NY, NJ Regs Give Clarity To Cannabis Investors, Ancillaries

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New laws and regulations are likely to be implemented in both New Jersey and New York in the very near future, which will greatly affect parties' abilities to work with marijuana businesses.

Regulating Parties that Deal with Marijuana Businesses

In states with regulated marijuana industries, parties involved in financial dealings with cannabis businesses must comply with state marijuana laws regulating their transactions with, and interests in, licensed marijuana businesses.

Among others, these rules require the qualification and approval of certain involved parties, and the timely and transparent disclosure — and in some cases, express preapproval — of certain business dealings.

Where applicable, these rules also impose restrictions on a party's ability to hold multiple interests, lend money, or provide goods or services throughout a state's marijuana industry.

Violations of relevant regulations may cause licensees to incur penalties that can extend as far as license cancellation.

While the relevant rules vary among the states, each state's marijuana regulations define, determine eligibility and regulate the conduct of owners or true parties of interest in the license-holding marijuana business.[1]

These definitions can greatly affect a party's ability to hold an interest in, lend money to, or contribute goods or services to a marijuana business.

New York's Amended Regulations

In May, New York's Office of Cannabis Management released highly anticipated revisions to its adult-use cannabis rules and regulations. Of those, some of the most significant changes were those made to its definition of a "true party of interest" in a New York state marijuana business.

New York, like many states, has a multitiered licensing structure for adult-use cannabis.

Under New York's licensing structure, which separates supply — cultivation, processing and distribution — from retail, any person or entity having any direct or indirect interest in an applicant or licensee in the supply tier is prohibited from holding any direct or indirect interest in an applicant or licensee in the retail tier, i.e., retail operations such as dispensaries.

The reverse also applies, prohibiting licensees from achieving complete vertical integration in New York's marijuana industry.

According to the OCM, "[t]his key principle of the law creates opportunity, opens the market to more potential players, and will help establish a diverse and equitable industry."[2]

Because true parties of interest are considered licensees, the rule also applies to them. Furthermore, as with applicants and licensees, true parties of interest are also subject to potentially cumbersome personal and entity disclosure requirements, as well as criminal background checks.

Therefore, the definition of true party of interest is critical, especially to investors and lenders and those who contract with the cannabis-related business.

The original definition of true party of interest developed by the OCM included:

- "[E]ach person with a right to receive some or all of the revenue, gross profit, or net profit from the licensed entity during any full or partial calendar or fiscal year"; and
- "[E]ach person with a financial interest in the applicant or licensee."

Excepted from the definition, however, were those who:

- "[R]eceive[s] payment for rent on a fixed basis under a lease or rental agreement relating to [the] applicant or licensee";
- "[C]onsult[s] receiving a flat or hourly rate of compensation from the applicant or licensee under a contractual agreement"; and
- Have "a contract or agreement for services with an applicant or licensee, such as a branding or staffing company, as long as the applicant or licensee retains the right to and controls the business

Subsequently, the OCM issued guidance providing that, in determining who will be considered a true party of interest for these categories, one becomes a true party of interest in a license if, over the course of a calendar year, they receive the right to or actual payment from a licensee exceeding the greater of 10% of gross revenues; 50% of net profits; or $100,000.

While this guidance was certainly better than the original definition in that it provided minimum thresholds, and thereby lessened the potential number of parties that would become regulated as true parties of interest, there were two main issues.

First, the $100,000 threshold was simply too low, especially due to the significant dollar value of individual contracts and services in the startup process, any of which could very well exceed $100,000, making even ancillary service or product providers regulated parties.

Second, the thresholds were contained in guidance, which did not have the force of law.

Given these issues, the OCM's proposed amended regulations:

- Include revenue thresholds; and

- Increase the $100,000 figure to $250,000 in all of the implicated definitions, including the definitions of "financial interest" and "financier."

The proposed revised rules were published in the New York State Register on June 14, beginning a 45-day public comment period ending on July 29.

However, even if the proposed amended regulations do ultimately go into effect as written, and explained herein, above, it is important to note that there remain myriad ways for investors and service providers to get trapped in the complex regulatory web of OCM regulations, as a true party of interest or otherwise.

It remains important in New York, as in other jurisdictions, to have a robust understanding of the regulatory scheme before diving in head first.

New Jersey's New Law

In June, lawmakers in both the New Jersey Senate and Assembly passed a law[3] that would expand the rights of marijuana business owners, as well.

The new regulations would allow individuals and entities to own up to 35% ownership interest in as many as seven Class 5 retail licenses, contrasted with New York's limitation on having an ownership interest greater than 20% in more than three retail licenses. In contrast, the existing regulations only permit ownership interest in a single retail license.

New Jersey's regulations do not use the specific true party of interest term but do define owners in a manner similar to New York's true party of interest definition.

"Owners" is defined to include "[a]ny person or entity that holds at least a five percent aggregate ownership interest in a cannabis business or testing laboratory license applicant or license holder."[4]

The existing regulations prohibit owners from holding more than "one cannabis cultivator, one cannabis manufacturer, one cannabis retailer, and one cannabis delivery service license."[5]

The new regulations would drastically expand these rights for certain existing and prospective interest holders. Most importantly, however, these new regulations apply only to diversely owned businesses, [6] and not to impact zone businesses [7] or social equity businesses,[8] meaning the license holder must be certified as a minority-owned business, woman-owned business, disabled veteran-owned business or as any combination thereof.

The new law also imposes additional restrictions on certain parties related to their transactions with the marijuana business.

For example, under the new law, those who provide financial assistance or intellectual property to Class 5 cannabis retailer licensees may not require the marijuana business to pay the full value of the financial assistance or intellectual property, plus applicable interest
and fees, if the value is:

- Less than $100,000 in five years;
- Between $100,001 and $250,000 in seven years; or
- More than $250,000 in 10 years.

Further, the new law would grant the New Jersey Cannabis Regulatory Commission the authority to review any agreement to provide financial assistance or intellectual property to a licensee to determine whether the terms of the agreement — including interest rates, returns and fees — are "commercially reasonable and consistent with the fair market value for the terms generally applicable to agreements of a comparable nature."[9]

Should the commission determine the terms of an agreement are not commercially reasonable or consistent with the fair market value generally applicable to the services to be provided under the agreement, the commission can withhold approval, essentially requiring the parties to renegotiate a new agreement that, as determined by the commission, is commercially reasonable and consistent with the fair market value for the terms generally applicable to agreements of a comparable nature.

If New Jersey's governor signs the bill into law, the ownership rights with respect to Class 5 retail licenses in New Jersey will be greatly expanded, potentially alleviating, at least for certain entities, the harsh restrictions faced by investors, as well as even ancillary service and product providers to marijuana businesses in the state.

Investing in, Loaning Money to and Contributing Goods or Services to Marijuana Licensees

Many investors, lenders and ancillary service and product suppliers in the marijuana industry are reluctant to invest in or provide services or products to marijuana businesses based on the multitude of rules and regulations affecting their ability to do so.

Indeed, owners of and true parties of interest in licensed marijuana businesses may be required to submit to personal and financial prequalification investigations, including criminal history investigations, and also may be required to make additional disclosures to the licensing agency, including demonstrating the sources of funds for their transactions with the licensed marijuana business.

Often, owners and true parties of interest must be deemed eligible by the state prior to holding an interest in the marijuana business, loaning funds to the marijuana business, and in some cases, even before providing goods or performing services under a contract with a marijuana business.

Further, in some states, eligibility and vetting requirements can extend all the way to corporate entity members' spouses.

These changes in New York's regulations will expand parties' abilities to provide funds, goods or services to marijuana businesses by reducing the potential number of parties that would become regulated as true parties of interest.

In New York, parties that wish to provide funds, goods or services to marijuana businesses — but not be subject to true party of interest-level vetting procedures, disclosure requirements, horizontal and vertical interest restrictions, and more — have a greater ability to do so, provided they

- Structure their business dealings below the applicable state-specific thresholds; and
- Ensure their contractual terms do not provide for or permit the relevant entity to rise to the level of a true party of interest in any marijuana businesses either through control of the business, right to control the business, right to seize or possess certain assets of the business, and more.

While this is a sophisticated endeavor, these regulatory changes clarify some previously murky legal waters that often discouraged legitimate money, goods and service providers from engaging with the marijuana industry.

Whether marijuana licensees in New York or New Jersey will experience an increased willingness, in practice, of the same to engage in business dealings with them is yet to be determined.

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[1] Note: In most mature states, the interests of "financiers" and "financial interest holders" have been carved out from the definition of owners and true parties of interest, and face less state regulation.
[2] https://cannabis.ny.gov/system/files/documents/2022/11/office-of-cannabismanagement-previews-new-adult-use-cannabis-regulations.pdf.
[3] NJ A4151 (2022-2023, Regular Session).
[4] NJ Admin. Code § 17:30-1.2.
[5] NJ Admin. Code § 17:30-6.8.
[6] NJ Admin. Code § 17:30-6.4.
[7] NJ Admin. Code § 17:30-6.5.
[8] NJ Admin. Code § 17:30-6.6.
[9] NJ A4151 (2022-2023, Regular Session).

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