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Issues in the Enforceability of Cannabis Contracts

There have been many challenges to the enforceability of contracts related to the cannabis industry. Given that cannabis is illegal at the federal level, parties to cannabis contracts face challenges in drafting contracts to ensure enforceability. Though California passed AB 1159 which, among other things, provides that compliant commercial cannabis activity is a lawful object of a contract and not against public policy, parties to cannabis contracts should still proceed with caution when drafting contracts.

There are many different types of contracts that cannabis companies may enter into such as management agreements, employment agreements, LLC agreements, leases, and acquisition agreements. This article will discuss generally some issues surrounding enforceability of cannabis contracts and will list some current best practices.

As an initial matter, parties to cannabis contracts should strongly consider always including choice of law and venue provisions. Further, parties should strongly consider making the choice of law and the venue be where the business is licensed and also consider excluding federal courts as a potential venue to litigate disputes since federal judges will not hear cases to enforce contracts regarding an illegal substance. As a practical matter (and to avoid disclosing sensitive information in court), arbitration may be the most practical dispute resolution avenue.

Even though a contract may be governed by state law, parties should still address federal law. For instance, one party may fear that the other may try to use federal law as a defense to a breach of contract since the contract itself is illegal under federal law. To address, parties should consider adding express language providing that federal law will not be a defense to a breach of the contract. Additional considerations related to federal law are discussed further in this article.

Due to specialized issues that arise in cannabis rules and regulations, there may be unintended issues arising in contracts. For instance, in California, "owners" or "holders of a financial interest" of a cannabis business may need to be disclosed to the State of California, disclosed on the license, fingerprinted, and subject to a background check. If an employment agreement (or any agreement for that matter) contains a payment provision based on royalties, share of revenue, or commissions, a person receiving such payments may inadvertently be classified as a holder of a financial interest of a cannabis business.

Classification as an "owner" is not only dependent on having a financial interest. Participation in the control or direction of a cannabis business could cause the party exercising that control to also be classified as an "owner" of the cannabis business and, thus, may be subject to the previously mentioned requirements. A common example of a party which may be construed as an "owner" is an investor with customary investor protections and veto rights typically negotiated by investors generally.

As another example, cannabis companies often put a significant amount of investment in equipment. In their lease agreement, they should consider whether the landlord should get possession of fixtures or have a right of entry to any facilities.

Another basic provision parties should consider adding is one that addresses compliance with local and state laws, rules, and regulations. For example, if one party to a contract is a "plant-touching" entity, the other party should require that the plant-touching entity represent and warrant that it has obtained all approvals, permits, and licenses to operate its business, that it will timely comply with all state and local rules and regulations (which can include timely filing of certain reports, payment of taxes and fees, and so on), and that it will maintain good standing. If a party to a contract requires certain information from, for example, suppliers or vendors, it should consider requiring the other party to provide copies of the relevant documents. A plant-touching party should agree to obtain any additional licenses or permits as applicable law and rules change. It would behoove the parties to also negotiate for reasonable audit rights in order to confirm each other's compliance with law and other matters and for the right to receive notice if the other party receives any notice of a material violation, suspension, or cancellation of any permit to operate a cannabis business.

It also almost goes without saying that parties need to recognize that the rules applicable to cannabis are constantly changing. Therefore, parties should strongly consider adding provisions that enable the parties to negotiate an amendment to the contract due to changes in cannabis law, changes in federal enforcement priorities, or if terms are deemed illegal by state or local courts or government agencies. Further, if the parties agree to such provisions, consideration should be given as to who determines whether an amendment is necessary and whether an amendment should be entered into if it is *required* or merely *advisable*. If the parties are unable to agree on an amendment, the contract should also allow either party to terminate the agreement.

In addition, despite the parties' best efforts, there will almost always be ambiguities in language. Another consideration that parties often neglect is that the agreement should be interpreted to ensure compliance. This can go a long way to resolve differences of interpretation between the parties.

No relationship lasts forever. Parties to cannabis contracts should consider adding exit options to their contracts in case, among other things, federal enforcement priorities change such that a party is in violation of civil or criminal law if it continues its obligations under the contract. The contract should also allow a party to terminate if state or local laws change such that performing under the contract violates law. In addition, it is worth considering adding language that upon the occurrence of certain events (such as a crackdown by a federal agency), then the contract is automatically terminated.

An interesting and novel issue is calculating damages. Because the industry is in its early stages, calculating damages is very difficult. One approach taken by some attorneys is to add a liquidated damages clause, but there are issues to address if taking that approach. Consulting with an attorney is critical.

A non-legal issue that often arises in the cannabis industry is that the parties on opposite sides of a contract may have significantly different attitudes toward conducting business. Without indulging too much into stereotypes, cannabis operators may have less experience with negotiating deals than investors. Operators may conduct business informally on "handshake" deals. Investors, on the other hand, typically have much more experience negotiating complicated agreements, working with attorneys, and so on. In addition, investors may view cannabis businesses from a purely opportunistic perspective, while some operators may have much more emotional attachment to the business and industry. This dynamic, of course, may reveal itself in negotiations and throughout the business relationship.

There are other considerations and provisions that one would be advised to consider in a cannabis contract. This article discussed a few of these issues, along with some current best practices. As the industry and the law evolve, new practices will emerge and, hopefully, a standard and customary practice will also develop.

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