

# New York's **Illegality Doctrine** and Its Implications for **Cannabis Contracts**

BY PAUL D. SARKOZI  
AND RICHARD TROTTER

As more states have legalized cannabis for recreational use, courts have increasingly been asked to adjudicate disputes arising from commercial cannabis contracts. Many of these contracts resemble ordinary commercial agreements negotiated and executed by sophisticated commercial parties, with one notable exception—they relate in one way or another to the growth, sale or distribution of marijuana, which remains a Schedule 1 substance that is illegal under the federal Controlled Substances Act. As a result, litigants have asserted various permutations of the illegality defense to the enforcement of what might otherwise be valid commercial contracts. For New York businesses,

PAUL D. SARKOZI is a partner at Tannenbaum Helpern Syracuse & Hirschtritt. RICHARD TROTTER is an associate at the firm.



By  
**Paul D.  
Sarkozi,**



And  
**Richard  
Trotter**

investors and practitioners, this begs the question: How will courts apply New York's own illegality doctrine to commercial cannabis disputes?

Recent efforts to legalize recreational cannabis in New York were unsuccessful; the issue has been deferred by the New York State legislature until 2020. Consequently, New York State courts have yet to address the impact of federal illegality on the enforcement of contracts. However, there is a deep body of New York case law that demonstrates the broader outlines of New York's illegality doctrine, and offers some insights into how New York courts might

ultimately deal with illegality objections.

Below, we provide some examples of how cannabis litigants have sought—with varying degrees of success—to utilize illegality objections to their advantage, and how courts in other jurisdictions have dealt with such arguments. We have also provided a summary of the current state of New York's own illegality doctrine, as well as some examples of how that doctrine may ultimately be applied to commercial cannabis disputes if and when New York does legalize its recreational use.

Illegality objections to the enforcement of commercial cannabis contracts are inevitable so long as marijuana remains illegal under federal law. Those businesses that anticipate such objections will be better positioned to mitigate or nullify their potential impact on the enforceability of commercial cannabis contracts,

either through a more informed negotiation of the agreement, or—if necessary—through litigation.

### **Illegality Arguments and Outcomes in Other Jurisdictions.**

Litigants have asserted illegality arguments and defenses in a variety of cannabis-related litigation contexts.

For example, in *Green Earth Wellness Ctr. v. Atain Specialty Ins. Co.*, an insurer argued that the enforcement of an insurance policy through compelling coverage of damage to the insured’s marijuana plants and products would violate public policy and, as a result, that the insurance policy was therefore unenforceable. 163 F. Supp. 3d 821, 835 (D. Colo. 2016). The U.S. District Court for the District of Colorado rejected the insurer’s argument, finding that the insurer, “having entered into the policy of its own will, knowingly and intelligently, is obligated to comply with its terms or pay damages for having breached it. Id. The court also noted the “continued erosion of any clear and consistent federal policy in this area” in reaching its conclusion. Id.

Similarly, in *Bart St. III v. ACC Enterprises*, a lender sued the defendants for breach of a multi-million-dollar loan agreement and the accompanying promissory notes. 2018 WL 4682318, at \*1 (D. Nev. Sept. 27, 2018). The defendants—

the owners/operators of a cannabis cultivation plant—argued that the agreement and the notes were unenforceable because they funded the cultivation of cannabis, which is unlawful under federal law. Id. at \*4. The U.S. District Court for the District of Nevada found that some provisions of the promissory notes required the defendants to engage in plainly legal activities (such as paying off their prior lenders), and held that those portions of the notes were therefore enforceable. Id. at \*5. However, the court also noted that because the plaintiffs lent the defendants the money with knowledge that defendants were engaged in plainly illegal activities, the court could not “order any remedy that permits defendants to directly use Plaintiff’s funds for cannabis cultivation or gain ownership in defendant’s cannabis business.” Id. As a result, the court declined to enforce the provision that would have otherwise given the plaintiff the right of first refusal for an ownership in defendants’ business, as well as the provision that required the defendants to use the proceeds as operating capital for their cannabis business.

In a recent decision by the U.S. District Court for the Northern District of California, the court rejected the plaintiff’s attempts to nullify an arbitration clause and class action waiver contained in the defendant’s



“click-wrap” agreement on the grounds that defendant’s business—maintaining a mobile application that facilitates the delivery of cannabis products from dispensaries to consumers—violated federal law. *Williams v. Eaze Solutions*, 2019 WL 5312956, at \*1 (N.D. Cal. Oct. 21, 2019). The court found that the federal illegality of cannabis did not nullify the arbitration provision or the class action waiver because those provisions were severable from the rest of the contract, and enforceable notwithstanding the federally unlawful object of the overall agreement. Id. at \*4-5.

**New York’s Illegality Doctrine.** New York’s illegality doctrine holds that contracts that violate laws enacted to “protect the public health and safety” are generally unenforceable; however, there are a number of significant exceptions and countervailing considerations that limit the application of this rule. See *Eber Bros. Wine & Liquor v. Rare Spirits*, 21 Misc.3d 201, 208 (Sup. Ct. Monroe County 2008).

For example, “if the statute does not provide expressly that its violation will deprive the parties of their right to sue on the contract, and the denial of relief is wholly out of proportion to the requirements of public policy ... the right to recover will not be denied.” *Grape Solutions v. Majestic Wines*, 2015 WL 2207528 (Sup. Ct. N.Y. County May 11, 2015) (quoting *Benjamin v. Koeppel*, 85 N.Y.2d 549, 553 (1995)). In addition, “to constitute a valid defense to an action on a contract, the alleged illegality must be central to or a dominant part of the plaintiffs’ whole course of conduct in performance of the contract.” *FCI Grp. v. City of N.Y.*, 54 A.D.3d 171, 177 (1st Dept. 2008). The defense is inapplicable where it would result in “a substantial forfeiture to one party while allowing the other party, who has already reaped the benefit of the transaction, to avoid the corresponding obligation.” *Grape Solutions*, 2015 WL 2207528, at \*4. “This is particularly true where the two parties are equally culpable with respect to the illegal conduct,” and nullification of a contractual right or obligation on illegality grounds is especially disfavored where the party asserting the illegality defenses is using it as “a sword for personal gain rather than a shield for the public good.” *Charlebois v. J.M. Weiler Associates*, 72 N.Y.2d 587, 595 (1988). As a result, the court should

consider “the quality of the illegality, the extent of public harm, the relative guilt of the parties, and the cruelty of forfeiture involved in a denial of remedy.” *Murray Walter v. Sarkisan Bros.*, 107 A.D.2d 173, 178 (3d Dept. 1985).

For example, in *Eber Bros. Wine & Liquor v. Rare Spirits*, the plaintiff and defendant entered into a contract for the purchase and delivery of French wines, but the contract contained a payment term that violated a provision of the New York Alcoholic Beverage Control Law. 21 Misc.3d at 208. The defendant moved for summary judgment based in part upon its argument that the agreement was therefore unenforceable. Relying on principles of fairness that prevent “people from getting other people’s property for nothing when they purport to be buying it,” the court rejected the defendant’s argument and denied its motion for summary judgment. *Id.* at 210.

In *Unger v. Leviton*, the plaintiff sued to recover his share of profits earned upon the sale of real property, allegedly owed pursuant to a partnership agreement with the defendant. *Unger v. Leviton*, 5 Misc.3d 925, 925 (Sup. Ct. Nassau County 2004). The defendant asserted an illegality defense based on a knowingly false statement made by both parties to the U.S. Department of Housing and Urban

Development in violation of a federal statute. In rejecting the defendant’s illegality argument, the court noted that New York’s general rule against the enforcement of illegal contracts is not “reflexively and universally applied, particularly where public policy is not served by its application, or overriding considerations of fairness require a different result.” *Id.* at 928. The court concluded that denying enforcement of the contract at issue would “do nothing to serve the public interest” underlying the federal statutes, and that doing so would “yield the unjust result of punishing one wrongdoer and rewarding the other for the same joint act.” *Id.* at 930.

In short, rather than simply voiding or otherwise refusing to enforce a contract that implicates some form of ostensibly illegal conduct, New York courts engage in a case-by-case analysis that is strongly guided by principles of fairness, the relative culpability of the parties to the contract, and the burden of declining to enforce such an agreement.

**How Might New York Courts Apply the Illegality Doctrine to Cannabis Disputes.** Because the Controlled Substances Act that makes the possession and sale of cannabis illegal under federal law does not expressly provide for the voiding of the parties’ contractual rights, New York courts will

consider the myriad of other factors that inform the application of New York's illegality doctrine, including: (1) the extent to which voiding part or all of a cannabis-related contract would serve the public policy animating marijuana's Schedule 1 status; (2) whether the equitable consequences of refusing to enforce such a contract would be disproportionate to that policy; (3) to what extent the illegal cannabis-related activity embodied by the contract is or is not the primary purpose of the agreement; and (4) whether the party asserting the illegality defense is equally culpable to its counter-party, and whether it has already reaped some benefit from the agreement it is seeking to nullify on illegality grounds.

For example, a New York court might enforce a contract for the sale of cannabis from one party to another where the seller has already received the cannabis-product in question, and refuses payment on illegality grounds, because it is equally culpable and has already benefited from the contract. By the same token, a New York court might reject an argument of illegality asserted by a cannabis company that incurred some contractual liability—such as an obligation to pay rent to a landlord, or an account payable to a vendor that provided it with a good or service to facilitate its cannabis

business—on similar grounds.

However, the illegality analysis becomes more complicated where the sale and/or distribution of a cannabis product is more central to the contract at issue. For example, would a New York court enforce an agreement to pursue a joint venture in which the parties were expressly obligated to pursue the growth, sale or distribution of marijuana? In such a case, the illegal conduct would go to the very heart of the contract, and one could imagine a scenario in which one party were seeking to extricate itself from such an agreement prior to reaping any substantial benefits from the agreement. Such factors would likely increase the strength of an illegality argument under New York law.

Nevertheless, while some preliminary conclusions about the application of New York's illegality doctrine to cannabis-related contracts can be drawn, some critical questions will not be answered unless and until New York legalizes recreational use. Perhaps most intriguingly, it is unclear what effect the legalization of recreational marijuana under New York law would have on New York courts' assessment of the policy interests embodied by cannabis' continued illegal status under federal law.

For example, would New York's legalization of recreational marijuana inform a court's assessment of

the policy interest in public health and safety promoted by the relevant provisions of the Controlled Substances Act? A New York court might conclude that the policy interest in maintaining marijuana's illegal status under federal law is diluted or otherwise counterbalanced by New York's policy interest in legalization. If the federal policy interest in outlawing marijuana is weakened, the illegality argument under New York law will also be harder to make. That said, it is also possible that New York courts might view the policy goals of New York State and the federal government as entirely separate, with one having no bearing on the other.

Interested observers should therefore pay close attention not only to the legislative status of New York's legalization bill, but also the way in which legal status under state law impacts New York courts' application of the New York illegality doctrine.