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Bankruptcy Courts Inflict Pain on Mary Jane

*By Michael J. Lichtenstein**

In this article, the author explains that, to date, bankruptcy courts and appellate courts have shown little sympathy to debtors who continue to engage post-petition in a cannabis-related business (including leasing property, equipment, manufacturing and selling).

Twenty-one states, along with Washington, D.C., and Guam, have acted to legalize recreational marijuana.¹ While the U.S. House of Representatives passed a marijuana decriminalization bill in April 2022, and shortly thereafter several senators introduced the Cannabis Administration and Opportunity Act (federally decriminalize marijuana),² that legislation has not been passed.³ Notwithstanding the groundswell of support to legalize marijuana growing, use and sales, the vast majority of bankruptcy courts have declined to afford debtors relief when they have any involvement with marijuana. For example: “Can a debtor in the marijuana business obtain relief in the federal bankruptcy court? No.”⁴

The frequently articulated basis for this approach is a disinclination to allow debtors relief in a federal bankruptcy court when their revenue source violates a federal law, the Controlled Substances Act.⁵ In most, but not all (some creditors have been the movants), the cases in which bankruptcy courts have been asked to deny bankruptcy protection to marijuana-related debtors,⁶ the movant seeking such relief has been the Office of the U.S. Trustee, a branch of the U.S. Department of Justice, that operates in the bankruptcy courts. The

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¹ Where Is Marijuana Legal? A Guide to Marijuana Legalization, Claire Hansen, Horus Alas, and Elliott Davis Jr., U.S. News & World, Feb. 16, 2023.

² According to the National Center for Complementary and Integrative Health, cannabis refers to all products derived from the Cannabis Sativa plant while marijuana refer to parts or products of that plant that contain substantial amounts of TCH (tetrahydrocannabinol), [https://www.nccih.nih.gov/health/cannabis-marijuana-and-cannabinoids-what-you-need-to-know#:~:text=The%20word%20%22cannabis%22refers%20to,amounts%20of%20tetrahydrocannabinol%20\(THC\).](https://www.nccih.nih.gov/health/cannabis-marijuana-and-cannabinoids-what-you-need-to-know#:~:text=The%20word%20%22cannabis%22refers%20to,amounts%20of%20tetrahydrocannabinol%20(THC).)

³ Id.

⁴ In re Arenas, 535 B.R. 845, 847 (10th Cir. BAP, 2015).

⁵ 21 U.S.C. §§ 801-971.

⁶ Including debtors who grow, distribute or sell marijuana or marijuana equipment or lease property to marijuana growers.

U.S. Trustees' duties include supervising the administration of bankruptcy cases and acting in the public interest to promote the efficiency and integrity of the bankruptcy system.⁷

CHAPTER 11 AND CHAPTER 13 CASES

Chapter 11 (and Chapter 13 for individuals) of the U.S. Bankruptcy Code are designed to provide individuals and entities with a brief respite to allow for a reorganization⁸ and restructure of debts resulting in a fresh start. Under either chapter, a debtor files a plan of reorganization,⁹ which must satisfy several requirements set forth in the Bankruptcy Code.¹⁰ Both Chapter 11 and Chapter 13 cases contain the following requirement: "the plan has been proposed in good faith and not by any means forbidden by law."¹¹

CHAPTER 11 CANNABIS CASES

In re Way to Grow, Inc.,¹² involved two related Chapter 11 debtors that sold equipment for indoor hydroponic and gardening-related supplies. The debtors represented that their future business expansion plan was to the growing cannabis industry which relies heavily on hydroponic gardening.¹³ The secured creditor, which had been involved in a pre-bankruptcy dispute with the debtors, filed a motion to dismiss the Chapter 11.¹⁴ While other issues were raised in the motion to dismiss, the bankruptcy court characterized the "main event" as the debtors' connections to the marijuana industry.

Reviewing the marijuana/bankruptcy courts landscape, the court summarized prior decisions as follows: "Accordingly, 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

⁷ *In re Great Lakes Cultivation, LLC*, 2022 LEXIS 148145 *2 (E.D. Mich., Aug. 18, 2022).

⁸ In Chapter 11, a debtor (either an entity or an individual) can also liquidate assets rather than reorganize.

⁹ Chapter 11 (11 U.S.C. § 1123 et seq.) and Chapter 13 (11 U.S.C. § 1322 et seq.). Chapter 12 is for farmers so it may be that there will be cases under that chapter, too (11 U.S.C. § 1201).

¹⁰ *Id.*

¹¹ 11 U.S.C. § 1129(a)(3); 11 U.S.C. § 1325(a)(3).

¹² 597 B.R. 111 (Bankr. D. Colo. 2018).

¹³ *Id.* at 115.

¹⁴ *Id.* at 114.

considered proceeds of CSA violations.”¹⁵ Having reviewed existing case law, the bankruptcy court determined that it had to first evaluate whether the debtors were engaging in ongoing violations of federal law.¹⁶ If the answer was yes, the court concluded that it would have to dismiss the Chapter 11 proceeding.¹⁷ While the court concluded that the debtors were not liable for aiding and abetting or conspiracy under the Controlled Substances Act, the court did find that the debtors had actual knowledge that they were selling equipment which would be used to manufacture a controlled substance.¹⁸

One of the debtors’ statements that was introduced into evidence that the court relied upon was that one of the debtors was now “the leading one-stop solution for indoor plant, product and cannabis growers in Colorado and California.”¹⁹ The court also reviewed an internal email from the debtors’ director of operations instructing managers to “remove from sight” anything ‘MJ related’ in your stores.”²⁰ The court then considered whether the debtors’ business could survive if all ties to marijuana were severed and concluded that would be highly improbable.²¹ Accordingly, the court granted the motion to dismiss.²²

In another Chapter 11 case, the debtor, which manufactured and installed custom cabinets, occupied two buildings owned by the debtor’s owner.²³ Pre-petition, the owner signed a lease for part of the property in the debtor’s name to a tenant that was going to operate a medical marijuana dispensary.²⁴ The U.S. Trustee sought to dismiss the Chapter 11 for cause because of “the Debtor’s entanglement with a medical marijuana dispensary business.”²⁵ The court agreed that even if legal under Michigan law, operating a medical

¹⁵ Id. at 117. See id. at 117-123 for a comprehensive review of how courts had treated marijuana related debtors.

¹⁶ Id. at 123.

¹⁷ Id.

¹⁸ Id. at 126-129.

¹⁹ Id. at 131.

²⁰ Id.

²¹ Id. at 132.

²² Id. See also *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799, 803, 811 (Bankr. Colo, 2012) (finding that debtor’s lease of warehouse facilities to tenants that used the space to cultivate marijuana meant that the debtor was violating the Controlled Substances Act and therefore the Chapter 11 should either be dismissed or converted to Chapter 7).

²³ *In re Basrah Custom Design, Inc.*, 600 B.R. 368, 372 (Bankr. E.D. Mich. 2019).

²⁴ Id.

²⁵ Id. at 378.

marijuana dispensary violated the Controlled Substances Act.²⁶ Relying in part on the pre-petition state court's findings, the bankruptcy court concluded that the debtor and its owner sought bankruptcy protection to avoid the lease so that they could enter into a more lucrative lease with a marijuana related tenant.²⁷ Finding that the true purpose of the bankruptcy was for the debtor and its shareholder to have the bankruptcy court assist them in violating federal law, the court granted the motion and dismissed the case.²⁸

In *Arm Ventures, LLC*,²⁹ the secured creditor filed a motion to dismiss the debtor's Chapter 11 proceeding alleging bad faith, including the Chapter 11 filing on the eve of the third scheduled foreclosure and because the debtor's reorganization plan contemplated funding from income generated from marijuana. Initially, the bankruptcy court directed that the debtor file an amended plan that did not rely on income derived from medical marijuana.³⁰ However, the debtor filed an amended plan that still relied on income for medical marijuana as its sole funding source.³¹ Considering whether the plan was filed in good faith, the court concluded that it was not, in part because it was highly unlikely that the debtor would obtain both state and federal approval to manufacture and sell medical marijuana.³² Even so, the court denied the creditor's motion to dismiss and provided the debtor one more opportunity to file a reorganization plan within fourteen days that did not depend on marijuana as a source of income.³³

Bucking the national trend somewhat, there are two cannabis-related opinions where courts refused to dismiss a Chapter 11 or to overturn an order confirming the Chapter 11 debtor's plan. However, in both cases, the debtor was no longer involved with cannabis in any way. In *Garvin v. Cook Invs, NW*,

²⁶ Id.

²⁷ Id. at 382.

²⁸ Id. at 385.

²⁹ 564 B.R. 77, 78 (Bankr. S.D. Fla. 2017).

³⁰ Id. at 81.

³¹ Id. at 83.

³² Id. at 83-84.

³³ Id. at 86. The court noted further that if no such plan was filed, the Chapter 11 would be converted to a Chapter 7 liquidation. See also *In re Kittrell*, 2020 LEXIS 2809 *11 (Bankr. Ariz., Oct. 6, 2020) (refusing to reopen individual Chapter 11 proceeding where debtor admitted that he was engaged in and profited from the medical marijuana industry and noting that: "A person cannot choose to engage in behavior that is criminal under federal law and then expect to receive relief under the federal Bankruptcy Code.").

SPNWX, LLC,³⁴ five related real estate entities filed for Chapter 11 and proposed a joint reorganization plan. The bankruptcy court confirmed the plan which paid all creditors in full and provided for the debtors to continue as a going concern.³⁵ After confirmation, the U.S. Trustee sought to have the plan “go up in smoke” because one of the tenants used its property to grow marijuana.³⁶ The U.S. Trustee argued that the lease violated federal law and therefore the plan was proposed by a means forbidden by law.³⁷

The U.S. Court of Appeals for the Ninth Circuit disagreed and affirmed the plan confirmation, pointing out that the Bankruptcy Code directs courts to “police the means of a reorganization plan’s proposal, not its substantive provisions.”³⁸ The Ninth Circuit noted that the debtor’s amended plan rejected the lease with the tenant which used the premises exclusively as a marijuana establishment.³⁹ Further, the amended plan was structured so that the monthly plan obligations would be funded without revenue from the marijuana-related tenant.⁴⁰ Looking only at whether the plan was proposed lawfully, not at the substantive provisions, the Ninth Circuit agreed with the bankruptcy court’s plan confirmation.⁴¹

In a recent California bankruptcy court decision,⁴² the court refused to dismiss a Chapter 11 proceeding filed by a debtor that had previously been in the business of wholesale manufacturing and packaging cannabis products. Prior to filing bankruptcy, the debtor ceased operations and sold its assets to a publicly traded Canadian company whose sole business was cannabis growth and sales.⁴³ The debtor received shares in the purchaser entity and proposed to sell those shares to fund its plan of reorganization.⁴⁴ The U.S. Trustee filed a motion to dismiss the Chapter 11 because of the connection to marijuana.⁴⁵ The bankruptcy court denied the motion to dismiss in part because the movant

³⁴ 922 F.3d 1031, 1033 (9th Cir. 2019).

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.* at 1034.

⁴⁰ *Id.*

⁴¹ *Id.* at 1036.

⁴² *In re Hacienda Co., LLC*, 2023 LEXIS 332 *1 (Bankr. C.D. Cal., Jan. 20, 2023).

⁴³ *Id.* at *2.

⁴⁴ *Id.*

⁴⁵ *Id.* at *1.

failed to establish any ongoing violation of the Controlled Substances Act as opposed to any pre-petition violations.⁴⁶ Further, under the plan, the debtor's sale of the stock to pay creditors would terminate any connection with cannabis.⁴⁷

The court pointed that Congress did not establish a zero tolerance policy that requires dismissal of any bankruptcy case involving a violation of the Controlled Substances Act.⁴⁸ For example, the Bankruptcy Code has no specific remedy for violations of the Controlled Substances Act.⁴⁹

Furthermore, dismissing every bankruptcy case that had a connection with illegal activity would be contrary to Congress' directives under the Bankruptcy Code.⁵⁰ The court pointed to cases like PG&E and Bernard Madoff as examples of cases involving illegal activity that were not dismissed.⁵¹

In conclusion, the bankruptcy court determined that Congress has provided courts some discretion to determine whether dismissal is appropriate based on the facts and circumstances of each case.⁵²

CHAPTER 13 CANNABIS CASES

Many courts have also dismissed Chapter 13 cases that are marijuana-related in some way. For example, in *In re Blumsack*,⁵³ the Chapter 13 debtor was employed by a marijuana dispensary and sought to fund his plan with his wages from the dispensary. The U.S. Trustee objected to the plan and filed a motion to dismiss because the debtor's activities violated federal law.⁵⁴ While retail distribution of marijuana is legal under Massachusetts law, the trustee pointed out that such activity violates the Controlled Substances Act.⁵⁵

⁴⁶ Id. at *7.

⁴⁷ Id. at *8.

⁴⁸ Id. at 11.

⁴⁹ Id.

⁵⁰ Id. at 12.

⁵¹ Id. at 13.

⁵² Id. at 17. In *In re CWNevada LLC*, 602 B.R. 717, 747 (Bankr. Nev. 2019) the bankruptcy court dismissed the Chapter 11 filed by a debtor that had marijuana business operations but commented that: "There may be cases where Chapter 11 relief is appropriate for an individual or a non-individual entity directly engaged in a marijuana-related business."

⁵³ 2023 LEXIS 108 *1 (Bankr. C.D. Mass., Jan. 17, 2023).

⁵⁴ Id. at *4.

⁵⁵ Id.

The U.S. Trustee argued further than the Chapter 13 plan could not be confirmed because the debtor could not demonstrate that he filed a petition in good faith because the wages were derived from activities that violated federal law.⁵⁶ The bankruptcy court agreed with the U.S. Trustee, pointing out that in the debtor's schedules filed with the court, he stated that he worked in sales as a "budtender" in a retail cannabis dispensary.⁵⁷ The court found that the debtor's activities violated the Controlled Substances Act by selling cannabis, distributing cannabis and possessing cannabis with intent to distribute.⁵⁸

In *In re Mayer*,⁵⁹ a creditor filed a motion to dismiss the debtor's Chapter 13 proceeding on the grounds that the debtor's sole source of income was from a marijuana-related business which violated the Controlled Substances Act. Both the Chapter 13 trustee and the U.S. Trustee supported the motion.⁶⁰ While the debtor proposed a plan that would be funded by revenues from a company he owned and a potential inheritance, the court did not believe there was sufficient evidence to show that either of these income streams were feasible.⁶¹ The court concluded that the only reliable assets that could support a plan would be derived from the ongoing Controlled Substances Act violations and therefore dismissed the Chapter 13 for cause.⁶²

An unusual Chapter 13 case involved a 92-year-old legally blind debtor who lived in an assisted living facility.⁶³ The debtor commenced a Chapter 13 proceeding to avoid a foreclosure of her commercial real property.⁶⁴ While one tenant that operated a marijuana dispensary paid rent post-petition, the debtor's Chapter 13 plan called for the debtor to sell the commercial property to pay the creditors.⁶⁵ Despite this intention, the bankruptcy court *sua sponte* dismissed the case on the grounds that the debtor's acceptance of post-petition rent from the marijuana dispensary was an ongoing "criminal violation that disqualified her from bankruptcy relief."⁶⁶

⁵⁶ Id. at *5.

⁵⁷ Id. *16.

⁵⁸ Id.

⁵⁹ 2022 LEXIS 256 *1 (Bankr. Ariz. Jan. 31, 2022).

⁶⁰ Id. at *2.

⁶¹ Id. at 12-13.

⁶² Id. at *14.

⁶³ *In re Olsen*, 2018 LEXIS 480 *1 (9th Cir. BAP, Feb. 5, 2018).

⁶⁴ Id.

⁶⁵ Id.

⁶⁶ Id.

The Ninth Circuit Bankruptcy Appellate Panel (BAP) vacated and remanded because the bankruptcy court failed to make adequate findings of fact to allow the appellate court to discern what standard the bankruptcy court had used to support its finding.⁶⁷ The BAP noted that the bankruptcy court had not cited any specific Bankruptcy Code provision in dismissing the case.⁶⁸ “When a court imposes the harsh penalty of dismissal in circumstances such as those presented here, it is imperative that it state with clarity and precision its factual and legal bases for doing so.”⁶⁹

CHAPTER 7 CANNABIS CASES

Chapter 7 is a liquidation process for individuals or entities in which the corporate debtor ceases to operate, a Chapter 7 trustee is appointed and that trustee is charged with liquidating the debtor’s assets. In several cases, the U.S. Trustee has filed a motion to dismiss Chapter 7 cases related to cannabis, arguing in part that a Chapter 7 trustee cannot be compelled to liquidate assets garnered through violations of federal law. For example, in *In re Arenas*,⁷⁰ the Chapter 7 debtors, who grew and dispensed medical marijuana and leased a building to tenants who dispensed medical marijuana, sought to convert from Chapter 7 to Chapter 13 (so they could reorganize). The U.S. Trustee objected to the conversion motion and requested that the case be dismissed.⁷¹

The bankruptcy court concluded that, even though lawful under Colorado law, the debtors’ activities violated the Controlled Substance Act.⁷² Accordingly, the bankruptcy court denied the motion to convert and dismissed the Chapter 7 case because “engaging in federal criminal conduct demonstrated a lack of good faith.”⁷³

The BAP for the U.S. Court of Appeals for the Tenth Circuit agreed with the bankruptcy court, affirmed the decision and noted that while the debtors had not engaged in “intrinsically evil conduct” they could not obtain bankruptcy relief because the marijuana business activities constituted federal crimes.⁷⁴ The Tenth Circuit’s BAP noted that nothing could be more burdensome to the

⁶⁷ Id. at 2.

⁶⁸ Id. at 10.

⁶⁹ Id. at 11.

⁷⁰ 535 B.R. at 847.

⁷¹ Id.

⁷² Id.

⁷³ Id.

⁷⁴ Id. at 849-50.

Chapter 7 trustee (other than exposing him to physical violence) than requiring him to possess, sell and distribute marijuana assets in violation of federal law.⁷⁵ In affirming the bankruptcy court decision, the Tenth Circuit's BAP acknowledged that the debtors were unfortunately caught between pursuing a business that was legal and beneficial under Colorado law but which was proscribed and criminal under deferral law (which federal judges have sworn to uphold).⁷⁶

In *In re Great Lakes Cultivation, LLC*, the debtor, a company that grew and sold medical marijuana, commenced a Chapter 7 proceeding.⁷⁷ All of the debtor's equipment was used in the manufacture of marijuana and all of its income was derived solely from marijuana sales.⁷⁸ The U.S. Trustee moved to dismiss the Chapter 7 proceeding, arguing that the case was not filed in good faith, that proceeding would require the Chapter 7 trustee to violate the Controlled Substances Act and potentially expose her to liability.⁷⁹ The bankruptcy court granted the motion to dismiss for cause, finding that the Chapter 7 trustee could not administer the debtor's marijuana and marijuana-related assets without violating the Controlled Substances Act, public policy did not support using federal law to benefit the debtor whose activities were illegal under federal law and the debtor's violations of the Controlled Substances Act showed bad faith which made it ineligible for bankruptcy relief.⁸⁰

The district court affirmed, agreeing with the bankruptcy court's rationale for dismissing the case based upon the illegality of administering the debtor's assets.⁸¹

First, the Chapter 7 trustee would be placed in the position of administering assets that violated federal law or, if she abandoned the marijuana, would be violating her fiduciary duty to preserve the estate's assets.⁸²

Further, the district court agreed that, because the debtor used its assets in the manufacture of marijuana, the Chapter 7 trustee could not lawfully possess or administer those assets.⁸³

⁷⁵ Id. at 852.

⁷⁶ Id. at 854.

⁷⁷ 2022 LEXIS 148145 at *5.

⁷⁸ Id.

⁷⁹ Id. at *6-7.

⁸⁰ Id. at *8-9.

⁸¹ Id. at 11.

⁸² Id. at *13.

⁸³ Id. at *16.

CONCLUSION

To date, bankruptcy courts and appellate courts have shown little sympathy to debtors who continue to engage post-petition in a cannabis-related business (including leasing property, equipment, manufacturing and selling). Despite the number of states that have legalized marijuana related activities, bankruptcy courts continue to dismiss cases based on violations of the federal Controlled Substances Act. It appears that, unless and until the federal laws mirror the state laws legalizing cannabis production, manufacture and sales, cannabis debtors will fare poorly in bankruptcy court. The one exception is for debtors that were engaged in cannabis-related activities pre-petition, have either ceased or can demonstrate that a plan would be funded from non cannabis related revenues.

