

## LEASING TO A MEDICAL MARIJUANA TENANT A WISE NEW REAL ESTATE MOVE?

By: **Susan R. Fox, Attorney at Law**  
[www.foxlegal.net](http://www.foxlegal.net)

It's no secret that one of the most active aspects of an otherwise relatively moribund commercial real estate market in Colorado is found in the demand for medical marijuana ("MM") facilities. Purchase-and-sale transactions are relatively simple: a willing buyer and a willing seller complete the sale, and the seller need not worry thereafter about what the buyer does with the property. Leases, however, generally create long-term relationships, and care should be taken by both parties when entering into a lease for a MM facility.

There are many types of medical marijuana facilities, and potential lease transactions exist in almost all use categories:

- Industrial: indoor grow farms, labs
- Retail: storefront dispensaries, MM physicians
- Office: dispensaries, MM brokers, MM physicians, labs
- Land: Given Colorado's climate, land leases for outdoor grow farms are unlikely.

Landlords and their potential MM tenants have some very unique things to consider when entering into a lease.

### **Background: The vague and confusing state of the law**

How did we get here, and what are the current legal issues that make leasing to MM facilities problematic?

To begin, marijuana is a "controlled substance", the possession, use and sale of which is illegal under a number of federal statutes, and there are also statutes allowing federal agents to confiscate real property used in the commission of a crime. U.S. Attorney General Eric Holder recently announced the current U.S. Justice Department's policy of not enforcing federal drug laws related to marijuana, so long as state law is complied with. The problem in Colorado (not alone among the states), is that state law is a confusing and inadequate mess. Moreover, Holder said that the U.S. Justice Department would continue to enforce federal laws against drug traffickers who "falsely masquerade" as legitimate medical dispensaries. It is important to remember that the federal laws still exist, notwithstanding the stated *policy* of the current administration concerning enforcement. This policy will not be binding upon future administrations, and it could even change during this administration. And there will always be law enforcement officers who disagree with the policy will be looking for every opportunity to find that MM operators have acted in such a way that the policy does not apply.

Marijuana is also a controlled substance under Colorado law. Possession, use and sale of marijuana remain crimes except to the extent that one can bring oneself under the protection of the constitutional amendment and implementing statute discussed below. Penalties for violating

drug laws include incarceration, loss of driving privileges, and seizure of property used in connection with the crime.

Local ordinances also govern the use of marijuana in additional ways, such as Denver's ordinance allowing seizure of real and personal property deemed to be a "public nuisance" (see Article III of the Denver Municipal Code, Sections 37-70 through 37-87), and recently-enacted moratoria on new MM facilities and zoning laws in numerous jurisdictions (see, for example, Commerce City's Ordinance No. 1770).

An amendment to the Colorado Constitution, passed pursuant to the initiative process in 2000, added Article XVIII, Section 14 to the Constitution. It creates an *affirmative defense* to criminal prosecution under state law for certain medical patients with "debilitating conditions", their "primary care-givers", and certain actions by physicians, so long as they comply with the requirements of the amendment and statutes and regulations enacted pursuant to it. Patients must apply to be listed in a state registry and be issued a registry card. In 2001, as directed by the constitutional amendment, the state legislature enacted enabling legislation which is codified in C.R.S. 18-18-406.3 of the criminal statutes and C.R.S. 25-1.5-106 of the statutes which govern the Colorado State Department of Public Health and Environment ("CDPHE"). CDPHE, as required by the constitutional amendment and enabling legislation, adopted regulations concerning its oversight of the medical marijuana registry program, at 5CCR 1006-2.

The CDPHE regulations included the definition of "primary care-giver" taken directly from the constitutional amendment: " 'Primary care-giver' means a person, other than the patient and the patient's physician, who is eighteen years of age or older and has significant responsibility for managing the well-being of a patient who has a debilitating medical condition." Neither the constitutional amendment nor the enabling statute, however, defined the phrase, "significant responsibility for managing the well-being of a patient who has a debilitating medical condition". So the CDPHE undertook to define that phrase in its regulations. It defined "significant responsibility for managing the well-being of a patient who has a debilitating medical condition" as "assisting a patient with daily activities, including but not limited to transportation, housekeeping, meal preparation, shopping, making any necessary arrangement for access to medical care or services and *provision of medical marijuana*." [Regulation 2, prior to amendment in 8/30/2009; emphasis added]

In the summer of 2009, the CDPHE held hearings on proposed amendments to its regulations. The most controversial of the proposed amendments would have provided that no person could be a primary care-giver for more than five patients at a time. The hearing concerning this proposed regulation was attended by hundreds of people, a large number of whom were passionate proponents of the use of medical marijuana. As the result of the hearing, the proposed five-patient limit was not adopted, and the list of examples of activities which constitute "significant responsibility for managing the well-being of a patient who has a debilitating condition" was amended to insert the word, "or" between each example. Thus, under the revised CDPHE regulations, *the provision of medical marijuana alone* met the definition of "significant responsibility for managing the well-being of a patient who has a debilitating medical condition". This action of the CDPHE, together with U.S. Attorney General Holder's announcement that the U.S. Department of Justice would not be enforcing federal laws against

MM operators who comply with state law, ignited the explosion in the number of "medical marijuana dispensaries" in Colorado. However, note that the term "dispensary" is found nowhere in the constitutional amendment, the implementing statute or the CDPHE regulations. Those who seek to supply marijuana to patients entitled to receive it must fit themselves within the definition of "primary care-giver"; there is currently no permit or license requirement for, or registry of, primary caregivers.

On October 29, 2009, the Colorado Court of Appeals decided *People v. Clendenin*, Colo. Court of Appeals No. 08CA0624, finding the statute constitutional and dealing with the definition of "primary care-giver". The appellate court confirmed the lower court's conviction of Stacy Clendenin, who was found guilty of cultivation of marijuana, possession with intent to distribute marijuana, possession of marijuana concentrate, possession of marijuana – eight ounces or more, and possession of drug paraphernalia, after the police found in her home 44 marijuana plants, \$572 in cash and 67 medium sized zip lock bags (presumably containing marijuana). The Court of Appeals held that, in order to qualify as a "primary care-giver" under the constitutional amendment and enabling statute, a person must do more than merely supply marijuana to the patient, a decision that was directly at odds with the CDPHE regulations, under which simply providing marijuana to a qualified patient would bring a person within the definition of "primary care-giver". [Because Ms. Clendenin was convicted prior to the enactment of the CDPHE regulations, the Court of Appeals said that it did not need to address the issue of whether the CDPHE regulations comport with the constitutional amendment.]

On November 3, 2009 the CDPHE, recognizing the fact that its regulations, which permitted someone to qualify as a primary care-giver on the sole basis of providing marijuana to a qualified patient, were in conflict with the *Clendenin* decision, revoked its definition of "significant responsibility for managing the well-being of a patient who has a debilitating medical condition". On the following Tuesday, November 10, Denver District Court Judge Larry Naves struck down CDPHE's action on procedural grounds. The negation of the CDPHE's withdrawal of its definition does not, however, resolve the problem, since the Court of Appeals decision still stands unless and until it should be overturned on appeal to the State Supreme Court, and it is hard to see how the CDPHE regulations would stand if the question were directly presented to the Court.

The concurring opinion by Judge Loeb in *Clendenin* pointed out that the major inadequacy with the constitutional amendment and implementing statute is the fact that, "although qualifying patients and primary care-givers may be protected from criminal liability [for possessing, growing and using marijuana], nothing in the amendment protects their original suppliers from prosecution or conviction on drug-related charges." In other words, under state criminal law, certain people are exempt from liability for growing, possessing and using certain quantities of marijuana, but the people who supply them are not! The only people who are registered are patients; care-givers are not registered or in any way regulated. As noted above, the word "dispensary" is found nowhere in the constitutional amendment, statute or CDPHE regulations. Also, it is important that the constitutional amendment and law allow patients and their care-givers to *grow* marijuana. Nothing allows "care-givers" to buy it wholesale and sell it retail.

Recently, quite a few local cities and municipalities have enacted new zoning regulations and even moratoria on medical marijuana facilities, and state legislators have pledged to address the inadequacies of the law in the 2010 legislative session. See Commerce City's Ordinance No. 1770. Stay tuned for flurries of state statutes and local ordinances, and disputes about which prevail over which!

### **Three perspectives on a potential MM lease transaction.**

With so many people now paying attention and urging better legislation and regulation -- including those already engaged in the MM industry -- potential tenants are looking to buy or lease up space before more legislation and regulations are enacted. The best solution for the MM operator, of course, is to purchase and own its own space. But that will not be feasible for many of them, and they will be seeking to lease space. So what are landlords, tenants and their brokers to do *NOW*?

#### **The broker considering whether to represent a MM tenant**

Many of the considerations that will be germane to a broker in considering whether to represent a MM operator will also be germane to the landlord who is considering whether to lease space to a MM operator, so the broker's perspective will not be treated separately from the landlord's considerations, which follow.

#### **The landlord considering whether to lease to a MM tenant, and its broker**

The risks of having a MM operator in one's property are many. The primary risk is that the leased space and/or the building in which it is located may be seized under federal, state or local drug or public nuisance laws. Subsection 1(e) of the constitutional amendment says that "where property has been seized in connection with the claimed use of medical marijuana [sic -- the drafters probably meant "claimed use of marijuana"]", it "shall not be harmed, neglected, injured or destroyed while in possession of state or local law enforcement officials", and no property interests shall be forfeited under state law [sic -- the drafters omitted "or local law"] unless the owner has pleaded guilty of been convicted of a criminal offence. This does not help with respect to federal law if the policy should be changed, and does not speak to seizure under local law (see, for example, Article III of the Denver Municipal Code, Sections 37-70 through 37-87). Moreover, seizure and forfeiture of property used in connection with the MM operation will still be real possibilities in the event that the MM operator goes afoul of existing or future state laws concerning MM, and the landlord is deemed to have participated in or failed to correct a situation the landlord knew or should have known was in violation of law.

Other concerns for the landlord include safety and security issues, concerns of other tenants in a multi-tenant building or center (such as image, smoke, traffic, noise and security), the risk that one will be leasing to a front for illegal activity (or that an operator who starts out trying to be oh-so-legitimate will become not-so-legitimate over time), potential liability to persons harmed by persons under the influence who obtained their marijuana at the facility of one's tenant (similar to "dram shop" liability); the risk that the operator will quickly go out of business due to new regulations with which it cannot comply, competition or lack of business

experience; and the risk that the U.S. Justice Department will change its enforcement policy. Intensive due diligence by the landlord and/or the landlord's broker is a must. In addition to the normal financial, credit status, business experience, and other investigation of a potential tenant that a landlord or its broker will do, the following are recommended:

- Conduct a criminal background check of the tenant and, if it is a corporation, LLC or other entity, its principals. This step is critical if the property owner is to have a prayer of a defense to defending a forfeiture action on the basis that it is an "innocent owner".
- Do not forget the regulations promulgated and administered by the Treasury Department's Office of Foreign Assets Control ("OFAC"), which prohibit U.S. persons from engaging in transactions with certain prohibited companies, individuals, nations and residents of certain countries, or persons acting on their behalf. There are very stiff penalties (monetary fines and imprisonment) for non-compliance. Landlords should be ascertaining that all potential tenants, and their officers, directors and major equity owners are not on OFAC's list of "Specially Designated Nationals and Blocked Persons ("SDN list").<sup>1</sup> Of course, this check should be done with *all* tenants; do not even consider entering into a lease with a tenant who shows up on the SDN list, or whose principals do.
- Require a detailed business plan with a detailed description of all activities contemplated. It may be advisable to make this operational description of all activities to be carried on an exhibit to the lease and to prohibit any activities that are not described in the exhibit.
- Developing a questionnaire about the operator's plans would be useful. Relevant questions would include asking whether plants will be grown on-site or off-site, proposed hours of operation, list of products to be sold (e.g., accessories? food products with or without marijuana? seeds? plants? seedlings? dried flowers?), whether the operator will run a walk-in or appointment-only facility, what activities will be allowed on-site (smoking? infusion? music? pool tables or other recreational use? lounging?), plans for security, and more. This questionnaire, completed and signed by the tenant, could become part of the business plan exhibit referenced above. Continued compliance with the business plan should be a condition of continued occupancy.
- Double-check any covenants that govern the building or center.
- Patients with debilitating conditions will be customers of dispensaries. Is the property sufficiently ADA-compliant to accommodate such persons?
- Double-check current zoning. Many local governments have, or are in the process of enacting new zoning ordinances in response to MM concerns.
- Check with landlord's insurance broker: Can the MM tenant get the insurance required in landlord's current lease form? Are the requirements of landlord's lease sufficient for the operations of a MM tenant? Will landlord's insurance premiums be increased by the presence of a MM tenant? What affect will the presence of a MM tenant have on the insurance held by other tenants?

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<sup>1</sup> The SDN list is updated frequently, and can be found at [www.treas.gov/offices/eotffc/ofac/sdn/index.html](http://www.treas.gov/offices/eotffc/ofac/sdn/index.html). OFAC also has a hotline, 1-800-540-6322. Experts recommend that due diligence include searching alternative spellings for names being searched, trade names and aliases, and checking for "false positives".

- Consider the effect of a MM tenant on other tenants, and review their leases. Landlords will not want to give other tenants grounds upon which they may claim the right to terminate their leases.
- Consider future plans for the building or center.
- Remember that most landlords' lenders have a right to approve or disapprove leases/tenants. While some lenders may be lackadaisical about exercising this right, they may very well start paying more attention with respect to medical marijuana tenants.

### **The MM tenant looking at potential lease premises and landlords**

The MM operator seeking to lease space will also want to do its own due diligence with respect to zoning, covenants affecting use of the building; character and reputation of the landlord, building or center; security, ADA accessibility, other tenants and nearby neighbors who might complain and thus create operational hassles, and many of the same matters that the landlord will be concerned with, as listed above.

### **Negotiating and drafting the lease: Common clauses to look at again**

Many of the clauses that are commonly found in commercial leases should be looked at with a fresh eye in connection with the lease of space for use by a MM operator. Consider:

- Use clauses –
  - As mentioned above, from the landlord's point of view, the "permitted use" clause should be very tight, and using an exhibit which details permitted activities will be a good idea.
  - Do not forget "boilerplate" clauses that require the tenant to use the premises in compliance with all laws. MM facilities currently cannot be in compliance with federal laws, even if there is a moratorium on enforcement of those laws. And given the current state of Colorado law, it is debatable whether it is even possible for dispensaries to be in compliance with Colorado law. Some "notwithstanding the foregoing..." language is going to be required.
  - Note that the Colorado Attorney General has issued an opinion stating that medical marijuana facilities must obtain retail licenses and pay state and local sales taxes on all products sold, including food products, except seeds. A landlord may want the MM tenant to specifically acknowledge this responsibility, and not just rely on the "comply with all laws" boilerplate. Requiring production of the retail sales licenses and any other permits required in the local jurisdiction would be a good idea.
- Environmental clauses - Indoor growing, and even storage of marijuana, done inexpertly, can lead to serious mold problems; consider pre- and post-occupancy environmental audits. Landlords will, of course, want tenants to bear the expense of the audits, while tenant will bargain for the opposite. Should a landlord beef up the right-to-inspect clause, with the right to insist upon an environmental audit or inspection during the term if it has a reason to believe that an environmental problem is developing? On the other hand, would that undermine any "innocent owner" defense that may exist to seizure and forfeiture of the real property under various federal, state and local seizure and forfeiture laws?

- Rent - Prospective MM tenants are enticing landlords with percentage rent clauses and even offering them equity positions in their businesses. Landlords should be very cautious about this. While a landlord is already at risk of property seizure because a lease puts it in legal privity with its tenant, sharing in a MM tenant's profits further undermines any prayer of making use of the innocent owner defense.
- "No nuisance to other tenants" clauses - Consider the possibilities of smoke, odors, increased traffic, loitering by patients, and increased burglary risks as possibilities for violation of the "covenant of quiet enjoyment" or other clauses in the leases of other tenants.
- Operating expense and utility usage clauses - Indoor grow farms use lots of electricity and water; dispensaries may have a lot of traffic requiring increased security measures. In a multi-tenant property, a fair way of requiring a MM tenant to bear these additional expenses should be dealt with.
- Clauses that deal with security - Are existing security provisions sufficient? A landlord will want the right to make the MM tenant pay for additional security measures, if necessary. What kinds of security will be required? The kinds of security one might use for a jewelry store or gun shop might be looked at for models: security cameras, systems that require a visitor to be buzzed in, on-site security guards, reinforced doors, etc.
- Insurance clauses – As mentioned above, can the MM tenant get the insurance required in landlord's current lease form, or will modifications be necessary to accommodate the MM operator? Will such insurance be good enough? If landlord's insurance premiums are increased by the presence of a MM tenant, landlord will want tenant to pay for the increase.
- Signage – Depending upon where the MM tenant is located, other tenants in the building or project, and even neighboring properties, signage might be a very important subject during the lease negotiations.
- Rules and Regulations - Will the MM tenant's operations violate any rules and regulations for the building or center? Are the building's or center's operating hours appropriate for a MM tenant? If the landlord should modify the rules and regs for the MM tenant, it runs the risk of violating not-uncommon clauses in other tenants' leases that require the landlord to enforce rules and regulations in an even-handed manner.
- Lease term and options - Landlord may want short terms and heavy conditions on option terms.
- Early termination rights – This might be one of the most important lease clauses. Landlords may want the right to terminate a MM tenant for reasons additional to those which are already contained in their standard leases, such as if regulations are imposed upon the MM industry with which the tenant cannot comply, if security becomes a problem, if the federal government's enforcement policy changes, or if other tenants complain. Tenant may also want the right to terminate early if new regulations make it impossible or impractical to continue to operate, or it fails to qualify for a license under a future law.
- Parking clauses – Does the lease's parking clause work for the MM tenant's operations? Does landlord have sufficient rights to control parking, require tenant to furnish license plate numbers of its employees, and other protections? On the other hand, the tenant will want to know that parking is going to be adequate, especially considering its medically-debilitated customers.

- Audit rights – The landlord may want to be sure that its rights to audit the MM tenant's books and records extends not only to its sales tax records, but also receipts and waivers its customers sign, and records it may be required to keep pursuant to future laws and regulations.
- Assignment and subleasing clauses – Both sides of a leasing transaction will want to look at this clause closely. A landlord will want to be able to conduct criminal background checks on assignees or subtenants, for example.
- Tenant build-out – Security cameras, special lock systems and other security provisions may require wall and roof penetrations and other considerations. Grow rooms have many special HVAC and utility requirements. Landlord and tenant should be clear about what is allowed, required and expected, both at the beginning and end of the lease term.
- Exclusive right clauses – MM tenants may ask for exclusive rights, just as any other specialized tenants.

In summary, leasing to a MM operator is anything but "business as usual". We are in an interim period, operating under a very sketchy legal framework until the legislature comes up with a much more detailed and comprehensive law which, it is hoped, will include clear provisions to protect landlords who lease real property to MM operators. The safest thing to do for now, for a landlord, is to wait until we have that more comprehensive law. Nevertheless, the above considerations are offered for those landlords and tenants who just cannot wait.

## Attachments

- 1 Colorado Constitution, Article 18, Section 14
- 2 Excerpts from the Colorado Revised Statutes
  - 18-18-406, C.R.S., Offense relating to marihuana and marihuana concentrate
  - 18-18-406.3, C.R.S., Medical use of marijuana by persons diagnosed with debilitating medical conditions, *etc.*
  - 18-18-410 and -411, C.R.S., Class 1 Public Nuisance; Keeping, maintaining, controlling, renting, or making available property for unlawful distribution or manufacture of controlled substances
  - 18-18-501, C.R.S., Administrative inspections and warrants
  - 25-1.5-106, C.R.S., Medical marijuana program – powers and duties of the department [of Public Health and Environment]
- 3 Denver Municipal Code, Article III, Sections 37-70 through 37-87, Civil Abatement of Public Nuisances
- 4 CDPHE Regulations, 5 CCR 1006-2, Medical Use of Marijuana
- 5 Commerce City Ordinance No. 1770
- 6 Colorado Court of Appeals opinion, *People v. Clendenin*, No. 08CA0624 , 10-29-09
- 7 Colorado Attorney General's opinion No. 09-06, 11-16-09