

Why Marijuana Assets May Not Be Administered in Bankruptcy

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Marijuana continues to be regulated by Congress as a dangerous drug, and as the Supreme Court has recognized, the federal prohibition of marijuana takes precedence over state laws to the contrary.¹ The primacy of federal law over state law is hardly a novel proposition and has been the rule since the ratification of the Constitution. Thus, whenever a marijuana business files for bankruptcy relief, a threshold question is whether the debtor can be granted relief consistent with the Bankruptcy Code and other federal law. If the answer to that question is no, the United States Trustee Program (USTP), in its role as the watchdog of the bankruptcy system, will move to dismiss.

Illegal enterprises simply do not come through the doors of the bankruptcy courthouse seeking help to further their criminal activities. To obtain bankruptcy relief, some may try to hide the nature of their business or income, but bankruptcy courts require full financial disclosure and are not a hospitable forum for continuing a fraudulent or criminal scheme.

Marijuana businesses are a unique and unprecedented exception to this rule because they often involve companies that openly propose to continue their illegal activity during and after the bankruptcy. Those cases present a challenge to the bankruptcy system because they generally involve assets that are illegal even to possess. In contrast to other types of cases involving illegal businesses, in which the criminal activity has already terminated and the principal concern of the bankruptcy court is to resolve competing claims by victims for compensation, a marijuana bankruptcy case may involve a company that not only is continuing in its business, but is even seeking the affirmative assistance of the bankruptcy court

¹ Controlled Substances Act, 21 U.S.C. §§ 801 *et seq.* (the “CSA”); *Gonzales v. Raich*, 545 U.S. 1, 12 (2005).

in order to reorganize its balance sheet and thereby facilitate its violations of the law going forward.

The USTP's response to marijuana-related bankruptcy filings is guided by two straightforward and uncontroversial principles. First, the bankruptcy system may 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. Second, bankruptcy trustees and other estate fiduciaries should not be required to administer assets if doing so would cause them to violate federal criminal law.

The USTP's policy of seeking dismissal of marijuana bankruptcy cases that cannot lawfully be administered is not a new one, but rather it is a policy that has been applied consistently over two presidential administrations and under three Attorneys General. Nor are these concerns unique to marijuana. These same principles would also guide the USTP's response in a case involving any other type of ongoing criminal conduct or administration of illegal property.

Although a recent *ABI Journal* article² takes the USTP to task for its marijuana enforcement efforts, it is noteworthy that the author fully agrees with the USTP's position as to the first of the two principles described above and appears to agree to a significant extent with the second. As the author concedes, "it hardly needs explanation that a bankruptcy court should not supervise an ongoing criminal enterprise regardless of its status under state law."³ As to the second principle, "[i]t would obviously violate federal law for the trustee to sell marijuana."⁴

Given these concessions, the author's disagreement with the USTP's position would appear to be limited to a fairly narrow range of cases – those where administration of the estate would not require the trustee to sell marijuana (but would require the trustee to administer other marijuana-derived property), or where the debtor is a "downstream" participant in a marijuana business, such as a lessor of a building used for a marijuana dispensary.⁵

Yet under the CSA, there is no distinction between the seller or the grower of marijuana and the supposedly more "downstream" participants whom the article proposes to protect: all are in violation of federal criminal law. In particular,

² Steven J. Boyajian, "Just Say No to Drugs? Creditors Not Getting a Fair Shake When Marijuana-Related Cases Are Dismissed," *ABI Journal*, September 2017, at 24.

³ *Id.* at 25.

⁴ *Id.*

⁵ *Id.* at 74.

section 856 of the CSA specifically prohibits knowingly renting, managing, or using property “for the purpose of manufacturing, distributing, or using any controlled substance;” section 863 of the CSA makes it a crime to sell or offer for sale any drug paraphernalia – which is defined to include, among other things, “equipment, product, or material of any kind which is primarily intended or designed for use” in manufacturing a controlled substance; and section 855 provides for a fine against a person “who derives profits or proceeds from an offense [of the CSA].”⁶ Thus, not only would a trustee who offers marijuana for sale violate the law but so, too, would a trustee who liquidated the fertilizer or equipment used to grow marijuana, who collected rent from a marijuana business tenant, or who sought to collect the profits of a marijuana investment.

Although cases involving illicit proceeds of Ponzi schemes and other criminal activities – seen in such notorious cases as Enron, Dreier LLP, and Madoff – are administered in bankruptcy, they deal with the aftermath of fraud, usually after individual wrongdoers had been removed from the business. Such cases are wholly inapposite analogies to a marijuana case where the illegal activity is still continuing through the bankruptcy administration process and where bankruptcy relief may allow the company to expand its violations of law in the future. Nor do any of those cases involve proposed chapter 11 and 13 plans where the feasibility of the plan itself is directly premised on the continued receipt of profits from an illegal enterprise. And none of them requires the courts or trustees to deal with property of the kind described in the CSA, for which mere possession is a federal crime.

Similarly, although the author cites two decades-old decisions in support of his claim that “courts have not always shied away from handling marijuana-related bankruptcies,”⁷ it is noteworthy that neither of those decisions involved active marijuana operations or would have required a bankruptcy trustee to administer any illegal marijuana assets.⁸ Both *Chapman* and *Kurth Ranch* involved bankruptcy cases that were filed *after* law enforcement had arrested and seized the assets of marijuana growers. The legal issues raised by the current wave of marijuana filings were simply not present in those cases – neither case involved an ongoing violation of law, and in neither case were there any marijuana assets to be administered, because all illegal assets had been seized and disposed of prepetition.

Finally, the article suggests that the “ongoing conflict over marijuana policy” is one that should take place outside the bankruptcy system. The USTP

⁶ Controlled Substances Act, 21 U.S.C. §§ 801 *et seq.*

⁷ *Id.* at 25.

⁸ See *Dep’t of Revenue v. Kurth Ranch*, 511 U.S. 767 (1994); *In re Chapman*, 264 B.R. 565 (B.A.P. 2001).

agrees. But that does not mean that the USTP or the courts should turn a blind eye to bankruptcy filings by marijuana businesses. Rather than make its own marijuana policy, the USTP will continue to enforce the legislative judgment of Congress by preventing the bankruptcy system from being used for purposes that Congress has determined are illegal.