

'Legal' Marijuana: The Implications for Commercial Real Estate

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Governor Phil Murphy has strongly advocated for the legalization of adult recreational marijuana in New Jersey. If New Jersey legalizes recreational use of marijuana, the impact on the New Jersey commercial real estate market will be significant. Michael McGuinness, CEO of NAIOP New Jersey, has predicted that the legalization of marijuana in New Jersey will be “transformational and will likely drive up rents for older industrial buildings in the 20,000- to 50,000-square-foot range with 15-foot or higher ceilings.”¹

This prediction has been borne out in other markets that legalized recreational marijuana. It is not uncommon for marijuana dispensaries to pay a substantial premium for rental space, sometimes as much as “four times the going rental rate,”² because of the federal illegality of marijuana. As a result, at least two real estate investment trusts have been established to focus exclusively on the industry: Innovative Industrial Properties, a publicly traded REIT on the New York Stock Exchange, and Kalyx Development, a private REIT that has in excess of 600,000 square feet of industrial space.³

While excitement for the marijuana industry grows, a black cloud remains in the form of federal law.

Federal Overview

Marijuana is a Schedule I drug under the Controlled Substances Act.⁴ An analysis at the federal level must begin with the supremacy clause of the U.S. Constitution, which provides that federal law preempts state law.⁵ As such, notwithstanding the legality of marijuana under state law, growing, producing and dispensing marijuana, whether for medicinal or recreational purposes, remains subject to federal criminal and civil liability.

Depending on the quantity possessed, distributed, dispensed, or manufactured, violations of the act can result in a fine of up to \$10,000,000 for an individual and \$50,000,000 for non-individuals; and for repeat offenders, a fine of up to \$20,000,000 for individuals and \$75,000,000 for non-individuals. Additionally, the act authorizes imprisonment of up to life, again depending on the quantity possessed, distributed, dispensed, or manufactured. Property forfeiture is also authorized under 21 U.S.C. §§853 and 881(a)(7), and in the event of a violation of the Racketeer Influenced and Corrupt Organizations Act of 1970.⁶ Liability under the act also extends to landlords and property managers.

A series of Justice Department guidance documents (collectively, the Justice Department memos) issued between Oct. 2009 and Feb. 2014, provided the industry with a level of comfort for a period of time. Essentially, the Justice Department memos provided that if a party were to grow, process or sell marijuana in compliance with state law, and undertook certain measures outlined in the memos, then, generally speaking, the federal government would leave enforcement to the states. On Jan. 4, of this year, however, Attorney General Jeff Sessions rescinded the Justice Department memos.

There have been a number of appropriation bills enacted, beginning in Dec. 2014, that bar the Department of Justice from utilizing appropriated funds to

interfere with delineated states, Guam and Puerto Rico implementing their own laws authorizing cultivation, use, possession and distribution of medical marijuana. This legislation, known as the Rohrabacher-Blumenauer amendment, had an expiration date of Sept. 30, of this year, at the time of this writing.

Although marijuana businesses are illegal under federal law, they are still required to pay federal income taxes. While most businesses are entitled to claim deductions against their gross income in order to arrive at their respective taxable net income, pursuant to Section 280E of the Internal Revenue Code of 1986, as amended, deductions for expenses incurred in the business of producing or selling marijuana are disallowed. The prohibition extends to all of the business's deductions, even those that are not illegal *per se*, such as rent.

New Jersey Compassionate Use Medical Marijuana Act

New Jersey's Compassionate Use Medical Marijuana Act⁷ became effective Oct. 1, 2010. Pursuant to N.J.S.A. §24:6I-4, the Department of Health is required to set up a registry of qualifying patients and their primary caregivers. The act provides for a physician to issue a certification authorizing a qualified patient's use of medical marijuana.⁸ If the qualifying patient is a minor, then the custodial parent or guardian must be given an explanation of potential risks and benefits and provide their consent to the treatment.⁹ The act also sets out detailed requirements for establishing an alternative treatment center (ATC).¹⁰ Regulations for the implementation and administration of the act can be found at N.J.A.C. §8:64 *et seq.*¹¹

Subchapter 7 of the regulations establishes the general procedure for applying for an ATC permit.¹² The commercial real estate industry should note that applications must include information on all persons and entities having a five

percent or greater ownership interest in the center, "whether direct or indirect and whether the interest is in profits (such as percentage rent), land or building, including owners of any business entity that owns all or part of the land or building."¹³ In addition, the municipality must approve the operation, requiring both a zoning analysis and a determination whether the municipality has enacted an ordinance banning a marijuana business.¹⁴

On Jan. 23 of this year, Governor Murphy signed Executive Order No. 6. The order required the department and the Board of Medical Examiners to review New Jersey's medical marijuana program. In response to the governor's executive order, on March 23 the department issued the *NJ Health Executive Order 6 Report*. The report includes certain measures that take effect immediately (*e.g.*, the addition of debilitating conditions and the reduction of registration fees), and identifies other recommendations that will require regulatory or statutory action to implement. For purposes of the real estate industry, one of the significant department recommendations that will require further regulatory action is a provision that will permit satellite ATC locations for dispensing and cultivation, thereby increasing the demand for additional real estate. While the department acknowledged the need to formally amend the relevant regulations, it stated that it would consider waivers on a case-by-case basis to permit current ATCs to dispense at satellite locations and permit more than one cultivation site per ATC in advance of the formal rulemaking process.

Presently, there are numerous bills pending in the New Jersey Legislature, including expanding the state's existing medical marijuana program, legalizing adult use of marijuana and decriminalizing the possession of certain limited quantities of marijuana. There is also a full panoply of bills pending at the federal

level that cover the same general areas of reform.

Implications for the Real Estate Industry

Indisputably, cannabis is growing in social acceptance. Entrepreneurs are sensing opportunities for profit in this nascent industry as the political jockeying continues. Going forward, commercial landlords will inevitably seek to capitalize on this entrepreneurial spirit, but should also be keenly aware of the need to protect their investments in an uncertain and evolving legal landscape. To this end, consideration must be given to lease protections, casualty and liability insurance coverage, title insurance, environmental concerns and mortgage financing.

General Leasing and Tenant Issues

As discussed above, marijuana remains illegal under federal law. Under Section 856(a)(1-2) of the act, liability extends to those who “lease, rent, use, or maintain any place...for the purpose of manufacturing, distributing, or using” marijuana. Liability also extends to those who “manage...any place... either as an owner, lessee, agent, employee, occupant, or mortgagee, and knowingly and intentionally rent, lease, profit from, or make available for use, with or without compensation, the place for the purpose of” carrying on a marijuana business. In fact, U.S. attorneys have pursued *in rem* forfeiture actions against and have seized real estate used for growing and storing marijuana in states in which such business is permitted.¹⁵

The risk of federal prosecution cannot simply be contracted away or shifted to the tenant. However, landlords willing to lease space to the cannabis industry in spite of such risk must include certain protective lease provisions not found in standard commercial lease forms. The lease should require the

tenant to comply strictly with all state laws governing the operation of the cannabis business, all applicable zoning restrictions, and the requirements of any easements, covenants or restrictions that benefit or burden the property.

The standard lease obligation to comply with federal law must be tailored for this unique circumstance.

A lease agreement should specifically require that the tenant observe all federal guidelines that have been or may be issued by the Department of Justice, the Department of Treasury and other federal agencies with respect to cannabis businesses (*e.g.*, the Financial Crimes and Enforcement Network (FinCEN) guidance and any successors to the rescinded Justice Department memos), to the extent that such guidelines articulate grounds for permitting or not prosecuting cannabis business activity.

A lease agreement should also provide for an early termination option that gives the landlord the right to terminate the lease if the tenant fails to comply with state law and applicable federal guidelines or if any enforcement action is commenced or threatened against the landlord as a result of the tenant’s activities. In the event of such termination, the tenant must also be required to remove all cannabis product and equipment from the leased premises in compliance with the law. Further, the landlord should consider requiring a sizeable cash security deposit that the landlord can draw upon without restriction, to fund the defense of its interests in the property and ensure compliance with all legal requirements. It is worth noting, however, that the enforceability of such provisions remains untested and, even if enforceable against a tenant, such provisions would not, by themselves, circumscribe the power of federal prosecutors under federal law or offer a landlord a legal defense.

Cannabis businesses also pose practical and operational challenges for land-

lords, regardless of the legal status of such activities. Marijuana emits a strong odor, which could create serious conflicts with other tenants in multi-tenanted buildings. Tenants should be required to employ appropriate equipment and methods to mitigate odors. Buildings housing cannabis businesses may experience increased risk of fire due to highly flammable processes used in processing marijuana. Tenants should be required to install and maintain appropriate fire suppression systems. Marijuana cultivation and storage can be utility intensive, placing strains on water and electrical services. Increased utility capacity and the costs thereof should be addressed in the lease agreement. The nature of the cannabis business also necessitates heightened security and surveillance. A landlord should reserve the right to conduct regular inspections to ensure compliance with the lease’s requirements, carefully tailored to reflect the tenant’s unique security and operational requirements. Furthermore, with access to traditional banking services still largely unavailable to the cannabis industry, landlords may need to be prepared to accept payments of rent in cash or cryptocurrency.

Title Insurance

Although marijuana-related businesses have been legal under state law in some states for medicinal or recreational purposes for some time now, the title insurance industry has not embraced the field. In fact, currently, most title companies will not insure title in a transaction in which the property will be used for a marijuana-related operation. On June 7, 2017, First American Title Insurance Company issued an underwriting communication advising its title offices, title insurance agents, and approved attorneys in New Jersey to contact the local underwriter if contacted to provide title insurance in, or to serve as the escrow/closing agent for, a

transaction involving a marijuana-related business. One author, however, has confirmed that at least one title company will consider insuring title to property with a known or proposed marijuana-related operation on a case-by-case basis, provided it determines the legal and financial risks to be low, and subject to an exception for loss or damage resulting from the marijuana-related operation. Additionally, recent title commitments reviewed by one author contain a new Schedule B, Part I notice, as follows:

Notice: Please be aware that due to the conflict between federal and state laws concerning the cultivation, distribution, manufacture or sale of marijuana, the Company is not able to close or insure any transaction involving Land that is associated with these activities.

Casualty and Liability Insurance

Procuring and maintaining adequate casualty and liability insurance may pose a challenge for a landlord or lender considering doing business with a cannabis facility. Although many insurance brokers offer property and liability insurance coverage to the cannabis industry, many traditional insurance carriers have denied claims for losses related to cannabis industry activities, even in states where such activities are legal under state law, arguing that the object of the insurance coverage is illegal under federal law. Some courts have enforced these coverage denials for cannabis business losses due to the federal prohibition, while other courts have found that such claims may *not* be denied on public policy grounds alone.¹⁶

More importantly, insurance carriers may specifically exclude coverage from their policies for losses related to cannabis industry activities. In fact, in 2015, Lloyds of London, considered by many to be the world's leading specialty insurance market, stopped insuring marijuana-related businesses altogether due

to the conflict between state and federal laws and concerns over running afoul of U.S. anti-money laundering laws.¹⁷

Landlords considering leasing space to a cannabis business should carefully review their insurance coverage, and their tenant's insurance coverage, to confirm that losses arising from any cannabis-related activity are not excluded from coverage under the applicable policies. Landlords should work with insurance brokers and consultants who have experience in arranging and reviewing coverage for cannabis-related businesses. In the event that insurance is unavailable from a traditional insurance carrier, a landlord should consider whether self-insurance or establishing a captive insurer may be appropriate options for casualty and liability coverage. Both of these alternatives carry risk and added cost.

Industrial Site Recovery Act

Depending on the particular cannabis operation at a property, the business may be classified as an industrial establishment subject to the Industrial Site Recovery Act (ISRA), thereby subjecting the property to an environmental review and possible cleanup requirements.¹⁸ Pharmaceutical and medicine manufacturing has a North American Industry Classification System (NAICS) number 32541, and wholesale distribution of drugs and druggist sundries has a NAICS number 424210. Both NAICS numbers are subject to ISRA. On the other hand, certain operations of a marijuana business are specifically not subject to ISRA: marijuana grown under cover (NAICS # 111419); marijuana grown in an open field (NAICS # 111998); marijuana merchant wholesalers (NAICS # 424590); and marijuana stores (NAICS #453998).

Mortgage Loans

The continued status of marijuana as a Schedule I controlled substance under

federal law also creates a dilemma for both property owners and tenants of commercial real estate in the context of mortgage financing.

First, a cannabis business, even one that is licensed under the Compassionate Use Act, is likely to have considerable difficulty obtaining institutional mortgage financing. Most financial institutions, including those chartered under state law, are subject to multiple federal regulators such as the Federal Deposit Insurance Corporation and the Federal Reserve. It is a basic premise of the regulation of financial institutions that they will abide by all federal laws. As previously discussed, the act makes it a crime to manufacture, distribute, dispense or possess any controlled substance except as authorized by the act. There are no stated exceptions for marijuana produced or dispensed under any state medical or recreational marijuana program. The Money Laundering Control Act of 1986, which makes money laundering a federal crime, includes within the definition of money laundering, any banking transaction with a customer involving the proceeds of a known specified unlawful activity.¹⁹ As a result, a mortgage loan to a marijuana business would *de facto* constitute money laundering on the part of the financial institution that makes such a loan. In addition, most violations of the act also constitute "racketeering activity" under the Racketeer Influenced and Corrupt Organizations Act.²⁰

Second, in spite of the guidance published by the FinCEN on Feb. 14, 2014,²¹ few financial institutions have proven willing to risk the liability and reputational damage that may arise from being found in violation of money laundering and other federal laws. The FinCEN guidance attempts to clarify how financial institutions can provide services to marijuana-related businesses, consistent with their obligations under federal law. The guidance outlines strict detailed due

diligence procedures for financial institutions to follow in connection with marijuana business customers, mandates ongoing monitoring of a marijuana-related business and its related parties, designates several levels of ‘suspicious activity reports’ a financial institution must file for any transaction with a marijuana-related business, reiterates the need to file currency transaction reports for cash payments over \$10,000, and identifies an extensive list of potential ‘red flags’ for suspicious activity the financial institution is obligated to monitor for. However, the FinCEN guidance is not intended to alter federal law that makes marijuana illegal, cannot be relied upon as a legal defense against prosecution, is not binding on federal prosecutors and can be changed without warning.

Finally, the guidance is based upon the Justice Department memos. When U.S. Attorney General Sessions rescinded the memos, the effect and future of the FinCEN guidance was cast in further doubt. As a result of how little, if any, assurance the FinCEN guidance offers financial institutions, few are willing to undertake the onerous administrative burdens of complying with the conditions of the guidance or run the risk of legal liability for violating federal law in order to make a mortgage loan to a marijuana business.

To eliminate any doubt among Small Business Administration (SBA) lenders, in April, the U.S. SBA published revised guidelines that expressly prohibit banks from making SBA-backed loans to any company that has a direct business relationship with a cannabis or hemp business.²²

In addition to the obstacles under federal law to a financial institution financing commercial real estate of a marijuana business, it has already been noted that a loan policy of title insurance would not be available, nor would flood insurance under the Federal Emer-

gency Management Act, if the property were in flood hazard area. The issues related to property casualty insurance and liability insurance for a marijuana business property have also been noted. Finally, the collateral value of any commercial real estate owned or operated by a marijuana business is vastly undermined by the fact that it is always subject to the risk of forfeiture under federal law. These further obstacles to a commercial mortgage loan would also serve as impediments to obtaining financing from a private lender, not just a licensed financial institution.

Even if the mortgagor itself is not directly engaged in a marijuana business, if it were to lease all or a portion of its property to a tenant in a marijuana business, either before the mortgage loan is made or at any time during the term of the loan, all of the foregoing issues would be implicated.

Conclusion

While the trend appears to favor the continued growth of the marijuana industry, any negative change in policy or regulation at the federal level could swiftly end both the recreational and medical sectors of the industry. As such, each party to a real estate transaction involving a marijuana business—landlord, tenant and lender—must approach the transaction with care and appropriate safeguards addressing all existing risks and potential industry developments. ♪

Endnotes

1. Michael G. McGuinness, Thinking green: The role of indoor farming in older industrial space, *Real Estate NJ*, July 18, 2017.
2. Subrina Hudson, Real Estate: High rents draw in landlords, *Los Angeles Business Journal*, Dec. 19, 2016 – Jan. 1, 2017, Volume 38, Number 51.
3. Patricia Kirk, Pot Warehouses Are Going Through a Boom, *National*

4. 21 U.S.C. §801 *et seq.*
5. U.S. Const. Art. VI cl. 2.
6. 18 U.S.C. §§1961 *et seq.*
7. N.J.S.A. §24:6I-1 *et seq.*
8. N.J.S.A. §24:6I-5.
9. *Id.*
10. *See* N.J.S.A. 24:6I-7.
11. The Regulations expire on Dec. 19, 2018.
12. N.J.A.C. §§8:64-7.1-7.11.
13. N.J.A.C. §8:64-7.1.
14. *Id.*
15. *See, e.g., United States v. 2601 W. Ball Rd.*, No. 8:12-cv-01345-AG-MLG (C.D. Cal. Aug. 21, 2012); *United States v. 1840 Embarcadero*, 932 F. Supp. 2d 1064 (N.D. Calif. 2013); *City of Oakland v. Lynch*, 798 F.3d 1159 (9th Cir. 2015); *see also* U.S. Department of Justice, Press Release, April 4, 2018, Sweeping Two-Day Operation Targets International Organized Crime in Sacramento Area Neighborhoods, at <https://www.justice.gov/usao-edca/pr/sweeping-two-day-operation-targets-international-organized-crime-sacramento-area>.
16. *See Tracy v. USAA Cas. Ins. Co.*, 2012 WL 928186 (D. Hawaii 2012), *but see Green Earth Wellness Center v. Attain Specialty Insurance*, 163 F. Supp. 3d 821 (D. Colo. 2016).
17. *See Amy O’Connor, Lloyds Stops Insuring Marijuana Firms Due to US Law Conflicts*, *Insurance Journal*, June 24, 2015 at <https://www.insurancejournal.com/news/national/2015/06/24/372808.htm>.
18. N.J.S.A. 13:1K-6 *et seq.*
19. Money Laundering Control Act of 1986, 18 U.S.C. §1957.
20. 18 U.S.C. §§1961 *et seq.*
21. <https://www.fincen.gov/sites/default/files/shared/FIN-2014-G001>.
22. https://www.sba.gov/sites/default/files/resourcefiles/SBA_Policy_Notice_5000-17057.