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DECLARING *DANK*RUPTCY: EXPLORING AVENUES TO RELIEF FOR DEBTORS INVOLVED WITH CANNABIS

Danny O'Connor

I. INTRODUCTION

In 1996, California became the first state to legalize marijuana for medical use.[1] In 2012, Colorado upped the ante, becoming the first to legalize its use recreationally.[2] Today, only five states mirror the federal government's treatment of marijuana as an illegal substance.[3] This 26-year span of state-level cannabis legalization has ultimately produced one of the most acute tests of the United States' federalist system of government.[4]

Looming over these states the Controlled Substances Act (CSA), mandates a strict federal ban on marijuana.[5] The result of this awkward tension between the states and the federal government is the proliferation of entire intra-state economies existing wholly outside the auspices of federal law.[6] Indeed, in 2017, the combined sales revenue for legalized state cannabis industries was $8 billion.[7] That same year, however, approximately 659,700 people were arrested for federal marijuana-related violations.[8] Even where an individual or business grows, buys, and sells cannabis exclusively within the state where they reside (or are incorporated), the Supreme Court has unequivocally made clear that such activity may be regulated under the CSA by virtue of Congress's interstate commerce powers.[9]

Outside the context of criminality, however, the disparate legal treatment of cannabis between the federal government and the states has

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1. Sarah Trumble, *Timeline of State Marijuana Legalization Laws*, THIRD WAY (Apr. 19, 2017), https://www.thirdway.org/infographic/timeline-of-state-marijuana-legalization-laws.

2. *Id.*

3. Idaho, Wyoming, Kansas, Tennessee, and South Carolina completely disallow the sale or use of cannabis. Jay D. Befort, *The Continuing Saga of Medical and Recreational Marijuana Under the Bankruptcy Code*, NAT'L ASS'N ATT'Y GENS. (Aug. 24, 2021), https://www.naag.org/attorney-general-journal/the-continuing-saga-of-medical-and-recreational-marijuana-under-the-bankruptcy-code/#.

4. Natalie Fertig, *The Great American Cannabis Experiment*, POLITICO (Oct. 14, 2019, 8:01 AM), https://www.politico.com/agenda/story/2019/10/14/cannabis-legal-states-001031.

5. 21 U.S.C. § 801. [hereinafter the CSA]. The term "cannabis" refers to a family of plants of which "marijuana" is a member. *See* Harold B. Hilborn, *2018 Farm Bill Legalizes Hemp, but Obstacles to Sale of CBD Products Remain*, NAT'L L. REV. (Mar. 5, 2019), https://www.natlawreview.com/article/2018-farm-bill-legalizes-hemp-obstacles-to-sale-cbd-products-remain.

6. Fertig, *supra* note 4.

7. *Id.*

8. *Id.*

9. Gonzales v. Raich, 545 U.S. 1, 22 (2005).

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produced considerable, uneven outcomes in another, perhaps unexpected, area of the law: bankruptcy. The bankruptcy system, promulgated by Title 11 of the United States Code, is federal law, prompting the question of whether an individual possessing cannabis, or cannabis-adjacent, assets may seek the financial fresh-start relief that bankruptcy law provides. One judge, presiding over the United States Bankruptcy Court for the Federal District of Colorado, aptly described the situation:

> Whether, and under what circumstances, a federal bankruptcy case may proceed despite connections to the locally "legal" marijuana industry remains on the cutting-edge of federal bankruptcy law. Despite the extensive development of case law, significant gray areas remain. Unfortunately, the courts find themselves in a game of whack-a-mole; each time a case is published, another will arise with a novel issue dressed in a new shade of gray.[10]

This Comment examines these significant gray areas and illuminates the various approaches adopted by the federal courts faced with them. This Comment also observes the access to bankruptcy relief (or lack thereof) for cannabis-adjacent entities – those that do not directly grow or sell cannabis, but transact business with organizations and entities that do. Section II of this Comment provides an overview of the overarching goals of the bankruptcy system, discussing how those goals are accomplished through the three primary forms of bankruptcy relief: Chapter 7, Chapter 13, and Chapter 11. Section II also provides, in conjunction with this overview, examples of cases within each chapter where the bankruptcy courts faced debtors whose estates included cannabis-related assets. Section II concludes by discussing the passage of the 2018 Agricultural Improvement Act ("2018 Farm Bill") and its impact on cannabis-adjacent entities filing for bankruptcy.[11]

Section III of this Comment argues that the inconsistent adjudication of cannabis-bankruptcy cases is neither required by the Bankruptcy Code, nor does it further the Code's goals. Section III also demonstrates that the passage of the 2018 Farm Bill should provide an opening for cannabis-adjacent entities to successfully re-organize or liquidate through the bankruptcy process. Section III concludes with observations on the societal inequities substantiated by the bankruptcy courts' status quo treatment of cannabis. This Comment concludes in Section IV by looking to the future of U.S. cannabis legislation, and the policy implications it portends for the bankruptcy system.

10. *In re* Malul, 614 B.R. 699, 701 (Bankr. D. Colo. 2020).

11. 7 U.S.C.A. § 9001 (West) [hereinafter 2018 Farm Bill or Farm Bill].

II. BACKGROUND

Article I, Section 8 of the United States Constitution authorizes Congress to "enact uniform Laws on the Subject of Bankruptcies."[12] Until 1898, Congress largely used this power on an ad hoc basis to help revive failed railroad enterprises.[13] In 1978, Congress passed the Bankruptcy Reform Act, establishing many of the underlying foundations of the bankruptcy system as it is known today.[14] At the highest level, the bankruptcy system has been described by courts to serve two overarching societal goals: (1) to ensure the equitable treatment of creditors through the distribution of the debtor's assets; and (2) to give the debtor a fresh start, at least with regard to their financial life.[15] The debtor is granted this fresh start through the discharge of their pre-bankruptcy debts following the adjudication of their case.[16] Notably, this discharge is not a constitutional right, but rather a legislative benefit created by Congress that may be withheld at its discretion.[17]

This Comment now turns to a brief overview of this system. While the intricacies of the Bankruptcy Code are far too numerous to cover here, this Section seeks to provide a foundation for understanding the unique issues faced by cannabis and cannabis-adjacent debtors.

A. Bankruptcy Overview: Chapter 7

The prototypical form of relief under the Bankruptcy Code is a discharge pursuant to Chapter 7.[18] Under a Chapter 7 discharge, the bankruptcy trustee, an appointed administrative official (typically a local attorney) gathers the majority of the debtor's property into a separate legal entity, called the bankruptcy estate.[19] Certain property may be deemed exempt and thus kept out of the estate and retained by the debtor.[20] Conversely, liens and mortgages encumbering the debtor's property pursuant to state law remain in place despite the debtor's filing for relief.[21]

Individuals, corporations, partnerships, and other business entities are

12. U.S. CONST. art. I, § 8.

13. Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 23 (1995).

14. *Id.* at 35.

15. 9 AM. JUR. 2D *Bankruptcy* § 5 (2022).

16. *Id.*

17. *Id.*; *see also* United States v. Kras, 409 U.S. 434, 446 (1973).

18. 11 U.S.C. § 524.

19. *Chapter 7 – Bankruptcy Basics*, U.S. CTS., https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-7-bankruptcy-basics (last visited Feb. 27, 2022).

20. *Id.*; *see also* 11 U.S.C. § 522.

21. *Chapter 7 – Bankruptcy Basics*, *supra* note 19.

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all eligible for Chapter 7 relief.[22] A Chapter 7 case officially begins when the debtor files a petition with the bankruptcy court located in the jurisdiction where the individual debtor lives, or where the business debtor is organized, incorporated, or has its primary place of business.[23] The debtor must also produce a dizzying array of financial documentation, the most important being schedules of assets and liabilities.[24] Once the petition is filed, the automatic stay of the Bankruptcy Code comes into effect, halting virtually all collection efforts by the debtor's creditors, regardless of whether their payment obligations are subject to liens or security interests.[25] Additionally, if an individual debtor's current monthly income is greater than the median level of the state in which they reside, the Bankruptcy Code requires application of the means test to determine whether allowing the debtor to proceed with Chapter 7 relief will constitute abuse of the system.[26]

Throughout this process, the bankruptcy trustee acts as impartial administrator of the bankruptcy estate whose primary goal is maximizing the payments made to the debtor's general, unsecured creditors.[27] In many cases, those payments amount to nothing.[28] If there are assets to distribute, however, the trustee will sell them and apply the proceeds to the creditor's claims on a pro-rata basis.[29] Assuming the debtor successfully maneuvers their way through this process, the court will grant them a discharge, relieving their personal liability for all debt obligations assumed prior to filing the bankruptcy petition.[30]

B. Bankruptcy Overview: Chapter 13

Chapter 13 offers several of the same advantages as Chapter 7, with the important caveat that Chapter 13 relief is only available to individual debtors – business organizations other than sole proprietorships are not eligible.[31] Rather than a full discharge of debts, Chapter 13 enables

22. 11 U.S.C. §§ 101(41), 109(b).

23. *Chapter 7 – Bankruptcy Basics*, *supra* note 19.

24. *Id.*

25. 11 U.S.C. § 362.

26. *Id.* § 707(b). The various complexities of the means test are well beyond the scope of this Comment. For present purposes, it is worth noting the test requires debtors that meet certain income levels to either convert their case to Chapter 13, or have their case dismissed entirely. *Id.*

27. *Chapter 7 – Bankruptcy Basics*, *supra* note 19.

28. *Id.*

29. *Id.*

30. 11 U.S.C. § 522(a).

31. *Chapter 13 – Bankruptcy Basics*, U.S. CTS., https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-13-bankruptcy-basics (last visited Feb. 27, 2022); *see also* 11 U.S.C. § 109(e).

individuals with regular incomes to develop a repayment plan for some or all of their debts via a court-supervised process.[32] Many individual debtors utilize this option as a means to save their homes from foreclosure and avoid the upfront filing fees many attorneys require for Chapter 7 filings.[33] Chapter 13 repayment plans contemplate a three-year repayment timeline for most debtors, are statutorily prohibited from spanning more than five years.[34]

Once a debtor files a Chapter 13 petition, they have fourteen days to file their proposed repayment plan.[35] The debtor must repay secured creditors the full value of their collateral.[36] Unsecured creditors, on the other hand, must be paid all of the debtor's projected disposable income over the length of the plan less the amount determined necessary for the debtor's essential living expenses.[37] Unsecured creditors must also receive at least as much value under the repayment plan as they would have received had the debtor liquidated their assets in a Chapter 7 proceeding.[38]

In lieu of discharge or approval of a repayment plan, the court may dismiss the debtor's case for a variety of reasons set forth by the Bankruptcy Code.[39] The grounds for dismissal in both Chapter 7 and Chapter 13 cases loom large over filings by debtors with cannabis assets, and this Comment now turns to addressing them through case law.

1. In re Arenas

In re Arenas involved debtors who were married, living in Colorado, and licensed under state law to grow and sell marijuana.[40] The debtors also leased a piece of real estate they owned to a third party, who used it as a marijuana dispensary.[41] After litigation with their lessees resulted in a state court judgment against them, the debtors filed a Chapter 7 petition

32. *Chapter 13 – Bankruptcy Basics*, *supra* note 31.

33. *Id.*

34. 11 U.S.C. § 1322(d).

35. FED. R. BANKR. P. 3015.

36. *Chapter 13 – Bankruptcy Basics*, *supra* note 31. A secured creditor refers to a creditor who secures the debtor's repayment obligation by taking a security interest in the debtor's personal property or "collateral." If a debtor fails to repay, outside of bankruptcy, a secured creditor may repossess the collateral pursuant to state law. *See Secured Creditor*, INVESTOPEDIA (Mar. 31, 2021), https://www.investopedia.com/terms/s/secured-creditor.asp; *see also* U.C.C. § 9-102(a)(73) (AM. L. INST. & UNIF. L. COMM'N 1994).

37. *Chapter 13 – Bankruptcy Basics*, *supra* note 31.

38. 11 U.S.C. § 1325.

39. 11. U.S.C. § 707.

40. *In re* Arenas, 535 B.R. 845, 847 (B.A.P. 10th Cir. 2015).

41. *Id.*

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with the bankruptcy court in the Federal District of Colorado.[42] The debtors later motioned to convert their case to Chapter 13.[43] The United States Trustee objected to the conversion and moved to have the entire case dismissed.[44] The bankruptcy court found that, while the debtors' cannabis-related activities were legal under Colorado law, they were federally illegal pursuant to the CSA, thus precluding them from receiving relief under the Bankruptcy Code.[45] On that basis, the court dismissed the debtor's petition.[46]

On appeal, the Bankruptcy Appellate Panel for the Tenth Circuit affirmed the dismissal of the debtors' petition.[47] Of primary significance to the court's holding was the requirement, found in Chapter 13 of the Bankruptcy Code, that a prospective repayment plan be "proposed in good faith and not by any means forbidden by law."[48] In determining whether the debtor lacked good faith, the court applied the test developed in *Flygare v. Bolden*.[49] Noting that no single part of this multi-factor test was individually dispositive, the court focused on just one – the burden the repayment plan's administration would place on the trustee.[50]

The court reasoned that the only way the debtors could make payments under their proposed repayment plan was with income substantially derived from cannabis sales and rental income from their dispensary-lessee.[51] Because cannabis is illegal under the CSA, the court held that approval of the debtors' Chapter 13 plan would necessarily require the bankruptcy trustee to break federal laws by distributing cannabis assets for the repayment of creditors.[52] This fact, the court noted, meant the debtors had failed to propose a confirmable Chapter 13 plan, which, by extension, meant they had failed to propose a repayment plan in good faith "and not by any means forbidden by law."[53]

The court also addressed the debtor's argument that dismissing their case amounted to adopting a per se rule prohibiting debtors engaged in a state's cannabis industry from seeking bankruptcy relief.[54] The court

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.* at 851 (emphasis omitted); *see also* 11 U.S.C. § 1325(a)(3).

49. *Arenas*, 535 B.R. at 852. The court also noted here that the *Flygare* test is the accepted standard used in Tenth Circuit for determining whether a debtor satisfies the good faith language of § 1325(a)(3). *See* Flygare v. Boulden, 709 F.2d 1344, 1347 (10th Cir. 1983).

50. *Arenas*, 535 B.R. at 852.

51. *Id.*

52. *Id.*

53. *Id.* at 851.

54. *Id.*

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responded by stating that the debtors' involvement in the cannabis industry was not the *sine qua non* of denying their petition.[55] Rather, it was the inability of the debtors to present a repayment plan that could compensate their creditors without forcing the trustee to distribute significant cannabis assets in violation of federal law which required dismissal.[56] Placing an emphasis on the relevance of the CSA in its dismissal of the debtors' case, the court articulated its view that the debtors had not engaged in any "intrinsically evil conduct."[57] Instead, the debtors had found themselves at the awkward crossroads between conflicting state and federal law.[58]

2. In re Burton

While the actual presence of cannabis assets in the bankruptcy estate was the linchpin of the *Arenas* court's holding, the Bankruptcy Appellate Panel for the Ninth Circuit, in *In re Burton*, took a harsher stance in their dismissal of debtors' Chapter 13 petition.[59] In *Burton*, the debtors were a husband and wife seeking Chapter 13 bankruptcy relief.[60] Included in the debtors' asset schedules was a sixty-five percent ownership interest in Agricann, an entity authorized by Arizona law to grow and sell medical marijuana.[61] The debtors also listed as an asset a pending breach of contract claim of undisclosed value against Natural Remedy Patient Center LLC, another Arizona cannabis entity.[62] The contracts at issue contemplated Agricann's cultivating, growing, and selling cannabis plants.[63]

After the debtors failed to have a repayment plan approved, one of their creditors motioned for the court to convert their case to a Chapter 7 proceeding.[64] The court held a preliminary hearing on the motion to convert and issued an order to show cause ("OSC") requiring the debtors to demonstrate why their case should not be dismissed due to their ownership interest in an entity deriving income from the cannabis industry.[65] In response to the OSC, the debtors asserted that Agricann had gone out of business in 2016, and therefore they no longer received any

55. *Id.*
56. *Id.* at 852–53.
57. *Id.* at 849.
58. *Id.* at 854.
59. *In re* Burton, 610 B.R. 633, 634 (B.A.P. 9th Cir. 2020).
60. *Id.*
61. *Id.*
62. *Id.*
63. *Id.* at 635.
64. *Id.*
65. *Id.*

income from it.[66] Additionally, they asserted that they did not expect to receive any payment from the pending litigation in which Agricann was a party.[67] Finally, the debtors stated their intention to abandon their interest in Agricann from the bankruptcy estate, after which they would divest themselves from the business entirely.[68]

Despite these assertions by the debtors, the appellate panel nonetheless affirmed the bankruptcy court's blanket dismissal of the debtors' bankruptcy case.[69] The court indicated that, although Agricann was no longer a functioning business, it was involved in litigation in which it sought recovery for breach of a contract that had contemplated its involvement in growing and selling cannabis, thus precluding the debtors from seeking bankruptcy relief.[70] The court also noted that the debtors' assertion that they would not receive any distributions from the litigation was not credible, due to the fact that the litigation was still being pursued.[71] Even if the debtors proposed a feasible repayment plan without including any cannabis assets, the mere possibility of receiving payment from the ongoing litigation implicated the possibility of tainted money flowing into the estate, which would necessarily require the trustee to distribute assets obtained illegally under the CSA.[72]

3. In re MedPoint Management, LLC

Creditors are also vulnerable to the sting of a dismissed petition in cases involving cannabis debtors. In the case of *In re MedPoint Management, LLC*, a group of four Arizona-based creditors learned this the hard way.[73] The debtor, MedPoint Management ("Medpoint"), was characterized by the bankruptcy court as a dispensary management entity ("DME").[74] Because the Arizona law legalizing the use of medical marijuana required state-registered dispensaries to operate as not-for-profit businesses, various DMEs formed to serve as repositories for these dispensaries' revenues.[75] After Medpoint defaulted on multiple six-figure unsecured loans made by several of their aggrieved creditors, the creditors filed an involuntary Chapter 7 petition to force the company into the

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.* at 636.

70. *Id.*

71. *Id.* at 640.

72. *Id.*

73. *In re* Medpoint Mgmt., LLC, 528 B.R. 178 (Bankr. D. Ariz. 2015), *vacated in part*, No. AZ–15–1130–KuJaJu, 2016 WL 3251581 (B.A.P. 9th Cir. June 3, 2016).

74. *Id.* at 180.

75. *Id.*

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bankruptcy court.[76]

The creditors argued that MedPoint was not itself engaged in any illegal activity under the CSA, highlighting the fact that the business did not grow or sell cannabis.[77] The creditors further pointed out that MedPoint had applied for and received a Federal Tax ID number and held a bank account with Wells Fargo, highly atypical of state-registered cannabis businesses due to most large banks' unwillingness to open accounts for them.[78] Accordingly, the creditors asserted that a bankruptcy trustee could liquidate MedPoint's assets without violating the CSA or otherwise running afoul of the contrary holdings of previous bankruptcy decisions involving cannabis debtors.[79]

In response, MedPoint cited *In re Arenas* to argue that a bankruptcy trustee could not lawfully administer the estate's cannabis-related assets.[80] While it was true, MedPoint argued, that it did not directly grow or sell cannabis, its exclusive source of revenue came from dispensary clients.[81] For one of these clients, MedPoint handled all business relationships and cultivation operations.[82] As such, nearly all its assets derived, albeit indirectly, from the growth and sale of medical marijuana.[83] Ironically, MedPoint never challenged that it had defaulted on the loans issued by the petitioning creditors.[84]

The bankruptcy court agreed with MedPoint, finding the company's extensive involvement with medical marijuana dispensaries provided ample grounds to dismiss the petition for cause pursuant to the Bankruptcy Code.[85] The bankruptcy court further held that the petitioning creditors' dealings with MedPoint also amounted to a violation of the CSA.[86] Accordingly, the court found that the creditors came to it with unclean hands and were precluded from seeking relief under the Bankruptcy Code.[87]

76. *Id.*

77. *Id.* at 183.

78. *Id.*

79. *Id.*

80. *Id.* at 182.

81. *Id.* at 181.

82. *Id.*

83. *Id.*

84. *Id.* at 183.

85. *Id.* at 184; *see also* 11 U.S.C. § 707(a)(1) ("The court may dismiss a case under this chapter only after notice and a hearing and only for cause, including – unreasonable delay by the debtor that is prejudicial to creditors.").

86. *Medpoint Mgmt.*, 528 B.R. at 186–87.

87. *Id.*

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4. Green Earth Wellness v. Atain Specialty Insurance Co.

Although not a bankruptcy case, the insurance contract dispute between cannabis grower Green Earth Wellness Center, LLC ("GWC") and its insurance provider, Atain Specialty Insurance Company ("Atain"), provides important additional context on the federal courts' approach to cannabis assets in litigation. In *Green Earth*, GWC made an insurance claim, pursuant to a policy purchased from Atain, after thieves broke into one of their growth facilities and stole several marijuana plants.[88] Atain refused to honor the claim, arguing that it was not covered by the policy, prompting GWC to file suit for breach of the insurance contract.[89] Atain responded by filing a motion asking the Federal District Court of Colorado to determine, as a matter of law, if it was legal for Atain to pay for the damages GWC incurred from the stolen marijuana plants.[90] Atain also filed a motion for summary judgment, specifically pointing to a provision of the policy excluding "[c]ontraband" from coverage and asserting that the stolen marijuana plants constituted contraband.[91]

The court rejected this argument, noting that the policy did not define the term contraband.[92] From there, the court applied traditional contract principles to the insurance policy to determine if the stolen marijuana plants fell within its coverage.[93] The court ultimately denied Atain's motion for summary judgment, reasoning that Atain had almost certainly contemplated coverage of the marijuana plants when it formed a business relationship with GWC, estopping them from making a contrary assertion in summary judgment proceedings.[94] Crucially, the court further noted that paying GWC the damages of its lost marijuana plants pursuant to the insurance policy did not require Atain to directly purchase marijuana, and thus was unlikely to amount to a violation of the CSA.[95]

C. Bankruptcy Overview: Chapter 11 Reorganization

Another major form of financial, fresh-start relief offered by the Bankruptcy Code is provided by Chapter 11, commonly referred to as

88. Green Earth Wellness Ctr., LLC v. Atain Specialty Ins. Co., 163 F. Supp. 3d 821, 824 (D. Colo. 2016).

89. *Id.*

90. *Id.* Atain essentially sought to avoid honoring the insurance contract on the theory that paying for the damages incurred from the stolen marijuana plants would amount to the company itself purchasing marijuana in contravention of the CSA. *Id.*

91. *Id.* at 832.

92. *Id.*

93. *Id.* at 833.

94. *Id.*

95. *Id.* at 835.

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reorganization.[96] While Chapter 11 is available to individuals, it is primarily utilized by business organizations and typically filed in instances where the business is saddled with substantial debt but desires to maintain its existence as a going concern.[97] The debtor must file the same schedules of assets and liabilities required under Chapters 7 and 13.[98] Additionally, the debtor must submit a written reorganization plan to the court.[99] The reorganization plan must contain comprehensive information concerning the assets, liabilities, and business affairs of the debtor sufficient to enable their creditors to make an informed judgment about the viability of the plan post-bankruptcy.[100] The plan must also specify how each class of creditor claims will be addressed post-bankruptcy, and the extent to which creditors' contractual rights to repayment will be modified.[101] Once the debtor completes this step, the creditors collectively vote by ballot for their approval or disapproval of the plan.[102]

Similar to Chapter 13 repayment plans, Chapter 11 reorganization plans must be "proposed in good faith and not by any means forbidden by law."[103] Bankruptcy courts have generally found that a Chapter 11 plan is proposed in good faith when there is "a reasonable likelihood that [the plan] will fairly achieve a result consistent with the objectives and purposes of the Bankruptcy Code."[104] For purposes of finding good faith in the Chapter 11 context, the Bankruptcy Code places emphasis on the following objectives: preserving jobs in the community, allowing businesses to survive and avoid liquidation, giving debtors a fresh start, maximizing fair and equitable relief for creditors, and achieving fundamental justice.[105] As one court aptly described the good faith requirement:

> The requirement of good faith must be viewed in light of the totality of circumstances surrounding establishment of a Chapter 11 plan, keeping in mind the purpose of the Bankruptcy Code to give debtors a reasonable opportunity to make a fresh start. Where the plan is proposed with the legitimate and honest purpose to reorganize and has a reasonable hope of

96. *Chapter 11 – Bankruptcy Basics*, U.S. CTS., https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics (last visited Feb. 28, 2022).

97. *Id.*

98. *Id.*

99. 11 U.S.C. §§ 1121, 1125.

100. *Chapter 11 – Bankruptcy Basics*, *supra* note 96.

101. 11 U.S.C. § 1123.

102. *Id.* § 1126.

103. 11 U.S.C. § 1129(a)(3)

104. AM. JUR. 2D *Bankruptcy* § 2876 (2022).

105. *Id.*

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success, the good faith requirement of section 1129(a)(3) is satisfied.[106]

In Chapter 11 cases, the role of the trustee is assumed by the debtor, who takes on the title "debtor in possession" ("DIP").[107] The Bankruptcy Code requires the DIP to perform all the functions of a conventional trustee, such as accounting for estate property, evaluating creditor claims, and regularly filing reports with the court.[108] At the same time, the DIP may continue to operate their business in due course.[109]

Subject to certain exceptions, debtors in Chapter 11 cases have a one-time, absolute right to convert their case to a Chapter 7 case.[110] Any interested party may motion the court to either convert the case to a different chapter or dismiss it for cause.[111] Otherwise, the plan will be presented to the creditors for confirmation, subject to the complex creditor voting provisions of the Bankruptcy Code.[112] Confirmation of a Chapter 11 plan discharges a debtor from all pre-petition debts as well as those that arose between the filing of the petition and the plan confirmation.[113] Thereafter, the debtor must follow the plan's repayment and reorganization requirements, as well as comply with any further orders from the bankruptcy court.[114]

The cannabis-adjacent debtors mentioned above generally seek relief under Chapter 11.[115] Recently, a core issue in these cases has hinged on the relevance of the 2018 Farm Bill to their proposed reorganization plans. Accordingly, this Comment briefly discusses the background and content of the 2018 Farm Bill.

D. The Agricultural Improvement Act of 2018

In December 2018, the Agricultural Improvement Act of 2018, commonly referred to as the 2018 Farm Bill, was signed into law.[116] The primary purpose of the Act was to set general policy guidelines for the

106. *In re* Sun Country Dev., Inc., 764 F.2d 406, 408 (5th Cir. 1985) (citations omitted).

107. *Chapter 11 – Bankruptcy Basics*, supra note 96.

108. 11 U.S.C. §§ 1106, 1107.

109. *Id.*

110. *Id.* § 1112(a). The debtor may convert their case unless (1) they are not a DIP; (2) the chapter 11 petition was filed involuntarily; or (3) the case was converted to Chapter 11 after previously being filed under a different section of the code. *Id.*

111. *Id.* § 1112(b). This section provides various examples of what constitutes "cause." This first of these examples is "substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation." *Id.* § 1112(b)(4)(A).

112. *Id.* §§ 1126-29; *see also Chapter 11 – Bankruptcy Basics*, supra note 96.

113. 11 U.S.C. § 1141(d).

114. *Id.* § 1142.

115. *See supra* Section I.

116. Hilborn, *supra* note 5.

country's agricultural and nutritional industries for the succeeding five years.[117] However, the Act also federally legalized the sale of hemp, along with products derived from hemp. Notably, hemp products contain tetrahydrocannabinol ("THC"), the intoxicating chemical found in marijuana, which is explicitly banned by the CSA.[118] Under the 2018 Farm Bill, the key distinction between hemp products and marijuana turns on the concentration of THC in the plant.[119] The 2018 Farm Bill allows for the legal sale of products derived from cannabis plants with less than 0.3 percent concentration of THC.[120]

While the CSA originally classified any form of marijuana containing THC as an illegal substance, the 2018 Farm Bill removed hemp from the CSA's definition of marijuana, reclassifying it as a separate, federally legal, cannabis product.[121] This appeared to fully lift the federal ban on hemp, although the U.S. Food and Drug Administration ("FDA") announced shortly after the Act's passage that it would continue its policy of strictly regulating products containing cannabis or derived from cannabis pursuant to its statutory authority.[122]

Regardless of the FDA's stance, the passage of the 2018 Farm Bill officially created a distinction in federal law between cannabis and marijuana. In the bankruptcy context, this new state of affairs seemingly opened the door for creative cannabis-adjacent debtors seeking to reorganize their distressed businesses under Chapter 11 of the Bankruptcy Code. This Comment now examines the burgeoning case law of debtors relying on the 2018 Farm Bill for the viability of their reorganization plans.

1. In re Way to Grow

In re Way to Grow involved the Chapter 11 petition of a business debtor that specialized in the sale of indoor hydroponic farming equipment and other gardening supplies.[123] In considering the debtor's eligibility for Chapter 11 relief, the court determined that while such farming equipment could be used for a wide variety of crops, the overwhelming majority of the debtor's sales were to Colorado-based marijuana growers.[124] After an

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117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.* In the remainder of this Comment, "marijuana" refers to products derived from cannabis plants with a concentration above the 0.3 percent concentration limit set by the Farm Bill.

121. 7 U.S.C. § 12619.

122. Hilborn, *supra* note 5.

123. *In re* Way To Grow, Inc., 597 B.R. 111, 115 (Bankr. D. Colo. 2018).

124. *Id.* at 130. The court cited testimony from one of the debtor's storefront managers that as many as 95 percent of his customers used the debtor's equipment to grow marijuana. *Id.*

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extensive review of cannabis debtor case law, the bankruptcy court concluded it was impossible to approve of the debtors' reorganization plan without sanctioning further violations of the CSA, and accordingly dismissed their petition.[125]

The debtor's case was dismissed on December 14, 2018, less than a week before the passage of the 2018 Farm Bill.[126] With the wrench of legalized hemp thrown into the mix, the debtors appealed to the Federal District Court for the District of Colorado and argued, in essence, that they could submit a viable reorganization plan focused on federally legal hemp cultivation.[127] The district court dismissed this argument, noting that the debtors cited nothing in the record to support that contention, nor had they advanced that argument to the bankruptcy court.[128] The court offered the following on the implications of the 2018 Farm Bill:

> This Court does not opine on whether the timing of the Agriculture Improvement Act's passage excuses Debtors' failure to develop a proper record or to advance the argument. The Court only holds that the bankruptcy court did not err, much less clearly err, by failing to address this argument, which was never presented to it and could not have been a potential basis for relief until after the bankruptcy court issued its decision.[129]

While this debtor was out of luck due to procedural defects, the court's refusal to definitively comment on the relevance of the 2018 Farm Bill left the door open, for a short time, to future cannabis business debtors in formulating reorganization plans.

2. In re United Cannabis

On April 20, 2020, a Colorado-based marijuana grower called United Cannabis Corporation ("UCANN"), filed a Chapter 11 petition in the Federal District Court of Colorado.[130] Within two days of their filing, the bankruptcy magistrate issued an order to show cause instructing UCANN to justify why its case should be allowed to proceed.[131] In response to the

125. *Id.* at 132.

126. Jake Ayres, *Chapter 420 Bankruptcy?: How In re United Cannabis Could Open the Doors to Bankruptcy Relief for Cannabis-Adjacent Businesses*, LEXOLOGY (Sep. 12, 2020), https://www.lexology.com/library/detail.aspx?g=b60b3d15-e29a-4bc5-8e6c-a7eaca969fec; *see also supra* Section II(D).

127. *Way to Grow, Inc.*, 610 B.R. at 355.

128. *Id.*

129. *Id.* at 355-56.

130. Ayres, *supra* note 126; *see also* Oliva B. Waxman, *Here's the Real Reason We Associate 420 with Weed*, TIME (Apr. 13, 2018), https://time.com/4292844/420-april-20-marijuana-pot-holiday-history (providing a thorough explanation of the relevance of April 20th to popular culture).

131. Ayres, *supra* note 126.

order, UCANN argued that its $4 million bankruptcy estate was largely composed of legalized hemp and cannabidiol ("CBD") products.[132] The United States Trustee submitted its own response questioning the credibility of UCANN's assertions, highlighting the fact that UCANN had heavily marketed itself as a marijuana grower throughout its existence.[133] UCANN's response to the court's order, however, resurrected the argument the *In re Way to Grow* debtors presented on appeal — Can a company with marijuana-derived income seek Chapter 11 relief by demonstrating a viable reorganization plan centered around federally legal hemp products?

While the bankruptcy court's OSC decision remained pending, the United States Trustee filed a motion to dismiss UCANN's petition, based on UCANN's alleged violations of the CSA.[134] UCANN, likely to its detriment, did not file a memorandum in opposition to the trustee's motion.[135] In January 2021, the bankruptcy court granted the trustee's motion, issuing a one-page order dismissing UCANN's case for "good cause" but without elaborating on its reasoning.[136]

III. DISCUSSION

By declining to comment on the potential interplay between the 2018 Farm Bill and the Bankruptcy Code, the Colorado district court effectively maintained the status quo after *In re Way to Grow*. Accordingly, the question posed by UCANN and the *Way to Grow* debtors remains unanswered. This Comment now attempts to fill in the gaps left by the bankruptcy courts.

Part A of this Section argues that the 2018 Farm Bill provides a clear avenue to bankruptcy relief for cannabis-adjacent debtors. Part A also argues that encouraging such debtors to reorganize around hemp-derived products can provide clarity to the scope of the 2018 Farm Bill as well as aid the development of the burgeoning hemp industry. Part B of this Section addresses the approach employed by the Ninth Circuit in *In re Burton*, arguing that denial of bankruptcy relief based solely on a debtor's pre-petition involvement with marijuana thwarts the goals of the Bankruptcy Code. Part B further argues that falling back on the CSA, without further elaboration, is an unsound basis to deny these debtors

132. *Id.*

133. *Id.*

134. Deborah Kennedy & Andrew Kline, *Another Blow to Bankruptcy Relief for Marijuana-Adjacent Debtors*, JD SUPRA (Jan. 27, 2021), https://www.jdsupra.com/legalnews/another-blow-to-bankruptcy-relief-for-4412557.

135. *Id.*

136. *Id.*; *see also In re* United Cannabis Corp., No. 20-BK-12692 (Bankr. D. Colo. Sept. 15, 2022) (West).

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bankruptcy relief and runs counter to the equitable considerations traditionally handled by bankruptcy courts. Part C contemplates the unjust effects of the current bankruptcy regime on society at large.

A. The 2018 Farm Bill Provides a Sound Basis for Chapter 11 Reorganizations by Cannabis-Adjacent Debtors.

Without the benefit of a full opinion in the *UCANN* proceeding, the lack of opposition to the United States Trustee's motion to dismiss the case likely bolstered the judge's view that the company could not feasibly pivot from marijuana to hemp and sufficiently satisfy its creditors. While UCANN's Chapter 11 plan may not have been feasible, evidence suggests that the burgeoning hemp industry can provide a firm platform for distressed marijuana companies seeking to reorganize under Chapter 11. Within just two years of the 2018 Farm Bill's passage, hemp quickly soared to becoming one of the top ten most heavily produced farm products in the United States.[137] CBD, the most common hemp-derived product, has blossomed into a multibillion-dollar market.[138]

While the debtors in *UCANN* and *Way to Grow* were dismissed from bankruptcy court, the Eastern District of Kentucky approved a substantial Chapter 11 plan for a hemp-grower based in the state.[139] The reorganization called for the sell-off of $77 million of the distressed company's assets, including 15,000 bales of hemp.[140] Considering this development, cannabis-adjacent debtors should have a much stronger argument for utilizing bankruptcy relief to pivot their operations to federally legal hemp.

Beyond hemp and CBD, various other hemp-derived products indicate reorganization avenues for distressed cannabis-adjacent debtors. One hemp-derivative product, Delta-8 THC ("D-8"), has seen an explosive rise in popularity since the 2018 Farm Bill's passage.[141] Additionally, hemp has uses beyond consumption. Some farmers have begun partnering with clothing organizations such as Patagonia to utilize hemp farming to

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137. Joan Oleck, *Legal Hemp, Notably CBD, Generates Astonishing Revenues. So Why Is the Industry Struggling So Hard?*, FORBES (Dec. 24, 2020), https://www.forbes.com/sites/joanoleck/2020/12/24/legal-hemp-notably-cbd-generates-astonishing-revenues-so-why-is-the-industry-struggling-so-hard/?sh=75b1b5b566d4.

138. *Id.*

139. Eric Sandy, *Judge Approves $77 Million Bankruptcy Sale for GenCanna*, CANNABIS BUS. TIMES (May 22, 2020), https://www.cannabisbusinesstimes.com/article/gencanna-bankruptcy-court-complaints-contractors-hemp-processing-facility; *see also In re* GenCanna Glob. USA, Inc., 619 B.R. 364 (Bankr. E.D. Ky. 2020).

140. Sandy, *supra* note 139.

141. Oscar Sacirbey, *Is Delta-8 THC a Threat to the Marijuana Industry?*, MJBIZDAILY (Feb. 1, 2022), https://mjbizdaily.com/is-delta-8-thc-a-threat-to-the-marijuana-industry.

produce more sustainable fiber for use in clothing production.[142] While these industries are still in nascent stages, they present unique entrepreneurial opportunities for distressed marijuana companies seeking to pivot to a potentially more profitable industry. Bankruptcy courts should observe this new reality and acknowledge the potential of the 2018 Farm Bill to unlock a new avenue of options for distressed cannabis-adjacent debtors and their creditors. Working with debtors to reorganize their businesses, and subsequently pivoting away from an as-yet federally illegal industry, almost certainly achieves the fresh start goals of the Bankruptcy Code more so than outright dismissal of debtors' petitions.

B. Consideration of a Debtor's Pre-Bankruptcy Involvement in Marijuana Businesses Should Focus on the Policy Goals of Bankruptcy.

By dismissing the debtors' petition in *In re Burton*, the Ninth Circuit indicated intense hostility to debtors with previous involvement in marijuana businesses legalized under state law. Creditors within the Ninth Circuit were given a similar warning by the bankruptcy court's decision in *In re Medpoint Management, LLC* – that seeking relief as a cannabis-industry participant is tantamount to entering court with unclean hands. While this Comment does not suggest that bankruptcy courts should ignore the CSA and facilitate full-scale liquidation of marijuana products, it does suggest that courts should more carefully work with individual debtors seeking to use bankruptcy as a means to exit the industry.

The opinions from the Tenth Circuit and the Federal District of Colorado offer reasoned approaches to achieving the goals of the Bankruptcy Code when dealing with cannabis and cannabis-adjacent debtors. Particularly, the *Green Earth* decision suggests that a federal court can adjudicate a contract dispute involving a direct marijuana grower.[143] Even though the practical effect of Atain honoring its insurance policy with the debtor would lead to the purchase of new marijuana plants, the court determined that the contract itself did not violate public policy.[144] This line of reasoning offers especially strong

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142. Sophie Quinton, *The Hemp Boom Is Over. What Now?*, PEW CHARITABLE TRS.(July 9, 2021), https://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2021/07/09/the-hemp-boom-is-over-what-now.

143. *See supra* Section II(B)(4).

144. Green Earth Wellness Ctr., LLC v. Atain Specialty Ins. Co., 163 F. Supp. 3d 821, 835 (D. Colo. 2016); *see also In re* Malul, 614 B.R. 699, 709 (Bankr. D. Colo. 2020).

> Taken together, *Green Earth Wellness* and *Ginsburg* stand for the proposition contracts that can be performed without violating the CSA are likely enforceable even if the transaction's subject matter involves CSA violations. In both cases, the underlying contracts would require no more than the payment of money, which is not *per se* illegal under federal law.

Id.

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arguments to cannabis-adjacent debtors, who contract to provide services and equipment to marijuana growers but otherwise do not themselves directly violate the CSA. Furthermore, the Bankruptcy Code allows the trustee to reject executory contracts that are unfavorable to the estate.[145] To the extent that courts can work with debtors and trustees to shed contractual obligations that violate the CSA, the bankruptcy cases of these debtors should be allowed to proceed.

Even when courts fall back on the CSA as a basis for dismissing a cannabis-debtor's bankruptcy petition, the ultimate effect of the decision may not actually advance the drug enforcement policy of the CSA. The *In re Way to Grow* court acknowledged this quandary. In discussing an ongoing state court lawsuit by one of the debtor's creditors to seize control of the company under its state-law remedies, the court noted:

> Ironically, if [the creditor], as the party arguing Debtors are violating federal law, wrests control of the Debtors back from Byrd in the [Larimer County lawsuit], he will almost certainly continue, and perhaps expand, the Debtors' ongoing marijuana-related operations. This irony is not lost on the Court but provides no legal basis for an alternate outcome. The Court casts no aspersions upon the Debtors or their businesses. The result in this case is dictated by federal law, which this Court is bound to enforce.[146]

Indeed, it is truly ironic for a bankruptcy court – whose primary goals are providing fresh start relief to debtors and fair treatment to creditors – to effectively sanction one creditor taking over a federally illegal business from its debtor and continuing to operate that business for its own benefit.

Bankruptcy courts are courts of equity.[147] Accordingly, they are well positioned to seek the most justiciable outcomes for parties that seek relief. This is especially so when faced with a burgeoning area of the law, such as cannabis legalized by individual states. In the business reorganization context, the primary focus of the bankruptcy courts should be whether debtors are attempting to reorganize their business for a legitimate and honest purpose, and whether their reorganization plans have a reasonable hope for success.[148] In the context of individual

145. *See* 11 U.S.C. § 365(a) ("Except as provided in section 765 and 766 of this title and subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.").

146. *In re* Way to Grow, Inc., 610 B.R. 338, 343 (Bankr. D. Colo. 2019).

147. *See* 11 U.S.C. § 105(a).

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

Id.

148. *See supra* Section II(C).

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consumer bankruptcies filed under Chapter 7 or Chapter 13, courts should focus on achieving a fresh start for the debtor and equitable repayment to the debtor's creditors. By anchoring their focus on the underlying goals of the bankruptcy system, courts are more likely to achieve the most justiciable outcomes for debtors and their creditors.

A handful of bankruptcy courts have begun to embrace this notion. For example, one debtor in Michigan was permitted to proceed with a Chapter 13 repayment plan on the condition that he discontinue his state-licensed medical marijuana operation.[149] Rather than retreating under the auspices of the CSA, or acquiescing to the contrary assertions of the United States Trustee, the court acknowledged the unique situation of the debtor:

> In the court's view, the Debtor cannot conduct an enterprise that admittedly violates federal criminal law while enjoying the federal benefits the Bankruptcy Code affords him. . . . At the same time, the Debtor filed his case in good faith, and it is quite obvious from his credible testimony that he is in dire need of bankruptcy relief and the court's assistance. The court is willing to assist, provided, however, the Debtor discontinues the medical marijuana business.[150]

A memorandum opinion by Judge Alan Jaroslovsky of the Northern District of California similarly embraced the goals of bankruptcy, noting that the inability to liquidate certain assets of the debtor in a Chapter 7 proceeding did not equate to the debtor being wholly ineligible for bankruptcy relief.[151] While these two cases do not reflect the prevailing judicial norm, they stand as strong examples of focusing the adjudication of a bankruptcy case on the overarching goals of the bankruptcy system. Dismissing a debtor's petition solely on the basis of their pre-petition involvement with marijuana does not effectively further these goals. Rather, focusing on discharging the debtors' debts while simultaneously facilitating an exit from illegal marijuana-related activities better achieves the goals of the Bankruptcy Code and the CSA.

C. Inconsistent Application of Federal Law Leads to Inequitable Results.

The consequences of unequivocally barring cannabis and cannabis-adjacent debtors from seeking bankruptcy relief not only diminishes the policy aims unique to the bankruptcy system, it threatens to further

149. *In re* Johnson, 532 B.R. 53, 58 (Bankr. W.D. Mich. 2015).

150. *Id.* at 59.

151. *In re* Wright, No. 07-10375 (Bankr. N.D. Cal. Aug. 3, 2007) (BL Court Dockets) ("The court finds the U.S. Trustee's arguments regarding the unavailability of Chapter 7 to be both flawed and premature. The mere fact that a trustee cannot liquidate the debtor's assets does not make the debtor ineligible for Chapter 7 relief.").

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substantiate a grossly inequitable situation in the states that have pressed on with marijuana legalization. According to a 2017 survey, 81 percent of marijuana business owners in the United States are white.[152] Fortune Magazine estimates that as of 2022, less than two percent of cannabis entrepreneurs in the United States are Black.[153] A primary reason for this is the substantial cost of entry to the industry. In California, for example, the average start-up costs for a brick-and-mortar dispensary add up to nearly $250,000, followed by annual six-figure costs for leasing building space.[154] For small business owners, the risk of borrowing money and taking on these costs, without the safety net of bankruptcy relief, can be insurmountable.

At the same time, Black Americans are estimated to be 3.6 times more likely to be arrested for marijuana related offenses than white Americans.[155] When bankruptcy courts bar their doors to debtors with previous or ongoing involvement in the growing cannabis industry, they effectively guarantee the industry's only participants will be those privileged enough to weather the enormous financial risk of not having access to bankruptcy. In the future, bankruptcy judges ought to take these considerations into account.

IV. CONCLUSION

The debate over federal marijuana legalization will likely occupy a front stage seat in the United States for years to come. In April 2022, the House of Representatives passed legislation to decriminalize marijuana, removing it from the CSA's Schedule I list of illegal substances.[156] Although the bill is unlikely to pass in the Senate, it demonstrates the enormous strain caused by a small green plant on the country's federalist system of government.

In the interim, bankruptcy courts must adopt a consistent approach to cannabis and cannabis-adjacent debtors that come through their doors. This approach should focus on working with individual debtors to grant the fresh start relief the Bankruptcy Code was designed to offer, as well

152. Courtney Connley, *Cannabis Is Projected to Be a $70 Billion Market by 2028 – Yet Those Hurt Most by the War on Drugs Lack Access*, CNBC (July 1, 2021), https://www.cnbc.com/2021/07/01/in-billion-dollar-cannabis-market-racial-inequity-persists-despite-legalization.html.

153. Amiah Taylor, *Black Cannabis Entrepreneurs Account for Less Than 2% of the Nation's Marijuana Businesses*, FORTUNE (Apr. 26, 2022) https://fortune.com/2022/04/26/black-cannabis-entrepreneurs-marijuana-businesses-marijuana-laws.

154. *Id.*

155. Connley, *supra* note 152.

156. Johnathan Weisman, *House Votes to Decriminalize Cannabis*, N.Y. TIMES (Apr. 1, 2022), https://www.nytimes.com/2022/04/01/us/politics/marijuana-legalization.html.

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as ensuring their creditors are treated fairly and equitably. Similarly, in the context of Chapter 11 reorganizations, debtors, creditors, and the courts should utilize the 2018 Farm Bill to craft reorganization plans that allow financially distressed cannabis-adjacent entities to pivot from the federally illegal marijuana industry to the legal hemp industry. By utilizing these solutions, the bankruptcy system can achieve its primary goals without circumventing federal law.

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