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Resolving Cannabis Disputes in New York

The Marijuana Regulation and Taxation Act, legalizing adult use of cannabis in New York, has provided a framework for the potential multi-billion dollar, highly regulated industry but passage of the bill is only the first step before growers, distributors and retailers can legally sell cannabis to consumers.

BY PAUL D. SARKOZI

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On March 31, 2021, the Marijuana Regulation and Taxation Act (MRTA) ushered in a new era in New York, legalizing adult use of cannabis and providing a framework for what has been projected to be a multi-billion dollar industry in the state by 2027. Passage of the bill, however, is only the first step. Adult-use cannabis will be a highly regulated industry. As such, substantial steps still need to be taken before growers can cultivate cannabis crops, distributors will have products to ship and retailers can legally sell cannabis to consumers. The first steps will proceed this summer.

A five-member Cannabis Control Board (CCB), to be appointed by the Governor, the State Senate and the State Assembly, is in the process of being formed and will then promulgate and pass regulations. After that, the CCB will begin accepting, reviewing and issuing a range of licenses for, inter alia, cannabis cultivators, processors, distributors, dispensaries and consumption lounges. After that, the cannabis business will be off and running. And if the track record in other states serves as a guide, so too will cannabis litigation and arbitration.

In other states where adult use of cannabis has been legalized, there have been a range of sophisticated court battles. In *Arkansas Dep't of Fin. and Admin. v. Carpenter Farms Medical Group*, 2020 Ark. 213, 601 S.W.3d 111 (2020), multiple challenges were made to the process that was used in awarding and denying a marijuana cultivation license. In *Bertolino v. Fracassa,* 2018 WL 11291738 (Mass. Super., Sept. 5, 2018), investors sought to assert claims for violations of Massachusetts Uniform Securities Act based on alleged misrepresentations in soliciting investments in cannabis company.

In *Dreger v. Dolan*, 2019 WL 1897116 (Ill. App. Ct., May 17, 2019), a majority partner of medical cannabis dispensary was ordered to make $100,000 distribution to allow minority partner to stay current on dispensary licensing requirements. Finally, in *Harvest Health & Recreation v. Falcon International* (D. Ariz., No. 2:20-cv-00035-DLR), a petition to compel arbitration, revealed a wide-range dispute seeking termination/rescission of a merger agreement, the return of $51.7 million, and the appointment of a receiver based on alleged misrepresentations and breaches of representation and warranties.

Cannabis and the Commercial Division

When parties seek to resolve their cannabis disputes in court in New York, the first issue they will have to address is whether to seek

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recourse in state court or federal court. There are many reasons to believe that the Commercial Division, rather than federal court, will be called upon in the first instance.

First, continued federal illegality of cannabis under the Controlled Substances Act can limit the scope of what a federal court can do. For example, federal bankruptcy courts consistently hold that they will not address insolvency issues for cannabis companies because federal courts cannot properly administer what is deemed to be an illegal estate. See, e.g., *In re Arenas*, 535 B.R. 845 (10th Cir. B.A.P. (Colo.) 2015); *In re Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015). Federal District Courts have also held that they are constrained from imposing remedies that will be construed as endorsing or participating in conduct barred by federal law (e.g., the Controlled Substances Act). See *Sensoria v. Kaweske*, 2021 WL 103020, *6 (D. Colo. Jan. 12, 2021).

Second, interstate commerce involving cannabis continues to be illegal. Consequently, New York licensed growers and processors will be dealing with New York licensed dispensaries or consumption lounges, and when there are claims for contract breaches among these entities, such wholly intrastate commerce is less likely to give rise to federal court diversity jurisdiction.

Finally, unsuccessful applicants for coveted cannabis licenses will need to turn to state court Article 78 proceedings to challenge CCB decisions awarding the licenses. One such battle in the medical marijuana industry (which has been legal in New York since the passage of the Compassionate Care Act 2014) was brought under Article 78 in Albany Supreme Court earlier this year and recently has been transferred to the Appellate Division, Third Department for decision. See *Hudson Health Extracts v. New York State Department of Health*, N.Y. Sup. Ct., Albany Cnty., McGrath, J., Index No. 901198-21 (Dkt. No. 56, May 20, 2021); see also J. Smith, *Lawsuit Casts Spotlight on New York's Initial Medical Cannabis Licensing, Questions Scoring*, MJ Biz Daily, Feb. 26, 2021.

Arbitration of Cannabis Industry Disputes

Parties, however, may seek to avoid the courts altogether in favor of alternative dispute resolution. Historically, cannabis industry contracts have included mandatory arbitration provisions. In this way, even if courts refused to enforce cannabis contracts on the grounds of illegality, parties could get an arbitrator to resolve the dispute. Most of those concerns have subsided in state courts where state laws permit cannabis sales.

However, even though medical marijuana is now legal in 36 states and adult use sales are legal in almost 20 states, these legacy mandatory arbitration provision continue to channel disputes into arbitration instead of into the courts.

There are other practical reasons that the cannabis industry has embraced arbitration. Commercial arbitration rules generally streamline proceedings and limit discovery. Depositions are often the exception, rather than the rule, and even where permitted are limited in number. Nascent cannabis businesses looking to invest money in growing the company instead of resolving disputes may find these cost-saving features attractive.

Finally, so long as recourse to the courts are not required to compel or stay arbitration or to confirm an award, arbitration allows parties to resolve their disputes privately. As such, parties that might be concerned about preparing affidavits in which they might be forced to

admit to behavior that constitutes a federal crime can, in the first instance, avoid creating such a public record.

According to an American Arbitration Association (AAA) press release, AAA cannabis caseload increased 100% in 2020, totaling $172 million in claims, the seventh largest among all industries. Additional information provided by AAA Vice President Jeffrey Zaino reflects that almost a third of cannabis cases had claims in excess of $1 million and the average claim amount exceeded $6 million. Although most of the AAA cannabis cases were filed in the western United States (such as Colorado and California), where adult use cannabis has been legal for some time, there have been cannabis cases filed in 23 states and New York has the fourth most cannabis filing. According to Zaino, most of the disputes arise from: (1) operating agreements, (2) consulting agreements, (3) management agreements, (4) joint venture agreements and (5) purchase/sales agreements.

Court filings in aid of or to confirm or vacate arbitration awards highlight the sophisticated nature of commercial cannabis disputes submitted to arbitrators. For example, in *Broumand v. Abbot*, 2019 WL 4899058 (N.Y. Sup. Ct., N.Y. Cnty., Oct. 4, 2019), New York Commercial Division Justice Jennifer Schecter compelled arbitration of a minority investor's derivative and direct claims that that the managers and majority investors breached their fiduciary duties and non-compete obligations by establishing a competing cannabis company and freezing claimant out.

In Florida, a recently filed petition reveals how parties used arbitration to resolve disputes under a joint venture agreement that impacted rights to a medical marijuana license. See *Florida MCBD v. Sun Bulb Co.*, No. 21-CA-001562 (Fla Cir. Ct., 20th Jud. Cir., March 8, 2021). In that case, the claimant asked the arbitration panel to determine whether a Florida grower breached contractual and fiduciary obligations when it jettisoned a joint venture partner after an unsuccessful application for a medical marijuana license in favor a new business partner, whether the original joint venture partner maintained an interest in the license application even after the joint venture's termination, whether trade secrets were misappropriated, and the value of the parties' interests in the license application.

Notably, Justice Schecter is currently hearing a related case, in which Florida MCBD is seeking relief against some of the other parties doing business with Sun Bulb, seeking relief for unjust enrichment, aiding and abetting a breach of fiduciary duty, civil conspiracy, conversion and fraudulent conveyance. See *Florida MCBD v. Columbia Care*, N.Y. Sup. Ct., N.Y. Cnty., Schecter, J., Index No. 652126/2020.

One issue that is being addressed in the pending motion to dismiss is the scope of collateral estoppel and res judicata that the New York court will apply based on the determinations of the arbitrators. Given the number of cannabis industry cases that are being heard in arbitration and their impact on other parties and business relationships, this issue is likely to recur in cases throughout the country over the next several years.

Conclusion

New York courts and arbitrators have already been called upon to help resolve disputes involving the medical marijuana industry—whether in determining Article 78 petitions, as described above, or deciding whether to enjoin a sale that would transfer a medical marijuana license based on a letter of intent. See *Cresco Labs New York v. Fiorello Pharmaceuticals*, N.Y. Sup. Ct., N.Y. Cnty., Borrok, J., Index No. 652343/2018 (Dkt. No. 142, Oct. 15, 2019). As the industry grows over the next two years and beyond, there will be substantial opportunity for New York courts, mediators, arbitrators and litigators to apply their commercial dispute resolution skills.