How Cannabis Cos. Can Comply With NJ Industrial Site Law

By **Matthew Karmel** (April 4, 2023)


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New Jersey's adult-use cannabis industry is growing steadily, with $196 million in revenue during the first six months as reported at the end of 2022, but several legal issues can increase costs for the unwary.[1]

In fact, New Jersey's Industrial Site Recovery Act may impose significant environmental liabilities and associated costs on unsuspecting Class 2 cannabis manufacturers, including liability and costs for historical contamination.

ISRA requires investigation and remediation of all historical contamination, whether or not it is caused by the manufacturer, each time certain businesses go through a change of ownership or control, or cease operations, including as a result of a lease termination, subject to specific exceptions and limitations.

Cannabis businesses that may be subject to ISRA will want to take additional precautions through due diligence, contracting and perhaps even obtaining environmental insurance, to limit potential liability.

However, ISRA does not apply to all businesses or transactions, and will not apply to all Class 2 cannabis manufacturers. In fact, the provisions of ISRA only apply if the cannabis business has a North American Industry Classification System code listed in the regulations implementing ISRA.[2]

A Class 2 cannabis manufacturer may fall under a few different NAICS codes, including:

- 311812, Commercial Bakeries: This "industry comprises establishments primarily engaged in manufacturing fresh and frozen bread and bread-type rolls," as well as other fresh bakery products, except cookies and crackers.[3] Cannabis businesses that operate as a commercial bakery with cannabinoid-infused products, except for cookies and crackers, would fall into this category.

- 311821, Cookie and Cracker Manufacturing: This "industry comprises establishments primarily engaged in manufacturing cookies, crackers, and other products, such as ice cream cones."[4] Cannabis businesses that operate as a commercial bakery and produce only cookies and crackers infused with cannabinoids would fall into this category.

- 325411, Medicinal and Botanical Manufacturing: This industry comprises establishments that manufacture uncompounded medicinal chemicals and their derivatives — i.e., generally for use by pharmaceutical preparation manufacturers — and/or grading, grinding and milling uncompounded botanicals.[5] Cannabis businesses that extract cannabinoids would fall into this category.

- 424590, Other Farm Product Raw Material Merchant Wholesalers: "This industry comprises establishments primarily engaged in the merchant wholesale distribution of farm products (except grain and field beans, livestock, raw milk, live poultry, and fresh fruits and vegetables)."[6] Cannabis businesses that sell raw cannabis products to merchants would fall into this category.

However, even if a cannabis business conducts subject operations, it is possible that a business will have multiple operations at a single location, and then the dominant use must be determined for purposes of ISRA.

The only code noted above subject to ISRA is 325411, medicinal and botanical manufacturing, but other ISRA-subject codes not listed above could apply in certain situations.

Class 2 cannabis manufacturers with medicinal and botanical manufacturing as the dominant use may need to comply with the requirements of ISRA each time a change of ownership or operations, or a cessation of operations, including a lease termination, occurs.

Cannabis businesses that may be subject to ISRA should consider the following risk mitigation activities to protect themselves from historical environmental liability.

Conduct appropriate environmental due diligence.

Given the competitive licensing process, cannabis businesses often streamline site acquisition processes to limit costs incurred before the award of a license.

While all cannabis businesses should be careful to conduct a minimum level of environmental due diligence, cannabis businesses that may be subject to ISRA have an added incentive to conduct comprehensive due diligence, as they may be required to investigate and remediate all historical contamination upon an ISRA triggering event.

Comprehensive environmental due diligence in New Jersey includes both a Phase I and, if recommended, Phase II environmental site assessment, as well as a preliminary assessment and, if recommended, a site investigation.

These assessments set a baseline and identify any environmental issues that will need to be addressed during an ISRA trigger so that those issues can be remedied before the cannabis business begins operating at the site.

Negotiate contractual environmental protections.

Whether or not your business conducts detailed environmental due diligence, cannabis businesses that may be subject to ISRA should also negotiate specific contractual provisions relating to ISRA.

For instance, in a lease scenario, the businesses should clarify whether the landlord or tenant would be responsible for ISRA triggers, as both the landlord and tenant can cause an ISRA trigger.

The businesses should also clarify what aspects of ISRA the landlord or tenant would be responsible for, and whether those obligations will survive the termination of the lease.

Lastly, businesses should negotiate the level of remediation that will be required if a discharge is identified.

Tenants may want landlords to remediate to an unrestricted or residential standard. As for their own remediation, tenants may want to be permitted to use a restricted or nonresidential standard, as this can reduce the cost of the remediation.

In a purchase scenario, buyers and sellers should carefully negotiate the responsibility for preexisting contamination, as well as associated indemnities and representations.

While some historical risks can be evaluated through due diligence, other risks, such as historical bodily injury claims and damage to natural resources, are not always capable of reasonable evaluation, and buyers should be wary in accepting these unquantifiable, unknown risks.

Consider business structures that will limit the applicability of ISRA.

There are some business and transaction structures that minimize the applicability of ISRA. While these structures will not always be appropriate, it can be helpful to consider ISRA applicability in evaluating business structures and transactions.

For instance, transfers between upstream owners of cannabis businesses may be exempt from ISRA, and certain types of mergers and other transactions are also exempt pursuant to specific criteria.

However, if appropriate environmental due diligence and contractual protections are in place, limiting the applicability of ISRA is less important.

Obtain pollution legal liability insurance.

As a final matter, if cannabis businesses do not have the option of pursuing the above tactics — because of leverage, timing or other factors — they can still obtain protection from historical environmental issues by procuring pollution legal liability insurance.

This insurance is written on a custom basis, and terms and exclusions should be negotiated. Still, this insurance can be an effective component of a risk mitigation strategy.

Cannabis businesses will have special considerations when obtaining pollution legal liability insurance, including the identification of insurance companies that are willing to underwrite cannabis projects.

Conclusion

In summary, cannabis businesses should protect themselves by conducting due diligence on historical contamination, carefully allocating environmental risks and liabilities in leases and other real estate contracts, and perhaps even obtaining pollution legal liability or other environmental insurance.

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practice group at Offit Kurman Attorneys At Law.

[1] https://www.nj.gov/cannabis/documents/Quarterlies/Rec%20Med%20sales%20Q3%2022.pdf.

[2] N.J.A.C. 7:26 B — Appendix C, https://www.nj.gov/dep/rules/rules/njac7_26b.pdf.

[3] https://www.naics.com/naics-code-description/?code=311812.

[4] https://www.naics.com/naics-code-description/?code=311821&v=2022.

[5] https://www.naics.com/naics-code-description/?code=325411&v=2022.

[6] https://www.naics.com/naics-code-description/?code=424590&v=2022.