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Breaking Bad: Restructuring Illegal Businesses

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Breaking Bad: Restructuring Illegal Businesses

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1) Circuit Court

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

Holding: The Ninth Circuit Court of Appeals affirmed the lower court rulings confirming the plan and overruling the US Trustee's objection where debtor real estate holding company's revenue was derived from, in part, a tenant that was involved in a marijuana growing operation, which was legal under the law of the State of Washington and illegal under federal law.

Issue: Under 11 U.S.C. § 1129(a)(3), what does it mean to propose a plan by means forbidden by law?

Analysis: Section 1129(a)(3) forces us to focus on the manner of the plan's proposal. 922 F.3d at 1035. The Ninth Circuit engaged in statutory interpretation and noted that "the phrase 'not by any means forbidden by law' modifies the phrase '[t]he plan has been proposed.'" *Id.* The Court was concerned that the Trustee's position would require it to rewrite the statute completely and not rely upon its "clear meaning." *Id.* The Court also concluded that this interpretation of the Bankruptcy Code would not facilitate legal violations. *Id.* at 1036. The Court noted that it could still consider gross mismanagement under Section 1112(b) and confirmation did not insulate anyone from criminal prosecution.

Conclusion: The Ninth Circuit concluded is affirmance by stated: "There is thus no need to "convert the bankruptcy judge into an ombudsman without portfolio, gratuitously seeking out possible 'illegalities' in every plan," a result that would be "inimical to the basic function of bankruptcy judges in bankruptcy proceedings." *Id. (quoting In re Food City, Inc.* 110 B.R. 808, 812 (Bank. W.D. Tex. 1990)).

b) *Bartch v. Barch*, No. 23-1211, 2024 WL 3560748, (10th Cir. July 29, 2024)

Holding: In a consolidated appeal from a decision by the U.S. District Court for Colorado and the U.S. District Court for Maryland (see below), the Tenth Circuit Court of Appeals held that any illegality of the parties' contract did not deprive the co-owner of Article II standing to bring claim for breach of contract and the record was not sufficiently developed to determine whether enforcement order violated Controlled Substances Act (CSA) or public policy.

Issue: The 10th Circuit was asked to address a question about the nature and extent to which a federal court may act to resolve a dispute related to a marijuana business that operates legally under state law. More particularly, in the appeal from Colorado (No. 23-1211) (the appeal of the judgment enforcement order), appellants Mackie and Trellis argued that (A) appellee lacked standing to seek an order directing the sale of an interest in a marijuana business because such an order would violate the CSA, and (B) the district court lacked authority to enter the judgment enforcement order under Colorado's execution and post-judgment proceedings. *Id.* at *4. In the appeal from Maryland (No. 24-1049) (the appeal from the original judgment reconsideration order), appellants argue that appellee lacked standing to seek damages for breach of contract in the original proceeding because the relief requested would violate the CSA.

Analysis: As to the issue of standing, the Court engaged in traditional analysis reviewing injury-in-fact and the Court's ability to fashion a remedy. The fact that the property specified in the District Court's order was a marijuana business does not affect standing. On the ultimate issue of judgment enforcement involving a marijuana business, the 10th Circuit remanded for additional findings of the District Court. The Circuit Court concluded that the judgment enforcement order does not specifically order [appellants] Mackie and Trellis to engage in marijuana activities that would violate the CSA. Nonetheless, compliance with the order, the Circuit Court observed, may effectively require them to do so. Accordingly, the Circuit Court asked for a better developed record to answer that question. *Id.* at *12.

2) District Court

a) *Bartch v. Barch*, Civ. No. 23-0101-BAH, 2024 WL 943430 (D. Md. March 5, 2024).

Holding: The U.S. District Court for District of Maryland denied motion to dismiss by judgment debtor where judgment creditors sought charging order over cannabis retailer and distributions from retailer. Judgment debtor argued unsuccessfully that the court lacked the authority to enter and to enforce charging order due to illegality of the cannabis retailer under federal law.

Result: Appeal consolidated before the 10th Circuit. *See* 1.b. above.

b) *In re Way to Grow, Inc.*, 610 B.R. 338 (D. Colo. 2019).

Holding: District Court affirmed the dismissal of debtors' bankruptcy cases "for cause" as debtor's business relied on selling equipment and supplies to persons and entities growing marijuana, and debtors knew that the equipment and supplies would be used to grow marijuana.

Issue: Whether the bankruptcy court correctly denied the debtors' stay pending appeal following the dismissal of their bankruptcy cases "for cause."

Analysis: The District Court reviewed the federal crimes related to marijuana and then concluded that their businesses would only be feasible with revenue from illegal activities. As the District Court noted, "Such conduct is legal under the laws of Colorado and California, where Debtors operate, but remains illegal under federal law." The bankruptcy court heard testimony from one manager that 95% of his store's customers were using debtor's products to grow marijuana, and from another store manager that the "vast majority" of his customers were doing likewise. In another instance, the testimony was that the figure was closer to 65%. Weighing this evidence, the bankruptcy court concluded, "Whether marijuana-related customers account for 65% or 95% of Debtors' revenue, eliminating all such revenue would be devastating to the Debtors. The bankruptcy court concluded that "It is inconceivable Debtors could terminate any sales to known marijuana cultivators and still operate profitably." 610 B.R. 338, 354–55 (D. Colo. 2019)

3) Bankruptcy Appellate Panel

a) *In re Blumsack*, 657 B.R. 505 (B.A.P. 1st Cir. 2024)

Holding: In affirming the dismissal of a Chapter 13 plan, the 1st Circuit BAP held that a cannabis dispensary worker in Massachusetts is not categorically unable to file a chapter 13 petition in good faith. However, the debtor's illegal activity renders the plan as not having been proposed in good faith.

Issue: Whether the bankruptcy court erred in denying confirmation of the Chapter 13 debtor's plan as not in good faith when it was funded by the debtor's revenue in violation of the Controlled Substances Act.

Facts and Posture: Debtor Scott H. Blumsack worked at a cannabis dispensary in the Commonwealth of Massachusetts, where state law permits the retail sale of marijuana. He

proposed to use his earnings from his employment at the dispensary to fund a plan. The UST, relying upon the Controlled Substances Act, asked the bankruptcy court to deny confirmation of the debtor's plan and to dismiss his case. The court granted both requests, and the debtor appealed.

Analysis: The bankruptcy court erred in fashioning a rule of law that categorically prohibits an individual employed in the cannabis industry from seeking chapter 13 relief. However, the debtor's case was properly dismissed for cause. The debtor was unable to point the BAP to any case law supporting the notion that a chapter 13 plan is proposed in good faith and by lawful means, as required by § 1325(a)(3), when the income the debtor would use to fund that plan is derived from activities criminalized by federal law. The debtor attempted to distinguish cases in which the debtor owned assets used in marijuana business. The BAP reasoned that the nature of the debtor's employment, by itself, does not render him ineligible to file a chapter 13 petition in good faith. However, his Plan would have funneled his income from the dispensary into the chapter 13 trustee's office, and from there to creditors, bringing the proceeds of illegal activity directly into the administration of the bankruptcy case. In this respect, this case is analogous to other cases in which the courts appropriately balked at bankruptcy administration of assets illegal under the CSA (or the proceeds thereof). Here, where the debtor proposed to fund his reorganization with the proceeds of illegal activity, the degree of connection between that criminal activity and the debtor's reorganization efforts crossed a line into bad faith territory. On these facts, the BAP agreed with the bankruptcy court that the plan did not satisfy § 1325(a)(3). Id. at 516–17.

4) Bankruptcy Courts

a) *In re Callaway*, No. 24-30082-DM, 2024 WL 3191673 (Bankr. N.D. Cal. June 26, 2024).

Issue: Whether administering the ownership interests of LLCs that engage in marijuana business is necessarily equivalent to administering marijuana assets such that the Chapter 7 trustee would be forced to administer assets in violation of the Controlled Substances Act of 21 U.S.C. Sections 801-904.

Holding: In denying the motions to dismiss, Judge Montali held that the trustee's own personal determination that he cannot lawfully administer the assets of this case is insufficient cause to dismiss the debtor's case as there are other options.

Analysis: The Court discussed the CSA and the "cause" standard. The Court then distinguished the marijuana cases arising in Chapter 11 and 13. In those cases, the Court reasoned that the issues involved the actual or anticipated post-petition conduct expected

of the debtor, the debtor-in-possession or the chapter 13 trustee, almost entirely in the context of use of income or funds from businesses that are in violation of the CSA during chapter 11 reorganization or administration of a chapter 13 plan. In summary, those cases involved the role of a trustee in the continued administration of income derived from a marijuana business. Unlike the Chapter 7 cases, the debtor was a separate entity than the entity that engages in the marijuana business. As such, the trustee was not in danger of having to administer tangible marijuana assets held by those business. The Court drew a distinction between realizing profits from a marijuana business versus monetizing an intangible ownership interest. *Id.* at *6.

b) *In re The Hacienda Company, LLC*, 654 B.R. 155 (Bankr. C.D. Cal. 2023).

Holding: Judge Bason concluded that the United States Trustee failed to establish "cause" to dismiss the debtor's bankruptcy, where the UST asserted that the debtor failed to withdraw from an ongoing criminal conspiracy to violate the Controlled Substances Act.

Issue: Whether the UST was entitled to dismissal of the debtor's chapter 11 case based upon the debtor's prepetition, manufacturing and packaging of cannabis products before ceasing operations and transferring its value to Canadian company and selling vacant land that debtor had intended for use as cannabis cultivation center.

Analysis: The Court's analysis starts by noting that the standard for dismissal under § 1112 and confirmation under § 1129 is "preponderance of the evidence" rather than "beyond a reasonable doubt." The Court observes, however, that the UST only refers to "likely" violations of criminal law. The Court also concluded that Congress' mandate that bankruptcy courts "shall" dismiss or convert a bankruptcy case for "cause" under § 1112(b) does not mean that any violation of criminal law requires dismissal. Rather, the Court reasoned that the statute gives it discretion to determine whether dismissal is warranted based on all the facts and circumstances.

In addressing the UST's new arguments (second motion to dismiss), the Court found that the debtor did withdraw from a (possible) technical ongoing conspiracy to violate the CSA. However, the UST did not show how debtor's orderly postpetition liquidation of its stock in the Canadian cannabis entity offends the principles in the Bankruptcy Code in any way, let alone establishes sufficient "cause" to mandate dismissal under § 1112. In the circumstances of this case, the Court found and concluded that dismissal would undermine the Congressional mandates embodied in the rest of the Bankruptcy Code. 654 B.R. 155, 168.

c) *In re CWNevada LLC*, 602 B.R. 717 (Bankr. D. Nev. 2019).

Holding: Judge Nakagawa granted motion to dismiss based on abstention on creditor's motion against debtor LLC's Chapter 11 petition.

Background: Debtor cultivated, produced, and distributed medical and recreational marijuana ("Marijuana Business"). It also produced and distributed products that contain cannabidiol ("CBD Business"). Debtor apparently operated or once operated marijuana cultivation, production, or dispensary facilities at up to five Nevada locations: three in Las Vegas, one in North Las Vegas, and one in Pahrump. Debtor's health plan coverage apparently encompasses 54 subscribers. Debtor's business operations apparently are authorized under Nevada law. Debtor's Marijuana Business is prohibited under federal law by provisions of the Controlled Substances Act, 21 U.S.C. § 841(a)(1) and 21 U.S.C. § 812(c), Schedule I(c)(10) [Marihuana] and Schedule I(c)(17) [Tetrahydrocannibinols]. Debtor's CBD Business, however, may no longer be prohibited under federal law as a result of the Agriculture Improvement Act of 2018, Pub. L. 115-334, 132 Stat. 4490.

The Agriculture Improvement Act became effective on December 20, 2018, when the bill was signed into law. The Act amended the term "Marihuana" under the Controlled Substances Act to exclude hemp "as defined under section 1639o of Title 7." See 21 U.S.C. § 802(16)(B). The Act also amended Schedule I(c)(17) of the Controlled Substances Act to exclude from the definition of "Tetrahydrocannabinols" the "tetrahydrocannabinols in hemp (as defined under section 1639o of Title 7)." See 21 U.S.C. § 812(c), Schedule I(c)(17). Under 7 U.S.C. § 1639o(1), the term hemp "means the plant Cannabis sativa L. and any part of that plant, including the seeds thereof and all derivatives, extracts, cannabinoids, isomers, acids, and salts of isomers, whether growing or not, with a delta-9 tetrahydrocannibinol concentration of not more than 0.3 percent on a dry weight basis." (Emphasis added.) Because products derived from hemp plants containing restricted concentrations of tetrahydrocannabinols ("THC"), which is the active ingredient in marijuana, are no longer in violation of the Controlled Substances Act, the Food and Drug Administration ("FDA") apparently will assume a regulatory role for such products.

Under these circumstances, the portion of the Debtor's operations devoted to the Marijuana Business appears to be in violation of federal law, while the portion devoted to the CBD Business might be excluded from the Controlled Substances Act if the CBD products sold by the Debtor are derived from the type of hemp permitted under federal law. Notwithstanding its operations of these two businesses in accordance with Nevada law, Debtor apparently defaulted on payment of many of its obligations. *Id.* at 723–25.

Analysis: The Court commences its analysis by distinguishing the Ninth Circuit's decision in the Chapter 11 debtor in Garvin as that debtor was not engaged in the

cultivation, production and distribution of marijuana. In the instant case, the Court reasoned that, unlike the debtor in Garvin, this is not a case where proceeds of the Marijuana Business would provide merely "indirect support" for a confirmed plan. Rather, the Marijuana Business operated by the debtor appeared to be the primary source of the Debtor's revenue and appears to be in clear violation of the Controlled Substances Act. Moreover, Garvin was not confronted with whether dismissal based on abstention under Section 305(a) is appropriate. Lastly, unlike Garvin, this debtor faces multiple state court actions brought by creditors clamoring to enforce their claims against limited assets.

The Court did not establish a *per se* prohibition. Rather, the Court wrote: "There may be cases where Chapter 11 relief is appropriate for an individual or a non-individual entity directly engaged in a marijuana-related business. For the reasons discussed above, this case is not one of them." Similarly, the Court concluded that the interests of creditors and the Debtor would be better served by dismissal of the case. *See* 11 U.S.C. § 305(a)(1). The parties may return to State Court where the Receivership Application, among other matters, may be fully addressed. *Id.* at 717.

d) *In re Mayer*, Case No. 2:21-bk-06572-DPC, 2022 WL 18715955 (D. Ariz. January 31, 2022).

Holding: Judge Daniel Collins granted motion to dismiss chapter 13 case as to do otherwise would be to permit an ongoing violation of the CSA.

Issue: Whether Motion to Dismiss filed by creditor and joined by UST and Trustee should be granted in Chapter 13 case as debtor's only income was from a marijuana related business.

Analysis: Debtor's only reliable assets from which he could fund a chapter 13 plan came from a business whose operations violate the CSA. Debtor did not show the Court evidence of any non-CSA violative assets which could support a viable or feasible chapter 13 plan. The Dismissal Motion is hereby granted.

5) Secondary Authorities

a) Matthew T. Faga and Ryan L. Blansett, *Hacienda: The Gradual Liquidation of Cannabis Assets In Bankruptcy,* 2023 No. 7 Norton Bankr. L. Adviser NL 1

b) Laura N. Coordes, *Open Door or False Passage? Why Cases in the Ninth Circuit are Unlikely to Lead to Bankruptcy Access for Marijuana-Related Debtors,* 42 No. 9 Bankruptcy Law Letter NL 1 (Sept. 2022).

c) Brittani Bushman, *The Growing Cannabis Problem: A Look at Marijuana-Related Bankruptcies and the Infeasibility of the Feasibility Doctrine*, 84 Alb. L. Rev. 159, 159 (2021).

d) Claudia Z. Springer, Jake A. Ziering & Amir Shachmurove, *The Bankruptcy Code's Cannabis Challenge: The Past, Present, and Future of Bankrupt Cannabis Businesses,* 30 No. 2 J. Bankr. L & Prac. NL Art. 1 (April 2021).

e) Michael R. Herz, *The Difficulty Trustees Face in Cannabis-Related Cases Plus, A Look at State Court Alternatives for Debtors*, Am. Bankr. Inst. J., September 2020.

f) Joe Schomberg, *Major Buzzkill the Relationship Between Legalized Cannabis in Illinois and the U.S. Bankruptcy Code*, 108 Ill. B.J. 26, 27 (2020).

g) Jerrold L. Bregman, *9th Cir. Affirms Ch. 11 Plan Indirectly Supported by State-Legal Marijuana*, Am. Bankr. Inst. J., August 2019.

h) Steven J. Boyajian, *Just Say No to Drugs? Creditors Not Getting A Fair Shake When Marijuana-Related Cases Are Dismissed*, Am. Bankr. Inst. J., September 2017.

i) Clifford J. White III & John Sheahan, *Why Marijuana Assets May Not Be Administered in Bankruptcy*, Am. Bankr. Inst. J., December 2017.

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Valerie Bantner Peo is a shareholder with Buchalter, PC in San Francisco, where her practice focuses on creditors' rights, finance and commercial litigation, with significant experience at the trial and appellate levels in bankruptcy, federal and state court. She regularly represents financial institutions, including agribusiness lenders and alternative lenders, software licensors, commercial landlords and tenants, equipment lessors, officers and directors, companies in distress, and creditors' committees and other fiduciaries. Ms. Banter Peo chairs Women@Buchalter and currently serves on the board of directors of the International Women's Insolvency & Restructuring Confederation (IWIRC). In 2023, she chaired the inaugural IWIRC@INSOL conference in Tokyo and also received the IWIRC Fetner Award, presented to a member whose contributions to IWIRC have helped to fuel growth and expansion of IWIRC's mission globally. Ms. Banter Peo served on the Attorney Committee for the 2019 and 2023 Roadways to the Federal Bench event produced by the Judicial Conference Committee, and she is a past chair of the Executive Committee of the San Francisco Bar Association's Commercial Law and Bankruptcy section. She was recognized in *Northern California Super Lawyers* from 2019-23, and in 2024, was recognized in *The Best Lawyers in America* for Bankruptcy and Creditor/Debtor Rights/Insolvency and Reorganization Law. Ms. Banter Peo received her B.A. from Smith College and her J.D. *cum laude* from the University of California, Hastings College of Law. Following law school, she clerked for Hon. Edward D. Jellen (ret.) of the U.S. Bankruptcy Court for the Northern District of California.

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