

Arbitration: The Solution to the Cannabis Industry Regulatory Morass

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March 06, 2024

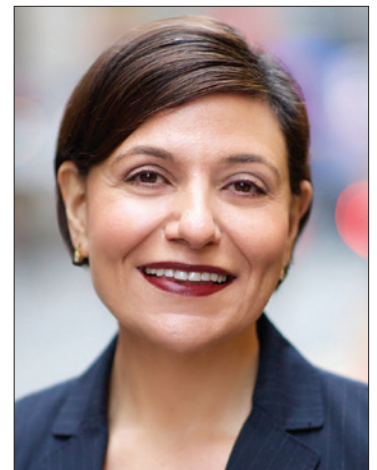
Thirty-eight states have legalized cannabis for medical purposes while twenty-four states and the District of Columbia also allow its recreational use. And yet, the use and possession of cannabis remains illegal under federal law. The consequences of this prohibition on the commercial aspects of the industry are significant: it limits interstate activities and thus hinders growth as well as basic routine activities such as acceptance of credit card payments. A number of businesses and investors interested in dealing with the cannabis industry have been reluctant to do so given the risk of running afoul of the federal laws and operating in a gray legal and regulatory landscape.

The concern is multi-faceted and includes questions related to mechanisms for the resolution of disputes arising from transactions with cannabis businesses: Will federal law be applied to negate a transaction or to penalize transaction parties? How will federal and state courts handle such disputes?

In this article, I outline the impact of the current regulatory landscape on the cannabis industry and its prospects. I focus on the legal concerns it raises and the potential opportunities arbitration offers in fostering growth by offering out of state and foreign stakeholders a safety net to counter the fragmented regulatory structure.

Federal/State Dichotomy

Under the current legal landscape, cannabis businesses can operate in states which have legalized it but they can't sell across state lines. The supply chain and sale apparatus must remain within the confines of the state in which cannabis is permitted and the business operates: grow, produce, trade, possess, distribute, buy and sell within a single state. These activities must obviously comply with the specific state regulations



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in which they operate, which differ from state to state.

Generally, the federal position has restricted interstate commerce while giving the states a free hand in regulating, unhindered by any overarching federal rules or requirements. The lack of federal oversight has led to a highly fragmented industry operating under differing rules from state to state.

Some state laws have been struck down as violating the Dormant Commercial Clause, which in effect prevents states from adopting protectionist measures (such as residency requirements). However, the state cannabis regulatory regimes have otherwise largely been left to the discretion of the state legislatures.

An Unclear Legal Landscape

The somewhat unique regulatory regime in which the cannabis industry finds itself naturally leads to peculiar legal issues and uncertainties. In most instances, state courts will freely turn to the state regulatory regime to decide on cannabis-related disputes. However, the manner in which a federal court would handle a cannabis dispute is uncertain.

In some instances, the federal prohibition will likely lead a federal court to dismiss certain (or all) claims if they relate to an activity that is prohibited by the federal laws. On the other hand, a federal judge may hear specific claims relating to matters that are subject to federal law, such as intellectual property disputes, if they are not directly related to activities expressly prohibited by the federal law.

Such legal uncertainties have been a key deterrent to parties looking to engage with the cannabis industry and partake in its growth. By opting for arbitration and carefully drafting a tailored dispute resolution agreement, parties can avoid many of these uncertainties, including the risks of dismissal or bifurcation of claims.

Considerations for the Agreement

With very rare exceptions, both federal and state courts enforce arbitration agreements. For transactions within the cannabis commercial and investment ecosystem, a court is likely to uphold an arbitration agreement notwithstanding the federal prohibition. It will do so based on the severability argument which provides that an arbitration agreement will be enforced by a court provided it is deemed valid by the court, regardless of the merits or legality of the underlying contract.

In sum, if the parties have agreed to arbitration and that arbitration agreement is found to be valid, they can be assured that a court will move the dispute to arbitration and arbitrators will be tasked with deciding the issues pertaining to the remainder of the contract and underlying transactions.

Parties can therefore freely turn to arbitration to manage the dispute resolution process and alleviate some of the concerns related to the current federal regulatory regime.

To start, parties can specify that the Federal Arbitration Act governs the arbitration agreement itself but explicitly state that state law (assuming it is a state where cannabis is legal) applies to the underlying contract. By doing so, they limit the risk of either party claiming that the underlying transaction is governed by the federal laws prohibiting cannabis.

Further, an arbitration agreement can highlight matters to be considered solely under state law, including, for example, public policy matters. The parties are therefore assured that, notwithstanding the federal prohibition, the arbitrators will look to state law, and only state law, for such matters that could be prohibited under federal law.

Parties can also agree to the exclusive jurisdiction of state courts for enforcement of both their arbitration agreement as well as the related award. This further mitigates the risk of a public policy argument based on the federal prohibition.

In situations involving foreign investors, the benefit of arbitration is all the more clear given the tangible risk that a domestic or foreign court would deem all, or portions, of a cannabis-related contract unenforceable in light of the federal prohibition. This, in itself, should motivate the parties to opt for arbitration at the onset and agree the governing law and seat of arbitration taking into account any applicable international rules for cross-border transactions.

To the extent possible, both domestic and foreign parties should also consider the jurisdictions where enforcement of an award could be sought and craft a provision that gives them the protections afforded to them by states and foreign jurisdictions that have legalized cannabis.

There are obviously other benefits to turning to arbitration: speed and efficiency of the process that may be key given the fast-paced growth of the industry and risks associated with potentially perishable goods; confidentiality, which could be particularly important for competitive stakeholders; and knowledgeable adjudicators with an openness and understanding of the business and its legal and business complexities.

Abolishing the Federal Prohibition

There's a strong desire to open the markets to increase supply and demand efficiency throughout the production and investment chain. The abolishment of the federal prohibition would likely entail significant immediate cost savings since businesses would then be permitted to deduct their expenses to reduce their tax burden (such as rent, payroll, etc ...). But the overall benefits would be even greater: it would allow for a more streamlined supply chain process and a broader centralized process, thus fostering cost efficiencies in scaling.

It would also likely lead to lower costs of capital with increased financing opportunities. More

generally, it would eliminate the hurdles faced by investors, financial institutions and other parties that are interested in engaging with the cannabis industry but have hesitated to do so given the uncertainty of the regulatory landscape.

There is a substantial chance that federal legalization of cannabis will take place in the near future. When it does, the federal and state legislatures will have the challenging, lengthy and costly task of deciding what to do with state laws that are inconsistent with the new legislation. The current regime will most likely need to be revamped to ensure a harmonious national structure that favors interstate commerce and complies with federal rules. We should expect a broad array of disputes to arise among the various stakeholders when such change takes effect.

Once federal legalization occurs, parties will in some cases have access to both the state and federal courts to decide on these matters. However, some states that have not legalized cannabis may still choose to enforce their laws despite federal legalization. In those jurisdictions, a party might face the uncertainty of whether state law is preempted; arbitration would then likely be viewed as the right choice.

In instances where both federal law and the relevant state law permit cannabis, parties may continue to see the benefit of arbitration as a more "neutral" and business-friendly forum to resolve disputes that will inevitably stem from a unique set of facts and conflicting laws. And until then, arbitration may actually be the only option for cannabis businesses and investors. The opportunity to turn to arbitration in lieu of courts should, in and of itself, help the cannabis industry in its growth aspirations by allowing it to tap into out of state sources for capital and consolidation.