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Feature

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U.S. Continues to Wait for the Federal Legalization of Cannabis

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The reluctance of bankruptcy courts to allow debtors in the cannabis business to access traditional bankruptcy relief has remained somewhat consistent over the last five years, with a few courts easing their gatekeeping functions by permitting companies with remote or former ties to the cannabis industry to pursue bankruptcy relief. The Controlled Substances Act (CSA)[1] makes it a crime to manufacture, distribute and dispense marijuana, and supersedes any state law that has legalized the manufacturing, distributing and dispensing of marijuana through the application of the commerce clause.[2]

The tension between (x) the CSA's enforcement of marijuana and (y) state laws that legalize or decriminalize marijuana has continued to evolve in the context of bankruptcy courts that have been faced with distressed debtors seeking relief under chapters 7, 11 and 13. Procedurally, the dispute as to whether the CSA prohibits a debtor's access to a particular Bankruptcy Code provision has come up in various contexts, including general estate administration and plan confirmation, resulting in the dismissal of many cases.

However, recent cases signify a slight shift — providing a very limited path for businesses to seek relief under the Code. These cases involve specific sets of facts where the debtor (1) had remote connections with a cannabis business or (2) formerly operated or received income in connection with a cannabis business.

Estate Administration

In the case-administration process, the legal basis for dismissal of cases where the debtors were state-licensed to grow/dispense marijuana was the inability of the chapter 7 or 13 trustee to administer the estate or plan with assets that related to illegal activity. For example, in *In re Arenas*, the bankruptcy appellate panel (BAP) concluded that dismissal of a chapter 7 case was proper where the trustee would have been required to administer (1) rental income from the marijuana business and (2) proceeds of the joint debtors' growing and selling of marijuana.[3] Similarly, in *In re Great Lakes Cultivation LLC*, the district court concluded that dismissal of a chapter 7 case was proper where the trustee could not lawfully administer the debtor's assets that were comprised of medical marijuana.

These cases represent the prevalent view by bankruptcy courts that cannabis growers, processors, distributors, retailers and any other cannabis-related businesses are prohibited from seeking bankruptcy relief due to their ongoing violations of the CSA.[4] Even cannabis-related landlords and equipment dealers have been found to violate the CSA and, as a result, have had their bankruptcy cases dismissed.[5]

In contrast, in *In re Calloway*, the bankruptcy court recently held that a chapter 7 debtor's interest in a limited liability company (LLC) engaging in the marijuana business was not cause for dismissal of the case, because the chapter 7 trustee was not at risk of administering assets in violation of the CSA.[6] In *Callaway*, a creditor, the chapter 7 trustee and

1 21 U.S.C. §§ 801-971.
2 *See Gonzales v. Raich*, 545 U.S. 1, 29 (2005).
3 *Arenas v. United States Tr. (In re Arenas)*, 535 B.R. 845 (B.A.P. 10th Cir. 2015).
4 2022 WL 3569586 (E.D. Mich. Aug. 18, 2022).
5 *See, e.g., In re Way to Grow Inc.*, 610 B.R. 338 (D. Colo. 2019) (affirming bankruptcy court's decision to dismiss debtors' chapter 11 cases where their businesses relied on knowingly selling equipment to cannabis growers); *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012) (finding cause for dismissal where debtor knowingly maintained leases with cannabis growers during pendency of its chapter 11 case).

the U.S. Trustee each filed motions to dismiss the case for cause, alleging that the debtor's ownership interests in the LLC would require the chapter 7 trustee to violate the CSA.

The bankruptcy court held that (1) administering an ownership interest of an LLC that engages in the marijuana business was "not necessarily equivalent to administering marijuana assets"; and (2) the trustee's own personal conclusion that he could not lawfully administer the estate's assets was not cause for dismissal, and thus, the trustee was "not in danger" of administering assets in violation of the CSA. The court observed that there were other "tools in the bankruptcy toolbox" to address the trustee's concerns, including (1) abandoning any assets that were burdensome to the estate pursuant to § 554 of the Bankruptcy Code; (2) not continuing as chapter 7 trustee and having the U.S. Trustee act as trustee under 28 U.S.C. § 586(a)(2); and (3) seeking denial of the debtor's discharge if the debtor "misbehaved" pre- or post-petition.

Plan Confirmation

In the plan-confirmation context, a number of courts, when faced with the issue, found that the plan filed by the applicable debtor, who was licensed by the state to grow/dispense marijuana, did not comply with the two Bankruptcy Code sections that require that the plan be (1) proposed in good faith and not by means forbidden by law; and (2) feasible. These courts concluded that because the applicable debtors were *continuing* to engage in conduct that violated federal law and the plan would be funded by income generated from such conduct, the plan requirements set forth in § 1129(a)(3) and (11) could not be satisfied.

For example, in *In re ARM Ventures*, the court ruled that the plan was not feasible and was filed in bad faith where the commercial real estate debtor expected future rents from a tenant that had sought (but not yet obtained) federal and state approval to grow and sell marijuana.[7] Similarly, the court in *In re Blumsak* denied confirmation of a chapter 13 plan (and dismissed the case for cause) that was to be funded by income derived by the debtor's employment in distributing cannabis.[8]

In contrast, the Ninth Circuit in *Garvin v. Cook Investments NW, SPNWY LLC* interpreted § 1129(a)(3) to mean that a plan must not be proposed in an unlawful manner and expressly found that such provision did not preclude confirmation of a plan that contained substantive provisions that were premised on illegality.[9] Rather, the court concluded that it was only required to look at the plan proposal — not the terms of the plan — for plan-confirmation purposes and confirmed a plan that included continuing to lease to an entity that grew marijuana. Notably, the debtor was not engaged in the cultivation, production or distribution of marijuana. The BAP in *In re Olson* likewise affirmed a chapter 11 plan where the plan derived indirect support from rental income from a lessor engaged in a marijuana business.[10]

To expand on this approach, some courts (predominantly in the Ninth Circuit) have declined to apply a bright-line rule that requires the dismissal of all cases having any relationship to the cannabis industry. For example, the bankruptcy court in *In re Hacienda* utilized its discretion in confirming the debtor's chapter 11 plan and declining to dismiss the debtor's case, observing that dismissing every case with connection to illegal activity under nonbankruptcy law would harm the constituencies that Congress attempted to protect through the tools of the Bankruptcy Code.[11]

Prior to its bankruptcy filing, the debtor in *Hacienda* ceased operations and transferred its cannabis business to a publicly traded Canadian company and received a 9.4 percent interest in the Canadian company in exchange. At the time of this transfer, cannabis was legal under both California state law and Canadian law. After the bankruptcy filing, the debtor believed that maximum value for its estate would be achieved by liquidating its 9.4 percent interests and paying creditors over time with these distributions.

The U.S. Trustee filed two separate motions to dismiss the debtor's case, arguing in its first motion that the debtor distributed or conspired to distribute cannabis in violation of the CSA. The bankruptcy court denied this motion after finding that there was no *ongoing* violation of the CSA, as the debtor had not been distributing cannabis at that time and had no intent to use its remaining assets to invest in any cannabis-related enterprise in the future. The court left the door open to a future motion to dismiss if there were facts to show that the debtor's proposed liquidation would be an actual violation of a criminal statute.

In its ruling, the court expressly relied on *In re Burton* for the proposition that there is no *per se* rule requiring dismissal where the presence of cannabis is near a case; rather, courts should explicitly articulate their factual bases for dismissing a cannabis-related case.[12]

The U.S. Trustee argued in its second motion that "cause" existed to dismiss the case based on the debtor's alleged violation of the CSA. It claimed that the debtor's proposed plan was a conspiracy to violate federal criminal laws because it proposed to repay creditors with assets derived from alleged criminal activity (its interests in the Canadian company), and because federal courts generally close their doors on issues involving illegal contracts. In its thoughtful decision, the bankruptcy court explained its findings to support its conclusion that the U.S. Trustee failed to satisfy "cause" to warrant dismissal, which included the following: (1) the debtor was not engaged in the ongoing distribution of cannabis during the case and did not intend to after the interests were liquidated, at which time all connections to cannabis would cease, including profiting from cannabis; and (2) there was no showing that a future bankruptcy trustee would be forced to violate the CSA in connection with estate administration.

The *Hacienda* court looked to the debtor's indirect connection with any violation of a criminal law, the debtor's intent to liquidate and pay creditors, and the benefits of the

6 663 B.R. 109 (Bankr. N.D. Cal. 2024).
7 564 B.R. 77 (S.D. Fla. 2017).
8 647 B.R. 584 (Bankr. D. Mass. 2023).
9 922 F.3d 1031 (9th Cir. 2019).
10 2018 WL 989263 (B.A.P. 9th Cir. 2018).

11 654 B.R. 155 (Bankr. C.D. Cal. 2023).
12 *Burton v. Maney (In re Burton)*, 610 B.R. 633, 637-38 (B.A.P. 9th Cir. 2020); *accord*, *In re Roberts*, 644 B.R. 220, 231 (Bankr. D. Colo.).

monetization of the stock for the estate and the creditors, and interpreted § 1112(b) as granting the bankruptcy court discretion to determine whether "a debtor's connection to cannabis profits and any past or future investment in cannabis enterprises warrants dismissal of this bankruptcy case." While the bankruptcy court concurrently issued a memorandum decision confirming the debtor's chapter 11 plan[13] so as not to be viewed as condoning illegal behavior, it noted that a debtor's connection to cannabis could result in a dismissal of its bankruptcy case and that federal prosecutors would not be precluded from pursuing remedies for violations of the CSA or other nonbankruptcy laws.

Conclusion

While a few bright-line rules have emerged, there has been an evolving consensus by several courts, including *Hacienda* and *Calloway*, that the mere presence of marijuana near a bankruptcy case should not automatically prohibit a debtor from seeking bankruptcy relief. Rather, as explained in *In re Olson*, a bankruptcy court should articulate its legal and factual bases for dismissal in cases involving marijuana by evaluating whether and how the debtor was actually violating the CSA, and explaining why dismissal of the case was necessary.

Decisions such as those in *Olson*, *Calloway* and *Hacienda* represent a willingness by a few bankruptcy courts to apply a more nuanced approach to looking at the debtor's relationship to the cannabis business and any cannabis-related assets, such that the closer the debtor's relationship to cannabis plants or products in both time and connection, the more likely it is that the case will be dismissed.[14]

Even courts that have felt constrained to follow the traditional approach of dismissing cases involving cannabis have nonetheless expressed empathy for debtors who are in need of bankruptcy relief but face little to no practical alternatives, articulating that such debtors do not seek bankruptcy relief in bad faith, and that "[b]ut for the marijuana issue, this would be a relatively run-of-the-mill Chapter 11 proceeding."[15] Other courts have expressed frustration with continued congressional inaction and have noted that the fact that until such action is taken, all parties that participate in the marijuana industry "face a creeping absurdity" that while they can rely on state law to expand cannabis businesses and investments, such businesses "expose all of them to possible federal criminal prosecution."[16] Such uncertainty also applies to state and local governments that receive taxes from these businesses.[17]

The U.S. Drug Enforcement Administration has proposed transferring cannabis from Schedule I of the CSA to Schedule III, and this is based on the U.S. Department of Health and Human Services' view that cannabis has at least one accepted medical use and a lower potential for abuse and physical or psychological dependence.[18] This proposal signals a potential shift in how cannabis could be treated in the near future, which can include making federal bankruptcy relief available for state-legalized cannabis businesses. Unfortunately, until federal legislation is put in place, access to bankruptcy courts for distressed businesses in the cannabis industry will continue to remain limited. **abi**

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13 2023 WL 6143216 (Bankr. C.D. Cal. 2023).
14 One court took it a step further: While the court ultimately dismissed the case, it recognized the possibility that chapter 11 relief could be appropriate for an individual or entity directly involved with marijuana-related businesses. *See In re CWNevada LLC*, 602 B.R. 717, 747 (Bankr. D. Nev. 2019).
15 *Way to Grow*, 597 B.R. 111, at 132-33 (Bankr. D. Colo. 2018).
16 602 B.R. at 739-40.
17 *Id.*
18 *See* Schedules of Controlled Substances: Rescheduling of Marijuana (proposed May 16, 2024; to be codified at 21 C.F.R. pt. 1308), *available at* dea.gov/sites/default/files/2024-05/Scheduling NPRM 508.pdf (last visited Nov. 19, 2024).