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Marijuana and Bankruptcy? Not Really

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The legalization of marijuana for medical use in some states has provided new business opportunities. Like many others, parties engaged in or deriving income from the legal commercialization of medical marijuana, either directly or through another party (*e.g.*, via lease or license) ("Marijuana-Related Parties"), are not immune to financial distress, and sometimes, seeking bankruptcy relief may be strategic or necessary. Unfortunately, Marijuana-Related Parties have found elusive the protections and benefits under the Bankruptcy Code.

Marijuana and the Controlled Substances Act

Enacted in 1970, the Controlled Substances Act, 21 U.S.C. § 801 *et seq*. ("CSA"), embodies the federal government's policy concerning the manufacture, distribution, import, export and possession of certain controlled substances that are categorized under five "Schedules." 21 U.S.C. § 812. Marijuana is a controlled substance under Schedule I of the CSA. Schedule I controlled substances are considered to have: 1) a high potential for abuse; 2) no accepted medical use in treatment; and 3) a lack of accepted safety for use while under medical supervision.

Federal offenses and penalties concerning controlled substances are set forth in §§ 841 through 865 of the CSA. For example, it is "unlawful for any person knowingly or unintentionally to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance." 21 U.S.C. § 841(a)(1). It is also unlawful to knowingly open, lease, rent, use, maintain, manage or control any place for the purpose of manufacturing, distributing, or using a controlled substance. *Id*. at § 856(a). Penalties for violating the CSA may include imprisonment, fines, criminal forfeitures and civil penalties. *See, e.g., id*. at §§ 841(b), 853, 856(b), 856(d).

In late August 2013, the U.S. Department of Justice ("DOJ") issued a memorandum updating its guidance to federal prosecutors regarding the CSA and its enforcement with respect to marijuana. The revised stance was in response to the increasing number of states at the time enacting laws legalizing marijuana for medical purposes. The DOJ prioritized eight areas of enforcement of the CSA against marijuana-related activity for federal prosecutors. Outside of those eight priorities, the federal government relied on state and local authorities to address marijuana-related activity through enforcement of their own laws.

Legalization of Medical Marijuana Under State Law

As of September 2015, medical marijuana is legal in 23 states, including Alaska, Arizona, California, Colorado, Connecticut, Delaware, Hawaii, Illinois, Maine, Maryland, Massachusetts, Michigan, Minnesota, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, Oregon, Rhode Island, Vermont, and Washington. *See* http://bit.ly/1XZWJRU. It is also legal in the District of Columbia and Guam. The laws governing marijuana-related activity, such as possession amount and the number of plants permitted, vary within each of those jurisdictions.

Marijuana-Related Parties Are Not Expressly Precluded from Being 'Debtors'

Section 109 of the Bankruptcy Code governs who may be a debtor. A plain reading of that section suggests that Marijuana-Related Parties are not among the types of persons precluded from seeking bankruptcy relief. The cases have shown, however, that eligibility under § 109 does not dictate effective bankruptcy relief for Marijuana-Related Parties. *See, e.g., In re Arenas*, 535 B.R. 845, 849 (B.A.P. 10th Cir. 2015) (deciding "whether engaging in the marijuana trade, which is legal under Colorado law but a crime under federal law, amounts to 'cause' including a 'lack of good faith' that effectively disqualifies these otherwise eligible debtors from bankruptcy relief").

Bankruptcy Relief?

What effect does engaging in conduct that is legal under state law but illegal under federal law have on bankruptcy relief?

1.* In re Arenas**: ***Voluntary Chapter 7 and Conversion to Chapter 13 Are Not Viable Options. Frank and Sarah Arenas owned a building that consisted of two units. One unit was used by Mr. Arenas to grow and sell marijuana and the other unit was leased to a marijuana dispensary. Mr. Arenas' marijuana business and the lease to the dispensary were both legal activities under Colorado law. A dispute arose and the Arenases brought an eviction proceeding against the dispensary. The proceeding resulted in a $40,000 attorney's fees award against them and they filed for Chapter 7.

In light of the marijuana-related activities, the Chapter 7 trustee sought guidance from the Office of the United States Trustee ("UST") as to whether the assets could be administered. The UST concluded it was problematic and moved to dismiss the case for cause under § 707(a). The Arenases objected and moved to convert their case to chapter 13. The court denied the motion to convert and granted the motion to dismiss. *In re Arenas*, 514 B.R. 887 (Bankr. D. Colo. 2014).

On appeal, the Bankruptcy Appellate Panel ("BAP") of the U.S. Court of Appeals for the Tenth Circuit affirmed the lower court's order. As to the motion to convert, the BAP found that a feasible plan could not be proposed because their monthly income from non-marijuana-related sources was insufficient to fund a plan and found that the Chapter 13 trustee would be in the untenable position of disobeying federal law by taking possession, selling and distributing marijuana assets. The BAP also rejected the argument that the lower court erred by effectively adopting a per se rule rendering debtors ineligible for bankruptcy relief if they were engaged in the marijuana business.

Turning to dismissal of the case, the BAP found that the Chapter 7 trustee could not administer the estate because selling and distributing proceeds from marijuana assets would be federal offenses under the CSA. While not raised by the Arenases in the lower court, the BAP stated that the offenses could not be avoided by abandoning the marijuana assets. Abandonment would simply let the Arenases retain their business as they received a discharge, which was only a privilege and not a constitutional right. Meanwhile, creditors would receive nothing and would be stayed from pursuing any state law rights due to the automatic stay and the discharge injunction. According to the BAP, this type of prejudicial

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delay would have constituted sufficient cause to dismiss the case.

On Oct. 16, 2015, the Arenases filed their notice of appeal of the BAP's ruling to the Tenth Circuit. The appeal remains pending.

2.* In re Johnson *and* In re McGinnis: *Chapter 13 Is Available But … The Bankruptcy Court for the Western District of Michigan also tackled the marijuana and bankruptcy dilemma in a Chapter 13 context. *In re Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015). Jerry Johnson ("Johnson") was a licensed grower and seller of medical marijuana under Michigan law. He filed for Chapter 13 to prevent a foreclosure sale of his house. About one-half of his monthly income was from Social Security benefits and the other one-half was from his cultivation and sale of marijuana.

The court took the position that it would not support any "impropriety of requiring the Standing Trustee to hold the proceeds of the Debtor's criminal activity and to use those funds to pay claims under a court-approved plan." *In re Johnson*, 532 B.R. at 56. Although the court recognized that Johnson's marijuana business violated federal law, it did not consider dismissal to be the only option. The court gave Johnson the opportunity to choose between the marijuana business and seeking bankruptcy relief. In the interim, the court refrained from immediately dismissing the case and enjoined Johnson from conducting his marijuana business while the case was pending. In the end, Johnson chose bankruptcy protection, and per the court's requirements he: 1) stopped growing, selling and distributing marijuana; 2) abandoned and destroyed the marijuana plants, products and inventory in order to "remove the shadow that the contraband casts" on the case, the trustee and the court; and 3) surrendered his marijuana business identification card. *In re Johnson*, 532 B.R. at 59. Johnson's Chapter 13 plan was confirmed.

In another case, the debtor ("McGinnis") filed for Chapter 13 in Oregon and proposed to fund the plan from sources that included: 1) a warehouse that would be leased by a company owned by McGinnis with space rented to medical marijuana growers; and 2) profits from McGinnis' own medical marijuana operation. *In re McGinnis*, 453 B.R. 770 (Bankr. D. Or. 2011). The court found his marijuana-related activities to be in violation of federal law. Also, because McGinnis' plan depended on revenue derived from marijuana-related activities, the court concluded that the plan was not proposed in good faith and not by any means forbidden by law as required under § 1325(a)(3) and it cast into doubt the feasibility of the plan under § 1325(a)(6). Nevertheless, the court provided McGinnis a window to submit an amended chapter 13 plan that would meet the Bankruptcy Code requirements. Absent an amended plan, the court was prepared to dismiss or convert the case. McGinnis never filed an amended plan and chose to dismiss his case instead.

3.* In re Medpoint Management, LLC: *Involuntary Chapter 7 Not Viable. What about an involuntary Chapter 7 against a Marijuana-Related Party? That was the issue presented in *In re Medpoint Management, LLC*, 528 B.R. 178 (Bankr. D. Ariz. 2015). There, a nonprofit was authorized to operate a medical marijuana dispensary under Arizona law. Under that state's law, dispensaries are required to operate on a not-for-profit basis. Therefore, dispensary-management companies were frequently used by dispensaries as repositories for revenue derived from marijuana. Medpoint Management, LLC ("Medpoint") was a dispensary-management company.

Creditors ("Petitioning Creditors") of Medpoint filed a Chapter 7 involuntary petition against it. Medpoint's assets were marijuana-related and included revenue from intellectual property licensing of the name and trademark for certain marijuana products being sold. Medpoint opposed the involuntary petition and argued that the trustee would not be able to administer marijuana-related assets against federal law. The court concluded that under the CSA a trustee had to place the government's interest in protecting public health first and that the risk of a forfeiture or seizure of the marijuana-related assets or a charge for facilitating a CSA offense was not acceptable for a trustee and the estate. Thus, there was sufficient cause to dismiss the involuntary petition against Medpoint under § 707(a).

4. Unclean Hands and "Gross Mismanagement." Marijuana-Related Parties and parties having business dealings with them should also be aware that the unclean hands doctrine may apply. Post-petition marijuana-related activities may also invite allegations of gross mismanagement.

One debtor landlord in Colorado learned first-hand the ramifications marijuana can have in a bankruptcy case. *In re Rent-Rite Super Kegs West Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012). There, the debtor leased warehouse space to tenants who legally grew marijuana under Colorado law. Approximately 25% of the debtor's income came from the rent it received. The debtor did not grow marijuana, but the court determined that the debtor violated the CSA because of the tenant's marijuana-related activities. The debtor knowingly and intentionally leased space to a tenant whose activities violated federal law. The court determined that warranted application of the clean hands doctrine and the debtor's conduct satisfied "cause" to dismiss or convert the case under § 1112(b). Because plan confirmation under § 1129(a)(3) requires plans to be proposed in good faith and "not by any means forbidden by law," the debtor's plan, which would have been funded through illegal activities, had no reasonable expectation of being confirmed. The court added that the debtor's post-petition lease to a tenant who continued to disregard federal law amounted to gross mismanagement of the estate and was further grounds for "cause."

Unclean hands was likewise addressed in *Medpoint*. There, the court concluded that the Petitioning Creditors lacked clean hands because each of them knew or should have known that Medpoint was engaged in marijuana-related activities that were illegal under federal law. Because of the Petitioning Creditors' unclean hands, they could not then seek the relief they sought from the court. *In re Medpoint Management, LLC*, 528 B.R. at 186-87.

But the unclean hands doctrine might not bar a creditor's request for relief in all situations. In *Northbay Wellness Group, Inc. v. Beyries*, 789 F.3d 956 (9th Cir. 2015), the U.S. Court of Appeals for the Ninth Circuit reversed a lower court's decision preventing a company that was engaged in marijuana-related activity from seeking the nondischargability of a claim against an individual Chapter 7 debtor. The debtor was a former member of the company's board of directors, had served and was paid as the company's attorney, and was accused of stealing $25,000 from a legal defense trust fund that the company entrusted with the debtor. The lower court denied the company a judgment of nondischargeability because the nature of its business was illegal under federal law. But the court of appeals concluded that the debtor's wrongful conduct outweighed the illegality of the company's business and that "[a]llowing [the debtor] to avoid through bankruptcy his responsibility for misappropriating his client's money would undermine the public interest in holding attorneys to high ethical standards." *Id*. at 961.

Conclusion

Marijuana-Related Parties looking for refuge or affirmative relief under the Bankruptcy Code face a considerable hurdle. There appears to be no difference whether the Marijuana-Related Party filed for voluntary bankruptcy relief or an involuntary petition was filed against him/her/it. Nor does it appear to matter whether the Marijuana-Related Party is directly engaged in the marijuana trade or just derives revenue from a party engaged in the marijuana trade. Courts may have sympathy for those in need of bankruptcy relief, but unless and until Congress changes the law to decriminalize marijuana, courts routinely take the position that such relief is not available to Marijuana-Related Parties.

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