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Bankruptcy Issues in the Cannabis Industry: Strategies Under State and Federal Law for Marijuana, CBD, and Hemp

State-Appointed and Private Receiverships, Alternative Restructurings, Assignments for the Benefit of Creditors, Latest Cases

WEDNESDAY, NOVEMBER 13, 2019

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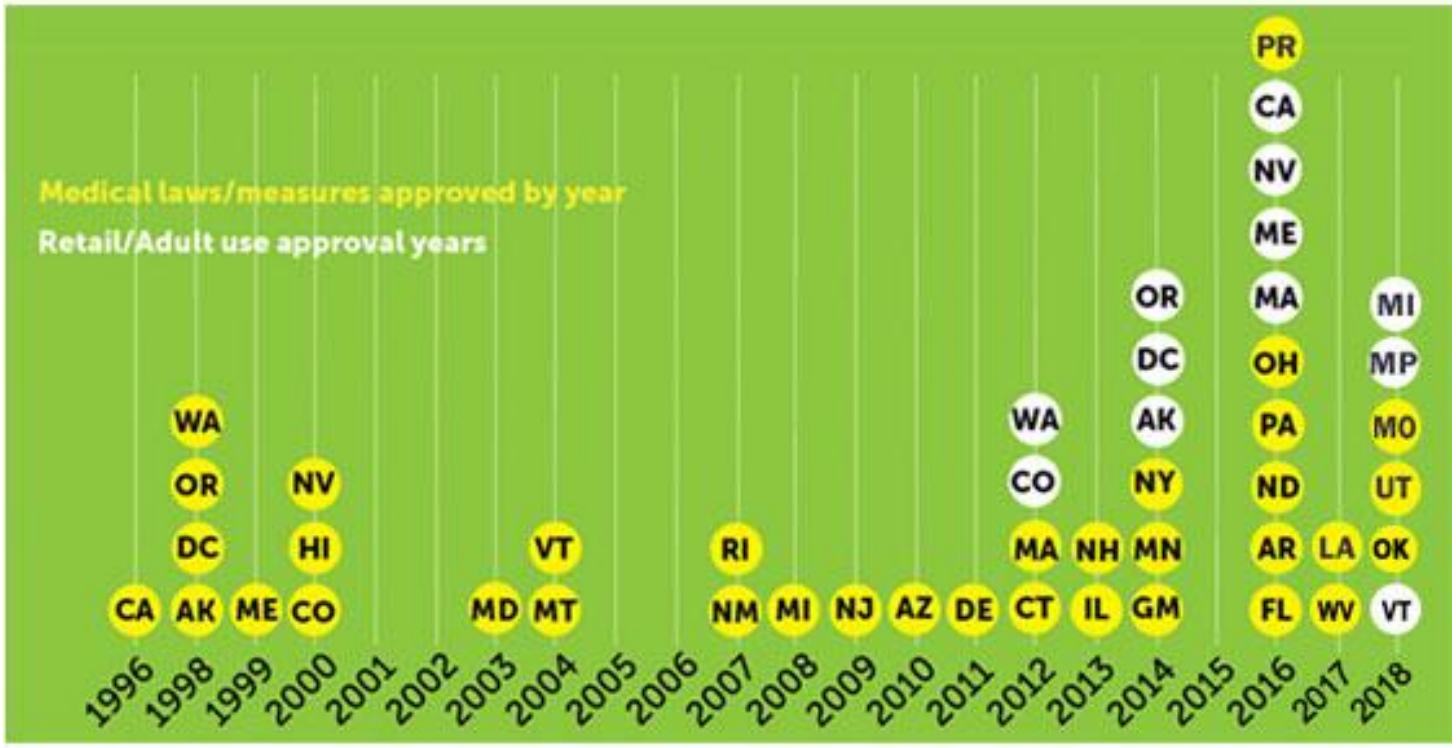
Legal Cannabis in the U.S. – General Facts

- There are currently 33 medical states and 11 adult use states (some overlap, e.g., Colorado)



Controlled Substances Act

- Cultivators and Dispensaries (21 U.S.C. § 841(a)(1))
  - ". . . it shall be unlawful for any person knowingly or intentionally to manufacture, distribute, dispense, or possess with intent to manufacture, distribute or dispense, a controlled substance"
- Ancillary Companies (21 U.S.C. § 843(a)(7))
  - "It shall be unlawful for any person knowingly or intentionally to manufacture, distribute, export, or import any . . . equipment, chemical, 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 . . ."
- Landlords (21 U.S.C. § 856(a)(1))
  - ". . . it shall be unlawful to knowingly open, lease, rent, use, or maintain any place, whether permanently or temporarily, for the purpose of manufacturing, distributing, or using any controlled substance"
- Management (21 U.S.C. § 856(a)(2))
  - ". . . it shall be unlawful to manage or control any place, whether permanently or temporarily, either as an owner, lessee, agent, employee, occupant, or mortgagee, and knowingly and intentionally rent, lease, profit from, or make available for use, with or without compensation, the place for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance"

Bankruptcy Code Provisions At Issue With Cannabis Companies

- Focusing on Chapter 11, although similar provisions are applied in Chapter 7 and 13 proceedings.
- Courts are concerned with condoning post-confirmation business operations that are illegal under federal law
- Courts have dismissed cases under multiple Code provisions:
  - Section 1112(b)(1) – dismissal for “cause”
  - Section 1129(a)(3) – plan has to be proposed in “good faith and not be any means forbidden by law”
  - Section 1129(a)(11) – plan has to be feasible
- Motions to dismiss have been brought by Office of United States Trustee and other parties in interest
  - Involuntary debtors have also moved to dismiss involuntary petitions on cannabis grounds
- Chapter 15
  - Cross border cases
  - Section1506 public policy exception

Guidance from Department of Justice

- Ogden Memorandum (Oct. 2009)
  - Prioritizes prosecution of traffickers and disruption of illegal drug manufacturing
  - DOJ will not focus resources on individuals acting in compliance with state laws
- Cole Memoranda
  - First Cole Memorandum (June 2011) clarified that Ogden Memorandum was not meant to shield large-scale cultivation centers from federal enforcement even if acting in compliance with state law
  - Second Cole Memorandum (Aug. 2013) identifies enforcement priorities and provides that DOJ will rely on state/local governments to enact laws relating to cannabis
  - Third Cole Memorandum (Feb. 2014) links violation of Bank Secrecy Act and money laundering statutes to the Second Cole Memorandum's enforcement priorities
  - Sessions Memorandum (Jan. 2019) rescinds prior DOJ guidance and directs federal prosecutors to weigh all relevant considerations in determining cannabis-related prosecutions
- Attorney General Barr recently said that he would "not go after" cannabis companies in states where cannabis is legal

Federal Legislation Addressing Cannabis

- Because cannabis remains illegal under federal law, banks will not take the money or make loans due to anti-money laundering concerns
- President Trump had said that he would sign the STATES (Strengthening the Tenth Amendment Through Entrusting States) Act if it reaches his desk
  - This would amend the CSA to exempt from federal enforcement individuals and companies acting in compliance with state laws on cannabis
- SAFE (Secure and Fair Enforcement) Banking Act
  - Opens banking and insurance to cannabis companies
  - Passed the House by a vote of 321-103 on Sept. 25, 2019

Hemp and the 2018 Farm Bill

- Under the Agriculture Improvement Act of 2018 (the "2018 Farm Bill"), cannabis plants and derivatives that contain no more than 0.3 percent delta-9-tetrahydrocannabinol (THC) on a dry weight basis (*i.e.*, hemp) are no longer controlled substances under the Controlled Substances Act.
  - Before the 2018 Farm Bill, hemp was a Schedule I controlled substance under the Controlled Substances Act. Many aspects of the domestic production of hemp had been limited to persons who were registered under the CSA.
  - The 2018 Farm Bill legalized the production of hemp as an agricultural commodity.
- Cannabis with a THC level exceeding 0.3 percent is still considered "marijuana," which remains classified as a Schedule I controlled substance under the CSA.

Hemp Production and the U.S. Department of Agriculture Interim Final Rule

- To produce hemp, a farmer must be licensed or authorized under a state or tribal hemp program or through the USDA hemp program.
- Hemp production is legal in 46 states. (Idaho, Mississippi, New Hampshire and South Dakota ban production of hemp within their borders.)
- As required by the 2018 Farm Bill, on October 29, 2019 the U.S. Department of Agriculture released an interim final rule for regulations establishing a domestic hemp production program.
  - If a state or tribe wants to have primary regulatory authority over the production of hemp in its territory, it must submit, for the approval by the USDA, a plan concerning the monitoring and regulation of such hemp production.
- State and tribal plans to regulate the production of hemp must include certain requirements, including:
  - maintaining information on the land where hemp is produced; testing the levels of delta-9 tetrahydrocannabinol; disposing of plants that do not meet requirements; and licensing.

CBD and the Food & Drug Administration

- The 2018 Farm Bill preserved the Food and Drug Administration's ("FDA") authority to regulate products containing cannabis and cannabis-derived compounds under the federal Food, Drug and Cosmetic Act.
- Even after passage of the 2018 Farm Bill, cannabidiol ("CBD") products remain subject to the same laws and requirements as FDA-regulated food and drug products that contain any other substance.
- FDA has approved one cannabis-derived and three cannabis-related drug products. There currently are no other FDA-approved drug products that contain CBD.
- The FDA has issued warning letters to several companies that have marketed CBD products to treat diseases or for other therapeutic uses, including:
  - Curaleaf Inc.
  - Rooted Apothecary LLC
  - Herbal Healer Academy, Inc.
  - Alternative Laboratories
  - Nutra Pure LLC

Garvin v. Cook Investments

- In *Garvin v. Cook Investments NW, SPNWY, LLC*, 922 F.3d 1031 (9th Cir. 2019), the Ninth Circuit affirmed a bankruptcy's court's confirmation of a Chapter 11 plan that was filed by a group of debtors, one of which had leased property to a marijuana grower.
- The debtors moved to reject the lease with the grower, and filed a Chapter 11 plan that did not depend on the continuation of the lease, or on the revenue generated from the tenant's marijuana business.

Garvin v. Cook Investments (continued)

- The bankruptcy court confirmed a Chapter 11 plan that paid all creditors in full and provided for the debtors to continue as a going concern.
- The U.S. Trustee appealed the bankruptcy court's order confirming the Chapter 11 plan, arguing that the plan violated Section 1129(a)(3) of the Bankruptcy Code because it was not proposed in "good faith and not by any means forbidden by law."
- The Ninth Circuit rejected the U.S. Trustee's argument, holding that the requirement that a plan be proposed in "good faith and not by any means forbidden by law" directs courts to look only to the *proposal* of a plan, not the *terms* of the plan.
  - The Ninth Circuit observed that the U.S. Trustee's interpretation of Section 1129(a)(3) would render some of the language of that statute meaningless, and would make other subsections of Section 1129(a) of the Bankruptcy Code redundant.

Potential Limitations of the *Garvin* Holding

- *Garvin* did not address the issue of whether the Chapter 11 case should have been dismissed in the first place, making this case of somewhat limited precedential value.
- Earlier in the bankruptcy case, the U.S. Trustee had moved to dismiss the case of the entity that had leased the property to the marijuana grower, based on that debtor's alleged "gross mismanagement of the estate."
- The Ninth Circuit determined that the U.S. Trustee did not properly preserve that argument on appeal. Accordingly, the Ninth Circuit never reached the question of whether leasing property to a marijuana grower constitutes "gross mismanagement of the estate."

Way to Grow, Inc., Case No. 18-03245, District of Colorado (Sept. 19, 2019)

- Debtors sold indoor hydroponic and gardening-related supplies.
  - Expansion plans were tied to the cannabis industry, although the debtors also had customers using the hydroponic products to grow other crops
- A secured creditor moved to dismiss the cases, citing the CSA
- The Bankruptcy Court found that the debtors were violating section 843(a)(7) of the CSA
  - Debtors had reasonable cause to believe that the equipment and product they sold would be used, by at least some of their customers, to manufacture marijuana
  - The Bankruptcy Court dismissed the cases "for cause" under section 1112(b) of the Bankruptcy Code
- District Court affirmed holding:
  - A cannabis company violates section 1129(a)(3) of the Bankruptcy Code by proposing a plan that relies on profits generated from marijuana
  - The inability to propose a good faith plan is cause for dismissal under section 1112(b)

Way to Grow (cont'd)

- The District Court questioned the narrow interpretation of section 1129(a)(3) given by the Ninth Circuit in *Garvin*:
  - The court ultimately avoided opining on what it means for a plan to be "proposed … not by any means forbidden by law" by grounding its holding on section 1129(a)(3)'s requirement that a plan be "proposed in good faith"
  - Because the plan relied on profits generated by the cannabis business, the plan could not be proposed in good faith
- Implications
  - Another decision that blocks cannabis companies from obtaining bankruptcy relief
  - Second court to take issue with *Garvin* (first was *In re Basrah Custom Design, Inc.*, 600 B.R. 368 (Bankr. E.D. Mich. 2019))
  - Reminder to the Office of the U.S. Trustee that motions to dismiss cannabis cases will be well received by most, if not all, of the bankruptcy courts

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

- Background:
  - Debtor was a custom cabinet manufacturer, which occupied two conjoined buildings.
  - The buildings were owned by an *affiliate* of the Debtor's principal, which entered into a lease with a purchase option with a dispensary.
  - There was an issue regarding which entity was the owner or lessor of the buildings and the UST moved to dismiss the case "for cause" on the basis that owning or renting a place operating as a dispensary violates the CSA.
  - Debtor alleged it filed bankruptcy to disentangle itself from the cannabis space by rejecting the dispensary lease.
- Holdings:
  - Although the Court found that *the lease was not property of the estate* and the Debtor was not the lessor, the Court found that: (a) the sole purpose of the filing was to facilitate the principal's efforts to avoid the dispensary lease and (b) the debtor filed bankruptcy with unclean hands.
  - Court found that cause existed under § 1112(b)(1) to dismiss the case.
  - Court speculated that if the dispensary requested stay relief to evict the Debtor, the Court would have to refuse because the dispensary would also have unclean hands.
    - Just as "a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime," Rent-Rite, 484 B.R. at 805 (footnote omitted), neither can a federal court be asked to enforce any creditor protections under the Bankruptcy Code, such as the relief-from-stay provisions of 11 U.S.C. § 362(d), in aid of a creditor's commission of a federal crime.
  - Court also acknowledged that the 1129(a)(3) good faith issue was not before the Court, it nevertheless felt compelled to address *Garvin* in a footnote, stating:
    - The decision of the Ninth Circuit Court of Appeals in Garvin is not binding on this Court, and, with respect, this Court does not necessarily agree with the Garvin court's holding about § 1129(a)(3). And, respectfully, one might reasonably question whether the Garvin court should have refused to decide the § 1112(b) dismissal issue. That refusal, on waiver grounds, arguably is questionable, because it allowed the affirmance, by a federal court, of the confirmation of a Chapter 11 plan under which a debtor would continue to violate federal criminal law under the CSA.

Involuntary Bankruptcy Petitions – The Basics

- Creditors force the debtor into bankruptcy proceedings
- Not to be used as an everyday debt-collection device
- Code provides penalties for filing frivolous involuntary petitions

Involuntary Bankruptcy Petitions – Filing Requirements

- Must be sought by:
  - 3 creditors
  - Holding noncontingent claims
  - Totaling at least $15,775
- Less than 3 creditors can file *only if* debtor has less than 12 creditors
- Involuntary relief granted if debtor is (i) generally not paying debts as they come due or (ii) if an appointed custodian took possession of substantially all of debtor's property within 120 days of filing

Involuntary Bankruptcy Petitions – A Warning

- If determined that involuntary petition was filed in bad faith, court can order:
  - Judgment against petitioning creditor for debtor's attorneys' fees and costs
  - Compensatory and punitive damages

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

- The Bankruptcy Court for the District of Arizona dismissed an involuntary chapter 7 bankruptcy case filed against a former operator of a medical marijuana dispensary on the basis that the trustee could not lawfully administer the estate, and the petitioning creditors knew the debtor was involved in the marijuana business and therefore had "unclean hands."
- Medpoint operated a medical marijuana dispensary under the Arizona Medical Marijuana Act. At the time that four of Medpoint's creditors filed the involuntary chapter 7 petition, Medpoint's only significant asset was a marijuana-themed trademark, for which it received a licensing fee.

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

- Medpoint moved to dismiss the petition, arguing that a bankruptcy trustee could not lawfully administer its estate, which Medpoint alleged arose from the marijuana industry. Alternatively, Medpoint argued its petitioning creditors all knew that Medpoint was involved in the marijuana business and they therefore had "unclean hands."
- Medpoint's creditors acknowledged courts had dismissed prior cases involving the disposition of marijuana-related assets, but they asserted this case was different for two reasons. First, Medpoint's income did not directly arise from the cultivation or sale of marijuana, but rather from the intellectual property license that other companies used to market marijuana products. Second, the creditors cited the recently enacted "Cromnibus Act," which prohibits the use of funds from the U.S. Department of Justice to prosecute marijuana businesses that are otherwise legal under state law.

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

- The court rejected the petitioning creditors' arguments and dismissed the involuntary petition. The court adopted the reasoning of *In re Arenas*, 514 B.R. 887 (Bankr. D. Colo. 2014), and *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012), that a debtor's estate could not be lawfully administered where that estate involved marijuana-related property and that requiring a trustee to oversee the estate would put that trustee in an "untenable position." The fact that Medpoint's only significant asset was its trademark license did not alter the court's decision. The court found Medpoint could conceivably be prosecuted under an accomplice-liability theory under the Controlled Substance Act, exposing its assets to forfeiture. The court deemed this possible forfeiture or seizure of Medpoint's property to be too great of a risk for a trustee to administer the estate.
- The court was also not persuaded by the recent passage of the Cromnibus Act. The court reasoned that the Cromnibus Act does not prohibit prosecution for marijuana-related offenses, but instead only bars the DOJ from using its own funds to prosecute such crimes. The court observed that nothing prevents the DOJ from using other funds to prosecute offenders, and the court identified money obtained through the DOJ's Asset Forfeiture Program as a possible source of funds to bring such actions.

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

- The court also found the petitioning creditors clearly knew Medpoint's assets arose from the marijuana business. Three of those four creditors signed agreements stating Medpoint was in the medical marijuana business, and the fourth signed an agreement with Medpoint to build a marijuana cultivation facility. Because the marijuana business violates federal law, the creditors' hands were unclean and they could not take advantage of the equitable powers of the Bankruptcy Code. Finally, the court denied Medpoint's request to find the petitioning creditors in bad faith and impose sanctions on them. The record reflected that Medpoint could not pay its debts, and the propriety of an involuntary petition against a marijuana-related business was a novel issue of law. As a result, the facts did not support a sanctions award.

Innovative and Alternative Strategies

- Chapter 15
- State Court Receivership
- Assignment for the Benefit of Creditors
- Out-of-Court Workout

Innovative and Alternative Strategies
Chapter 15

- Overview:
  - In certain circumstances, a company may be able to commence a restructuring case in Canada and effectuate it in the United States under chapter 15 of the Bankruptcy Code.
    - Example: a large cannabis company with a presence in Canada.
  - No bankruptcy estate → nothing to administer.
  - 11 U.S.C. § § 1112 (dismissal) and 1129 (bad faith plan) do not apply.
- Advantages:
  - May be available to companies that "touch the plant."
- Disadvantages:
  - Untested theory.
    - 11 U.S.C. § 1506 – "Nothing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States."
  - Expensive and only available under limited circumstances.

Innovative and Alternative Strategies
Chapter 15 (continued)

- Ascent Industries:
  - CSE listed licensed producer and dealer (operating licenses were suspended).
    - Distribution and production licenses in Nevada (Sweet Cannabis)
    - Cultivation, production, and distribution licenses in Oregon
  - Commenced a CCAA proceeding on 3.1.2019 (Ernst & Young appointed Monitor)
  - Canadian assets sold to Gulf Bridge on 4.5.2019 for $29 million.
  - Creditors include Staples, Praxair, Southern Irrigation, Pace Chemicals

Innovative and Alternative Strategies

State Court Receivership

- Overview:
  - Creditors and/or shareholders can seek appointment of a receiver.
    - Purpose must be to preserve property during the litigation or sell assets.
  - Receiver takes control of all property at issue.
  - Receiver temporarily operates the business and runs sale process.
- Advantages:
  - Available to companies that "touch the plant."
    - Washington - RCW 7.60.010 *et seq.*
      - Courts may appoint a receiver over a marijuana business.
      - Statute provides 60-day stay similar to 11 U.S.C. § 362.
    - Oregon - OAR 845-025-1260
      - Standards for Authority to Operate a Licensed Business as a Trustee, a Receiver, a Personal Representative or a Secured Party: (1) The Commission may issue a temporary authority to operate a licensed business to a trustee, the receiver of an insolvent or bankrupt licensed business, the personal representative of a deceased licensee, or a person holding a security interest in the business for a reasonable period of time to allow orderly disposition of the business.
- Disadvantages:
  - Loss of control.
  - No stay of litigation.
  - Limited ability to avoid preferences.

Innovative and Alternative Strategies

Assignment for the Benefit of Creditors

- Overview:
  - Purpose is to implement an orderly liquidation of the company's assets.
  - Assignee is selected by agreement between company and creditors.
  - Assets are assigned to assignee.
  - Assignee runs a sale process.
  - Assignee sells assets to buyer.
- Advantages:
  - Creditors are notified of the assignment and file claims.
  - Assignee distributes sale proceeds to creditors.
  - Assignee can pursue preference claims and fraudulent transfer claims.
- Disadvantages:
  - License transfer issues.
    - May be avoided if assignor sells cannabis assets to buyer and the sale proceeds are assigned to the assignee for distribution to creditors.
  - Lack of transparency for creditors.
  - Loss of control.
  - No quasi-judicial immunity.

Innovative and Alternative Strategies

Article 9 Sale

- Overview:
  - Creditor sells collateral (public or private sale).
  - Creditor may credit bid for assets.
  - Distribution scheme set forth in the UCC.
- Advantages:
  - Available to companies that “touch the plant.”
  - Fast and inexpensive.
  - Mitigates fraudulent transfer risk.
  - Option for a private sale.
- Disadvantages:
  - Litigation over commercial reasonableness.
    - Unsecured creditors may contest value.
  - Loss of control.
  - State licensing issues.

Innovative and Alternative Strategies

Out-of-Court Workout

- Need to identify underlying issue.
  - Liquidity issues → Capital infusion / loan workout.
  - Mismanagement → Chief Restructuring Officer.
- Requires consensual agreement with creditors.
- Need to engage turnaround advisors (restructuring attorneys / consultants).
- Advantages:
  - Creditors may be willing to meet and consider a workout if they are concerned about dissemination of assets and lack of oversight.
  - Flexible, less disruptive, less reputational / brand damage.
  - Client stays in control. No trustee.
- Disadvantages:
  - Bankruptcy binds creditors to a plan.
  - Creditors may not be as willing to consider a workout where there is no threat of bankruptcy filing and they are being asked to accept less than full repayment.
  - No automatic stay; can't reject burdensome agreements.

Thank You

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