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Indemnities in leases for marijuana establishments - by Rob Schlein

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Operators of cannabis dispensaries – “marijuana establishments” as defined in the regulations of the Cannabis Control Commission (CCC) of Massachusetts – have generally accepted that they will pay premium rent for space that is no different than any other “vanilla box” typically used by a retailer. In addition to the rent, the tenant will typically bear the expense, one way or the other, for the cost of building out the vanilla box to meet security requirements and otherwise comply with the CCC regulations.

To the tenant/operator, this premium rent is understandable in light of the additional risk a landlord undertakes in leasing property to a marijuana establishment. However, landlords may accept the premium rent but also seek to shift the risks to tenants through an indemnity in which the tenant agrees to hold the landlord harmless from those risks.

A party giving an indemnity—the “indemnitor”—typically takes on the ultimate responsibility for monetary loss relating to the risk described in the indemnity. The indemnitor also agrees to pay the cost of defending a lawsuit or claim relating to the indemnified matter. The cost of defense can be thousands of dollars, even if the tenant is ultimately not required to pay the underlying claim. If a tenant agrees to an indemnity, it should be as narrowly defined as possible, and ideally it should be limited to matters that are within the tenant/indemnitor’s ability to control or mitigate.

Indemnities

The broadest and potentially most dangerous indemnity can be the shortest and simplest – “tenant hereby indemnifies, exonerates and agrees to defend the landlord from any loss, liability or damage related to this lease or the use and operation of the premises as a marijuana establishment.”

These few words could make the tenant responsible for a variety of issues:

Forfeiture

While federal forfeiture of the rental property on account of the sale or growth of state-legal cannabis is unlikely, it is something that the real estate community is deeply worried about. If it were to happen, the damages could be the fair market value of the forfeited property.

Failure to comply with law: This failure could be the overall non-compliance with federal law, or the failure of the tenant to operate in compliance with the CCC's regulations and its license. The latter liability is clearly more likely in the tenant's control.

Loss of financing or inability to finance

A landlord may seek to make the tenant responsible for the landlord's inability to finance the property. It may also seek to hold the tenant liable if an existing lender declares a default under the landlord's loan documents relating to the use of the facility as a cannabis establishment. The damages relating to loss of financing could be enormous, including the cost of securing new financing and any increase in the interest rate over the life of the loan, and could be compounded if the financing covered multiple properties, or if the landlord lost the property to foreclosure.

Banking violations relating to receipt of rent based on cannabis proceeds

The tenant could end up defending a RICO or money laundering charge on behalf of the landlord.

Other tenants' complaints

Landlords could seek to make the tenant liable for the loss of other tenants, or nuisance complaints or complaints about odors, or even the inability to find new tenants for vacancies in a project.

Possible Responses

Of course, the best stance for the tenant is to remind the landlord that the tenant is paying the landlord a premium rent precisely to compensate for the risks. The lease would then contain indemnities only against typical real estate risks – for example, loss resulting from a lease default other than a default relating to the cannabis operation, and liability for injury caused by customers and invitees not covered by insurance.

The second level of response for the tenant would be to indemnify only for matters reasonably within its control – failure to maintain odor control, damage to the landlord resulting from the tenant's failure to comply with its CCC licenses or applicable law or damage to the landlord resulting from the tenant's failure to comply with local permitting or its Community Host Agreement.

While not entirely satisfactory, if the landlord is adamant that the tenant indemnify it against the risk of big ticket items not within the tenant's control – the loss of the real estate, inability to finance, or even loss of other tenants – the tenant should consider giving the landlord a right to terminate the lease and end the perceived threat. While it is not easy to consider losing a space the tenant worked hard to permit, the remedy will usually be accepted by landlords and will permit the tenant to continue in business and find another location.

If there is to be a termination right instead of an indemnity, it will typically be in the control of the

landlord. The right should be triggered only by an objective and verifiable occurrence, such as receipt of notice of a forfeiture proceeding or a notice of default from a lender relating to the tenant's operation. Except in the case of an imminent loss, the lease should provide some breathing room for the tenant in the requirement of a substantial notice period (perhaps 30 or 60 days) to give the parties time to possibly mediate or discuss a plan to address the situation.

Conclusion

Leasing to cannabis use exposes landlords to a variety of risks in addition to those typical of retail leasing. In the lease, the parties can resolve who bears which risks through the use of indemnities and other remedies, including termination rights.

Landlords may agree to bear some of the risks, either because they don't perceive them as practical, or "real world" problems, or because they are compensated for the risk in the premium rent. Other risks, particularly those in the day-to-day control of the operator, should be borne by the tenant. Finally, risks that, even if unlikely, are so large that an indemnified loss would bankrupt the tenant are more realistically addressed by means of the right to terminate the lease.

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