WHAT HAPPENS WHEN A "LEGAL" MARIJUANA BUSINESS GOES UP IN SMOKE?

BY TIM DURKEN

So what happens when the boom of legal marijuana goes bust for a grower, dispensary or its stakeholders? The answer is not a straightforward one because federal bankruptcy is off the table.

I. LEGAL MARIJUANA IS GREEN ($$) AND GROWING IN THE STATES

Legal marijuana sales hit $5.4 billion in the United States last year. Sales are expected to rise to $6.7 billion this year and $21.8 billion by 2020 according to a recent report.

Twenty-three states have legalized the use of medical marijuana, including Massachusetts, whose voters approved medical marijuana by a 63 percent to 37 percent margin in November 2012. As of early 2016, six medical marijuana dispensaries are licensed and operating in Massachusetts (Ayer, Brockton, Brookline, Lowell, Northampton and Salem) and another dozen have received provisional approval.

Four states (Alaska, Colorado, Oregon and Washington) and the District of Columbia have legalized recreational use of marijuana. A Massachusetts bill is pending, but Governor Charlie Baker has voiced opposition to full legalization. If the Legislature and governor do not enact the bill, marijuana advocates are planning a ballot initiative for November 2016. Several polls show a majority of Massachusetts voters favor full legalization, making legal marijuana a serious possibility this year.

The rapidly expanding legalization of marijuana across the country is creating a "gold rush" for entrepreneurs and investors seeking a piece of the profits. There are big opportunities — and risks — for these new businesses and their stakeholders.

II. FEDERAL MARIJUANA PROHIBITION IS AN ONGOING BUZZKILL

While states have been moving to legalize it, the federal government continues to criminalize marijuana as a "Schedule I" drug with "no currently accepted medical use" under the Controlled Substances Act.[1] Under federal law, it is not only illegal to sell marijuana, it is also criminal to knowingly fund the operations of or take the proceeds from a marijuana business, as well as manage or control any real property used for it. Federal law also prohibits banks from doing business with marijuana sellers, forcing marijuana businesses to operate as "cash only" businesses.

During President Obama's administration, the federal government has taken an evolving approach to enforcement of federal marijuana laws. The Department of Justice has advised federal law enforcement officers and prosecutors not to enforce federal marijuana laws against marijuana businesses that are legal under state law. The DOJ even asked the Supreme Court

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in December 2015 not to hear a neighboring state's challenge to Colorado's recreational marijuana laws.

The omnibus Consolidated Appropriations Act of 2016, signed by President Obama this past December, bars the DOJ and DEA from expending federal funds to prosecute the use, possession and sale of medical marijuana in those states that previously legalized it, although it did not address the use of forfeiture proceeds (which are substantial and available) for enforcement. The omnibus act and enforcement spending prohibition expires when the current federal fiscal year concludes on Sept. 30, 2016.

Marijuana however remains an illegal Schedule I drug under the CSA and its sale constitutes a federal crime. The next president could take a different approach and decide to aggressively enforce the CSA against medical and recreational marijuana businesses that are

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A DIFFERENCE OF OPINIONS

BY JUSTIN P. ROSTOFF

May a property owner who is "underwater" on her mortgage force her mortgagee bank to accept the deed to the property in satisfaction of the debt in bankruptcy? Two bankruptcy judges sitting in Massachusetts have issued decisions within the last 12 months reaching opposite conclusions on this question. This conflict has created a lack of predictability when it comes to the handling of Schedule A (real property) assets in Massachusetts bankruptcies.

Section 1322(b) of the Bankruptcy Code sets forth a list of provisions that may be included in a Chapter 13 plan, including "the vesting of property of the estate, on confirmation of the plan or at a later time, in the debtor or in any other entity." Section 1325(a)(5)(C) instructs the Bankruptcy Court to confirm a plan if it provides with respect to an allowed secured claim that the debtor surrenders the property securing such claim to the holder of the claim. But neither "vest" nor "surrender" are defined within the Code, so interpretation and application of these bankruptcy provisions are left to the sitting judge.

This comment will provide an overview of Judge Hoffman's opinion and reasoning in *In re Sagendorph*,[1] allowing a debtor to unilaterally vest surrendered property in a mortgagee, and Judge Boroff's opinion and reasoning in *In re Weller*,[2] where such unilateral vestment was denied.

IN RE SAGENDORPH: PERMITTING UNILATERAL VESTMENT

The debtor owned an income-producing property in Ware, Massachusetts, subject to a mortgage issued to Wells Fargo Bank, but after default Wells Fargo never foreclosed on the property. Upon filing for Chapter 13 bankruptcy, the debtor produced a plan that read

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in relevant part, "[p]ursuant to §§ 1322(b)(8) and (9), title to the property …. shall *vest* in Wells Fargo … upon confirmation … and the Confirmation Order shall constitute a deed of conveyance of the property … . All secured claims will be paid by *surrender* of the collateral and foreclosure of the security interest." Wells Fargo objected to the plan's confirmation because of the forced vesting in satisfaction of its debt.

According to Wells Fargo, the vestment provision of Section 1322 is a permis-

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legal under state law. Marijuana investors, lenders, landlords and other interested parties are rightfully wary of the risks they may face under federal law.

III. "LEGAL" MARIJUANA IS TOO SEEDY FOR FEDERAL BANKRUPTCY COURTS

Unfortunately, for individuals and businesses who knowingly deal with a medical or recreational marijuana business that is legal under state law but remains illegal under federal law, the federal courts have largely held that bankruptcy is not available to them.

In the 2012 case of *In re Rent-Rite Super Kegs West Ltd.*, the debtor derived 25 percent of its revenue from leasing its warehouse to marijuana growers.[2] The bankruptcy court found that the debtor's business — arguably legal under Colorado law — was a continuing violation of the CSA, which makes it a federal crime to knowingly and intentionally lease the space for the purpose of unlawfully manufacturing, storing, distributing or using marijuana. The court recognized that although "federal prosecutors may well choose to exercise their prosecutorial discretion and decline to seek indictments under the CSA where the activity that is illegal on the federal level is legal under Colorado state law," "[u]nless and until Congress changes that law, … a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing criminal federal crime."

The court further found that the real property remained subject to criminal forfeiture, that the federal government's police powers were not enjoined by the automatic stay, and that no plan could be confirmed because no plan "that relies in any part on income derived from criminal activity" could be "proposed in good faith and not by any means forbidden by law" as required by Section 1129(a)(3). Accordingly, the *In re Rent-Rite Super Kegs West Ltd.,* court concluded that "cause" existed for the debtor's "gross mismanagement of the estate" and lack of "clean hands" (i.e., the continuing violation of the CSA) requiring dismissal or conversion of the case under Bankruptcy Code Section 1112(b)(4). The court also questioned whether a Chapter 7 trustee upon conversion could administer an estate whose "major asset" "is the location of ongoing criminal activity."

In the 2014 case of *In re Arenas*, the same bankruptcy judge dismissed a Chapter 7 bankruptcy filing by a married couple who owned a two-unit commercial building. One unit was used by the husband to grow marijuana to sell wholesale and the other unit was leased to a third-party marijuana dispensary — both activities legal under Colorado law.[3] The court found "cause" to dismiss the case under Bankruptcy Code Section 707(a) because the Chapter 7 trustee could not take control of and administer the building and 25 marijuana plants without himself committing a federal crime in violation of the CSA. The court reasoned that the Chapter 7 trustee would be unable to liquidate the valuable (albeit illegal) non-exempt assets for the benefit of creditors. The court also denied a motion to convert the Chapter 7 case to Chapter 13 because any plan proposed by the debtors would be funded by proceeds or rents derived from the sale of marijuana, "a means forbidden by law," and involve the Chapter 13 trustee administering and distributing the illegal funds. A 10th Circuit Bankruptcy Appellate Panel affirmed.

In the 2015 case of *In re Johnson*, the Bankruptcy Court ordered that a Chapter 13 individual debtor must choose between continuing his state authorized business of cultivating and selling medical marijuana and availing himself of the benefits of the Bankruptcy Code, which he desperately needed to avoid foreclosure on his residence. The Bankruptcy Court rejected the debtor's effort to segregate the illegal proceeds and fund a Chapter 13 plan solely with his social security income. The court ordered as a condition of the debtor's eligibility to proceed in bankruptcy that the debtor immediately cease growing and selling marijuana and destroy the remaining marijuana plants, product and inventory.[4]

In *In re Medpoint Management LLC*, following the *Rent-Rite Super Kegs* and *Arenas* decisions, the bankruptcy court dismissed an involuntary Chapter 7 petition by petitioning creditors against a marijuana dispensary management company.[5] The court concluded that the petitioning creditors had "unclean hands" because they had entered into contracts with the debtor knowing it was in the business of managing and operating a medical marijuana business that was illegal under federal law. The court observed that the petitioning creditors were not without remedies and may well pursue the debtor in state court for breach of contract and fraudulent transfer claims.

In *Northbay Wellness Group Inc. v. Beyries*, an attorney-debtor filed for bankruptcy and a medical marijuana dispensary challenged the dischargeability of a judgment against the attorney for the theft of $25,000 from a legal defense trust fund. The dispensary argued under Section 523(a)(4) that the judgment was a non-dischargeable debt for fraud or defalcation while acting as a fiduciary.[6] The bankruptcy court held that the dispensary's illegal marijuana sales prevented it from obtaining relief under the "unclean hands" doctrine and the district court affirmed. But in 2015, a panel of the Ninth Circuit Court of Appeals reversed because the doctrine of "unclean hands" requires a balancing of the wrongful activity by the parties and the attorney who partnered in the business "was as responsible as [the dispensary] for its illegal marijuana sales" so "[t]hat illegal activity must be attributed to both parties" and "does not tip the balance in either direction."

IV. A BLUNT TRUTH: A MARIJUANA BUSINESS RESTRUCTURING IS SUBSTANTIALLY MORE DIFFICULT WITHOUT THE BANKRUPTCY OPTION

Reorganization of a distressed marijuana business is more difficult without the usual benefits of federal bankruptcy protection. In bankruptcy, owners and management can continue

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to control and run the business, benefit from the automatic stay of actions against the debtor, cure defaulted or accelerated obligations, assume and assign or reject executory contracts and unexpired leases for real property and equipment, sell property free and clear of liens, and confirm a reorganization plan to restructure debt and other obligations with the affirmative vote of a majority of creditors and cram down a restructuring plan over a class of dissenting creditors.

In contrast, state remedies of assignment for the benefit of creditors (colloquially called ABCs) and receivership require owners and management to give up control of the business to an assignee or receiver and are designed for liquidation of its assets. Without the option and threat of bankruptcy, it is more difficult for a troubled marijuana business to negotiate and get unanimous support of its major creditors — and a single holdout could disrupt or doom any potential reorganization. Given the probable lack of bankruptcy protection, marijuana businesses need to hire experienced restructuring professionals early in the process in the hope of constructing a reorganization plan that maintains the going concern value of the business and benefits all parties, if possible.

V. PREPLAN EXIT AND WIND-DOWN OPTIONS BEFORE THE MARIJUANA BUSINESS IS CHRONICALLY IMPAIRED

Both marijuana businesses and their stakeholders should consult with experienced restructuring attorneys before embarking into a new venture to preplan exit and wind down options.

Management and owners will benefit from planning and contracting for exit options, for return of equity in specific liquidity events, and to wind down a failed enterprise to avoid personal liability. The prohibition of banks accepting cash from marijuana businesses requires owners to be particularly acute to the issue of cash holdings and transfers to their personal bank accounts. Care is required to avoid fraudulent transfer clawback liability and a loss of limited liability protection of corporations and LLCs for commingling assets under alter-ego or veil-piercing causes of action.

Upon distress, management and owners should carefully consider an orderly liquidation by an assignment for the benefit of creditors under state law if the entity can obtain the assent of a majority of its unsecured creditors to be bound by the ABC wind-down and distributions.[7] The bankruptcy priority scheme and preference avoidance actions will not apply so owners may prioritize payments for taxes, employees, and debts backed by guarantees to limit their personal exposure, and legitimate debts held by insiders subject to fraudulent transfer clawback.

Creditors of a marijuana business likely will not be able to prosecute an involuntary bankruptcy petition against the debtor and knowing participants may not have access to other federal courts under the "unclean hands" doctrine. Accordingly, these stakeholders must also look to state law remedies.

Lenders should seek to obtain mortgages on real property, security interests in personal property, and personal guarantees that can be enforced under state law. Because the business may not be able to open bank accounts subject to a security interest, the lender may want to require the borrower to pay over and maintain cash balances directly with the lender. Upon default, lenders may exercise state court remedies for judgment, foreclosure, collection, breach of contract, fraudulent transfers and, if appropriate, the appointment of a receiver to preserve assets, operate the business, and liquidate its assets and pay claims.

Lenders are not the only creditors of a marijuana business who may have to look to state law. Landlords, lessors and counterparties may seek to terminate their contracts, take possession of their property and assert breach of contract claims for damages. Suppliers may seek to reclaim delivered goods. Employees may file actions for unpaid wages and benefits against the debtor and responsible management. Taxing authorities may seek to enforce liens and recover unpaid taxes.

All of these individual creditors may find themselves in the kind of "race to the courthouse" to recover from a debtor's limited assets — a race that federal bankruptcy is designed to prevent.

VI. CONCLUSION

The legal landscape for a distressed marijuana business and its stakeholders operating legally under state law does not include the bankruptcy option available to other businesses. Interested parties should consult with experienced restructuring attorneys to better understand these risks and find out how to protect their interests prior to and during times of financial distress. ■

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1 *See* 21 U.S.C. §§ 801-904.

2 484 B.R. 799 (Bankr. D. Colo. 2012). 514

3 B.R. 887 (Bank. D. Colo. 2014), aff'd, 535 B.R. 845 (10th Cir. B.A.P. 2015).

4 532 B.R. 53 (Bankr. W.D. Mich. 2015).

5 528 B.R. 178 (Bankr. D. Ariz. 2015).

6 789 F.3d 956 (9th Cir. 2015).

7 Mass. G.L. ch. 203, §§ 40-42.