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EARN MCLE CREDIT

TAX BENEFITS FOR START-UPS

page 25

Class Certification post *Tobacco II*

page 12

On Direct: John H. Haney

page 8

PLUS

PATENT EXHAUSTION

page 30

Space to GROW

Los Angeles lawyers David W. Wensley *(right)* and Amir Sadr review the current regulatory framework governing medical and recreational cannabis in California and analyze how its operation may affect the state's real estate

page 20

by DAVID W. WENSLEY and AMIR SADR

SPACE TO GROW

Legalization of marijuana presents significant opportunities for property owners looking to cash in on California's budding cannabis industry

With voter approval of Proposition 64, the Adult Use of Marijuana Act (AUMA), in November 2016,[1] the recreational use of cannabis by adults age 21 and older became legal in the state of California. Over 56 percent of voters expressed their approval of AUMA,[2] indicating that a significant portion of California's population no longer stigmatizes cannabis use, even for recreational purposes. Broad voter support may also suggest that commercial property owners view the cannabis industry as a legitimate opportunity to secure new tenants and increase returns on their investments.

As of January 1, 2018, when the state began issuing temporary licenses for recreational cannabis operations, the growing consensus is that the legal cannabis industry will develop exponentially. The rise in consumer demand for legal cannabis has led to increased prices for raw land and industrial buildings for grow operations, industrial facilities for manufacturing and distribution, and retail space for the sale of cannabis and cannabis-related products. Annual gross revenue projections for the nation's legal cannabis industry are estimated to grow from approximately $6.7 billion per year in 2016 to more than $20 billion by 2021,[3] and California is expected to garner a material share of the country's overall cannabis market.[4]

Legalized recreational cannabis use and operations are expected to provide significant opportunities for a broad range of property owners looking to cash in on California's budding cannabis industry. The unique risks and legal landscape governing real estate transactions for cannabis operations also will cause an increase in demand for legal counsel specializing in this area of law. Since the statutory and regulatory climate governing the cannabis industry at the federal, state, and local levels is rapidly evolving and not entirely clear, the current environment raises legal and ethical issues for attorneys considering whether to represent property owners in connection with cannabis operations. Attorneys must exercise caution in delving into this practice area, as the laws, regulations, and policies governing cannabis operations are still in the developing stages and subject to the unpredictable impulses of federal, state, and local officials.[5]

Regulatory Framework

In 1996, voters passed Proposition 215, the Compassionate Use Act, making California the first state to legalize the medical use

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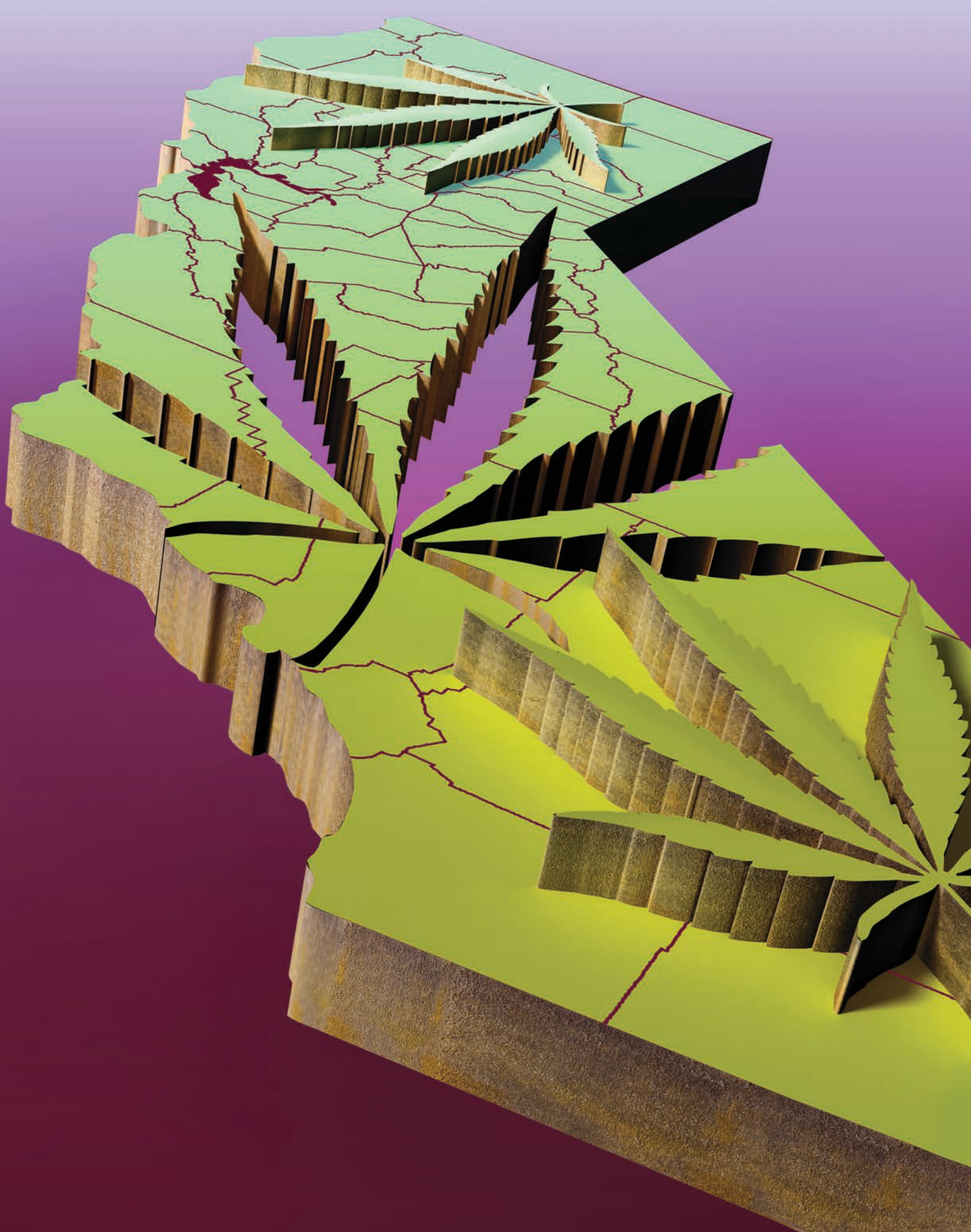

of cannabis.[6] In 2003, the California Legislature passed Senate Bill 420, the Medical Marijuana Program Act, creating a regulatory framework for the medical use of cannabis.[7] Subsequently, in 2015, the state revamped its medicinal cannabis statutes with the passage of the Medicinal Cannabis Regulation and Safety Act (MCRSA), which created a state licensing system and updated and clarified statutes governing medicinal cannabis.[8]

With the passage of Proposition 64, state regulators faced a dilemma whether to continue with two separate regulatory tracks for legalized cannabis—one for medical use under MCRSA and another for adult recreational use under AUMA—or to consolidate them. In June 2017, Governor Jerry Brown signed the Medicinal and Adult-Use Cannabis Regulation and Safety Act (MAUCRSA),[9] which called for merging the medical and recreational laws into one unified system. Under MAUCRSA, three regulatory agencies govern legal cannabis in California: 1) the Department of Consumer Affairs, Bureau of Cannabis Control, 2) the Department of Food and Agriculture, Manufactured Cannabis Safety Branch; and 3) the Department of Public Health, CalCannabis Cultivation Licensing. Acting as the lead regulatory agency, the Bureau of Cannabis Control is tasked with issuing state licenses for dispensaries, distributors, testing labs, and the many anticipated microbusinesses that will develop to serve the industry and consumers.[10] The California Department of Food and Agriculture is responsible for issuing state licenses to cannabis cultivators and operating a "track-and-trace" system to track the seed-to-sale process for cannabis in the state.[11] Finally, the Department of Public Health issues state licenses to businesses that manufacture cannabis products such as edibles, oils, lotions, and other cannabis-containing products.[12] Cannabis operators may apply for and obtain one or more of the various available business license types, with the exception of test lab operators, which are prohibited from licensure for any other commercial cannabis activity.[13]

Local Jurisdiction Licensing

California's cannabis laws grant local governments the authority to allow, limit, or ban the number of cannabis operations within their city or county limits.[14] State agencies may only issue a temporary or permanent license to a cannabis operation if the applicant has a valid permit, license, or other form of authorization issued by their local jurisdiction.[15] Therefore, ultimate control over a prospective cannabis operator's ability to conduct business lies with the city or county.

The lack of uniform laws among cities and counties across California means property owners interested in leasing to a cannabis operation must first determine if their local jurisdiction permits cannabis operations within its borders. If cannabis operations are locally permissible, property owners and their legal counsel must carefully examine the intricacies of local requirements and restrictions for the property and cannabis business type in question. For example, many local jurisdictions impose greater limitations than those set forth under MAUCRSA, including, without limitation, requirements limiting proximity to schools and government buildings, hours of operations, the onsite use of cannabis in open areas and the total number or concentration of cannabis operations within a city or county.[16] A locality may also require the cannabis operator to show proof that it is current on local, state, and federal taxes. Finally, many local jurisdictions require evidence of sufficient funds to operate a cannabis business.

Legal counsel must also consider specific restrictions under MAUCRSA, including, among other things, the fact that cannabis operations must be located at least 600 feet away from a K-12 school or youth center, the licensed premises must contain digital video surveillance throughout the space and retailers may only sell and operate between the hours of 6:00 A.M. and 10:00 P.M. Pacific Standard Time.[17] Also, under MAUCRSA, an applicant may obtain more than one cannabis license type for a specific location, provided the licensed premises at the location are "separate and distinct."[18] As of early December 2017, what qualifies as separate and distinct had not been established by the three regulatory agencies in California and will likely be determined on a case-by-case basis through the licensing application process. Commercial property owners and cannabis applicants must consider the potential costs in connection with constructing demising walls and additional entrances to meet the "separate and distinct" standard. Furthermore, under MAUCRSA, the cultivation licensing application requires the cannabis operator to meet the "average electricity greenhouse gas emissions intensity required by a local utility provider" under California's existing Renewables Portfolio Standard Program.[19]

Lease Provisions and Considerations

To operate a cannabis business, a prospective tenant must first overcome three major hurdles: 1) whether the type of cannabis operation being considered for the property is permissible by the locality, 2) whether the property is properly zoned for the specific type of operation or whether the requisite land use permits and/or approvals may be obtained, and 3) whether the prospective tenant qualifies for applicable state and local cannabis business licenses.

License Contingency or Condition Subsequent Clause. Once the cannabis operator has overcome the aforementioned hurdles, in order to apply for a California state license the prospective tenant/operator must obtain a signed lease or alternative form of authorization from a property owner granting permission to operate a cannabis business on the subject premises. However, possession of a valid license by the state is a prerequisite for the cannabis business to operate from the subject premises in compliance with applicable law.[20] This condition creates a dilemma for landowners because the landowner must enter into a signed lease with a prospective cannabis operator who is not yet, and may never be, authorized to operate its cannabis operation. This circumstance mandates that the lease or other agreement between the landowner and cannabis operator contain a license contingency or condition subsequent provision, which provides for a unilateral (in favor of the landlord) or a mutual (in favor of both the landlord and tenant) right to terminate the lease should the cannabis operator ultimately fail to obtain the requisite state and local licenses within a specified time.

As in any commercial lease, landowners should also consider security or collateral for the tenant's surrender and restoration obligations of the leased premises. Many prospective cannabis businesses will likely require possession of the landlord's property prior to obtaining the necessary state and local licenses to plan construction, security, and business operations. Therefore, the license contingency or condition subsequent provision should incorporate appropriate surrender and restoration terms so the landlord may recover possession of its property in an acceptable condition if the operator fails to obtain the applicable business licenses necessary to operate in compliance with state law. The landlord should also endeavor to defer payment of any broker commissions, tenant improvement allowances, or performance of any other landlord obligations until all licensing requirements are satisfied.

Compliance with Applicable Laws. Most boilerplate lease agreements require the landlord and tenant to act and comply in accordance with all applicable laws. While cannabis operations

may be legal under California state and local laws, the federal government has not legalized cannabis use. The possession, cultivation and distribution of medical or recreational cannabis remains illegal under the federal Controlled Substances Act (CSA) and cannabis remains categorized as a Schedule I drug.[21] As a Schedule I drug, cannabis is treated as a substance that has a "high potential for abuse" and "no currently accepted medical use in treatment in the United States."[22]

The U.S. Department of Justice (DOJ) maintains authority to prosecute state legal cannabis businesses under various federal laws, including federal drug and money laundering statutes.[23] Moreover, related businesses and professionals working in or with the cannabis industry may also be prosecuted as co-conspirators or aiders and abettors under the federal statute.[24] As discussed in the *Los Angeles Lawyer* article, "High Time,"[25] federal enforcement of cannabis laws is currently uncertain. During the Obama administration, the DOJ adopted a set of guidelines commonly referred to as the Cole Memo on "Guidance Regarding Marijuana Enforcement," which set recommendations on enforcement policies and practices related to cannabis operations.[26] However, on January 4, 2018, Attorney General Jeff Sessions rescinded the Obama-era Cole Memo guidelines and instead granted federal prosecutors with the authority to decide how to enforce federal laws prohibiting cannabis operations in states where its use has been legalized.[27]

Yet, pursuant to an amendment to the omnibus spending bill commonly referred to as the Rohrabacher-Blumenauer Amendment (originally the Rohrabacher-Farr Amendment), the U.S. Court of Appeals for the Ninth Circuit ruled that DOJ is prohibited from spending funds to prosecute individuals engaged in conduct that strictly complies with state medical marijuana laws.[28] It is not clear if this ruling extends to recreational use of cannabis or whether the DOJ will be granted funding to implement Attorney General Session's enforcement policy.

Regardless, the Ninth Circuit's ruling coupled with the Attorney General's latest position creates a quandary for property owners and cannabis operators. Property used to facilitate the cultivation, distribution, and manufacturing of cannabis may still be subject to federal asset forfeiture laws, and there is a risk that the federal government could seize such property.[29] Property owners can also be charged with aiding and abetting a violation of the CSA.[30] Simultaneously, however, as noted, under MAURCSA, the authorization of a property owner by lease, license, or other arrangement is a prerequisite to obtain a license and comply with state law. This creates a significant legal issue for property owners because by signing a lease with a cannabis operator, a commercial landlord cannot claim ignorance as to the cannabis operation on their property and avail themselves of the so-called "innocent owner defense" under federal law.[31] Consequently, the applicable law provision in any lease for a cannabis operation should be modified to include a carve-out for the CSA and its underlying regulations.

Rent, Security Deposit, and Collateral Issues. Due to the extensive regulations and jurisdictional control over cannabis businesses, properties suitable and available for cannabis operations may, due to limited supply vis à vis increasing demand, command greater rents. As witnessed in a number of states where cannabis operations are legalized, property owners will likely demand higher rents and greater security to offset the perceived risks in leasing to a cannabis operator as opposed to a more traditional tenant. These risks include the possibility that the cannabis business will not be able to maintain its required licenses and will be shut down by governmental authorities; the federal government will no longer refrain from prosecuting federal laws against California cannabis operators despite compliance with state and local laws; and the fear of potential negative stigma for surrounding tenants and businesses mandating additional consideration from property owners that lease to a cannabis operator.

To address these risks, in addition to higher rents, property owners should also consider whether extraordinary security or collateral to secure performance by the cannabis operator is warranted. A larger security deposit, letter of credit, or personal guaranty of a financially creditworthy party should be considered to secure the cannabis tenant's obligations to pay rent, comply with applicable laws, and surrender and restore the premises timely upon lease expiration or earlier termination.

Unique Use Controls. Whether through traditional agricultural means or industrial indoor grow operations, cannabis growers present unique issues that property owners need to consider. For example, indoor cannabis farming operations typically require extraordinary electricity and water use beyond that of other indoor industrial uses. These extra costs are typically passed through to the operator in a single-tenant scenario, however in a multitenant project the lease should address methods for measuring and charging the cannabis operator appropriately for its potentially extraordinary use.

In addition, cannabis businesses remain largely cash-based due to the illegality of cannabis operations under federal law.[32] It may be appropriate to consider drafting lease provisions that recognize the significant amounts of cash that may be held on the premises and necessitate unique protections or increased security at the property to mitigate potential vandalism and theft. Under MAUCRSA, alarm systems, commercial grade locks, secure storage, and 24-hour video surveillance are required for any area containing cannabis and cannabis products.[33] Leases should be drafted to appropriately allocate the burden of such additional risks and costs as between the landlord and the cannabis operator.

For multitenant projects and buildings, property owners and their legal counsel must examine whether the intended cannabis operation is permitted under existing private covenants, including CC&Rs (covenants, conditions, and restrictions) and leases with other tenants at the property. Many institutional quality projects are encumbered by private restrictions or leases that may prohibit cannabis operations. In the retail arena, many national and regional retail operators insist on imposing restrictions on the landlord against various "undesirable" uses, which may expressly or by implication include cannabis operations.

Required Licenses and Notice. Lease agreements with cannabis operators, as noted, should include an express covenant requiring the operator to obtain and continuously maintain any and all necessary permits, licenses, or governmental approvals required for use of the premises. These leases should also include a provision requiring the cannabis operator to provide the landlord with a copy of all permits and impose an obligation to notify the landlord of receipt of any notice from federal, state, or local authorities relating to the tenant's cannabis operations.

Operations/Odor/Nuisance/Loitering. As the smell and nature of the cannabis plant is distinct, a lease should include strict language protecting against issues relating to nuisance, odor, and pests in and around the premises. Landlords may wish to consider requiring above-standard ventilation and filtration systems to prevent the odor and other forms of nuisance from impacting adjacent tenants and businesses. In addition, the lease should include language to prevent loitering by customers and the presence of persons under the influence or appearing to be under the influence in and around the premises.

Lending. Since cannabis remains illegal at the federal level, a pressing challenge for real property owners and investors considering leasing to a cannabis operator is the impact of a potential "illegal use" on the property owner's existing or contemplated real property financing. Most, if not all, real property loan agreements, deeds of trust, mortgages, and related security agreements contain provisions requiring the borrower to keep the subject property in compliance with all applicable laws and advising that the subject property may not be used for illegal activities. Consequently, most traditional lenders are presently unwilling to lend on property leased for cannabis operations and such an operation could be a violation of the express terms of the governing loan documents. Attorneys should discuss with their clients whether there is existing or contemplated financing for the property, and, if so, the client should be advised that leasing to a cannabis operator may run afoul of their obligations to their lenders and compromise their financing arrangements.

Conflicting State and Federal Laws

As of December 2017, the California State Bar had not published a formal opinion whether an attorney may ethically represent a client under California's cannabis laws or as to any party engaging in business with cannabis operators. However, the Los Angeles County Bar Association and the Bar Association of San Francisco have issued formal opinions on the matter. Both bar associations have concluded that an attorney may ethically advise a client on how to comply with California cannabis laws but may not advise the client to violate federal law and must advise the client that conducting business relative to cannabis operations may violate federal law.[34]

Attorneys should consider all of the above issues, particularly the conflict in federal and state laws, and be aware of the potential risks associated with representing a real estate client leasing property to a cannabis operation. Attorneys should incorporate specific language addressing these risks in any engagement letter with a prospective client desiring to conduct business with a cannabis operator or seeking to operate a cannabis business. The engagement letter should clearly state that cannabis currently remains a Schedule I substance under the CSA and is illegal at the federal level. Second, the engagement letter should clarify that representation will exclude legal advice on any illegal aspects related to possession, growth, distribution, or sale of cannabis. Third, the letter should include a statement that representation will not be construed as aiding in the commission of an illegal act or violation of federal law. The engagement letter should also include a caveat that such legal representation is limited to advising the client as to compliance with current California law. Finally, due to the ever-evolving nature of California state and local cannabis laws, as well as the uncertainty of federal enforcement policies, it is recommended that the engagement letter include a statement regarding the risks of the potential unenforceability of leases and other agreements involving the cultivation, distribution, possession, or use of cannabis.

Progressing Landscape

Whether one favors or opposes legal cannabis, most Californians can agree that legal cannabis operations will have a significant impact on the state's economy and its commercial real estate industry. Commercial cannabis activity in California is expected to add significant tax revenue to state and local government through licensing fees and taxes. Property values in cities and counties permitting cannabis businesses have already skyrocketed in California and will likely continue to do so until supply matches demand. Factories, warehouses, and self-storage facilities, among other property types, have been transformed into cultivation sites for cannabis grow operations. Retail storefronts have been repurposed to top-quality cannabis dispensaries with finishes comparable to those of other more traditional major retail tenants. Real property owners and state agencies alike must continue to evaluate this progressing landscape in search of ways to legally profit from the cannabis industry.

It is important to understand that all commercial real estate contracts and transactions are unique, as is the real property involved. Cannabis laws in California at the state and local levels are rapidly changing. Effective representation of commercial real property owners contemplating leasing property to a cannabis-related business or a cannabis operator will require an expertise in this area of law and the ability to stay apprised of new developments for a quickly evolving and highly regulated industry. ■

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[1] Health & Safety Code §§11018 *et seq.*; Bus. & Prof. Code §§26000 *et seq.*

[2] Peter Hecht, *California Voters Approve Proposition 64 and the Recreational Use of Marijuana,* Sacramento Bee, Nov. 08, 2016, *available at* http://www.sacbeecom/news/politics-government/election/california-elections/article113422398.html.

[3] *North America Marijuana Sales to Top $20.2 Billion by 2021, Grew 30 Percent in 2016,* Bus. Wire, Jan. 3, 2017, http://www.businesswire.com.

[4] Patrick McGreevy, *Legal Marijuana Could Be a $5-Billion Boon to California's Economy*, L.A. Times, June 10, 2017, *available at* http://www.latimes.com.

[5] For the purposes of this article, the authors do not distinguish among cannabis, marijuana, and THC-free cannabinoid products. All references herein are to cannabis as it may be defined and regulated by federal, state, and local laws. This article is not intended to provide practice tips for representing cannabis operations, provided, however, that many of the same legal and ethical issues may apply to representing cannabis operations.

[6] Health & Safety Code §11362.5.

[7] Health & Safety Code §§11362.7 *et seq.*

[8] Health & Safety Code §§11018 *et seq.*; Bus & Prof. Code §§26000 *et seq.*

[9] S.B. 94, 2017-18 Leg. (June 27, 2017).

[10] *See* Bureau of Cannabis Control California, http://bcc.ca.gov.

[11] *See* CalCannabis: What We Do, CalCannabis Cultivation Licensing, Cal. Dep't of Food & Agric., http://calcannabis.cdfa.ca.gov (last viewed Dec. 21, 2017).

[12] *See* Manufactured Cannabis Safety Branch, Cal. Dep't of Public Health, https://www.cdph.ca.gov/Programs/CEH/DFDCS/Pages/MCSB.aspx (last viewed Dec. 21, 2017).

[13] *See* What You Need to Know, Bureau of Cannabis Control Licensing Information, Bureau of Cannabis Control, https://cannabis.ca.gov/wp-content/uploads/sites/13/2017/03/17191_Information_Workshop_v3.pdf (last viewed Dec. 21, 2017).

[14] *Id.*

[15] *Id.*

[16] *See, e.g.,* L.A. Mun. Code. Ch. X, art. 4 (2017).

[17] *See* Cal. Code Regs. tit. 16, §§5000 *et seq.* A youth center is defined as "any public or private facility that is primarily used to host recreational or social activities for minors, including, but not limited to, private youth membership organizations or clubs, social service teenage club facilities, video arcades, or similar amusement park facilities." Health & Safety Code §11353.1.

[18] Bus. & Prof. Code §26053.

[19] *See* Bus. & Prof. Code §8305. For more information regarding California's existing Renewables Portfolio Standard Program, *see* Quick Links, Renewables Portfolio Standard, Cal. Energy Comm'n, http://www.energy.ca.gov/portfolio (last viewed Dec. 21, 2017).

[20] *See* Apply for a License Here!, Bureau of Cannabis Control California, http://bcc.ca.gov.

[21] 21 U.S.C. §§801 *et seq.*

[22] 18 U.S.C. §1956.

[23] 18 U.S.C. §§1956, 1957; 21 U.S.C. §§841, 856.

[24] 21 U.S.C. §812 (b)(1).

[25] Julia Sylva, *High Time*, L.A. Lawyer, Mar. 2017, at 16-17.

[26] Memorandum from James M. Cole, U.S. Deputy Attorney General, on Guidance Regarding Marijuana Enforcement to all U.S. Attorneys (Aug. 29, 2013), *available at* https://www.justice.gov/iso/opa/resources/305201382913275685746 7.pdf.

[27] *See, e.g.,* Sadie Gurman, *Sessions terminates US policy that let legal pot flourish*, AP News, Jan. 4, 2018, https://apnews.com/19f6bfec15a74733b40eaf0ff9162bfa.

[28] U.S. v. McIntosh 833 F. 3d 1163 (9th Cir, 2016).

[29] 21 U.S.C. §§853, 881; 18 U.S.C. §§983, 985.

[30] 18 U.S.C. §2; 21 U.S.C. §846.

[31] *See* Bus. & Prof. Code §§19311-19312, 26030-26031.

[32] *See* Cannabis Banking Working Group, Cal. State Treasurer, http://www.treasurer.ca.gov/cbwg (last viewed Dec. 21, 2017).

[33] *See* Cal. Code Regs. tit. 16, §§5000 *et seq.*

[34] *See* L.A. County Bar Ass'n, Comm. on Prof. Responsibility & Ethics, Formal Op. 527, 9 (2015) *and* Bar Ass'n of San Francisco Legal Ethics Comm., Formal Op. No. 2015-1, 2-3 (June 2015).