Potential Marijuana Status Change Would Shift Industry Risks

By **Ian Stewart** (September 5, 2023)

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Last week saw the most significant development in federal marijuana policy for the past 50 years. It was reported on Aug. 30 that the U.S. Department of Health and Human Services has recommended that marijuana be reclassified from Schedule I to Schedule III within the Controlled Substances Act.

This recommendation follows an executive order issued by President Joe Biden last October that directed HHS to perform a scheduling review of marijuana.

The recommendation by HHS will be evaluated by the U.S. Drug Enforcement Administration, which has final authority to reschedule a drug under the CSA. Following potential — and expected by many — DEA approval, a rulemaking process would be initiated.

Reactions to the Recommendation by HHS

The immediate exuberance that followed the reporting of this development included a surge in marijuana stock prices and public statements by industry leaders hailing the news as a game changer for an industry that has faced significant headwinds over the past few years.

Removal of marijuana from Schedule I would allow cannabis companies to avoid the draconian impact of Section 280E of the Internal Revenue Service Code, which prevents most business deductions and results in exceedingly high effective tax rates that have impeded profitability for most cannabis companies.

An end to Schedule I status should see additional banks and insurance companies deciding to service the market. The same is true for other ancillary service providers that are needed by the cannabis industry, such as large testing laboratories, distribution companies and brands that will now wish to be associated with the cannabis industry.

Though the large majority of cannabis industry insiders would strongly prefer that marijuana be completely removed from the CSA and regulated in much the way alcohol is regulated, the lack of any progress at the federal level means that any significant change is welcome as an improvement to the status quo. This includes a decision to reclassify marijuana as Schedule III.

Unforeseen Risks

This optimism should nevertheless be tempered with caution over certain unintended consequences and unforeseen risks that may arise out of marijuana's Schedule III status. Below, we address some of the key questions that cannabis companies and insurance entities should be asking with respect to the short- and long-term impact of this development on insurable risks to the cannabis industry.

Schedule I vs. Schedule III

Under the CSA, a Schedule I drug has no currently accepted medical use and a high

potential for abuse. Schedule I drugs include heroin, LSD and MDMA. Multiple petitions have been filed over the past 50 years seeking reclassification or removal of marijuana and THC within the CSA.

The DEA has consistently rejected those petitions, most recently in 2016, by devaluing or ignoring evidence of medical use for marijuana and its safety under the supervision of a physician, and by relying on U.S. obligations under international drug control treaties.

In addition, a number of unsuccessful bills have been introduced in Congress to resolve problems caused by marijuana's Schedule I status, most notably the SAFE Banking Act, which has passed in the House of Representatives seven times and has yet to achieve a vote in the Senate.

In comparison, Schedule III drugs are defined as having a moderate to low potential for physical and psychological dependence. They do have accepted medical uses but carry a risk of misuse or abuse. Schedule III drugs require a prescription and their distribution is regulated. Examples of Schedule III drugs include ketamine, anabolic steroids and Tylenol with codeine.

Impact on Insurable Exposures

It may seem counterintuitive, but insurable exposures may increase in the wake of rescheduling.

Although the removal of marijuana from Schedule I should have an overall positive long-term impact on cannabis property, commercial liability, product and specialty risk exposures by allowing the industry to mature like other regulated markets, one should expect a tumultuous transition following a decision to reschedule to Schedule III.

Several reasons for this are discussed below.

An Increase in Unregulated Cannabis Products

Decreasing the significant criminal exposure that accompanies Schedule I status would likely result in a marked increase in unregulated marijuana products, similar to the explosion of intoxicating hemp-derived products seen in the wake of the 2018 Farm Bill, which removed hemp and its derivatives from the CSA.

The ongoing illicit market for cannabis products has been a significant problem for the regulated industry. An increase in these unregulated products due to a perception of decreased criminal risk would further affect the profitability of cannabis companies and may cause additional pressure on licensed operators to cut corners around expensive regulatory compliance.

Uncertainty Around Federal Regulation and Enforcement

Even as a Schedule III drug, marijuana would remain a controlled substance subject to strict controls around its manufacture, distribution, possession and use. This prescription drug model is totally incompatible with state medical and adult-use cannabis regulations because cannabis companies would continue to illegally distribute a drug, albeit a legal drug.

Any lack of clarity around how enforcement decisions would be made by the DEA or the U.S.

Food and Drug Administration would result in an unacceptable environment of uncertainty that in many ways is worse than the status quo. Banks, insurance companies and other institutions may show continued reluctance to service the cannabis industry if there is ongoing uncertainty around the legality of distributing a Schedule III drug under the authority of state cannabis regulations.

During the rulemaking process, the federal agencies must therefore issue clear guidance on their enforcement posture, and will hopefully use enforcement discretion to leave well-regulated state medical and adult-use markets alone.

Interstate Commerce Versus State Regulations

Another question that must be addressed immediately during the federal rulemaking process is how to handle the inevitable interstate commerce of cannabis products. The removal of marijuana from Schedule I erases the raison d'etre for the intrastate model and would facilitate the transition to interstate commerce.

The collision between interstate commerce and intrastate cannabis regulatory structures would result in additional legal uncertainty and compliance hurdles for cannabis companies and their insurers.

The intrastate model was born out of necessity due to the federal illegality of marijuana. Each adult-use and medicinal state has developed its own unique regulatory structure, with more recently legalized states employing lessons learned by implementing or discarding the more experimental ideas of the early states. As a result, many states use starkly different regulatory approaches.

In addition, the intrastate model means that all licensed cannabis operations are independently self-contained within each state, with no cannabis products allowed to cross state lines. This requires multistate operators to recreate entire supply chains in each new state, resulting in difficult problems with product uniformity and quality control, and the inability to scale operations due to inefficiencies caused by duplication of overhead and labor costs.

It is a mistake to believe, however, that the removal of marijuana from Schedule I would result in any immediate change to state regulations. Those regulations would continue to exist and be enforced unless or until a comprehensive federal regulatory plan is created that allows for continued state oversight and control, similar to the way alcohol is regulated.

This is harder than it sounds. While multiple legalization bills have been introduced in Congress over the past few years, none of them have contained an adequately detailed regulatory plan that explains how the federal government will engage with and provide oversight to dozens of disparate state regulatory schemes. That plan will be required if rulemaking proceeds after the anticipated approval of reclassification by DEA.

Currently, cannabis products that are compliant in their state of origin fall out of compliance upon crossing the border into a new state, regardless of Schedule I concerns. It will be important to quickly move toward uniformity on testing standards, terminology, warnings and other label requirements.

The various state cannabis regulators communicate with each other regularly on numerous issues, including the topic of facilitating this inevitable transition. Interstate commerce would nevertheless certainly result in a period of increased confusion as companies attempt

to realign their operations to stay compliant in a starkly transformed regulatory environment.

Interstate commerce also would tear down the artificial supply and demand forces created by the intrastate regulatory model. So-called export states would cultivate and transport marijuana to import states that have high consumer demand but limited ability to grow large amounts of high-quality marijuana.

Meanwhile, cannabis manufacturing and processing operations should gravitate to locations with the most competitive property prices, labor costs and tax rates, similar to the way most industry sectors choose to locate their businesses.

In sum, interstate commerce would bring significant new disruptive market forces that would increase uncertainty, complicate compliance, realign supply with demand, and result in surprising winners and unforeseen losers. That is a potentially ripe environment for claims and litigation for which the cannabis industry and its insurers should be prepared.

Will This Development Facilitate New Players Entering the Cannabis Insurance Market?

There are currently more than 30 insurance companies and managing general underwriters that write many lines of coverage for the cannabis industry, primarily on a surplus lines basis. The market capacity for property, commercial general liability, product liability, commercial auto and workers' compensation has expanded to the extent that it is now relatively easy for most licensed cannabis operators to find multiple options for good coverage.

Those policies nevertheless remain somewhat more expensive than similar policies purchased by companies in other market sectors, and locating adequate excess insurance limits continues to be problematic for larger cannabis companies. Specialty lines coverage remains fragmented and expensive despite new offerings for D&O, employment practices liability and cyber liability.

Most large commercial insurance carriers have remained hesitant to enter the cannabis insurance space primarily due to Schedule I and related banking concerns. Reputational risk is a secondary and largely fading consideration.

Removal of marijuana from Schedule I would likely result in a number of new insurance entities entering the cannabis space, though we expect that some large commercial carriers will remain hesitant so long as significant uncertainty exists around the federal regulation and enforcement discussed above.

Depending on how all of this plays out over the coming months, we could see a dramatically changed landscape for cannabis regulation at the state and federal levels. Cannabis companies and their insurers should pay close attention to how these changes may affect their exposures and whether modifications to policy forms are needed to stay abreast of this constantly evolving market.

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