
Cannabis Biz Real Estate Loan Considerations for Lenders

By Mark Levenson and Jeffrey Wendler —

Now that cannabis sales are legal in some states, real estate lenders are interested in financing the land used by cannabis companies.

Although the U.S. Drug Enforcement Administration has proposed changing its rules to reclassify marijuana from an illegal Schedule 1 drug like heroin to a Schedule 3 drug like ketamine,[1] since cannabis sales are still illegal under federal law,[2] lenders must make adjustments for cannabis transactions.



In a typical loan transaction, lenders rely on the borrower to represent that their business operations are in compliance with law, but since cannabis operations are illegal under federal law, lenders must make changes to their form documents allowing the loan to proceed as long as the cannabis company does not engage in restricted cannabis activities.

It's not just loan documents that need to be modified — it's the entire transactional framework. The lender has to verify that any title company hired by the borrower can both insure title and handle money transfers at the real estate closing. The lender also needs to expand its upfront due diligence review to ensure that the cannabis business is properly licensed under state law and complies with zoning codes.

This article highlights various issues the lender must address.

Preliminary Issues

Title Companies

Title companies play a significant role in real estate finance transactions because they: (1) insure that the borrower owns the real property; (2) insure the legal description of the real property matches a survey of the land; (3) handle special searches of the property, borrower and guarantor; and (4) are used by lenders and borrowers to allocate and disburse the lender and borrower payments at the loan closing.

As a result of the federal illegality issue, many title companies will not issue title or handle the loan closing since it involves the processing and routing of funding.[3] The lender must interject itself in the selection of the title company to confirm the title company will issue title and act as escrow agent for the closing.

The lender cannot afford to have a borrower-selected title company back out of the transaction in the future because it only then realized that handling the funding may be illegal under federal law.

Cannabis Transactions Requiring More Due Diligence

In a noncannabis loan transaction, prior to scheduling the closing, the lender requires the delivery and lender's satisfactory review of standard due diligence documents. In cannabis transactions, lenders should also require

the delivery and review of additional cannabis documents to verify that business operations are in compliance with state cannabis laws and that zoning allows cannabis activities.

The lender should require deliveries of:

- Copies of all valid state cannabis licenses issued to the borrower on the property and allowing the use thereof;
- The local governmental authority's letter confirming the cannabis operations comply with municipal laws;
- A zoning letter from the municipality, a zoning opinion from the borrower's zoning counsel, or a PZR report, to confirm zoning compliance; and
- A temporary certificate of occupancy or certificate of occupancy allowing cannabis cultivation, processing or sale facilities at the property, if construction is completed.

Loan Document Changes

In addition to the satisfactory review of due diligence items, the lender will simultaneously require its counsel's drafting of a standard set of form loan documents. In a cannabis transaction, however, these form loan documents will be insufficient.

The lender, therefore, needs to add specialized cannabis language to the definitions, events of default, informational notice covenants, license covenants and "compliance with laws" sections.

Compliance With Law Covenant

Every lender's standard loan documents require the borrower to covenant that its business operations will not violate any state or federal law.

Since cannabis is still illegal under federal law,^[4] but the borrower is licensed under state law to sell cannabis,^[5] borrowers will want to modify the compliance with laws covenant so that a mere violation of federal law is not, itself, an event of default.

The lender cannot, however, just delete this provision because of a state license. The lender would be unprotected if the borrower engaged in restricted cannabis activities. Instead, the lender must tailor the covenant to focus on specific cannabis violations that could result in federal law enforcement problems.

One suggestion is to layer in several lender protections. For example, modify the compliance with laws covenant to state:

(a) The Improvements shall be operated in accordance with all applicable laws ... and borrower will operate in compliance with all licenses and permits granted pursuant to state cannabis laws. Notwithstanding the foregoing, borrower acknowledges that although certain state cannabis laws have legalized the cultivation and sale of cannabis and related products (a) federal cannabis laws may result in circumstances where activities permitted under state cannabis laws may contravene federal cannabis laws and (b) engagement in restricted cannabis activities may contravene federal cannabis laws. Accordingly for this Loan, each representation, covenant and other provision hereof relating to compliance with 'applicable law' (or words of similar effect) will be subject to the following: engagement that is permitted under state cannabis laws

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but contravenes federal cannabis laws, and in respect of which the applicable governmental authority have agreed to forego or have otherwise suspended enforcement of such federal cannabis laws, will not, in of itself, be deemed non-compliance with applicable laws (Emphasis added).

Notwithstanding the foregoing, the lender, in its sole discretion, must have a right to determine if the borrower's cannabis operations are an event of default.

A two-prong approach is suggested for restricted cannabis activities. It will be an event of default if (1) the borrower engages in a restricted cannabis activity, or (2) state cannabis laws change so that the borrower's existing compliant business activities now become a restricted cannabis activity.

Define the restricted cannabis activities in the loan documents, using real world examples, like the following, to identify specific events of default and put the borrower on notice:

- Any violations of the state cannabis laws or borrower's license;
- Notwithstanding compliance with state cannabis laws, any activity which a governmental authority, like the DEA, asserts is unlawful under federal cannabis law;
- When a borrower skims money from its operations and makes payments to criminal enterprises or to persons subject to economic or financial sanctions by the U.S. government;
- Diversion of cannabis and related products from states where it is legal under state cannabis laws to other states in the U.S. where it is illegal, e.g., interstate trafficking;
- When a legal cannabis sale is merely a cover or pretext for the illegal trafficking of other controlled substances, e.g., fentanyl, illegal drugs like heroin, or other illegal activity; and
- Directly or indirectly, aiding, abetting or otherwise participating in a criminal enterprise with any person in any of the foregoing activities.

The New Jersey Cannabis Regulatory Commission website has highlighted many of the above activities as well as others as a focus of federal law enforcement.[6]

Lender should add cannabis laws definitions, like the following, to its agreements:

The 'federal cannabis law' means any federal laws of the United States treating cannabis and related products as illegal or as controlled substances.

The 'state cannabis law' means (a) any law enacted by any state of the United States which legalizes cannabis and related products in some form, and which implements regulatory and enforcement systems to control the cultivation, distribution, sale, and/or possession of cannabis and related products, and (b) any regulation, ordinance, rule, order, policy, decree, judgment, consent decree, writ, injunction, settlement agreement, or governmental requirement enacted, promulgated or imposed or entered into or agreed by any governmental authority of such state under, pursuant to or in connection with such law.

Events of Default

The lender should add new cannabis events of default similar to the following:

- The borrower's cannabis license is revoked, suspended or not renewed, and such revocation is not reversed, or the license is reinstated within 10 days of such revocation, suspension or nonrenewal;
- The borrower sells, encumbers or transfers its cannabis licenses without lender consent;
- The borrower fails to renew its cannabis license or any licenses for cultivation, processing or sale; or
- The borrower engages in a restricted cannabis activity.

Additional Covenants

In the noncannabis loan context, lenders require borrowers to covenant that the borrower will comply with the lender's loan requirements during the loan term. In a cannabis transaction, where the lender is already subject to potential federal law enforcement interference, requiring the borrower to continue a licensed legal cannabis operation without any restricted cannabis activities is more consequential.

The lender should address this issue by bulking up the covenant document section to require the borrower to: (1) renew its cannabis licenses in a timely manner and deliver copies of any renewals to the lender within 10 business days of such renewal; (2) not sell, transfer or lease its cannabis license without lender consent; and (3) not engage in any restricted cannabis activities.

Most lenders already require borrowers to provide notice of potential governmental investigations, but in the cannabis context advance notice of governmental action is crucial. The lender should add specialized informational notice covenants to the loan documents, so the lender knows about potential investigations and can act accordingly.

If the borrower does not inform the lender of a governmental subpoena regarding "suspicious payments," it will be far too late for the lender to act once the DEA seizes the borrower's business.

Borrowers should be required to deliver to the lender:

- Any letter, note, document, call, text, fax, direct message sent on Instagram or Snapchat or other official or unofficial communication from a governmental authority pertaining to (1) the growing or selling of cannabis; (2) notice of enforcement proceedings, complaints, violations of state cannabis laws, and/or (3) a violation, suspension, enforcement proceeding against, nonrenewal or cancellation of the borrower's cannabis license;
- Any reports, notices or writings received from any governmental authority relating to the suspension, enforcement proceedings against, nonrenewal, cancellation or violations of law by the cannabis operation, or at the cannabis operation at the property;
- Any notices received by the borrower from any governmental authority relating to the commission of any restricted cannabis activities by the borrower; and
- Any pending or threatened litigation, action or proceeding against or involving the borrower that affects the borrower's cannabis license or state cannabis law.

Conclusion

Loans to cannabis companies require substantial additional due diligence work. Preclosing requirements and loan documents must be adapted to address unique cannabis challenges, and the title company must agree in advance to both issue title and handle the escrow closing.

Mark Levenson is chair of the real estate department at Sills Cummis & Gross P.C.

Jeffrey Wendler is of counsel to the real estate department at Sills Cummis & Gross P.C.

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[1] See Associated Press article published on April 30, 2024: “US poised to ease restrictions on marijuana in historic shift, but it’ll remain controlled substance” https://apnews.com/article/marijuana-biden-dea-criminal-justice-pot-f833a8dae6ceb31a8658a5d65832a3b8?utm_source=Email&utm_medium=share.

[2] See The Controlled Substances Act, 21 U.S.C. § 801 et. seq.

[3] See The Money Laundering Control Act, 18 U.S.C. § 1956 and 18 U.S.C. 1957.

[4] See The Controlled Substances Act, 21 U.S.C. § 801 et. seq.

[5] See New Jersey Appellate Court decision - In a May 1, 2024 New Jersey Appellate Court decision (Botteon v. Borough of Highland Park, No. A-1227-22, 2024 N.J. Super. Unpub. LEXIS 818 (App. Div. May 1, 2024), Judge Sabatino, P,J,A,D. writing for the Court, held that Highland Park’s code section allowing cannabis retailers to operate in the Borough, subject to the Borough’s operating, licensing, and tax regulations and New Jersey’s state marijuana law (The Cannabis Regulatory, Enforcement Assistance, and Marketplace Modernization Act, N.J.S.A. 24:61-31 to 56) were not preempted by the federal Controlled Substances Act, 21 USC 21 U.S.C. § 801 et. seq. <https://www.njcourts.gov/system/files/court-opinions/2024/a1227-22redacted.pdf>.

[6] See NJ Cannabis Regulatory Commission web page at <https://www.nj.gov/cannabis/resources/cannabis-laws/>.