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Captives and Cannabis: A joint venture?

Seeing through the regulatory haze

Joe Holahan, attorney at Morris, Manning and Martin, breaks down the current state of cannabis regulation in the US and highlights the role captives can play in the industry

In 1996, California voters passed Proposition 215, making California the first US jurisdiction to legalise the cultivation and possession of marijuana for medical purposes. Today, 30 states, the District of Columbia, Puerto Rico and Guam have enacted laws legalising medical marijuana. In addition, ten states have legalised adult recreational use of marijuana and its derivatives in one capacity or another.

Yet marijuana—cannabis—remains illegal under US federal law. Marijuana is a Schedule I drug under the Controlled Substances Act (CSA) of 1970. As such, it cannot be legally prescribed for any reason, with the sole exception being used as part of a federally approved research study. In addition, it is a federal crime punishable by imprisonment to knowingly manufacture, distribute or dispense marijuana. Thus, even a state-licensed cannabis business operated in strict compliance with state law is considered a criminal enterprise for purposes of US federal law. Federal law also makes it a crime to engage in certain financial transactions, including transactions involving an insurer, with money known to be derived from the cultivation, distribution or sale of cannabis.

Legislative View

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Hashing it out

In January, US Attorney General Jeff Sessions rescinded what is known as the Cole Memo, which was Department of Justice guidance to federal prosecutors issued during the Obama administration. The Cole Memo advised US attorneys to focus their enforcement of the CSA on certain priority areas such as preventing the distribution of marijuana to minors and the diversion of marijuana from states where it is legal to those where it is not. The Cole Memo implicitly suggested that US attorneys should not prosecute businesses operated in strict compliance with state law, although it left decisions concerning whom to prosecute to the discretion of each prosecutor.

At present, the view concerning the legal status of cannabis in the US is muddy at best. Yet the picture has some bright spots. In response to pressure from states that have legalised cannabis, President Trump recently stated that the administration will not target cannabis businesses operated in compliance with state law. The President also pledged to support efforts to enact federal legislation protecting such businesses. In addition, guidance issued by the US Treasury department for banks and other financial institutions wishing to provide services to cannabis businesses without being subject to penalty remains in effect. Finally, Congress has continued to renew a federal law known as the Rohrabacher-Blumenauer Amendment, which prohibits the Department of Justice from using federally appropriated funds to prevent states from "implementing their own laws that authorise the use, distribution, possession, or cultivation of medical marijuana." Note the limitation to medical marijuana. The Ninth Circuit Court of Appeals has held that this law is a defense to federal prosecution for persons who have "strictly complied with all relevant conditions imposed by state law." The Ninth Circuit includes the Westernmost US states. The Courts of Appeal in other US Circuits, however, have yet to rule on this issue.

What is going on here? Madison surely would understand. The American polity was born in a climate of deep distrust of centralised authority and fear that the states would be deprived of their newly won sovereignty over internal affairs by a tyrannical national authority. Balanced against this sentiment was the practical need for a national government to protect and unify the nation—but only by limited and clearly delineated means. The push and pull between state and federal authority evident at the founding continues to play out.

Blunt enforcement

Under modern Supreme Court jurisprudence, the power of the federal government to regulate interstate commerce is construed to extend even to purely local economic activity if it is deemed to have a 'substantial effect' on interstate commerce. The requisite 'substantial effect' does not have to be great. A case decided by the Supreme Court in 2005, Gonzalez v. Raich, 545 US 1 (2005), illustrates the state of the law very well. Diane Monson and Angel Raich were California residents who suffered from a variety of serious medical conditions and were prescribed marijuana by licensed, board-certified physicians in accordance with California's Compassionate Use Act, which authorises the limited use of marijuana for medicinal purposes. Monson cultivated marijuana for her own use. Raich obtained it from two caregivers, who provided locally grown marijuana to her free of charge.

In 2002, local law enforcement officers and agents from the federal Drug Enforcement Administration (DEA) paid a visit to Monson's home. The local officials concluded her marijuana was entirely lawful under California law and left. In what surely counts as bad manners for guests, the DEA agents then seized her marijuana plants and destroyed them on the ground they were unlawful under the CSA.

Monson and Raich responded by bringing a lawsuit seeking injunctive and declaratory relief against federal enforcement of the CSA to the extent it prohibited them from possessing,

obtaining or manufacturing cannabis for their personal medical use in accordance with California law. They argued that the CSA's prohibition on marijuana as applied to their purely intrastate manufacture and use of the drug for medical purposes, which was lawful in California, exceeded Congress's authority under the constitution to regulate interstate commerce.

The Supreme Court disagreed. By a six-to-three majority, the Supreme Court held that Congress's power to regulate interstate commerce includes the power to prohibit the local cultivation and use of marijuana in compliance with California law. Citing a depression-era case involving federal controls on wheat production, the court ruled that even Monson's cultivation of marijuana in her home solely for her own use could be regulated under federal law because this type of activity, if engaged in by many persons, would have a "substantial effect on supply and demand in the national market" for marijuana". Under the holding in Gonzalez v. Raich, there is no question federal law may override state laws legalising cannabis.

High expectations

Which brings us back to present situation. Today, the legal—state legal—cannabis business is booming. In 2017, the industry is estimated to have had sales of nearly $9 billion. It is estimated that legal sales of cannabis will reach $21 billion nationally by 2021.

The federal prohibition on marijuana, however, has placed a drag on the growth of the cannabis industry. Many investors, financial institutions and service providers are reluctant to be involved with the industry due to the latent threat of federal prosecution. Banking services are especially difficult to obtain. Insurance capacity also is lacking, and what insurance is available can be expensive. Crop insurance for outdoor grow reportedly cannot be had at any price. There are also questions about the scope of available coverages and the threat that standard exclusions and common law prohibitions against the insurance of illegal activities could compromise coverage even for businesses operated in compliance with state law.

As this edition of the Captive Insurance Times illustrates, the captive industry can help by providing alternative vehicles for self-insurance and direct access to international reinsurance markets. Those who provide services to cannabis businesses should take steps to mitigate their legal risk. Important steps would include, among other things, following what federal guidance there is in this area, operating in accordance with applicable state laws, conducting reasonable due diligence on clients and separating cannabis-related operations from other operations.

Political hotbox

What is the outlook for the future? An effort is afoot in the Congress to enact legislation protecting cannabis businesses operated in accordance with state law. Nevertheless, it is unclear whether Congress will take meaningful action any time soon. Its inertia has much to do with the political heat cannabis attracts and the general inability of Congress in recent years to reach consensus on difficult issues. Congressional inaction is also a function of concerns within the industry that new legislation could result in cannabis being reclassified under the CSA, giving the Food and Drug Administration authority to regulate it.

Notwithstanding the lack of a formal solution, as state tax revenues from cannabis grow, the risk of adverse federal action diminishes. The tension between state and federal laws may continue for some time to come, perhaps eventually with new guidance from federal authorities concerning activities that will draw their attention versus those that will be left to the states to regulate.

In the meantime, the industry will need to proceed with caution, watching federal actions closely to evaluate the posture of law enforcement authorities and taking affirmative steps to mitigate its legal risk. **CIT**

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> **Joe Holahan, attorney,** Morris, Manning and Martin