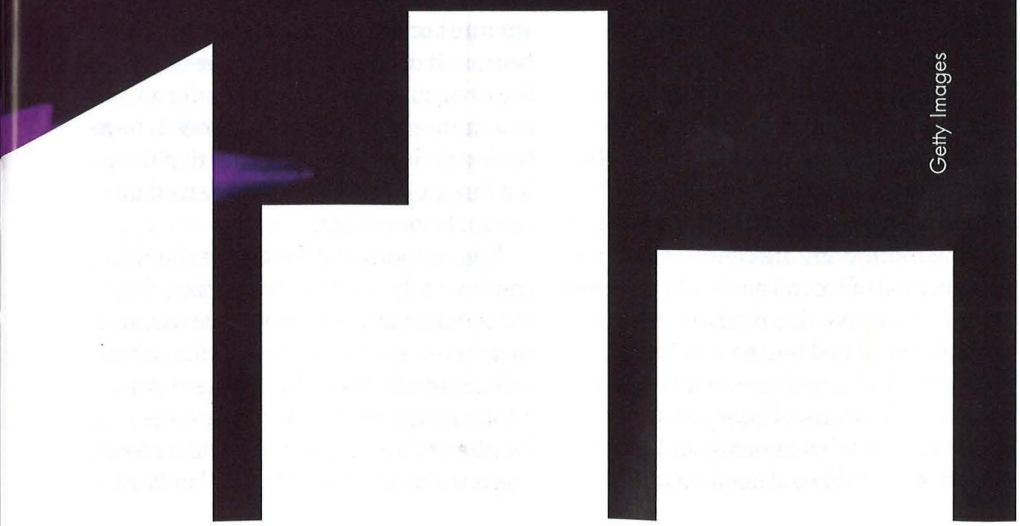
# CANNABIS LEASES

## Landlord and Tenant Considerations

**By Jack Fersko**



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The economic impact of the cannabis industry in the US is expected to exceed $100 billion in 2023. One of the motivating forces behind the push for legalization of cannabis in many US states is the revenue generated for state and local governments. As of May 2021, states reported $7.9 billion in tax revenue from legal marijuana sales. The tax revenue from the cannabis industry has been a boon to municipalities as well. It is estimated that Seattle earned approximately $9.08 million in tax revenue in 2022, and Los Angeles upwards of $55.1 million.

Although excitement for the marijuana industry continues to grow nationally, there nevertheless remains a cloud in the form of the federal government. Marijuana remains a Schedule I drug under federal law, specifically the Controlled Substances Act. 21 U.S.C. § 801 et seq.

### Federal Overview

*US Constitution.* The Supremacy Clause of the US Constitution provides that federal law preempts state law. U.S. Const. amend. X. The Tenth Amendment provides that powers not specifically delegated to the federal government by the Constitution belong to the states. The federal government cannot compel the states either to enact laws that are in the federal interest or to spend money enforcing federal laws. Nevertheless, even if a person is permitted by state law to use marijuana or conduct business within the industry, such person remains subject to criminal and civil action under the full panoply of applicable federal laws.

*Controlled Substances Act.* Marijuana is a Schedule I drug under Title II of the Controlled Substances Act. Under § 841 of the Act, those violating the Act may be liable for a fine of upwards of $10 million for an individual and $50 million if a nonindividual defendant, and for a

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repeat offender, a fine of upwards of $20 million for an individual and $75 million if a nonindividual defendant, all depending on the quantity possessed, distributed, dispensed, or manufactured. In addition, the same section authorizes imprisonment of up to life, again depending on the quantity possessed, distributed, dispensed, or manufactured.

Important to those operating in the real estate industry, potential liability under § 856(a) of the Act also rests with those who lease space for manufacturing or distributing marijuana, as well as those who manage such facilities. Fines and imprisonment are not the only risk presented at the federal level, as property forfeiture is another remedy available to the federal government.

*FinCEN Guidance.* The Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) issued "Guidance to clarify Bank Secrecy Act (BSA) expectations for financial institutions seeking to provide services to marijuana-related businesses." The introductory language of the guidance is important because it provides that its intent is to clarify "how financial institutions can provide services to marijuana-related businesses consistent with their BSA obligations" and expects that the guidance will "enhance the availability of financial services for, and the financial transparency of, marijuana-related businesses."

The FinCEN guidance sets out a protocol of due diligence that a financial institution should undertake of a customer to assess the risk of providing financial services to the customer. In addition, a financial institution providing banking or other services to a marijuana-related business must file suspicious activity reports because of its illegality under federal law, even when legal under state law.

*Appropriation Bills.* Since December 2014, the appropriation bills enacted by Congress have barred the Department of Justice from using appropriated funds to prosecute operators of medical marijuana facilities functioning in compliance with state medical marijuana statutes.

*Tax Issues.* Although the medical marijuana business is illegal under federal law, such businesses are still required to pay federal income taxes. Although most businesses are entitled to claim deductions against their gross income to arrive at their respective taxable net income, under § 280E of the Internal Revenue Code of 1986, as amended, deductions for expenses incurred in the business of producing or selling marijuana are prohibited. The prohibition extends to all of the businesses' deductions, even those that are not illegal per se, such as rent, telephone, salaries, etc. The result is higher taxes to be paid by a marijuana operation, which is a factor to be considered by a landlord when evaluating a prospective tenant's financial condition.

## Selected Lease Issues

Although marijuana-related businesses have been legal in certain states for some time now, the field remains in its infancy, and the full panoply of issues parties will need to address (and how) in commercial and industrial real estate transactions is not yet clear.

To begin, there are title insurance issues pertaining to cannabis-related businesses. For example, recently, the author has learned that Westcor Land Title Insurance Company will insure title involving a cannabis-related facility with an insurance limit of $20 million. Schedule B will, however, include a coverage exception for violations of any Schedule I drug laws.

To the current understanding of this author, however, Westcor is the exception. Chicago Title Insurance Company, Old Republic National Title Insurance Company, and First American Title Insurance Company will not offer title insurance or settlement or escrow services for marijuana-related transactions.

There also is a host of banking issues facing any cannabis-related business. Traditional institutional lending is problematic. Notwithstanding the FinCEN guidance, parties within the traditional lending community are concerned about the potential of federal money-laundering charges if they provide banking services to cannabis-related businesses. Many businesses lack a sufficient management track record, earnings history based on audited financial statements, and, most importantly, viable collateral—a lender cannot take possession of growing plants and finished products and sell such collateral to satisfy the business debt. As such, the industry has, in part, turned to private debt and equity sources of capital and credit unions.

In addition, there is a host of issues a landlord and tenant must address when undertaking a lease transaction involving a cannabis-related business. Some themes have developed. Below is a very general discussion of a limited number of issues to evaluate in a lease transaction.

*Due Diligence.* One of the first steps a landlord should take when considering whether to lease property to a cannabis-related business is whether the lease will violate any existing loan covenants, including those related to legal compliance. If so, a landlord will need to either turn down the transaction or seek alternative financing, in which latter event the landlord may face a prepayment penalty for the early payoff of its existing loan. The ability and cost to refinance the property and the cost of any prepayment fee must be factored into the landlord's evaluation of the economics of the deal with the cannabis-related business in order to assess whether to move forward with the lease. In addition, as with all lease transactions, a landlord needs to determine whether its loan covenants require lender approval of the lease transaction. Often, a breach of this covenant can result in a landlord-borrower violating a nonrecourse loan provision, thereby converting the loan to a recourse loan. If required, a landlord should discuss the transaction with its lender early on to determine if the lender will approve the lease. A tenant must undertake a similar evaluation because it does not want to invest in a lease negotiation or operate under an assumption that its real estate needs have been satisfied, only to find out that there is a threshold lender consent issue that cannot be overcome.

The landlord and the tenant should confirm early on in the transaction that the municipality will permit the use, and that there are no zoning restrictions that will negatively affect the planned operations, including by way of example, location, hours of operation, and advertising. It is also important for the landlord

and the tenant to understand what local permits, approvals, licenses, variances, and waivers, if any, are required for the tenant's operations at the leased premises; whether there is a limit on the number of cannabis operations that are allowed within the municipality and, if so, how many for each of the various types of operations (e.g., cultivation, manufacturing, wholesaling, and retail); whether there is an open license application process or one that is limited to once per year; and what process the municipality will follow in reviewing and approving applications.

Finally, the landlord should investigate the tenant's capital and financing plans to ensure the tenant is well capitalized and has the requisite financing to construct its facility and operate its business. To this end, the landlord should obtain a description of the improvements to be made to the leased premises, including any enhancements to, and effects on, the electrical, ventilation, plumbing, and waste disposal systems and structure, as well as a capital improvements budget. A landlord also needs to consider some of the economic "oddities" of the cannabis market, including the effect of Section 280E and the cost of banking for a cannabis operation (which, anecdotally, the author understands can range upwards of $5,000 per month) on a tenant's net profits and cash flow.

*Letters of Intent.* Very often, parties will enter into a letter of intent to set forth the key business issues for a lease transaction. This is particularly significant in a cannabis lease setting because there may be a time lag between the date on which the parties enter into the transaction and when the tenant secures all licenses, permits, and approvals at the local and state levels to permit it to commence operations. Typically, a tenant will have to show regulators that it has control of a site for its operations as a part of the licensing process. For a landlord, this can mean a property will be committed for a tenancy before possession is delivered and business commences. Usually, a landlord will require a tenant to make nonrefundable payments of an agreed-upon amount during this preliminary period. Although a tenant may not commence operations, a tenant may be permitted to commence certain preliminary alterations so long as they are of a nonstructural nature and some security is posted to cover restoration should the tenant not secure all requisite licenses, permits, and approvals to commence operations. Below are some general points for parties to consider including in a letter of intent for a cannabis operation, in addition to those points that generally are included in a non-cannabis lease transaction letter of intent:

- Type of license to be secured;
- Period for securing the license at the state and local levels;
- Requirement that the tenant apply for and diligently pursue approvals;
- Payments due to the landlord during the application process;
- Requirement for the tenant to deliver to the landlord all applications and notices of any hearings and decisions;
- Termination rights if municipal- and state-required licenses are not secured within an agreed-upon timeframe; and
- A landlord acknowledgment of the tenant's intended use of the premises and its illegality at the federal level.

*Permitted Use.* If a property owner is prepared to lease to a cannabis business and has satisfied itself from a financing standpoint, then the property owner must examine what statutory or regulatory impositions it may confront. For example, in New Jersey a landlord is considered a "vendor-contractor." N.J. Admin. Code § 17:30-6.8(s). As such, a landlord in New Jersey may be subject to, and any cannabis business that enters into a lease in New Jersey needs to include a provision requiring that a landlord agree to submit to, a financial probity review. A landlord must be prepared for the Cannabis Regulatory Commission to review a litany of documentation and information, including:

- The entity's organizational chart and business formation documents;
- Pending and past litigation for the previous five years;
- Documentation for any company in which the entity owns a 25 percent or more ownership interest;
- Tax returns;
- Minutes of meetings and resolutions passed by the entity's governing board during the previous two calendar years;
- Financial statements, bank statements, and notes and loans payable and receivable; and
- Any other information that the Commission deems relevant.

A landlord must enter such transactions with its eyes wide open and understand that its tenant is operating in a highly regulated industry.

In states that allow both medicinal and recreational marijuana-related businesses, it is important to understand that each has specific licensing requirements and limitations. Therefore, the use clause should delineate with some specificity the limitation on the use and tie the use to the permits required for, and issued to, the cannabis business. A tenant, however, should consider reserving a right to expand into other licensed cannabis businesses in addition to what may initially be applied for or operated, as the regulations may permit multiple licensure.

Finally, a landlord should consider that

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odors may be emitted, particularly in a multi-tenanted facility, and appropriate mitigation methods should be required (such as air scrubbers), and with respect to certain processes that are highly flammable, the landlord should consider whether they should be permitted, even if licensed.

*Prohibited Use.* Just as there are certain permitted uses that need to be expressly addressed within a lease, so too are there certain prohibited uses, which, depending on the license under which the cannabis business will operate, a landlord must be prepared to accept. For example, in New Jersey, a cannabis retailer may not operate in a location in which there also operates "a grocery store, delicatessen, indoor food market, or other store engaging in retail sales of food; or ... a store that engages in licensed retail sales of alcoholic beverages. ..."

*Compliance with Law.* Operation of a cannabis facility is illegal under federal law. Consequently, there should be a carve-out from any federal law compliance obligation, limited to this finite situation, because there remain a multitude of other, and unrelated, federal laws with respect to which ongoing compliance should be required, including, for example, the Americans with Disabilities Act and the Occupational Safety and Health Act.

In addition, similar to the permitted-use clause discussed above, the obligation of the cannabis business to comply with all of the relevant provisions of the medical and adult use cannabis laws and the related regulations should be delineated clearly and unambiguously. From a landlord's perspective, a tenant's obligation to comply with these laws and regulations should include any capital expenses required in connection with such compliance. These may arise from security and ventilation requirements, among other regulations. A landlord also should consider ongoing evaluation of the tenant's operations consistent with the standards of the FinCEN guidance.

Consideration should also be given to a waiver of a defense to the enforcement of a lease or guaranty predicated on the federal illegality of the use. An example of such a lease clause is as follows:

> Tenant acknowledges that the use, storage, possession, distribution, and sale of cannabis remains illegal under federal law, and that a license is required from the State of [_____] [and the City of _____] for the operation of the Premises for the Permitted Uses. Tenant waives any defense, legal and equitable, to the enforcement of this Lease, premised on (a) the fact that the Permitted Uses are illegal under federal law; (b) the fact that the Lease may commence prior to the issuance of a license from the State of [_____] [and the City of _____], or both, for the Permitted Uses; (c) the fact that the Permitted Uses cannot be carried out if the Tenant fails to secure or maintain a license from the State of [_____] [and the City of _____]; or (d) any similar facts, conditions, or circumstances.

The parties should also consider a similar clause for any lease guaranty.

*Controlling Law and Jurisdiction.* The lease should spell out that all disputes will be governed by state law, not federal law, and that the state courts will have exclusive jurisdiction so that matters do not end up before a federal court that may well not recognize the legality of a state-authorized cannabis operation. To this end, the parties should consider including a waiver of the right to commence an action in, and to transfer an action to, the federal courts. A landlord also should require the same waiver from all guarantors of a lease.

*Security, Maintenance, Repair, and Replacement.* Cannabis laws and regulations usually impose specific security obligations. A tenant therefore needs to reserve the right to undertake such security procedures and alterations.

Because a tenant may need to make a number of improvements to the premises in conjunction with its operations, including modifications to HVAC systems, security measures, and piping associated with cultivation activities, a landlord should require that a tenant provide the landlord with all plans and specifications pertaining to such work. In addition, both parties would be well served to establish very clear restoration requirements, and from a landlord's perspective, determine any additional security for restoration.

*Utilities.* Marijuana-related businesses place a high demand on water and other utilities, including electricity. If not separately metered, consider submetering at the tenant's expense, or provide for these utilities to be reasonably estimated by the landlord.

*Common Areas.* Although a landlord may control the common areas in a multi-tenanted facility, a landlord should avoid any liability for a failure of another tenant or any third party to abide by any restrictions that may be imposed upon the tenant under applicable cannabis laws and regulations. For example, what if a third party engages in unlawful drug activity affecting the tenant's license? Similarly, a tenant needs to examine the use of the common area and whether there is a need for some responsibility to be imposed on the landlord to protect the tenant's license.

*Default and Termination.* A landlord should have a right to declare a default,

or reserve a right of termination, in the event that federal law enforcement priorities change, a federal enforcement action is commenced against the landlord or its property, insurance requirements cannot be satisfied, or a necessary license is suspended or revoked. A tenant should have the same concerns and negotiate for similar termination rights. The parties will have to wrestle with whether notice and cure rights should apply to any of these situations, particularly a suspension or revocation of a license, and whether a legitimate appeal of such license suspension or revocation stays termination. The landlord will have to factor in the implications of any of these scenarios on its financing covenants in determining a negotiation position.

In addition, since a license-holder may be required to go through an annual license renewal process at both the municipal and state levels, both the landlord and tenant should reserve a right of termination should a license not be renewed. The issue that will be front and center in such a situation will concern a termination fee should the tenant fail to receive a renewal license, particularly if due to an act or omission in the operation of the business.

*Indemnification.* Because of the continuing illegal nature of a marijuana-related business at the federal level, high security risks, and potential criminal and civil forfeiture, a landlord needs a broad and well-funded indemnity. In addition, opponents of marijuana-related businesses have used theories of common law nuisance and the federal RICO law to block cannabis operations. It may well be that a landlord is made a party to such litigation, potentially materially and adversely affecting the landlord's own business investment and financing covenants. An indemnity that appropriately addresses such potential issues is warranted and should be given careful consideration, along with meaningful collateral to backstop the indemnity.

*Rent and Method of Payment.* A landlord should require that all rent obligations be paid by the tenant by either wire transfer or check and should expressly prohibit the payment of rent in cash. A landlord may want to consider charging percentage rent as a part of the tenant's rental obligation. If so, it will be important to confirm that this is permitted under the jurisdiction's statutory and regulatory structure.

*Further Assurances.* The cannabis laws and regulations are often changing, and as a result, the requirements for a license-holder may require further assurance, certifications, disclosures, and assistance from a landlord. As such, a tenant should require a landlord to provide such further assurances as may be necessary in connection with a license-holder's renewal of its license or obtaining an additional form of cannabis license.

On a similar level, a landlord should consider a requirement for a tenant to pay to a landlord any additional fees, taxes, or related costs that may be incurred specifically in connection with the cannabis activity/business conducted on the property, including increased insurance and financing costs.

*Insurance.* A landlord must understand both the scope and quality of the insurance coverage available to its tenant operating as a cannabis business. Marijuana operations pose unique insurance issues that stem from the high usage of water (presenting potential issues of mold), the highly flammable nature of certain processing techniques, the increased need for security, and the federal illegality of the operation. Anecdotally, this author has been informed that coverages such as general liability, excess, property, and automobile insurance for cannabis businesses are limited because few insurance companies will accept the exposure. Policies typically are written through surplus lines carriers that are not admitted by a state's insurance commission. In addition, premiums are high, and the general liability coverage typically is written on a claims-made basis rather than the preferred occurrence-form basis, which creates added risk for a landlord and business owner. Some insurance issues to evaluate include:

- Whether the state's statutory or regulatory framework requires certain insurance coverage.
- The defined terms of the policy and how they compare with the statutory definition—for example, what term does the policy use—"marijuana," "cannabis"—and do the defined terms match or create a gap in coverage based on state law definitions?
- Policy exclusions—for example, does the policy exclude coverage for a violation of law or regulation?
- Will a cannabis manufacturer that uses high heat in its manufacturing process cause higher property insurance premiums, or a difficulty in securing a policy in the first instance?
- What security measures may be required to protect against theft? If the business employs an armed guard, is there an exclusion for claims under a general liability policy involving a use of firearms?
- What liability may exist on the retail side arising from a "budtender's" product recommendation?
- For commercial general liability insurance coverage, are there any specific policy exclusions such as civil claims based on the Racketeer Influenced and Corrupt Organizations Act, class action claims, or claims based on a failure to maintain a valid license within the particular state of operation?
- Should a landlord require that its tenant secure crop coverage if it is a cultivator?

There are some states that do offer specific policies for cannabis businesses, such as California, Colorado, and Nevada. These policies do need to be reviewed carefully to understand fully the scope and quality of the coverage provided by the policies.

## Conclusion

The trend appears to favor the continued growth of the cannabis industry and its ultimate legalization at the federal level. Pending that outcome, landlords and tenants need to think creatively about potential issues and appropriate protective covenants to ensure that their respective business risks are protected and rewarded. ■