

CANNABIS IN ONTARIO – THE LANDLORD AND TENANT PERSPECTIVE

This paper served as the background to the comments of Dennis Daoust (a partner in the law firm of Daoust Vukovich LLP) presented at the P.M. Springfest in March, 2019. Dennis can be reached at the following email address: ddaoust@dv-law.com or by phone at 416.597.9339.

TYPES OF CANNABIS USE RELATED TO REAL ESTATE

There are three general categories of cannabis use related to real estate:

Medical Cannabis

On August 11, 2016, the Access to Cannabis for Medical Purposes Regulations came into effect. These regulations provide that Cannabis for medical purposes would be available by medical prescription and that medical cannabis could not be purchased over the counter. In each case, the prescription must be filled by mail.

Cannabis can only be produced by licensed growers and producers.

No Stores (not even drug stores) can sell medical cannabis over the counter.

The legalization of cannabis for recreational purposes has virtually no impact on the status quo of medical cannabis. Comments set out later in this paper will address real estate related concerns pertaining to the growing, production and distribution of cannabis including medical cannabis and recreational cannabis.

Cosmetics

In 2018 the Federal Medical Cannabis Act removed cannabis from the Controlled Drug Substances Act and now regulates its production, distribution and sale through rigid market regulations. Although phytocannabinoid (“CBD”) present in cannabis is thought to have little psychoactive effects, it continues to be listed under the Prescription Drug List. This precludes it from being considered as a natural health product and, Health Canada took the extra step of specifically excluding CBD from the Natural Health Products Act in 2018. CBD will not be available for sale as a natural health product until its classification is changed. It can be expected that the classification might change at some point. There is a lot of pressure to open up the CBD market having regard to its popularity in US and European markets and that may shorten the time frame but the timing is still hard to predict.

Edibles and Consumables

The Canadian government has proposed a plan to regulate the licensed sale of other cannabis products including edibles, drinks and extracts which is expected to come into force in October of 2019. Specific guidelines will be imposed limiting the amount of THC (the “psychoactive component of cannabis”) as well as other compounds in edibles and beverages such as alcohol and

caffeine. The restrictions will also prevent the products from making health claims similar to those that are already in place with regard to cannabis in general. Note that the sale of these items in restaurants, taverns and coffee shops is not expected to be legalized.

Recreational Cannabis

On October 17, 2018, the Federal Cannabis Act came into effect. It:

1. removed the criminal prohibition on the possession and distribution of cannabis for recreational purposes;
2. set out requirements pertaining to the possession, growth and production of cannabis for recreational use; and
3. established industry wide rules regarding packaging, serving sizes, marketing and security of premises used for the cultivation, processing and sale of cannabis, among other things.

The regulatory framework for distribution and sales was left to the provinces and territories.

Recreational Cannabis on Ontario

The following timeline sets out the milestones:

2017 – Cannabis Control Act of Ontario ensures that cannabis must be sold in accordance with the Ontario Cannabis Retail Corporation Act, 2017 and the Cannabis License Act 2018.

August 13, 2018 – The Ontario government announces that it will implement a private sector model for the retail sale of cannabis in Ontario. This created a dramatic shift in the retail cannabis marketing world in Ontario. Previously it was expected that there would be 150 retail cannabis stores in Ontario, each operated as a subsidiary of the Liquor Control Board of Ontario.

October 17, 2018 – Cannabis is legalized across Canada and cannabis stores opened in the provinces and territories except Nunavut and Ontario. In Ontario cannabis could only be purchased from the Ontario Cannabis Store (“OCS”) by means of online purchases with the product being delivered by mail.

November 14, 2018 – Ontario proclaimed the Cannabis Licensed Regulations.

December 13, 2018 – Ontario announced a change to the cannabis license regulations due to cannabis shortage from federally licensed producers. A phased approach was set in place involving a temporary cap of 25 retail store licenses for all of Ontario (6 in the GTA) and the Alcohol and Gaming Commission of Ontario (the “AGCO”) was mandated to implement a lottery system to determine who was eligible for the licenses.

January 11- 12, 2019 – Lottery draws were conducted (25 winners announced).

April 1, 2019 – Target date for opening of Ontario Retail Cannabis Stores. Severe penalties were established for failure to open on April 1, 2019 and, loss of license can occur for failure to open within one year.

October 2019 – The next wave of legalization is expected to occur. It will permit the sale of edibles and consumables containing cannabis and will set out regulations and restrictions.

Registrar Standards for Cannabis Retail Stores

The Cannabis License Act and regulations provide that the Registrar has authority to establish standards and requirements in the following areas:

- store premises, equipment and facilities including surveillance and security
- the prevention of unlawful activities
- advertising and promotional activities
- training related to the responsible sale and use of cannabis
- the protection of assets
- record keeping and measures to maintain confidentiality and security of records
- compliance with federal cannabis tracking system

Attached to this paper as Exhibit 1 is a copy of the Cannabis Retail Regulation Guide published by the AGCO. It contains comprehensive and detailed information relating to the matters noted above.

Types of Commercial Real Estate Affected by Legalization of Cannabis

Growing Facilities – Note that in most cases, cannabis would be grown in buildings where the environment needed for efficient productive growth can be maintained.

Production, Packaging and Shipping – Industrial type locations are needed for the production, packaging and shipping as well as the warehousing of cannabis products.

Retail Outlets – The restrictions and requirements pertaining to the operation of retail outlets will be discussed in detail later in this paper.

Edible Production Facilities – When edible cannabis products are legalized, it can be expected that major demands for kitchen facilities, food and beverage production will be a significant part of commercial real estate operations.

Disposal Facilities – Cannabis has a limited shelf life and, the standards and requirements related to its production can be expected to result in the need to dispose of expired or faulty products. Stringent regulations surrounding the disposition of cannabis and cannabis products will need to be complied with. Facilities that are able to satisfy those requirements will be needed.

GENERAL CONCERNS

Uncertainty Associated with Application and Compliance Requirements

Virtually all aspects of the cannabis industry are new and, there is a lack of full understanding of the many restrictive requirements that need to be complied with in order to obtain licenses authorizing all or any of the growing, production, packaging, storage and sale as well as the disposition or destruction of cannabis products. Delays in obtaining authorizations due to a lack of expertise or experience in completing applications should be expected. There is also a risk of having licenses revoked for failure to comply and the risk of fines and other penalties must be considered. As one might expect, inspections of the facilities will be conducted by authorities on a regular and diligent basis.

There are very stringent requirements pertaining to security of the premises, restrictions and requirements pertaining to storing, packaging and labelling, distribution, security back ground checks for specific individuals, record keeping, and many other matters. Failure to comply poses a substantial business risk.

Uncertainty Related to New and Changing Statutes, Regulations Guidelines and Standards

Even a cursory review of the timelines and the changes that have surprised and challenged potential and existing business owners discloses a volatile, shifting environment. As experience is developed, it is only realistic to expect that there will be further changes that will have significant impacts on businesses, including, of course, landlords and tenants of commercial space.

Examples of the problems associated with new regulations and restrictions include fire and safety regulations. In November 30, 2018 article published by Jensen Hughes (a major specialty, engineering consulting and scientific research firm) entitled “Stirring the Pot” – Mitigation Hazards in Marijuana Facilities, it is noted that the marijuana industry is expanding more rapidly than the research into hazard and risk mitigation. The hazards associated with growing, extraction and dispensary facilities are not well understood by proprietors, the design industry and enforcement authorities. The need for security may prompt proprietors to opt for forms of security devices such as hasps and locks or deadbolts and other hardware that can cause safety issues in an emergency. Security plans responding to safety concerns will need to be in place.

Similarly, there are problems with electrical equipment that can create significant fire ignition hazards especially in grow operations due to the extensive application of high current drawing appliances to boost production. There may also be the need for sophisticated climate control, air scrubbers and Co2 generation systems. Existing building electrical systems are not designed for those high demand uses.

There is also an ignition hazard unique to marijuana manufacturing facilities. The THC extraction process is a closed operation by design, to take advantage of solvent recovery using butane or

isopropyl alcohol. Commercial THC extraction units are available but few are tested or listed with accredited testing agencies.

Plastic sheeting is often used to cover wall and ceiling surfaces to prevent moisture damage. If it is ignited, it can rapidly spread a fire. Hydroponics operations requires large quantities of plastic bins. The fuel load may be closer to a storage warehouse holding Group A Plastics that are more traditional agricultural operation.

There are also problems relating to plumbing, ventilation and exhaust venting which can cause damage to the building structure and can also facilitate smoke and fire to spread within a building.

Insurance and Risk Transfer Issues

It should be anticipated that as the result of the risks identified above, many of which would be present not only in growing facilities but also production, storage and other facilities, there will be increased insurance costs and coverage exposures that will need to be addressed.

Transfer and Sales of Businesses - Financing

Due to the specialized nature of cannabis operations, restrictions on assigning and subletting will be of critical importance and, obtaining financing for the installation of or establishment of cannabis related operations will be a challenge.

Design and Operational Issues

Shipping and receiving facilities will require very special attention because there are restrictions against sharing or shipping facilities and storage facilities. Restrictions pertaining to the transportation of cannabis products will also need to be complied with.

Advertising and promotion restrictions will need to be adhered to.

In certain operations, particularly, retail, that may also be concerns pertaining to crowd control and image control loitering in similar matters.

GENERAL LEASE RECOMMENDATIONS

Security Deposits

To protect against the risk of tying up property for substantial periods and, potentially effecting operations or improvements tailored to a tenant's requirements, and the risk of a lease being terminated particularly where a leasehold allowance or inducement has been paid, substantial deposits are highly recommended.

Exit Strategies

Careful consideration toward developing exit strategies particularly from the tenant's perspective is required. The possibility that the tenant through no fault of its own, due to governmental changes or industry changes may be unable to continue to operate its business is a real possibility. For example, there were a significant number of agreements to lease and leases entered into with the OCRC (a branch of the LCBO) for retail locations in Ontario and, with the change in government and the decision to move to a private retail model, the OCRC was unable to operate business. Analysis of liquidated damages clauses will be essential. In addition, because of the lack of experience in the industry, there a significant risk that operators of businesses will find that they are unable to compete or that they simply are not able to operate profitably. Tenants will be well advised to consider termination options exercisable after specified periods within the term. Inevitably, of course, termination rights will be accompanied by lease termination payments.

A number of clauses typically found in commercial leases will require very careful and special attention in the context of cannabis related operations. Examples are set out below:

Plans Approval Process

The review of plans specifications and working drawings for tenant improvements will require additional expertise. It should be anticipated that the cost of reviewing plans and specifications may be aggravated by the need for landlords and tenants to retain specialized experts. Extra time and cost will be involved.

Building and Operating Permits

Due to the layers of specialized permits that are required in connection with cannabis operations, negotiating time lines and condition dates for obtaining required approvals will require a flexible creative approach.

Use Clauses

Tenants will need to negotiate use clauses to account for the possible inability to obtain licenses or to maintain licenses and, to provide for the tenant's ability to assign or sublet the premises for other uses. Use clauses will also need to accommodate the potential for additional products being legalized such as edibles and consumables. Conversely landlords will need to pay particular attention to the use clause having regard to the potential for existing restrictive covenants interfering with sales by the tenant, applicable zoning bylaws and other restrictive clauses. The potential for cannabis uses interfering with other uses in adjacent premises or projects must also be anticipated. Hours of operation, restrictions against loitering, the cost of providing additional security for crowd control or other security matters, the potential for the image of a project or property to be negatively impacted, the emanation of undesirable odours or other effects, and the appropriateness of uses for the design of the building will all need to be addressed.

Sale of the Business, Transfers, Changes of Control

Typical assignment, sublease, lease transfer clauses in commercial leases contain restrictions and requirements that can be obstacles to a tenant that has made a substantial investment in improving and equipping its space. For example, it is not unusual for the landlord to have the right to terminate the lease if the tenant requests consent to assign or sublease the premises. It is important to note also that it's common for a change of control of the tenant (such as a sale of the issued shares of a corporate tenant) to be treated as an assignment of the lease.

It is also common for a lease to provide that if the tenant receives money or other valuable consideration in connection with a sale of its business which is attributable to the rental value of the leased space, the money or consideration must be paid to the landlord. This would typically entail sorting out what part of the proceeds of the sale of the business reflects the rental value of the space as opposed to the goodwill and the value of the improvements installed and paid for by the tenant.

Another factor to consider is that the landlord will want to be satisfied that the assignee or transferee has all the required governmental licenses, and sufficient experience to run the business successfully.

All of the matters noted above need to be addressed in the lease negotiation.

Alterations and Restorations

Restrictions regarding alterations to the premises, the installation of new equipment, the installation or modification of machinery or other production facilities will involve substantial risks which the landlord will need to address. In addition, reviewing and dealing with these changes will necessarily involve extra costs and administration. The condition in which the premises are left at the end of the term will also be of significant concern.

Inspection Rights

Enhanced Inspection Rights will need to be incorporated during the term and particularly toward the end of the term. Tenants on the other hand will be well advised to ensure that any inspection of access to the premises by the landlord or its representatives is supervised and controlled.

Hazardous Substances

The restrictions against the introduction of hazardous substances or the creating of hazardous situations such as mold, seepage, and other environmental risks will require significant attention.

Insurance and Risk Transfer

Insurance and risk management will need to be robust. There may be additional insurance costs, additional forms of insurance that become part of the industry and additional hazards and

exposures to liability will need to be responded by the insurance industry. The types of insurance that are required and the cost of providing that insurance or dealing with enhanced insurance costs will need to be addressed.

The release and indemnity provisions (risk transfer clauses) will need to be robust. Landlords will be well advised to insist upon strongly awarded indemnities to protect them from liability loss, cost and expenses associated with cannabis related uses which, as noted above, are not fully understood at this point. Tenants on the other hand will certainly need to restrict the indemnities that landlords will seek particularly having regard to the fact that contractual liability endorsements (which cover indemnities) under their insurance policies may not cover the broad range of indemnities that landlords will seek.

Incremental Property Management Costs

Landlords may find it necessary to install additional security features and will hire additional security personnel to manage the risk associated with cannabis operations. These costs would need to be managed.

Compliance Issues

Landlords will be well advised to ensure that at all times, a record of each licenses which the tenant has obtained as well and up to date copies and confirmation that they are in good standing are provided. Failure to keep permits up to date and in good standing should be a default under the lease.

If alterations are required as a result of existing or new, the requirements imposed by governmental authorities, the cost would typically be passed on to the tenant. On the other hand, the tenant may require the right to terminate instead of making the alterations if the nature of the alteration makes the liability of the tenant's business impossible.

Managing Complaints or Problems Associated With Noxious Effects Will Require Careful Consideration

Criteria to determine whether and when a particular odour of other unpleasant effect is or is not something that needs to be changed or stopped will need to be discussed and settled on.

Exclusive Use Restrictions in Favour of Tenants

Inevitably, particularly in connection with retail operations, the tenant will seek restrictive covenants to control competition. This will be particularly important when edible and consumable as well as cosmetic products become legal for sale and distribution.

RETAIL OUTLET SPECIAL CONSIDERATIONS

The general considerations that are outlined above would be applicable for the most part to growing, producing, distributing, and warehousing cannabis products and, several of them would be particularly relevant to retail outlets. Retail outlets will in addition require extra careful handling.

Retail store operators are required to enter into a wholesale supply agreement with the Ontario Cannabis Store. The ability to function will be dependent on the good standing of that agreement. The term, renewability, and continuing good standing of that agreement will be critical. Also, each store will require a Retail Operator License, a Retail Store Authorization, and a Cannabis Retail Manager License.

Attached as Exhibit 1 is the Cannabis Retail Regulation Guide published by the AGCO. Following are some highlights from that guide:

Retail Operator License

An applicant will be ineligible if:

- it has been convicted or charged under any cannabis legislation or it has been involved with any criminal organizations,
- false information has been provided,
- applicant is in default in filing of any tax returns,
- applicant is a corporation and to the extent that it is controlled by more than 9.9% by a licensed producer of cannabis products or their affiliates, the applicant does not demonstrate financial responsibility and its ability to operate the business, or if the applicant will not have sufficient control over the conduct of the business.

Retail Store Authorization

In addition to the requirements for the Retail Operator License, a retail store will not be authorized if the applicant hires or plans to hire someone who does not have a Cannabis Retail Manager License or, if the AGCO determines that it is not in the public interest. In that regard notice has to be posted in the local community and on the AGCO website concerning a proposed store and if the municipality or local submits omissions within 15 days after posting of the notice noting concerns to public safety, the protection of use and the prevention of illicit activities, the store may not be authorized. In all respect, the store or the facility must comply with the applicable statutory, regulatory, and Standards Requirements or, if it is determined that the applicant will not have sufficient control of the store.

Retail Manager License

Every store must have a license retail manager who is a human being, and who will supervise, manager or hire employees, manage sales, manage compliance with governmental requirements, be responsible for the buying or cannabis for the store, and enters into all contracts relating to the

store. A retail manager will be ineligible if it fails to comply with any of the other requirements noted above pertaining to the retail operator license.

Non-Transferability

The retail manager license is not transferable.

Store Locations

There are restrictions on where stores can be located. For example, they cannot be within 150 meters of an educational institution.

Specific Physical Requirements Pertaining to Retail Stores

Each retail store must comply with the following:

1. There must be separation of the store from other businesses.
2. The store must be enclosed by walls separating it from other commercial establishments.
3. There must not be an outdoor area.
4. The store cannot be entered or passed through in order to access another commercial business or activity (other than a common area of an enclosed mall).
5. Storage and receiving areas must be exclusive (this can be accomplished by managing hours of access and providing security guard to enforce it).

Training

Everyone working in the store must have completed an AGCO training program before starting to work.

Operations

Operations are limited between 9:00 am to 11:00 pm on any day, each store must display the official seal of the OGCO.

There are very detailed and comprehensive record keeping requirements.

There must be measures in place to avoid redirection of cannabis products sold from the store into an illegal market. (This seems to be a rather general or vague requirement and complying with it will be a challenge).

Only specifically permitted items may be sold.

Information concerning responsible use of the product must be made available to patrons.

No self service or vending facilities are permitted.

The product must not be visible from outside the store.

Advertising and promotion restrictions will prohibit any giveaways or other promotional benefits.

Registrar's Standards

Attached as Exhibit 2 is a copy of the Registrar's Standard for cannabis retail stores. The Registrar is the Registrar under the Alcohol, Cannabis and Gaming Regulations and the Public Protection Act. Highlights are as follows:

- Retail Managers can only be accountable for one store.
- Any changes to the directors or partners of the licensee must be reported
- No third party is entitled to share profits from the sale or be liable for the licensee's obligations.
- Secure high resolution surveillance systems must be operating at all times.
- Cannabis must be stored securely and accessible only by staff.
- Out dated or defective cannabis must be kept separate and be disposed of in accordance with the regulations and standards.
- All points of access to the store must be secured.
- There could be no visibility of cannabis or cannabis accessories from outside the store.
- Destruction of cannabis has to be in accordance with the prescribed methods, must be recorded by a surveillance system on the premises, and must be performed monthly.
- Records of transportation must be maintained and transportation must be secured. The licensed retail manager must supervise transportation.
- The list of records that must be maintained up to date is daunting.
- There will be signage restrictions and as mentioned above, controlled promotions.

Conclusion

The operation of any business related to cannabis cannot be achieved successfully without expert advice. Although there are many attractive opportunities associated with cannabis related businesses, the pitfalls are significant and at this point not fully understood. Moreover, as additional changes occur in the regulations and other governmental requirements and as the industry evolves, new pitfalls must be anticipated.