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Up in Smoke: Why Marijuana Companies Can't File Bankruptcy and How That Could Change

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Voters in eight states, including California and Florida, recently approved ballot initiatives to legalize the recreational and medical use of marijuana. Presently, 28 states permit the use of marijuana to different extents.

Even before the entry of these states to the market, the multibillion dollar marijuana industry was growing quickly. As the industry has grown, so has the number and variety of individuals and businesses, including sophisticated investors, who have jockeyed to profit from its growth. However, despite its growth in recent years, the industry faces a host of challenges stemming from the reality that using or profiting from marijuana in any fashion, even if it is legal under state law, remains a federal crime under the Controlled Substances Act of 1970 (the CSA).[1] This article examines one of these challenges: the ability to take advantage of the Bankruptcy Code.

Recent court decisions have made it clear that individuals and businesses that under state law lawfully earn income that in *any way* derives from marijuana are *entirely* foreclosed from seeking bankruptcy protection. Because of this broad exclusion, even businesses that are not directly involved in the production, distribution, or sale of marijuana may be denied the protection of the bankruptcy courts. However, a close examination of these cases reveals their limitations and potential opportunities for certain individuals and business to seek bankruptcy protection, despite receiving income from marijuana sales.

In re Rent-Rite Super Kegs W. Ltd. (*Rent-Rite*) was the first reported decision to address how the conflict between the CSA and state law affects the ability of a business that profits from marijuana

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to seek bankruptcy relief.[2] In *Rent-Rite*, the debtor filed a bankruptcy petition under Chapter 11 (the reorganization chapter) of the U.S. Bankruptcy Code (the Code) in Colorado. The debtor owned a warehouse and leased space to certain tenants for the cultivation of marijuana. The rent received by the debtor equaled 25 percent of its income. The bank who held a mortgage on the warehouse filed a motion to dismiss the bankruptcy case on the grounds that filing for bankruptcy was illegal under the CSA. The bankruptcy court agreed, holding that, even though the debtor's business operation was legal under Colorado law, it had discretion to dismiss or convert the bankruptcy case due to the debtor's violation of the CSA based on: (1) the unclean hands doctrine and; (2) §1112(b) of the Code, which provides that a case may be dismissed for "cause." *Rent-Rite* is the only reported decision to address this issue under Chapter 11. The judge in *Rent-Rite* appeared to be hostile to what he considered the debtor's open disregard of the CSA.

More recently, the courts have adopted a more nuanced approach in addressing the ability of individuals who derive their income from marijuana businesses. In *In re Arenas*[3] the debtors, a married couple, jointly owned a commercial building in Denver that consisted of two units. One of the debtors grew and sold marijuana in one unit and the other unit was leased to a non-affiliated marijuana dispensary. The debtors derived approximately 70 percent of their income from marijuana and the remainder of their income was obtained from a pension and Social Security income.

The debtors filed a petition under Chapter 7 of the Code (the liquidation chapter). During the bankruptcy case, the non-affiliated dispensary expressed an interest to the Chapter 7 trustee to purchase the property. The Office of the U.S. Trustee (an agency within the U.S. Department of Justice (the DOJ) responsible for overseeing the administration of bankruptcy cases) filed a motion to dismiss the case, arguing that it would be impossible for the Chapter 7 trustee to sell the property, which was entirely used by two marijuana businesses, without violating federal law. The debtors opposed the U.S. Trustee motion to dismiss and filed a motion to convert their case to one under Chapter 13 of the Code (the chapter for individuals who want to adjust their debts rather than liquidate). The bankruptcy court found that there was "cause" to dismiss the Chapter 7 case (under §707(a)) and to refuse to convert the case to a Chapter 13 (under §1307(c)).

The Bankruptcy Appellate Panel (BAP) affirmed the dismissal of the case and refused to convert the case for two reasons. First, the BAP agreed with the bankruptcy court that neither a Chapter 7 nor Chapter 13 trustee could lawfully administer the bankruptcy estate's assets, because doing so would require a trustee to knowingly violate federal law (the CSA). Second, the BAP agreed that the debtors did not have sufficient non-marijuana derived income to feasibly fund their Chapter 13 plan of rehabilitation.

In *In re Johnson*[4] the Michigan bankruptcy court, applying reasoning slightly different than in *Arenas* (and relying on distinct sections in Chapter 13), came to the same conclusion, i.e., that income and other assets illicitly obtained under federal law cannot be administered in a bankruptcy case. *Johnson* was a Chapter 13 case in which the debtor was a licensed "caregiver" and marijuana grower under the Michigan Medical Marihuana Act. The debtor earned nearly half of his income from his marijuana business (the remainder was social

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security income). As in *Arenas*, the U.S. Trustee moved to dismiss the case. Although the court in *Johnson* agreed with the U.S. Trustee that bankruptcy relief was not available to the debtor due to his illegal income, the court found that that did not necessarily require dismissal of the case. The court gave the debtor a choice—either he continues with the bankruptcy case which would require him to cease operating his marijuana business and destroy all his marijuana plants and products or he continues with the marijuana business and voluntarily dismisses the bankruptcy case.

On the surface, these three cases seem to represent an insurmountable barrier to the filing of bankruptcy by *any* individuals and business who earn *any* income from marijuana. However, this may not be the case.

First, all three judges acknowledged that their decisions were based on the discretion granted to them under the Code and guided by equitable principles. Therefore, the facts and circumstances of a case will dictate the result to a greater extent that the applicable law. In *Johnson*, the court found that the debtor did not file the Chapter 13 petition in bad faith, while the court in *Arenas* found that the Chapter 13 petition was filed in bad faith as a matter of law because the debtor was engaged in a business that violated the CSA.

Second, in *Johnson* and *Arenas*, no party other than the U.S. Trustee requested that the cases be dismissed. However, the DOJ has demonstrated a willingness to adapt to the legalization of marijuana under states' laws. For example, after the previous string of ballot initiatives the DOJ issued a memorandum in August 2013 updating its CSA enforcement policy with respect to marijuana.[5]

Third, in *Johnson* and *Arenas*, the U.S. Trustee argued that the case should be dismissed because it required the trustee to violate federal law by administering marijuana assets. In those cases there were assets for the trustee to administer for the benefit of creditors. But it is unclear what the outcome would have been if there are no assets for a trustee to administer. (The vast majority of Chapter 7 cases filed by individuals are "no-asset" cases.)

Fourth, as demonstrated in *Johnson*, a debtor may be able to avoid the bar on bankruptcy if it disposes of all its marijuana assets and ceases earning marijuana-related income prior to the filing. Simply liquidating the assets and retaining the illicit proceeds will likely not be enough. The unanswered question revolves around whether a debtor that at one time profited from marijuana in even the slightest way will be forever precluded from seeking bankruptcy relief.

Lastly, it is important to note the stark difference in tone and language employed by the courts in *Rent-Rite* on the one hand, and *Johnson* and *Arenas*, decided three years later, on the other. In *Rent-Rite*, the court was unabashedly critical of the debtor's violation of the CSA (remember that the debtor in that case was not a marijuana business but leased property to such a business). In *Johnson* and *Arenas*, the courts were sensitive to the debtors' plight, even labeling their circumstances as "unfortunate." This contrast is no doubt due to the debtors in *Johnson* and *Arenas* being individuals who subsisted on Social Security, but may also be partly the result of the growing legitimization of commercial marijuana.

As the marijuana industry becomes "mainstream," restructuring practitioners will continue to challenge the legal authority discussed above and bankruptcy courts will be more reluctant to deny bankruptcy relief to a growing segment of the economy. Stay tuned.

1. 21 U.S.C. 801 et seq.
2. 484 B.R. 799, 803 (Bankr. D. Colo. 2012).
3. 535 B.R. 845 (10th Cir. BAP 2015).
4. 532 B.R. 53 (Bankr. W.D. Mich. 2015).
5. Available at https://www.justice.gov/iso/opa/resources/305201382913275685746 7.pdf.