The Unique Problems of Litigating in the Cannabis Industry

By Paul D. Sarkozi, Richard W. Trotter and Alexandra Kamenetsky Shea

As the medicinal and recreational marijuana industries accelerate at breakneck speed, courts, attorneys and litigants are starting to grapple with the unique thicket of legal issues implicated by the commercialization of a substance that remains illegal under federal law. Thirty-three states currently allow their citizens to use marijuana for medicinal purposes, and 10[1] have legalized it for recreational use, but there are few signs of legalization at the federal level. Nevertheless, in 2018, investment in cannabis-related businesses quadrupled to nearly $13.8 billion,[2] and legal marijuana was a $10.4 billion industry in the United States alone.[3] With this level of investment, deal-making and growth, commercial litigation is inevitable, and businesses should be prepared to navigate the unique challenges of litigating claims with a nexus to the marijuana industry. Below, we have sought to provide three examples of potentially unique challenges that businesses may face when pursuing marijuana-related litigation.

State Court Receivership Proceedings

Because marijuana is still a Schedule I controlled substance under the Controlled Substances Act (21 U.S.C. § 801 et. seq.), federal bankruptcy is not an option for marijuana-related businesses.[4] Bankruptcy courts have repeatedly dismissed bankruptcy proceedings implicating a debtor involved in the marijuana industry on the basis that federal courts cannot properly administer an illegal estate.[5] They have even refused to consider bankruptcy cases involving businesses that do not actually participate in the cultivation or sale of marijuana. For example, one bankruptcy court dismissed a bankruptcy petition filed by a company whose only income was fees from a trademark licensed to a medical marijuana company,[6] and another refused to confirm a bankruptcy plan by a landlord that leased commercial space to marijuana businesses.[7]

Unable to obtain the customary protections associated with a federal bankruptcy proceeding—most notably, an automatic stay against collections and ongoing or impending litigation—distressed marijuana-related businesses may wish to consider the option of filing a state court receivership proceeding instead. For example, Washington State (where recreational marijuana is legal) provides a state-law version of a federal bankruptcy proceeding through a comprehensive receivership statute.[8] The statute even provides a stay similar to the one provided by federal bankruptcy law.[9] But state laws, and the strength and scope of state receivership laws, will vary. For example, in Colorado (where recreational marijuana is also legal), the Colorado Medical Enforcement Division has taken the position that marijuana businesses cannot be put into receivership without a license issued by the Division. Obtaining such a license could prove difficult. In the context of regulatory approval of cannabis-related mergers and acquisitions, regulators in Pennsylvania and New York are currently withholding their approval of several cannabis-related corporate transactions.[10] It might therefore be unrealistic to assume that a cannabis-related business could obtain an operational license in order to qualify for a state insolvency proceeding, or other kind of out-of-court restructuring.

In addition, the impact and scope of a state law stay and other state law protections for marijuana businesses remain unclear. For example, does a state court receivership proceeding stay an ongoing federal litigation, or does the Supremacy Clause of the U.S. Constitution dictate that the federal action may proceed notwithstanding the fact that state law may purport to impose a stay of all litigation against the entity in receivership? Similarly, what effect would a stay in a state like Washington have on the enforcement of judgments or collection proceedings pending in other states where marijuana remains illegal? Would a Texas court stay an enforcement proceeding against a marijuana-related business with assets in Texas because of a Washington State receivership proceeding, or would doing so violate Texas law and policy? Are contractual clauses accelerating debt or terminating an agreement upon the filing of an insolvency proceeding—which are known as *ipso facto* clauses and which are typically unenforceable in a federal bankruptcy proceeding—enforceable in state receivership proceedings?

The answers to these questions will have enormous implications for both marijuana-related businesses, their business partners, and any individual or entity that may be adverse to them in some way. And while the legal uncertainty can, in some instances, create potential risks for everyone from landlords to lenders, it may also provide businesses on both sides of a transaction or dispute with opportunities for creative legal solutions to a still evolving spate of legal issues.

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Novel Arguments of Policy and Law

Marijuana-related businesses may also face novel arguments sounding in equity, law or policy when they try to enforce contracts or attempt to otherwise assert their legal rights—particularly in states where marijuana remains illegal or highly restricted.

For example, New York common law can potentially bar a claim brought by a plaintiff under the doctrine of *in pari delicto* where both parties are equally at fault.[11] The public policy behind this doctrine provides that courts should not be involved in disputes between wrongdoers, and should not take part in awarding any relief to either party.[12] So long as recreational marijuana remains illegal in New York, parties may find themselves subject to such an equitable defense to the enforcement of an otherwise valid right or agreement. In addition, New York courts will not enforce a contract that violates public policy.[13] Other states, such as Pennsylvania[14] and Texas,[15] have similar rules. As a result, contracts may not be enforced as written or at all, and parties that thought they would be able to enforce an otherwise valid agreement may be unable to do so.

However, there may be ways for businesses to minimize the risk of such equitable and policy-based arguments. For example, marijuana-related businesses may wish to include comprehensive arbitration provisions in their vendor or distribution agreements—in an attempt to avoid the policy implications that might arise in state or federal court—and carefully select their choice of law provisions, to ensure that the law that governs the contract would protect against an *in pari delicto* or public policy argument in opposition to enforcement. Lenders to marijuana businesses could also include a lender-only option to arbitrate any potential disputes with the borrower, in order to bolster their ability to obtain effective relief should state or federal courts prove to be problematic or unviable options.

Marijuana-related commercial disputes may also face procedural hurdles to litigation in certain fora still subject to criminal laws outlawing the recreational or medicinal use of marijuana altogether. For example, while some federal courts have recently held that there is no *per se* bar to a cannabis company's standing to sue for trademark infringement or trade secret misappropriation under federal law,[16] the issue is far from settled.[17] Such novel procedural complications will demand a more nuanced approach to what might have otherwise been the more straightforward strategic considerations associated with a commercial dispute unrelated to the marijuana industry.[18]

For all the legal uncertainty and corresponding risks for businesses operating in the cannabis space, the current hodgepodge of state and federal laws may also provide unique opportunities for some businesses to gain an early advantage on their competition. For example, the Trademark Trial and Appeal Board recently reaffirmed that trademarks for marijuana-related products cannot be registered.[19] However cannabidiol or "CBD"—a non-psychoactive derivative of the cannabis plant—was legalized at the federal level in 2018, and the U.S. Patent and Trademark Office recently confirmed that applications for registration of CBD-related trademarks will no longer be rejected out of hand.[20] CBD companies may therefore be able to file an "Intent to Use" trademark application with the USPTO in order to stake their intellectual property claim. If and when marijuana is also legalized at the federal level, CBD businesses with a recognized brand and trademark—and plans to expand into a newly legal marijuana industry—could have an early foothold in the ensuing litigation battle for marijuana-related trademark supremacy.

Judgment Enforcement Issues

If a court does determine that a contract is valid and that a party adverse to a marijuana-related business is entitled to a money judgment, the prevailing judgment creditor will then have to consider how best to enforce a money judgment against a judgment debtor that may not maintain a traditional bank account and may not have traditional assets. Marijuana businesses do not usually maintain traditional bank accounts and often operate largely in cash. Banks are wary about working with and lending to marijuana entities because the proceeds of their business are directly derived from a substance that is illegal under federal law. Only one in about 30 banks or credit unions in the United States will accept a cannabis company as a customer and those that do take on cannabis companies often charge them significant fees for doing so.[21] Therefore, a judgment creditor may not be able to simply levy upon a marijuana company's bank account as a way of collecting the monies owed.[22]

In addition, traditional property execution may also prove thorny. A marijuana-related business's largest assets are typically its cannabis inventory and its state regulator license—but can a creditor even take possession of these assets without the appropriate permission of the state regulator? Will an enforcement officer or sheriff be permitted, albeit even temporarily, to take possession of the marijuana and provide it to the creditor? What rights, if any, does an unlicensed entity have to enforce a judgment against these kinds of assets when marijuana licenses are granted to a specific ownership group and are not transferable?

Because enforcing a money judgment against a marijuana-related business may be difficult, it may be prudent to consider alternative security interests at the outset of a commercial transaction. For example, a landlord may want to require a larger security deposit from a tenant that operates in the cannabis space. A lender may want to obtain security interests in assets of the marijuana company that are not subject to regulatory licenses, such as real property. Alternatively, the lender may consider requesting personal guarantees from company principals or pledges of the stock of subsidiaries for the marijuana entity's debts.

Conclusion

These are just some of the issues that may arise in the context of marijuana-related litigation. As the industry expands and tests the legal limits of what is possible, marijuana businesses will undoubtedly continue to face legal issues of first impression for many years. The businesses operating in this industry should therefore place a premium on the retention of experienced counsel capable of helping them traverse such an uncertain legal landscape.

Endnotes

1. An eleventh state, Illinois, has enacted legislation that will make recreational use legal beginning in 2020.
2. Grace Donnelly, *Cannabis Investments Nearly Quadrupled in 2018*, Fortune, http://fortune.com/2018/12/20/cannabis-investments-2018/.
3. *For the legal pot industry, 2018 was a gold rush*, CBS News, https://www.cbsnews.com/news/for-the-legal-pot-industry-2018-was-a-gold-rush/.
4. Some federal courts, however, appear to have taken note of the changed political and medical views concerning marijuana and begun questioning cannabis's continued classification in the same category as heroin and cocaine. In *Washington v. Barr*, 925 F.3d 109 (2d Cir. 2019) for example, plaintiffs sought the reclassification of marijuana as a Schedule I drug under the Controlled Substances Act, contending that quick court action was needed because of the plaintiffs' urgent medical need for cannabis treatment. Instead of affirming the District Court's Fed. R. Civ. P. 12 dismissal based upon the plaintiffs' failure to exhaust administrative remedies before the Drug Enforcement Agency (DEA), the United States Court of Appeals for the Second Circuit held its consideration of the appeal in abeyance for six months and indicated it would take "whatever action might become appropriate if the DEA does not act with adequate dispatch" to consider whether classification as a Schedule I drug was still proper.
5. *See In re Arenas*, 535 B.R. 845 (10th Cir. B.A.P. 2015); *In re Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015).
6. *In re Medpoint Management, LLC*, 528 B.R. 178 (Bankr. D. Ariz. 2015) (partially vacated on other grounds).
7. *In re Arm Ventures, LLC*, 564 B.R. 77 (Bankr. S.D. Fla. 2017).
8. *See* RCW 7.60.010 *et seq.*
9. *See* RCW 7.60.110.
10. *See* Eric Sandy, *Harvest Health & Recreation Acquires CannaPharmacy, But Pennsylvania Isn't so Sure*, Cannabis Business Times, https://www.cannabisbusinesstimes.com/article/harvest-health-recreation-pennsylvania-merger-acquisition-dispensary-licenses/.
11. *See In re Allou Distribs., Inc.*, 387 B.R. 365 (Bankr. E.D.N.Y. 2008); *Sacher v. Beacon Assocs. Mgmt. Corp.*, 114 A.D.3d 655, 657 (2d Dep't 2014).
12. *In re Granite Partners, L.P.*, 194 B.R. 318, 328 (Bankr. S.D.N.Y. 1996).
13. *See Transparent Value, LLC v. Johnson*, 93 A.D.3d 599 (1st Dep't 2012).
14. *See American Assoc. of Meat Processors v. Casualty Reciprocal Exchange*, 527 Pa. 59 (Pa. 1991).
15. *Lee v. El Paso County*, 965 S.W.2d 668 (Texas Ct. of Appeals 1998).
16. *See Siva Enterprises v. Ott*, 2018 WL 6844714, at *5 (C.D. Cal. Nov. 5, 2018); *Lochirco Fruit & Produce Co., Inc. v. Tarukino Holdings, Inc.*, 2019 WL 157939, at *3 (W.D. Wash. Jan. 9, 2019).
17. *See Goodin v. Vendley*, 356 F. Supp. 3d 935, 943 (N.D. Cal. 2018).
18. In a recent New York Supreme Court Commercial Division Case, Justice Cohen elected to opine on jurisdictional issues concerning a contract dispute where one entity was operating in the cannabis industry. *See High Street Capital Partners LLC v. ICC Holdings LLC*, 2019 WL 2106093, at *4 (N.Y. Sup. Ct. May 14, 2019).
19. *In re Canopy Growth Corporation*, Serial Nos. 8647885, 86475899 (TTAB July 16, 2019).
20. *See* Kyle Jaeger, *Federal Agency Updates Rules on Trademarks for Hemp and CBD Products*, Marijuana Moment, https://www.marijuanamoment.net/federal-agency-updates-rules-on-trademarks-for-hemp-and-cbd-products/.
21. John Hudak and Aaron Klein, *Banks don't want to work with marijuana companies. It's time for that to change*, CNN Business, https://www.cnn.com/2019/03/14/perspectives/cannabis-businesses-banking/index.html.
22. Recent federal legislative efforts have also sought to address this concern. In March 2019, the Secure and Fair Enforcement (SAFE) Banking Act (H.R. 1595) was approved by the House Financial Services Committee. The Act, if approved by the House and Senate and signed into law by the President, would largely enable banks to provide services to cannabis-related businesses that are in compliance with state law without fear of being subject to criminal or civil prosecutions and penalties (such as the loss of federal deposit insurance) for money-laundering. Claire Hansen, *House Committee Approves Marijuana Banking Bill*, US News & World Report, https://www.usnews.com/news/national-news/articles/2019-03-28/house-committee-approves-marijuana-banking-bill. The Senate Banking Committee held a hearing on marijuana business banking access on July 23, 2019. *See* Angelica LaVito, *Senate cannabis hearing shows challenges to rewriting pot laws despite growing support in Congress*, CNBC, https://www.cnbc.com/2019/07/23/senate-cannabis-hearing-shows-challenges-to-rewriting-pot-laws-despite-support.html.