AMERICAN BANKRUPTCY INSTITUTE

2019 Southwest Bankruptcy Conference

Cannabis and Bankruptcy: The Impermissible Contact High

Hon. Scott C. Clarkson
U.S. Bankruptcy Court (C.D. Cal.); Santa Ana

Peter S. Davis
Simon Consulting, LLC; Phoenix

Jason Rosell
Pachulski Stang Ziehl & Jones LLP; San Francisco

Katherine E. Anderson Sanchez
Dickinson Wright PLLC; Phoenix

2019

CANNABIS AND BANKRUPTCY: THE IMPERMISSIBLE CONTACT HIGH

Moderator:
Jason Rosell
Pachulski Stang Ziehl & Jones LLP

Panelists:
Judge Clarkson
United States Bankruptcy Court for the C.D. Cal.

Peter Davis
Simon Consulting

Katherine Sanchez
Dickinson Wright PLLC

September 6, 2019 at 3:15 p.m.

MEET THE PANELISTS

Scott C. Clarkson has served as a United States Bankruptcy Judge for the Central District of California since January 20, 2011. His undergraduate degree is from Indiana University, Bloomington, Indiana (1979) and he received his J.D. degree from George Mason University School of Law, Arlington, Virginia (1982).

Peter S. Davis has nearly 20 years of experience in complex receiverships, forensic accounting, fraud detection, bankruptcy matters, valuations and damages. Mr. Davis has served as Receiver in regulatory matters brought by the SEC, FTC, Arizona Corporation Commission, the Arizona State Board of Education, as well as lenders and shareholders. His areas of expertise include understanding and interpreting complex financial data, fraud detection and deterrence, and determination of damages. He received his Bachelor of Science in Accounting from Loyola Marymount University and his Master of Business Administration from Arizona State University.

MEET THE PANELISTS

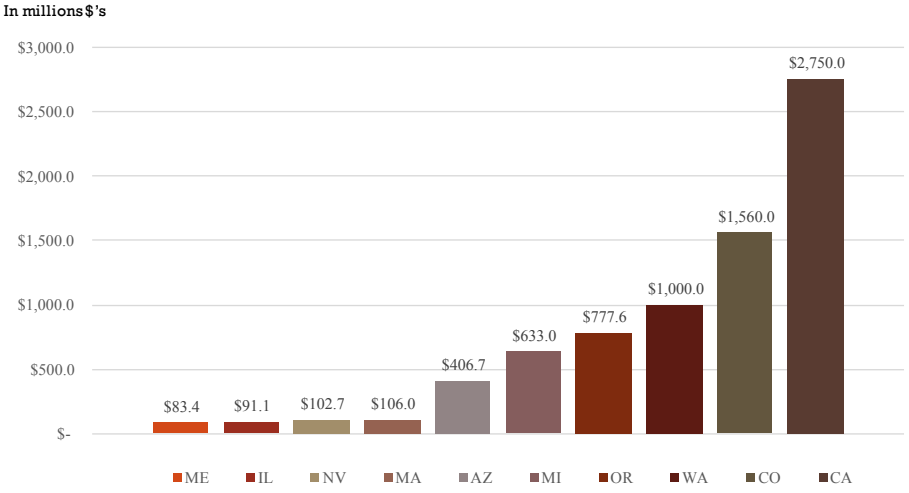
Jason Rosell is a senior associate at Pachulski Stang Ziehl & Jones LLP. His experience includes representing debtors and creditors in complex insolvency cases. He is a member of the boards of the Turnaround Management Association Northern California chapter and Bay Area Bankruptcy Forum. He holds a bachelor's degree in Computer Information Systems, MBA, and JD from Arizona State University.

Katherine Anderson Sanchez, an associate at Dickinson Wright PLLC, is an insolvency professional with experience in all aspects of bankruptcy cases. In addition to her insolvency experience, Ms. Sanchez represents creditors in litigation and enforcement of debt as well as banks and other lenders in loan origination, loan workouts, receiverships and foreclosures. Ms. Sanchez is the current chair of the Bankruptcy Section of the State Bar of Arizona and a member of the Arizona Bankruptcy American Inn of Court. Ms. Sanchez is an Arizona native and a three-time graduate of the University of Arizona.

AGENDA

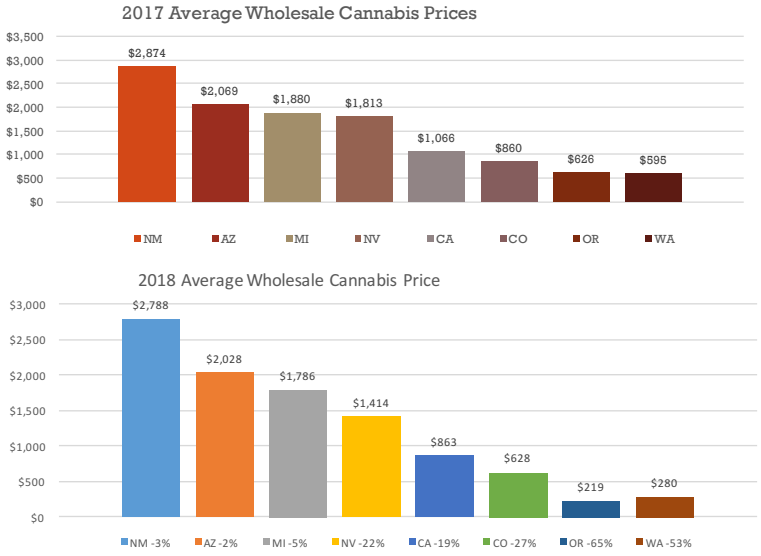
- Current Cannabis Market
- Controlled Substances Act
- Consumer Bankruptcy Issues
- Recent Cannabis Bankruptcy Cases
- Practical Workarounds

CANNABIS SALES REVENUES BY STATE

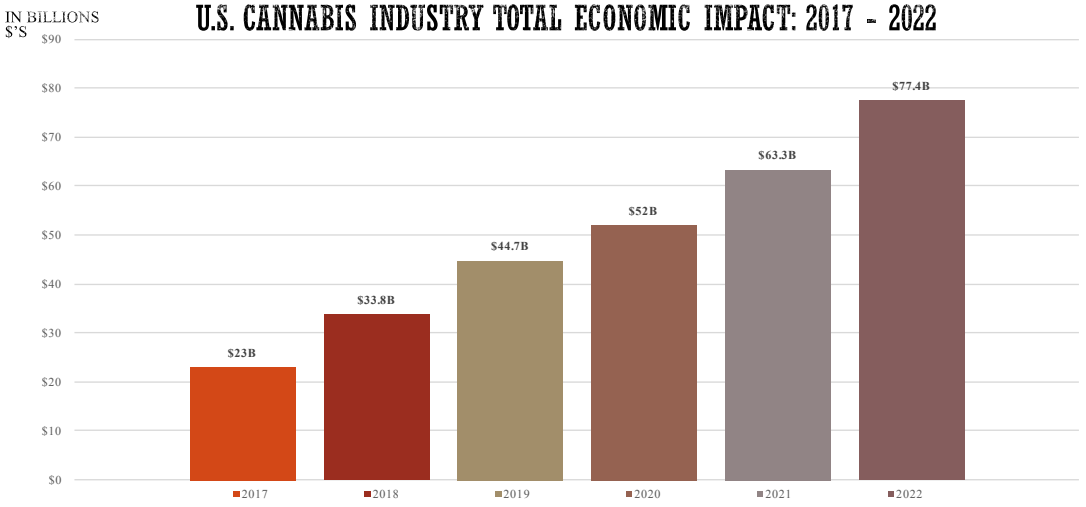


SOURCE: FORBES: HERE'S HOW MUCH MONEY STATES ARE RAKING IN FROM LEGAL MARIJUANA (MAY 4, 2018)

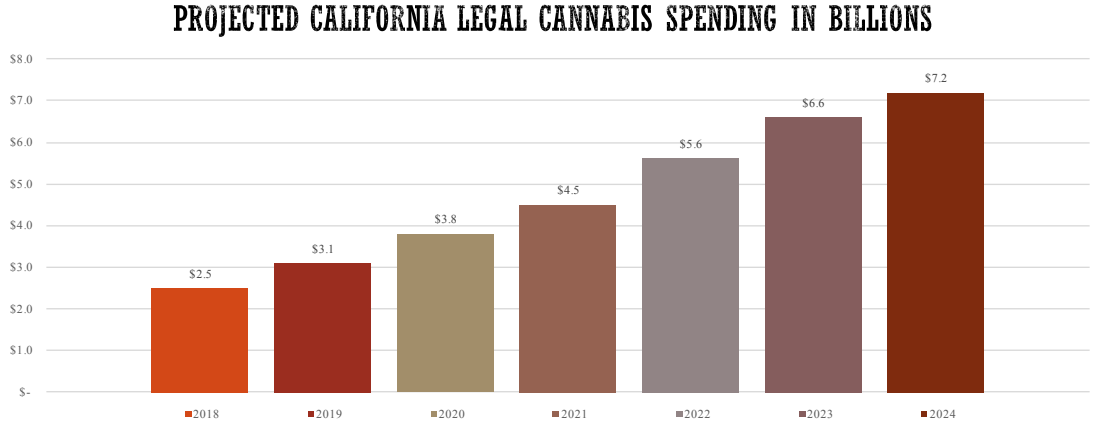
CANNABIS PRICE TREND



SOURCE: MARIJUANA BUSINESS DAILY (OCTOBER 29, 2018)

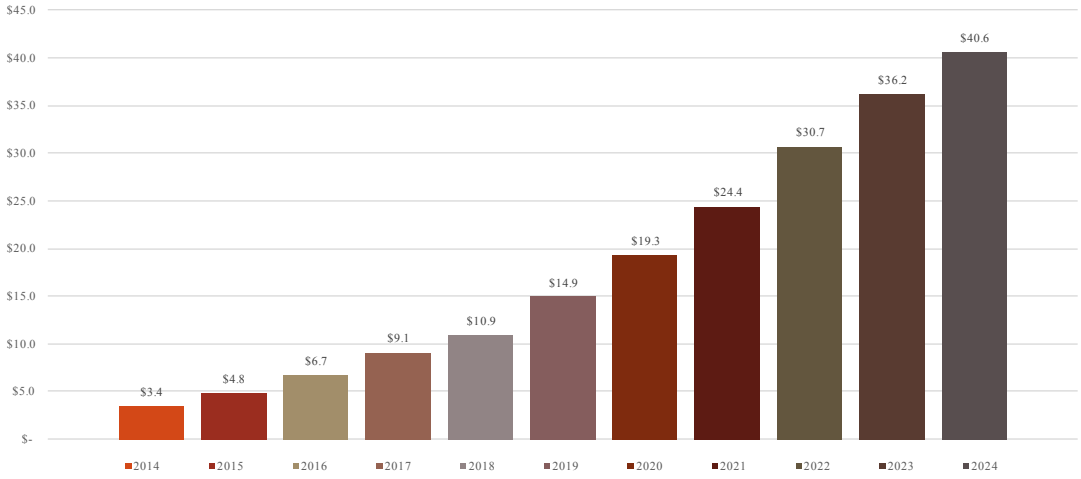


Source: Marijuana Business Daily (May 29, 2018)



SOURCE: ARCVIEW MARKET RESEARCH/BDS ANALYTICS

GLOBAL LEGAL CANNABIS SPENDING



SOURCE: ARCVIEW MARKET RESEARCH/BDS ANALYTICS

RECENT MATERIAL TRANSACTIONS

- **TerrAscend Acquires California-based The Apothecarium for $118 Million**
  - $73.7 million in cash plus $44.7 million in stock.
  - 3 retail shops in California and a vertically integrated operation in Nevada.
- Altria Invests $1.8 Billion in Cronos Group
  - U.S. tobacco giant invested $1.8 billion Ontario-based cannabis producer Cronos Group.
- Gotham Green Partners to Invest $250 Million in MedMen
  - Private equity fund Gotham Green Partners will invest up to $250 million in MedMen, a California-based multistate marijuana operator, in the form of a convertible credit facility.
- BlackRock Invests $11 Million in Curaleaf
  - One of the world's largest money managers disclosed an $11 million investment in Curaleaf Holdings, a Massachusetts-based medical cannabis company.
- **Pax Labs Raises $420 Million for Post-Money Valuation of $1.7 Billion (April 2019)**
  - Pax Labs is a SF-based electronic vaporizer company.
- Cresco Labs to Acquire Original House for $823 Million
  - Cresco, a Chicago-based vertically integrated cannabis company that trades on the Canadian Securities Exchange, agreed to acquire Origin House, a Canadian firm that delivers more than 50 brands to 500+ dispensaries in California, for $823 million in an all-stock deal.

RESTRUCTURING OPPORTUNITIES

- Consumers in Washington and Oregon can buy an ounce of cannabis for $35.
  - Oregon has $2 grams and $28 ounces.
- Oregon 2019 Recreational Marijuana Supply and Demand Legislative Report:
  - As of January 1, 2019, the recreational market has **6.5 years' worth of supply**.
  - This report finds that **supply in the recreational market is twice the level of current demand**.
- Open retail licensing in Washington creates intense competition.
  - Jefferson County – 7 dispensaries for 30,000 residents
- Consensus is that oversupply – not a decline in demand – is causing downward price pressure.
- 95% of Oklahoma's 4,982 cannabis business license applications have been approved.
  - Population of Oklahoma is 4M (1 cannabis license for every 800 people).

STATES/DISTRICT WITH LEGAL USE OF RECREATIONAL CANNABIS

State	Legal Age	Medical	Recreational	Date Legalized
Alaska	21 years +	Legal	Legal	Feb 24, 2015
California	21 years +	Legal	Legal	Jan 1, 2018
Colorado	21 years +	Legal	Legal	Nov 6, 2012
Maine	21 years +	Legal	Legal	Nov 2016
Massachusetts	21 years +	Legal	Legal	July 2018
Michigan	21 years +	Legal	Legal	Dec. 2018
Nevada	21 years +	Legal	Legal	Jul 1, 2017
Oregon	21 years +	Legal	Legal	Jan 1, 2015
Vermont	21 years +	Legal	Legal	Jan 11, 2018
Washington	21 years +	Legal	Legal	Jan 1, 2012
Washington D.C.	21 years +	Legal	Legal	Nov 2014

PROCON.ORG 33 LEGAL MEDICAL MARIJUANA STATES AND DC (5/24/19)

STATES WITH LEGAL USE OF MEDICAL CANNABIS

State	Legal Age	Medical	Recreational	Date Legalized
Arizona	N/A	Legal	Illegal	N/A
Arkansas	N/A	Legal	Illegal	N/A
Connecticut	N/A	Legal	Illegal	N/A
Delaware	N/A	Legal	Illegal	N/A
Florida	N/A	Legal	Illegal	N/A
Hawaii	N/A	Legal	Illegal	N/A
Illinois	N/A	Legal	Illegal	N/A
Maryland	N/A	Legal	Illegal	N/A
Michigan	N/A	Legal	Illegal	N/A
Minnesota	N/A	Legal	Illegal	N/A
Missouri	N/A	Legal	Illegal	N/A
Montana	N/A	Legal	Illegal	N/A
New Hampshire	N/A	Legal	Illegal	N/A
New Jersey	N/A	Legal	Illegal	N/A
New York	N/A	Legal	Illegal	N/A
North Carolina	N/A	Legal	Illegal	N/A
North Dakota	N/A	Legal	Illegal	N/A
Ohio	N/A	Legal	Illegal	N/A
Oklahoma	N/A	Legal	Illegal	N/A
Pennsylvania	N/A	Legal	Illegal	N/A
Rhode Island	N/A	Legal	Illegal	N/A
Utah	N/A	Legal	Illegal	N/A
West Virginia	N/A	Legal	Illegal	N/A

PROCON.ORG 33 LEGAL MEDICAL MARIJUANA STATES AND DC (5/24/19)

THE GROWTH OF HEMP-BASED CBD

- CBD is a non-psychoactive compound found in cannabis plants and believed to have therapeutic properties.
- 2018 Farm Bill effectively legalized the production of hemp and removed many of the federal roadblocks to sales of hemp-derived products, namely CBD.
- CBD Market: $16B by 2025 (Cowen & Co.) / $22B by 2022 (Brightfield Group).
- Walgreens will begin selling CBD topicals in 1,500 stores in nine states.
- CVS will begin selling hemp lotions and transdermal patches in 800 stores.
- In April 2019, Rite Aid began selling CBD topicals in more than 200 stores.
- The FDA has approved a purified form of the drug substance CBD for the treatment of seizures associated with Lennox-Gastaut syndrome or Dravet syndrome in patients 2 years of age and older. That means FDA has concluded that this particular drug product is safe and effective for its intended use.

SAFE BANKING ACT

- March 2019 – 493 banks and 140 credit unions actively servicing cannabis businesses.
  - Treasury Department's Financial Crimes Enforcement Network (FinCEN)
- Secure and Fair Enforcement (SAFE) Banking Act would permit marijuana-related businesses in states with existing regulatory structures to access the federal banking system (i.e., access to loans, lines of creditor, and other banking services).
- Status:
  - Bipartisan bill co-Sponsored by 172 members of congress.
  - Bill cleared the House Financial Services Committee in March 2019 (bipartisan vote of 45 to 15)
- Supporters:
  - National Association of Attorneys General
  - National Association of State Treasurers
  - All 50 state banking associations
  - 38 attorneys general support the SAFE Act
  - 20 governors signed letter encouraging passage
- "Not incorporating an $8.3 billion industry into our banking system is hurting our public safety and economy"
  - California AG Xavier Becerra

CONTROLLED SUBSTANCES ACT

- 28 U.S.C. § 841(a)(1) – Cultivators / Dispensaries
  - ". . . it shall be unlawful for any person knowingly or intentionally to manufacture, distribute, dispense, or possess with intent to manufacture, distribute or dispense, a controlled substance"
- 28 U.S.C. § 843(a)(7) – Ancillary Companies
  - "It shall be unlawful for any person knowingly or intentionally to manufacture, distribute, export, or import any . . . equipment, chemical, product, or material which may be used to manufacture a controlled substance . . . knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance . . ."
- 21 U.S.C. § 856(a)(1) – Landlords
  - ". . . it shall be unlawful to knowingly open, lease, rent, use, or maintain any place, whether permanently or temporarily, for the purpose of manufacturing, distributing, or using any controlled substance"
- 21 U.S.C. § 856(a)(2) – Management
  - ". . . it shall be unlawful to 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"

CONSUMER BANKRUPTCY ISSUES
TYPICAL SCENARIOS

- Consumer debtor works in a dispensary and sole source of income is a paycheck from a management company.
- Consumer debtor owns a commercial building and one of the tenants is a dispensary.
- Consumer debtor owns interest in management company and manages a marijuana cultivator.
- A portion of debtor's income derived from sale of medical marijuana.

CANNABIS BANKRUPTCY CASES
THE UNITED STATES TRUSTEE

- UST Letter to Chapter 7 and 13 Trustees – April 26, 2017:
  - "In recent months, we have noticed an increase in the number of bankruptcy cases involving marijuana assets. This is to reiterate and emphasize the importance of prompt notification to your United States Trustee whenever you uncover a marijuana asset in a case assigned to you. **Our goal is to ensure that trustees are not placed in the untenable position of violating federal law by liquidating, receiving proceeds from, or in any way administering marijuana assets.** In some cases, trustees move to dismiss or object to a chapter 13 plan confirmation on grounds unrelated to the controlled substance. You should continue to file any motions or objections you deem appropriate. **It is the policy of the United States Trustee Program that United States Trustees shall move to dismiss or object in all cases involving marijuana assets on grounds that such assets may not be administered under the Bankruptcy Code** even if trustees or other parties object on the same or different grounds."
- WSJ reported that the UST began a concerted effort in 2017 to dismiss cannabis-related bankruptcy cases.
  - "We simply will not allow the bankruptcy code to be used to evade federal law regardless of state statute."
    - Clifford J. White III, director of the U.S. Trustee program, speech 2017.
- UST took 88 marijuana-enforcement actions from 2010 through 2018, mostly objections and motions to dismiss.
  - More than half (53) occurred in 2017 and 2018.
  - Majority (29) involved chapter 13.
- More than 60,000 marijuana industry employees in California.
- More than 211,000 people employed in cannabis industry.

CANNABIS BANKRUPTCY CASES

THE UNITED STATES TRUSTEE

- *In re: Holly Christine Adair*, Case No. 19-30181 (Bankr. D. Ore. 2019)
  - Background:
    - Chapter 13 case in Oregon.
    - 59 year old woman worked for GreenForce Staffing, **a cannabis industry staffing agency**.
    - Debtor sought chapter 13 protection weeks after her husband of 35 years died suddenly of a blood clot in his lungs.
    - Debtor learned the couple had fallen behind on their mortgage payments while her husband was in the hospital and commenced a chapter 13 case to avoid foreclosure.
  - UST Objection to Confirmation and Motion to Dismiss:
    - A "chapter 13 bankruptcy plan that is funded through marijuana income cannot be confirmed" and necessarily not proposed in good faith under 11 U.S.C. § 1325.
    - Proposed plan could expose chapter 13 trustee to liability.
    - "Cause" exists to dismiss because a chapter 7 liquidation would impermissibly facilitate a violation of federal law because it would permit the Debtor to obtain bankruptcy relief while continue to engage in an ongoing criminal enterprise.
  - Outcome:
    - Debtor voluntarily dismissed the case.

CANNABIS BANKRUPTCY CASES

THE "COMMON THEME" IN CHAPTER 13

- *In re Howard Misle*, Case No. 18-15705, Bankr. D. Nevada 2018, Doc. No. 57. No dismissal of involuntary case solely because debtor owned an interest in marijuana grow facilities.
- *Olson v. Van Meter (In re Olson)*, 2018 Bankr. LEXIS 480 (B.A.P. 9th Cir. Feb. 5, 2018)
  - Elderly chapter 13 debtor obtained rental income from a marijuana dispensary on real property she proposed to sell under her plan. The bankruptcy court *sua sponte* dismissed the bankruptcy case because the debtor was accepting rental income during the postpetition period from a source engaged in a business that violated federal law.
  - BAP vacated and remanded the case, stating that the bankruptcy court needed to make more findings of fact and conclusions of law to support dismissal.
  - **In concurring opinion, Judge Tighe opined that a bankruptcy court has to, among other things, make findings to support its conclusions that the CSA was being violated.**
  - "When a court imposes the harsh penalty of dismissal in circumstances such as those presented here, it is imperative that it state with clarity and precision its factual and legal bases for doing so."

CANNABIS BANKRUPTCY CASES

THE "COMMON THEME" IN CHAPTER 13

- *In re Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015). Court enjoined debtor from conducting medical marijuana business while case was pending. Allowed opportunity to file a plan without marijuana income.
- *In re Arenas*, 514 B.R. 887 (Bankr. D. Colo. 2014)
  - Court dismissed a chapter 7 case of debtor that operated a marijuana grow facility because the chapter 7 trustee cannot take control of the property without himself violating 21 U.S.C. § 856(a)(2)
  - "The impossibility of lawfully administering the Debtors' bankruptcy estate under chapter 7 constitutes cause for dismissal of the Debtors' case under 11 U.S.C. § 707(a)."
- *In re McGinnis*, 453 B.R. 770 (Bankr. D. Or. 2011). Plan could not be confirmed under 11 U.S.C. § 1325(a)(3) where plan was to be funded in part from proceeds of marijuana enterprise. Plan was not feasible where proceeds were from illegal marijuana enterprise.

CANNABIS BANKRUPTCY CASES

NON-INDIVIDUAL CASES

- *In re Rent-Rite Super Kegs West Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012)
  - Chapter 11 debtor derived 25% of its revenue from leasing warehouse space to a cannabis business. Court believed this put the secured creditor's collateral at risk of forfeiture and constituted gross mismanagement and unclean hands under section 1112(b).
  - Debtor subsequently stipulated to stay relief for the secured creditor and filed a motion to reconsider, which was granted.
- *In re Medpoint Management LLC*, 528 B.R. 178 (Bankr. D. Ariz. 2015)
  - Court dismissed an involuntary chapter 7 case against a "medical marijuana business."
    - Debtor was a defunct dispensary management company that owned IP ("Bloom" name and trademark) and licensed IP thru entities that ultimately licensed it to dispensaries.
  - Court observed "without deciding, that it is quite possible that Medpoint's IP and the IP licensing revenues could be seized or forfeited, and that Medpoint could be or could have been guilty of facilitation of a crime under the CSA." Court also found that Medpoint "could be or could have been guilty of violating the CSA under an accomplice theory of liability."
  - As in *Rent-Rite*, the Court found 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."
  - Petitioning creditors not eligible to file involuntary petition because of *in pari delicto* – creditors knew the debtor was in the marijuana business and voluntarily chose to engage in the business.

CANNABIS BANKRUPTCY CASES
NON-INDIVIDUAL CASES

- *In re Way to Grow, Inc., et al.*, 597 B.R. 111 (Bankr. D. Colo. 2018)
  - Court dismissed chapter 11 cases of family of companies that provide equipment for indoor hydroponic and gardening-related supplies through their various retail outlets.
  - Court found that the company is violating 21 U.S.C. § 843(a)(7), which makes it a federal crime to distribute "equipment, chemical, product or material which may be used to manufacture a controlled substance . . . knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance . . . ."
- *In re Basrah Custom Design, Inc.*, 600 B.R. 368 (Bankr. E.D. Mich. 2019)
  - Court dismissed the chapter 11 case of a custom cabinet manufacturer, which occupies two conjoined buildings. The buildings are owned by an affiliate of the Debtor's principal, which entered into a lease with a purchase option with a dispensary.
  - UST moved to dismiss the case "for cause" on the basis that owning or renting a place operating as a dispensary violates the CSA.
  - Debtor alleged it filed bankruptcy to disentangle itself from the cannabis space by rejecting the dispensary lease.
  - Although the Court found that the lease was not property of the estate and the Debtor was not the lessor, the Court found that: (a) the sole purpose of the filing was to facilitate the principal's efforts to avoid the dispensary lease and (b) the debtor filed bankruptcy with unclean hands.
  - Court speculated that if the dispensary requested stay relief to evict the Debtor, the Court would have to refuse because the dispensary would also have unclean hands.
    - Just as "a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime," Rent-Rite, 484 B.R. at 805 (footnote omitted), neither can a federal court be asked to enforce any creditor protections under the Bankruptcy Code, such as the relief-from-stay provisions of 11 U.S.C. § 362(d), in aid of a creditor's commission of a federal crime.

CANNABIS BANKRUPTCY CASES
CALIFORNIA / 9TH CIR.

- *Garvin v. Cook Invs. NW, SPNWY, LLC*, 922 F.3d 1031 (9th Cir. 2019)
  - Bankruptcy court confirmed a chapter 11 plan where debtor rejected a marijuana grower's lease and plan payments would be funded from rent derived from non-marijuana leases.
  - Ninth Circuit held that the requirement under 11 U.S.C. § 1129(a)(3) that a plan must be proposed in good faith only requires bankruptcy courts to review a proposed plan to ensure that it does not *depend upon* any violation of law.
  - Although under the debtor's plan the debtor derived income from the lease of property to a marijuana grower in violation of 21 U.S.C.S. § 856(a)(1), the plan provided for the creditors' repayment and the debtors' ongoing operations, so it was consistent with the objectives and purpose of the Bankruptcy Code.

CANNABIS BANKRUPTCY CASES

CALIFORNIA / 9TH CIR.

- *In re Cwnevada LLC*, 2019 Bankr. LEXIS 1770 (Bankr. D. Nev. May 15, 2019)
  - Debtor was a cannabis cultivator and dispensary and also produced CBD to treat epilepsy.
  - Debtor defaulted on certain loan obligations, faced a receivership application, and commenced chapter 11.
  - Court acknowledged that (a) the CBD business may no longer be illegal under the 2018 Farm Act and (b) a DIP is required to operate in accordance with state law. 28 U.S.C. § 959(b).
  - The Court went on to distinguish numerous cases, concluding generally that (a) the chapter 11 and 13 cases show a general willingness to allow a debtor to propose a feasible plan that does not rely on income received in violation of the CSA and (b) the chapter 7 cases demonstrate that the mere involvement of cannabis-related assets, income, or connections is not dispositive to whether a particular case is permitted to proceed.
  - In dismissing the case, the Court highlighted that the (a) Debtor had not opened a DIP bank account as required under section 345(b) and (b) had not engaged a separate disinterested counsel. The Court abstained under section 305(a), finding that the interests of creditors and the Debtor would be better served by dismissal.
  - "There may be cases where Chapter 11 relief is appropriate for an individual or a non-individual entity directly engaged in a marijuana-related business."

PRACTICAL WORKAROUNDS

- Pre-Bankruptcy Planning
  - Can you disentangle yourself from the cannabis industry?
  - Can you reorganize around hemp / CBD?
  - Can you surrender your cannabis to a secured lender prior to filing?
- Assignments for the Benefit of Creditors
  - License transfer issues
- Receiverships

PRACTICAL WORKAROUNDS

RECEIVERSHIPS

- Mismanagement
- High Levels of Debt / Insolvency
- Board Deadlock
- Sample Statute:
  - Oregon: OAR 845-025-1260
    - Standards for Authority to Operate a Licensed Business as a Trustee, a Receiver, a Personal Representative or a Secured Party: (1) The Commission may issue a temporary authority to operate a licensed business to a trustee, the receiver of an insolvent or bankrupt licensed business, the personal representative of a deceased licensee, or a person holding a security interest in the business for a reasonable period of time to allow orderly disposition of the business.

THANK YOU!

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U.S. Department of Justice

Executive Office for United States Trustees

Office of the Director *Washington, DC 20530*

April 26, 2017

Dear Chapter 7 and Chapter 13 Trustees:

Your role in administering bankruptcy estates is indispensable to the effective and lawful functioning of the entire bankruptcy system. I know that in the past few years, the United States Trustees have reached out to you to ensure that we are informed about all cases assigned to you that involve marijuana assets, which are proscribed under federal law and may not be administered under the Bankruptcy Code.[1] This directive pertains even in cases in which such assets are not illegal under state law.

In recent months, we have noticed an increase in the number of bankruptcy cases involving marijuana assets. This is to reiterate and emphasize the importance of prompt notification to your United States Trustee whenever you uncover a marijuana asset in a case assigned to you. Our goal is to ensure that trustees are not placed in the untenable position of violating federal law by liquidating, receiving proceeds from, or in any way administering marijuana assets. In some cases, trustees move to dismiss or object to a chapter 13 plan confirmation on grounds unrelated to the controlled substance. You should continue to file any motions or objections you deem appropriate. It is the policy of the United States Trustee Program that United States Trustees shall move to dismiss or object in all cases involving marijuana assets on grounds that such assets may not be administered under the Bankruptcy Code even if trustees or other parties object on the same or different grounds.

I appreciate your continued and heightened attention to our directive for prompt notification of all cases involving marijuana assets. I am grateful for all the work you do every day to uphold the integrity of the bankruptcy system and to satisfy the highest fiduciary standards. Your accomplishments, while not always heralded, are much appreciated.

Sincerely yours,

Clifford J. White III
Director

cc: Deputy Director/General Counsel
United States Trustees
Assistant United States Trustees

[1] Cases involving marijuana assets include cases in which the marijuana assets would leave the estate through exemption or abandonment.

Office of the Attorney General
Washington, D. C. 20530

January 4, 2018

MEMORANDUM FOR ALL UNITED STATES ATTORNEYS

FROM: Jefferson B. Sessions, III
Attorney General

SUBJECT: Marijuana Enforcement

In the Controlled Substances Act, Congress has generally prohibited the cultivation, distribution, and possession of marijuana. 21 U.S.C. § 801 *et seq*. It has established significant penalties for these crimes. 21 U.S.C. § 841 *et seq*. These activities also may serve as the basis for the prosecution of other crimes, such as those prohibited by the money laundering statutes, the unlicensed money transmitter statute, and the Bank Secrecy Act. 18 U.S.C. §§ 1956-57, 1960; 31 U.S.C. § 5318. These statutes reflect Congress's determination that marijuana is a dangerous drug and that marijuana activity is a serious crime.

In deciding which marijuana activities to prosecute under these laws with the Department's finite resources, prosecutors should follow the well-established principles that govern all federal prosecutions. Attorney General Benjamin Civiletti originally set forth these principles in 1980, and they have been refined over time, as reflected in chapter 9-27.000 of the U.S. Attorneys' Manual. These principles require federal prosecutors deciding which cases to prosecute to weigh all relevant considerations, including federal law enforcement priorities set by the Attorney General, the seriousness of the crime, the deterrent effect of criminal prosecution, and the cumulative impact of particular crimes on the community.

Given the Department's well-established general principles, previous nationwide guidance specific to marijuana enforcement is unnecessary and is rescinded, effective immediately.[1] This memorandum is intended solely as a guide to the exercise of investigative and prosecutorial discretion in accordance with all applicable laws, regulations, and appropriations. It is not intended to, does not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal.

[1] Previous guidance includes: David W. Ogden, Deputy Att'y Gen., Memorandum for Selected United States Attorneys: Investigations and Prosecutions in States Authorizing the Medical Use of Marijuana (Oct. 19, 2009); James M. Cole, Deputy Att'y Gen., Memorandum for United States Attorneys: Guidance Regarding the Ogden Memo in Jurisdictions Seeking to Authorize Marijuana for Medical Use (June 29, 2011); James M. Cole, Deputy Att'y Gen., Memorandum for All United States Attorneys: Guidance Regarding Marijuana Enforcement (Aug. 29, 2013); James M. Cole, Deputy Att'y Gen., Memorandum for All United States Attorneys: Guidance Regarding Marijuana Related Financial Crimes (Feb. 14, 2014); and Monty Wilkinson, Director of the Executive Office for U.S. Att'ys, Policy Statement Regarding Marijuana Issues in Indian Country (Oct. 28, 2014).

In re Cwnevada LLC

United States Bankruptcy Court for the District of Nevada

May 15, 2019, Decided; June 3, 2019, Entered on Docket

Case No.: 19-12300-MKN, Chapter 11

Reporter
2019 Bankr. LEXIS 1770 *; __ B.R. __; 2019 WL 2420032

In re: CWNEVADA LLC, Debtor.

Counsel: [*1] For MICHELE L. ROBERTS, Debtor: GEORGE HAINES, DAVID KRIEGER, HAINES & KRIEGER, L.L.C., HENDERSON, NV.

For KATHLEEN A. LEAVITT, Trustee: KATHLEEN A. LEAVITT, LAS VEGAS, NV.

Judges: Honorable Mike K. Nakagawa, United States Bankruptcy Judge.

Opinion by: Mike K. Nakagawa

Opinion

ORDER REGARDING CREDITOR 4FRONT ADVISORS LLC'S MOTION TO DISMISS BANKRUPTCY PETITION OR, ALTERNATIVELY, MOTION FOR RELIEF FROM THE AUTOMATIC STAY TO ALLOW RECEIVERSHIP AND CONTEMPT PROCEEDINGS TO CONTINUE[1]

On May 15, 2019, the court heard Creditor 4Front Advisors LLC's Motion to Dismiss Bankruptcy Petition or, Alternatively, Motion for Relief from the Automatic Stay to Allow Receivership and Contempt Proceedings to Continue ("Dismissal Motion"). The appearances of counsel were noted on the record. After arguments were presented, the matter was taken under submission.

BACKGROUND

On April 16, 2019, a voluntary petition for Chapter 11 reorganization ("Petition") was filed by CWNevada LLC ("Debtor"). (ECF No. 1). Attached to the Petition is a "Resolution Authorizing Bankruptcy" that identifies BCP Holding 7, LLC ("BCP Holding") as managing member of the Debtor, and that authorizes BCP Holding to seek Chapter 11 relief for the Debtor. The Petition filed [*2] on behalf of the Debtor is signed by Brian C. Padgett ("Padgett") as manager of BCP Holding, and by Michael D. Mazur, as the Debtor's general counsel.

The voluntary Petition is a "skeleton" petition inasmuch as it is not accompanied by a schedule of assets and liabilities ("Schedules"), a statement of financial affairs (SOFA"), or any of the initial information required to obtain bankruptcy relief. Moreover, the Petition is not accompanied by a "creditor matrix" setting forth the names and addresses of the Debtor's creditors. The Petition is accompanied by an unsigned List of Creditors Who Have the 20

[1] In this Order, all references to "ECF No." are to the number assigned to the documents filed in the instant case, or any other specifically identified case, as the documents appear on the dockets maintained by the clerk of court. All references to "Section" are to the provisions of the Bankruptcy Code, 11 U.S.C. §§ 101-1532. All references to "Local Rule" are to the Local Rules of Practice for this bankruptcy court. All references to "FRE" are to the Federal Rules of Evidence.

Largest Unsecured Claims and Are Not Insiders ("20 List"). (ECF No. 4). Only ten creditors are identified on the 20 List.[2]

On the same day the skeleton Petition and 20 List were filed, a Notice of Chapter 11 Bankruptcy Case ("Bankruptcy Notice") was issued by the clerk of the court informing creditors that a meeting of creditors would be held on May 16, 2019. (ECF No. 3). Because a creditor matrix was never filed by the Debtor, it appears that the Bankruptcy Notice was served only on the creditors appearing on the 20 List. (ECF No. 12).

On April 17, 2019, an Ex Parte Application for Order [*3] Authorizing Rule 2004 Examination ["2004 Exam"] of Brian C. Padgett ("2004 Exam Request") was filed by The CIMA Group, LLC ("CIMA Group"). (ECF No. 8). On April 19, 2019, the clerk of the court signed an order granting the request pursuant to Local Rule 5075(a)(2)(L) because the 2004 Exam Request sought to conduct the examination more than fourteen days later and did not include a request for production of documents ("CIMA 2004 Order"). (ECF No. 10). On the same date, CIMA Group filed a 2004 Exam notice which included a Subpoena for Rule 2004 Examination ("2004 Subpoena") that required the witness to produce various documents. (ECF No. 11).[3]

On April 23, 2019, 4Front Advisors LLC ("4Front") filed the instant Dismissal Motion seeking dismissal of the Chapter 11 case based on Section 305(a)(1),[4] or, Section 1112(b).[5] In the alternative, 4Front seeks relief from the automatic stay under Section 362(d) to allow it to proceed with collection activities under non-bankruptcy law. Numerous documents are attached to the Dismissal Motion and marked as exhibits "1" through "24." (ECF No. 18). In support of the Dismissal Motion, 4Front filed [*4] the declarations of Kris Krane ("Krane Declaration")[6] and Cory L. Braddock ("Braddock Declaration").[7] (ECF Nos. 20 and 21).[8]

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[2] The absence of a creditor matrix is significant because bankruptcy relief depends on proper notice being given to creditors and other parties in interest. Moreover, a "creditor" under Section 101(10)(A) includes any entity that has a "claim" against the bankruptcy estate on the date the bankruptcy petition is filed. Under Section 101(5)(A), a claim includes any "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured..."

[3] Local Rule 2004(c) provides as follows: "Production of documents may not be obtained via an order under Fed. R. Bankr. P. 2004. Production of documents may, however, be obtained via subpoena as provided by Fed. R. Civ. P. 45(a)(1)(C), as adopted by Fed. R. Bankr. P. 9016." (Emphasis added.) It appears that the 2004 Subpoena commands both testimony and production of documents based on the CIMA 2004 Order. The latter command appears to run afoul of Local Rule 2004(c). In addition, Local Rule 5075(a)(2) authorizes the clerk of the court to sign various orders on behalf of the court for certain matters, including 2004 Exam requests. That authorization applies to "[o]rders authorizing examinations to be taken under Fed. R. Bankr. P. 2004 if the date set for examinations is set on not less than fourteen (14) days' notice and the request for examination does not include a request for production of documents. Orders that do not meet these requirements and orders under Fed. R. Bankr. P. 2004(d), must be signed by a judge..." Local Rule 5075(a)(2)(L) (emphasis added). The language of Local Rule 5075(a)(2)(L) is simply inconsistent with the language of Local Rule 2004(c) that precludes a production of documents from being obtained through an order authorizing a 2004 Exam. As a party in interest, CIMA Group is permitted to conduct a 2004 Exam of the Debtor's principal and should not be whipsawed, of course, between two poorly drafted local rules. CIMA Group has noticed a motion to be heard on June 19, 2019, if necessary, to address compliance with the CIMA 2004 Order and 2004 Subpoena. (ECF Nos. 70 and 74).

[4] Section 305(a) provides that a bankruptcy court, after notice and a hearing, may dismiss a bankruptcy case at any time if "the interests of creditors and the debtor would be better served by such dismissal..." 11 U.S.C. § 305(a)(1).

[5] Section 1112(b) provides that a bankruptcy court, after notice and a hearing, shall dismiss a Chapter 11 case, or convert it to Chapter 7, for cause, whichever is in the best of creditors and the estate. See 11 U.S.C. § 1112(b)(1). Examples of "cause" include "gross management of the estate." Id. at § 1112(b)(4)(B). To avoid dismissal or conversion, a party in interest must establish, *inter alia*, that there is a reasonable justification of the act or omission constituting cause, and that the act or omission will be cured within a reasonable amount of time. Id. at § 1112(b)(2)(B).

[6] Through the written testimony of its co-founder, 4Front maintains that it is a "nationally recognized consultant in the legal cannabis industry." Krane Declaration at ¶ 5. 4Front apparently entered into an agreement with the Debtor on March 10, 2014, to provide consulting services "to assist [Debtor] in applying for highly valuable and competitive licenses to operate sate-legal

On April 25, 2019, a combined joinder in the Dismissal Motion was filed on behalf of Highland Partners NV LLC, MI-CW Holdings NV Fund 2 LLC, and MI-CW Holdings LLC (collectively "Highland Partners"), as well as by Green Pastures Fund, LLC Series 1 (CWNevada, LLC), Jakal Investments, LLC, Green Pastures Group, LLC, Jonathan S. Fenn Revocable Trust, and Growth Properties, LLC (collectively "Green Pastures"). (ECF No. 26). In support of that combined joinder ("Highland Joinder"), Highland Partners and Green Pastures filed the declarations of David J. Malley, Esq. ("Malley Declaration"), Christopher R. Miltenberger, Esq. ("Miltenberger Declaration"), and Brandon Kanitz ("Kanitz Declaration"). (ECF Nos. 27, 28, and 29).

On April 26, 2019, a joinder in the Dismissal Motion was filed on behalf of Timothy Smits Van Oyen ("Van Oyen"). (ECF No. 37).

On May 2, 2019, a joinder in the Dismissal Motion was filed on behalf of MC Brands, LLC ("MC Brands"). (ECF No. 47).

On May 7, 2019, a limited joinder in the Dismissal Motion was filed on behalf of The [*5] CIMA Group ("CIMA Joinder"), to which is attached copies of three documents marked as exhibits "1" through "3." (ECF No. 50).

On May 7, 2019, Debtor filed an opposition to the Dismissal Motion ("Opposition") to which is attached four documents marked as exhibits "A" through "D." (ECF No. 51). The Opposition is supported by the Declaration of Brian C. Padgett ("Padgett Declaration"). (ECF No. 52). On the same date, Debtor filed oppositions to the Highland Joinder, as well as the joinders filed by Van Oyen and MC Brands. (ECF Nos. 54 and 55).

On May 8, 2019, Debtor filed an opposition to the CIMA Joinder ("Additional Opposition"). (ECF No. 56).

On May 8 and May 9, 2019, Debtor filed a request for judicial notice ("RJN") of numerous documents marked as exhibits "A" through "O." (ECF Nos. 57 and 60). Exhibits "A" through "J" apparently consist of copies of the "Register of Actions" or list of docket entries for proceedings of public record pending in State Court, and in this bankruptcy court.[9] Exhibits "K" through "O" consist of documents that were not, until now, of public record.[10]

On May 13, 2019, 4Front filed a reply in support of the Dismissal Motion ("4Front [*6] Reply"), to which is attached five documents marked as Exhibits "A" through "E." (ECF No. 68). On the same date, Highland Partners filed a reply in support of the Highland Joinder ("Highland Reply"). (ECF No. 69). On the same date, CIMA Group filed a

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marijuana facilities in Nevada." Id. at ¶ 6. In addition to that assistance, 4Front apparently provided "consulting services relating to the design and operation of successful retail cannabis dispensaries as permitted under Nevada state law." Id. at ¶ 7.

[7] Through the written testimony of its legal counsel, 4Front maintains that it obtained an arbitration award against the Debtor that it seeks to confirm in an action pending in "Nevada state court." Braddock Declaration at ¶¶ 3, 4 and 5. Based on the arbitration award, 4Front apparently filed an application for the appointment of a receiver ("Receivership Application"), the hearing on which was continued by the Eighth Judicial District Court, Clark County, Nevada ("State Court") on several occasions and eventually set for April 17, 2019. Id. at ¶¶ 6 through 13. The State Court apparently entered an order requiring the Debtor to show cause on May 6, 2019, why it should not be held in contempt for violating a prior order. Id. at ¶ 14.

[8] Paragraphs 17 through 39 of the Braddock Declaration offer authentication under FRE 901 of the twenty-four exhibits attached to the Dismissal Motion.

[9] The court can take judicial notice under FRE 201 of the documents filed in the state court proceedings, as well as in this bankruptcy court. See U.S. v. Wilson, 631 F.2d 118, 119 (9th Cir. 1980); Conde v. Open Door Mktg., LLC, 223 F. Supp. 3d 949, 970 n.9 (N.D. Cal. 2017); Green v. Williams, 2012 U.S. Dist. LEXIS 128135, 2012 WL 3962458, at *1 n.1 (D. Nev. Sept. 7, 2012); Bank of Am., N.A. v. CD-04, Inc. (In re Owner Mgmt. Serv., LLC Trustee Corps.), 530 B.R. 711, 717 (Bankr. C.D. Cal. 2015).

[10] Exhibits "K" through "N" appear to be authenticated under FRE 901 by paragraphs 13, 12, 11, and 10 of the Padgett Declaration. Exhibit "O" is a copy of a document entitled "Cannex Notice of Meeting and Management Information Circular Relating to the Special Meeting of Security Holders to be Held on April 18, 2019" ("Cannex Notice"), the source of which is not addressed by the Padgett Declaration.

reply in support of the CIMA Joinder ("CIMA Reply"), to which is attached a single document marked as exhibit "1." (ECF No. 71).[11]

DISCUSSION

Debtor is in the business of cultivating, producing, and distributing medical and recreational marijuana ("Marijuana Business"). See Padgett Declaration at ¶¶ 4-5. It also is in the business of producing and distributing products that contain cannabidiol ("CBD") which apparently are used, *inter alia*, to treat epilepsy ("CBD Business"). Id. at ¶ 6. Debtor apparently operates or once operated marijuana cultivation, production, or dispensary facilities at up to five Nevada locations: three in Las Vegas, one in North Las Vegas, and one in Pahrump. See CWNevada Investor Update, February 2016, attached as Exhibit "1" to Dismissal Motion, at pages 13-17; see also Benchmark Insurance Company - Workers Compensation and Employers Liability Insurance, 04/26/2019 to 04/26/2020, attached as Exhibit "N" to RJN [*7] and as Exhibit "A" to Opposition. Debtor's health plan coverage apparently encompasses 54 subscribers. See Health Plan of Nevada Bill Statement for May 2019, attached as Exhibit "M" to RJN and as Exhibit "B" to Opposition. Debtor apparently made a payment of $81,850 to the Nevada Department of Taxation ("NDOT") on April 23, 2019. See Marijuana Tax Return dated March 29, 2019, attached as Exhibit "K" to RJN and as Exhibit "D" to Opposition.[12]

Debtor's business operations apparently are authorized under Nevada law.[13] Debtor's Marijuana Business is prohibited under federal law by provisions of the Controlled Substances Act, 21 U.S.C. § 841(a)(1) and 21 U.S.C. § 812(c), Schedule I(c)(10) [Marihuana] and Schedule I(c)(17) [Tetrahydrocannibinols].[14] Debtor's CBD Business, however, may no longer be prohibited under federal law as a result of the Agriculture Improvement Act of 2018, Pub. L. 115-334, 132 Stat. 4490.

The Agriculture Improvement Act became effective on December [*8] 20, 2018, when the bill was signed into law. The Act amended the term "Marihuana" under the Controlled Substances Act to exclude hemp "as defined under section 1639o of Title 7." See 21 U.S.C. § 802(16)(B). The Act also amended Schedule I(c)(17) of the Controlled

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[11] The Office of the United States Trustee ("U.S. Trustee") is a component of the United States Department of Justice ("Justice Department") and exercises oversight responsibilities in bankruptcy cases through regional offices located throughout the United States. See 28 U.S.C. § 586. The U.S. Trustee has not joined in the instant Dismissal Motion, nor has it filed a statement expressing any view on the merits of this matter. Likewise, the U.S. Trustee did not enter an appearance at the hearing in this matter. Similarly, neither the Nevada Department of Taxation, Nevada Department of Health and Human Services, nor any other Nevada agency has joined in the Dismissal Motion, or expressed any view. Nor did any Nevada governmental agency enter an appearance at the hearing.

[12] That exhibit is a photocopy that is obscured by a "sticky note" reflecting someone's handwriting and also what appears to be a receipt stapled to the original of the document. That receipt indicates that the NDOT received a total of $81,850 consisting of a check in the amount of $12,000, and cash in the amount of $69,850.00.

[13] Nevada is one of many states that has enacted legislation to decriminalize marijuana. See generally NLJ Staff, *The Elephant in Nevada's Hotel Rooms: Social Consumption of Recreational Marijuana, A Survey of Law, Issues, and Solutions*, 2 Nev.L.J. Forum 99 (2018) [hereafter "NLJ Survey"].

[14] Violations of the Controlled Substances Act are subject to criminal prosecution, with a range of penalties including incarceration and fines. See 21 U.S.C. §§ 841(b)(1)(A)(vii), 841(b)(1)(B)(vii), 841(b)(1)(C), and 841(b)(1)(D). See generally Brian T. Yeh, *Drug Offenses: Maximum Fines and Terms of Imprisonment for Violation of the Federal Controlled Substances Act and Related Laws*, Congressional Research Service, January 20, 2015, available at https://fas.org/sgp/crs/misc/RL30722.pdf (last visited May 31, 2019). Persons who attempt or conspire in a violation of the Controlled Substances Act also may be subject to prosecution. See 21 U.S.C. § 846. Compare 18 U.S.C. § 2(a) (a person who aids, abets, counsels, commands, induces or procures the commission of an offense against the United States is punishable as a principal). The statute of limitations for the Justice Department to prosecute a violation of the Controlled Substances Act is five years. 18 U.S.C. § 3282. See, e.g., United States v. Mancuso, 718 F.3d 780, 787 n.1 (9th Cir. 2013) (five-year statute of limitations applies to federal prosecution under Controlled Substances Act).

Substances Act to exclude from the definition of "Tetrahydrocannabinols" the "tetrahydrocannabinols in hemp (as defined under section 1639o of Title 7)." See 21 U.S.C. § 812(c), Schedule I(c)(17). Under 7 U.S.C. § 1639o(1), the term hemp "means the plant Cannabis sativa L. and any part of that plant, including the seeds thereof and all derivatives, extracts, cannabinoids, isomers, acids, and salts of isomers, whether growing or not, with a delta-9 tetrahydrocannibinol concentration of not more than 0.3 percent on a dry weight basis." (Emphasis added.) Because products derived from hemp plants containing restricted concentrations of tetrahydrocannabinols ("THC"), which is the active ingredient in marijuana, are no longer in violation of the Controlled Substances Act, the Food and Drug Administration ("FDA") apparently will assume a regulatory role for such products.[15]

Under these circumstances, the portion of the Debtor's operations devoted to the Marijuana Business appears to be in violation of federal law, [*9] while the portion devoted to the CBD Business might be excluded from the Controlled Substances Act if the CBD products sold by the Debtor are derived from the type of hemp permitted under federal law. Notwithstanding its operations of these two businesses in accordance with Nevada law, Debtor apparently defaulted on payment of many of its obligations, including the claim of 4Front. Before 4Front's Receivership Application could be heard by the State Court, however, Debtor filed its voluntary Chapter 11 Petition.

No one disputes that the Debtor is a limited liability company formed under Nevada law. A limited liability company is treated as a "corporation" under Section 101(9)(A)(iv), and therefore is a "person" as defined under Section 101(41). See AE Rest. Assocs. LLC v. Giampietro (In re Giampietro), 317 B.R. 841, 844 n.3 (Bankr. D. Nev. 2004).[16] Under Section 109(a), a person that resides, has a place of business, or has property in the United States, may be a debtor in bankruptcy. Because the Debtor in this case resides and has a place of business in Nevada, it is eligible under Section 109(a) to file a bankruptcy petition. Additionally, under Section 101(15), a person is included in the term "entity." Under Section 301(a), a voluntary bankruptcy petition commencing a case may be filed by an entity. Because the Debtor is both a person and an entity, it clearly was permitted [*10] under Section 301(a) to file its voluntary Chapter 11 Petition.

As a result of filing a bankruptcy petition, the automatic stay arose under Section 362(a), applicable to all entities, barring various acts and actions from being taken or continued against the Debtor or property of the bankruptcy estate. See 11 U.S.C. § 362(a)(1 through 8). Property of the bankruptcy estate includes, *inter alia*, all legal and equitable interests of the Debtor in property as of the commencement of the case. See 11 U.S.C. § 541(a)(1).[17] So when the Chapter 11 petition was filed in the instant case, 4Front, Highland Partners, Green Pastures, CIMA Group, MC Brands, Van Oyen, and all other creditors were barred from continuing with their State Court litigation against the Debtor, or engaging in any other acts against the Debtor or any property of the Debtor. See generally Hillis Motors, Inc. v. Hawaii Auto. Dealers' Ass'n, 997 F.2d 581, 585 (9th Cir. 1993).[18]

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[15] See Statement from FDA Commissioner Scott Gottlieb, M.D., on new steps to advance agency's continued evaluation of potential regulatory pathways for cannabis-containing and cannabis-derived products, April 2, 2019, available at https://www.fda.gov/news-events/press-announcements/ statement-fda-commissioner-scott-gottlieb (last visited May 31, 2019).

[16] In Giampietro, the bankruptcy court determined that Nevada limited liability companies are subject to the alter ego doctrine that is applied to pierce the veil of Nevada corporations. 317 B.R. at 846-48. In 2017, the Nevada Supreme Court reached the same conclusion. See Gardner v. Eighth Judicial District Court, 405 P.3d 651, 656 (Nev. 2017).

[17] The Bankruptcy Code makes clear that it is the commencement of a case under Sections 301, 302 and 303 that "creates an estate." 11 U.S.C. § 541(a). Prior to the commencement of a case, a debtor simply holds interests that may ultimately become property of the bankruptcy estate. After a bankruptcy estate comes into existence, it may thereafter acquire interests in additional property that also become property of the bankruptcy estate. See 11 U.S.C. § 541(a)(7). Amongst the "legal or equitable interests of the debtor in property as of the commencement" of a bankruptcy case, see 11 U.S.C. § 541(a)(1), are any claims or causes of action that the debtor may assert against any parties. See Sierra Switchboard Co. v. Westinghouse Elec. Corp., 789 F.2d 705, 707 (9th Cir. 1986).

[18] This includes taking possession of or exercising control over property of the bankruptcy estate, or enforcing a lien against property of the estate. See 11 U.S.C. §§ 362(a)(3 and 4). Even if a party is not a creditor having a claim against the Debtor, it is still an "entity" to which the automatic stay applies. The automatic stay described in Sections 362(a)(1, 2, 3 and 6) does not

A fundamental purpose for allowing businesses and individuals to reorganize in Chapter 11 is to preserve jobs, pay creditors as much as they would receive in a Chapter 7 liquidation, and to preserve the investment equity of shareholders. See U.S. v. Whiting Pools, Inc. (In re Whiting Pools, Inc.), 462 U.S. 198, 203, 103 S. Ct. 2309, 2312-13, 76 L. Ed. 2d 515 (1983); In re Mohave Agrarian Group, LLC, 588 B.R. 903, 915 (Bankr. D. Nev. 2018). Because a voluntary Chapter 11 debtor remains in possession of property of its bankruptcy estate, and because it has the rights, powers [*11] and duties of a bankruptcy trustee, see 11 U.S.C. § 1107(a), a Chapter 11 debtor in possession has a fiduciary responsibility to all creditors of the bankruptcy estate. See Woodson v. Fireman's Fund Ins. Co. (In re Woodson), 839 F.2d 610, 614 (9th Cir. 1988) ("[Debtor's] failure to notify his creditors of the $1 million in a timely fashion is especially troubling because [Debtor] is not an ordinary litigant. As debtor in possession he is the trustee of his own estate and therefore stands in a fiduciary relationship to his creditors."). A debtor in possession also is required to manage and operate the property in its possession according to the requirements of state law. See 28 U.S.C. § 959(b).

Creditors who oppose a Chapter 11 debtor's efforts can object at any time during the case and to any plan of reorganization that might be proposed. A Chapter 11 debtor in possession typically has an exclusive period of 120 days to propose a plan of reorganization, after which time a creditor may file its own plan. See 11 U.S.C. § 1121(b). As a general rule, a Chapter 11 debtor can propose a plan of reorganization to which all of its creditors agree, and such a consensual plan is confirmed without the necessity of a "cramdown" of plan treatment.[19] If all creditors do not agree, then the plan may be confirmed through cramdown only if the [*12] treatment of the objecting creditors' claims is "fair and equitable." 11 U.S.C. § 1129(b). It is under this legal framework that the court addresses this Dismissal Motion.[20]

1. The Arguments of the Parties.

After describing a litany of events that allegedly preceded the commencement of this Chapter 11 proceeding, see Dismissal Motion at 2:6 to 10:20, 4Front offers eight separate, but overlapping arguments in favor of its request: (1) that Debtor is ineligible for relief under bankruptcy law, id. at 10:25 to 13:20, (2) that all parties are better served by abstention under Section 305(a) through dismissal of the case, id. at 13:23 to 14:10, (3) that appointment of a receiver in State Court offers a superior forum to resolve disputes, id. at 14:12 to 15:13, (4) that the Debtor commenced the Chapter 11 proceeding to frustrate creditor rights, id. at 15:15 to 16:2, (5) that economy and efficiency supports abstention by dismissal, id. at 16:4 to 17:10, (6) that dismissal is warranted under Section 1112(b) because of bad faith,[21] id. at 17:13 to 18:3, (7) that dismissal is warranted based on the doctrine of unclean hands, id. at 18:5-24, and (8) that the automatic stay should be lifted to permit the actions in State Court to proceed, id. [*13] at 18:27 to 19:19. MC Brands simply joins in all of the arguments raised by 4 Front. Highland Partners, Green Pastures, and Van Oyen join in the arguments based on Section 305(a) and Section 1112(b). See Highlands Joinder at 6:15-27 and 7:2 to 10:20; Van Oyen Joinder at 2:1-2. The "joinder" filed by CIMA Group, however, seeks

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apply to certain activity, such as an action by a governmental unit to enforce the unit's police and regulatory power. See 11 U.S.C. § 362(b)(4).

[19] "Cramdown" is simply a description of what is permitted in bankruptcy: if creditors and interest holders do not agree to the proposed treatment of their claims, the court may confirm a proposed plan over their objections if certain conditions are met.

[20] Bankruptcy permits individuals and non-individuals to obtain a discharge of their personal liability to pay a debt. The Bankruptcy Code provides the statutory framework for which a discharge may be obtained. No one disputes, however, that a party that files for bankruptcy protection does not have a constitutional right to receive a discharge of debts. See U.S. v. Kras, 409 U.S. 434, 446, 93 S.Ct. 631, 638 (1973).

[21] Although 4Front seeks dismissal of the case under Section 1112(b), it does not request appointment of a Chapter 11 trustee under Section 1104(a).

the appointment of a Chapter 11 trustee under Section 1104(a) in the event the case is not dismissed under Section 1112(b).[22] See CIMA Joinder at 8:2 to 12:2.[23]

Debtor does not dispute the characterization of most of the events leading up to the filing of its Chapter 11 petition. See Opposition at 2:26 to 4:4. Instead, it offers eight separate but overlapping arguments of its own: (1) that a Chapter 11 plan will be proposed in good faith, see Opposition at 4:12 to 6:2, (2) that the Justice Department is currently barred from expending funds to enforce the marijuana restrictions applicable under the Controlled Substances Act, id. at 6:5 to 7:13, (3) that abstention through dismissal under Section 305(a) will not better serve the interests of the Debtor, id. at 7:14 to 9:3, (4) that the Debtor is in the process of establishing relationships with banks that currently do business with 4Front, id. at 9:5-12, (5) that the Debtor has workers compensation, [*14] employee health, and automobile insurance in place, and made a tax payment to the NDOT on April 23, 2019, id. at 9:14-27, (6) that the doctrine of unclean hands does not bar bankruptcy relief, id. at 10:2-13, (7) that the balance of hardships favor keeping the automatic stay in place, id. at 10:15 to 11:8, and (8) that civil contempt proceedings currently pending in State Court may be exempt from the automatic stay, id. at 11:11-17.

2. The Existing Case Law is Distinguishable.[24]

Interspersed amongst the parties arguments are citations to various decisions by other courts suggesting why a marijuana-related bankruptcy case should, or should not, be dismissed. None of those decisions, however, are controlling under the circumstances of the case now before this court.[25]

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[22] As previously mentioned, see discussion at 3, supra, 4Front seeks dismissal under Section 305(a), or, in the alternative, Section 1112(b). A decision on a motion to dismiss under Section 1112 must be rendered no later than fifteen days after a hearing commences, unless the moving party consents or compelling circumstances otherwise requires. See 11 U.S.C. § 1112(b)(3).

[23] Although CIMA Group's request for the appointment of a Chapter 11 trustee first appeared in its joinder filed the day before the Debtor's opposition was due, see CIMA Joinder at 6:16 to 12:2, Debtor's written opposition to that joinder does not discuss whether appointment of a trustee is appropriate. See Additional Opposition at 2 ("Debtor hereby adopts all previous arguments made in their Opposition to 4Front Advisors, LLC's Motion as if fully set forth herein..."). In any event, the bankruptcy court may appoint a Chapter 11 trustee *sua sponte*, see Fukutomi v. U.S. Trustee (In re Bibo, Inc.), 76 F.3d 256 (9th Cir. 1996), if it determines the appointment of a Chapter 11 trustee to be in the interests of creditors, equity security holders, and other interests of the estate. See 11 U.S.C. § 1104(a)(2).

[24] Not surprisingly, a variety of cases have been filed in this court by individual or non-individual debtors that receive or propose to receive income from a source authorized under state law to cultivate or distribute marijuana. See, e.g., In re Warwick Properties, LLC, Case No. 17-15065-MKN (voluntary Chapter 11 limited liability company whose tenant cultivated marijuana on California real property as authorized by California law); In re Perez, Case No. 19-12284-MKN (voluntary individual Chapter 7 debtor apparently employed by a Nevada marijuana dispensary licensed under Nevada law); In re Misle, Case No. 18-15705-BTB (involuntary individual Chapter 7 debtor who receives income from an entity that manages marijuana cultivation facilities under Nevada law); In re Redrock Enterprises, LLC, Case No. 15-13493-ABL (voluntary Chapter 11 by debtor who proposed to lease property to a tenant engaged in marijuana operation under Nevada law); In re Olson, Case No. 17-50081-BTB (Chapter 13 debtor who received rental income from medical marijuana dispensary operating under Nevada law).

[25] Cases involving marijuana-related individual and non-individual debtors have become the boogeyman of bankruptcy jurisprudence. Some courts have shied away, and other courts have approached such cases with caution. The bankruptcy debtor's actual connection to the potential illegal activity — whether direct, indirect, remote, or near — appears to be a significant consideration. It is worth noting, however, that bankruptcy courts have a long history of considering cases involving debtors whose activities and operations have included past, present and possibly ongoing violations of applicable non-bankruptcy, civil and criminal laws. See, e.g., Midlantic Nat'l Bank v. New Jersey Dept. of Envt'l Prot., 474 U.S. 494, 106 S.Ct. 755, 88 L. Ed. 2d 859 (1986)(voluntary Chapter 11 of waste oil processor that possessed leaking containers of cancer-causing substances in violation of state and local law was converted to Chapter 7, rather than dismissed); In re Freedom Industries, Inc., Case No. 14-bk-20017 (Bankr. S.D. W.Va. Jan. 17, 2014)(voluntary Chapter 11 filed by chemical producer after chemical spill contaminated Elk River; Chapter 11 plan of reorganization confirmed even though the debtor and officers were subsequently sentenced for

A. The Most Recent Decision of the Ninth Circuit Court of Appeals.

On May 2, 2019, sixteen days after the Debtor commenced this Chapter 11 proceeding, the Ninth Circuit Court of Appeals ("Ninth Circuit") [*15] entered its decision in Garvin v. Cook Investments NW, SPNWY, LLC (In re Cook Investments NW), 922 F.3d 1031 (2019). That Chapter 11 proceeding was commenced in the bankruptcy court for the Western District of Washington and encompassed five related real estate entities. One of those entities, Cook Investments NW DARR ("Cook DARR"), leased property to an unrelated third party licensed under Washington law to grow marijuana. That lease violated, however, the provision of the Controlled Substances Act that prohibited the knowing lease of any space "...for the purpose of manufacturing, distributing, or using any controlled substance..." 21 U.S.C. § 856(a)(1). The U.S. Trustee filed a motion under Section 1112(b)(1) to dismiss the Chapter 11 proceeding based on gross mismanagement as defined under Section 1112(b)(4)(B). The bankruptcy court denied the motion on the debtors' representation that an amended plan would include a rejection of the lease with the marijuana grower and payments under the plan therefore would not depend on a source that violates federal law. See Geiger v. Cook Investments NW, SPNWY, LLC (In re Cook Investments NW), 2017 WL 10716993, at *1 (W.D. Wash. Dec. 18, 2017). The bankruptcy court gave the U.S. Trustee leave to renew the motion at the time of confirmation of the amended plan.[26]

The debtors filed an amended plan along with a separate motion to reject the marijuana tenant's lease. The U.S. Trustee objected to confirmation of the [*16] amended plan, but not to the motion to reject the lease. An order was entered authorizing rejection of the lease. The U.S. Trustee objected that the amended plan was not proposed in good faith under Section 1129(a)(3), but did not renew the motion to dismiss under Section 1112(b)(1) based on gross mismanagement. The bankruptcy court overruled the plan objection and confirmed the amended plan under Section 1129(a).[27] Id. at *1-2. On appeal, the federal district court affirmed both the plan confirmation order and the order denying the U.S. Trustee's motion to dismiss. As to dismissal based on gross mismanagement, the district court concluded that the U.S. Trustee had waived the objection by failing to renew the prior motion. Id. at *3. The district court also concluded that it was not an abuse of discretion to deny dismissal because the debtors might be able to propose a Chapter 11 plan that does not rely on income from the marijuana lease. Id. at *4. The district court emphasized that the debtors' plan of reorganization provided for payment of the single creditor whose judgment would be paid in full from non-marijuana income. Id.

On further appeal, the Ninth Circuit again affirmed. In particular, the circuit panel addressed the U.S. Trustee's objection that the debtors' [*17] Chapter 11 plan did not meet Section 1129(a)(3) because it had not "been proposed in good faith and not by any means forbidden by law." The Ninth Circuit held that the good faith requirement under Section 1129(a)(3) "...directs courts to look only to the proposal of a [Chapter 11] plan, not to the terms of the plan." 922 F.3d at 1035. (Emphasis added). Because the Debtor's plan had been negotiated during the Chapter 11 proceeding in good faith, it had not been proposed by any means forbidden by bankruptcy or non-bankruptcy law. Id. at 1033-34. With respect to any alleged violations of the Controlled Substances Act, the court observed:

> We do not believe that the interpretation compelled by the text [of Section 1129(a)(3)] will result in bankruptcy proceedings being used to facilitate legal violations. To begin, absent waiver, as in this case, courts may

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criminal violations of the federal Clean Water Act and federal Refuse Act). See also NCR Staff, *Catholic Dioceses and Orders that Filed for Bankruptcy and Other Major Settlements*, National Catholic Reporter (May 31, 2018), available at https://www.ncronline.org/news/accountability/catholic-diocesese-and-orders-filed-bankruptcy-and-other-major-settlements (last visited May 31, 2019) (listing all Catholic diocese bankruptcy proceedings filed from July 6, 2004 through approximately February 28, 2018, to address sexual abuse claims against clergy).

[26] Although the debtors were the subject of a prior state court judgment that precipitated the Chapter 11 filing, id. at *1, the U.S. Trustee sought dismissal of the bankruptcy case solely under Section 1112(b), and not dismissal based on abstention under Section 305(a).

[27] Section 1129(a) sets forth sixteen separate requirements that generally apply to all Chapter 11 plan proponents seeking to confirm a plan. Only individual Chapter 11 debtors, however, are subject to the requirements under Section 1129(a)(15).

> consider gross mismanagement under § 1112(b). And confirmation of a plan does not insulate debtors from prosecution for criminal activity, even if that activity is part of the plan itself...There is thus no need to "convert the bankruptcy judge into an ombudsman without portfolio, gratuitously seeking out possible 'illegalities' in every plan," a result that would be "inimical to the basic function of bankruptcy judges in bankruptcy [*18] proceedings."

Id. at 1036 (citations omitted).[28] With respect to dismissal for gross management within the meaning of Section 1112(b)(4)(B), the Ninth Circuit concluded that the U.S. Trustee had waived the objection by failing to renew its motion at plan confirmation. The circuit panel reached that conclusion because the motion was not presented under Section 1112(b)(1) and therefore there was no opportunity for the bankruptcy court to consider whether any claim of gross mismanagement could be cured under Section 1112(b)(2).[29] Id. at 1034.

While the Ninth Circuit's decision in Garvin is controlling when a good faith objection to plan confirmation is raised under Section 1129(a)(3), there is no proposed Chapter 11 plan before the court at this time. Similarly, the Garvin decision does not address other requirements for Chapter 11 plan confirmation, such as feasibility under Section 1129(a)(11).[30] At this stage, the Debtor wants to remain under the protection of the automatic stay while it tries to formulate a plan of reorganization. The Garvin panel did not preclude consideration of a motion to dismiss under Section 1112(b)(1), even at plan confirmation, but did not do so only because the U.S. Trustee had waived the ground by failing to renew its prior motion. So procedurally, the Garvin [*19] decision offers no guidance on whether dismissal under Section 1112(b)(1) on the basis of mismanagement under Section 1112(b)(4)(B), or any other ground, would be appropriate in the present case.

On the other hand, the more obvious factual distinction is that the Chapter 11 debtor in Garvin was not engaged in the cultivation, production and distribution of marijuana. Unlike the debtor in Garvin, this is not a case where proceeds of the Marijuana Business would provide merely "indirect support" for a confirmed plan.[31] Rather, the Marijuana Business operated by the Debtor appears to be the primary source of the Debtor's revenue and appears to be in clear violation of the Controlled Substances Act.

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[28] In Chapter 11 and Chapter 13 proceedings, however, bankruptcy judges have been directed to make an independent determination of whether the statutory requirements for confirmation of a debtor's proposed plan have been met. See, e.g., Liberty Nat'l Enters. v. Ambanc La Mesa Ltd. P'Ship (In re Ambanc La Mesa Ltd. P'Ship), 115 F.3d 650, 653 (9th Cir. 1997) (Chapter 11 plan confirmation); United Student Aid Funds, Inc. v. Espinosa (In re Espinosa), 559 U.S. 260, 276-77, 130 S.Ct. 1367, 1380-81, 176 L. Ed. 2d 158 (2010) (Chapter 13 plan confirmation). See also In re Las Vegas Monorail Co., 462 B.R. 795, 798 (Bankr. D. Nev. 2011) (Chapter 11); In re Escarcega, 573 B.R. 219, 231 (B.A.P. 9th Cir. 2017) (Chapter 13). Moreover, federal judges are directed to report to the appropriate United States attorney all the facts and circumstances of a case in which the judge has reasonable grounds to believe that a bankruptcy crime or any violation of "other laws relating to insolvent debtors, receiverships or reorganization plans have been committed, or that an investigation should be had in connection therewith..." 18 U.S.C. § 3057(a).

[29] If there are unusual circumstances establishing that conversion or dismissal of a Chapter 11 case is not in the best interests of creditors and the estate, such relief is prohibited if the debtor establishes a reasonable likelihood that a plan will be confirmed in a reasonable amount of time, and, *inter alia*, that any act constituting cause, including gross mismanagement, will be cured within a reasonable amount of time fixed by the court. See 11 U.S.C. § 1112(b)(2)(A and B).

[30] Section 1129(a)(11) requires a Chapter 11 plan proponent to demonstrate that plan confirmation "is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan." The Chapter 11 plan proponent must "demonstrate that any necessary financing or funding has been obtained, or is likely to be obtained." In re Trans Max Techs., Inc., 349 B.R. 80, 92 (Bankr. D. Nev. 2006). The Bankruptcy Code "...does not require the debtor to prove that success is inevitable, and a relatively low threshold of proof will satisfy §1129(a)(11)...But the court must still have a reasonable and credible basis for making the necessary findings..." Id. (citations and quotations omitted).

[31] See Garvin, 922 F.3d at 1035 ("Because it appears that [debtors' principal] continues to receive rent payments from [the marijuana producer], which provides at least indirect support for the Amended Plan, the [U.S.] Trustee asserts that [the Chapter 11] pan was 'proposed...by...means forbidden by law.'").

Perhaps more important is that the Garvin decision does not address whether dismissal independently based on abstention under Section 305(a) is appropriate. The debtors in Garvin were not subject to multiple state court actions brought by creditors clamoring to enforce their claims against limited assets. The Debtor in the current case is.

Under these circumstances, the recent decision in Garvin is informative, but neither procedurally nor factually apposite.[32]

B. The Remaining Cases Cited by the Parties.

The other cases [*20] cited by the parties involved marijuana-related bankruptcy relief under various chapters of the Bankruptcy Code, but under very different circumstances. Three other non-bankruptcy cases cited by the parties are not persuasive.

(1) Chapter 13 Cases.

Relief under Chapter 13 is available only to individuals who are eligible under Section 109(e) and who are willing to devote their future disposable income to the payment of creditors. Individuals essentially commit to earn income from their labors over time in exchange for a discharge in Chapter 13. Because individuals cannot be subjected to forced labor, they cannot be placed into Chapter 13 involuntarily. See 11 U.S.C. § 303(a).

In In re McGinnis, 453 B.R. 770 (Bankr. D. Or. 2011), a Chapter 13 debtor proposed a plan that would be partially funded by the debtor's own marijuana business and rental income derived from other marijuana-related businesses. After an evidentiary hearing in which the Chapter 13 trustee objected, the court denied confirmation because the plan's reliance on income derived from the marijuana industry violated the good faith requirement under Section 1325(a)(3).[33] The court further concluded that because the contemplated marijuana operations were illegal under both federal and Oregon law,[34] debtor could not satisfy Section 1325(a)(6) [*21] , which requires proof of a debtor's

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[32] A Chapter 11 plan may provide for the liquidation of the assets of the estate, see 11 U.S.C. § 1129(a)(11), but confirmation of a plan does not discharge the debtor if the plan provides for liquidation of all or substantially all property of the estate, the debtor does not engage in business after consummation of the plan, and the debtor would be denied a discharge if the case was a case under Chapter 7. See 11 U.S.C. § 1141(d)(3). A non-individual entity is not eligible for a discharge in Chapter 7. See discussion at 23, infra. A non-individual entity engaged solely in the cultivation, production and distribution of marijuana faces a difficult choice when seeking Chapter 11 relief: if it commits to disposing of its marijuana assets and to not engage in business, it will not receive a Chapter 11 discharge. If such a non-individual entity does not commit to ceasing operations that are in violation of the Controlled Substances Act, however, its Chapter 11 proceeding may well be subject to dismissal based on gross mismanagement established under Section 1112(b)(4)(B). The debtors in Garvin had substantial operations that did not violate the Controlled Substances Act and were able to engage in business even after rejecting the marijuana tenant's lease. Thus, a Chapter 11 discharge was available to the debtors in Garvin and occurred at the time their plan of reorganization was confirmed. See 11 U.S.C. § 1141(d)(1).

[33] Section 1325(a)(3) parrots the language in Section 1129(a)(3), and requires the court to find that a proposed Chapter 13 plan "has been proposed in good faith and not by any means forbidden by law." 11 U.S.C. § 1325(a)(3).

[34] Oregon law allowed a medical marijuana cultivation operation to be reimbursed for supplies and utility expenditures, but not to obtain a profit from the operation. 453 B.R. at 772-73. Oregon's non-profit requirement for medical marijuana cultivation businesses perhaps reflected a social policy to provide effective alternatives to traditional medicine, e.g., to address the side effects of chemotherapy, as a treatment for chronic pain, etc. A similar non-profit requirement for recreational marijuana presumably would not reflect a similar social policy any more than a non-profit requirement for the liquor industry. With more states authorizing the cultivation, production and distribution of recreational marijuana products, it is clear that the marijuana industry increasingly is based on profit motivations rather than altruism.

ability "to make all payments under the plan and to comply with the plan."[35] The court, however, expressed a willingness to consider confirmation of any amended plan that did not rely on funding from illegal sources of income. As a result, the court denied plan confirmation but permitted the debtor to file an amended plan. In the event a timely amended plan was not filed, the court indicated that it would issue an order to show cause for dismissal or conversion to Chapter 7. Id. at 773-74.[36]

In In re Johnson, 532 B.R. 53 (Bankr. W.D. Mich. 2015), the U.S. Trustee moved to dismiss a Chapter 13 case because part of the debtor's income came from the sale of medical marijuana permitted under Michigan law. The court credited the debtor's testimony that all plan payments made to the trustee came from his Social Security income but nevertheless concluded that the court could not, and would not, allow the debtor to remain in a bankruptcy case that assisted in the advancement of an illegal activity. The court, however, did not agree with the U.S. Trustee that dismissal was a foregone conclusion, but instead gave the debtor the option to remain in bankruptcy by ceasing his illegal business operations. Specifically, the court enjoined the debtor from continuing with his marijuana business, ordered him to destroy all marijuana plants, and scheduled a further evidentiary hearing to determine the debtor's compliance with these conditions. Id. at 59. The court also provided the debtor with the option to terminate the injunction by moving to dismiss his own case under [*22] Section 1307(b). Id.[37]

In Olson v. Van Meter (In re Olson), 2018 Bankr. LEXIS 480, 2018 WL 989263 (B.A.P. 9th Cir. Feb. 5, 2018), a Chapter 13 debtor obtained rental income from a marijuana dispensary on real property she proposed to sell under her plan. The bankruptcy court *sua sponte* dismissed the bankruptcy case because the debtor was accepting rental income during the post-petition period from a source engaged in a business that violated federal law. On appeal, the bankruptcy appellate panel vacated and remanded the case, stating that the bankruptcy court needed to make more findings of fact and conclusions of law to support dismissal. In her concurring opinion, Judge Tighe expressed her opinion that "[a]lthough debtors connected to marijuana distribution cannot expect to violate federal law in their bankruptcy case, the presence of marijuana near the case should not cause mandatory dismissal." 2018 Bankr. LEXIS 480, [WL] at *7. Judge Tighe also provided additional clarification regarding the detail she believes to be necessary in future rulings involving similar cases:

> I concur in the memorandum and write separately to emphasize (1) the importance of evaluating whether the Debtor is actually violating the Controlled Substances Act and (2) the need for the bankruptcy court to explain its conclusion that dismissal was mandatory under [*23] these circumstances. 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 of dismissal is important to avoid incorrectly deeming a debtor a criminal and denying both debtor and creditors the benefit of the bankruptcy laws.

2018 Bankr. LEXIS 480, [WL] at *6.

The common theme in all of these Chapter 13 cases is the willingness of the bankruptcy court to allow the voluntary debtor to propose a feasible plan that does not rely on income received through a violation of the Controlled Substances Act.

(2) Chapter 11 Cases.

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[35] Section 1325(a)(6) is the "feasibility" requirement in Chapter 13 that requires the individual debtor to demonstrate that he or she can actually perform the terms of the proposed payment plan. See KEITH M. LUNDIN & WILLIAM H. BROWN, CHAPTER 13 BANKRUPTCY, 4TH EDITION, § 198.1, at ¶ [2], Sec. Rev. June 15, 2004, www.Ch13online.com.

[36] Because the debtor did not file an amended Chapter 13 plan, the case was dismissed after the court issued an order to show cause and the debtor filed a motion for voluntary dismissal. (McGinnis ECF No. 62).

[37] The debtor confirmed a Chapter 13 plan, but his case ultimately was dismissed when he defaulted on his plan payments. (Johnson ECF No. 87).

Relief under Chapter 11 is available to both individuals and non-individuals, and may be initiated both voluntarily and involuntarily. For individual Chapter 11 debtors, a bankruptcy discharge is obtained only upon completion of payments of a confirmed plan. See 11 U.S.C. § 1141(d)(5). For non-individual Chapter 11 debtors, a bankruptcy discharge is obtained upon confirmation of a plan unless the plan does not provide for continued operations. See discussion at note [*24] 32, supra.

In In re Rent-Rite Super Kegs W. Ltd., 484 B.R. 799 (Bankr. D. Colo. 2012), creditors sought to dismiss a voluntary Chapter 11 case filed by the owner of a warehouse. Dismissal was sought because twenty-five percent of the non-individual debtor's revenues came from warehouse tenants engaged in the medical marijuana industry. Although the tenants' operations were authorized under Colorado law, the bankruptcy court found that the revenue source violated the Controlled Substances Act and subjected the secured creditor's real property collateral to potential criminal forfeiture proceedings under federal law. Id. at 805-06. The court, therefore, found that "cause" existed under Section 1112(b) due to gross mismanagement and application of the unclean hands doctrine. Id. at 809. Because the remaining seventy-five percent of the debtor's revenues were not derived from the marijuana tenants, however, the court scheduled a further hearing to determine whether conversion or dismissal would be in the best interests of creditors. Id. at 810-11.[38]

In In re Arm Ventures, LLC, 564 B.R. 77 (Bankr. S.D. Fla. 2017), the Chapter 11 debtor, which did not have any income derived from marijuana-related sources as of the petition date, proposed a plan that contemplated leasing real property to an affiliate that would generate income from medical marijuana as permitted [*25] by Florida law. The secured creditor sought dismissal based on a variety of factors, including the debtor's reliance on marijuana-related sources of income to fund its plan. The court agreed that it could not confirm such a plan, but it provided the secured creditor with relief from the automatic stay in lieu of dismissal. Id. at 86-87. The court also gave the debtor two weeks to file an amended plan that did not rely on marijuana-related sources of income, absent which the court would convert the case to Chapter 7 and the secured creditor would be authorized to immediately proceed with its foreclosure sale. Id. at 86 & n.23.[39]

In In re Way to Grow, Inc., 597 B.R. 111 (Bankr. D. Colo. 2018), the Chapter 11 debtors' business

> involve[d] the sale of equipment for indoor hydroponic and gardening-related supplies. As to their customers' uses of their products, Debtors have represented "[w]hile the hydroponic gardening equipment may and is used for many types of crops, the Debtors' future business expansion plan is tied to the growing cannabis industry which is heavily reliant on hydroponic gardening."

Id. at 115. After discussing various bankruptcy decisions involving debtors engaged in illegal activities, including the decision in Rent-Rite, the court discussed "three [*26] basic propositions" gleaned from this caselaw:

> First, a party cannot seek equitable bankruptcy relief from a federal court while in continuing violation of federal law. Second, a bankruptcy case cannot proceed where the court, the trustee or the debtor-in-possession will necessarily be required to possess and administer assets which are either illegal under the CSA or constitute proceeds of activity criminalized by the CSA. And third, the focus of this inquiry should be on debtor's marijuana-related activities during the bankruptcy case, not necessarily before the bankruptcy case is filed.

Id. at 120. Utilizing these principles, the court found "cause" existed to dismiss the case under Section 1112(b) because the debtors' business violated the Controlled Substances Act. Specifically, after conducting a four-day evidentiary hearing, the court did not find credible the debtors' explanation that it would try to distance itself from selling its products to entities engaged in marijuana-related activities. The court further found that the reduction of

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[38] According to the docket in the Rent-Rite case, approximately two years later (April 17, 2014), the bankruptcy court entered an order dismissing the Chapter 11 proceeding pursuant to a stipulation between the U.S. Trustee and the debtor in possession. (Rent-Rite ECF No. 175).

[39] According to the docket in the Arm Ventures case, the debtor filed a proposed amended plan of reorganization (Arm Ventures ECF No. 149), but the plan was never confirmed. Instead, the Chapter 11 proceeding was later dismissed. (Arm Ventures ECF No. 261).

debtors' revenue from marijuana-related sources would devastate the debtor's income stream, thereby making confirmation difficult, if not impossible. Finally, even [*27] if the court required the debtors to extricate themselves from the marijuana industry, the court concluded that the cost and effort of ensuring compliance would be inefficient, costly, and difficult to monitor:

> In any event, the Court does not believe such an order [requiring the debtor to extricate itself from marijuana-related sources of business], or the remediation it would require, would be effective in this case. The Court cannot simply order Debtors to cease all sales to customers known to be involved in marijuana cultivation, because the usefulness of Debtors' products in illegal grow operations will continue to attract marijuana horticulturalists to Debtors' business, including those growing marijuana solely for personal use. Debtors have already acquired a venerable reputation for expertise in hydroponic marijuana growing, and it is difficult to imagine how Debtors could prevent customers from continuing to patronize Debtors' stores because of this reputation. Indeed, the evidence does not show Debtors' essential business model has changed post-petition, which, of course, is the relevant time to determine whether Debtors may remain in bankruptcy. In any event, any such order [*28] would require the Court, and interested parties, to monitor the Debtors' sales and customers, which would be very difficult and inefficient. Further, in light of the acrimonious nature of [the relationship between the party-in-interest moving for dismissal] with the Debtors, the Court can be reasonably certain such an order would lead to costly and time-consuming future litigation over the Debtors' compliance.
> To prevent this Court from violating its oath to uphold federal law, under the specific facts of this case, the Court sees no practical alternative to dismissal.

Id. at 132.[40]

The common theme of these voluntary Chapter 11 cases is the bankruptcy court's consideration of whether the debtor in possession could propose a feasible plan that did not rely on income received through a violation of the Controlled Substances Act.

(3) **Chapter 7 Cases**.

Relief under Chapter 7 is available to both individuals and non-individuals, and may be initiated both voluntarily and involuntarily. For individual Chapter 7 debtors, the property of the bankruptcy estate is administered by a bankruptcy trustee, see 11 U.S.C. § 704(a), and a bankruptcy discharge is obtained if no timely objections are filed by parties in interest. See [*29] 11 U.S.C. § 727(b). For non-individual Chapter 7 debtors, the property of the bankruptcy estate is administered by a bankruptcy trustee, but a discharge is not available. See 11 U.S.C. § 727(a)(1).

In Arenas v. U.S. Trustee (In re Arenas), 535 B.R. 845 (B.A.P. 10th Cir. 2015), the U.S. Trustee moved to dismiss a voluntary Chapter 7 case in which the individual debtors sold marijuana and obtained rental income from an entity engaged in the marijuana industry that was lawful under Colorado law. In response, the debtors sought to convert the case to Chapter 13. The bankruptcy court denied conversion and dismissed the case. The bankruptcy appellate panel for the Tenth Circuit affirmed and expressed their agreement "with the bankruptcy court that while debtors have not engaged in intrinsically evil conduct, the debtors cannot obtain bankruptcy relief because their marijuana business activities are federal crimes." Id. at 849-50. The appellate panel concluded that the debtors likely would be unable to satisfy the "good faith" requirement under Section 1325(a)(3) to confirm a Chapter 13 plan, and neither a Chapter 7 or 13 trustee could administer assets without violating federal law. Id. at 852.[41] It further observed that allowing the debtors to remain in Chapter 7 would prejudicially delay creditors, who would likely receive no

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[40] The debtors subsequently appealed the bankruptcy court's order, although the district court denied their request for a stay pending appeal. See Way to Grow, Inc. v. Inniss (In re Way to Grow, Inc.), 2019 U.S. Dist. LEXIS 9205, 2019 WL 669795 (D. Colo. Jan. 18, 2019).

[41] There is disagreement on whether a bankruptcy trustee who merely requests the disposal of marijuana-related assets is acting in violation of the Controlled Substances Act. See Steven J. Boyajian, "*Just Say No to Drugs? Creditors Not Getting a Fair Shake When Marijuana-Related Cases are Dismissed,"* XXXVI ABI Journal 9, 24-25, 74-75, September 2017.

distribution on [*30] their claims, while the debtors would receive a discharge and would be allowed to continue business operations that were illegal under the Controlled Substances Act. Id. at 853-54.

In In re Medpoint Mgmt., LLC, 528 B.R. 178 (Bankr. D. Ariz. 2015), vacated in part on other grounds, 2016 Bankr. LEXIS 2197, 2016 WL 3251581 (B.A.P. 9th Cir. June 3, 2016), an involuntary Chapter 7 case was filed against a non-individual entity that provided management services to medical marijuana businesses licensed under Arizona law. The alleged debtor stated "that all of its assets are marijuana-related," and counsel for the U.S. Trustee also expressed her belief that the alleged debtor did not have "any legal, non-marijuana assets that a trustee could lawfully administer." 528 B.R. at 184. The court dismissed the case because its continuation would require a Chapter 7 bankruptcy trustee to violate federal law and subject the bankruptcy estate to possible forfeiture of the alleged debtor's assets. Id. at 186.[42] The court also found that the petitioning creditors, who voluntarily conducted business with an entity engaged in illegal activities, were barred from seeking relief under the "unclean hands" doctrine. Id. at 186-87.[43]

In Northbay Wellness Group, Inc. v. Beyries, 789 F.3d 956 (9th Cir. 2015), an attorney [*31] stole money from his client, i.e., a medical marijuana dispensary, and subsequently filed a personal, voluntary Chapter 7 bankruptcy. The dispensary instituted an adversary proceeding seeking to except its claim from discharge, but the bankruptcy court dismissed the adversary complaint under the "unclean hands" doctrine. The Ninth Circuit reversed and remanded, explaining that the bankruptcy court failed to balance the parties' respective wrongdoings as required under that doctrine:

> The Supreme Court has emphasized, however, that the doctrine of unclean hands "does not mean that courts must always permit a defendant wrongdoer to retain the profits of his wrongdoing merely because the plaintiff himself is possibly guilty of transgressing the law." [*Johnson v.] Yellow Cab [Transit Co.*], 321 U.S. [383, 387, 64 S. Ct. 622, 88 L. Ed. 814 (1944)]. Rather, determining whether the doctrine of unclean hands precludes relief requires balancing the alleged wrongdoing of the plaintiff against that of the defendant, and "weigh[ing] the substance of the right asserted by [the] plaintiff against the transgression which, it is contended, serves to foreclose that right." *Republic Molding Corp. v. B.W. Photo Utils.*, 319 F.2d 347, 350 (9th Cir. 1963). In addition, the "clean hands doctrine should not be strictly enforced when to do so would frustrate [*32] a substantial public interest." *EEOC v. Recruit U.S.A., Inc.*, 939 F.2d 746, 753 (9th Cir. 1991).

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[42] Apparently, the authority of a bankruptcy trustee to waive the attorney-client privilege between a corporate debtor and its legal counsel was not raised. See Commodity Futures Trading Comm. v. Weintraub, 471 U.S. 343, 354, 105 S. Ct. 1986, 1994, 85 L. Ed. 2d 372 (1985). When the activity of the corporate client is admittedly in violation of federal law, the criminal penalties for which extend to multiple parties and for many years, see discussion at note 14, supra, the potential legal consequences of a waiver may be extraordinary.

[43] In Misle, see note 24, supra, an involuntary Chapter 7 case was filed against an individual. The alleged debtor sought dismissal of the case based on his representation that his entire income is derived from marijuana sources authorized under Nevada law, but which are in violation of the Controlled Substances Act. See Order Denying Motion for Dismissal on Involuntary Case, entered January 2, 2019 ("Misle Order"), at 2-3. (Misle ECF No. 57). The alleged debtor conceded, however, that (1) he had a 50% interest in a non-marijuana related entity, though he claimed that his ex-wife had exclusive control over that entity, (2) a Chapter 7 trustee could not legally take control of that entity, and (3) his ex-wife would likely not make any distributions to him. See Misle Order at 2-3 & n.5 and 5 n.11. The alleged debtor further relied on a letter and memo prepared by the Executive Office of the United States Trustee in arguing that trustees should not be put in the position to administer assets that would subject them to potential violations of federal law. Although the bankruptcy court agreed with this premise, the court found it premature to speculate as to the position of the U.S. Trustee, who had not yet entered an appearance. Id. at 4-5. The court further raised the possibility that a trustee might not be violating federal law if the marijuana-related assets were not property of the estate based on a non-marijuana-related, government forfeiture case entitled U.S. v. French, 822 F.Supp.2d 615 (E.D. Va. 2011). Id. at 4. Finally, the court opined that it did not have sufficient evidence from the alleged debtor that he did not have viable non-marijuana related assets that could be used to pay his creditors. For these reasons, the court declined to adopt a per se rule, as the alleged debtor urged, to dismiss the involuntary case based solely on the existence of marijuana-related business operations. Id. at 5-6. The individual alleged debtor appealed the order denying dismissal of the involuntary case, and the bankruptcy court stayed the involuntary case pending the outcome of the appeal. (Misle ECF No. 104).

Id. at 960. The Ninth Circuit additionally observed "that the doctrine of unclean hands cannot prevent recovery of funds stolen from a client by his or her lawyer." Id. at 961.[44]

The common theme in all of these Chapter 7 cases is that the mere involvement of marijuana-related assets, income, or connections to the debtor, is not dispositive of whether a particular case is permitted to proceed.[45]

(4) Non-Bankruptcy Cases.

Two of the other cases cited by the parties address the likelihood of prosecution under the Controlled Substances Act, rather than whether particular conduct is in fact illegal under federal law. The remaining case addresses the appointment of a receiver under Colorado law, but does not address the Controlled Substances Act at all. As previously discussed, there is no meaningful dispute that the Marijuana Business operated by the Debtor is not permitted by federal law.

In U.S. v. McIntosh, 833 F.3d 1163 (9th Cir. 2016), several defendants from California and Washington, which authorized the cultivation of medical marijuana, sought to enjoin their convictions for various marijuana-related violations of the Controlled Substances Act. They argued that Congress approved a rider to successive

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[44] Proper application of the unclean hands doctrine is designed to preserve public confidence in, as well as the integrity of the court, by preventing it from becoming a participant in inequitable conduct. See Precision Instrument Mfg. Co. v. Automotive Maintenance Machinery Co., 324 U.S. 806, 814-15, 65 S.Ct. 993, 997-98, 89 L. Ed. 1381, 1945 Dec. Comm'r Pat. 582 (1945); In re Leeds, 589 B.R. 186, 200 (Bankr. D. Nev. 2018).

[45] In Misle, the bankruptcy court raised the prospect under U.S. v. French that a debtor's interest in property may not become property of a bankruptcy estate if the property was acquired through an illegal act that would be subject to forfeiture under federal law. In French, creditors filed an involuntary Chapter 7 petition against an individual, and an order for relief was subsequently entered. Months prior to the bankruptcy filing, however, the debtor had pled guilty to wire fraud and money laundering, and the government obtained orders of forfeiture of the debtor's personal property assets that were involved and/or obtained through the commission of those crimes. The Chapter 7 trustee asserted an interest in the forfeited property as a bona fide purchaser under Section 544(a). In entering summary judgment against the trustee, the court recognized that the "relation back" doctrine under 21 U.S.C. § 853(c) "vests all forfeited property in the United States upon the commission of the act giving rise to forfeiture." 822 F.Supp.2d at 619. (Emphasis added). Therefore,

> by operation of the "relation back" doctrine, [the debtor's] forfeited property vested in the United States at the time of his criminal acts, *i.e.* in 2005—six years prior to the creation of the bankruptcy estate. Upon her appointment, the [Chapter 7] Trustee merely stands in the shoes of the debtor as a bona fide purchaser. Because [the debtor] lacked an ownership

appropriations bills (referred to as "§ 542")[46] that prohibited the Justice Department from spending any of its funds "to prevent States [who have legalized medical marijuana] from implementing their own State laws that authorize the use, distribution, possession, or cultivation of medical [*34] marijuana." Id. at 1169-70. In examining its jurisdiction and appellants' standing, the Ninth Circuit found, among other things, that "[e]ven if Appellants cannot obtain injunctions of their prosecutions themselves, they can seek—and have sought—to enjoin [the Justice Department] from *spending funds* from the relevant appropriations acts on such prosecutions." Id. at 1172 (emphasis in original). Thereafter, the court held that § 542 only prohibits the Justice Department from utilizing funds to prosecute individuals who are in full compliance with applicable state medical marijuana laws:

> Individuals who do not strictly comply with all state-law conditions regarding the use, distribution, possession, and cultivation of medical marijuana have engaged in conduct that is unauthorized, and prosecuting such individuals does not violate § 542. Congress could easily have drafted § 542 to prohibit interference with laws that address medical marijuana, but it did not. Instead, it chose to proscribe preventing states from implementing laws that authorize the use, distribution, possession, and cultivation of medical marijuana.

Id. at 1178. The Ninth Circuit therefore vacated and remanded appellants' cases with instructions for the district courts [*35] to conduct evidentiary hearings to determine whether or not appellants' operations fully complied with their respective state's medical marijuana laws. Id. at 1179.

In U.S. v. Kleinman, 880 F.3d 1020 (9th Cir. 2017), an individual appealed his conviction of various marijuana-related offenses based, in part, on the Justice Department's prohibited use of funds under § 542. In affirming his conviction, the Ninth Circuit first found that appellant's conviction, which was entered prior to the passage of § 542, would not be vacated because § 542 did not change the illegality of marijuana-related offenses under federal law:

> § 542 does not require a court to vacate convictions that were obtained before the rider took effect. In other words, when a defendant's conviction was entered before § 542 became law, a determination that the charged conduct was wholly compliant with state law would *not* vacate that conviction. It would only mean that the [Justice Department's] continued expenditure of funds pertaining to that particular state-law-compliant conviction *after* § 542 took effect was unlawful. That is because, as we explained in *McIntosh*, § 542 did not change any substantive law; it merely placed a temporary hold on the expenditure of money for a certain purpose.

> interest in the forfeited property at the creation of his bankruptcy estate, the Trustee also lacks an ownership interest and thus, lacks standing to challenge the forfeiture order.

Id. at 619. Although it did not rule on the issue, the district court in French acknowledged other caselaw holding that a similar result applies even when the forfeiture order is entered after the creation of the bankruptcy estate. Id. at n.3, citing, e.g., U.S. v. Zaccagnino, 2006 U.S. Dist. LEXIS 100944, 2006 WL 1005042 (C.D. Ill. Apr. 18, 2006).

A more persuasive authority than French, however, is the decision by the bankruptcy appellate panel for the Ninth Circuit in U.S. v. Klein (In re Chapman), 264 B.R. 565 (B.A.P. 9th Cir. 2001). In Chapman, the appellate court concluded that a civil forfeiture action for assets used in the manufacture and distribution of marijuana is excepted from the automatic stay under Section 362(b)(4) as an exercise of the police and regulatory power of the federal government. Id. at 570-71. The court acknowledged that a civil forfeiture judgment may have the effect of retroactively eliminating property from the Chapter 7 bankruptcy estate because of the relation-back doctrine. Id. at 572. The appellate court concluded, however, that the federal government could complete its forfeiture action "even if the end result is that the Proceeds [from the sale of the assets] [*33] are not property of the estate." Id. (Emphasis added). The resulting uncertainty is that a bankruptcy case might be filed for a marijuana-related entity, but the assets held at the time of the bankruptcy petition might be forfeited in favor of the federal government retroactive to the date of the debtor's violation of the Controlled Substances Act. See generally Craig Peyton Gaumer, *When Two Worlds Collide: The Relationship and Conflicts between Asset Forfeiture and Bankruptcy Law*, 21-May Am.Bankr.Inst.J. 10 (May 2002).

[46] Debtor refers to § 542 as the "Rohrbacher-Farr Amendment," see Opposition at 6:5 to 7:8, in arguing that the Justice Department may not expend funds to prosecute marijuana offences under the Controlled Substances Act. Although the Congressional appropriations process was once predictable, including the attachment of riders to spending bills, that may no longer be true.

Id. at 1028 (emphasis in original). [*36]

In Yates v. Hartman, 2018 Colo. App. LEXIS 303, 2018 WL 1247615 (Colo. App. Mar. 8, 2018), a spouse sought the appointment of a receiver over medical and recreational marijuana entities held in a marital dissolution proceeding. The entities were authorized to operate under Colorado law, and none of the parties asserted that their operations otherwise were illegal under the Controlled Substances Act. The appellate court concluded that any receiver must possess the proper licenses under Colorado law to operate the entities. 2018 Colo. App. LEXIS 303, [WL] at *3-4. It therefore reversed the trial court's appointment of a receiver. 2018 Colo. App. LEXIS 303, [WL] at *4.

The relevant theme of these non-bankruptcy cases[47] is that while Congress may act to deny funding for federal prosecution of marijuana offenses under the Controlled Substances Act, it has not acted to legalize the cultivation, production and distribution of marijuana.[48] Until it does so, all parties engaged in or having a significant connection with the marijuana industry face a creeping absurdity[49]: they can rely in good faith on more and more state laws to increasingly form new businesses, increasingly invest and loan millions of dollars,[50] and increasingly enter into occupations that expose all of them to possible federal criminal prosecution.[51] Moreover, state and local

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[47] The Yates v. Hartman decision raises a potential issue in any judicial proceeding that involves a party engaged in state-licensed activity: can a state court-appointed receiver, or an assigned bankruptcy trustee, continue to conduct operations of the subject entity without express approval of the licensing authority? In Nevada's long-established gaming industry, a temporary gaming license may be sought from the Nevada Gaming Commission by a state-court receiver or bankruptcy trustee for continued operation of a casino or other gaming establishment. See Nev. Gaming Reg. 9.030. The court is not aware of whether similar authority exists for Nevada's fledgling marijuana industry and the State of Nevada has not provided such information in this Chapter 11 proceeding.

[48] Congress' efforts to criminalize the cultivation, production and distribution of marijuana, even if such activity occurs solely within the borders of a particular state, does not rule afoul of the U.S. Constitution. See Gonzales v. Raich, 545 U.S. 1, 22, 125 S.Ct. 2195, 2208-09, 162 L. Ed. 2d 1 (2005). Under 21 U.S.C. § 811(h)(2), Congress appears to have delegated its authority over the substances included on the Schedules to the Controlled Substances Act to whomever currently serves as the Attorney General of the United States. See Touby v. United States, 500 U.S. 160, 165, 111 S.Ct. 1752, 1756, 114 L. Ed. 2d 219 (1991); Washington v. Sessions, 2018 U.S. Dist. LEXIS 30586, 2018 WL 1114758, at *3 (S.D.N.Y. Feb. 26, 2018). Unfortunately, recent occupants of the position have taken widely divergent views on the enforcement of the federal laws, including the Controlled Substances Act, pertaining to marijuana. See generally NLJ Survey, supra, at 115-120. See, e.g., Memorandum to All United

governments that [*37] derive tax revenues from medical and recreational marijuana businesses face continuous uncertainty.[52]

3. The Evidence Presented by the Parties.

States Attorneys, [former] Attorney General Jefferson B. Sessions, January 4, 2018, attached as Exhibit "E" to 4Front Reply ("Given the Department's well-established general principles, previous nationwide guidance specific to marijuana enforcement is unnecessary and is rescinded, effective immediately.")(Emphasis added); Sacramento Nonprofit Collective v. Holder, 552 Fed.Appx. 680, 683 (9th Cir. Jan. 15, 2014) ("Appellants claim that the Government is judicially estopped from enforcing the CSA because in a prior lawsuit involving different plaintiffs, the parties entered into a joint stipulation to dismiss the sole remaining claim in that case — that the Tenth Amendment barred federal enforcement of the CSA with respect to medical marijuana use under California law — in light of the Ogden Memorandum. But the Appellants over-read the statements made in both the Ogden Memorandum and during the course of the prior litigation; at no point did the Government promise not to enforce the CSA. Appellants therefore identify no clear inconsistency between the Government's current and prior positions as is required to invoke the doctrine of judicial estoppel.")(Emphasis added).

[49] See U.S. v. Lozoya, 920 F.3d 1231, 1242 (9th Cir. 2019) (acknowledging a "creeping absurdity" of the appellate court's holding as to proper venue for prosecution of federal crimes occurring on transcontinental air flights, i.e., in the federal judicial district over which the aircraft was flying when the alleged federal criminal act occurred).

[50] Commercial actors who deal with marijuana-related businesses authorized under state law apparently acknowledge the risk that they may be parties to a violation of the Controlled Substances Act. See, e.g., January 9, 2018, $3,000,000 Line of Credit Facility, between MI-CW Holdings NV Fund 2 LLC and CWNevada, LLC, at Representations and Warranties, Paragraph 6(d) ("Borrower (i) has all necessary permits, approvals, authorizations, consents, licenses, franchises, registrations and other rights and privileges...to allow it to own and operate its business with any violation of law (excluding the federal Controlled Substances Act and related regulations) or the rights of others; (ii) is duly authorized, qualified and licensed under and in compliance with all applicable laws, regulations, authorizations and orders of public authorities (other than the federal Controlled Substances Act and related regulations);..."). (Emphasis added). (Ex. "5" to Kanitz Declaration).

[51] In the Misle involuntary Chapter 7 case, the bankruptcy court expressed a version of this absurdity as follows: "As previously noted, recreational marijuana is legal in Nevada, and trustees in this district have presumably administered cases in which individual debtors possessed and/or used marijuana during the bankruptcy case. In such circumstances, is the court required to dismiss every individual bankruptcy case upon the debtor's admission that he or she possesses and/or uses marijuana for personal use? That is the natural progression of the Alleged Debtor's proposed per se rule and would only serve to invite abuse by opportunistic debtors who could simply use this mandatory 'get out of bankruptcy' card at any time they see fit." Misle Order at 3 n.6. While Misle was an involuntary proceeding filed against an individual, it illustrates the prospect of more voluntary bankruptcy petitions being filed under any chapter by individuals and non-individuals solely for the purpose of triggering the automatic stay under Section 362(a). See discussion at 8-9, supra. If the disclosure of marijuana-related assets or activities requires a bankruptcy court to dismiss a case after a petition is filed, the debtor may have obtained temporary protection from creditors without any intention of obtaining a bankruptcy discharge of debts. While Congress has provided a partial solution for individuals who repeatedly file consumer bankruptcy petitions, see 11 U.S.C. §§ 362(c)(3) and (c)(4), it has provided no meaningful solution for non-individual debtors that repeatedly file Chapter 11 petitions.

[52] See NLJ Survey, supra, at 118 ("Since Nevada legalized recreational marijuana, there have been an estimated $126 million in sales and $19 million in marijuana excise and wholesale taxes independent of sales tax and state and local licensing fees for marijuana dispensaries. With nearly 300 licensed businesses, the Nevada Dispensary Association estimates that the marijuana industry employs 8,700 people and invested $280 million in real estate. Further, the state awaits the funds from the 15 percent excise tax on marijuana sales, approximately $40 million, that it has earmarked for public education over the next biennium. Nevada, like other states, awaits the recreational marijuana industry's harvest."). Compare Candace Carlyon, "*We Don't Serve Your Kind Here: Federal Courts and Banks Don't Dance with Mary Jane*," 26 Nevada Lawyer, Issue 2, at 9 (February 2018) [hereafter "Nevada Lawyer"] ("The result of the conflict between state and federal law creates a dangerous situation in which businesses are booming but unable to deposit receipts without disguising the source of their funds. The case nature of the business, without any ability to deposit receipts, places the businesses, their employees and their customers in a dangerous situation. The ripple effect created by these successful businesses is huge. The receipts from marijuana-related businesses are paid over to vendors, landlords, employees and governmental agencies: all of these need to deposit those payments.").

The burden of proof on this Dismissal Motion rests with 4Front as the party seeking relief. See, e.g., In re Rosenblum, 2019 Bankr. LEXIS 1160 (Bankr. D. Nev. Mar. 15, 2019) (order denying former spouse's alternative requests for dismissal, abstention, appointment of trustee, or relief from stay). The evidentiary record before the court consists of the written testimony offered by declarants Krane, Braddock, Malley, Miltenberger, Kanitz, and Padgett, the exhibits offered by the declarants, and the documents for which judicial notice has been requested. No objections have been raised as to any of the written testimony offered, the exhibits accompanying the declarations, or to the matters [*38] for which judicial notice was requested. Likewise, various documents have been attached as "exhibits" to the written legal arguments, some of which are not authenticated, but no objections have been raised to the inclusion of those documents as part of the record.

Among other things, Krane attests that 4Front entered into a consulting agreement with the Debtor in March 2014, for which it has not been paid under an arbitration award. See Krane Declaration at ¶¶ 6, 10, 11 and 12. As counsel for 4Front, Braddock attests, *inter alia*, that in May 2017, 4Front sued the Debtor in State Court to collect payments under the consulting agreement. See Braddock Declaration at ¶ 3. He also attests that prior to the Debtor's commencement of this Chapter 11 proceeding, 4Front took numerous steps to confirm and enforce an arbitration award in its favor, including prosecution of its Receivership Application and a request to hold the Debtor in contempt. Id. at ¶¶ 6 and 14. Braddock further attests that the State Court entered a judgment confirming the arbitration award, and the Debtor still refused to pay. Id. at ¶ 16.

As counsel for Highland Partners, and on behalf of both Highland Partners and Green [*39] Pastures, Malley attests that in July 2018, these parties commenced additional State Court actions against the Debtor for breach of a lease as well as certain loan agreements. See Malley Declaration at ¶ 5. He also attests that numerous other legal actions have been commenced in State Court by other parties. Id. at ¶ 8. As counsel for Green Pastures, Miltenberger attests that in May 2015, Green Pastures entered into an agreement with the Debtor to purchase certain promissory notes but that the Debtor has been in default since no later than June 2018. See Miltenberger Declaration at ¶¶ 5, 6 and 7. As the manager of an asset management firm, Kanitz attests that in May 2017, Highland Partners entered into a commercial lease with the Debtor for premises located at 3132 Highland Drive and 3152 Highland Drive, in Las Vegas. See Kanitz Declaration at ¶ 4. He also attests that between June and November 2016, certain members of Highland Partners entered into agreements with the Debtor to purchase certain promissory notes, and also to loan additional funds to the Debtor, all of which agreements have been breached. Id. at ¶ 5. Kanitz also attests that in September 2017 and January 2018, other [*40] members of Highland Partners entered into other transactions with the Debtor, including a secured line of credit, all of which have been breached. Id. at ¶ 6.

As the manager of BCP Holding, which is the manager of the Debtor, Padgett attests, *inter alia*, that on March 14, 2019, a judgment was entered by the State Court confirming an arbitration award in favor of 4Front in the amount of $4,987,092.29. See Padgett Declaration at ¶ 7. He also attests that the Debtor has workers compensation and liability insurance coverage in place through April 26, 2020. Id. at ¶ 10. Padgett also attests that the Debtor has employee health insurance as well as automobile insurance in place as of April 8, 2019. Id. at ¶¶ 11 and 12. He attests that the Debtor made a payment of $81,850 to the Nevada Department of Taxation on April 23, 2019. Id. at ¶ 13. Padgett attests that an eviction proceeding has been commenced by "Renaissance one landlord" with respect to a commercial lease "which is critical to CWNevada's operations." Id. at ¶ 15. He also attests that the "Debtor is in the process of establishing banking relationships at the very same banks that 4Front has established its relationships with." Id. at [*41] ¶ 20.

In addition to the exhibits previously mentioned in this order, see discussion at 5-6, supra, the record encompasses copies of various documents submitted by 4Front, including: the Declaration of Anthony Imbimbo in Support of CWNevada's Opposition to Motion to Affirm Arbitration Award ("Imbimbo Declaration") filed in State Court on or about February 14, 2019, in Case No. A-17-755479-C (Ex. "4"); the final arbitration award in favor of 4Front in the amount of $3,741,803.92 (Ex. "8"); the State Court order and final judgment confirming the arbitration award (Ex. "9"); a preliminary injunction entered by the State Court on March 14, 2019, enjoining the Debtor from "selling, transferring, or otherwise disposing of any assets in their possession, custody, and/or control, including any Nevada cannabis license and cash received (except as needed for normal business operations) from the lawful sale of

cannabis through their Nevada retail dispensaries until this court orders otherwise" (Ex. "11"); a State Court complaint entitled Maria Navarrete, et al. v. CWNevada, LLC, et al., Case No. A-19-792575-C, filed April 4, 2019, alleging, *inter alia*, that the Debtor was in default in payment [*42] of employees at three Nevada marijuana dispensaries operating under the name "Canopi" (Ex. "13"); email correspondence dated April 10, 2019, from a revenue officer at the Nevada Department of Taxation indicating that a balance of $388,890.45 was then-owing by the Debtor, along with various periodic statements of taxes due (Ex. "14"); an ex parte application for order to show cause why the Debtor should not be held in contempt, filed by 4Front in State Court on April 12, 2019 (Ex. "15"); an email dated April 13, 2019, from Padgett to Van Oyen and Kanitz ("Padgett Email") (Ex. 16); the U.S. Trustee's Guidelines for Region 17 as of December 16, 2016 ("UST Guidelines") (Ex. "A"); and the UST List of Authorized Depositories, District of Nevada, Fourth Quarter CY 2018 ("Approved Depository List") (Ex. "B").

Copies of various documents also were submitted by Highland Partners and Green Pastures, including: the Declaration of Brian Padgett dated September 5, 2018, filed in State Court in Case No. A-18-777270-B ("2018 Padgett Declaration") (Ex. "1" to Malley Declaration); the Convertible Note Purchase Agreement dated May 20, 2015, between various purchasers (including Green Pastures) and the [*43] Debtor (Ex. "1" to Miltenberger Declaration); a Commercial Lease dated May 24, 2017, for the Debtor's lease of premises from Highland Partners for an industrial building located at 3132 Highland Drive and 3135 Highland Drive in Las Vegas (Ex. "1" to Kanitz Declaration); a Series B Preferred Convertible Note Purchase Agreement dated November 7, 2016, between the Debtor and Appleseed Ventures Growth Opportunity Fund LLC, that includes, as Schedule 7(f), the CWNevada, LLC, Financial Statements for the Year Ended December 31, 2015 ("2015 Financial Statement") (Ex. "2" to Kanitz Declaration); and, a Promissory Note dated June 9, 2017, memorializing a loan to the Debtor in the amount of $161,802.81, obtained from Appleseed Ventures Growth Opportunity Fund LLC (Ex. "3" to Kanitz Declaration).

CIMA Group also submitted a number of documents, including the following: CIMA Group's emergency ex parte application for appointment of receiver and notice of suspension of registration, filed on April 13, 2019, in State Court in Case No. A-17-755479-C ("CIMA Group Application") (Ex. "1" to CIMA Joinder); the Notice of Verified Third-Party Claim and Demand for Surety, filed on February 15, 2019 on behalf [*44] of Brian Padgett, in State Court in Case No. A-18-773230-B ("Padgett Claim") (Ex. "2" to CIMA Joinder); and the Affidavit of Timothy Smits Van Oyen, a member of the Debtor[53], filed on May 13, 2019, in State Court in Case No. A-17-755479-C ("Van Oyen Affidavit") (Ex. "1" to CIMA Reply).

4. Dismissal Based on Abstention is Warranted under Section 305(a).

The production and distribution of CBD products is not prohibited by the Controlled Substances Act if the THC concentrations in the particular hemp plant conform to the limitations prescribed under Title 7. See discussion at 7, supra. No one challenges Padgett's written testimony that a portion of the Debtor's operations includes a CBD Business. According to the Debtor's independent accountant, however, as of February 14, 2019, the Debtor's

> Current inventory on hand includes over [redacted] pounds of Cannabis Flower broken down into various sales weights (valued at $[redacted]), Cannabis Trim of [redacted]) valued at $[redacted]) pound for a total of $[redacted], Edible Products of [redacted] units (valued at $[redacted]), Concentrates of [redacted] units (valued at $[redacted]), and Work in Process inventory (valued at $[redacted]). The fair market [*45] value of this inventory totals $[redacted].

See Imbimbo Declaration at ¶ 7. Inasmuch as the recent inventory provided by its independent accountant may or may not include any CBD products, it is difficult to determine the significance of the Debtor's CBD Business.

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[53] As of December 31, 2015, Van Oyen had a twenty percent (20%) ownership interest in the Debtor while Padgett had a sixty percent (60%) ownership interest. See Statement of Equity set forth in 2015 Financial Statement.

Moreover, there is no evidence of whether any portion of the Debtor's CBD Business includes the type of CBD products that are excluded from the Controlled Substances Act.[54]

Upon the commencement of a Chapter 11 proceeding, a debtor in possession ordinarily is required to close its existing bank accounts "and establish new debtor in possession accounts to be used for all transactions during the pendency of the case." UST Guidelines at 4.4.6(b). The new accounts must be established at a depository institution meeting the requirements of Section 345(b). Those requirements are designed to ensure the safety of the funds held by a trustee or debtor in possession as a fiduciary of a bankruptcy estate. A list of approved depositories is maintained by the U.S. Trustee. See UST Guidelines at 4.4.6(a)(1). Padgett attests that the Debtor is attempting to establish debtor in possession accounts with the "very same banks that 4Front has established its relationships with." Padgett [*46] Declaration at ¶ 20. While 4Front has offered no evidence to the contrary, the Debtor's factual and legal position is a false equivalency: 4Front is not a debtor in possession and is not subject to the same requirement. The names of thirty-nine approved financial institutions, including Bank of Nevada, Bank of George, First Security Bank of Nevada, and Heritage Bank of Nevada, have been provided to the voluntary Chapter 11 debtor in possession. See Approved Depository List at 1. Because Debtor has never filed any Schedules nor a SOFA that would disclose any bank accounts that existed when it filed its voluntary Chapter 11 Petition, or which were closed prior to filing the Petition, the court does not know whether the Debtor even had any bank accounts to close.[55] At the very least, however, Debtor should be able to identify an approved depository institution in which it has attempted to open its required debtor in possession accounts.[56] It has not done so.

As a non-individual, fictitious legal entity, Debtor cannot proceed without legal counsel. See generally United States v. High Country Broadcasting Co. Inc., 3 F.3d 1244, 1245 (9th Cir. 1993). The voluntary Chapter 11 petition was signed by the Debtor's general counsel, and such counsel conceded at the hearing on the Dismissal Motion [*47] that the Debtor must obtain separate, disinterested, bankruptcy counsel. The record also reveals that Padgett holds the majority of the membership interests of the Debtor, see note 53, supra, and also is the manager of BCP Holding, which is the manager of the Debtor. The record further discloses that Padgett previously provided some nature of legal services to the Debtor. See 2015 Financial Statement at Note 3: Related Party Transactions.[57] The record also reveals that the Debtor's general counsel also represents Padgett personally and filed the Padgett

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[54] A marijuana-related business that cultivates, produces and distributes products that are both illegal and legal, with some proceeds subject to forfeiture and other proceeds not, may create the type of "tracing" concern commonly associated with Ponzi schemes. See Cunningham v. Brown, 265 U.S. 1, 11-13, 44 S.Ct. 424, 426-27, 68 L. Ed. 873 (1924). Compare U.S. v. Gettel, 2017 U.S. Dist. LEXIS 145811, 2017 WL 3966635 (S.D. Cal. Sep. 7, 2017)(resolution of competing claims to proceeds of real property that are the subject of government forfeiture). If the proceeds of a marijuana-related business are commingled, what test will be applied to determine which proceeds were subsequently used to acquire additional assets? Which of the subsequently acquired assets are subject to forfeiture and which of them are not? Which assets might be excluded from the bankruptcy estate, and which might not?

[55] The difficulties that a marijuana business authorized under state law has in establishing bank accounts is often discussed. See Nevada Lawyer, supra, at 8-9. In this instance, it appears that the Debtor made a portion of its April 23, 2019 tax payment to NDOT using a check. See discussion at note 12, supra. Assuming the item referenced was a typical check from a checking account, rather than a check associated with a credit line, there should be information available as to the banking institution where the Debtor does business. That information does not appear in the record.

[56] In its opposition to the Dismissal Motion, Debtor quotes from "Page 199" of the Cannex Notice referring to "banking relationships with 1st Bank of Colorado, Century Bank of Massachusetts, and Bank of Springfield in Illinois." See Opposition at 9:7-10. Unfortunately, there appears to be no part of the Cannex Notice that includes a page 199. More important, even if 4Front has relationships with those financial institutions, none of them appear on the Approved Depository List.

[57] During 2015, Debtor paid $117,625.00 in legal and professional fees. See 2015 Financial Statement, Statement of Income. The document does not state whether any portion of the fees were paid to Padgett for legal services.

Claim in one of the actions pending in State Court.[58] In that claim, Padgett represents that he "is the owner of all rights, title and interest" to funds that previously had been garnished by CIMA Group. See Padgett Claim at ¶¶ 3-4. Moreover, he also alleges that pursuant to a previously perfected security interest, he "has the right of possession, and owns all rights, title and interest in all of the assets of CWNevada, including but not limited to all personal property, accounts, money, deposit accounts, products and the proceeds therefrom that existed or acquired afterwards." (Additional emphasis added). Id. at ¶ 5. Assuming these representations [*48] are accurate, Padgett at one time, or perhaps continuously, has provided legal services to an entity whose operations have resulted in nine separate lawsuits that are pending in various stages in State Court. See Padgett Declaration at ¶¶ 8, 14 and 15.[59] More important, despite apparently perfecting only a security interest in the assets of the Debtor, he has made a verified claim in State Court that he actually owns all of the assets of the Debtor. In essence, the record before this court indicates that Padgett has taken positions that may be in actual and direct conflict with the interests of the Debtor, and that he also may be subject to claims by the Debtor that would be property of the bankruptcy estate.

The necessity of independent counsel to advise the Debtor is amply demonstrated by the record. While the Debtor is a limited liability company that, according to the Chapter 11 Petition, is managed by BCP Holding, as the managing member of the Debtor, see Resolution Authorizing Bankruptcy attached to Petition, it apparently is managed by a board of directors consisting of Padgett, Van Oyen, and Jennifer Lazovich. See 2018 Padgett Declaration at ¶ 3. Van Oyen had a twenty [*49] percent (20%) membership interest in the Debtor as of the end of 2015, see note 53, supra, and remains a member of the Debtor at this time. See Van Oyen Affidavit at ¶ 2. In addition to the board members he identifies, Padgett attests that the Debtor had two "shadow" directors, who apparently represented members of the Highland Partners and Green Pastures groups that purchased various promissory notes from the Debtor. See 2018 Padgett Declaration at ¶ 4. Whatever may be the validity or source of the alleged intrigue in the management of the Debtor, there is no dispute that Van Oyen joined in the Receivership Application brought in State Court by 4Front and also joins in the instant Dismissal Motion. Thus, there appears to be no consensus amongst the Debtor's management in favor of Chapter 11 relief.[60]

Notwithstanding the significant issues concerning management, the record also suggests that the Debtor's financial woes have been understated by that management. No one disputes that the April 23, 2019 payment was made to NDOT in the amount of $81,850. See Padgett Declaration at ¶ 13.[61] That is a significant sum. The record also suggests, however, that as of May 3, 2019, the balance owing [*50] by the Debtor was $405,076.91. See Van Oyen Affidavit at ¶ 4. In other words, the tax payment made by the Debtor seven days after filing the Chapter 11 petition barely made a dent in the amount likely owed to the State of Nevada. Additionally, no one disputes that the Debtor is the subject of an eviction proceeding for "a commercial lease which is critical to the CWNevada's

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[58] The Padgett Claim includes a verification executed under penalty of perjury by general counsel on behalf of Padgett. See Padgett Claim at 3.

[59] As late as September 5, 2018, it appears that as the attorney for the Debtor, Padgett prepared his own declaration that was filed in State Court. See 2018 Padgett Declaration at ¶ 1.

[60] Given the infighting amongst the Debtor's board of directors, including the alleged "shadow directors," it is not surprising that communications devolved into childishness immediately before the Chapter 11 petition was filed. See Padgett Email ("Since we are coming to the end of this clown convention, I'll tell you, smartest thing Jannotta did was not joining in on this one. I doubt any of you are fit to hold licenses. Heat's about to turn up boys."). Notwithstanding the churlish tone of the email, it is not clear whether it was sent on behalf of the Debtor, as counsel for the Debtor, or, on behalf of the author.

[61] That payment was made seven days after the Debtor commenced this Chapter 11 proceeding. If Padgett owns all of the Debtor's money, as he claims, those funds must have been borrowed from Padgett, or was an additional capital contribution, either of which was subject to prior court approval under Section 364(b). If Padgett has only a security interest in the Debtor's assets, then the funds likely constitute "cash collateral" under Section 363(a) that cannot be used without consent or prior court approval under Section 362(c)(2). If other creditors assert a security interest or lien against the same assets, then the funds also cannot be used by the Debtor except with the consent of those creditors or prior court approval. A bankruptcy trustee, of course, can thoroughly investigate these assertions by waiving the attorney-client privilege of a non-individual debtor. See discussion at note 42, supra.

operations." Padgett Declaration at ¶ 15. The record also suggests that as of May 3, 2019, the Debtor was $117,500 in arrears as to that commercial lease of the dispensary premises located at 6540 Blue Diamond Road in Las Vegas, in addition to related obligations. See Van Oyen Affidavit at ¶¶ 5 and 6. Management simply ignores or apparently is unaware that a Chapter 11 debtor in possession is required to perform its obligations under any unexpired lease of commercial real property, particularly the payment of scheduled rent. See 11 U.S.C. § 365(d)(3).

The court has considered the role of the "unclean hands" doctrine in a bankruptcy case involving a marijuana-related debtor and the many parties that willingly do business with such an entity. It is clear that the Marijuana Business of this Debtor is not authorized under the Controlled [*51] Substances Act. It is equally clear that 4Front is a "national consultant in the cannabis industry," see note 6, supra, and therefore has potential legal exposure under the Controlled Substances Act. Compare Rent-Rite (voluntary Chapter 11 dismissed based on gross mismanagement and unclean hands of the debtor), with Medpoint Mgmt. (involuntary Chapter 11 dismissed based on, *inter alia*, unclean hands of petitioning creditors who did business with marijuana-related alleged debtor). Likewise, Highland Partners, Green Pastures, Van Oyen, MC Brands, and CIMA Group have potential legal exposure. See note 14, supra. When all sides to a pending dispute may be accused of wrongdoing, a court in equity may simply deny relief to all sides and dismiss the case. See, e.g., Green v. Higgins, 217 Kan. 217, 535 P.2d 446 (Kan. 1975) (denial of both claims and counterclaims on finding that the conduct of both plaintiff and defendant had been willful, fraudulent, illegal, and unconscionable). But bankruptcy courts, like all courts, are required to consider the circumstances of each case rather than routinely dismissing entire swaths of petitions and requests filed by parties seeking legal relief.[62] Public confidence and the integrity of the court, see note 44, [*52] supra, require no less. Thus, the court is not convinced that the "unclean hands" doctrine has an appropriate role in this case.

There may be cases where Chapter 11 relief is appropriate for an individual or a non-individual entity directly engaged in a marijuana-related business. For the reasons discussed above, this case is not one of them.

For the same reasons, the court instead concludes that the interests of creditors and the Debtor would be better served by dismissal of the case. See 11 U.S.C. § 305(a)(1). The parties may return to State Court where the Receivership Application, among other matters, may be fully addressed. Having reached this conclusion, it is unnecessary to address 4Front's alternative request for dismissal under Section 1112(b), as well as the request for appointment of a Chapter 11 trustee under Section 1104(a). Because dismissal of the case results in a termination of the automatic stay under Section 362(c), it also is unnecessary to address 4Front's alternative request for relief from stay.

IT IS THEREFORE ORDERED that the Creditor 4Front Advisors LLC's Motion to Dismiss Bankruptcy Petition or, Alternatively, Motion for Relief from the Automatic Stay to Allow Receivership and Contempt Proceedings to Continue, Docket [*53] No. 18, be, and the same hereby is, **GRANTED**.

IT IS FURTHER ORDERED that the above-captioned Chapter 11 proceeding is **DISMISSED** pursuant to 11 U.S.C. § 305(a)(1).

IT IS FURTHER ORDERED that all pending hearings in connection with the above-captioned Chapter 11 proceeding are **VACATED**.

Entered on Docket

June 03, 2019

/s/ Mike K. Nakagawa

Honorable Mike K. Nakagawa

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[62] If there are 8,700 residents of Nevada employed by the marijuana industry, see discussion at note 52, supra, then the impact of automatically denying a bankruptcy fresh start to those residents and their dependents would be unconscionable.

United States Bankruptcy Judge

End of Document

In re Basrah Custom Design, Inc.

United States Bankruptcy Court for the Eastern District of Michigan, Southern Division

May 21, 2019, Decided

Case No. 18-56801, Chapter 11

Reporter
600 B.R. 368 *; 2019 Bankr. LEXIS 1582 **; 67 Bankr. Ct. Dec. 68

In re: BASRAH CUSTOM DESIGN, INC., Debtor.

Subsequent History: Reconsideration denied by In re Basrah Custom Design, Inc., 2019 Bankr. LEXIS 1860 (Bankr. E.D. Mich., June 18, 2019)

Counsel: [**1] For Basrah Custom Design, Inc., dba Basrah Store Fixtures And Display, Debtor In Possession: Stuart Sandweiss, Southfield, MI.

For Daniel M. McDermott, U.S. Trustee: Leslie K. Berg (UST), Detroit, MI; Sean M. Cowley (UST), United States Trustee, Detroit, MI.

Judges: Thomas J. Tucker, United States Bankruptcy Judge.

Opinion by: Thomas J. Tucker

Opinion

[*370] **OPINION REGARDING THE UNITED STATES TRUSTEE'S MOTION TO DISMISS, THE DEBTOR'S MOTION TO REJECT LEASE, AND THE MOTION BY MJCC 8 MILE, LLC FOR RELIEF FROM STAY**

I. Introduction

Among other things, this Chapter 11 case raises the question whether the Debtor's entanglement with a medical marijuana dispensary business, which business is illegal under federal criminal law but not necessarily illegal under Michigan law, requires the dismissal of this federal bankruptcy case. The Court concludes that dismissal is required.

This case came before the Court on March 6, 2019, for a hearing on three motions, namely: (1) the United States Trustee's motion to dismiss this case (Docket # 30, the "Dismissal Motion"); (2) the motion by the Debtor entitled "Debtor's Motion to Reject Executory Lease with MJCC 8 Mile, LLC" (Docket # 37, the "Lease Rejection Motion"); and (3) the motion by MJCC [**2] 8 Mile, LLC for relief from the automatic stay (Docket # 43, the "Stay Relief Motion").

After the hearing, after obtaining leave of Court to do so,[1] the Debtor filed a supplemental brief in further support of its position on the pending motions, and the United States Trustee and MJCC 8 Mile, LLC filed responses to the Debtor's supplemental brief.[2] The Court has reviewed those post-hearing papers filed by the parties.

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[1] *See* Order Allowing Debtor's Supplemental Brief, [etc.], filed March 18, 2019 (Docket # 90).

[2] Docket ## 88-1, 96, 99.

The Court has considered all of the oral and written arguments of the parties, and all of the briefs and exhibits filed by the parties. For the reasons stated in this opinion, the Court will deny the Debtor's Lease Rejection Motion, grant the United States Trustee's Dismissal Motion, and deny the Stay Relief Motion as moot.

II. Jurisdiction

This Court has subject matter jurisdiction over this bankruptcy case and this [*371] contested matter under 28 U.S.C. §§ 1334(b), 157(a) and 157(b)(1), and Local Rule 83.50(a) (E.D. Mich.). This is a core proceeding under 28 U.S.C. §§ 157(b)(2)(A), 157(b)(2)(G), and 157(b)(2)(O).

This proceeding also is "core" because it falls within the definition of a proceeding "arising under title 11" and of a proceeding "arising in" a case under title 11, within the meaning of 28 U.S.C. § 1334(b). Matters falling within either of these categories in § 1334(b) are deemed to be core proceedings. [**3] *See Allard v. Coenen (In re Trans-Industries, Inc.*), 419 B.R. 21, 27 (Bankr. E.D. Mich. 2009). This is a proceeding "arising under title 11" because it is "created or determined by a statutory provision of title 11," *see id.*, including Bankruptcy Code §§ 1112, 365, and 362. And this is a proceeding "arising in" a case under title 11, because it is a proceeding that "by [its] very nature, could arise only in bankruptcy cases." *See id.* at 27.

III. Discussion

A. Background

The Debtor filed this Chapter 11 bankruptcy case on December 16, 2018.[3] The Debtor is a Michigan corporation that "is in the business of manufacturing and installing custom cabinets[.]"[4] The Debtor occupies and uses two conjoined buildings, located at 7451 and 7461 West 8 Mile Road, Detroit, Michigan. That real estate (the "Nocha Property") is owned by Weaam Nocha, who is the President and sole shareholder of the Debtor.[5] It is undisputed that the Debtor is not, and never has been, an owner of the Nocha Property.[6]

B. The November 16, 2016 Lease, and the Debtor's pre-petition state court litigation with MJCC 8 Mile, LLC

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[3] This is the Debtor's second Chapter 11 bankruptcy case. The Debtor filed its first such case in this Court on April 19, 2013 (Case No. 13-47956). That case was dismissed on October 25, 2013, with a 180-day bar to refiling, after the Debtor failed to timely file a plan and disclosure statement. *See* Order Dismissing Case, filed October 25, 2013 (Docket # 79 in Case No. 13-47956).

[4] Debtor's Obj. to the U.S. Trustee's Mot. to Dismiss (Docket # 40) at 2, ¶ 3.

[5] *See* Debtor's Obj. to the U.S. Trustee's Mot. to Dismiss (Docket # 40) at 2, ¶ 4; Petition (Docket # 1) at 4; Statement Regarding Authority to Sign and File Petition, filed December 16, 2018 (Docket # 3); Statement of Debtor Regarding Corporate Ownership, and List of Equity Security Holders, filed December 25, 2018 (Docket # 10). The Debtor admitted that Weaam Nocha is the owner of the Nocha Property, in answering the United States Trustee's motion to dismiss. (Debtor's Obj. to the U.S. Trustee's Mot. to Dismiss (Docket # 40) at 2, ¶ 4.) But in another pleading, involving a different motion, the Debtor stated that the Nocha Property is owned by "Weaam Nocha . . . and his wife, Rafah Dawood[.]" (Debtor's Mot. to Enforce the Automatic Stay, [etc.] (Docket # 104) at 1-2, ¶ 2; Debtor's Br. (Docket # 104-1) at 2-3). But in that same pleading, the Debtor stated that this property is owned by "Nocha and/or Dawood." (*See* Debtor's Mot. to Enforce the Automatic Stay, [etc.] (Docket # 104) at 2, ¶ 5; Debtor's Br. (Docket # 104-1) at 3, 18). In yet another pleading, the Debtor stated that the Nocha Property is owned "by Weaam Nocha and/or his wife, Rafah Dawood." (Debtor's Obj. to MJCC's Mot. to Lift Stay (Docket # 73) at 3). This inconsistency in the Debtor's pleadings is not material to the Court's decision on the pending motions.

[6] *See, e.g.*, Debtor's Obj. to the U.S. Trustee's Mot. to Dismiss (Docket # 40) at 4, ¶ 21.

Before filing this bankruptcy case, the Debtor, Weaam Nocha, and others were defendants in a state court lawsuit filed by MJCC 8 Mile, LLC, captioned *MJCC 8 Mile, LLC v. Basrah Custom Design, Inc., et al.*, Case No. 17-001663 [**4] (Wayne County, [*372] Michigan Circuit Court) (the "State Court Lawsuit").

In the State Court Lawsuit, MJCC 8 Mile, LLC ("MJCC") claimed to have the right to possession of the Nocha Property under a written lease, which lease also gave MJCC an option to purchase the Nocha Property. MJCC sought enforcement of that lease and the purchase option. The lease was executed on November 16, 2016, and is referred to in this Opinion as the "November Lease" or the "November 2016 Lease." A copy of the November Lease appears in the record of this case as Exhibit 1 to the brief filed by the Debtor on February 8, 2019.[7]

The November Lease named the Debtor as the "Landlord" and MJCC as the "Tenant," and it was signed on November 16, 2016 by Weaam Nocha for the Debtor, as "Its Owner," and by MJCC.

Under the November Lease, MJCC leased the part of the Nocha Property located at 7461 West 8 Mile Road, for an initial term of 5 years, renewable by MJCC for 6 additional 5-year terms.[8] During that lease term, MJCC also had the option to lease the adjacent part of the Nocha Property, located at 7451 West 8 Mile Road, also for an initial term of 5 years, renewable by MJCC for 3 additional 5-year terms.[9] The November Lease [**5] also gave MJCC an option to purchase the Nocha Property, for $1.2 million.[10]

It is undisputed, and was clearly understood by all parties at the time of the signing of the November Lease, that MJCC's purpose in entering into the November Lease was to use the Nocha Property to operate a medical marijuana dispensary. And this is clear from the face of the November Lease. For example, the document stated that "[t]he Premises will be used for a licensed medical marijuana dispensary (the '**Designated Use**') and for no other purpose whatsoever."[11] And the initial 5-year term of the Lease was to begin "on the date Tenant receives approval from the City of Detroit for its Designated Use[.]"[12]

The defendants in the State Court Lawsuit were the Debtor, Weaam Nocha, Rafaa Nocha (Weaam Nocha's wife, a/k/a Rafaa Dawood), Holden Dawood (the Nochas's son), and DMCC, LLC (a limited liability company formed by the defendants). All of the defendants jointly defended against MJCC's claims, and opposed the efforts of MJCC to obtain possession of or purchase the Nocha Property. One of their primary defenses was that MJCC "fraudulently tricked" Weaam Nocha into signing the November Lease.[13]

It is undisputed that in seeking relief in the State Court Lawsuit, and in now seeking stay relief in this Court, MJCC has sought possession and ownership of the Nocha Property, in order to use that property as a medical marijuana dispensary. Such a marijuana business apparently would not violate Michigan law, but as [*373] discussed below, it would violate federal criminal law.

C. The State Court Decision

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[7] Docket # 41-1.

[8] *See* November Lease at 1, ¶ 1 and Ex. A thereto.

[9] *See id.* at 12, ¶ 39 and Ex. B thereto.

[10] *See id.* at 12, ¶ 40 and Ex. C thereto; *see also* discussion of the relief granted by a decision of the state court in the State Court Lawsuit discussed below.

[11] November Lease at 2, ¶ 4 (emphasis in original).

[12] *Id.* at 1, ¶ 1.

[13] The Debtor continues to make this assertion in this bankruptcy case. (*See, e.g. [**6]* , Debtor's Obj. to the U.S. Trustee's Mot. to Dismiss (Docket # 40) at 2, ¶ 8).

The State Court Lawsuit went to trial, and on December 7, 2018, the state court found for MJCC, in a lengthy written opinion and order, entitled "Finding of Facts and Conclusions of Law" (the "State Court Decision"). A copy of the State Court Decision appears in the record of this case as Exhibit 4 to the Debtor's brief filed on February 8, 2019.[14]

As discussed in Part III.D of this Opinion, below, the findings and conclusions of the State Court Decision are binding in this Court, on the Debtor, Weaam Nocha, and MJCC, under the doctrine of collateral estoppel. For this reason, and because they are important to this Court's decision on the pending motions, the Court will describe the state court's findings and conclusions in detail.

In the State Court Decision, the state court found and concluded, [**7] among other things, that:

- Weaam Nocha was ***not*** tricked or fraudulently induced into signing the November Lease;[15]
- at the time the November Lease was signed, the Nocha Property was owned solely by Weaam Nocha;[16]

- Weaam Nocha signed the November Lease as an agent of the Debtor, ***and*** the Debtor in turn signed the November Lease as agent of and on behalf of the owner of the property at issue, Weaam Nocha;[17]
- the November Lease, including the purchase option it contains, is valid and enforceable by MJCC;[18]
- the term of the November Lease began on November 10, 2016, and MJCC's right to exclusive possession of the Nocha Property began on November 26, 2016.[19]

[*374] The State Court Decision found that the Nocha Property is one of the very few properties located within the City of Detroit that is available and suitable for conducting a medical marijuana dispensary. The state court found that "there are very few fully compliant properties in the City [of Detroit]" where one can "open a medical marijuana dispensary."[20] This is "due to the tight restrictions imposed by Detroit's Medical Marijuana Zoning Ordinance."[21] But

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[14] Docket # 41-4.

[15] *See, e.g.*, State Court Decision at ¶¶ 69, 96, 97.

[16] *Id.* at ¶¶ 155, 156, 168.

[17] *See id.* at ¶¶ 63, 124, 155, 156, 158, 165-170, 176. This latter finding of the state court, that the Debtor signed the November Lease as agent of and on behalf of the sole owner, Weaam Nocha, makes sense because the state court found that Weaam Nocha, not the Debtor, was the "sole owner" of the Nocha Property. Moreover, Weaam Nocha's status as the real party-in-interest lessor under the November Lease is clearly implied in the state court's findings that (1) "as the sole owner of the [Nocha] Property, Mr. Nocha had full authority to grant possessory rights to the [Nocha] Property;" *id.* at ¶ 158; and (2) the Debtor had the authority, as agent, to bind Weaam Nocha to "lease the [Nocha] Property;" *see id.* at ¶¶ 165-167, 170.

[18] *See id.* at ¶¶ 94, 106, 123.

[19] *See id.* at ¶¶ 53, 58, 109, 152. The November Lease was signed on November 16, 2016, and states in the first paragraph that its "Effective Date" was November 16, 2016. (November Lease at 1). As the State Court Decision found, MJCC's right to exclusive possession of the Nocha Property began 10 days after the Effective Date of the November Lease, *i.e.*, on November 26, 2016. (*See* State Court Decision at ¶ 109; November Lease at 3, ¶ 8).

The "term" of the November Lease, and MJCC's obligation to pay rent, was defined to occur "beginning on the date [MJCC] receives approval from the City of Detroit for its Designated Use [*i.e.*, as a 'licensed medical marijuana dispensary']." (*See* November Lease at 1, ¶ 1; 2, ¶ 4). As the State Court Decision found, this identical language was contained in an earlier lease signed by the parties on February 15, 2016 (referred to in the State Court Decision as the "February Lease"), which February Lease was later replaced by the November Lease. And the State Court Decision also found that this required approval from the City of Detroit was obtained by MJCC on November 10, 2016. (*See* State Court Decision at ¶¶ 15, 53, 58, 152). Although the State Court Decision found in one paragraph of the decision that the City of Detroit's approval was a "conditional" approval,

the Nocha Property is such an available [**8] property — as the state court put it, the property is "in the 'green zone.'"[22]

The state court also found that the efforts by Weaam Nocha, the Debtor, and the other defendants to avoid enforcement of the November Lease, including its purchase option, were motivated by a desire to make more money from the Nocha Property, either by (1) renting or selling the Nocha Property to MJCC, or someone else in the medical marijuana business, for a higher rent or a higher sale price than the $1.2 million price set by the purchase option in the November Lease; or (2) using the property to open and operate a marijuana dispensary themselves.

The State Court Decision described, in detailed findings:[23]

- how Weaam Nocha and his wife, Rafaa, continually demanded more money from MJCC for the lease or purchase of the Nocha Property, even after the November Lease was signed, demanding, for example, an increase in rent from the $5,000.00 per month in the November Lease[24] to $7,500.00 per month, and demanding $1.5 million to sell the property to MJCC instead of the $1.2 million agreed to in the November Lease's purchase option;[25]

- how MJCC refused the Nochas's greater financial demands, and instead insisted on [**9] performance of the November Lease;[26]

- how the Nochas then reacted by refusing to honor the November Lease;[27] and

- how all of the state court defendants — *i.e.*, the Debtor, Weaam Nocha, Rafaa Nocha, and their son Holden Dawood — then decided to open and operate a medical marijuana dispensary themselves at the Nocha [*375] Property, and went to great lengths to try to do so; including the defendants' formation of a new LLC — the defendant DMCC, LLC — to obtain a license from the City of Detroit to operate a medical marijuana dispensary.[28]

(State Court Decision at ¶ 58 ("On November 10, 2016, the City of Detroit granted MJCC conditional approval for a license to operate a [medical marijuana] Dispensary.")), the State Court Decision made clear in at least two other paragraphs that the November 10, 2016 approval by the City of Detroit was sufficient to trigger the beginning of the Lease "term" under the identical language in the February Lease and the November Lease. (*See* State Court Decision at ¶ 53 (finding that MJCC's obligation to pay rent under the terms of the February Lease began when it "obtained approval from the City of Detroit to operate a medical marijuana dispensary at the Property . . . [which it obtained on] November 10, 2016"), ¶ 152 (finding that "the date [MJCC] receive[d] approval from the City of Detroit for its Designated Use [a licensed medical marijuana dispensary]" was November 10, 2016 ("MJCC obtained approval from the City of Detroit on November 10, 2016, but Defendants refused to give them possession.")

[20] State Court Decision at ¶¶ 2-3.

[21] *Id.* at ¶ 2.

[22] *Id.* at ¶ 5.

[23] *See, e.g., id.* at ¶¶ 54-56, 55 n.5, 59, 70-79, 139-147.

[24] November Lease at 1, ¶ 2(a).

[25] *See, e.g.*, State Court Decision at ¶¶ 70-74, 55 & n.5.

[26] *See, e.g., id.* at ¶¶ 72, 76.

[27] *See, e.g., id.* at ¶ 76.

[28] *See, e.g., id.* at ¶¶ 76-79, 139-147.

Based on its detailed findings, the state court entered a judgment in favor of MJCC and against the defendants.[29] For relief, "given the validity of the November 2016 Lease," the State Court Decision ordered that MJCC could elect one of two options.[30]

Under the first option, MJCC could elect to have a "[d]eclaratory judgment that the November 2016 Lease is valid and enforceable." Under this option, MJCC was required to "exercise[] its option [under the November 2016 Lease] to purchase the entire property (7451 and 7461) for [$]1.2 million" and MJCC would obtain the "immediate transfer of ownership to [**10] DMCC to Plaintiff[] along with possession of the Property."[31]

Under the second option, MJCC could elect to have a declaratory judgment that "the November 2016 [L]ease [is] null and void," plus a money judgment in the total amount of $713,658.72.[32] Under this option, "Defendants would maintain ownership of the property and the Marijuana license."[33]

MJCC elected the first of these alternative forms of relief, and desires to close, as soon as possible, on its purchase of the Nocha Property for the $1.2 million price. This is so MJCC can begin to operate its medical marijuana dispensary business on the Nocha Property as soon as possible.

Nine days after the State Court Decision, and in direct response to it, the Debtor filed this bankruptcy case. The Debtor and the other state court defendants also filed an appeal of the State Court Decision to the Michigan Court of Appeals, which appeal is pending.

D. The preclusive effect of the State Court Decision, under the doctrine of collateral estoppel

As the Debtor's counsel conceded during the hearing, the findings and conclusions of the state court in the State Court Decision are binding on the Debtor and MJCC. Those parties are precluded from [**11] contesting such findings and conclusions in this bankruptcy case, under the doctrine of collateral estoppel. And this is so even though the Debtor has appealed the State Court Decision.

This Court previously has explained how collateral estoppel applies in bankruptcy cases, under the federal Full Faith and Credit Statute, 28 U.S.C. § 1738:[34]

> "In determining whether a state court judgment precludes relitigation of issues under the doctrine of collateral estoppel, the Full Faith and Credit Statute, 28 U.S.C. § 1738, requires bankruptcy courts to "'consider first the law of the [*376] State in which the judgment was rendered to determine its preclusive effect.'" *Bay Area Factors v. Calvert (In re Calvert*), 105 F.3d 315, 317 (6th Cir. 1997)(quoting *Marrese v. Am. Acad. of Orthopaedic Surgeons*, 470 U.S. 373, 375, 105 S. Ct. 1327, 84 L. Ed. 2d 274 (1985)). If the state courts would not deem the judgment binding under collateral estoppel principles, then the bankruptcy court cannot do so

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[29] *Id.* at 27.

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] The Full Faith and Credit Statute states, in relevant part:

> The . . . judicial proceedings of any court of any . . . State . . . shall have the same full faith and credit in every court within the United States . . . as they have by law or usage in the courts of such State . . [**12] . from which they are taken.

28 U.S.C. § 1738.

> either. But if the state courts would give preclusive effect to the judgment, then the bankruptcy court [generally] must also give the judgment preclusive effect[.]"

Taleb v. Kramer (In re Kramer), 543 B.R. 551, 553 (Bankr. E.D. Mich. 2015) (footnote omitted) (quoting *McCallum v. Pixley (In re Pixley*), 456 B.R. 770, 775-76 (Bankr. E.D. Mich. 2011)); *see also In re Indiana Hotel Equities, LLC*, 586 B.R. 870, 875 (Bankr. E.D. Mich. 2018) (same).

Because the State Court Decision was entered in the Wayne County Circuit Court in the state of Michigan, the Court must look to Michigan law to determine the collateral estoppel effect of that decision. As this Court has explained in prior cases,

> Under Michigan law, the following requirements must be met in order for collateral estoppel to apply:
>
> 1) there is identity of parties across the proceedings,
> 2) there was a valid, final judgment in the first proceeding,
> 3) the same issue was actually litigated and necessarily determined in the first proceeding, and
> 4) the party against whom the doctrine is asserted had a full and fair opportunity to litigate the issue in the earlier proceeding.
>
> *Phillips v. Weissert (In re Phillips*), 434 B.R. 475, 485 (6th Cir. BAP 2010) (citation omitted).
>
> • . .
>
> Under Michigan law, an issue is "actually litigated" if it is "put into issue by the pleadings, submitted to the trier of fact for determination, and is thereafter determined." *Phillips*, 434 B.R. at 486 (majority opinion) (quoting *Latimer v. William Mueller & Son, Inc.*, 149 Mich.App. 620, 386 N.W.2d 618, 627 (1986)); *Phillips*, 434 B.R. at 490 (Rhodes, J., concurring) (same).
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> . . .
>
> An issue that is "actually litigated" is also considered to be "necessarily determined" if "it is necessary to the judgment." *See id.* at 493; *see also Rohe Scientific Corp. v. Nat'l Bank of Detroit*, 133 Mich.App. 462, 350 N.W.2d 280, 282 (1984) (citation omitted) . . . . *Pixley I*, 456 B.R. at 776, 778-79.

Lenchner v. Korn (In re Korn), 567 B.R. 280, 298-99 (Bankr. E.D. Mich. 2017).

With respect to each of the findings and [**13] conclusions recounted in this Opinion from the State Court Decision, all of the requirements for the application of collateral estoppel are met: (1) the relevant parties (the Debtor, Weaam Nocha, and MJCC) are the same; (2) the State Court Decision is a valid, final judgment; (3) the issues were actually litigated and necessarily determined by the State Court Decision; and (4) all the parties in the State Court Lawsuit, including the Debtor, Weaam Nocha, and MJCC, had a full and fair opportunity to litigate the issues decided in the State Court Decision.

The State Court Decision is considered a valid, final judgment for collateral estoppel purposes, even though the Debtor and Weaam Nocha have appealed that decision to the Michigan Court of Appeals. *See Taleb v. Kramer*, 543 B.R. at 559 ("[U]nder Michigan law, a final . . . judgment has preclusive effect under the doctrine of collateral estoppel . . . even when the judgment is on appeal or the time for appeals [*377] has not yet expired."). Collateral estoppel therefore applies, and in effect, the parties to the State Court Decision, including the Debtor, Weaam Nocha, and MJCC, are bound by the findings and conclusions in the State Court Decision, unless and until that State [**14] Court Decision is reversed, vacated, or modified on appeal. And counsel for the Debtor explicitly conceded this, during the hearing.

E. Discussion of the Debtor's motion to reject the November 2016 Lease, under Bankruptcy Code § 365.

In its Lease Rejection Motion, the Debtor seeks an order allowing it to reject the November 2016 Lease. MJCC opposes that motion on several grounds. The United States Trustee also opposes that motion, because he seeks dismissal of this case.

The Court must deny the Debtor's Lease Rejection Motion, for two reasons. First, the November Lease is not a lease that the Debtor may reject under 11 U.S.C. § 365, because the Debtor is not a real party in interest under that lease. Rather, the Debtor signed the November Lease only in its capacity as agent for the one and only owner of the Nocha Property at issue, namely, Weaam Nocha. This is conclusively established by the State Court Decision, as noted in parts III.C and III.D of this Opinion. As a result, the Debtor cannot assume or reject the November Lease under § 365. That section says that a "trustee," which includes a Chapter 11 debtor-in-possession under 11 U.S.C. § 1107(a), "subject to the court's approval, may assume or reject any executory contract or unexpired lease [**15] **of the debtor**." 11 U.S.C. § 365(a) (emphasis added). Many of the subsections in § 365 use this phrase, executory contract or unexpired lease "of the debtor," and thereby reinforce the point that § 365 applies only to such contracts "of the debtor." *See, e.g.*, 11 U.S.C. §§ 365(b)(1), 365(b)(4), 365(c), 365(d)(1), 365(d)(2), 365(e)(1), 365(e)(2), 365(f)(1), 365(f)(2), 365(f)(3), 365(g), 365(i)(1).

The November Lease is not a lease "of the debtor" but rather is a lease of the Debtor's 100% shareholder, Weaam Nocha, who at the time of the November Lease was the only owner of the subject property. (As noted in Part III.A of this Opinion, it is undisputed that the Debtor is not and never has been an owner of the subject property.) The Debtor therefore cannot assume or reject the November Lease, so the Debtor's Lease Rejection Motion must be denied.

That Motion also must be denied for a second reason, namely, because this bankruptcy case must be dismissed, for the reasons discussed below.

F. Discussion of the United States Trustee's Dismissal Motion

The United States Trustee (the "UST") seeks dismissal of this bankruptcy case, for "cause" under 11 U.S.C. § 1112(b)(1). That section states:

> (b)(1) Except as provided in paragraph (2) and subsection (c), on 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 [**16] chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause unless the court determines that the appointment under section 1104(a) of a trustee or an examiner is in the best interests of creditors and the estate.

11 U.S.C. § 1112(b)(1). In partially defining what the general "cause" standard in § 1112(b)(1) means, "[s]ection 1112(b)(4) contains a nonexhaustive list of examples of 'cause' justifying dismissal of a Chapter [*378] 11 case." *In re Creekside Sr. Apartments, L.P.*, 489 B.R. 51, 60 (B.A.P. 6th Cir. 2013).

> In determining whether cause exists to dismiss a case under § 1112(b), a court must engage in a "case-specific" factual inquiry which "focus[es] on the circumstances of each debtor." *United Savs. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.* (*In re Timbers of Inwood Forest Assocs., Ltd.*), 808 F.2d 363, 371-72 (5th Cir.1987) (en banc), *aff'd*, 484 U.S. 365, 108 S.Ct. 626, 98 L.Ed.2d 740 (1988); *In re Great Am. Pyramid Joint Venture*, 144 B.R. 780, 791 (Bankr.W.D.Tenn.1992).

Id.; see also In re Skymark Properties II, LLC, 597 B.R. 391, 395-96 (Bankr. E.D. Mich. 2019).

1. The federal Controlled Substances Act

The UST seeks dismissal of this case because of the Debtor's entanglement with a medical marijuana dispensary business. That business may well be legal under Michigan law,[35] and the Court will assume as much for purposes

[35] Effective December 4, 2008, Michigan enacted legislation to allow the medical use of marijuana under state law, in the act known as the "Michigan Medical Marihuana Act," Mich. Comp. Laws Ann. §§ 333.26421 through 333.26430. This Act was passed by voter initiative, by the approval of Michigan voters in the November 2008 election. This Act was later amended, with

of deciding the Dismissal Motion. But it is clear that such a marijuana dispensary business is illegal under federal law.

There is no dispute that operating a medical marijuana dispensary is a violation of the federal Controlled Substances Act, 21 U.S.C. §§ 801-904 (the "CSA"). Marijuana is an illegal [**17] Schedule I controlled substance under the CSA, *see* 21 U.S.C. § 812(c)(10), despite the adoption by several states in recent years of laws permitting the sale and use of marijuana for medical and/or recreational purposes. *See generally Gonzales v. Raich*, 545 U.S. 1, 10-15, 125 S. Ct. 2195, 162 L. Ed. 2d 1 (2005). As the Supreme Court explained in *Gonzales v. Raich*,

> In enacting the CSA, Congress classified marijuana as a Schedule I drug. 21 U.S.C. § 812(c). . . . By classifying marijuana as a Schedule I drug, as opposed to listing it on a lesser schedule, the manufacture, distribution, or possession of marijuana became a criminal offense, with the sole exception being use of the drug as part of a Food and Drug Administration preapproved research study. §§ 823(f), 841(a)(1), 844(a); *see also United States v. Oakland Cannabis [*379] Buyers' Cooperative*, 532 U.S. 483, 490, 121 S.Ct. 1711, 149 L.Ed.2d 722 (2001).
> • . .
> Despite considerable efforts to reschedule marijuana, it remains a Schedule I drug.

545 U.S. at 14-15 (footnote omitted). Of the statutes cited by the Supreme Court in *Gonzales v. Raich*, 21 U.S.C. § 841(a)(1) makes it a crime "knowingly or intentionally . . . to manufacture, distribute, or dispense" a controlled substance, including marijuana, and that statute provides for criminal penalties including imprisonment and fines. *E.g.*, 21 U.S.C. § 841(b)(1)(D).

And as the UST points out, operating a medical marijuana dispensary, or owning or renting a place operating as such a dispensary, also would [**18] be a federal crime under 21 U.S.C. § 856(a). That section states:

Except as authorized by this subchapter, it shall be unlawful 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**.

21 U.S.C. § 856(a)(1)-(2) (emphasis added). Violation of this statute subjects one to possible imprisonment of up to 20 years, and a possible criminal fine of up to $2 million "for a person other than an individual," as well as the possibility of substantial civil penalties. *See* 21 U.S.C. §§ 856(b), 856(d).

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amendments that became effective April 1, 2013, December 20, 2016, and April 10, 2017. Also added to Michigan law, in 2016, was the "Marihuana Tracking Act" (effective December 20, 2016 and later amended effective March 21, 2019), Mich. Comp. Laws Ann. §§ 333.27901 through 333.27904, and the "Medical Marihuana Facilities Licensing Act" (effective December 20, 2016 and later amended effective January 26, 2018, January 1, 2019, March 28, 2019, and April 16, 2019), Mich. Comp. Laws Ann. §§ 333.27101 through 333.27801.

Recently, Michigan enacted legislation to make marijuana legal under state and local law for recreational use, for adults 21 years of age or older. This legislation was passed by voter initiative, by the approval of Michigan voters in the November 2018 election. It became effective on December 6, 2018, and is known as the "Michigan Regulation and Taxation of Marihuana Act," Mich. Comp. Laws Ann. §§ 333.27951 through 333.27967. Among other things, this Act provides for the licensing, regulation, and taxation of "marihuana establishments." The Act gives the Michigan Department of Licensing and Regulatory Affairs up to one year after the effective date of the Act (*i.e.*, until December 6, 2019) to promulgate rules for implementation of the Act. *See* Mich. Comp. Laws Ann. §§ 333.27953(b), 333.27953(h), 333.27957, 333.27958, 333.27966.>

2. Bankruptcy cases

Because of these federal statutes, several bankruptcy courts have found cause to dismiss a bankruptcy case filed by a debtor whose income was derived, directly or indirectly, at least in part, from the business of selling marijuana. For example, in *In re Rent-Rite Super Kegs West Ltd.*, 484 B.R. 799, 802-04 (Bankr. D. Colo. 2012), the bankruptcy court [**19] found that the Chapter 11 debtor had "unclean hands," and that "cause" existed under 11 U.S.C. § 1112(b) to dismiss or convert the bankruptcy case, because the debtor derived roughly 25% of its revenues from leasing warehouse space to tenants engaged in the business of growing marijuana. The court found that the debtor's business "involves a continuing violation of the federal Controlled Substances Act," even though the marijuana growing activity was "arguably legal under Colorado law." 484 B.R. at 802 (footnote omitted). The court held that "a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime." *Id.* at 805 (footnote omitted).

This is so, the *Rent-Rite* court held, "even if the Debtor is never charged or prosecuted under the CSA," and even though, generally, "federal prosecutors may well choose to exercise their prosecutorial discretion and decline to seek indictments under the CSA where the activity that is illegal on the federal level is legal under . . . state law." 484 B.R. at 805.

In another case arising in Colorado, *Arenas v. United States Trustee (In re Arenas*), 535 B.R. 845 (B.A.P. 10th Cir. 2015), the Bankruptcy Appellate Panel (the "B.A.P.") for the Tenth Circuit affirmed [*380] the bankruptcy court's dismissal of a Chapter [**20] 7 case filed by a marijuana grower and his wife. The B.A.P. stated:

> Possessing, growing, and dispensing marijuana and assisting others to do that are federal offenses. But like several other states, Colorado has legalized these acts and heavily regulates them, triggering a flourishing marijuana industry there. **Can a debtor in the marijuana business obtain relief in the federal bankruptcy court? No**.

535 B.R. at 847 (emphasis added).

In *Arenas*, one of the joint debtors was licensed in Colorado "to grow and dispense medical marijuana," and he did so in one of the two units of a commercial building that the debtors jointly owned.[36] The debtors leased the other unit of their building to an LLC that operated a marijuana dispensary. *Id.* The bankruptcy court denied a motion by the debtors to convert their case to Chapter 13, and granted a motion by the United States Trustee to dismiss the case, for cause under 11 U.S.C. § 707(a). *Id.* at 848. The B.A.P. affirmed the bankruptcy court's decisions. The B.A.P. found that while the debtors' activities were legal under Colorado state law, they violated the CSA. *Id.* at 847. It held that "while the debtors have not engaged in intrinsically evil conduct, the debtors cannot obtain bankruptcy relief because [**21] their marijuana business activities are federal crimes." *Id.* at 849-50. The B.A.P. also held that a bankruptcy trustee could not administer the marijuana assets, including the marijuana plants and the debtors' building, because that would violate federal criminal law. *See id.* at 852-53. The court noted that "[t]he CSA criminalizes virtually every aspect of selling, manufacturing, distributing and profiting from the use of controlled substances." *Id.* at 852 n.40 (citing 21 U.S.C. §§ 841(a)(1) and 856(a)).

Finally, in the case of *In re Way to Grow, Inc.*, 597 B.R. 111 (Bankr. D. Colo. 2018), the bankruptcy court dismissed the Chapter 11 cases of three affiliated companies, because of the debtors' involvement in a marijuana-related business. That involvement was more indirect than that of the debtors in the other cases, discussed above. In *Way to Grow*, the court described the debtors' business as follows:

> Debtors' business involves the sale of equipment for indoor hydroponic and gardening-related supplies. As to their customers' uses of their products, Debtors have represented "[w]hile the hydroponic gardening equipment may [be] and is used for many types of crops, the Debtors' future business expansion plan is tied to the growing cannabis industry which is heavily reliant on hydroponic gardening."

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[36] *Id.*

597 B.R. at 114-15 (footnote omitted). [**22] After citing certain provisions of the CSA, namely 21 U.S.C. §§ 812 and 841(a)(1), quoted above, the court in *Way to Grow* further noted that

> the CSA prohibits any person from possessing or distributing "any equipment . . . product or material which may be used to manufacture a controlled substance . . . knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance" in violation of federal law. The CSA also expressly provides any person who "conspires to commit any offense" under the CSA shall be subject to the same penalties as the principal.

597 B.R. at 116 (footnotes omitted) (citing 21 U.S.C. §§ 843(a)(6), 843(a)(7), and 846).

The *Way to Grow* court observed that "bankruptcy courts have consistently dismissed cases where debtors engaged in [*381] ongoing CSA violations, or where a debtor's reorganization efforts depend on funds which can be considered proceeds of CSA violations." 597 B.R. at 117.[37] The court ultimately concluded that the debtors' business violated the CSA, both before and after filing their bankruptcy cases:

> Debtors certainly know they are selling products to customers who will, and do, use those products to manufacture a controlled substance in violation of the CSA. Debtors tailor their business to cater to [**23] those needs, tout their expertise in doing so, and market themselves consistent with their knowledge. There is no evidence this business model has materially changed post-petition.
>
> The Court concludes Debtors' business model and execution thereof fundamentally violates § 843(a)(7). These violations continue post-petition, ...

Id. at 131. Because of this, the court found, "inescapably," that there was cause to dismiss the bankruptcy case under 11 U.S.C. § 1112(b). *Id.* at 132. And because the court saw "no practical alternative to dismissal," the court dismissed the bankruptcy case. *Id.* This result, the court held, was necessary "[t]o prevent this Court from violating its oath to uphold federal law[.]" *Id.*[38]

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[37] The *Way to Grow* court noted that "there remains an ever-shifting landscape of federal enforcement of marijuana criminalization where the same activity is fully legal under state law." 597 B.R. at 117 (footnote omitted). As an example of this "ever-shifting landscape," the court cited the Trump administration's 2018 revocation of the enforcement policy announced in 2013 by the Obama administration. *Id.* at 117 n.24 (citing "James M. Cole, Deputy Attorney General, MEMORANDUM FOR ALL UNITED STATES ATTORNEYS: GUIDANCE REGARDING MARIJUANA ENFORCEMENT (Aug. 29, 2013) (commonly known as the "Cole Memo"); *but see* Jeffrey B. Sessions, Attorney General, MEMORANDUM FOR ALL UNITED STATES ATTORNEYS: MARIJUANA ENFORCEMENT (January 4, 2018) (revoking Cole Memo)").

[38] In addition to the cases discussed in this Opinion, this Court has reviewed and considered all of the cases cited by the parties. And the Court is aware of the May 2, 2019 decision by the Ninth Circuit Court of Appeals, in *Garvin v. Cook Invs. NW*, No. 18-35119, 922 F.3d 1031, 2019 U.S. App. LEXIS 13235, 2019 WL 1945280 (9th Cir. May 2, 2019). In *Garvin*, the Court of Appeals for the Ninth Circuit affirmed a bankruptcy court's confirmation of a Chapter 11 plan, over the objection of the UST, even though one of the debtors had a tenant who was involved in a marijuana growing operation. But *Garvin* involved only a narrow issue of law that is not before this Court. The issue was whether the debtors' plan met the confirmation requirement in 11 U.S.C. § 1129(a)(3), that the plan be "proposed . . . not by any means forbidden by law." The court of appeals held that this provision in § 1129(a)(3) applies only to the "means of a reorganization plan's *proposal*, not its substantive provisions." *Garvin*, 2019 U.S. App. LEXIS 13235, 2019 WL 1945280, at *1, 3 (italics in original). Thus, the court held that the quoted prong of § 1129(a)(3) was not violated by the substance of the confirmed plan, including the debtor's continuing to lease its building to a marijuana grower in violation of federal law.

In *Garvin*, earlier in the bankruptcy case, before the plan was confirmed by the bankruptcy court, the UST had filed a motion to dismiss, based on the one debtor's leasing to a marijuana grower. The dismissal motion argued that "cause" existed to dismiss that debtor's case, because of "gross mismanagement of the estate" by the debtor, within the meaning of 11 U.S.C. § 1112(b)(4)(B). 2019 U.S. App. LEXIS 13235, 2019 WL 1945280, at *2. The bankruptcy court denied that dismissal motion, "but with leave to renew [it] at the plan confirmation hearing." *Garvin*, 2019 U.S. App. LEXIS 13235, 2019 WL 1945280, at *2. But the UST failed to renew its dismissal motion at the confirmation hearing, and instead argued only its objection to confirmation based on § 1129(a)(3). In affirming confirmation of the debtors' plan, the court of appeals ruled that the UST waived its dismissal motion argument under § 1112(b). For this reason, the court of appeals refused to address that issue.

[*382] **3. This case**

a. "Cause" exists under § 1112(b)(1) to dismiss or convert this case.

The UST argues that the Debtor has filed and is pursuing this bankruptcy case with unclean hands, because the Debtor's purpose is not to disentangle from any marijuana-based business, but rather to enable its owner to profit from a marijuana business. The UST argues that the Debtor's real purpose is to use this bankruptcy case to help enable the Debtor's 100% shareholder, Weaam Nocha, to [**24] obtain a better marijuana-based deal than what is provided by the November Lease and the State Court Decision.

The Debtor denies that it has unclean hands. The Debtor says that it wants to disentangle itself from the November Lease, by rejecting that lease. The Debtor insists that it does not want to be involved in the marijuana business, but rather just wants to try to reorganize its custom cabinet business, and continue doing that business, at its existing location.

But this Court is bound to reject these assertions by the Debtor. It is clear and obvious to this Court, from the findings and conclusions in the State Court Decision, that the Debtor's sole shareholder, Weaam Nocha, caused the Debtor to file this bankruptcy case for the sole purpose of evading the State Court Decision, and avoiding the enforcement of the November Lease, so that Weaam Nocha does not have to sell the Nocha Property to MJCC for only $1.2 million. Weaam Nocha obviously wants to realize more money for himself, as owner of the Nocha Property, than what the enforcement of the State Court Decision will give him, either by (1) renting or selling the Nocha Property to MJCC, or to some other marijuana dispensary [**25] business, for a higher rent or a higher sale price than $1.2 million; or (2) using the property to operate a marijuana dispensary himself, as he started to do with the help of his immediate family members before the State Court Decision was issued. Weaam Nocha did not cause the Debtor to file this bankruptcy case for the benefit of the Debtor or the Debtor's creditors, but rather solely for his own benefit — a benefit that depends on activity that is illegal under the CSA.

Borrowing from the words used by the UST in its motion, Weaam Nocha wants to use this bankruptcy case "to set aside this illegal contract [*i.e.*, the November Lease] so that he can negotiate a better illegal contract."[39]

Under Weaam Nocha's control, the Debtor denies these things. But these denials are precluded by the State Court Decision's findings and conclusions. The Debtor and Weaam Nocha both are bound by the findings and conclusions in the State Court Decision, under the doctrine of collateral estoppel. That means that they are precluded from now making assertions that are contrary to the findings and conclusions of the State Court Decision. And those findings and conclusions, described in Part III.C of this Opinion, [**26] inescapably lead to this Court's conclusions of what that the actual purpose of this bankruptcy case is.

The assertion that the Debtor, Weaam Nocha, and his family do not want the Nocha Property to be used or involved in the marijuana business, especially, is belied [*383] by the state court's detailed findings about all the efforts Weaam Nocha and his family went to in order to operate their own marijuana dispensary business at the Nocha Property, after refusing to honor the November Lease with MJCC. And then, only nine days after losing the State Court Lawsuit, Weaam Nocha caused the Debtor to file this bankruptcy case (1) to try to "reject" the November Lease under Bankruptcy Code § 365; and (2) to try to obtain the benefit of the automatic stay to delay MJCC's

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The decision of the Ninth Circuit Court of Appeals in *Garvin* is not binding on this Court, and, with respect, this Court does not necessarily agree with the *Garvin* court's holding about § 1129(a)(3). And, respectfully, one might reasonably question whether the *Garvin* court should have refused to decide the § 1112(b) dismissal issue. That refusal, on waiver grounds, arguably is questionable, because it allowed the affirmance, by a *federal* court, of the confirmation of a Chapter 11 plan under which a debtor would continue to violate *federal* criminal law under the CSA.

[39] UST Mot. (Docket # 30) at 1.

obtaining ownership of the Nocha Property while Weaam Nocha, the Debtor, and the other state court defendants appeal the State Court Decision.

The actual purpose of filing and prosecuting this bankruptcy case is for the Debtor and its 100% shareholder to use this bankruptcy court, and the Bankruptcy Code, to assist them in obtaining a result that is contrary to federal criminal law under the Controlled Substances Act, and therefore contrary to federal [**27] public policy.

This federal court cannot allow itself to be used in this way. The Court finds that the Debtor has unclean hands, and that there is "cause" to dismiss or convert this case, under 11 U.S.C. § 1112(b)(1).

b. There is no practical alternative to dismissal

Having found that cause exists to dismiss or convert this case under § 1112(b)(1), the Court next must determine which of these choices is "in the best interests of creditors and the estate."[40] The Court finds that dismissal, rather than conversion to Chapter 7, is in the best interests of creditors and the estate, for the following reasons.

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. The Debtor does not want to liquidate in Chapter 7. Rather, the Debtor has expressed a desire to continue operating its custom cabinets business, even though that business is relatively small,[41] and there is no reason to think that the Debtor cannot continue to operate its custom cabinets business outside of bankruptcy. Nor has any creditor of the Debtor advocated for the conversion and liquidation of the Debtor in Chapter 7. There is no reason to think that [**28] a liquidation of the Debtor in Chapter 7 is in the best interests of the creditors or the estate.

Second, like the court in the *Way to Grow* case, discussed in Part III.F.2 of this Opinion, this Court sees "no practical alternative to dismissal" in this case. *See Way to Grow*, 597 B.R. at 132. Conversion is not a practical alternative. As discussed in Part III.E of this Opinion, the Court has ruled that the Debtor cannot reject (or [*384] assume) the November Lease under § 365(a), because that lease is not a lease or executory contract "of the debtor." That ruling will thwart the bankruptcy strategy in this case of the Debtor and its owner, Weaam Nocha. But even with that ruling, the continued pendency of this bankruptcy case, whether in Chapter 11 or in Chapter 7, creates an impossible situation for this Court.

One major problem has to do with the automatic stay. After this Court's ruling on the Debtor's Lease Rejection Motion, Weaam Nocha will be forced by the state court, under the State Court Decision, to sell the Nocha Property to MJCC, and MJCC then will become the owner of that property. As owner, MJCC will have the exclusive right to possession of the Nocha Property, under Michigan law. But the Debtor operates [**29] its custom cabinet business from that property, and currently is in sole possession of that property. While this bankruptcy case remains pending, under either Chapter 11 or Chapter 7, the automatic stay will prevent MJCC from taking any action to wrest away possession of the Nocha Property from the Debtor, even after MJCC becomes the owner of the Nocha Property.

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[40] No one has argued that it is in the best interests of the creditors and the estate to appoint a Chapter 11 trustee under 11 U.S.C. § 1104(a) or to appoint an examiner. *See* 11 U.S.C. § 1112(b)(1). The Court finds that neither of these choices is in the best interests of the creditors and the estate. This is so because neither of these options would serve any useful purpose in this case, and also for the same reasons why dismissal, rather than conversion, is in the best interests of the creditors and the estate, as discussed below. So the choice under § 1112(b)(1) is between dismissal and conversion.

[41] The Debtor's monthly operating reports filed in this case show that the Debtor's income from its custom cabinets business is rather small. These reports show that the Debtor's *total* income was *zero* for the partial month of December 16-31, 2018 (Docket # 31 at 2); $16,000.00 in January 2019 (Docket # 62 at 2); $48,500.00 in February 2019 (Docket # 91 at 2); $10,000.00 in March 2019 (Docket # 103 at 2), and $13,000.00 in April 2019 (Docket # 112 at 2).>

See, e.g., 11 U.S.C. §§ 362(a)(1), 362(a)(3);[42] *Convenient Food Mart No. 144, Inc. v. Convenient Indus. of Am., Inc. (In re Convenient Food Mart No. 144, Inc.*), 968 F.2d 592, 594 (6th Cir. 1992) (holding that a bankruptcy debtor in possession of real estate, which has no right to possession, but which has a "tenancy at sufferance" under Kentucky law, has a "possessory interest in real property" that is protected by the automatic stay); *Chrysler LLC v. Plastech Engineered Prods., Inc. (In re Plastech Engineered Prods., Inc.*), 382 B.R. 90, 106 (Bankr. E.D. Mich. 2008) (holding that even a bankruptcy debtor's "bare possessory interest" in certain tooling was protected by the automatic stay, under 11 U.S.C. § 362(a)(3)).

In a normal case, when a bankruptcy debtor is in possession of real property that belongs to another person, and the debtor has no right to possession of that property under applicable non-bankruptcy law, it might be relatively easy for the owner of the property to file a motion seeking relief from the automatic stay, and obtain [**30] such relief. Such relief from the stay would be to permit that owner to prosecute an eviction action in an appropriate non-bankruptcy court, to obtain possession of the property. (MJCC has filed a motion for relief from stay in this case.)

But this is not a normal case. In this case, the Court likely would have to refuse to grant any stay relief, or any other relief, requested by MJCC, because MJCC also has unclean hands. The granting of stay relief to MJCC obviously would assist MJCC in its efforts to open and operate a medical marijuana dispensary, in violation of federal law. Just as "a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime," *Rent-Rite*, 484 B.R. at 805 (footnote omitted), neither can a federal court be asked to enforce any *creditor* protections under the Bankruptcy Code, such as the relief-from-stay provisions of 11 U.S.C. § 362(d), in aid of a *creditor's* commission of a federal crime.

This Court is unwilling and unable to assist a party like MJCC to violate federal [*385] law. So this Court likely would not grant stay relief to MJCC, even after MJCC became the owner of the Nocha Property.

Thus, the continuation of this [**31] bankruptcy case, under either Chapter 11 or Chapter 7, would leave the Court and the parties stuck in the middle of a continuing tug-of-war between two parties with unclean hands (the Debtor and MJCC), with the Court unable and unwilling to grant relief to either party. To use a metaphor employed by the UST, the only practical solution is to "cut the Gordian knot,"[43] by dismissing this case. Such dismissal is available here, at the request of a party that does *not* have unclean hands — the UST. And dismissal will leave the Debtor, Weaam Nocha, and MJCC to continue their battles in the state court, where those battles belong.

So the Court will dismiss this bankruptcy case. And in order to prevent any attempted evasion by anyone of the Court's decisions today, the Court will bar the filing of any new bankruptcy case, by or against the Debtor, for a period of two years. This should give ample time for the Debtor's pending state court appeal to conclude. Imposing this bar to a new bankruptcy filing is within the Court's discretion and authority, under 11 U.S.C. § 105(a), and also under 11 U.S.C. § 349(a). *See In re Packard Square LLC*, 575 B.R. 768, 783 (Bankr. E.D. Mich. 2017); *In re Packard Square LLC*, 577 B.R. 533, 537-38 (Bankr. E.D. Mich. 2017), *aff'd.*, 586 B.R. 853 (E.D. Mich. 2018)*; In re Skymark Properties II, LLC*, 597 B.R. 391, 403 (Bankr. E.D. Mich. 2019).

G. Discussion of the Stay Relief Motion

The Court's decision to dismiss this bankruptcy case will make [**32] MJCC's Stay Relief Motion moot. The automatic stay will terminate upon the dismissal of this case. *See* 11 U.S.C. §§ 362(c)(1) and 362(c)(2)(B). So the Court will deny the Stay Relief Motion, as moot.

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[42] Under § 362(a)(1), the filing of the bankruptcy petition in this case operates as a stay, among other things, of the "commencement or continuation . . . of a judicial . . . action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title." Under § 362(a)(3), the automatic stay prevents, among other things, "any act to obtain possession" not only of "property of the estate," but also of "property **from** the estate." (emphasis added).

[43] *See* UST Suppl. Br. (Docket # 96) at 2.

IV. Conclusion

For the reasons stated in this Opinion, the Court will enter orders (1) denying the Debtor's Lease Rejection Motion; (2) granting the UST's Dismissal Motion, and dismissing this case, with a two-year bar to refiling; and (3) denying the Stay Relief Motion, as moot.

Signed on May 21, 2019

/s/ Thomas J. Tucker

Thomas J. Tucker

United States Bankruptcy Judge

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Garvin v. Cook Invs. NW, SPNWY, LLC

United States Court of Appeals for the Ninth Circuit

December 3, 2018, Argued and Submitted, Seattle, Washington; May 2, 2019, Filed

No. 18-35119

Reporter
922 F.3d 1031 *; 2019 U.S. App. LEXIS 13235 **; 67 Bankr. Ct. Dec. 34

GREGORY M. GARVIN, Acting United States Trustee for Region 18, Appellant, v. COOK INVESTMENTS NW, SPNWY, LLC; COOK INVESTMENTS NW, FERN, LLC; COOK INVESTMENTS NW, LLC; COOK INVESTMENTS NW, DARR, LLC; COOK INVESTMENTS NW, ARL, LLC, Appellees.

Prior History: [**1] Appeal from the United States District Court for the Western District of Washington. Benjamin H. Settle, District Judge, Presiding. D.C. No. 3:17-cv-05516-BHS.

Garvin v. Cook Invs. NW, SPNWY, LLC (In re Cook Invs. NW, SPNWY, LLC), 2018 U.S. Dist. LEXIS 49640 (W.D. Wash., Mar. 26, 2018)

Disposition: AFFIRMED.

Summary:

SUMMARY*

Bankruptcy

The panel affirmed the district court's decision affirming the bankruptcy court's order confirming the second amended Chapter 11 plan of five real estate holding companies.

One of the debtors leased property to a company that used the property to grow marijuana. The United States trustee objected that the lease violated federal drug law, and so the plan was unconfirmable under 11 U.S.C. § 1129(a)(3) because it was proposed by means forbidden by law.

The panel held that § 1129(a)(3) directs bankruptcy courts to police the means of a reorganization plan's proposal, not its substantive provisions. The panel affirmed confirmation of the plan because it was not proposed by any means forbidden by law.

Counsel: Sonia Carson (argued) and Mark B. Stern, Appellate Staff; Annette L. Hayes, Acting United States Attorney; Joseph H. Hunt, Assistant Attorney General; Civil Division, United States Department of Justice, Washington, D.C.; Wendy Cox, Trial Attorney; P. Matthew Sutko, Associate General Counsel; Ramona D. Elliott, Deputy Director/General Counsel; Department [**2] of Justice, Executive Office for United States Trustees, Washington, D.C.; for Appellant.

James L. Day (argued) and Aditi Paranjpye, Bush Kornfeld LLP, Seattle, Washington, for Debtors-Appellees.

Judges: Before: Susan P. Graber, M. Margaret McKeown, and Morgan Christen, Circuit Judges. Opinion by Judge McKeown.

Opinion by: M. Margaret McKeown

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* This summary constitutes no part of the opinion of the court. It has been prepared by court staff for the convenience of the reader.

922 F.3d 1031, *1031; 2019 U.S. App. LEXIS 13235, **2

Opinion

[*1033] McKEOWN, Circuit Judge:

Facing insolvency, five real estate holding companies owned and managed by Michael Cook (collectively, "Cook" or the "Cook companies") sought Chapter 11 protection. Cook's foray into Chapter 11 was by most standards a resounding success. It culminated with the Second Amended Joint Debtors' Plan of Reorganization ("Amended Plan"), which paid all creditors in full and provided for Cook to continue as a going concern. The Amended Plan was confirmed by the bankruptcy court.

But now the United States Trustee ("Trustee") asks that the Amended Plan go up in smoke, because one of the Cook companies leases property to N.T. Pawloski, LLC ("Green Haven"), which uses the property to grow marijuana. The Trustee complains that, even if Green Haven's business complies with Washington law, the lease itself violates federal drug law. The Trustee reasons that this [**3] violation proves the Amended Plan was "proposed . . . by . . . means forbidden by law" and is thus unconfirmable under 11 U.S.C. § 1129(a)(3).

The problem with the Trustee's theory is that it ignores the plain text of § 1129(a)(3), which directs bankruptcy courts to police the means of a reorganization plan's *proposal*, not its substantive provisions. Resolution of this appeal rests on a straightforward question of statutory interpretation rather than on any conflict between federal and state drug laws. We affirm confirmation of the Amended Plan because it was not proposed "by any means forbidden by law."

BACKGROUND

Cook Investments NW, DARR, LLC ("Cook DARR"), one of the Cook companies, owns commercial real estate in Darrington, Washington (the "Darrington Property"). Cook DARR leased the Darrington Property to two tenants, one of which was Green Haven. The lease with Green Haven (the "Green Haven Lease") provides that Green Haven will use the Darrington Property exclusively as a marijuana establishment. Although Green Haven appears to be in compliance with Washington law, the Green Haven Lease puts Cook in violation of the federal Controlled Substances Act, 21 U.S.C. §§ 801-971, which prohibits "knowingly . . . leas[ing] . . . any place [**4] . . . for the purpose of manufacturing, distributing, or using any controlled substance," *id.* § 856(a)(1).

In 2009, one of the Cook companies defaulted on a loan from Columbia State Bank. The loan was secured by Cook's real estate holdings, including the Darrington Property. The bank won default judgments against Cook in state court. Although Cook and the bank reached forbearance agreements, Cook failed to fulfill the agreements' terms. The bank then obtained state-court orders appointing receivers for Cook's properties. At that point, all of the Cook companies filed Chapter 11 bankruptcy petitions, which the bankruptcy court ordered jointly administered.

The Trustee filed a motion to dismiss Cook DARR's Chapter 11 case, asserting that the Green Haven Lease constituted gross mismanagement and thus cause to dismiss under 11 U.S.C. § 1112(b). The bankruptcy court denied the motion to dismiss, but with leave to renew at the plan confirmation hearing.

Cook filed the Amended Plan, which provides for repayment of all creditors' claims in full and for Cook to continue as a going concern. The Amended Plan incorporates [*1034] by reference an earlier Chapter 11 Plan Agreement between Cook and Columbia State Bank, but in the Amended [**5] Plan Cook rejected the Green Haven lease and structured the plan so that his monthly obligations would be paid without revenue from Green Haven. Cook's counsel also explained at argument that, pursuant to the Amended Plan, Cook's other tenants pay their rent directly to Columbia State Bank in satisfaction of its claim, while Green Haven rents were presumably paid directly to Cook.

The bankruptcy court confirmed the Amended Plan, over the Trustee's objection that it violated § 1129(a)(3)'s requirement that a plan be "proposed in good faith and not by any means forbidden by law." The Trustee was the only objector; Cook's creditors fully supported the Amended Plan, which satisfactorily provided for their repayment.

Because the Trustee failed to renew its motion to dismiss at the confirmation hearing, the district court affirmed the denial of the motion to dismiss Cook DARR's case. Following confirmation, the Trustee moved for a stay, but the district court denied the request. As a result, Cook has continued to make payments pursuant to the Amended Plan during the pendency of this appeal. The unsecured creditors have been repaid and the secured creditor, Columbia State Bank, is in the process of being [**6] repaid.

ANALYSIS

On appeal, the Trustee first challenges the bankruptcy court's refusal to dismiss Cook DARR under § 1112(b) for "gross mismanagement of the estate." 11 U.S.C. § 1112(b)(4)(B). We need not decide the merits of this issue because, like the district court, we conclude the Trustee waived the argument by failing to renew its motion to dismiss.

The bankruptcy court initially denied the motion to dismiss but explicitly invited the Trustee to renew the motion at the plan confirmation hearing. The Trustee chose, at its peril, not to do so. As the district court put it: "The Trustee failed to renew the motion or subsequently raise the gross mismanagement argument. Although the Debtors fail to raise waiver, it seems to be plain error for this Court to reverse the bankruptcy court's denial when the Trustee failed to renew its motion." This failure was especially significant because it meant the bankruptcy court had no opportunity to consider whether the claimed gross mismanagement had been "cured." As a consequence, neither the bankruptcy court, nor the district court, nor this court could properly determine the applicability of the exception to dismissal for "unusual circumstances." *See* 11 U.S.C. § 1112(b)(2) (exception to dismissal [**7] for unusual circumstances applies only if, *inter alia*, cause for dismissal "will be cured within a reasonable period of time"); *cf. Walsh v. Nev. Dep't of Human Res.*, 471 F.3d 1033, 1037 (9th Cir. 2006) (holding that a claim raised in the complaint was waived when it was not re-raised in response to a motion to dismiss, because "the district court had no reason to consider the contention that the claim . . . could not be dismissed" (internal quotation marks omitted)).[1]

We therefore turn to the issue of confirmation. To be confirmed, the Amended Plan had to satisfy § 1129(a), which provides that "[t]he court shall confirm a plan only if" sixteen enumerated requirements are met. The third requirement is that "[t]he plan has been proposed in good faith [*1035] and not by any means forbidden by law." 11 U.S.C. § 1129(a)(3). Only the second prong is at issue here. Because it appears that Cook continues to receive rent payments from Green Haven, which provides at least indirect support for the Amended Plan, the Trustee asserts that it was "proposed . . . by . . . means forbidden by law." 11 U.S.C. § 1129(a)(3).

We determine de novo the proper interpretation of § 1129(a)(3). *See Tighe v. Celebrity Home Entm't, Inc. (In re Celebrity Home Entm't, Inc.)*, 210 F.3d 995, 997 (9th Cir. 2000) (reviewing de novo the bankruptcy court's interpretation of the Bankruptcy Code). Whether the Amended Plan was confirmable depends on whether § 1129(a)(3) forbids [**8] confirmation of a plan that is proposed in an unlawful manner as opposed to a plan with substantive provisions that depend on illegality, an issue of first impression in the Ninth Circuit.

Like the First Circuit Bankruptcy Appellate Panel, we conclude that § 1129(a)(3) directs courts to look only to the proposal of a plan, not the terms of the plan. *Irving Tanning Co. v. Me. Superintendent of Ins. (In re Irving Tanning Co.)*, 496 B.R. 644, 660 (B.A.P. 1st Cir. 2013). This reading accords with both the statutory text, which does not refer to the substance of the plan, and the weight of persuasive authority. *See In re Gen. Dev. Corp.*, 135 B.R. 1002, 1007 (Bankr. S.D. Fla. 1991) ("Courts addressing the issue have uniformly held that Section 1129(a)(3) does not require that the contents of a plan comply in all respects with the provisions of all nonbankruptcy laws and regulations." (internal quotation marks omitted)).

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[1] Although Cook did not raise this issue, the district court ruled on this ground, and the Trustee addressed the issue in its briefing, so Cook's failure to raise waiver did not prejudice the Trustee. *See Hall v. City of Los Angeles*, 697 F.3d 1059, 1071 (9th Cir. 2012) ("We may consider an issue sua sponte . . . if the opposing party will not suffer prejudice.").

It is true that some bankruptcy courts have accepted the Trustee's interpretation. In concluding that a bankruptcy case should be dismissed "[b]ecause a significant portion of the Debtor's income [wa]s derived from an illegal activity," the Bankruptcy Court of Colorado stated that "§ 1129(a)(3) forecloses any possibility of this Debtor obtaining confirmation of a plan that relies in any part on income derived from a criminal activity." *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799, 809 (Bankr. D. Colo. 2012) (footnote omitted). But such decisions fail to "square[] that [**9] understanding with subsection (a)(3)'s express focus on the manner of the plan's *proposal*." *Irving Tanning*, 496 B.R. at 660.

Turning to the statute, the phrase "not by any means forbidden by law" modifies the phrase "[t]he plan has been proposed." An interpretation that reads the words "has been proposed" out of the second prong of the requirement would be grammatically nonsensical, i.e., "The plan has been . . . not by any means forbidden by law." Moving the reference to illegality to before "proposed" fares no better, i.e., "The plan, not by any means forbidden by law, has been proposed in good faith." The Trustee's position would require us to rewrite the statute completely, rather than resort to its clear meaning. *See Duncan v. Walker*, 533 U.S. 167, 174, 121 S. Ct. 2120, 150 L. Ed. 2d 251 (2001) ("It is our duty to give effect, if possible, to every clause and word of a statute." (internal quotation marks omitted)).

A contrary interpretation not only renders the words "has been proposed" meaningless, but makes other provisions of § 1129(a) redundant. For example, § 1129(a)(1) requires that "[t]he plan complies with the applicable provisions of this title." If § 1129(a)(3) is read to mean that the plan must comply with all applicable law, there would be no need for a separate requirement that the plan comply with the provisions of the Bankruptcy [**10] Code specifically.[2]

[*1036] We do not believe that the interpretation compelled by the text will result in bankruptcy proceedings being used to facilitate legal violations. To begin, absent waiver, as in this case, courts may consider gross mismanagement issues under § 1112(b). And confirmation of a plan does not insulate debtors from prosecution for criminal activity, even if that activity is part of the plan itself. *In re Food City, Inc.*, 110 B.R. 808, 812 (Bankr. W.D. Tex. 1990). There is thus no need to "convert the bankruptcy judge into an ombudsman without portfolio, gratuitously seeking out possible 'illegalities' in every plan," a result that would be "inimical to the basic function of bankruptcy judges in bankruptcy proceedings."[3] *Id.*

Because the Amended Plan was lawfully proposed, the Bankruptcy Court correctly concluded that it met the requirements of 11 U.S.C. § 1129(a).

AFFIRMED.

End of Document

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[2] Section 1129(a)(16), which requires that "transfers of property under the plan [comply] with [certain] applicable provisions of nonbankruptcy law," would be similarly redundant under the Trustee's interpretation.

[3] Cases directing courts to look to the "totality of the circumstances" to determine whether a plan was proposed in good faith do not change the analysis here. Under the good faith prong of § 1129(a)(3), courts must determine whether the plan "achieves a result consistent with the objectives and purposes of the Code." *Platinum Capital, Inc. v. Sylmar Plaza, L.P. (In re Sylmar Plaza, L.P.)*, 314 F.3d 1070, 1074 (9th Cir. 2002); *see also In re Emmons-Sheepshead Bay Dev. LLC*, 518 B.R. 212, 225 (Bankr. E.D.N.Y. 2014) ("The good-faith test speaks more to the process of plan development than to the content of the plan." (internal quotation marks omitted)); *In re 431 W. Ponce de Leon, LLC*, 515 B.R. 660, 673 (Bankr. N.D. Ga. 2014) (holding both that, "[i]n assessing whether the plan was proposed in good faith, the assessment is focused on the plan itself" and "§ 1129(a)(3) requires that only the *plan's proposal*, as opposed to the contents of the plan, be in good faith and in compliance with all nonbankruptcy laws" (internal quotation marks omitted)). Here, the Amended Plan provides for the creditors' repayment and the debtors' ongoing operations, so it is consistent with the objectives and purpose of the Bankruptcy Code.

Olson v. Van Meter (In re Olson)

United States Bankruptcy Appellate Panel for the Ninth Circuit

December 1, 2017, Argued and Submitted, at Reno, Nevada; February 5, 2018, Filed

BAP No. NV-17-1168-LTiF

Reporter
2018 Bankr. LEXIS 480 *

In re: PATRICIA G. OLSON, Debtor.PATRICIA G. OLSON, Appellant, v. WILLIAM ALBERT VAN METER, Chapter 13 Trustee; CODY BASS; CITY OF SOUTH LAKE TAHOE; UNITED STATES OF AMERICA; U.S. BANK, N.A., Appellees.

Notice: This disposition is not appropriate for publication. Although it may be cited for whatever persuasive value it may have (see Fed. R. App. P. 32.1), it has no precedential value. See 9th Cir. BAP Rule 8024-1.

Prior History: [*1] Appeal from the United States Bankruptcy Court for the District of Nevada. Bk. No. 3:17-bk-50081-BTB. Honorable Bruce T. Beesley, Bankruptcy Judge, Presiding.

Counsel: Anne J. Williams of the Law Offices of J. Craig Demetras argued for Appellant Patricia G. Olson.

Seth Joseph Adams of Woodburn & Wedge argued for Appellee Cody Bass.

Judges: Before: LAFFERTY, TIGHE,** and FARIS, Bankruptcy Judges. Memorandum by Judge Lafferty. Concurrence by Judge Tighe.

Opinion by: Lafferty

Opinion

MEMORANDUM

Memorandum by Judge Lafferty

Concurrence by Judge Tighe

The Debtor is 92 years old, legally blind, and resides in an assisted living facility. She sought chapter 13[1] relief to stop foreclosure of her commercial real property. One of the tenants at that property operated a marijuana dispensary on the premises and continued to pay rent to Debtor postpetition. Debtor's plan called for her to sell the commercial real property to pay off all creditors. At the hearing on the motion to sell and reject the lease with the tenant, the bankruptcy court dismissed the case sua sponte on the ground that Debtor's postpetition acceptance of rents from the dispensary business was an ongoing criminal violation that disqualified her from bankruptcy relief.

Because [*2] the bankruptcy court did not make adequate findings for us to discern the standard under which it concluded that dismissal was mandatory, we VACATE and REMAND.

** Hon. Maureen A. Tighe, U.S. Bankruptcy Judge for the Central District of California, sitting by designation.

[1] Unless specified otherwise, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532.

FACTS[2]

Prepetition, Debtor Patricia G. Olson was the general partner of Olson Bijou Center, L.P., a California limited partnership ("OBC"). OBC owned real property on Lake Tahoe Boulevard in South Lake Tahoe, California, known as the Olson Bijou Shopping Center (the "Shopping Center Property").

Beginning in January 2013, Appellee Cody Bass began leasing space in the Shopping Center Property from OBC; although the record includes only an unsigned copy of the lease, the signature block on the lease indicates that it was to be signed by Debtor's son, Patrick Olson, as manager of OBC.[3] The lease expressly authorized Mr. Bass to operate a "dispensary."[4] Pursuant to that authority, Mr. Bass operated at the leased premises Tahoe Wellness Cooperative ("TWC"), a marijuana dispensary authorized under California law. Both the operation of the dispensary business and the leasing of the premises for such a business, however, potentially violated the federal Controlled Substances Act, 21 U.S.C. §§ 801-904 ("CSA"). The CSA classifies marijuana as a controlled substance, [*3] 21 U.S.C. § 812, and makes it unlawful 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.

21 U.S.C. § 856(a).

In early 2016, Mr. Bass and OBC entered into a letter of intent for Mr. Bass to purchase the Shopping Center Property for $4.2 million; Mr. Bass made a $25,000 payment to Debtor's attorney pursuant to the letter of intent. Shortly thereafter, Mr. Bass, OBC, and Debtor entered into an option agreement, which expired on March 3, 2016. Mr. Bass tendered an additional $50,000 to be applied to the purchase price if the option were exercised. According to Mr. Bass' declaration in support of his opposition to the motion to sell, he gave notice on April 1, 2016, that he was exercising the option agreement. He asserted that this notice [*4] was timely based on a First Amendment to Option Agreement attached to his declaration, which extended the deadline for exercising the option to April 4, 2016 and appears to be signed by Debtor. But in Debtor's second declaration in support of pending motions, she stated that Mr. Bass came to her assisted living facility on March 3, 2016, the day the option agreement expired, and asked her to sign papers, but she did not understand what she may have signed, and she believed Mr. Bass misled her into "signing something."[5]

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[2] The parties did not include all relevant documents in their excerpts of record. We have thus exercised our discretion to review relevant imaged documents from the bankruptcy court's electronic docket. See O'Rourke v. Seaboard Sur. Co. (In re E.R. Fegert, Inc.), 887 F.2d 955, 957-58 (9th Cir. 1989); Atwood v. Chase Manhattan Mort. Co. (In re Atwood), 293 B.R. 227, 233 n.9 (9th Cir. BAP 2003).

[3] In Debtor's declaration in support of the motion to reject lease, she stated that she believed the lease "agreements" were taken from her residence by government law enforcement authorities in May 2015. In Debtor's second declaration in support of the motions to sell and to reject, she stated, "[t]here is no signed lease agreement between Mr. Bass and me."

[4] The lease also required Mr. Bass to "comply with all statutes, codes, ordinances, orders, rules and regulations of any Federal, California, municipal or other governmental or quasi-governmental entity . . . ."

[5] We include these "facts" merely to provide some context for the proceedings before the bankruptcy court, and for no other purpose. And we should be particularly circumspect in this instance, in which we remand after determining that the bankruptcy court neither articulated the legal basis for its decision sua sponte to dismiss this case, nor identified with precision the facts which it must have determined, or upon which it might have relied, under any cognizable theory, in dismissing the case. Accordingly, we neither make any determination concerning what appear to be disputed facts, nor "weigh" any such facts, nor determine credibility, nor even, indeed, opine regarding what facts might be relevant under the as-yet-undetermined legal standard to be applied by the bankruptcy court on remand.

OBC and Debtor did not perform under the option agreement, and, in May 2016, Mr. Bass sued OBC, Debtor, and Mr. Olson in El Dorado County Superior Court for damages and specific performance.

The Shopping Center Property was encumbered by a deed of trust in favor of U.S. Bank, N.A. In August 2016 U.S. Bank recorded a notice of default, and in December 2016 it recorded a notice of sale. The foreclosure sale was set for February 1, 2017.

On January 30, 2017, Debtor filed a chapter 13 petition, which stayed both the foreclosure and the Bass litigation. That same day, she filed a quitclaim deed transferring OBC's interest in the Shopping Center Property to herself individually. Mr. Bass continued [*5] to pay rent postpetition to Debtor or her counsel.

About a month after the bankruptcy filing, the bankruptcy court approved a stipulation between Debtor and U.S. Bank for the use of cash collateral for Debtor's ordinary operating expenses and maintenance of the Shopping Center Property as well as assisted living expenses and health insurance, through April 2017. In exchange, Debtor granted U.S. Bank a postpetition replacement lien on all rents generated from the Shopping Center Property and agreed to make adequate protection payments of $4,000 per month. According to the stipulation, at that time expected rental income was $16,220 per month, including TWC's monthly rental payment of $10,200. In early May 2017, the court approved another cash collateral stipulation extending the agreement to use cash collateral through July 31, 2017 and modifying the budget to exclude the rent from TWC. There is no evidence in the record to indicate whether the postpetition rents paid by Mr. Bass were used to make payments pursuant to the initial cash collateral stipulation; other than Debtor's counsel's oral representation that the May 2017 rent payment was being held in a safe in his office, the record [*6] does not show what happened to those funds at all.

Debtor's proposed chapter 13 plan called for monthly payments of $150 for 12 months and $2,100 for 48 months. The plan also provided that Debtor would sell the Shopping Center Property within six months of plan confirmation and use the net proceeds to pay all administrative, priority, and unsecured claims.

In April 2017, Debtor filed a motion to sell free and clear under § 363(f) the Shopping Center Property and the adjacent property, which she also owned, for $3 million. Among the conditions of the sale of the Shopping Center Property were (i) court approval of the rejection or termination of Mr. Bass' lease and the commencement of eviction proceedings by Debtor; and (ii) court-ordered rejection, termination, or voiding of the option agreement with Mr. Bass. Debtor also filed a motion to reject the lease and the option agreement with Mr. Bass.[6] In her declaration in support of the motion to reject, Debtor stated that she had entered into the lease with Mr. Bass in January 2013 and that Mr. Bass "currently operates a medical marijuana dispensary at 3443 Lake Tahoe Blvd[.]" In a subsequent declaration filed May 11, 2017, Debtor further testified: [*7]

> 1. I am 92-years [sic] old and legally blind. I live in an assisted living facility in Sparks, Nevada.
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> . . . .
>
> 9. At times prior to the filing of this case, my son, Patrick Olson, acted and served as my attorney-in-fact. In doing so, Patrick managed most of my financial affairs, which included the management of 949 Bal Bijou Road and 3443 Lake Tahoe Blvd. Patrick's duties included obtaining leases for the properties, collecting rents and paying all expenses, such as the secured mortgage payment to U.S. Bank, real property taxes and insurance premiums.
>
> 10. In 2012, Patrick Olson, through Olson Bijou Center L.P., leased space at 3443 Lake Tahoe Blvd. to Cody Bass.
>
> . . . .
>
> 15. I wish to end any involvement with Mr. Bass and his illegal business. I do not want to use money from Mr. Bass to fund my Chapter 13 Plan. I don't want to sell my property to Mr. Bass and do not want to finance his purchase of 3343 Lake Tahoe Blvd. I wish only to terminate any dealings with Mr. Bass and to sell my property and pay my creditors in full.

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[6] The City of South Lake Tahoe (the "City") filed a joinder in the motion to reject on the ground that Mr. Bass' permit to operate the dispensary had expired and had not been renewed because the Debtor had not provided her written consent.

Mr. Bass opposed both motions. In his declaration in support of his opposition to the motion to sell, Mr. Bass confirmed that he had been operating a marijuana dispensary [*8] on the premises pursuant to the terms of his lease with OBC and that he had paid rent to the Debtor postpetition.

Shortly thereafter, the chapter 13 trustee filed a motion to dismiss for failure to make plan payments and for failure to file an amended plan. Mr. Bass also filed a motion to dismiss the case on grounds that Debtor's acceptance of rents from his marijuana dispensary violated the CSA. Neither of those motions were heard because they were mooted by the bankruptcy court's sua sponte dismissal of Debtor's case.

At the initial hearing on the motion to sell and motion to reject, the bankruptcy court questioned whether it could authorize the sale, given that the Debtor had been accepting rents from leasing a marijuana dispensary; the parties argued the issue, and the court continued the matter for a few days to study the relevant authorities. At the continued hearing, the court heard additional argument but concluded, based on its interpretation of relevant case law, that because Debtor had continued to receive rent postpetition, the case had to be dismissed:

> I think it's a crime for Ms. Olson to be accepting rents from an illegal operation, so I am dismissing this case. . . . My [*9] finding is this debtor is leasing property for an unlawful purpose under federal law, although lawful under state law . . . and has continued to accept rents during the course of her bankruptcy.

Hr'g Tr. (May 22, 2017) at 6:4-5; 22-25. In response to a request for clarification from Debtor's counsel, the court explained:

> [I]f the debtor has committed a crime during the course of the bankruptcy and continued for several months to commit a crime during the course of the bankruptcy, I think that is a basis for not providing relief to the debtor. Had the debtor, prior to filing bankruptcy or not during the bankruptcy had not committed the crime of taking money from a marijuana operation, I would feel differently. But that's not what happened here. Because you don't, in my opinion, get to go through five or six months of a bankruptcy knowingly receiving illegal proceeds and then say, oh, I'm not going to take those anymore, I want to sell the property now, so I get to play here. I don't think that's correct.

Id. at 7:17-8:3. The bankruptcy court entered its sua sponte order dismissing the case on May 31, 2017; the court also granted a stay pending appeal. Debtor timely appealed.

JURISDICTION [*10]

The bankruptcy court had jurisdiction pursuant to 28 U.S.C. §§ 1334 and 157(b)(2)(A). We have jurisdiction under 28 U.S.C. § 158.

ISSUE

Whether the bankruptcy court abused its discretion in dismissing Debtor's chapter 13 case.

STANDARD OF REVIEW

We review a bankruptcy court's dismissal of a chapter 13 case for abuse of discretion. Ellsworth v. Lifescape Med. Assocs., P.C. (In re Ellsworth), 455 B.R. 904, 914 (9th Cir. BAP 2011). A bankruptcy court abuses its discretion if it applies the wrong legal standard, misapplies the correct legal standard, or if its factual findings are clearly erroneous. TrafficSchool.com, Inc. v. Edriver Inc., 653 F.3d 820, 832 (9th Cir. 2011).

DISCUSSION

Ordinarily, a bankruptcy court grants or denies relief based on a specific provision in the Code. Here, the bankruptcy court did not specify what Code section or other authority it relied upon in dismissing Debtor's case. The court concluded, apparently based on case law from other jurisdictions, that Debtor's postpetition receipt of rental payments from a tenant that operated a marijuana dispensary on property she owned was (i) a violation of the CSA that (ii) constituted grounds for dismissal of the case. The legal basis for dismissal could have been bad faith under § 1307(c), but the bankruptcy court made no bad faith finding and did not engage in the totality of the circumstances analysis required for dismissal under that Code section. [*11]

Alternatively, the bankruptcy court may have been acting pursuant to its inherent power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." § 105(a). But, if acting pursuant to its inherent powers, the court could act only "within the confines of the Bankruptcy Code." Law v. Siegel, 571 U.S. 415, 134 S. Ct. 1188, 1194-95, 188 L. Ed. 2d 146 (2014) (citations omitted). And where a statute adequately addresses the conduct at issue, the court's inherent powers should be invoked only when that statute does not fully address the situation at hand. See Chambers v. NASCO, Inc., 501 U.S. 32, 50, 111 S. Ct. 2123, 115 L. Ed. 2d 27 (1991) ("[I]f in the informed discretion of the court, neither the statute nor the Rules are up to the task, the court may safely rely on its inherent power [in imposing a sanction for bad faith litigation conduct].").

But the bankruptcy court did not articulate the legal basis for its ruling or make findings to support its conclusions that the CSA was being violated and that that violation was grounds for dismissal. When a court imposes the harsh penalty of dismissal in circumstances such as those presented here, it is imperative that it state with clarity and precision its factual and legal bases for doing so.

The standard for dismissal of a chapter 13 case is set forth [*12] in § 1307(c). That section provides that on request of a party in interest and after notice and a hearing, the bankruptcy court may convert a chapter 13 case to chapter 7, or may dismiss a case, whichever is in the best interests of creditors and the estate, for "cause." § 1307(c).[7] Section 1307(c) sets forth a non-exclusive list of factors that constitute "cause" for conversion or dismissal.[8] In dealing with questions of conversion and dismissal, the bankruptcy court engages in a two-step process: "First, it must be determined that there is 'cause' to act. Second, once a determination of 'cause' has been made, a choice must be made between conversion and dismissal based on the 'best interests of the creditors and the estate.'" Nelson v. Meyer (In re Nelson), 343 B.R. 671, 675 (9th Cir. BAP 2006).

Although not listed, bad faith is cause for dismissal. Leavitt v. Soto (In re Leavitt), 171 F.3d 1219, 1224 (9th Cir. 1999). In determining bad faith, the bankruptcy court is to apply a totality of the circumstances analysis, considering (1) whether the debtor misrepresented facts in her petition or plan, unfairly manipulated the Bankruptcy Code, or otherwise filed her chapter 13 petition or plan in an inequitable manner; (2) the debtor's history of filings and dismissals; (3) whether the debtor only intended to defeat state court litigation; and (4) whether [*13] egregious behavior is present. Id.

On appeal, Debtor assumes the bankruptcy court dismissed her case on grounds of bad faith by arguing that the bankruptcy court abused its discretion in not considering the totality of the circumstances, especially the fact that Debtor was using the bankruptcy to sever her ties with Mr. Bass' business. But the bankruptcy court did not invoke § 1307(c), nor did it explicitly find bad faith.

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[7] Although that statute requires a request by a party in interest or the United States trustee, the bankruptcy court may dismiss or convert a case sua sponte under § 105(a). Tennant v. Rojas (In re Tennant), 318 B.R. 860, 868-70 (9th Cir. BAP 2004). Additionally, despite § 1307's requirement of notice and a hearing, due process is satisfied if the impacted party has had an opportunity to be heard. See id. at 870 (noting that the concept of notice and a hearing is flexible and depends on what is appropriate in the circumstances). Debtor does not argue that her due process rights were violated, nor does she dispute that the court had the authority to sua sponte dismiss the case.

[8] Those enumerated factors include: unreasonable delay by the debtor that is prejudicial to creditors; failure to commence making timely payments; denial of confirmation of a plan; and material default by the debtor with respect to a term of a confirmed plan.

The bankruptcy court stated that it had "looked at the cases," but did not articulate any rules drawn from those cases that applied to the facts before it. The case law addressing facts such as those presented here is sparse, and there is no controlling authority in the Ninth Circuit.

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., Inc. v. Jensen (In re Medpoint Mgmt., LLC), BAP No. AZ-15-1130-KuJaJu, 2016 Bankr. LEXIS 2197, 2016 WL 3251581 (9th Cir. BAP Jun. 3, 2016); In re Johnson, 532 B.R. 53, 56-57 (Bankr. W.D. Mich. 2015);[9] In re Rent-Rite Super Kegs W., Ltd., 484 B.R. 799, 810 (Bankr. D. Colo. 2012). The bankruptcy court here made no finding, however, that the trustee would be administering the proceeds of an illegal business, and there is no evidence [*14] in the record that the rents were to be used to fund the plan.

Some courts have held that a bankruptcy filing or a plan of reorganization proposed by a debtor who is involved in an illegal enterprise is not in good faith, even where the debtor does not have a subjective bad motive, is in legitimate need of bankruptcy relief, and there is otherwise no indicia of an attempt to abuse the bankruptcy process. In re Arenas, 535 B.R. at 852-53; In re Rent-Rite Super Kegs W., Ltd., 484 B.R. at 809. Related to the good faith analysis, some courts have concluded that a debtor engaged in an illegal business who seeks bankruptcy relief comes into court with unclean hands and is not eligible for relief. In re Rent-Rite Super Kegs W., Ltd., 484 B.R. at 807; cf. In re Medpoint Mgmt., LLC, 528 B.R. at 186-87 (petitioning creditors who knew the putative debtor was engaged in a federally prohibited medical marijuana business had unclean hands and could not seek relief from the bankruptcy court).

The bankruptcy court here made no finding of bad faith or unclean hands. Further, it concluded that it was a crime for Debtor to be accepting rents from Mr. Bass' business without making any findings showing that all the elements of a CSA violation had been established (such as the requirement that the conduct be "knowing").

The foregoing cases suggest possible reasons for the [*15] court's decision, but without specific findings and conclusions, we cannot determine whether or how the court found those cases applicable to the facts of this case, nor can we adequately evaluate the propriety of the bankruptcy court's ruling.

Accordingly, on remand, the bankruptcy court should articulate the findings that led it to determine that Debtor was violating the CSA and what legal standard it relied upon in dismissing the case.

CONCLUSION

For the reasons set forth above, we VACATE and REMAND.

Concur by: TIGHE

Concur

TIGHE, Bankruptcy Judge, CONCURRING.

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[9] In In re Johnson, the bankruptcy court acknowledged the problems created when a debtor who operates a marijuana business that is legal under state law seeks bankruptcy relief, noting that continued operation of the marijuana business would result in the court and the trustee tacitly supporting the debtor's criminal enterprise. 532 B.R. at 56-57. Nevertheless, the court ruled that it would permit the debtor to remain in chapter 13 on the condition that he stop engaging in the marijuana business. Id. at 58. The bankruptcy court here explicitly disagreed with this approach.

I concur in the memorandum and write separately to emphasize (1) the importance of evaluating whether the Debtor is actually violating the Controlled Substances Act and (2) the need for the bankruptcy court to explain its conclusion that dismissal was mandatory under these circumstances. 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 [*16] deeming a debtor a criminal and denying both debtor and creditors the benefit of the bankruptcy laws.

As the memorandum details, there are a number of situations where the federal prohibition on marijuana distribution prevented debtors from reorganizing or liquidating under federal bankruptcy laws. Typically, these were cases where the debtor sought to continue to distribute marijuana postpetition or where a trustee would be asked to accept proceeds of a drug-related business, situations where federal law would clearly be violated. See, e.g., In re Arenas, 535 B.R. 845 (debtors themselves grew and sold marijuana); In re Rent-Rite Super Kegs W., Ltd., 484 B.R. 799 (debtor's ongoing postpetition leases with marijuana-growing tenant exposed debtor to criminal liability and primary asset to forfeiture).

This Debtor's plan did not necessarily require the rental income from the dispensary to fund the proposed payments. It provided for minimal plan payments until a sale motion could be filed and the Debtor's real property sold. The sale of Debtor's real property would have been simply a liquidation of legal estate assets. In fact, but for the marijuana-related proceeds, the sale of real property to fund a plan is a common scenario because of the ability in bankruptcy [*17] to sell property subject to a bona fide dispute free and clear of a lien. See § 363(f)(4).

If, on remand, the basis for dismissal is the court's concern that Debtor committed a crime by receiving postpetition rent derived from a marijuana business, an explicit finding of the facts required for criminal liability is needed. Section 856(a)(2) of Title 21 prohibits a person with a premises from knowingly and intentionally allowing its use for the purpose of distributing drugs. United States v. Tamez, 941 F.2d 770, 774 (9th Cir. 1991). A violation of section 856(a) also requires a showing that a primary or principal use of the premises is for drug distribution or manufacture. See United States v. Mancuso, 718 F.3d 780, 794-96 (9th Cir. 2013). Any prosecution of this crime would require a showing that Debtor knew that Mr. Bass leased the property to operate a marijuana dispensary, and that she intended to allow that use.

The Debtor's personal knowledge is an especially critical inquiry for an elderly, blind woman residing in assisted living with an attorney-in-fact in charge of the lease. Although Debtor stated in her second declaration in support of the motion to reject the lease that Bass was operating a medical marijuana dispensary, the record does not indicate when Debtor became aware of this. She stated in that declaration that she did not want [*18] to be involved in leasing to a marijuana business.

Any prosecution of 21 U.S.C. § 856(a)(2) would need to prove beyond a reasonable doubt that Debtor herself "knowingly and intentionally" leased the property where the marijuana is distributed. See Elonis v. United States, 135 S. Ct. 2001, 2009, 192 L. Ed. 2d 1 (2015) (general rule is that a guilty mind is a necessary element in the proof of every crime); Morissette v. United States, 342 U.S. 246, 252, 72 S. Ct. 240, 96 L. Ed. 288 (1952) ("wrongdoing must be conscious to be criminal"). Debtor's son's knowledge in acting for her cannot be imputed to Debtor for purposes of showing criminal knowledge and intent. Nor can Mr. Bass' intent and knowledge be imputed to the Debtor.

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. Although debtors connected to marijuana distribution cannot expect to violate federal law in their bankruptcy case, the presence of marijuana

near the case should not cause mandatory dismissal.[1] I believe this focus on specific federal violations along with the further analysis required by the lead memorandum properly address the challenge of a marijuana related case.

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[1] Cf. Northbay Wellness Grp., Inc. v. Beyries, 789 F.3d 956, 960-61 (9th Cir. 2015) (bankruptcy court abused its discretion by failing to conduct the balancing test required by doctrine of unclean hands, and instead determining that unclean hands applied solely because the creditor had engaged in marijuana distribution).

In re Way to Grow, Inc.

United States Bankruptcy Court for the District of Colorado

December 14, 2018, Decided

Case No. 18-14330 MER, Case No. 18-14334 MER, Case No. 18-14333 MER, Chapter 11, Jointly Administered Under Case No. 18-14330

Reporter
597 B.R. 111 *; 2018 Bankr. LEXIS 4142 **

In re: WAY TO GROW, INC., PURE AGROBUSINESS, INC., GREEN DOOR AGRO, INC., Debtors.

Counsel: [**1] For James Blaha, Blue Moose, LLC, Creditors (1:18bk14330): Joshua M. Hantman, Denver CO.

For Corey Inniss, Creditor (1:18bk14330): Annette W Jarvis, Salt Lake City UT; Gregory S. Tamkin, Denver CO; Andrea Ahn Wechter, Denver CO.

For Susan Inniss, Creditor (1:18bk14330): Joshua M. Hantman, Denver CO.

For Dean/Carson South Platte, LLC, Creditor (1:18bk14330): Kevin S. Neiman, Denver CO.

For Pension Benefit Guaranty Corporation, Creditor (1:18bk14330): Rhonda Baird, Washington DC.

For Boscoe Children, L.L.L.P., Creditor (1:18bk14330): Amanda Holland Halstead, Denver CO.

For Isuzu Finance of America, Inc., Creditor (1:18bk14330): Dennis A. Dressler, Chicago IL.

For Cheyenne Avenue Holdings, LLC, Creditor (1:18bk14330): Timothy M. Swanson, Denver CO.

For Hawthorne Hydroponics LLC Markus Williams & Young Llc, Creditor (1:18bk14330): Matthew T. Faga, Denver CO.

For Red Fisch, LLC, Creditor (1:18bk14330): Barry L. Wilkie, Denver CO.

For Green Door Agro Inc., a California corporation, Pure Agrobusiness, Inc., a Nevada corporation, Way To Grow, Inc., a Colorado corporation, Debtors (1:18bk14330): Lee M. Kutner, Lead Attorney, Denver CO; Keri L. Riley, Denver CO.

For Byron G. Rogers Federal Building, US [**2] Trustee (1:18bk14330): Robert Samuel Boughner, Byron G. Rogers Federal Building, Denver CO.

For Pure Agrobusiness, Inc., a Nevada corporation, Debtor (18-14334-MER): Lee M. Kutner, Keri L. Riley, Denver, CO.

For US Trustee, U.S. Trustee (18-14334-MER): Robert Samuel Boughner, Denver, CO.

For Green Door Agro Inc., a California corporation, Debtor (18-14333-MER): Lee M. Kutner, Keri L. Riley, Denver, CO.

For US Trustee, U.S. Trustee (18-14333-MER): Robert Samuel Boughner, Denver, CO.

Judges: Honorable Michael E. Romero, Chief United States Bankruptcy Judge.

Opinion by: Michael E. Romero

Opinion

[*114] **ORDER**

THIS MATTER comes before the Court upon the Motion to Dismiss or Abstain[1] filed by Secured Creditor Corey Inniss ("**Inniss**"); the Objection to the Motion to Dismiss[2] filed by Debtors Way to Grow, Inc., Pure Agrobusiness, Inc. and Green Door Agro, Inc. ("**Debtors**"); Inniss's Reply in support of the Motion to Dismiss;[3] and the Debtors' Response to the Reply.[4] The Court held a four day evidentiary hearing on the Motion to Dismiss on October 15-16, 2018, and November 8-9, 2018.

BACKGROUND

As of the Petition Date, Way to Grow, Inc. ("**Way to Grow**") and Green Door Agro, Inc. ("**Green Door**") owned and [**3] operated seven retail outlets in Colorado and an internet sales presence. Green Door has a sales facility in California. Way to Grow and Green Door are both subsidiaries of Pure Agrobusiness, Inc. ("**Pure Agro**"). Pure Agro also owns 100% of a non-debtor affiliate, Crop Supply, Inc., which caters to the Debtors' commercial clients, but is funded by Debtors.[5] Richard Byrd ("**Byrd**") is the owner and principal manager of the Debtors.

Debtors' business involves the sale of equipment for indoor hydroponic and gardening-related supplies. As to their customers' [*115] uses of their products, Debtors have represented "[w]hile the hydroponic gardening equipment may and is used for many types of crops, the Debtors' future business expansion plan is tied to the growing cannabis industry which is heavily reliant on hydroponic gardening."[6]

Byrd acquired ownership and control of the Debtors through a sale transaction with Inniss, who founded Way to Grow in Colorado in 2002. During Inniss's ownership, Way to Grow grew from a single store in Fort Collins to a chain of seven retail stores throughout Colorado's Front Range. Several of the Debtors' seven storefronts were in locations leased to the Debtors by Susan [**4] Inniss, the mother of Corey Inniss. James Blaha ("**Blaha**"), Susan Inniss's former husband, also leased a location to the Debtors through his wholly-owned entity, Blue Moose, LLC ("**Blue Moose**").

The events leading to this bankruptcy case began on January 1, 2016, when Byrd and Inniss entered into an agreement for the sale of Way to Grow ("**Purchase Agreement**").[7] As set forth in Section 2.2 of the Purchase Agreement, the consideration for the sale consisted of: 1) a cash payment to Inniss of $2,500,000; 2) a secured promissory note to Inniss ("**Note**") for the principal amount of $22,500,000; and 3) 12,500,00 shares of Byrd's common stock in Pure Agro, Debtors' holding company, with a par value of $0.001.[8] According to Debtors' Amended Schedules and Statement of Financial Affairs, Inniss owns approximately 21.26% of the stock in Pure Agro.[9] Pursuant to Section 3 of the Note, Debtors' pledged collateral securing its obligations to Inniss consists of "any and all property and assets" of the Debtors, including after-acquired property, accounts receivable and inventory.[10]

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[1] ECF No. 93 ("**Motion to Dismiss**").

[2] ECF No. 122 ("**Objection**").

[3] ECF No. 139 ("**Reply**").

[4] ECF No. 166 ("**Response**").

[5] Exh. E p. 15.

[6] Exh. 3, at ¶ 1.

[7] Exh. 8.

[8] *Id.* at ¶ 2.2.

[9] Exh. E, p. 11.

[10] Exh. A, ¶ 3.

A short time after the sale closed, on April 6, 2018, Inniss, individually and derivatively on behalf of Pure Agro as a shareholder, filed a complaint [**5] against the Debtors and Byrd in the District Court for Larimer County, Colorado.[11] On April 9, 2018, Inniss moved to appoint a receiver over Pure Agro and its subsidiaries in the State Case, seeking to oust Byrd as the Debtors' manager. Debtors filed bankruptcy before a receiver was appointed.

Because Debtors filed this bankruptcy in the face of a receivership, Inniss argues this case is no more than a continuation of the two-party dispute between Inniss and Debtors arising from the pending receivership proceedings. Inniss asserts this Court should dismiss or abstain from these bankruptcy proceedings in favor of allowing the State Case to proceed through conclusion.

From the beginning of this case, Debtors represented an intent to reorganize by rejecting over-market leases and otherwise reducing expenses. Through August 2018, Debtors' Monthly Operating Reports disclosed cumulative net cash flow of $109,320 on revenues of $2,027,246 and expenses of $1,917,928.[12] Meanwhile, Debtors' profit and loss statements reveal a total net operating loss of $607,865 through August 2018.[13]

Inniss argues these net operating losses, together with other financial performance issues, constitute violations [**6] of this Court's orders on the Debtors' use of Inniss's cash collateral. In response, Debtors maintain [*116] their gradual progress towards reorganization, including rejecting over-market leases, will result in significant savings not yet reflected in its financial disclosures. It is true during the case, Debtors rejected four leases for its Colorado retail locations in Lakewood, Colorado Springs, Pueblo, and Fort Collins, and closed its location in Silverthorne.[14] A motion to reject one of Debtors' Denver leases remains pending.[15] One of Debtors' store managers also testified Debtors reduced their workforce as part of its cost-saving measures.

These first two issues — Debtors' alleged violations of the cash collateral order and the purported two-party nature of the dispute — are essentially secondary issues to the main event, namely, the Debtors' connections to the marijuana industry. As discussed extensively below, bankruptcy courts nationwide have wrestled with the issue whether companies connected to marijuana businesses legal under state law are eligible for bankruptcy protection, where those connections constitute continuing violations of federal law.

ANALYSIS

A. LEGAL FRAMEWORK FOR MARIJUANA [**7] RELATED BANKRUPTCY CASES

Pursuant to the Controlled Substances Act of 1970 ("**CSA**"),[16] marijuana[17] is designated a Schedule I controlled substance under federal law.[18] Therefore, under the CSA, it is a federal crime to "manufacture, distribute, or

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[11] Case No. 2018CV30331 ("**State Case**").

[12] Exh. EE, p. 2.

[13] *Id.* at p. 11.

[14] *See* ECF Nos. 151, 244, 333 and 335. Debtors filed a motion to reject the lease for their location in Silverthorne at ECF No. 51, but an order on that motion does not appear on the docket. However, Byrd testified at trial the Silverthorne location has been closed.

[15] ECF No. 336.

[16] Unless otherwise specified, all references herein to "Section," "§,"and "CSA" refer to Title 21 U.S.C. § 101, *et seq.*

[17] The CSA refers to cannabis and marijuana products as "marihuana."

[18] § 812.

dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance[.]"[19] Further, the CSA prohibits any person from possessing or distributing "any equipment . . . product or material which may be used to manufacture a controlled substance . . . knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance" in violation of federal law.[20] The CSA also expressly provides any person who "conspires to commit any offense" under the CSA shall be subject to the same penalties as the principal.[21]

Notwithstanding the absolute federal prohibition on the use, sale or cultivation of marijuana, several states, including Colorado, have legalized marijuana for both medical and recreational use.[22] In *Gonzales v. Raich*, the U.S. Supreme Court definitively held the federal government's designation of marijuana as a controlled substance supersedes contrary state law through application [**8] of the commerce clause.[23] [*117] As a result, there remains an ever-shifting landscape of federal enforcement of marijuana criminalization where the same activity is fully legal under state law.[24]

Of course, bankruptcy laws and bankruptcy courts are purely creatures of federal law. Accordingly, bankruptcy courts have consistently dismissed cases where debtors engaged in ongoing CSA violations, or where a debtor's reorganization efforts depend on funds which can be considered proceeds of CSA violations.

The seminal case on the issue from this District is Judge Howard Tallman's (Ret.) decision in *In re Rent-Rite Super Kegs West Ltd.*[25] There, the court considered a motion to dismiss a Chapter 11 case in which the debtor derived 25% of its revenue from leasing warehouse space to marijuana businesses.[26] Finding this activity plainly prohibited under § 856(a), the court concluded the debtor was in continuing violation of federal law during its bankruptcy case.[27] Analyzing Colorado's legal framework for marijuana legalization, Judge Tallman noted Colorado [**9] law "make[s] it clear that their provisions apply to state law only. Absent from either enactment is any effort to impede the enforcement of federal law."[28] Accordingly, the court concluded:

> [E]ven if the Debtor is never charged or prosecuted under the CSA, it is conducting operations in the normal course of its business that violate federal criminal law. Unless and until Congress changes that law . . . a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime.[29]

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[19] § 841(a)(1).

[20] § 843(a)(6) refers to possession of drug manufacturing equipment while § 843(a)(7) refers to distribution of such equipment. As discussed in detail below, the *scienter* required for conviction under either sub-section is the same.

[21] § 846.

[22] *See* Colo. Const., Art. XVIII, Sections 14 and 16 (legalizing marijuana for medical and recreational use, respectively).

[23] *Gonzales v. Raich*, 545 U.S. 1, 125 S. Ct. 2195, 162 L. Ed. 2d 1 (2005).

[24] *See, e.g.*, James M. Cole, Deputy Attorney General, MEMORANDUM FOR ALL UNITED STATES ATTORNEYS: GUIDANCE REGARDING MARIJUANA ENFORCEMENT (Aug. 29, 2013) (commonly known as the "**Cole Memo**"); *but see* Jeffrey B. Sessions, Attorney General, MEMORANDUM FOR ALL UNITED STATES ATTORNEYS: MARIJUANA ENFORCEMENT (January 4, 2018) (revoking Cole Memo).

[25] 484 B.R. 799 (Bankr. D. Colo. 2012).

[26] *Id.*

[27] *Id.* at 810.

[28] *Id.* at 806.

[29] *Id.* at 805.

As additional grounds for dismissal, Judge Tallman further concluded the debtor was barred from bankruptcy relief by the clean hands doctrine:

> The Debtor freely admits that it leases space to those who are engaged in the cultivation of marijuana. Even if the Debtor's [*sic*] holds a good faith — albeit misguided — belief that Colorado state law would prevail over the federal law or that the federal law is unlikely to be enforced, that is quite beside the point. The Debtor has knowingly and intentionally engaged in conduct that constitutes a violation of federal criminal law and it has done so with respect to its sole income producing [**10] asset."[30]

Based on these conclusions, the *Rent-Rite* court found it necessary to dismiss the bankruptcy case pursuant to 11 U.S.C. § 1112(b).[31]

Two years later, in *In re Arenas*, Judge Tallman expanded the holding of *Rent-Rite* to dismiss a bankruptcy case where the bankruptcy trustee would be required to administer marijuana-related assets.[32] [*118] In *Arenas*, the debtors, who operated a marijuana grow facility, filed for relief under Chapter 7 of the Bankruptcy Code. A Chapter 7 trustee was appointed in the ordinary course.[33] The Office of the United States Trustee ("**UST**") moved to dismiss. Assessing the ability of a Chapter 7 trustee to administer marijuana assets, Judge Tallman reasoned:

> Here, the Debtors' chapter 7 trustee cannot take control of the Debtors' Property without himself violating § 856(a)(2) of the CSA. Nor can he liquidate the inventory of marijuana plants Mr. Arenas possessed on the petition date because that would involve him in the distribution of a Schedule I controlled substance in violation of § 841(a) of the CSA. The Court finds that administration of this case under chapter 7 is impossible without inextricably involving the Court and the Trustee in the Debtors' ongoing criminal violation of the CSA. . . . To allow the Debtors to remain in a chapter 7 [**11] bankruptcy case under circumstances where their Trustee is unable to administer valuable assets for the benefit of creditors would allow them to receive discharges without turning over their non-exempt assets to the Trustee. That would give the Debtors all of the benefits of a chapter 7 bankruptcy discharge while allowing them to avoid the attendant burdens. The impossibility of lawfully administering the Debtors' bankruptcy estate under chapter 7 constitutes cause for dismissal of the Debtors' case under 11 U.S.C. § 707(a).[34]

The *Arenas* debtors further sought to avoid dismissal by seeking to convert their case from Chapter 7 to Chapter 13. Denying that request, the court concluded the debtors' plan payments would necessarily be funded by proceeds of a criminal enterprise under federal law, and therefore conversion was not in good faith.[35] The court reasoned a plan could not be administered by a Chapter 13 trustee who would be prohibited from receiving or distributing funds derived from CSA violations.[36]

On appeal, the Bankruptcy Appellate Panel for the Tenth Circuit ("**BAP**") affirmed Judge Tallman's opinion dismissing the Arenas' bankruptcy case.[37] The question presented to the BAP was whether "a debtor [**12] in the

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[30] *Id.* at 807.

[31] *Id.* at 811.

[32] 514 B.R. 887 (Bankr. D. Colo. 2014).

[33] *Id.*

[34] *Id.* at 891.

[35] *Id.* at 894.

[36] *Id.*

[37] 535 B.R. 845 (10th Cir. BAP 2015)

marijuana business [can] obtain relief in the federal bankruptcy court?"[38] The BAP answered this question with a resounding "No."

The BAP agreed with Judge Tallman "that while the debtors have not engaged in intrinsically evil conduct, the debtors cannot obtain bankruptcy relief because their marijuana business activities are federal crimes."[39] Applying the eleven factors to determine good faith set forth by the U.S. Court of Appeals for the Tenth Circuit in *Flygare v. Boulden*,[40] the BAP [*119] agreed the debtors could not show an employment history to support future income unrelated to marijuana, the trustee could not legally administer and distribute marijuana derived assets, and, while their motives were not improper, the debtors were not acting in good faith according to an objective standard.[41] That is, the inability to propose a confirmable plan made it "objectively unreasonable" for the debtors to seek Chapter 13 relief.[42]

Finally, the BAP addressed the Arenas' argument the case should not be *per se* dismissed or converted, but rather, the trustee should simply abandon the marijuana assets:

> It is not clear that a bankruptcy court may order a trustee to abandon assets *sua sponte*. And even [**13] if the court can do that, this bankruptcy estate, shorn of its marijuana assets, would likely yield no dividend to the creditors. The debtors would get a discharge and get to keep (via abandonment) their marijuana assets while being protected from collection activities. This also strikes us as prejudicial delay that amounts to cause for dismissal.[43]

This Court addressed a marijuana-related issue only once, in *B Fischer Industries, LLC*.[44] There, debtor manufactured allegedly knowingly sold butane for use in manufacturing marijuana concentrates.[45] The Court dismissed the bankruptcy case on March 8, 2017, on the debtor's motion. However, a creditor pursued a motion for sanctions relating to the bankruptcy filing and the Court retained jurisdiction for purposes of adjudicating the creditor's motion.[46] A discovery dispute arose requiring the Court to analyze the applicability of the crime-fraud exception to the attorney-client privilege where the alleged crime involves a marijuana-related offense.[47] Relevant to the issues in this case, the Court in *B. Fischer* found debtor's pre-petition sale of butane "*may*" have violated the

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[38] *Id.* at 847.

[39] *Id.* at 849-50.

[40] 709 F.2d 1344 (10th Cir. 1983) (the ten factors are "(1) the amount of the proposed payments and the amount of the debtor's surplus; (2) the debtor's employment history, ability to earn and likelihood of future increases in income; (3) the probable or expected duration of the plan; (4) the accuracy of the plan's statements of the debts, expenses and percentage repayment of unsecured debt and whether any inaccuracies are an attempt to mislead the court; (5) the extent of preferential treatment between classes of creditors; (6) the extent to which secured claims are modified; (7) the type of debt sought to be discharged and whether any such debt is non-dischargeable in Chapter 7; (8) the existence of special circumstances such as inordinate medical expenses; (9) the frequency with which the debtor has sought relief under the Bankruptcy Reform Act; (10) the motivation and sincerity of the debtor in seeking Chapter 13 relief; and (11) the burden which the plan's administration would place upon the trustee.").

[41] 535 B.R. at 852-53.

[42] *Id.*

[43] *Id.* at 854.

[44] *In re B Fischer Industries, LLC*, No. 16-20863-MER, ECF No. 147 (Bankr. D. Colo. Sept. 27, 2017).

[45] *Id.*

[46] *Id.*

[47] *Id.*

CSA, but regardless, the inquiry should not focus strictly on pre-petition [**14] activities.[48] Rather, the focus should be on the time wherein debtor sought bankruptcy relief and thereafter.[49]

On a post-petition basis, the Court concluded it could not find the debtor's sales of butane to a pass-through non-debtor affiliate necessarily violated the CSA.[50] Of course, this was the correct inquiry as pertaining to a potential exception to the attorney-client privilege, but, nonetheless, the Court agreed "a debtor's pre-petition involvement in the marijuana industry is not a *per se* bar to relief under [*120] the Bankruptcy Code."[51] Finding the creditor failed to meet her burden of establishing the debtor's violation of the CSA, the Court denied her crime-fraud motion.[52]

Taken together, the decisions in *Rent-Rite, Arenas* and *B. Fischer* elucidate three basic propositions. First, a party cannot seek equitable bankruptcy relief from a federal court while in continuing violation of federal law. Second, a bankruptcy case cannot proceed where the court, the trustee or the debtor-in-possession will necessarily be required to possess and administer assets which are either illegal under the CSA or constitute proceeds of activity criminalized [**15] by the CSA. And third, the focus of this inquiry should be on debtor's marijuana-related activities during the bankruptcy case, not necessarily before the bankruptcy case is filed.

Certainly, many other bankruptcy courts in marijuana-legalization states have addressed similar issues and, for the most part, have reached similar conclusions.

In *In re McGinnis*,[53] debtor proposed Chapter 13 plan to be funded by: 1) a business leasing a warehouse to a marijuana grower; 2) the debtor's own marijuana grow operation; and 3) rental income from property housing tattoo artists.[54] Because the plan was to be funded through operations dependent "on a product the cultivation and sale of which violates federal law[,]" the court held the plan was proposed by means forbidden by law and could not be confirmed pursuant to 11 U.S.C. § 1325(a)(3).[55] Further, due to the federal illegality of the operations, the court found "the predicted income stream from the marijuana operations is [not] reasonably certain to produce sufficient income to fund the Plan[,]" and therefore concluded the plan failed the feasibility requirement of 11 U.S.C. § 1325(a)(6).[56]

In *Northbay Wellness Group v. Beyries (In re Beyries)*, plaintiff sold medical marijuana.[57] Debtor was their attorney. [**16] [58] Plaintiff sought a non-dischargeability judgment based on the attorney's knowing misrepresentations concerning plaintiff's sales tax obligations.[59] While the court held the debt met the elements of 11 U.S.C. § 523(a)(4), the court ruled it could not enter a judgment for plaintiff because they engaged in unlawful

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[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] *Id.*

[52] *Id.*

[53] 453 B.R. 770 (Bankr. D. Or. 2011).

[54] *Id.* at 771.

[55] *Id.* at 772.

[56] *Id.* at 773.

[57] No. 10-1181, 2011 Bankr. LEXIS 4710, 2011 WL 5975445 (Bankr. N.D. Cal. Nov. 29, 2011).

[58] *Id.* at *1.

[59] *Id.*

activity.[60] Even though the activity was legal under state law, in a federal court the parties were "conspiring to sell contraband."[61] The court found the plaintiff *in pari delicto* and dismissed the adversary.[62]

On appeal, the U.S. Court of Appeals for the Ninth Circuit reversed and remanded the bankruptcy court's order dismissing the adversary.[63] The Ninth Circuit determined the parties' engagement in a marijuana business did not automatically [*121] require application of *in pari delicto*.[64] Instead, *in pari delicto* requires a balancing test of the parties' respective wrongdoing.[65] Had the bankruptcy court properly conducted the required balancing test, the Ninth Circuit would have concluded the debtor's wrongdoing outweighed the plaintiff's. Debtor misappropriated client trust funds, and could not escape liability for that theft through a bankruptcy discharge simply because the creditor-plaintiff's business [**17] is marijuana.[66]

In re Medpoint Management LLC[67] involved an involuntary Chapter 7 petition filed against a medical marijuana business. The debtor's assets consisted entirely of marijuana products and related intellectual property.[68] The petitioning creditors' claims arose from credit extended or services knowingly provided in furtherance of debtor's marijuana business. Upon debtor's opposition to an order for relief, the court dismissed the involuntary bankruptcy case.[69] The court reasoned the possibility of forfeiture of the debtor's marijuana assets pursuant to CSA imposed an unacceptable risk to a Chapter 7 estate and trustee.[70] Further, the court held it could not issue an order for relief which would effectively order a Chapter 7 trustee to possess and administer assets in violation of federal law.[71] The court also found the petitioning creditors were not eligible to file the involuntary petition because of *in pari delicto*. The creditors knew the debtor was in the marijuana business, voluntary chose to engage in that business with them, and therefore had unclean hands precluding them from petitioning a federal court for relief.[72] Finally, the court declined to sanction the creditors, finding [**18] no bad faith in filing the involuntary petition, because the marijuana business presented a novel issue, and the debtor appeared insolvent and properly in bankruptcy but for the marijuana issue.[73]

In *In re Johnson*,[74] a Chapter 13 debtor was a licensed "caregiver" and marijuana grower operating legally under Michigan law. The UST filed a motion to dismiss. Debtor's income was $1,203 per month from social security and

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[60] *Id.*

[61] *Id.* at *2.

[62] *Id.*

[63] 789 F.3d 956 (9th Cir. 2015).

[64] *Id.* at 959-60.

[65] *Id.* at 960.

[66] *Id.*

[67] 528 B.R. 178 (Bankr. D. Ariz. 2015).

[68] *Id.* at 181-82.

[69] *Id.* at 188.

[70] *Id.* at 185.

[71] *Id.*

[72] *Id.* at 186-87.

[73] *Id.* at 187-88.

[74] 532 B.R. 53 (Bankr. W.D. Mich. 2015).

$1,000 per month from his marijuana business.[75] First, the court noted all federal judges take an oath to uphold federal law, and allowing a marijuana case to proceed in federal court violates this oath.[76] No matter what precautions were taken, allowing the case to remain in bankruptcy would result in both trustee and the court supporting the debtor's criminal enterprise.[77] Second, the court looked to 28 U.S.C. § 959(b), which prohibits federal officers from holding contraband or proceeds or instrumentalities of federal criminal activity.[78] The court held this prohibition applies [*122] to trustees in bankruptcy cases.[79] Third, the debtor's intent to continue his marijuana business post-petition constituted being "engaged in business" for purposes of 11 U.S.C. § 1304, requiring court approval for expenditure of funds pursuant [**19] to 11 U.S.C. § 363(c).[80] The court could not approve any expenditures related to a marijuana business.[81] Nonetheless, the court declined to dismiss the case and gave the debtor a shot at a discharge, but enjoined him from conducting his marijuana business or using any property of the estate in furtherance of illegal activity.[82] The court further ordered the trustee to abandon all marijuana plants within the estate and ordered the debtor to destroy all his marijuana plants and byproducts as a condition remaining in bankruptcy.[83]

In *In re ARM Ventures, LLC,*[84] debtor proposed a plan which would be funded through income generated by the sale of marijuana products. The court held a plan cannot be confirmed unless the business generating the income is legal under both state law and federal law.[85] That is, a reorganization plan dependent on marijuana income can *per se* be proposed in bad faith.[86] Indeed, debtor's tenant was not licensed by the state of Florida to grow marijuana, and was very unlikely to get a federal license.[87] Therefore, the court concluded debtor's plan was not feasible and the bankruptcy case was ripe for dismissal.[88] However, given the significant non-insider unsecured debt, the court declined [**20] to dismiss.[89] Instead, based on the debtor's bad faith arising from his illegal activities, the court granted stay relief to the debtor's major secured creditor.[90] However, the court stayed any foreclosure sale for 14 days to provide debtor an opportunity to file a plan that would not depend on the sale of marijuana as a source of income.[91]

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[75] *Id.* at 55.

[76] *Id.* at 56.

[77] *Id.*

[78] *Id.*

[79] *Id.* at 57.

[80] *Id.*

[81] *Id.*

[82] *Id.* at 59.

[83] *Id.*

[84] 564 B.R. 77 (S.D. Fla. 2017).

[85] *Id.* at 85.

[86] *Id. at 86.*

[87] *Id.* at 84.

[88] *Id.*

[89] *Id.*

In *NW, SPNWY, LLC v. Cook Investments NW*,[92] debtor leased commercial property to a marijuana grower. As part of its plan, debtor proposed to reject the marijuana grower's lease. Because debtor's plan did not depend on future income derived from illegal activity, the court concluded the debtor's plan was confirmable.[93] On appeal and upon an objector's motion for stay pending appeal, the U.S. District Court for the Western District of Washington began with the simple observation "[b]ankruptcy courts are neither regulatory nor criminal courts."[94] The court continued "[a] rudimentary search of relevant authorities reveals that numerous courts have confirmed plans regardless of whether actual provisions of the plans result in the violation of federal or state laws."[95] Because the plan itself would not violate [*123] federal law, but instead would be funded through [**21] proceeds of purely legal activity (because debtor rejected the marijuana lease), the district court denied the motion for stay pending appeal.[96]

Finally, in *Olson v. Van Meter*,[97] the debtor filed Chapter 13 to prevent foreclosure on commercial property leased to the operator of a marijuana dispensary.[98] Debtor's plan called for sale of this real property to pay off creditors, and as a result required rejection of the lease with the marijuana dispensary.[99] Nonetheless, the court dismissed the case *sua sponte* on grounds the debtor's post-petition acceptance of rents from the dispensary business was ongoing criminal violation precluding federal bankruptcy relief.[100]

The Bankruptcy Appellate Panel for the Ninth Circuit reversed and remanded.[101] First, the appellate panel held the bankruptcy court did not sufficiently articulate the legal basis for its ruling or make findings to support its conclusion the debtor was violating federal law.[102] The appellate panel held the court could not summarily dismiss the bankruptcy case, but rather was required to take evidence and make findings on issues of bad faith and unclean hands, as well as whether the debtor was actually committing a controlled substances act [**22] violation.[103] The appellate panel reasoned "[a]lthough debtors connected to marijuana distribution cannot expect to violate federal law in their bankruptcy case, the presence of marijuana near the case should not cause mandatory dismissal."[104]

B. DEBTORS' POTENTIAL VIOLATIONS OF THE CSA

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[90] *Id.* at 86-87.

[91] *Id.*

[92] No. 17-5516, 2017 U.S. Dist. LEXIS 136129, 2017 WL 3641914 (W.D. Wash. August 24, 2017).

[93] *Id.* at *1.

[94] *Id.* at *2.

[95] *Id.*

[96] *Id.* at *6.

[97] No. NV-17-1168-LTiF, 2018 Bankr. LEXIS 480, 2018 WL 989263 (9th Cir. BAP Feb. 5, 2018).

[98] *Id.* at *1.

[99] *Id.* at *3.

[100] *Id. at *6.*

[101] *Id.*

[102] *Id.*

[103] *Id.* at *7.

[104] *Id.*

1. Complicity - Aiding and Abetting and Conspiracy

Based on these authorities, this Court's first inquiry must be whether the Debtors are engaged in ongoing violations of federal law. If the analysis is answered in the affirmative, Debtors' bankruptcy cases may not proceed and would be ripe for dismissal.

There is no evidence before the Court that the Debtors directly "manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance[.]"[105] Therefore, if the Debtors are violating § 841(a)(1), they are doing so indirectly, through one or more theories of legal complicity.

The first such allegation of Debtors' indirect criminal activity is Inniss's assertion Debtors' sale of hydroponic equipment to marijuana grow operations constitutes aiding and abetting CSA violations by its customers. Under federal law, aiding and abetting criminal activity is itself criminalized [**23] pursuant to 18 U.S.C. § 2, which provides "[w]hoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal." This is not to say aiding and abetting is an independent crime. Rather, 18 U.S.C. § 2 "simply abolishes the common-law distinction [*124] between principal and accessory."[106]

"'[U]nder § 2, those who provide knowing aid to persons committing federal crimes, with the intent to facilitate the crime, are themselves committing a crime.'"[107] "[A] person is liable under § 2 for aiding and abetting a crime if (and only if) he (1) takes an affirmative act in furtherance of that offense, (2) with the intent of facilitating the offense's commission," i.e., "with full knowledge of the circumstances constituting the charged offense."[108] "Mere presence at a crime scene or knowledge alone that a crime is being committed is insufficient."[109] "[A] defendant must share in the intent to commit the underlying offense."[110]

Concomitant with his assertion the Debtors are aiding and abetting CSA violations, Inniss invokes conspiracy as an alternate theory of complicit liability pursuant to § 846. In the Tenth Circuit, to obtain a conviction for conspiracy [**24] in violation of § 846, the government must establish beyond a reasonable doubt: 1) there was an agreement to violate the law; 2) the defendant knew the essential objectives of the conspiracy; 3) the defendant knowingly and voluntarily took part in the conspiracy; and 4) the co-conspirators were interdependent.[111] "[T]he evidence that supports a conviction for conspiracy can also be used to support a conviction for aiding and abetting in the possession of illegal narcotics with intent to distribute."[112] The main difference between conspiracy and

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[105] 21 U.S.C. § 841(a)(1).

[106] *United States v. Cooper*, 375 F.3d 1041, 1049 (10th Cir. 2004).

[107] *United States v. Deiter*, 890 F.3d 1203, 1214 (10th Cir. 2018) (quoting *Rosemond v. United States*, 572 U.S. 65, 134 S. Ct. 1240, 188 L. Ed. 2d 248 (2014)).

[108] *Deiter*, 890 F.3d at 1203 (quoting *Rosemond*, 572 U.S. at 71, 75-77); *see also Nye & Nissen v. United States*, 336 U.S. 613, 619, 69 S. Ct. 766, 93 L. Ed. 919 (1949) ("[T]o aid and abet another to commit a crime it is necessary that a defendant in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed." (quotation marks omitted)); *United States v. Rosalez*, 711 F.3d 1194, 1205 (10th Cir. 2013) (for an aiding and abetting conviction, the government must prove the defendant "shared in the intent to commit the underlying offense, willfully associated with the criminal venture, and aided the venture through affirmative action" (quotation marks omitted)).

[109] *Rosalez*, 711 F.3d at 1205.

[110] *Id.*

[111] *United States v. Isaac-Sigala* , 448 F.3d 1206, 1210 (10th Cir. 2006).

[112] *United States v. Carter*, 130 F.3d 1432, 1441 (10th Cir. 1997) (internal citation and quotation omitted).

aiding and abetting is unlike co-conspirator liability, in that "liability as an aider and abetter is not contingent upon a prior 'agreement or conspiracy to perform' a criminal act."[113]

"A conviction for aiding and abetting can rest on a wide range of underlying conduct, including 'acts, words or gestures encouraging the commission of the offense,' either before or at the time of the offense."[114] "Some mental state beyond 'mere assent' or 'acquiescence' is also required."[115] "Even mere 'words or gestures of encouragement' constitute affirmative acts capable of rendering one liable [*125] under this theory."[116] Because of this, the Tenth Circuit has held "a defendant may [**25] not stumble into aiding and abetting liability by inadvertently helping another in a criminal scheme unknown to the defendant."[117]

Of course, there are limitations to both theories of complicit liability. Importantly, Byrd testified Debtors are not "in" the marijuana industry but are instead "riding the wave." Debtors' position is they are not participating in violations of the CSA, but rather, merely providing general information to their customers which is useful and applicable to growing almost any type of crop, not just marijuana. There is case law supporting Debtors' theory providing information to customers does not violate the CSA.

In *Mann v. Gulickson*,[118] a dispute arose over a contract for hydroponic and licensing consulting to the marijuana industry. The business was to "provide consulting and information services to persons desiring to engage in hydroponic farming" and to "provide consulting and documentation preparation services to persons or entities desiring to establish medical cannabis dispensaries and related businesses in states where such activities were legal."[119] At no time did these companies possess, cultivate or distribute cannabis plants.[120] Instead, its income was derived [**26] solely from the sale of consulting services and information packs and document preparation.[121]

The question before the court in *Gulickson* was whether a contract for these services was enforceable notwithstanding the CSA.[122] The court held the contract could be enforced because of California's liberal policy of the "legality" element of contracts.[123] In a footnote the court observed:

> [The] object of the contract here is not *necessarily* illegal. The parties agreed Gullickson would pay Mann to purchase the Companies. . . . There is no evidence in the record that the Companies actually possess, use, cultivate, or distribute marijuana—medical or otherwise.
>
> Moreover, while Gullickson argues the businesses "conspire" to do so, this so-called conspiracy appears to be based entirely on providing information to customers. In *Conant v. Walters*, the Ninth Circuit affirmed an

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[113] *U.S. v. Bowen*, 527 F.3d 1065, 1078 (10th Cir. 2008) (quoting *U.S. v. Pursley*, 474 F.3d 757, 759 (10th Cir. 2007)).

[114] *Williams v. Trammell*, 782 F.3d 1184, 1192 (10th Cir. 2015).

[115] *Id.* at 1193 (quoting *Wingfield v. Massie*, 122 F.3d 1329, 1332 (10th Cir. 1997)).

[116] *Id.*

[117] *U.S. v. Rufai*, 732 F.3d 1175, 1190 (10th Cir. 2013).

[118] No. 15-CV-03630-MEJ, 2016 U.S. Dist. LEXIS 152125, 2016 WL 6473215, at *7 (N.D. Cal. Nov. 2, 2016).

[119] *Id.* at *1.

[120] *Id.* at *2.

[121] *Id.*

[122] *Id.* at *3.

[123] *Id.* at *4.

> injunction prohibiting federal officials from revoking a physician's registration, or even investigating a physician's conduct, based on the physician's recommendation that a patient use marijuana.[124]

In *Green Earth Wellness Center, LLC v. Atain Specialty Insurance Co.*,[125] the U.S. District Court for the District of Colorado addressed another [**27] breach of contract claim against this backdrop. Green Earth operated a medical marijuana business, for which Atain provided commercial liability insurance.[126] Green Earth made two claims [*126] under its policy, both of which Atain denied.[127] The first claim was for damage to Green Earth's marijuana plants because of a wildfire; the second was for the theft of some of its marijuana plants.[128]

Green Earth sued Atain for breach of contract, among other things.[129] Atain moved for summary judgment, arguing public policy based on the federal prohibition on marijuana required denying coverage for Green Earth's losses.[130] The court noted that "the nominal federal prohibition against possession of marijuana conceals a nuanced (and perhaps even erratic) expression of federal policy."[131] The *Green Earth* court explained that because of "a continued erosion of any clear and consistent federal public policy in this area. . . . the Court declines Atain's indirect invitation to declare the Policy void on public policy grounds."[132] The court found that "Atain, having entered into the Policy of its own will, knowingly and intelligently, is obligated to comply with its terms or pay damages for having breached it."[133] The court consequently [**28] denied Atain's summary judgment motion.

Pursuant to these authorities, to determine whether Debtors are complicit through aiding and abetting their customers' violations or conspiring with them to do so, the Court must decide whether Debtors' conduct rises above the level of merely providing information to customers, and instead, evidences a specific intent for the Debtors to assist their customers in violating § 841(a)(1). Additionally, to find conspiracy liability under § 846 the Court must further find an agreement between Debtors' and their customers to violate the law.

The Court concludes the Debtors are violating neither § 846 nor 18 U.S.C. § 2. As to conspiracy liability, there is insufficient evidence before the Court concerning an actual agreement between Debtors and their customers to violate the CSA. While, as discussed in further detail below, the Debtors may be aware at least some of their customers will use equipment purchased from the Debtors to manufacture a controlled substance (and this may give rise to a separate violation of the CSA), the Debtors' sales are never contingent or directly affected by the crop being grown. As in Gullickson, the contracts between Debtors and their customers, if any, [**29] do not specifically contemplate, depend upon, or require any activity that is necessarily illegal.

Likewise, the Court concludes the Debtors' business activities do not evidence a specific intent to violate the CSA. Under Rosalez, which this Court is bound to follow, aiding and abetting liability requires more than "knowledge

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[124] *Id.* at *7 n.4 (citing Cnuant v. Walters, 309 F.3d 629, 639 (9th Cir. 2002) (indicating rejection of government's argument that a doctor's "recommendation" of marijuana encourages illegal conduct by the patient)).

[125] 163 F. Supp. 3d 821, 823 (D. Colo. 2016).

[126] *Id.* at 823.

[127] *Id.* at 823-24.

[128] *Id.* at 824.

[129] *Id.*

[130] *Id.*

[131] *Id.* at 832.

[132] *Id.* at 834.

[133] *Id.* at 835.

alone that 'a crime is being committed[.]'"[134] Instead, the Court would need to conclude Debtors share the same intent as their customers to violate the CSA and willfully associate themselves with their customers' criminal ventures.[135] The Debtors' mens rea does not meet this exacting standard.

The Debtors' business is not limited in scope to marijuana sales. The evidence certainly shows many of the Debtors' customers [*127] are in the marijuana industry. As discussed below, this fact is no secret to the Debtors. However, by its nature and as shown by the evidence, the Debtors' business serves a broad customer base consisting of both commercial and individual horticulturalists, growing a variety of legal crops. Debtors' intent is to sell its product to any clientele engaged in hydroponic horticulture, and Debtors' products are generally applicable to those activities regardless [**30] the specific crop grown. Without sharing its marijuana-connected customers' specific intent to cultivate and distribute marijuana, Debtors are not aiding and abetting violations of the CSA.

2. Sale of Drug Manufacturing Equipment

While the Debtors are not violating the CSA through complicity in their marijuana growing customers' crimes, another provision of the CSA produces violations based upon a lesser mens rea of simply knowing how Debtors' products will be used. Specifically, § 843(a)(7) makes it a federal crime to "manufacture" or "distribute" any "equipment, chemical, product or material which may be used to manufacture a controlled substance . . . knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance . . . ."[136]

In U.S. v. Truong,[137] the Tenth Circuit analyzed the "reasonable cause to believe" element of § 843(a)(6), which makes it unlawful to possess any equipment, chemical or product which may be used to manufacture a controlled substance knowing, intending, or having reasonable cause, that it will be used to manufacture a controlled substance. Sections 843(a)(6) and (7) are nearly identical, with sub-section (a)(6) criminalizing possession of drug manufacturing [**31] equipment, and sub-section (a)(7) criminalizing manufacture, distribution or exportation of drug manufacturing equipment. While both seem applicable in this case because Debtors both possess and sell their hydroponic equipment, the Court will refer primarily to sub-section (a)(7) as it is the sale of equipment which concerns the Court. In any event, according to Truong and other cases cited below, the scienter requirement of each sub-section (and, separately, possession and distribution of chemical precursors charged under § 841(c)(2)) are the same, so the distinction is practically without a difference.

In Truong, the defendant sold large quantities of pseudoephedrine, which can be used to manufacture methamphetamine.[138] Observing § 843(a)(6) contains "an unusually specific mens rea requirement[,]" the Court of Appeals held "[i]t is not sufficient for the government to prove that the defendant knew, intended, or had reasonable cause to believe that the substance would be abused or would be used illegally. Nor is it sufficient for the government to prove that the defendant was negligent or reckless with respect to the risk . . . . The government must prove the defendant was aware, or had reasonable [**32] cause to believe, that the substance would be used for the specific purpose" of manufacturing drugs.[139]

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[134] Rosalez, 711 F.3d at 1205.

[135] *Id.*

[136] 21 U.S.C. § 843(a)(7).

[137] 425 F.3d 1282 (10th Cir. 2005). As discussed supra, the distinction between sub-section (a)(6) and (a)(7) has no substantive bearing on the Court's analysis, and therefore *Truong's* references to sub-section (a)(6) apply equally to the Court's analysis under sub-section (a)(7).

[138] *Id.* at 1284.

[139] *Id.* at 1289.

Thus, under the law of this Circuit the "reasonable cause to believe" [*128] standard employed by both §§ 843(a)(6) and (a)(7) is "akin to actual knowledge."[140] That is, the inquiry is "entirely subjective, the inquiry is not to be viewed from the perspective of a hypothetical reasonable person."[141] In Truong, to convict, the jury was required to infer the defendant "had actual knowledge, or something close to it, that the pseudoephedrine and ephedrine he sold would be used to manufacture methamphetamine."[142] "A defendant's own actions or words may . . . reveal his knowledge that he is selling" material which will be used to manufacture a controlled substance.[143]

Ultimately, the Tenth Circuit held the government had not sufficiently proven actual knowledge the products sold would be used to manufacture drugs, reversing the defendant's conviction.[144] The only evidence the government presented to prove the defendant had actual knowledge pseudoephedrine could be used to manufacture methamphetamine was the defendant's statement he did not know how the pseudoephedrine he sold would be used.[145] There was no evidence the defendant [**33] had ever learned of any connection between pseudoephedrine and methamphetamine production, and no evidence any of defendant's statements indicated he knew the his pseudoephedrine would be used for such a purpose.[146] Even though there was evidence to permit the jury to infer defendant was "up to no good[,]" and even though the evidence showed a reasonable person would be on notice "something nefarious was going on[,]" the "unusually specific mens rea requirement of 21 U.S.C. §§ 841 and 843" requires more.

Notably, *Truong* is considered as reflecting the minority view of the mens rea required to violate § 843(a)(6) or (a)(7), and § 841(c)(2)[147]. At least three other circuits have held these statutes allow conviction either upon subjective knowledge or an objective "cause to believe."[148] In U.S. v. Williamson, the Tenth Circuit Court of Appeals mildly distinguished Truong, without changing the court's interpretation of the "reasonable cause to believe" standard, by explaining Truong depended on the court's view "based on only the information known to the specific defendant, a reasonable person would not have had reason to believe that the pseudoephedrine [*129] would be used to make methamphetamine."[149]

Even as the minority view, the [**34] Court is bound to follow Truong and apply its interpretation of the scienter requirement under § 843(a)(6) and 841(c)(2) to this Court's analysis under § 843(a)(7). In this case, however, the

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[140] *Id.* (citing United States v. Saffo, 227 F.3d 1260, 1269 (10th Cir. 2000)).

[141] United States v. Buonocore, 416 F.3d 1124, 1133 (10th Cir. 2005).

[142] Truong, 425 F.3d at 1289.

[143] *Id.* at 1290.

[144] *Id.* at 1291.

[145] *Id.*

[146] *Id.*

[147] Section 841(c)(2) criminalizes knowingly or intentionally possessing or distributing "a listed chemical knowing, or having reasonable cause to believe, that the listed chemical will be used to manufacture a controlled substance . . . ." The "reasonable cause to believe" standard set forth in § 841(c)(2) uses the exact same language as § 843(a)(6) and (a)(7), and therefore the scienter requirement is the same.

[148] *Cf. Truong*, 425 F.3d 1282 with *U.S. v. Galvan,* 407 F.3d 954, 957 (8th Cir. 2005) (rejecting jury instruction that required actual knowledge for conviction under Section 841(c)(2)), U.S. v. Kaur, 382 F.3d 1155. 1157-58 (9th Cir. 2004) (holding the "reasonable cause to believe" standard of Section 841(c)(2) incorporates both subjective and objective considerations), and *U.S. v. Prather*, 205 F.3d 1265, 1270 (11th Cir. 2000) ("[T]he jury thus needed to find either that he knew the pseudoephedrine would be used to manufacture methamphetamine or that he had reasonable cause to believe that it would be."). *See also U.S. v. Khattab*, 536 F.3d 765, 769 (7th Cir. 2008) (discussing circuit split).

[149] 746 F.3d 987, 994 n.2 (10th Cir. 2014).

rules delineating the "reasonable cause to believe" standard may have little effect, because the Court finds the Debtors indeed have actual knowledge they are selling equipment which will be used to manufacture a controlled substance.

As the Court reads § 843(a)(7), the important distinction for purposes of criminality is not the specific product being sold, but whether the seller of such product knows how equipment will be used. There is little doubt hydroponic supplies are "equipment" related to marijuana cultivation. Indeed the Tenth Circuit has held evidence of the existence of a hydroponic grow operation supports a warrant for search and seizure on a charge of producing a controlled substance with intent to distribute.[150]

There is ample evidence in this case proving Debtors have "reasonable cause to believe" the equipment they sell to at least some of their customers will be used to manufacture marijuana. First, Inniss testified meeting the needs of cannabis growers is essential to Debtors' business, because those growers will simply [**35] buy their hydroponic equipment elsewhere if Debtors cannot meet their needs. Inniss also testified Debtors' business increased significantly and immediately upon the federal government issuing the Cole Memo.[151] Inniss testified negotiations for the sale of the business to Byrd were "very specific in terms of cannabis." Inniss referred to Byrd as "Mr. Marijuana Entrepreneur" and testified the "whole thesis" of the transaction was to combine Byrd's California marijuana-related operations with the Debtors' operations in Colorado. Inniss testified the Debtors have always chosen products based on their favorability of use in marijuana cultivation, including by customizing Debtors' pesticide inventory to provide products approved for use in marijuana cultivation by the Colorado Department of Agriculture. Debtors even sell some products that Inniss testified would be cost-prohibitive for use in cultivating any crop except marijuana, because marijuana is the highest yielding cash crop which can be grown. Even further, Inniss testified Debtors sell so-called "bubble bags" which are specifically used to make "water hash," a concentrated marijuana derivative.

The Court finds Inniss's testimony credible. [**36] Despite the acrimony in the parties' relationship, Inniss based his testimony on personal experience both as the founder and principal operator of the Debtors' business for many years before the sale to Byrd. Inniss's testimony confirms the Debtors' business model and operations have not materially changed since the sale to Byrd, and as a result Inniss's testimony regarding the business of what were once his companies is both credible and based upon first-hand, personal knowledge.

Many of Debtors' largest customers use aliases with Debtors rather the real name of their business.[152] While the Court can [*130] simply infer the use of aliases knowingly disguises some nefarious activity, Innis gave unrebutted testimony linking the aliases on Debtors' customer lists to specifically identified dispensaries and grow operations, all of which Inniss said he has disclosed to Byrd.

Debtors have participated, in some fashion, in the "Cannabis Cup" since at least 2016. The Cannabis Cup is a cannabis industry trade show and the world's biggest marijuana grow competition. Other "grow offs" attended by Debtors include the Indo Expo, The Grow Off, and Max Yields. At these and similar events, Debtors have given [**37] away promotional materials bearing the Way to Grow name in the form of lighters and rolling papers, which, together, are strongly associated with marijuana use.[153] Debtors have booths at the events and use them to build closer relationships to marijuana dispensaries and growers. Debtors have contributed prize money to be awarded to the winners of the grow-offs. Debtors do "cross-promotions" with dispensaries and advertise deals on a cannabis talk show.

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[150] *U.S. v. Montgomery*, 262 Fed. Appx. 80, 84 (10th Cir. 2008) (unpublished).

[151] The enforcement of federal marijuana laws in the District of Colorado has not materially changed since the Cole Memo was revoked by Attorney General Jeffrey Sessions in early 2018.

[152] Exh. 8, p. 19.

[153] Exhs. 40 and 41.

Bradley Hale, who has been the store manager for the Debtors' Boulder location since May 2011, testified he, and all of his co-workers, were themselves marijuana growers who bought supplies from the Debtors before becoming employees. Most of Hale's interactions with customers have been about cannabis. Hale described Way to Grow stores as having a "Cheers Bar" atmosphere, where everyone knows your name and forming personal relationships is key to sales. Hale confirmed Debtors choose products based on favorability of use in marijuana cultivation. Hale also confirmed the "trim bags" and "bubble bags" sold by Debtors are specifically intended for use with cannabis. As recently as August 2018, Hale testified Debtors engaged in cross-promotions [**38] with dispensaries at local grow-offs. Hale testified as much as 95% of customers in his store are using Debtors' products to grow marijuana.[154]

Cody Ross, manager of Debtors' Fort Collins location for the past five years, and with experience in other of the Debtors' stores, testified "everybody just assumes" customers talking generally about help with plants are talking about marijuana plants. Ross testified Debtors have a reputation for being experts in "advising on cannabis growing and . . . in selling products that are geared toward cannabis[.]" Ross has even visited cannabis growing facilities which are also Debtors' customers. A list of approved products for use in cannabis cultivation is made available in the store; Debtors do not have that for any other plants. Customers sometimes bring marijuana plants, or, more commonly, photographs of marijuana grow operations, to Debtors' stores, and Debtors' employees "typically" offer products to those customers based on those photographs. If there was any doubt remaining from his testimony, Ross expressly stated, "I know what a lot of them grow" and then, when asked if they grow cannabis, responded "Yes, sir" as to the "vast majority" of [**39] those customers.

Next, the Court reviewed press statements and so-called "investor decks" prepared by an investment banking firm on behalf of the Debtors. These show Byrd has commented to Bloomberg Markets, "[w]e are the picks and shovels play for what we're calling the Green Rush."[155] In a statement to Business Wire, Byrd stated, [*131] "[w]ith the merger of Way to Grow completed in January 2016, Pure Agro is now the leading one-stop solution for indoor plant, product and cannabis growers in Colorado and California."[156] In March 2016, Byrd commented to the BusinessDen publication that Debtors' new location would "cater to commercial cannabis growers instead of private hobbyists growing at home."[157]

An investor deck prepared on behalf of the Debtors by an investment banking firm specifically refers to marijuana as "the catalyst for hydroponic R&D."[158] The investor decks said the company would "take advantage of the current growth of the marijuana industry" and will "leverage the marijuana industries profitability[.]"[159] A second investor deck gave statistics on marijuana legalization and growth trends.[160] Yet another, dated January 2018, identifies, by name (and logo), five marijuana dispensaries as Debtors' [**40] "Notable Customers."[161]

Finally, the Court reviewed a very-telling e-mail drafted by Joe Pyle, Debtors' VP of Operations, to all of Debtors' store managers.[162] In the e-mail, dated June 28, 2018, Pyle instructed the managers to "remove from sight" anything "MJ related in your stores" such as "tv screens with MJ related content, the 3 a light book, pictures,

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[154] Byrd later disputed this figure as being closer to 65%.

[155] Exh. 11, p. 1.

[156] *Id.* p. 2.

[157] Exh. 18; see also Exh. 19 (press release touting advances in marijuana legalization as relating to hydroponics supply industry).

[158] Exh. 24.

[159] *Id.* p. 12.

[160] Exh. 25 pp. 20-21.

[161] Exh. 59, p. 20.

[162] Exh. 52.

posters, anything."[163] Pyle further instructed the managers to "not discuss MJ directly with any customers and do not allow customers to bring anything plant related into your stores."[164] While, on the one hand, the e-mail evidences what may be post-petition remedial measures, it clearly demonstrates Debtors' prior use of marijuana related signage in their stores, as well as consciousness of the negative effects continued use of marijuana signage may have on Debtors' ability to remain in bankruptcy.

Considering this abundant evidence, Debtors' efforts to distance themselves from knowledge of their customers' use of their products is simply not credible. Even though the Court concludes Debtors do not share their customers' specific intent to violate the CSA, Debtors certainly know they are selling products to customers who will, and do, [**41] use those products to manufacture a controlled substance in violation of the CSA. Debtors tailor their business to cater to those needs, tout their expertise in doing so, and market themselves consistent with their knowledge. There is no evidence this business model has materially changed post-petition.

The Court concludes Debtors' business model and execution thereof fundamentally violates § 843(a)(7). These violations continue post-petition, placing this case squarely within the rule adopted by Judge Tallman in Rent-Rite Super Kegs. To use Judge Tallman's words, even if the Debtors "are never charged or prosecuted under the CSA,[they] are conducting operations in the normal course of [their] business that violate federal criminal law."[165] This Court cannot enforce federal [*132] law in aid of the Debtors because Debtors' ordinary course activities constitute a continuing federal crime. The Court finds this is, inescapably, cause to dismiss this bankruptcy case under 11 U.S.C. § 1112(b).

Having reached this conclusion, the Court nevertheless considered whether any alternative to outright dismissal, or other post-petition changes to Debtors' business, could cure the ongoing violations of federal law in this case. However, [**42] unlike In re Johnson[166] and In re ARM Ventures, LLC,[167] the evidence demonstrates extreme improbability the Debtors could survive if they were to sever all ties to their marijuana customers. Debtors' business activities constituting violations of the CSA are a major part of Debtors' ordinary course of business. Whether marijuana-related customers account for 65% or 95% of Debtors' revenue, eliminating all such revenue would be devastating to the Debtors. It is inconceivable Debtors could terminate any sales to known marijuana cultivators and still operate profitably.

In any event, the Court does not believe such an order, or the remediation it would require, would be effective in this case. The Court cannot simply order Debtors to cease all sales to customers known to be involved in marijuana cultivation, because the usefulness of Debtors' products in illegal grow operations will continue to attract marijuana horticulturalists to Debtors' business, including those growing marijuana solely for personal use. Debtors have already acquired a venerable reputation for expertise in hydroponic marijuana growing, and it is difficult to imagine how Debtors could prevent customers from continuing to [**43] patronize Debtors' stores because of this reputation. Indeed, the evidence does not show Debtors' essential business model has changed post-petition, which, of course, is the relevant time to determine whether Debtors may remain in bankruptcy. In any event, any such order would require the Court, and interested parties, to monitor the Debtors' sales and customers, which would be very difficult and inefficient. Further, in light of the acrimonious nature of Inniss's relationship with the Debtors, the Court can be reasonably certain such an order would lead to costly and time-consuming future litigation over the Debtors' compliance.

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[163] *Id.*

[164] *Id.*

[165] *Rent-Rite*, 484 B.R. at 805.

[166] 532 B.R. at 53.

[167] 564 B.R. at 77.

To prevent this Court from violating its oath to uphold federal law, under the specific facts of this case, the Court sees no practical alternative to dismissal.

C. Other Arguments for Dismissal

Inniss raises several further issues allegedly supporting dismissal or abstention. These include Debtors' alleged violations of the Court's cash collateral orders and the two-party nature of the dispute between Debtors and Inniss. Having found cause to dismiss upon the Debtors' continuing violations of the CSA, the Court need not address the remainder of these issues. [**44] The Court notes, however, it found the testimony of Debtors' financial advisor, John Thomspon, to be very credible, and the Court likely would have concluded based on Thompson's testimony the Debtors are not violating the Court's cash collateral orders. The Court also notes, having taken judicial notice of the claims registers in this case, this bankruptcy is far from a two-party dispute.

CONCLUSION

A bankruptcy court, as a court of limited and equitable jurisdiction, very rarely finds itself analyzing potential violations of [*133] federal criminal law. In this case, such analysis is unavoidable due to the divergence between the non-enforcement of federal marijuana laws. This Court is bound to follow the law as written and may not depart therefrom based on enforcement decisions made by the executive branch.

The result in this case may be viewed by many as inequitable. The Debtors are insolvent, and their business could benefit significantly from reorganization under the Bankruptcy Code. The Debtors likely did not seek bankruptcy relief in bad faith on a subjective standard. But for the marijuana issue, this would be a relatively run-of-the-mill Chapter 11 proceeding. As stated, even following [**45] those courts which have crafted alternatives to dismissal when debtors were violating the CSA would produce no practical or efficient alternative to dismissal in this case. At bottom, if the result in this case is unjust, Congress alone has power to legislate a solution.

Ironically, if Inniss, as the party arguing Debtors are violating federal law, wrests control of the Debtors back from Byrd in the State Case, he will almost certainly continue, and perhaps expand, the Debtors' ongoing marijuana-related operations. This irony is not lost on the Court but provides no legal basis for an alternate outcome. The Court casts no aspersions upon the Debtors or their businesses. The result in this case is dictated by federal law, which this Court is bound to enforce.

Accordingly, it is ORDERED the, Court's previous orders for joint administration of Debtors' cases are TERMINATED, the Motion to Dismiss is GRANTED, and Debtors' cases are DISMISSED. All pending motions are DENIED as moot and any scheduled hearings are VACATED.

Dated December 14, 2018.

BY THE COURT:

/s/ Michael E. Romero

Michael E. Romero, Chief Judge

United States Bankruptcy Court

End of Document

In re Rent-Rite Super Kegs W. Ltd.

United States Bankruptcy Court for the District of Colorado

December 19, 2012, Decided

Case No. 12-31592 HRT, Chapter 11

Reporter
484 B.R. 799 *; 2012 Bankr. LEXIS 5904 **; 90 A.L.R. Fed. 2d 777; 2012 WL 6642678

In re: RENT-RITE SUPER KEGS WEST LTD., Debtor.

Counsel: [**1] For Rent-Rite Super Kegs West LTD, Debtor: Jeffrey Weinman, Denver, CO; Mark A. Larson, Denver, CO; Patrick D. Vellone, Denver, CO.

For US Trustee, U.S. Trustee: Alan K. Motes, United States Trustee Program, Denver, CO.

Judges: Howard R. Tallman, Chief Judge.

Opinion by: Howard R. Tallman

Opinion

[*802] **ORDER ON MOTION TO DISMISS**

This case comes before the Count on *Secured Creditor VFC Partners 14 LLC's Motion to Dismiss* (docket #31) (the "Motion").

The Debtor's business involves a continuing violation of the federal Controlled Substances Act. *See* 21 U.S.C. §§ 801-904. Debtor candidly acknowledges that it derives roughly 25% of its revenues from leasing warehouse space to tenants who are engaged in the business of growing marijuana. This activity — arguably legal[1] under Colorado law — forms the basis for the instant Motion filed by VFC Partners 14 LLC ("VFC"). VFC seeks dismissal of this case under the "clean hands doctrine" and argues that Debtor's activities, which the Court finds to be illegal under federal law, make it unworthy of the equitable protection of the bankruptcy court. In addition, VFC argues that Debtors' case was filed in bad faith and should be dismissed on that basis.

At the preliminary hearing on November 27, 2012, the parties confined their arguments to the legal issue of whether the case must be dismissed under the clean hands doctrine.

I. FACTUAL BACKGROUND[2]

1. This case was filed on October 18, 2012.

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[1] The Court has not heard evidence with [**2] respect to the details of the growing operations conducted by Debtor's tenants and makes no findings with respect to their compliance with the Colorado Medical Marijuana Code. COLO. REV. STAT. §§ 12-43.3-101 to 1001. For the purposes of this Order only, the Court assumes that Debtor's activities are lawful under Colorado state law.

[2] The Court only heard legal argument at the preliminary hearing. With the exception of the Debtor's acknowledgment that it leases warehouse space to tenants who use the space to cultivate marijuana, the facts recited herein do not constitute the Court's finding of fact but are included as background information only.

[*803] 2. The Debtor owns a warehouse building located at 3850 to 3900 E. 48th Avenue, Denver, Colorado (the "Warehouse"). Debtor values the property at $2.3 million.
3. On July 22, 2005, Debtor executed a promissory note to Commercial Federal Bank, FSB, in the face amount of $1.8 million (the "Note"). That obligation is secured by a Deed of Trust, Assignment of Rents and Security Agreement dated April 6, 2001, and modified on July 22, 2005, granting Commercial Federal a lien on the Debtor's Warehouse including rents and personal property (the "Deed of Trust").

4. On December 21, 2011, the Note and Deed of Trust were assigned to [**3] VFC.
5. Approximately 25% of the Debtor's income is produced from leasing space in the Debtor's Warehouse to tenants who use that space for the cultivation of marijuana.

II. DISCUSSION

A. Debtor's Business Operations Violate the Controlled Substances Act

For the reasons that follow, the Court concludes that the Debtor engages in conduct that, while legal under Colorado law, violates the federal Controlled Substances Act ("CSA").

The CSA has been described by the United States Supreme Court as "a lengthy and detailed statute creating a comprehensive framework for regulating the production, distribution, and possession of five classes of 'controlled substances.'" *Gonzales v. Raich*, 545 U.S. 1, 24, 125 S. Ct. 2195, 162 L. Ed. 2d 1 (2005). Under the CSA, marijuana is classified as a Schedule I controlled substance. 21 U.S.C. § 812 Schedule I(c)(10). When a substance is placed on Schedule I, that represents a legislative [**4] judgment that "[t]he drug or other substance has a high potential for abuse; ... [t]he drug or other substance has no currently accepted medical use in 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." 21 U.S.C. § 812(b)(1). "Under the CSA, any person who seeks to manufacture, distribute, or possess a Schedule I controlled substance must apply for and obtain a certificate of registration from the Drug Enforcement Agency (DEA). *Monson v. Drug Enforcement Admin.*, 522 F.Supp.2d 1188, 1192 (D.N.D. 2007) (citing 21 U.S.C. §§ 822-23). At hearing, the Debtor did not argue that any of its tenants, whose operations are at issue here, are operating under DEA approval.

Under § 856 of the CSA, it is a federal crime to

> manage or control any place, ... as an owner, ... 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.

21 U.S.C. § 856(a)(2).[3]

Debtor freely admits that it leases Warehouse space to tenants who use the space for the cultivation of marijuana. The Court, therefore, finds that the Debtor [*804] is engaged in an ongoing criminal violation of the federal Controlled Substances Act.

The Debtor argues the law is in flux. Under state law in Colorado, it is legal to cultivate and distribute marijuana for medical purposes. COLO. CONST. art. XVIII, § 14; COLO. REV. STAT. §§ 12-43.3-101 to-1001. Voters recently took marijuana legalization a step further and passed, by referendum, Amendment 64 to the Colorado Constitution, which legalizes the recreational production and sale of marijuana and possession of up to one ounce of marijuana. COLO. CONST. art. XVIII, § 16.

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[3] Section 856 is known as the "crack house statute." *U.S. v. Miller*, 698 F.3d 699, 705 (8th Cir. 2012). [**5] It is, perhaps, harsh that a statute aimed at controlling crack houses is written so broadly that it embraces the Debtor's conduct. The Court has no evidence before it that suggests Debtor's activities have anything in common with the evil that § 856 of the CSA was purportedly written to combat.

That there is a sharp difference between state and federal law where the growing of marijuana is concerned does not make the controlling law unsettled or ambiguous. The Debtor [**6] cannot reasonably argue that legalization of marijuana cultivation on the state level nullifies the provisions of the CSA.

The Court has considered the extent to which it is necessary to determine whether the CSA preempts the provisions of Colorado state law under the Supremacy Clause of the United States Constitution. U.S. CONST., art VI, cl. 2. The Supremacy Clause provides that federal law "shall be the supreme Law of the Land ... any Thing in the Constitution or Laws or any State to the Contrary notwithstanding." *Id*. This case does not present an issue of federal preemption.

The United States Supreme Court has had many opportunities to construe the Supremacy Clause. It recently said that

> Congress may, of course, expressly pre-empt state law, but "[e]ven without an express provision for preemption, we have found that state law must yield to a congressional Act in at least two circumstances." First, "state law is naturally preempted to the extent of any conflict with a federal statute." Second, we have deemed state law pre-empted "when the scope of a [federal] statute indicates that Congress intended federal law to occupy a field exclusively."

Kurns v. Railroad Friction Products Corp. , 132 S. Ct. 1261, 1265-66, 182 L. Ed. 2d 116 (2012) [**7] (quoting *Crosby v. National Foreign Trade Council*, 530 U.S. 363, 372, 120 S. Ct. 2288, 147 L. Ed. 2d 352 (2000); *Freightliner Corp. v. Myrick*, 514 U.S. 280, 115 S. Ct. 1483, 131 L. Ed. 2d 385 (1995)).

Here, Congress has expressly disclaimed any intention to preempt state police powers in the CSA by occupying the field with respect to the area of recreational drug use. It provides that

> No provision of this subchapter shall be construed as indicating an intent on the part of the Congress to occupy the field in which that provision operates, including criminal penalties, to the exclusion of any State law on the same subject matter which would otherwise be within the authority of the State, unless there is a positive conflict between that provision of this subchapter and that State law so that the two cannot consistently stand together.

21 U.S.C. § 903. Section 903 removes any concerns with respect to field preemption and explicitly restricts any question of preemption to those cases where a "positive conflict" exists between the provisions of the CSA and state law. A "positive conflict" my be found to exist between state law and federal law where "it is impossible for a private party to comply with both state and federal requirements, or where state law stands [**8] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Sprietsma v. Mercury Marine, a Div. of Brunswick Corp*., 537 U.S. 51, 64, 123 S. Ct. 518, [*805] 154 L. Ed. 2d 466 (2002) (internal quotation marks and citations omitted).

But conflict preemption is not an issue here. Colorado constitutional amendments for both medical marijuana, COLO. CONST. art. XVIII, § 14, and the more recent amendment legalizing marijuana possession and usage generally, COLO. CONST. art. XVIII, § 16, both make it clear that their provisions apply to state law only.[4] Absent from either enactment is any effort to impede the enforcement of federal law. *See, e.g., Ter Beek v. City of Wyoming*, 297 Mich. App.446,__ NW.2d __, 2012 Mich. App. LEXIS 1510 (Mich. Ct. App. 2012) (concluding that Michigan Medical Marijuana Act did not hinder enforcement of federal CSA because it only granted immunity from prosecution under state law).

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[4] *See, e.g*., COLO. CONST. art. XVIII, § 14(2)(a) ("[A] patient or primary care-giver charged with a violation of the *state's criminal laws* related to the patient's medical use of marijuana will be deemed to have established an affirmative defense to such allegation .... ") (emphasis added); COLO. CONST. art. XVIII, § 14(2)(e) [**9] (Any ... property interest shall not be forfeited *under any provision of State law* providing for the forfeiture of property other than as a sentence imposed after conviction of a criminal offense or entry of a plea of guilty to such offense.") (emphasis added); COLO. CONST. art. XVIII, § 16(3) ("[T]he following acts are not unlawful and shall not be an offense *under Colorado law or the law of any locality within Colorado* .... ") (emphasis added).

Federal preemption is not an issue because no part of the Colorado law must give way in order for federal authorities to fully enforce the CSA. The fact that there is a difference in legislative philosophy creates no conflict that requires an analysis of federal preemption under the Supremacy Clause. That marijuana cultivation may not be criminally prosecuted under the laws of the state of Colorado is simply of no consequence and has no bearing on the Court's finding that Debtor's business operation constitutes a continuing criminal violation of the federal Controlled Substances Act.

Debtor points out that federal authorities have never notified it that it is in violation of the law and that it has never been charged or convicted of any federal [**10] or state crime. But the fact that a violator is never charged, tried or convicted does not change the fact that the crime has been committed.

In light of Colorado's laws and constitutional amendment legalizing marijuana, federal prosecutors may well choose to exercise their prosecutorial discretion and decline to seek indictments under the CSA where the activity that is illegal on the federal level is legal under Colorado state law. Be that as it may, even if the Debtor is never charged or prosecuted under the CSA, it is conducting operations in the normal course of its business that violate federal criminal law. *See, e.g., U.S. v. Stacy*, 734 F. Supp. 2d 1074, 1078-81 (S.D. Cal. 2010) (criminal defendant cannot rely on public statements of non-prosecution policy issued by administration officials or justice department). Unless and until Congress changes that law, the Debtor's operations constitute a continuing criminal violation of the CSA and a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime.[5]

B. VFC's Collateral is at Risk

Due to the Debtor's ongoing criminal activity under the CSA, VFC's collateral is [*806] placed at risk of forfeiture. The criminal penalty applicable to a violation of subsection (a) of 21 U.S.C. § 856 is "a term of imprisonment of not more than 20 years or a fine of not more than $500,000, or both, or a fine of $2,000,000 for a person other than an individual." 21 U.S.C. § 856(b). Because the Debtor is committing an ongoing criminal violation that is punishable by a prison sentence of more than one year, the forfeiture statute comes into play. "All real property... which is used, or intended to be used, in any manner or part, to commit, or to facilitate the commission of, a violation of [the Controlled Substances Act] punishable by more than one year's imprisonment" is subject to forfeiture. 21 U.S.C. § 881(a)(7). Thus, VFC's Collateral is at risk. Moreover, under 11 U.S.C. § 362(b)(4), the automatic stay does not enjoin governmental entities against actions that constitute an exercise of governmental police [**12] powers. *See, e.g., In re WinPar Hospitality Chattanooga, LLC.*, 404 B.R. 291, 296 (Bankr. E. D. Tenn. 2009) (Title 11 U.S.C. § 362(a) did not stay civil forfeiture action under 18 U.S.C. § 981 to seize $7.2 million proceeds from estate's sale of the debtor's only asset — a piece of real estate subject to forfeiture because it was purchased with the proceeds of criminal activities.).

The Debtor might argue that any such Risk is highly theoretical, speculative and remote. As a practical matter, the Court suspects that is true. Yet, the Court cannot use the adjudicative authority granted to it by Congress to force VFC to bear even a highly improbable risk of total loss of its collateral in support of the Debtor's ongoing violation of federal criminal law.

C. The "Clean Hands Doctrine" is Applicable to Bankruptcy Proceedings

The simple act of filing a voluntary bankruptcy petition invokes protections under the Bankruptcy Code including the automatic stay. 11 U.S.C. § 362. The protections invoked by a debtor by filing a bankruptcy petition are enforced by the bankruptcy courts. 28 U.S.C. § 1334.

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[5] This is not to suggest that a Colorado state court would view the controlling law differently [**11] or that the federal system has any greater interest than the state in insuring its courts are not used to aid in the commission of a criminal offense.

Traditionally, bankruptcy courts are regarded as courts of equity. *See, e.g. Young v. U.S.*, 535 U.S. 43, 49-50, 122 S. Ct. 1036, 152 L. Ed. 2d 79 (2002); [**13] *U.S. v. Energy Resources Co., Inc.*, 495 U.S. 545, 549, 110 S. Ct. 2139, 109 L. Ed. 2d 580 (1990) ("[B]ankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships."); *Pepper v. Litton*, 308 U.S. 295, 304, 60 S. Ct. 238, 84 L. Ed. 281 (1939) ("for many purposes 'courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity"') (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 240, 54 S. Ct. 695, 78 L. Ed. 1230 (1934)). Nonetheless, a bankruptcy court's equitable powers "must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206, 108 S. Ct. 963, 99 L. Ed. 2d 169 (1988).

The Debtor seeks to reorganize its financial affairs under the shelter of the Bankruptcy Code. A reorganization under chapter 11 affords a debtor the protection of the automatic stay in order for the debtor to use that breathing spell to formulate its reorganization plan. The Court's power to adjust the debtor-creditor relationship in the process of confirming a plan of reorganization goes to the essence of the Court's equitable jurisdiction and requires the Court to look to equitable factors to determine the propriety of the Debtor's filing.

In the case of *Marrama v. Citizens Bank*, 549 U.S. 365, 127 S. Ct. 1105, 166 L. Ed. 2d 956 (2007), [**14] the Supreme Court held that the bankruptcy court's equitable powers, as set out in 11 U.S.C. § 105(a), were sufficient authority to deny a debtor's [*807] request to convert his case from chapter 7 to chapter 13. The debtor in that case had fraudulently under-reported his assets in his schedules and he sought the conversion after the chapter 7 trustee determined that the debtor owned assets that could be administered in the chapter 7 case. Despite the fact that 11 U.S.C. § 706 contains no qualification of the right to convert to chapter 13, except that the debtor must be eligible to be a debtor under that chapter, the Supreme Court deemed the debtor's bad faith to be sufficient to invoke the bankruptcy court's equitable powers and to disallow the conversion. *Id.* at 375.

> "[T]he equitable maxim that 'he who comes into equity must come with clean hands' ... closes the doors of a court of equity to one tainted with inequitableness or bad faith relative to the matter in which he seeks relief.... That doctrine is rooted in the historical concept of court of equity as a vehicle for affirmatively enforcing the requirements of conscience and good faith .... '[E]quity does not demand that its suitors [**15] shall have led blameless lives,' as to other matters, it does require that they shall have acted fairly and without fraud or deceit as to the controversy in issue."

Precision Instrument Mfg. Co. v. Automotive Maintenance Machinery Co., 324 U.S. 806, 814-15, 65 S. Ct. 993, 89 L. Ed. 1381, 1945 Dec. Comm'r Pat. 582 (1945) (citations omitted). Thus, as a court that utilizes equitable principles, this Court, like the bankruptcy court in *Marrama*, recognizes that a debtor's bad faith — in this case, the Debtor's criminal violation — in suitable cases will result in a denial or a limitation of the relief a debtor may hope to be granted.

The Court finds that the Debtor's misconduct is of such a nature to justify the application of the clean hands doctrine. "[O]ne's misconduct need not necessarily have been of such a nature as to be punishable as a crime or as to justify legal proceedings of any character. Any willful act concerning the cause of action which rightfully can be said to transgress equitable standards of conduct is sufficient cause for the invocation of the [clean hands] maxim by the chancellor." *Id.* at 15. The Debtor freely admits that it leases space to those who are engaged in the cultivation of marijuana. Even if the Debtor's holds [**16] a good faith — albeit misguided — belief that Colorado state law would prevail over the federal law or that the federal law is unlikely to be enforced, that is quite beside the point. The Debtor has knowingly and intentionally engaged in conduct that constitutes a violation of federal criminal law and it has done so with respect to its sole income producing asset. Worse yet, every day that the Debtor continues under the Court's protection is another day that VFC's collateral remains at risk.

D. 11 U.S.C. § 1112

VFC argues for application of the clean hands doctrine to bar the Debtor's bankruptcy filing. But any equitable doctrine the Court applies is always done strictly within the confines of the Bankruptcy Code's statutory scheme. *See, generally, Ahlers*, 485 U.S. at 206.

Title 11 U.S.C. § 1112(b) provides the statutory framework for dismissal or conversion of a chapter 11 case. It provides in relevant part, that

> (b)(1) ... 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 unless the court determines that the appointment [**17] under section 1104(a) of a trustee or an [*808] examiner is in the best interests of creditors and the estate.
> ...
> (4) For purposes of this subsection, the term 'cause' includes—
> (A) substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation;
> (B) gross mismanagement of the estate;
> (C) failure to maintain appropriate insurance that poses a risk to the estate or to the public;
> (D) unauthorized use of cash collateral substantially harmful to 1 or more creditors;
> (E) failure to comply with an order of the court;
> (F) unexcused failure to satisfy timely any filing or reporting requirement established by this title or by any rule applicable to a case under this chapter;
> (G) failure to attend the meeting of creditors convened under section 341(a) or an examination ordered under rule 2004 of the Federal Rules of Bankruptcy Procedure without good cause shown by the debtor;
> (H) failure timely to provide information or attend meetings reasonably requested by the United States trustee (or the bankruptcy administrator, if any);
>
> (I) failure timely to pay taxes owed after the date of the order for relief or to file tax returns due after the date of the [**18] order for relief;
> (J) failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court;
> (K) failure to pay any fees or charges required under chapter 123 of title 28;
> (L) revocation of an order of confirmation under section 1144;
> (M) inability to effectuate substantial consummation of a confirmed plan;
> (N) material default by the debtor with respect to a confirmed plan;
> (O) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and
> (P) failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.
> . . .

11 U.S.C. § 1112(b).

The statute sets out a two step process. First, the Court must determine if "cause" exists for dismissal or conversion of the chapter 11 case. Next, the Court must determine whether dismissal or conversion of the case is in the best interests of creditors and the estate. *Rollex Corp. v. Associated Materials, Inc. (In re Superior Siding & Window, Inc.)*, 14 F.3d 240, 242 (4th Cir. 1994).

A finding of "cause" in any context is, at bottom, an equitable determination. Congress specifically understood, [**19] in drafting § 1112(b)'s list of factors that a court may consider in its determination of "cause" for dismissal or conversion, that it was not restricting a court's ability to consider other factors that are not enumerated there. The legislative history to § 1112 states that

> Subsection (b) gives wide discretion to the court to make an appropriate disposition of the case when a party in interest requests. The list [appearing in [*809] § 1112(b)] is not exhaustive. The court will be able to consider other factors as they arise, and to use its equitable powers to reach an appropriate result in individual cases.

H.R. REP. NO. 95-595 at 406, 1978 U.S.C.C.A.N 5963, 6362. It is, therefore, appropriate for the Court to give consideration, in addition to the enumerated factors in § 1112(b), to VFC's equitable clean hands argument.

1) 11 U.S.C. § 1112(b)(4)(B)

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. 11 U.S.C. § 1112(b)(4)(B). In this case, the Court finds gross mismanagement. The Debtor has freely acknowledged that it engages in conduct that exposes the Debtor to criminal [**20] liability and that exposes its primary asset to forfeiture. It acknowledges that its criminal behavior has continued post-petition. The fact that it engaged in this conduct and entered into the leases with its tenants pre-petition does not constitute mismanagement of the estate because the estate is a post-petition entity. However, the Debtor entered its bankruptcy case with the offending leases in place and has maintained those leases during the pendency of its chapter 11 bankruptcy case. 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.

2) Debtor's Lack of Clean Hands

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 [**21] § 1112(b) and requires dismissal or conversion of this chapter 11 bankruptcy case. As detailed above, the Court finds that the Debtor is engaged in an ongoing criminal violation of the CSA.

Title 11 U.S.C. § 1129(a)(3) provides that a plan may only be confirmed if it is "proposed in good faith and not by any means forbidden by law." Because a significant portion of the Debtor's income[6] is derived from an illegal activity, § 1129(a)(3) forecloses any possibility of this Debtor obtaining confirmation of a plan that relies in any part on income derived from a criminal activity. This Debtor has no reasonable prospect of getting its plan confirmed. Even if § 1129 contained no such good faith requirement, under no circumstance can the Court place itself in the position of condoning the Debtor's criminal activity by allowing it to utilize the shelter of the Bankruptcy Code while continuing its unlawful practice of leasing space to those who are engaged in the business of cultivating a Schedule I controlled substance.

*3) [**22] Best interests of Creditors and of the Estate*

The Court has found that "cause" exists for dismissal or conversion of the Debtor's case. Once a court finds "cause" for dismissal or conversion of a chapter 11 [*810] case, it must determine whether dismissal is in the best interests of the creditors and of the estate or whether conversion of the case better serves those interests. 11 U.S.C. § 1112(b)(1). The record before the Court is not sufficient for the Court to make that determination.

When it analyzes the best interests of creditors and the estate under § 1112(b)(1), the Court would normally look to the assets that may be 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 judgments and chase assets to execute on. *See, e.g. Rollex Corporation v. Assoc. Materials, Inc. In re Superior Siding & Window, Inc.)*, 14 F.3d 240, 243 (4th Cir. 1994) ("The inquiry for [the best interests] element cannot be completed without comparing the creditors' interests in bankruptcy with those they would have under state law.").[7]

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[6] To be clear, the Court does not suggest there is some less significant portion of a Debtor's income that may be derived from illegal activity and that might pass muster under § 1129(a)(3).

[7] Collier suggests a much more expansive [**23] list of factors to be considered.

The Court has reviewed [**24] the Debtor's schedules. The Debtor lists the value of its Warehouse at $2.3 million. It lists the value of its personal property at $1.5 million. The debt to VFC, its primary secured creditor, is around $1.7 million. Debtor shows approximately $50,000.00 of secured real property tax claims but shows no priority unsecured debt. The Debtor's schedule of non-priority unsecured debt runs to 18 pages or approximately 120 creditors and lists debts that total approximately $1.1 million. On the face of the Debtor's schedules, Debtor reports substantial equity in property that may be used for the payment of creditors.

In a more mundane case, that might be the end of the analysis. But here, the Court must also consider whether consequences of the Debtor's criminal conduct impact the ability of a chapter 7 trustee to administer a chapter 7 estate. There have been no motions filed in this case seeking abandonment or stay relief with respect to the Debtor's Warehouse. Therefore, 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 [**25] responsibility for a site where continuing criminal conduct is taking place. That raises a question of the feasibility of chapter 7 estate administration and is an issue on which the United States Trustee is likely to want to provide input.

E. The Final Hearing

At the preliminary hearing in this matter the Court heard legal argument. The [*811] thrust of the parties arguments went to the "cause" prong of the § 1112(b) analysis and the Court has been able to make its determination that "cause" exists for dismissal or conversion of the case. However, the Court finds that the record it has before it does not allow it to make the determination of whether dismissal or conversion is in the best interests of the creditors and the estate.

The Court reserved Tuesday, January 22, 2013, as a final hearing date in the event that it could not fully resolve the pending Motion based on the legal argument presented at the preliminary hearing. The Court will use that date to hear evidence and argument with respect to whether conversion or dismissal is in the best interests of the creditors and the estate. The parties should be prepared to address any issues that are relevant to that determination. The Court [**26] will be interested in the usual economically oriented issues concerning the nature of a debtor's assets and the extent to which administration of the assets by a chapter 7 trustee is likely to produce a distribution to creditors. In addition, because of the unusual nature of this case, the Court will also be interested in the feasibility of estate administration and the impact of the Debtor's conduct on the ability of a chapter 7 trustee to administer the assets.

III. CONCLUSION

In accordance with the above discussion, it is

ORDERED that the Court hereby finds that "cause" exists, under 11 U.S.C. § 1112(b), for conversion of this case to a case under chapter 7 or dismissal of the case. It is further

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(1) whether some creditors received preferential payments, and whether equality of distribution would be better served by conversion rather than dismissal, (2) whether there would be a loss of rights granted in the case if it were dismissed rather than converted, (3) whether the debtor would simply file a further case upon dismissal, (4) the ability of the trustee in a chapter 7 case to reach assets for the benefit of creditors, (5) in assessing the interest of the estate, whether conversion or dismissal of the estate would maximize the estate's value as an economic enterprise, (6) whether any remaining issues would be better resolved outside the bankruptcy forum, (7) whether the estate consists of a "single asset," (8) whether the debtor had engaged in misconduct and whether creditors are in need of a chapter 7 case to protect their interests, (9) whether a plan has been confirmed and whether any property remains in the estate to be administered, and (10), whether the appointment of a trustee is desirable to supervise the estate and address possible environmental and safety concerns.

7 COLLIER ON BANKRUPTCY ¶ 1112.04[7] (16th ed.).

ORDERED that the Court will conduct a final hearing on **Tuesday, January 22, 2013, at 9:00 a.m**. in Courtroom C203, Byron G. Rogers U.S. Courthouse, 1929 Stout Street, Denver, Colorado, concerning the issue of whether conversion of this case to a case under chapter 7 or dismissal of the case is in the best interests of the creditors and of the bankruptcy estate. The parties shall, on or before **January 15, 2013**, (a) deliver to opposing counsel, a list and photocopies of the proposed exhibits pre-marked [**27] for identification in accordance with Local Bankruptcy Rule 9070-1(a)(2)(C) and a schedule of witnesses who will be called as well as a schedule of witnesses who may be called, and (b) file with the Court only the list of exhibits and schedules of witnesses. The original plus two copies of each exhibit shall be tendered to the Court at the commencement of the hearing. The copies shall be used by the Court and the law clerk, and the original shall be used by the witnesses. Any party wishing to file a hearing brief in connection with this matter shall do so no later than **January 15, 2013**.

Dated this 19th day of December, 2012.

BY THE COURT:

/s/ Howard R. Tallman

Howard R. Tallman, Chief Judge

United States Bankruptcy Court

End of Document

In re Medpoint Mgmt.

United States Bankruptcy Court for the District of Arizona

April 6, 2015, Decided

Involuntary Chapter 7 Proceedings, Case No: 2:14-bk-15234-DPC

Reporter
528 B.R. 178 *; 2015 Bankr. LEXIS 1125 **; 73 Collier Bankr. Cas. 2d (MB) 781; 60 Bankr. Ct. Dec. 248

In re MEDPOINT MANAGEMENT, LLC, an Arizona limited liability company, Purported Debtor.

Subsequent History: Vacated by, in part, Remanded by Medpoint Mgmt., Inc. v. Jensen (In re Medpoint Mgmt., LLC), 2016 Bankr. LEXIS 2197 (B.A.P. 9th Cir., June 3, 2016)

Counsel: [**1] For MEDPOINT MANAGEMENT, LLC, dba BLOOM DISPENSARY, Debtor: JONATHAN B. FRUTKIN, CAROLYN R. TATKIN, THE FRUTKIN LAW FIRM PLC, SCOTTSDALE, AZ.

For Jason Jensen, 7511 IRA Investments, LLC, Mike Danzer, U.S. TRUSTEE, Petitioning Creditors: ANTHONY W. AUSTIN, FENNEMORE CRAIG, PHOENIX, AZ.

Judges: DANIEL P. COLLINS, CHIEF UNITED STATES BANKRUPTCY JUDGE.

Opinion by: DANIEL P. COLLINS

Opinion

[*180] **ORDER GRANTING MEDPOINT MANAGEMENT'S MOTION TO DISMISS**

Mike Danzer, 7511 IRA Investments, LLC, Jason Jensen, and Robert Brown (collectively "Petitioning Creditors") filed an involuntary chapter 7 petition ("Petition") against Medpoint Management, LLC ("Medpoint") on October 7, 2014 (DE 1).[1] Medpoint filed a Motion to Dismiss or for Abstention ("Motion") on December 31, 2014, and requested a hearing on damages (DE 34). Petitioning Creditors responded on January 14, 2015 (DE 37) ("Response"), and Medpoint replied ("Reply") (DE 42). The Court heard oral argument on the Motion on January 29, 2015 (DE 45). At the hearing, the Court requested additional briefing on the potential forfeitability of Medpoint's assets under the Controlled Substance Act ("CSA").[2] Petitioning Creditors filed their Supplemental Opposition ("Opposition") (DE 48), and [**2] Medpoint filed its Legal Memorandum ("Memorandum") (DE 47) on February 17, 2015. The parties filed simultaneous responses on February 24, 2015. The Court heard oral argument on the supplemental pleadings on March 4, 2015 (DE 52), after which it took the Motion under advisement. The Court now grants the Motion in part and dismisses the Petition.[3]

Background

1. ANW's Relationship with Medpoint

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[1] The Court has jurisdiction over this matter under 28 U.S.C. §§ 157 and 1334.

[2] The CSA is codified in 21 U.S.C. § 801, et seq.

[3] The Court denies Medpoint's request to set a hearing on damages.

Arizona Nature's Wellness ("ANW") is an Arizona nonprofit entity which holds an Arizona Department of Health Services-issued Dispensary Certificate ("Certificate"). The Certificate allows ANW to operate the "Bloom"-branded medical marijuana dispensary ("Dispensary") under the Arizona Medical Marijuana Act ("AMMA"), codified in A.R.S. §§ 36-2801-2819. AMMA requires that all state-registered dispensaries "be operated on a not-for-profit basis," and that dispensaries' bylaws "contain such provisions relative to the disposition of revenues and receipts to establish and maintain [their] nonprofit character." A.R.S. § 36-2806(A). This requirement has resulted in a proliferation of dispensary-management entities [**3] which serve as repositories of dispensary revenues, while dispensaries maintain their nonprofit nature.

Medpoint is (or was) such an entity. Medpoint is an Arizona limited liability company with two members, Ask Nice Twice, LLC ("ANT"), and Here Is Now, LLC ("HIN"). ANT is the manager of Medpoint. Yuri Downing ("Downing") is the 100% owner of both ANT and HIN, and is Medpoint's statutory agent.

Medpoint formerly managed ANW's marijuana business, business relationships [*181] and cultivation operations. Medpoint first came into contact with ANW when Medpoint purchased a 100% membership interest in Tier Management, LLC ("Tier") from Petitioning Creditor Mike Danzer ("Danzer") on January 3, 2013 ("Danzer Sale Agreement"). *See* Motion at Ex. G: Danzer Sale Agreement (DE 34-7). Medpoint acquired Danzer's Tier interest because on January 2, 2013, Tier had entered into a Cultivation and Dispensary Services Agreement with ANW ("Tier Service Agreement"). *See* Motion at Ex. A: Tier Service Agreement (DE 34-1). Medpoint purchased the Tier interest in order to acquire the Tier Service Agreement. *See* Response at Ex. A: Downing Depo., at 27:25-29:17 (DE 37). ANW needed a management entity to partner with because, [**4] for example, ANW had no employees.[4]

Under the terms of the Danzer Sale Agreement, Tier, now controlled by Medpoint, continued servicing ANW under the terms of the Tier Service Agreement. *See* Motion at Ex. G: Danzer Sale Agreement, at ¶¶ 2.1.13, 2.1.15 (DE 34-7). Medpoint, through Tier, continued servicing ANW under the Tier Service Agreement until December 11, 2013, when Medpoint signed a separate Cultivation and Dispensary Services Agreement ("Medpoint Service Agreement") with ANW. The Medpoint Service Agreement superseded the Tier Service Agreement. *See* Opposition at Ex. A: Medpoint Service Agreement, at ¶ 29 (DE 48). ANW terminated the Medpoint Service Agreement on May 27, 2014, alleging dissatisfaction with Medpoint's performance under the Medpoint Service Agreement. This is somewhat puzzling, because ANW was a captive entity under the terms of the Medpoint Service Agreement, which Agreement allowed Medpoint to appoint ANW's board. Reply at 3:16-20 (DE 42).[5] Medpoint is not currently performing any management services for ANW or any other entity. Motion at ¶ 15 (DE 34). ANW now contracts for dispensary and cultivation management services with Bloom Master Fund I, [**5] LLC ("BMF").[6] Response at Ex. A: Downing Depo., at 57:22-25 (DE 37).[7]

2. Medpoint's Current Assets and Ties to Other Entities

Medpoint owns the "Bloom" name and trademark ("IP") under which ANW sells its marijuana products. *See* Motion at Ex. B: Trade Name Registration (DE 34-2). Medpoint currently licenses the IP to Bloom IP Industries, LLC ("Bloom Industries") for $8,000 per month. *See* Motion at Ex. J: IP Licensing Agreement (DE 34-10).[8] This is Medpoint's only current source of revenue.

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[4] *See* note 8, *infra*.

[5] The Court did not find such a provision in either the Medpoint Service Agreement or the Tier Service Agreement.

[6] The record contains no hard facts regarding the agreement between ANW and BMF. No written contract between BMF and ANW (if any exists) is attached to any of the pleadings. Downing is a current employee and former member of BMF.

[7] The Court attaches a diagram showing the various entities' relationships before and after ANW terminated the Medpoint Service Agreement.

[8] Bloom Industries is a wholly-owned subsidiary of BMF, ANW's current management entity.

In addition to the IP and the revenue it generates, Medpoint's other assets include: (1) its 100% membership interest in Tier; and (2) its causes of action [**6] relating to [*182] ANW's alleged wrongful termination of the Medpoint Service Agreement.[9]

3. Petitioning Creditors' Claims against Medpoint

The Petitioning Creditors consist of Danzer, 7511 IRA Investments, LLC ("7511"), Jason Jensen ("Jensen"), and Robert Brown ("Brown").

Danzer's claims against Medpoint arose from the Danzer Sale Agreement, by which Medpoint bought Danzer's 100% interest in Tier. Under the terms of the Danzer Sale Agreement, Medpoint paid Danzer $150,000 down, and signed a promissory note for two more payments of $150,000 each. *See* Motion at Ex. G: Danzer Sale Agreement (DE 34-7). Medpoint defaulted on the Danzer Sale Agreement. *See* Response at Ex. A: Downing Depo., at 45:25-46:2 (DE 37). Danzer also entered into [**7] a Consulting Agreement with Medpoint on January 3, 2013, whereby he would provide services relating to managing construction of a marijuana cultivation facility. *See* Motion at Ex. F: Danzer Consulting Agreement (DE 34-6). Medpoint never paid Danzer any of the $5,000 monthly fees due under the Consulting Agreement. Response at Ex. A: Downing Depo., at 47:9-48:6 (DE 37).

Jensen also signed a Consulting Agreement with Medpoint on January 3, 2013, whereby he would provide project management services relating to the grow house construction. *See* Motion at Ex. E: Jensen Consulting Agreement (DE 34-5). Medpoint never paid Jensen's monthly fees under the Consulting Agreement. Response at Ex. A: Downing Depo., at 50:20—51:3 (DE 37). The Consulting Agreement attached to the Motion does not reference medical marijuana, but the Court does not doubt that Jensen was aware of the nature of Medpoint's business.

On August 27, 2013, Robert Brown loaned Medpoint $100,000 ("Brown Loan"). *See* Motion at Ex. D: Brown Loan (DE 34-4). Medpoint has not repaid the Brown Loan. Response at Ex. A: Downing Depo., at 55:18—20 (DE 37). The first recital of the Brown Loan acknowledges that Medpoint is in the medical marijuana [**8] business.

On September 9, 2013, 7511 loaned Medpoint $400,000 ("7511 Loan"). *See* Motion at Ex. C: 7511 Loan (DE 34-3). Medpoint defaulted on the 7511 Loan. 7511 claims Medpoint owes it $400,000. The first recital of the 7511 Loan acknowledges that Medpoint is in the medical marijuana business.

Issue

The issue before this Court is whether it can or should enter an involuntary order for relief against Medpoint despite the fact that Medpoint's current and former business affairs are illegal under applicable federal criminal statutes. This question appears to be a matter of first impression in the District of Arizona. The Court finds that cause exists under section 707(a) to dismiss the Petition.[10]

Medpoint's Arguments

Medpoint argues that a bankruptcy trustee cannot lawfully administer a bankruptcy [*183] estate's marijuana-related assets without violating the CSA. *In re Arenas*, 514 B.R. 887, 891-892 (Bankr. D. Colo. 2014) ("For the Trustee to take possession and control of the Debtors' Property and marijuana inventory would directly involve him

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[9] Infinite Bloom, LLC was previously a wholly-owned Medpoint subsidiary. Medpoint sold Infinite Bloom to BMF for $11,100 on June 2, 2014. *See* Opposition at Ex. B: Asset Sale Agreement (DE 48). Infinite Bloom employed the 74 employees who performed Medpoint's management services for ANW. Medpoint sold Infinite Bloom to BMF "so that [BMF] wouldn't have to switch all the employee contracts and everything else . . . ." Response at Ex. A: Downing Depo., at 113:2-5 (DE 37).

[10] All section numbers refer to Title 11 of the United States Code unless stated otherwise.

in the commission of federal crimes."). In *Arenas*, the court held that the inevitable illegality of the trustee's administration of illegal [**9] estate assets constituted cause to dismiss under section 707(a). *Id.* Alternatively, Medpoint cites *Northbay* for the proposition that the Court must dismiss this case because Petitioning Creditors' hands are unclean due to their involvement in a medical marijuana enterprise. *Northbay Wellness Grp. v. Beyries*, 2012 U.S. Dist. LEXIS 133377, 2012 WL 4120409 at *4 (N.D. Cal., Sept. 18, 2012) (affirming that unclean hands doctrine prevented bankruptcy court from granting relief to plaintiff medical marijuana business seeking a nondischargability determination, because it was engaged in activity which was illegal under federal law).

Lastly, Medpoint argues that the Court could alternatively suspend all proceedings under section 305(a). Medpoint argues that the conflict between state and federal law makes the bankruptcy court "the most inefficient and troublesome" forum. Motion at 13:11. Medpoint notes that Petitioning Creditors' claims are grounded in state law. *Id.* at 13:18.

Petitioning Creditors' Arguments

Petitioning Creditors deny that Medpoint is currently engaged in any illegal activity and deny that either the IP or the IP licensing revenues are forfeitable under the CSA. Petitioning Creditors distinguish Medpoint from the marijuana-related parties in the cases Medpoint cites, noting that those cases involved operating dispensaries [**10] or growers. Response at 4—6. Petitioning Creditors deny they have unclean hands, arguing that nothing in the record or Motion indicates that their claims "are in any way related to the actual proceeds of the sale of marijuana or ongoing illegal activity." *Id.* at 6:19—20. Petitioning Creditors deny that Medpoint used their funds to purchase marijuana or any other illegal substance. *Id.* at 6:23—24. Petitioning Creditors observe that Medpoint "applied for and received a Federal Tax ID number," and that Medpoint banked at Wells Fargo, an FDIC-insured bank. *Id.* at 7:8—11. As to Medpoint's section 305(a) argument, Petitioning Creditors urge that suspending all proceedings would not be in the best interests of creditors, citing the BAP's decision of *In re Eastman*, 188 B.R. 621, 624—625 (9th Cir. BAP 1995) (under section 305(a), "the test is whether both the debtor and the creditors would be 'better served' by a dismissal.").

Lastly, Petitioning Creditors argue that even though medical marijuana may be technically illegal, with the passage of the Consolidated and Further Continuing Appropriations Act ("Cromnibus Act"), there can be no federal enforcement actions against Arizona medical marijuana businesses. The Cromnibus Act is significant because it provides funding for the entire [**11] federal government through September 30, 2015. Section 538 of the Cromnibus Act states: "None of the funds made available in this Act to the Department of Justice may be used, with respect to the state[] of . . . Arizona . . . to prevent [Arizona] from implementing [its] own [law] that authorize[s] the use, distribution, possession, or cultivation of medical marijuana." Cromnibus Act, Pub. L. 113-235, § 538 (2014).

The United States' Trustee's Position

At the January 29 hearing on the Motion, counsel for the United States Trustee ("UST") expressed concern and skepticism regarding a trustee's ability to administer a bankruptcy estate for Medpoint. ECRO audio file of Jan. 29, 2014 hearing (DE 46). Posing a hypothetical to the Court, she [*184] asked: "So, you're going to ask a trustee to look at a management contract for illegal activities, essentially. So what is that trustee going to do?" Counsel for the UST was not convinced that Medpoint had any legal, nonmarijuana assets that a trustee could lawfully administer. Id. Medpoint affirms that all of its assets are marijuana-related. Memorandum at 4—6 (DE 47).

Analysis

The Court analyzes three general arguments in reaching its decision on the Motion: (1) whether there is cause to dismiss the Petition; [**12] (2) whether Petitioning Creditors have unclean hands, and if they do, whether this Court can or should enter an order for relief; and (3) whether Petitioning Creditors acted in bad faith in filing the Petition.

1. Cause to Dismiss under Section 707(a)

Under section 707(a), the Court may dismiss a chapter 7 case for cause after notice and a hearing. In *Arenas*, the bankruptcy court found cause to dismiss the debtor's case because the debtor's assets included marijuana and marijuana-related assets. *In re Arenas*, 514 B.R. 887, 892 (Bankr. D. Colo. 2014) ("The impossibility of lawfully administering the Debtors' bankruptcy estate under chapter 7 constitutes cause for dismissal of the Debtors' case under 11 U.S.C. § 707(a)."). The *Arenas* court held that "Debtors' chapter 7 trustee . . . [could not] take control of the Debtors' Property without himself violating §856(a)(2) of the CSA," nor "liquidate the inventory of marijuana plants Mr. Arenas possessed on the Petition Date" without violating §841(a) of the CSA. *Id.* at 891. Because the trustee was unable to perform his duties, the court found the bankruptcy case was futile.

In *Vel Rey*, the chapter 7 trustee wanted to operate the debtor's property to increase its sale value. *In re Vel Rey Properties, Inc.*, 174 B.R. 859 (Bankr. D. D.C. 1994). The trustee asked the bankruptcy court for immunity from liability for any noncompliance with D.C.'s [**13] housing regulations while he readied the property for sale. *Id.* at 863. The court denied the trustee's request, noting that if either the trustee or the United States Trustee refused to serve for "concern[] about personal liability . . . the court could simply dismiss the case for cause under § 707." *Id.* at 866 (citing *Ohio v. Commercial Oil Serv. Corp., Inc.*, 58 B.R. 311 (Bankr. N.D. Ohio 1986)).

In another District of Colorado bankruptcy case, the debtor-in-possession was a landlord who received approximately 25% of its revenue from a marijuana entity. *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799, 802—803 (Bankr. D. Colo. 2012). The bankruptcy court found that renting to the marijuana entity exposed debtor to criminal liability and forfeiture of the real property. *Id.* at 809. Because of the risks associated with the marijuana tenant, the bankruptcy court held that the debtor's continuing lease with the marijuana entity constituted "gross mismanagement of the estate" and was cause to dismiss under section 1112(b)(4)(B). *Id.* The Court is strongly persuaded by the reasoning in this line of cases.

The Court is also persuaded by the UST's argument that the appointment of a chapter 7 trustee would place that trustee in an untenable position. A trustee would have good reason to worry about his/her risk exposure relating to the administration of a marijuana-related entity's estate:

> Where [**14] the Bankruptcy Code has conferred special powers upon the trustee and where there was no common-law limitation on that power, Congress has [*185] expressly provided that the efforts of the trustee to marshal and distribute the assets of the estate must yield to governmental interest in public health and safety.

Midlantic Nat'l Bank v. New Jersey Dept. of Envtl. Prot., 474 U.S. 494, 502, 106 S. Ct. 755, 760, 88 L. Ed. 2d 859 (1986) (citing *Ohio v. Kovacs*, 469 U.S. 274, 105 S. Ct. 705, 711-712, 83 L. Ed. 2d 649 (1985)). The first section of the CSA shows that Congress enacted it in its "governmental interest in public health and safety." In that section, Congress finds and declares: "The illegal importation, manufacture, distribution, and possession and improper use of controlled substances have a substantial and detrimental effect on the health and general welfare of the American people." CSA, 21 U.S.C. § 801(2) (emphasis added). Marijuana is a schedule-I controlled substance under the CSA. *See* CSA, 21 U.S.C. § 802(6) (defining a controlled substance to include any drug or substance "included in schedule I . . . of this part B of this subchapter."); CSA, 21 U.S.C. § 812(c), Schedule I at (c)(17). A bankruptcy trustee would need to yield to the government's interests in protecting the public's health, as expressed by the CSA.

The Court observes, without deciding, that it is quite possible that Medpoint's IP and the IP licensing revenues could [**15] be seized or forfeited, and that Medpoint could be or could have been guilty of facilitation of a crime under the CSA. *See* Deputy A.G. James M. Cole, U.S. DOJ, Memorandum at 2 (June 29, 2011) ("Persons who are in the business of cultivating, selling or distributing marijuana, and those who knowingly facilitate such activities, are in violation of the Controlled Substances Act, regardless of state law."). Both ANW and Medpoint could be or could have been guilty of violating the CSA under an accomplice theory of liability. *See* 18 U.S.C. § 2(a) (establishing aiding and abetting liability for crimes against the U.S.).

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.[11] Other courts have dismissed cases for similar concerns regarding a trustee's potential risk exposure. *See In re Charles George Land Reclamation Trust*, 30 B.R. 918, 924 (Bankr. D. Mass. 1983) (dismissing a chapter 7 case for cause because neither a trustee nor the United States Trustee would take the case, due to the "potentially unlimited and untested liability standards of both the State and Federal Superfund statutes.").

Petitioning Creditors' argue that the Cromnibus Act essentially eliminates the risk of federal enforcement actions against medical marijuana operations. This argument aslo fails to sway the Court. That the Cromnibus Act prohibits the Department of Justice ("DOJ") from using that funding for enforcement against medical marijuana operations does not foreclose the possibility of enforcement. For example, in 2012, the DOJ's Asset Forfeiture Program "recorded total net forfeiture deposits [*186] of $4.2 billion" via coordinated actions involving the FBI, ATF, DEA, and other law enforcement [**17] agencies. Dept. of Justice, Asset Forfeiture Program FY 2014 Performance Budget at 1. The Court cites this as an example of a possible non-Cromnibus Act source of funding for enforcement actions against medical marijuana businesses. The Attorney General can spend money from the DOJ's Asset Forfeiture Fund "to seize . . . property . . . pursuant to any law enforced or administered by the Department of Justice, or [for] any other necessary expense incident to the seizure . . . of such property . . ." 28 U.S.C. § 524(c)(1)(A). The Court takes this to mean that DOJ can use existing forfeiture proceeds to prosecute claims against Medpoint under the CSA (and seek forfeiture of Medpoint's assets) even though this year's budget allotment could not be used for such prosecution. The Court also notes that the Cromnibus Act only applies to funding through September 30, 2015. The next spending bill approved by Congress might not prohibit the DOJ from using its general funds to enforce the CSA against Arizona's medical marijuana businesses.

The Court will not enter an order for relief which would then result in the appointed chapter 7 trustee necessarily violating federal law (the CSA) in carrying out his or her duties under the Code. The dual risks [**18] of forfeiture of Medpoint's assets and a trustee's inevitable violation of the CSA in administration of a Medpoint chapter 7 estate constitute cause for this Court to dismiss Petitioning Creditors' involuntary Petition under section 707(a). The Court grants Medpoint's Motion.

2. Unclean Hands Doctrine

The bankruptcy court is a court of equity. *Young v. United States*, 535 U.S. 43, 50, 122 S. Ct. 1036, 1041, 152 L. Ed. 2d 79 (2002). "The 'unclean hands' defense applies to conduct immediately related to the cause in controversy." *In re Everett*, 364 B.R. 711, 723 (Bankr. D. Ariz. 2007) (citation omitted). "[B]ecause of the clean hands doctrine a federal court should not, in an ordinary case, lend its judicial power to a plaintiff who seeks to invoke that power for the purpose of consummating a transaction in clear violation of law." *See Johnson v. Yellow Cab Transit Co.*, 321 U.S. 383, 387, 64 S. Ct. 622, 624, 88 L. Ed. 814 (1944). "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 his claim." *Hall v. Wright*, 240 F.2d 787, 794-95 (9th Cir. 1957).

When Medpoint entered into the various agreements with Petitioning Creditors, it was very much in the business of managing and operating a medical marijuana business. Medpoint drained off ANW's cash so that ANW, a not-for-profit entity, would not hold an inordinate amount of cash. In effect, the profitability of ANW's business was usurped [**19] by Medpoint via the Medpoint Service Agreement and IP License Agreement. Medpoint's former wholly-owned subsidiary, Infinite Bloom, LLC, employed over 70 people to run and manage ANW's sales and

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[11] The Court declines to make a finding on the issue of whether Medpoint's assets (the [**16] IP, its licensing revenues, its interest in Tier, and claims against ANW and others) are or are not forfeitable/seizable under the CSA and/or other federal law. However, such an issue could very well be central to a bankruptcy court's decision in future cases in states which allow the production and sale of "medical marijuana." The same is true for the issue of the enforceability and seizability/forfeitability of contracts and negotiable instruments. *See* 21 U.S.C. § 881(a)(6) (providing that "negotiable instruments" used to facilitate any violation of the CSA are subject to forfeiture and that "no property right shall exist in them.").

cultivation.[12] Medpoint also hired consultants to help with the construction of a cultivation facility, and branded the cannabis products with the Bloom trademark. Medpoint still licenses that IP to BMF (via Bloom Industries) for ANW's use. Medpoint's IP surely provides value to BMF in the sale of ANW's marijuana products.

Petitioning Creditors knew or should have known that Medpoint's activities [*187] were illegal under federal law. Medpoint did not dupe them into entering the medical marijuana business. Danzer, Brown, and 7511 signed various loan or other documents which expressly stated that Medpoint was in the medical marijuana business and that, under federal law, the production, marketing and sale of marijuana was and remains illegal. *See, e.g.*, Motion at Ex. C: 7511 Loan at 1 (DE 34-3) ("Marijuana is designated as a Class One Controlled Substance by the US Federal Government and pursuant to Federal Law is not approved for sale or distribution in the State of Arizona . . . ."). [**20] Jensen signed his Consulting Agreement with Medpoint to help it construct a medical marijuana cultivation facility. All the Petitioning Creditors knew or should have known there were serious possible criminal ramifications to Medpoint's business relationships with ANW and with marijuana products. 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. The unclean hands defense arises from and applies to Petitioning Creditors' medical marijuana-related claims against Medpoint. Petitioning Creditors' hands are unclean and they cannot now seek relief from this Court.[13]

3. No Bad** [**21] **Faith

Under sub-sections 303(i)(1) and (2), the Court may award Medpoint a judgment for its fees and/or costs associated with the successful Motion, or for proximate actual, and/or punitive damages resulting from a bad faith involuntary petition.

The Court makes bad faith determinations by factual findings, judging the facts against what a reasonable person would have done or believed. *See In re Wavelength*, 61 B.R. 614, 620 (9th Cir. BAP 1986). In doing so, the Court considers the totality of the circumstances. *Higgins v. Vortex Fishing Systems, Inc.*, 379 F.3d 701, 705 (9th Cir. 2004). In support of its request for a damages hearing, Medpoint alleges that Petitioning Creditors filed the Petition "for the purpose of seizing control of the medical marijuana license to permit continuing operations of a business that operates in clear violation of federal law." Motion at 11:22—24 (DE 34). Medpoint attaches a draft of a letter containing a settlement offer from Petitioning Creditors' counsel to ANW's board members. Motion at Ex. K: Pre-Litigation Demand (DE 34-11) ("Demand Letter"). The Demand Letter is unsigned, and Petitioning Creditors deny that they ever actually sent it.

Putting aside the question of the Demand Letter's admissibility under Federal Rule of Evidence 408, the Court finds that the Demand Letter is evidence of Petitioning Creditors' unclean hands but not of [**22] their bad faith. The Demand Letter is evidence that Petitioning Creditors were involved in the medical marijuana business. The Court declines to find that Petitioning Creditors acted in bad faith by preparing the Demand Letter.

The viability of an involuntary chapter 7 petition filed against a debtor on account of debts relating to state-licensed [*188] medical marijuana operations is a novel question of law in this District. The Court does not find that Petitioning Creditors' acted unreasonably in filing the Petition. The record shows that Medpoint is not and cannot meet its ongoing financial obligations to numerous creditors, in amount and number sufficient to justify an involuntary petition under section 303(b). The record before this Court does not contain facts to support a finding of

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[12] *See* note 8, *supra*.

[13] *Northbay*, an unpublished opinion, reached a similar conclusion regarding a marijuana entity in California, stating that: "While the sale of marijuana may be legal under certain circumstances in California, it is unquestionably illegal under federal law. Appellants' hands were unclean, as a matter of federal law." *Northbay Wellness Grp., Inc. v. Beyries*, No. C 11-06255 JSW, 2012 U.S. Dist. LEXIS 133377, 2012 WL 4120409, at *4 (N.D. Cal. Sept. 18, 2012). California also allows the production and sale of medical marijuana.

Petitioning Creditors' bad faith. As the Ninth Circuit BAP has noted, "[n]ot every failed reason for filing an involuntary petition amounts to 'bad faith.'" *In re Macke Int'l Trade, Inc.*, 370 B.R. 236, 257 (9th Cir. BAP 2007). Petitioning Creditors' unclean hands do not equate to a finding of their bad faith in this instance. Finding no bad faith, there is no need for a hearing on damages proximately caused by a filing that is not in bad faith.

Conclusion

Despite this Court's refusal to grant [**23] Petitioning Creditors' requested relief, they still have other options for pursuing recourse against Medpoint. They may well have state-law causes of action against Medpoint which might be enforced in state court. For example, at his deposition, Downing seemingly admitted that Medpoint defaulted on or breached various loan agreements and consulting agreements. The record also contains facts which might support fraudulent transfer claims against Medpoint and/or BMF under Arizona fraudulent transfer laws. Granting Medpoint's Motion will not give it a windfall, because Petitioning Creditors still have the opportunity to pursue their claims to hold Medpoint accountable in state court.

Arizona law is in conflict with the CSA. Arizona has chosen not to enforce the CSA against businesses such as Medpoint. However, as a federal court, this Court must adhere to federal law. Neither the alleged lack of enforcement funding nor the apparent lack of political will to enforce the CSA alters the fact that a person engaged in marijuana related business activities in Arizona is in violation of federal law. Petitioning Creditors may themselves have also violated the CSA and attempted to profit from those [**24] violations. At a minimum, they come to this Court with unclean hands. The Court has neither the authority nor the will to enter an order for relief or endanger a trustee who might be assigned to administer drug tainted assets for the benefit of creditors who assumed the risk of doing business with an enterprise engaged in violations of federal law.

Accordingly,

IT IS ORDERED that Medpoint's Motion is granted, and the Petition is dismissed.

IT IS FURTHER ORDERED that Medpoint's request for a hearing on damages is denied, as the Court will not grant Medpoint fees, costs, or damages.

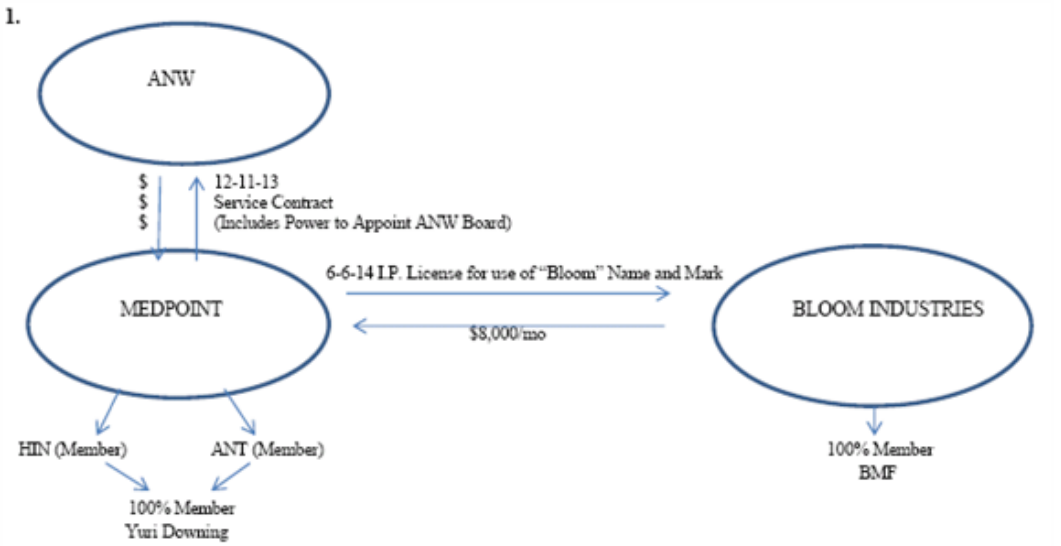
DATED: April 6, 2015.

/s/ Daniel P. Collins

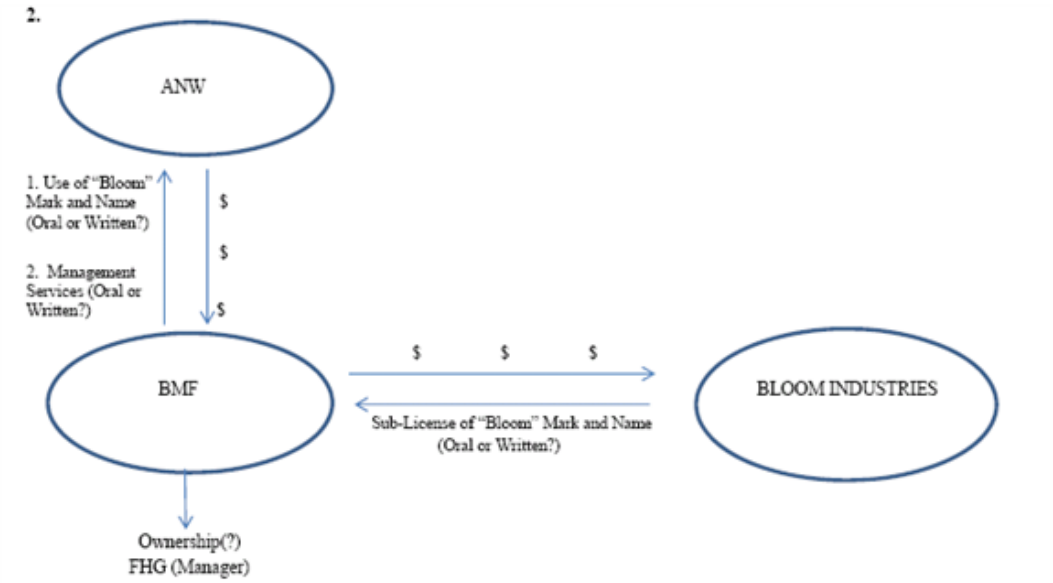
DANIEL P. COLLINS

CHIEF UNITED STATES BANKRUPTCY JUDGE

MEDPOINT



[*189]



Key:

ANW = Arizona Nature's Wellness, an Arizona corporation (Not For Profit)

Medpoint = Medpoint Management, LLC, an Arizona limited liability company (For Profit)

HIN = Here Is Now, LLC, an Arizona limited liability company (For Profit)

ANT = Ask Nice Twice, LLC, an Arizona limited liability company (For Profit)

Bloom Industries = Bloom IP Industries, LLC, a Delaware limited liability company (For Profit)

BMF = Bloom Master Fund I, LLC, a Delaware limited liability company (For Profit)

FHG = Future Health Group, [**25] LLC, a Nevada limited liability company

528 B.R. 178, *189; 2015 Bankr. LEXIS 1125, **25

End of Document

In re Arenas

United States Bankruptcy Court for the District of Colorado

August 28, 2014, Decided

Case No. 14-11406 HRT, Chapter 7

Reporter
514 B.R. 887 *; 2014 Bankr. LEXIS 3642 **; 72 Collier Bankr. Cas. 2d (MB) 447

In re: FRANK ANTHONY ARENAS and SARAH EVE ARENAS, Debtors.

Subsequent History: Affirmed by Arenas v. United States Trustee (In re Arenas), 2015 Bankr. LEXIS 2821 (B.A.P. 10th Cir., Aug. 21, 2015)

Counsel: [**1] For Frank Anthony Arenas, dba FA Husbandry LLC, dba FSA LLC, dba Twenty Eighth Larimer LLC, Sarah Eve Arenas, Debtors: David M. Serafin, Denver, CO.

Trustee: Joseph Rosania, Louisville, CO.

For US Trustee, U.S. Trustee: Alan K. Motes, United States Trustee Program, Denver, CO.

Judges: Honorable Howard R. Tallman, United States Bankruptcy Judge.

Opinion by: Howard R. Tallman

Opinion

[*888] **ORDER ON THE UNITED STATES TRUSTEE'S MOTION TO DISMISS AND THE DEBTORS' MOTION TO CONVERT**

This case comes before the Court on *United States Trustee's Motion to Dismiss Debtors' Case under 11 U.S.C. §707(a)* (docket #17); and Debtor's *Motion to Convert Chapter 7 Case to One under Chapter 13 Pursuant to 11 U.S.C. §348(a) and FED. R. BANKR. P. 1017(f)(2)* (docket #23).

I. FACTUAL BACKGROUND

Mr. Arenas is engaged in the business of producing and distributing marijuana[1] on the wholesale level in the state of Colorado. According to his uncontradicted testimony, he possesses all of the required licenses and permits necessary to legally engage in his business under the laws of the state of Colorado. Mr. Arenas does not possess, and has not applied for, any type of license or permit from the Drug Enforcement Administration to allow him to lawfully operate his business of producing and distributing marijuana under [**2] the federal Controlled Substances Act, 21 U.S.C. § 801 et seq. (the "CSA").[2]

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[1]

> "Marijuana" or "marihuana" means all parts of the plant of the genus cannabis whether growing or not, the seeds thereof, the resin extracted from any part of the plant, and every compound, manufacture, salt, derivative, mixture, or preparation of the plant, its seeds, or its resin, including marihuana concentrate.

COLO. CONST. art. 18, § 16.

[2] The CSA adopts the spelling "marihuana." As reflected in Colorado's constitutional provision, the two spellings are

[*889] The Debtors jointly own a commercial building located at 2863 Larimer Street, Denver, Colorado (the "Property"). The building consists of two units. Mr. Arenas carries on his business operations in one of the units and the Debtors lease the other unit to a marijuana dispensary that operates under the name of Denver Patients Group, LLC ("DPG").

Mrs. Arenas suffered a stroke in 2011 and is disabled. Her income consists [**3] of a Social Security Disability benefit and a pension benefit. Those sources total approximately $3,000.00 per month. The remainder of the family's monthly income — $4,265.16 according to the Debtors' Schedule I — is derived from the lease with DPG and from the operation of Mr. Arenas' growing business.[3] There is no evidence that Mrs. Arenas participates in the growing business.

II. DISCUSSION

The Court finds Mr. Arenas to be a candid and credible witness. In accordance with Mr. Arenas' uncontradicted testimony, the Court finds the Debtors' business operations and ownership and operation of their Property are not illegal under the laws of the state of Colorado and that the Debtors are in compliance with applicable state regulations. Mr. Arenas' testimony also establishes that his business [**4] operations and the Debtors' control over their Property are unlawful under the CSA. Both the Debtors' activity of leasing space to a marijuana dispensary and Mr. Arenas' cultivation of marijuana on the property makes the Debtors liable for criminal penalties under the CSA.

The United States Trustee (the "UST) moves to dismiss the Debtors' case for cause under 11 U.S.C. § 707(a). The UST bases his position largely on the analysis contained in the Court's prior case of *In re Rent-Rite Super Kegs West Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012). The Debtor invites the Court to reexamine it's decision in the *Rent-Rite* case.

In *Rent-Rite*, the Court addressed issues concerning a chapter 11 debtor's activities with respect to medical marijuana — activities that are legal under Colorado law but that constitute criminal violations of the CSA. The case came before the Court on a creditor's motion to dismiss the debtor's chapter 11 reorganization case under § 1112(b) of the Bankruptcy Code. The Court held:

> Unless and until Congress changes [federal drug] law, the Debtor's operations constitute a continuing criminal violation of the CSA and a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime.

Rent-Rite, 484 B.R. at 805. The legal principles discussed [**5] in *Rent-Rite* apply with equal force to this case.

In *Rent-Rite* the Court found that the Debtor's operation of a warehouse that was partially rented to a tenant engaged in the cultivation of marijuana was a violation of the CSA. Specifically, the debtor violated 21 U.S.C. § 856(a)(2). That provision makes it unlawful to own or control premises that are knowingly used for the manu [*890]

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interchangeable. The CSA defines the term "marihuana" as

> all parts of the plant Cannabis sativa L., whether growing or not; the seeds thereof; the resin extracted from any part of such plant; and every compound, manufacture, salt, derivative, mixture, or preparation of such plant, its seeds or resin.

21 U.S.C. § 802(16).

[3] The evidence is unclear whether Mr. Arenas conducts his growing operation personally, under a d/b/a, or through a corporate entity. However, that is not a distinction of consequence because a corporate form cannot be used to shield its owner from criminal liability. *See First Nat. City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611, 630, 103 S. Ct. 2591, 77 L. Ed. 2d 46 (1983) ("the Court has consistently refused to give effect to the corporate form where it is interposed to defeat legislative policies.").

facture or distribution of a controlled substance.[4] Marijuana is classified as a Schedule I controlled substance under the CSA. In addition to the Debtors' ownership of premises that are used in the production and distribution of a controlled substance, Mr. Arenas' growing operation violates the CSA. *See* 21 U.S.C. § 841(a)(1) ("Except as authorized by this subchapter, it shall be unlawful for any person knowingly or intentionally . . . to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance . . . ."). *See, also, United States v. Oakland Cannabis Buyers' Cooperative*, 532 U.S. 483, 121 S. Ct. 1711, 149 L. Ed. 2d 722 (2001).

Cases like this case and *Rent-Rite* arise because of the conflict between the marijuana policies reflected in state law and the federal marijuana prohibition. The Debtor has provided the Court with a law review article that speaks to some of the ramifications of those conflicting policies. Robert A. Mikos, *On the Limits of Supremacy: Medical Marijuana and the States' Overlooked Power to Legalize Federal Crime*, 62 Vand. L. Rev. 1421 (2009). The Court has read Professor Mikos' article with some interest. The article was written in 2009, prior to any state legalizing recreational marijuana. At the time, 13 states had legalized medical marijuana.

Professor Mikos recognizes that, even though many courts and commentators frequently view the conflict in terms of Constitutional preemption of state law by the federal law, there is no such preemption and the states are perfectly free to legalize and regulate the use of medical marijuana. *See also Rent-Rite*, 484 B.R. at 804-805.

Professor Mikos' analysis "suggests that as long as states go no further [than passive legalization] — and do not actively assist marijuana users, growers, and so on — they may continue to look the other way when their [**7] citizens defy federal law." Mikos at 1424. As a result, "[t]he federal ban may be strict — and its penalties severe — but without the wholehearted cooperation of state law enforcement authorities, its impact on private behavior will remain limited. Most medical marijuana users and suppliers can feel confident they will never be caught by the federal government." *Id*.

The point that Professor Mikos makes goes to the heart of the Debtors' dilemma. He does not suggest that state legalization somehow nullifies federal law and prevents federal enforcement of the CSA within state borders. To the contrary, he frankly recognizes that marijuana production and distribution continue to be federal crimes even in those states that have legalized those activities. State legalization works, in his view, only because it is the states that have been on the forefront of enforcement of marijuana laws. Once the states decriminalize marijuana and stop enforcing a prohibition on its distribution and use, the federal government lacks the resources to fill that void. *Id*.

Nothing in Professor Mikos' article supports the notion that the Debtors are not involved in an activity that is a federal crime. It may be extremely unlikely [**8] that they will ever be arrested and prosecuted for their violations of the CSA.[5] Nonetheless, [*891] those violations of federal law create significant impediments to the Debtors' ability to seek relief from their debts under the federal bankruptcy laws in a federal bankruptcy court.

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[4] A controlled substance is defined in the CSA as "a drug or other substance, or immediate precursor, included in schedule I, II, III, IV, or V of part B of this subchapter. The term does not include distilled spirits, wine, malt beverages, or tobacco, as those terms are defined [**6] or used in subtitle E of the Internal Revenue Code of 1986." 21 U.S.C. § 802(6).

[5] The U.S. Department of Justice has issued guidance to U.S. Attorneys that identifies eight federal law enforcement priorities including "[p]reventing the distribution of marijuana to minors; . . . [p]reventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels; [and] [p]reventing the diversion of marijuana from states where it is legal under state law in some form to other states . . . ." Memorandum from James M. Cole, Deputy Attorney General, on Guidance Regarding Marijuana Enforcement, August 29, 2013. U.S. Attorneys are advised that "enforcement of state law by state and local law enforcement and regulatory bodies should remain the primary means of addressing marijuana-related activity . . . ." so long as those federal law enforcement priorities are adequately protected by state regulations. *Id*. The same memorandum goes on to emphasize that "[t]his memorandum does not alter in any way the Department's authority [**9] to enforce federal law. . . . Neither the guidance herein nor any state or local law provides a legal defense to a violation of federal law, including any civil or criminal violation of the CSA." *Id*. Thus, the Justice Department is unlikely to prosecute violations of the CSA in Colorado where the conduct in question is legal under Colorado state law. But, that is a policy that represents an exercise of prosecutorial discretion and is subject to change at any time. Moreover, the fact that a crime is not prosecuted makes it no less of a crime.

Under our federal system of government, a state is perfectly free to, as Professor Mikos puts it, "continue to look the other way when their citizens defy federal law." *Id.* By the same token, the states have no power to require any branch of the federal government to do the same. A state citizen that chooses to defy one federal law puts himself in an awkward position when he seeks relief under another federal statute — especially when granting that relief directly involves a federal court in administering the fruits and instrumentalities of federal criminal activity.

Here the United States Trustee seeks dismissal of the Debtors' case under § 707(a). Both [**10] § 1112(b) — relied upon by the creditor in *Rent-Rite* — and § 707(a) provide that a case may be dismissed "for cause." The Debtors have also filed a motion under § 706(a) to convert their case to a case under chapter 13.

A. Motion to Dismiss

The fundamental bargain underpinning a chapter 7 consumer liquidation case is that a debtor turns over his non-exempt assets to a chapter 7 trustee so those assets may be liquidated for the benefit of creditors. In return, the debtor receives a discharge of his dischargeable debts. Here, the Debtors' chapter 7 trustee (the "Trustee") cannot take control of the Debtors' Property without himself violating §856(a)(2) of the CSA. Nor can he liquidate the inventory of marijuana plants Mr. Arenas possessed on the petition date[6] because that would involve him in the distribution of a Schedule I controlled substance in violation of § 841(a) of the CSA. The Court finds that administration of this case under chapter 7 is impossible without inextricably involving the Court and the Trustee in the Debtors' ongoing criminal violation of the CSA.

There is some indication that the Debtors' Property represents an asset of value for the bankruptcy estate.[7] But [**11] it is an asset that cannot be administered for the benefit of creditors. For the Trustee to [*892] take possession and control of the Debtors' Property and marijuana inventory would directly involve him in the commission of federal crimes. To allow the Debtors to remain in a chapter 7 bankruptcy case under circumstances where their Trustee is unable to administer valuable assets for the benefit of creditors would allow them to receive discharges without turning over their non-exempt assets to the Trustee. That would give the Debtors all of the benefits of a chapter 7 bankruptcy discharge while allowing them to avoid the attendant burdens. The impossibility of lawfully administering the Debtors' bankruptcy estate under chapter 7 constitutes cause for dismissal of the Debtors' case under 11 U.S.C. § 707(a).

B. Motion to Convert

The Debtors are not entitled to convert their case to a case under chapter 13 because their reorganization would be funded from profits of an ongoing criminal activity under federal [**12] law and would necessarily involve the Chapter 13 Trustee in administering and distributing funds derived from the Debtors' violation of the CSA.

Ordinarily, a chapter 7 case may be converted to a chapter 13 case at any time. 11 U.S.C. § 706(a). The Debtors seek to convert their case to a case under chapter 13 as an alternative to the Trustee selling their Property for the benefit of creditors.

The Supreme Court made clear in the case of *Marrama v. Citizens Bank*, 549 U.S. 365, 127 S. Ct. 1105, 166 L. Ed. 2d 956 (2007), that bankruptcy courts must give full effect to § 706(d), which provides that "a case may not be converted to a case under another chapter . . . unless the debtor may be a debtor under such chapter." 11 U.S.C. § 706(d). In *Marrama*, the Supreme Court found the debtor had committed acts that constituted cause for dismissal of a chapter 13 case under 11 U.S.C. § 1307(c) for bad faith. Because there was cause to dismiss the case under § 1307(c), the Supreme Court found that the debtor was ineligible to be a debtor under chapter 13 and § 706(d)

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[6] Mr. Arenas testified that he had approximately 25 plants that he valued at $250.00 each.

[7] The Trustee withdrew his report of no distribution in this case and Mr. Arenas testified that he was aware that Denver Patients Group, LLC, had been in discussion with the Trustee about purchasing the Property.

required his motion to convert his case to be denied. *Marrama*, 549 U.S. at 373-74 ("In practical effect, a ruling that an individual's Chapter 13 case should be dismissed or converted to Chapter 7 because of prepetition bad-faith conduct . . . is tantamount to a ruling that the individual does not qualify as a debtor under [**13] Chapter 13."). In *Marrama*, it was the debtor's pre-petition bad faith that provided cause for dismissal under § 1307(c).

Here, there is cause for dismissal § 1307(c) on account of the Debtors' bad faith due to their inability to propose a confirmable chapter 13 plan.[8] Section 1325 of the Bankruptcy Code sets forth the requirements that must be satisfied for a court to confirm a proposed chapter 13 reorganization plan. Among the other requirements, a court must find that a debtor's plan "has been proposed in good faith and *not by any means forbidden by law*." 11 U.S.C. § 1325(a)(3) (emphasis added). Here, the evidence is that any plan of reorganization the Debtors might propose would be funded by a means forbidden by law, thus precluding the Court from confirming [*893] any chapter 13 plan the Debtors might propose. Any plan proposed by the Debtors would be executed with income derived from the Debtors' production and sale of a Schedule I controlled substance and from leasing space in their Property, which is used by their tenant for the distribution of a Schedule I controlled substance. Those activities are unlawful under the CSA. Any plan proposed by the Debtors would necessarily be executed by unlawful means and the Court would be unable to find, under § 1325(a)(3), that their [**14] plan is "proposed in good faith and *not by any means forbidden by law*."

There are cases holding that the identical chapter 11 confirmation requirement that "[t]he plan has been *proposed* . . . not by any means forbidden by law," 11 U.S.C. § 1129(a)(3) (emphasis added) "focuses not on the terms of the plan and its means of implementation but on the manner in which the plan 'has been *proposed*.'" *In re Irving Tanning Co*., 496 B.R. 644, 660 (B.A.P. 1st Cir. 2013). *See also In re Sovereign Group*, 1984-21 Ltd., 88 B.R. 325, 328 (Bankr. D. Colo. 1988). Yet — at least in the chapter 13 context — the requirement, appearing in the same sentence, that "[t]he plan has been *proposed* in good faith . . . ," 11 U.S.C. § 1325(a)(3) (emphasis added), is based on a totality of the circumstances. *See In re Cranmer*, 697 F.3d 1314, 1318 (10th Cir. 2012) ("The [**15] good faith determination is made on a case-by-case basis considering the totality of the circumstances.").

The totality of the circumstances good faith analysis, employed by the courts under § 1325(a)(3), goes far beyond a narrow procedural reading to the term "proposed." *See, e.g., In re Melander*, 506 B.R. 855, 870 (Bankr. D. Minn. 2014) (plan not proposed in good faith where plan found to constitute an abuse of the spirit of Chapter 13 due to the excess expenses claimed); *In re Tucker*, 500 B.R. 457, 463-64 (Bankr. N.D. Miss. 2013) (modification not proposed in good faith where debtor sought to surrender uninsured collateral after it sustained fire damage); *In re Rodriguez*, 487 B.R. 275, 285-86 (Bankr. D. N.M. 2013) (plan not proposed in good faith where debtor manipulated the Bankruptcy Code to discharge ex-spouse claim based on misappropriation of retirement funds while debtor contributes over $700.00 monthly to his own retirement); *In re Amos*, 452 B.R. 886, 894 (Bankr. D. N.J. 2011) (plan not proposed in good faith where debtors proposed plan to pay $0 to unsecured creditors while retaining and making mortgage payments on second home).

In § 1325(a)(3) the word "proposed" refers to two separate clauses within the same sentence. As a result, the subsection creates two separate conditions to confirmation: 1) that the plan be *proposed* "in good faith" and 2) that the plan be *proposed* "not by any means forbidden by law." 11 U.S.C. § 1325(a)(3). "The normal [**16] rule of statutory construction assumes that identical words used in different parts of the same act are intended to have the same meaning." *Sorenson v. Secretary of Treasury*, 475 U.S. 851, 860, 106 S. Ct. 1600, 89 L. Ed. 2d 855 (1986) (citations and internal quotes omitted). Here, the Court is not construing a word used in different parts of a statute but is construing a single word that refers to two separate clauses within a single sentence. It would be anomalous to find that Congress intended for the word "proposed" to carry a broad "totality of the circumstances" meaning with respect to the "good faith" clause and a limited procedural meaning in connection with the "not by any means

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[8] "'Bad faith' sounds like a subjective inquiry . . .. Despite its sound, however, 'bad faith' has an objective meaning as well as a subjective one." *In re TCI Ltd*., 769 F.2d 441, 445 (7th Cir. 1985). The Court does not suggest that the Debtors are animated by an improper motive and are *subjectively* acting in bad faith. The Debtors are seeking relief to which they would surely be entitled but for the unique circumstances of this case. But those circumstances — the impossibility of confirming a chapter 13 plan — make it objectively unreasonable to seek chapter 13 relief and establish the Debtors' *objective* bad faith.

[*894] prohibited by law" clause.[9] The Court concludes that § 1325(a)(3) requires it to examine the lawfulness of a plan's means of implementation in order to satisfy the requirement that "the plan has been proposed . . . not by any means forbidden by law." 11 U.S.C. § 1325(a)(3).

The Court need not speculate or make uncertain predictions of future events to conclude [**17] that the Debtors are unable to lawfully propose a confirmable plan. Mr. Arenas testified that Mrs. Arenas' combined monthly income from Social Security Disability and from a pension benefit is just less than $3,000.00 per month. Mr. Arenas' income, reflected on Schedule I of the Debtors' schedules, is listed as $4,265.16. That consists of lease payments from Denver Patients Group, LLC, a marijuana dispensary, and income from Mr. Arenas' marijuana growing business. Both of Mr. Arenas' sources of income violate the CSA. Only Mrs. Arenas income of approximately $3,000.00 represents funds that are lawful under federal law. The Debtors' reported monthly expenses exceed $7,000.00. The evidence persuades the Court that the Debtors cannot, under the present circumstances, feasibly propose a chapter 13 plan that does not depend upon income from sources that are illegal under the CSA for the plan's execution.

Because the Debtors lack any legal means of proposing a confirmable plan, the Court finds that they are acting in bad faith. Under the rationale of the *Marrama* case, the Debtors are ineligible for relief under chapter 13 and their motion to convert must be denied under 11 U.S.C. § 706(d).

C. Constitutional [**18] Issues

The Debtor argues that the CSA violates the Tenth Amendment to the U.S. Constitution. The Tenth Amendment provides that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. CONST. amend. X.

In the case of *Gonzales v. Raich*, 545 U.S. 1, 125 S. Ct. 2195, 162 L. Ed. 2d 1 (2005), the Supreme Court considered whether the CSA violated the Commerce Clause of the U.S. Constitution. U.S. CONST. art. I, § 8. Users and growers of marijuana in the state of California sought to enjoin enforcement of the CSA with respect to purely intrastate activities that are legal under California's Compassionate Use Act of 1996. CAL. HEALTH&SAFETY CODE § 11362.5 et seq. (West). The Supreme Court held that "the power vested in Congress by Article I, § 8, of the Constitution '[t]o make all Laws which shall be necessary and proper for carrying into Execution' its authority to 'regulate Commerce with foreign Nations, and among the several States' includes the power to prohibit the local cultivation and use of marijuana in compliance with California law." *Raich*, 545 U.S. at 5, 22. In other cases, the Supreme Court "long ago rejected the suggestion that Congress invades areas reserved to the States by the Tenth Amendment simply because it exercises its authority under the Commerce Clause in a manner that displaces the States' exercise of their police powers." *Hodel v. Va. Surface Mining & Reclamation Ass'n*, 452 U.S. 264, 291, 101 S. Ct. 2352, 69 L. Ed. 2d 1 (1981). Since Congress acted within its Constitutional [*895] powers under the Commerce Clause when it [**19] enacted the CSA, it did not violate the Tenth Amendment. *See Raich v. Gonzales*, 500 F.3d 850, 867 (9th cir. 2007) ("Thus, after *Gonzales v. Raich*, it would seem that there can be no Tenth Amendment violation in this case. Raich concedes that recent Supreme Court decisions have largely foreclosed her Tenth Amendment claim.").

III. CONCLUSION

The Court regards the legal analysis necessary for the resolution of this case to be relatively straight-forward while recognizing that the result is devastating for the Debtors. The Debtors' need the relief that would otherwise be available to them under the Bankruptcy Code. It is relief that, under the circumstances, the Court cannot provide. As

[9] Granted, that seems to be how some courts have construed the identical phrase appearing in 11 U.S.C. § 1129(a)(3) as it applies to chapter 11 cases. But, because this is a case under chapter 13, the Court expresses no opinion as to how that language should be construed in a chapter 11 context.

a federal court, the Court cannot force the Debtors' Trustee to administer assets under circumstances where the mere act of estate administration would require him to commit federal crimes under the CSA. Nor can the Court confirm a reorganization plan that is funded from the fruits of federal crimes. The Debtors' ownership and control over premises that are used in the production and distribution of a Schedule I controlled substance as well as Mr. Arenas' direct involvement in the production and sale of a Schedule I controlled substance violate the CSA. The Debtors' activities preclude the orderly operation [**20] of a case under either chapter 7 or chapter 13 of the Bankruptcy Code. Because the Court finds cause to dismiss the Debtor's chapter 7 case under § 707(a) and because the Court cannot permit the Debtors to convert their case under § 706(a), the case must be dismissed. Therefore, it is

ORDERED that Debtor's *Motion to Convert Chapter 7 Case to One under Chapter 13 Pursuant to 11 U.S.C. §348(a) and FED. R. BANKR. P. 1017(f)(2)* (docket #23) is DENIED. It is further

ORDERED that the *United States Trustee's Motion to Dismiss Debtors' Case under 11 U.S.C. §707(a)* (docket #17) is GRANTED.

Dated this 28th day of August, 2014.

BY THE COURT:

/s/ Howard R Tallman

Howard R. Tallman, Judge

United States Bankruptcy Court

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Will U.S. Cannabis Companies Find Grass Is Greener in Canada for Restructuring?

By Jason Rosell, Pachulski Stang Ziehl & Jones LLP

Recreational cannabis use became legal in Canada on October 17, 2018. Canada is now the second country in the world—and the first G-7 nation—to authorize a national cannabis market.[1] The passage of Bill C-45, otherwise known as the Cannabis Act, marks a historical moment for advocates of cannabis legalization.

In the United States in 2018, cannabis supporters celebrated smaller victories, with nine states and the District of Columbia now allowing for recreational cannabis use and 30 states allowing for medical cannabis use. Yet cannabis remains illegal in the United States at the federal level.

The uncertainty and conflict surrounding the legality of cannabis in the United States have not stunted the substantial investments that continue to flow into the burgeoning international cannabis industry. In August 2018, for example, Constellation Brands, the public company behind Robert Mondavi wine and Corona beer, announced a $4 billion investment in Canopy Growth Corporation, a Canadian public company and leading provider of medicinal cannabis products. This latest investment increased Constellation Brands' stake from 9.9 percent to 38 percent, with an option to purchase shares sufficient to increase its stake to more than 50 percent.

Similarly, in May 2017, ScottsMiracle-Gro, the lawn and garden products leader, announced that it was selling its international business in Europe and Australia and investing $150 million of the proceeds into growth areas like hydroponics and soilless gardening, both often used in marijuana cultivation. In yet another example, in 2015, Pax Labs, a manufacturer of portable vaporizers, raised $46.7 million from established investors, including Fidelity Investments.

This appetite for risk in the United States is not surprising considering the projected growth in the cannabis industry. In California, where recreational cannabis became legal on January 1, 2017, legal cannabis sales are expected to reach $3.1 billion in 2018 and grow to $7.6 billion by 2022. In the United States, legal cannabis sales are expected to reach $24.1 billion by 2025, up from $6.6 billion in 2016.[2]

Notwithstanding the industry's projected growth, business failures, whether from insufficient capital, natural disasters, or plain old-fashioned bad management, are inevitable. Traditionally, companies that fail or face financial distress in the United States can file bankruptcy, which allows for either a financial or operational reorganization or the orderly liquidation of assets to maximize value for stakeholders. However, cannabis companies are effectively prohibited from filing bankruptcy in the United States.[3]

Bankruptcy Courts generally dismiss cannabis-related cases on grounds that either (1) a bankruptcy trustee cannot administer the assets without violating federal law or (2) a Chapter 11 or Chapter 13 bankruptcy plan cannot comply with the good faith requirements of Section 1129 of the Bankruptcy Code because such a plan would necessarily seek to violate federal law, *i.e.*, the Controlled Substances Act.[4]

This result—the unfortunate byproduct of U.S. states allowing conduct that the federal government does not—is causing substantial challenges for restructuring professionals. Traditionally, bankruptcy serves as a storm shelter for distressed companies, but its protections are not available to the myriad cannabis companies expanding under the hope of full legalization.

In other words, cannabis companies—and their creditors—are left exposed at a time when a distressed storm is gathering on the horizon for them. The projected growth of the legal cannabis industry is attracting sophisticated investors, whose investments are driving a robust industry consolidation in search of economies of scale. There will inevitably be losers—but with access to U.S. Bankruptcy Courts effectively shut off to cannabis companies, how will these distressed companies effectively restructure or liquidate?

Assignments for the benefit of creditors (ABCs) and state court receiverships may be viable options, but each has its drawbacks. Specifically, an ABC does not stay litigation, and litigious creditors can frustrate a potential sale of the company. In addition, the assignee of an ABC is generally selected by the company and lacks the power or ability to conduct a fulsome forensic investigation, something investors may want to pursue if they suspect mismanagement of funds. State court receivers generally are not authorized under applicable receivership statutes to recover preferential payments to creditors or insiders that occurred prior to the receivership.

Chapter 15 – Comity vs. Public Policy

A creative option exists for U.S. cannabis companies with a presence in Canada looking to effectuate a restructuring or orderly liquidation: a Canadian insolvency proceeding coupled with a Chapter 15 proceeding in the United States.[5] Though this scenario remains untested, it is established that Canada allows cannabis companies to institute insolvency proceedings. For example, in the context of its restructuring process under the Bankruptcy and Insolvency Act, Peloton Pharmaceuticals Inc. sold its assets to Aurora Cannabis Inc., a publicly traded company listed on the Toronto Stock Exchange. The transaction was done through a proposal providing for a reorganization of Peloton's share capital, allowing creditors to be paid in full.

Further, this option has the potential to apply to a great many cannabis companies. Established cannabis companies based in the United States are no stranger to Canada. In fact, there is a growing trend of stateside companies tapping the Canadian capital markets. For example, MedMen Enterprises Inc., a vertically integrated cannabis company with cultivation, manufacturing, and dispensary operations, operates in California, New York, and Nevada, and recently listed its shares publicly on the Canadian Securities Exchange with an approximate $1.75 billion market cap.

Unlike common Chapter 7 or Chapter 11 plenary insolvency proceedings, Chapter 15 cases are specialized ancillary proceedings intended to provide effective mechanisms for dealing with cases of cross-border insolvency. Importantly, cases commenced under Chapter 15 also provide many of the protections afforded to companies in Chapter 7 or Chapter 11, including a stay of all pending litigation and collection efforts to provide a distressed company with breathing room to restructure. 11 U.S.C. Sections 1501(a) and 1520.

However, there are several key differences between an ancillary Chapter 15 case and a plenary Chapter 7 or Chapter 11 case. In the context of distressed cannabis companies, the key relevant difference is that, unlike a plenary case, an ancillary Chapter 15 case does not create an estate under Section 541(a) of the Bankruptcy Code.[6] Accordingly, the hypothetical concerns of the United States Trustee regarding administering cannabis assets are not applicable.

Nevertheless, any debtor seeking Chapter 15 recognition of a Canadian insolvency proceeding should be prepared for the United States Trustee to dispute the filing. The United States Trustee can reasonably be expected to argue that the public policy exception applies such that a U.S. Bankruptcy Court should refuse to recognize the foreign reorganization of a cannabis business as "*manifestly contrary to the public policy of the United States*." 11 U.S.C. Section 1506 (emphasis added).

But hope for future cannabis debtors is not lost. The public policy exception of Chapter 15 was adopted from the model law put forth by the United Nations Commission on International Trade Law (UNCITRAL). Thus, UNCITRAL's interpretation of the public policy exception is instructive. Member countries of UNCITRAL have historically viewed the exception as limited to issues of a constitutional nature and for narrow construction in an international context. UNCITRAL added the word "manifestly" to its model law to make this intended narrow scope clear on the face of the statue.[7]

Further, there is case law from U.S. Bankruptcy Courts to support the limited public policy exception in Section 1506. In *RSM Richter Inc. v. Aguilar*, the court noted that the legislative history of Section 1506 limits its use to "the most fundamental policies of the United States" and ruled that certain claims resolution mediation procedures implemented by the Ontario Superior Court were fair and impartial and not manifestly contrary to the public policy of the United States.[8]

In *In re Metcalfe & Mansfield Alternative Investments*, the Bankruptcy Court considered whether enforcing non-debtor releases contained in a Canadian order would be manifestly contrary to the public policy of the United States and noted that the releases and the Canadian lower court's jurisdiction to grant them had been approved by the Canadian Court of Appeals.[9] The Bankruptcy Court also noted that the Section 1506 public policy exception was to be narrowly construed, that "[t]he relief granted in the foreign proceeding and the relief available in a U.S. proceeding need not be identical," and that comity should be granted to the Canadian orders.[10]

In contrast, the court in *In re Qimonda* took a more expansive approach to the exception on remand, ultimately declining to defer to the German law that permitted the administrator to terminate patent licenses. The *Qimonda* court found that failure to apply Section 365(n) of the Bankruptcy Code would undermine the public policy of the United States of promoting technological innovation.[11]

While controversial for its broader interpretation of the public policy exception, the decision in *In re Qimonda* is at least arguably consistent with the widely accepted understanding that the exception should be limited to "the most fundamental policies of the United States;" the promotion of technological innovation is commanded by the U.S. Constitution itself. Article I, Section 8, Clause 8.

Prior to remand, the District Court in *In re Qimonda* espoused the following three principles to guide courts in applying the public policy exception:

1. The mere fact of a conflict between foreign law and U.S. law is not sufficient to support a public policy exception

2. Deference should not be afforded to a foreign proceeding if its procedural fairness is in doubt and cannot be cured

3. An action should not be taken in a Chapter 15 proceeding where it would frustrate a U.S. court's ability to administer the Chapter 15 case or would severely impinge a U.S. constitutional right.[12]

Applying these factors, a U.S. Bankruptcy Court may legitimately conclude that the recognition of a Canadian plenary proceeding involving cannabis assets is not contrary to public policy. First, as recognized in *Qimonda*, a conflict between foreign law and U.S. law is not sufficient to support the public policy exception. Second, there is nothing to suggest that Canadian insolvency proceedings are inherently unfair, as they are consistently recognized in the United States. Third, recognition of a Canadian cannabis proceeding would not frustrate the U.S. court's ability to administer a Chapter 15 case or infringe on U.S. constitutional rights. To the contrary, recognition of a Canadian cannabis proceeding would provide a forum for U.S. creditors to adjudicate their claims in a fair and equitable manner.

Conclusion

Until cannabis becomes legal on a federal level in the United States and companies and their creditors operating in the space are able to access the country's Bankruptcy Courts, a Canadian plenary proceeding coupled with a Chapter 15 ancillary proceeding may be a practical and creative solution. This idea may face staunch opposition, but practitioners should welcome the challenge and strive to forge a new path.

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1. Uruguay legalized cannabis in 2013, although legal retail sales did not begin until 2017.
2. The State of the Legal Marijuana Markets, 6th Edition, produced by Arcview Market Research & BDS Analytics.
3. *In re Arenas*, 514 B.R. 887 (Bankr. D. Colo. Aug. 28, 2014) (marijuana grower's Chapter 7 case dismissed because the trustee could not administer the business without violating federal law); *In re McGinnis*, 453 B.R. 770 (Bankr. D. Or. 2011) (the Bankruptcy Court denied confirmation of a Chapter 13 plan on feasibility, stating the sale and cultivation of marijuana is illegal under federal law).
4. A plan must be proposed in good faith. Courts have held that a plan proposed by a debtor that is involved in an illegal enterprise is not in good faith, even where the debtor does not have a subjective bad motive. *Arenas v. U.S. Trustee (In re Arenas)*, 535 B.R. 845, 852-53 (10th Cir. BAP 2015); *In re Rent-Rite Super Kegs W., Ltd.,* 484 B.R. 799, 809-10 (Bankr. D. Colo. 2012). Moreover, some courts have concluded that a debtor engaged in an illegal business who seeks bankruptcy relief comes into court with unclean hands and is not eligible for relief. *Id.* at 807; cf. I*n re Medpoint Mgmt., LLC,* 528 B.R. 178, 184-87 (Bankr. D. Ariz. 2015) (petitioning creditors who knew the debtor was engaged in the cannabis business had unclean hands and could not seek relief from the Bankruptcy Court).
5. In the event a cannabis company is accessing Canadian capital markets without a presence in Canada or by a non-Canadian entity, it may be worthwhile to establish a Canadian holding company with a presence in Canada.
6. *In re JSC BTA Bank,* 434 B.R. 334, 341 (Bankr. S.D.N.Y. 2010).
7. Guide to Enactment of Model Law of 1997, ¶¶ 87–89. The Guide to Enactment was revised in 2013.
8. *RSM Richter Inc. v. Aguilar (In re Ephedra Products Liability Litigation)*, 349 B.R. 333 (S.D.N.Y. 2006).
9. *In re Metcalfe & Mansfield Alternative Investments*, 421 B.R. 685 (Bankr. S.D.N.Y. 2010).
10. *Id.* at 697-98.
11. *In re Qimonda AG*, 462 B.R. 165 (Bankr. E.D. Vir. 2011), certified for direct appeal, 470 B.R. 374 (E.D. Va. 2012), aff'd, *Jaffé v. Samsung Elecs. Co*., 737 F.3d 14 (4th Cir. 2013).
12. *In re Qimonda AG Bankr. Litig.,* 433 B.R. 547, 570 (E.D. Va. 2010).

About The Author

Jason Rosell is an attorney at Pachulski Stang Ziehl & Jones LLP. His experience includes representing debtors and creditors in complex cross-border insolvency cases and assignments for the benefit of creditors. He is a member of the board of the TMA Northern California Chapter and has moderated panels on cannabis restructuring opportunities. Rosell holds a bachelor's degree in computer information systems, an MBA, and law degree, all from Arizona State University.