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Marijuana's Journey from Greenhouse to Courthouse

Can Cannabis Debtors Seek Bankruptcy Protection?

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In 1970, Congress passed the Controlled Substances Act (CSA),[1] a "lengthy and detailed statute creating a comprehensive framework for regulating the production, distribution, and possession" of five newly created schedules of controlled substances.[2] Schedule I drugs are categorized as the most dangerous because of their "high potential for abuse, lack of any accepted medical use, and absence of any accepted safety for use in medically supervised treatment."[3]

Marijuana was classified as a Schedule I drug in part based on the recommendation of the assistant secretary of the agency now called the Department of Health and Human Services, "at least until the completion of certain studies now underway."[4] To date, almost 50 years later, marijuana remains classified as a Schedule I drug.

Despite marijuana's classification as a Schedule I drug pursuant to the CSA, in 1995 California passed the Compassionate Use Act, permitting cannabis use for medicinal purposes.[5] Other states have since followed suit with their own medical and recreational marijuana regulatory schemes. As such, businesses involved in cannabis are faced with a labyrinth of confusing, contradictory and multijurisdictional regulations that affect everything from finance and banking to zoning and land use.

These problems are particularly accentuated when an individual or business in the cannabis industry is facing insolvency. Because bankruptcy is a federal remedy, bankruptcy courts have historically been reluctant to grant relief to debtors involved with marijuana, regardless of any applicable state law. Recent cases suggest that the tide might be turning, and cannabis businesses might soon have a clearer path toward bankruptcy protection.

Without delving too deeply in the weeds, this article examines the current state of the law from the perspective of the cannabis debtor and its creditors. It concludes with certain practice pointers for chapter 11 debtors and potential debtors in the marijuana business.

1 21 U.S.C. § 801, *et seq.*
2 *Gonzales v. Raich*, 545 U.S. 1, 24 (2005).
3 *Id.* at 2.
4 *Id.* at 14 (citing 21 U.S.C. § 812(b)(1).
5 Cal. Health & Safety Code § 11362.5(b).

The Voluntary Cannabis Debtor

Patricia Olson was 92 years old, legally blind and in desperate need of bankruptcy protection to prevent foreclosure of her commercial real property. Notwithstanding Olson's sympathetic circumstances, on May 31, 2017, the U.S. Bankruptcy Court for the District of Nevada dismissed her chapter 13 case.[6] The reason? One of her tenants operated a marijuana dispensary on the premises.[7]

On appeal, Olson successfully argued that the bankruptcy court failed to properly articulate and apply the appropriate standard for dismissal.[8] However, it was a pyrrhic victory, as she voluntarily dismissed her case before a decision on remand was issued.[9]

Olson is not alone. Bankruptcy courts across the nation have dismissed cases where a debtor is involved in the cannabis industry. In one of the first published cannabis decisions, *Rent-Rite*, the U.S. Bankruptcy Court for the District of Colorado found cause to dismiss a chapter 11 case where the debtor knowingly leased warehouse space to tenants who used that premises for marijuana-cultivation purposes.[10] The court provided several intersecting rationales supporting dismissal, all of which have ossified over the years into well-settled principles leading to a similar result.

Perhaps because the secured lender moved to dismiss the debtor's case, *Rent-Rite* reflected concern that the lender's collateral — a warehouse — was at risk of seizure by the federal government.[11] Acknowledging that the risk of forfeiture was "theoretical, speculative, and remote," the court refused to "force [the secured lender] to bear even a highly improbable risk of total loss of its collateral in support of the [d]ebtor's ongoing violation of federal criminal law."[12]

The court ultimately found that cause existed to dismiss or convert the case under § 1112(b) for three reasons. *First*, the court found that the debtor "gross-

6 Order, *In re Olson*, No. 17-50081, D.E. 97 at 1 (Bankr. D. Nev. May 31, 2017) (*sua sponte* dismissing case based on finding that debtor did not qualify for relief under Bankruptcy Code because she has received rental income from medical marijuana dispensary).
7 *Olson v. Meter (In re Olson)*, BAP No. NV-17-1168-LTiF, 2018 WL 989263, at *4 (B.A.P. 9th Cir. Feb. 5, 2018).
8 *Id.* at *6.
9 *In re Olson*, Case No. 17-50081, D.E. 259, 261 (Bankr. D. Nev. June 8, 2018).
10 *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799, 811 (Bankr. D. Colo. 2012).
11 *Id.* at 805-06; *see also* 21 U.S.C. § 881(a)(7).
12 *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 806.

ly mismanaged the estate" by filing its petition with the cannabis leases in place and maintaining those leases during the pendency of the case.[13] *Second*, the court noted the debtor's unclean hands — its ongoing violation of the CSA — as a basis for dismissal.[14] *Third*, the court reasoned that the debtor had "no reasonable prospect of getting its plan confirmed" because any plan that the debtor could propose would rely on income derived from an illegal activity under the CSA.[15]

However, the bankruptcy court could not conclude, on the record before it, whether dismissal or conversion was in the best interest of creditors.[16] The court was particularly concerned with the feasibility of placing the estate into a chapter 7, noting that any trustee would be responsible for a property facilitating ongoing criminal conduct.[17] After much legal wrangling among the debtor, secured lender and U.S. Trustee, the debtor ultimately stipulated to the dismissal of its case.[18]

Two years later, the hypothetical concern of a chapter 7 trustee having to administer assets subject to illegal activity that Hon. **Howard R. Tallman** (now retired) raised in *Rent-Rite* was placed squarely before him in *Arenas*.[19] In *Arenas*, following a chapter 7 petition filing and a motion to convert to chapter 13, the U.S. Trustee objected to the motion to convert and moved to dismiss the chapter 7 cases of a husband and wife who owned a commercial building with two units, one of which was used by the husband for his marijuana wholesaling business; the other unit was leased to a dispensary.[20]

After the bankruptcy court denied their motion and dismissed their case, the debtors appealed to the Tenth Circuit Bankruptcy Appellate Panel (BAP).[21] In affirming the bankruptcy court's order, the Tenth Circuit BAP reasoned that it would be "impossible for the chapter 7 trustee to administer the Arenases' estate because selling and distributing the proceeds of the marijuana assets would constitute federal offenses."[22]

Rent-Rite and *Arenas* provide the rationales invoked in nearly every decision dismissing bankruptcy cases involving the cannabis industry. Last December, the U.S. Bankruptcy Court for the District of Colorado dismissed the chapter 11 cases of a gardening supply store that marketed and sold equipment to marijuana growers.[23] In doing so, the court retraced the evolution of the law since *Rent-Rite* and *Arenas*, ultimately finding "no practical alternative to dismissal."[24]

There might be hope on the horizon. In *Arm Ventures*, the U.S. Bankruptcy Court for the Southern District of Florida declined to dismiss a chapter 11 landlord/debtor's case — even though it was "ripe for dismissal" — and instead offered the debtor 14 days to propose a plan that did not depend on marijuana as a source of income.[25]

More recently, in a matter of first impression, the U.S. Bankruptcy Court for the Western District of Washington in *Cook* declined to dismiss the single-asset real estate chapter 11 case of a debtor leasing space to a marijuana grower operating lawfully under Washington state law.[26] In an unpublished opinion, the court denied the U.S. Trustee's motion to dismiss and distinguished *Rent-Rite* and *Arenas* on the basis that the debtor could, under the facts of the case, potentially propose a plan that would reject the offensive lease and that would not rely on income from the cultivation of marijuana.[27] Moreover, the court suggested that *Rent-Rite*'s asset-forfeiture concern might be overstated in light of a Department of Justice memorandum instructing federal prosecutors not to prosecute CSA violations where the actor is operating within a "robust" state legalization regime.[28]

The *Cook* court ultimately confirmed the debtors' reorganization plan, again over the U.S. Trustee's objection.[29] The court noted that the debtors had rejected the marijuana lease and proposed a plan that did not rely on marijuana income.[30] Moreover, unlike in *Rent-Rite*, the secured lender agreed to its treatment under the plan.[31] The U.S. Trustee's appeal of that confirmation order remains pending.[32]

Cannabis Creditors

It is one thing for courts to block a debtor from voluntarily availing itself of bankruptcy protections, but what about when an insolvent's *creditors* seek to place the entity into bankruptcy? Should otherwise-proper petitioning creditors also suffer the same fate? The answer, at least according to one court, appears to be "yes."

In *Medpoint Management*, the U.S. Bankruptcy Court for the District of Arizona dismissed an involuntary chapter 7 petition brought against a former manager of a marijuana business.[33] Although the court noted many of the same concerns — *i.e.*, the risk of asset forfeiture and the trustee's inability to administer the estate — the court emphasized that all of the petitioning creditors had knowingly entered into business with the putative debtor, which was a marijuana business. Accordingly, the court concluded that they all had unclean hands and could not seek relief under the Bankruptcy Code.

Medpoint stands for the novel (and perhaps counterintuitive) proposition that a debtor might be able to defeat an involuntary petition by engaging in illegal conduct. The result is all the more striking because the purpose of an involuntary petition is to protect *creditors* from the mistakes or preferences of an insolvent.[34] In the case of a voluntary

13 *Id.* at 809; *see also* 11 U.S.C. § 1112(b)(4)(B).
14 *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R at 809.
15 *Id.*
16 *Id.*; *see also* 11 U.S.C. § 1112(b)(1).
17 *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 810.
18 *In re Rent Rite*, Case No. 12-31592 (Bankr. D. Colo. April 17, 2014) (dismissing chapter 11 case).
19 *In re Arenas*, 514 B.R. 887 (Bankr. D. Colo. 2014), *aff'd sub nom.*, *Arenas v. U.S. Trustee (In re Arenas)*, 535 B.R. 845 (B.A.P. 10th Cir. 2015).
20 *Arenas*, 535 B.R. at 847.
21 *Id.* at 848, 854.
22 *Id.* at 853-54.
23 Order at 28, *In re Way to Grow Inc.*, Lead Case No. 18-14330, D.E. 379 at 20 (D. Colo. Dec. 14, 2018).
24 *Id.* at 27.
25 *In re Arm Ventures LLC*, 564 B.R. 77, 56-87 (Bankr. S.D. Fla. 2017) (reasoning that there is significant noninsider unsecured debt and that at this juncture, dismissal is not in best interests of those creditors).
26 *In re Cook Invs. NW, SPNWY LLC, et al.*, No. 16-44782, D.E. 67 (Bankr. W.D. Wash. March 9, 2017) (denying motion to dismiss with leave to renew).
27 *Id.* at 6.
28 *Id.*; *see also* James M. Cole, Deputy Attorney General, Memorandum for All U.S. Attorneys: Guidance Regarding Marijuana Enforcement (Aug. 29, 2013) (commonly referred to as the "Cole Memo"); *but see* Jeffrey B. Sessions, Attorney General, Memorandum for All U.S. Attorneys: Marijuana Enforcement (Jan. 4, 2018) (revoking Cole Memo).
29 *In re Cook Invs. NW, SPNWY LLC, et al.*, No. 16-44782, D.E. 152 at 10:1-2 (Bankr. W.D. Wash. 2017).
30 *Id.* at 9:19-22.
31 *Id.* at 9:22-23.
32 *See generally Geiger v. Cook Invs., et al. (In re Cook Invs. NW, et. al)*, Case No. 3:17cv5516 (W.D. Wash.).
33 *In re Medpoint Mgmt. LLC*, 528 B.R. 178 (Bankr. D. Ariz. 2015), *vacated in part by Medpoint Mgmt. LLC v. Jensen, et al. (In re Medpoint Mgmt LLC)*, BAP No. AZ-15-1130-KuJaJu, 2016 WL 3251581 (B.A.P. 9th Cir. June 3, 2016).
34 *In re Forever Green Athletics Fields Inc.*, 804 F.3d 328, 332 (3d Cir. 2015).

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petition filed by a marijuana entity, the insolvent debtor has chosen to step into federal court because its best outcome can be achieved by a bankruptcy petition filing. However, most debtors hauled into federal court by a group of creditors would rather remain far, far away from the courthouse door.

Similarly, the ability of a creditor involved in cannabis with a debtor to enforce its rights in bankruptcy has been questioned. In *Beyries*, decided in the U.S. Bankruptcy Court for the Northern District of California, a medical marijuana business attempted to establish the nondischargeability of certain debts against their attorney-turned-chapter 7 debtor.[35] The bankruptcy court agreed that at least some of the debt was nondischargeable pursuant to § 523(a)(4) of the Bankruptcy Code, but refused to enter judgment for plaintiffs "because they were engaged in unlawful activity."[36]

Pointers for Cannabis Debtors in Chapter 11

Currently, there does not appear to be much wiggle room for grower and dispensary companies whose business model is premised upon generating income from marijuana growing or distribution, to reap the Bankruptcy Code benefits. Chapter 11 will pose the challenge, among others, for a debtor to confirm a plan premised on the lease or continued use of assets that are illegal under the CSA. For this reason, marijuana growers and dispensaries should strongly consider state court insolvency proceedings, such as receiverships and assignments for the benefit of creditors.

While cannabis issues still will pose obstacles for real estate owners leasing property to growers or dispensaries, savvy counsel can also take steps to minimize the risk of dismissal. More particularly, prior to a bankruptcy petition filing, landlords should consider negotiating favorable termination and eviction clauses to be invoked in the event of the landlord's looming insolvency. Otherwise, the landlord might be strapped with a lease in bankruptcy that it cannot terminate so long as the tenant is not in breach. Multiple courts have shunned landlords for continuing to accept rent during the post-petition period or worse, basing a proposed plan on continued receipt of funds from the grower or distributor tenant.

In *Cook*, the U.S. Trustee took the position that removing a cannabis tenant was the *only* way, in its view, for the debtor to stay in bankruptcy (as opposed to rejection of the lease).[37] The U.S. Trustee lost before the bankruptcy court, but whether its position ultimately prevails on appeal remains to be seen.

Once in bankruptcy, absent a prenegotiated termination right or a breach by the tenant, the debtor/landlord might be stuck with the remedy of rejecting the lease and proposing a plan that is not funded by the tenant's rent payment. This strategy may permit a debtor to evade dismissal before some courts, but others might find that rejection is not sufficient becausea tenant may continue occupying the property under 11 U.S.C. § 365(h).

In addition, a court may conclude that entering a bankruptcy case with a cannabis lease constitutes a disqualifying factor regardless of whether rent is accepted post-petition or whether the tenant is evicted during the pendency of a bankruptcy case. Lastly, a landlord may refuse payment from a cannabis tenant post-petition as another way to lessen the risk of dismissal, but there is little judicial guidance regarding this approach. The most prudent way for a landlord to avoid dismissal is to evict the cannabis tenant prior to filing for bankruptcy, but this is not always practical.

Conclusion

Navigating through the cannabis thicket in bankruptcy can be difficult, but under the right circumstances, the doors to the bankruptcy court might be starting to creak open ever slightly for certain types of businesses, particularly real estate owners. abi

35 *Northbay Wellness Grp. v. Beyries (In re Beyries)*, Adv. No. 10-1181, 2011 WL 5975445, at *1 (Bankr. N.D. Cal. Nov. 29, 2011), *reversed in part by Northbay Wellness Grp. Inc. v. Beyries*, 607 Fed. App'x 693 (9th Cir. 2015).

36 *Id.* at *1.

37 *Cook*, Case No. 16-44782, D.E. 56 at 14:16-20, D.E. 146 at 13:13-19 (Feb. 23, 2017) ECF No. 56.