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Feature

By B. Summer Chandler

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Is Relief Available for Debtors in the Marijuana Business?

Editor's Note: *For more on this issue, listen to ABI podcast episode 168 (Oct. 6, 2015), available at abi.org/newsroom/podcasts.*

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Twenty-three states and the District of Columbia authorize the use of marijuana in some form for medical purposes.[1] The fact that almost half of all U.S. states now permit medical marijuana use is significant, particularly in light of the fact that close to half of these jurisdictions have legalized the use of marijuana in the last five years.[2] In addition, in the past three years, four states and the District of Columbia have legalized marijuana for recreational use.[3]

Despite the fact that many states have legalized the cultivation, sale and use of marijuana, these actions remain illegal under the federal Controlled Substances Act of 1970 (CSA).[4] Moreover, it is also illegal under the CSA to "rent, lease, profit from or make available for use" a location for the manufacture, storing or distribution of a controlled substance.[5] In addition, federal criminal law criminalizes actions to aid and abet the manufacture, distribution or dispensing of marijuana.[6]

Not surprisingly, the legalization of marijuana for medical and recreational uses has resulted in the development of a multi-billion-dollar industry consisting of producers, developers and distributors, and the landlords, vendors and others who do business with these new entrepreneurs.[7] Inevitably, some of these burgeoning marijuana businesses and the companies that service them will fail.

Given that the marijuana business is illegal under federal law, what happens if these failing businesses seek relief under federal bankruptcy laws? This article examines two cases that have recently addressed this question.

The Chapter 7 Case of *In re Arenas*

The Tenth Circuit Bankruptcy Appellate Panel (BAP) recently considered whether a debtor in the marijuana business may obtain relief from his debts in bankruptcy. It answered that question with a clear "no," confirming the ruling of the bankruptcy court.[8] Frank Arenas was licensed in Colorado to grow and dispense medical marijuana. He and his wife also leased a building to third parties who dispensed medical marijuana from it. After a judgment was entered against them, the Arenases filed for chapter 7 relief.

The U.S. Trustee filed a motion to dismiss the bankruptcy case for "cause" under § 707(a) of the Bankruptcy Code, arguing that it would be impossible for a chapter 7 trustee to administer the assets of the debtors without violating federal law. In response, the debtors moved to convert their case to a chapter 13 reorganization case, arguing that in chapter 13, a trustee is not required to manage or sell the debtor's assets.

The bankruptcy court found that "cause" for dismissal existed, because "[f]or the Trustee to take

1 Julie Anderson-Hill, "Banks, Marijuana and Banking," 65 *Case W. Res. L. Rev.* 597, n.2 (2015) (collecting applicable statutes).
2 *Id.*
3 Colorado and Washington state first passed ballot measures legalizing recreational marijuana use. Colo. Const. art. XVIII, § 16 (2012); Wash. Rev. Code § 69.50.401(3) (2015). Alaska, Oregon and the District of Columbia followed. Alaska Ballot Measure 2: An Act to Tax and Regulate the Production, Sale and Use of Marijuana (2014) (codified at Alaska Stat. §§ 17.38.010 to .900); Oregon Ballot Measure 91: Control, Regulation and Taxation of Marijuana and Industrial Hemp Act (2014) (allowing home possession and cultivation beginning in July 2015 and allowing marijuana business applications beginning in January 2016); Washington, D.C., Initiative 71: Legalization of Possession of Minimal Amounts of Marijuana for Personal Use Act of 2014 (codified at Wash. Rev. Code § 69.50.4013(3) (2014)). Ohio voters rejected a ballot proposal on Nov. 3, 2015, that would have legalized both recreational and medical marijuana by 65 to 35 percent.
4 21 U.S.C. § 801, *et seq.* (2014).
5 *See* § 856(a)(2).
6 18 U.S.C. § 2 ("Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal.").
7 *See, e.g.*, Mark W. Gifford, "Colorado's Pot Laws and Legal Ethics," 37-Aug *Wyo. Law.* 12 (2014) (stating that since decriminalization of recreational marijuana use, "[t]housands of new jobs have been created [and] [s]ome sources project annual marijuana sales in excess of $1 billion; others caution that several hundred million dollars is more realistic").
8 *In re Arenas*, 535 B.R. 845 (B.A.P. 10th Cir. 2015).

possession and control of the Debtors' Property and marijuana inventory would directly involve him in the commission of federal crimes."[9] The court explained that allowing the debtors to remain in a chapter 7 case when the trustee "is unable to administer valuable assets for the benefit of creditors would allow them to receive discharges without turning over their nonexempt assets to the Trustee. That would give the Debtors all of the benefits of a chapter 7 ... discharge while allowing them to avoid the attendant burdens."[10]

The court also denied the debtors' motion to convert to chapter 13. In reaching its decision, the court found that "there is cause for dismissal [under] § 1307(c) on account of the Debtors' bad faith due to their inability to propose a confirmable chapter 13 plan."[11] The court explained that among the requirements set forth in § 1325 of the Bankruptcy Code that must be satisfied in order for the court to confirm a proposed reorganization plan is the requirement that the court must find that a debtor's plan has been proposed in good faith and not by any means forbidden by law.[12] Since their reorganization plan would necessarily be funded from profits of an ongoing criminal activity under federal law, the court would be unable to make that finding and confirm any plan proposed by the debtors.[13] The debtors' inability to propose a confirmable chapter 13 plan constituted bad faith under § 1307(c), and dismissal rather than conversion was warranted.

The Arenases appealed the decision to the Tenth Circuit BAP, which affirmed the bankruptcy court's decision. First, the BAP agreed with the bankruptcy court that the debtors would be unable to propose a chapter 13 reorganization plan in "good faith and not by any means forbidden by law," and thus, no plan could be confirmed.[14] In reaching this conclusion, the BAP rejected the debtors' contention that "when the bankruptcy court held that they could not propose a Chapter 13 plan in good faith, it erred by adopting a *per se* rule that debtors who are engaged in the marijuana business are not eligible for bankruptcy relief."[15] The BAP noted that this contention "oversimplifies the court's reasoning."[16] Next, the BAP explained that the bankruptcy court had engaged in an analysis of the requisite factors and determined that the debtors would be unable to propose a feasible plan.[17]

In affirming the bankruptcy court's determination that any proposed plan would be infeasible, the BAP noted that the debtors' "non-marijuana income" was less than half of the debtors' monthly expenses, and as such, any chapter 13 plan would necessarily have to be funded through the debtors' marijuana business — a criminal activity under federal law.[18] In addition, the chapter 13 trustee would be required to administer and distribute funds that had been obtained through activities that are illegal under federal law. Thus, "[t]here is no way [that] the Trustee could administer the plan without committing one or more federal crimes."[19] For these reasons, the BAP affirmed the bankruptcy court's denial of the debtors' motion to convert to chapter 13.

The BAP affirmed the bankruptcy court's dismissal of the debtor's case "for cause" based on the trustee's inability to lawfully administer marijuana assets included in property of the estate.[20] The BAP agreed with the bankruptcy court that administering the marijuana assets would require the trustee to violate federal law.[21] Conversely, if the trustee abandoned the marijuana assets, the debtors would receive the benefits of chapter 7 discharge without the burden of having to turn over non-exempt assets.[22]

In its conclusion, the BAP noted that "the debtors are unfortunately caught between pursuing a business that the people of Colorado have declared to be legal and beneficial, but which the laws of the United States — laws that every ... Judge swears to uphold — proscribe and subject to criminal sanction."[23]

The Chapter 13 Case of *In re Johnson*: Possibility for Relief?

The *Arenas* decision, and other courts that have considered the question of whether a debtor engaged in a marijuana business that is legal under state law will be denied relief under federal bankruptcy laws, make the outcome for financially distressed marijuana businesses — and those who transact business with such companies — look bleak. At a minimum, case law in the chapter 7 context suggests that there may be no circumstances under which a debtor engaged in the marijuana business might be permitted to obtain chapter 7 relief.[24] But are there some circumstances under which a debtor might otherwise be given relief under the Bankruptcy Code? At least one chapter 13 case suggests that the answer to that question may be "yes."

The court in *In re Johnson*[25] considered the U.S. Trustee's motion to dismiss the chapter 13 case of Jerry Johnson, who operated a medical marijuana business under the Michigan Medical Marijuana Act (MMMA). The U.S. Trustee argued that the bankruptcy court should not enforce the protections of the Bankruptcy Code to aid violations of the CSA. Johnson argued that he kept the proceeds from his marijuana business segregated from his other income and that he had used his non-marijuana-related income to cover the plan payments that had been made.

In considering the motion to dismiss, the court noted that "federal judicial officers take an oath to uphold federal law, and countenancing the Debtor's continued operation of his marijuana business under the court's protection is hardly consistent with that oath."[26] Moreover, the court found that even if the debtor segregated marijuana proceeds from other funds that the debtor received, and used only those legal funds to make plan payments, "the

9 *In re Arenas*, 514 B.R. 887 (Bankr. D. Colo. 2014).
10 *Id.*
11 *Id.* at 892.
12 *Id.* (citing 11 U.S.C. § 1325(a)(3)).
13 *Id.* at 893.
14 *In re Arenas*, 535 B.R. at 851-52.
15 *Id.* at 852.
16 *Id.*
17 *Id.*
18 *Id.*
19 *Id.*
20 *Id.* at 853.
21 *Id.*
22 *Id.*
23 *Id.* at 854.
24 *Id.* at 853 (affirming bankruptcy court's dismissal of chapter 7 case because, among other reasons, trustee would be unable to administer estate assets without violating federal criminal law); *In re Medpoint Mgmt. LLC*, 528 B.R. 178, 184-86 (Bankr. D. Ariz. 2015) (finding trustee's inevitable violation of CSA, among other reasons, constitutes cause to dismiss involuntary petition under § 707(a)).
25 *In re Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015).
26 *Id.* at 56.

court and the Standing Trustee carrying out their respective statutory duties will inevitably support the Debtor's criminal enterprise."[27]

The court explained that it is the automatic stay that would permit the debtor to retain possession and use of assets that would permit the debtor to continue his illegal operations — such as his residence where he grew the marijuana, as well as the horticultural equipment and fertilizers that he used to grow it. "To the extent that the Debtor is 'engaged in business' within the meaning of § 1304(a), which seems likely, his continued operation of the business depends upon the court's acquiescence."[28] The court further found that "as a statutory matter, the same reasons that preclude the Standing Trustee from holding contraband or using proceeds or instrumentalities of federal criminal activity apply to a debtor in possession."[29] As such, it would not be possible for the debtor to continue to operate his marijuana business and remain in chapter 13.

Despite the fact that the debtor's activities constituted crimes under federal law, the court found that "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."[30] In light of the good faith of the debtor and his genuine need for bankruptcy protection, and in light of Michigan's policies regarding medical marijuana, the court concluded that

> [t]o balance the court's (and the Debtor's) obligations under federal law, including federal criminal law, the Debtor's legitimate need for relief under chapter 13, and Michigan's policy choices reflected in the MMMA, the court will refrain from dismissing the Debtor's case at this time, but will enjoin him from conducting his medical marijuana business (and violating the CSA) while his case is pending.[31]

Thus, in *Johnson*, the case was not automatically dismissed based on "bad faith" or "unclean hands" solely because at the time the debtor filed for bankruptcy protection, he operated a business that was illegal under federal law. Rather, provided that the debtor agreed to discontinue his marijuana business while his case was pending, he would be permitted to stay in bankruptcy and receive his discharge at the appropriate time. Moreover, the court in *Johnson* expressly rejected the contention that the debtor's post-petition violation of federal law by the operation of his medical marijuana business rendered the debtor *per se* ineligible for relief under the Bankruptcy Code.[32] Rather, the *Johnson* court explained that "[t]he Debtor's business is patently incompatible with a bankruptcy proceeding, but his financial circumstances are not."[33]

Finally, the debtor in *Johnson* received approximately half of his income from Social Security benefits and was able to choose to use that income to cover his plan payments. Not every debtor will have the benefit of having a source of income that is separate from the income derived from a marijuana business and that is sufficient to cover the necessary payments in a chapter 13 case. Still, *Johnson* does illustrate that under some circumstances, a debtor in the marijuana business might be able to turn to the bankruptcy courts for relief.

Conclusion

Arenas demonstrates that debtors in the marijuana business face significant risk, even though their conduct may be legal under state law. However, the *Johnson* decision suggests that a debtor who has engaged in a marijuana business may, under some circumstances, be permitted to obtain relief. abi

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27 *Id.* at 57.
28 *Id.* (citing 11 U.S.C. § 1304(b)).
29 *Id.* at 58.
30 *Id.* at 59.
31 *Id.*
32 *Id.* at 57; *but see In re Rent-Rite Super Kegs West Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012) (finding that whether characterized as "unclean hands" doctrine or simply as part of the totality-of-the-circumstances analysis, chapter 11 debtor's continued criminal activity, in deriving roughly 25 percent of its revenues from leasing space to tenants who were engaged in business of growing marijuana, satisfied requirement of "cause" and required dismissal or conversion of its chapter 11 case and questioning whether conversion to chapter 7 would even be permissible).
33 *In re Johnson*, 532 B.R. at 57; *see also In re McGinnis*, 453 B.R. 770, 773 (Bankr. D. Or. 2011) (denying confirmation of chapter 13 plan where plan payments would be funded by debtor's marijuana business and thus could not satisfy requirements of Bankruptcy Code, but providing that if "[d]ebtor can propose an amended Plan of Reorganization [that] meets the requirements of the Bankruptcy Code, [the judge] would be prepared to allow its confirmation").