

California Contract Ruling Should Concern Cannabis Cos.

By **Makai Fisher and Matt Williams** (June 16, 2020, 1:08 PM EDT)

Contracts are the lifeblood of any business venture. Cannabis businesses, like all other businesses, make agreements to hire employees, procure material inputs, form partnerships, obtain financing, sell product and much more.

But what about contracts entered into before marijuana was decriminalized — are those agreements valid? A recent California appellate decision, *Metsch v. Heinowitz*, gives a troubling answer, with wide-ranging impacts on any cannabis business more than a few years old.

Metsch v. Heinowitz concerns two written agreements executed in January 2014 between the operators of a cannabis edibles company.[1] The plaintiffs entered into a partnership/ownership agreement with a business partner and a consulting agreement with a pastry chef to form the core of their marijuana baking business.

By September 2015, their business relationship had gone south — the plaintiffs alleged that one partner breached his agreement and stole partnership property, and claimed that the baker had breached her consulting agreement.[2]

In August 2017, the plaintiffs sued their partner and the pastry chef in San Diego Superior Court, bringing causes of action for breach of contract, breach of fiduciary duty and conversion.[3]

The two defendants — the former partner and the pastry chef — claimed that the contract-based causes of action rested on an illegal transaction, therefore, the contracts were unenforceable.[4] The plaintiffs alleged the venture was legal because it only provided medical marijuana products, which were legal under California law.[5]

The trial court and the California Court of Appeal's Fourth Appellate District disagreed, finding that their business was unlicensed and did not qualify under the medical marijuana statute.[6] Instead, their venture was a commercial cannabis operation, for which licenses only became available in 2017.[7]

Thus, the contracts were entered into when the underlying object — selling recreational marijuana — was illegal, and "where the object or the consideration of the agreement is illegal — 'the entire contract is void.'"[8] Importantly, the court reaffirmed that the proper time to assess the illegality of a contract is when



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the contract was executed — here, 2014, when marijuana was illegal — and not at the time of the lawsuit.[9]

Certainly, an argument could be made — and was made — that the subsequent change in law relates back to retroactively validate an illegal contract, particularly when the contract's illegality turns on the changed legal status of contract's object (e.g., marijuana).

Indeed, after Proposition 64 passed in 2016, legalizing recreational marijuana in California, the San Francisco district attorney announced the retroactive application of the law to recall marijuana convictions.[10]

If the legalization of marijuana was retroactively applied in criminal cases, why not in contract cases? The Metsch court did consider whether changes in the law affect executed contracts, holding that because "there is no evidence that the parties here agreed to incorporate subsequent changes in the law into either of the contracts at issue" enforcing the agreements "would result in improperly modifying the contract without the parties' consent." [11]

The Metsch court, however, seems to have ignored the fact that the terms of the contract would not be changed with legalization of marijuana, simply the validity of the contract.

As of now, no published appellate court opinions have considered this problem — at least in the context of marijuana — making the Metsch court one of the first in the nation to weigh in on the enforceability of contracts executed while marijuana was illegal.

Undoubtedly, Metsch will not be the last word on the issue. It is easy to imagine another court retroactively applying laws legalizing marijuana and validating previously invalid contracts. Indeed, by choosing not to publish its decision, the appellate court left the door open for other courts, or even the same court, to come to a different result the next time this issue arises.

Still, the Metsch opinion sends a strong reminder to California courts that contracts must have a lawful object to be enforceable. For licensed medical marijuana businesses operating under earlier compassionate use regulations, this appellate opinion has no effect. But for recreational marijuana businesses that could not obtain licenses until 2017, at the earliest, this case suggests that any contract executed before licensure may not be enforceable.

Metsch specifically concerned partnership and consulting agreements, but the reasoning behind the decision would likely apply to any other contract, including employment agreements, sourcing/distribution agreements, financing agreements, contracts with vendors and so on.

As the Metsch court stated, where the underlying agreements concern illegal marijuana transactions, "the courts will not assist in providing relief to plaintiffs, regardless of the merits of the claims." [12] If a contract cannot be enforced in court, the parties are left with no legal mechanism to compel compliance with its terms.

Although the current state of the law controlling marijuana business contracts executed prelegalization is arguably in a gray area, one court has voiced its opinion, and the legal reasoning of Metsch may very well prevail. In light of the potentially broad reach of Metsch — and to avoid being the next test case — there are steps cannabis companies can take now to assess and manage the risk of unenforceable agreements. Specifically, cannabis companies in California should consider the following measures:

- Identify any contracts executed before the business received a cannabis license.

- Determine which contracts have not expired or been cancelled.
- Prioritize the contacts that are core to your business (e.g., employment contracts with key employees or distribution agreements).
- Seek to renew or renegotiate pre-2017 contracts in order of importance.

Metsch may be the first in a line of decisions questioning the validity of prelegalization agreements. It is worth noting, however, that contracts entered in today, in a post-legalization jurisdiction, still run the risk of unenforceability in federal court.[13]

Regardless, cannabis companies should use this early warning from Metsch to their advantage. Evaluating your company's entire portfolio of business contracts may seem like a herculean task. But, as Metsch pointedly demonstrates, ensuring you have valid and enforceable contracts now may help you avoid costly litigation later.

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[1] No. D074999, 2020 WL 1933189, at *2 (Cal. Ct. App. Apr. 22, 2020).

[2] Id.

[3] Id.

[4] Id.

[5] Id. at *3.

[6] Id.

[7] Id.

[8] Id. at *6 (quoting Civ. Code §§ 1598, 1608).

[9] Id. at *7.

[10] <https://sfdistrictattorney.org/san-francisco-leads-way-providing-relief-under-proposition-64>.

[11] Metsch, 2020 WL 1933189 at *7 (citing Swenson v. File, 3 Cal. 3d 389, 395 (1970)).

[12] Id. at *5.

[13] See, e.g., Polk v. Gontmakher, No. 2:18-CV-01434, 2019 WL 4058970, at *2 (W.D. Wash. Aug. 28, 2019).