

State-Legalized Marijuana Businesses and Access to the Bankruptcy Code

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A Practice Note discussing the federal statutory scheme governing marijuana, its tension with state laws governing marijuana businesses, and the ability or inability of marijuana-related businesses to access the relief provided under federal bankruptcy law. This Note also addresses the alternatives available to marijuana-related businesses and creditors when facing financial insolvency.

The industry for marijuana businesses and the associated opportunities for investment continue to expand as more states:

- Pass ballot initiatives decriminalizing and legalizing marijuana use.
- Enact state legislation and administrative rules and regulations.

However, as with any business venture there is always the risk of failure.

In most instances of insolvency, bankruptcy laws are available to debtors and creditors to provide relief and an opportunity to maximize value for the benefit of creditors, shareholders, and other stakeholders. However, state-legalized marijuana businesses in financial distress face obstacles in accessing the relief available to other businesses under the Bankruptcy Code. Marijuana businesses have been denied access to bankruptcy relief on the basis that, while permitted under the laws of various states, marijuana manufacture, distribution, and dispensing remain federal crimes under the Controlled Substances Act (CSA) (21 U.S.C. §§ 801-971). The inability to obtain bankruptcy relief is largely due to the fact that marijuana historically has been associated with criminal activity and is only now becoming legitimized by the states.

Against this background, this Note explores:

- The federal legal framework governing marijuana and its tension with new state laws.

- The current state of the bankruptcy law.
- The challenges marijuana businesses face when attempting to access the bankruptcy courts.
- Strategies and alternatives that can be considered by marijuana businesses and their creditors when facing insolvency.

FEDERAL LEGAL FRAMEWORK

THE CONTROLLED SUBSTANCES ACT

The CSA governs the manufacture, distribution, and dispensation of controlled substances in the US. A controlled substance is defined as “a drug or other substance, or immediate precursor, included in schedule I, II, III, IV, or V [of the CSA]... ” (21 U.S.C. § 802(6)). The CSA defines marijuana as “all parts of the plant *Cannabis sativa* L., whether growing or not,” its seeds, or resin, including the form of a compound, manufacture, salt, derivative, or mixture (21 U.S.C. § 802(16)). In 2018, the CSA was amended by the Agriculture Improvement Act of 2018, Public Law 115-334, to exclude hemp (PL 115-334 § 12619) and the tetrahydrocannabinols (THC) (PL 115-334 § 12608(b)) found in hemp from the definition of marijuana.

Marijuana and THC, the principal psychoactive constituent of marijuana, are Schedule I controlled substances under the CSA (21 U.S.C. § 812(c)), which are identified as substances that:

- Have a high potential for abuse.
- Have no currently accepted medical use in the US.
- Are not considered to be safe to use under medical supervision.

(21 U.S.C. § 812(b)(1).)

FEDERAL MARIJUANA ENFORCEMENT

The primary enforcement agency of the CSA is the Drug Enforcement Agency (DEA), a department within the Department of Justice (DOJ). Following the enactment of state laws decriminalizing or legalizing marijuana for medicinal or recreational use, the DOJ published guidance, in a series of memos, for its US Attorneys when considering the prosecution of a person that, while violating federal law, is otherwise compliant with state law. While recent DOJ actions rescinded much of the earlier guidance (see Sessions Memo - January 4, 2018), each memo states that it does not “alter in any way

[the DOJ's] authority to enforce federal law, including federal laws relating to marijuana, regardless of state law."

Ogden Memo - October 19, 2009

The Ogden Memo provides clarification and guidance to federal prosecutors in states that enacted laws authorizing the use of medical marijuana. The memo prioritizes prosecution of significant traffickers and disruption of illegal drug manufacturing and trafficking networks. The memo further emphasizes that federal prosecutors "should not focus federal resources in States on individuals whose actions are in clear and unambiguous compliance with existing state laws... ."

The memo contains a list of factors that indicate illegal drug trafficking activity, outside of the otherwise state-authorized use. These factors include:

- Unlawful possession or use of firearms.
- Violence.
- Sale to minors.
- Conditions inconsistent with state law, including evidence of money laundering or excessive financial gains.
- Amounts of marijuana inconsistent with compliance with state or local law.
- Illegal possession or sale of other controlled substances.
- Ties to criminal enterprises.

These factors and the Ogden Memo generally are intended to provide prosecutors with guidance on their investigative and prosecutorial discretion. (Memorandum from David W. Ogden, Deputy Attorney General, to Selected United States Attorneys on Investigations and Prosecutions in States Authorizing the Medical Use of Marijuana (Oct. 19, 2009).)

First Cole Memo - June 29, 2011

The First Cole Memo updates the Ogden Memo regarding enforcing the CSA in states and jurisdictions that implemented legislation regulating commercial cultivation of medical marijuana.

This memo clarifies that the DOJ never intended the Ogden Memo to shield private, large-scale, profitable marijuana cultivation centers from federal enforcement or prosecution, even when they are in compliance with state law. The First Cole Memo also clarifies that using federal resources to enforce the CSA against cancer patients or their caregivers may not be efficient. (Memorandum from James M. Cole, Deputy Attorney General, for United States Attorneys on Guidance Regarding the Ogden Memo in Jurisdictions Seeking to Authorize Marijuana for Medical Use (Jun. 29, 2011).)

Second Cole Memo - August 29, 2013

The Second Cole Memo further updates the Ogden Memo to address state initiatives to legalize the possession of small amounts of marijuana and to regulate its production and sale. The Second Cole Memo highlights eight specific enforcement priorities relating to noncompliance with other state laws, including preventing:

- The distribution of marijuana to minors.
- Marijuana sales revenue from being funneled to criminal enterprises, gangs, and cartels.

- The movement of marijuana from states in which use is legalized to states where it is not.
- State-authorized marijuana activity as a cover for illegal activity.
- Violence and the use of firearms in the cultivation and distribution of marijuana.
- Drugged driving and other adverse public health consequences associated with marijuana use.
- Growing marijuana on public lands and any environmental threat posed by that production.
- Marijuana possession or use on federal property.

The memo states that "conduct in compliance with [state laws and regulations] is less likely to threaten the federal priorities set forth... ." The memo specifies that it relies on state and local governments to enact laws relating to marijuana within the rubric of effective regulatory and enforcement systems to address any issues that pose a threat to public safety or health. (Memorandum from James M. Cole, Deputy Attorney General, to All United States Attorneys on Guidance Regarding Marijuana Enforcement (Aug. 29, 2013).)

Third Cole Memo - February 14, 2014

The Third Cole Memo links possible violations of the Bank Secrecy Act (31 USC §§ 5311-5332) and money laundering statutes to the enforcement priorities listed in the Second Cole Memo (see Practice Note, Bank Secrecy Act: Compliance Issues ([W-010-6003](#))). The Third Cole Memo points out that prosecution of a person for financial crimes associated with marijuana "does not require an underlying marijuana-related conviction under federal or state law." Published with corresponding Department of Treasury guidance (see Department of Treasury Financial Crimes Enforcement Network Guidance - February 14, 2014), the memo puts the onus on financial institutions to conduct due diligence to identify customer conduct in violation of the eight priority factors. Notably, the memo states that financial institutions that act "willfully blind" by failing to conduct appropriate due diligence are subject to potential prosecution. (Memorandum from James M. Cole, Deputy Attorney General, to All United States Attorneys on Guidance Regarding Marijuana Related Financial Crimes (Feb. 14, 2014).)

Department of Treasury Financial Crimes Enforcement Network Guidance - February 14, 2014

Concurrent with the publication of the Third Cole Memo, this Department of Treasury guidance outlines how financial institutions may provide services to state-legal marijuana-related businesses while maintaining compliance with the Bank Secrecy Act. This guidance lays out the due diligence requirements for financial institutions when considering whether a marijuana business implicates one of the enforcement priorities (see Second Cole Memo - August 29, 2013) or is in violation of state law. However, even though a financial institution may provide services to a marijuana-related business, it must file suspicious activity reports even when the institution "reasonably believes, based on its customer due diligence, [that the business] does not implicate one of the Cole Memo priorities or violate state law..." (Department of the Treasury Financial Crimes Enforcement Network, Guidance FIN-2014-G001 (Feb. 14, 2014)).

Sessions Memo - January 4, 2018

The Sessions Memo rescinds previous DOJ guidance on federal marijuana enforcement but does not rescind the Department of Treasury Guidance of February 14, 2014. It instead directs federal prosecutors “to weigh all relevant considerations, including federal law enforcement priorities set by the US Attorney General, the seriousness of the crime, the deterrent effect of criminal prosecution, and the cumulative impact of particular crimes on the community.” The Sessions Memo also directs federal prosecutors to use their investigative and prosecutorial discretion. (Memorandum from Jefferson B. Sessions III, Attorney General, to All United States Attorneys on Marijuana Enforcement (Jan. 4, 2018).)

LIMITED PERMITTED USES OF MARIJUANA UNDER FEDERAL LAW

As a matter of policy, there are several limited circumstances under which possession or use of marijuana use is permitted by:

- The DEA (see Permitted Uses by the DEA).
- The National Institute on Drug Abuse (see Permitted Uses by the NIDA).

Permitted Uses by the DEA

In a policy statement, the DEA stated that Schedule I controlled substances may only be used for legitimate medical, scientific, research, and industrial purposes. The DEA policy statement notes that “consistent with the purposes and structure of the CSA, persons who become registered to grow marijuana to supply researchers will only be authorized to supply DEA-registered researchers whose protocols have been determined ... to be scientifically meritorious.” (See Applications To Become Registered Under the Controlled Substances Act To Manufacture Marijuana To Supply Researchers in the United States, 81 Fed. Reg. 53846-01, 53848 (Aug. 12, 2016).)

Certain THC-derived drugs, such as dronabinol (a synthetic form of THC), are approved by the FDA and included in the CSA on different schedules. For example:

- Marinol (dronabinol), a drug intended to treat nausea associated with chemotherapy treatment and anorexia associated with weight loss in patients with AIDS, is listed as a Schedule III controlled substance.
- Syndros (dronabinol in the form of an oral solution), is listed as a Schedule II controlled substance.

(See US Department of Justice, Drug Enforcement Agency, Lists of Scheduling Actions Controlled Substances Regulated Chemicals, March 2018.)

Permitted Uses by the NIDA

Additionally, the NIDA supplies researchers with marijuana from its farm at the University of Mississippi in tightly controlled channels (see NIDA’s Role in Providing Marijuana for Research).

DRUG-INVOLVED PREMISES

The Illicit Drug Anti-Proliferation Act of 2003 (21 U.S.C. § 856) expanded the CSA’s so-called “crack-house statute” to include drug-involved premises. This expansion of the CSA made it unlawful to “manage or control any place, whether permanently or temporarily,

either as an owner, lessee, agent, employee, occupant, or mortgagee, and knowingly and intentionally rent, lease, profit from, or make available for the purpose of unlawfully manufacturing, storing, distributing, or using controlled substance” (21 U.S.C. § 856(a)(2)). Real property owners linked to unlawful activities with controlled substances are also subject to civil forfeiture (21 U.S.C. § 881(a)(7)). Though there was some concern that this expansion of the CSA was likely to cause certain business owners, such as concert promoters and event organizers, to be held personally accountable for the illegal acts of others, proponents of this change stated that the Anti-Proliferation Act was not intended to affect legitimate venues where there was incidental drug use at events. (See Illicit Drug Anti-Proliferation Act of 2003: A Summary of Opposing Viewpoints.)

CONFLICTS BETWEEN MARIJUANA BUSINESSES AND THE BANKRUPTCY CODE

Reorganization under any Chapter of the Bankruptcy Code has specific provisions that are implicated when a debtor engages, either directly or indirectly, in a state-legalized marijuana business. Critical to addressing marijuana based business failure is understanding how the provisions of the Bankruptcy Code conflict with the CSA and other federal laws regarding marijuana.

For overviews on reorganization under the various chapters of the Bankruptcy Code see:

- Practice Note, Bankruptcy: Overview of the Chapter 11 Process ([4-380-9186](#)).
- Practice Note, Individual Chapter 11 Bankruptcy: Overview ([W-008-8977](#)).
- Practice Note, Small Business Chapter 11 Case: Overview ([W-000-7094](#)).
- Practice Note, Chapter 7 Liquidation: Overview ([W-000-6231](#)).
- Comparison: Chapter 11 vs 12 vs 13: Checklist ([W-002-1928](#)).
- Practice Note, Municipal Bankruptcy: Using and Avoiding Chapter 9 in Times of Fiscal Stress ([W-001-4150](#)).

States have been decriminalizing marijuana since 1973, when Oregon decriminalized the use of non-medical marijuana. Currently, ten jurisdictions have enacted laws authorizing the use of marijuana for recreational purposes and 35 states either have enacted laws or have had ballot measures pass authorizing some form of marijuana use for medical purposes, subject to various conditions and requirements (see Practice Note, State Medical and Recreational Laws Chart: Overview ([7-523-7150](#))). As more states continue to pass laws decriminalizing or legalizing marijuana, investors are attempting to claim their share of this lucrative market. Some of the market participants are likely to fail and then seek protection under the Bankruptcy Code.

Because it remains a crime under federal law to possess or use marijuana, bankruptcy is not an option for the reorganization or liquidation of most failing marijuana businesses. Bankruptcy courts have almost been universally opposed to granting access to those businesses operating in, or around, marijuana. Underlying the courts’ decisions is the tension between state laws legalizing or decriminalizing marijuana and the CSA’s treatment of marijuana and THC as Schedule I controlled substances.

The Office of the US Trustee has taken the position, in Congressional testimony given in June 2017 and most recently in a paper issued in December 2017 (see *Why Marijuana Assets May Not Be Administered in Bankruptcy*), that a marijuana business cannot seek federal bankruptcy relief because the business itself violates the CSA, despite any state licenses permitting the operation of the marijuana business.

The specific treatment of marijuana businesses in bankruptcy may differ depending on whether the debtor:

- Is directly engaged in marijuana businesses, such as cultivators and dispensaries (see *Cultivators and Dispensaries*).
- Provides ancillary services to marijuana businesses, such as commercial landlords (see *Ancillary Services*).

Marijuana businesses have also attempted to use the Bankruptcy Code defensively to avoid bankruptcy proceedings (see *Using Bankruptcy Defensively*).

CULTIVATORS AND DISPENSARIES

The courts' rationale in denying marijuana businesses access to bankruptcy reorganization or liquidation is perhaps most easily understood in those cases involving either individuals or companies directly engaged in the cultivation and sale of marijuana. These cases are a small but representative sample of cases where the courts have prevented those directly engaged in marijuana businesses from availing themselves of the Bankruptcy Code's protections. As the caselaw suggests, those individuals and companies directly engaged in the cultivation and sale of marijuana are precluded from seeking relief as a debtor under the Bankruptcy Code.

Arenas v. United States Trustee (In re Arenas)

In *Arenas*, one debtor was licensed in Colorado to grow and dispense medical marijuana and both debtors leased a building to third parties that dispensed medical marijuana from the building (535 B.R. 845 (10th Cir. B.A.P. 2015)). The debtors originally filed under Chapter 7, but later sought to convert their cases to Chapter 13. The US Trustee objected to the conversion and argued instead that the cases should be dismissed for cause under section 707(a) of the Bankruptcy Code. The bankruptcy court denied the conversion motion and held that cause existed to dismiss the cases because the debtors were engaging in federal criminal conduct by continuing to violate of the CSA.

On appeal, the Bankruptcy Appellate Panel affirmed the bankruptcy court's denial of the conversion motion, holding that the debtors were unable to propose a Chapter 13 plan in good faith because:

- To be feasible, the plan had to be funded with rental income generated by the marijuana dispensary which was operating in violation of the CSA.
- The Chapter 13 trustee cannot administer the plan without committing federal crimes (making payments to creditors from the rental income generated by the illegal activity).
- The debtors were unable to propose a confirmable plan because seeking relief under Chapter 13 is not fair given that the debtors then obtain a discharge, but the Chapter 13 Trustee cannot pay claims with funds generated from illegal activity (535 B.R. 845, 852-53).

The court in *In re Mother Earth's Alternative Healing Cooperative, Inc.*, Case No. 12-10223-LT11, Dkt. No. 54 (Bankr. S.D. Cal. Oct. 23, 2012) came to a similar result and dismissed a Chapter 11 case filed by a state-legalized marijuana grower because the debtor could not file a plan that complied with both Bankruptcy Code section:

- 1129(a)(3)'s requirement that the plan be proposed in good faith and not by means forbidden by law.
- 1129(a)(11)'s requirement that the plan be feasible.

In re Wright

The analysis of fairness by the court in *Arenas* is at odds with the decision in *In re Wright*, Case No. 07-10375, Dkt. No. 32 (Bankr. N.D. Cal. August 3, 2007). In *Wright*, the debtors grew marijuana for sale to medical clinics under California law. The bankruptcy court held that the debtors were not eligible for Chapter 13 because they were unable to comply with section 1326(a)(3) of the Bankruptcy Code and propose a plan in good faith and not by any means forbidden by law because their marijuana business violated the CSA.

The court rejected the US Trustee's argument that Chapter 7 was unavailable to the debtors as "flawed and premature," stating:

"The mere fact that a trustee cannot liquidate the debtor's assets does not make the debtor ineligible for Chapter 7 relief... [I]n an individual Chapter 7 case there are two purposes: liquidation of an estate and discharge of a debtor. The ability to liquidate an estate is not a prerequisite to a discharge. In any event, this discussion is moot until and unless the debtors seek relief in Chapter 7."

In light of the court's reasoning, the debtors later filed a notice converting their cases to Chapter 7 and no objection was filed by the US Trustee or any other party in interest. *Wright* therefore is at odds with the decision in *Arenas*, particularly regarding the availability of Chapter 7 for individual debtors engaged in state-legalized marijuana cultivation. *Wright*, however, is an outlier case. The majority of courts do not allow individuals directly engaged in marijuana businesses to access Chapter 7.

The question of whether a marijuana business that is no longer operating is permitted to access Chapter 7 to liquidate its assets remains unanswered. Allowing a Chapter 7 debtor to proceed in these circumstances benefits creditors because a Chapter 7 trustee can then be charged with maximizing the value of the assets and making a distribution to creditors.

In re Johnson

In *In re Johnson*, the Chapter 13 debtor held a license as a marijuana grower under the Michigan Medical Marihuana Act (MMA) (532 B.R. 53 (Bankr. W.D. Mich. 2015)). In that case, the debtor had income from both Social Security benefits and proceeds from the debtor's marijuana business. The debtor intended to fund his Chapter 13 plan using Social Security benefits that he would segregate from the proceeds of his marijuana business. The US Trustee filed a motion to dismiss, arguing that because the debtor was involved in a marijuana business, allowing the debtor to benefit from the protections of the Bankruptcy Code is a violation of the CSA.

The bankruptcy court held that the debtor's proposed segregation of funds did not cure the legal defects with the debtor's case and the debtor was not permitted to use estate property in violation of federal criminal law. The court also expressed concern that the debtor was improperly asking the court's acquiescence to permit the continuous operation of the debtor's marijuana business because section 1304(b) of the Bankruptcy Code gives the court authority to order a Chapter 13 debtor to discontinue his or her business operations.

The court's refusal to automatically dismiss the case is notable. The court instead gave the debtor a choice of whether to either continue his medical marijuana business or obtain relief under the Bankruptcy Code.

ANCILLARY SERVICES

The US Trustee has taken the position that those leasing commercial space to state-legalized marijuana businesses are generally precluded from accessing the bankruptcy courts. Underlying this position is the fact that the CSA makes no distinction between a seller or grower of marijuana and those renting space to the seller or grower.

Arm Ventures

In *Arm Ventures, LLC*, the debtor owned a commercial building in Miami Beach that it leased to multiple tenants (564 B.R. 77 (Bankr. S.D. Fla. 2017)). One of the tenants had applied for state and federal approval to cultivate and sell medical marijuana, but its applications had not yet been granted. The debtor proposed a Chapter 11 plan that relied on income generated from its tenants, including the tenant that intended to sell medical marijuana.

The court held that the plan was unconfirmable because plans proposed to be funded from income generated by the sale of marijuana cannot be confirmed unless the business is legal under both state and federal law (*Arm Ventures, LLC*, 564 B.R. at 84). Because the federal government has only ever given one approval, to the University of Mississippi, to grow, harvest, and store marijuana for researchers, the court found that the plan was not feasible under section 1129(a)(11) of the Bankruptcy Code. The bankruptcy court also found that the plan was not filed in good faith, as required by section 1129(a)(3) of the Bankruptcy Code, because "the very fact that the [plan] is based on income derived from the sale of marijuana can be deemed 'bad faith.'" However, because there were significant non-insider unsecured claims, the court declined to dismiss the case, opting instead to grant the secured lender's motion for stay relief to allow it to foreclose on the commercial building.

In re Rent-Rite Super Kegs West

In *In re Rent-Rite Super Kegs West Ltd.*, the debtor owned a warehouse and approximately 25% of its revenue was derived from tenants engaged in state-legalized marijuana cultivation (484 B.R. 799 (Bankr. D. Colo. 2012)). A creditor with a deed on the warehouse, VFC Partners (VFC), sought dismissal of the bankruptcy case arguing that the debtor was barred from seeking relief under the unclean hands doctrine and because the bankruptcy case was filed in bad faith.

The bankruptcy court held that the debtor was engaged in an ongoing criminal violation of the CSA by virtue of leasing space for

the cultivation of marijuana and this placed VFC's collateral at risk of forfeiture (*Rent-Rite*, 484 B.R. at 803-04). The debtor's conduct, therefore, justified the application of the unclean hands doctrine:

"The Debtor has knowingly and intentionally engaged in conduct that constitutes a violation of federal criminal law and it has done so with respect to its sole income producing asset. Worse yet, every day that the Debtor continues under the Court's protection is another day that VFC's collateral remains at risk."

(*Rent-Rite*, 484 B.R. at 807.)

The court held that the debtor's actions constituted "gross mismanagement of the estate" for purposes of section 1112(b) of the Bankruptcy Code and that the debtor's "continued criminal activity satisfies the requirement of 'cause' under § 1112(b) and requires dismissal or conversion of this chapter 11 bankruptcy case" (*Rent-Rite*, 484 B.R. at 809). Also underlying the dismissal of the case was the court's position that the debtor cannot propose a plan because section 1129(a)(3) of the Bankruptcy Code prohibits confirmation of a plan that relies in any part on income derived from criminal activity.

In re Basrah Custom Design, Inc. and Garvin v. Cook Investments

In *In re Basrah Custom Design, Inc.* 600 B.R. 368 (Bankr. E.D. Mich. 2019), the bankruptcy court held that since the purpose of the bankruptcy case was to allow the debtor's principal to either lease commercial space to a marijuana grower or to enter into the marijuana growing business itself, both in violation of the CSA, the debtor had unclean hands. Therefore, the bankruptcy court dismissed the debtor's case for cause under section 1112(b) of the Bankruptcy Code.

The *Basrah* court rejected the Ninth Circuit's narrow interpretation of section 1129(a)(3) of the Bankruptcy Code in *Garvin v. Cook Investments NW, SPNWX, LLC*, 922 F.3d 1031 (9th Cir. 2019). In *Garvin*, the Ninth Circuit held that section 1129(a)(3) of the Bankruptcy Code forbids confirmation of a plan that is proposed in an unlawful manner, but does not forbid confirmation of a plan that has substantive provisions that depend on illegality. Under section 1129(a)(3), therefore, the court would only need to look at the proposal of a plan and not the terms of the plan, to determine whether the plan can be confirmed.

Though the *Basrah* decision does not overrule the *Garvin* decision, the *Basrah* decision indicates that whatever gains the cannabis industry made in *Garvin* are likely to be scaled back, at least outside of the Ninth Circuit. Going forward, the US Trustee will certainly continue to aggressively seek dismissal of cannabis bankruptcies for cause under section 1112(b) of the Bankruptcy Code. The *Basrah* decision is also a reminder that cannabis businesses may be precluded from seeking relief in a bankruptcy case filed by a non-cannabis business counterparty, if that relief would assist them in their cannabis business in violation of the CSA.

In re: Way to Grow, Inc.

In *In re Way To Grow, Inc.*, Case No. 18-14330-MER, Dkt. No. 379 (Bankr. D. Co. Dec. 14, 2018), the debtors, who sold indoor hydroponic and gardening supplies, had business expansion plans tied to the cannabis industry, although the debtors also had customers using their products to grow other crops. A secured

creditor moved to dismiss the debtors' cases, arguing that the debtors should be barred from seeking bankruptcy relief because their business violated the CSA.

The bankruptcy court found that the debtors were indirectly violating Section 843(a)(7) of the CSA, which makes it a federal crime to "manufacture" or "distribute" any "equipment, chemical, product or material which may be used to manufacture a controlled substance ... knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance." While the debtors' sale of hydroponic equipment did not evidence a specific intent to assist their customers in violating the CSA because the debtors were not selling exclusively to customers in the marijuana industry, there was substantial evidence that the debtors had cause to believe that the equipment they sold would be used, by at least some of their customers, to manufacture marijuana, in violation of the CSA. Significantly, the court found that the "Debtors tailor their business to cater to [the needs of customers who have intent to violate the CSA], tout their expertise in doing so, and market themselves consistent with their knowledge." Additionally, the debtors' business was so tied to the marijuana industry that if the debtors were to eliminate their marijuana-related income in order to cure the ongoing violations of the CSA, it "would be devastating to the Debtors." The court found that it had no alternative but to dismiss the bankruptcy cases.

Here, the debtors did not grow or distribute marijuana, and did not lease space where the marijuana was produced or processed. Instead, the debtors sold equipment that was used to both grow marijuana as permitted under state law, as well as other crops. This case puts those who derive income from the sale of product used by marijuana businesses at significant risk of being precluded from access to the bankruptcy courts.

USING THE BANKRUPTCY CODE DEFENSIVELY

In re Medpoint Mgmt.

In certain cases, exclusion from bankruptcy may be preferable for marijuana businesses. In *In re Medpoint*, three creditors filed an involuntary Chapter 7 case against Medpoint, a business the sole income consisted of fees from a trademark licensed to a medical marijuana dispensary (*In re Medpoint Mgmt.*, 528 B.R. 178 (Bankr. D. Ariz. 2015)). Medpoint moved to dismiss the involuntary case arguing it was not eligible for bankruptcy because:

- The Chapter 7 trustee would be unable to administer estate assets without violating the CSA.
- The three petitioning creditors had unclean hands due to their own involvement in a medical marijuana enterprise.

The bankruptcy court dismissed the involuntary bankruptcy, agreeing that it was not permitted to require a Chapter 7 trustee to administer assets that were obtained in violation of the CSA.

The court also held that the petitioning creditors were barred from instituting the involuntary petition under the unclean hands doctrine. All three of the creditors had contracted with or loaned funds to Medpoint. The court found that the creditors knew or should have known that the nature of Medpoint's business was illegal under federal law. Therefore, the creditors were unable to seek relief from the bankruptcy court. *Medpoint* is a rare case because

a marijuana-related business asserted its violation of the CSA defensively, in an effort to avoid bankruptcy.

For more information on involuntary bankruptcy, see Practice Note, *The Involuntary Bankruptcy Process* ([0-522-5462](#)).

Northbay Wellness Group, Inc. v. Beyries

Also of interest is the Ninth Circuit Court of Appeals' decision in *Northbay Wellness Group, Inc. v. Beyries* (789 F.3d 956 (2015)). In *Northbay*, the debtor was the former attorney for a medical marijuana dispensary. The dispensary filed an adversary action against the debtor, alleging that its claim against the attorney for misappropriation of trust funds was non-dischargeable under section 523 of the Bankruptcy Code. The bankruptcy court held that while this claim is ordinarily non-dischargeable, the doctrine of unclean hands precluded judgment for the dispensary because the dispensary created the funds using the proceeds from marijuana sales.

On appeal, the US Court of Appeals for the Ninth Circuit reversed, ruling that the doctrine of unclean hands:

- Requires balancing the alleged wrongdoing of the plaintiff against that of the defendant.
- Necessitates weighing the substance of the right asserted by the plaintiff against the transgression, which is alleged to have foreclosed that right.
- Cannot be enforced when to do so frustrates a substantial public interest.

The Ninth Circuit held that if the bankruptcy court properly applied these principles to the case at hand, it was likely to have concluded that the attorney's wrongdoing outweighed Northbay's wrongdoing, regarding both harm caused to one another and harm caused to the public.

In *Northbay*, for the first time, a circuit court held that a party engaged in state-legalized marijuana business is not *per se* precluded from accessing the bankruptcy courts. Notably, however,, the debtor in *Northbay* was not the marijuana business and the wrongdoing of the debtor was egregious.

STRATEGIES AND ALTERNATIVES FOR MARIJUANA BUSINESSES AND CREDITORS

Case law continues to evolve as bankruptcy courts grapple with marijuana business insolvency issues. Open questions include whether:

- The US Trustee's concerns about using bankruptcy relief to aid in the bankruptcy of a marijuana business are mitigated or alleviated altogether if a particular case:
 - does not involve an operating business; or
 - does not involve a debtor entitled to a discharge, such as a Chapter 7 liquidation case commenced by a corporate debtor.
- Creditors should be denied the benefits of a bankruptcy proceeding that:
 - maximizes value;
 - aids in a transparent liquidation; and
 - provides distributions to creditors.

If bankruptcy relief is not available, debtors and creditors engaged in a marijuana business operating under state law may resort to state law remedies and non-bankruptcy liquidation proceedings. These alternatives can include:

- Statutory and common law receiverships (see Practice Note, Corporate Receiverships: Overview ([W-013-1951](#))).
- Assignments for the benefit of creditors (see Practice Note, Assignments for the Benefit of Creditors: Overview ([W-006-7771](#))).
- Procedures for winding up the affairs of a corporation under state statute.
- Remedies available to secured creditors under the Uniform Commercial Code (see Practice Note, UCC Article 9 Secured Party Sales ([W-008-7326](#))).
- Remedies available to mortgage holders under applicable state law.

While these alternatives do not provide for an automatic stay, the ability to obtain a discharge or other rights, powers, and remedies available exclusively to a debtor under bankruptcy law, they do provide effective forms of relief and, in many instances, can be less expensive and take less time to undertake than a bankruptcy case.

For more information on the importance of the automatic stay in bankruptcy, see Practice Note, Automatic Stay: Overview ([9-380-7953](#)).

It is also important to keep in mind that, in typical out-of-court workouts, the ability to file a bankruptcy case at any time during the process gives the debtor significant leverage in negotiating the best outcome for itself and its creditors. However, without the ability of a company engaged in the marijuana business to access the bankruptcy courts, creditors hold more leverage at the bargaining table and marijuana business debtors must plan accordingly.

For more information about out-of-court restructurings, see Practice Note, Out-of-Court Restructurings: Overview ([9-502-9447](#)).

RECEIVERSHIPS

There is at least one recently reported case of a receivership in the context of a marijuana business (see *Yates v. Hartman*, 2018 WL 1247615 (CO Ct. App. March 8, 2018)). At issue in *Yates* was the dissolution of a marriage and a request for the appointment of a receiver over marital property, including over a group of marijuana businesses, which involved several licensed medical and recreational marijuana entities. The question arose regarding the court's authority to appoint a receiver not licensed to operate a marijuana business under Colorado's Medical Marijuana Code and Retail Marijuana Code. There was no dispute that a court has the equitable power to appoint a receiver, only whether these appointments must comply with marijuana licensing laws.

The court held that "although courts have the equitable power to appoint receivers, they must make these appointments in compliance with the marijuana licensing laws enacted by the General Assembly."

Receivers have also been appointed in recent state court cases, although those court decisions are not reported.

STATE LAW REMEDIES

The state law remedies afforded to secured creditors relating to defaults by typical business owners are also available for dealing with a marijuana business borrower in financial distress. For example:

- Mortgage holders can foreclose on their mortgages and exercise their available rights and remedies.
- Creditors holding security interests in personal property can exercise the rights and remedies under Article 9 of the Uniform Commercial Code as adopted in their jurisdiction (see Practice Note, UCC Article 9 Secured Party Sales ([W-008-7326](#))).

Every circumstance involving a borrower in distress must be carefully analyzed. A strategic plan for maximizing value and paying creditors must be developed and implemented in consultation with attorneys and other advisors. State law still imposes fiduciary duties on officers and directors of a licensed marijuana business, including duties of care and loyalty. When a company becomes insolvent, creditors become the beneficiaries of those fiduciary duties. These creditors must then keep close watch on how their respective borrowers intend to proceed in the absence of access to federal bankruptcy courts.

PUBLIC POLICY CONCERNS

Without access to bankruptcy relief, marijuana business and their creditors have lost a powerful tool in responding to financial distress. This raises various public policy questions regarding the treatment of marijuana businesses, including whether:

- State licensed marijuana businesses, creditors, and other stakeholders should be deprived of the benefits of bankruptcy relief when the underlying business is fully licensed and in compliance with state laws, rules, and regulations.
- It is in the public's interest to aid in the legal operation of marijuana businesses under state law, rather than have the industry continue to remain within the criminal realm.
- Depriving marijuana businesses of access to bankruptcy relief that is otherwise available to every other legally operated business stifles the public interest.

Because these policy issues are likely to continue to evolve over time, parties should carefully consider the full collection of state law remedies and tools that are available until then.

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