Legal Sidebar

Bankruptcy for Marijuana Businesses?

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Much ink has been spilled about the disparity between state and federal marijuana laws and the resulting risks to individuals and companies in—or providing services to—medical and recreational marijuana businesses that operate legally under the laws of more than 20 states even while such activities remain unlawful under federal law. Recent bankruptcy court cases suggest that one such risk may be the ultimate unavailability to both debtors and creditors of the protections, benefits, and predictability of the U.S. Bankruptcy Code when state-regulated marijuana businesses fail.

Two recent cases from the U.S. Bankruptcy Court for the District of Colorado address this issue in the context of motions to dismiss the case (or convert the case to another chapter of the Bankruptcy Code, a frequent alternative to a motion to dismiss in bankruptcy cases) based on the debtor's relationship to a marijuana business that is legal under state law, but not under federal law. The 2012 case was filed under chapter 11 of the Bankruptcy Code, which generally allows businesses to reorganize their obligations while continuing in business. Petitioner Rent-Rite owned a warehouse. Approximately one quarter of its revenues came from warehouse space rented to tenants in the business of growing medical marijuana, which was legal under state law. The warehouse was subject to a lien and deed of trust by a creditor who moved for dismissal, arguing that the debtor was not worthy of bankruptcy protection under the "clean hands doctrine" since the act of renting to a marijuana-growing business is in violation of the federal Controlled Substances Act (CSA). The court noted that the "clean hands doctrine" is an equitable doctrine that is applicable in bankruptcy proceedings. It also noted that the debtor's warehouse (and creditor's collateral) was at risk of forfeiture so long as the violation of the CSA was ongoing.

Asserting that it must always apply equitable doctrines within the confines of the Bankruptcy Code itself, the court looked to that Code to determine whether the chapter 11 case should be either converted to a chapter 7 liquidation or dismissed. In a chapter 11 case, the debtor generally remains in possession of the bankruptcy estate and is responsible for its management, while in a chapter 7, a trustee takes over to administer the case. The court found that the debtor had grossly mismanaged the bankruptcy estate:

> It is that post-petition presence of activity on the Debtor's property...that violates the CSA; exposes the Debtor to criminal liability; and exposes both the Debtor and its mortgage creditor to forfeiture of the Warehouse that constitutes gross mismanagement of the estate and requires the Court to either convert this case to a case under chapter 7 or to dismiss it.

The court left open the question as to whether its finding of "cause" to convert or dismiss was a result of an application of the "clean hands doctrine." Furthermore, it postponed a determination of whether it was in the best interests of the creditors and the estate to convert the case to a chapter 7 liquidation. Although the debtor's petition reported substantial equity that could be used to pay creditors,

> the Court must also consider whether consequences of the Debtor's criminal conduct impact the ability of a chapter 7 trustee to administer a chapter 7 estate...[that] would contain a major asset that is the location of ongoing criminal activity and subject to forfeiture under the CSA....That raises a question of the feasibility of chapter 7 estate administration.

On August 28, 2014, the same court and judge issued a similar ruling when it approved a dismissal of a chapter 7 case at the request of the administering bankruptcy trustee (*In re Arenas* 2014 Bankr. LEXIS 3642 (Bankr. D. Colo. Aug. 28, 2014)). The debtors, Anthony and Sarah Arenas, owned a two-unit building: one unit used for Mr. Arena's medical marijuana production and distribution business—operated in compliance with Colorado law—and the other rented to a medical marijuana dispensary. The debtors sought relief from their creditors through chapter 7. In chapter 7, debtors relinquish all non-exempt property to a bankruptcy estate administered by a trustee who oversees liquidation and distribution of assets in an ordered manner to satisfy approved claims filed against the estate. Individuals' personal responsibility for their debts is discharged under chapter 7 (with certain exceptions). The bankruptcy court concluded that the Arenas's chapter 7 case could not be managed "without inextricably involving the Court and the Trustee in the Debtor's ongoing criminal violation of the CSA." As a result, the court found sufficient cause to dismiss the case. Additionally, the court held that the case could not be converted to a reorganization under a different chapter of the Bankruptcy Code, chapter 13, because the Arenas could not afford to repay creditors under a reorganization plan (a plan confirmed by a court is required to exit a chapter 13 or chapter 11 reorganization) without relying upon revenue from their marijuana-related business, which constitutes illegal income under federal law. (The debtors have appealed the decision to the Tenth Circuit Court of Appeals.)

Additionally, a chapter 13 case from Oregon and a chapter 11 case from California were each dismissed based on a court's finding that a reorganization plan that will be funded with income derived from income that is illegal under federal law cannot be confirmed (and also cannot be converted to a chapter 7 liquidation for the reasons stated above). Although not yet addressed by a court, another question may arise in the future with regard to chapter 13 plans where the debtor has sufficient income that is legal under federal law to fund a plan but has additional income related to a marijuana business that is legal within the state but illegal under federal law. A court could conceivably allow a debtor to fund a plan using only the income legal under federal law. Although creditors could be paid a portion of the debt owed them in this case, they might object to receiving payments based only on a portion of the debtor's total income.

At this point, some commentators doubt whether bankruptcy can be an option for debtors and creditors of medical and recreational marijuana businesses. Because of the expansive scope of federal anti-money laundering statutes, similar concerns likely would be relevant to third-party service providers to marijuana businesses and their creditors. As such, there is a risk that bankruptcy protections may not be available for certain debtors and creditors involved with a marijuana-related business so long as marijuana remains illegal under federal law.