Podcast: Cannabis and Bankruptcy, Ep. 1: Considerations for Individuals

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It's no secret that pockets of the cannabis industry are experiencing financial distress, and this is generating fear and concern for marijuana licensees and their lenders as well.

Starting a cannabis business is often discussed, but maintaining a business, particularly during a downturn in the industry, is a completely different ballgame.

In this first installment of our three-part series exploring issues involving cannabis and bankruptcy, we'll give an overview of the various forms of bankruptcy (Chapters 7, 11, and 13) and insolvency options available and explore one recent case where a cannabis employee was denied bankruptcy protection.

Heidi Urness: I'm Heidi Urness, chair of McGlinchey's Cannabis Practice Group and resident in Seattle. We have a three-part series on cannabis and bankruptcy. In this first installment, we'll discuss a recent case involving the availability of bankruptcy protections to an employee of a cannabis business. In coming episodes, we'll dive into bankruptcy and insolvency options available to businesses and considerations for cannabis creditors as well.

Joined with me today are two of my firm colleagues and our New Orleans office. Timothy Bird is a commercial litigator with bankruptcy experience and Rudy Cerone brings more than 40 years of experience in bankruptcy law.

In the cannabis industry, starting a business is often talked about, but maintaining a business, particularly during downturn in the industry, is a completely different ballgame. Bankruptcy is a bit of a dirty word in the cannabis industry because there's a lot of uncertainty and fear regarding whether or not the protections of the Bankruptcy Code are available to industry participants. Can you start by telling me a little bit about what is bankruptcy and whether or not bankruptcy means all hope is lost for a business or its creditors?

Bankruptcy allows debtors to take advantage of the automatic stay, which is a very important bankruptcy concept that prevents creditors from taking any actions against the debtor or property of the estate. This gives the debtor relief from the pressure of creditors, and it allows it to either reorganize under Chapter 11 or liquidate under Chapter 7.

Tim Byrd: Right. So, Heidi, generally bankruptcy, it's a federal statutory scheme. It provides a framework for debtors to discharge their debts and resolve various disputes with creditors. It also allows companies to be preserved and rehabilitated to maximize value to creditors. It allows debtors to take advantage of the automatic stay, which is a very important bankruptcy concept that prevents creditors from taking any actions against the debtor or property of the estate. This gives the debtor relief from the pressure of creditors, and it allows it to either reorganize under Chapter 11 or liquidate under Chapter 7. It's also a favorable venue for creditors to litigate in. Secured creditors can protect their interest in collateral and unsecured creditors are protected from inequitable transfers of the debtor's property in the immediate run up to the bankruptcy filing.

Rudy Cerone: Heidi, bankruptcies are actually dealt with in the U.S. Constitution. From the very beginning, Article One, Section Eight of the Constitution provides that Congress shall enact uniform laws on the subject of bankruptcy. So bankruptcies have been part of our legal system since the very beginning. The most recent version of the bankruptcy laws is what we call the Bankruptcy Code. That was enacted in 1978, and that's what we'll be discussing a bit today.

Heidi Urness: Thanks so much, Tim and Rudy. So to jump into this topic, can you tell us a little bit about why a business would file for bankruptcy in the first place?

Rudy Cerone: Heidi, normally, a company in financial distress needs what we call a breathing space. As Tim mentioned, the automatic stay is a provision of the Code that stops all collection activity by any creditor and allows the debtor a period of time within which to reorganize its financial affairs. The reasons that that they would file is basically a cash flow problem, where they're not generating enough income to pay their debts as they normally become due. It's also used when a business is over leveraged and there's too much debt to support the assets of the company. And it can also be used to clean up a balance sheet.

Heidi Urness: So I know when a lot of folks start looking into these issues, they get confused between the various chapters of the Bankruptcy Code that you just introduced to us, Rudy. Can you tell us a little bit about, let's go ahead and start with Chapters 13 and 7. It's my understanding is that these chapters apply to individuals, not businesses, when they're applying for bankruptcy. Is that correct?

Chapter 7 is applicable to any company or individual that would be seeking bankruptcy protection. And Chapter 7 is basically a liquidation where the company that files basically says, I can't stay in business any longer, turns over all of its assets to a bankruptcy trustee, who then liquidates the assets and pays the creditors.

Rudy Cerone: Actually, Chapter 7 is applicable to any company or individual that would be seeking bankruptcy protection. And Chapter 7 is basically a liquidation where the company that files basically says, I can't stay in business any longer, turns over all of its assets to a bankruptcy trustee, who then liquidates the assets and pays the creditors in accordance with the priorities set forth in the Bankruptcy Code.

Now, there's a couple of other provisions that are available to individuals. As you mentioned, Chapter 13 is the most common, that a person can in essence reorganize his or her financial affairs over a period of three to five years, and then receive a discharge and get a fresh start at the conclusion of that plan. Businesses generally will file a Chapter 11 to reorganize. Chapter 11 of the Bankruptcy Code applies mainly to businesses, but high net worth individuals can also avail themselves of Chapter 11.

Heidi Urness: Great. Thanks so much, Rudy. So, what would be the difference between an individual choosing to file a Chapter 7 versus a 13?

Rudy Cerone: Normally, Chapter 13s are filed by individuals who want to protect significant assets from distribution to the creditors. And mainly that's, for individuals, that's mainly their homes. If there's substantial equity in a home and a debtor wants to retain ownership, they can file a 13, which will allow them to retain the home and then dedicate their disposable income over a period of 36 to 60 months to repay their debts.

Heidi Urness: Now, my understanding is that there's a bit of a conflict in law between the federal illegality of cannabis and the availability of this bankruptcy relief to individuals and businesses. In January, we received a new case *In re: Blumsack*, that was handed down by a Massachusetts Bankruptcy Court, that appeared to block that individual from being able to obtain relief under Chapter 13. Can you explain to us a little bit about what happened there, and then maybe we can dig into how listeners can avoid that result for themselves in the future?

Rudy Cerone: Sure. It's an interesting case, Heidi, because it involved a person who was a "bud tender" at a cannabis business, which is legal under Massachusetts law. And the debtor filed a Chapter 13, again, in order to protect his assets and dedicate his disposable income to fund the payments under the plan that requires a Chapter 13 trustee to administer those payments and distribute the payments to the creditors. And there's a basic tension between the availability of bankruptcy protection and the administration of the estate by a Chapter 13 trustee and the Controlled Substances Act, which is the, as you know, the Federal Act that makes possession, manufacture, cultivation, etc., of cannabis illegal under federal law. And so the issue in the case, which is not unique to individuals, but also applies, is how close to a cannabis business can an individual be in order to be eligible to file for a Chapter 13 bankruptcy? So that was the basic issue in the case.

There's a basic tension between the availability of bankruptcy protection and the administration of the estate by a Chapter 13 trustee and the Controlled Substances Act, which is the, as you know, the Federal Act that makes possession, manufacture, cultivation, etc., of cannabis illegal under federal law. So the issue in the case, which is not unique to individuals, but also applies, is how close to a cannabis business can an individual be in order to be eligible to file for a Chapter 13 bankruptcy?

Heidi Urness: So in this case, we were talking about a budtender. If the issue is how close can you go to a cannabis business, does this case stand for the proposition that *all* employees of a cannabis business may be prohibited under a Chapter 13 bankruptcy? Even if, for example, they just work in an offsite warehouse?

Rudy Cerone: The case makes clear that it's not a bright line rule as to how close can you be to a federally illegal cannabis business to be able to be eligible for a bankruptcy case. The court made very clear in the decision that it was only deciding the issues in that case before it, and it limited the decision specifically to the facts of that

case. The debtor in the case made some interesting arguments along those lines of what you just brought up is, FedEx delivers packages to cannabis businesses, and various other ways that cannabis businesses reach out to the broader community. It's what we would call a "slippery slope" type of an argument. And the court made clear, well, those may very well be good arguments, but those are policy arguments that the court would not address.

I think that the key to this particular case was what the court said at the very end was that the adverse effects of the ruling on the broader issues that you brought up, are something that really has to be addressed by Congress, that the judge's hands were tied by the fact that the income derived by the budtender was from an illegal source. And it would involve administration of those illegally gained funds by a court fiduciary, the Chapter 13 trustee. And that just wasn't allowed under various provisions of Chapter 13.

Heidi Urness: Is there anything that Blumsack could have done in this case to possibly have gotten a different result?

Rudy Cerone: Yeah, he could have stopped working for the cannabis business and cut off the source of the illegal funds. And it's going to tie in with the *Hacienda* case we're going to talk about in a bit on the commercial side, where it's the ongoing illegal activity and ongoing source of illegal funds that are being administered in the bankruptcy case that gives the courts the heartburn that they have.

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Heidi Urness: That sounds sort of like an interesting idea to tell someone who's financially struggling to quit the job that they have. It seems like it's coming down to a bit of a timing issue.

Rudy Cerone: Absolutely. And I really do think that the judge in the case in Massachusetts, the *Blumsack* case, was sending a message to Congress: "If you don't want this bad result, then you have to harmonize the bankruptcy provisions with the reality of the situation that cannabis is legal under state law, but illegal under federal law."

Heidi Urness: Tim, so with all of these tensions between the laws and the policies, what is the take home message of *Blumsack*?

Tim Byrd: Right. So, you know, Rudy articulated the friction and the policy issues that these courts are dealing with. But in terms of where the jurisprudence is today, you know, the *Blumsack* opinion reiterates the theme that we're seeing around the country where Bankruptcy Courts refuse to allow cannabis companies, and even employees connected to the cannabis industry, from invoking the protections of the Bankruptcy Code. In light of these decisions, if we're going to give advice to an individual contemplating bankruptcy, it's, best practice, you're probably going to have to, you know, quit your job and cut ties to the cannabis industry if you want to get bankruptcy protection from your creditors, as the law stands today.

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Heidi Urness: Well, I guess that's helpful advice for individuals, but that's going to be a lot more difficult advice to follow for businesses, if that's going to be a resounding theme throughout this jurisprudence moving forward.

Thank you for that great discussion of the recent *Blumsack* case involving the availability of bankruptcy protections to employees and individuals involved in the cannabis industry. Join us next time for a discussion of the recent *Hacienda* case, which may offer a glimmer of hope that businesses with former cannabis connections, and the right set of facts, could use bankruptcy to liquidate and pay off their creditors.

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