Bankruptcy relief for cannabis-adjacent debtors? It gets hazy

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You may have heard this before: As cannabis remains a Schedule I drug under the federal Controlled Substances Act ("CSA"), cannabis companies cannot seek bankruptcy relief under federal law. Not so fast. Access to bankruptcy can be highly fact-dependent.

When the debtor in question is adjacent to cannabis operations, the analysis often turns on the degree to which it is involved in operations that violate federal law and its dependence on such operations to reorganize or satisfy creditor claims. The more heavily the debtor is involved in cannabis operations, or dependent on them to fund a plan of reorganization or administer a liquidation, the less likely it is the debtor will be allowed bankruptcy protection.

The case law addressing cannabis-adjacent debtors exists along a spectrum of varying levels of debtor involvement with cannabis companies.

Courts will consider, among other factors, whether the debtor's assets are derived directly or indirectly from cannabis operations, and the amount and relative contribution of such assets to the debtor's total earnings.

Cannabis-adjacent debtors have not fared well in their efforts to obtain bankruptcy relief. However, based on decisions out of the 9th U.S. Circuit Court of Appeals, and a recent decision in Colorado, all hope for bankruptcy protection for such debtors may not be lost.

Where's the line?

The case law addressing cannabis-adjacent debtors exists along a spectrum of varying levels of debtor involvement with cannabis companies.

Specifically, questions of bankruptcy eligibility have arisen where the debtor is directly involved in the sale of cannabis or where it has some connection to a third party's cannabis operations. That connection may be through the lease of its real property, its provision of products or services, or its direct or indirect ownership interest in such operations.

In evaluating the scope of a debtor's connections to illegal cannabis operations, courts will be influenced by whether the operations at issue can be characterized as "plant-touching." That characterization, however, is itself subject to interpretation, and thus, is not dispositive of the issue of eligibility, as the case law demonstrates.

Direct involvement in cannabis

Courts are prone to dismiss bankruptcy cases where the debtor's plan of reorganization or a trustee's satisfaction of creditor claims requires the sale and/or possession of cannabis in violation of federal law.

In 2015, the Bankruptcy Appellate Panel (the "BAP") for the 10th U.S. Circuit Court of Appeals, in *In re Arenas,* would not allow a chapter 13 case where the plan would be funded by income derived from illegal cannabis operations. There, the debtors owned property used for medical cannabis production and distribution and leased space to a dispensary.

The BAP affirmed the denial of a motion to convert the debtors' chapter 7 case to a chapter 13 case. It also affirmed dismissal of the chapter 7 case, reasoning chapter 7 protection was unavailable, as it would have required the trustee's possession and administration of cannabis assets in violation of federal law.

The U.S. District Court for the Eastern District of Michigan in *In re Great Lakes Cultivation, LLC* reached a similar conclusion in 2022. There, the debtor grew and sold medical marijuana and all of its income was derived from its cannabis business. The court affirmed dismissal, rejecting the company's argument that, because its cannabis plants were abandoned and its remaining assets (*e.g.*, office equipment, furniture, security equipment, shovels and fans) were not inherently illegal, the assets could be possessed and administered by the trustee.

Providing services/products or leasing property to a cannabis company

In 2012, in *In re Rent-Rite Super Kegs*, the U.S. Bankruptcy Court for the District of Colorado determined that debtor's receipt of 25% of its income from real property leased to a cannabis grower licensed under state law constituted "continued criminal activity." This resulted in unclean hands and "gross mismanagement of the estate" under Section 1112(b) of the Bankruptcy Code, providing cause for dismissal or conversion of the chapter 11 to a chapter 7 liquidation.

The court also found that, because the debtor derived a significant portion of its income from criminal activity, any plan would necessarily be proposed by "means forbidden by law" and, therefore, not confirmable under Section 1129(a)(3).

Similarly, in 2019, the U.S. District Court for the District of Colorado in *In re Way to Grow, Inc.* affirmed the bankruptcy court's dismissal of a debtors' chapter 11 bankruptcy, because the debtors relied on profits derived from the sale of hydroponic gardening supplies, including to cannabis growers, and future business plans included marketing to the cannabis industry, meaning the debtor could not propose a plan in good faith.

For the most part, cannabis adjacent businesses have not been permitted federal bankruptcy relief. However, the denial of bankruptcy protection for future debtors is not a foregone conclusion.

These cases illustrate the expected result, but in what appear to be outlying decisions, the 9th U.S. Circuit Court of Appeals has permitted bankruptcies to proceed where a debtor leased property to a cannabis company.

In 2018, in *In re Olson*, the BAP for the 9th Circuit refused to dismiss a chapter 13 case of a 92-year old blind woman who rented her commercial property to a cannabis grower through a third-party manager. The BAP determined that the bankruptcy court made no finding of bad faith or unclean hands and improperly concluded that acceptance of rents from a cannabis business was a crime without making any findings regarding the elements of a CSA violation. The court ultimately remanded the case back to the bankruptcy court to articulate its findings that led to dismissal.

In 2019, in *Garvin v. Cook Invs. NW, SPNWY, LLC*, the 9th Circuit refused to dismiss the chapter 11 petition of an individual debtor-landowner who had rejected a property lease with a cannabis grower. The court reasoned that "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." Given the proposal was not unlawful, the court affirmed the bankruptcy court's approval of the plan.

Garvin has been criticized by other courts outside of the 9th Circuit, which have not followed its narrow reasoning.

Ownership of a cannabis company

Where the debtor owns an equity interest in a cannabis company, courts will assess the relationship of the debtor and its assets to the cannabis-related operations of the issuer.

In 2022, in *In re Mayer*, the U.S. Bankruptcy Court for the District of Arizona dismissed a debtor's chapter 13 bankruptcy. As a major shareholder, the debtor received all of his income from a business that derived most of its revenue from the sale of extraction and processing equipment used by both cannabis and non-cannabis companies. Although the debtor was a step removed from cannabis operations, the court found that the only reliable source of income for the debtor's plan came "directly and exclusively" from cannabis-related business.

Even if connections to cannabis operations cease prior to filing, a bankruptcy petition may be subject to dismissal. In 2020, in *In re Burton*, the BAP for the 9th Circuit affirmed dismissal of a bankruptcy proceeding where the debtors, who owned a majority interest in a medical cannabis business, had ceased receiving income from that business. The cannabis business, however, remained a party to pending litigation with potential recoveries. The BAP concluded that the debtors failed to demonstrate that the potential litigation recoveries "would not result in proceeds of an illegal business becoming part of the bankruptcy estate, requiring the trustee and the court to administer assets that constitute proceeds of activity criminalized by the CSA."

Contrast that with *In re Roberts,* where the bankruptcy case was not dismissed outright by the U.S. Bankruptcy Court for the District of Colorado in 2022. The court noted, based on the limited record before it, that the debtor's alleged relationship to two cannabis businesses was more attenuated than those of the debtors in *Arenas*, suggesting that dismissal may not be warranted. But the bankruptcy court ultimately ruled that it needed a more developed record to determine the extent of the debtor's connections to cannabis and whether those connections required dismissal of the bankruptcy.

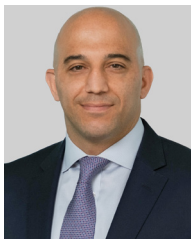
Conclusion

For the most part, cannabis adjacent businesses have not been permitted federal bankruptcy relief. However, the denial of bankruptcy protection for future debtors is not a foregone conclusion.

Although decisions allowing bankruptcy cases to proceed may be viewed as outliers, they demonstrate that not all cannabis adjacent debtors will need to wait until cannabis is rescheduled before bankruptcy becomes a viable option. Entities and individuals with a connection to a cannabis business and their creditors should be aware of the fact-specific analyses conducted by courts to determine bankruptcy eligibility and plan accordingly.

Joseph Cioffi is a regular contributing columnist on consumer and commercial financing for Reuters Legal News and Westlaw Today.

About the authors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