Bankruptcy Courts Remain Inaccessible To Cannabis Cos.

By **Mark Salzberg** (January 7, 2020)

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Courts struggled last year to find a balance between state-licensed cannabis activity and the federal right to seek bankruptcy protection under the Bankruptcy Code. During 2019, we had the first circuit-level opinion in the bankruptcy/cannabis space that appeared to open the door to bankruptcy courts, albeit slightly. We also had lower court opinions slamming that door shut.

Below, we look at a few of the most important decisions issued throughout 2019 and analyze the current state of the law.

The Ninth Circuit's Garvin Decision

On May 2, 2019, the U.S. Court of Appeals for the Ninth Circuit issued its decision in Garvin v. Cook Investments NW.[1] In this case, the U.S. Trustee Program appealed confirmation of a plan of reorganization under which one of the debtors leased property to a marijuana grower licensed under Washington law.

The trustee argued that the plan should not have been confirmed because it was not "proposed in good faith and not by any means forbidden by law," as required by Section 1129(a)(3) of the Bankruptcy Code, because the lease to the grower violated the Controlled Substances Act.

The bankruptcy court rejected the trustee's arguments and confirmed the plan. On appeal, the district court affirmed the bankruptcy court's holding, and the trustee appealed to the Ninth Circuit.

The Ninth Circuit affirmed the lower courts, holding that Section 1129(a)(3) 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. In other words, Section 1129(0(3) requires the court only to look at the proposal of a plan and not the terms of the plan. Because there was nothing in the proposal of the plan at issue that was unlawful, the Ninth Circuit affirmed the orders of the district court and bankruptcy court confirming the plan.

At first blush, the Garvin opinion appears to open the door to cannabis bankruptcy filings. However, upon close examination of the facts, the ruling is not a complete victory for the cannabis industry. Most importantly, the trustee failed to renew its motion to dismiss the debtors' bankruptcy cases for gross mismanagement under Section 1112(b) of the Bankruptcy Code, and the Ninth Circuit held that the trustee had therefore waived this argument.

If this motion had been properly brought it is possible, if not likely, that the bankruptcy cases would have been dismissed. The trustee is not likely to make that mistake again, and will certainly file motions to dismiss in any cannabis case. Moreover, the Ninth Circuit made clear that confirmation of a plan does not insulate a debtor from prosecution for criminal activity, even if that criminal activity is part of the plan itself. Thus, while the Garvin opinion provides some comfort to cannabis companies, it does not cure the tension that exists between state law legalizing cannabis and the CSA.

The Garvin Decision Is Criticized by Two District Courts

It did not take long for the Garvin decision to be attacked. Most recently, the U.S. District Court for the District of Colorado questioned the holding in Garvin in its decision In re Way to Grow Inc.[2]

In Way to Grow, the debtors sold indoor hydroponic and gardening-related supplies. Although the debtors' expansion plans were tied to the cannabis industry, the debtors also sold their products to customers that used the hydroponic products to grow inoffensive crops. A secured creditor moved to dismiss the cases, arguing that the debtors should be barred from bankruptcy relief because their business violated the CSA.

The bankruptcy court found that the debtors were 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."

The bankruptcy court pointed to substantial evidence that established that the debtors had reasonable cause to believe that the equipment and product they sold would be used, by at least some of their customers, to manufacture marijuana. On this basis, the bankruptcy court dismissed the cases for-cause under Section 1112(b) of the Bankruptcy Code.

On appeal, the district court framed the issues before it as (1) the availability of bankruptcy protection to debtors that depend on the marijuana business, and (2) whether the debtors in the case before it ran such a business. As to the first issue, the district court held that a debtor cannot propose a good-faith reorganization plan that relies on profits generated from marijuana. The court then held that the inability to propose a good faith plan is cause for dismissal under Section 1112(b).

The district court questioned the Ninth Circuit's narrow interpretation of Section 1129(a)(3), but ultimately avoided opining on what it means for a plan to be "proposed ... not by any means forbidden by law" by grounding its holding on Section 1129(0(3)'s requirement that a plan be "proposed in good faith." Here, the district court held that because the plan relied on profits generated by the cannabis business, the plan could not be proposed in good faith.

The Way to Grow decision followed the decision the U.S. Bankruptcy Court for the Eastern District of Michigan made In re Basrah Custom Design Inc.,[3] dismissing the debtor's case for cause under Section 1112(b). The bankruptcy court held that the debtor had unclean hands, since the purpose of the bankruptcy case was to allow the debtor's principal to either lease commercial space to a marijuana grower or enter into the marijuana growing business himself, all in violation of the CSA.

The ultimate holding of Bashrah was not surprising since most courts have dismissed cannabis company bankruptcy cases utilizing the same rationale. What was surprising was the length to which the bankruptcy court went to criticize the Garvin court's interpretation of Section 1129(a)(3). After all, the issue of good faith under Section 1129(0(3) was not before the bankruptcy court. Nonetheless, the court felt compelled to address Garvin in a footnote, stating:

> The decision of the Ninth Circuit Court of Appeals in Garvin is not binding on this Court, and, with respect, this Court does not necessarily agree with the Garvin court's holding

> about § 1129(a)(3). And, respectfully, one might reasonably question whether the Garvin court should have refused to decide the § 1112(b) dismissal issue. That refusal, on waiver grounds, arguably is questionable, because it allowed the affirmance, by a federal court, of the confirmation of a Chapter 11 plan under which a debtor would continue to violate federal/criminal law under the CSA.

Also troubling to cannabis companies, and those doing business with them, is the bankruptcy court's consideration of whether the case should be dismissed or converted. The bankruptcy court held that conversion would serve no purpose since it would likely lead to a stay relief motion being brought by MJCC 8 Mile LLC, a state-licensed cannabis company, seeking possession of the commercial property where MJCC was operating its business. The court noted that such a motion was untenable given that the court would be in essence sanctioning MJCC's violation of the CSA:

> In this case, the Court likely would have to refuse to grant any stay relief, or any other relief, requested by MJCC, because MJCC also has unclean hands. The granting of stay relief to MJCC obviously would assist MJCC in its efforts to open and operate a medical marijuana dispensary, in violation of federal law. Just as a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime, neither can a federal court be asked to enforce any creditor protections under the Bankruptcy Code, such as the relief-from-stay provisions of 11 U.S.C. § 362(d), in aid of a creditor's commission of a federal crime.

Way to Grow and Basrah were certainly wakeup calls to the cannabis industry, especially after the seemingly positive ruling in Garvin. Not only does a for-cause dismissal remain a distinct possibility (or probability), but Basrah is a sign that those in the cannabis industry may be precluded from seeking any relief in a bankruptcy case filed by a business counterparty if that relief would assist them in their cannabis businesses in violation of the CSA.

Individual Cannabis Cases

Garvin and Way to Grow dealt with business debtors whose income was, in whole or in part, derived from legal marijuana businesses. Basrah dealt with a business whose principal owned, through a separate company, a building that was leased to a dispensary. What about an individual who uses some of his or her income to legally purchase marijuana and who also needs bankruptcy protection? Are they similarly blocked from bankruptcy?

On July 25, 2019, the U.S. Bankruptcy Court for the District of Colorado issued its decision In re Andrick.[4] The debtors in Andrick were a husband and wife who filed bankruptcy petitions under Chapter 13 of the Bankruptcy Code. Chapter 13 allows individuals with regular income to propose a plan to repay all or a part of their debts. As part of the Chapter 13 process, the debtors had to disclose their current monthly income and a calculation of their disposable income.

In their disposable income calculations, the debtors disclosed that they spent $900 per month on medical marijuana. Claiming a special circumstances deduction for the medical marijuana, the debtors' plan provided for a distribution to unsecured creditors of approximately 38%. If the deduction for medical marijuana was disallowed, meaning that the $900 monthly allowance for medical marijuana would be counted as disposable income that could be distributed to creditors, unsecured creditors would receive close to a 100%

distribution under the plan.

The U.S. Trustee objected to the debtors' plan, arguing in relevant part, that even though medical marijuana is legal in Colorado, the purchase of medical marijuana violated federal law, and that the proposed plan improperly required the court to authorize the use of post-petition income for the purchase of illegal drugs. According to the trustee, because the proposed plan failed to provide for payment of all disposable income, the plan could not be confirmed.

The debtors' response was long on empathy but short on legal argument. The debtors argued that the wife "suffers from a chronic and severely painful medical condition for which marijuana is the only effective remedy" and that she only uses marijuana for pain control and not for recreation. The debtors argued that because medical marijuana is legal in Colorado and the wife holds a valid license to use medical marijuana, the claimed special circumstances is permissible.

The bankruptcy court rejected the debtors' argument. Citing to U.S. Supreme Court precedent, the court rejected the argument that marijuana use for medical purposes creates an exception to the application of the CSA. Without any such exception, the debtors' use of medical marijuana, though legal under Colorado law, remained illegal under federal law, and therefore the "deduction of a medical marijuana expense cannot be allowed as either an ongoing out-of-pocket medical expense or as a deduction for special circumstances." Because the debtors' plan did not contribute all of their projected disposable income, the court denied confirmation of the debtors' plan.

The court's holding in Andrick was not surprising and is consistent with other courts that have dismissed cases, or rejected plans, filed by debtors whose incomes came, in whole or in part, from legal marijuana businesses. However, what is troubling about Andrick is the predicament the court's holding creates for people who need bankruptcy protection and who also use medical marijuana. Many financially strapped individuals have too much income to qualify for Chapter 7, and are forced to file under Chapter 13.

Under Chapter 13, these debtors need to pay all disposable income to their creditors for the duration of the plan. Without having the ability to deduct the cost of medical marijuana from their disposable income, these debtors will likely be unable to afford what to many is a legitimate medical product. It becomes an untenable choice: Do I file bankruptcy to get relief from my creditors and obtain a fresh start, or do I continue being able to purchase medical marijuana? This could lead individuals to forsake bankruptcy relief for the relief afforded by medical marijuana.

Where Are We Now?

In short, the bankruptcy courts remain off-limits to companies that operate in the cannabis space. This relegates struggling cannabis companies to other forms of relief, primarily assignments for the benefit of creditors under state law and state law receiverships.

However, neither of these provide cannabis companies the ability to restructure or to maximize value through a free-and-clear sale under Section 363 of the Bankruptcy Code. Instead, these remedial provisions lead inextricably to liquidation of the struggling company, an outcome that may not be in the best interests of the company or its creditors.

While bankruptcy may be unavailable to domestic cannabis companies, the availability of bankruptcy relief for cross-border insolvencies has not, to date, been tested. For instance,

the legal cannabis industry in Canada under stress for many reasons, including a black market for cheaper cannabis. Many Canadian cannabis companies also have operations and assets in the U.S.

Typically, a distressed Canadian company with U.S. assets would begin an insolvency proceeding in Canada and then file a petition under Chapter 15 of the Bankruptcy Code in an American bankruptcy court, seeking recognition of the Canadian proceeding to administer its operations and assets in the U.S.

However, any Chapter 15 filing by a Canadian cannabis company is certain to elicit a motion to dismiss from the U.S. Trustee. Furthermore, it remains an open question whether the public policy exception under Section 1506 of the Bankruptcy Code would provide support for the motion to dismiss. Section 1506 provides that "[n]othing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States."

Compelling arguments can be made for a narrow interpretation of Section 1506 and that recognition of the Canadian proceeding is an appropriate exercise of international comity. This issue is very likely to be addressed in the near future, as the Canadian cannabis market restructures.

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[1] Garvin v. Cook Investments, NW, SPNYW, LW, 922 F.3d 1031 (9th Cir. 2019). (http://cdn.ca9.uscourts.gov/datastore/opinions/2019/05/02/18-35119.pdf).

[2] In re Way to Grow, Inc., 2019 U.S. Dist. LEXIS 207846 (D. Colo. Sept. 18, 2019). (https://www.esquireglobalcrossings.com/wp-content/uploads/sites/21/2019/10/Order-Affirming-Bankruptcy-Court-Decision.pdf).

[3] In re Basrah Custom Design, Inc., 600 B.R. 368 (Bankr. E.D. Mich. 2019) (https://www.esquireglobalcrossings.com/wp-content/uploads/sites/21/2019/06/Basrah-Opinion.pdf).

[4] In re Andrick, 604 B.R. 577 (Bania. D. Colo. 2019) (https://www.esquireglobalcrossings.com/wp-content/uploads/sites/21/2019/09/Andrick-Order.pdf).