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How Cannabis Cos. Are Adapting in Shifting Bankruptcy Arena

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Although the possession and sale of cannabis[1] remain federally illegal under the Controlled Substances Act,[2] the U.S. Department of Justice has largely exercised a general policy of nonprosecution for state-regulated cannabis enterprises.

The cannabis industry has grown into a multibillion-dollar market within this legal gray area. Currently, 37 states and the District of Columbia have implemented state legislation allowing for cannabis companies to operate.[3]

Nevertheless, businesses engaged in growing, processing, distributing or selling cannabis products for adult recreational or medicinal purposes in accordance with state laws and regulations are in violation of the CSA, which largely serves to deny these enterprises access to important federal legal rights — none more so than federal bankruptcy protection.

With the federal forums that traditionally address insolvency matters unavailable, failing cannabis companies that wish to avoid an unstructured wind-down are generally forced to seek state-controlled alternatives to bankruptcy, such as receiverships.

However, federal courts have begun to demonstrate more openness to downstream businesses in the cannabis industry and to entities that are no longer directly engaged in the industry.

Hope for Judicial Reform: Cannabis-Related Companies in Bankruptcy

Again, a cannabis debtor is generally ineligible for protection under the U.S. Bankruptcy Code.[4]

Indeed, the DOJ's U.S. Trustee Program follows an office-wide directive under which a trustee must seek dismissal of any bankruptcy petition by a marijuana-related business — regardless of whether the debtor is proposing to continue operation or seeking liquidation of a terminated enterprise and regardless of whether the debtor is a direct or downstream participant in the cannabis supply chain.

According to the USTP directive, this policy is derived from the principles that:

- Reorganization plans that permit or require continuation of federally illegal activity may not be confirmed because the bankruptcy system may not be used as an instrument in the ongoing commission of a crime; and
- Bankruptcy trustees and other estate fiduciaries should not be required to administer assets if doing so would cause them to violate federal criminal law.

But recent instances of judicial pushback on the blanket USTP policy has given hope for the emergence of a more holistic approach to downstream and indirect participants in the cannabis industry.

For example, in its 2019 opinion in *Garvin v. Cook Investments NW*,[5] the U.S. Court of Appeals for the Ninth Circuit affirmed the confirmation of a Chapter 11 bankruptcy plan for five real estate holding companies, one of which leased property to a Washington State cannabis business that utilized the real estate to grow cannabis, over the trustee's objection that it violated the Title 11 of the U.S. Code, Section 1129(a)(3), requirement that a plan be "proposed in good faith and not by any means forbidden by law."

The Ninth Circuit held that Section 1129(a)(3) directs the bankruptcy courts to police the means of a reorganization plan's proposal and forbids confirmation of a plan that is proposed in an unlawful manner but does not preclude confirmation of a plan with substantive provisions that depend on illegality — such as the continued operation of a cannabis business in a leased premises.[6]

Notably, however, in *Garvin*, the Ninth Circuit determined that the trustee had waived its argument that the bankruptcy court had improperly denied its motion to dismiss the petition for cause under Section 1112(b) and thus did not reach that issue.[7]

The U.S. Bankruptcy Court for the Central District of California reached this question in its *Hacienda Company LLC* decision in September.[8]

In *Hacienda*, the bankruptcy court kept its doors open for a debtor who, at one time, manufactured, packaged and distributed cannabis, but had since ceased operations and transferred its assets to a publicly traded Canadian company that engages exclusively in cannabis growth and sales — which is legal under Canadian law.

In exchange for the assets, the debtor received approximately $35 million in the Canadian company's equity. Approximately 18 months after the debtor ceased operations, it filed for bankruptcy intending to sell the shares in the Canadian company and distribute the proceeds to creditors.

The U.S. trustee's first motion to dismiss alleged that the debtor itself was effectively engaged in the sale of cannabis products, but the bankruptcy court did not find that the U.S. trustee had met its burden. In its second request, the U.S. trustee asserted that the debtor had not taken sufficient steps to withdraw from an ongoing conspiracy to violate the CSA.

In denying the U.S. trustee's second motion to dismiss, the bankruptcy court concluded that there is no per se statutory requirement for dismissal of every bankruptcy case involving a CSA violation by a cannabis business.

The court held that to create such a bright-line rule and dismiss every case that had a connection with this illegal activity would disrupt the goals of the Bankruptcy Code and harm the constituencies that the U.S. Congress attempted to protect under the Bankruptcy Code.

In rejecting such a bright-line rule, the bankruptcy court stated the following: “There is no doubt that a debtor’s connections with cannabis can, in some circumstances, result in dismissal of their bankruptcy case.”

But in this case, the debtor is attempting to divest itself of its investment in a Canadian cannabis business that is legally traded on a Canadian stock exchange. Nothing that the debtor proposes to do post-petition will foster a single additional sale of cannabis products, nor will it add a single dollar to any cannabis-related enterprise.

The debtor’s proposed plan provides for an orderly liquidation for the benefit of creditors, much as a receiver under the money laundering statutes would do.

The *Hacienda* decision reflects a holistic approach to a cannabis-related bankruptcy that considers both the timing of the cannabis-related conduct and how connected the debtor is to the cannabis industry.

This shift may signal a turn toward greater judicial tolerance for bankruptcy petitions filed by struggling cannabis companies — or at least those that cease operations prepetition.

Cannabis Companies in Bankruptcy

Nevertheless, it remains to be seen how widely the *Hacienda* reasoning will be adopted, or whether its approach will be extended to overt cannabis companies.

U.S. trustees act as the watchdog in bankruptcy proceedings and, in accordance with their operative mandate, discussed above, generally seek to dismiss a cannabis bankruptcy for cause under Section 1112(b) of the Bankruptcy Code.[9]

Struggling cannabis and cannabis-related enterprises therefore must continue to consider receiverships and other state-controlled or out-of-court alternatives to an unstructured wind-down, which may leave creditors in pursuit of business owners personally to satisfy debts.

Cannabis Receivership: Better Than Nothing, but Not For the Faint of Heart

All receivers appointed by a court must follow state regulatory requirements, and in the cannabis arena there is generally a cannabis regulator, a taxing authority or a state attorney general’s office involved as well.

For example, the matter of *Teneo Funds SPVI I LLC v. Ermont Inc.* in the Suffolk County Superior Court of the Commonwealth of Massachusetts,[10] which concluded in September, was the first instance in which a Massachusetts cannabis company was liquidated through a court-appointed receivership. Under the Massachusetts Cannabis Control Commission’s regulations, the court-appointed receiver needed the commission’s prior approval.

Further, the change in ownership for Ermont, a medical cannabis operator, also required approval from the commission before the sale of Ermont's assets to MariMed Inc., a multistate operator, could proceed.

Once appointed, a receiver's options run the gamut from operating the company as-is, restructuring operations to maximize profit, or liquidating the business as a whole or in pieces. The receiver has a fiduciary responsibility to determine the option that best satisfies creditors, like the duties required of a trustee in a bankruptcy.

Given the complex interplay between the receivership system and state cannabis statutes and regulations, and the fraud potential arising from the all-cash nature of most marijuana businesses, cannabis receivership is not for the faint of heart.

A case study comes from *In re: Marriage of Humphrey*,[11] where the Colorado Court of Appeals ruled that because Colorado law requires anyone who owns, operates, manages, controls or works in a licensed marijuana business to be licensed in accordance with the Colorado Medical Marijuana Code or the Colorado Retail Marijuana Code, a Colorado court could not appoint a receiver to oversee cannabis operations who had not received the necessary marijuana licenses.

In *Marriage of Humphrey*, a court presiding over a divorce proceeding authorized a receiver to control and operate marital property that included several licensed medical and recreational cannabis businesses.

The Colorado Department of Revenue, the state marijuana regulatory authority, represented by the Colorado attorney general's office, moved to intervene in the proceeding and sought the modification of the receivership order to require the receiver obtain such licensing.

The lower court denied the motion to modify and, on appeal, the Colorado Court of Appeals ruled that the lower court's appointment of an unlicensed receiver, in violation of Colorado's marijuana statutes and regulations, exceeded its equitable powers.[12]

Ultimately, in *Yates v. Sterling Consulting Corp.*, which arose out of the *Marriage of Humphrey* litigation, the Colorado Court of Appeals affirmed a Denver district court order refusing to discharge the receiver whose initial refusal to obtain the necessary state cannabis licenses prompted the appeal in *Marriage of Humphrey*.

In *Yates*, the receiver's principal surrendered his marijuana appointee license amid the Denver district court's conduct of an inquiry into the propriety of the receiver's management of the receivership estates cannabis business assets. The receiver argued that the principal's surrender of his required cannabis license automatically effected its discharge.

The lower court disagreed and entered an order appointing a second receiver and stripping the receiver of its power to control the cannabis businesses but refusing to discharge it, given the court's concerns about the receiver's performance and the effective release of claims that would come with such a discharge.

Marriage of Humphrey and *Yates* demonstrate that even though receivership can be a viable option for cannabis entities denied access to the federal bankruptcy system, it is not without its own risks and complexities, and requires careful management.

Our Cannabis Practice provides advice on issues related to applicable federal and state law. Marijuana remains an illegal controlled substance under federal law.

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[1] For purposes of this article, “cannabis” refers to marijuana, which means all cannabis that tests as having a delta-9 tetrahydrocannabinol (THC) concentration level of higher than 0.3% on a dry weight basis.

[2] The act lists marijuana and THC, its main psychoactive ingredient, as Schedule I controlled substances. See 21 U.S.C. § 812(c).

[3] After Ohio’s legalization of recreational marijuana possession and sale takes effect on December 7, 2023, 24 states and the District of Columbia will have legalized both adult-use and medical marijuana. An additional thirteen states have legalized medical marijuana only. Kentucky in March 2023 enacted a bill that will create a medicinal cannabis program in that state effective January 1, 2025.

[4] See, e.g., *In re Arenas*, 535 B.R. 845 (10th Cir. BAP 2015) (debtors’ marijuana business, while legal under state law, was illegal under federal law, and thus the debtors could not propose a confirmable plan in good faith).

[5] 922 F.3d 1031 (9th Cir. 2019).

[6] Id. at 1035-36.

[7] Note also that the real estate holdings at issue in *Garvin* were subject to state-court orders appointing receivers that predated the debtor’s bankruptcy petition and the Ninth Circuit did not address the potential interplay with state marijuana licensing obligations and state requirements for the transfer of ownership in a cannabis business.

[8] *In re Hacienda Company, LLC*, Case No. 22-15163, 2023 WL 6143216 (Bankr. C.D. Cal. Sept. 20, 2023).

[9] The Bankruptcy Code does not define “cause,” so a Trustee is afforded leeway in asserting justifications for dismissal. For example, all of the following have been held to constitute sufficient “cause” to dismiss a case:

- Violation of nonbankruptcy law is itself a sufficient “cause” to dismiss the bankruptcy.
- Violation of nonbankruptcy law establishes a debtor’s lack of good faith.
- Violation of nonbankruptcy law may constitute “gross mismanagement” of the estate.
- Violation of nonbankruptcy law disrupts fundamental equitable principals by requiring the court to violate federal law in confirming a reorganization plan.

[10] Suffolk Superior Court No. 2184CV01563 (Mass. Super. Ct.).

[11] 488 P.3d 348 (Colo. App. 2018).

[12] No. 21CA1777 (Colo. App. March 23, 2023) (unpublished opinion), 2023 WL 2639577.

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