

Don't Let Your Development Go to Pot! Tips for Leasing to Marijuana Retailers

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By Robert Eisenberg



While anti-drug activists continue to do a slow burn, Prime Minister, Justin Trudeau's Liberal government is (leisurely) marching forward on carrying out one of its most well-publicized campaign promises: the legalization of marijuana. At a recent session of the United Nations General Assembly, Health Minister Jane Philpott announced that the Canadian government isn't just blowing smoke, but will instead begin the process of legalizing the use of cannabis in 2017 through a joint process with the provinces and territories.

Though this new policy is good politics, it also highlights the potentially-lucrative opportunity for landlords and tenants. For example, a Forum Research survey found that 31% of adult Canadians would use marijuana if it were legalized[1]. Extrapolating from data which suggests that the existing marijuana industry, supplying approximately 45,000 medicinal pot users, is worth from a low of \$80 million to a high of \$100 million per year, industry analysts suggest that the market for legal marijuana (medicinal and recreational) in Canada could top \$22.6 billion per year, eclipsing the combined sales of beer, wine and spirits![2]

The Current Legal and Regulatory Landscape

At present, cannabis is a controlled substance under the federal *Controlled Drugs and Substances Act* and the production, possession and distribution of marijuana is illegal, with the exception of medicinal uses[3]. In August 2016, in response to the Federal Court of Appeal's ruling in *R. v. Allard*, 2016 FC 236, the federal government replaced the existing *Marijuana for Medical Purposes Regulations* with the *Access to Cannabis for Medical Purposes Regulations*[4]. Under these new regulations, Health Canada authorizes specific producers to distribute dried marijuana, fresh marijuana and cannabis oil to eligible persons. As of October 20, 2016, there are 36 licenced producers in Canada, 21 of which are in Ontario.

These licenced distributors are currently the only entities who can legally sell/distribute marijuana in Canada – and that is only via mail/courier. The distributors are largely located in industrial areas. Other stores – so-called “dispensaries” – are technically illegal and are currently subject to periodic raids by local police forces. However, with the seemingly-inevitable legalization of recreational marijuana, the enthusiasm for such raids varies across police forces. Nevertheless, until further action is taken by the federal government, landlords should likely avoid leasing premises for the sale of marijuana by non-licenced distributors for this reason alone.

Although the Ontario government still hopes to corner the budding marijuana market by restricting the sale of cannabis to LCBO stores, only 38% of Ontarians believe that this is the best sales channel (with over 50% believing that it should be sold from specialized dispensaries or drug stores)[5]. Of course, distribution mechanisms may vary by province; it remains possible that commercial landlords will start seeing marijuana retailers as tenants as early as next year. Indeed, it was recently announced that Shoppers Drug Mart, the largest pharmacy chain in the country, has applied for a licence to distribute medical marijuana[6].

Nevertheless, despite the high hopes for profits, negotiating commercial leases with marijuana retailers will, to be blunt, remain fraught with risk even after legalization, and savvy landlords and tenants should keep in mind several issues when deciding to lease space for such businesses.

Use Clause and Compliance with Laws

A lease typically has a standard clause prohibiting using the leased premises for any use prohibited by law. Once the sale of marijuana is legalized, this clause will likely no longer be sufficient to prevent the sale of cannabis products. Landlords who want to prevent a prospective tenant from selling cannabis products should explicitly prohibit such a use in their lease forms. Another point to consider is whether an existing lease or a boilerplate clause prohibiting illegal uses will be effective in keeping recreational marijuana-related businesses from operating within existing leased premises. Once the cultivation and sale of marijuana becomes legal, these clauses alone may no longer be effective in keeping existing tenants from changing their use or from assigning or subletting (subject to the wording of the landlord's approval rights) to a third party who wants to pursue such an endeavour. The more precise the lease is in specifying what activities are permitted and prohibited (e.g. medical retail, recreational retail, growing, warehousing, smoking on the premises) the better!

Moreover, provincial and municipal laws/by-laws need also be respected, including fire and electrical safety, and waste management. Municipal governments also have the ability to zone areas where marijuana for medical purposes may be produced and to enforce local laws. Landlords and tenants should make sure that cannabis-related businesses are permitted in their developments, and should ensure that their buildings comply with all relevant laws/by-laws (see more on this below).

The complicated – and in flux – web of federal, provincial and municipal laws, by-laws and regulations presents landlords with unique challenges in performing their due diligence, and creates additional administrative headaches (such as familiarizing themselves with regulations and requiring the tenant to provide updated copies of its licence to prove that it is in conformity with it) which need to be weighed against the benefits of leasing to such tenants.

Impact on Other Tenants and on Common Areas

One of the major issues to consider before leasing space to a marijuana dispensary is how it will affect other tenants. As previously mentioned, there is still a stigma surrounding the consumption of marijuana and other tenants may raise objections to a prospective marijuana-related tenant. More practically speaking, before leasing space to such a tenant, a prudent landlord should check existing leases to ensure that it is not restricted from entering into such a lease.

Likewise, even if no party objects to the sale of marijuana from premises in a development, it is a shared concern of both the landlord and existing tenants that the customers of the dispensary do not partake of their purchases on-site. There is a possibility that, having purchased marijuana in the development, overeager customers will consume cannabis products in the common areas of a development (ex. hallways, stairwells, parking lots) or on the street immediately outside. This raises additional concerns about loitering and safety. Clear provisions should be written into the lease, allocating responsibility for ensuring that no marijuana is consumed on-site, and giving the landlord self-help rights in the event of a tenant default. Conversely, if it is the landlord's responsibility to "police" the common areas, then it should be permitted to charge the costs of doing so back to the tenant[7].

A further concern, the severity of which will vary depending on the specific use of the premises, is ventilation. Obviously, at the most extreme end of the spectrum would be a marijuana consumption "café" or similar venue, where additional ventilation will likely be required in order to prevent odours from escaping into the common areas or neighbouring premises. However, ventilation will always be a concern of varying degree since marijuana has a very strong and distinct odour, even if it is not being smoked. Landlords need to take seriously the issue of ventilation, since a failure to properly ventilate/ensure that premises are ventilated may invite claims of a breach of the covenant of quiet enjoyment from afflicted tenants.

Finally, many leases often include provisions preventing tenants from engaging in any business which could “tend to lower the character of the development or harm or tend to harm the business or reputation of the landlord or reflect unfavourably on the development, the landlord or other tenants in the development”. Sophisticated third-party tenants may try to use such a clause to prevent the landlord from leasing space to a cannabis business due to the associated social stigma.

Leasehold Improvements and Utilities

Depending on the nature of their business, a marijuana-related tenant may have unique needs to customize the leased premises. For example, a grow-op requires significant amounts of light, water and air circulation. It should be clearly spelled-out in the lease who is responsible for installing these business-specific improvements, who pays for them, and whether or not the tenant is entitled (or required) to remove them at the expiry of the term.

Moreover, Health Canada has published a Guidance Document on “Building and Production Security Requirements for Marihuana for Medical Purposes”^[8] which should be consulted to ensure that the leased premises are constructed in conformity therewith. Some special leasehold improvements which may need to be installed include security walls or windows.

Insurance Risks

Landlords and tenants should speak with their insurers to confirm that the proposed use of the premises will not violate their insurance policies *before* entering into the lease so as to avoid the potential for a cancellation of insurance after the fact. Any additional costs in the landlord’s insurance should be passed on to the tenant, and the landlord should be entitled to terminate the lease if its insurance is put in jeopardy due to the tenant’s business.

Termination Rights

Due to the unseemly public perception of marijuana dispensaries, prudent landlords will strive for strong rights to terminate the leases of such tenants in cases where their presence in the development causes problems for the landlord or for third parties. While some of these potential termination rights are fair (for example, where there is the threat of a cancellation of the landlord’s insurance), other termination rights (such as where a lender or prospective purchaser wants the tenancy terminated due to the nature of the business) may be more difficult to obtain.

Since licenced producers are currently limited in what substances they can sell and in what quantities, it stands to reason that full legalization will bring with it similar restrictions. It would also be prudent to stipulate that a breach by the tenant of the conditions of its licence will be a breach of the lease, entitling the landlord to terminate.

Finally, since the legal framework governing the sale of marijuana is in flux, a broad termination right would serve both parties well: for example, if the sale of marijuana becomes restricted to specialized vendors (such as licenced pharmacies or governmental agencies such as the LCBO), then the lease should terminate, and the parties will want to think about cost recoupment.

Indemnities

Ignoring the common conception that marijuana businesses are “shady” actors, the risk does exist with such tenants (as with many small businesses) that they may default on their obligations under the lease. While personal indemnities from the business’ principals may be obtainable, a letter of credit may be a more preferable option for a landlord since it removes the risk of a judgment-proof tenant or indemnifier.

Such security has become even more important as recent reports suggest that some major Canadian banks are refusing to give bank

accounts to companies associated with the marijuana industry[9]. Such banks are unlikely to accept these companies as clients until the federal government clarifies its plans for legalizing marijuana.

Conclusion

While the state of the nascent cannabis industry remains in a state of flux pending the federal government's new legislation, landlords and tenants should begin to prepare for a world of legalized marijuana, and the role retail cannabis products will play in their developments. Even once legalized, leasing to marijuana businesses should be approached with a high degree of caution since these leases should not be treated the same as those of other retailers, but rather extra consideration must be given to the unique needs and challenges of these potential tenants. With careful planning, landlords and tenants can ensure that their dreams of sharing in the profits of this burgeoning industry are more than just a pipe dream.

[1]The Forum Poll, "Majority Approve of Legalized, Regulated, Taxed Cannabis"(8 November 2015), Forum Research Inc., online: <<http://poll.forumresearch.com/post/2426/most-want-it-licensed-and-sold-through-government-agencies/>>.

[2]Robert Benzie, "Recreational weed could be a \$22.6B industry: study", *The Star*(27 October 2016), online: <<https://www.thestar.com/news/queenspark/2016/10/27/recreational-weed-could-be-a-226b-industry-study.html>>.

[3]*Controlled Drugs and Substances Act*, SC 1996, c 19.

[4]*Access to Cannabis for Medical Purposes Regulations*, SOR/2016-230.

[5]The Forum Poll, "6-in-10 Approve of Legal Pot"(28 April 2016), Forum Research Inc., online: <<http://poll.forumresearch.com/post/2509/almost-a-quarter-will-use-it-when-legal/>>.

[6]Pete Evans, "Shoppers Drug Mart formally applies to distribute medical marijuana", *CBC News* (25 October 2016), online: <<http://www.cbc.ca/news/business/shoppers-drug-mart-medical-marijuana-1.3820131>>.

[7]See our earlier newsletter from November 2013: <http://www.weirfoulds.com/the-covenant-for-quiet-enjoyment>

[8] Health Canada, Guidance Document, "Building and Production Security Requirements for Marijuana for Medical Purposes" (19 June 2013).

[9]Mark Gollom, "Canadian banks likely to be leery of legal marijuana sellers 'until the dust has settled'", *CBC News* (13 September 2016), online: <<http://www.cbc.ca/news/business/marijuana-selling-legalization-banks-1.3758957>>.

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