Real Estate and Cannabis Regulations in California: Lending, Leasing and Conflict of Laws

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Richard P. Ormond – Presenter

With an extensive background that includes business, banking, receivership law, commercial litigation and work-out experience, Richard Ormond is known for his ability to solve complex business disputes for his clients. He has particular experience with disputes involving Preferred Equity Structures, Bridge Lending, CMBS and other debt facilities. As a trusted advisor, Mr. Ormond also guides his clients through their day to day legal concerns and considerations.

Representative clients include financial institutions, state and federal receivers, loan servicers, CUSO's, private investors and investment funds, private equity groups, developers and high-net worth families (and family office).
Presentation Overview

- The Legalization of Medicinal and Recreational Marijuana
- Risks under the Civil Asset Forfeiture Act
- Real Estate Considerations for Marijuana-Based Businesses
- Bankruptcy Cases Involving Marijuana-Based Businesses
- Can Lawyers Provide Legal Advice for Marijuana-Related Activities?
- Banking Issues Arising from Legalized Marijuana
- Questions and Answers

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Presentation Overview (continued)

- The current marijuana laws and how they impact real estate and real estate financing;
- The Federal Legal Conflict
  - Status and Explanation;
  - Seizure concerns;
  - Enforcement realities;
- how to navigate the legal pitfalls for secured lenders;
  - New loans
  - Old loans (with facilities on the premises)
  - Deposits
  - Risks

- Landlord tips and advisements;
  - Dispensary concerns;
  - Grow Facilities;
  - Lease Types;
  - Risks.

- The new proposed law and its impact on real estate and banking.
The Legalization of Medicinal and Recreational Marijuana

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Do you think the use of marijuana should be made legal, or not?

GALLUP®
The History of Marijuana Legalization in California

**Proposition 64**

**CALIFORNIA REPUBLIC**

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Marijuana Legalization by State

As of November 9, 2016
National Conference of State Legislatures
(www.ncsl.org/research/health/state-medicalmarijuana-laws.aspx)

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California Proposition 64 – Marijuana Legalization

- Passed with 57% of the votes.
- Legalized marijuana use by adults 21 or older.
- Designated state agencies to license and regulate the industry.
- Imposed 15% tax on retail sales and cultivation taxes on growers.
  - Exempts medical marijuana from some taxation.
- Established packaging, labeling, advertising, and marketing standards and restrictions for marijuana products.
  - Marketing and advertising of marijuana directly to minors prohibited.
- Provides for local regulation and taxation of marijuana.
- Authorizes resentencing and destruction of records for prior marijuana convictions.

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Treatment of Marijuana Under Federal Law

- **Controlled Substances Act (CSA), 21 U.S.C §§ 801 et seq.**
  - Establishes five classifications ("Schedules") of regulated drugs based on potential for abuse, accepted medical use and other factors.
  - Marijuana is listed as a schedule I drug—the most dangerous category.
  - Schedule I drugs are deemed to have a high potential for abuse and no accepted medical use.
  - Schedule I drugs include heroin and LSD, but not cocaine.
  - Simple possession, manufacture, distribution and dispensing of marijuana are illegal under the CSA.
  - Criminal penalties include fines of up to $2 million and 20 years in prison.
  - Conspiring to commit an offense under the GSA is subject to the same penalties as prescribed for the offense itself. (21 U.S.C. § 846.)
Key Decisions on Applicability of Federal Law


- The Supreme Court held that there is no medical necessity exception to the CSA’s prohibitions on manufacturing and distributing marijuana.
  - “The statute reflects a determination that marijuana has no medical benefits worthy of an exception.”
  - “medical necessity is not a defense to manufacturing and distributing marijuana.”

Gonzales v. Raich, 545 U.S. 1 (2005)

- The Supreme Court held that the Commerce Clause gave Congress the authority to prohibit the local cultivation and use of marijuana, despite California’s state law to the contrary.


- “We note that if either the MMPA or the CUA affirmatively authorized cultivation, possession, or distribution of medical marijuana, by individuals or collectives, it would raise serious questions of federal preemption by the Controlled Substances Act ….
- “The Controlled Substances Act defines marijuana as a schedule I drug, and prohibits any possession or use of marijuana except in the course of federally approved research projects. …
- “A local statute that authorizes conduct prohibited by federal law is an “obstacle” to accomplishing federal objectives and is therefore preempted.”
Department of Justice prosecuted the largest medical marijuana dispensary in the United States, located in Oakland, California.

In 2014, Congress approved an amendment introduced by Reps. Sam Farr (CA-D) and Dana Rohrabacher (CA-R) that would block the DOJ from using federal funds to go after state-legal medical marijuana program. Congress reauthorized that amendment in 2015.

The Ninth Circuit held that the amendment prohibited the Department of Justice from spending money granted by the appropriations bill to prosecute organizations or otherwise prevent certain states “from implementing their own State laws that authorize the use, distribution, possession, or cultivation of medical marijuana.”

Holding prevents the government from spending money on prosecutions of people whose marijuana activities were legal in their states and fully complied with those laws.
Civil Asset Forfeiture Act

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Civil Asset Forfeiture Risks for Marijuana Facilities

1. “All real property, including any right title, and interest . . . which is used . . . in any manner or part to commit, or to facilitate the commission of [violation of the CSA] shall be subject to forfeiture.” 28 U.S.C. § 881(a)(7).

2. Lienholders are “owners” of real property.

3. Innocent owner defense under Civil Asset Forfeiture Reform Act has two key elements: Owner **before** illegal conduct giving rise to forfeiture occurs is an “innocent owner” if
   • was not aware of illegal conduct giving rise to forfeiture; or
   • upon learning of such conduct, did all that reasonably could be expected under the circumstances to terminate the illegal use of property.

Owner who acquires property **after** illegal conduct occurs is “innocent owner” if at time of acquisition it
   • was a bona fide purchaser or seller for value; and
   • did not know and was reasonably without cause to believe that the property was subject to forfeiture.
Steps to Mitigate Against the Risk of Forfeiture

1. Review loan or agreement documents for “violation of laws,” recourse carve-outs and Borrower liability for tenant illegal uses.

2. Underwriting and due diligence to address potentially illegal uses.
   - Appraisal, description of tenants
   - Site inspections
   - Rent roll and property financials

3. Post-closing, asset management procedures to address potentially illegal uses.
Important Issues for Marijuana Businesses

- Licensing and Registration
- Different Lines of a Marijuana Businesses
- Ground Lease v. Commercial Lease
- Green Rider for Leases and Loans
- Secured Transactions/Secured Leases
- Due Diligence Requirements
- Risks and Conflict of Laws

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Issues for Marijuana Businesses

- Client Profiles
- Products Sold
- Cash Management
- Bank Deposits

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Important Issues for Marijuana Businesses

- Security
- Cash Management
- Tax Considerations
- Banking (more to come later…)

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Bankruptcy Issues for Marijuana Based Business

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Bankruptcy courts “should not be ‘a haven for wrongdoers.’”

*Lockyer v. Mirant Corp.*, 398 F.3d 1098, 1107 (9th Cir. 2005)

28 U.S.C. § 959(b):

“[A] trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.”

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Critical Issues for Dealing with Marijuana Bankruptcies

- **Appointment of a Chapter 7 or a Chapter 11 Trustee**
  - Constraints on operating or liquidating the business.
  - Asset forfeiture and money laundering risks not palatable.
    - Chapter 7 debtor could not operate his business legally under the Controlled Substances Act even though he possessed all of the required licenses and permits necessary for producing and distributing marijuana in the State of Colorado.
    - "For the Trustee to take possession and control of the Debtors’ Property and marijuana inventory would directly involve him in the commission of federal crimes."
    - The inevitable illegality of the trustee's administration of illegal estate assets constituted cause to dismiss under section 707(a).

- **Chapter 11 Practical Concerns**
  - Inability to open debtor in possession bank accounts.
  - Lack of access to DIP financing.

- **Chapter 13 Practical Concerns**
  - Distinction between how a chapter 13 trustee administers a bankruptcy case versus a chapter 7 trustee.
Critical Issues for Dealing with Marijuana Bankruptcies

- **Dismissal for Cause**
  - **Lack of “Good Faith”**
    - U.S. Trustee moved to dismiss chapter 13 case of a debtor that operated a medical marijuana business under the Michigan Medical Marijuana Act.
    - “The Debtor filed his case in good faith, and it is quite obvious from his credible testimony that he is in dire need of bankruptcy relief and the court’s assistance.”
    - “To balance the court’s (and the Debtor’s) obligations under federal law . . . the Debtor’s legitimate need for relief under chapter 13, and Michigan’s policy choices reflected in the MMMA, the court will refrain from dismissing the Debtor’s case at this time, but will enjoin him from conducting his medical marijuana business (and violating the CSA) while his case is pending.”
  - **In re Medpoint Mgmt., 528 B.R. 178, 180 (Bankr. D. Ariz. 2015)**
    - Cause existed to dismiss the involuntary chapter 7 petition because the purported debtor was a medical marijuana dispensary-management entity.
    - Neither the alleged lack of enforcement funding nor the apparent lack of political will to enforce the Controlled Substance Act altered the fact that a person engaged in marijuana related business activities in Arizona was in violation of federal law.
    - The prospects of a possible forfeiture or seizure of the debtor’s assets posed an unacceptable risk to a chapter 7 estate and to a chapter 7 trustee.
**Northbay Wellness Group v. Beyries, 789 F.3d 959 (9th Cir. 2015)**

- Bankruptcy Court dismissed the adversary proceeding because the plaintiffs, a medicinal marijuana dispensary and its principal, were engaged in the unlawful sale of marijuana in violation of federal law.
- The defendant was an attorney who had embezzled $25,000 from the marijuana dispensary’s client trust account.
- The Ninth Circuit reversed and remanded finding that “the bankruptcy court abused its discretion by applying the doctrine of unclean hands to bar Northbay’s request for a judgment of non-dischargeability.”
- The defendant “was on Northbay’s board of directors and partnered in Northbay’s business, so he was as responsible as Northbay for its illegal marijuana sales. That illegal activity must be attributed to both parties in the weighing of wrongdoing, so it does not tip the balance in either direction.”


- Court denied motion for summary judgment in breach of contract action where defendant asserted that plaintiff marijuana related business had unclean hands because engaged in violations of federal law.
Banking Issues Arising from Legalized Marijuana

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The DOJ’s Guidance: **RESCINDED JANUARY 2018**

Department of Justice Priorities on Enforcing the Controlled Substances Act

- Preventing the distribution of marijuana to minors.
- Preventing marijuana revenue from going to criminal enterprises and cartels.
- Preventing the diversion of marijuana from states where it is legal under state law in some form to other states.
- Preventing state-authorized marijuana activity from being used as a cover for the trafficking of other illegal drugs or other illegal activity.
- Preventing violence in the cultivation and distribution of marijuana.
- Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use.
- Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers.
- Preventing marijuana possession or use on federal property.

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Financial Crimes Enforcement Network’s guidance based on the 2013 “Cole” Memo provides that a financial institution should conduct customer due diligence that includes:

- Verifying with state authorities whether the business is duly licensed and registered.
- Reviewing the license application (and related documentation) submitted by the business for obtaining a state license to operate its marijuana-related business.
- Requesting from state licensing and enforcement authorities information about the business and related parties.
- Assessing the normal and expected activity for the business, including the types of products to be sold and the customers to be served (e.g., medical vs. recreational).
- Ongoing monitoring of publicly available sources for adverse information about the business and related parties.
- Ongoing monitoring for suspicious activity, including for any of the red flags described in this guidance.
- Refreshing information obtained as part of customer due diligence on a periodic basis and commensurate with the risk.

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• Formation of the Fourth Corner Credit Union
  – Following the issue of the 2013 “Cole Memo” and the 2014 FinCen guidance, Fourth Corner was formed to become the banking institution for the marijuana industry.
  – The Federal Reserve rejected their application for a master account to allow it to transact business and transfer funds through the fed wire system.

• Fourth Corner Seeks to Compel the Issuance of a Master Account
  – Fourth Corner sued and sought an injunction to force the Fed to issue a master account.
  – “Courts cannot use equitable powers to issue an order that would facilitate criminal activity.”
  – The Cole and FinCen memos “simply suggest that prosecutors and bank regulators might ‘look the other way’ if financial institutions don’t mind violating the law. **A federal court cannot look the other way.**”
  – The District Court denied the injunction and Fourth Corner appealed.

• Oral Argument was set for November 16, 2016 in the Tenth Circuit
  – Stay tuned . . .
“Suspicious Activities Reports” for Marijuana Businesses

“The obligation to file a SAR is unaffected by any state law that legalizes marijuana-related activity.”

“A financial institution is required to file a SAR if, consistent with FinCEN regulations, the financial institution knows, suspects, or has reason to suspect that a transaction conducted or attempted by, at, or through the financial institution:

- involves funds derived from illegal activity or is an attempt to disguise funds derived from illegal activity;
- is designed to evade regulations promulgated under the BSA, or
- lacks a business or apparent lawful purpose.
- Because federal law prohibits the distribution and sale of marijuana, financial transactions involving a marijuana-related business would generally involve funds derived from illegal activity.”

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Types of Suspicious Activity Report Filings

“Marijuana Limited” SAR Filing

- Used if financial institution reasonably believes, based on its customer due diligence, activities do not implicate one of the Cole Memo priorities or violate state law.

“Marijuana Priority” SAR Filing

- Used if financial institution reasonably believes, based on its customer due diligence, activities implicate one of the Cole Memo priorities or violates state law.

“Marijuana Termination” SAR Filing

- Used if financial institution terminates relationship with marijuana-related customer in order to maintain compliance with anti-money laundering program.

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Red Flags to Distinguish Priority SARs

- A bank customer appears to be using a state-licensed marijuana-related business as a front or pretext to launder money derived from other criminal activity (i.e., not related to marijuana) or derived from marijuana-related activity not permitted under state law.

- The business is unable to produce satisfactory documentation or evidence to demonstrate that it is duly licensed and operating consistently with state law.

- The business is unable to demonstrate the legitimate source of significant outside investments.

- A bank customer seeks to conceal or disguise involvement in marijuana-related business activity. For example, the customer may be using a business with a non-descript name (e.g., a “consulting,” “holding,” or “management” company) that purportedly engages in activity unrelated to marijuana.

- Review of publicly available sources and databases about the business, its owner(s), manager(s), or other related parties, reveal negative information, such as a criminal record, involvement in the illegal purchase or sale of drugs, violence, or other potential connections to illicit activity.

- The business, its owner(s), manager(s), or other related parties are, or have been, subject to an enforcement action by the state or local authorities responsible for administering or enforcing marijuana-related laws or regulations.

- A marijuana-related business engages in international or interstate activity, including by receiving cash deposits from locations outside the state in which the business operates, making or receiving frequent interstate transfers, or otherwise transacting with entities located in different states.
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QUESTIONS?

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