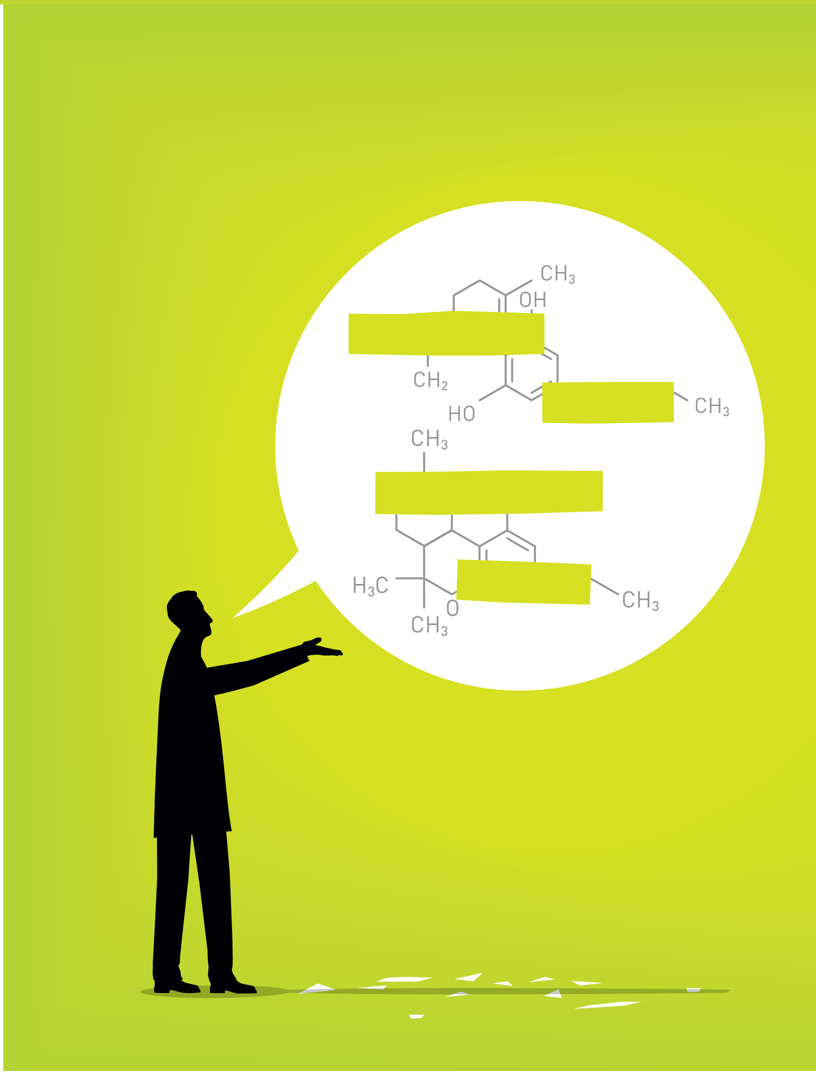


Cannabis Conundrum

Cross-border intellectual property licensing for cannabis businesses

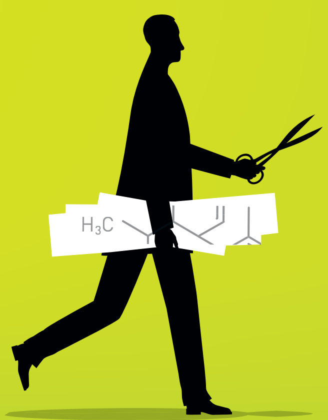
BY STACIA LAY

More than six years after Washington state voters approved I-502, the initiative that legalized the production and sale of marijuana, the state's legal and regulatory framework for cannabis continues to experience growing pains and uncertainty. Take, for example, the licensing of intellectual property rights in connection with the production and branding of cannabis products. This issue has recently received attention in Washington courts and the Washington Legislature. While some clarity may be on the horizon with respect to this issue, unanswered questions will likely remain, including the impact that cross-border license agreements might have on the tenuous federal-state détente regarding the legality of marijuana.

THE *HEADSPACE* TRADEMARK CASE

In January 2017, California entity Headspace International LLC sued, among others, Podworks Corp., a Washington cannabis business, in Washington state court alleging trademark claims under Washington law. Headspace, as an out-of-state entity, was not and could not be a marijuana business licensee under Washington's cannabis licensing framework. As a result, Headspace did not use its trademark on any cannabis products of its own in Washington. Instead, Headspace based its trademark claims in Washington on its agreement with a cannabis business that is licensed to operate in Washington, X-Tracted Laboratories 502, Inc. Under that agreement, Headspace licensed to X-Tracted its trademark and its "proprietary chemical process to create highly refined essential plant oils." X-Tracted, in turn, used the process and trademark in the production and branding of cannabis products in Washington.

In the trial court, Podworks successfully moved to dismiss Headspace's claims. Podworks argued in part that because Headspace could not, as an out-of-state entity, be lawfully involved in the production and sale of marijuana in Washington, it couldn't demonstrate the lawful use of its mark in commerce in Washington, which is necessary to establish trademark claims. The trial court agreed that Headspace had not alleged any trademark claim based on its mark having been lawfully placed in commerce in Washington. On that basis, the



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court dismissed all of Headspace's claims.

The Washington Court of Appeals disagreed, concluding that Headspace's allegation that it had, in fact, made use of its trademark in commerce in Washington via its licensee's (X-Tracted) use of the trademark on cannabis products was sufficient, at least at this early stage of the case. *Headspace Int'l LLC v. Podworks Corp.*, 5 Wn. App. 2d 883 (2018). As to whether that use was lawful given Headspace's status as an out-of-state entity, the court concluded that the licensing arrangement as alleged was lawful, rejecting various arguments to the contrary by Podworks.

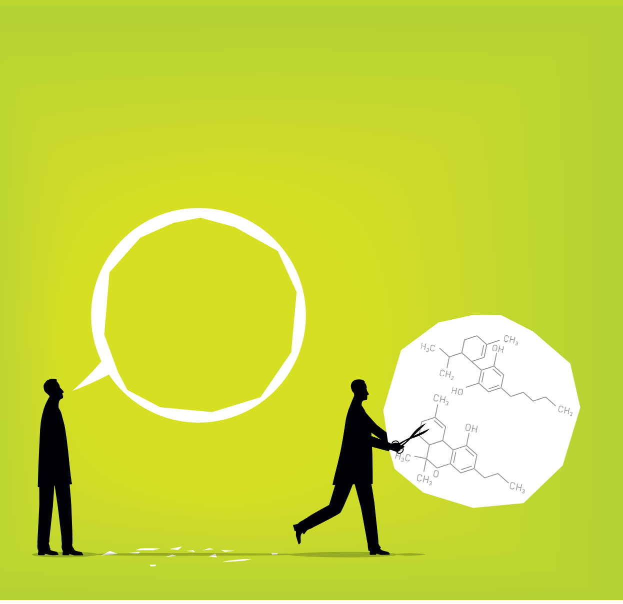
Among other things, Podworks argued that to be a valid trademark license, Headspace's agreement with X-Tracted would require Headspace to exercise such control over the quality of X-Tracted's cannabis products that Headspace would be a "true party of interest" of the Washington cannabis business. Washington's cannabis licensing framework requires all "true parties of interest" to be vetted by the Washington State Liquor and Cannabis Board (LCB) and listed on a marijuana business's license. "True parties of interest" include, among others, those receiving or having the right to receive a percentage of the profits from the marijuana business. But the appellate court rejected the argument that a trademark licensor's control over the quality of the goods on which the licensed trademark was used necessarily made the licensor a "true party of interest" in its licensee's cannabis business. Notably, the court commented that if the license agreement (which was not provided in connection with the motion to dismiss) specified that Headspace would receive a percentage of X-Tracted's profits, Headspace would be a "true party of interest" in cannabis licensee X-Tracted. But the court found the allegations of Headspace's complaint to be consistent with the theory that the license agreement did not provide for such profit-sharing.

Podworks sought review by the Washington Supreme Court, arguing that to permit a cross-border agreement such as California entity Headspace's license agreement with a Washington cannabis business conflicted with Washington's cannabis regulatory framework, which was carefully drawn to avoid conflict with federal law by, for example, precluding legal marijuana activities from crossing state borders. In early March 2019, the Washington Supreme Court declined to hear the case.

Federal stance on marijuana enforcement

In an August 2013 memorandum to U.S. Attorneys known as the "Cole Memorandum," Deputy Attorney General James Cole outlined federal enforcement priorities with respect to marijuana. In the view of the Cole Memorandum, cannabis businesses that are subject to strong and effective state regulatory and enforcement systems are less likely to implicate federal enforcement priorities. Therefore, the memorandum, despite having no impact on the illegal status of marijuana under federal law, provided some assurance to cannabis businesses complying with state law that wide-scale federal enforcement actions were not in the offing.

That assurance was questioned in January 2018, however, when then-Attorney General Jeff Sessions rescinded all previous marijuana-specific nationwide enforcement guidance, including the Cole Memorandum. But Sessions' 2018 memorandum didn't explicitly repudiate any of the previous guidance on marijuana enforcement. Rather, it concluded that such additional guidance was unnecessary, as prosecutors should "follow the well-established principles that govern all federal prosecutions," which require prosecutors to "weigh all relevant considerations" when making prosecution decisions. Thus, while the rescinding of the Cole Memorandum understandably raised concerns in the legal cannabis industry, it appears to have had little practical impact on the federal government's generally hands-off approach to cannabis businesses that are complying with state laws that are consistent with federal enforcement priorities.



CANNABIS IP LICENSING AND THE LEGISLATURE

In 2017, the Washington Legislature weighed in on the issue of intellectual property license agreements for cannabis businesses with a new provision codified at RCW 69.50.395. This provision explicitly permits licensed marijuana businesses to enter into such agreements in particular circumstances—for example, for the license of trademarks registered under federal or Washington state law. The new provision also required that the agreements be disclosed to the LCB. This new provision was cited in the *Headspace* case, with the appellate court rejecting the argument that adoption of the provision meant, by implication, that intellectual property license agreements were prohibited before it was adopted.

It remains unclear what effect, if any, the specter of cross-border licensing of intellectual property among cannabis businesses will have on the lurking legal conflict between federal law and state law on the treatment of marijuana.

Although the new statutory provision clears up the confusion surrounding whether Washington marijuana businesses are barred from entering into agreements licensing intellectual property in connection with cannabis products, it leaves a number of questions unanswered, such as:

- What role will such agreements play in the LCB's exercise of its authority in licensing and regulating Washington cannabis businesses?
- How much control and what kinds of control mechanisms over the quality of the licensed party's cannabis products make the intellectual property licensor a "true party of interest" in the licensed party?
- Will any payment structure tied to sales in a license agreement make the intellectual property licensor a "true party of interest" in the licensed party, thereby effectively limiting the payment mechanism to a flat-fee arrangement?

Although the LCB was tasked with adopting regulations to flesh out RCW 69.50.395, no such regulations have yet been adopted, and draft regulations have raised concerns in the cannabis industry. However, new legislation passed by the Washington Legislature and signed by Gov. Jay Inslee on May 13, 2019, answers at least some of the questions left open by the 2017 statute and the absence of implementing regulations from the LCB. ESHB 1794 amends RCW 69.50.395 and, at least according to some supporters, fleshes out the details of the intent behind the 2017 provision. Among other things, the amendment:

- Permits a license agreement for a trademark registered under federal or Washington law, or under any other state or international trademark law;
- permits intellectual property license agreements to provide for a royalty fee based on sales of the product using the intellectual property, provided that the royalty fee doesn't exceed 10 percent of the licensee's gross sales from the product;
- permits the contracting parties to grant exclusive rights to the intellectual property;
- permits the licensor to impose quality-control standards to preserve the integrity of the intellectual property; and
- permits assignment of the licensor's improvements of the intellectual property.

And perhaps most notably, the amendment provides that if the parties to the agreement comply with all the requirements set forth in the amendment, the intellectual property licensor is not required to qualify as a marijuana business licensee (e.g., a "true party of interest") for purposes of the agreements authorized in the amendment.

THE FUTURE OF CANNABIS IP LICENSE AGREEMENTS

The amendment to RCW 69.50.395 provides some certainty as to a number of the open questions mentioned above. It allows more flexibility in the payment arrangements specified in intellectual property license agreements for cannabis businesses by permitting a limited royalty rate based on sales, a more typical payment mechanism for such agreements. It also permits the rights owner to impose quality controls over use of its intellectual property to protect those rights, a vital component of, for example, trademark license agreements. The amendment's authorization of license agreements for international trademarks also opens up possibilities for Canadian businesses, which have enjoyed robust growth due to that country's recent legalization of cannabis on a nationwide scale. And perhaps most importantly, the amendment permits agreements containing such terms without requiring the intellectual property rights owner to qualify as a marijuana business licensee under Washington's strict cannabis licensing framework.

But new questions will undoubtedly arise even with passage of the amendment. In particular, it remains unclear what effect, if any, the specter of cross-border licensing of intellectual property among cannabis businesses will have on the lurking legal conflict between federal law and state law on the treatment of marijuana. Previous guidance from the U.S. Department of Justice relating to that conflict stated that federal law enforcement priorities were focused on issues such as preventing revenue from marijuana sales from going to criminal enterprises, gangs, and cartels; preventing the diversion of marijuana from states where it's legal to states where it's not; and preventing state-authorized marijuana activity from being used as a pretext or cover for other illegal activity or other illegal drug trafficking. As long as states that have legalized marijuana implement strict regulatory and enforcement mechanisms, the Justice Department indicated that activity in compliance with those mechanisms is less likely to threaten these federal enforcement priorities and, therefore, require federal action. Although that guidance was rescinded by former Attorney General Jeff Sessions in January 2018, the principle it espoused has not appeared to change. It remains to be seen, however, whether the possibility of cross-border license agreements between cannabis businesses will have any impact on the current stay of the federal enforcement hand. NWL

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