Advisory

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Federal bankruptcy unavailable to cannabis companies per DOJ directive

The legal cannabis industry is expected to sustain high rates of growth in the coming years. But the industry faces legal and organizational challenges due to strict federal cannabis policies. A directive from the Director of the United States Trustees earlier this year reminds cannabis businesses of the precautions they will want to take in planning for insolvency.

While medical cannabis is now legal in twenty-nine states and the District of Columbia [1], cannabis remains an illegal substance under federal law. The federal government categorizes cannabis as a Schedule I drug under the Controlled Substances Act, alongside drugs such as heroin, LSD, and MDMA. A Schedule I drug is considered to have "no currently accepted medical use" and "a high potential for abuse."

The federal categorization of cannabis has repercussions on whether bankruptcy law is available for distressed companies with cannabis-based assets or operations. Bankruptcy law is federal, and bankruptcy proceedings are brought in the federal court system.

The Department of Justice (DOJ) affirmatively denied federal bankruptcy protection to companies with cannabis assets this April in a directive to the U.S. Trustees. Director of the U.S. Trustees Clifford White issued a letter stating that cases involving cannabis assets "may not be administered under the Bankruptcy Code . . . even in cases in which such assets are not illegal under state law." [2]

Under several forms of bankruptcy, a trustee is appointed to carry out the administrative process. This may involve taking over and selling the assets of a debtor's estate to distribute the proceeds to creditors in a chapter 7 liquidation proceeding, or making payments to creditors based on a repayment plan in a chapter 13 adjustment of debts proceeding. The DOJ's position is that a trustee could not carry out these responsibilities legally in a case involving marijuana assets, since they would be selling and handling profits from an illegal drug. Even in cases that do not involve a trustee, such as certain chapter 11 reorganizations, the DOJ states that federal law prohibits an individual or company from using a repayment plan that contemplates paying back debts from profits made through an illegal substance. [3]

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Bankruptcy courts had previously dismissed cases involving cannabis-based assets due to the federal classification of cannabis, even where the company was legal under state law. In Rent-Rite Super Kegs W. Ltd., 484 B.R. 799 (Bankr. D. Colo. 2012), a warehouse owner-operator who received 25% of its income from its tenant's marijuana cultivation sought to reorganize its business under chapter 11. The court dismissed the case, finding both cause and lack of good faith where the debtor's activity violated the Controlled Substances Act. Similarly, in Arenas v. United States Trustee, 533 B.R. 845 (10th Cir. B.A.P. 2015), the appellate court affirmed the bankruptcy court's dismissal of a debtor's chapter 7 petition and refusal to convert the case into a chapter 13 bankruptcy, on grounds that the trustee could not lawfully administer the estate's marijuana assets and on grounds that debtors did not have sufficient non-marijuana derived income to fund a chapter 13 plan.

Cannabis companies should therefore become familiar with alternative options and have in place a plan for reorganization early on. There are some limited state law remedies that businesses may be able to use, though some are admittedly underdeveloped in their application to cannabis companies. These options include receiverships, assignments for the benefit of creditors, and compositions. Utilization of these alternatives may be conditioned on meeting other licensing or regulatory requirements.

The DOJ's position and current federal case law are at odds with growing acceptance of cannabis in American society. An October 2016 Gallup poll reported that national support for legalizing cannabis is at 60%, the highest it has been in the past forty-seven years that the poll has been conducted. Legislation that would remove cannabis from the Controlled Substances Act, and also grant bankruptcy relief to cannabis-related businesses, have been introduced in the U.S. House of Representatives and in the U.S. Senate earlier this year, but neither has yet to pass. [4] Demand for medical marijuana, as well as growing research and development, is expected to continue in coming years. While the Food and Drug Administration (FDA) has not approved the marijuana plant itself as medicine, there are currently two FDA-approved medications that contain cannabinoid chemicals, and other marijuana-based medications are undergoing clinical trials. [5]

These developments are highly relevant to businesses and interested parties in Connecticut. Connecticut signed its law legalizing medical cannabis on May 31, 2012. Connecticut has a growing medical cannabis industry regulated by the Department of Consumer Protection. There are nine dispensary facilities and four producers that have been licensed by the state. [6] Medical sales totaled $29,300,000 in 2016, and they are projected at $104,900,000 for 2021.

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Footnotes:

[1] "State Medical Marijuana Laws," September 14, 2017, National Conference of State Legislatures, http://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx.

[2] Clifford J. White, Executive Office for United States Trustees, letter to Chapter 7 and Chapter 13 U.S. Trustees, April 26, 2017, https://www.justice.gov/ust/file/marijuana_assets.pdf/download.

[3] "Individuals or Businesses with Marijuana Assets or Income," Frequently Asked Questions, U.S. Trustee Program, The United States Department of Justice, accessed November 10, 2017, https://www.justice.gov/ust/frequently-asked-questions-faqs-consumer-information#marijuana_faq2.

[4] Responsibly Addressing the Marijuana Policy Gap Act, S. 780, 115th Cong. (2017); Responsibly Addressing the Marijuana Policy Gap Act, H.R. 1824, 115th Cong. (2017).

[5] "What is medical marijuana?" National Institute on Drug Abuse, last updated April 2017, https://www.drugabuse.gov/publications/drugfacts/marijuana-medicine; "Is marijuana safe and effective as medicine?" National Institute on Drug Abuse, last updated August 2017, https://www.drugabuse.gov/publications/marijuana/marijuana-safe-effective-medicine.

[6] "Medical Marijuana Statistics," Connecticut Department of Consumer Protection, accessed December 12, 2017, http://www.ct.gov/dcp/cwp/view.asp?a=4287&Q=533228&PM=1&dcpNav=|.