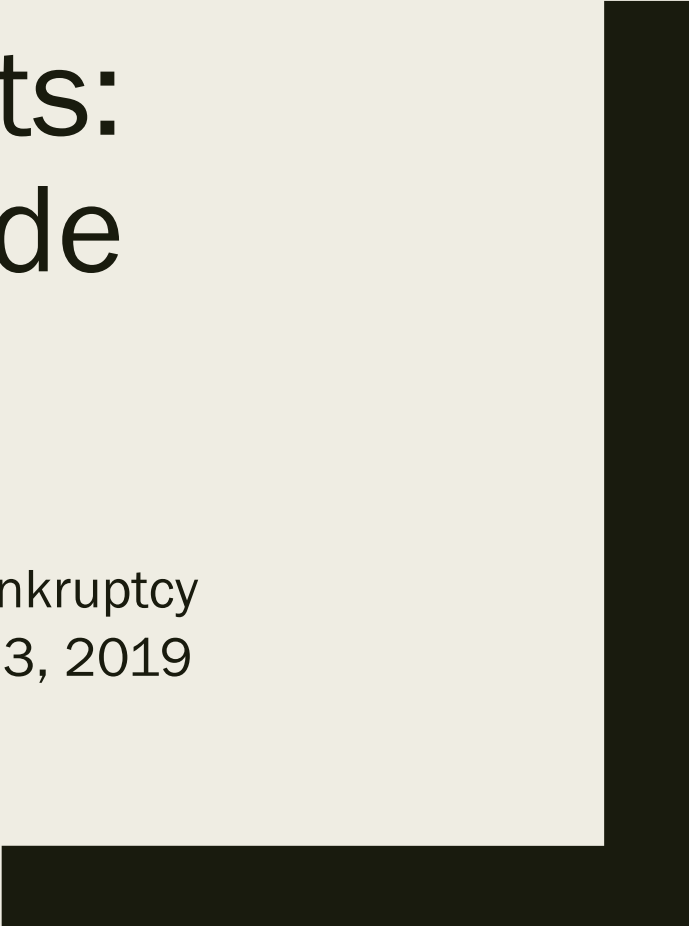




In re Cook Investments: The Chronic & the Code

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- Jim Day is a partner in the Seattle law firm of Bush Kornfeld LLP and specializes in the resolution of complex commercial creditor-debtor issues, with an emphasis on the representation of companies in chapter 11 reorganizations and out-of-court workout negotiations and agreements. Much of his time since 2007 has been spent in workout activities in the residential, commercial and retail real estate sectors, including multiple engagements involving a dozen or more lenders holding claims aggregating over \$100 million. He has significant experience in a variety of other industries, including manufacturing, high tech and internet-based entities, fishing and maritime, telecom, and franchised restaurants. He is AV-rated by Martindale-Hubbell and has been named a Super Lawyer by Washington Law & Politics each year since 2003. Jim is a graduate of the University of Washington School of Law, and previously served as law clerk to the Honorable Sidney C. Volinn, U.S. Bankruptcy Court, Western District of Washington, on both trial matters and appeals before the Bankruptcy Appellate Panel of the Ninth Circuit.

The Basics

- Recreational marijuana is currently legal in 11 states and the District of Columbia (including Illinois, effective January 1, 2020)
 - *Washington: I-502 passed in November 2012 by a 56 – 44% margin.*
- Medical marijuana legal in another 20 states
- Wholly illegal in 19 states
- Projected Revenues:
 - *Washington State: \$730 million for 2017-19 budget cycle*
 - Excise tax rate: 37% on retail sales
 - *Federal collections: \$4.7 billion in 2017*

Federal Legal Issues

- Controlled Substances Act (21 U.S.C. § 812)
 - *Marijuana classified as a Schedule I Drug, which the statute defines as:*
 - *“[H]igh potential for abuse”*
 - *“[N]o currently accepted medical use in treatment in the United States”*
 - *“[L]ack of accepted safety for use of the drug or other substance under medical supervision”*
 - *Included with LSD, Heroin and Ecstasy*

- Bankruptcy Code = federal law

Changing of the Guard

- United States Trustee Directive of April 26, 2017:
 - *Memorandum Directing Chapter 7 and Chapter 13 Trustees to move to dismiss or object in all cases involving marijuana assets on grounds that such assets may not be administered under the Bankruptcy Code*
- Sessions Memorandum, January 4, 2018 – “Announcing a return to the rule of law”
 - *Directs all US Attorneys to enforce the laws enacted by Congress*



In Re Cook Investments

- Case 16-44782 (W.D. WA), filed November 21, 2016
- Five jointly administered cases, four commercial real estate lessors
- One debtor, Cook Darrington, leased property to I-502 producer (Green Haven)
- Case filed to effect workout of \$6.5MM secured debt

In Re Cook Investments, Motion to Dismiss

- 341 meeting: Marijuana lease identified
- One week later: UST files motion to dismiss for “cause”
- Section 1112(b)(4)(B): per se violation of CSA constitutes “Gross mismanagement of the estate” (Says who?)
- UST sought dismissal only of Darrington/lessor’s case

In Re Cook Investments, Response to Motion to Dismiss

- UST apparently the only federal government agency seeking to prosecute in states with comprehensive legalization schemes
 - *DOJ: Cole Memorandum – August 29, 2013: Directing USAOs to direct prosecutorial focus elsewhere in states with robust legalization framework*
 - *Congress: Rohrabacher-Farr Amendment: Blocks DOJ funding for prosecutions in states having legalized medical marijuana (every appropriations bill since Sept 2014)*
 - *US v. McIntosh, 833 F.3d 1163 (9th Cir. 2016) (enforcing funding bar)*

In Re Cook Investments, Response to Motion to Dismiss

- IRS: Billions of dollars of revenue collected
 - *26 USC § 280E: No deductions for business expenses (higher effective rate)*
- Supreme Court: *Nebraska v. Colorado*, 577 US ___, 144 Orig (March 21, 2016)
 - Denying motion for leave to file complaint
 - US Constitution, Article III, Section 2 and 28 USC § 1251(a): original jurisdiction
- DEA: No wholesale enforcement actions

In Re Cook Investments, Response to Motion to Dismiss

- “Gross mismanagement of the estate” - Section 1112(b)(4)(B)
- UST authority:
 - *In re Rent-Rite Super Kegs West Ltd., 484 BR 799 (Bankr. D. Colo. 2012)*
 - *In re Arenas, 514 BR 887 (Bankr. D. Colo 2014)*
 - *In re Medpoint Management, LLC, 528 BR 178 (Bankr. D. Ariz. 2015)*
- Motion Denied. Court holds that Debtors “may be able to propose a plan that does not rely on the income from the marijuana operation lease.”
 - *Invited UST to renew motion in conjunction at confirmation hearing*

In Re Cook Investments, Second to Motion to Dismiss

- A month later, UST files second motion to dismiss all cases based on untimely monthly reports
 - *One month was six weeks in arrears, another month was two weeks delinquent*
- Motion denied, little comment from court

In re Cook Investments Debtors File Joint Plan

- Debtors file joint plan
 - Anticipates rejection of Green Haven lease
 - Eliminates all references to Green Haven, both lease and lease income
 - Remaining cash flow more than sufficient to fund plan payments
 - All creditors, including Debtors' secured lender, vote in favor of plan
- Debtors reject Green Haven lease (without opposition)
- UST objects to plan
 - **11 U.S.C. §1129(a)(3):** "The court shall confirm a plan only if...[t]he plan has been proposed in good faith and not by any means forbidden by law."
 - UST only argued second part, did not argue lack of good faith
- UST does not renew motion to dismiss

In re Cook Investments Plan Confirmation Hearing

- Debtors make offer of proof – all confirmation standards under section 1129(a) and (b) satisfied except for section 1129(a)(3)
 - *UST accepts offer of proof, Court so finds*
- Sole issue is 1129(a)(3)'s requirement that: “[t]he plan has been **proposed** in good faith and not by any **means** forbidden by law.”
 - Debtors: “*Proposed*” modifies “*by any means forbidden by law.*” 1129(a)(3)'s intent is to evaluate manner by which the plan was proposed; substantive content left for other sections
 - UST: *Plan is “forbidden by law”* Debtor cannot satisfy 1129(a)(3) where any involvement of any marijuana asset in a bankruptcy case, even where plan implementation doesn't rely on marijuana-related assets or income

In re Cook Investments Plan Confirmed

- Court Confirms Plan:
 - Rejects Debtors' interpretation of 1129(a)(3)
 - Determines that 1129(a)(3) requires that a Plan not be proposed by any "means" forbidden by law
 - Here, Plan was neither based upon violations of CSA, nor dependent on Green Haven lease income (lease rejected)

In re Cook Investments

Appellate Review

- UST appealed both denial of MTD and Confirmation Order to District Court
- Both Bankruptcy Court and District Court deny UST's Motion for Stay Pending Appeal
- District Court Affirms, March 26, 2018
 - *Also denies UST's Motion for Stay Pending Appeal*
- UST appeals to Ninth Circuit (Case No. 18-35119)
 - *UST does not request stay from Ninth Circuit*
- Argument conducted Monday, December 3rd, 2018

In re Cook Investments Appellate Review

- Garvin v. Cook Investments NW, 922 F.3d 1030 (9th Cir. 2019)
 - *Opinion filed May 2, 2019*
 - *Affirms district court's affirmance of bankruptcy court order confirming plan*
 - *Ninth Circuit sidestepped "tension" between CSA and Bankruptcy Code*
 - *Adopted Debtors' interpretation of section 1129(a)(3)*
 - "Plain text" of statute directs bankruptcy court to "police the means of a reorganization plan's *proposal*, not its substantive provisions."
 - To read otherwise would make sections 1129(a)(1) and (a)(16) superfluous
 - 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."

In re Cook Investments

Takeaways

- Ninth Circuit only – for now
- Eliminates basis for objecting to plan confirmation based on substantive content
- May reflect a more appellate openness to regarding marijuana companies and access to bankruptcy relief
- Ruling narrow:
 - *Court did not address tension between bankruptcy relief and CSA*
 - *Likely only helpful for chapter 11 debtor that has survived motion to dismiss*
 - *Plan did not rely on marijuana assets or income – lease had been rejected*

How Far Do We Go? Who is in Harm's Way?

- Equipment lessors – leases a copy machine to a marijuana retailer
- Apartment building owners – need to determine tenant's income source each month?
- Retailers – did *Sears* need to determine each customer's source of income?
- Service providers: plumbers, yard service, contractors
- Restaurants: Does *Restaurants Unlimited* need to trace source of guest payments?
- *In re Adair* (Bankr. D. Or. 2019): debtor works for employment agency that supplies workers to marijuana business (UST moved to dismiss, debtor voluntarily dismissed case)
- *In re Way To Grow*, 597 BR 111: debtor sold equipment used by marijuana industry; court dismissed case under sec. 1112(b).



Violations of Other Federal Law Not Eligible for Bankruptcy Relief?

- Widget manufacturer: Outstanding OSHA violations
- Chain of auto repair shops or dry cleaners: Outstanding EPA violations
- Trucking firm: Outstanding NHTSA safety violations; half of fleet violating emission standards
- *Any* business: Unpaid federal income and withholding taxes

Relevant Case Law

- *In re Rent-Rite Super Kegs West Ltd.*, 484 BR 799 (Bankr. D. Colo. 2012) (where “[b]ecause a significant portion of the Debtor’s income is derived from an illegal activity, §1129(a)(3) forecloses any possibility of this Debtor obtaining confirmation of a plan that relies in any part on income derived from a criminal activity)
- *In re Arenas*, 514 BR 887 (Bankr. D. Colo 2014) (dismissing case where debtors could not “under the present circumstances, feasibly propose a chapter 13 plan that does not depend on income from sources that are illegal under the CSA for the plan’s execution.”)
- *In re MedPoint Management*, 528 B.R. 178) (dismissal of a Chapter 7 involuntary petition stating that a trustee could not administer marijuana assets without violating federal law)
- *In re McGinnis*, 453 B.R. 770, 772 (Bankr. D. Or. 2011) (denying confirmation of chapter 13 plan where plan depended on cultivation and sale of medical marijuana)
- *In re Arm Ventures LLC*, 564 B.R. 77 (Bankr. S.D. Fla. 2017) (holding that filing a Chapter 11 while relying on rental income from a marijuana business was bad faith)
- *In re Johnson*, 532 BR 53 (Bankr. W.D. Mich 2015)