

Podcast: Cannabis and Bankruptcy, Ep. 2: Considerations for Businesses

May 11, 2023

This is the second installment in a three-part series exploring issues in cannabis and bankruptcy. In this episode, we'll dive into bankruptcy protections available to businesses, including a case in which the Bankruptcy Court rejected a categorical prohibition for all debtors with any connection to marijuana.

Heidi Urness: I'm Heidi Urness, chair of McGlinchey's Cannabis Practice Group and resident in Seattle. Joining me today are two of my firm colleagues in our New Orleans office. Timothy Byrd is a commercial litigator with bankruptcy experience, and Rudy Cerone brings more than 40 years of experience in all sides of bankruptcy law.

I want to talk a little bit about this idea of continuing violations and bring us back to the *Hacienda* case that Rudy mentioned. But before we jump into that, I'd like to clarify briefly, can you tell us a little bit about Chapter 11 bankruptcy as relevant to cannabis businesses and the *Hacienda* case?

Chapter 11 allows a debtor to reorganize their business while continuing to operate the business. After you file a Chapter 11 petition, the automatic stay is immediately triggered, which prevents creditors from taking any action against the debtor.

Timothy Byrd: Generally, Chapter 11 allows a debtor to reorganize their business while continuing to operate the business. It allows them to reject burdensome contracts. You can stop making debt payments temporarily, and with court approval, you can borrow money to fund your operations. In terms of the Chapter 11 process, after you file a Chapter 11 petition, the automatic stay is immediately triggered, which prevents creditors from taking any action against the debtor. The existing management team can continue to operate the business unless the Chapter 11 trustee is appointed. And later in the process, a plan of reorganization is proposed. It's voted on and typically approved by creditors whose claims are impaired. That's Chapter 11 in a nutshell.

Heidi Urness: It sounds like there are many additional benefits to a Chapter 11 petition, including this automatic stay. You mentioned that the stay applies to creditors. Does it apply to the business as well? Is the business

allowed to keep operating? Is the business allowed to borrow more money, or does it need to stop in its tracks as well?

Rudy Cerone: Heidi, normally, a business is not prevented from continuing to operate. In fact, that's the purpose of Chapter 11. It's to give the business breathing space from the time it files its petition until, as Tim mentioned, a plan of reorganization is proposed and confirmed. It allows the debtor to shed some of its unproductive assets, such as product lines or business lines, that kind of thing. It allows the creditor to eliminate unprofitable executory contracts and unexpired leases. That's why you see retail businesses around the country use Chapter 11 so effectively. After they file, they can eliminate shopping center leases and minimize the impact on their balance sheet. It's very beneficial to businesses that creditors are temporarily prohibited from taking adverse actions against the debtor outside of bankruptcy, which gives them the breathing room that they need to reorganize their finances and/or their business operations, depending on the case circumstances.

The only bright line rule that we have is if you're in the cannabis industry business-wise, you cannot use the protections of the United States Bankruptcy Code.

Heidi Urness: That sounds like a great option for businesses, but it also seems to fly in the face of this "continuing business activity" issue that we just addressed in *Blumsack*. So can you tell me briefly before we dive into all of the issues, is Chapter 11 bankruptcy available to a marijuana-licensed business or a cannabis ancillary business?

Rudy Cerone: Not if they have ongoing business operations in the industry. That's pretty clear. Even under the *Hacienda* case, which we'll mention in a bit, there was no continuing violation of the Controlled Substances Act by the debtor in that case. And so I think the only bright line rule that we have is if you're in the cannabis industry business-wise, you cannot use the protections of the United States Bankruptcy Code.

Heidi Urness: Okay. Let's talk about that case in detail. You're talking about *In re: Hacienda Company*, and the United States Trustee's (UST) Office's motion to Dismiss was denied in January of 2023. Can you tell us a little bit about the business of *In re: Hacienda* and how they were transitioning from being participants in the marijuana industry to cutting ties with any continuing activity?

Rudy Cerone: Sure, and the facts of this case are very important. We will talk about that so you can get a feel for what happened in the case and why the court ruled as it did. As recited in the opinion, *Hacienda* was in the wholesale manufacturing and packaging of cannabis products, that's what its business line was. And they operated under the brand name Lowell Farms. In September 2021, they ceased all of their business operations, and once they did, in order to gain some value from their assets, they made an intellectual property sale. They basically sold the name Lowell Farms to a Canadian company where it's legal, under Canadian federal law, to operate a cannabis business. In exchange for that sale, they received 9.4% of the shares in the Canadian company, and that was the only asset that *Hacienda* had at the time it filed for bankruptcy, about 18 months later, in September 2022. And when they filed, they filed a statement of intention with the Bankruptcy Court to let the participants, the shareholders, and the stakeholders in the case know what they intended to do. And they intended to liquidate the company's assets, which are basically the shares in the Canadian company, to generate funds to pay their creditors at least something on the debt they were owed.

That was the question that the Bankruptcy Court was presented with: Is ownership of shares in a company outside of the United States, that is legal in that jurisdiction, sufficient to warrant a denial of that company's right to file a Chapter 11 to maximize the value of the assets for the benefit of the creditors of the company?

Heidi Urness: So that passive ownership of stock, they maintained that at the time that they filed the bankruptcy petition?

Rudy Cerone: They did, and it was basically the only asset of the estate. And so that was the question that the Bankruptcy Court was presented with: Is ownership of shares in a company outside of the United States, that is legal in that jurisdiction, sufficient to warrant a denial of that company's right to file a Chapter 11 to maximize the value of the assets for the benefit of the creditors of the company? It was important to note that there were no ongoing violations of the Controlled Substances Act, and they're under Chapter 11. As Tim mentioned, a trustee normally is not appointed. Pre-existing management of the company is the one that does the administration of the estate. So there would be no appointment of a federal fiduciary to administer the proceeds of the sale of the stock, which arguably could be considered illegal. And there was no intent at all to involve a fiduciary in the administration of those proceeds.

Heidi Urness: There seem to be many benefits to bankruptcy for both the marijuana business and its creditors. So who is filing these motions and trying to get folks like Blumsack and Hacienda kicked out of court?

Rudy Cerone: That's a very interesting question, Heidi, because even though there are restrictions on creditors temporarily, the ultimate purpose of bankruptcy is to get the creditors, in as efficient a way as possible, as much money as possible on their pre-existing claims. It's interesting that these motions are not being brought by creditors in these cases. They're being brought by an entity called the United States Trustee's Office. The UST is the watchdog of the bankruptcy system in the United States. It's interesting, however, that the UST is an arm of the United States Justice Department, and you can imagine why they're bringing it. They're part of the Fed, right? They're part of the Feds to enforce the Controlled Substances Act. Well, they're just an office in the Department of Justice. So they're being told by Big Justice to take a hard line in these cases so that there's no illegality continuing and operating inside the bankruptcy system.

The difference from the normal cannabis case to Bernie Madoff is that Bernie stopped his illegal activity before the bankruptcies were filed. That's the real distinction in these cases – ongoing illegal activity.

Heidi Urness: Now, this issue of illegality was highlighted by the court in almost a humorous way. They mentioned some other cases they'd administered involving substantial criminal activity. Do you mind giving us a little bit of insight into what the court mentioned there?

Rudy Cerone: Bernie Madoff comes to mind as one of the cases mentioned, and obviously, Bernie was one of the biggest fraudsters in United States history. He violated numerous federal statutes and is in federal prison as a result. The difference is that from the normal cannabis case to Bernie Madoff is, Bernie stopped his illegal activity before the bankruptcies were filed. That's the real distinction in these cases is ongoing illegal activity. If Bernie was still doing his pyramid scheme and everybody knew that it was illegal, he wouldn't be in a bankruptcy case.

Heidi Urness: It's an interesting call out. But then again, what about some of the other cases that they mentioned, Pacific Gas and Electric (PG&E) and Enron? Should those cases have been thrown out because the company has ever engaged in any violation of a non-bankruptcy statute?

Rudy Cerone: The court did mention PG&E and some others and mentioned that it could not be a bright line rule, a per se rule, that a debtor could not have any illegal activity at all in order to be denied access to the Bankruptcy Code. It's a matter of degree, I suspect, that the court was looking at because in *Hacienda*, again, all the activity had stopped.

Heidi Urness: So does the *Hacienda* opinion mean that marijuana businesses are in the clear, or is there anything else that could happen in this case that could jeopardize *Hacienda's* ability to stay in bankruptcy?

Under *Hacienda*, the takeaway is that you may be able to use Chapter 11 if there is no ongoing violation of the Controlled Substances Act in the proposed plan.

Rudy Cerone: That's very interesting, Heidi, because the court made clear that it was only deciding the motion before it called a motion to dismiss, where the evidentiary record is very limited. It specifically kept the door open to the development of further information, further evidence, and further argument. And it made clear that if it's proven that there is a violation of the Controlled Substances Act by the liquidation of the cannabis stock held by this debtor, the court may then, at that point, dismiss the case.

Heidi Urness: So what lessons or roadmaps for marijuana businesses or creditors can we discern from the *Hacienda* case?

Timothy Byrd: Under *Hacienda*, the takeaway is that you may be able to use Chapter 11 if there is no ongoing violation of the Controlled Substances Act in the proposed plan. To recap, in *Hacienda*, the debtor was no longer in business. It simply owns stock in a cannabis-related business. And the court looked at the passive ownership of stock with the intent to liquidate it, which could terminate any connection with cannabis. There were also some unusual circumstances in the case because it was in the best interest of the creditors to keep the case in bankruptcy. The debtor had eliminated any direct involvement in the cannabis industry, at least on the pleadings. And there was a good chance of a substantial distribution to the creditors. But in terms of big takeaways, I don't think this is a bright line rule, and cannabis companies can use *Hacienda* as support to invoke bankruptcy productions.

Heidi Urness: Thank you for that great discussion. We've now talked about two cases addressing bankruptcy for individuals and businesses. In our final upcoming episode, we'll explore what these recent rulings mean for creditors and prospective creditors of the cannabis industry.

Subscribe wherever you listen to podcasts:



Related people

Timothy G. Byrd, Jr.

Rudy J. Cerone

Heidi Urness