Commercial Leases Involving Cannabis Businesses

A Practical Guide for Landlords and Their Counsel

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As the cannabis industry continues to grow in Colorado, commercial landlords and their counsel will encounter tenants with cannabis-related businesses more frequently. This article addresses issues unique to these lease transactions and offers suggestions for structuring such leases to maintain regulatory compliance.

The prolific rise of the cannabis[1] industry in Colorado over the past decade has had a pervasive effect on the industries that support it, including the commercial real estate industry. Real estate attorneys are increasingly encountering cannabis-related matters in their general practice, so it is critical that practitioners understand the state's legal framework regulating cannabis and how their clients fit into it.

This article explores the cannabis legal landscape as it relates to commercial landlords in Colorado. It addresses factors landlords should consider before entering the cannabis space, offers suggestions for structuring lease provisions in the cannabis industry context, and discusses the potential impact of Internal Revenue Code (IRC) § 280E on property owners.[2]

General Considerations for Landlords

Leasing to cannabis operators can benefit landlords, but before jumping in with both feet, real estate owners should weigh these benefits against the inherent challenges of such an arrangement.

Opportunities

Above all, landlords stand to benefit from charging a premium on rent. This is often justified by the increased risks the landlord assumes by leasing to a cannabis operator. It's also driven by supply and demand. Landlords can often charge a higher base rent where there's greater competition for properties that satisfy the licensing requirements. In Colorado, local jurisdictions can regulate the time, place, and manner of cannabis operators, so they may implement zoning and setback requirements

unique to marijuana operations.[3] For example, in Denver, in addition to complying with general zoning requirements, a dispensary may not be located within 1,000 feet of another dispensary, a school, an alcohol or drug treatment facility, or a childcare establishment.[4] A property that satisfies all of these requirements will be attractive to cannabis tenants.

Further, depending on the local jurisdiction, the tenant may be required to make substantial improvements to the property to obtain its license, including bringing the property up to code and implementing security measures.[5] Colorado cannabis licensees are also required by law to install on a licensed premises an alarm system and continuous monitoring, through the use of cameras and optional security personnel,[6] and must use commercial grade locks.[7] A landlord stands to benefit long into the future from such improvements to the property and security systems.

Challenges

Despite the attractions to the cannabis industry, cannabis-related leasing arrangements also present property owners with unique challenges. First and foremost, landowners should be aware that conventional lending is largely unavailable to the cannabis industry at the present time due to marijuana's status as a Schedule I drug under the federal Controlled Substances Act (CSA).[8] Federal banking reform efforts to address this issue are ongoing but have thus far been unsuccessful. Most notably, the Secure and Fair Enforcement Banking Act (SAFE Banking Act) was introduced in the House of Representatives by Colorado Rep. Ed Perlmutter. It passed in September 2019, becoming the first stand-alone marijuana bill to be passed by a House floor vote,[9] but it has been stalled in the Senate's banking committee ever since. The SAFE Banking Act would provide safe harbor protection to financial institutions that work with state licensed marijuana businesses.[10] Until Congress passes meaningful reform in this area, institutional investment remains largely unavailable to cannabis operators, creating capital shortages and a lack of financial institutions willing to serve as depositories. This often extends to real estate loans where the underlying property is used for cannabis-related activities.

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Property owners with existing financing should review their loan documents before leasing to cannabis tenants to ensure that entering into a proposed lease will not cause the loan to go into default. Virtually all commercial loan agreements contain a provision requiring borrowers to comply with all applicable laws. And unless a lease agreement is specifically drafted to be used in connection with a cannabis operation, there is unlikely to be a necessary carve-out from such covenant for federal laws prohibiting the trafficking of cannabis (discussed below). Thus, entering into a lease where the subject property will be operated for a federally illegal purpose requires attention to the landlord's financing documents.

Other challenges relate to the general nature of the cannabis tenant. For example, the tenant's revenue stream is somewhat uncertain; a tenant who loses the required licenses to operate also loses the revenue needed to pay rent. Moreover, cannabis operators do not currently have access to federal bankruptcy protection, which can make it more difficult for them to liquidate assets and pay creditors.[11] And most marijuana businesses still operate largely on a cash basis, making them an easy target for theft.

There are a few considerations involving federal law that may directly affect landlords. As discussed in more detail below, the Internal Revenue Service might attempt to apply IRC § 280E to landlords with business income and expenses related to the cannabis industry.[12] And while federal enforcement has largely been limited in recent years to operators who also violate state laws or regulations, there is potential exposure to property owners in the form of civil asset forfeiture in connection with a possible RICO action.[13]

Navigating the Legal Landscape

In Colorado, the implementation, management, and enforcement of the state's regulatory scheme is relegated to the Colorado Department of Revenue, Marijuana Enforcement Division (MED). The MED oversees the industry at the state level and is responsible for issuing business licenses, vetting potential licensees,

and monitoring licensees' activities. But Colorado has a dual-licensing system that requires marijuana businesses to also be approved to operate by the applicable local jurisdiction.[14] This system also permits local jurisdictions to prohibit the operation of regulated marijuana businesses, and a majority of Colorado local governments currently do so.[15] The following discussion examines state-level regulatory considerations for landlords.

An Overview of State Regulations

The type of a person's or entity's economic interest in a cannabis-related business determines the level of disclosure required to the MED and the level of scrutiny the MED will apply to vet such person or entity for a state license. Economic interests in a marijuana business generally fall into two categories: (1) equity holders and those who receive a share of the company's revenue, and (2) counterparties to contracts with the business.

Equity holders are further delineated by the business percentage they hold and/or their ability to control the licensed business into two groups—controlling beneficial owners (CBOs) and passive beneficial owners (PBOs). CBOs have a 10% or greater stake in the company and/or are in a position to control the business.[16] In certain cases involving qualified institutional investors, the investor will not be considered a CBO until it holds at least 30% of the company's equity. Conversely, PBOs hold less than 10% of the company's equity and are not in a controlling position.

For purposes of this regulatory analysis, "control" is defined as "the possession, direct or indirect, of the power to direct or cause the direction of the management or policies of a [p]erson, whether through the ownership of voting [o]wner's interests, by contract, or otherwise."[17] In addition to equity holders, this definition of control extends to those who exercise control through contractual arrangements.

Generally, those who do business with a marijuana operation on a commercial contractual basis are considered indirect financial interest holders (IFIHs). IFIHs include holders of a commercially reasonable royalty (this generally relates to intellectual property), holders of debt instruments that are convertible into the company's equity, and the catch-all "contract counterparty."[18] Leases of real property and equipment are expressly included in the list of examples of what might constitute a contract counterparty. However, as discussed below, how one's lease is structured may impact how the MED treats the landlord from a regulatory perspective and whether the landlord is required to undergo vetting.

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Disclosure and Vetting Generally

The MED generally vets people and money. It aims to identify the individuals involved in the business and where the company's money is coming from and going to. CBOs are subject to the highest level of scrutiny—they must apply for and receive a finding of "suitability" from the MED.[19] The suitability application includes, among other things, financial disclosures, fingerprints, and background checks.[20] Both entity CBOs and individual CBOs are required to submit suitability applications, although the form of the application varies slightly depending on the nature of the applicant. Moreover, those who will be CBOs by virtue of their equity holdings must be preapproved by the MED, meaning they must be found suitable before effectuating their equity interests.[21] On the other hand, individuals who are CBOs by virtue of their controlling position in the business (e.g., corporate directors and officers or non-equity managers of an LLC) must submit a suitability application within 45 days of assuming such role.[22]

IFIHs are on the other end of the spectrum. Generally, IFIHs are not subject to disclosure or vetting. However, an individual or an entity having more than one IFIH with a marijuana business is subject to disclosure.[23] The MED then has the discretion to seek further information and/or require that the individual or entity undergo some form of vetting.[24] For example, a landlord who has a lease with the cannabis business tenant and a separate equipment lease, loan, or management agreement has more than one IFIH with a marijuana business.

PBOs are also not generally subject to disclosure or vetting. However, a PBO that also holds an IFIH must disclose this fact and thus becomes subject to discretionary vetting by the MED.[25] A landlord leasing property to a marijuana business who also takes a small amount of equity in the company is a PBO with an IFIH.

As stated above, Colorado's regulatory scheme involves both a state and a local component. Thus, local jurisdictions maintain wide discretion regarding the extent of the industry's presence in the locality. Accordingly, local jurisdictions may enact more stringent disclosure and vetting requirements than the MED. For example, the Town of Dillon requires personal and financial disclosures, fingerprinting, and background checks from any person holding more than 1% equity in a licensed marijuana business, while the MED typically reserves this level of vetting for CBOs.[26] Therefore, clients looking to enter the cannabis space should review with their counsel the rules and regulations in the applicable local jurisdiction.

Disclosure and Vetting Regarding Leases

By and large, landlords are treated as IFIHs by the MED. However, a landlord that takes performance-based rent or has too much control of a licensed business may be considered a beneficial owner. If the landlord receives a percentage of revenue that equals or exceeds 10% of the company's overall net profits, the landlord will likely be considered a CBO and be required to submit a suitability application.

Leases are also required to be disclosed in connection with all cannabis license applications that a tenant submits. A marijuana business is required to submit an initial application to obtain its license, an annual renewal application, and an application in connection with certain change of ownership transactions. If a lease has been amended or extended since the tenant's most recent license application, such amended or extended agreement must be submitted in connection with the tenant's next application.[27]

Drafting Cannabis Leases

The following is a comprehensive but non-exhaustive analysis of key provisions that a practitioner should address when drafting a lease for a landlord and a cannabis tenant.

Rent Provisions

Base rent should be set at a flat rate rather than derive from a percentage-based formula. As discussed above, anyone who receives a defined share of the marijuana business revenue is considered to have an owner's interest in the business, regardless of actual equity ownership. Thus, a landlord taking base rent calculated using a percentage of the tenant's revenue would fall into this category and could be subject to vetting as a CBO depending on the percentage of the company's revenue that is actually received. However, a flat rent rate may be structured to take advantage of the tenant's business growth by setting the rate to fluctuate periodically (e.g., year-over-year) depending on historical performance metrics. For example, base rent might increase by a certain percentage, or to a fixed increased amount, if the tenant's revenue increases above a certain threshold or the tenant achieves a defined revenue growth rate from one year to the next.

The rent commencement date is another rent-based consideration. If the tenant is in the process of applying for its marijuana business license when the lease begins, it will not yet be generating revenue to pay rent. In this case, it is often advisable to delay the rent commencement date until after the tenant obtains its license.[28] The lease can address this by including a termination provision in the event that the tenant fails to obtain a license. Unfortunately, delaying the lease's start date is not an option because operators must show they are or will be entitled to possession of the licensed premises at the time they submit a license application.[29]

Finally, landlords should consider requiring an above-market security deposit to offset the increased risk of leasing to a cannabis operator.

Compliance with Laws

All leases contain a standard covenant that a tenant shall remain in compliance with all laws applicable to its operations during the term of the lease. While counterintuitive for general real estate practitioners, this provision requires the inclusion of specific federal law carve-outs related to cannabis business tenants, because the landlord and tenant must acknowledge that the tenant will not be in compliance with the CSA or other laws that may be violated by virtue of the tenant's violation of the CSA (e.g., RICO and anti-money laundering laws). Drafting attorneys should strive to construct these carve-outs as narrowly as possible. For example, rather than carving out the CSA entirely, a well-crafted provision will carve out only the tenant's compliance with the CSA's marijuana provisions.

Conversely, landlord's counsel should ensure that the tenant is expressly obligated to comply with all state and local marijuana laws and regulations applicable to it, including keeping its licenses in good standing at all times during the term of the lease.

Tenant's Control and Use of the Premises

Colorado law requires that all marijuana licensees have full control over their licensed premises.[30] This can be achieved by either direct ownership of the property or a lease that affords the tenant legally sufficient control, which means the tenant has full control of and exclusive access to the property.

While not explicitly required by law or regulation, the MED prefers that a tenant's permitted use under its lease include the specific contemplated marijuana operations (e.g., cultivation, manufacturing, and/or dispensing). Including such a narrowly tailored permitted use provision in a lease also prevents a tenant from conducting unwanted activities, such as cultivation or manufacturing, on the leased premises without first obtaining the landlord's consent. Here is an example of a tailored and regulatory-compliant permitted use provision for a medical and retail dispensary lease:

> The premises shall be used and occupied by tenant only for the sale of medical and retail marijuana and marijuana related products and for no other purpose. Tenant shall not initiate, submit an application for, or otherwise request any land use approvals or entitlements with respect to the premises, including, without limitation, any variance, conditional use permit, or rezoning, without first obtaining landlord's prior written consent, which may be given or withheld in landlord's sole discretion.

Landlord's Access to Premises

As part of the requirement that the tenant have full control of the premises, a cannabis business lease must also restrict a landlord's manner of access to certain areas of the premises. At first blush, this concept often confounds landlords, who hold legal title to the property. However, Colorado's requirement that a licensee have full control over restricted areas of its licensed premises includes prohibiting unauthorized access by landlords, who may not enter such areas unless accompanied by an authorized employee of the licensed business.[31] Thus, drafters must be careful to limit a landlord's access to the leased premises in accordance with all applicable laws. Specific provisions at issue here include those regarding the landlord's entry to the premises generally, access to perform environmental testing, access in the event of default, and access for purposes of auditing books and records.

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Automatic Termination

In addition to standard lease termination provisions, a lease with a marijuana business tenant should contain automatic termination provisions that relate specially to marijuana laws and the tenant's requirement to maintain its marijuana license in good standing. A lease should automatically terminate if:

- there is a change in Colorado law or the applicable local jurisdiction's laws that would render the tenant's business illegal under such laws;
- there is a change in the federal government's enforcement priorities such that the tenant is in jeopardy of investigation or prosecution due to its marijuana activities; and
- the tenant materially violates applicable marijuana laws or loses its state or local marijuana license.

Alternatively, these termination provisions might be drafted to be in the landlord's sole discretion. However, the lease should terminate immediately in the event that the landlord exercises such discretion.

Governing Law and Venue Selection

Virtually all leases in Colorado provide that the lease is to be governed under Colorado law, but practitioners should note the importance of selecting the governing law and venue in leases with marijuana business tenants (and other cannabis-related contracts). The enforceability of cannabis-related contracts must be considered because courts generally may not enforce contracts where the subject matter of the agreement is illegal. Fortunately, Colorado law expressly provides that cannabis-related contracts are enforceable in Colorado courts.[32] Thus, a cannabis lease should be governed by Colorado law, and venue for disputes should be limited to the state or county courts of Colorado. Some parties may prefer to have disputes resolved in binding arbitration to maintain the privacy of their involvement in the cannabis industry. In any event, there is a very real risk that federal courts, even those located in Colorado, will refuse to enforce contracts that relate to cannabis activity.

Indemnification Provisions

There are two key considerations for indemnification provisions in cannabis business leases. First, environmental indemnity for the landlord is more critical than in a standard commercial lease. This is particularly true in the context of cultivation and manufacturing operations, which will inevitably cause hazardous substances to be brought onto the leased premises. Second, landlords should require tenants to indemnify them for any damages sustained as a result of any federal enforcement action in connection with their tenants' federally illegal businesses.

Reformation Covenant

Because the MED (and likely the applicable local licensing authority) will review the lease in connection with the tenant's license application, it is advisable to include a provision acknowledging this fact, and a corresponding covenant to reform the agreement as may be required by applicable governmental authorities, while also maintaining (as nearly as possible) the original intent of the business arrangement between the parties.

Tenant Guarantees

Finally, to account for the increased risk of leasing to a marijuana business, virtually all landlords will ask for one or more personal guarantees from the tenant's principals. This is often a point of contention between landlords and tenants, and a middle ground may be to have the guarantees become unnecessary upon the tenant meeting certain metrics or after a specified passage of time.

IRC § 280E

IRC § 280E prohibits a taxpayer from taking ordinary and necessary business deductions in connection with carrying on any trade or business that consists of trafficking in Schedule I or II federally controlled substances in violation of federal law.[33] As "marihuana" is still listed on Schedule I of the CSA,[34] all state-sanctioned cannabis operators are currently trafficking in a federally controlled Schedule I substance in violation of federal law. Thus, all cannabis operators are also subject to compliance with § 280E when filing their annual tax returns and must pay taxes on their gross income, deducting only costs of goods sold.

Recent Case Law

In 2018, the US Tax Court decided two seminal cases regarding the application of § 280E to cannabis-related businesses. First, in *Patients Mutual Assistance Collective Corp. v. Commissioner of Internal Revenue*, the court determined that an IP holding company was subject to § 280E, despite limiting its operations to brand licensing and the sale of non-marijuana products, because the entity was commonly owned by its sister marijuana operating entity and did not meet the requirements for establishing a true separate trade or business.[35]

Later, in *Alternative Health Care Advocates v. Commissioner*, the court decided that a third-party management company was also subject to § 280E given the fact that all of its revenues were derived from the operation of a business that trafficked in controlled substances.[36] The court rejected the taxpayer's argument that it was not subject to § 280E because it never took title to any of the marijuana assets.[37]

Considerations for Landlords

Generally, one would not presume that a property owner could be deemed to traffic in controlled substances simply by virtue of leasing its property to a tenant that operates a marijuana business. On the other hand, the landlord's income in connection with such a lease (i.e., the rent) may constitute proceeds derived from sales of a controlled substance. In any event, the IRS has expressed interest in seeking to apply § 280E to landlords and other ancillary businesses servicing the cannabis industry.[38] While few experts expect that such challenges would be successful, especially in the context of a true third-party relationship between the landlord and tenant, real estate practitioners should be aware of such risks when advising their clients who desire to lease to cannabis operators.

Conclusion

As the cannabis industry becomes a mainstay in Colorado, even landlords who do not actively seek out opportunities to lease property to marijuana businesses may soon find themselves thrust into this exciting new world. It thus behooves all commercial property owners, and especially their counsel, to understand the dense regulatory framework that underlies the industry. Armed with this knowledge, landlords will be better positioned to enter lease negotiations with potential cannabis business tenants. They will be aware of, and prepared for, their likely exposure to the MED and other regulatory agencies and thus better able to draft lease provisions that account for such laws and regulations. CL


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NOTES

1. The US Code uses an antiquated spelling of "marihuana" and does not refer to "cannabis." This article employs the modern spelling "marijuana," unless quoting a body of law that uses the antiquated spelling. Where a particular law uses the term "cannabis," this article also employs the term "cannabis." For purposes of this article, any use of the term "cannabis" means "marijuana," and not "hemp" (as those terms are defined in the CSA), except as otherwise expressly provided herein.
2. This article does not discuss commercial real estate leasing as it relates to hemp businesses.
3. CRS § 44-10-301.
4. Denver, Colo., Mun. Code § 6-211.
5. Colo. Code Regs. §§ 212-3:3-220 to 225.
6. Colo. Code Regs. § 212-3:2-225.
7. Colo. Code Regs. § 212-3:3-220B.1.
8. 21 USC § 812.
9. Secure and Fair Enforcement Banking Act of 2019, H.R. 1595, 116th Cong.
10. Alovisetti, "Moving Forward with the MORE Act: A Look into Current Cannabis Legislation," Vicente Sederberg LLP (Nov. 18, 2019), https://vicentesederberg.com/insights/cannabis-legislation-more-act.
11. *In Garvin v. Cook Invs. NW, SPNWY, LLC*, 922 F.3d 1031 (9th Cir. 2019), the Ninth Circuit seemingly opened the door for cannabis companies to use federal bankruptcy protections. The court adopted a narrow interpretation of 11 USC 1129(a)(3)'s confirmation requirement that a plan be proposed "not by any means forbidden by law," *id.* at 1035, holding that this requirement applies only to the "means of a reorganization plan's proposal, not its substantive provisions." *Id.* at 1033. However, in the first cannabis related bankruptcy matter following *Garvin*, the US Bankruptcy Court for the Eastern District of Michigan issued its opinion in *In re Basrah Custom Design, Inc.*, 600 B.R. 368 (Bankr. E.D. Mich. 2019), which dismissed the Ninth Circuit's narrow interpretation of § 1129(a)(3).
12. Schroyer, "Former IRS attorney warns of upcoming 'tsunami' of marijuana-related 280E audits," Marijuana Bus. Daily (Oct. 10, 2019), https://mjbizdaily.com/former-irs-attorney-warns-of-upcoming-tsunami-of-marijuana-related-280e-audits.
13. 18 USC § 1964.
14. CRS § 44-10-301.
15. CRS § 44-10-104.
16. Colo. Code Regs. § 212-3:1-115.
17. *Id.*
18. *Id.*
19. Colo. Code Regs. § 212-3:2-235A.1.
20. Colo. Code Regs. § 212-3:2-235D.
21. Colo. Code Regs. § 212-3:2-235B.3.a.
22. Colo. Code Regs. § 212-3:2-235B.3.c.
23. Colo. Code Regs. § 212-3:2-230A.3.
24. Colo. Code Regs. § 212-3:2-240.
25. Colo. Code Regs. § 212-3:2-230A.3.b.
26. Dillon, Colo., Mun. Code § 6-8-90.
27. Colo. Code Regs. § 212-3:2-225G.
28. The time it takes to receive a license from the MED constantly fluctuates. At the time of publication, the MED was generally issuing new licenses in about one to three months following its receipt of an application. However, if certain tenant improvements are required, the licensing timeline may be extended to upwards of 10 months.
29. Colo. Code Regs. § 212-3:2-220A.6.
30. Colo. Code Regs. § 212-3:3-210.
31. Colo. Code Regs. § 212-3:3-205.
32. CRS § 13-22-601.
33. "No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted." 26 USC § 280E.
34. "Unless specifically excepted or unless listed in another schedule, any material, compound, mixture, or preparation, which contains any quantity of the following hallucinogenic substances, or which contains any of their salts, isomers, and salts of isomers whenever the existence of such salts, isomers, and salts of isomers is possible within the specific chemical designation: (10) marihuana." 21 USC § 812(c).
35. *Patients Mut. Assistance Collective Corp. v. Comm'r*, 151 T.C. 176, 198–205 (T.C. 2018).
36. *Alt. Health Care Advocates v. Comm'r*, 151 T.C. 225, 238–242 (T.C. 2018).
37. *Id.* at 241–42.
38. Schroyer, *supra* note 12.