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# Insight Into California's Increasing Cannabis Litigation

By **Alexa Steinberg and Steven Stein** (June 1, 2022, 3:17 PM EDT)

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California's cannabis industry has gone from experiencing a green rush to growing pains.

Licensed operators are facing headwinds from black-market purveyors stealing market share, increased competition resulting from an influx in new licenses, and sky-high taxes and regulatory fees. Many licensed operators are treading water with the hopes that market conditions will improve, they'll land investors or they'll be acquired.

This swirl of challenges creates the perfect storm for dispute and a rise in cannabis-related litigation. Unhappy investors who thought they'd be reaping a windfall are increasingly heading to the courtroom. Business partners who are fed up with lackluster revenue — and each other — are doing the same.

Add into the mix that the growth and maturation of the industry has cannabis companies facing the same types of claims that businesses in other industries face, and one thing is clear: Cannabis-related litigation is here to stay.

Here is a taste of the kind of disputes are we seeing and what can be done to avoid them.

**Breach of Contract Claims**

Not long ago, it was still an open question as to whether cannabis-related contracts could even be enforced in state court. Under California law, contracts must have a lawful object, and it goes without saying that cannabis remains federally illegal.

In 2018, we saw a major shift in cannabis-related disputes when the California Legislature enacted Civil Code Section 1550.5, providing that cannabis-related contracts have a lawful object.

The handful of cases addressing Section 1550.5 and related issues have indicated that such contracts would be enforceable under California law.[1]

Since Section 1550.5 was enacted, the enforceability of cannabis-related contracts has ceased to be a major focal point of cannabis-related litigation. Instead, we've noticed two other issues that are now a

major focal point, both of which differentiate cannabis-related breach of contract claims from others.

First, cannabis-related agreements are often not well documented. In many instances, agreements between parties are not reduced to writing, but instead are handshake deals made on the honor system. These can be hard to defend in court.

Further, when a written agreement does exist, they generally are not well drafted, leaving out fundamental provisions and memorializing undeveloped agreement terms. Although this is a remnant of the industry being nascent and relatively unsophisticated until recent years, it makes breach of contract claims incredibly difficult to litigate, sometimes turning disputes into "he said, she said" arguments.

If a cannabis company finds itself in this position, it should consider formally documenting a preexisting informal or improperly drafted agreement before a claim can arise.

If you aren't able to do so before a claim arises, the evidence contemporaneous with when the parties made the agreement will be key in establishing its terms and whether it's enforceable.

Second, proving damages for cannabis-related breach of contract claims can be more challenging than others. Many cannabis disputes involve an investor receiving a percentage of revenue generated by the business.

As such, a damages claim can involve projecting a cannabis business' revenues, profitability and value, which is challenging due to the ever-shifting regulatory landscape, the availability of licenses at any given time, and the supply and demand of the cannabis market as a whole.

In turn, this can make it difficult to settle cannabis-related disputes, because the parties can diverge starkly in their evaluation of potential damages.

If you face this issue, you might want to consider mediating the dispute so a neutral third party can evaluate the parties' claims and try to bridge this gap. And if it looks like the litigation is moving forward, retaining a forensic consultant with cannabis expertise could give you a strategic advantage.

**Ownership Disputes**

As California continues to scrutinize ownership disclosures, businesses become more lucrative, and operators struggle to achieve a meeting of the minds, we are seeing an increase in litigation concerning the ownership of and investment in cannabis businesses all along the supply chain.[2]

In our experience, there are two primary drivers of such disputes in the cannabis industry.

The first is the economic uncertainty in the cannabis industry. We have seen this be the root of unrest and disagreement within ownership or management. Such disputes often stem from how the business is being managed and operated, or as a result of decreased revenues or the inability to move product. In turn, we have started to see that owners are looking to separate from their partners and want out.

The second driver of ownership disputes is culture clash. Cannabis businesses are sometimes co-owned by longtime operators in the industry that can take a more laissez-faire approach, and more sophisticated investors that bring expertise from other industries and often, a more buttoned up and risk-averse approach to business.

These particular partnership disputes can interfere with the operations of the business, which in turn can prevent the business from taking on new investors and new capital, and it can add fuel to the fire of a distressed business.

As such, while we'd generally recommend exploring alternative dispute resolution in connection with cannabis-related disputes, that's particularly true in connection with partnership disputes as protracted litigation can threaten the viability of the business.

**Breach of Fiduciary Duty Claims**

As an offshoot of ownership disputes, we are starting to see an increase in litigation concerning cannabis-related breach of fiduciary duty claims.[3]

Cannabis-related businesses formed before 2017 operated as nonprofit mutual benefit corporations to keep in compliance with the Compassionate Use Act, or Proposition 215 — the law enacted in 1996 legalizing and permitting the use of medical cannabis in California. Most have since been converted to for-profit entities, which come with added duties and responsibilities to owners and officers alike.

Officers and directors owe fiduciary duties of loyalty and care to the company. It is often the case that individuals in the cannabis industry own multiple companies that hold multiple licenses all up and down the supply chain, often so that operators can have vertically integrated business.

This often leads to situations where an officer or director may stand on both sides of a prospective transaction, and there is the potential to engage in self-dealing — that is, where the officer or director may stand to receive a benefit distinct from any other shareholders' benefit due to entering a business transaction with him or herself and risk violating his or her duty to the company.

Officers and directors should be looking out for the best interests of the company, and not their personal gain. Cannabis operators should be particularly diligent in evaluating these types of potential business transactions and the potential for self-dealing.

**Landlord-Tenant Disputes**

Landlord-tenant disputes are another source of litigation in the cannabis space that can be a major disruption to operations, leading to licensing issues and even evictions, not to mention substantial legal fees and headaches.

One way to avoid landlord-tenant disputes is to cut them off at the pass with a carefully tailored lease agreement. That means avoiding or being careful about using form leases.

Landlords often use such leases because they have been vetted, they're less costly than a draft lease agreement, and their terms as uniform. But the fact that their terms are uniform is also the problem — there are too many unique aspects to having a cannabis tenants that form leases do not address.

For example, it's common for landlords to have an interest in the tenant's cannabis business, which can trigger disclosure obligations to state and local authorities, yet a form lease might be silent on this point.[4]

As another example, it's essential to determine what constitutes a fixture with respect to a grow facility for cannabis tenants. Are grow lights, the irrigation system or fans fixtures? And if so, does the landlord get to keep them?

There should also be a provision addressing what happens in the event of a forfeiture proceeding. If the government seizes assets of a cannabis tenant that are located at the premises, does that give the landlord the right to terminate the lease?

It's also important that landlords and cannabis tenants are aware of and upfront about the activity that occurs at the premises. Some landlords try to have it both ways — they want the higher rents typically generated by cannabis tenants, but don't want to be associated with cannabis, or even to know that the tenant is engaging in cannabis-related activities.

In our view, this head-in-the-sand approach is not the right one, as it's at odds with disclosure-driven policy underlying California's cannabis laws and regulations.

**Employment Issues**

There is a complex web of labor laws and regulations to comply with in California. Cannabis companies in particular seem to struggle to comply with these laws and regulations.

This is for several reasons. Some cannabis operators started their businesses during a time when the norm was to pay employees under the table. Some employees are reluctant to be on the payroll due to the stigma of being associated with a substance that remains federally illegal.

And cannabis companies often have a relaxed workplace culture, meaning that sometimes employees might not be required to clock in or out or take state-mandated breaks, and employers might not pay overtime in compliance with state law.

But labor claims can come with steep penalties. To avoid them, it's important that cannabis companies become familiar with and take the steps necessary to comply with applicable labor laws and regulations.

**Intellectual Property-Related Litigation**

Intellectual property infringement is increasingly a problem for cannabis businesses.

As has been widely reported, knockoff or counterfeit cannabis products pose a threat to licensed operators.[5] Such products can use the same or similar branding as products sold by licensed operators but be sold at a much lower price because black-market operators do not bother to jump through the hoops of obtaining licenses and testing their products to ensure they comply with applicable regulations.

Knockoff vape products in particular have been an issue.[6]

Law enforcement agencies have not always prioritized taking action against these black-market operators. To protect the value and integrity of their brand, some cannabis companies have pursued infringement claims against such knockoff or counterfeit products. But this can be difficult because the U.S. Patent and Trademark Office will not grant trademarks relating to unlawful uses, and cannabis remains federally illegal.[7]

Some cannabis companies have established trademarks through cannabis-adjacent products such as hemp, nonpsychoactive CBD and smoking accessories. Others have registered trademarks in states where cannabis is legal. Still others have raised the issue of knockoffs with state and local officials in the hopes of generating enforcement actions. And some cannabis companies have tried all of the above.

Under these circumstances, actively pursuing litigation could be beneficial to a cannabis company. With the cannabis industry in flux, developing and maintaining the value of a brand is increasingly important.

**Conclusion**

Although these are simply examples of the types of disputes that cannabis companies are facing, they underscore that the cannabis industry is becoming ever more mainstream and increasingly being treated as any other industry business, especially in the courtroom.

Understanding the root of disputes that are plaguing so many cannabis companies is the first step toward working to prevent them or — failing that — preparing to deal with them.

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[1] See, e.g., Gopal v. Luther, 2022 WL 504983, at *4 (E.D. Cal. Feb. 18, 2022) ("While the court is faced with a contract that the [federal Controlled Substances Act ('CSA')] would likely prohibit, the contract may well be enforceable under California law."); Indian Hills Holdings, LLC v. Frye, 2021 WL 5994036, at *8 (S.D. Cal. Dec. 17, 2021) ("[S]tates like California appear to fall within the CSA's exemption for illegality because California authorizes the manufacturing of drug paraphernalia, which would include the [products] at issue in this case."); Williams v. Eaze Sols., Inc., 417 F. Supp. 3d 1233, 1240-42 (N.D. Cal. 2019) (enforcing arbitration provision in cannabis-related contract); Swamp Capital, LLC v. Shaw, 2022 WL 190337, at *1 (Cal. Ct. App. Jan. 21, 2022) (upholding verdict in favor of enforcing contract for ownership interest in cannabis dispensary without consideration of CSA).

[2] See, e.g., Swamp Capital, supra, at *1; Holistic Supplements, L.L.C. v. Stark, 61 Cal. App. 5th 530, 536 (2021); Callahan v. 2241-2249 2nd St. LLC, 2021 WL 1084477, at *1–2 (Cal. Ct. App. Mar. 22, 2021); Little Cottage Caregivers v. Meiri, 2020 WL 4915447, at *1-*6 (Cal. Ct. App. Aug. 21, 2020).

[3] See, e.g., Swamp Capital, supra, at *7-*9; Gopal, supra, at *1, *3.

[4] For example, cannabis licensees are required to disclose to the state all financial interest holders, which includes a "landlord who has entered into a lease agreement with the commercial cannabis business for a share of the profits." Cal. Code Regs. tit. 4, § 15004(a)(3)(B).

[5] https://www.latimes.com/california/story/2019-08-25/knockoff-cannabis-products-headache-for-california-legal-weed.

[6] https://www.latimes.com/business/story/2019-09-17/as-illnesses-spread-fake-vape-gear-sells-on-l-a-streets.

[7] See Examination Guide 1-19, Examination of Marks for Cannabis and Cannabis-Related Goods and Services after Enactment of the 2018 Farm Bill (May 2, 2019); Kiva Health Brands LLC v. Kiva Brands Inc., 402 F. Supp. 3d 877, 890-91 (N.D. Cal. 2019) ("Although the parties have not identified, and the Court has not seen, any directly relevant authority about the interplay of state marijuana laws and federal trademark law, the Court is persuaded that the illegality of [defendant's] products under federal law renders [defendant] unable to challenge [plaintiff's] federal trademark."); Wunderwerks, Inc. v. Dual Beverage Co. LLC, 2021 WL 5771138, at *3 (N.D. Cal. Dec. 6, 2021) ("There are serious questions going to the validity of plaintiff's mark due to the fact that it encompasses an illegal product [cannabis] – rendering plaintiff's likelihood of success on the merits of its federal claims unlikely.").