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Introduction

Although title 11 of the United States Code (the "Bankruptcy Code") does not explicitly prohibit cannabis businesses from filing for bankruptcy, there are many hurdles that continue to preclude cannabis industry participants from obtaining bankruptcy relief.[1] Chapter 11 of the Bankruptcy Code provides a debtor with an opportunity to reorganize its financial affairs in order to continue to operate while providing the fair and equitable distribution among creditors.[2] When the continuation of the debtor's business is not viable, chapter 7 of the Bankruptcy Code provides a court-supervised procedure for liquidating the debtor's assets to pay creditors.[3] Under both forms of relief, bankruptcy courts have routinely held cannabis-related debtors may not obtain relief under the Bankruptcy Code pursuant to provisions governing bankruptcy procedures, despite debtors' compliance with state law.[4]

Principally, cannabis is classified as a Schedule I controlled substance by the Federal Controlled Substances Act (the "CSA").[5] "The CSA criminalizes virtually every aspect of

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[1] *See* Vivian Cheng, Comment, *Medical Marijuana Dispensaries in Chapter 11 Bankruptcy*, 30 Emory Bankr. Dev. J. 105, 106 (2013).
[2] 11 U.S.C. §§ 1101–74 (2016); *see also* 7 COLLIER ON BANKRUPTCY, ¶ 1100.01, at 1100.01 (16th 2019).
[3] 11 U.S.C. §§ 701–66.
[4] *See In re Rent-Rite Super Kegs West Ltd.*, 484 B.R. 799, 809 (Bankr. D. Colo. 2012) (dismissing a chapter 11 case for cause pursuant to section 1112(b)); *In re Medpoint Mgmt., LLC*, 528 B.R. 178, 186 (Bankr. D. Ariz. 2015) (dismissing a Chapter 7 case for cause pursuant to section 707(a)).
[5] *See* 21 U.S.C. § 821 (2019).

selling, manufacturing, distributing and profiting from the use of controlled substances."[6] The CSA even criminalizes cannabis-adjacent activity including the sale of equipment used in the manufacturing of cannabis and leasing premises to be used in the manufacturing or distribution of cannabis.[7]

Consequently, a violation of the CSA has served as the basis for denying cannabis-related debtors bankruptcy relief. In Chapter 11 cases, a debtor's first challenge is that such a violation may serve as "cause" for dismissal or conversion under section 1112(b) of the Bankruptcy Code.[8] If the debtor's case is not dismissed for cause at this stage, a court may later choose not to confirm the debtor's Chapter 11 plan of reorganization because the plan fails to meet the requirements of section 1129(a)(3).[9] Moreover, in the Chapter 7 context, a court may dismiss a debtor's case because a trustee could not legally administer the liquidation of the debtor's assets.[10] Accordingly, bankruptcy courts are largely unavailable to such debtors today. However, under the right circumstances in the Ninth Circuit, cannabis-adjacent debtors may be able to proceed with bankruptcy relief.[11]

I. A Debtor's Petition for Chapter 11 Reorganization may be Dismissed "for Cause" Pursuant to Section 1112(b) Because Their Cannabis-Related Activity Violates the CSA

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[6] *Arenas v. U.S. Trustee (In re Arenas)*, 535 B.R. 845, 852 n.40 (B.A.P. 10th Cir. 2015) (citing 21 U.S.C. §§ 841(a)(1), 856(a)).
[7] *See e.g.,* 21 U.S.C. § 842(a)(11) (criminalizing the distribution of a "laboratory supply" used in the manufacturing of cannabis, which includes "chemicals, products, materials, or equipment"); 21 U.S.C. § 856(a) (criminalizing the act of leasing any place for the purpose of manufacturing or distributing cannabis).
[8] *E.g.*, *In re Rent-Rite*, 484 B.R. at 809.
[9] *See* Order After Hearing Dismissing Chapter 11 Case at 2–3, *In re Mother Earth's Alt. Healing Coop., Inc.*, No. 12-10223-11 (Bankr. S.D. Cal. Oct. 23, 2012) [hereinafter "*Mother Earth's*"].
[10] *In re Arenas*, 514 B.R. 887 (Bankr. D. Colo. 2014), *aff'd sub nom.*, *Arenas*, 535 B.R. at 853–54 (dismissing a Chapter 7 case reasoning it would be impossible for the trustee to administer the estate because utilizing the proceeds of marijuana assets would be a federal offense).
[11] *Garvin v. Cook Invs. NW, SPNWY, LLC*, 922 F.3d 1031, 1036 (9th Cir. 2019).

Under section 1112(b) of the Bankruptcy Code, the court may dismiss or convert a debtor's Chapter 11 case if "cause" exists.[12] The essential role of the cause standard is to promote the basic purposes of Chapter 11.[13] Basic purposes include salvaging viable business enterprises and maximizing creditors' return; providing a forum for the most accommodating negotiated resolution of a debtor's case; and producing a reasonable opportunity for a plan's confirmation.[14] Section 1112(b) sets out a two-part framework.[15] First, the court must determine if there is "cause" to dismiss.[16] Then, the court looks to whether dismissal is in the best interests of the creditors and the estate.[17]

Section 1112(b)(4) includes a non-exhaustive list of items that constitute "cause."[18] U.S. Trustees have repeatedly argued, and courts have subsequently found, that cause exists in cannabis-related cases as a result of the debtor's "gross mismanagement of the estate" for operating businesses that contravene federal law[19] or the unenumerated item of filing in "bad faith."[20]

A. Post-Petition Cannabis-Related Activity may Constitute "Cause" for a Debtor's "Gross Mismanagement of the Estate"

Pursuant to section 1112(b)(4)(B), a court may find "cause" for dismissal where a debtor grossly mismanages the estate.[21] This subsection focuses on the management of the estate, rather

[12] 11 U.S.C. § 1112(b).
[13] *Cheng*, *supra* note 1, at 108.
[14] 7 COLLIER, *supra* note 2, at ¶ 1112.04[5].
[15] *In re Rent-Rite*, 484 B.R. at 807–08.
[16] *Id.* at 808.
[17] *Id.*
[18] 7 COLLIER, *supra* note 2, at ¶ 1112.04[5].
[19] 11 U.S.C. § 1112(b)(4)(B).
[20] *See In re Rent-Rite*, 484 B.R. at 809 (holding the debtor's post-petition activity in violation of the CSA constitutes gross mismanagement of the estate); *see also In re Arm Ventures LLC*, 564 B.R. 77, (Bankr. S.D. Fla. 2017) (finding the debtor's federal law violations constituted "bad faith" cause for the dismissal).
[21] 11 U.S.C. § 1112(b)(4)(B).

than the debtor.[22] Therefore, the court's inquiry only focuses on the debtor's post-petition mismanagement, not their activity prior to the bankruptcy filing.[23] The reasoning behind this enumerated item is that a debtor-in-possession owes a fiduciary duty to its creditors as a result of the significant powers vested in the debtor by the Bankruptcy Code.[24] Mismanagement may typically include failure to maintain an effective corporate management, to comply with the requirements of the Bankruptcy Code, and to keep the court and other parties in interest appraised of the debtor's business operations.[25]

In the context of cannabis-related bankruptcy cases, the court has held post-petition, cannabis-related activity constitutes "gross mismanagement of the estate" because the debtor knowingly violated the CSA, exposed themselves to criminal liability, and exposed both the debtor and the creditors to forfeiture of the estate's assets.[26] The court in *Rent-Rite* explained entering into the leases in violation of the CSA pre-petition did not constitute gross mismanagement, but rather, the maintenance of such offending leases during the pendency of their Chapter 11 bankruptcy case did.[27] Although not expressly stated, such a finding is consistent with the promotion of the basic purposes of Chapter 11 bankruptcy. So long as there is a risk that estate assets may be subject to forfeiture as a result of criminal prosecution, successful reorganization that "[maximizes] property available to satisfy creditors" may not be possible.[28] Therefore, any post-petition, cannabis-related activity in violation of the CSA constitutes "gross mismanagement of the estate" and is cause for dismissal.

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[22] 7 Collier, *supra* note 2, at ¶ 1112.04[6][b].
[23] *Id.*
[24] *Id.* (quoting *In re Gateway Access Solutions, Inc.*, 374 B.R. 556, 565 (Bankr. M.D. Pa. 2007).
[25] *Id.*
[26] *In re Rent-Rite*, 484 B.R. at 809; *see also Garvin*, 922 F.3d at 1036 (suggesting the operation of a cannabis-related business may constitute "gross mismanagement of the estate" under section 1112(b)).
[27] *Id.*
[28] *See* 7 COLLIER, *supra*, at ¶ 1112.04[5][a] (quoting *Bank of America Nat' l Tr. & Sav. Ass' n v. 203 N. LaSalle St. P' ship*, 526 U.S. 434, 435 (1999)).

B. A Cannabis-Related Chapter 11 Case May Be Dismissed for "Cause" on the Basis of a Bad Faith Filing

Although not enumerated in Section 1112(b)(4), dismissal for "cause" may include lack of good faith in filing for bankruptcy relief. "When determining whether a Chapter 11 case should be dismissed as a bad faith filing, [the court] must consider factors that evidence an intent to abuse the judicial process and the purposes of the reorganization provisions."[29] In considering such, the court may look to whether there is a realistic opportunity to effectively reorganize and whether it is evident that the debtor seeks merely to delay or frustrate the creditors legitimate efforts to enforce their rights.[30]

"The simple act of filing a voluntary bankruptcy petition invokes the protections under the Bankruptcy Code including the automatic stay."[31] As a court of equity, a bankruptcy court is required to enforce its equitable powers "within the confines of the Bankruptcy Code."[32] An automatic stay is meant to give the debtor breathing room in order to formulate a reorganization plan.[33] However, when there is no realistic opportunity for that plan to be successful, bankruptcy courts have utilized the "clean hands doctrine" not only to deny the debtor an automatic stay, but also bankruptcy relief all together. *Id.* (citing *Marrama v. Citizens Bank*, 549 U.S. 365, 375 (2007)); *see also Precision Instrument Mfg. Co. v. Automotive Maintenance Machinery Co.*, 324 U.S. 806, 814–15 (1945) ("The equitable maxim that he who comes into equity must come with clean hands closes the doors of a court of equity to one tainted with inequitableness or *bad faith* relative to the matter in which he seeks relief.") (emphasis added) (internal citations and quotations omitted).

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[29] *In re Arm Ventures LLC*, 564 B.R. at 82 (internal quotation marks omitted).
[30] *Id.*
[31] *In re Rent-Rite*, 484 B.R. at 806.
[32] *Id.* (citations omitted).
[33] *Id.*

Courts have held a debtor's ongoing CSA violations constitute unclean hands that does not satisfy their "good faith" requirement and is "cause" for dismissal because the reliance on income derived from illegal activity forecloses any possibility of the plan's confirmation.[34] As a court of equity, the court may not allow a debtor to use the Bankruptcy Code's protections while continuing its violation of the CSA.[35] Like the debtor in *Rent-Rite*, it would be hard for any debtor whose cannabis-related activity is the sole income producing asset to satisfy the good faith requirement for reorganization under Chapter 11. Even a cannabis-adjacent debtor, who sells equipment and materials used by both cannabis and non-cannabis customers, may not be able to satisfy this requirement because it would be inconceivable that such debtors could still operate profitably without any sales to known cannabis manufacturers or that the debtor could even prevent such customers from patronizing their business.[36] Additionally, a court may also find cause for dismissal if a debtor's sole purpose for filing was to avoid eviction—thus, delaying creditors' ability to enforce their rights.[37] However, if a debtor proposes a plan that derives sufficient revenue from other assets, a court may not dismiss a debtor's case for lack of good faith.[38]

A debtor's case may survive this stage, despite the existence of cause, because dismissal or conversion is not in the best interests of the creditors and estate. In the second part of the 1112(b) framework, a court normally looks to whether distribution may be made through additional available assets and balances creditors' expectations of distribution in a Chapter 7 case.[39] As was the case in *Rent-Rite* and *Arm Ventures*, dismissal may not be in the creditors'

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[34] *In re Rent-Rite*, 484 B.R. at 809 (citing 11 U.S.C. § 1129(a)(3)).
[35] *Id.*
[36] *In re Way to Grow, Inc.*, 610 B.R. 338, 355 (D. Colo. 2019).
[37] *Mother Earth's*, *supra* note 9, at 2–3.
[38] *See Id.*; *see also In re Arm Ventures*, 564 B.R. at 86 (allowing a debtor to propose a plan that did not depend on cannabis related proceeds, although the case was "ripe for dismissal").
[39] *In re Rent-Rite*, 484 B.R. at 810.

best interests because the debtor possesses additional, non-cannabis related assets that may be used for the payment of creditors.[40] Conversion to Chapter 7 liquidation, which presents additional challenges discussed *infra*, may not be in the best interests of the creditors because the debtor's criminal activity negatively impacts a Chapter 7 trustee's ability to administer the estate.[41] In either situation, a debtor's case that is not dismissed or converted would then move to the confirmation stage.

II. Depending on the Jurisdiction, a Court May Not Confirm a Chapter 11 Plan Due to the Failure to Propose a Plan by Lawful Means Under Section 1129(a)(3)

Under section 1129(a)(3) of the Bankruptcy Code, a plan or reorganization must be "proposed . . . not by any means forbidden by law."[42] This imposes a negative requirement that the plan must not have been proposed by any unlawful means.[43]

Pursuant to this section, U.S. Trustees have argued provisions of a cannabis-related debtor's plan that allow the debtor to continue to receive revenue from the cannabis-related activity constitutes unlawful means and, thus, it must not be confirmed.[44] However, courts disagree on the interpretation of this requirement.[45] Therefore, whether a debtor's cannabis-related activity constitutes unlawful means prohibited by section 1129(a)(3) largely depends on the case's jurisdiction.

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[40] *Id.*; *In re Arm Ventures*, 564 B.R. at 86.
[41] *In re Rent-Rite*, 484 B.R. at 810.
[42] 11 U.S.C. § 1129(a)(3).
[43] 7 COLLIER, *supra* note 2, at ¶ 1129.02[3].
[44] *See Means*, Black Law Dictionary (defining "means" as "[a]vailable resources . . . for the payment of a debt"); *see also In re McGinnis*, 453 B.R. 770, 772 (Bankr. D. Or. 2011) (interpreting the identical Chapter 13 provision to mean that a plan "must be in compliance with not only Title 11, but other applicable federal and state law").
[45] *See Garvin*, 922 F.3d at 1035 (interpreting section 1129(a)(3) only focusing on the plan's proposal); *In re Arenas*, 514 B.R. at 894 (concluding the identical Chapter 13 provision requires an inquiry into the lawfulness of a plan's means of implementation).

In the Ninth Circuit, section 1129(a)(3) directs its focus on "the manner of the plan's proposal."[46] Therefore, a court's inquiry should only focus on the legality of the plan's proposal, as opposed to the legality of its provisions.[47] The Ninth Circuit stated this interpretation was consistent with the absence of any reference to the plan's substance in the statutory text, and consistent with persuasive authority stating section 1129(a)(3) does not require a plan's substance comply in all respects with all non-bankruptcy laws.[48] Therefore, a plan in the Ninth Circuit will not be denied confirmation merely because the plan provides that the debtor may continue to receive revenue from cannabis-related activity. Nevertheless, courts in other circuits focus on the means of implementation of the plan; therefore, a plan that depends on revenue from cannabis-related activity will likely not be confirmed.[49]

III. A Debtor's Chapter 7 Case May be Dismissed Because a Trustee Would be Unable to Legally Liquidate the Debtor's Assets

Section 707(a) of the Bankruptcy Code provides three examples that constitute cause for dismissal in Chapter 7 cases, but like section 1112(b) of Chapter 11, this list is not exhaustive.[50] The court has broad discretion in dismissing a case under section 707(a) and, in doing so, must consider any extenuating circumstances and the interests of the parties.[51] For example, dismissal may be appropriate if the trustee would be required to operate or sell the debtor's business or assets in violation of federal law in order to administer the bankruptcy case.[52]

"The fundamental bargain underpinning a [Chapter 7 case] is that a debtor turns over his non-exempt assets to a chapter 7 trustee so those assets may be liquidated for the benefit of

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[46] *Id.* at 1035.
[47] *Id.*
[48] *Id.* at 1035 (citing *In re Gen. Dev. Corp.*, 135 B.R. 1002, 1007 (Bankr. S.D. Fla. 1991)).
[49] 7 COLLIER, *supra* note 2, at ¶ 1129.02[3][b]; *see also In re Basrah Custom Design, Inc.*, 600 B.R. 368, 381 n.38 (Bankr. E.D. Mich. 2019) ("[T]his Court does not necessarily agree with the *Garvin* court's holding about § 1129(a)(3).").
[50] 11 U.S.C. § 707(a) (2016); 6 COLLIER ¶ 707.03[1] (16th 2019).
[51] 6 COLLIER, *supra* note 50, at ¶ 707.03[1].
[52] *Id.*

creditors," and in return the debtor is discharged from certain debts.[53] In cannabis-related cases, a trustee would be violating the CSA when he or she took control of the debtor's assets, and when attempting to liquidate the debtor's assets.[54] Accordingly, "[t]he impossibility of lawfully administering the [estate] constitutes cause for dismissal of the Debtors' case under 11 U.S.C. § 707(a)."[55]

Thus, a debtor, whose primary operations are manufacturing or selling cannabis, would likely have their Chapter 7 case dismissed because liquidation of their primary assets would require a trustee to violate the CSA. With respect to cannabis-adjacent debtors, dismissal may depend on the legality of specific assets under the CSA. Nonetheless, such debtors still may have their Chapter 7 cases dismissed unless they have sufficient additional non-cannabis-related, non-exempt assets that could be legally liquidated to satisfy creditors' claims. In any case, "[t]o allow [debtors] to remain in a Chapter 7 bankruptcy case under circumstances where their Trustee is unable to administer valuable assets for the benefit of creditors would allow them to receive discharges without turning over their non-exempt assets to the Trustee."[56]

Conclusion

Eleven states plus the District of Columbia have legalized the recreational use of cannabis, and thirty-three states have legalized it in some form. [57] Nonetheless, bankruptcy courts still largely remain off limits to cannabis-related debtors so long as cannabis remains a controlled substance prohibited by the CSA. A debtor seeking Chapter 11 relief, may have their bankruptcy case dismissed for cause for gross mismanagement of the estate or for their lack of good faith in

[53] *In re Arenas*, 514 B.R. at 891.
[54] *Id.* (citing provisions of the CSA that make it unlawful to maintain control of drug-involved premises and to distribute a controlled substance).
[55] *Id.* at 892.
[56] *Id.*
[57] *See Legal Recreational Marijuana States and DC*, PROCON.ORG, https://marijuana.procon.org/legal-recreational-marijuana-states-and-dc/ (Jun. 24, 2019).

filing. In some jurisdictions, even if the debtor's case were to make it to the plan confirmation stage, the plan may not be confirmed as a result of the cannabis-related debtor's inability to propose a plan by lawful means. Finally, a cannabis related debtor that either files for or has their case converted to Chapter 7 relief, may have their case dismissed for cause due to the inability for a trustee to legally liquidate and administer the estate. In all cases, the success of a debtor's case may turn on surrounding circumstances like the debtor's post-petition activity, their ability to utilize additional non-exempt assets, or the jurisdiction in which the case is filed. Accordingly, the current state of bankruptcy jurisprudence remains restrictive to a debtor connected to the cannabis industry.