3 Bankruptcy Rulings Highlight Barriers For Pot-Adjacent Cos.

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Since at least 2017, when U.S. Trustee Program Director Clifford White distributed an official policy letter and testified before Congress, the U.S. Trustee's Office has consistently sought dismissal of bankruptcy cases filed by debtors with assets or income derived from marijuana.

At first glance, this policy seems incongruous, since an increasing number of states have legalized cannabis products in varying contexts, both medical and recreational, and the U.S. Department of Justice has diverted resources away from marijuana-related prosecutions. This contrast, however, can be explained by the fact that a bankruptcy petitioner is actively seeking protection under federal law while continuing to commit a federal crime under the Controlled Substances Act.

In most cannabis-related dismissals, the debtors have a direct relationship with cannabis or cannabis products.

For instance, in In re: Rent-Rite Super Kegs West Ltd.,[1] decided shortly after recreational marijuana was legalized in Colorado, the debtor derived around 25% of its revenue from leasing warehouses to tenants who grew marijuana. The U.S. Bankruptcy Court for the District of Colorado found that this activity violated federal law and constituted "gross mismanagement of the estate" under Title 11 of the U.S. Code, Section 1112(b)(4)(B), and concluded that the debtor's petition had been filed in bad faith.

In In re: Johnson,[2] the debtor derived almost half of his income from growing and selling marijuana. In response to the U.S. Trustee's motion to dismiss, the U.S. Bankruptcy Court for the Western District of Michigan found the debtor's business to be "patently incompatible with a bankruptcy proceeding" and ordered that the debtor cease operating his marijuana business if he wanted to stay in bankruptcy.

In In re: Way to Grow Inc.,[3] the debtor sold equipment for indoor hydroponic gardening and related supplies, which was marketed to and purchased by businesses in the cannabis industry. The Colorado Bankruptcy Court dismissed the case, finding that the debtors knew they were selling products to customers who likely used them to manufacture marijuana in violation of federal law.

In In re: Basrah Custom Design Inc.,[4] the debtor's sole shareholder had leased a portion of real estate to a company that operated as a medical marijuana dispensary. The U.S. Bankruptcy Court for the Eastern District of Michigan granted the U.S. Trustee's motion to dismiss because the debtor's sole purpose for filing was to reject the lease and find another medical marijuana tenant who would pay higher rent. In the court's words, the debtor

sought to use bankruptcy "to set aside this illegal contract so that he can negotiate a better illegal contract."

Several decisions this year have expanded on this barrier to bankruptcy so that even those debtors, like the one in Way to Grow, that have a more attenuated connection to the cannabis industry are still barred from filing, making federal bankruptcy relief equally unavailable to downstream participants in the cannabis industry, i.e., those debtors who do not grow or dispense marijuana or sell other related illegal products.

The result is that if a business sells or leases property to another business that grows or dispenses marijuana, or sells its products knowing they will be used by another business for illegal marijuana-related activities, the debtor is viewed as enabling violation of federal law and excluded from bankruptcy protection.

This year, three cases — In re: Burton,[5] In re: Malul[6] and In re: Pharmagreen Biotech Inc.[7] — have pushed this seemingly harsh policy even further, as bankruptcy courts dismissed debtors' cases when they only had the potential of receiving income from a downstream cannabis distributor.

In Burton, the individual debtors owned the majority interest in an entity that cultivated and sold marijuana. When the U.S. Trustee sought dismissal of their Chapter 13 case, the debtors argued that because the entity was defunct and not being used to fund their plan, dismissal was unnecessary.

However, during the bankruptcy proceedings and while no longer operating, the debtors' former business was engaged in two state court lawsuits, seeking recovery for breaches of contract related to its business operations.

The Colorado Bankruptcy Court dismissed the case based upon the debtors' potential recovery of assets that would violate the CSA, concluding that dismissal was appropriate because if the lawsuits were successful, the Chapter 13 trustee would have to administer assets connected to illegal activity. The court was not persuaded by the debtors' argument that they were unlikely to recover any proceeds in the lawsuits.

Likewise, in Malul, the individual debtor moved to reopen her case to disclose a potential asset related to her investment in a medical marijuana business. She did not disclose this asset in her Chapter 7 schedules because the investment was not yet a complete loss and she was unaware of her potential claims against the business. But upon learning about her potential legal claims five years later, the debtor sued the business's former principal in state court.

When the debtor sought to reopen her case to administer this asset, the bankruptcy court expressed concern that the Chapter 7 trustee would be administering illegal assets and allowed interested parties to challenge its conditional order reopening the case. Interestingly, the Chapter 7 trustee sought to approve a settlement of the debtor's claims, which would have provided the estate a lump sum payment expressly made "with traceable funds that do not originate from a marijuana enterprise."

The U.S. Trustee nevertheless objected to both the settlement motion and reopening the case, arguing that administration of the estate would require the Chapter 7 trustee to engage in illegal activity by seeking "to recover the debtor's investment in a marijuana business from a related marijuana business or alter ego of the marijuana business."

In its analysis, the Bankruptcy Court for the District of Colorado expressly distinguished precedent holding that "contracts that can be performed without violating the CSA are likely enforceable even if the transaction's subject matter involves CSA violations,"[8] with the Burton case, where "the damages ... arose entirely out of the Burtons' ownership of an interest in an entity created for the specific purpose of engaging in CSA violations" and thus "there would be no litigation recovery but for the existence of the equity interest."[9]

Ultimately, the bankruptcy court in Malul held that the debtor's "mere possession of those rights and interests, and certainly her prosecution of litigation claims in furtherance of those rights and interests, constitute ongoing criminal violations of the CSA,"[10] and declined to reopen the case to administer the asset.

In Pharmagreen, the debtor was not operating a growing or distribution center related to cannabis and never intended to do so within the U.S., but instead was seeking a cannabis license in Canada and intended to participate in the cannabis industry post-bankruptcy.

Two creditors moved to dismiss, arguing that the debtor's business model was clearly premised on violations of federal law and the debtor's assertion that it would not be in the cannabis industry until the bankruptcy was concluded was "more a matter of convenience than actual fact."

In a short order, the U.S. Bankruptcy Court for the District of Nevada agreed and dismissed the case because the debtor "does not qualify as a debtor based on its contemplated business operations which include the cultivation and sale of marijuana."

Malul, Burton and Pharmagreen further foreclose the possibility of bankruptcy relief for businesses even remotely connected to the production or distribution of cannabis products.

While marijuana businesses in financial distress can certainly consider alternatives to bankruptcy, such as state law receiverships, assignments for the benefit of creditors or consenting to foreclosure sale, these options often do not provide the same level of protection and benefits under the federal Bankruptcy Code, such as orderly administration, a discharge of debt and an automatic nationwide injunctive stay of creditors' collection efforts.

To the extent these alternatives are litigated, they are likely to be before courts with jurisdiction only over the business's assets within that court's geographic jurisdiction — as opposed to bankruptcy courts, which have nationwide authority. Even as proponents of marijuana legalization increasingly become mainstream, the bankruptcy courthouse doors remain firmly shut against would-be debtors with any connection to the industry.

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[1] In re Rent-Rite Super Kegs West Ltd. 484 B.R. 799 (Bankr. D. Colo. 2012).

[2] In re Johnson, 532 B.R. 53 (Bankr. W.D. Mich. 2015).

[3] In re Way to Grow, Inc., 597 B.R. 111 (Bankr. D. Colo. 2018).

[4] In re Basrah Custom Design, Inc., 600 B.R. 368 (Bankr. E.D. Mich. 2019).

[5] Burton v. Maney (In re Burton), 610 B.R. 633 (B.A.P. 9th Cir. 2020).

[6] In re Malul, 614 B.R. 699 (Bankr. D. Colo. 2020).

[7] In re Pharmagreen Biotech, Inc., No. 20-50780-BTB (Bankr. D. Nev. October 7, 2020).

[8] See Malul at 709.

[9] See id. at 711.

[10] See id. at 713.