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Code to Code

BY STEVEN J. BOYAJIAN

Just Say No to Drugs?

Creditors Not Getting a Fair Shake When Marijuana-Related Cases Are Dismissed

Steven J. Boyajian
Robinson & Cole LLP
Providence, R.I.

Steve Boyajian is counsel in the Providence, R.I., office of Robinson & Cole LLP.

Bankruptcy serves dual purposes: (1) afford relief to honest debtors and (2) ensure the equitable distribution of assets to a debtor's creditors. In a recent string of cases, bankruptcy courts have generally rejected requests for relief from debtors and creditors with relationships to marijuana businesses. In so doing, bankruptcy courts have prioritized federal criminal law over creditors who rely on the protections afforded by the Bankruptcy Code. This is the position of the U.S. Department of Justice (DOJ), too. The Executive Office of U.S. Trustees (EOUST) recently sent a directive to private trustees reminding them that "marijuana assets [*i.e.*, marijuana, the proceeds derived therefrom, and the assets used in its production and distribution] ... may not be administered under the Bankruptcy Code," and indicating that U.S. Trustees will seek dismissal of all cases involving "marijuana assets."[1]

In a spirited video response to the directive, Hon. **Keith Lundin** (ret.) noted the long experience of bankruptcy courts and fiduciaries in dealing with assets derived from illegal activity.[2] Indeed, some of the largest and most notable bankruptcies recently have involved assets attributable to far-reaching criminal conspiracies: Enron, Drier LLP and Madoff Securities (although not technically a bankruptcy). The fact that estate assets were derived from criminal conduct did not impede their effective administration in the bankruptcy courts.

Judge Lundin argued that the competing claims to marijuana assets, such as a federal forfeiture of a building subject to a creditor's mortgage, are precisely the types of matters that bankruptcy courts are set up to address.[3] Further, Judge Lundin noted that the DOJ, which regularly appears on behalf of federal agencies in bankruptcy cases, may have placed its thumb on the scales by directing private trustees, who are neutral by design, to accede to the government's position that marijuana assets may not legally be administered in bankruptcy.[4]

Almost one-fifth of the U.S. population lives in states or territories where adult recreational use of marijuana is legal under state law, and an estimated 200 million people live in the 34 states or territories where medicinal use of marijuana is permitted.[5] As states decriminalize marijuana use and production, state-legalized marijuana is likely to play some part in the financial affairs of an increasing number of debtors. By extension, a growing number of creditors will be subject to the legal uncertainties that exist at the intersection of bankruptcy and criminal law. For the sake of creditors, it would be best if the ongoing conflict over marijuana policy take place outside of bankruptcy court so that cases can continue to be administered for the benefit of creditors.

Brief History of Marijuana Cases

Courts have not always shied away from handling marijuana-related bankruptcies. In a landmark double-jeopardy case, *Dep't of Revenue v. Kurth Ranch*, the U.S. Supreme Court affirmed the disallowance of claims filed by the Montana Department of Revenue in the bankruptcies of several debtors who were collectively engaged in Montana's then-largest known marijuana-farming operation.[6] The

1 Letter from Clifford J. White, Director, Executive Office of U.S. Trustees to Chapter 7 and Chapter 13 Trustees of April 26, 2017, *available at* https://www.justice.gov/ust/file/marijuana_assets.pdf/download (unless otherwise indicated, all links in this article were last visited on July 28, 2017).
2 *See* "Up in Smoke, Bankruptcy Workshop," Season 2, Episode 3, *available at* lundinonchapter13.com.
3 *Id.*
4 *Id.*
5 Avantika Chilkoti, "States Keep Saying Yes to Marijuana Use. Now Comes the Federal No.," *N.Y. Times*, July 16, 2017, at A18.
6 511 U.S. 767, 782 (1994).

bankruptcy court had disallowed Montana's claim for a tax on illicit drugs (approximately $900,000) on double-jeopardy grounds and ordered the state to pay approximately $30,000 to the bankruptcy trustee.[7] This amount represented the amount of the taxes that had already been collected, presumably from the marijuana assets associated with the debtors' farming operation.[8]

In affirming the decision of the lower courts, the Supreme Court held that Montana's tax constituted an unconstitutional second punishment for criminal offenses for which the debtors had been previously prosecuted and sentenced.[9] None of the written decisions in the string of appeals from the bankruptcy court to the Supreme Court disclosed an objection by the U.S. Trustee to the administration of marijuana assets in bankruptcy or a suggestion that such administration was illegal under federal law.

In *United States v. Klein (In re Chapman)*, the Ninth Circuit Bankruptcy Appellate Panel (BAP) recounted the facts that led to its consideration of whether the automatic stay would prevent the U.S. from proceeding with a forfeiture action.[10] The debtor had filed a chapter 7 petition in response to a forfeiture action in which the government alleged that the debtor's home was used for the manufacture and distribution of marijuana.[11] When the trustee sought to sell the home, the government objected,[12] arguing that the home was not property of the estate because under applicable federal law, the government's interest in the property, after judgment in the forfeiture action, would relate back pre-petition to the date of the crime justifying the forfeiture.[13]

The district court decided that the government's interest in the property did not relate back pre-petition because it had not yet obtained a judgment in the forfeiture action.[14] Therefore, the district court permitted the sale of the property by the trustee.[15] Ultimately, while the BAP decided that the automatic stay did not prevent the government from proceeding with the forfeiture action (with the sale proceeds remaining as the *res* in place of the debtor's home), there was no suggestion that the trustee's liquidation of the property violated federal law or that the bankruptcy should have been dismissed because of the existence of marijuana assets in the estate.

Recent Denial of Relief to Debtors — and Their Creditors

While older decisions on the subject are scarce, it is apparent that marijuana assets have been administered in bankruptcy without any suggestion that cases should be dismissed or that trustees were violating federal law by administering marijuana assets. This suggests that the EOUST's present position that "marijuana assets ... may not be administered under the Bankruptcy Code" and trustees would be "violating federal law by liquidating, receiving proceeds from, or in any way administering marijuana assets" might be born not so much from the illegality of marijuana under federal law as from the increasing legality of marijuana under state law. Regardless, more recent decisions on the subject indicate that bankruptcy courts are accepting the EOUST's position.

For example, in *Arenas v. United States Trustee (In re Arenas)*, the Tenth Circuit BAP affirmed the denial of the chapter 7 debtors' motion to convert to chapter 13 and the dismissal of the case, stating bluntly, "Can a debtor in the marijuana business obtain relief in the federal bankruptcy court? No."[16]

The joint debtors owned a building in which one unit was used for the operation of the husband's marijuana cultivation and wholesale business, and the other was rented to a marijuana dispensary.[17] Given the debtors' reliance on federally proscribed sources of income, the court denied the debtors' motion to convert, reasoning that the debtors could not propose a chapter 13 plan "in good faith and not by any means forbidden by law" as required by 11 U.S.C. § 1325(a)(3).[18] This aspect of *Arenas* is unsurprising, and it hardly needs explanation that a bankruptcy court should not supervise an ongoing criminal enterprise regardless of its status under state law. Less obvious is why the case should have been dismissed.

The court accepted the U.S. Trustee's argument that the trustee would necessarily violate the Controlled Substances Act in the administration of the estate.[19] Exactly why the trustee would need to violate the Controlled Substances Act is unclear. It would obviously violate federal law for the trustee to sell marijuana.[20] However, neither the court's opinion nor the U.S. Trustee's brief explain how the Controlled Substance Act would subject a chapter 7 trustee to criminal liability for asking the responsible federal authorities to dispose of the estate's marijuana and liquidating other estate property for distribution to creditors in accordance with the priorities of 11 U.S.C. § 726.[21] Left unsaid, and seemingly unconsidered, was the fact that the dismissal deprived the debtors' substantial creditor body of the right to an orderly and equitable distribution of the estate's assets and the potential augmentation of the estate through exercise of the trustee's avoidance powers.

The effect of dismissal on creditors can be seen more starkly in *In re Medpoint Mgmt.*, in which the court granted an alleged debtor's motion to dismiss an involuntary chapter 7 petition on the basis that the estate could not be effectively administered were an order for relief to enter.[22] In *Medpoint*, four petitioning creditors filed an involuntary chapter 7 petition against a marijuana dispensary-management company that did not engage in the manufacturing or distribution of marijuana, but offered business services to dispensaries.[23] It does not appear that the alleged debtor

7 *In re Kurth Ranch*, 145 B.R. 61, 76 (Bankr. D. Mont. 1990).
8 *Id.* at 65.
9 *Kurth Ranch*, 511 U.S. at 782-83.
10 264 B.R. 565, 567 (B.A.P. 9th Cir. 2001).
11 *Id.*
12 *Id.*
13 *Id.*
14 *Id.*
15 *Id.* at 568.
16 535 B.R. 845, 847 (B.A.P. 10th Cir. 2015).
17 *Id.* at 847.
18 *Id.* at 851-52.
19 *Id.* at 853-54.
20 *See* 21 U.S.C. § 841.
21 The suggestion is made by citation in a footnote that the trustee would necessarily violate 21 U.S.C. § 856(a), which generally prohibits making available any space for "the purpose of" the manufacture, storage, distribution or use of controlled substances. *See In re Arenas*, 535 B.R. at 852, n.40. However, were the trustee to ask the responsible federal authorities to take and destroy the estate's marijuana, it is unclear how control of the estate's empty real estate would constitute a criminal offense.
22 528 B.R. 178 (Bankr. D. Ariz. 2015), *vacated in part on other grounds by Medpoint Mgmt. v. Jensen (In re Medpoint Mgmt.)*, BAP No. AZ-15-1130-KuJaJu, 2016 Bankr. LEXIS 2197 (B.A.P. 9th Cir. June 3, 2016).
23 528 B.R. at 180, 181-82.

seriously contested that the petitioning creditors held claims of the requisite amount, or that it was failing to pay its debts as they became due. Rather, the alleged debtor's defense that its reliance on revenue from federally proscribed sources would result in any trustee violating federal law in the administration of the estate, and the petitioning creditors had unclean hands due to their dealings with a marijuana-related enterprise.[24] The court dismissed the involuntary petition, thereby allowing the alleged debtor to use its own federally proscribed conduct as a shield to protect it from the collection efforts of creditors holding seemingly undisputed claims. The court reasoned, "The dual risks of forfeiture of Medpoint's assets and a trustee's inevitable violation of the [Controlled Substances Act] in administration of a Medpoint chapter 7 constitutes cause" for dismissal of the involuntary petition.[25]

Medpoint creates two problems for creditors of marijuana-related businesses that hope to rely on their rights under the Bankruptcy Code. First, *Medpoint* illustrates the fact that downstream participants in the marijuana trade might be as ineligible for relief under the Bankruptcy Code as debtors who participate directly in the manufacture and sale of marijuana. This increases the risk that unwitting creditors will be deprived of rights under the Bankruptcy Code due to the federally proscribed conduct of businesses that appear legitimate. For example, if a building owner begins leasing space to a marijuana-related business in the tenth year of a 20-year mortgage loan, the unwitting lender could be deprived of its rights under the Bankruptcy Code and left to decide how to foreclose or take possession of a building containing illegal substances without the aid of judicial supervision.[26] Second, *Medpoint* uses the specter of forfeiture of estate assets as grounds for dismissal of bankruptcy proceedings, thereby creating a class of stranded assets that are even less suited to liquidation outside of bankruptcy than they are to orderly liquidation in bankruptcy.[27]

The Forfeiture Problem

As illustrated by *Chapman* and recognized by *Medpoint*, the forfeiture of marijuana assets can have serious consequences to a bankruptcy estate. However, the possibility of forfeiture alone should not dissuade courts or trustees from administering marijuana-related cases since trustees and creditors may well have claims that take priority over the government's right to forfeiture of certain assets.[28] There are two classes of assets that are subject to forfeiture under the Controlled Substances Act: tainted property and substitute property.[29] Tainted property consists of those assets that constitute proceeds of or are otherwise derived from criminal activity.[30] Substitute property consists of "untainted property that the government may seize to satisfy a forfeiture judgment if the tainted property is unavailable."[31] With respect to tainted property, the government's right to the property relates back to the time of the act giving rise to the right of forfeiture. Therefore, it is likely that the government's interest in tainted assets will be superior to the rights of a bankruptcy trustee appointed after a debtor engaged in the marijuana trade.

However, with respect to substitute property, the government's rights do not relate back.[32] Consequently, upon the filing of a bankruptcy petition, a bankruptcy estate may well obtain rights to untainted substitute property that are superior to the government's. In the normal order of things, this property would be distributed to creditors, including the government under 11 U.S.C. § 726(a)(4). However, dismissal of a bankruptcy case where the estate includes tainted and untainted property allows the government to seek forfeiture of substitute property without the hindrance of claims that would take priority under the Bankruptcy Code. This fact is what makes the EOUST's directive to independent trustees troubling. The U.S. stands to gain at the expense of creditors when marijuana-related bankruptcies are dismissed without consideration to the availability of untainted assets for distribution to creditors.

Conclusion

Making the bankruptcy courts a battleground in the conflict between state and federal marijuana policies may result in precedent that erodes the critical role bankruptcy courts and fiduciaries play in unwinding the financial affairs of criminal enterprises in a manner that is fair to creditors. While it is sensible that marijuana businesses not be allowed to operate under the supervision of bankruptcy courts, it does not follow that the bankruptcy system should be off-limits to parties who have some relationship to the marijuana trade. abi

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24 *Id.* at 182-83.
25 *Id.* at 186.
26 *See, e.g., In re Rent-Rite Super Kegs West Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012) (finding cause to dismiss or convert property owner's chapter 11 proceeding where substantial portion of debtor's rents were derived from lease to marijuana grower). For a further discussion of the risks presented to creditors of downstream marijuana-related businesses, *see* Candace C. Carlyon and Matthew R. Carlyon, "Bankruptcy Courts Deny Relief to Marijuana Businesses," XXXIII *ABI Journal* 12, 42-43, 89, December 2014, *available at* abi.org/abi-journal.
27 *See id.*
28 *See United States v. Erpenbeck*, 682 F.3d 472, 478 (6th Cir. 2012).
29 *See id.* at 477.
30 *See* 21 U.S.C. § 853(a).
31 *Erpenbeck*, 682 F.3d at 477.
32 *Id.* at 477-78.