

I. BACKGROUND: FEDERAL AND STATE LAWS

The Supremacy Clause of the U.S. Constitution states that federal law “shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the Constitution or laws of any State to the contrary notwithstanding.”¹

A. Federal Controlled Substances Act (“CSA”):

- Under the CSA, it is unlawful for an individual to knowingly or intentionally “manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense a controlled substance.”²
- It is also unlawful under the CSA to
 - (1) knowingly open, lease, rent, use, or maintain any place, whether permanently or temporarily, for the purpose of manufacturing, distributing, or using any controlled substance;
 - (2) 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.”³
- Marijuana is a Schedule I drug.⁴
- A Schedule I drug is a “drug or other substance [that] has a high potential for abuse,” has “no currently accepted medical use treatment in the United States” and “[t]here is a lack of accepted safety for use of the drug or other substance under medical supervision.”⁵

B. States that Permit the Use, Sale, and Distribution of Medical Marijuana

- So far, 33 states have legalized the use, sale, and distribution of medical marijuana, which directly conflicts with the federal CSA. Presented below are laws from five of those states.
- Arizona:
 - Arizona Medical Marijuana Act.⁶
 - Allows a patient with an Arizona registry ID card to use cannabis for medical purposes
 - *State v. Jones*, a recent Arizona Supreme Court case, expanded the interpretation of A.R.S. § 36-2801(8) and held that hashish and marijuana are not two distinct forms of cannabis.⁷ “[T]he definition of marijuana in § 36-2801(8) includes resin, and by extension of hashish, and that § 36-2811(B)(1) immunizes the use of such marijuana consistent with AMMA.”⁸
 - Arizona licensed 31 new dispensaries in 2016.⁹
- California:
 - Medicinal and Adult-Use Cannabis Regulation and Safety Act.¹⁰
- Colorado:

¹ U.S. Const., Art. VI, cl. 2.

² 21 U.S.C. § 841(a)(1).

³ 21 U.S.C. § 856 (a).

⁴ 21 U.S.C. § 812, Sched. 1(c)(10).

⁵ 21 U.S.C. § 812(b)(1)(A)-(C).

⁶ 36 Ariz. Rev. Stat. §§ 36-2801—36-2819.

⁷ *State v. Jones*, 440 P.3d 1139, 1142 (Ariz. 2019).

⁸ *Id.* at 1144.

⁹ *Arizona Medical Marijuana Laws & Regulations*, Americans For Safe Access, https://www.safeaccessnow.org/arizona_medical_marijuana_laws.

¹⁰ Cal. Prof. Code §§ 26000-26001.

- Medical use of marijuana for persons suffering from debilitating medical conditions.¹¹
- Uniform Controlled Substances Act of 2013: Offenses relating to marijuana and marijuana concentrate—definitions.¹²
- Medical marijuana program.¹³
- Michigan: Michigan Medical Marijuana Act.¹⁴
- Washington: Washington State Medical Use of Cannabis Act.¹⁵

C. The Conflict:

Even though legalization of recreational and medical marijuana use is changing at the state level, there is an inevitable conflict between state laws and the federal CSA. This conflict is apparent in the context of bankruptcy. Entities in the cannabis industry face challenges when seeking bankruptcy relief; their actions may be legal under state law, but not under federal law. Because U.S. Bankruptcy Courts are courts of federal jurisdiction¹⁶ the challenge arises when debtors (and sometimes creditors) seek relief in bankruptcy court. Their actions, deemed legal under state law, are considered criminal conduct under federal law. The following cases provide a glimpse of bankruptcy courts’ approaches to this issue.

II. BANKRUPTCY CASELAW

In re Arenas and *In re Rent-Rite Super Kegs W. Ltd.*, are two cases whose decisions turn on (1) whether there is cause for dismissal or conversion of the case and (2) whether the dismissal or conversion of the case is in the best interest of the creditors.

A. Cause for dismissal is prejudicial delay

- *In re Arenas*, 535 B.R. 845 (B.A.P. 10th Cir. 2015).
 - Facts: Debtors (husband and wife) owned building with two units. In one unit, debtors grew and sold marijuana, while the other unit was leased to third parties who used the space to dispense medical marijuana. Debtors filed a Chapter 7 then wanted to convert to Chapter 13. The U.S. Trustee sought dismissal of the bankruptcy case. The bankruptcy court held that debtors’ conduct violated the CSA and denied the motion to convert to Chapter 13. Debtors were also denied relief in Chapter 7 because “engaging in criminal conduct demonstrated lack of good faith that would bar confirmation of their Chapter 13 plan.”¹⁷
 - Issue: “Can a debtor obtain relief in the federal bankruptcy court?”¹⁸
 - Rule: “The court may dismiss a case under this chapter only after notice and a hearing and only for cause, including—(1) unreasonable delay by the debtor that is prejudicial to creditors.”¹⁹ “Cause” includes a nonexhaustive list of examples.²⁰

¹¹ C.R.S.A. Const. Art. XVIII, § 14.

¹² Colo. Rev. Stat. Ann. § 18-18-406—18-18-406.6.

¹³ Colo. Rev. Stat. Ann. §25-1.5-106.

¹⁴ Mich. Comp. Laws Ann. §§ 333.26423-333.26430.

¹⁵ Wash. Rev. Code Ann. §§ 69.51a.005-69.51a.903.

¹⁶ U.S. Const., Art. I, § 8, cl. 4.

¹⁷ *In re Arenas*, 535 B.R. at 847.

¹⁸ *Id.*

¹⁹ 11 U.S.C. § 707(a)(1).

²⁰ 11 U.S.C. § 1307(c)(1)-(11).

- Held: Affirmed the bankruptcy court, because debtors violated the CSA.
- Reasoning: “[W]hile the debtors have not engaged in intrinsically evil conduct, the debtors cannot obtain bankruptcy relief because their marijuana business activities are federal crimes.”²¹ The Bankruptcy Court did not abuse its discretion in denying motion to convert to Chapter 13. Thus, there was cause to deny the motion to convert to Chapter 13. The court reasoned that debtors’ marijuana business activities violated the federal CSA.²²
 1. The court found the debtors’ “monthly income from sources other than marijuana was not enough to fund their plan . . . the debtors could only fund their plan with income from marijuana activity, because their other sources of income would not be enough.”²³
 2. Additionally, the Trustee would have violated federal law by administering the assets linked to contraband.²⁴ If the Trustee did not administer the assets, there would have been prejudicial delay: “If the Trustee abandoned the Assets, the debtors would retain their business after exposing the Trustee to grave risk, provide the creditors with little or no recovery, and receive a discharge, protected all the while from their creditors’ collection efforts by the automatic stay and then the discharge injunction.”²⁵
 3. Further, the court found lack of good faith on the part of the debtors, despite having good intentions, because “[i]f the debtors are incapable of proposing a confirmable plan, it is objectively unreasonable for them to seek Chapter 13 relief whether their intentions are kindly or not.”²⁶

B. Cause for dismissal is gross mismanagement and unclean hands.

- *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012).
 - Facts: Around 25% of debtor’s income came from leasing warehouse space to tenants who cultivated marijuana. Creditor (VFC Partners 14 LLC) moved to dismiss Chapter 11.
 - Issue: “[W]hether the case must be dismissed under the clean hands doctrine.”²⁷
 - Rule: Two Step Process:
 1. Step 1: Whether there is “cause” for dismissal or conversion of the Chapter 11 case:
 1. 11 U.S.C. § 1112(b)(4)(A)-(P) provides a non-exhaustive list of potential causes to dismiss or convert the case. One example is gross mismanagement: “Where a court finds ‘gross mismanagement of the estate’ by a debtor, that finding compels a conclusion that ‘cause’ exists for dismissal or conversion of the chapter 11 case.”²⁸

²¹ *In re Arenas*, 535 B.R. at 849-850.

²² *Id.* at 846.

²³ *Id.* at 852.

²⁴ *Id.*

²⁵ *Id.* at 853.

²⁶ *Id.* at 852-53.

²⁷ *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799, 802 (2012).

²⁸ *Id.* at 809; 11 U.S.C. § 1112(b)(4)(B).

- Unclean hands²⁹ may be one cause for dismissal or conversion. A plan may be confirmed only if “[t]he plan has been proposed in good faith and not by any means forbidden by law.”³⁰
2. Step 2: Whether dismissal or conversion of said case is in the best interest of creditors and the estate:
 2. To determine this step, the court would usually look to assets available for distribution and balance the creditors’ reasonable expectation of a distribution in a Chapter 7 case against the inevitable race to the courthouse by individual creditors to obtain judgements and chase assets to execute on.
 - Held: Court found cause to dismiss or convert the case to Chapter 7.
 - Reasoning: Debtor acknowledged its conduct “expose[d] the Debtor to criminal liability and thus expose[d] its primary asset to forfeiture. It acknowledge[d] that its criminal behavior has continued post-petition.”³¹

Forfeiture under the CSA

The creditor’s collateral was at risk of forfeiture, because “[a]ny person convicted of a violation of [the federal CSA] punishable by imprisonment for more than one year shall forfeit to the United States, irrespective of any provision of State law –

- (1) Any property constituting, or derived from, any proceeds the person obtained, directly or indirectly, as the result of such violation;
- (2) Any of the persons’ property used, or intended to be used, in any manner or part, to commit, or to facilitate the commission of, such violation.”³²
 - Debtor engaged in unlawful activity, because while the activity was legal under Colorado law, it violated the federal CSA.³³
 - i. Step 1 “Cause”: Court found “gross mismanagement” of estate. The debtor engaged in criminal conduct post-petition. “It is that post-petition presence of activity on the Debtor’s property—pursuant to leases that it knowingly entered into—that violates the CSA; exposes the Debtor to criminal liability; and exposes both the Debtor and its mortgage creditor to forfeiture of the Warehouse that constitutes gross mismanagement of the estate and requires the Court to either convert this case to a case under chapter 7 or to dismiss it.”³⁴
 - Unclean hands.³⁵ “Whether it is characterized, strictly speaking as an application of the clean hands doctrine or simply as part of the Court’s totality of the circumstances “cause” analysis, the Debtor’s continued criminal activity satisfies the requirement of “cause” under §1112(b) and requires dismissal or conversion of this chapter 11 bankruptcy case.”³⁶
 - ii. Step 2 “Best Interests to Creditors”: The court left this open and also considered consequences of the debtor’s criminal conduct. There was no motion filed in this case for abandonment or stay relief regarding the

²⁹ See *infra* p. 5 Section D.

³⁰ 11 U.S.C. § 1129(a)(3).

³¹ *Id.* at 809.

³² 21 U.S.C. § 853(a).

³³ *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 811.

³⁴ *Id.* at 809.

³⁵ See *infra* p. 5 Section D.

³⁶ *Id.*

warehouse. Thus, “immediately upon conversion, the chapter 7 estate would contain a major asset that is the location of ongoing criminal activity and is subject to forfeiture under the CSA. The trustee who is appointed in the case would have responsibility for a site where continuing criminal conduct is taking place.”³⁷ The record did not permit the court to decide whether dismissal or conversion was in the best interests of creditors, but there was cause to dismiss or convert the case.

C. Whether reorganization plan was proposed “by any means forbidden by law.”

Unlike the decision *In re Rent-Rite Super Kegs W. Ltd.*, the decision in *Garvin v. Cook Invs.* turns on the court’s interpretation of whether the plan was “*proposed* in good faith and not by any means forbidden by law” (emphasis added). The Ninth Circuit affirmed the bankruptcy court’s confirmation of a plan of reorganization even though at least part of the plan would be funded by debtor’s marijuana-related business.

- *Garvin v. Cook Invs. NW, SPNY, LLC*, 922 F.3d 1031 (9th Cir. 2019).
 - Facts: Debtor, owner of five real estate holding companies, filed for Chapter 11 relief. The bankruptcy court confirmed the Chapter 11 reorganization plan over the U.S. Trustee’s argument that the plan was not confirmable because Green Haven, a tenant of one property, grew marijuana on the property in violation of the CSA.³⁸
 - Issue: Whether 11 U.S.C. § 1129(a)(3) prevents the court from confirming a plan “that is proposed in an unlawful manner as opposed to a plan with substantive provisions that depend on illegality.”³⁹
 - Rule: For a Chapter 11 reorganization plan to be confirmed, it is necessary that “the plan has been proposed in good faith and not by any means forbidden by law.”⁴⁰
 - Held: Ninth Circuit affirmed confirmation of the reorganization plan.
 - Reasoning: In interpreting 11 U.S.C. § 1129(a)(3), the court said the district court looked to proposal of a plan, not the terms of the plan (or substance of the plan). The court applied the plain meaning of the statute and found that the plan was not “proposed by any means forbidden by law.”
 - Note: The US Trustee had argued early in the case that having a tenant in the marijuana business was gross mismanagement under § 1112(b). The bankruptcy judge denied the motion to dismiss but gave leave to renew at confirmation; the US Trustee did not renew the motion to dismiss at confirmation. The Ninth Circuit (and the district court) held that the US Trustee had waived this argument by failing to renew its motion to dismiss at plan confirmation. If the court had considered gross mismanagement issues under §1112(b) (i.e., if the US Trustee had renewed its motion to dismiss at plan confirmation), it’s possible that the case would have come out differently.

D. Cause for dismissal was unclean hands.

³⁷ *Id.* at 810.

³⁸ *Garvin*, 922 F.3d at 1033.

³⁹ *Id.* at 1035.

⁴⁰ 11 U.S.C. § 1129(a)(3).

The following cases discuss unclean hands as “cause” for dismissal or conversion. Under the Unclean Hands Doctrine, “[O]ne who does not come into equity with clean hands, and keep them clean, must be denied all relief, whatever may have been the merits of his claim.”⁴¹

- *In re Basrah Custom Design, Inc.*, 2019 WL 2202742 (Bankr. E.D. Mich. May 21, 2019).
 - Facts: Debtor, a Michigan corporation that manufactured and installed custom cabinets, filed Chapter 11 bankruptcy. Debtor used and occupied two conjoined buildings owned by the president and only shareholder of the debtor. The November lease named Debtor as landlord and a medical marijuana dispensary as tenant. The lease stated that “Premises will be used for licensed medical marijuana dispensary and for no other purpose whatsoever.” The U.S. Trustee sought dismissal of the case. The Trustee claimed debtor had unclean hands, because the motive of the president of the debtor was to profit from the marijuana business, rather than “disentangle [itself] from any marijuana-based business.”⁴² In contrast, the debtor argued that it in fact wanted to disentangle itself from marijuana activity.⁴³
 - Issue: Whether debtor’s entanglement with a medical marijuana dispensary business, legal under Michigan law, requires dismissal of the federal bankruptcy case.
 - Rule: 11 U.S.C. § 1112(b)(1): “[O]n request of a party in interest, and after notice and a hearing, the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause”
 - Held: Yes, dismissal was required.
 - Reasoning: The court found the debtor had unclean hands because the president’s motive was to make more money off of the marijuana business by either (1) leasing the property to another marijuana business for higher rent or (2) using the property himself to operate a marijuana business.⁴⁴ The court therefore found the president of the debtor corporation did not seek to disentangle himself from illegal activity but sought instead to continue the illegal operations in violation of the federal CSA in order to profit from it.⁴⁵
 - Dismissal, as opposed to conversion, was in the best interest of the creditors and the estate:
 - “First, a conversion to Chapter 7 would mean a liquidation of the Debtor, and the termination of the Debtor’s business of manufacturing and installing custom cabinets.”⁴⁶ The debtor does not want the assets liquidated, as it was apparent the president wanted to continue the marijuana business activity.⁴⁷ Also, no “creditor of the Debtor advocated for the conversion and liquidation of the Debtor in Chapter 7. There is no reason to think that a liquidation of the Debtor in Chapter 7 is in the best interests of the creditors or the estate.”⁴⁸
 - “Second . . . this Court sees “no practical alternative to dismissal” in this case.”⁴⁹ The court was not willing to grant stay relief requested by the

⁴¹ *In re Medpoint Mgmt., LLC*, 528 B.R. 178 (Bankr. D. Ariz. 2015) (citing *Hall v. Wright*, 240 F.2d 787, 794-95 (9th Cir. 1957)).

⁴² *In re Basrah Custom Design, Inc.*, 2019 WL 2202742 at 11.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.* at 12.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

tenant, because the tenant also has unclean hands. If the court granted the stay, it would essentially aid the tenant's illegal operations.⁵⁰

- *Northbay Wellness Group, Inc. v. Beyries*, 789 F.3d 956 (9th Cir. 2015).
 - Facts: Beyries, who was both an attorney and Chapter 7 debtor, stole \$25,000 from his creditor/client, Northbay Wellness Group, a medical marijuana dispensary in California. The debtor filed for bankruptcy and the creditor brought an adversary proceeding to determine the debt was nondischargeable. The bankruptcy court dismissed the creditor's complaint because their marijuana sales prevented the court from granting relief.⁵¹
 - Issue: Whether the bankruptcy court "abused its discretion by applying the doctrine of unclean hands to bar [creditor] Northbay's request for a judgment of nondischargeability."⁵²
 - Rule: "A plaintiff with unclean hands cannot obtain a judgment of nondischargeability."⁵³ The doctrine of unclean hands "requires that the plaintiff 'shall have acted fairly and without fraud or deceit to the controversy in issue.'"⁵⁴ Determining whether unclean hands precludes relief requires "weigh[ing] the substance of the right asserted by [the] plaintiff against the transgression which, it is contended, serves to foreclose that right."⁵⁵
 - Held: Yes, the bankruptcy court abused its discretion. Reversed.
 - Reasoning: The court noted the debtor "was on Northbay's board of directors and partnered in Northbay's business, so he was as responsible as Northbay for its illegal marijuana sales. That illegal activity must be attributed to both parties in the weighing of wrongdoing, so it does not tip the balance in either direction."⁵⁶ Not only did the debtor violate the CSA, but the debtor also stole \$25,000 from the creditor, his client. The court found that the debtor's "wrongdoing outweighed Northbay's, both as to harm caused to each other and as to harm caused to the public."⁵⁷ Absolving the debtor of responsibility would be tantamount to permitting a lawyer to steal from his client and contrary to the public interest.⁵⁸

As discussed in brief above, unclean hands may be cause for dismissal or conversion of a bankruptcy case. However, in the following Arizona case, the involuntary debtor involved in the marijuana industry was the one arguing it has "unclean hands" as a defense.

- *In re Medpoint Mgmt., LLC*, 528 B.R. 178 (Bankr. D. Ariz. 2015).
 - Facts: The involuntary debtor is an LLC involved in marijuana-related business activity.⁵⁹ The debtor moved to dismiss the involuntary Chapter 7 petition filed against it, arguing that the bankruptcy trustee would violate federal law by

⁵⁰ *Id.* at 13.

⁵¹ *Northbay Wellness Group, Inc.*, 789 F.3d at 959.

⁵² *Id.*

⁵³ *Id.* (citing *In re Uwimana*, 274 F.3d 806 (4th Cir. 2001)).

⁵⁴ *Id.* (citing *Ellenburg v. Brockway, Inc.*, 763 F.2d 1091, 1097 (9th Cir. 1985)).

⁵⁵ *Id.* at 960 (citing *Republic Molding Corp. v. B.W. Photo Utils.*, 319 F.2d 347 (9th Cir. 1963)).

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.* at 961.

⁵⁹ *In re Medpoint Mgmt., LLC*, 528 B.R. at 180.

administering assets of the debtor.⁶⁰ The debtors argued that creditors had unclean hands

because they too were involved with marijuana-related activity. Lastly, the debtor noted the conflict between state and federal law, making the bankruptcy court “the most inefficient and troublesome forum.”⁶¹ The creditors argued that the Consolidated and Further Continuing Appropriations Act (“Cromnibus Act”) safeguarded marijuana businesses in Arizona from federal prosecution.⁶² The U.S. Trustee posed concerns regarding her administration of illegal assets.⁶³

- Issues:
 1. Whether there is cause to dismiss the petition;
 2. Whether petitioning creditors can or should be entitled to an order of the court entering an order of relief; and
 3. Whether petitioning creditors acted in bad faith in filing the petition.⁶⁴
- Rule:
 1. “The Court may dismiss a chapter 7 case for cause after notice and a hearing.”⁶⁵
 2. “Under the ‘clean hands’ doctrine, one who does not come into equity with clean hands, and keep them clean, must be denied all relief, whatever may have been the merits of the claim.”⁶⁶
- Held: There was cause to dismiss the petition. Creditors’ request for relief was denied in favor of Debtor. The court granted Debtor’s motion to dismiss.
- Reasoning:
 1. Yes, there was cause to dismiss under 11 U.S.C. § 707(a). The court looked to *In re Arenas* to find that the chapter 7 trustee would be violating the CSA by liquidating the assets linked to illegal activity. The court also relied on *In re Rent-Rite Super Kegs W. Ltd.* Further, “The Court finds that the prospects of a possible forfeiture or seizure of Medpoint’s assets poses an unacceptable risk to a chapter 7 estate and to a chapter 7 trustee.”⁶⁷ However, the court did not make a finding regarding the forfeitability of the assets.⁶⁸ Additionally, despite the creditors’ argument, the court noted the Cromnibus Act would not bar the Department of Justice from prosecuting marijuana businesses under the CSA, and the funding provided to the Department of Justice to prevent enforcement was only through September 30, 2015.⁶⁹
 2. “Petitioning Creditors’ hands are unclean and they cannot now seek relief from this Court.” The court noted that the creditors knew or should have known that they were getting themselves into “marijuana-related business affairs.”⁷⁰ “Petitioning Creditors nonetheless decided to contract with Medpoint to pursue potentially lucrative investments or lending profits, and/or consulting fees, none of which could be realized but for Medpoint’s marijuana-related business affairs.”⁷¹

⁶⁰ *Id.* at 181-182.

⁶¹ *Id.* (citing Motion at 13:11).

⁶² *Id.* at 183.

⁶³ *Id.* at 184.

⁶⁴ *Id.*

⁶⁵ *Id.* at 184.

⁶⁶ *Id.* at 186 (citing *Hall v. Wright*, 240 F.2d 787, 794-95 (9th Cir. 1957)).

⁶⁷ *Id.* at 185.

⁶⁸ *Id.* at 185 n. 11.

⁶⁹ *Id.* at 185-86.

⁷⁰ *Id.* at 187.

⁷¹ *Id.*

3. The court found no bad faith on the part of the creditors.

- *In re Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015).
 - Facts: Debtor was a caregiver who also had a marijuana business and also grew marijuana in the basement of his residence. (The court inferred that the debtor's truck was used to transport marijuana to the patients or the dispensary). The bankruptcy estate included the debtor's residence, truck, and horticultural items (fertilizer, growing lights). Approximately half of debtor's income came from his marijuana-related business activity.⁷² Debtor testified his payments to the Chapter 13 trustee derived from his Social Security income (\$1,203) not from his marijuana business.⁷³ The U.S. Trustee moved to dismiss, arguing that debtor's involvement in marijuana activity violated the CSA.⁷⁴
 - Issue: Whether debtor's business, legitimate under state law but criminal under federal CSA, precludes the court from granting him the relief available under the U.S. Bankruptcy Code.
 - Rule: "There is no constitutional right to obtain a discharge of one's debts in bankruptcy."⁷⁵
 - Held: Yes, the debtor's medical marijuana business precluded the court from granting him relief under the U.S. Bankruptcy Code, unless the debtor abandoned and destroyed the contraband (marijuana and marijuana products) in his bankruptcy estate.
 - Reasoning: While debtor claimed he had segregated his income and attempted to sanitize his plan payments, "money is fungible and the arrangement would [have] invariably taint[ed] the court and the Standing Trustee," since they would be supporting the debtor's criminal conduct.⁷⁶ "Debtor's financial life is inextricably bound up with his federal criminal activity through the Chapter 13 plan, even if he segregates proceeds of that activity. The two aspects of the Debtor's life cannot be hermetically sealed from each other, and the pervasive benefits of bankruptcy will invariably advance both."⁷⁷
 - The court gave the debtor the option either to continue with his marijuana business or seek relief under the Bankruptcy Code. "In the court's view, the Debtor cannot conduct an enterprise that admittedly violates federal criminal law while enjoying the federal benefits the Bankruptcy Code afford him."⁷⁸ If the debtor sought relief, the court required he cease growing, selling, and distributing marijuana immediately as well as cease using the property from bankruptcy estate to continue the criminal activity.⁷⁹ However, if the debtor wanted to continue his marijuana business, he would need to file a motion to dismiss under § 1307(b).⁸⁰
 - US Trustee's motion to dismiss was denied without prejudice.

⁷² *In re Johnson*, 532 B.R. at 55.

⁷³ *Id.* at 55-56.

⁷⁴ *Id.* at 54.

⁷⁵ *Id.* 59 (citing *United States v. Kras*, 409 U.S. 434 (1973)).

⁷⁶ *Id.* 56-57.

⁷⁷ *Id.* at 57.

⁷⁸ *Id.* at 59.

⁷⁹ *Id.*

⁸⁰ *Id.*

Summary of US Trustee’s Position in Bankruptcy Cases⁸¹

- The bankruptcy system cannot be used as an instrument in the ongoing commission of a crime
- 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 CSA does not distinguish between the seller or grower of marijuana and more “downstream” participants; all are violating federal criminal law
- Although bankruptcy may be used to administer the illicit proceeds of criminal activities (e.g., Enron), those cases deal with the aftermath of fraud; the parties are not currently involved in a fraudulent or criminal scheme

III. SOLUTIONS

There are ways debtors may avoid these challenges when seeking bankruptcy relief.

(1) Sanitizing plan payments/Segregating income:

Debtors may be able to use non-marijuana-related income to fund a reorganization plan by segregating their marijuana-related income from other sources of income. However, this option requires sufficient funds that are not tainted with marijuana activity. For example, debtors in *In re Arenas* would not have had enough money, even if their case had been converted to a Chapter 13, to fund a reorganization plan with funds that came from a source other than marijuana activity.

However, it is unlikely that this will help the debtor avoid violating the federal law. In fact, some courts do not allow debtors to sanitize their plan payments. For example, the court in *In re Johnson* explained that sanitizing the plan payments would not have been enough because “money is fungible and the arrangement would invariably taint the court and the standing trustee, because the trustee would be supporting the debtor’s criminal conduct.”⁸² Further, the benefits of obtaining bankruptcy relief would have advanced “[t]he two aspects of the Debtor’s life.”⁸³

(2) Abandonment and destruction of contraband:

Debtors may abandon and subsequently destroy marijuana and marijuana products included in the bankruptcy estate before or after filing for bankruptcy.⁸⁴

⁸¹ Clifford J. White III, *Why Marijuana Assets May Not Be Administered in Bankruptcy*, 36-DEC Am. Bankr. Inst. J. 34 (2017).

⁸² *In re Johnson*, 532 B.R. at 56-7.

⁸³ *Id.* at 57.

⁸⁴ Matthew W. Hoelscher, *Legalization and Reorganization: Marijuana in Chapter 13*, NACTT Quarterly, 2018; *In re Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015).

(3) Receiverships:

Debtors should consider “state court insolvency proceedings, such as receiverships and assignments for the benefit of creditors.”⁸⁵ “[A] receivership occurs when a court orders an asset, typically real estate or a business enterprise, to be placed in the custody of a receiver appointed by the court, for the benefit of creditors [T]he receiver generally takes control of the property, collects any income from the property, and liquidates the property for the benefit of its creditors, must like a trustee in bankruptcy would.”⁸⁶ Further, “receiverships remain open for business for marijuana-related businesses.”⁸⁷

(4) Termination and Eviction Clauses:

If the debtor is a landlord whose tenants grow, dispense, or distribute cannabis, the debtor can negotiate termination and eviction clauses with their tenants to state that in the event of the landlord’s bankruptcy, the landlord may evict the tenant before filing.⁸⁸

(5) Legislative Proposals:

The Strengthening the Tenth Amendment Through Entrusting States (STATES) Act, S. 3032

- Introduced by Senators Elizabeth Warren (D-Mass) and Cory Gardner (R-Colo) on June 7, 2018
- Would amend the CSA so that, as long as states (and federally recognized tribes) comply with certain protections, its provisions no longer apply to any person acting in compliance with State (or tribal) laws relating to the manufacture, production, possession, distribution, dispensation, administration, or delivery of marijuana
- Would amend the CSA’s definition of “marihuana” to exclude industrial hemp
- General idea is to recognize state laws legalizing cannabis

The SAFE Banking Act, HR 1595

- Would provide a safe harbor for financial institutions to work with cannabis businesses that operate in compliance with state laws
- Would prevent federal banking regulators from punishing banks for working with cannabis-related businesses that are obeying state laws or halting their services, taking action on loans made to those businesses, or limiting a depository institution’s access to the Deposit Insurance Fund
- Would protect ancillary businesses that work with the cannabis industry from being charged with money laundering and other financial crimes
- Would require the Financial Industry Examination Council to develop guidance to help credit unions and banks understand how to lawfully serve cannabis businesses
- Bill was approved by the House Financial Services Committee in late March 2019, along with an amendment from Rep. Steve Stivers (R-Ohio) that would extend the same treatment to insurers⁸⁹

68 G. David Dean and Katherine M. Devanney, “Marijuana’s Journal from Greenhouse to Courthouse: Can Cannabis Debtors Seek Bankruptcy Protection?” ABI Journal. May 30, 2019.

⁸⁶ Daniel A. White, *Excusal and Absention: Receiverhip Issues in Bankruptcy*, 28 No. 2 J. Bankr. L. & Prac. NL Art. 3.

⁸⁷ *Id.*

⁸⁸ Matthew W. Hoelscher, *Legalization and Reorganization: Marijuana in Chapter 13*, NACTT Quarterly, 2018.

⁸⁹ Victoria Guida, *House Panel Approves Landmark Bill to Let Banks Serve Pot Businesses*, Politico, Mar. 28, 2019, <https://www.politico.com/story/2019/03/28/marijuana-bill-house-financial-services-1303494>.

IV. BANKING AND MARIJUANA-RELATED ENTITIES

Marijuana-related entities are challenged not only when it comes to their fight in the bankruptcy court, but also in their growing need to store their cash profits. Banks refuse to allow these entities to open bank accounts let alone apply and receive loans. Because the marijuana industry deals largely with cash, problems quickly arise from the safety of employees and company profits to inefficient and costly tax payments. The following discusses these risks and challenges in greater detail and ways entities, such as private banks, are helping to mitigate them.

- Ray Stern, *Banking on Pot: Arizona's Banks and Medical-Marijuana Dispensaries Seek an Unprosecutable Relationship*, Phoenix New Times (Dec. 29, 2014), <https://www.phoenixnewtimes.com/news/banking-on-pot-arizonas-banks-and-medical-marijuana-dispensaries-seek-an-unprosecutable-relationship-6666923>.
 - GreenStar Payment Solutions of Denver is a firm that provides debit card services to recreational and medical marijuana dispensaries in Arizona, Colorado, among other states.

- Robb Mandelbaum, *Where Pot Entrepreneurs Go When the Banks Just Say No*, N.Y. Times, (Jan. 4, 2018), <https://www.nytimes.com/2018/01/04/magazine/where-pot-entrepreneurs-go-when-the-banks-just-say-no.html>.
 - Issue: Individuals and companies in the marijuana industry have nowhere to store their cash earnings. Because possession, use, sales, and distribution of marijuana is illegal under the federal CSA, banks refuse to provide checking accounts for those in the marijuana industry. The industry predominantly deals with cash, which is accompanied by problems such as risk of violent crime against employees.
 - Private banks are beginning to allow marijuana-related businesses to open checking accounts.
 - In particular, Safe Harbor Private Banking, a division of Partner Colorado, a credit union in Arvada, Colorado, does not lend money, “because the federal authorities could seize whatever collateral backs a loan.”
 - Safe Harbor’s manager and chief executive of Partner Colorado, Sundie Seefried, says her chances of prosecution are less than 20%.
 - How it works:
 - Safe Harbor is “the nosiest banker” because it “delve[s] deeply into nearly every aspect of their clients’ finances and operations.”
 - An hour-long interview to get to know its clients
 - Document collection: clients must list the owners, investors, vendors, customers, financial statements, tax forms, organizing documents, state licenses, leases, handbooks, etc.
 - Frequent inspection of premises (ex: every three months) by Safe Harbor bankers to ensure Colorado’s laws are followed.
 - Bankers track every transaction to ensure nothing goes into the illicit market
 - If unusual deposit, for example from a new source, “the banker holds the money until the client can account for it.”
 - Safe Harbor will close any accounts that do not comply (with the then applicable Cole memo) “to weed out less-committed clients.”

- Creditors receive high interest rates for loans to marijuana companies and marijuana companies have a hard time getting loans from banks, because they “lack lienable collateral.” These businesses’ net worth is largely connected to cannabis.
 - In Washington, a third party may liquidate cannabis whether the cannabis was first proposed as loan collateral.
- Jeff Daniels, *California Senate passes legislation to create state-chartered cannabis banks*, CNBC (May 21, 2019), <https://www.cnbc.com/2019/05/21/california-senate-passes-bill-to-create-state-chartered-cannabis-banks.html>.
- Senate Bill 5.1 passed “Under the state legislation . . . private banks or credit unions can apply for a limited purpose state charter so they can provide depository services to licensed cannabis businesses.” Senate Bill 5.1 “still requires approval of the Assembly and California Gov. Gavin Newsom to become law.”
 - “The Democratic lawmaker’s bill would set up special checks by pot businesses as a way to pay state and local taxes, fees and rent.”
 - Nonetheless, these businesses will not be able to get a loan.
- Nick Kovacevich, *California’s Cannabis Banking Moves Forward*, Forbes (June 11, 2019), <https://www.forbes.com/sites/nickkovacevich/2019/06/11/californias-banking-moves-forward/#7a52c891fbba>.
- From the bill, the Cannabis Limited Charter Banking and Credit Union Law “would authorize the limited charter bank or credit union to issue special-purpose checks to cannabis businesses in order to pay government fees, taxes, rent and vendor invoices.”
- Jeffrey Gramlich and Kimberly Houser, *Marijuana Business and Sec. 280E: Potential Pitfalls for Clients and Advisers*, The Tax Adviser, (June 30, 2015), <https://www.thetaxadviser.com/issues/2015/jul/houser-jul15.html>.
- Under 26 U.S.C. § 280E, entities in business with controlled substances, namely Schedule I and II of the federal CSA, are generally prohibited from deducting their expenses.
 - However, the Supreme Court case *James v. United States* held that illegal income that came from embezzlement was taxable.⁹⁰ The Court further noted that businesses that deal with illegal activity may deduct business expenses. Exceptions to this rule includes marijuana: marijuana businesses are prohibited from deducting business expenses.
 - Nonetheless, § 280E does not apply if marijuana-related activity is not the primary good of the business.⁹¹
 - There is risk to professionals such as attorneys and accountants whose clients work in the marijuana industry. While marijuana use, sale, and growth is legal at the state level, because it is still illegal at the federal level, professionals such as attorneys and

⁹⁰ *James v. United States*, 366 U.S. 213 (1961)

⁹¹ See *Californians Helping to Alleviate Medical Problems, Inc. v. Comm’r of Internal Revenue*, 128 T.C. 173 (2007) (holding that medical marijuana dispensary’s deductions were permitted because business provided not only medical marijuana but mainly provided other caregiving services such as counseling, hygiene products, support groups, and computer access).

accountants must take caution if they knowingly aid and abet marijuana business clients.

- Brad Auerbach, *How Cannabis Entrepreneurs Feel About Sessions' Reversal of the Cole Memo*, Forbes (Mar. 3, 2018), <https://www.forbes.com/sites/bradauerbach/2018/03/03/how-cannabis-entrepreneurs-feel-about-sessions-reversal-of-the-cole-memo-#3d12204dc4ae>.
 - The Cole Memo, drafted by Deputy Attorney General under the Obama administration James Cole, was recently rescinded by Attorney General Jeff Sessions of the Trump administration in early 2018. With chances of federal prosecution on the horizon, the marijuana industry will suffer from even more challenges now that investors and banks will be hesitant to do business with them.
 - Nathaniel Gurien, CEO of FinCann, says that there is an “expected renewal of the Rohrbacher-Blumenauer budget amendment (which prohibits use of federal funds for DOJ enforcement of federal marijuana laws against state-sanctioned medical marijuana licensees).” At this point, entrepreneurs in the cannabis industry are expecting a “chilling effect” when it comes to investment and banking.
 - Erik Knutson, CEO of Keep Brands says that “cash transactions will once again be the norm” and this will lead to an increase in violent crime.
 - Arnaud Dumas de Rauly, Chief Strategy Officer for The Blin Group, said that the upside to all of this is “current businesses will be forced to be more rigorous with their operations, cash-flow, and compliance strategies.”

General addition to give a sense of the scope/size of the industry: As of November 2018, there were approximately 28,000 marijuana/cannabis businesses in operation, employing about 150,000 people in the United States. These businesses manage and control approximately \$9 billion in cash revenues.⁹²

⁹² James P. Crumlish, *The Growth, Development, and Difficulties of the Current Marijuana Business*, NACVA/CTI QUICKREAD, Dec. 5, 2018, http://quickreadbuzz.com/2018/12/05/the-growth-development-and-difficulties/?utm_campaign=website&utm_source=nacva&utm_medium=email