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The Commerce of Cannabis Enters the Warehouse and New Retail Space

Featured Story

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As the risk of disintermediation by e-commerce continues to grow, cultural tastes and their corresponding sumptuary laws change to enable the emergence of an entirely new sector for a product that 60 percent of Americans, according to a Pew Research poll, say they want to buy but that has been, until recently, illegal: marijuana. To date, marijuana has been legalized in some form in 29 states and the District of Columbia.

Against this backdrop of change, a fascinating story is playing out in eight states (Washington, Oregon, California, Nevada, Alaska, Colorado, Massachusetts, and Maine) and D.C., where marijuana is legal for recreational use and where a number of key stakeholders—lenders, insurance companies, building owners, growers, retailers, and investors—have grappled with the interesting and often

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unforeseen challenges of bringing cannabis products from their former place in a shadow economy into the bright light of everyday retail shopping.

Advocates of legalization have long argued that retail marijuana would be a boon to state coffers—and recent evidence bears this out: from 2014 to 2015, the state of Colorado collected a total of $211 million in taxes and licensing fees, and excluding licensing fees for 2016, the state generated over $1 billion in total marijuana sales, collecting $151.4 million in taxes through October 2016. Oregon has collected $25 million in tax revenues since it legalized marijuana in July 2015; and by July 2016, Washington State had collected more than $250 million in excise taxes since legalization in 2014.

But what would a cannabis economy look like at scale? Jonathan Robbins, chair of Akerman's Cannabis Practice, addressed this and other business considerations in "Marijuana Tipping Point," a *Law360* article published in November 2016. Robbins points to California, in particular, which has the largest economy in the country and the sixth-largest economy globally. The state's passage in November 2016 of Proposition 64, the Adult Use of Marijuana Act, according to Robbins, could eventually generate more than $1 billion annually in state and local taxes and create more than 100,000 jobs in the new cannabis economy.

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Legalized marijuana is already a $45-billion marketplace, according to a recent study by the Tax Foundation, which estimated that if legalized nationally, cannabis commerce could generate $28 billion in annual tax revenues for federal, state, and local governments—including $7 billion in federal revenues. It's anybody's guess, of course, whether such a green rush will sweep the country, especially given that Attorney General Jeff Sessions is openly hostile to the marijuana sector and could undermine or even roll back recent state legalization efforts, according to sector observers. For now, cannabis remains a booming sector—but it's also one that has been accompanied by unforeseen business challenges for the retail and industrial real estate sectors.

Financing a Green Project Has Its Challenges

For starters, this new retail subset has an unusual banking, lending, and credit challenge. That's because the Treasury Department still requires banks to report activity that may violate federal law, and, since marijuana is still illegal under federal law, banks that lend to businesses that cultivate, transport, and dispense marijuana put themselves "at risk of running afoul of financial reporting obligations," writes Robbins. You can't buy legalized pot from a retail store with a credit card, nor can a grower—or, in fact, any business that touches the marijuana plant—get a traditional loan from a bank. The cannabis economy has been, in other words, at least for now, largely a cash business. You could call it a problem of riches, according to Robbins. Landlords and lenders have had a difficult time underwriting cash-based tenants—identifying assets, establishing creditworthiness, or accepting payments. But alternative forms of financing and investment have emerged. Crowdfunding and activity by real estate investment trusts to target medical-use cannabis facilities have become platforms that can help cannabis-related companies find the investors they need without running afoul of federal regulations.

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Marijuana retail outlets have absorbed new costs—as the cash-based sector continues to prompt increases in security expenses. Marijuana growers, moreover, need large, industrial-size indoor spaces—and word has gotten around to warehouse property owners, resulting in skyrocketing industrial lease rents. Real estate that was $4 a square foot six months ago is now $20 a square foot, which will need to be a consideration in any business model. Insurance liability and leasing hazards also exist. Companies that extract essential oils derived from marijuana and add these oils to food and other products use an extraction process where things can go explosively wrong at an industrial scale. Such companies are now paying more for insurance policies that can also exclude coverage for some industrial accidents—and this has added unforeseen risk to operations.

Due Diligence – the Golden Key to the Green Rush

All of these considerations require greater due diligence for stakeholders. Commercial landlords considering leasing space to cannabis-sector tenants need to carefully consider the potential risk under federal law and also need to amend standard leasing documents to provide for termination rights in the event of any enforcement actions, litigation, or adverse change in applicable law. Local land-use and zoning laws need to be understood. Investors need to properly vet a cannabis company's cash management structure to ensure compliance with federal anti-money-laundering statutes.

Increased confidence in the commerical real estate market has taken hold since the U.S. presidential election.

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Protecting a cannabis company's product brand, trademark, patents, and marketing innovations has also become a challenge—once again because the federal agency that regulates these things—the U.S. Patent and Trademark Office—requires that applicants for patent and trademark protection demonstrate "legal use" of a commercial product. Until cannabis is legalized at the federal level, in other words, cannabis trademarks and brands will fall under a patchy mosaic of more-limited, state-level protections. California, perhaps the biggest potential market for the sector, has not yet registered trademarks used on cannabis, but this could soon change.

> Private equity groups are entering the game —on average investors plan to invest half a million dollars on

cannabis businesses in 2017.

So far, investors in the cannabis economy have been relatively small and local—and some of this has been legislated into the new state marijuana laws, many of which have been written to favor and encourage the development of local small-business owners—in an effort to give local small businesses a head start, before the big industrial agricultural fish move in. These local-hero laws for small businesses should also be considered, even as increasingly bigger fish are moving into the market—private equity groups are entering the game, manufacturers of industrial lighting systems and irrigation systems, kiosk companies, and software companies that provide seed-to-sale tracking information. Celebrities have introduced branded cannabis products. Bigger players and many hundreds of millions of dollars have entered the market, much of it now coming from hedge funds and private equity investors. In other words, and a rapidly maturing market is opening up endless opportunities in the retail and warehouse segments of real estate.