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Advising Financially Distressed Companies in the Cannabis Industry

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Background

- Several states have legalized the cultivation, distribution and use of marijuana.
- Some states have legalized it only for medical purposes, while others have also legalized for recreational purposes.
- However, marijuana remains illegal under federal law (the Controlled Substances Act).
- Because marijuana is illegal under federal law, marijuana businesses (even those that are legal under state law) typically are unable to use the U.S. Bankruptcy Code to restructure their debts or to sell their assets.

The Controlled Substances Act

- The Controlled Substances Act (21 U.S.C. § 801 *et seq.*) governs the importation, manufacture, distribution and dispensation of controlled substances in the United States.
- The statute established five schedules of controlled substances: Schedules I, II, III, IV and V.
- Marijuana is classified as a “Schedule I” substance. Schedule I substances are those deemed to have:
 - a high potential for abuse;
 - no currently accepted medical use in treatment in the U.S.; and
 - a lack of accepted safety for use under medical supervision.
- Possession, manufacture, distribution and dispensing of marijuana is illegal under the Controlled Substances Act.

Premises Housing Marijuana Businesses

- Under 21 U.S.C. § 856, it is illegal:
 - to knowingly open, lease, rent, use, or maintain any place, whether permanently or temporarily, for the purpose of manufacturing, distributing or using any controlled substance, or
 - to 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.

Previous Department of Justice Guidance

- Ogden Memo (2009):
 - Provided guidance to federal prosecutors in states that authorized the medical use of marijuana.
 - Guidance dealt with how to deploy resources to enforce the Controlled Substances Act in connection with federal prosecutors' broad discretion to address federal criminal matters.
 - Memo stated that the prosecution of significant traffickers of illegal drugs and the disruption of illegal drug manufacturing and trafficking networks were a core priority.
 - Likely not an efficient use of resources to focus on individuals whose actions are “in clear and unambiguous compliance with existing state laws providing for the medical use of marijuana.”

Previous Department of Justice Guidance (cont'd)

- First Cole Memo (2011):
 - Updated the Ogden Memo for jurisdictions that have considered or implemented legislation permitting and regulating the commercial cultivation and distribution of medical marijuana.
 - Clarified that it was “likely not an efficient use of federal resources to focus enforcement efforts on individuals with cancer or other serious illnesses who use marijuana as part of a recommended treatment regimen consistent with applicable state law, or their caregivers.”
 - Stated that the Ogden Memo was never intended to shield “large-scale, privately-operated industrial marijuana cultivation centers” from federal enforcement action and prosecution, even where those activities purportedly comply with state law.

Previous Department of Justice Guidance (cont'd)

- Second Cole Memo (2013):
 - Addressed state initiatives to legalize possession of small amounts of marijuana (not just for medical use).
 - Described eight federal enforcement priorities with respect to marijuana (such as preventing distribution of marijuana to minors, preventing revenue from marijuana sales from going to criminal enterprises, and preventing violence and the use of firearms in the cultivation and distribution of marijuana).
 - Outside of the federal enforcement priorities, the federal government relies on state and local law enforcement to address marijuana activity consistent with their own laws.
 - Guidance rested on the expectation that states will implement strong and effective regulatory and enforcement systems to minimize threats to federal enforcement priorities.

Previous Department of Justice Guidance (cont'd)

- Third Cole Memo (2014):
 - Clarified that federal money laundering statutes, the unlicensed money remitter statute and the Bank Secrecy Act remain in effect with respect to marijuana-related conduct.
 - For example, if a financial institution or individual provides banking services to a marijuana-related business knowing that the business is diverting marijuana to states where marijuana sales are illegal, or is being used by a criminal organization to conduct financial transactions, prosecution under federal financial crimes laws may be appropriate.

U.S. Treasury Department Guidance

- U.S. Treasury Department Financial Crimes Enforcement Network (FinCEN) Guidance (2014).
 - Clarified how financial institutions can provide services to marijuana-related businesses consistent with their Bank Secrecy Act (“BSA”) obligations, and aligned the information provided by financial institutions in BSA reports with federal and state law enforcement priorities.
 - Stated that in assessing the risk of providing services to a marijuana-related business, a financial institution should conduct customer due diligence. As part of its due diligence, a financial institution should consider whether a marijuana-related business implicates one of the Cole Memo enforcement priorities or violates state law.
 - Stated that the obligation to file a Suspicious Activity Report is unaffected by any state law that legalizes marijuana.

Sessions Memo

- Sessions Memo (2018):
 - Rescinded the Ogden Memo and the three Cole Memos, because “nationwide guidance specific to marijuana enforcement is unnecessary.”
 - Stated that “[i]n deciding which marijuana activities to prosecute under these laws with the Department's finite resources, prosecutors should follow the well-established principles that govern all federal prosecutions.”
 - Federal prosecutors should “weigh all relevant considerations, including federal law enforcement priorities set by the Attorney General, the seriousness of the crime, the deterrent effect of criminal prosecution, and the cumulative impact of particular crimes on the community.”

Pending Legislation

- Proposed STATES Act (Strengthening the Tenth Amendment Through Entrusting States) would amend the CSA to exempt from federal enforcement parties that comply with state marijuana laws.
- SAFE (Secure and Fair Enforcement) Banking Act would open banking and insurance channels to cannabis companies.
- Neither of these pieces of legislation has become law.

Bankruptcy Currently Not an Option for Marijuana-Related Businesses

- Because it remains a federal crime to grow, distribute, possess or use marijuana, bankruptcy generally is not an option for failing marijuana-related businesses (including businesses that are not directly involved with cultivating or dispensing the drug), even those that are legal under state law.
- U.S. Trustee's policy is to seek dismissal of cannabis bankruptcy cases that cannot lawfully be administered, because:
 - The bankruptcy system should not be used as an instrument in the ongoing commission of a crime and reorganization plans that permit or require continued illegal activity may not be confirmed, and
 - Bankruptcy trustees and other estate fiduciaries should not be required to administer assets if it would cause them to violate federal law.

Previous Bankruptcy Cases – Cultivators and Distributors

- Individuals and entities that are directly engaged in the cultivation and sale of marijuana are typically unable to seek relief as a debtor under the Bankruptcy Code. Their cases will almost always be dismissed, at least if a party seeks dismissal.
- *Arenas v. U.S. Trustee (In re Arenas)*, 535 B.R. 845 (10th Cir. B.A.P. 2015). Bankruptcy Appellate Panel affirmed bankruptcy court's order denying the debtors' motion to convert Chapter 7 case to Chapter 13, and granting the US Trustee's motion to dismiss the case.
 - Debtors lacked the “good faith” required for Chapter 13 relief because their business was illegal under federal law. Additionally, if the case were to proceed in Chapter 13, the debtors would be unable to propose a feasible plan and the Chapter 13 trustee would be administering an illegal estate.
 - Chapter 7 case was dismissed “for cause.”

Cultivators and Distributors

- *In re Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015). Debtor had a medical marijuana business that complied with state law. US Trustee filed motion to dismiss his Chapter 13 case. Debtor sought to fund his Chapter 13 plan using only his Social Security benefits, and not from the proceeds from his marijuana business.
 - Court noted that even if the debtor segregated the proceeds of his marijuana business from his Social Security benefits, money is fungible and the arrangement would taint the court and the bankruptcy trustee.
 - Court enjoined the debtor from conducting his medical marijuana business while the bankruptcy case was pending.
- *In re Mother Earth's Alternative Healing Cooperative, Inc.*, Case No. 12-10223 (Bankr. S.D. Cal. Oct. 23, 2012). Bankruptcy court dismissed a Chapter 11 case filed by a medical marijuana grower, because the debtor would be unable to propose a Chapter 11 plan in good faith, and any plan would not be feasible.

Cultivators and Distributors

- *In re Medpoint Management, LLC*, 528 B.R. 178 (Bankr. D. Ariz. 2015), *vacated in part* 2016 WL 3251581 (9th Cir. B.A.P. 2016). Involuntary Chapter 7 case was filed against debtor, whose sole income was fees from a trademark licensed to a medical marijuana company.
 - Bankruptcy court held that “cause” existed to dismiss the involuntary case. Court did not want to require the Chapter 7 trustee to administer assets in violation of the CSA.
- But see *In re Wright*, Case No. 07-10375 (Bankr. N.D. Cal. Aug. 3, 2007). Bankruptcy court ruled that debtors were not eligible for Chapter 13, **but** stated that the debtors may be eligible for relief under Chapter 7. Debtors later converted their case to Chapter 7, and the U.S. Trustee did not object to the conversion.

Previous Bankruptcy Cases – Landlords

- Landlords that lease commercial space to marijuana businesses may also be precluded from seeking bankruptcy relief, even if the landlords do not participate in the marijuana business themselves.
- *In re Arm Ventures, LLC*, 564 B.R. 77 (Bankr. S.D. Fla. 2017). Debtor's single asset was a commercial building that it owned. One of the tenants sold medical marijuana.
 - Debtor proposed a Chapter 11 plan that relied on income generated from its tenants (including the marijuana dispensary).
 - Bankruptcy Court held that a Chapter 11 plan that funded partly from income generated by rent from a tenant in the marijuana business could not be confirmed.
 - The court allowed the lender to foreclose on the building.
- *In re Rent-Rite Super Kegs West Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012). Debtor owned a warehouse in which about 25% of the revenue was derived from tenants that cultivated marijuana.
 - Bankruptcy court dismissed the debtor's bankruptcy case.

Garvin v. Cook Investments (A Silver Lining?)

- In *Garvin v. Cook Investments NW, SPNWY, LLC*, 922 F.3d 1031 (9th Cir. 2019), the Ninth Circuit affirmed a bankruptcy court's confirmation of a Chapter 11 plan that was filed by a group of debtors, one of which had leased property to a marijuana grower.
- The debtors moved to reject the lease with the grower, and filed a Chapter 11 plan that did not depend on the continuation of the lease, or on the revenue generated from the tenant's marijuana business.

Garvin v. Cook Investments (continued)

- The bankruptcy court confirmed a Chapter 11 plan that paid all creditors in full and provided for the debtors to continue as a going concern.
- The U.S. Trustee appealed the bankruptcy court's order confirming the Chapter 11 plan, arguing that the plan violated Section 1129(a)(3) of the Bankruptcy Code because it was not proposed in "good faith and not by any means forbidden by law."
- The Ninth Circuit rejected the U.S. Trustee's argument, holding that the requirement that a plan be proposed in "good faith and not by any means forbidden by law" directs courts to look only to the *proposal* of a plan, not the *terms* of the plan.
 - The Ninth Circuit observed that the U.S. Trustee's interpretation of Section 1129(a)(3) would render some of the language of that statute meaningless, and would make other subsections of Section 1129(a) of the Bankruptcy Code redundant.

Garvin v. Cook Investments (continued)

- *Garvin* did not address the issue of whether the Chapter 11 case should have been dismissed in the first place, making this case of limited precedential value.
- Earlier in the bankruptcy case, the U.S. Trustee had moved to dismiss the case of the entity that had leased the property to the marijuana grower, based on that debtor's alleged "gross mismanagement of the estate."
- The Ninth Circuit determined that the U.S. Trustee did not properly preserve that argument on appeal. Accordingly, the Ninth Circuit never reached the question of whether leasing property to a marijuana grower constitutes "gross mismanagement of the estate."

Way to Grow, Inc.

- *In Way to Grow, Inc.*, Case No. 18-03245 (D. Colo. Sept. 19, 2019), the District Court disagreed with the Ninth Circuit’s analysis in *Garvin*:
- Debtors sold indoor hydroponic and gardening-related supplies.
 - Expansion plans were tied to the cannabis industry, although the debtors also had customers using the hydroponic products to grow other crops.
- A secured creditor moved to dismiss the cases, citing the CSA.
- The bankruptcy court found that the debtors violated section 843(a)(7) of the CSA.
 - Debtors had reasonable cause to believe that the equipment and product they sold would be used to manufacture marijuana.
 - The Bankruptcy Court dismissed the cases “for cause” under section 1112(b) of the Bankruptcy Code.
- The district court affirmed, holding:
 - A cannabis company violates section 1129(a)(3) of the Bankruptcy Code by proposing a plan that relies on profits generated from marijuana.
 - The inability to propose a good faith plan is cause for dismissal under section 1112(b).

Alternatives to Bankruptcy

- Instead of bankruptcy, marijuana-related business or their creditors may use non-bankruptcy proceedings and state law remedies, including:
 - Assignments for the benefit of creditors.
 - Receiverships.
 - Foreclosure under the Uniform Commercial Code, and remedies available to mortgage holders under state law.
 - Out-of-court workouts.
 - Chapter 15 (?)

Assignments for the Benefit of Creditors (ABCs) Generally

- The debtor assigns its property to a third party assignee in trust, for the benefit of the debtor's creditors. Debtor can choose assignee.
- The assignee is a fiduciary to creditors. He/she liquidates assets, and proceeds are distributed to the debtor's creditors.
- ABCs are a state law construct.
 - Some states (*e.g.*, California, Delaware, New York and New Jersey) have statutes addressing ABCs.
 - In other states (*e.g.*, Illinois), ABCs are governed by common law instead of statute.
- In some states (*e.g.*, New York), a state court oversees ABCs.
- In other states (*e.g.*, California), there is no state court oversight.

Assignments for the Benefit of Creditors (ABCs) Generally

- No automatic stay in an ABC.
- ABCs typically do not provide for the discharge of debts.
- Potential license transfer issues.

Receiverships Generally

- If an entity fails to pay debts as they come due or otherwise fails to meet legal obligations, a receiver may be appointed by:
 - A court order;
 - Regulatory department action; or
 - Private agreement.
- Receiver may also be appointed when the entity is insolvent and assets are likely to be misappropriated or wasted.
- A receiver is a disinterested person who collects and protects the property of the entity. Receiver is an officer of the appointing court.
- Receiver's powers and duties are set forth by the underlying receivership documents.
- Receivers generally liquidate the entity, but could be appointed to operate a business as a going concern.
- The court may enjoin actions against the receivership estate (similar to the automatic stay).

Receiverships Generally

- Advantages:
 - May be available to companies that “touch the plant” in states that permit marijuana use.
- Disadvantages:
 - Management loses control of the business.
 - No stay of litigation.

Differences Between ABCs and Receiverships

- Receiverships may be filed in state and federal court.
 - An ABC is a state law construct (either statute or common law). In some states, ABCs are conducted outside the purview of the state courts.
- Receiver's interests are generally aligned with the creditor seeking the appointment.
 - An ABC assignee acts in a fiduciary capacity for all creditors.
- Creditors choose and seek appointment of a receiver.
 - The debtor selects the assignee in an ABC.

Foreclosure and Disposition Under UCC § 9-610

- Section 9-610 of the UCC provides that after default, a secured creditor may sell, lease, license or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing.
- Collateral could be sold either to the secured creditor or to a third party.
- Could be a “friendly” or “adversarial” foreclosure vis-à-vis the borrower.
- Potential license transfer issues.

Foreclosure and Disposition Under UCC § 9-610 (cont'd)

- Overview:
 - Secured creditor repossesses the collateral and can then sell the collateral to itself (sometimes) or to someone else.
 - Lender must provide notice to borrower and other lienholders.
 - Disposition must be “commercially reasonable.”
 - No judicial proceedings and no court supervision.
 - Foreclosure sale transfers title of the collateral, but not necessarily possession. Lender still needs to repossess collateral.
 - Foreclosure discharges junior liens, but not senior liens.
 - UCC § 9-615 governs application of proceeds and deficiency claims.
 - The borrower’s contracts and leases are not automatically assigned to the foreclosing lender or to the buyer.

Foreclosure and Disposition Under UCC § 9-610 (cont'd)

- To repossess collateral, the secured creditor may:
 - exercise its right to self-help repossession (but cannot breach the peace);
 - require the borrower to assemble and deliver the collateral; or
 - use judicial foreclosure.
- In a non-consumer transaction, the secured creditor must provide notice to other lienholders at least 10 days before the sale.
- Parties entitled to notice:
 - Borrower;
 - Any secondary obligor; and
 - Other parties having an interest in the collateral.
 - Lien search must be done “not later than 20 days or earlier than 30 days before the notification date.”

Out-of-Court Workouts

- Requires consensual agreement with creditors.
- Advantages for Borrowers:
 - Creditors may be willing to meet and consider a workout if they are concerned about dissemination of assets and lack of oversight.
 - Flexible. Borrower and creditors can make any lawful deal they want.
 - Less disruptive and less reputational damage.
 - Management remains in control of the business.
- Disadvantages for Borrowers:
 - Cannot bind dissenting creditors in an out-of-court workout. In contrast, dissenting creditors can be bound to a bankruptcy plan.
 - Borrowers in the cannabis industry cannot plausibly threaten a bankruptcy filing if there is no deal.
 - No automatic stay.

Chapter 15 (U.S. Recognition of Foreign Insolvency Case)

- In certain circumstances, a company may be able to commence a plenary insolvency case in a jurisdiction in which cannabis is legal, and have that foreign insolvency case recognized in the United States under Chapter 15 of the Bankruptcy Code.
- No bankruptcy estate in Chapter 15 cases.
- Sections 1112 (dismissal of Chapter 11 cases) and 1129 (Chapter 11 plan confirmation requirements) do not apply in Chapter 15 cases.

Chapter 15 (continued)

- Advantages:
 - May be available to companies that “touch the plant,” at least in states where cannabis is legal.
- Disadvantages:
 - Company likely needs a nexus with a jurisdiction that has legalized cannabis (e.g., Canada).
 - Chapter 15’s “public policy exception” may doom the case in the U.S.
 - See 11 U.S.C. § 1506 – “Nothing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States.”

Thank You!

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