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**Re: Kuburovich vs. California - DA Forensic Accounting Report**

## Background

On December 9th, 2010, the Santa Clara County Specialized Enforcement Team (SCCSET) executed a search warrant at three business locations, one office, and three personal residences of individuals connected to the Medileaf Medical Cannabis Dispensary (Medileaf). (See Report 10-5551, Supplement 12.) Medileaf had been organized as a mutual benefit non-profit corporation, a cooperative, pursuant to California state law and had been in operation since June 2009. The financial information seized in the search was provided to Taver Chong (Chong), an employee of Santa Clara County District Attorney. Chong prepared reports titled "Forensic Accounting Interim Report and Forensic Accounting Report." (See Exhibits 6 & 7) The reports summarize financial activity and purport to support alleged narcotic crimes and associated violations against Medileaf and its directors.

## Forensic Report

The first and perhaps most important rebuttal we will argue is that Chong's report does not appear to support the charges filed by the Santa Clara County District Attorney and does not make a supportable case that any crime or malfeasance was committed or that Medileaf produced any "Profit" (as proscribed by SB 420 and defined by California Corporations Code Section 12201). The Chong report asserts that improprieties arise from the approximately $20,000 of questionable expenses. In addition, the report criticizes Medileaf's bookkeeping and internal control environment without stating specifically what those deficiencies were or how the asserted control deficiencies violated SB 420 or Prop 215 and give rise to criminal behavior (See Final Forensic Accounting Report page 11, 12, & 13).

We also note the report includes several significant omissions and misstatements which overstate Medileaf's favorable results of operations particularly with respect to the assertion that key personnel benefitted from Medileaf funds. As this discussion and analysis will point out, the operations of Medileaf very likely returned a loss and not a profit for the period analyzed by Chong. To the contrary, outside parties and key personnel loaned Medileaf substantial funds to operate, which were not repaid. This report will discuss facts and circumstances showing that Chong's report cannot be used to represent the economic reality of Medileaf operations, to understand meaningful internal controls, or to support an assertion of legal non-compliance.

The Chong report does not allege any misconduct by the Medileaf principals or employees beyond the unsupported assertion that there were material weaknesses in internal control, possible excessive payments, and nepotism. The report merely raises the possibility that key employees may have benefitted unjustly from Medileaf. The report's conclusions do not allege that any crime was committed or even provide support for the charges filed. In his implied presumption of "Profit", Chong fails to consider, address, explain, or account for material front end organization and startup costs, servicing of business debts, does not present evidence to support implied improper distributions to founders and principals and/or their related entities, and challenges the basis of Medileaf's status as a non-profit collective because of alleged and unsupported weaknesses in its internal control environment. Additionally, the report attempts to rely on the incomplete recording of payments to collective members for medicine (Major Bookkeeping Issue, - page 8) as a basis to disqualify the protections of the law. We will discuss and rebut these assertions more fully in the comments that follow.

During the search warrant execution, the SCCSET interviewed employees and principals. The SCCSET member's questions emphasized the structure of the business as a Profit generating entity and Chong piles on with the assertion that compensation paid to principals and employees was excessive. (See Gilroy Police Incident Report #10-5551 Supplement 6, page 8 and 9.) In addition, Chong's report details payments to principals and related controlled third party vendors for services and for work performed, (see Forensic Accounting Interim Report page 4 - 7). This discussion will argue that the entity was never profitable and will discuss the definition and role of "Earnings" and "Profit" in the not-for-profit collective/cooperative setting and that payments made to key employees and related party vendors were for reasonable business expenses.

Chong's report can be viewed as a misguided attempt to reach an opinion from an incomplete set of books that would give rise to a finding of Profit pursuant to the Jackson case (discussed more fully below) where, "*...if fairly complete financial records are not maintained, especially when combined with a high volume of business, a trier could reasonably conclude the organization is operating for profit*". Chong did not make an effort to understand what the missing pieces might be that would bring clarity to the related incomplete financial statements he generated from the incomplete QuickBooks files.

The Chong report also asserts that conditions were ripe for the unjust benefit of key personnel who had check signing authority. It is instructive to be mindful that this check signing authority was over funds advanced by the same intimately associated group of founders who would have no incentive to steal from themselves. To be meaningful, internal controls must relate to actual risks. Patient members are not at risk for business losses. Members are free to move on and use any other dispensary source to obtain their medicine. It is disingenuous to argue that member patient interests were compromised by weaknesses in internal control. Chong does not detail how the control environment fails to meet the guidance of SB 420 or Proposition 215.

Chong's report admits the books are not complete, but asserts that this is part of the inadequate internal control environment. What is more likely is that the books were seized in the middle of an accounting cycle and before complete transactions were entered. Our analysis (see Exhibit 1) of these incomplete books finds that the needed broad brush missing and correcting entry to clean up these books was the recording of the cost of consigned inventory that would clear the negative balance in the vendor payable account and charge operations for the related cost of goods sold (see further discussion of this incomplete bookkeeping matter in the following section - Major Bookkeeping Issues). It is a fact that most small businesses keep books on a "need to know" basis and rely on outside professionals to make adjustments when needed to produce supporting financial statements for taxes, banks, regulators, investors, etc. For many small entities, books are finalized and closed on an annual basis prior to preparing annual income tax returns. Chong also asserts that US Generally Accepted Accounting Principles (GAAP) were not consistently utilized and that somehow that is a deficiency and is disqualifying. It should be noted that SB 420 and Prop 215 do not mandate GAAP accounting. Further, GAAP is not consistent with the tax basis of accounting which is an absolutely required convention for purposes of income tax compliance and likely sufficient for any other dispensary purpose.

Chong's report cites internal control deficiencies including accountability, separation of duties, conflicts of interest, lack of due care, nepotism, and a high volume of cash transactions (See Forensic Accounting Report, page 11 & 12). Management and the board of directors took reasonable steps to be accountable to members such as making a copy of the bylaws on the front desk at all times and publicizing how members can participate with the board of directors. Members typically have very little interest in dispensary operations beyond good advice, fair prices, and quality medicine. Member interests and accountability to members is discussed more fully in the comments that follow.

Chong also cites nepotism and a high volume of cash transactions as added risk. The BusinessDictionary.com defines Nepotism as follows:

> *Practice of appointing relatives and friends in one's organization to positions for which outsiders might be better qualified. Despite its negative connotations, nepotism (if applied sensibly) is an important and positive practice in the startup and formative years of a firm where complete trust and willingness to work hard (for little or no immediate reward) are critical for its survival.*

While it is true that relatives and friends were employed, Chong does not show that this practice was detrimental to any third party stakeholder or member or would give rise to any criminal activity. A high volume of cash (currency) transactions and related custody issues are inherent to cannabis dispensaries and the existence of cash does not by itself indicate any impropriety. Medileaf maintained adequate records to account for sales, including those sales paid for with currency, and all sales were properly recorded in their books. There is no evidence that any significant losses or conversions resulted from lack of controls over cash or other assets. Cash over/short discussed later was found not to be material.

For Chong's final point, lack of due care, he asserts that accounting and bookkeeping problems put the entire operation at risk by creating inaccurate records that put all assets at risk and allowed a criminal risk due to misreporting of tax. However, as mentioned prior, the books were not final when seized. Per book entry classifications are subject to change in a final closing, often with the aid of a tax accountant so as to true up the records prior to tax return filing. It is a fact that Goyko Kuburovich's sister is a CPA and was available and willing to help Medileaf make necessary adjustments to their books. Management should not be punished for the status of interim uncompleted bookkeeping seized without notice that are then asserted to be the major reason for denial of protections of the law.

It is also important to be mindful that known costs such as debt servicing and startup costs are not included in Quickbooks. We estimate that the startup costs for three dispensaries and a significant grow operation could exceed $1,000,000. (See Medileaf startup budget and grow spreadsheets per Exhibit 5.) It would be logical to assume that this funding could only be repaid through successful operations of Medileaf, which would seek to replace this third party funding with equity generated by earnings of Medileaf over time. We do not believe that SB 420 intended that a not-for-profit dispensary would be precluded from earning sufficient returns be able to repay startup debt.

Medileaf debt is further evidenced by a separate summary worksheet not generated by Quickbooks, noting $160,000 in indebtedness, as well as check payments with memos alluding to outside debt service. See item # 73428-005437 & Forensic Accounting Report Pg. 3. In addition, debt proceeds are evidenced by 2 checks from a separate business account owned by Medileaf Principal, Batzi Kuburovich. The checks totaled $144,812, were deposited into Medileaf's account, and were labeled "loan." Moreover, startup costs incurred to develop and establish each storefront, as well as to purchase equipment for product cultivation were not considered for purposes of Chong's report, but our estimates of these costs are detailed per Exhibit #5. Startup costs for purchase of cultivation equipment exceeded $526,000, which are depreciated, (deducted), over the useful life of the asset. The useful life of most non-real estate assets is three to seven years. The impact of storefront development cost and related absorption is material to Medileaf operations. The operating statement cannot be considered complete without a provision to absorb development cost depreciation expenses. Also, the balance sheet cannot be considered complete without recording these assets and the related debt obligations associated with their acquisition.

The report section titled "Cash" provides an incomplete summary of cash deposits and withdrawals. See Forensic Accounting Report page 8. Cash in the form of currency is a prevalent form of liquidity in the cannabis industry. Due to Federal restrictions prohibiting banks from working with cannabis businesses, dispensaries generally deposit minimum currency into a bank account. Keeping currency deposits at a minimum helps avoid account termination. Typically, this undeposited currency is used to fund medicine purchases among other expenses. The banking system is essential to process checks, and minimizing the risk of being disinvited from a bank is a prudent business practice.

**Cash**

Chong's report lists certain cash transactions from Medileaf and related bank accounts. Checks written to cash were very possibly used to fund medicine purchases. Chong makes no allegation of impropriety with respect to the cash activity discussion.

The most significant cash activity listed by Chong are from the accounts of Kristel Kuburovich and his report implies but falls short of alleging any impropriety related to these sizable deposits. Our analysis of these accounts indicates that the two wire transfers into the account in the amount of $356,640 were from third party loans, proceeds of which were used to purchase property for Medileaf operations and to advance working capital funds, also for the benefit of the collective. Additional deposits to the business account of $152,000, cited by Chong over 5 months and made after December 31, 2009, are from various sources which we did not investigate, other than to determine that they did not appear as QuickBooks disbursements to her account during the period except for a single check payment in the amount of $445. (See Exhibit 2.)

**Compensation: Key Employees**

Wages were paid to the principals and workers as compensation for services rendered. The report suggests Medileaf was ripe for financial malfeasance and questions the business purpose for payments to key employees and board members. The salaries mentioned are ordinary for the region and are a reasonable wage to receive for work performed. Mr. and Mrs. Kuburovich worked full-time from the inception of the entity in October 2009 until its closing and were paid a salary for only a few months of their work. Aside from wages, Mr. and Mrs. Kuburovich did not receive any other significant compensation payments from Medileaf. Thus, the average wage for 14 months of work was far below the average local wage. For example, Mr. Kuburovich was paid an average of $1,054 per month. Mrs. Kuburovich was paid $1,249 per month. The average wages per Chong's report are summarized below.

Caregivers who operate, or are employed by dispensaries are allowed to receive reasonable compensation for their time and services. The law does not prevent a collective or dispensary principal/member from drawing a salary. For analysis, salaries paid to directors and workers are listed in Schedule 1 below.

Schedule 1, (See Forensic Accounting Interim Report, page 4 to 6)

| Key Employee Payments From October 2009 to December 2010 | | |
|---|---|---|
| Employee | Amount Paid | Reason |
| Goyko (Batzi) Kuburovich | $14,753 | Compensation |
| Goyko (Batzi) Kuburovich | $8,159 | Compensation |
| Patricia (Patty) Kuburovich | $17,484 | Compensation |
| Neil Forrest | $65,016 | Compensation |
| Kristel | $10,700 | Compensation |

Bruce Ziegelman served as the controller and development coordinator for Medileaf. He served as the principal of each company listed below. For example, El Toro Partners provided various admin, bookkeeping, and purchasing functions. In addition, Security Ventures provided on-site security personnel. The expense paid for each service appears reasonable in the context of business activity. Mr. Ziegelman drew compensation from El Toro Partners, LLC. Thus, $90,262 is reasonable for his work as an entity controller and development coordinator.

Schedule 2

| Vendor Payments From October 2009 to December 2010 Bruce Ziegelman Related Activity | | |
|---|---|---|
| Vendor | Amount Paid | Reason |
| Bruce Ziegelman | $9,343 | Medileaf Controller Compensation |
| El Toro Partners, LLC | $80,919 | Admin, Controller Compensation |
| New Concept | $22,861 | Office Furniture |
| Security Ventures | $110,335 | Onsite Security Personnel |
| ZF Associates | $61,630 | Bookeeping and Financial Services |

The report section titled "Questionable Expenses" summarized expenses in "BD expenses" per Quickbooks. "BD" expenses may mean "Board Expenses." The expense included trips to Lake Tahoe and Hawaii. The expense included airfare, hotels, and Cirque de Soleil tickets. The total expense, per report, for the trips was approximately $9,000. In addition, Medileaf spent more than $8,000 at restaurants on 72 occasions. However, the internal revenue code defines allowable expenses as "ordinary and necessary" to business operations. Expenses to attend business conventions for the purpose of developing business relationships, meeting with suppliers, staff training, and meals and entertainment with business associates are deductible business expenses when related to business activity. Expenses for two events were mentioned in Chong's report. A dinner at a Mexican restaurant for $1,132 on 4/19/10 and airfare and hotel accommodations to Hawaii. Medileaf management has advised us that both events were ordinary and necessary for operations. The dinner on 4/19/10 was a thank you for all Medileaf board members, employees, volunteers, and vendors. The event was held in anticipation a trade show in South San Francisco in which Medileaf sponsored a booth. The dinner was attended by over 30 people who were associated with Medileaf. (See Exhibit 5 for restaurant menu and photos). The trip to Hawaii was the first annual board member retreat. A meeting agenda and minutes were prepared but were seized in the police raid.

Another expense the report listed was $4,000 spent on gas. Since this was the only remuneration received for the use of various personal autos in the business at $0.50 per mile this equates to roughly 8,000 equivalent miles for say a year, for three dispensaries for roughly 650 miles a month which we would argue is reasonable. These various expenses deemed questionable by Chong are, in our opinion, reasonable and necessary for Medileaf operations particularly when viewed in light of the minimal compensation paid to key personnel. With total Medileaf revenue exceeding $1.5 million, a total of approximately $20,000 in questioned expenses is too small of an amount to be considered significant. The questionable expenses do not provide a large enough benefit to anyone to be considered malfeasance or even inappropriate.

**Major Bookkeeping Issues**

The most serious and significant bookkeeping problem Chong describes is that a debit to the "Growers Payable" account is booked for each sale. Chong says the debits are not applied against any existing "Growers Payable" credit balance and, accordingly, the Growers Payable account nets to a substantial debit balance. According to Chong -

> *"The most serious and significant GAAP departure has to do with how sales are booked in the general ledger. A debit to Growers Payable is booked for each sale. But these debits are not applied to existing accounts that need to be paid, resulting in a significant negative (debit) balance for accounts payable."*

Our detailed analysis of this anomaly pointed out by Chong finds that the needed missing and correcting entry to clean up these books was the recording of consigned inventory sold that would clear the negative balance in the vendor payable account and charge operations for the related cost of goods sold. However, there is more to the picture to fully understand what was going on with the bookkeeping. Prior to March 10, 2010, when sales were entered, a debit entry was made to the Growers Payable and an entry was made entering the product into inventory asset. When the Grower was paid, a credit entry was made to accounts payable, a debit to cash, a credit to inventory asset and a debit to COGS. This effectively completes and books up the transaction. Beginning in March, only partial entries were made which did not include cost of goods sold and the related reduction of vendor payable accounts. An entry was made in April to catch up the March activity consistent with Jan-Feb. Thereafter, this part of the entry was not made, giving rise to the anomaly recognized by Chong. (See the attached Exhibit 1 with Chong's accounting together with the entries made to finalize and correct the books.)

Chong notes that sales taxes payable are booked correctly, indicating that gross sales are properly recorded.

Chong also notes that daily cash register reconciliations are over or short by large margins. Our review showed total over or shorts included 5 instances of > $100 for a total of $1,531.94 and all the rest combined < $100 reported per Quickbooks. Most of the large over/shorts had been marked for review by management. The two largest were for $900 and $2,000 and were likely for medicine purchase payments that did not get recorded as part of the daily closeout/deposit.

**Minor Bookkeeping Issues**

Chong also notes that intercompany receivable and payable accounts do not match. We prepared a chart to show the discrepancies, (See Exhibit #6). This is a matter that would likely have been dealt with in a normal close and update where intercompany balances would be reconciled to each other. Substantial work remained to update the books to the date Medileaf operations ceased. However, this is a common situation for small entities and does not violate SB 420 or Prop 215.

**Conclusion:**

It is our opinion that Chong's report is misleading and does not accurately present the net financial position, the results of operations, or key employee and officer compensation for Medileaf and should be disregarded. The report omits consideration of significant known costs because the data analyzed is clearly incomplete. As the principals and employees interviewed by the SCCSSET explained, Medileaf was likely generating losses on a monthly basis which is consistent with our analysis on the attached Exhibit 1. (See Gilroy Police Incident Report #10-5551 Supplement 6, page 8 and 9.) Mr. Kuburovich founded Medileaf and worked full-time for the duration of operations but was only paid for several months of work. No evidence that he received excessive benefits or compensation was noted in Chong's report. The facts and circumstances show that the entity was legally entitled to generate

Earnings but was likely operating at a loss and, accordingly, could not have had Profits.

**Revenues, Expenses, Earnings, and Profits for Cooperatives**

*Jackson Case as a Test of Presumed Profitability*

The People v. Jovan Jackson, which occurred in 2012, outlined guidance to determine valid cooperative or collective operations under SB420. Specifically, a dispensary would have to show that its membership consists of qualified patients, that its members collectively associate to cultivate and dispense marijuana, and that the dispensary is not engaged “for-profit.” To determine for-profit status, the jury was directed to consider the size of the dispensary’s membership, the volume of purchases from the dispensary, the member’s participation in the operation and governance of the collective, the testimony of the operators of the collective, its formal establishment as a nonprofit organization, and presence or absence of any financial records, the presence or absence of processes by which the collective was accountable to its members, and any other evidence of profit or loss. Also, when a lack of fairly complete financial records and accountability to members exists, especially when combined with a high volume of business, a trier could reasonably conclude the organization was operating for profit.

Operations permitted under SB420 must be considered in the context of the above factors, with no single factor governing the outcome. Medileaf was established with the intention to operate within the protection of SB420 and reasonably met the listed factors. Accordingly, Medileaf was established as a mutual benefit non-profit corp. The bylaws outlined membership accountability mechanisms. Medileaf maintained a record of its members, provided membership materials, and provided accountability with its membership. The members were offered opportunities to participate in dispensary governance and a yearly financial report was available. In addition, operational information was available to members at all times. Each member was entitled to receive an annual financial report, was entitled to vote, and receive notice of special member meetings.

Perhaps more important than financial accountability, Medileaf was also accountable to membership by implementing best practices to provide high quality medication to meet a wide range of medical needs. Per Yelp customer reviews, Medileaf maintained a well-lit entry lobby and sales area with medicine clearly labeled, all medicine tested, and prices clearly marked. Further, accountability was evidenced through caring, personable, and knowledgeable bud-tenders. The bud tenders were known for describing the benefits and alternatives of the different types of cannabis strains and other medicines so that members could make informed decisions regarding medication choice. Members had a choice of lab-tested diverse cannabis options as well as other forms of medicine. Medileaf received positive comments regarding medicine choice, appearance, and effectiveness. Thus Medileaf remained accountable to member interests by providing a safe, welcoming, well-resourced, and informative environment to purchase medication.

Jackson indicates that if fairly complete financial records are not maintained, especially when combined with a high volume of business, a trier could reasonably conclude the organization is operating for profit. Medileaf had an accounting system and qualified staff in place to produce quality reports and it is reasonable to assume that it would produce necessary records on a timely basis when needed. However, the expectation that books should be complete for 2010, at the time of the unannounced surprise records seizure, is not reasonable because most small entities do not keep contemporaneously updated books due to limited accounting resources and lack of need. Small entities do not have systems in place to update books as often as larger entities. To most small entities, the most relevant deadlines are income tax filing deadlines, which at the time of the raid were still several months away and with allowable extensions almost a year away. Also, per Medileaf bylaws, annual reports would be available to members 120 days after year end. However, the raid occurred on December 9th, 2010. Thus, Medileaf books had not been updated at the time of the seizure. Moreover, due to the size and limited resources, presentation of completed books is an unreasonable expectation for the 2010 calendar year. It is instructive to note that income tax returns were filed for the year 2009 and bookkeeping completed for Medileaf's initial year of operation.

*Cooperatives Must Not Operate "For Profit"*

The Medical Marijuana Program Act (SB420) allows the use of cooperatives under H&S §11362.775, and does not allow them to operate "for profit" (see H&S §11362.765(a)). However, there is no guidance as to what "for profit" means for this purpose in SB420.

To better understand the meaning of the prohibition of "profit" in the context of a cooperative corporation, it's necessary to examine the California Corporations Code (Corp Code) that cooperative corporations allowed by SB420 must follow.

In like manner, Corp Code §12201 also disallows a cooperative from operating for profit, as it states that cooperatives are "not organized to make a profit for themselves, as such, or for their members, as such, but primarily for their members as patrons." (By way of example regarding patronage, in the context of profits for patronage, a cooperative can return "profits" earned on sales of oranges to the patrons that sold their oranges to the coop. This concept does not apply to a medical cannabis cooperative as patrons do not organize to sell their products, only to purchase medicine.)

*"Earnings" vs "Profits"*

Corporate Code §12201 distinguishes between earnings and profits and states that "The earnings, savings, or benefits of the corporation shall be used for the general welfare of the members...of the corporation, in the form of cash, property, evidences of indebtedness, capital credits, memberships, or services." It is also instructive to note that the California Attorney General Guidelines promulgated in response to SB 420 (See Exhibit 2 – page 8) states-

> *Cooperative corporations are "democratically controlled and are not organized to make a profit for themselves, as such, or for their members, as such, but primarily for their members as patrons." (Id. at § 12201.) The earnings and savings of the business must be used for the general welfare of its members or equitably distributed to members in the form of cash, property, credits, or services.*
>
> *California law does not define collectives, but the dictionary defines them as "a business, farm, etc., jointly owned and operated by the members of a group." (Random House Unabridged Dictionary; Random House, Inc. © 2006.) Applying this definition, a collective should be an organization that merely facilitates the collaborative efforts of patient and caregiver members including the allocation of costs and revenues. As such, a collective is not a statutory entity, but as a practical matter it might have to organize as some form of business to carry out its activities.*

An article written by David Gurnick provides further context on cooperatives and has been cited in several court decisions. Gurnick noted that profits are permissible as long as the business was conducted primarily for the members' mutual benefit. (See Exhibit #3, Gurnick, Consumer Cooperatives: What They Are and How They Work (July/Aug 1985) L.A. Lawyer, p. 24) Our analysis above is similar to the findings in the case of People v. Colvin*. The court found and stated:

*""The dispute concerns what it means to "collectively or cooperatively" cultivate medical marijuana. The MMPA's legislative history tells us little about section 11362.775 or what it means to associate to "collectively or cooperatively ... cultivate [medical] marijuana." It merely reveals that an initial version of the section would have directed the Department of Health Services to promulgate regulations*

*ensuring the consistency [16] and quality of medicinal marijuana and protect against its illegal diversion, and that some groups were concerned it would lead to "mafia-like" organizations of marijuana growers. (See, e.g., Lopez, Traditional Values Coalition, Mem. to Assem. Com. on Pub. Safety Chair Mark Leno & Vice Chair Jay La Suer, June 27, 2003.)*

*But, in general, cooperatives are organizations that provide services for use primarily by their members. (Gurnick, Consumer Cooperatives: What They Are and How They Work (July/Aug. 1985) L.A. Lawyer, p. 23.) "Entities such as production, service, purchasing, and marketing cooperatives engage on a cooperative basis in producing or procuring goods, services or supplies for members and patrons and promoting use of their members' products and services." (Ibid.) Cooperatives perform functions its individual members could not do alone as effectively and conduct business for the mutual benefit of members.9 (Gurnick, at pp. 23, 24.)""*

* People v. Colvin, 203 Cal. App. 4th 1029, 137 Cal. Rptr. 3d 856, 2012 Cal. App. LEXIS 200, 2012 WL 579867 (Cal. App. 2d Dist. 2012)

Accordingly, a collective's operations first results in either an excess of revenue or expenses. An excess of revenues can be either "earnings" or "profits". To the extent that the Collective can demonstrate use of any excess revenues for the "general welfare" of the members, then that amount would be characterized as "earnings" under the statute. Alternatively, if no such use can be demonstrated, there would be finding of "profits".

*Earnings as a Necessary Component of a Cooperative*

It is in the public interest to allow earnings for a collective to serve the welfare of its members for any number of reasons, including but not limited to the following:

1) Start-Up Costs: When a collective is organized, it needs to obtain funds in the form of loans from its organizers and others for start-up costs to underwrite facilities, purchase of equipment, inventory, working capital and to fund its operating expenses prior to achieving break-even. Funds received from earnings are needed to repay these loans over time. Without earnings to pay its loans, there would be no way a lender could be repaid. For typical marijuana retail dispensary, (and Medileaf is no exception), operations start-up costs are substantial.

2) Working Capital: The collective needs funds from earnings to accumulate its working capital and provide funding for the following typical needs:
    a. To provide funds to underwrite business risks, such as legal defenses and other non-routine operating costs.
    b. To provide funds to pay its income taxes and other business taxes, (IRC 280E is an especially burdensome tax statute.)
    c. To provide funds for expansion to lower cost of operations for each member.
    d. To provide funds for unanticipated expenses and uncertainties. Without a healthy level of accumulated funds held, unanticipated expenses could not be funded and disrupt operations for its membership. State and local regulations are fluid and changing regulations can be operationally very costly.

As an example, we might assume a collective generates $200,000 of accumulated cash funds from earnings. If it plans to utilize the funds to expand its operations, broaden medicine choices, serve more patients, hire more personnel, increase security, lower costs, or hold reserves to fund a possible legal defense, earnings to fund those needs would not constitute "profit" in the context of the law.

It is also instructive to look at the IRC Section 531 Accumulated Earnings Tax which taxes a corporation that accumulates excessive profits beyond its reasonable needs. We submit that the spirit and intent of this tax on unreasonable accumulations of "profit" is consistent with CA Corporations Code section 12201 which, in like manner, prohibits the unreasonable accumulation of profits in a cooperative beyond what may be necessary to advance the interests of the members. The IRS manual which provides guidance to field agents in section 4.10.13.2.3 (03-16-2015) directs agents to consider the following to be reasonable needs for purposes of avoiding the accumulating earnings tax.

a. Expansion of the business
b. Acquisition of a business
c. Retiring indebtedness
d. Providing necessary working capital
e. Making investments or loans to suppliers or customers
f. Need to meet competition
g. Reserves for various business risks and contingencies including potential liability from litigation and unsettled business conditions

h. Need to finance pension or profit sharing plans
i. Possible loss of principal customer or vendor
j. Possible liability arising from a contractual obligation
k. A possible business reversal
l. Reserves to hedge against competition

We also suggest that when considering the public interest in pursuing these charges that a new state law, The Medical Marijuana Regulation and Safety Act (AB266, AB243, & SB643) takes effect on January 1, 2016. That statute legalizes "commercial cannabis activity" and allows for-profit organizations to operate under new state medical marijuana operational licenses, including "an individual, firm, partnership, joint venture, association, corporation, limited liability company, estate, trust, business trust, receiver, syndicate, or any other group or combination acting as a unit".

*Conclusion:*

It is our conclusion and considered opinion that Medileaf met the requirements of Proposition 215 (the Compassionate Use Act of 1996), SB 420, and the guidelines promulgated from the Jackson case and should be accordingly be provided the related protections. Medileaf operations produced losses for the period from its inception to the date of the raid. (See Exhibit 1 – Adjusted Statements of Operations.) Even if it could be established that Medileaf operations produced an excess of revenues over expenses, that excess would be characterized as "earnings", which are not prohibited under SB 420 and the underlying Corporations Code. Moreover, earnings are in the public interest and are necessary to provide for any number of financial requirements and to provide for a healthy and financially stable balance sheet in the service of its members. Such earnings are separate and distinct from "profits" although both are generated from operations.

Very truly yours,

Lynn Wubbels

Exhibits:
1. Medileaf Operations Summary
2. California Attorney General Guidelines
3. Gurnick, Consumer Cooperatives: What They Are and How They Work (July/Aug 1985) L.A. Lawyer
4. Restaurant menu and photos