, at 1–2.

<sup>45</sup> *Id.* at 3.

<sup>46</sup> See *infra* note 102 and accompanying text.

<sup>47</sup> See, e.g., Kimberly A. Houser, *Legalizing Marijuana: State and Federal Issue: What Inconsistent Federal Policy Means for Marijuana Business Owners: Washington’s I-502 and the Federal Controlled Substances Act*, 50 GONZ. L. REV. 305, 327 (2014); Scheuer, *Marijuana Industry’s Challenge*, *supra* note 21, at 524–26.

<sup>48</sup> *Id.*

<sup>49</sup> Mona Zhang, *Marijuana Investors Aren’t Scared by Sessions’ Change in Pot Policy*, FORBES (Jan. 6, 2018), <https://www.forbes.com/sites/monazhang/2018/01/06/marijuana-investors-arent-scared-by-sessions-change-in-pot-policy/#744afc480fba>.

<sup>50</sup> Walsh, *supra* note 5, at 295.

<sup>51</sup> *Id.* at 296.

<sup>52</sup> Memorandum from Jefferson B. Sessions, III, Att’y Gen., to all U.S. Att’y’s (Jan. 4, 2018) (on file with the Department of Justice).

Dana Rohrabacher and Rep. Sam Farr,<sup>53</sup> Rohrabacher-Farr amended the Consolidated and Further Continuing Appropriations Act 2015 to prohibit the Justice Department from using any appropriated funds to interfere with or prevent the implementation of medical marijuana laws in thirty-two states plus the District of Columbia.<sup>54</sup>

All subsequent appropriations bills included the Rohrabacher-Farr amendment.<sup>55</sup> The version appearing in the 2018 appropriations bill covers forty-six states, two territories, and the District of Columbia:

None of the funds made available under this Act to the Department of Justice may be used, with respect to any of the States of Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming, or with respect to the District of Columbia, Guam, or Puerto Rico, to prevent any of them from implementing their own laws that authorize the use, distribution, possession, or cultivation of medical marijuana.<sup>56</sup>

The Justice Department's initial position on Rohrabacher-Farr was that the prohibition barred enforcement action only against the states (or state officials) directly—that is, it did not prevent prosecution, civil enforcement, or asset forfeiture actions against individual violators of federal marijuana statutes.<sup>57</sup> Instead, the Justice Department continued to defer to the eight priorities outlined in the 2013 Cole Memo in determining

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<sup>53</sup> See 160 Cong. Rec. H4878 (daily ed. May 28, 2014).

<sup>54</sup> Pub. L. 113-235, Title V, § 538; 128 Stat. 2130, 2217 (2014).

<sup>55</sup> See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, § 542, 129 Stat. 2242, 2332–33 (2015); Consolidated Appropriations Act, 2017, Pub. L. 115-31, § 537, 131 Stat. 135 (2017); Consolidated Appropriations Act, 2018, Pub. L. 115-141, § 538, 132 Stat. 348 (2018).

<sup>56</sup> Consolidated Appropriations Act, 2018, Pub. L. 115-141, § 538, 132 Stat. 348 (2018).

<sup>57</sup> Patty Stemler, *Guidance Regarding the Effect of Section 538 of the Consolidated and Further Continuing Appropriations Act of 2015 on Prosecutions and Civil Enforcement and Forfeiture Actions Under the Controlled Substances Act*, SCRIBD, <https://www.scribd.com/doc/273620932/Depart-of-Justice-S;ays-Medical-Marijuana-Law-Doesn-t-Impact-Prosecutions> (last visited June 29, 2018).

whether to proceed with an enforcement action.<sup>58</sup> Courts considering the Justice Department's strict interpretation have generally dismissed it.<sup>59</sup>

The Ninth Circuit's approach in *United States v. McIntosh* is instructive. *McIntosh* involved ten consolidated interlocutory appeals and petitions for writs of mandamus from three district courts.<sup>60</sup> In each of the cases, the defendants were indicted for alleged marijuana grow operations in violation of the Controlled Substances Act.<sup>61</sup> However, the defendants' operations were within states covered by Rohrabacher-Farr. Accordingly, the defendants sought to enjoin their respective prosecutions on the basis of Rohrabacher-Farr's prohibition against the use of funds by the Department of Justice.<sup>62</sup>

After dispensing with preliminary issues of jurisdiction and standing, the court tackled the statutory text itself. According to the Ninth Circuit, the plain meaning of the Rohrabacher-Farr text "prohibits DOJ from spending money on actions that prevent the Medical Marijuana States' giving practical effect to their state laws that authorize the use, distribution, possession, or cultivation of medical marijuana."<sup>63</sup> The court rejected the Justice Department's interpretation, holding that prosecution of private individuals prevents states from giving "practical effect" to their respective medical marijuana laws:

DOJ, without taking any legal action against the Medical Marijuana States, prevents them from implementing their laws that authorize the use, distribution, possession, or cultivation of medical marijuana by prosecuting individuals for use, distribution, possession, or cultivation of medical marijuana that is authorized by such laws. By officially permitting certain conduct, state law provides for non-prosecution of individuals who engage in such conduct. If the federal government prosecutes such individuals, it has prevented the state from giving practical effect to its law providing for non-prosecution of individuals who engage in the permitted conduct.<sup>64</sup>

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<sup>58</sup> *Id.*

<sup>59</sup> *See, e.g.,* *United States v. McIntosh*, 833 F.3d 1163 (9th Cir. 2016); *United States v. Samp*, 2016 U.S. Dist. LEXIS 171732 (E. Dist. Mich. Dec. 13, 2016); *Alpenglow Botanicals, LLC v. United States*, 2016 U.S. Dist. LEXIS 183041 n.1 (Dist. Colo. Dec. 1, 2016).

<sup>60</sup> *McIntosh*, 833 F.3d at 1168.

<sup>61</sup> *Id.* at 1169.

<sup>62</sup> *Id.*

<sup>63</sup> *Id.* at 1176.

<sup>64</sup> *Id.* at 1176–77.

However, the *McIntosh* court was careful not to allow its ruling to be interpreted too broadly. The court stressed that only the text of an appropriations rider—not the expressions of intent in legislative history—may be considered in determining the scope of the prohibition against the spending.<sup>65</sup> Thus, Rohrabacher-Farr does not forbid any federal prosecution against persons engaged in the marijuana industry; the limitation instead applies only (i) to the use of Justice Department funds, (ii) in the specifically identified states, (iii) to the extent that the use of funds would prevent the implementation of state laws authorizing the use, distribution, possession, or cultivation of medical marijuana.

Importantly, under *McIntosh*, the Justice Department may act against an individual or business who is not in strict compliance with state medical marijuana laws because such a prosecution would not prevent the implementation of state medical marijuana laws.<sup>66</sup> Accordingly, the Ninth Circuit did not dismiss the criminal indictments. Rather, the court held that the defendants were entitled to preliminary hearings to determine whether their conduct strictly complied with all relevant provisions of the state medical marijuana laws.<sup>67</sup>

Lastly, the court noted that nothing in Rohrabacher-Farr decriminalizes marijuana, even for medical use.<sup>68</sup> The issue is that the Department of Justice currently cannot spend funds to prosecute medical marijuana market participants in the states covered by Rohrabacher-Farr.<sup>69</sup> In a footnote, the court acknowledged that anyone in any state—including those covered by Rohrabacher-Farr—who possesses, distributes, or manufactures marijuana for medical or recreational purposes commits a federal crime.<sup>70</sup>

In addition, even though the Justice Department is limited in its enforcement abilities, Rohrabacher-Farr's prohibition does not extend to agencies within other departments, and therefore federal intervention is not entirely prohibited.<sup>71</sup> For example, the Internal Revenue Service, which is a part of the Treasury Department, may continue denying

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<sup>65</sup> *Id.* at 1178.

<sup>66</sup> *Id.* at 1178.

<sup>67</sup> *Id.* at 1179.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> *See* United States v. Tote, 2015 U.S. Dist. LEXIS 76572 n.1 (E. Dist. Cal. June 12, 2015) (“It must also be noted that the arresting agency in this case is the United States Forest Service, an agency of the United States Department of Agriculture, not the Department of Justice. Under the Rohrabacher-Farr Amendment the Forest Service’s actions would not bar them from enforcing federal law, but, once the matter was referred to the Department of Justice for actual prosecution in a court, their action would be barred under the amendment.”).

business expense deductions for marijuana-related businesses due to the fact that they engaged in criminal trafficking of controlled substances.<sup>72</sup> Likewise, the United States Border Patrol, under the Department of Homeland Security, may ask at border checkpoints whether state law-compliant medical marijuana users are in possession of marijuana.<sup>73</sup>

Thus, while Rohrabacher-Farr offers some protection against criminal prosecution (or other enforcement action) by the federal government, that protection is limited to persons who are in strict compliance with state medical marijuana laws.<sup>74</sup> Those courts acknowledging the restrictions imposed by Rohrabacher-Farr nevertheless recognize that marijuana remains illegal under federal law, and there is no legal protection against legal consequences imposed by other federal agencies.<sup>75</sup> Furthermore, Rohrabacher-Farr offers no protection with regards to state recreational marijuana statutes.<sup>76</sup>

### III. SECURITIES FRAUD, INVESTOR RECOVERY RIGHTS, AND PARTICULAR CONCERNS FOR THE MARIJUANA INDUSTRY

The technically criminal, but largely unenforced nature of the marijuana industry creates complications beyond criminal law, implicating a number of corporate and business law issues for entities in the industry. As discussed previously, the scholarship thus far has focused on the implications for the marijuana-related entities themselves.<sup>77</sup> This article, however, focuses on the implications for investors in such entities by examining what relief such investors should expect under federal securities laws given that they are investing in criminal enterprises.

Thus, having reviewed the criminal nature of marijuana-related businesses, this article now turns to an overview of federal securities law and the anti-fraud provisions thereunder.<sup>78</sup> This article will specifically focus on Section 12 of the 1933 Securities Act (the “1933 Act”)<sup>79</sup> and

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<sup>72</sup> See *Green Solution Retail, Inc. v. United States*, 855 F.3d 1111, 1114 (10th Cir. 2017).

<sup>73</sup> See *Marrufo v. United States Border Patrol*, 2016 U.S. Dist. LEXIS 49109 (D.N.M. Apr. 11, 2016). In fact, the court in *Marrufo* held that it was not a violation of the Rohrabacher-Farr prohibition for the Justice Department to use funds to represent the U.S. Border Patrol in the action because such involvement was not the prevention of New Mexico from implementing its medical marijuana program. *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> See *id.*

<sup>76</sup> See *Green Solution Retail, Inc.*, 855 F.3d at 1114.

<sup>77</sup> Mare, *supra* note 1918; Scheuer, “*Legal*” *Marijuana Contracts “Illegal”?*, *supra* note 20; Scheuer, *Marijuana Industry’s Challenge*, *supra* note 21; Newell, *supra* note 22.

<sup>78</sup> State law may also offer protection to investors, in the event the investment falls outside the federal definition of “security” or the fraud falls outside the scope of federal securities laws. See, e.g., Colo. Rev. Stat. § 11-51-501; Cal. Corp. Code § 25401; 2 Del. Code § 73-201. However, this article’s analysis is on federal law, as it is federal law that criminalizes marijuana nationwide.

<sup>79</sup> Pub.L. 73–22, 48 Stat. 74 (1933).

Section 10(b) of the Securities Exchange Act of 1934 (the “1934 Act”).<sup>80</sup> Unless an exemption applies, an investment in a marijuana-related business likely qualifies as a “security” subject to regulation under both statutes.<sup>81</sup> The United States Supreme Court broadly construed the concept of a “security” to include any “investment of money in a common enterprise with profits to come solely from the efforts of others,”<sup>82</sup> which would almost certainly include an investment in a marijuana-related business.<sup>83</sup>

The applicability of a particular federal anti-securities fraud provision depends on whether the fraud is committed in the context of a registration of securities or in the context of a purchase or sale. The 1933 Act generally requires that issuers register their securities before offering the securities to the public.<sup>84</sup> Thus, the anti-fraud provisions of Section 12 of the 1933 Act create a private cause of action against any person who offers to sell a security that is unregistered or who offers to sell a security and makes a fraudulent statement in connection therewith:

- (a) In general. Any person who—
- (1) offers or sells a security in violation of section 77e of this title, or
  - (2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraphs (2) and (14) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b), to the person purchasing such security from him, who may sue either at

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<sup>80</sup> Pub.L. 73–291, 48 Stat. 881 (1934).

<sup>81</sup> 15 U.S.C. § 77b(a)(1) (2018); 15 U.S.C. § 78c(10) (2018).

<sup>82</sup> *SEC v. W. J. Howey Co.*, 328 U.S. 293, 301 (1946).

<sup>83</sup> Walsh, *supra* note 5, at 275, 280, 282.

<sup>84</sup> 15 U.S.C. § 77e (2018).

law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.<sup>85</sup>

Section 10(b) of the 1934 Act, on the other hand, prohibits securities fraud in the “purchase or sale” of a security:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.<sup>86</sup>

The SEC has clarified the concept of securities fraud under the 1934 Act with the so-called Rule 10b-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

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<sup>85</sup> 15 U.S.C. § 77i (2018).

<sup>86</sup> 15 U.S.C. § 78j(b) (2018).

in connection with the purchase or sale of any security.<sup>87</sup>

The essential difference between Section 12 of the 1933 Act and Rule 10b-5 under the 1934 Act is who may be sued: a defrauded investor may sue only his seller under Section 12 of the 1933 Act but may sue the person making the fraudulent statement under Rule 10b-5, regardless of whether that person was involved in a transaction with the defrauded investor.<sup>88</sup>

While neither the 1934 Act nor Rule 10b-5 create an express private cause of action for violations of the federal securities fraud prohibition, the United States Supreme Court has declared that a private cause of action is implied by the Act.<sup>89</sup> Investors have an express private cause of action under Section 12 of the 1933 Act.<sup>90</sup>

Private actions by investors for securities fraud may take the form of either a direct action or a derivative action.<sup>91</sup> A direct action is instituted by a defrauded investor (usually as a class action) against the defrauding entity, due to a personal injury suffered by the investor (or class).<sup>92</sup> A derivative claim, on the other hand, arises when an equity investor sues a wrongdoer for injury suffered by the corporation because the corporation refuses to pursue the action.<sup>93</sup> The injury suffered by the equity investor (reduction in value of shares due to false information) derives from the harm suffered by the corporation.<sup>94</sup> Most securities fraud claims are pursued as direct claims as it is a personal injury suffered by the investor that triggers the recovery right, even if the claim also contains elements of harm more closely associated with derivative actions.<sup>95</sup>

In the marijuana-related business context, FINRA's warning concerning "pump and dump" schemes reflects the securities fraud concerns of both Section 12 and Rule 10b-5.<sup>96</sup> Information regarding the potential investment is provided to investors arrives via the use of "instrumentalities of interstate commerce" such as fax, email, or text

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<sup>87</sup> 17 C.F.R. § 240.10b-5 (2018).

<sup>88</sup> See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

<sup>89</sup> *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 (1971).

<sup>90</sup> 15 U.S.C. § 77l(a) (2018). The defrauding offeror or seller "shall be liable, subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction . . ." *Id.*; see also *Blue Chip Stamps*, *supra* note 88.

<sup>91</sup> Richard A. Booth, *Direct and Derivative Claims in Securities Fraud Litigation*, 4 VA. L. & BUS. REV. 277, 295–97 (2009).

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

messages.<sup>97</sup> Aggressive estimates for growth and investment return are submitted as the “pump” with little actual business history to support the estimates.<sup>98</sup>

Additionally, even if the business has a legitimate financial history to report to potential investors, issues with accuracy or auditability may make the financial statements misleading. At least nine state public accounting boards have cautioned accountants about risks and difficulties related to providing accounting services to marijuana-related businesses.<sup>99</sup> Criminal conduct by marijuana-related businesses (even those in full compliance with state-level regulatory systems) implicates federal anti-money laundering statutes and imposes additional burdens on financial institutions.<sup>100</sup> Virtually any transaction between any financial institution and any marijuana-related business entity is potentially subject to civil and criminal penalty.<sup>101</sup>

FinCEN guidance<sup>102</sup> provides some relief but places the burden of proof on the financial institution to verify that the marijuana-related business transactions are in compliance with state law and federal prosecutorial policy.<sup>103</sup> Because these and other financial regulatory issues are governed by Treasury Department regulations, enforcement is not limited by Rohrabacher-Farr’s restrictions.<sup>104</sup> Furthermore, because the FinCEN guidance was issued in concert with and in reliance upon the now-revoked Cole Memos, it is unclear whether the guidance may still be relied upon.<sup>105</sup>

As a result of the restrictions on financial institutions, marijuana-related businesses have difficulty obtaining banking and other financial services. Of the more than 11,300 banks and credit unions in the United States,<sup>106</sup> only 400 (less than 4%) reported that they provided financial

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<sup>97</sup> *Marijuana Stock Scams*, *supra* note 14.

<sup>98</sup> *Id.*

<sup>99</sup> *Providing Services to Businesses in the Marijuana Industry: A Sample of Current Board Positions*, AICPA (Jan. 2018), <https://www.aicpa.org/content/dam/aicpa/advocacy/state/downloadabledocuments/marijuana-state-board-positions.pdf>.

<sup>100</sup> See Julie Andersen Hill, *Marijuana, Federal Power, and the States: Banks, Marijuana, and Federalism*, 65 CASE W. RES. L. REV. 598 (2015).

<sup>101</sup> *Id.* at 610–17.

<sup>102</sup> *BSA Expectations Regarding Marijuana-Related Businesses*, FINANCIAL CRIMES NETWORK ENFORCEMENT (Feb. 14, 2014), [http://www.fincen.gov/statutes\\_regs/guidance/pdf/FIN-2014-G001.pdf](http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2014-G001.pdf).

<sup>103</sup> Hill, *supra* note 100, at 614–16.

<sup>104</sup> *Id.* at 607.

<sup>105</sup> Memorandum, *supra* note 34.

<sup>106</sup> Fed. Deposit Ins. Corp., *2017 Annual Report* 87 (2018) (reporting that there were 5,738 FDIC-insured institutions as of 2017); Nat’l Credit Union Admin., *2017 Annual Report* 183 (2018) (reporting that there were 5,573 federally insured credit unions as of 2017).

services to marijuana-related businesses as of September 30, 2017.<sup>107</sup> Thus, many marijuana-related businesses are cash-only businesses, and cash-only businesses are more difficult to tax and regulate.<sup>108</sup> Additionally, without reliable accounting and assurance systems to verify financial results, the fraud concerns raised by the SEC and FINRA are compounded.<sup>109</sup>

IV. UNCLEAN HANDS AND *IN PARI DELICTO*: DIFFICULTIES IN RESOLVING THE DEFENSES DUE TO INCONSISTENCY IN APPLICATION AND UNCERTAINTY IN FEDERAL POLICY

To be clear, investors in marijuana-related businesses face a number of uncertainties that typical investors do not.<sup>110</sup> Marijuana is illegal, so investors face the risk of an enforcement crackdown terminating the entire industry.<sup>111</sup> Furthermore, investors bear additional risks as to the availability and accuracy of information, as many of the marijuana-related businesses are un-auditable due to the lack of financial services available to them.<sup>112</sup>

Yet these risks relate to the unlawful nature of the marijuana-related business itself—not to the potentially wrongful nature of an investment in such a business. If the purchase of securities in an enterprise that is criminal is itself wrongful, then the investor must be prepared to overcome the affirmative defenses of unclean hands and *in pari delicto* in any securities fraud action resulting therefrom. These similar but distinct defenses essentially bar wrongdoers from seeking a remedy from a court based on the wrongful conduct. However, understanding the distinction in the two doctrines—and how courts frequently confuse the two—is helpful in understanding the additional legal uncertainty that defrauded marijuana investors face.

Both unclean hands and *in pari delicto* have their roots in the equitable maxim, “[h]e that hath committed (an) inequity shall not have equity.”<sup>113</sup> The doctrine of unclean hands is commonly described by the

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<sup>107</sup> *Marijuana Banking Update*, FINCEN,

[https://www.fincen.gov/sites/default/files/shared/273281%20EA%204th%20Q%20MJ%20Stats\\_Public\\_Web.pdf](https://www.fincen.gov/sites/default/files/shared/273281%20EA%204th%20Q%20MJ%20Stats_Public_Web.pdf) (last visited June 29, 2018).

<sup>108</sup> Hill, *supra* note 100, at 600–03.

<sup>109</sup> See *Investor Alert*, *supra* note 13; *Marijuana Stock Scams*, *supra* note 14.

<sup>110</sup> *Investor Alert*, *supra* note 13; *Marijuana Stock Scams*, *supra* note 14.

<sup>111</sup> *Investor Alert*, *supra* note 13.

<sup>112</sup> *Id.*

<sup>113</sup> Gene G. Harter & Lawrence B. Ordower, *Rule 10b-5: The In Pari Delicto and Unclean Hands Defenses*, 58 CAL. L. REV. 1149, 1162 (1970).

maxim, “[h]e who comes into equity must come in with clean hands.”<sup>114</sup> The doctrine of *in pari delicto* can be thought of as derivative of the unclean hands maxim and a separate common law rule.<sup>115</sup>

Essentially, both doctrines permit courts to refuse to become involved in a dispute between two wrongdoers.<sup>116</sup> The rationale is the preservation of the legitimacy of the courts: courts should advance legitimate public policy aims, and where granting relief to one party would undermine a policy goal, the courts should abstain.<sup>117</sup> Thus, application of either unclean hands or *in pari delicto* requires that a court examine the underlying policy goals behind the claims asserted and the wrongful conduct forming the basis of the defense or defenses.

The doctrines differ in a couple of notable respects, however. First and foremost is the consideration of the relative fault of the plaintiff compared to the defendant asserting the defense. *In pari delicto* translates to “in equal guilt.”<sup>118</sup> Technically, it is therefore applicable only where the plaintiff’s fault or wrongful conduct is equally or more objectionable than the defendant’s.<sup>119</sup> If the plaintiff has committed some wrong, but that wrong is not as wrongful as the defendant’s conduct, then strict traditional application of *in pari delicto* will not defeat the claim.<sup>120</sup> Unclean hands, on the other hand, does not require that the court compare the relative fault of plaintiff and defendant.<sup>121</sup> The inquiry is whether the plaintiff has engaged in some wrongful conduct with regards to the claim before the court.<sup>122</sup>

Second, despite the merger of law and equity, courts have traditionally confined unclean hands to actions seeking equitable relief, whereas *in pari delicto* is applied to both equitable actions and actions for legal damages.<sup>123</sup> T. Leigh Anenson has found that courts in Wyoming, District of Columbia, Georgia, Iowa, Missouri, Pennsylvania, Minnesota, North Dakota, New Jersey, Texas, Illinois, Ohio, Arizona, Colorado, and

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<sup>114</sup> *Id.* at 1163.

<sup>115</sup> *Id.*

<sup>116</sup> *Id.* at 1163–64; see also Brian A. Blum, *Equity’s Leaded Feet in a Contest of Scoundrels: The Assertion of the In Pari Delicto Defense Against a Lawbreaking Plaintiff and Innocent Successors*, 44 HOFSTRA L. REV. 781, 786–88 (2016); William J. Lawrence, *Application of the Clean Hands Doctrine in Damage Actions*, 57 NOTRE DAME L. REV. 673, 674–77 (1982).

<sup>117</sup> Harter & Ordower, *supra* note 113, at 1164; Blum, *supra* note 116, at 786–88; Lawrence, *supra* note 116, at 675.

<sup>118</sup> Blum, *supra* note 116, at 783.

<sup>119</sup> *Id.* at 802–03; Harter & Ordower, *supra* note 113, at 1163.

<sup>120</sup> Blum, *supra* note 116, at 802–803. Blum also notes, however, that many courts will continue to perform a policy analysis even after determining that the plaintiff’s wrongful conduct is not worse than the defendants, suggesting that the “equal guilt” component is not a threshold. *Id.* This is in accord with the modern trend with regards to disregarding the distinctions between *in pari delicto* and unclean hands. See Anenson, *supra* note 4.

<sup>121</sup> Lawrence, *supra* note 116, at 676.

<sup>122</sup> *Id.*; see also Blum, *supra* note 114, at 799–800.

<sup>123</sup> See Anenson, *supra* note 4; see also Blum, *supra* note 114, at 800.

Massachusetts have refused to extend unclean hands to actions for legal damages.<sup>124</sup>

However, courts are not consistent in distinguishing between unclean hands and *in pari delicto*, or confining unclean hands to equitable actions. The modern trend is to disregard the difference between law and equity, and apply the doctrines regardless of the nature of the relief requested.<sup>125</sup> Anenson finds more recent decisions from California, Oregon, Maryland, Michigan, New York, Connecticut, and Rhode Island extending unclean hands to legal actions.<sup>126</sup> Anenson also identifies decisions from the federal courts of appeal and district courts in the Eleventh, Fourth, Ninth, Seventh, Sixth, and Fifth Circuits as extending unclean hands to purely legal actions,<sup>127</sup> with the Third Circuit refusing to do so.<sup>128</sup>

The law/equity split has particular relevance in the securities law context, as there has been some debate over the decades as to whether unclean hands, *in pari delicto*, or both defenses, may be available in a particular securities action. For example, in *Kuehnert v. Texstar Corp.*, the Fifth Circuit considered a Rule 10b-5 fraud case in which the defendant asserted both unclean hands and *in pari delicto*, arguing that the plaintiff's action was barred because the defrauded plaintiff himself intended to use the false information to defraud others.<sup>129</sup> The court held that both unclean hands and *in pari delicto* were available defenses, although application of the defenses was solely within the discretion of the trial court.<sup>130</sup>

The Third Circuit, less than a decade later, refused to consider unclean hands in a similar Rule 10b-5 fraud case on the basis that the plaintiffs sought only damages.<sup>131</sup> However, the court cited favorably to *Kuehnert* for the proposition that *in pari delicto* could—and under the facts of the case, should—bar recovery in a private action under Rule 10b-5.<sup>132</sup>

The United States Supreme Court addressed the situation in the following decade in two separate cases. The first, *Bateman Eichler, Hill Richards, Inc. v. Berner*, examined whether *in pari delicto* bars a private damages action under Rule 10b-5.<sup>133</sup> The Court held that it may:

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<sup>124</sup> Anenson, *supra* note 4, at 69.

<sup>125</sup> *Id.*

<sup>126</sup> *Id.* at 73–74.

<sup>127</sup> *Id.* at 89–90.

<sup>128</sup> *Id.* at 73.

<sup>129</sup> *Kuehnert v. Texstar Corp.*, 412 F.2d 700, 702 (5th Cir. 1969).

<sup>130</sup> *Id.* at 704.

<sup>131</sup> *Tarasi v. Pittsburgh Nat'l Bank*, 555 F.2d 1152, 1156 n. 9 (3d Cir. 1977).

<sup>132</sup> *Id.* at 1163–64.

<sup>133</sup> *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 301 (1985).

Accordingly, a private action for damages in these circumstances may be barred on the grounds of the plaintiff's own culpability only where (1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public.<sup>134</sup>

In *Pinter v. Dahl*, the Court extended the *Bateman Eichler* rule to a private action for rescission under Section 12 of the 1933 Act,<sup>135</sup> but also held that *in pari delicto* would only be appropriate where the plaintiff acted more as a promoter of the business rather than a mere investor.<sup>136</sup> Both cases adopted a traditional analysis of *in pari delicto*, emphasizing the requirement that the plaintiff's fault must be at least equal to the defendant's for the doctrine to apply.<sup>137</sup>

However, neither case clarifies whether *Bateman Eichler's in pari delicto* rule should extend to situations in which unclean hands may be an available defense. The rule, as articulated, would suggest that it does. "The plaintiff's own culpability"<sup>138</sup> is the trigger for both unclean hands and *in pari delicto*. But *Pinter* seemed to caution against equating unclean hands with *in pari delicto*:

Contemporary courts have expanded the defense's application to situations more closely analogous to those encompassed by the "unclean hands" doctrine, where the plaintiff has participated "in some of the same sort of wrongdoing" as the defendant. In *Perma Life*, however, the Court concluded that this broadened construction is not appropriate in litigation arising under federal regulatory statutes.<sup>139</sup>

Thus, while there is a clear rule for applying *in pari delicto* in federal securities fraud cases, the applicability and scope of the unclean hands defense is an open question. However, plaintiffs in securities fraud cases may seek either equitable or legal relief.<sup>140</sup> Indeed, for a defrauded

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<sup>134</sup> *Id.* at 310–11.

<sup>135</sup> *Pinter v. Dahl*, 486 U.S. 622, 633 (1988).

<sup>136</sup> *Id.* at 639.

<sup>137</sup> *Bateman Eichler*, 472 U.S. at 312–14; *Pinter*, 486 U.S. at 635–37.

<sup>138</sup> *Bateman Eichler*, 472 U.S. at 310.

<sup>139</sup> *Pinter*, 486 U.S. at 632; see *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134, 138 (1968).

<sup>140</sup> *E.g.*, *Pinter*, 486 U.S. at 627 (Plaintiffs sought the equitable remedy of rescission, as opposed to damages); *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1972) (Plaintiffs sought the legal remedy of damages and the equitable remedy of injunction); see Nicholas R. Weiskopf, *Remedies Under Rule 10b-5*, 45 ST. JOHN'S L. REV. 733, 751–52 (1971) ("[A]mple case authority exists for the proposition that the defrauded seller or purchaser may, at his option, seek rescission in lieu of such

investor, an action for the equitable remedy of rescission or a legal claim for damages should result in the same outcome if the securities are virtually worthless, such as in a pump-and-dump scheme.<sup>141</sup>

Therefore, under the *Bateman Eichler* rule, the focus should not be on the technical distinction between unclean hands and *in pari delicto*, but instead should be on the policy implications of permitting either defense. In *Bateman Eichler*, the Supreme Court recognized the policy concerns in applying *in pari delicto* to bar the securities fraud lawsuit:

We also believe that denying the *in pari delicto* defense in such circumstances will best promote the primary objective of the federal securities laws -- protection of the investing public and the national economy through the promotion of "a high standard of business ethics . . . in every facet of the securities industry." Although a number of lower courts have reasoned that a broad rule of *caveat tippee* would better serve this goal, we believe the contrary position adopted by other courts represents the better view.

To begin with, barring private actions in cases such as this would inexorably result in a number of alleged fraudulent practices going undetected by the authorities and unremedied. The SEC has advised us that it "does not have the resources to police the industry sufficiently to ensure that false tipping does not occur or is consistently discovered," and that "[without] the tippees' assistance, the Commission could not effectively prosecute false tipping -- a difficult practice to detect." . . . The *in pari delicto* defense, by denying any incentive to a defrauded tippee to bring suit against his defrauding tipper, would significantly undermine this important goal.

Moreover, we believe that deterrence of insider trading most frequently will be maximized by bringing enforcement pressures to bear on the sources of such information -- corporate insiders and broker-dealers.<sup>142</sup>

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damages."); Samuel W. Buell, *What is Securities Fraud?*, 61 DUKE L.J. 511, 517 (2011) (describing securities fraud's origins as connecting "to both law and equity jurisdiction").

<sup>141</sup> Weiskopf, *supra* note 140, at 752 ("Where securities purchased in a tainted transaction are worthless at the time of sale, the recovery of damages and the award of rescission will produce identical results- recovery of the full purchase price by the defrauded purchaser.") (internal citations omitted).

<sup>142</sup> *Bateman Eichler*, 472 U.S. at 315-16 (internal citations omitted).

Thus, *Bateman Eichler* establishes that the public policy behind securities fraud actions favors permitting fraud suits to move forward despite *in pari delicto* concerns.

But in the context of the marijuana industry, the competing policy of federal controlled substances enforcement complicates the analysis. As discussed in depth above, despite the enforcement restrictions imposed by Rohrabacher-Farr, use, distribution, possession, or cultivation of marijuana is illegal under federal law.<sup>143</sup> A court could recognize the competing federal policies at issue and defer to the basic maxim underlying either unclean hands or *in pari delicto* to dismiss the action: a court should not give comfort to a person engaged in unlawful conduct. However, it would not be unreasonable for a court to conclude that Rohrabacher-Farr is an expression of federal policy itself, and that to the extent the criminal conduct of the business enterprise is within the scope of Rohrabacher-Farr (for example, the business operates solely within the medical marijuana industry within the states or territories covered by Rohrabacher-Farr and in complete compliance with state law), the securities law policy priorities should control.<sup>144</sup> Thus, courts should clarify the extent to which unclean hands and *in pari delicto* apply as a matter of policy in such circumstances.

#### V. TOWARDS A CLEARER RULE FOR UNCLEAN HANDS AND *IN PARI DELICTO* IN SECURITIES LAW

In sum, investors in a marijuana-related business not only bear enhanced risks associated with accuracy and availability of information, but also enhanced legal risks that any claim for fraud deriving therefrom will not be allowed. Under current jurisprudence, perhaps the only clear outcome is that *in pari delicto* will bar a plaintiff who is an insider or promoter of the business from recovering.<sup>145</sup> Beyond that single factual determination, other factors that may play into the analysis are (i) whether the plaintiff pursues an equitable or legal remedy, (ii) whether the distinction between law and equity matters to the court, (iii) whether the business engages in the medical marijuana industry only or also in the

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<sup>143</sup> See Part III.

<sup>144</sup> See *Tarr v. USF Reddaway, Inc.*, 2017 U.S. Dist. LEXIS 216637, at \*14–16 (D. Or. Nov. 7, 2017). *Tarr* involved a wrongful death action in which the Oregon district court sat in diversity jurisdiction. *Id.* at 1. The plaintiff sought, inter alia, economic damages relating to the decedent's medical marijuana business operating legally under Washington law. *Id.* at 15. The defendant sought to bar the recovery on the basis that such a business is illegal under federal law. *Id.* The court allowed the plaintiff to proceed with the claim, stating, “[m]arijuana's legal status is unique. It is neither fully legal nor illegal. Because Tarr's family cannabis business is allegedly legal under Washington law, I conclude that in a diversity action, Plaintiff may recover economic damages based on projected profits from that business.” *Id.*

<sup>145</sup> *Pinter*, 486 U.S. at 639.

recreational segment, (iv) whether the business has fully complied with all state law requirements, and (v) the plaintiff investor's knowledge and belief as to all of the foregoing. Furthermore, because, the application of either unclean hands or *in pari delicto* is at the discretion of the court, there is a greater risk of conflicting decisions from district to district, or even judge to judge within a district.

Accordingly, the author believes that the courts should clarify and adopt a clearer rule for the application of unclean hands and *in pari delicto* in the securities law context, where the business is alleged to have engaged in conduct that is prohibited by law. The author would propose the following two-step rule that is, substantially, in line with current unclean hands and *in pari delicto* jurisprudence, but simpler in its application.

First, the court should ascertain whether the plaintiff was an insider, promoter, or active participant in the fraud; for instance, did the plaintiff have a duty to protect investors from the fraud perpetrated? If so, the plaintiff investor's claim should be barred. Such a rule is consistent with both *Bateman Eichler* and *Pinter*, and both federal securities and criminal law enforcement policies would be promoted by denying the investor a remedy.

Second, if the plaintiff investor was not under a duty to protect others from fraud—that is, the plaintiff was merely an investor in a business engaging in illegal activities—the court should determine whether the plaintiff investor at the time of the fraud was aware that the business was planning to engage in activities clearly prohibited by federal policy. Was the plaintiff investor willing to ignore the illegal nature of the business in the quest for profit? If so, the claim should be barred.

This second prong maintains the focus on the plaintiff's conduct. If the plaintiff willingly accepts the risk of participating in a clearly illegal business operation, then the plaintiff's objections to resulting investment losses are less concerning from a policy perspective. However, a truly innocent investor's claims should not be barred.

The second prong does require the court also to determine whether there is a clear federal policy on the matter. With regards to marijuana, a court should conclude that federal policy as to recreational marijuana is clear—there has been no legislative restriction on criminal enforcement of recreational marijuana businesses, and therefore, an investor who knowingly invests in a recreational marijuana business should be willing to bear the risk associated with participating in an illegal scheme. With regards to medical marijuana, Congress has established its preferred policy via Rohrabacher-Farr: the federal government's intervention in the medical marijuana industry should be limited. Therefore, innocent

investors in the medical marijuana industry should be allowed to proceed with their security fraud claims.

While the foregoing test does not necessarily establish a true bright-line for courts to apply, it does at least eliminate the need to distinguish between unclean hands and *in pari delicto*. Furthermore, it provides direction on how courts should weigh investor culpability in light of competing policy provisions, which is where the true analysis under both unclean hands and *in pari delicto* lies. It also encourages promoters or insiders to share information about the nature of the business with investors by including more explicit disclaimers to any investment solicitation materials. An investor ignoring such a warning does so at his or her own peril. Lastly, even though the rule as articulated above is examined in light of federal marijuana policy, it could be easily adapted to any number of situations in which federal law enforcement policy may conflict with federal securities law—conflicts that can be remedied by clear action on the part of lawmakers.

In sum, the rule protects truly innocent investors whose culpability stems from inconsistent enforcement and lawmaking by policymakers. It does not protect investors who blatantly ignore consistent federal policy, nor does it protect persons who are truly culpable in the fraud itself.

#### CONCLUSION

Marijuana is criminally illegal. That a majority of states now permit marijuana sales in some form does not change that fact. Furthermore, federal limitations on prosecution in those states do not extend to private actions between industry participants. Accordingly, investors in marijuana-related businesses—criminal enterprises under federal law—bear the risk that any action for securities fraud may be barred by the doctrines of unclean hands and *in pari delicto*.

However, federal lawmakers bear some blame in creating such a situation, by their failure to legislatively articulate a clear and consistent policy with regards to marijuana. Marijuana is criminally prohibited, but federal law enforcement cannot use any funds to interfere with state medical marijuana programs. Thus, it is no surprise that investors would assume that securities fraud claims would not be barred.

Courts, therefore, should clarify existing case law with regards to unclean hands and *in pari delicto* in the securities fraud context. While previous United States Supreme Court cases have permitted claims to proceed where federal securities law policy was supported, those cases did not have to weigh competing federal law enforcement priorities against securities law priorities. In the marijuana-related business context—or in any context where the business is engaged in activity prohibited by federal

law—courts must consider the totality of federal policy in determining whether to permit the action to proceed.

The author proposes a two-step analysis. First, was the plaintiff investor an insider, promoter, or participant in the fraud, such that the plaintiff was under a duty to protect other investors from the fraud? If so, the claim should be dismissed, consistent with current law. Second, was the plaintiff investor at the time of the fraud aware that the business was to engage in activities clearly prohibited by federal policy? If so, the action should be barred. If not, the action should proceed.

In the marijuana context, Congress has established a clear federal policy as to recreational marijuana: it is criminally illegal to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, marijuana, and Congress has not otherwise restricted enforcement of this statute. Accordingly, investors in marijuana-related businesses engaged in the recreational marijuana industry should be prohibited by the unclean hands or *in pari delicto* defenses.

However, Congressional policy is not clear as to medical marijuana, as the Rohrabacher-Farr appropriations amendment prohibits prosecution or other Justice Department action against participants in state-authorized medical marijuana programs. Because of this Congressional action, the stated federal policy is non-intervention in the medical marijuana industry. Consistent with such policy, investors in marijuana-related businesses subject to Rohrabacher-Farr protections should be permitted to pursue federal securities fraud claims.