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Fortune or forfeiture: real estate lending in the cannabis space

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With expectations of doubling in the next five years, the cannabis industry will require significant funding to fuel its fast and furious growth. Funding will be needed in particular for property acquisitions, which will serve as cultivation and distribution facilities, and as retail storefronts. Financial institutions and other lenders are eyeing the opportunity to provide real estate financing to marijuana-related businesses ("MRBs"), but to succeed, lenders must be mindful of added layers of complexity relative to traditional real estate financing and MRB lending generally.

So long as marijuana remains classified as a Schedule 1 controlled substance under the Controlled Substances Act, real property owned or utilized by a marijuana-related business is technically subject to forfeiture to the U.S. government.

When an MRB faces financial distress, a mortgage lender's ability to recover will depend not only on the value of real property, but also on applicable cannabis laws, at the state, local and federal levels. Improper structuring or failing to anticipate challenges could result in collateral forfeiture and even liability for supporting an MRB's operations.

Collateral at risk

So long as marijuana remains classified as a Schedule 1 controlled substance under the Controlled Substances Act (the "CSA"), real property owned or utilized by an MRB is technically subject to forfeiture to the U.S. government. That is because, in the strictest sense, regardless of an MRB's place in the production or retail chain, its land is necessarily being used "to commit, or to facilitate the commission of, a violation of" the CSA. Accordingly, forfeiture is possible, which could have the harsh consequence of rendering a mortgage lender unsecured. *See* 21 U.S.C.S. 881(a)(7).

Mortgage lenders can mitigate risk by ensuring, through comprehensive diligence, that the MRB is in full compliance with applicable state laws and regulations, including licensing requirements, as federal enforcement is more likely for an MRB that violates local cannabis laws. (The Department of Justice's "Cole Memo" issued in 2013 and 2014 provided enforcement priorities for cannabis, stating that conduct in compliance with a jurisdiction's "strong and effective regulatory and enforcement system[ ]" is "less likely to threaten" the priorities identified therein. Although the Cole Memo was rescinded in 2018, it appears still to be relied on in practice, with little changing in respect of federal enforcement since its rescission.)

Relative to traditional credit documents, deal documents should provide more robust representations and warranties and indemnities, along with broader inspection and audit rights, to enable the lender to monitor and guard against non-compliance (a challenge in such a cash-heavy industry). Further, traditional credit enhancements, such as guaranties and cross collateralization (ideally with property wholly unrelated to cannabis), take on greater importance when evaluating an MRB credit transaction.

Risk of MRB's operations

Beyond risks to collateral, mortgage lenders, like other lenders in the cannabis space, face potential liability if they are found to finance activities that facilitate CSA violations. Banks and other financial institutions (broadly defined) also run the risk of violating the Bank Secrecy Act ("BSA"), which is aimed at combatting money laundering.

The DOJ currently leaves enforcement in the cannabis industry to the discretion of each district's prosecutor's office. It appears, however, based on remarks of federal officials, including former FDIC Chairwoman McWilliams' remarks in June 2020, that enforcement risk is low for lenders serving state-compliant MRBs and following the Department of the Treasury's 2014 BSA guidance ("FinCEN guidance").

The FinCEN guidance provides tailored guidelines for lenders that are subject to the BSA, and incorporates the priorities identified in the Cole Memo. It calls for ample due diligence and the submission of Suspicious Activity Reports ("SARs") pursuant to a multi-tiered

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system, with the lowest tier "Marijuana Limited" SARs filed for MRBs that are state-compliant and do not raise red flags.

REITs on the rise

A benefit specific to the real estate sector is the potential for a lender to qualify as a real estate investment trust ("REIT"), which has already become an increasingly popular vehicle for real estate-based financing to MRBs. REITs are generally considered not subject to the BSA, potentially reducing the risk of federal enforcement. They also provide considerable tax benefits, which enhance yield expectations. As a result, cannabis REITs have been successfully lending to MRBs in recent years, with some estimating that current industry participants are valued at approximately $6.5 billion.

REITs commonly operate on a sale-leaseback structure but may also make traditional mortgage loans (which tend to have more flexibility for borrowers), often to property owners that lease to MRBs. To qualify as a REIT, among other requirements, the entity must derive at least 75% of its income from real-estate related sources and distribute at least 90% of taxable income to shareholders annually.

Land use limitations

Limitations on land use when in the hands of a borrower will likely continue when in the hands of a foreclosing lender. As such, issues concerning zoning regulations, restrictive land covenants, state nuisance laws and limits like those set forth in New York's Marijuana Regulation and Taxation Act ("MRTA") have the potential to upend collateral value if not anticipated and addressed.

For example, the application of nuisance laws to offensive odors, which has been recognized in New York, can reasonably be expected to extend to certain cannabis operations. In *Abrams v. Board of Managers of 25 Beekman Place Condominium*, a 2019 case before the New York Supreme Court, the court found plaintiffs had adequately pled a nuisance claim based on "substantial, unreasonable and recurring" cooking odors. Nuisance laws might be similarly applied to MRBs that operate on-site consumption facilities that are likely to emit odors that some consider offensive.

With respect to zoning laws, the MRTA provides that retail storefronts and adult-use consumption sites cannot be "within five hundred feet of a school grounds . . .or within two hundred feet of a house of worship." MRTA §§ 72(6) (retail space); 77(4) (onsite consumption). Localities may also establish their own zoning laws restricting where MRBs may operate, and covenants running with property may further limit land use.

To avoid upending collateral value and borrower defaults, lenders should ensure that growing, manufacturing, and distributing cannabis at the mortgaged premises are permitted by local zoning laws and do not conflict with the rights of neighboring property owners. In addition, in sale-leaseback transactions, beyond the protections of diligence, representations and warranties and indemnities, loan documents should authorize the lender to remove the borrower/tenant in the event regulatory or zoning issues arise.

The path to enforcement

Of course, thorough preparation notwithstanding, sometimes enforcement is the lender's only option.

State enforcement options, including receiverships and foreclosures, may be available to mortgage lenders in the cannabis space. In proceedings in various states, however, licensing issues may crop up, particularly where a receiver or other entity steps in to operate an MRB's business or where land on which cannabis is grown or sold is transferred. As New York law requires a license to "cultivate, process, distribute, deliver or dispense cannabis" and prohibits assignments without prior approvals, an unlicensed receiver, secured lender or buyer may face similar challenges in a New York proceeding.

Beyond risks to collateral, mortgage lenders, like other lenders in the cannabis space, face potential liability if they are found to finance activities that facilitate Controlled Substances Act violations.

The uncertainty, however, may not last long. It is possible New York will promulgate regulations to address potential licensing issues arising in cannabis receiverships, as certain other states have done.

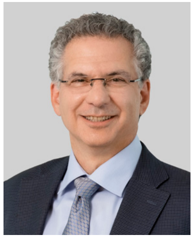
Washington, for example, has enacted regulations governing cannabis receiverships and has a separate licensing program for receivers. Washington's regulations were put to the test in 2017 when a landlord initiated a receivership over its MRB tenant. In accordance with the regulations, the receiver successfully worked with the applicable Washington regulatory agency to obtain the necessary approvals and licensing to operate the business and sell the MRB's cannabis inventory.

Conclusion

Real estate lenders willing to undertake the challenges presented by evolving cannabis laws are bound to reap success as legalization spreads across the U.S. Risks to both collateral and lender can be mitigated through comprehensive diligence, enhanced protective provisions and a vigilant watch for regulatory changes. Where there's a will to lend, there's a way to succeed.

Joseph Cioffi is a regular contributing columnist on consumer and commercial financing for Reuters Legal News and Westlaw Today.

About the authors



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