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Distressed Cannabis: Growing Room for Bankruptcy in Ninth Circuit

Tough economic conditions are leaving cannabis businesses with fewer financing and transaction options. Chapter 11 bankruptcy, a tool which many businesses have used to reorganize or liquidate, has historically been inaccessible to cannabis and cannabis-adjacent businesses because potential (or actual) breaches of the Controlled Substances Act (CSA) were viewed as *per se* cause for dismissal. But the Los Angeles bankruptcy court presiding over [The Hacienda Company, LLC](#) recently denied a motion to dismiss the case of a debtor in the business of wholesale manufacturing and packaging of cannabis products.^[1] The decision gives hope that bankruptcy could be a viable path to maximize value for creditors and purchasers through a sale structured as one of intellectual property (IP), rather than one of an operating cannabis business.

The decision in *Hacienda* builds on the other recent U.S. Court of Appeals for the Ninth Circuit decisions allowing narrow windows for cannabis-adjacent debtors to benefit from bankruptcy.

In [Garvin v. Cook Investments NW, SPNWY, LLC](#), the Ninth Circuit affirmed confirmation of a Chapter 11 plan of a real estate holding company that leased property used to grow marijuana.^[2] The debtor's plan provided for rejection of the marijuana grower's lease and payment of all creditors' claims solely out of revenues unrelated to cannabis activities. The Ninth Circuit held that the debtor had proposed the plan by lawful means and rejected the reasoning that a bankruptcy case should be automatically dismissed where income had been derived from illegal activity.

Similarly, in [In re Olson](#), the Ninth Circuit Bankruptcy Appellate Panel (BAP) reversed the dismissal of the bankruptcy case of a landlord who had a cannabis dispensary as a commercial tenant.^[3] There, the debtor sought to reject that offending lease in connection with a sale of the real property. In reversing the dismissal, the BAP observed that the debtor was using bankruptcy to sever ties with the dispensary and that there were no findings showing that a trustee would have to engage in illegal activity by continued operation of the business.

Hacienda goes one step further by allowing a debtor that was once a direct participant in the cannabis market to remain in bankruptcy.

Hacienda formerly operated Lowell Herb Co., a cannabis wholesaler and packager. Prior to filing for bankruptcy, the debtor sold their assets and operations to a publicly traded Canadian company in exchange for a 9.4% share of the equity in the acquiring entity. The acquiror's operation of the debtor's business was legal under Canadian law. The debtor then filed for Chapter 11 to sell the shares and distribute proceeds to creditors.

The U.S. Trustee Program (U.S. Trustee) filed a predictable objection, arguing that the case should be dismissed for "cause" under section 1112(b) of the Bankruptcy Code. But the bankruptcy court rejected any notion that a debtor's pre-bankruptcy connection to cannabis requires dismissal. Rather, the bankruptcy court has discretion to decide whether cause for dismissal exists. The bankruptcy court explained:

- **A trustee liquidating a cannabis business does not necessarily violate the CSA.** Bankruptcy courts are understandably concerned with incidents wherein trustees are obligated to violate the CSA by selling cannabis or cannabis-related assets, or otherwise profiting from and/or investing in cannabis. But the bankruptcy court made clear that issue was not at play in this case; Hacienda no longer had any cannabis business or assets. Its sole operations were passive ownership of the 9.4% equity interest in a Canadian company that would be operating in compliance with Canadian law.
- **Operation of a cannabis business should not be an automatic disqualifier for bankruptcy.** The bankruptcy court observed that "some of the largest bankruptcy cases, like those of Pacific Gas & Electric

Co. of "Erin Brockovich" fame, Enron Corporation, and Bernie Madoff, involve alleged or actual criminal activity." Each of those cases benefitted from the Bankruptcy Code despite violations of nonbankruptcy law.^[4]

- **Even where "cause" is established, bankruptcy courts retain discretion.** Section 1112(b)(2) of the Bankruptcy Code permits debtors to remain in bankruptcy where the court specifically finds "unusual circumstances." Hacienda was able to establish "unusual circumstances" because it had deliberately divested itself of involvement in the cannabis business and because "any dismissal would undermine a very realistic possibility of a substantial payment to creditors."^[5]

While the *Hacienda* case sets forth a framework that may be workable for an orderly liquidation in the Ninth Circuit, the U.S. Trustee overseeing bankruptcies continues to oppose all cannabis-related filings. The U.S. Trustee has already filed a notice of appeal in *Hacienda* and will likely continue its opposition absent a change in policy guidance.

Courts within the Ninth Circuit have carved out unique ground among the federal courts for cannabis cases. Courts in other circuits, by contrast, are keeping a tight leash on cannabis filings. For example, in August 2022, in *In re Great Lakes Cultivation, LLC*, the U.S. District Court for the Eastern District of Michigan faced a similar case where the debtor was attempting to wind down their business, but ultimately ordered dismissal of the case. Great Lakes had ceased operations and sought to liquidate.^[6] A critical difference, however, was that Great Lakes still owned 300 marijuana plants at the time of their bankruptcy filing. While the debtor argued that a Chapter 7 trustee could simply abandon the marijuana plants and liquidate the remaining equipment, the district court found their argument unavailing and affirmed dismissal.

Likewise, a bankruptcy court in Massachusetts just tossed the Chapter 13 bankruptcy case of an individual who is an employee of a marijuana dispensary.^[7] The bankruptcy court found that a debtor deriving income from marijuana sales "objectively lacks good faith" and could not take advantage of bankruptcy protection.

The *Hacienda* decision suggests that, in the Ninth Circuit at least, one key to remaining in federal bankruptcy court is divestiture from ongoing cannabis activity and eliminating risk of future violations of the CSA.

Takeaway

If you are a cannabis business headed for wind-down, the *Hacienda* opinion suggests you might be able to liquidate through federal bankruptcy courts in certain circumstances. Success will depend on a number of factors, including whether your business is located, or organized, within the Ninth Circuit and the extent to which pre-bankruptcy planning can make the court comfortable that the proposed restructuring or liquidation in bankruptcy will not contribute to continued violations of the CSA, while protecting the interests of creditors and other interest holders. Otherwise, cannabis businesses are not able to access federal bankruptcy protections and must rely on other avenues for insolvency and liquidation, such as state-law assignee for benefit of creditors (ABCs), receiverships, out-of-court workouts, or other means.

Cannabis companies looking to liquidate through federal bankruptcy should seek experienced counsel.

^[1] *In re The Hacienda Company, LLC*, Case No. 22-15163 (NB) (Bankr. C.D. Cal. Jan. 20, 2023) [Docket No. 102] (the Hacienda Opinion).

^[2] *Garvin v. Cook Investments NW, SPNWY, LLC*, 922 F.3d 1031 (9th Cir. 2019).

^[3] *In re Olson*, Case No. 17-1168, 2018 WL989263 (9th Cir. B.A.P. Feb. 5, 2018).

[4] *Hacienda Opinion*, 8-9.

[5] *Hacienda Opinion*, 10.

[6] *In re Great Lakes Cultivation, LLC*, Case No. 21-12775, 2022 WL 3569586 (E.D. Mich. Aug. 18, 2022).

[7] *In re Blumsack*, Case No. 21-40248, 2023 WL 214293 (EDK) (Bankr. D. Mass. Jan. 17, 2023).

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