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Smoke & Mirrors: Bankruptcy Relief Remains Elusive for Marijuana Businesses and their Creditors

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Introduction

Today, twenty-three states and the District of Columbia allow marijuana for medical purposes, and four of those states and the District of Columbia have legalized the drug's recreational use.[1] Despite this tidal shift in state laws and public opinion, marijuana remains a Schedule I substance under the Controlled Substances Act ("CSA"), meaning the federal government does not recognize its use in medical treatment, classifies the drug as having a high potential for abuse, and that no prescriptions may be written for it.[2] Moreover, the CSA specifically makes it illegal to "rent, lease, profit from or make available for use" real property for the distribution or manufacture of a controlled substance.[3] Federal law also criminalizes any action that "aids, abets, counsels, commands, induces or procures" the sale and use of a controlled substance.[4]

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[1] B. Summer Chandler, *It's All Going to Pot: Is Relief Available for Debtors in the Marijuana Business?*, 34-DEC, AM. BANKR. INST. J. 46 (2015).
[2] 21 U.S.C. § 812(c).
[3] 21 U.S.C. § 856(a)(2).
[4] 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 principal.").

The legalization of marijuana at the state level has resulted in a multibillion dollar industry of producers, distributors, not-for-profit vendors, and for-profit management companies.[5] A corollary of this bloom in industry is the inevitability that sooner or later, some of these companies will seek bankruptcy relief. So as public opinion evolves, laws change, and jurisprudence develops, one question emerges: can a medical marijuana company legal under state law seek relief under title 11 of the United States Code (the "Bankruptcy Code")?

This article will explore the present question in a threefold approach. Part I analyzes the role of judicial discretion in "for cause" dismissal pursuant to 11 U.S.C. § 707(a). Part II examines the common law doctrine of "unclean hands" and its application to marijuana-related bankruptcies. Part III concludes by analyzing the convergence of these doctrines as preventing creditors from filing involuntary chapter 7 petitions against their debtors.

I. A Court May Dismiss A Marijuana-Related Bankruptcy Case "For Cause" Under § 707(a)

Section 707(a) provides that a court has discretion to dismiss a chapter 7 case "for cause" after notice and a hearing.[6] "Cause" is not explicitly defined by the Bankruptcy Code.[7] Although § 707(a) provides that "cause" may be found in "unreasonable delay by the debtor that is prejudicial to creditors," or "nonpayment of any [court] fees."[8] However, the statute is read as

[5] *See* Mark W. Gifford, "Colorado's Pot Laws and Legal Ethics," 37-Aug *Wyo. Law*. 12 (2014)(articulating how "[t]housands of new jobs have been created" and some sources "project annual marijuana sales in excess of $1 billion").
[6] 11 U.S.C. § 707(a).
[7] *See* Dianne v. Simmons (*In re* Simmons), 200 F.3d 738, 743 (11th Cir 2000).
[8] 11 U.S.C. § 707(a).

being "illustrative and not exhaustive."[9] Determination of what constitutes cause under § 707(a) is entirely within the discretion of the bankruptcy court.[10]

A. A Court May Dismiss A Chapter 7 Case If The Trustee Is Unable To Perform Without Violating the Law

Courts have discretion to dismiss for cause when a bankruptcy trustee is unable to discharge their duties in administering a bankruptcy estate without violating the law. In *Vel Rey Properties*, a chapter 7 trustee wanted to operate a debtor's rental real properties in a certain way to increase their value.[11] The issue, however, was that he wanted to operate the properties in such a way that would violate Washington, D.C.'s municipal housing regulations.[12] The court denied the trustee's request for [what specifically]from personal liability should he operate the property against the regulations.[13] According to the court, the trustee could refuse to administer the estate for "concern[] about personal liability" in which case the court could simply dismiss the case for cause."[14] The *Vel Rey* court summed up how courts generally view the intersection of legal compliance and bankruptcy relief, stating that "bankruptcy is not intended to be a haven for law breakers. If the debtor cannot be liquidated or reorganized in compliance with state laws, the bankruptcy is not the place for the debtor."

Courts find cause for dismissal not only when violation of state laws is at stake, but also when trustees simply are not sure the proper way to comply with state laws. In *Ohio v.*

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[9] *See* Dianne v. Simmons (*In re* Simmons), 200 F.3d 738, 743 (11th Cir 2000)(holding that § 707(a) examples of what constitutes "cause" are "nonexclusive").

[10] *In re* Cecil, 71 B.R. 730, 734 (Bankr. W.D. Va. 1987)(dismissing a chapter 7 petition for bad faith filing is a determination of cause that "rests within the sound discretion of the bankruptcy court"); *see also In re* Eastman, 188 B.R. 621 (9th Cir. 1995). *See generally in re* Heatley, 51 B.R. 518, 519—520 (Bankr. E.D. Pa. 1985)(in exercising its discretion of dismissal for cause, the bankruptcy court is guided by "general equitable principles, including the balancing of competing interests").

[11] *In re* Vel Rey Properties, Inc., 174 B.R. 859, 863 (Bankr. D. D.C. 1994).

[12] *Id.*

[13] *Id.*

[14] *Id* at 866.

Commercial Oil Serv. Inc., the court dismissed a bankruptcy case under § 707 because the chapter 7 trustee lacked the technical expertise in how to handle that bankruptcy estate's hazardous waste assets without violating environmental laws.[15] Not only did the court have reservations about complying with environmental laws, but the court also cited generally to concerns about public safety and the welfare of the trustee in administering the hazardous assets.[16]

B. A Court May Dismiss A Business' Chapter 7 or 11 Case Because of its Marijuana Assets

Courts will find cause for dismissal when a trustee cannot discharge their duties without violating law, and the legalization of marijuana at the state level has further complicated this issue. When debtors whose assets are in some respect marijuana-related seek bankruptcy relief, courts generally find cause for dismissal under § 707(a). In *Arenas*, for example, the bankruptcy court for the District of Colorado held that the debtor's chapter 7 trustee could neither "take control of the Debtor's Property without himself violating § 856(a)(2) of the CSA," nor "liquidate the inventory of marijuana plants Mr. Arenas possessed on the Petition Date" without violating § 841(a) of the CSA.[17]

Denial of bankruptcy relief for marijuana-related business is not only limited to chapter 7 cases, but has been extended to chapter 11 as well. When Mother Earth's Alternative Healing Cooperative, a California medical marijuana dispensary, filed for chapter 11 in California, its trustee moved to dismiss under § 1129(a)(3) of the Bankruptcy Code, arguing that the funding a chapter 11 plan through the ongoing sale of marijuana would violate the "not by any means

[15] 58 B.R. 311, 316—317 (Bankr.. N.D. Ohio 1986).
[16] *Id.*
[17] *In re* Arenas, 514 B.R. 887, 892 (Bankr. D. Colo. 2014).

forbidden by law" condition that courts consider in confirming a chapter 11 plan.[18] The court granted the trustee's motion to dismiss, emphasizing how it would confirm a chapter 11 plan that was in violation of the CSA.[19]

Furthermore, not only is bankruptcy relief unavailable to marijuana businesses, but courts have denied landlords of marijuana businesses from seeking recourse through bankruptcy. In *Rent-Rite Super Kegs*, the District of Colorado held that because a chapter 11 landlord debtor received 25% of its revenue from a marijuana entity, it was therefore exposed to criminal liability and potential forfeiture of the property.[20] The court held that continuing to lease the property to a marijuana entity rose to the level of "gross mismanagement of the estate" sufficient for dismissal not under § 707(a), but under § 1112(b)(4)(B).[21] The denial of bankruptcy relief is widespread, limited not just to the marijuana-related manufacturers and distributors themselves, but extending also to those doing business with them, such as landlords.

II. The common law doctrine of "unclean hands" generally prevents marijuana-related businesses and their creditors from seeking bankruptcy relief

It is a well-settled principle that a "federal court should not, in an ordinary case, lend its judicial power to a plaintiff who seeks to invoke that power for the purpose of consummating a transaction in clear violation of the law."[22] Because bankruptcy courts are traditionally viewed

[18] *See* United States Trustee's Response to Debtors Motion to Dismiss Chapter 11 Bankruptcy, *In re* Mother Earth's Alt. Healing Coop., Inc., No. 12-10223-11 (Bankr. S.D. Ca. dismissed Oct. 23, 2012)(citing 11 U.S.C. § 1129(a)(3) (2012)).
[19] *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).
[20] *In re* Rent-Rite Super Kegs W. Ltd., 484 B.R. 799, 802—803 (Bankr. D. Colo. 2012).
[21] *See id.*; *see also* 11 U.S.C. § 1112(b)(4)(B) (2012).
[22] *See* Johnson v. Yellow Cab Transit Co., 321 U.S. 383, 387 (1944).

as being courts of equity,[23] "one who does not come into equity with clean hands, and keep them clean, must be denied all relief, whatever may have been the merits of his claim."[24]

In *Northbay Wellness Group, Inc. v. Beyries*, the District Court for the Northern District of California applied the doctrine of unclean hands to prevent a plaintiff medical marijuana business from seeking a nondischargeability determination.[25] A medical marijuana dispensary, Northbay Wellness, had given its attorney $25,000 to establish a defense fund in the event that someone should sue the dispensary.[26] Thereafter, the attorney became a debtor under chapter 7.[27] Northbay Wellness Group wanted its money back, and understood that if a court deemed the debt dischargeable, they would not be able to recover the $25,000.[28] Therefore, they petitioned the bankruptcy court to issue a nondischargeability determination.[29] The bankruptcy court held that the debt was dischargeable and the district court affirmed,[30] thus denying Northbay Wellness Group any recourse to the funds.[31] The district court noted that because the funds in question were held by Northbay's counsel as a fiduciary, they would usually qualify as a § 523 exception to discharge and be nondischargeable.[32] However, because the funds were generated through the sale of marijuana, the doctrine of unclean hands barred application of § 523.[33] Northbay Wellness's hands were unclean due to its involvement in a medical marijuana enterprise, and therefore the court had to deny their motion for a dischargeabililty determination.

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[23] *See* Young v. United States, 535 U.S. 43, 50 (2002).
[24] *See* Hall v. Wright, 240 F.2d 787, 794—95 (9th Cir. 1957).
[25] *See* Northbay Wellness Grp., Inc. v. Beyries, No. C11-06255 JSW, 2012 WL 4120409, at *4 (N.D. Cal. Sept 18, 2012).
[26] *Id.* at *3
[27] *Id*.
[28] *Id*.
[29] *Id*.
[30] *Id*.
[31] *Id*.
[32] 11 U.S.C. 523(a)(4) (2012)("A discharge under § 727…of this title does not discharge an individual debtor from any debt…for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny").
[33] 2012 WL 4120409, at *3–4 (holding that "[w]hile the sale of marijuana may be legal under state law, it is a serious federal crime which cannot be legalized by a state.").

III. Bankruptcy relief is unavailable to not only marijuana-related businesses, but also their creditors

In *In re Medpoint Management, LLC*, the United States Bankruptcy Court for the District of Arizona dismissed an involuntary chapter 7 petition filed against a medical marijuana distributor.[34] Although Arizona law permits its Department of Health Services to register dispensaries "operated on a not-for-profit basis" for the legal sale of marijuana,[35] the drug remains a Schedule I substance under the CSA.[36] Because Arizona law requires dispensaries to maintain a nonprofit nature, there has been a "proliferation of dispensary-management entities which serve as repositories of dispensary revenues."[37] When Medpoint Management, one such entity, defaulted on several of its loans and obligations, a group of creditors filed an involuntary chapter 7 petition against Medpoint.[38] The petitioning creditors' claims against Medpoint included unpaid amounts under two promissory notes, unpaid fees arising under two distinct consulting agreements, and over $500,000 in outstanding loans.[39] Medpoint moved to dismiss arguing that the "unclean hands doctrine" prevents not only any marijuana-related business but also any of their creditors from seeking relief from the federal bankruptcy courts.[40]

The court granted Medpoint's motion for two reasons. First, because the petitioning creditors "knew or should have know that Medpoint's activities were illegal under federal law," the doctrine of unclean hands applies and the creditors were therefore ineligible to seek relief.[41] Second, since Medpoint's chapter 7 estate would inevitably be made up of primarily marijuana-

[34] *In re* Medpoint Management, LLC, 528 B.R. 178, 180 (Bankr. D. Ariz. 2015).
[35] *See* Arizona Revised Statutes §§ 36—2081—2819.
[36] 28 U.S.C. § 801 *et. seq.*
[37] *See* 528 B.R. at 180.
[38] *Id.* at 182.
[39] *Id.*
[40] *Id.* at 182—83.
[41] *Id.* at 186—87.

related assets illegal under federal law and hence at risk for forfeiture, the court held that this was sufficient "cause" for dismissal pursuant to the court's authority under § 707(a).[42]

Conclusion

The denial of bankruptcy relief to marijuana-related businesses and their creditors flows from a conflict between state laws and the federal Controlled Substances Act. In denying bankrupt marijuana-related entities bankruptcy relief, judges rely on § 707(a) of the code and the doctrine of "unclean hands." However, because the doctrine of unclean hands allows judicial interpretation to incorporate laws not at issue in a present case, federal law is preempting state law in spheres where it might not have the constitutional authority to do so. The Controlled Substances Act has never been challenged on constitutional grounds, and some academics have argued that there could be a substantive due process argument that the CSA exceeds he federal government's constitutional mandate under the Fourth and Fourteenth Amendments.[43] So even though states are free to make legal substances otherwise illegal under the CSA, such as marijuana, so long as bankruptcy remains a federal question, neither marijuana-related business nor their creditors will be able to seek bankruptcy relief.

[42] *See id*. at 185–86. Medpoint's creditors argued that the Cromnibus Act essentially eliminates the possibility that federal enforcement actions against medical marijuana operations could result in substantial risk of forfeiture of property. The court was not persuaded: "That the Cromnibus Act prohibits the Department of Justice ("DOJ") from using that funding for enforcement against medical marijuana operations does not foreclose the possibility of enforcement. For example, in 2012, the DOJ's Asset Forfeiture Program 'recorded total net forfeiture deposits of $4.2 billion' via coordinated actions involving the FBI, ATF, DEA, and other law enforcement agencies."

[43] *See* Eric Tennen, *Is the Constitution in Harm's Way? Substantive Due Process and Criminal Law*, BOALT J. OF CRIM. L. 3 (2004).