Rachel Gillette

Partner
303.295.8241
Denver
rkgillette@hollandhart.com

George H. Singer

Partner
303.290.1093
Denver
ghsinger@hollandhart.com

Why Bankruptcy Is A Budding Alternative For Cannabis Cos.

Insight — October 12, 2023

Law360 - Expert Analysis

Bankruptcy can be a remarkable tool for rehabilitating a struggling business, preserving jobs and going-concern value, and liquidating the assets of an insolvent company.

The drafters of this country's bankruptcy laws believed a collective process that provides protection for a struggling company and enables an efficient administration of value to stakeholders can enhance recoveries.[1]

Hundreds of American companies each year seek bankruptcy protection to rehabilitate their businesses or liquidate.[2] Yet, the bankruptcy system cannot currently help restructure or liquidate most companies that operate in the cannabis industry.[3]

A set of recent decisions from the U.S. Bankruptcy Court for the Central District of California in In re: The Hacienda Co. LLC has signaled a retreat from what most have considered a zero-tolerance policy requiring dismissal of any bankruptcy case involving cannabis-related businesses or assets.

The widespread legalization of cannabis throughout the country and need for a more practical and uniform approach for all legal businesses warrants a more expansive set of rules.

Blunt Enforcement

Even though cannabis has become mainstream and a multi-billion dollar industry,[4] legal options for insolvent cannabis businesses remain challenging.

Cannabis companies and individuals related to the business have typically been denied the ability to reorganize or liquidate through bankruptcy.

The issue is rooted in the fact that while the majority of states has legalized some form of cannabis, it remains illegal under a federal law known as the Controlled Substances Act.[5]

The U.S. Trustee's Office received a mandate from the U.S. Department of Justice to obtain dismissal of a bankruptcy case even where a debtor's

connections to cannabis are remote or ancillary to its production, sale or distribution.[6]

The director of the executive office for the office in fact penned a letter in 2017 setting forth the government's position that, given the illegality of cannabis under federal law, the U.S. Trustee's Office shall, as a matter of policy, "move to dismiss or object in all cases involving marijuana assets." The breadth of the mandate is unmistakable.

Since federal bankruptcy protection is only available to businesses that are legal under federal law, courts have denied relief to those directly involved in cannabis operations as well as to those who are determined to be sufficiently adjacent to such operations.[7]

This is particularly true where the company remains operating, or its assets directly relate to the business of growing, producing or transporting cannabis.

Digging into the Weeds: The Hacienda Co. Part 1

Hacienda was in the business of wholesale manufacturing and packaging of cannabis products. The company ceased operations in 2021.

Shortly thereafter, it sold its intellectual property to a publicly held, Canadian cannabis company in exchange for approximately $35 million of stock. Hacienda sought bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code to dispose of its remaining asset — the stock — and address its obligations to creditors.

The company filed a status report declaring its intention "to propose a plan of reorganization that provides for Debtor to sell off the shares of [stock] it owns in an orderly fashion and use the proceeds from the stock to pay creditors."

In response, the U.S. Trustee's Office promptly filed a motion to dismiss the bankruptcy case. The request for dismissal was based exclusively on the debtor's proximity to cannabis.

The bankruptcy court examined the dismissal provisions of Chapter 11 and found that violations of law can be cause for dismissal.[8] But, "dismissal is one of the more extreme remedies" and not appropriate in every case.

Ongoing violations that transpire after the bankruptcy filing are far more problematic. The court determined that the degree of connection to the criminal activity is also important to the dismissal decision.

The court found a debtor's passive ownership of stock, held for the purposes of liquidation to pay creditors, is much different than an intention to profit from an ongoing plan to distribute cannabis.[9] Congress did not adopt a zero-tolerance policy requiring dismissal of every bankruptcy case involving a violation of the CSA or other applicable law.[10]

The court found an equivalence between violations of the CSA and other nonbankruptcy laws for purposes of determining eligibility for relief.

The court correctly observed that dismissing every case with a connection to illegal activity would be contrary to congressional directives with respect to the Bankruptcy Code. Such a position would effectively close the doors for administering some of the largest business bankruptcy cases for the benefit of creditors.

Enron Corp., Madoff Investment Securities LLC and Petters Group are examples of bankruptcy cases that prove this point. All involved alleged or actual criminal activity.

The victims of the illegal activity in bankruptcy cases are often the largest creditors with the most to lose. Mandated dismissal in every case would harm the ability to preserve and recover assets to satisfy their claims.

Smaller cases and cases involving individual debtors who have crossed the line into illegality would also be implicated by a rule requiring dismissal. This approach could well harm the very governmental agencies that are charged with enforcing the law, such as the Department of Justice, which encompasses the U.S. Trustee's Office itself.[11]

Such agencies' ability to police criminal activity and recover for victims might be significantly impaired if bankruptcy was automatically and per se unavailable in all cases.

The bankruptcy court took the middle ground. It adopted an approach that affords the court discretion to determine, given the circumstances and facts, whether dismissal is appropriate.

The court found that Hacienda's termination of its connection to cannabis and other illegal activity prior to the Chapter 11 bankruptcy filing to be a significant factor in denying the U.S. Trustee's Office's motion to dismiss the case.[12]

Digging into the Weeds: The Hacienda Co. Part 2

The debtor, consistent with its expressed intentions at the beginning of the bankruptcy case, filed a Chapter 11 liquidating plan.

Hacienda proposed to sell the stock it owned and distribute the funds to its creditors on a pro rata basis, distributing any excess funds after payment to the company's equity holders.

Once again, the U.S. Trustee's Office filed a motion to dismiss the bankruptcy case. The U.S. Trustee's Office argued that the debtor continued to violate the CSA by holding an asset derived from illegal activity.

In addition, the U.S. Trustee's Office asserted that Hacienda's liquidation of the stock to pay creditor claims and provide a dividend to equity holders

violated federal criminal money laundering statutes.

On Sept. 20, the bankruptcy court issued an order denying the U.S. Trustee's Office's second motion and confirmed the debtor's Chapter 11 plan. The court relied on its prior decision denying an earlier motion, noting that Congress did not adopt a zero-tolerance policy that automatically required dismissal of any case involving a violation of criminal law.

The court reasoned that Congress has shown a willingness to avoid punishing a debtor that may have violated law "when the real victims would be innocent creditors."[13]

The court observed that the debtor proposed a liquidation in bankruptcy under a federal court's supervision, thereby doing exactly what the criminal statutes endorse: namely, the liquidation of assets obtained from criminal activity and distribution of proceeds obtained therefrom to creditors, including any victims of the unlawful activity.

The court was not persuaded under the circumstances of the case that "any federal court policy of not condoning illegality should override Congress' mandates to administer bankruptcy cases, with all of the resulting benefits [injuring] to innocent creditors and other parties in interest."[14]

A Growing Problem

The cannabis industry continues to report growing adoption and increasing revenue, with worldwide legal cannabis sales expected to rise by 15%, to $37 billion, in 2023.[15]

Yet, due to their legal status under federal law, cannabis-related companies in the U.S. do not have the access to banking services and bankruptcy protections that other businesses do.

This makes capital raising, cash management, financing growth, restructuring, preserving value and liquidating harder, and increases costs.

Global banking turmoil, shrinking sources of risk capital, rising interest rates and an unforgiving regulatory environment all threaten to further squeeze legal U.S. cannabis companies.

A need exists for additional tools to address financial distress in the cannabis sector.

Conclusion

Congress and the courts should, like the societal shift evidenced by increased legalization throughout this country, move in the direction of a more permissive attitude toward cannabis.

Cannabis companies should have the very same opportunity to obtain financing, reorganize and orderly liquidate like every other legal business

entity.

The existence of illegal activity under federal law does not, in any event, justify depriving a fundamental business tool available to every other sector of commerce.

As the bankruptcy court in In re: The Hacienda Co. LLC correctly observed, the preservation of value and creditor protection through a court-supervised administration supports adopting a case-by-case assessment.

A blanket prohibition of bankruptcy as an option is not required or consistent with the intent of Congress. This is particularly true when the business is no longer operating at the time of the bankruptcy filing.[16]

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[1] Congress explained its underlying purpose in unmistakable terms when it enacted Chapter 11: "The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders." H.R. Rep. No. 595, at 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179. Embracing this objective, the United States Supreme Court has likewise explained that "the policy of Chapter 11 is to permit successful rehabilitation of debtors." NLRB v. Bildisco & Bildisco, 465 U.S. 513, 527 (1984). Accord United States v. Whiting Pools, Inc. , 462 U.S. 198, 203 (1983) (quoting legislative history).

[2] Indeed, many notable business owners, such as Walt Disney, Henry Ford, and Milton Hershey, as well as blue-chip companies, such as General Motors, Sears, J.C. Penney, K-Mart, American Airlines, Polaroid, and Marvel, have benefitted from bankruptcy protection.

[3] Financially distressed companies in states where cannabis is legal have to rely on limited state law options to address insolvency issues, such as workouts, receiverships and assignments for the benefit of creditors.

[4] An increasing number of states across the country continue down the path of legalization of cannabis. There are currently 24 states in the United States that have legalized its recreational use and many more have approved cannabis for medical purposes as well.

[5] 21 U.S.C. § 801 et seq.

[6] A U.S. Department of Justice memorandum dated April 26, 2017, and

issued to all trustees stated:

In recent months we have noticed an increase in the number of bankruptcy cases involving marijuana assets. This is to reiterate and emphasize the importance of prompt notification to your United States Trustee whenever you uncover a marijuana asset in a case assigned to you. Our goal is to ensure that trustees are not placed in the untenable position of violating federal law by liquidating, receiving proceeds from, or in any way administering marijuana assets. It is the policy of the United States Trustee Program that the United States Trustees shall move to dismiss or object in all cases involving marijuana assets on grounds that such assets may not be administered under the Bankruptcy Code even if trustees or other parties object on the same or different grounds.

[7] Companies that are directly involved in the manufacture, sale, and distribution of cannabis have been easily denied bankruptcy eligibility; however, closer call cases are where a party has a direct or indirect ownership in a cannabis company or where it has some other connection through a lease of real property or providing products or services to a third party's operations. See, e.g., In re Great Lakes Cultivation, LLC (E.D. Mich. 2022) (affirming dismissal and rejecting argument that since cannabis plants were abandoned and its remaining assets were not inherently illegal, the assets could not be possessed and administered by the trustee); Arenas v. United States Tr. (In re Arenas), 535 B.R. 845 (10th Cir. B.A.P. 2015) (affirming denial of debtor's motion to convert Chapter 7 case to Chapter 13 and order dismissal since administration of cannabis assets would be a violation of federal law); In re Burton , 610 B.R. 633 (9th Cir. B.A.P. 2020) (affirming dismissal where debtors, who owned majority interest in a medical cannabis business had the prospect of receiving potential litigation recoveries that would be proceeds of an illegal business that would need to be administered in bankruptcy); In re Way to Grow, Inc. , 610 B.R. 338 (D. Colo. 2019)(finding dismissal to be appropriate when a Chapter 11 debtor runs a business dedicated to servicing the cannabis industry in violation of federal law); In re Basrah Custom Design, Inc. , 600 B.R. 368 (Bankr. E.D. Mich. 2019) (dismissing bankruptcy case to avoid notion that bankruptcy court could be used to assist debtor in violating federal law); In re Rent-Rite Super Kegs West Ltd. , 484 B.R. 799 (Bankr. D. Colo. 2012) (receipt of 25% of debtor's income from real property grower under state law constituted "criminal activity" providing cause for dismissal of bankruptcy case).

[8] In re The Hacienda Co. , LLC, 2:22-bk-15163-NB [Dkt. No. 102], 647 B.R. 748 (Bankr. C.D. Cal. Jan. 20, 2023) (emphasis in original) (The Hacienda Company – I).

[9] It is this facts and circumstances point that is material to the focus of using bankruptcy as potential tool under current law.

[10] Id. at *7-8.

[11] Id. at *11.

[12] The U.S. Trustee's Office filed a Notice of Appeal and Statement of Election seeking to appeal the bankruptcy court order denying its motion to dismiss the case to the district court. The district court dismissed the appeal, finding that the U.S. Trustee's Office failed to satisfy the standards for appealing an interlocutory order. United States v. Hacienda Co., LLC (In re Hacienda Co., LLC), 2023 U.S. Dist. LEXIS 83968 (C.D. Cal. April 5, 2023).

[13] In re The Hacienda Co., LLC, BKY Case No. 2:22-bk-15163-NB [Dkt. No. 199], at 13 (Bankr. Sept. 20, 2023) ("The Hacienda Company II").

[14]Id.

[15] Arelis Agosto, Legal Cannabis Sales Expected to Reach $37 Billion in 2023, Global X (May 18, 2023). The United States market is expected to make up 81% of global sales. Id.

[16] A bankruptcy court would be overstepping its role and acting contrary to Congressional directives in the Bankruptcy Code if it did not sift the circumstances and exercise discretion for the benefit of creditors, employees, equity investors and other constituencies—even though the debtor's connections with cannabis are clear. The Hacienda Company II, at 19.
