

Cannabis Companies are Taking a Hit in Court

By **PRIYA SOPORI**

Those who entered into California's cannabis industry expecting to reap surging profits may find the current business landscape ripe for only one thing: litigation. Some are fighting off unhappy investors and business partners no longer "high" on their agreements; others have come to realize (sometimes belatedly) that they need to comply with California's strict labor and employment laws; and others must chase down counterfeiters or defend their products against class action suits brought by consumers. No matter the case, litigation eats into the profits of a cannabis company and creates a headache that no business needs, especially during an already challenging time.

Here are some of the most common legal disputes landing cannabis companies in court, and ways they can be avoided.

BREACH OF CONTRACT

Handshake deals or verbal agreements may have suited the cannabis industry in its nascent stages, but the reality today is that contracts need to be set down on paper (with the advice of sharp counsel) to avoid litigation challenges down the line. Breach of contract claims are particularly complicated in lawsuits involving new or growing businesses when trying to prove lost profits, such as in cases where an investor is entitled to a share of profits. A neutral mediator is often the first step, but if litigation proceeds, a forensic consultant with cannabis expertise may need to be called in.

OWNERSHIP DISPUTES

California continues to scrutinize ownership disclosures, and litigation over ownership of and investment in cannabis businesses is becoming more frequent, especially when a business is struggling. These disputes may prevent the business from taking on new investors and new capital. Exploring alternative dispute resolution in connection with cannabis-related disputes is particularly important in connection with partnership disputes, as protracted litigation can threaten the viability of the business.

BREACH OF FIDUCIARY DUTY

Most cannabis companies today operate as for-profit entities, and their owners and officers have fiduciary responsibilities of loyalty and care to the company. Individuals in the cannabis industry often own multiple companies that hold multiple licenses up and down the supply chain. This can lead to situations where an officer or director stands on both sides of a prospective transaction, resulting in potential "self-dealing." Cannabis operators should be particularly diligent in evaluating these types of potential business transactions and the potential for self-dealing.

LANDLORD-TENANT DISPUTES

Standard commercial form leases are vetted, uniform, and cost-effective for landlords, but fail to address the unique aspects of having cannabis tenants. If a landlord has interest in a tenant's cannabis business, for example, it can



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trigger disclosure obligations to state and local authorities not typically outlined on a form lease. Carefully tailored leases can help address this and other cannabis-specific issues such as ownership of fixtures (lighting, irrigation, and HVAC equipment) or how to proceed in the event of a forfeiture.

EMPLOYMENT ISSUES

California's complex web of labor laws and regulations can ensnare cannabis companies, particularly those still functioning as they had when the norm was to pay employees under the table (not uncommon with employees reluctant to be on the payroll of a company handling a product illegal under federal law). The relaxed workplace culture often found in the cannabis industry could also mean that employees are not clocking in or out, taking breaks, or being paid overtime in compliance with state law. Labor claims can come with steep penalties, so cannabis companies should familiarize themselves and comply with applicable labor laws and regulations.

INTELLECTUAL PROPERTY

Knockoff or counterfeit cannabis products do not undergo the rigorous licensing and testing procedures that their legitimate counterparts do. They are sold at prices that cannibalize the market. Law enforcement has not generally prioritized taking action against these bad actors, so some companies have pursued infringement claims against knockoffs. Unfortunately, because the U.S. Patent and Trademark Office does not grant trademarks relating to cannabis, other legal avenues must be explored. Nevertheless, developing and maintaining the value of a brand, and pursuing litigation to protect it, could be critical to success.

FALSE CLAIMS

Like any other company selling goods or services, cannabis businesses are subject to the protections afforded to consumers via the False Claims Act. In 2022, a cannabis company in California found itself facing a class action lawsuit over falsely advertised THC levels, which violated the Act and frustrated consumers. Cannabis companies must accurately advertise and label their products, lest they end up in similar hot water.