



The Business, Regulatory and
Legal Challenges - and
Opportunity - of a Legalized Cannabis
Marketplace in New Jersey

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INTRODUCTION

The Murphy Administration is committed, both in pursuit of social justice and economic benefit, to legalizing and regulating cannabis production and consumption early in its tenure. New Jersey's introduction is more of a timing and policy issue, but predictions of expedited passage may be premature, as emerging and inherent New Jersey political issues and lessons learned in other venues that have embraced legal cannabis will make New Jersey the most complicated state ever to legalize and regulate cannabis.

These states, namely Colorado and Washington, have found that negative impacts from permitted use of a "gateway" drug have not been realized, which should be a comfort to New Jersey in their quest to legalize cannabis. Consumption among teens and adults has remained constant post-legalization and overdose and other adverse health indicators are actually on the decline. Regulatory issues have settled into a best-practice mode, with regulations for permitting and operating strategies; requirements for "seed-to-sale" record keeping; security and insurance standards; and health, safety, and agricultural standards readily available for adaptation in New Jersey.

The thorough – and, so far, lauded – process undertaken by Massachusetts, which legalized recreational cannabis in a 2017 Referendum, demonstrates the insights that are being applied by later-entering states to assure functional regimes. On the other hand, California's Regulations, published the same week as initial task force recommendations in Massachusetts, have been met by a mix of responses with consumers worried that there

won't be nearby supply, and cultivators concerned that there are virtually no limits on production. To say the least, much is left to play out.

Despite an eager governor-elect, willing legislature, and fast-organizing entrepreneurs, New Jersey's issues are greatly distinguished from those in Washington and Colorado (the early and most successful entrants in legal cannabis) and California and Nevada (whose missteps provide cautionary tales).

In addition to being the first state to enact legislation and promulgate regulations on recreational cannabis, New Jersey holds complexities not faced by other states unrelated to the production, distribution, sale, and use of marijuana, but attributed to a simple fact of life: this is New Jersey, and almost everything is harder here.

New Jersey's most obvious hazard is developing a process/policy for regulated cannabis without regard to the myriad of opportunity to maximize the revenue inuring to the State and the best business practices that are available to create an efficient, regulated marketplace. This could occur if we fall prey to the style of politicking that undermined the recent casino expansion legislation. Perhaps more threatening is that instead of anticipating issues in the way Massachusetts has (to the point where it has created a special task force related to transport issues over Federally-governed waters to Nantucket and Martha's Vineyard), this new marketplace is left to reacting to a mess created by lack of insight (as California did when it realized Los Angeles had more marijuana dispensaries than it had Starbucks).

HOME RULE — PROPERTY TAXES - DELIVERY

Always considered the third rail of the New Jersey political scene, is the issue of home rule. Creating a new marketplace for cannabis will be fertile ground for this issue as well. At the outset, a distinction between legalizing possession and private consumption of cannabis; and where product can be grown, processed, packaged, and sold must be acknowledged. While a uniform and statewide approach to the former issue is critical, each municipality must be allowed to decide if it will participate in the latter. Specifically, to be politically feasible, municipalities must be permitted to decide whether they will allow cannabis to be grown, processed, packaged, or sold within their municipal borders, despite that they cannot preclude the private possession or consumption of cannabis in their municipalities.



Massachusetts' Referendum universally allows cannabis enterprises except in two scenarios: those municipalities that voted "YES" for recreational cannabis could ban local enterprise (production and retail facilities) but not consumption, by a Referendum; and those who voted "NO" could ban local enterprise through a Council vote. Bans also can be customized – some would prohibit local "lounges" where public consumption would be legal. Others would allow production but restrict retailing and vice-versa. In New Jersey, where constitutional "Home Rule" provisions are more pronounced than in Massachusetts, the control of local government will be much stronger and may be influenced by the incentive to participate in tax revenues derived from the local activity. In California, local governments can restrict or prohibit cannabis enterprises and while the State Referendum was favored by nearly 54% of voters, most municipal governments that have taken a position have expressed the intention of forbidding sale and cultivation. In Massachusetts, municipalities are allowed to impose local "impact fees" which amount to additional property taxes that can be passed along to the consumer; in addition to a state excise tax, which amounts to additional sales tax, creating a potential 20% tax rate on cannabis-related sales. In Washington, the sales tax is 36% but there are no local tax provisions.

New Jersey municipalities will likely favor the Massachusetts model, but there will be great tension around cutting up the tax pie in Trenton, where the Administration needs to close a \$3 billion revenue gap. As much as the State needs new revenues, cannabis enterprises will be very popular in some New Jersey areas desperate for new rates and economic activity. A generational initiative to revive Atlantic City, Camden and Newark could be even further bolstered by centering cannabis activity there. Or will local opposition to steering cannabis to urban areas overcome economic drivers? Will there be economic incentives to locate there? Or will impatient non-urban areas resist steering locations of cannabis businesses to the point where the legislative process slows or is undermined by parochial concerns?

Delivery services have proven to be a highly effective and locally desirable alternative to brick and mortar storefront locations. Many cannabis activists advocate for home delivery regimes – so called "Weed on Wheels" programs – that are said to reduce costs and improve public safety. If the State limits on-site consumption and retail purchase, emphasizing home delivery could be a route to greater State revenues, but leave the municipalities out of the tax revenue stream – a tough sell in New Jersey, especially to a legislature of locally elected

representatives, many of who hold local offices or serve municipalities as clients of their law firms.



BANKING AND COMMERCE

The existing tension created by the continued Federal treatment of cannabis as a Class I drug and a state creating a legal marketplace within its borders is perhaps most apparent when dealing with banking relationships. The U.S. Department of Treasury's 2014 statement on its Financial Crimes Enforcement Network (FinCEN) puts the burden on the bank to establish whether a customer's business activity "implicates one of the Cole Memo priorities or violates state law." The Cole Memo was a document originally drafted by former U.S. Attorney General James M. Cole in 2013 and issued to all U.S. attorneys indicating law enforcement priorities related to legal, statewide cannabis operations. Therefore, most national and international depository institutions won't work with cannabis companies, depriving them of ready access to checking, deposits, savings, credit card administration, funds transfers, lending and other services necessary to running a business. For practical purposes, this largely limits cannabis businesses to operating on a cash-only basis and complicates recordkeeping, taxes, and security.

The Murphy Administration has been advocating for a State Bank which, so long as it truly can exempt itself from Federal oversight, could overcome FinCEN obstacles and build a customer base with an expected \$2 billion in deposits. This could create an excellent environment and a great start for an institution whose mission is to provide loans that stimulate small business activity. But that would mean launching an unprecedented banking enterprise very quickly, lest the cannabis industry launch first and establish "sticky" banking solutions through other state-chartered banks or credit unions.

PUBLIC HEALTH, TESTING AND PRODUCT SAFETY GOVERNANCE, AND REGULATORY AUTHORITY

What is the allegory for regulating cannabis in State government? Most food, drug, and alcohol products – anything you put in or on your body – are regulated at the Federal level. But because marijuana is Federally illegal, how does the State assure consumer safety? Proposed legislation – and advocacy from liquor store representatives – seeks to structure New Jersey’s cannabis industry as though it can be managed as alcohol has been. However, legislative debate is shaping up to reveal that it is unlikely that the many gaps between cannabis legalization and liquor sales can be bridged and a greater level of sophistication and insight will emerge. Among a variety of issues, local boards of health cannot be expected to oversee cannabis kitchens, which process edibles and vapor products, although under current law many will presume to have that authority. Will the Department of Health and Senior Services – or its Hospital and Testing affiliates – re-purpose their infrastructure for application in this new area? Will the Department of Community Affairs promulgate non-health-related regulations as it does for housing and other consumer-facing industries? Will the State contract with an outside non-industry affiliated testing entity to provide vertical testing services (at a cost passed through to licensees) to ensure product potency and purity? What about packaging standards to assure that cannabis products are not accessible to children?

That seems to be too many questions to be answered adequately by one pending bill’s proposed “Division of Marijuana Enforcement,” an agency with no existing employees and a set of serious built-in objectors who have massive influence in Trenton, led by those who do business under the group name “law enforcement.” It seems far more likely that the state will eschew a costly new agency in favor of distributing new duties to existing structures coordinated by a central administrator.

Testing cannabis products for potency and purity will be essential to the marketplace and ensure that consumers are being exposed only to what they want and not subjected to product variance or hazards (pesticides). California’s new regulations provide a substantial testing program in line with other food and drug products.

One early administration action consistent with a social justice initiative would be to immediately decriminalize

possession. However, with pushback from legislators and local officials who have a broad range of concerns – and with the prospect that decriminalization further entrenches black market sources – reducing legitimate entrepreneurial and fiscal opportunities, it appears wise to hold off on any activity until all voices have been heard on the matter and the Administration can avoid missteps.



INDUSTRY STRUCTURE

A threshold issue for New Jersey’s entry into this new and challenging marketplace is whether the state government regulatory structure/taxation model is more desirable than empowering a business infrastructure to provide supply, controlled distribution, and retail delivery to the market. For example, the State Lottery operates as a service managed by the State Treasury which creates an RFP to promote competitive bidding to obtain a qualified vendor to provide the service. Whether legal cannabis production, quality control, and retail locations – or portions of the business – can be managed in such a fashion should be investigated and considered. Its advantages would include the ability to empower qualified cannabis operators to create the legal marketplace, significant licensing fees, guaranteed revenue streams for the state, and a highly efficient and accountable marketplace. This would necessarily involve the loss of direct control by the State, an aspect that may not be desirable to some.

In both California and Massachusetts, the cannabis enterprise application programs favor a free market, even offering special protections for boutique “craft-brew” operations. While old-school advocates like NORML are focused on users, the real lobbying action is industry-based and seems to favor a capitalized industry with

fewer players and a powerful state regulator dictating locations and industry standards to a far greater degree than other states. What does that mean to consumers? It means product variety will be reduced and availability will be tightly overseen. What will it mean to industry? It means that powerful players will create a form of marijuana utility that assures their returns and reduces their competition by prohibiting home growth and boxing out the little guy. What does it mean to the State? The opportunity to maximize revenues and minimize bureaucracy through centralized industry, perhaps even one run by a lead agency.

Most cannabis taxation models maximize sales tax and minimize application and licensing fees as a means of encouraging entry and proliferation – and State income taxes are a bonus. But New Jersey has a unique opportunity to front-load its revenues at a time of fiscal peril and enormous revenue shortage by creating an industry with fewer players who compete for licenses through a bidding process that could generate \$1 billion in upfront cash from players in everything from cultivation to distribution to data management to testing to you-name-it. The Murphy Administration might have its sights set on social justice, but it also can't avoid looking at the cash register – and the temptation will be very large to monetize the industry upfront.



Then there are New Jersey's existing medical dispensaries, authorized eight years ago under Jon Corzine, tortured to near meaninglessness by Chris Christie, and now staring down the barrel of either extinction or the prospect of cashing a lottery ticket. Even though some protection is likely, already patients who can buy cheaper and better product on the black market address their medical indications outside of the

medical marijuana program and there will be no way to stop them from buying more readily available and cheaper-still product from recreational producers. As not-for-profits whose competitors will not have similar regulatory constraints, the medical regime's capacity to re-capitalize and right-size their businesses will be hobbled. It may be necessary, at least on a moral level, for the legal marketplace to subsidize the continued existence of the distressed medical product marketplace. Exemption from taxation on the medical front or price supports may become necessary.

CRIMINALITY AND CANNABIS AS TOURISM

Kush Tourism, which specializes in marijuana tourism, notes that spikes in web searches related to cannabis tend to occur around legalization. Colorado's cannabis tourism business has driven growth in travel to that state – just as its commercial real estate market exploded with the demand for production facilities – but tourism-related searches are now waning as the result of legalization elsewhere. Colorado, for the most part, is a fly-in state: centrally located but distant from population density, it was to pot what gambling was to Vegas. Nevada, whose tourism business in Las Vegas dominates the State's economy, allows purchase but as of yet no County has acted to allow envisioned "lounges" where consumption would be permitted. Thus, the State's 40 million annual visitors are left with no legal place to smoke. Some are suggesting that New Jersey "experiment" by authorizing a cannabis marketplace in Atlantic City in an effort to jumpstart that troubled local economy. Utilizing this complex regulated marketplace in one troubled locale seems shortsighted at best and potentially disastrous to the creation of an efficient and effective statewide cannabis business.

While Ben Franklin observed that "New Jersey is a keg tapped at both ends," as a result of its proximity to New York and Philadelphia, Governor-Elect Phil Murphy will be governing a pipe smoked at both ends – at least until neighboring states enact programs of their own. In the short term, hotels may see some additional activity as cannabis travelers are further enticed to visit – especially to Atlantic City, which may finally solidify a hold on young travelers from out of state. But with the near ubiquity of public transportation from two of the largest cities in the country, most of our cannabis tourists will be, quite literally, day-trippers, making cannabis tourism a thorny problem.

Viewed economically, New Jersey wants people to visit because they bring new dollars into our economy. To attract them, we are likely to provide lounges and other accommodations, which is where New Jersey will see impacts to a far greater degree – both positive and negative – than states who earlier adopted their legalization programs. 20 million people live within a 40-minute train or bus trip to New Jersey. What shape will they be in when they depart (or try to depart) on their return trips from a visit to the cannabis lounge?

Costs of law enforcement related to cannabis have, for the most part, been reduced in legalized states, as a result of reduced enforcement and incarceration costs (although some DUI statistics are modestly higher in some states). But while the Cole Memo invokes a hands-off policy, allowing business in compliance with state law to operate, it maintains that marijuana is a dangerous narcotic and interstate transport remains a Federal offense. It will be New Jersey's obligation to care for our visitors while they are here – and to assure that they comply with the laws as they leave: no take-out.

This reminds us of the early days of the New York Lottery, when terminals at subway stations would have long lines of New Jerseyans at the World Trade Center who took a PATH train specifically to buy tickets when jackpots rose. While legal cannabis certainly represents an opportunity to balance the scales of justice, will the urgency to cash in a jackpot win for the State Treasury and some lucky entrepreneurs result in consequences that can be avoided with good insight and advance management?

ABOUT BRACH EICHLER'S CANNABIS PRACTICE

Brach Eichler is uniquely situated to provide advice and guidance across a wide range of business groups that may be interested in diversifying into the emerging cannabis market opportunity. Over the past 50 years, the Firm's practitioners have built trusted, personal relationships with their clients, rendering advice that is business-savvy and creative, yet practical. The firm's attorneys are thought leaders in their industries, known for "getting the deal done" with their clients' interests well represented and always top of mind. These qualities will be especially useful as the State moves forward to develop a cannabis marketplace. This type of opportunity, while not for the faint of heart, will be advantaged by the strength of Brach Eichler's resident Health, Corporate Formation, Regulatory, Compliance, Land Use, Employment, Tax, and Real Estate practices.

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