North Bay Business Journal
NORTH SAN FRANCISCO BAY AREA: SONOMA, NAPA AND MARIN COUNTIES

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SPECIAL REPORT **BANKING & FINANCE**

If there's pot, what is the lender's responsibility?

GUEST CONTRIBUTOR

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Lenders throughout California today face the risk of losing real estate collateral if that collateral is associated with illegal drugs.

The Department of Justice says marijuana cultivation and distribution have become more widespread in recent years. While the cultivation or distribution of marijuana may not be illegal under California law, it remains illegal under federal law. Under the Controlled Substances Act, a federal law, marijuana is labeled a "Schedule I" drug and is defined a dangerous drug with no medicinal value. For reference, cocaine, opium and amphetamine are labeled "Schedule II" drugs and are considered to have medicinal value.

In the 2009 "Ogden Memo," the Department of Justice stated it would likely not expend resources to enforce federal laws against marijuana users and caregivers acting in compliance with state law. However, in somewhat of a reversal, the DOJ last year signaled it is willing to enforce federal drug laws against any marijuana operation. This position was described in a memo from the U.S. Attorney's office last June describing the increase in marijuana operations in California and warning the government could enforce laws against such operations. Recently, the DOJ also notified certain lenders that the buildings securing their loans were being used in connection with marijuana cultivation or distribution.

A lender must consider what it means for its collateral to be used in connection with activities prohibited by the Controlled Substances Act. One of the biggest threats lenders face to their collateral is a civil forfeiture proceeding. Brought by the federal government under the Civil Asset Forfeiture Reform Act (CAFRA), this proceeding can result in the liquidation of collateral with the sale proceeds directed to federal authorities, leaving the lender with a large loss on its balance sheet.

During such a civil forfeiture proceeding, a lender can expect the DOJ to demand the opportunity to inspect the entire loan file, including phone logs, emails, financials, loan documents and the names of all persons the lender dealt with in connection with the loan. These documents could be used not only to determine the legitimacy of the lender's interest in the collateral, but also to provide circumstantial evidence of the lender's awareness of illegal marijuana activity.

The lender will not lose its collateral if it can show it is an "innocent owner" as defined in the CAFRA. To qualify, a lender must either not know of the illegal activity, or, do everything reasonably expected to prevent the illegal activity after it becomes aware of it. The lender may also be required to contact the authorities and report the activity in order to preserve its rights.

Generally, if the lender is not aware of the illegal activity before the loan was made and responded appropriately upon learning of the illegal activity, it will qualify as an "innocent owner." The lender would then be entitled to receive what it is owed by the borrower up to the amount of the forfeiture sale proceeds, after deductions for costs and expenses. Unless there is a large amount of equity in the property, the sale after forfeiture is unlikely to yield enough money to repay the loan made by the lender against the collateral.

If a lender becomes aware of the illegal activity after origination of the loan, it can maintain its "innocent owner" status by taking all reasonable steps to stop any illegal activity. In practice, this means that if a lender is informed by the borrower, or someone else, that the property is being used for marijuana distribution, it should give notice of a default under the deed of trust and demand that the illegal activity cease. In order to cure the default, the borrower would have to stop distributing or cultivating marijuana on the property. If the borrower is a landlord, it might have to evict the marijuana distributing tenant. If the borrower refuses to stop or prevent such activity, the lender may have no choice but to declare an event of default and foreclose on the property. In some cases, the lender may also be required to report the illegal activity to the authorities.

Unlike a criminal case, the government must only show it is more likely than not that the lender knew or should have known of the illegal activity to prove the lender is not an "innocent owner." The knowledge of any officer of the lender will provide a basis of "knowledge" by the lender. This showing of knowledge can be made by circumstantial evidence. Whether a lender should investigate the use of its collateral based on evidence it acquires will be a difficult question.

For example, suppose a borrower obtains a loan for the purpose of installing extensive ventilation and lighting equipment, and to qualify for the loan, the borrower lists ownership in a limited liability company named "Healthybuds." Would this be enough to defeat the lender's "innocent owner" claim in a civil forfeiture proceeding? Depending on the circumstances, it might. Another open question is whether a lender could be forced to disgorge loan payments received from a borrower the lender knew was engaged in illegal marijuana activity.

These concerns should be in the minds of all California lenders, especially those in North Coast where marijuana cultivation is prevalent. In theory, the DOJ can enforce the Controlled Substances Act against all growers and distributors of marijuana, whether grown or distributed in a commercial building or a residential property. It seems likely however, that justice department enforcement will be selective based on the criminal or commercial nature of the cultivation or distribution and other factors. For example, the DOJ has shown a willingness to prevent distribution of marijuana near schools. In an election year, it would not be surprising to see such enforcement efforts increase.

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