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Marijuana Businesses in Bankruptcy: Courts Just Say No

By Stuart I. Gordon and Matthew V. Spero*

A recent decision by a Colorado bankruptcy court confirms that bankruptcy courts generally do not permit marijuana-related businesses to seek relief under the Bankruptcy Code, even in states where marijuana use is legal.

As states move to legalize recreational marijuana, more companies are seizing the opportunity to jump into marijuana-related businesses. These companies can be directly involved in the manufacture and sale of marijuana products or peripherally involved, such as by providing marijuana sellers with the goods and materials they need to sell their products.

Although the idea of high profits can put stars in the eyes of marijuana business owners, not every marijuana-related company will be successful. Indeed, at least one thing is certain: Marijuana businesses are not immune from failing. And of course, when facing hard times, they may seek relief under the Bankruptcy Code.

However, numerous courts faced with bankruptcy filings by debtors connected to marijuana businesses that were legal under state law, but violated federal law, have decided that the debtors were not eligible for relief under the Bankruptcy Code. A recent decision by a Colorado bankruptcy court, in *In re Way to Grow, Inc.*,[1] illustrates their rationale.

BACKGROUND

The events leading to the *Way to Grow* filing in the U.S. Bankruptcy Court

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[1] *In re Way to Grow, Inc.*, Nos. 18-14330 MER, 18-14333 MER, 18-14334 MER (Bankr. D. Colo. Dec. 14, 2018), emergency motion for stay pending appeal denied, *In re Way to Grow, Inc.*, No. 18-14330 MER (Bankr. D. Colo. Dec. 18, 2018), motion for stay pending appeal denied, *Way to Grow, Inc. v. Inniss (In re Way to Grow, Inc.)*, No. 18-cv-3245-WJM (D. Colo. Jan. 18, 2019).

for the District of Colorado began on January 1, 2016, when Richard Byrd and Corey Inniss entered into an agreement for the sale of Way to Grow, Inc. (the "Purchase Agreement"). Way to Grow and a sister company, Green Door Agro, Inc., were subsidiaries of Pure Agrobusiness, Inc. The companies' business, conducted in retail stores in Colorado and on the internet, involved the sale of equipment for indoor hydroponic and gardening-related supplies. The companies indicated that although the hydroponic gardening equipment was and could be used "for many types of crops," their future business expansion plan was "tied to the growing cannabis industry," which was "heavily reliant on hydroponic gardening."

As set forth in Section 2.2 of the Purchase Agreement, the consideration for the sale consisted of:

(1) A cash payment to Inniss of $2,500,000;

(2) A secured promissory note payable to Inniss for the principal amount of $22,500,000; and

(3) Shares of Byrd's common stock in Pure Agrobusiness.

As collateral, Inniss took a lien on all property and assets of Pure Agrobusiness, Way to Grow, and Green Door, including after-acquired property, accounts receivable, and inventory.

On April 6, 2018, Inniss sued Pure Agrobusiness, Way to Grow, and Green Door, and moved to appoint a receiver over the three companies.

Pure Agrobusiness, Way to Grow, and Green Door (collectively, the "Debtors") filed petitions for relief in the U.S. Bankruptcy Court for the District of Colorado and then Inniss moved to dismiss the bankruptcy filing.

THE BANKRUPTCY COURT'S DECISION

The bankruptcy court granted the motion to dismiss.

In its decision, the bankruptcy court pointed out that several states, including Colorado, have legalized marijuana for medical or recreational use, or both. However, the bankruptcy court found that federal law prohibits the use, sale, or cultivation of marijuana, and cited *Gonzales v. Raich*,[2] where the U.S. Supreme Court held that the federal government's designation of marijuana as a controlled substance superseded contrary state law through application of the commerce clause.

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[2] *Gonzales v. Raich*, 545 U.S. 1 (2005).

Pursuant to the Controlled Substances Act of 1970 ("CSA"),[3] marijuana and other cannabis products are designated Schedule I controlled substances. The bankruptcy court indicated that the CSA makes it a federal crime to "manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance[.]" The CSA also prohibits any person from possessing or distributing "any equipment . . . product or material which may be used to manufacture a controlled substance . . . knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance" in violation of federal law.

The CSA also makes it a crime to conspire to commit any offense under the CSA.

To determine whether to dismiss the Debtors' petitions under Bankruptcy Code Section 1112, the bankruptcy court had to decide whether the Debtors were engaged in ongoing violations of the CSA. If they were so engaged, their bankruptcy cases could "not proceed and would be ripe for dismissal."

The bankruptcy court first found no evidence that the Debtors directly "manufacture[d], distribute[d], or dispense[d], or possess[ed] with intent to manufacture, distribute, or dispense, a controlled substance[.]" The bankruptcy court then found that the Debtors also were not aiding and abetting violations of the CSA.

Next, the bankruptcy court found that, although the Debtors were not violating the CSA through complicity in their marijuana growing customers' crimes, another provision of the CSA was violated based on a lesser *mens rea* by simply knowing how the Debtors' products would be used.

The bankruptcy court found "ample evidence" demonstrating that the Debtors had "reasonable cause to believe" that the equipment they sold to at least some of their customers would be used to manufacture marijuana. The bankruptcy court noted that, among other things, Inniss testified that meeting the needs of cannabis growers was essential to the Debtors' business because those growers would simply buy their hydroponic equipment elsewhere if the Debtors could not meet their needs; that the Debtors had always chosen products based on their preferred use in marijuana cultivation, including by customizing their pesticide inventory to provide products approved for use in marijuana cultivation by the Colorado Department of Agriculture; and that the Debtors sold some products that would otherwise be cost-prohibitive for use in cultivating any crop except marijuana, because marijuana was the highest yielding cash crop that could be grown.

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[3] 21 U.S.C. § 101 *et seq.*

The bankruptcy court also observed that many of the Debtors' largest customers used aliases with the Debtors rather than the real name of their businesses to conceal their identity, that the Debtors had participated, in some fashion, in the "Cannabis Cup"—a cannabis industry trade show and the world's biggest marijuana grow competition, and that the Debtors did "cross-promotions" with dispensaries and advertised on a cannabis talk show.

Accordingly, the bankruptcy court determined that the Debtors "certainly" knew they were selling products to customers who would, and did, use those products to manufacture a controlled substance in violation of the CSA. The bankruptcy court found the Debtors "tailor[ed] their business to cater to those needs, tout[ed] their expertise in doing so, and market[ed] themselves consistent with their knowledge."

The bankruptcy court found that the Debtors' business model and execution thereof "fundamentally violate[d]" the CSA and that these violations continued post-petition.

The bankruptcy court ruled that it could not enforce federal law in aid of the Debtors because the Debtors' ordinary course activities constituted a continuing federal crime. It concluded that there was, "inescapably, cause to dismiss this bankruptcy case under 11 U.S.C. § 1112(b)."

OTHER DECISIONS

Numerous other courts have reached the same conclusion as the bankruptcy court reached in *Way to Grow*.

In re Rent-Rite Super Kegs West Ltd.[4] is another Colorado case on point. There, the court considered a motion to dismiss a Chapter 11 case in which the debtor derived 25 percent of its revenue from leasing warehouse space to marijuana businesses. Finding this activity was plainly prohibited under the CSA, the court concluded that the debtor was in continuing violation of federal law during its bankruptcy case. It stated:

> [E]ven if the [d]ebtor is never charged or prosecuted under the CSA, it is conducting operations in the normal course of its business that violate federal criminal law. Unless and until Congress changes that law . . . a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a [d]ebtor whose activities constitute a continuing federal crime.

As additional grounds for dismissal, the court concluded that the debtor was

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

barred from bankruptcy relief by the clean hands doctrine:

> The [d]ebtor freely admits that it leases space to those who are engaged in the cultivation of marijuana. Even if the [debtor] holds a good faith—albeit misguided—belief that Colorado state law would prevail over the federal law or that the federal law is unlikely to be enforced, that is quite beside the point. The [d]ebtor has knowingly and intentionally engaged in conduct that constitutes a violation of federal criminal law and it has done so with respect to its sole income producing asset.

Based on these conclusions, the *Rent-Rite* court found the bankruptcy case should be dismissed pursuant to Bankruptcy Code Section 1112(b).

Two years later, in *In re Arenas*,[5] the same bankruptcy court expanded its holding in *Rent-Rite* to dismiss a bankruptcy case where the bankruptcy trustee would have been required to administer marijuana-related assets.

In *Arenas*, the debtors, who operated a marijuana grow facility, filed for relief under Chapter 7 of the Bankruptcy Code. A Chapter 7 trustee was appointed and the U.S. Trustee then moved to dismiss. Assessing the ability of a Chapter 7 trustee to administer marijuana assets, the court reasoned:

> Here, the Debtors' chapter 7 trustee cannot take control of the Debtors' Property without himself violating . . . the CSA. Nor can he liquidate the inventory of marijuana plants Mr. Arenas possessed on the petition date because that would involve him in the distribution of a Schedule I controlled substance in violation of § 841(a) of the CSA. The Court finds that administration of this case under chapter 7 is impossible without inextricably involving the Court and the Trustee in the Debtors' ongoing criminal violation of the CSA. . . . To allow the Debtors to remain in a chapter 7 bankruptcy case under circumstances where their Trustee is unable to administer valuable assets for the benefit of creditors would allow them to receive discharges without turning over their non-exempt assets to the Trustee. That would give the Debtors all of the benefits of a chapter 7 bankruptcy discharge while allowing them to avoid the attendant burdens. The impossibility of lawfully administering the Debtors' bankruptcy estate under chapter 7 constitutes cause for dismissal of the Debtors' case under 11 U.S.C. § 707(a).

The *Arenas* debtors further sought to avoid dismissal by seeking to convert

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[5] *In re Arenas*, 514 B.R. 887 (Bankr. D. Colo. 2014).

their cases from Chapter 7 to Chapter 13. In denying that request, the court concluded that the debtors' plan payments would necessarily be funded by proceeds of a criminal enterprise under federal law and, therefore, conversion was not in good faith. The court reasoned that a plan could not be administered by a Chapter 13 trustee who would be prohibited from receiving or distributing funds derived from CSA violations.

On appeal, the Bankruptcy Appellate Panel for the Tenth Circuit affirmed the decision dismissing the Arenas' bankruptcy case.[6] The question presented to the panel was whether a debtor in the marijuana business can obtain relief in the federal bankruptcy court. The panel answered the question with a resounding "No."

The panel agreed with the bankruptcy court "that while the debtors have not engaged in intrinsically evil conduct, the debtors cannot obtain bankruptcy relief because their marijuana business activities are federal crimes." It found that the debtors could not show an employment history to support future income unrelated to marijuana, the trustee could not legally administer and distribute marijuana derived assets, and, although their motives were not improper, the debtors were not acting in good faith based on an objective standard. The inability to propose a confirmable plan made it "objectively unreasonable" for the debtors to seek Chapter 13 relief.

Finally, the panel addressed the Arenas' argument that the case should not be dismissed or converted but, rather, that the trustee should simply abandon the marijuana assets:

> It is not clear that a bankruptcy court may order a trustee to abandon assets *sua sponte*. And even if the court can do that, this bankruptcy estate, shorn of its marijuana assets, would likely yield no dividend to the creditors. The debtors would get a discharge and get to keep (via abandonment) their marijuana assets while being protected from collection activities. This also strikes us as prejudicial delay that amounts to cause for dismissal.

Courts in other marijuana-legalized states have addressed similar issues and, for the most part, have reached the same conclusions.

For example, in *In re McGinnis*,[7] the debtor proposed a Chapter 13 plan to be funded by (i) a business that leased a warehouse to a marijuana grower, (ii) the debtor's own marijuana grow operation, and (iii) rental income from

[6] 535 B.R. 845 (10th Cir. BAP 2015).

[7] *In re McGinnis*, 453 B.R. 770 (Bankr. D. Ore. 2011).

property housing tattoo artists. Because the plan was to be funded through operations dependent "on a product the cultivation and sale of which violates federal law[,]" the court held the plan was proposed by means forbidden by law and could not be confirmed pursuant to Bankruptcy Code Section 1325(a)(3). Further, due to the illegality of the operations under federal law, the court found "the predicted income stream from the marijuana operations is [not] reasonably certain to produce sufficient income to fund the [p]lan" and, therefore, it concluded that the plan failed the feasibility requirement of 11 U.S.C. § 1325(a)(6).

In re Medpoint Management LLC[8] involved an involuntary Chapter 7 petition filed against a medical marijuana business. The debtor's assets consisted entirely of marijuana products and related intellectual property. The petitioning creditors' claims arose from credit extended or services knowingly provided in furtherance of the debtor's marijuana business. Upon the debtor's opposition to an order for relief, the court dismissed the involuntary bankruptcy case.

The court reasoned that the possibility of forfeiture of the debtor's marijuana assets pursuant to the CSA imposed an unacceptable risk to a Chapter 7 estate and the trustee. The court held that it could not issue an order for relief that would effectively order a Chapter 7 trustee to possess and administer assets in violation of federal law. The court also found that the petitioning creditors were not eligible to file the involuntary petition because of *in pari delicto*. The creditors knew the debtor was in the marijuana business, voluntarily chose to engage in that business with them, and, therefore, had unclean hands precluding them from petitioning a federal court for relief. Finally, the court declined to sanction the creditors, finding no bad faith in filing the involuntary petition, because the marijuana business presented a novel issue, and the debtor appeared insolvent and to be an otherwise proper bankruptcy debtor but for the marijuana issue.

In *In re Johnson*,[9] a Chapter 13 debtor was a licensed "caregiver" and marijuana grower operating legally under Michigan law. The U.S. Trustee filed a motion to dismiss. The debtor's income was $1,203 per month from Social Security and $1,000 per month from his marijuana business.

First, the court noted that allowing a marijuana case to proceed in federal court violated a federal judge's oath to uphold federal law. Furthermore, no matter what precautions were taken, allowing the case to remain in bankruptcy would result in both the trustee and the court supporting the debtor's criminal enterprise.

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[8] *In re Medpoint Management LLC*, 528 B.R. 178 (Bankr. D. Ariz. 2015).

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

Second, because 28 U.S.C. § 959(b) prohibits federal officers from holding contraband or proceeds or instrumentalities of federal criminal activity, the court held this prohibition applied to trustees in bankruptcy cases.

Third, the debtor intended to continue his marijuana business post-petition, which constituted being "engaged in business" for purposes of Bankruptcy Code Section 1304. The court found that it could not approve any expenditures related to a marijuana business pursuant to Bankruptcy Code Section 363(c).

Nonetheless, the court declined to dismiss the case and it gave the debtor a chance to obtain a discharge. However, it enjoined him from conducting his marijuana business or using any property of the estate in furtherance of illegal activity. The court further ordered the trustee to abandon all marijuana plants within the estate and ordered the debtor to destroy all his marijuana plants and byproducts as a condition of remaining in bankruptcy.

More recently, in *In re ARM Ventures, LLC,*[10] the debtor proposed a plan to be funded through income generated by the sale of marijuana products. The court held that a plan could not be confirmed unless the business generating the income was legal under both state law and federal law. The court concluded that the debtor's plan was not feasible and the bankruptcy case was ripe for dismissal. The court declined to dismiss given a significant non-insider unsecured debt. Instead, based on what the court found was the debtor's bad faith arising from his activities, the court granted stay relief to the debtor's major secured creditor. However, the court stayed any foreclosure sale for 14 days to provide the debtor an opportunity to file a plan that would not depend on the sale of marijuana as a source of income.

In *NW, SPNWY, LLC v. Cook Investments NW*,[11] the debtor leased commercial property to a marijuana grower. As part of its plan, the debtor proposed to reject the marijuana grower's lease. Because the debtor's plan did not depend on future income derived from illegal activity, the court concluded the debtor's plan was confirmable.

On appeal and upon an objector's motion for stay pending appeal, the U.S. District Court for the Western District of Washington began with the simple observation, "[b]ankruptcy courts are neither regulatory nor criminal courts." The district court continued, "[a] rudimentary search of relevant authorities reveals that numerous courts have confirmed plans regardless of whether actual provisions of the plans result in the violation of federal or state laws." Because

[10] *In re ARM Ventures, LLC,* 564 B.R. 77 (S.D. Fla. 2017).

[11] *NW, SPNWY, LLC v. Cook Investments NW*, No. 17-5516 (W.D. Wash. Aug. 24, 2017).

the plan itself would not violate federal law, but instead would be funded through proceeds of purely legal activity (because debtor rejected the marijuana lease), the district court denied the motion for stay pending appeal.

Finally, in *Olson v. Van Meter*,[12] the debtor filed a petition under Chapter 13 to prevent foreclosure on commercial property leased to the operator of a marijuana dispensary. The debtor's plan called for sale of this real property to pay off creditors, and as a result required rejection of the lease with the marijuana dispensary. Nonetheless, the court dismissed the case *sua sponte* on grounds that the debtor's post-petition acceptance of rents from the dispensary business was an ongoing criminal violation precluding federal bankruptcy relief.

The Bankruptcy Appellate Panel for the Ninth Circuit reversed and remanded. First, the panel held the bankruptcy court did not sufficiently articulate the legal basis for its ruling or make findings to support its conclusion that the debtor was violating federal law. The panel held that the court could not summarily dismiss the bankruptcy case, but rather was required to take evidence and make findings on issues of bad faith and unclean hands, as well as whether the debtor was actually committing a CSA violation. The appellate panel reasoned "[a]lthough debtors connected to marijuana distribution cannot expect to violate federal law in their bankruptcy case, the presence of marijuana near the case should not cause mandatory dismissal."

CONCLUSION

When a debtor is involved in a marijuana business, or a business related to marijuana, a bankruptcy court may well, in all likelihood, analyze potential violations of federal criminal law. As the cases discussed in this article suggest, when a bankruptcy court undertakes that analysis, it is likely to decide that it has no alternative but to dismiss the debtor's petition to the extent the business is a violation of federal law, even if the business activity may be legal under state law.

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[12] *Olson v. Van Meter*, No. NV-17-1168-LTiF (9th Cir. BAP Feb. 5, 2018). *Cf. Garvin v. Cook Investments NW*, No. 18-35119 (9th Cir. May 2, 2019) (affirming district court's decision affirming bankruptcy court's order confirming Chapter 11 plan of five real estate holding companies even though one of the debtors leased some property to a company that used it to grow marijuana).