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Mid-Year 2018 Update (Part II)

by Julie Schaeffer

About 2,400 commercial Chapter 11 petitions were filed through May 2018 versus 2,434 at the same point last year (and 5,757 in calendar-year 2017), according to data from American Bankruptcy Institute. Data refined by *Troubled Company Reporter* editors, to exclude contemporaneously filed cases being jointly administered, shows that about 752 of the corporate Chapter 11 cases filed through the end of May involved debtors with more than $1 million in assets. This count is down from 814 such cases filed through May of last year. According to *TCR*, there were 1,836 corporate Chapter 11 filings by debtors with more than $1 million in assets for all of calendar year 2017.

Beyond the numbers, how has 2018 restructuring activity been year to date? What have been the significant events? And what sectors have dominated?

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A Token Exception to Bankruptcy's "Keep off the Grass" Sign

by Dov Kleiner

Marijuana is an unusual substance, in that its sale can be explicitly legal in some states while at the same time being a federal crime everywhere else in the United States. While this oddity has many implications, the ever-increasing number of states that have legalized the use of medical, and in some cases, recreational, marijuana presents a particular dilemma for bankruptcy courts, which are creatures of federal law. That is because, regardless of what may be permitted under state law, the sale of cannabis and certain related activity is prohibited by the federal Controlled Substances Act, 21 U.S.C. §§ 801-904 (the "CSA"). In general, that

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has meant that cannabis and cannabis-related businesses do not have access to the bankruptcy courts. But, as a recent Ninth Circuit Bankruptcy Appellate Panel decision has shown, that exclusion is beginning to bump up against some limits, and judges may increasingly find ways to keep cannabis-related, if not focused, bankruptcies in their courtroom.

Where debtors are directly involved in the cannabis business, bankruptcy courts have been fairly uniform in dismissing cases or otherwise denying access to the bankruptcy process. Even when the debtor's business does not directly involve the growing, sale or distribution of cannabis, the United States Trustee's office, the agency charged with overseeing the administration of bankruptcy cases, has taken a clear position that the bankruptcy courts should be a closed off avenue. As Clifford J. White III, director for the Executive Office for U.S. Trustees wrote in a December 2017 ABI Article, "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." *"Why Marijuana Assets May Not be Administered in Bankruptcy"* (Clifford J. White III and John Sheahan), ABI Journal, December 2017, p.34.

While the US Trustee program has taken a strong advocacy position, federal courts must struggle with a delicate balancing act when the cannabis-related activity may be only tangential to the debtor's business. So, among the many activities prohibited by the CSA is leasing property to a cannabis grower or making a property available for the sale or distribution of marijuana regardless of how important or unimportant that particular parcel may be to a property owner's overall business. 21U.S.C. § 856(a). In addressing these concerns, the federal bankruptcy courts have been careful to ensure that the bankruptcy process is not used to enable a debtor to continue to participate in a federal crime and, for the most part, they have dismissed cases that were cannabis-related. So, for example, in *In re Arm Ventures, LLC*, 564 B.R. 77 (Bankr. S.D. Fla. 2017), the bankruptcy court dismissed the case of a commercial property owner when the debtor was unable to propose a chapter 11 plan that was not reliant on funding by a tenant that was engaged in manufacturing medical marijuana. See also, *In re Rent-Rite Super Kegs*, 484 B.R. 799 (Bankr. D. Col. 2012) (bankruptcy case dismissed where rent from cannabis business comprised 25% of debtor's income); *In re Medpoint Management, LLC*, 528 B.R. 178 (Bankr. D. Ariz. 2015) (involuntary petition dismissed because debtor provided management services and intellectual property to cannabis business). This is consistent with the reasoning federal courts have followed outside the bankruptcy arena when dealing with cannabis activity authorized under state law, see., e.g., *The Fourth Corner Credit Union v. Federal Reserve Bank of Kansas City*, (10th Cir. 2017)(court dismissed complaint filed by credit union challenging the Federal Reserve Bank of Kansas City's denial of a master account to the credit union because the credit union provided banking services to marijuana-related businesses).

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While dismissal of cases by federal courts where the debtor continues to be involved in activity that is criminal under federal law is not surprising, the question becomes more complicated when the prohibited activity is ancillary to the debtor's business or may not even be ongoing. In those circumstances, using the CSA to deny debtors the protection of federal insolvency laws to an entire enterprise based on a portion of its activity may give courts pause as the interest of debtor rehabilitation

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and creditor protection start to look more significant measured against what appears to be only a tangential connection to illicit activity. In what might be the signaling of a slight change of direction in the courts, the Bankruptcy Appellate Panel ("BAP") for the Ninth Circuit has taken that approach and given some guidance as to limited circumstances that may allow a cannabis-related business to avail itself of the bankruptcy courts. In *In re Olsen*, the BAP vacated a bankruptcy court order that dismissed a chapter 13 case on the grounds that the debtor's receipts of rents from a state law authorized marijuana dispensary was an ongoing criminal activity. *Olson v. Van Meter (In re Olsen)*, 2018 Bankr. LEXIS 480 (B.A.P. 9th Cir. Feb. 5, 2018). In *Olsen*, the BAP refused to accept a dismissal based on a conclusory finding predicated on the mere fact that the debtor had a lease with a marijuana business and remanded the case for further findings delineating the specific criminal activity and the legal standard for dismissing the case.

The facts of the Olsen case were complicated, even if the issues were simple. Mrs. Olsen, a partially blind 92-year old nursing home resident, was the principal of a shopping center that leased space to (among other tenants) a marijuana dispensary operating legally under California law. Pre-petition, she had entered into a contract for the sale of the shopping center to the dispensary's owner though that contract eventually became embroiled in litigation. At the same time as the sale litigation was underway, the property's secured lenders began foreclosure proceedings. To bring both the sale and the foreclosure litigations to halt, Mrs. Olsen filed for bankruptcy protection under Chapter 13. While the debtor filed a plan, which would have resulted in the sale of the property, the bankruptcy case never got that far. The bankruptcy court, on its own, dismissed the case based on its finding that the debtor was in violation of federal law for leasing its property to and collecting rent from a marijuana dispensary, even if the dispensary was operating legally under California state law. In dismissing the case, the bankruptcy court was not dissuaded by the debtor having attempted to distance herself from the cannabis business, having already ceased to take rent from the dispensary and moving to terminate rather than assume the lease. For the bankruptcy court, the critical factor was that the debtor had been collecting rent from an illegal activity for some period of time during the pendency of the case and was therefore a participant in criminal activity. *Olsen*, at *8.

In addressing these concerns, the federal bankruptcy courts have been careful to ensure that the bankruptcy process is not used to enable a debtor to continue to participate in a federal crime, and, for the most part, they have dismissed cases that were cannabis-related.

On first blush, the bankruptcy court decision below was not an outlier. As the B.A.P. noted:

> Some courts have held that, to the extent estate assets are used for or generated by the operation of a federally prohibited marijuana business, a trustee or debtor in possession may not administer those assets without violating federal law. *Arenas v. U.S. Tr. (In re Arenas)*, 535 B.R. 845, 852 (10th Cir. BAP 2015); *In re Medpoint Mgmt.*, LLC, 528 B.R. 178, 184-85 (Bankr. D. Ariz. 2015), vacated in part, *Medpoint Mgmt., LLC v. Jensen (In re Medpoint Mgmt., LLC*), BAP No. AZ-15-1130-KuJaJu, 2016 WL 3251581 (9th Cir. BAP Jun. 3, 2016); *In re Johnson*, 532 B.R. 53, 56-57 (Bankr. W.D. Mich. 2015); *In re Rent-Rite Super Kegs W.*, Ltd., 484 B.R. 799, 810 (Bankr. D. Colo. 2012).

Olsen, at *13.

In that context, the lower court's decision was unremarkable and

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followed a line of cases that emphasize the need to prevent federal courts from being complicit in a federal crime. But that rigid approach results in a mechanical analysis that leads to dismissal anytime cannabis is involved, no matter how tangential. And such appears to have been the concern in *Olsen* that underlined the approach taken by the BAP for the Ninth Circuit. Rather than adopting a rigid approach where any cannabis connection results in dismissal, the BAP focused on the specific "knowledge" requirement that the CSA imposed for prohibiting leasing space to a cannabis business and addressed the unique facts of this case, remanding the dismissal back to the bankruptcy court for additional findings. Specifically, the BAP required the bankruptcy court to make detailed finding about the degree to which the nearly blind, elderly debtor, residing in a nursing home and relying on others to operate the business, had actual knowledge of the source of rental income from a portion of her property, which was necessary to find that the debtor was a criminal under the federal statute. Further, the BAP required the bankruptcy court to detail with specificity the precise legal basis for the dismissal as no finding had been made in the lower court regarding the debtor's bad faith or "unclean hands".

While the *Olsen* decision was unanimous at the BAP level, Judge Maureen A. Tighe filed a concurring opinion that highlighted the over growing dilemma that state law marijuana legalization brings to the federal courts:

> With over twenty-five states allowing the medical or recreational use of marijuana, courts increasingly need to address the needs of litigants who are in compliance with state law while not excusing activity that violates federal law. A finding explaining how a debtor violates federal law or otherwise provides cause for dismissal is important to avoid incorrectly deeming a debtor a criminal and denying both debtor and creditors the benefit of the bankruptcy laws. Bankruptcy courts have historically played a role in providing for orderly liquidation of assets, equal payment to creditors, and resolution of disputes that otherwise would take many years to resolve.

Olsen, at *14 (Tighe, dissenting).

While *Olsen* does not represent a dramatic opening of the bankruptcy courts to cannabis businesses, it does suggest that the mere "presence of marijuana near the case should not cause mandatory dismissal." *Olsen*, at *17 (Tighe, dissenting). Rather, courts will continue to struggle to find a way to permit debtors to avail themselves of the protections of the bankruptcy code when the debtor's own ongoing activity is not in direct violation of federal law. More importantly, *Olsen* provides some guidance for property-owning debtors, who can attempt to pro-actively use the lease-rejecting powers of a bankruptcy proceeding to, as was done in *Olsen*, separate from the cannabis-related activity. Certainly, lenders to landlords that may be leasing property to legal dispensaries or distribution facilities will want to consider including provisions in their documents to ensure as much as possible that they, not the debtor, control the right to reject leases for any cannabis related business in the event of a bankruptcy and that cannabis-related leases can be terminated upon a foreclosure sale or bankruptcy sale or assignment of the property or lease. ¤

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