



2022 Focus November Conference  
November 3-4, 2022  
Washington D.C

## **The Growing Concern of Cannabis Impacting D&Os: The Risks and Emerging Markets for Coverage**

The cannabis industry is one of the fastest growing market in the United States, with annualized compound growth in excess of fifteen percent. Although 37 states have legalized medical marijuana, 12 states have low THC medical marijuana programs and 19 states (plus Washington D.C.) as of the July 2022 have legalized adult-use marijuana, marijuana remains an illegal Schedule I substance under the Controlled Substances Act. Still, this rapid growth has brought new capital into this market, with many new executives demanding Directors and Officers (“D&O”) insurance to be in place. Cannabis companies are increasingly the target of expensive lawsuits against the D&Os, while the market D&O insurance remains a challenge, leaving cannabis companies exposed to volatility from risky decisions and often unable to attract top executives whose personal assets may not be fully indemnified or protected. The panel will explore the types of claims commonly brought against directors and officers and the specific D&O risks facing cannabis companies. Topics include the D&O market and the types and kinds of coverage available to the industry. The panel also will review trends in D&O claims and cannabis reforms and how they may impact the future of D&O claims and coverage in the cannabis industry.

### **1) Overview of Claims Against Directors and Officers**

Corporate directors and officers of a Cannabis company or any other line of business are deemed to stand in a fiduciary relationship with the corporation and as such are required to discharge the duties of their respective positions in good faith and with that diligence, care and skill which ordinary prudent men and women would exercise under similar circumstances. This includes a duty of obedience, loyalty, diligence, and candor. Specifically, directors and officers are under a duty of obedience, to act within the scope of their power or authority, and to see that the corporation is managed in accordance with the corporation's charter, articles of incorporation and by-laws. As fiduciaries of their corporation, D&Os are subject to an undivided duty of loyalty to the corporation, which requires them to protect the corporation and refrain from doing anything adverse to its interests. Directors and officers are not necessarily precluded from engaging in other business, but they may not use their corporate positions to deprive

the corporation of profit or advantage which it might derive in the course of its business. Further, they must discharge their duties in good faith and with the care an ordinary prudent person in a like position would exercise under similar circumstances.

Directors and officers often look to the protection of the business judgment rule in connection with challenges to their business decisions. The rule is based upon the notion that management of the corporation is vested in the board of directors, and a court should not second guess the judgment of the board. For the business judgment rule to apply there must be (1) a business decision, (2) a decision by a disinterested director, (3) a duty of care in making an informed business decision following a reasonable effort to become familiar with the relevant and available facts, (4) no abuse of that discretion, and (5) the decision by the director was motivated by good faith. This is a vital defense for claims of breaches of fiduciary duties against D&Os, in the context of a cannabis corporation, or otherwise.

## **2) Evaluation of Cannabis Reform efforts in the United States**

States, not the Federal government, have been leading the charge regarding the reform on cannabis legalization. There are 37 states and the District of Columbia which permit the medical use of cannabis, with adult use of cannabis permitted in 19 of those states and the District of Columbia. The most recent is Rhode Island, where cannabis was legalized on May 25, 2022. State laws continue to evolve, even in those states where cannabis is still illegal. One prominent example is Minnesota in 2022, which now allows the sale and consumption of hemp-derived “edible cannabinoid” products that contain intoxicating levels of THC, though marijuana is still illegal there.

Though marijuana is classified within Schedule 1 of the Controlled Substances Act (“CSA”) and that there have been changes at the state level for adult use and/or medicinal use, changes at the Federal level has been slow. One such proposed bill is the Secure and Fair Enforcement (“SAFE”) Banking Act. The bill creates a safe harbor for financial institutions, including banks, credit unions and insurance companies, which would not be liable or subject to federal forfeiture action for providing financial services to a cannabis-related business. The SAFE Banking Act has been passed six times by the US House of Representatives but has yet to be considered by the US Senate. Another bill that was passed by the House in the Spring of 2022 is the Marijuana Opportunity Reinvestment and Expungement Act or the “MORE Act.” Amongst other things, the MORE Act institutes a tax on cannabis, with the funds designated to fund programs such as job training, legal aid and youth mentoring. While the US Senate has not put forward the MORE Act for consideration, it did in July introduce the Cannabis Administration and Opportunity Act (“CAOA”), under which it looks to legalize marijuana at the federal level while creating Food & Drug Administration monitoring requirements like those that already exist for tobacco and alcohol. The bill also includes other public safety measures and regulations, modifies tax policy on marijuana, requires additional federal research on the impact of marijuana use and removes drug testing for federal workers in most cases. This is at its early stage and remains to be seen what traction it will make going forward.

The FDA, SEC, and the IRS have become more recently involved with cannabis related matters. The FDA in May 2022 sent warning letters to cannabis companies such as ATRRx Inc., BioMD Plus LLC, and others for selling products labeled as containing Delta-8 THC in violation of the Federal Food, Drug, and Cosmetic (“FD&C”) Act. There have been SEC litigations, such as that against the D&Os of VerdeGroup Investment Partners and Sumichrast regarding securities offering fraud involving cannabis companies. There have been lawsuits involving the IRS regarding tax liabilities as well.

### **3) Litigation Statistics and Key Trends on D&O in general**

Publicly traded companies listed on U.S. exchanges are prohibited from making false or misleading statements or omitting information in connection with the sales of securities. The securities actions against D&Os often contain allegations of mismanagement, losses caused by noncompliance with state regulations, or failure to adequately disclose risks to investors and shareholders. Securities lawsuits against cannabis companies are becoming more frequent and more costly.

In 2021, securities filings in general decline for the second year in a row, with 2211 federal court securities class action lawsuits filed. This is a sharp decrease from the 320 federal court filings in 2020, a 34% decline. As a comparison, a total of 428 new securities class action cases were filed across U.S. state and federal courts in 2019, the highest number on record and nearly double the 1997-2018 average, according to Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse.

There are a number of possible reasons for decline in the number of securities class actions in Federal court, including the Covid-19 pandemic and certain securities matters being filed in state court. Still, one main reason appears to be the significant decline in the federal court merger objection class action lawsuits. In 2021, there were only 18 such lawsuits filed, compared to 102 in 2020. Most recently in the first half of 2022, there were 112 securities actions in state and Federal Court compared to 150 in the first half of 2020, reflecting a 25% decline. According to Stanford Law School's Securities Class Action Clearinghouse, 28 securities class action lawsuits were filed against U.S. and Canadian cannabis businesses within the past seven years. The majority of those were initiated in the past two years alone. While there have not been any specific statistical studies of cannabis securities litigation in 2022, anecdotal evidence suggest that these litigations remain prevalent.

### **4) Securities Actions Against Cannabis Companies**

As noted above, there have been many significant securities litigations where the directors and/or officers of cannabis companies have been named as a defendant. Some new cases filed in 2022 include *Greg Eddy v. Columbia Care Inc., et al.*, 22-cv-03773, in

the U.S. Dist. SD NY, which involved an alleged board conflict of interest during two cannabis companies merger, *Mallozzi v. Innovative Industrial Properties Inc. et al.*, 22-cv-02359, in the U.S. Dist., D NJ., which is an action against three of its chief officers for operating a cannabis properties-focused real estate investment trust of actually operating as a marijuana company lender, and *Maheep Goyal, derivatively on behalf of FSD BioSciences Inc. v. Anthony Durkacz et al.*, 2021-0629, Del Ct Chanc, which is a derivative action alleging that two D&Os schemed to destroy one unit to acquire another company for personal gain. It remains to be seen whether these new cases will follow the example of prior securities actions against cannabis companies that have resulted in significant settlements such as C\$83 million for *In Re: CannTrust Holdings Inc. Securities Litigation*, 19-cv-06396, U.S. Dist. SD NY. that was approved in September 2021 or the \$13 million in *Ortiz v. Canopy Growth Corp. et al.*, 19-cv-20543, U.S. Dist. D NJ, that was approved by the court in June 2022.

The securities litigations involving D&Os of cannabis companies do not always involve public companies. There have been a few, including some in 2022 that involve private companies. Some of these disputes involve general business issues, such as contract disputes in *FDAS Ventures LLC v. Mojo Capital LLC et al.*, 22STCV15530, in Cal Sup Ct. LA Cty and *Dynasty Capital 26 LLC v. Lily's Green Garden Inc. et al.*, 22-cv-02507, U.S. Dist Ct, ED NY. Others like *Wolf v. Altmann*, 22-cv-00397, U.S. Dist Ct, ED MO involves litigation between directors of cannabis companies. The rise of litigation with cannabis companies appears will continue as long as there are increased investments in them by the general public.

## **5) ESG Related Actions**

D&Os of cannabis companies have not been immune to litigation addressing environmental, social, and corporate governance (“ESG”) concerns. This has taken the form of #MeToo and racial type claims, Cyber claims, and actions involving alleged false statements regarding climate changes. One example is *Jones v. Blair Wellness Center LLC et al.*, 21-cv-02606, in the U.S. Dist Ct, D. MD, which involved a claim of discrimination based on race against her former employer and business owner, which was a cannabis retail business. An example of a cyber claim against a cannabis company is *Warshawsky et al. v. cbdMD Inc. et al.*, 20-cv-00562, U.S. Dist Ct WD NC, which is a class action was brought by customers who purchased cannabidiol products had their personal information compromised in cyberattacks. Further, one environmental claim was in *Acerra v. Trulieve Cannabis Corp.*, 2021 U.S. Dist. LEXIS 247894, at 2 (N.D. Fla. Dec. 30, 2021), which in dismissing the complaint, the court did find that the company’s description of “climate controlled” involving “an outdoor facility in Florida with no heat or air-conditioning does not measure up” was a “sufficient allegation of a material misstatement.” These ESG type litigations against the D&Os of cannabis companies show additional basis for the growing potential exposure to liability.

## **6) Where are D&O Claims Going From Here**

Directors and officers are often the face of the companies, and as such, they often have that great responsibility. The potential for liability for D&Os has evolved over the years and the ever changing landscape in connection with cannabis only heightens that exposure. While many believe that if the Federal government does legalize cannabis that some of these risks may disappear, but this is likely false optimism given all the various state regulations that will likely still be in place even if cannabis legalization becomes a reality. What does appear certain is the growing cannabis industry as a whole, which will likely continue with more states permitting licensed growth and licensed sales. The cannabis companies are looking to become more than a fringe industry and has the potential to disrupt the current market. The change of the cannabis industry will continue to impact those D&Os that lead their respective operations and for better or worse, the exposures to those D&Os are following.