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Is Bankruptcy An Option For Ancillary Marijuana Businesses?

By **Patricia Heer** (July 21, 2017, 12:14 PM EDT)

On June 8, 2017, Clifford J. White III, director of the U.S. Trustee Program,[1] proclaimed before a congressional subcommittee that "debtors with assets or income derived from marijuana may not proceed through the bankruptcy system."

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The statement, made by White while testifying before a House judiciary subcommittee on oversight of the UST Program, reiterated the position taken by U.S. trustees in bankruptcy cases. It is unclear, however, what types of businesses the UST Program will deem to have assets or income derived from marijuana.

To date, bankruptcy courts have denied relief under the United States Bankruptcy Code to marijuana cultivators and dispensaries, as well as their landlords, on the ground that those businesses violated the Controlled Substances Act — the federal law that regulates controlled substances such as marijuana.[2] In each case, bankruptcy courts found that the cultivators and dispensaries violated a particular CSA provision because they either manufactured, distributed or dispensed marijuana,[3] or because the landlords owned property being leased and used for the manufacture or distribution of marijuana.[4] In at least one case, however, involving an entity that licensed its brand name to a dispensary, the violation in question hinged on an accomplice theory of liability for violating the CSA.[5] This more attenuated violation may be consistent with the UST Program's broadly written position.

Nevertheless, as discussed below, the application of the UST Program's position and the limitation of bankruptcy relief has not been addressed at this stage, let alone settled, with respect to businesses that are ancillary to the core business of growing, processing and dispensing marijuana, such as lighting, security, software and growing-equipment entities (ancillary businesses). Moreover, there are options that may still be available for both marijuana businesses and ancillary businesses to manage their debt.

Limitations in Bankruptcy Cases Under Chapters 11, 13 and 7

Plans Must Be Proposed in Good Faith and Not by Means Forbidden by Law

A Chapter 11 proceeding is used primarily by business entities to reorganize their debts while they continue to operate. A Chapter 13 proceeding is also used to reorganize debts, but it is used by individuals rather than businesses.[6] Under each of these chapters, the debtor creates a plan under which the debtor proposes to repay all or part of its debts. Pursuant to the Bankruptcy Code, the plan must be proposed in good faith and not by any means forbidden by law. "[N]ot by any means forbidden by law" requires that the plan comply with not just the Bankruptcy Code but other applicable federal and state statutes as well. Bankruptcy courts have held, in both Chapter 11 and Chapter 13 cases, that a plan providing for payments funded by an activity violating the CSA is proposed by means forbidden by law. Such plans are therefore deemed patently unable to be confirmed/approved by a bankruptcy court and, as such, are not deemed to be proposed in good faith.

Further, because the plan payments come from prohibited activity, which may trigger a penalty of forfeiture, any payments made under such plans are potentially subject to forfeiture, which would

make them illusory.[7]

Trustees Must Be Able to Administer Assets

Alternatively, rather than reorganize, a debtor may choose to liquidate. In a Chapter 7 proceeding, the assets (that are not exempt from creditors) are collected, liquidated and distributed to creditors by a trustee appointed to the case under the UST Program. In a Chapter 13 case, the debtor's assets and the payments made under a Chapter 13 plan are also administered by a trustee appointed to the case under the UST Program.[8] Bankruptcy courts have held that for a trustee (whether in a Chapter 7 or 13) to take possession and control over a cultivator or dispensary's marijuana plants or of a landlord's leased real property utilized for growing and distributing marijuana, it would directly involve the trustee in commission of federal crimes.

Moreover, the prospect of a possible forfeiture or seizure of the assets and real property that the trustee would need to administer poses an unacceptable risk to a Chapter 7 estate and to a Chapter 7 trustee.[9]

Cases May Be Dismissed for Cause

Each of the bankruptcy cases (whether a Chapter 11, 13 or 7) can be dismissed for cause (as long as the dismissal is in the best interests of creditors and the estate). "Cause" includes, among other things, filing of a bankruptcy case in bad faith. Bad faith does not require improper motive; rather, it is satisfied when a debtor proposes a plan that is incapable of being confirmed. In Chapter 11 and 13 contexts, bankruptcy courts have held that a plan that is executed through unlawful activities under the CSA is incapable of being confirmed. The impossibility of confirmation establishes a debtor's bad faith and constitutes cause for dismissal.

Cause for dismissal has also been found to include seeking relief from the court with "unclean hands," which could include engaging in activities deemed criminal. Moreover, in Chapter 7 and 13 cases, courts have concluded that the impossibility of a trustee to lawfully administer a debtor's assets likewise constitutes cause to dismiss a case.

Bankruptcy courts have relied on the outlined propositions, which have been advised by the UST Program, to limit the relief available to various marijuana business that have come before the courts to date — denying confirmation of reorganization plans, refusing to convert cases to a case under another chapter, or outright dismissing cases.

Bankruptcy Cases of Cultivators and Dispensaries

In In re McGinnis, an individual cultivator and seller of marijuana in Oregon sought bankruptcy relief under Chapter 13.[10] The debtor's income to fund the Chapter 13 plan would have come partially from cultivating and selling marijuana, which the bankruptcy court found to violate the CSA. The bankruptcy court held that, because the debtor's Chapter 13 plan depended on violating federal law, the plan did not meet the requirement that it not be proposed by means forbidden by law. Consequently, the court denied confirmation of the Chapter 13 plan.

In In re Jerry L. Johnson, an individual debtor licensed to grow and sell marijuana under Michigan state law sought bankruptcy relief under Chapter 13.[11] Similar to In re McGinnis, the debtor's income was derived partially from the cultivation and sale of marijuana and partly from other sources. However, unlike in In re McGinnis, the debtor asserted that the income from the marijuana business was segregated and not used for funding the plan, which would instead be funded through his other income from Social Security. Nevertheless, the bankruptcy court held that money is fungible and even if the debtor's payments under the plan came from another source, the debtor's continuing operation of a marijuana business would require the court, the Chapter 13 trustee, and even the debtor, to violate the CSA. The court gave the debtor the option to stop operating the marijuana business or the case would be dismissed.

In In re Mother Earth's Alternative Healing, a medical marijuana dispensary in California sought Chapter 11 relief.[12] The bankruptcy court found that dispensing marijuana violated the CSA and that any payment under the dispensary's proposed plan could be subject to forfeiture and therefore be illusory. The bankruptcy court also held that the debtor could never have proposed a confirmable

plan because its federal illegality rendered it not proposed in good faith and not proposed by means not forbidden by law. Further, the court held that the impossibility of the dispensary proposing a viable plan of reorganization was indicative of its bad faith in initiating the bankruptcy case and thus constituted cause to dismiss the case.

Bankruptcy Cases of Landlords

In In re Rent-Rite Super Kegs, a property owner that operated a warehouse in Colorado that it partially rented to a state-legal marijuana cultivator and derived 25 percent of its revenue therefrom sought bankruptcy relief under Chapter 11.[13] The landlord also itself grew and distributed marijuana. The court found that the debtor violated the CSA by owning or controlling premises and letting them be used for the manufacture or distribution of a controlled substance and by cultivating and dispensing marijuana itself. Given the debtor was violating the CSA, the real property that was used to commit or to facilitate the commission of the violation was also subject to forfeiture.

Moreover, the bankruptcy court explained that bankruptcy courts are courts of equity because reorganization of a debtor's financial affairs involves adjusting the relationship between a debtor and creditor — relief that is available in equity. As part of determining the debtor's entitlement to such equitable relief, courts must look to equitable facts surrounding the debtor — including whether it has clean hands when seeking relief from the court. The court held that the debtor's knowing engagement in conduct that violated the CSA justified the application of the clean-hands maxim to preclude the debtor from receiving the relief it hoped for. Moreover, because the debtor had unclean hands, cause existed to dismiss the case. Further, cause also existed to dismiss the case because continuing to maintain the offending leases exposed the debtor to criminal liability and to forfeiture of the real property that constituted gross mismanagement of the debtor's assets and estate.

Further, the court held that because the debtor's plan funding derived from an illegal activity, the plan was not proposed in good faith and by means not forbidden by law. Consequently, the debtor had no prospect of getting its plan confirmed. The court added that it could not place itself in a position of confirming a plan that relied on income derived from a criminal activity.

In In re Arm Ventures, a landlord that owned commercial property in Florida and leased it to its affiliates, one of which sold marijuana-based products, filed a Chapter 11 case.[14] The landlord's reorganization plan was funded by income from the leases. The court held that a plan that proposes to be funded through income generated by the sale of marijuana products cannot be confirmed unless the business is legal under both state law and federal law. Otherwise, such plan is not proposed in good faith. The court, however, did not dismiss the case. It instead gave the debtor an opportunity to file another plan that would not be funded with income generated by the sale of marijuana-based products.

In In re Arenas, individual debtors whose income included lease income from a state-licensed marijuana dispensary filed a Chapter 7 case.[15] One of the debtors was also a state-licensed grower. The court held that the Chapter 7 trustee could not take control of the debtor's real property or liquidate the inventory of marijuana plants that the debtor possessed because both would violate the CSA. As such, the court held that cause existed to dismiss the case.

In response, the debtors sought to convert the case to a case under Chapter 13. The bankruptcy court ruled, as have the other courts before it, that because the debtor's plan would have been funded from an activity illegal under the CSA — the growing and dispensing of medical marijuana and leasing premises to a grower — it would not be a plan proposed in good faith and by a means not forbidden by law. Moreover, because the debtors could not propose a plan that could be confirmed, the debtor's filing of the case was in bad faith and sufficient to dismiss the case. Since the debtors would not be able to confirm a plan under chapter 13 and the case would have to be dismissed, the debtors could not qualify to be debtors in a Chapter 13 case.

Similar to the debtor's dilemma in the Chapter 7 case, in a Chapter 13 case, the trustee would have to administer the plan's payments, which would in turn cause the trustee to violate the CSA. The court ultimately denied the debtor's request to convert the case, and instead dismissed the case.

In In re Wright, however, where the debtor, a marijuana cultivator in California, filed a Chapter 13 case first and then contemplated a conversion to a Chapter 7, the bankruptcy court did not preclude

the debtor at the outset from pursuing a Chapter 7 case.[16] Although the bankruptcy court did deny confirmation of the debtor's Chapter 13 plan on the grounds that it relied on activity forbidden by federal law, the court gave the debtor the option to pursue a Chapter 7 case. The court held that the mere fact that a trustee cannot liquidate the debtor's assets does not make the debtor ineligible for Chapter 7 relief.

Extension of Bankruptcy Relief Limitation to Other Businesses

In In re Medpoint Management,[17] a management company that managed an Arizona medical marijuana dispensary (which needed to operate as a nonprofit entity pursuant to the state marijuana statute) was put into Chapter 7 by its creditors. Prior to the bankruptcy filing, the management company managed the dispensary's marijuana business, business relationships and cultivation operations. The management company's assets included a brand name and a trademark under which the dispensary sold its marijuana assets. Although the management entity ceased managing the dispensary prior to the bankruptcy, it continued licensing the trademark to a subsidiary of the dispensary's new managing company.

Without deciding the issue, the bankruptcy court held that it was quite possible that the brand name and the revenue that the managing company received from licensing the trademark "could be or could have been seized or forfeited ... and that [the managing company] could be or could have been guilty of facilitation of a crime under the CSA ... under an accomplice theory of liability."

In addition, the court held that a Chapter 7 trustee administering the assets would be violating the CSA in carrying out his duties under the Bankruptcy Code. As such, the court held that the risk of forfeiture and the trustee's violation constituted cause to dismiss the case.

Conclusions and Considerations

The UST Program has taken the position that debtors whose assets and income are derived from marijuana are not entitled to bankruptcy relief. The UST Program has not elucidated the contours of a debtor with assets and income derived from marijuana, and to date, bankruptcy relief has been limited in the cases of cultivators, dispensaries, their landlords and licensors.

It is still too early to tell whether the UST Program's position will extend to ancillary businesses because there may be limits to the applicability of these bankruptcy courts' decisions and the decisions actually left some options open.

As an initial matter, each of the cases is fact-specific, and the bankruptcy courts' decisions are based on case-by-case determinations of the business' current assets, conduct in relation to the CSA, and operations moving forward.

One potential option that may leave open bankruptcy relief to ancillary business is if the business can propose a plan that is not funded through income from services or goods provided to marijuana businesses.[18] As such, it would behoove an ancillary business to not only provide its services solely to marijuana businesses, but to nonmarijuana businesses as well, as the success of this option would depend, at least in part, on the extent of the entity's services to nonmarijuana businesses and its ability to prove that its sources of income were segregated.

Another option that may not preclude bankruptcy relief is for the ancillary business to stop providing its services to the marijuana business.[19] Although this may limit the ancillary business' ability to reorganize, again depending on the extent of its nonmarijuana business endeavors, the entity may be able to liquidate under Chapter 7. Such liquidation may be beneficial if the ancillary business' principals issued personal guarantees and the liquidation of the business' assets will provide sufficient funds to reduce the obligation on the guarantee.

Moreover, there are state court options that marijuana businesses and ancillary businesses can pursue. This includes potentially utilizing receiverships and assignments for the benefit of creditors in debt management.[20]

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[1] Statement of Clifford J. White III, Director of the United States Trustees before the House Judiciary Committee's Subcommittee on Regulatory Reform, Commercial and Antitrust Law on June 8, 2017. https://www.justice.gov/ust/file/testimony06082017.pdf/download

The U.S. Trustee Program is part of the U.S. Department of Justice and oversees administration of bankruptcy cases. It appoints and oversees trustees in bankruptcy cases, monitors the conduct of bankruptcy parties, and ensures compliance with applicable laws and procedures in the cases. Moreover, the U.S. trustee can raise and be heard on any issue in any bankruptcy case. 11. U.S.C. § 307.

[2] 21 U.S.C. § 801, et seq. The CSA categorizes drugs into five schedules. Marijuana is classified under schedule 1.

[3] 21 U.S.C. § 841(a) (it is unlawful "for any person knowingly or intentionally — to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance").

[4] 21 U.S.C. § 856(a)(2) (it is unlawful to "manage or control any place, ... as an owner, ... and knowingly and intentionally rent, lease, profit from, or make available for use, with or without compensation, the place for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance").

[5] In re Medpoint Mgt. LLC, 528 B.R. 178 (Bankr. D. Ariz. 2015).

[6] Chapter 11 proceedings are also available to individual consumers reorganizing their financial affairs where their debt exceeds the threshold permitted under Chapter 13.

[7] 21 U.S.C. § 881(a)(6) ("All moneys, negotiable instruments ... or other things of value furnished ... in exchange for a controlled substance ..., all proceeds traceable to such an exchange, and all moneys, negotiable instruments, and securities used or intended to be used to facilitate any violation of [the CSA]" is subject to forfeiture and no property right shall exist in them).

[8] While typically no trustee is appointed in a Chapter 11 case, the U.S. trustee still oversees the case and the conduct of the parties involved in it.

[9] 21 U.S.C. § 881(a)(7) ("All real property ... which is used, or intended to be used, in any manner or part, to commit, or to facilitate the commission of, a violation of [the CSA] punishable by more than one year's imprisonment" is subject to forfeiture and no property right shall exist in them).

[10] In re McGinnis, 453 B.R. 770 (Bankr. D. Or. 2011).

[11] In re Johnson, 532 B.R. 53 (Bankr. W.D. Mich. 2015).

[12] In re Mother Earth's Alternative Healing Coop. Inc., Case No. 12-10223, Doc. No. 54 (Bankr. S.D. Cal. Oct. 23, 2012).

[13] In re Rent-Rite Super Kegs West Ltd., 484 B.R. 799 (Bankr. D. Colo. 2012).

[14] In re Arm Ventures LLC, 564 B.R. 77 (Bankr. S.D. Fla. 2017).

[15] In re Arenas, 535 B.R. 845 (10th Cir. B.A.P. 2015).

[16] In re Wright, Case No. 07-10375, Doc. No. 32 (N.D. Cal. Aug 3, 2007).

[17] In re Medpoint Mgt. LLC, 528 B.R. 178 (Bankr. D. Ariz. 2015).

[18] This was proposed by the bankruptcy court in In re Arm Ventures, although precluded by another bankruptcy court in In re Johnson.

[19] This was actually proposed by the bankruptcy court to the debtor in In re Johnson.

[20] Certain of these options are in turn dependent on the willingness of insurance and bonding companies to allowing receivers, for instance, to take on the risk associated with operating or providing services to a marijuana business.

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