



FOUR CONCERNS FOR STATES LAUNCHING NEW CANNABIS PROGRAMS

Michael McGrody Amundsen Davis LLC

INTRODUCTION

Last year saw Rhode Island, Maryland and Missouri join the 18 other states and Washington D.C. that have legalized recreational cannabis since 2012. Medical cannabis is permitted in some form in 39 states and D.C. Interest in the industry remains incredibly high, with entrepreneurs, lawyers, accountants, etc. joining every day. As more jurisdictions come into the fold, the wiser lawmakers and business hopefuls will take a close look at some of the stumbling blocks encountered by the more mature markets

as they launched their cannabis programs. These include: (1) social equity concerns; (2) supply and demand dynamics; (3) tax policy; and (4) regulatory pervasiveness.

SOCIAL EQUITY

Social equity provisions in cannabis laws are designed to promote industry participation by those who were disproportionately impacted by the “War on Drugs.” These are most often going to be people from impoverished and/or minority communities. Social equity is a big deal in the

cannabis world, and rightfully so.

States with social equity programs, though, have found themselves bogged down in litigation related to constitutional and other challenges. Lawsuits inevitably delay the issuance of licenses. This, in turn, delays sales, which costs entrepreneurs and impacts tax revenues. These delays are helpful only to neighboring states and black-market operators.

Also, a social equity program that is not carefully crafted could be subject to abuses that undermine the goal of social

equity ownership. These can include sham ownership structures that merely appear to be operated by social equity candidates. Or the “lottery ticket” issue, where a legitimate social equity owner receives a license only to immediately sell it to an established firm.

In all likelihood, every newcomer state will try its hand at a social equity program, and existing markets will continue to tweak what is in place to promote social equity. To be successful, though, regulators and legislators should carve their program with a chisel, not a sledgehammer. And they should employ close oversight and monitoring of their programs in order to ensure that the rules are effective. Those interested in working or investing in the cannabis industry should anticipate that any new regulatory scheme will include some type of social equity benefits.

SUPPLY AND DEMAND DYNAMICS

New York optimistically awarded cannabis grower licenses before issuing retail licenses, with the hope that cannabis products would be ready to sell once shops opened. The dispensary licenses, though, were delayed, leaving cultivators with a stockpile of cannabis and nowhere to sell it. They had a huge legal supply and no legal demand. West Coast states have been complaining for years about a “flooded market” and unsustainably low prices. Some states, like Pennsylvania and Michigan, have seen a rapid switch from undersupply to oversupply.

This type of tumult is not good for business. Indeed, some West Coast cannabis business have shut their doors, which would have been unthinkable not too long ago. It is especially bad for the smaller operators – the “Mom and Pop” companies – that may lack the capital to ride out an extended period of low prices.

States should study these dynamics and their own populations in order to calculate a realistic estimate of legal usage upon the rollout of their programs. If a state is inclined to cap the number of cultivation and dispensary licenses, it should do so based on hard data to avoid the supply-and-demand roller coaster experienced by many mature markets.

TAX POLICY

A significant driving force behind many states’ cannabis legalization efforts is the potential for a new and significant stream of tax revenues. Invariably, states promise the moon. And invariably, they fail to deliver. Nevertheless, legal cannabis sales can inject hundreds of millions of dollars into a state’s coffers. For example, in 2022, Illinois collected \$445.3 million in tax revenues

on \$1.5 billion dollars of sales. Local municipalities also benefit from cannabis businesses’ sales and property taxes.

It can be tempting for a state to impose an awfully high tax burden on cannabis sales. After all, cannabis is a luxury (for recreational users anyway), and its use should arguably be somewhat discouraged by the government. This approach, though, ignores that cannabis can be easily purchased – without any taxes – on the black market. And with the growing acceptance of cannabis, the black market has thrived. Black market operators need not worry about federal taxes or regulatory compliance, so their products are available at a cheaper base price even before taking taxes into consideration. This is not a level playing field for legitimate cannabis operators, who must find a way to compete.

Estimates vary, but the black market seems to account for between 55% to 80% of California’s cannabis sales. Even accepting the lower estimates, that is an incredible number of transactions that are not taxed at all.

As new states craft their cannabis tax policies, they should strive to find a balance between maximizing tax revenues and discouraging black market transactions. It will take time and effort to arrive at the ideal tax rate, but it is worthwhile to try. At the same time, states should continue to enforce their laws against unregulated black marketeers. Doing so protects those cannabis businesses that operate above-board and in good faith.

REGULATORY Pervasiveness

The cannabis industry continues to occupy a Twilight Zone in terms of legality. Growing and selling cannabis is totally prohibited by federal law. Even so, dozens of states have fashioned programs legalizing intrastate cannabis commerce. This is largely because, among other reasons, the Department of Justice has little interest in expending its resources investigating and prosecuting responsible cannabis businesses. Key to the federal government’s “hands off” approach is that the states have, by and large, imposed stringent regulations on licensed businesses.

It is expensive to comply with any pervasive regulatory scheme. In the cannabis world, it may be even more costly not to comply, since operating outside the regulatory framework could be considered a criminal act.

As a result of this bizarre legal landscape, each state has implemented a unique regulatory framework for its cannabis industry. One frequently hears this referred to as a “patchwork of laws,” and it is. For example, a certain type of promotion or

advertisement may be permitted in New Jersey but prohibited in New York. Or a label specification could be required in Illinois but forbidden in Michigan. It is difficult, but vital, for multi-state operators to design practical compliance programs that will work with this patchwork of laws.

As new states come on board, they generally look at what other states have done and steal the best regulatory concepts. This is a good thing. The regulatory schemes of different states are growing more similar, which is an undeniably positive development. Rather than an ad hoc coalescence of rules, though, it would be great to see lawmakers convene to hammer out a uniform regulatory framework for adoption and implementation by all states that have legalized cannabis. This has been done with the Uniform Commercial Code, the Uniform Trade Secrets Act, the Interstate Family Support Act, and other laws. A uniform set of cannabis laws would dramatically simplify business operations, provide a sense of predictability and certainty, and pave the way for industry growth.

Of course, a comprehensive federal law could achieve the same result, but cannabis industry veterans stopped holding their breath for congressional action long ago.

CONCLUSION

It seems inevitable that all but a small handful of states will have legalized cannabis for recreational purposes within the next several years. Many of the issues they face as they devise their regulatory programs will have been addressed (both successfully and unsuccessfully) by predecessors. Even though each state will have some unique perspectives and challenges, there is a lot to be learned from what other states have done.

Similarly, those interested in joining the cannabis industry would do well to understand the regulatory landscape for their industry and what the landscape is likely to look like in the future. After all, the rules of the game will have a tremendous impact on a player’s success.



Michael McGrory is a partner in Amundsen Davis’s Chicago office. He founded the firm’s cannabis practice in 2013 with the advent of Illinois’ medical cannabis program and continues to serve as co-chair, providing counsel to all variety of businesses operating in the cannabis industry. Contact: mmcgrory@amundsendavislaw.com.