Updates
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Another Blow to Bankruptcy Relief for Marijuana-Adjacent Debtors

Though it appeared the smoke might blow in a more favorable direction, the hopes of marijuana-adjacent businesses using the Bankruptcy Code were snuffed out once again by the Bankruptcy Court in Colorado. The Controlled Substances Act (the CSA) makes it illegal to rent, lease, or make available for use or profit from a location for the manufacture, storing, or distribution of controlled substances. Federal law generally imposes criminal liability for aiding and abetting the unauthorized manufacture, distribution, or dispensing of marijuana, which is a Schedule 1 controlled substance. A number of courts have ruled that businesses whose operations constitute federal crimes cannot take advantage of the federal bankruptcy system.[1] Bankruptcy courts have even dismissed cases where the debtor does not operate a cannabis business, but operates ancillary businesses such as the manufacture or sale of equipment that may be used to cultivate marijuana (discussed below), or leasing real estate to marijuana growers.

Despite the CSA and other decisions denying bankruptcy relief, potential marijuana-adjacent debtors continue to try to take advantage of a narrow gap in the case law identified by a 2018 Colorado bankruptcy case.[2] The debtors in that case were engaged in the sale of hydroponic agriculture equipment. The Bankruptcy Court dismissed the petition, stating that although hydroponic equipment can be used to grow any number of crops, the overwhelming majority of the debtors' sales were to cannabis cultivators.[3] Congress passed the Agriculture Improvement Act of 2018—also known as the 2018 Farm Bill—legalizing hemp just days after the Bankruptcy Court dismissed the debtors' petition. The debtors appealed to the U.S. District Court for the District of Colorado arguing that their products could have been used by their customers for the now-legal cultivation of hemp, as opposed to cannabis. Though the district court affirmed the Bankruptcy Court's dismissal of the petition, the opinion stated that "[t]his 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" that "'the legalization of hemp means that they could reorganize based on the hemp market.'"[4] This brief reference to the tension between federally illegal cannabis and federally legal hemp as it relates to bankruptcy eligibility left the door ajar for debtors like United Cannabis.

United Cannabis Corporation (UCANN) filed for Chapter 11 relief on April 20, 2020, (clever!) and, shortly thereafter, Bankruptcy Judge Rosania issued an Order to Show Cause why the bankruptcy should not be dismissed. UCANN reported to the court that all of its current and future revenue and operations were from the sale of CBD, which is derived from hemp, though acknowledged it previously derived revenue from licensing a patent involving tetrahydrocannabinol (THC). The Office of the United States Trustee (the UST) responded that UCANN had previously manufactured and sold products containing THC and had licensed its patent covering formulations involving THC, implying that UCANN's current claims of dealing solely in legal products was irrelevant. Having not received a ruling on the court's Order to Show Cause, the UST filed a Motion to Dismiss the UCANN bankruptcy based on, in part, findings by a court-appointed examiner that UCANN "unequivocally violated the CSA prior to the bankruptcy filings by advertising and selling products containing THC and by aiding and abetting illegal CSA activities through their consulting business." The UST further stated that it was "more likely than not" that UCANN still had proceeds related to illegal activities because its activities are so intertwined with the marijuana industry.[5] Though UCANN continued to deny that it was in violation of the CSA, it did not object to the dismissal of its bankruptcy case, stating that it had not been able to generate the necessary revenue to maintain business operations. Judge Rosania issued a one-page order dismissing the case for "good cause," but failed to elaborate on his reasoning.

Takeaway

The dismissal of the UCANN bankruptcy is unlikely to be the end of the discussion of marijuana-adjacent businesses in bankruptcy. Open questions remain as to (1) whether a business that formerly operated in the cannabis (THC) space, but is now completely funded by CBD/hemp-related operations, can use the tools afforded by the Bankruptcy Code and (2) whether a company with some income derived from cannabis will be allowed to file for Chapter 11 protection if it can fund its reorganization without cannabis-derived income. As of now, the hurdles are high and case law is unfavorable for such companies seeking relief under the Bankruptcy Code. However, other state law alternatives remain available including receiverships, assignments for the benefit of creditors, and foreclosure under the applicable state law version of Article 9 of the UCC.

Endnotes

1. *Arenas v. United States Tr. (In re Arenas*), 535 B.R. 845, 847 (B.A.P. 10th Cir. 2015).
2. *In re Way to Grow, Inc.*, Case No. 18-14330-MER (Bankr. D. Colo.).
3. *In re Way to Grow, Inc.*, 597 B.R. 111 (Bankr. D. Colo. 2018).
4. *Way to Grow, Inc. v. Inniss (In re Way to Grow, Inc.*), 610 B.R. 338, 355-56 (D. Colo. 2019).
5. Perhaps importantly, the UST noted that UCANN failed to comply with reporting obligations under the Bankruptcy Code and was unable to make progress towards a plan of reorganization during the pendency of its Chapter 11 case.

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