MARIJUANA: THE INTERSECTION OF FEDERAL AND STATE LAW

By: Keri L. Riley*

Bankruptcy courts across the country have had to navigate the intersection between federal and state law with increased regularity as more states legalize the sale and production of marijuana. In 2018, Michigan voted to become the eleventh state to legalize recreational and medical marijuana, joining Colorado, Washington, Oregon, California, Nevada, Alaska, Vermont, Massachusetts, Maine and Washington, DC.[1] An additional twenty states have voted to legalize cannabis for medical use. While the trend of legalization of marijuana for medical and recreational use is likely to continue on a state level, it remains illegal on a federal level, forcing bankruptcy courts to navigate the intersection when businesses and individuals with some connection to marijuana file for bankruptcy.

Current Federal Law

The Controlled Substances Act [21 U.S.C. §§801 *et seq.*] ("CSA") was enacted by Congress in 1970 to consolidate the piecemeal drug laws and enhance federal enforcement powers.[2] In doing so, "Congress devised a closed regulatory system making it unlawful to manufacture, distribute, dispense, or possess any controlled substance except in a manner authorized by the CSA[,]" resulting in the creation of five schedules into which drugs are categorized based on use, effects, and addictive traits.[3] At the time of enacting the CSA, cannabis[4] was listed as a Schedule I drug, and remains a Schedule I drug to this day.[5]

In defining acts that are unlawful under the CSA, 21 U.S.C. § 841 provides:

> **(a)** Unlawful acts. Except as authorized by this title, it shall be unlawful for any person knowingly or intentionally--
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> **(1)** to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance; or
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> **(2)** to create, distribute, or dispense, or possess with intent to distribute or dispense, a counterfeit substance.

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[1] Business Insider, Nov. 7, 2018, https://www.businessinsider.com/legal-marijuana-states-2018-1

[2] *Gonzales v. Rich*, 545 U.S. 1, 12 (2005).

[3] *Id.* at 13-14.

[4] The CSA refers specifically to "marihuana" which has become interchangeable with "marijuana" and "cannabis" in subsequent years.

[5] *See* 21 U.S.C. § 812(c); 21 U.S.C. § 802(15); *Nat'l Org. for Reform of Marijuana Laws (NORML) v. Drug Enforcement Administration, U.S. Dep't of Justice*, 559 F.2d 735, 738 (D.C. Cir. 1977).

In addition to acts that are defined as unlawful under section 841, the CSA further provides that it shall be unlawful to engage in maintaining a drug involved premises[6] or sell drug related paraphernalia[7], as defined by 21 U.S.C. § 863(d). Additionally, it is an unlawful act to knowingly possess, distribute, manufacture, import, or export "any three-neck round-bottom flask, tableting machine, encapsulating machine, or gelatin capsule, or any equipment, chemical, product, or material which may be used to manufacture a controlled substance or listed chemical, knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance or listed chemical in violation of this title[.]"[8] In defining these unlawful acts, the CSA expressly sets forth the activities related to controlled substances, including cannabis, that are illegal under federal law.

Direct Connections to Marijuana

A. Dismissal is Mandated

While marijuana may be legal under federal law, bankruptcy courts must still turn to the CSA to determine if a debtor's business operations conflict with federal law, thus making the debtor ineligible for the protections afforded by the Bankruptcy Code. In the context of a Chapter 11 and a Chapter 13, a debtor must propose a plan in "good faith and not be any means forbidden by law."[9] In the context of a Chapter 7, courts have held that a trustee cannot take control of or administer assets when doing so would require the trustee to commit a felony.[10]

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[6] 21 U.S.C. § 856 states:

> **(a)** Unlawful acts. Except as authorized by this title, it shall be unlawful to--
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> **(1)** knowingly open, lease, rent, use, or maintain any place, whether permanently or temporarily, for the purpose of manufacturing, distributing, or using any controlled substance;
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> **(2)** manage or control any place, whether permanently or temporarily, either as an owner, lessee, agent, employee, occupant, or mortgagee, and knowingly and intentionally rent, lease, profit from, or make available for use, with or without compensation, the place for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance.

[7] 21 U.S.C. § 863 states:

> **(a)** In general. It is unlawful for any person--
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> **(1)** to sell or offer for sale drug paraphernalia;
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> **(2)** to use the mails or any other facility of interstate commerce to transport drug paraphernalia; or
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> **(3)** to import or export drug paraphernalia.

[8] 21 U.S.C. § 843(a)(6) and (a)(7).

[9] 11 U.S.C. §§ 1129(a)(3), 1325(a)(3).

[10] *See In re Arenas*, 514 B.R. 887, 895 (Bankr. D. Colo. 2014).

In those cases where the debtor has a connection to marijuana, the courts have based their decisions on whether the debtor was acting in direct violation of the CSA.[11] In the seminal case of *Rent-Rite*, the bankruptcy court focused on the ongoing violation of the CSA by the Chapter 11 debtor in holding that its case was subject to dismissal.[12] The debtor owned a warehouse located in Denver, Colorado, which was leased in part to tenants who used the space for the ongoing cultivation of cannabis.[13] Approximately 25% of the debtor's revenue was derived from leasing space to the cannabis cultivators.[14] After the debtor filed its Chapter 11 bankruptcy case, the primary secured creditor filed a motion to dismiss the case, arguing that the debtor's ongoing criminal activities should deprive the debtor of the protections afforded by the Bankruptcy Code.[15] In ruling on the motion to dismiss, the court held that the debtor was in direct violation of 28 U.S.C. § 856 by knowingly renting the space for the purposes of allowing the tenants to cultivate cannabis.[16] Because the debtor was knowingly violating the CSA under the assumption that Colorado law would preempt federal law, the court held that the bankruptcy court, as a federal court, could not be asked to enforce the protections of the Bankruptcy Code in aid of a debtor whose actions "constitute a continuing federal crime."[17] As a result, because of the debtor's ongoing criminal conduct, the court held that cause existed for dismissal or conversion of the debtor's case pursuant to 11 U.S.C. § 1112(b), subject to a determination as to which would be in the best interests of creditors.[18]

In *Arenas*, the debtors' violation of the CSA again formed the basis for dismissal of a Chapter 7 bankruptcy case.[19] The debtors were engaged in the cultivation and sale of marijuana, and also owned real property that was leased to a marijuana dispensary.[20] The debtors only other

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[11] *E.g., Arenas v. United States Trustee (In re Arenas)*, 535 B.R. 845, 851 (B.A.P. 10th Cir. 2015)(affirming the bankruptcy court's dismissal of the debtors' case because the debtors were violating the CSA by growing and selling cannabis, as well as leasing space to a cannabis dispensary); *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799, 803-04 (Bankr. D. Colo. 2012); *Olson v. Van Meter (In re Olson)*, BAP No. NV-17-1168-LTiF, 2018 Bankr. LEXIS 480, at *17-18 (B.A.P 9th Cir. Feb. 5, 2018)(holding that the bankruptcy court had committed reversible error by failing to make findings that the elements of the alleged CSA violation, including establishing the intent elements of the violation); *In re Johnson*, 532 B.R. 53, 58-59 (Bankr. W.D. Mich. 2015)(holding that the debtors' cultivation and sale of cannabis was "patently incompatible with a bankruptcy proceeding").
[12] 484 B.R. at 803-04.
[13] *Id.* at 803.
[14] *Id.*
[15] *Id.* at 802.
[16] *Id.* at 803-04.
[17] *Id.* at 805.
[18] *Id.* at 810-11.
[19] *In re Arenas*, 514 B.R. 887, 895 (Bankr. D. Colo. 2014).
[20] *Id.* at 888.

source of income was social security and pension benefits in an amount significantly less than their monthly expenses.[21] After the debtors filed their Chapter 7 bankruptcy case, the United States Trustee filed a motion to dismiss, asserting that it would be impossible for the Chapter 7 trustee to administer the assets of the estate without violating federal law.[22] In an effort to avoid dismissal, the debtors instead moved to convert their case to Chapter 13.[23] The bankruptcy court held that because the trustee would be in violation of the CSA if he took possession of the assets of the estate, namely the leased real property and the cannabis plants, the trustee could not administer the estate assets, allowing the debtors to receive the benefit of a discharge without allowing creditors to receive the benefit of the trustee's administration of the estate.[24] The court further held that the debtors could not convert their case to a Chapter 13, as the debtors could not propose a confirmable plan because they lacked sufficient income to do so, even with the income from cannabis.[25] Accordingly, the bankruptcy court held that cause existed to dismiss the debtors' case.[26]

On appeal to the Tenth Circuit Bankruptcy Appellate Panel, the debtors argued that the trustee could have abandoned the marijuana assets out of the estate as a means of curing the violation of the CSA.[27] The Bankruptcy Appellate Panel rejected this argument, holding that the debtors had violated federal law and were continuing to do so.[28] The court held that the debtors had exposed the trustee to violations of federal criminal law to the extent he administered the assets, stating that "nothing could be more burdensome to the Trustee's administration than requiring him to take possession, sell, and distribute marijuana assets in violation of federal criminal law."[29] The court further held that if assets were abandoned, the debtors would be able to retain their business while providing creditors with little to no recovery while receiving the benefit of a discharge, resulting in a prejudicial delay that would itself be cause for dismissal.[30] The court therefore held that dismissal of the case was warranted given the ongoing violation of the CSA, and therefore affirmed the decision of the bankruptcy court.[31]

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[21] *Id.* at 894.
[22] *Id.* at 889, 891.
[23] *Id.* at 891.
[24] *Id.* at 891-92.
[25] *Id.* at 894.
[26] *Id.* at 895.
[27] *Arenas*, 535 B.R. at 848, 854.
[28] *Id.* at 853-54.
[29] *Id.* at 852.
[30] *Id.* at 853-54.
[31] *Id.* at 854.

B. Dismissal Can Be Avoided If A Cure Is Possible

While these seminal cases seem to suggest that a case must be dismissed once it has been tainted by the presence of marijuana, recent cases suggest that when the CSA violation is curable, the debtor may still be entitled to the protections afforded by the Bankruptcy Code. For instance, in *Johnson*, the Chapter 13 debtor given the choice between continuing with his bankruptcy case, or continuing to cultivate and sell marijuana.[32] At the time of his bankruptcy filing, he was deriving income from cultivating and selling cannabis to three patients and a regulated dispensary in compliance with applicable Michigan law in addition to receiving social security income.[33] After filing his Chapter 13 bankruptcy case, the United States Trustee filed a motion to dismiss, asserting that because the debtor was engaged in growing and selling marijuana, the debtor should not be afforded the protections of the Bankruptcy Code to "aid violations of the federal Controlled Substances Act."[34] In ruling on the motion to dismiss, the court held that the debtor's financial life was "inextricably bound up with his federal criminal activity through his chapter 13 plan[.]"[35] The court held that that just as a trustee was precluded from using estate assets to violate federal law, including federal criminal law, so too is a debtor in possession.[36] The court held that the debtor's actions in growing and selling cannabis were a violation of the CSA, and stated that:

> The Debtor's business is patently incompatible with a bankruptcy proceeding, but his financial circumstances are not. In other words, if the Debtor were not engaged in post-petition criminal activity, there would likely be no controversy about his eligibility for relief under chapter 13. The problem, of course, is that he derives nearly half of his income from activity that Congress forbids as criminal. The Debtor, it seems, must choose between conducting his medical marijuana business and pursuing relief under the Bankruptcy Code.[37]

Because the debtor's business activity in cultivating and selling cannabis was a violation of the CSA, the court held that the debtor was required to choose between continuing to cultivate and sell cannabis, or continue with his bankruptcy case.[38]

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[32] 532 B.R. at 57.
[33] *Id.* at 55.
[34] *Id.* at 54.
[35] *Id.* at 57.
[36] *Id.* at 57.
[37] *Id.*
[38] *Id.* at 59.

In *Arm Ventures, LLC*, the debtor was again given the choice between continuing to derive income from the sale of cannabis, or proceed with a reorganization under Chapter 11.[39] The Debtor owned a 48.8% interest in a commercial building leased to three separate companies.[40] After filing its bankruptcy case, the debtor proposed a plan which proposed to lease a portion of the building to a medical marijuana dispensary.[41] The primary secured creditor filed a motion to dismiss, asserting that the debtor had filed its case in bad faith pursuant to 11 U.S.C. § 1112(b).[42] In ruling on the motion to dismiss, the court held that it was highly unlikely that the proposed tenant would be able to operate in accordance with federal law, as growing and selling cannabis was illegal under Federal Law and only one research facility had obtained a federal permit to grow and sell marijuana.[43] As a result, any income the debtor derived from leasing the facility to a medical marijuana dispensary would also be illegal under federal law.[44] The court ultimately declined to dismiss the case, recognizing that the best interests of creditors would be best served by allowing the debtor to remain in bankruptcy, but holding that the debtor must propose a plan that did not rely on income from marijuana, barring which the debtor's case would be subject to conversion to a case under Chapter 7.[45]

In each of these cases, the debtors were in clear violation of the CSA, whether by growing and selling marijuana, or by leasing a space to a grower or seller of marijuana. With a clear cut violation of federal law, the only question that remained for the courts to decide was whether the respective debtors could be successfully rehabilitated by stripping away the conduct that was violating federal law. If the bankruptcy case could not proceed without violating federal law, the only remaining option is dismissal.

Garvin v. Cook Investments NW, SPNWY, LLC

Downstream Marijuana Businesses

As states continue to legalize marijuana, the problem that marijuana poses to the bankruptcy court will spill over into other industries and professions. The interplay between state

[39] 564 B.R. 77, 86 (Bankr. D. Fla. 2017).
[40] *Id.* at 79.
[41] *Id.* at 81.
[42] *Id* at 80.
[43] *Id.* at 85.
[44] *Id.* at 84-85.
[45] *Id.* at 86.

and federal laws is also starting to reach those businesses that can be considered "downstream" marijuana related businesses, such as material and equipment suppliers or management companies that have no direct interaction with marijuana growers or distributors, but derive a profit from the marijuana industry. In these cases, the violation of the CSA may not be as clear cut, but bankruptcy courts are still required to determine whether these debtors can receive the benefits of the Bankruptcy Code.

The first example of a "downstream" marijuana related company is *In re Medpoint Management,* LLC. In *Medpoint Management*, the debtor was engaged in business as the holder of intellectual property, including a trade name for cannabis products, which it licensed to a medical marijuana dispensary.[46] The debtor had previously acted as the manager for the dispensary, creating an avenue for the dispensary to drain off cash to allow the dispensary to operate on a not-for-profit basis as required by Arizona state law.[47] Following the termination of the management contract, the debtor's only source of revenue was from licensing its intellectual property to the dispensary.[48] After a creditor filed an involuntary bankruptcy petition against Medpoint, the debtor moved to dismiss the case, asserting that all of its assets and revenues were directly tied to cannabis, and that a Chapter 7 trustee could not administer the assets without violating the CSA.[49] The bankruptcy court agreed with the debtor, stating that it "observ[ed], without deciding, that it is quite possible that Medpoint's IP and the IP licensing revenues could be seized or forfeited, and that Medpoint could be or could have been guilty of facilitation of a crime under the CSA."[50] Accordingly, the court dismissed the involuntary petition.[51]

More recently, the Colorado Bankruptcy Court considered the issue of a "downstream" marijuana related business in *In re Way to Grow, Inc.*[52] Way to Grow ("WTG") was a Colorado based gardening supply store that specialized in high end gardening supplies and indoor gardening products, including supplies for growing plants in a hydroponic environment. Prior to the bankruptcy filing, the owner of the company, Corey Inniss ("Inniss"), sold WTG to its parent company, Pure Agrobusiness, Inc. ("Pure") for a cash price of $2.5 million, a secured promissory

[46] *In re Medpoint Mgmt.*, 528 B.R. 178, 181 (Bankr. D. Ariz 2015), vacated on other grounds by *Medpoint Mgmt. v. Jensen (In re Medpoint Mgmt.)*, 2016 Bankr. LEXIS 2197 (9th Cir. B.A.P. June 3, 2016).
[47] *Id.* at 180, 186.
[48] *Id.* at 181.
[49] *Id.* at 183.
[50] *Id.* at 185.
[51] *Id.* at 188.
[52] 597 B.R. 111 (Bankr. D. Colo. 2018).

note in the original principal balance of $22,500,000, and 12,500,000 shares of stock in Pure. In Spring 2018, WTG, Pure, and another subsidiary of Pure, Green Door Agro, Inc. ("GDA") defaulted on the secured promissory note, resulting in Inniss filing a receivership action against the companies in state court. To avoid the appointment of the receiver and reorganize, WTG, Pure, and GDA filed their voluntary petitions for relief pursuant to Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of Colorado.

Shortly after the cases were filed, Inniss filed a Motion to Dismiss or Abstain, asserting that the debtors were ineligible for relief under the Bankruptcy Code because the debtors' connections with the marijuana industry constituted aiding and abetting pursuant to 18 U.S.C. § 2. Both the Debtors and Inniss agreed that the Debtors did not sell any marijuana, did not manufacture marijuana, and did not own real property that was leased to a marijuana grower or manufacturer. Instead, the focus was placed on the customers purchasing the products sold by WTG and GDA, the use to which those products were put, and the Debtors' knowledge, or lack thereof, of what their customers were doing with the products. The Debtors responded, arguing that because GDA and WTG were selling indisputably legal gardening supplies, and had no direct connections to marijuana, such as selling or distributing marijuana, and were not selling drug paraphernalia, WTG and GDA were not in violation of any federal law, and could therefore utilize the protections afforded by the Bankruptcy Code.

Following a four day trial, the Bankruptcy Court entered an Order granting the Motion to Dismiss or Abstain on the basis that the Debtors were violating 21 U.S.C. § 843(a)(7), a statute raised for the first time in Order, holding that the Debtors knew that they were distributing gardening supplies, knowing or having reasonable cause to believe that the products were being used to grow marijuana. In ruling on the Motion, the Court expressly held that the Debtors were not aiding and abetting a violation of the CSA, nor were the Debtors engaged in a conspiracy to violate the CSA. The Court stated

> The Debtors' business is not limited in scope to marijuana sales. The evidence certainly shows many of the Debtors' customers are in the marijuana industry. As discussed below, this fact is no secret to the Debtors. However, by its nature and as shown by the evidence, the Debtors' business serves a broad customer base consisting of both commercial and individual horticulturalists, growing a variety of legal crops. Debtors' intent is to sell its product to any clientele engaged in hydroponic horticulture, and Debtors' products are generally applicable to those activities regardless the specific crop

> grown. Without sharing its marijuana-connected customers' specific intent to cultivate and distribute marijuana, Debtors are not aiding and abetting violations of the CSA.

In holding that the Debtors had violated Section 843(a)(7) of the CSA, the Court held that there was ample evidence that the Debtors had reasonable cause to believe its products were being used to grow marijuana. The Court relied on evidence at trial that demonstrated that Inniss had tailored the product mix at WTG for marijuana growers, and that the product mix had not changed significantly since Pure acquired the company. The Court also relied on evidence that customers used aliases for accounts, prior promotions with cannabis growers, and the managers' knowledge of what their customers were growing. The Court held that while the "Debtors do not share their customers' specific intent to violate the CSA, Debtors certainly know they are selling products to customers who will, and do, use those products to manufacture a controlled substance in violation of the CSA. Debtors tailor their business to cater to those needs, tout their expertise in doing so, and market themselves consistent with their knowledge. There is no evidence this business model has materially changed post-petition." As a result, the Court held that the Debtors' conduct violated section 843(a)(7), and dismissal was therefore mandated. The Debtors have subsequently appealed the ruling to the United States District Court for the District of Colorado, and are awaiting a decision.

As more states continue to legalize marijuana, bankruptcy courts may be required to engage in a fact intensive analysis early in the case to determine whether the debtor has any connections to the marijuana industry, and the degree of those connections. In cases where the debtor's operations involve supplying equipment, providing management services, or deriving some form of income from a dispensary or a grow house, such as a janitor providing cleaning services, the bankruptcy court will likely be required to determine if the debtor can seek relief under the Bankruptcy Code. Questions will arise as to the percentage of income the debtor is receiving from marijuana-based operations, and the extent of the connection. Until clear cut lines are determined at a district court or circuit court level, it will likely be up to the discretion of the bankruptcy court to determine where the line is drawn, and what degree of connection to the marijuana industry is permissible.