

# Marijuana Series: Real Estate Opportunities Fueled by Legalization of Cannabis, The Landlord Perspective

March 5, 2018

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## THE TREND

Currently, 29 states and the District of Columbia have legalized the use of cannabis for medical purposes. The steady growth in sales of legal cannabis in North America has so far proven to be big business, not only for the growers and sellers, but also for owners of real estate holding inventory that may be well suited to serve the growing industry. In 2016 alone, sales of cannabis grew to 6.8 billion. This is an increase of 34% from 2015 sales. The current trend suggests that there will be legalization of both medical and recreational cannabis in additional states, including the State of New Jersey where medical use has been legalized and significant efforts are being made to make recreational use legal as well.

By way of example of the real estate ventures inspired by the legalization of cannabis, Innovative Industrial Properties is a real estate investment trust that buys buildings, renovates them and leases out space to medical marijuana growers. The company went public on the New York Stock Exchanges in 2016 and is said to be valued at about \$60 million. Among its holdings are properties in the State of New York, our neighbor, where medical marijuana is legal. Similarly, other real estate investors, even if at a much smaller scale, are likely to pursue the developing real estate opportunities surrounding the cannabis industry. Landlords can better prepare themselves for the cannabis boom by becoming knowledgeable of the potential issues that may present themselves in real estate leasing transactions with growers and sellers of cannabis.

## THE SPACE

Owners of factories, warehouses, self-storage facilities and other industrial-type facilities which may have sat idle for some time are now experiencing a renaissance in interest due, in large part, to the increased need for facilities able to be repurposed for the cultivation and processing of cannabis plants and related products. As cannabis, for both medical and recreational uses, becomes more widely accepted, spaces that can be converted for retail and growing use for the cannabis industry are also likely to see increased real estate transactional activity. In Denver, Colorado alone, there are in excess of 200 marijuana retail stores in spaces ranging from high end storefronts to former gas stations. In Brookline, Massachusetts, a retailer of marijuana products occupies a former bank building turned cannabis dispensary. The opportunities presented by the legalization of cannabis to repurpose dormant space seem endless.

For cultivation of cannabis products, large, relatively unobstructed spaces located in industrial-type areas able to accommodate the increased square footage needed to grow cannabis are ideal. Other critical elements include the ability to retrofit the space to allow for the climate-control systems necessary to create the high humidity growing environment,

the flexibility to implement the health and safety standards targeted to minimize the possible negative effects of such a tenancy (e.g. fumes, mold) and the capacity to upgrade the electrical infrastructure of the space so that it can handle the high intensity electrical use necessary for such operations. The ability to provide sufficient electrical power to meet the demands of the tenant grower is a significant factor to consider in the retrofit process. It takes a lot of power to grow cannabis. Finally, spaces which are relatively private or located in more remote areas are advantageous since they can be more easily monitored and secured via both manned and unmanned methods. The need for increased security becomes a greater focus with this type of tenancy. While you may require the tenant to pay for its own security, it may be prudent to add additional security to the common areas of the site at tenant's cost.

## THE TERMS

So, you have the space, how long do you lease it for? Because it can cost millions to retrofit the space, whether it is the landlord or the tenant who pays for the retrofit, initial term leases should typically exceed ten years in order to allow for the amortization of the retrofit costs. In addition, the tenant will likely want the option to renew the lease in increments of not less than 5 years each.

As for who pays for the retrofit, it depends on who has the available cash. Because marijuana is currently illegal at the federal level, many banks will not provide financing to buildings used by the industry. However, local banks may be more willing to take the risk, along with private investors, and, if you have cash stashed away sufficient to pay for the retrofit, that, too, is an option with the retrofit cost billed back to the tenant as part of the rent over the term of the lease. In addition to the issue of how to finance the retrofit, there is the issue of what impact these tenancies will have on existing financing. Landlords must be sure to review any financing documents encumbering their property for prohibition or limitation on certain uses and the steps to be followed in order to obtain approval for new tenancies.

It makes sense to structure the lease as a triple net lease with the tenant paying base rent to the landlord and all other costs and expenses incurred in connection with the space to be paid for by tenant (e.g. proportionate share of real estate taxes, insurance, utilities and security). While gross rent structures may work with tenants in other industries, the known and unknown costs associated with operating a cannabis cultivation facility should be a deterrent to any landlord considering anything other than a triple net lease. In fact, in performing the retrofit for the space, the landlord should be careful to include installations that will allow the landlord to monitor tenant's usage of electricity and other utilities. With monthly electricity consumption costs of \$10,000 relatively typical in the operation of these growing facilities, it makes sense to protect the landlord by ensuring that utilities do not eat up the rental stream. Additionally, so long as the legality of these operations remains in question; at least at the federal level, the lease should provide for tenant to pay the rent in cash or by money order upon landlord's demand.

What makes sense in terms of rental rates and how much of a security deposit to require will be based on what the market can bear, the amount of landlord's initial investment to prepare the space for the tenant's use and the level of risk that the landlord is taking by leasing space for an illegal use (at least at some level). Nevertheless, for the time being, market indicators all point to the fact that rent for facilities particularly suited for the cannabis industry have seen a dramatic increase in line with the number of states that have legalized cannabis production in one form or another. Because of the inherent risks, however, in leasing to such tenants, landlords should protect themselves by requiring a healthy upfront security deposit as well as the ability to draw down on the deposit if the lease is terminated due to compliance with laws issues.

Compliance with laws in connection with the retrofit process can be tricky given the lack of regulation at the local land-use level with respect to cannabis cultivation facilities. Depending on whether the tenant is purely a grower with no retail operations on site, parking and site traffic control may or may not be an issue. Local land use regulations will likely have to enact parking and other traffic control regulations to address the expanding industry.

Other possible areas of growth in terms of regulation may include laws enacted to protect the environment from noxious smells and fumes. Additional laws relating to the impact of the cannabis industry on energy conservation may also appear. That being the case, the lease should generally impose the burden on the tenant to comply with any and all laws applicable to the build out, use and operation of the space by the tenant including obtaining all of the necessary local and state approvals in connection with the retrofit. It will be important to stay apprised of such laws, including any new environmental laws, as they evolve. and, to the extent specific registration and/or licensing requirements are implemented, the tenant should have an ongoing obligation to provide proof to the landlord of compliance.

Particular attention should also be given to the condition in which the tenant is required to deliver the space to the landlord at the end of the lease term based upon the type of installations made by the tenant throughout the lease term. It is also important to be cognizant of any laws that require notice of cessation of operations. The tenant's installations may be so unique to the tenant's cannabis cultivation business that instead of creating value to the landlord, they create increased demobilization costs to the landlord if not properly imposed as a tenant responsibility.

Typically, leases will state specifically what use is permitted in the space. Given the variety of activities and products that can be produced by cannabis growers and the different safety risks that may be associated with producing one product versus another, it is important to be very specific in the lease as to what type of products may be produced in the subject space and what type of methods may be used. For example, hash oil is a popular cannabis product which can create an explosion when being produced; thus, special safety measures must be required of tenants to reduce the likelihood of a casualty.

Alternatively, landlords can simply choose to prohibit the manufacture of certain types of cannabis products. Given the tension between federal and state laws, it is prudent to include a disclaimer as to whether the use is legal and state, specifically, that no representations are being made as to the tenant's ability to operate in the space for tenant's intended purpose and, further, to include affirmative language permitting the landlord to terminate the lease upon reasonable notice in the event the continued use results in actual or threatened liability to the landlord or is determined to be illegal by a federal or local authority.

When negotiating such a provision, it can be expected that the tenant will want a similar right or, at a minimum, to set the parameters pursuant to which the landlord may terminate. Among other things, the tenant may ask for a black-out period to allow a particular growing cycle to be completed or to allow for the orderly transfer of product to a new facility or tenant may also wish to carve out high volume selling seasons such as the back to school or holiday seasons. In allowing such a termination right, landlord should build in a sufficient cushion to allow landlord to market the space, secure a new tenant and retrofit the space for the new tenant.

Traditionally leases contain restrictions on noxious uses to which all tenants are subject. Landlords will have to revise existing leases to allow for the incoming tenancies fueled by the cannabis industry as well as to redefine what constitutes a noxious use. Landlords will also have to consider the impact of such use on existing or targeted tenants. and As growers

expand and depending upon whether or not the industry is legalized at the federal level, suitable space may become scarce, which will trigger a greater need for exclusivity provisions on the part of the tenant.

Another consideration before entering into leases with tenants in this industry is whether such activities will be insurable. Will insurers make available liability, property, worker's compensation rent loss and/or rent interruption insurance for space leased to cannabis growers? Will the existence of such activities result in the cancellation of other policies? This is clearly an area that is in flux. A possible solution, at least with respect to insurance for cannabis operations, might be to require the tenant to self-insure.

#### The Future

The expansion of the cannabis industry seems inevitable although the manner in which it expands and the impact on the real estate industry and the economy as a whole is unknown. What is certain is the fluid nature of it all.