

# THE ARIZONA MEDICAL AND ADULT USE MARIJUANA PROGRAMS

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January 1, 2022

Summary. Within certain limits, Arizona confers legal immunity from criminal prosecution for the cultivation, manufacture, distribution, sale, possession, and use of “marijuana,” defined broadly, only if such activities are undertaken in compliance with the provisions of the Arizona Medical Marijuana Act, enacted by citizens’ initiative in 2010: A.R.S. §§ 36-2801 *et seq.*, as amended; and Regulations: 9 A.A.C. 17 (Ariz.Admin.Code §§ R9-17-101 *et seq.*) (collectively, the “AMMA”); and, as of November 3, 2020, in compliance with the provisions of the Smart and Safe Arizona Act, also enacted by citizens’ initiative: A.R.S. §§ 36-28501 *et seq.*; and Regulations: 9 A.A.C. 18 (Ariz.Admin.Code §§ R9-18-101 *et seq.*) (collectively, the “Adult Use Act”).

Unlike the AMMA, Arizona’s penal code distinguishes between “cannabis” and “marijuana,” defining the former as the extracted resin of the plant, classifying its manufacture, distribution, sale, possession, or use as more serious crimes, and imposing higher penalties for doing so. To some extent, the Adult Use Act intends to decriminalize “cannabis” use and possession within certain limits, but this summary does not focus on Arizona’s criminal laws concerning cannabis and marijuana.

## The Medical Marijuana Regime -- The Arizona Medical Marijuana Act

General. The Arizona Department of Health Services (“AZDHS” or “Department”) adopts and enforces the administrative rules governing Arizona’s Medical Marijuana Program (the “Medical Program”). It alone has authority to issue a dispensary license (sometimes referred to as “certificate”) and inspect dispensaries (retailers and wholesalers of medical marijuana) for AMMA compliance, with revocation of the license being the ultimate penalty for AMMA violations through an administrative process subject to judicial appeal.

Vertical Integration. ***Under this vertically-integrated regime, the dispensary exclusively owns, produces, cultivates, manufactures, and sells medical marijuana.*** Although a dispensary may contract with businesses to cultivate plants or extract resin for products, for example, each such business must be appointed by the dispensary to do that work on its behalf, typically pursuant to a carefully crafted written agreement prepared by legal counsel, and the appointment consists of a written designation to the Department, with the Department’s approval in the form of an “Approval to Operate” (“ATO”). Responsibility for such independent contractors’ compliance rests with the dispensary.

## Medical Marijuana Program Numbers

Limited Number of Licenses Issued. AZDHS issued approximately 143 medical marijuana dispensary licenses since the inception of the Program, of which 125 are open, occurring in two tranches commencing in 2011 and followed in 2016. The number of dispensary licenses is limited to the ratio of one dispensary

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for every ten registered, open pharmacies. Thus, additional allotments may occur if AZDHS determines that the number of licensed pharmacies has increased statewide.

Medical Patients. Arizona reports having approximately 275,000 registered medical marijuana patients (an 18% increase over 2019) or nearly 4% of its population of 7.3 million and approx. 3,000 cultivation facilities as of November 2021.<sup>2</sup> The two largest groups of patients are between the ages of 18-30 (73,000) and 31-40 (60,000), but significant numbers of patients are much older—*i.e.*, 41-70 (over 120,000). The vast majority of licensed patients resides in Maricopa County (approx. 185,000), whose largest city is Phoenix, and Pima County (approx. 38,000), whose largest city is Tucson.

Market Size. COVID-19's crushing business and social implications have not dampened market interest in the Medical Program. The Medical Program market saw 2019 sales of \$333.6 million, increasing 37% over total product sales in 2018. Substantial growth continued year over year in 2020 and 2021, and 2021's medical sales surpassed \$800 million.

### **Dispensaries are Non-Profits**

Organizational Regime. A medical marijuana dispensary must be operated on a nonprofit basis; thus, it pays no distributions or profits to its owners and typically has no members or owners, although it is often controlled and managed by a board of directors and/or officers or affiliated entities. Most dispensary nonprofit entities are corporations, although there are a few licensed limited liability companies and one partnership. Frequently the dispensary licensee is managed by one or more affiliated entities, usually an Arizona registered limited liability company, and the manager will enter into a management services agreement with the dispensary on terms very favorable to the manager. Management activities include production, executive functions, employment, accounting, marketing, and intellectual property maintenance.

Retail, Cultivation and Extraction Facilities. A medical marijuana licensee may only have one retail "dispensary" location and one onsite and one offsite cultivation facility, which is typically where resin-extraction and manufacture of edibles, tinctures, ointments, and other edible and non-edible medical marijuana products occurs. The AMMA does not limit the size of a cultivation or extraction facility, although local zoning codes may do so.

Centered on the Dispensary. The dispensary is responsible for all activities relating to its retail, cultivation, production, manufacturing and "kitchen" facilities, and must operate each of the foregoing in compliance with all applicable law including, without limitation, the AMMA. The ultimate risk to a dispensary for its cultivators', producers', manufacturers' or extractors' noncompliance is loss of the dispensary license through an administrative revocation process.

### **Dispensary Agent, Patient and Caregiver Registrations**

Only persons whom a dispensary has registered with AZDHS for a dispensary agent (or principal) card (referred to as the "DA Card") may work for, manage, volunteer for, or have a presence in a dispensary and its cultivation and production facilities. Prerequisites to obtaining a DA Card include fingerprinting and exclusion for certain felonies. A.R.S. § 36-1901. Persons visiting a medical marijuana facility as patients, contractors and service providers must be accompanied at all times by a registered dispensary

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<sup>2</sup> The November 2021 Monthly Report on the Arizona Medical Marijuana Program issued by the Arizona Department of Health Services, Licensing Division. All of the statistics cited in this paragraph are from this Report.

agent (“Dispensary Agent”). The term Dispensary Agent includes employees, managers, volunteers, officers, and other principals, including dispensary board members. Of late, AZDHS has been critical of dispensaries who admit unlicensed persons, such as the occasional landlord or investor, into the dispensary even for brief periods of time.

Qualifying patients must be licensed by AZDHS following a medical professional’s certification of the patient’s debilitating medical condition. Qualifying health conditions include cancer, chronic pain, Alzheimer’s, Crohn’s Disease, HIV/AIDS, and PTSD (there are 13 such conditions for which a patient may be certified for a “Patient Card”). Typical costs to a patient for the examination and application range from \$250-\$450, but the Patient Card is good for two years. Numerous doctor certification businesses have opened to serve persons seeking a Patient Card.

A person with a Patient Card may designate another person to cultivate, produce, and dispense to the patient his/her medical marijuana if the patient resides more than 25 miles from the closest dispensary. A caregiver must obtain the patient’s written designation and obtain a caregiver card from AZDHS before undertaking this care. Here, too, the caregiver card is subject to fingerprinting. Caregivers may grow a limited number of marijuana plants on behalf of a limited number of patients. Caregivers must receive no compensation from their patients, but may receive reimbursement for their reasonable costs and expenses. No caregiver, with or without a patient’s approval, nor any patient, may sell or distribute marijuana to anyone; marijuana in excess of the patient’s needs may be contributed to a dispensary or destroyed.

### **Issuance of New Medical Program Dispensary Licenses**

Since October, 2016 no new medical marijuana licenses have been issued. Unlike other states, Arizona’s Medical Program (and now the Adult Use Program described below) limits the number of medical marijuana dispensary licenses to one license for every 10 open, registered pharmacies. The Department is not currently accepting applications for or issuing new medical marijuana dispensary licenses.

### **The Adult Use Regime -- The Smart and Safe Arizona Act**

General. Although a citizen-led effort to legalize recreational cannabis-use for adults failed by a small margin in 2016, a public initiative known as the “Smart and Safe Arizona Act” (referred to herein as the “Adult Use Act”) passed by a margin of 20% on November 3, 2020. Again, as with the AMMA, the Adult Use Act centers all control over the sale, cultivation, production and extraction of marijuana in the “marijuana establishment”, the retailer licensee.

### **Adult Use Marijuana Program Numbers**

Arizona adult use marijuana sales hit a record high in November, 2021 with \$60 million in sales for the month, according to state tax officials.

### **Combined 2021 Numbers**

In all, the Medical and Adult Use Programs have combined 2021 sales through October of over \$1.3 billion and estimates for the year ending December 31, 2021 approximate \$1.5 billion in sales. See the below chart.

# Arizona marijuana sales in 2021

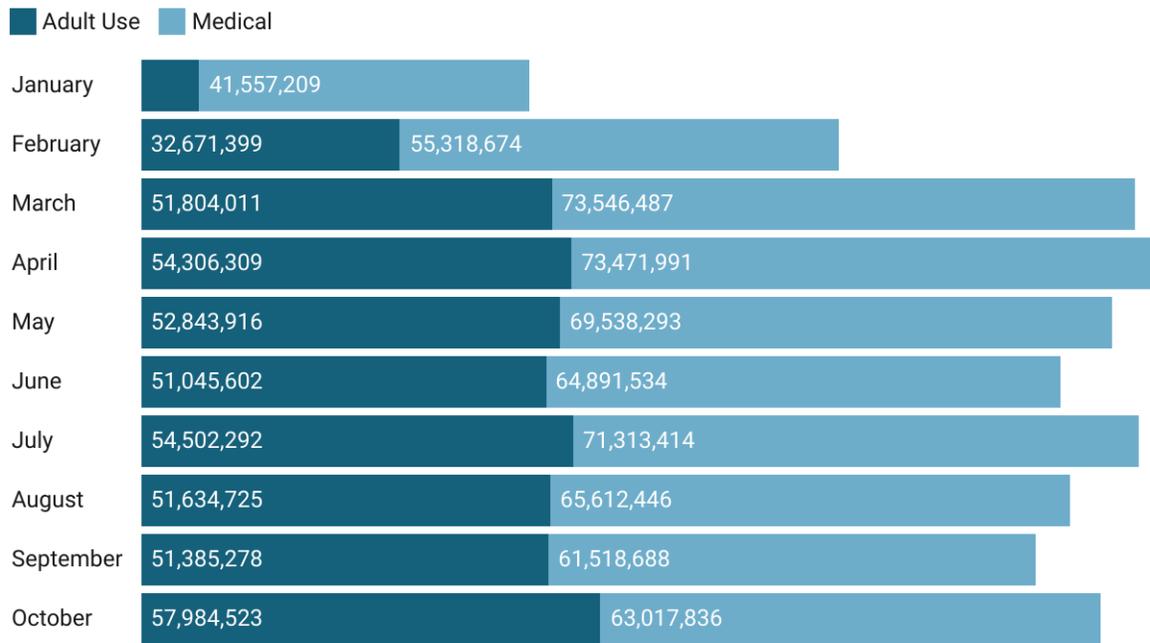


Chart: Jim Small/Arizona Mirror • Source: Arizona Department of Revenue • Created with Datawrapper

## Licenses

Licenses Issued. AZDHS issued approximately 130 marijuana establishment licenses to the medical marijuana licensees in January 2021. Like pursuant to the AMMA, the Adult Use Act limits the number of marijuana establishment licenses to one dispensary for every ten registered, open pharmacies. “Dual licenses”, “rural county licenses” and “social equity licenses” are the subject of the Adult Use Program.

Dual Licenses. With the passage of the Adult Use Act, AZDHS formulated numerous draft and then final regulations to implement the new law. The first set of regulations governed the issuance of Adult Use Act licenses to already-operating medical marijuana dispensary licensees, and by January 31, 2021 all of the approximate 130 such licensees applied and were issued a “dual license”. However, adult use marijuana sales must be conducted at the same location as the dispensary’s medical marijuana business. Additionally, each such dual licensee is permitted to cultivate onsite, cultivate at one offsite, and manufacture at another offsite location. During 2021, the State saw a land grab for cultivation acreage (outdoor) as well as large industrial warehouses for indoor cultivation. The Adult Use Act does not limit the size of a cultivation or manufacturing facility although local zoning codes may.

While a medical marijuana dispensary licensee must be operated on a nonprofit basis (see above), the Adult Use Act permits dual licensees (that is, a licensee with a medical and an adult use license) to convert from non-profit to for-profit status. To this author’s knowledge, very few have made this change.

Rural County Licenses. In mid-April 2021 AZDHS issued 13 adult use only licenses to “marijuana establishments” located in rural, underserved counties such as Greenlee, Graham and Santa Cruz. Although the first medical marijuana licenses issued in 2011 and 2016 were disbursed to locations throughout the State, these licenses were movable after 3 years; as a result, many of the rurally-located

dispensary licenses were moved to Maricopa or Pima Counties, the most populous counties in Arizona. The Adult Use Act intended to change this result by issuing not more than 2 licenses per rural county and prohibiting relocation of the license except to another location within the same county.

Social Equity Licenses. The Adult Use Act also directed AZDHS to establish a social equity ownership and operation program for the issuance of 26 adult use only licenses, meaning that these licenses have no eligibility to participate in the medical marijuana program. The Adult Use Act provided no details to AZDHS on eligibility, the definition of “social equity”, or the process of administrative and substantive review of applications. Numerous regulations were proposed and then adopted as final regulations with limited public input.

Pursuant to the Department’s regulations, these 26 social equity licenses were to be allocated to persons from a community disproportionately (negatively) affected by the United States’ war on drugs. Applications for social equity licenses were accepted by AZDHS during the period of December 1 through December 14, 2021. Over 1,500 applications were received, each applicant paying a \$4,000 fee. To qualify, an applicant entity (individual applicants were not acceptable applicants) must include one or more principals/owners holding at least 51% of the entitlements of ownership: profits and voting. Additionally, such principals/owners (referred to as “PO/BM’s”): (i) were mandated by AZDHS to take various courses offered by AZDHS on running a marijuana business, (ii) had to meet certain financial, criminal, demographic and relational requirements, and (iii) had to attest to not having entered into a contract that would negate the PO/BM’s ownership entitlements. These applicants did not need to designate a retail location, unlike all of the earlier application tranches. Numerous MSO’s (multi-state operators) ‘partnered’ with these qualifying PO/BM’s to provide capital and business expertise if the applicant was issued a social equity license.

Two lawsuits have been filed in the Superior Court of Maricopa County, Arizona, challenging the appropriateness of Arizona’s social equity program on the bases that it: (i) illegally prohibits an individual or group of individuals from making an application, and (ii) fails to serve the disproportionately disadvantaged communities for whom the program was intended.

The administrative review process of social equity applications has begun and rejections are already being issued where, for example, the application package fails to include requisite documentation.

**Centered on the Marijuana Establishment. *Like the Medical Program’s marijuana dispensary, the adult use marijuana establishment is responsible for all activities relating to its retail, cultivation, production, manufacturing and kitchen facilities, and must operate each of the foregoing in compliance with all applicable law including, without limitation, the Adult Use Act.*** The ultimate risk to a marijuana establishment licensee for its cultivators’, producers’, manufacturers’ or extractors’ noncompliance is loss of the adult use license through an administrative revocation process.

### **Marijuana Establishment Agent Registrations**

Only persons whom a dispensary registers with AZDHS for a marijuana establishment facility agent (or principal) card (referred to as the “FA Card”) may work for, manage, volunteer for, or have a presence in the establishment’s facilities. Prerequisites to obtaining an FA Card include fingerprinting and exclusion for certain felonies. A.R.S. § 36-1901. Persons visiting a marijuana establishment facility (e.g., contractors and service providers) must be accompanied at all times by a registered facility agent (“Facility Agent”). The term Facility Agent includes employees, managers, volunteers, officers, and other principals, including officers and board members.

## **Transferability of the Marijuana Establishment License**

General. Under Arizona’s Medical Program, the dispensary license is “non-transferable,” although the AMMA does not define that term, and it is not yet established by case law or regulatory interpretation whether non-transferability precludes the lease, license, use, mortgage, pledge, or other transfer of all or part of interests in the dispensary license. However, ***under the Adult Use Program the license is easily transferable except as to the social equity licenses.***

Dual Licensee and Rural County Licenses. With respect to holders of dual (medical and adult use) and rural county licenses, the Adult Use Program provides a relatively simple process for transfer, although any such transfer of a dual license must be to the same transferee. Generally, the Department only makes a cursory review of the sales documents and the current principals of the transferor apply for new DA and FA cards for the principals and board members of the transferee.

Sales prices of dual licenses now fall within the range of \$15M-\$30+M and in some cases the sales price does not meaningfully reflect a multiple of EBITDA or revenues. Many of these transactions have been for all cash and others have been a mix of cash and stock (typically issued by multi-state operators who are OTC or Canadian Stock Exchange listed). Some of these transactions have involved a seller-carryback feature. Pricing continues to rise.

Social Equity Licenses. These licenses have not yet been issued and the Adult Use Program’s regulations are being challenged in Maricopa County Superior Court. The transferability of these licenses is being challenged on the ground that free transferability to non-social equity qualifiers will defeat the purpose of the social equity program and minimize any positive effect upon the disadvantaged communities.

## **Additional Requirements Applicable to Both Programs**

### **Approvals to Operate and Zoning Conditions**

In addition to obtaining an AZDHS license to dispense marijuana, dispensaries and marijuana establishments must obtain various zoning permits and the “approval to operate” of AZDHS. An ATO is the AZDHS’ authorization to open and operate the retail site and/or its cultivation, production, and manufacturing facilities, following an AZDHS-conducted inspection.

County and municipal zoning laws often mandate that a marijuana facility (*i.e.*, dispensary, marijuana establishment, and their cultivation and production facilities) be physically located at least a specified distance from certain other uses (*e.g.*, 500 or 1,000 feet from a residence, school, place of worship or public park) and also limit the locating of a marijuana facility to certain zoning districts (*e.g.*, industrial or commercial). Many also require a special or conditional use permit (“UP”) with marijuana-specific stipulations (*e.g.*, additional security measures, prohibition on emissions and issuance of environmental permits). The UP will typically be granted following a public hearing and some local jurisdictions (*e.g.*, Phoenix) require an annual renewal. Additionally, many jurisdictions impose various building, size and setback conditions.

### **Laboratory Testing of Marijuana**

Arizona Senate Bill 1494, which became law effective August 27, 2019, provided new protections for marijuana patients and customers. As of November 1, 2020, all marijuana retailers were required to have their marijuana tested by an independent third-party laboratory that has a national or international accreditation and is certified by AZDHS to analyze marijuana cultivated for sale. No lab certificate is transferable.

Various AZDHS-promulgated security, recordkeeping, and verification regulations apply. Owners of such labs must show no familial or financial proximity to marijuana facilities. Additionally, a lab must provide AZDHS its policies and procedures describing security measures and inventory control procedures to be used in the lab (*e.g.*, electronic monitoring, restricted access and intrusion protection). Testing protocols include marijuana THC potency and the presence of pesticides, solvents, heavy metals, and microbes. Several product recalls have occurred.

### **COVID-19 Effects**

While many other types of retail businesses suffered a substantial drop in revenue during the COVID-19 crisis, Arizona licensed medical marijuana dispensaries enjoyed significant increases in monthly medical marijuana transactions and pounds sold. Shortly after the first cases of COVID-19 appeared in Arizona and the U.S., medical marijuana sales increased dramatically from less than \$700,000 for the month of February 2020 to \$950,000 in July 2020 (a 36% increase) and total monthly pounds from 16,000 to 19,000 for the same period (a 19% increase). Early 2021 numbers show similar results.

### **Import/Export and Interstate Commerce**

An Arizona licensed dispensary or marijuana establishment may buy from and sell marijuana and marijuana products to another such licensee. Medical marijuana patients may only buy their medicine from an Arizona licensed dispensary. No marijuana may be imported from or exported to another state or country.

### **Investment Analysis**

Numerous opportunities exist for entry into Arizona's growing marijuana market. Some of these opportunities include the acquisition of control of a dispensary or marijuana establishment, equity or debt financing, purchase or management of real estate serving a licensee, the provision of services to a marijuana facility, cultivation of marijuana, manufacture and production of lotions, edibles, extracts and other marijuana derivatives, and various product or equipment contracts. No such opportunity should be pursued without first having engaged in substantial and thorough due diligence activities and a financial analysis of key principals and entities involved.