

# Cannabis Related Collections Still a Race to the Courthouse

## Cannabis Business Legal News

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On April 20, 2020, a company called United Cannabis Corp. filed a Chapter 11 bankruptcy case in the United States Bankruptcy Court for the District of Colorado. United Cannabis listed debts to its 20 largest creditors at over \$4.9 million. United Cannabis also appears to be a cannabis-related business (or CRB). In other words, it appears that United Cannabis generates at least a portion of its revenue from operating in the cannabis industry. The problem with that is that in almost every case that has been filed in bankruptcy courts across the nation, both CRBs and individuals receiving income from their involvement with the cannabis industry have been barred from receiving bankruptcy relief. So while the bankruptcy process affords debtors and creditors a managed, supervised, and organized method by which to resolve their issues, for some of the reasons discussed herein, that process is so far not available to CRBs or to individuals who derive their income from the cannabis industry. Creditors of these businesses and individuals would do well to remember that if and when they start to see signs of distress with these sort of obligations.

As most readers know by now, the manufacture or sale of cannabis is illegal on the federal level as a violation of the Controlled Substances Act (the "CSA"). Readers may also know that the manufacture or sale of medical cannabis is now legal on a state level in a majority of states, and adult use laws are on the rise. This conflict between federal law and state law brings innumerable problems to the cannabis industry. But nowhere has this dichotomy between federal illegality and state legality wreaked greater havoc than in the bankruptcy context. Bankruptcy case law on the topic has been almost universal (and frustratingly rigid) in precluding both CRBs and the individuals involved with CRBs from relief under any Chapter of the Bankruptcy Code.

One of the main problems with CRBs or individuals involved with the industry and the Chapter 7 process is that their assets will often consist of cannabis itself, equipment used in the production of cannabis product or cash derived from the sale of cannabis. In a Chapter 7 bankruptcy case, a trustee is appointed and charged with assembling and liquidating a debtor's assets. In the case of a CRB or individual in the industry this would require an independent third party, the Chapter 7 trustee, to take possession of cannabis or cannabis-related assets and sell them (or put so-called cannabis cash into her or his trustee bank account

and thereby risk the closure of that bank account). But most states in which cannabis is legal require sellers of cannabis or cannabis-related assets to endure a thorough application and licensing process which the trustee would not have done. The Chapter 7 trustee would not have such a license. Even if a Chapter 7 trustee could get past the licensing hurdle, simply taking possession of these cannabis-related assets would be a violation of federal law. Any sale of those assets by the Chapter 7 trustee would certainly violate federal law. And to date, bankruptcy judges across the country have refused to force Chapter 7 trustees to violate federal law.

Similar problems await debtors under Chapter 13. Because Chapter 13 also involves a Chapter 13 Trustee, problems similar to a Chapter 7 exist. Although a Chapter 13 Trustee does not take possession of a debtor's assets and thus would never hold title to actual cannabis, as a Chapter 7 Trustee could, a Chapter 13 Trustee collects cash from the individual Chapter 13 debtor. If that debtor is deriving income from cannabis-related activity, and the Chapter 13 Trustee comes into possession of that cash, the Chapter 13 Trustee would also be violating federal law. And again, simply placing that cannabis cash into the Chapter 13 Trustee's bank account risks the closure of that bank account. Worse, in the Chapter 13 context, the Chapter 13 debtor involved in the cannabis industry not only derived her or his income from a cannabis-related activity, but in most instances the Chapter 13 debtor continues to be employed in the industry and thus will continue to derive their income from a federally illegal activity. Consequently, the Chapter 13 Trustee would be forced to collect and distribute funds derived from an illegal activity and thus violate federal law her or himself. Again, bankruptcy judges across the nation have universally refused to force Chapter 13 trustees into that position.

Unfortunately for United Cannabis, the above results do not differ in the case of a Chapter 11 filing. Bankruptcy courts have routinely used a variety of reasons to prohibit CRBs from access to bankruptcy relief. Chief among those reasons is the argument that proposing a plan which revolves around the debtor's ongoing and continued violation of federal law cannot be "proposed in good faith" – a basic requirement to have a plan of reorganization confirmed in a Chapter 11 case. Other bankruptcy courts have concentrated their prohibitions on confirming such cannabis-related plans of reorganization because such plans are proposed by a means forbidden by law – another basic requirement in any Chapter 11 case. Yet more bankruptcy courts have concluded that generating revenue through the cannabis industry (and thus committing ongoing acts which violate federal law and put the business at risk) constitutes "gross mismanagement" of the business and this conduct precludes access to federal courts, including bankruptcy courts. Whatever reason bankruptcy courts find, it is clear that Chapter 11 also remains unavailable to distressed entities or individuals involved in the cannabis industry.

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While creditors often complain about the bankruptcy process, that process does afford them a fair and equitable mechanism for the repayment of their claims. Without the availability of the bankruptcy process, creditors are forced back into the proverbial race to the courthouse. And as any litigant who has ever participated in that race in a distressed situation can tell you, no one really ever wins that race. The limited pool of money that might be available to repay creditors is oftentimes eroded by the litigation itself. More worrisome, the ongoing litigation often destroys the business' ability to effectively address its financial situation and continue as a going concern. But until the conflict between federal law and state law regarding cannabis is resolved, creditors dealing with defaults from cannabis-related businesses or the individuals associated with the cannabis industry (such as those currently listed in the United Cannabis case) may be left with few options other than to put on their trainers and sprint towards that courthouse.

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