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UP IN SMOKE: BANKRUPTCY AND CANNABIS

*Peter C. Alexander**

I. INTRODUCTION

The cannabis industry is poised for enormous growth in the United States. With medical marijuana legal in forty-seven states and the recreational use of marijuana legal in eleven states,¹ a number of businesses have been created to participate in this burgeoning economic sector. While many businesses hope for success, it is inevitable that some cannabis-related entities will suffer financial hardships, and some could find themselves in need of bankruptcy protection. Unfortunately, the U. S. Bankruptcy Code² (“the Code”) may not be available for many needing the fresh start that bankruptcy offers. This article examines the limitations that federal law imposes on debtors seeking bankruptcy relief and opines that those restrictions will have to soon disappear, or at least be relaxed, to allow participants in the cannabis industry to receive the benefits that bankruptcy is designed to afford.

II. CONTROLLED SUBSTANCES ACT

The Controlled Substances Act of 1970³ (CSA) is a federal law that places all substances which had been regulated in one fashion or another into one of five schedules.⁴ The placement scheme “is based upon the substance’s medical use, potential for abuse, and safety or dependence liability.”⁵ Cannabis is currently a Schedule I controlled substance,⁶ and it is listed among a group of drugs that includes heroin and morphine.⁷ Catego-

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1. *Marijuana Laws By State in 2020: A Legal Weed Map and Short Guide to Regulation*, O.BERK, <https://www.oberk.com/marijuanalawsbystatein2020> (last updated Aug. 1, 2019).

2. 11 U.S.C. §§ 101 *et seq.* (2018).

3. 21 U.S.C. §§ 801–971 (2018).

4. U.S. DRUG ENFORCEMENT ADMINISTRATION, THE CONTROLLED SUBSTANCES ACT, <https://www.dea.gov/controlled-substances-act> (last visited Jun. 26, 2020).

5. *Id.*

6. 21 C.F.R. § 1308.11(d)(31) (2018).

7. *Id.* at (c)(11), (15). Under the federal scheduling system, the government classifies marijuana as a Schedule I drug, meaning “it’s perceived to have no medical value and a high potential for abuse.” German Lopez, *Marijuana is Illegal Under Federal*

rizing substances by schedules helps to shape criminal penalties that may attach to their use,⁸ but the categorization is not the final word. In fact, the Obama administration relaxed its enforcement of federal laws involving marijuana, allowing states the relatively unfettered ability to permit the medical and/or recreational use of the drug pursuant to state law.⁹ However, the Trump administration has given federal prosecutors the green light to prosecute marijuana offenses, even in states where its use is legal.¹⁰

Classifying cannabis as a controlled substance at the federal level has serious ramifications. Many state-sanctioned marijuana businesses must function as cash-only enterprises and those businesses are not able to file for several federal tax deductions.¹¹ Also, as one prominent business reporter has noted, banks and credit card issuers are afraid to do business with the cannabis industry because of the possibility of being charged with a federal crime.¹² Consequently, the inability to use banks and/or credit cards makes it nearly impossible for businesses in the cannabis field to obtain start-up funds, operating loans, or expansion funding.¹³ Moreover, because most cannabis-related entities operate on a cash basis, there is one unexpected consequence that people often overlook. “The influx of cash tax payments has become an inconvenience to state tax offices, some of which have had to hire extra security or fortification to ensure safety. In Colorado alone, cannabis businesses have raised more than \$1 billion in tax revenues, according to New Frontier Data.”¹⁴ There has been some recent movement in Congress

Law Even in States that Legalize It, VOX (Nov. 14, 2018), <https://www.vox.com/identities/2018/8/20/17938372/marijuana-legalization-federal-prohibition-drug-scheduling-system>.

8. Lopez, *supra* note 7.

9. *Id.*

10. Charlie Savage & Jack Healy, *Trump Administration Takes Step That Could Threaten Marijuana Legalization Movement*, N.Y. TIMES (Jan. 4, 2018), <https://www.nytimes.com/2018/01/04/us/politics/marijuana-legalization-justice-department-prosecutions.html>; See also Blake Marvis, *Reefer Madness In Federal Court: An Overview of How Federal Courts Are Dealing with Cannabis Litigation and Why it Is Necessary to “Dig Into The Weeds,”* 23 LEWIS & CLARK L. REV. 967, 970 (2019).

11. Lopez, *supra* note 7 (“... as a result, their effective income tax rates can soar to as high as ninety percent or more.”).

12. Ellen Sheng, *Underbanked Cannabis Industry Struggles to Finance Double-Digit Growth, Leaving Business Owners Empty-Handed*, CNBC (Oct. 1, 2019), <https://www.cnbc.com/2019/10/01/underbanked-cannabis-industry-struggles-to-finance-double-digit-growth.html> (“Though medical or recreational use of marijuana is now legal in 33 states, marijuana is still classified as a schedule 1 substance under federal law . . . most financial institutions, such as banks, Visa and Mastercard, will not work with the cannabis industry, fearing federal prosecution.”).

13. *Id.*

14. *Id.*

to address the banking problem, but the proposed legislation is in its infancy.¹⁵

The legalization of cannabis also raises law-enforcement concerns. Police, attorneys, and others have long worried that there is no reliable standard to determine when someone is acting unlawfully because they are under the influence of cannabis.¹⁶ For example, in 2014, Illinois added to its Vehicle Code a provision to determine when a wrongdoer is operating a vehicle “under the influence” as a result of that state permitting the use of cannabis for medicinal purposes.¹⁷ That act states that an operator with five nanograms of THC (the main psychoactive compound in marijuana that gives the high sensation) in the blood or ten nanograms in other bodily substances is “under the influence” of the cannabis compound THC.¹⁸ The law, however has been criticized for having no scientific basis.¹⁹ Moreover, additional criticism has been leveled at law enforcement because many people believe that most “police officers are not trained to detect cannabis impairment.”²⁰

Beyond law enforcement concerns, because of the federal government’s position that most state-authorized marijuana activities are illegal under federal law, there are also significant bankruptcy implications. In *In re Basrah Custom Design, Inc.*, the U.S. Bankruptcy Court for the Eastern District of Michigan dismissed a debtor’s Chapter 11 filing because of that debtor’s involvement with a medical marijuana dispensary business.²¹ The debtor was not in the marijuana business, but it had filed for bankruptcy relief to try and escape the terms of a sales contract it had entered into with a state-licensed marijuana dispensary.²² The court concluded that, while the marijuana-business activity was lawful under Michigan law, it was illegal under federal law and therefore the case must be dismissed.²³ Citing 11 U.S.C. § 1112(b)(1), the court ruled that the debtor had unclean hands because of its involvement in the cannabis industry.²⁴ Adopting an argument advanced by the U.S. Trustee’s Office, the court explained that “operating a

15. David Zalubowski, *The Cannabis Banking Bill Isn’t just About Banking*, THE AGENDA (Sept. 25, 2019, 4:59 AM), <https://www.politico.com/agenda/story/2019/09/25/cannabis-banking-bill-000987> (“The SAFE Banking Act, as it’s known, seeks to provide protections to financial institutions that work with state-licensed cannabis businesses, extending them the same protections afforded other businesses.”).

16. See generally Ed Finkel, *Ready or Not, Cannabis is Here*, ILL. B.J., Jan. 2020 at 24, 25.

17. See 625 ILL. COMP. STAT. 5/11-501.2(a-5) (2019).

18. *Id.* at (b-5).

19. Finkel, *supra* note 16, at 25.

20. *Id.*

21. *In re Basrah Custom Design, Inc.*, 600 B.R. 368, 383 (Bankr. E.D. Mich. 2019).

22. *Id.* at 382.

23. *Id.* at 383.

24. *Id.*

medical marijuana dispensary, or owning or renting a place operating as such a dispensary, also would be a federal crime”²⁵ As a result, bankruptcy relief could not be afforded to a business engaged in illegal activity.²⁶

The bankruptcy court in Michigan is not an outlier. In *In re Rent-Rite Super Kegs West, Ltd.*, a bankruptcy court in Colorado dismissed a Chapter 11 case because the debtor “derived roughly 25% of its revenues from leasing warehouse space to tenants engaged in the business of growing marijuana.”²⁷ Likewise, in *Arenas v. United States Trustee (In re Arenas)*, the U.S. Court of Appeals for the Tenth Circuit affirmed the dismissal of a Chapter 7 bankruptcy that had been filed by a marijuana grower and his wife.²⁸ The *Arenas* court noted “[t]he CSA criminalizes virtually every aspect of selling, manufacturing, distributing and profiting from the use of controlled substances.”²⁹ Without a doubt, “bankruptcy courts have consistently dismissed cases where debtors engaged in ongoing CSA violations, or where a debtor’s reorganization efforts depend on funds which can be considered proceeds of CSA violations.”³⁰

One of the more aggressive decisions regarding marijuana-related entities in bankruptcy was written in 2015, when a bankruptcy judge in Michigan enjoined a debtor from operating his lawful marijuana business during the pendency of his Chapter 13 consumer reorganization bankruptcy.³¹ There, the debtor filed bankruptcy “after falling behind on his house payments, his utility payments, and at least one payment on his truck.”³² The court acknowledged that the debtor filed the petition in good faith, but concluded that, because the debtor’s income was derived in part from an illegal

25. *Id.* at 379 (citing 21 U.S.C. § 841(b)(1)(D) (2018)). The court also noted that the proposed activity would be a crime under 21 U.S.C. § 856(a), which provides:

Except as authorized by this subchapter, it shall be unlawful to—

- (1) knowingly open, lease, rent, use, or maintain any place, whether permanently or temporarily, for the purpose of manufacturing, distributing, or using any controlled substance;
- (2) 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 use, with or without compensation, the place for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance.

Basrah, 600 B.R. at 379.

26. See Paul R. Hage, Patrick A. Clishman, and Anupama Yerramalli, *Case Must Be Dismissed Where Debtor Intended to Lease Real Property to a Marijuana Dispensary*, AM. BANKR. INST. J., Aug. 2019, at 6, 6–7.

27. 484 B.R. 799, 802 (Bankr. D. Colo. 2012).

28. 535 B.R. 845 (B.A.P. 10th Cir. 2015).

29. 535 B.R. at n.40 (citing 21 U.S.C. §§ 841(a)(1) and 856(a)).

30. *In re Way to Grow, Inc.*, 597 B.R. 111, 117 (Bankr. D. Colo. 2018).

31. *In re Johnson*, 532 B.R. 53, 59 (Bankr. W.D. Mich. 2015).

32. *Id.* at 54.

activity under federal law, “the court will require him to discontinue growing, selling and transferring marijuana to any and all patients and dispensaries immediately and to cease using property of the estate to further this activity.”³³ This order is particularly troubling because, in a Chapter 13 case, creditors are paid from proceeds that the debtor pays monthly to the bankruptcy trustee overseeing his or her case!³⁴ Without the ability to make a living (albeit from cannabis), a debtor cannot fund a Chapter 13 plan. Additionally, the court ruled that the marijuana plants that were part of the debtor’s inventory were “contraband” and it ordered the abandonment of the plants and any products or inventory derived therefrom without further notice or opportunity for hearing.³⁵

The practice of courts interpreting the more-restrictive federal law as trumping the various state laws that permit cannabis growing, sales, and use is entirely consistent with the Supremacy Clause of the U.S. Constitution.³⁶ That clause provides “[t]his Constitution, and the Laws of the United States which shall be made in pursuance thereof . . . shall be the supreme Law of the Land”³⁷ As one federal appellate panel explained, “[f]ederal statutes do not preempt state law of their own force; rather, they do so as a result of the Supremacy Clause.”³⁸ Indeed, marijuana is “contraband” under federal law and, “in the event of a conflict between federal and state law with regard to marijuana, ‘federal law shall prevail’”³⁹ Bankruptcy courts that look to the CSA as a basis to deny bankruptcy relief to cannabis-related businesses are not wrong to defer to federal law; their decisions act as a safeguard of federalism.⁴⁰

Recently, there has been some movement to reform federal marijuana laws. In November, 2019, the Marijuana Opportunity Reinvestment and Expungement Act of 2019 was voted out of one congressional committee that was considering it.⁴¹ There is some hope that it will move through the House of Representatives quickly and be passed by the Senate; however,

33. *Id.* at 58.

34. See MARGARET HOWARD AND LOIS LUPICA, *BANKRUPTCY CASES AND MATERIALS* 202 (6th ed. 2016).

35. *Id.* at 58–59.

36. U.S. CONST. art. VI.

37. *Id.*

38. *Torres v. Precision Indus., Inc.*, 938 F.3d 752, 755 (6th Cir. 2019).

39. *United States v. Parker*, 219 F. Supp. 3d 183, 188 (D.D.C. 2016) (citing *Gonzales v. Raich*, 545 U.S. 1, 27–29 (2005)).

40. See generally Bradford R. Clark, *Separation of Powers as a Safeguard of Federalism*, 79 TEX. L. REV. 1321, 1323–25 (2001).

41. H.R. 3884, 116th Congress (2019). According to its sponsor, Representative Jerrold Nadler, the proposed law is intended to “decriminalize and deschedule [sic] cannabis, to provide for reinvestment in certain persons adversely impacted by the War on Drugs, to provide for expungement of certain cannabis offenses, and for other purposes.”

there has been some pushback, largely by Republican members of Congress.⁴²

Additionally, there has been one notable departure from the string of decisions that negatively view debtors who are involved in the cannabis industry. In *Garvin v. Cook Investments NW*, the U.S. Court of Appeals for the Ninth Circuit affirmed a bankruptcy court's order, which had confirmed a Chapter 11 plan that received "at least indirect support" from a tenant involved in the cannabis industry.⁴³ The tenant, an entity doing business as "Green Haven," used the property it leased to grow marijuana.⁴⁴ The debtor's plan was supported by its creditors, but the U.S. Trustee objected and argued that Green Haven's lease violates federal law and is "thus unconfirmable (sic.) under 11 U.S.C. § 1129(a)(3)."⁴⁵ The debtor's plan was confirmed over the Trustee's objection.⁴⁶

The appellate court was aware that Green Haven's plan was to be funded, in part, from proceeds from a lease that would enable the lessee to grow marijuana, an activity that is legal under local (Washington) law, but illegal under federal law.⁴⁷ However, the court explained that its ruling was focused on the narrow question of whether Section 1129(a)(3) "forbids confirmation of a plan that is proposed in an unlawful manner as opposed to a plan with substantive provisions that depend on illegality, an issue of first impression in the Ninth Circuit."⁴⁸ The Ninth Circuit followed decisions from a bankruptcy appellate panel in the First Circuit and a bankruptcy court in Florida and concluded "that Section 1129(a)(3) does not require that the contents of a plan comply in all respects with the provisions of all non-bankruptcy laws and regulations."⁴⁹ The court reasoned that the debtor's plan was lawfully proposed and Section 1129(a)(3) "directs courts to look only to the proposal of a plan, not the terms of the plan."⁵⁰

42. Jeff Smith, *US House passes federal cannabis legalization bill in historic vote*, MARIJUANA BUSINESS DAILY, Nov. 20, 2019, <https://mjbizdaily.com/us-house-panel-passes-federal-cannabis-legalization-bill-in-historic-vote> (citing complaints that the legislation is being rushed through the House of Representatives and widespread disagreement about how tax revenue should be distributed).

43. 922 F.3d 1031, 1035–36 (9th Cir. 2019).

44. *Id.* at 1033.

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.* at 1035.

49. *Garvin*, 922 F.3d at 1035 (citing *Irving Tanning Co. v. Me. Superintendent of Ins.* (*In re Irving Tanning Co.*), 496 B.R. 644, 660 (B.A. P. 1st Cir. 2013)); *In re Gen. Dev. Corp.*, 135 B.R. 1002, 1007 (Bankr. S.D. Fla. 1991).

50. *Garvin*, 922 F.3d at 1035 (citing *Irving Tanning Co. v. Me. Superintendent of Ins.* (*In re Irving Tanning Co.*), 496 B.R. 644, 660 (B.A.P. 1st Cir. 2013)).

III. BANKRUPTCY

In the United States, financially-distressed debtors have opportunities to discharge indebtedness or to restructure their indebtedness through processes identified in the U.S. Bankruptcy Code.⁵¹ The Code, enacted in 1978, “was intended to provide an orderly means by which to alter the relationship between debtors and creditors.”⁵² The Code is divided into chapters with five of those chapters providing discrete types of financial relief to honest but unfortunate individuals and businesses, to wit: Chapter 7 (liquidation),⁵³ Chapter 9 (municipal reorganization),⁵⁴ Chapter 11 (reorganization),⁵⁵ Chapter 12 (family-farmer-debt reorganization),⁵⁶ Chapter 13 (reorganization of debts for individuals with regular and steady income),⁵⁷ and Chapter 15 (cross-border insolvencies).⁵⁸ Bankruptcy courts have historically been regarded as federal courts of equity.⁵⁹ As Professor Margaret Howard has explained, bankruptcy’s purpose is twofold: “[i]t gathers, liquidates, and distributes the debtor’s assets for the benefit of creditors”⁶⁰ and it provides a fresh financial start for a debtor with clean hands.⁶¹

Within the Code, there are numerous provisions that incline debtors to act in good faith as they come under the protection of the bankruptcy system. For example, for individuals who seek to liquidate their debts under Chapter 7 of the Code, Section 707(b) allows for a case to be dismissed if a court finds that granting bankruptcy relief to this debtor would be “an abuse.”⁶² When a Chapter 13 case is filed by someone seeking to reorganize and pay debts pursuant to a consumer payment plan, a case could be dismissed for a variety of reasons, including unreasonable delay by a debtor that is prejudicial to creditors; failure to make the timely payments that are required in Chapter 13 cases; or failure to pay fees and charges imposed by federal law on a debtor in bankruptcy.⁶³ Also, a Chapter 13 plan could be

51. 11 U.S.C. §§ 101 *et seq.* (2018).

52. Peter C. Alexander, *Divorce and the Dischargeability of Debts: Focusing on Women as Creditors in Bankruptcy*, 43 CATHOLIC L. REV. 351, 354 (1994) (citing *In re Pommerer*, 10 B.R. 935, 946 (Bankr. D. Minn. 1981)).

53. 11 U.S.C. §§ 701–766 (2018).

54. *Id.* at §§ 901–946.

55. *Id.* at §§ 1101–1174.

56. *Id.* at §§ 1201–1231.

57. *Id.* at §§ 1301–1330.

58. *Id.* at §§ 1501–1532.

59. *See, e.g.*, *Pepper v. Litton*, 308 U.S. 295 (1939).

60. Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L.J. 1047, 1050 (1987).

61. *Id.*; *See also* *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934); *Williams v. U.S. Fidelity Co.*, 236 U.S. 549, 554–55 (1915); *Wetmore v. Markoe*, 196 U.S. 68, 77 (1904).

62. 11 U.S.C. § 707(b) (2018).

63. 11 U.S.C. § 1307(c) (2018).

deemed “unconfirmable” if the plan is not proposed in good faith or is proposed in violation of law.⁶⁴ Similarly, in Chapter 11 cases, plans of reorganization must be proposed in good faith and not in contravention of applicable laws.⁶⁵ As courts have explained, “good faith” requires that the plan be proposed with “‘honesty and good intentions’ and with ‘a basis for expecting that a reorganization can be effected.’”⁶⁶ Moreover, plans must have “a true purpose and fact-based hope of either ‘preserving going concern’ or ‘maximizing property available to satisfy creditors.’”⁶⁷

Beyond the possibility of a bankruptcy case being dismissed for failing to meet good-faith or other requirements that may apply to a particular type of bankruptcy, debtors whose activities merely relate to the cannabis industry must also worry that they will not even have an opportunity to propose a plan to obtain bankruptcy relief because courts have dismissed bankruptcy petitions solely because of the debtor’s relationship to cannabis. For example, the bankruptcy court in *In re Rent-Rite Super Kegs West, Ltd.* dismissed a Chapter 11 filing because the debtor did not have “clean hands,” which the court acknowledged is a condition precedent to receiving bankruptcy relief.⁶⁸ The court noted that, “[the] Debtor freely admits that it leases space to those who are engaged in the cultivation of marijuana.”⁶⁹ Then, the court concluded that,

[t]he 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.⁷⁰

In a surprising decision from a bankruptcy court in Florida, a debtor who owned a commercial building with several tenants was unable to con-

64. 11 U.S.C. § 1325(a)(3) (2018).

65. 11 U.S.C. § 1129(a)(3) (2018).

66. *In re Emmons Sheepshead Bay Dev. LLC*, 518 B.R. 212, 225 (E.D.N.Y. 2014) (citing *Koelbl v. Glessing (In re Koelbl)*, 751 F.2d 137, 139 (2d Cir. 1984)); *Manati Sugar Co. v. Mock*, 75 F.2d 284, 285 (2d Cir. 1935).

67. *In re GAC Storage El Monte, LLC*, 489 B.R. 747, 771 (Bankr. N.D. Ill. 2013) (quoting *In re American Consol. Transp. Cos., Inc.*, 470 B.R. 478, 493 (Bankr. N.D. Ill. 2012)). See also *In re Fernandez*, 97 B.R. 262, 263 (Bankr. E.D.N.C. 1989) (explaining that a plan offered by a debtor which proposed to retain his monthly salary to support his lavish lifestyle may be unconfirmable); Interestingly, in Chapter 11 cases, courts have also recognized that there is a good-faith requirement that serves as a prerequisite to filing a Chapter 11 petition for reorganization. See, e.g., *Matter of Madison Hotel Associates*, 749 F.2d 410, 425 (7th Cir. 1984); Eugene J. DiDanato, *Good Faith Reorganization Petitions: The Back Door Lets the Stranger In*, 16 Conn. L. Rev. 1, 3 (1983).

68. *Rent-Rite Super Kegs West, Ltd.*, 484 B.R. 799, 807 (Bankr. D. Colo. 2012)

69. *Id.* at 804.

70. *Id.* at 807.

firm a Chapter 11 plan of reorganization because one of its tenants *intended* to set up a dispensary to sell medical marijuana, even though the application in question had yet to be approved by the State of Florida.⁷¹ The court pointed to Section 1129(a)(11) of the Code, as well as Section 1129(a)(3), to assert that the debtor's plan was not feasible and not filed in good faith, respectively, because of the tentative relationship to cannabis-related activity.⁷²

Bankruptcy courts have tried to explain why relief is not available to individuals and businesses that derive income, in whole or in part, from cannabis, but those explanations are often truncated, leaving little room for analysis. In *In re CW Nevada LLC*, for example, a Colorado bankruptcy court dismissed a Chapter 11 petition and concluded that, “. . . while debtors have not engaged in intrinsically evil conduct, the debtors cannot obtain bankruptcy relief because their marijuana business activities are federal crimes.”⁷³

IV. BANKRUPTCY RELIEF FOR THE CANNABIS INDUSTRY

Debtors whose activities are part of or related to the cannabis industry are being denied important financial relief that, historically, has been available to all “honest, but unfortunate” individuals and business entities.⁷⁴ Since states have started to recognize the use of cannabis for medical and recreational purposes, there have been a number of people and businesses that have taken advantage of this new opportunity for financial success.⁷⁵ However, not all of the cannabis players have been successful. What bankruptcy courts have been saying, with very few exceptions, is that participation in the cannabis industry disqualifies a party for bankruptcy relief. Indeed, The Office of the United States Trustee, which oversees the administration of nearly all bankruptcy filings, has taken the firm position that, “the bankruptcy system may not be used as an instrument in the ongoing

71. *In re Arm Ventures, L.L.C.*, 564 B.R. 77, 84 (Bankr. S.D. Fla. 2017).

72. *Id.* at 85.

73. 602 B.R. 717, 735 (Bankr. D. Nev. 2019) (quoting *Arenas v. U.S. Trustee*, 535 B.R. 845, 849–50 (B.A.P. 10th Cir. 2015)).

74. *See, e.g.*, Juliet M. Moringiello, *Mortgage Modification, Equitable Subordination, and the Honest But Unfortunate Creditor*, 79 *Fordham L. Rev.* 1599, 1600 (2011).

75. *See* Adam C. Uzialko, *Cash in on Cannabis: Business Ideas for the Emerging Industry*, *BUSINESS NEWS DAILY*, Feb. 7, 2019, <https://www.businessnewsdaily.com/9722-cannabis-industry-business-ideas.html> (“The cannabis industry is quickly becoming big business. Last year, U.S. consumer spending eclipsed \$10 billion for the first time. Spending is projected to increase to \$23 billion by 2022.”).

commission of a crime, and reorganization plans that permit or require continued illegal activity may not be confirmed.”⁷⁶

So the question that follows from reading the few reported bankruptcy decisions in which debtors have been denied relief under the U.S. Bankruptcy Code is whether a case can be made that those individuals and businesses that operate as a part of the cannabis industry are the “honest, but unfortunate” entities that bankruptcy was designed to protect. That question is not so easy to answer; however, there appear to be a few paths that could allow for cannabis-related businesses and individuals to obtain bankruptcy relief.

A. Bankruptcy Courts Must Adopt a Narrower View of “Cannabis-Related Activity.”

Currently, a survey of case law leads one to conclude that a debtor who engages in any activity that relates in any way to the cannabis industry is committing a criminal act which would preclude bankruptcy relief.⁷⁷ That approach is too broad. Whether a debtor is growing marijuana and intending to fund a bankruptcy from the crop proceeds⁷⁸ or the debtor has no direct relationship to cannabis and is merely leasing property to an entity that intends to grow marijuana pursuant to state law,⁷⁹ bankruptcy courts are loathe to grant relief and justifiably so. Those examples are easy to understand. Bankruptcy is part of the federal judiciary and therefore great deference to federal law is expected. However, when a debtor files for bankruptcy relief in an effort to escape the terms of a sales contract it had entered into with a state-licensed marijuana dispensary, bankruptcy protection is also denied.⁸⁰

Admittedly, it is confusing to draw a line between cannabis activity that is undoubtedly illegal under federal law and activity that is arguably intended to prevent a violation of federal law. Likewise, it is hard to understand why lawful, cannabis-related activity precludes bankruptcy relief when there are several examples where one might think that a court would

76. Clifford J. White III & John Sheahan, *Why Marijuana Assets May Not Be Administered in Bankruptcy*, 36 AM. BANKR. INST. J. 34, 34 (2017).

77. See *In re Basrah Custom Design, Inc.*, 600 B.R. 368 (Bankr. E.D. Mich. 2019); *In re CW Nevada LLC*, 602 B.R. 717 (Bankr. D. Nevada 2019); *In re Way to Grow, Inc.*, 597 B.R. 111, 117 (Bankr. D. Colo. 2018); *In re Arm Ventures, L.L.C.*, 564 B.R. 77 (Bankr. S.D. Fla. 2017); *Arenas v. United States Trustee*, 535 B.R. 845 (B.A.P. 10th Cir. 2015); *In re Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015); *In re Rent-Rite Super Kegs West, Ltd.*, 484 B.R. at 802–04.

78. See *Arenas*, 535 B.R. at 847.

79. See *Rent-Rite Super Kegs West, Ltd.*, 484 B.R. at 802–04.

80. See *Basrah Custom Design, Inc.*, 368 B.R. at 372–73.

deny bankruptcy protection, but the debtor's behavior and/or reasons for filing bankruptcy are not absolute disqualifiers.⁸¹

There are also examples of courts taking a more relaxed approach when determining if a debtor, not involved in the cannabis industry, is seeking bankruptcy protection in good faith. In 2013, a Bankruptcy Appellate Panel in the First Circuit upheld a debtor's Chapter 11 reorganization plan, despite objections from some parties in the case that the plan failed pursuant to Section 1129(a)(3) of the Code.⁸² That provision requires Chapter 11 plans be "proposed in good faith and not by any means forbidden by law."⁸³ The court, in *In re Irving Tanning Co.*, was asked to deny confirmation of the proposed plan because it violated state property and self-insurance laws, namely "the Plan would appropriate for distribution to creditors certain interests in property that are not the Debtors'."⁸⁴ The *Irving* court explained that Section 1129(a)(3) "focuses not on the terms of the plan and its means of implementation but on the manner in which the plan 'has been proposed.'"⁸⁵ This interpretation of Section 1129(a)(3) makes sense.

The goal of bankruptcy is to use equitable powers to enable creditors to receive some payment toward the debts they are owed, if possible, and the Bankruptcy Appellate Panel's decision in *Irving* clearly advances that goal. As the court in *In re Buttonwood Partners, Ltd.* has stated:

Section 1129(a)(3) is derived from § 221(3) of the Bankruptcy Act⁸⁶ which stated that the court could confirm a plan if satisfied that "the proposal of the plan and its acceptance are in good faith and have not been made or procured by means or promises forbidden by this Act." Consequently, given the relationship between § 221(3) of the Act and § 1129(a)(3), it must be construed that the term "means forbidden by law" subsumes some conduct in connection with obtaining confirmation of such proposal. The enlargement from "forbidden by this Act" to "forbidden by law" merely "requires that the proposal of the plan comply with all applicable law, not merely the bankruptcy law."⁸⁷

81. See, e.g., *In re Baum*, 386 B.R. 649, 654 (Bankr. N.D. Ohio 2008) (reasoning that bankruptcy precipitated by excessive gambling is not automatically bad faith); *In re Johns-Manville Corp.* 26 B.R. 727, 735 (Bankr. S.D.N.Y. 1984) (finding that the asbestos manufacturer filing bankruptcy to stanch the flood of asbestos-related lawsuits that the company was facing did not constitute bad faith).

82. *In re Irving Tanning Co.*, 496 B.R. 644, 660 (B.A.P. 1st Cir. 2013).

83. 11 U.S.C. § 1129(a)(3) (2018).

84. *Irving Tanning Co.*, 496 B.R. at 659.

85. *Id.* at 660 (emphasis in original).

86. An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 541, 30 Stat. 544, 550 (1898), *repealed by* Pub. L. No. 95-598, 92 Stat. 2549.

87. 111 B.R. 57, 59-60 (Bankr. S.D.N.Y. 1990) (citing *In re Koelbl*, 751 F.2d 137, 139 (2d Cir. 1984)(footnote added).

The concept of “good faith” in bankruptcy has different meanings throughout the Code.⁸⁸ In the context of confirming a Chapter 11 plan, “good faith”:

. . . must be viewed in light of the totality of the circumstances surrounding establishment of a Chapter 11 plan, keeping in mind the purpose of the Bankruptcy Code to give debtors a reasonable opportunity to make a fresh start. Where the plan is proposed with the legitimate and honest purpose to reorganize and has a reasonable hope of success, the good faith requirement of section 1129(a)(3) is satisfied.⁸⁹

There is a glimmer of hope that relief might be afforded to cannabis-related entities because of one recent U.S. Court of Appeals decision; perhaps a reinterpretation of “good faith” will take place in order to promote the central tenet of bankruptcy law—to provide a fresh financial start. In 2019, in *Garvin v. Cook Investments*, the U.S. Court of Appeals for the Ninth Circuit affirmed a bankruptcy court that had confirmed a commercial landlord’s Chapter 11 plan that was indirectly supported with funds from a tenant in the marijuana business.⁹⁰ The lower court had approved the plan, over the objection of the United States Trustee, even though the debtor operated several commercial real estate holding companies and one of its tenants was involved in a marijuana-growing operation, which was lawful under state law but illegal under federal law.⁹¹ The court explained that Section 1129(a)(3), the “good faith” requirement, must be viewed more broadly than the United States Trustee was proposing. The judge explained that the good faith requirement in Chapter 11 cases “directs bankruptcy courts to police the means of a reorganization plan’s *proposal*, not its substantive provisions.”⁹²

The *Cook Investments* court expressed concern that the United States Trustee’s objection would require the court to “rewrite the statute [in question] completely.”⁹³ Section 1129(a)(3) simply states that “[t]he plan has been proposed in good faith and not by any means forbidden by law” and the court interpreted the phrase “not by any means forbidden by law” to modify the phrase “[t]he plan has been proposed.”⁹⁴ Consequently, the court focused on the language in Section 1129(a)(3) as expressly focusing

88. See Edith Jones, *The “Good Faith” Requirement in Bankruptcy*, 1988 ANN. SURV. BANKR. L. 2, 5 (1988).

89. *In re Geijssel*, 480 B.R. 238, 255 (Bankr. N.D. Tex. 2012) (quoting *In re Sun Country Dev. Inc.*, 764 F.2d 406, 408 (5th Cir. 1985)).

90. *Garvin v. Cook Invs. (In re Cook Invs.)*, 922 F.3d 1031 (9th Cir. 2019).

91. *Id.* at 1034.

92. *Id.* at 1035.

93. *Id.*

94. *Id.*

on the manner of the plan's proposal and not the activities specified in the plan.⁹⁵ In its final statement, the court distilled its position by writing, "Because the Amended Plan was lawfully proposed, the Bankruptcy Court correctly concluded that it met the requirements of 11 U.S.C. § 1129(a)."⁹⁶

A broader interpretation of "good faith" is needed to advance the main objective of bankruptcy, which is to give debtors "a reasonable opportunity to make a fresh start," and the courts in *Irving Tanning Co.* and *Cook Investments* stand as examples that relief for their respective debtors outweighed a restrictive definition of "good faith." If this trend continues, debtors involved in cannabis-related businesses may one day be able to seek relief in bankruptcy court on par with other classes of debtors.⁹⁷ Advocating for a relaxation in how a common bankruptcy term is defined is not unique. In consumer bankruptcy cases, a similar interpretive shift is slowly taking place regarding the dischargeability of student loans.

In Section 523(a)(8) of the Code, student-loan debt is not dischargeable "unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor's dependents."⁹⁸ For decades, bankruptcy judges have been loath to find undue hardship when presented with student loan dischargeability cases.⁹⁹ Nearly every bankruptcy court applies the three-part *Brunner* test to determine whether an undue hardship exists; the test is based on reasoning from *Brunner v. N.Y. State Higher Educ. Servs. Corp. (In re Brunner)*.¹⁰⁰ Bankruptcy courts have long interpreted *Brunner* as requiring a "certainty of hopelessness" before discharging a student loan,¹⁰¹ but a few recent decisions suggest that such a drastic standard may finally be breaking down. For example, in *Rosenberg v. N.Y. State Higher Education Services, Corp. (In re Rosenberg)*, a bankruptcy judge in the Southern District of New York granted a debtor's request to discharge a student loan and, in her reasoning, the judge wrote, "[t]he harsh results that often are associated with *Brunner* are actually the

95. *Id.* at 1035–36.

96. *Cook Investments*, 922 F.3d. at 1036.

97. The *Cook Investments* court warned, however, that "confirmation of a plan does not insulate debtors from prosecution for criminal activity, even if that activity is part of the plan itself." *Id.*

98. 11 U.S.C. § 523(a)(8) (2018).

99. *See, e.g., In re Clark*, 341 B.R. 238 (Bankr. N.D. Ill. 2006); *Lozada v. Educ. Credit Mgmt. Corp. (In re Lozada)*, 594 B.R. 212 (Bankr. S.D.N.Y. 2018); *Chance v. United States of America (In re Chance)*, 600 B.R. 51 (Bankr. S.D. Ind. 2019).

100. *Brunner v. N.Y. State Higher Educ. Servs. Corp.*, 831 F.2d 395 (2d Cir. 1987).

101. *See, e.g., Briscoe v. Bank of N.Y. (In re Briscoe)*, 16 B.R. 128, 131 (Bankr. S.D.N.Y. 1981); *Jean-Baptiste v. Educ. Credit Mgmt. Corp (In re Jean-Baptiste)*, 584 B.R. 574, 588 (Bankr. E.D.N.Y. Feb. 23, 2018).

result of cases interpreting *Brunner*. Over the past 32 years, many cases have pinned on *Brunner* punitive standards that are not contained therein.”¹⁰²

As courts of equity, bankruptcy courts should be flexible enough to modify interpretations of terms of art and other terms used in the practice. As times change, so should interpretations. The failure to do so may result in businesses that deserve to receive bankruptcy relief being shut out to the detriment of not only the debtor but also the creditors who might welcome the orderly restructuring of debts or liquidation of assets.

B. Bankruptcy Courts Must Interpret Section 1112(b) of the Code More Equitably.

Code Section 1112(b) provides:

Except as provided in paragraph (2) and subsection (c), on request of a party in interest, and after notice and a hearing, the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause¹⁰³

This section of the Code was enacted to give bankruptcy courts wide discretion to deny bankruptcy protection and relief to debtors whose filings were not within the spirit of bankruptcy in the United States. According to the legislative history relating to Section 1112(b):

Cause may include the continuing loss to or diminution of the estate of an insolvent debtor, the absence of a reasonable likelihood of rehabilitation, the inability to effectuate a plan, unreasonable delay by the debtor that is prejudicial to creditors, failure to file a plan within the appropriate time limits, denial of confirmation and any opportunity to modify or propose a new plan, revocation of confirmation and denial of confirmation of a modified plan, inability to effectuate substantial consummation of a confirmed plan, material default by the debtor under the plan, and termination of the plan by reason of the occurrence of a condition specified in the plan. This list is not exhaustive.¹⁰⁴

102. *Rosenberg v. N.Y. State Higher Educ. Servs. Corp.* (*In re Rosenberg*), 610 B.R. 454, 458–59 (Bankr. S.D.N.Y. Jan. 7, 2020) (criticizing other courts that stray from what *Brunner* actually intended). *See also* *Brondson v. Educ. Credit Mgmt. Corp.* (*In re Brondson*), 435 B.R. 791, 800–01 (B.A.P. 1st Cir. 2010) (criticizing courts that improperly interpret the *Brunner* test).

103. 11 U.S.C. § 1112(b) (2018).

104. 1 *Collier Pamphlet Edition* 11 U.S.C. § 1112 (2019) (citing Senate Report No. 95-989, 95th Cong., 2d Sess. 117 (1978)).

Nearly all of the § 1112(b) examples for finding cause to dismiss a Chapter 11 bankruptcy relate to a debtor's behavior while in bankruptcy. Cannabis-related individuals and businesses rarely gain entry into bankruptcy because they are typically denied the right to file bankruptcy based solely on the activity that they might have been involved in pre-bankruptcy or that might fund a Chapter 11 or a Chapter 13 plan.¹⁰⁵ Reliance on § 1112(b) to dismiss a debtor in a cannabis-related field is therefore misplaced. Moreover, if a cannabis-related debtor is able to file Chapter 11, and is deemed to be acting in good faith, the type of underlying business or underlying debt that the debtor has should not be used as a basis to dismiss its case. As long as a debtor is able to operate its business in Chapter 11, marshal its assets, determine the debts that it owes, and present an acceptable plan of reorganization, the bankruptcy stakeholders should not care that the reason for seeking bankruptcy protection in the first place has something to do with cannabis.

Bankruptcy is not unique as it attempts to deal with individuals and businesses involved in the cannabis industry. Many employers maintain a zero-tolerance drug policy in the workplace, requiring that employees refrain from alcohol use while on the job and, in the case of marijuana use, employees may not use marijuana even in their off time.¹⁰⁶ Businesses have maintained a stricter position regarding cannabis use because "impairment because of marijuana is usually much more difficult to detect and test for than alcohol."¹⁰⁷ However, the reasons most businesses and law enforcement cite in support of their zero-tolerance policies are because cannabis use can negatively impact an individual's ability to perform a job or task.¹⁰⁸ In the context of bankruptcy, a debtor's relationship to cannabis contributes directly to the debtor being able to perform as expected by the bankruptcy provisions. A debtor can fund a plan with the cannabis-related proceeds, or a debtor can wind down a business that has failed when the debtor could not succeed in its cannabis-related venture. A debtor's relationship to cannabis should not be judged through the same lens as is used outside of bankruptcy.

C. Cannabis-Related Debtors May Need to Seek Relief Outside of Bankruptcy

The U.S. Bankruptcy Code provides extraordinary relief for individuals and businesses in financial distress; however, the Code is not the sole source

105. *See supra* Section III.

106. *See* Adam C. Uzialko, *Cannabis at Work: How Employers Are Reacting to the Legalization of Marijuana*, BUSINESS NEWS DAILY (June 10, 2020) <https://www.businessnewsdaily.com/9386-legal-marijuana-employment-practices.html>.

107. *Id.*

108. *See* *Holder v. Interlake Steamship Co.*, 2018 WL 1725694 (W.D. Wisc. 2018).

for debt relief. To that end, cannabis-related debtors may have to explore non-bankruptcy alternatives to wind down their financial affairs or to reorganize their debts. For decades, creative debtors and creditors have used non-bankruptcy alternatives to reset their financial relationships. For example, the Uniform Commercial Code provides rights to secured creditors in Article 9.¹⁰⁹ Additionally, parties across America have long settled financial differences by using assignments for the benefit of creditors and composition agreements.¹¹⁰ Assignments for the benefit of creditors are the voluntary transfer of a business's assets to a third party to apply the assets (or the proceeds therefrom) to the debts owed to the business's creditors.¹¹¹ Composition agreements are contracts between an insolvent debtor and its creditors in which the creditors, in exchange for some consideration, agree to accept less than one-hundred percent of the money they are owed.¹¹² However, composition agreements are also contracts between the creditors as well because the creditors agree to forebear collection of the total amounts they are owed so long as the debtor is paying the creditors pursuant to the agreement.¹¹³

There are also non-bankruptcy alternatives that rely on alternative dispute resolution methods, sometimes referred to as "reorganizations in lieu of bankruptcy."¹¹⁴ In a reorganization in lieu of bankruptcy, the debtor convenes a meeting of her creditors and discloses her financial information as if she were filing a bankruptcy petition.¹¹⁵ After a complete disclosure is made, the debtor and the creditors work to determine what assets are available for liquidation and what funds would therefore be available for distribution to creditors.¹¹⁶ Then, the debtor's counsel serves as a facilitator as the creditors determine who should be paid how much and in what order.¹¹⁷

Even though there are tried-and-true alternatives to bankruptcy relief, they do not provide the same level of protection and they are often not as

109. See, e.g., UNIF. COMM. CODE §§ 9-607, 9-609 (2019).

110. See generally, Avrum H. Dannen, et al., *Strategy Planning—Overview Alternatives; Chapter 11—Debtor's Strategy*, I.S.B.A. Law Ed. Series C.L.E. Materials 32 (1988).

111. See Joe Schomberg, *Major Buzzkill: The Relationship Between Legalized Cannabis in Illinois and the U.S. Bankruptcy Code*, 108 ILL. B.J., 26 (2020). For an excellent explanation of assignments for the benefit of creditors, see Melanie Rovner Cohen & Joanna L. Challacombe, *Assignment for the Benefit of Creditors—A Contemporary Alternative for Corporations*, 2 DEPAUL BUS. L.J. 269 (1990);

112. See Composition with Creditors Law and Legal Definition, USLEGAL, <https://definitions.uslegal.com/c/composition-with-creditors>, (last accessed Jun. 27, 2020).

113. *Id.*

114. See Peter C. Alexander, *Bankruptcy Reorganizations Without the Bankruptcy Court: Reorganizations in Lieu of Bankruptcy*, 7 J. BANKR. L. & PRAC. 81 (2003).

115. *Id.* at 89–90.

116. *Id.*

117. *Id.* at 91.

transparent as relief under the U.S. Bankruptcy Code.¹¹⁸ Among other benefits, bankruptcy filers receive breathing room from creditors seeking to dismantle their assets. The automatic stay protects debtors while they are in bankruptcy¹¹⁹ and Chapter 11 debtors are given an exclusive period of time to propose their plans of reorganization so that they may dictate what assets will be sold to benefit creditors and in what fashion.¹²⁰ Debtors who are involved in the cannabis industry deserve the opportunity to avail themselves of the complete array of equitable relief options afforded to honest, but unfortunate debtors that is provided through bankruptcy.

V. CONCLUSION

The unprecedented growth of cannabis-related businesses in America almost assures that, sooner or later, there will be an increase in cannabis-related business failures. Currently, the prevailing view of most bankruptcy courts is that cannabis-related individuals and businesses are not eligible for bankruptcy relief because the reason they seek bankruptcy protection is the result of activity that was illegal under federal law. However, cannabis-related debtors are not without hope. They may be able to avail themselves of the safeguards under the Code if bankruptcy courts begin to focus on the debtor's behavior while in bankruptcy and not its pre-bankruptcy activities; define "good faith" more broadly; and interpret more generously the provisions of the Code that require cases to be dismissed. In addition, cannabis-related debtors that are in financial distress should consider non-bankruptcy alternatives so that they have some opportunity to restructure a failing business or to liquidate in an orderly fashion.

The bankruptcy system currently finds itself as a much-desired safety net for businesses involved in the fast-growing cannabis industry; however, most courts reject the idea that debtors involved in cannabis-related activities are entitled to bankruptcy relief. As more states permit medical and recreational marijuana use and as more courts read the Code more broadly to allow a wider range of businesses to come under the bankruptcy umbrella, there is hope that bankruptcy protection will be available to all honest, but unfortunate individuals and businesses.

118. For a review of non-bankruptcy alternatives, and concerns about them, see James L. Ryan, *Considering Non-Bankruptcy Alternatives in the Wake of the Revised Bankruptcy Code*, Vol. 20 DuPage County B. Assoc. Brief (2007–08), (February 13, 2020, 4:59 PM), <https://www.dcba.org/mpage/vol200308art3>.

119. 11 U.S.C. § 362 (2018).

120. 11 U.S.C. § 1121(b) (2018).