AMERICAN BANKRUPTCY INSTITUTE

2018 Winter Leadership Conference

"Realty Bites": Ethical Issues in Real Estate Cases

Hosted by the Ethics & Professional Development and Real Estate Committees

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CONCURRENT SESSION

2018

REALTY BITES – ETHICAL ISSUES IN REAL ESTATE CASES

MATERIALS PREPARED FOR THE

2018 ABI WINTER LEADERSHIP CONFERENCE

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SCOTTSDALE, ARIZONA

Discussion will arise from scenarios grounded in real estate and ethics, and focus on ethical issues surrounding initial interviews and conflict checks, ethically pursuing cases posing potential good/bad faith issues due to cannabis related uses of the real property, whether "zealous representation" is still a guiding principle, whether one may ethically use internet "information" as a litigant and Judge, and how to appropriately raise potential Judicial misconduct.

PANEL

Hon. Laurel Myerson Isicoff, Chief Bankruptcy Judge, S.D. Florida
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OUTLINE:

ISSUES FOR ETHICS IN REAL ESTATE CASES – ABI PANEL DEC. 2018

REALTY BITES – CHOMPING INTO CURRENT ETHICAL ISSUES IN RE CASES

ISSUES:

1) **WHEN IS A CLIENT RELATIONSHIP COMMENCED?**

   FIRM INTERVIEW – CAN YOU DISCLOSE TO CONFLICT CLIENT?

   COUNSEL SHOPPING & DEFENSES

2) **IS GOOD FAITH / BAD FAITH FILING STILL A CONCERN?**

   OBJECTIVE/SUBJECTIVE

   NEW CASES

3) **CAN A BUSINESS DERIVING REVENUE FROM MARIJUANA SALES OR PRODUCTION FILE CHAPTER 11 IN GOOD FAITH?**

   A. **NATURE OF DEBTOR: GROWERS, CLINIC/DISTRIBUTER/SELLER, LANDLORD**
   B. **28 USC 158? FEDERAL CONTROLLED SUBSTANCES ACT?**
   C. **OTHER?**
   D. **IS NOT FILING A BORDERLINE CASE A FAILURE TO MEET ZEALOUS REPRESENATION STANDARD**
      1. **Origin and current standing of "zealous" requirement**
      2. **Application to MJ cases?**

4) **ETHICAL USE OF INTERNET RESEARCH:**
   A. **LITIGANTS**
   B. **JUDGES**
      (JUDICIAL NOTICE / ABA RULE)

5) **IF A JUDGE OVERSTEPS, HOW DO LITIGANTS RAISE THE ISSUE(S)?**

THE CASE OF

THE HIGHLY REGARDED MALL

PARTIES:

HIGHLY REGARDED INVESTORS, LLC ("HRI") (POTENTIAL DEBTOR)
HIGHLY REGARDED FARMS, INC (SUBSIDIARY)
HIGHLY REGARDED DISPENSARIES, INC. (SUBSIDIARY)
CAL E. GROWER (PRINCIPAL/OWNER OF HRI)

M.T. RE Ventures – owner of Mall of the Freeway

Owner: R.E. Taylor

Lienholder: Oldway Lending, Inc.

Acapulco & Gold, PC: **potential Debtor's counsel for HRI**

Zonker, Harris & Trudeau: **retained counsel for HRI**

Jones Eng Lending: **potential DIP lender**

Potential Tenants:

HR Dispensaries, Inc. – medical marijuana dispensary

Collaborative Space Tech, a software development firm; and

Higher Authority Foods – processing and packaging plant (packaging HR Farms medicinal products)

HON. BANKRUPTCY JUDGE KAI BOSCH, District of Highland, CA

SCENE I A CLIENT INTAKE PHONE CALL

ACAPULCO & GOLD PC attorney Phil Gold receives a call from a prospective client, Cal Grower, principal of Highly Regarded Investors and related companies. Cal says:

- **He has an option contract to buy Mall of the Freeway for $7.5 Million and he is in danger of losing it due to its imminent expiration.**
- **His vision is to turn the Mall into a Cannabis Campus, featuring an interior climate controlled hydroponic farm to raise cannabis, with related businesses around the perimeter such as a Medical Marijuana dispensary, a medical marijuana food processing plan, a shop selling pipes and other equipment, a smoking lounge, and the first MJ related museum to be named after Hunter S. Thompson. His subsidiaries will be some of the tenants.**
- **He thinks he might call the whole project "Wayne's Wonderful World" or "Cloud Mall".**
- **He understands that a Chapter 11 might work to preserve the option rights while he raises the remaining green necessary to fund the purchase. He has already raised $2 million.**
- **He asks if he is short on the equity raise, can HRI buy the property and then use Chapter 11 to stretch out the existing secured lender instead of paying the lender off.**

Gold says, "interesting, but before I hear more, I need some information to run a conflict check…who is involved and what property? After my review I will email you."

Gold learns that:

- **His potential client would be HR Investors, owned by Cal E. Grower.**
- **The Mall property is owned by M.T. RE Ventures, LLC, owned by R.E. Taylor.**
- **The Mall is subject to a mortgage held by Oldway Lending, Inc.**

Gold runs a conflict check and learns that his firm has a long-standing and ongoing client relationship with Oldway. Gold emails Grower that he has a conflict and cannot take the matter.

<u>Issues:</u>

Grower emails back asking who the conflict relates to. Should or must Gold respond?

After running the conflicts check, Gold mentions to his law partner that he heard that Oldway may find itself holding a lien on something called Wayne's Wonderful World. Law

partner calls the CEO of Oldway to find out what's going on with the lien on Mall of the Freeway.

What can Partner tell the CEO about the call between Gold and Grower?

What if the information will be public in a week or two anyway?

Can Oldway hire Acapulco & Gold to represent Oldway in a bankruptcy of HR Investors:

Before HR closes on the property?

After HR closes on the property?

If Gold is walled off from the matter?

If Partner notices that the Schedules filed in the case fail to list any cash, but Gold told him that HR had already raised a portion of the purchase price, can he:

Mention this to CEO?

Ask about the issue at the 341 hearing?

SCENE II TO FILE OR NOT TO FILE

Zonker Harris attorneys consider filing the Chapter 11 for HRI. They mull over the following information:

- **HR Investors has now raised $4.20 million of the $7.5 million necessary to perform under its option contract.**
- **The funds are in an escrow account and may not be released pursuant to the terms and conditions in the related investor subscription agreements except for the purpose of closing on the purchase pursuant to the option.**
- **The subscription agreement does not specify the purpose for which the acquired property will be used, only that the entity will endeavor to repurpose and revive the property to enable a stream of revenue from rental use that will provide an acceptable rate of return to the investors.**

HR Investors Balance Sheet looks like this:

Cash:	**$80,000**	
Option Rights:	**$50,000**	**at cost/option fee paid**
Long Term Liab's	**$100,000**	**note to owner**
Credit lines/Cards	**$42,000**	**various**

Can HR Investors file a Chapter 11 in good faith?

a) **In its current financial state with the goal of saving the equity in the option and then dismissing the case;**
b) **To exercise the option and implement its redevelopment plan for the Cloud Mall / Wayne's Wonderful World?**
c) **If HR Investors acquires the property but does not become the operator or grower of any of the operations, but instead signs leases with HR Growers, HR Dispensaries, and the various other anticipated businesses, does that impact the good faith issue?**
d) **If the tenant mix includes Collaborative Space Tech, Starbucks, and Olive Garden along with the other tenants?**
e) **If none of the proposed tenants were affiliates or insiders of Debtor?**
f) **If Jones Eng Lending brings forth a proposal to fund a DIP loan and financing to emerge from the Chapter 11, and all other analysis shows that the Wayne's World project will be financially viable, and all creditors have accepted the Plan, can it meet confirmation criteria?**
    Federal Law?
    State Law?
    Good Faith?

g)if the Law in this area is still developing, but Zonker Harris both advises against the filing, and refuses to file the case upon client's request, has Zonker Harris failed to meet standards of Zealous Representation?

SCENE III MOTION TO DISMISS

Old Style files a Motion to Dismiss based on a bad faith filing. HRI's response offers articles from the Internet on: (1) the future of the MJ business in the USA, (2) the upcoming trend of repurposing regional malls as agricultural related centers, (3) a month's worth of

postings on the Blog "Greener Pastures" showing hundreds of area residents support the redevelopment and the Cloud Mall concept, can the internet evidence be:

Ethically submitted by counsel?

Ethically considered by the Court?

SCENE IV THE HEARING

Judge Kai Bosch opens the hearing on the Motion to Dismiss by stating, "This case has had a very calming effect on the Court. I have been doing my own research on the internet, toking/taking (chuckle) judicial notice you know, of many related articles. It does seem to the Court that medicinal marijuana is here to stay in Highland County, that the repurposing of the Mall will create new jobs and commerce locally and the public interest would be served by allowing Debtor to pursue confirmation of a reorganization plan consistent with their stated purposes. I believe that this reorganization case should go forward. I therefore deny the Motion to Dismiss. Debtor may lodge an appropriate order. Now, can someone pass me the plate of Brownies brought in by Debtor?"

ISSUES:

Oldstyle Lending is incensed by the ruling, but also believes that the Judge breached ethical duties by doing and relying on internet research, may have been impaired while on the bench, and wants to take action. What are the appropriate next steps?

POTENTIAL CLIENTS ARE POTENTIAL HEADACHES

BY

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THE AUTHOR ACKNOWLEDGES HIS RELIANCE ON THE ETHICS TIP COLUMN IN THE ABA JOURNAL, MARCH 2015, *THE ONCE AND FUTURE CLIENT* BY PETER GERAGHTY AND SUSAN MICHMERHUIZEN.

Model Rule 1.18 Adopted

Model Rule 1.18 was adopted by the ABA in 2002 based on the revisions proposed by the Ethics 2000 Commission. The Rule introduced the concept of a "**prospective client**" and set forth duties of confidentiality and loyalty owed to such a client. Prior to the Rule, litigation was focused on whether a client-lawyer relationship existed, and the results of the analysis were unpredictable, especially with respect to conflict of interest rules and unsolicited communications.[1] Only a handful of Southern states (AL, GA, MS, TX, and VA) have not adopted a version of Rule 1.19.[2]

Prospective Client

When you are faced with the potential application of the Rule to a fact situation, your analysis should begin with whether you have had a discussion or other communication (even if it was unilateral) with a person or a representative genuinely interested in forming a lawyer-client relationship. In the case of a unilateral solicitation from the person, he or she must have had a reasonable expectation that you would be interested in discussing such a relationship. If the person has communicated with you while posing as a prospective client just to disqualify you, the person does not qualify as a prospective client, and you owe that person no duty.[3]

What information is Confidential?

The information imparted during any consultation with a prospective client that should be protected is that non-public information which, if disclosed, could be **significantly harmful** to

[1] *Not Quite a Client*, Moore, Nancy J., ABA Journal, Jan. 2004, ABA Connection column.
[2] Current links to state Rules and variations of the Model Rule language can be found at www.americanbar.org/groups/professional_responsibility/resources/links_of_interest
[3] *See* State Bar of Virginia Ethics Op. 1794 (2004).

the prospective client. This could be sensitive information or information with long-term significance.[4] Obviously, the inquiry will be a highly factual question.[5]

Some examples of significant harm:

1. Sturdivant v. Sturdivant, 241 S.W. 3d 740 (Ark. 2006). The law firm could not represent the wife in a custody matter after being told "everything" by the former husband.
2. Cascades Branding Innovations LLC v. Walgreen Co., Not reported in F.Supp. 2d, 2012 WL 1570774 (N.D. Ill.). Disqualified counsel in a potential infringement case had consulted with the opposing party and learned its policies and litigation strategies ("playbook information").

In other cases, courts have found **no** significant harm:

1. Mayers v. Stone Castle Partners LLC, 1 N.Y.S. 3d 58, 2015 N.Y. Slip Op. 00295. Information had no potential to be significantly harmful in litigation.
2. In re Perry, 293 P.3d 170 (Mont. 2013). Three phone calls to law firm years earlier did not convey substantially harmful information.

Duty of Loyalty – Conflict of Interest

Once it is determined that a lawyer has received significantly harmful information from a prospective client, that knowledge is imputed to the law firm for the purposes of creating a disqualifying conflict of interest **unless** it can be shown that the lawyer took reasonable measures to avoid receiving more communications **plus** the firm timely implements an ethical screen **and**

[4] Opinion CI-10-03 (2011) (State Bar of Wisconsin)
[5] N.Y. City Formal Ethics Op. 2006-2 (2006)

gives prompt written notice to the prospective client. Alternatively, the affected client and the prospective client can give informed written consent waiving the conflict.[6]

Implementing an ethical screen means prohibiting communications between the lawyer(s) who consulted with the prospective client and the lawyer(s) who will be representing the adverse client. The imposition of the screen must be swiftly communicated to the entire firm in sufficient detail to alert the firm that this is an important and continuing ethical requirement. The lawyers who are being screened from each other should sign the notice to acknowledge their personal awareness of the screen's existence. Access to relevant files and communications should be restricted both physically and electronically.

An example of a notice establishing an ethical screen is attached as Addendum One.

Beauty Contests

Contestant firms in "Beauty Contests" must be particularly attentive to avoid being conflicted from representing other clients who may be adverse to orchestrator of the Contest. The best way to avoid a conflict is not to receive any significantly harmful information.[7] The firm might consider asking the orchestrator for a signed acknowledgment that the firm was not given any confidential information. If the firm did receive such information, it must resort to the ethical screen discussed above.

Information Intake

Lawyers and law firms should remain aware of the risks presented by potential clients, especially those who unilaterally contact lawyers to inquire about retention. Firms should insure that their websites contain appropriate warnings and disclaimers discouraging would-be potential clients from sending unilateral communications and disclaiming any intent to form a client-

[6] See N.Y. City Formal Ethics Op. 2006-2 (2006); N.C. Ethics Op. 2003-8 (2003).
[7] See e.g. the Association of the Bar of the City of New York Opinion 2013 (2013)

lawyer relationship as a result of any unilateral contacts. Lawyers should be sensitive to potential client rules and issues and advise prospective clients to refrain from sharing sensitive information until after a conflicts check has been performed. For multi-state firms, they should note that there are numerous versions of Rule 1.18 depending on the state or states involved.[8]

8. See Note 2 (supra).

ADDENDUM ONE

Re: Implementation of Ethical Wall to screen lawyers consulted by ABC Company in the Alpha case from lawyers representing XYZ Company in the Alpha case

ABC Company ("ABC") consulted with the Firm to represent it in the case of *Alpha v. Bravo et al* ("Alpha Case"). Frank S. discussed the representation with ABC but ultimately ABC retained another firm. Firm client XYZ Company ("XYZ") is a co-defendant and has retained the Firm to represent XYZ in the Alpha case.

Because ABC may have inadvertently shared material information with Frank S., it is necessary to erect an Ethical Wall to screen Frank S. from the Firm's work on behalf of XYZ on the Alpha case. Pursuant to this Ethical Wall, which is already in place, Frank S. cannot work on the representation of XYZ in the Alpha case, and likewise the attorneys and staff members representing XYZ in the Alpha case cannot consult with Frank S. about the case.

Accordingly, all attorneys, employees and staff of the Firm must comply with the following requirements. These requirements are simple but must be scrupulously followed. If you have any questions regarding these requirements, please address them directly to me.

1) XYZ team members cannot consult with Frank S. about the Alpha case.

Frank S. is prohibited from discussing his preliminary consultation with ABC about the Alpha case with any attorney or staff member of the Firm. This includes even general conversion if relating to any aspect of the consultation. This same prohibition applies to any other attorney or staff member having knowledge of the consultation.

2) Frank S. cannot work on XYZ matters related to the Alpha case.

Frank S. is not allowed to work on XYZ matters related to the Alpha case. This includes even rendering general advice if directed to our representation of XYZ in this matter. This same restriction applies to any other attorney or staff member consulted by ABC with respect to potential representation of ABC in the Alpha case.

3) Access to these files must be restricted.

Frank S. is not allowed to access XYZ files related to the Alpha case. The same restrictions apply to any other attorney or staff member consulted by ABC with respect to potential representation of ABC in the Alpha case.

4) There must be no communication with Frank S. regarding the representation of XYZ in the Alpha case.

Under no circumstances may anyone communicate with Frank S. regarding the representation of XYZ in the Alpha case. This includes communication regarding any issue or matter pertaining to the representation and even communication that might otherwise be considered casual conversation. This same restriction applies to any attorney or staff member consulted by ABC with respect to potential representation of ABC in the Alpha case.

5) The screening must be publicized.

This memorandum is being sent to every attorney and staff member at the Firm.

6) Acknowledgments will be executed evidencing this Ethical Wall

The XYZ team members, Frank S. and any other attorney or staff member consulted by ABC with respect to potential representation of ABC in the Alpha case must acknowledge receipt of this Ethical Wall by printing out a copy of this Ethical Wall, signing the hard copy and routing that signed copy to George M. Chair of the Ethics Committee.

"Cause I Gotta Have [Good Faith]"

Scott B. Cohen

September 4, 2014*

(updated October 2018* by Scott B. Cohen and Steven N. Berger)

for ABI WINTER LEADERSHIP CONFERENCE

December 8, 2018

***Since the publication of the original materials contained herein in September 2014, courts continue to consider good/bad faith as grounds for dismissal and conversion of Chapter 11 cases. Additional cases have been added at the end of the original article.**

Abstract: *These materials examine dismissal of a chapter 11 bankruptcy case for lack of "good faith" under 11 U.S.C. §1112(b). Consideration is given to traditional "bad faith" factors such as the debtor's financial condition, motives, and local economic environments. The analysis then turns to the various tests (i.e., subjective bad faith, totality of the circumstances, and objective futility) applied by the circuit courts. Lastly, an update of the case law is provided.*

I. Conversion or Dismissal under 11 U.S.C. §111. [FN5]

A. One remedy available to the court is conversion. 11 U.S.C. §1112(a). More specifically, §1112(a) provides the debtor a right to convert the Chapter 11 case to case under Chapter 7, unless (i) a trustee has been appointed, (ii) the case was commenced via an involuntary petition, or (iii) the case was converted from Chapter 7 or 13 to Chapter 11 by a party other than the debtor's. 11 U.S.C. §1112(a).

B. Alternatively, on a motion of any party in interest, and following notice and a hearing, the court must convert a Chapter 11 case to a Chapter 7 case, or dismiss the case (whichever is in the best interest of creditors and the estate), if the movant demonstrates "cause." 11 U.S.C. §1112(b)(1); 5 *Norton Bankr. L. & Prac.* 3d §103:6 (2014). A motion to convert or dismiss, unlike a motion for relief from the automatic stay, must be noticed to all creditors and parties-in-interest. *See* Fed.R.Bank.P. 2002(f)(2).

C. After the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), when "cause" exists, conversion or dismissal is mandatory (i.e., from "may" to "shall"), unless the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate. 11 U.S.C. §1112(b)(1).

D. Since BAPCPA, a motion for conversion or dismissal must be given accelerated docketing. Pursuant to 11 U.S.C. §1112(b)(3), the court must commence the hearing not later than 30 days after the filing of the motion and must decide the motion no later than 15 days after commencement of the hearing. BAPCPA, however, contains two exceptions to these time demands: 1) movant may waive them; or 2) "compelling circumstances" exist that prevent the court from meeting the established time limits. [Practice pointer: Neither expect nor promise that these timelines will govern as they are waivable. In my experience, bankruptcy judges are quite adept at extracting "voluntary" waivers from counsel.]

E. Section 1112(b)(4) lists sixteen non-exhaustive examples of "cause" for conversion or dismissal. 5 *Norton Bankr. L. & Prac.* 3d §103:6 (2014). The factors are as follows: §1112(b)(4)

(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 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.

F. It should not come as a surprise that, "[t]he bankruptcy court has broad discretion in deciding whether to dismiss or convert a Chapter 11 case." *Lumber Exch. Bldg. Ltd. Partnership v. Mutual Life Ins. Co. of New York (In re Lumber Exch. Bldg. Ltd. Partnership)*, 968 F.2d 647, 648 (8th Cir. 1992) (citations omitted); *In re SR Real Estate Holdings, LLC*, 506 B.R. 121, 125 (Bankr. S.D. Cal. 2014) ("Section 1112(b) allows the court broad discretion to convert or dismiss a case for cause.").

G. "Good faith" *per se* is not one of the enumerated examples in 11 U.S.C. §1112(b)(4). Moreover, "good faith" is not an eligibility requirement set forth in 11 U.S.C. §109.

H. Nonetheless, the U.S. Circuit Courts of Appeal have widely recognized "good faith" as an implied standard for bankruptcy petitions. *See, e.g., In re SGL Carbon Corp.*, 200 F.3d 154, 160 (3d Cir. 1999); *C-TC 9th Ave. P'ship. v. Norton Co.*, 113 F.3d 1304, 1310 (2d Cir. 1997); *Udall v. FDIC (In re Nursery Land Dev., Inc.*, 91 F.3d 1414, 1416 (10th Cir. 1996); *In Re Trident Assoc. L.P.*, 52 F.3d 127, 131 (6th Cir. 1995), cert. denied, 516 U.S. 869 (1995); *Marsch v. Marsch*, 36 F.3d 825, 828 (9th Cir. 1994); *First Nat'l Bank of Sioux City v. Kerr (In re Kerr)*, 908 F.2d 400, 404 (8th Cir. 1990); *Carolin Corp. v. Miller*, 886 F.2d 693, 699 (4th Cir. 1989); *Phoenix Piccadilly Ltd. v. Life Ins. Co.*, 849 F.2d 1393, 1394 (11th Cir. 1988); *Little Creek Dev. Co. v. Commonwealth Mortgage*, 779 F.2d 1068, 1072 (5th Cir. 1986); *In re Madison Hotel Assocs.*, 749 F.2d 410, 426 (7th Cir. 1984); *Connell v. Coastal Cable T.V.*, 709 F.2d 762, 765 (1st Cir. 1983). [FN6]

I. For over a century, courts have implied the "good faith" requirement into the U.S. Bankruptcy Code. *See Little Creek Dev. Co.*, 849 F.2d at 1071 ("Every bankruptcy statute since 1898 has incorporated literally, or by judicial interpretation, a standard of good faith for commencement, prosecution, and confirmation of bankruptcy proceedings.").

J. The purpose of the good faith standard is "to determine whether the petitioner's real motivation is 'to abuse the reorganization process,' and to cause hardship or to delay creditors by resort to the Chapter 11 device merely for the purposes of invoking the automatic stay, without an intent or ability to reorganize his financial activities." *Carolin Corp. v. Miller*, 886 F.2d at 702.

K. A "[d]ebtor bears the burden of proving that the petition was filed in good faith." *Leavitt v. Soto (In re Leavitt)*, 209 B.R. 935, 940 (9th Cir. BAP 1997) (citing *In re Powers*, 135 B.R. 980, 997 (Bankr.C.D.Cal.1991)). *See also In re Marshall, 721* F.3d 1032,1048 (9th Cir. 2013).

L. BAPCPA may have cleared up some confusion regarding the requirement that movant must initially establish "cause" including, but not limited to, debtor's "bad faith." *See* Patrick A. Jackson & Robert S. Brady, *Dismissal for Bad-Faith Filing under §1112(b)(l): Whose Burden Is It, Anyway?* ABI Journal, Vol. XXVIII, No. 10. (Dec/Jan. 2010).

M. Bankruptcy court has the inherent power to raise the issue of good faith filing in chapter 11 cases *sua sponte* as an inquiry into its jurisdiction. *In re Little Creek Dev. Co.*, 779 F.2d 1068 (5th Cir. 1986); *In re Loeb Apartments, Inc.*, 89 F.2d 461, 463 (7th Cir. 1937).

II. Bad Faith/Good Faith.

A. Totality of the Circumstances. The "good faith" standard turns, in part, on the totality of the circumstances of each case. *See Marsch*, 36 F.3d at 828 (noting that good faith "depends on an amalgam of factors and not upon a specific fact."); *Little Creek Dev. Co.*, 849 F.2d at 1068; *Carolin Corp. v. Miller*, 886 F.2d at 701; *In re SGL Carbon Corp.*, 200 F.3d 154, 165 (3d Cir. 1999) ("We also consider whether other evidence establishes the good faith of SGL Carbon's petition, that is, whether the totality of facts and circumstances support a finding of good faith."); *see generally* Alan Resnik, et al., *Collier on Bankruptcy* ¶1112.07 [2] (16th ed. 2011).

B. Factors. Courts have found bad faith when the following factors were involved:

- false or misleading information;
- failure to comply with court orders, rules or other procedures;
- use of the bankruptcy as a vehicle to defraud others;
- use of the bankruptcy filing to escape family obligations;
- the secretion of property, and other efforts to avoid the disclosure of assets;
- use of the bankruptcy process to avoid prior misconduct;
- filing a petition to avoid an obligation where the debtor is not in need of reorganization;
- the absence of legitimate debts;
- the absence of any likelihood of rehabilitation;
- use of the bankruptcy filing to resolve disputes between equity security holders;
- use of the bankruptcy system to frustrate the rights of creditors (particularly regarding single asset cases) or to coerce unfair treatment;
- serial filings without any change in financial condition; and
- the presence of factors typical of the "new debtor syndrome." Collier on Bankruptcy at ¶1112.07[2] (citations omitted). *See also In re Primestone Inv. Partners, L.P.*, 272 B.R. 554, 557 (D.Del. 2002) (listing 13 factors to consider for determination of good faith filing); *In re Stolrow's Inc.*, 84 B.R. 167 (9th Cir. BAP 1988) (using an 8 factor test).

C. Traditional Factors. Primary consideration is given to the debtor's "financial condition, motives, and the local financial realities." *In re Cedar Shore Resort, Inc.*, 235 F.3d 375 (8th Cir. 2000); *see also In re Little Creek Dev. Co.*, 779 F.2d 1068, 1072 (5th Cir. 1986) ("Determining whether the debtor's filing for relief is in good faith depends largely upon the bankruptcy court's on-the-spot evaluation of the debtor's financial condition, motives and the local financial realities.").

D. Objective Futility. For some courts, subjective bad faith standing alone is insufficient to warrant dismissal. *See In re Cohoes Indus. Terminal, Inc.*, 931 F.2d 222, 227 (2nd Cir. 1991) (holding that a "Chapter 11 bankruptcy may be deemed frivolous if it is clear that on the filing date there was no reasonable likelihood that the debtor intended to reorganize and no reasonable probability that it would eventually emerge from bankruptcy proceedings."); *Carolin Corp. v. Miller*, 886 F.2d 693 (4th Cir. 1989).

E. Three Tests for Bad Faith. One commentator has categorized the three tests for bad faith as follows: 1) "subjective bad faith plus objective futility"; 2) subjective bad faith standing alone; and 3) "totality of the circumstances". Kathleen A. Mullins, *Defining Bad Faith and Determining When it Warrants Dismissal of a Chapter 11 Case Under Section 1112(b) of the Bankruptcy Code*, 5 St. John's Bankr. Res. Lib. No. 11 (2013). While one can take issue with Mullins' categorization of the Circuit Courts and their adoption of a particular test, the taxonomy is a useful way of thinking about bad faith and the evidence needed to persuade the bankruptcy court.

F. The Ninth Circuit's Test for Bad Faith. Ms. Mullins concludes that the Ninth Circuit adopted the "subjective bad faith plus objective futility test." The Ninth Circuit followed the Fifth Circuit's *Little Creek* decision. *In re Arnold*, 806 F.2d 937, 939 (9th Cir.1986) ("The existence of good faith depends on an amalgam of factors and not upon a specific fact. The bankruptcy court should examine the debtor's financial status, motives, and the local economic environment."). *See also In re Marsch*, 36 F.3d 825, 828 (9th Cir.1994). In *Marsch*, however, the Ninth Circuit

makes clear that objective factors will also justify "cause" for dismissal. The confusion seems to lie in conflating sufficient conditions for necessary ones. That is, while objective factors in the Ninth Circuit may be indicative of bad faith, subjective factors standing alone still suffice. *See In re Detienne Associates Ltd. P'ship*, 342 B.R. 318, 324 (Bankr. D. Mont. 2006) ("*Marsch* does not hold, nor should it that regardless of how subjectively improper a debtor's motives, dismissal or relief from stay cannot be granted unless objective futility is established."); *In re ACI Sunbow, LLC*, 206 B.R. 213 (Bankr. S.D. Cal. 1997) (recognizing that the Ninth Circuit does not follow the Fourth Circuit's decision in *Carolin Corp*. and holding that either objective futility or subjective bad faith could be sufficient to warrant dismissal or relief from the automatic stay for bad faith).

G. Single-Asset Cases. Single-Asset cases are not per se bad faith filings. *In re LCGI Fairfield, LLC*, 424 B.R. 846 (Bankr. N.D. Cal. 2010) (finding that chapter 11 cases were not filed in bad faith despite the formation of a newly created entity to take property shortly before filing with no employees and no business operations). For the factors to be applied to determine bad faith in Single Asset Real Estate (SARE) cases, see *In re Phoenix Piccadilly, Ltd.*, 849 F.2d 1393, 1394 (11th Cir.1988) and *In re State St. Houses, Inc.*, 356 F.3d 1345, 1346 (11th Cir. 2004). [FN7] *See also* ABI Southwest materials entitled *Avoiding Bankruptcy Code Early Land Mines: Single Asset Real Estate*.

H. Solvency. Oftentimes, the good faith challenge centers on the solvency of the debtor. *See, e.g., In re Marshall, 721* F.3d 1032, 1046 (9th Cir. 2013) (concluding that the debtors' "technical solvency did not bespeak bad faith given that they faced the threat of future litigation, not to mention their very concrete obligation to satisfy" a $12 million fraud judgment); *In re SGL Carbon Corp.*, 200 F.3d 154, 165 (3d Cir. 1999) (noting that insolvency was not required and, in fact, chapter 11 encourages "early access to bankruptcy relief to allow a debtor to rehabilitate its business before it is faced with a hopeless situation."). "Although a debtor need not be *in extremis* in order to file such a petition, it must, at least, face such financial difficulty that, if it did not file at that time, it could anticipate the need to file in the future." *Matter of Cohoes Indus. Terminal, Inc.*, 931 F.2d 222, 228 (2d Cir. 1991) (citing *In re Johns Manville Corp.*, 36 B.R. 727 (Bankr.S.D.N.Y.1984)).

I. Good Faith under 11 U.S.C. § 1112 v. 11 U.S.C. § 1129(a)(3). Section 1129(a)(3) requires that a confirmable plan be one that is, among other things, "proposed in good faith and not by any means forbidden by law." The good faith test under Section 1129(a)(3) is more narrowly focused and aimed at determining whether the debtor displayed the requisite honesty and integrity in formulating, proposing, and confirming a plan. *In re Madison Hotel Assocs.*, 749 F.2d 410, 425-26 (7th Cir. 1984). If, however, the case was commenced in bad faith, the case should be dismissed or converted "well before formal consideration of the plan." *In re SGL Carbon Corp.*, 200 F.3d 154, 167 n. 19 (3d Cir. 1999).

III. Case Law.

A. *In re SR Real Estate Holdings, LLC*, 506 B.R. 121 (Bankr. S.D. Cal. 2014). Judge Latham granted creditor's motion to dismiss for bad faith filing after a hearing and an order designating the case a SARE case. The Court put great weight on the following facts: "(1) a SARE debtor with an asset encumbered at least six times over; (2) nearly $550 million in secured debt from two deeds of trust accruing interest at 15% and 31% over the past thirteen years; (3) fractionalized and interrelated interests in those trust deeds locked in a power struggle over how to proceed with the Property; and (4) a compelling history of multiple bankruptcy filings with multiple managers' unsuccessful attempts to bring the Property to profitable use." *Id.* at 129. Based upon "the totality of the circumstances," the court concluded that the debtor was using the bankruptcy system to cause delay and hinder the secured creditors from realizing upon their collateral. *Id.* Thus, the court concluded that the debtor filed the petition in bad faith. *Id.*

B. *In re Houston Regional Sports Network, L.P.*, 505 B.R. 468 (Bankr. S. D. Tex. 2014). Judge Isgur entered an order for relief following an involuntary Chapter 11 petition against the alleged debtor and denied the motion to dismiss. The issue of futility was raised by the Houston Astro's arguing that an order for relief against the putative debtor, Houston Regional Sports Network, should not be entered because reorganization was not possible. 505 B.R. at 479. The network had a partnership agreement with the Astro's which required the Astros to consent to any plan of reorganization. Based on the partnership agreement, the Astros could vote its own best interest, regardless of any fiduciary duty to the partnership. Moreover, the Astros said that they would veto any plan. First, the court found that the evidence did not support the Astro's threatened veto. Second, the court concluded that the Astro's appointed director was duty bound to meet fiduciary responsibilities. Lastly, the court rejected the futility argument as it did not permit the Astro's to create the futility.

1. *Houston Networks*, we may have a problem. First, despite being valid under state law, the bankruptcy court invalidated provisions in agreements that require unanimous consent for significant actions and transactions and disclaim fiduciary duties to the partnership. According to *Houston Networks,* in a bankruptcy proceeding, the protections in the organizational and governance documents may not be relied upon by the directors, joint venture partners, etc.
2. *Houston Networks* imposes fiduciary duties on these directors similar to a trustee of the debtor's estate.
3. *Houston Networks* bars movant from creating the futility that serves as the basis for dismissal. However, in every two-party dispute, the secured creditor rises before the court and says that it will not vote for any plan at any time. Under *Houston Networks*, has the secured creditor now engineered the futility it intends to rely upon for dismissal? Alternatively, is the futility merely a natural by-product of the debt structure, nature of the business, etc.?

C. *In re Marshall*, 721 F.3d 1032 (9th Cir. 2013). The Ninth Circuit affirmed confirmation of the debtor's plan and denial of the dismissal motion. In this case, the trustee of family trust opposed the Chapter 11 plan filed by his brother and his brother's wife and moved to dismiss their bankruptcy case for alleged bad faith. The Ninth Circuit held that the finding that the Chapter 11 plan was proposed in good faith was not clearly erroneous. Movant contended that the timing of the bankruptcy filing, which was within days of a state court's suggestion that J. Howard Marshall, III transfer assets to satisfy the fraud judgment, indicated bad faith. *Id* at 1048. Moreover, movant argued that the debtor's sole purpose in filing the petition was to avoid filing a supersedeas bond pending the appeal of the fraud judgment. The Ninth Circuit distinguished other decisions by noting that the debtor's liquid assets were insufficient to satisfy the judgment or cover the cost of the bond. *Id.* at 1048. Most importantly, the debtors had filed a reorganization plan, addressed the fraud judgment, and appeared to qualify for confirmation. *Id.* at 1049.

D. *In re Dewey Commercial Inv., L.P.*, 503 B.R. 643 (Bankr. E.D. Pa. 2013). Judge Colemen held that the debtor's case was commenced in bad faith and dismissed it. Co-limited partner moved to dismiss the debtor's Chapter 11 case alleging that the debtor's petition was filed in bad faith. The debtor had a singular asset which was its interest in the partnership. The debtor had few or no unsecured creditors and very few debts owing to nonmoving creditors. The debtor filed bankruptcy on the eve of the transfer of its only asset to the movant. The debtor was not an operating business and the only pressure it was receiving was from the movant. In short, the debtor was involved in a two-party dispute and the bankruptcy was filed largely to resolve the dispute.

1. *Dewey* illustrates two common themes in bad faith cases. First, *Dewey* is a two-party dispute case. The debtor knows that this is a problem and represents to the court that its dispute affects the rights of a significant number of parties. The court rejects debtor's argument and observes that, "the mere fact that the resolution of a two-party dispute may affect the interests of the principals of the Partnership and the Debtor does not transform a two-party dispute into a multi-party dispute." *Id.* at 653.

2. To make matters worse, the dispute involved the ownership of a partnership. Thus, the bankruptcy court was being asked to intervene in a governance fight. *Id.* Generally, bankruptcy courts hold that bankruptcy filings to resolve corporate governance disputes are an invalid bankruptcy purpose. *Id.* (citations omitted).

E. *In re Hyatt*, 479 B.R. 880 (Bankr. D. N.Mex. 2012). Motion to dismiss or convert individual Chapter 11 case for bad faith filing was denied. While the case involved a two-party dispute which was commenced to avoid posting a supersedeas bond, cause for dismissal or conversion did not exist. A motion to dismiss was conditionally denied, subject to the debtor proposing a confirmable plan of reorganization by a date established by the bankruptcy court.

F. *In re JER/Jameson Mezz Borrower II, LLC*, 461 B.R. 293 (Bankr. D. Del. 2011). Judge Walrath dismissed the Chapter 11 case for "bad faith" filing. The case had the typical indicia of bad faith such as it was commenced on the eve of a state court foreclosure sale, by a single asset debtor with few, if any, unsecured creditors and with no reasonable prospects of reorganizing. The case was unique in that the filing occurred after a junior mezzanine lender replaced the sole non-independent director of a mezzanine borrower and instructed the director to authorize the borrower to file for bankruptcy. The court dismissed for bad faith finding, among other things, the debtor filed its chapter 11 petition to hinder its senior mezzanine lender's foreclosure.

1. *Jameson* is important as it appears to be in contrast to *In re Gen. Growth Properties, Inc., (GGP)* 409 B.R. 43 (Bankr. S.D.N.Y. 2009) (declining to dismiss for alleged bad faith when filing was allegedly premature as

debtors were supposedly not yet in financial distress).

2. *Jameson* teaches the importance of timing. *Jameson* filed on the eve of foreclosure while *GGP* filed years before some of the notes were scheduled to mature and before they were in default.

3. *Jameson* involved an inter-creditor dispute (two lenders) while *GGP* involved a dispute between lenders and their borrowers. For the relevance of these distinctions and the ramifications of *Jameson*, see Kevin M. Baum, *Who's Fighting Means A Lot in A Mezzanine Borrower's Bankruptcy*, 31 Am. Bankr. Inst. J. 54 (August 2012).

IV. Recent Case Updates.

A. *In re Pinnacle Land Group, LLC, 2018 WL 4348051* (Bktcy W.D. PA. 2018). The facts in this case allow for a fascinating read - an imprisoned son, a mother allegedly duped out of ownership of her rental properties by an ex-con and associated actors – a tale of two debtor entities with the same name but formed in different jurisdictions - a borrower representative presented to the lender as a school teacher with impeccable credit and extensive real estate management experience, and a duped lender facing a cram-down plan.

The **legal issues** addressed by the court on motions to dismiss and for other remedies include the following:

1. Did conflicting information regarding the ownership and control of the two like-named business entities result in the wrong entity (the entity that owned no assets and that never operated) being the debtor in the case? The court looked to the intent of the parties regarding which entity had filed. It relied on the scheduled assets, the employer ID number, and its scheduled debts to make its determination. It rejected the purported lack of authority of the signer of the petition for the named entity as a basis to determine that the wrong entity filed: "*An unauthorized petition may be subject to dismissal, but that does not alter the identity of the purported debtor in the interim.*" Id. at 8.

2. Did the lack of authority by the petition signer provide grounds for dismissal? The court stated that an unauthorized filing may be validated by express or implied ratification. In this case, the school teacher/participant in the financing scheme appeared in the bankruptcy case and opposed dismissal. The Court found the actions constituted an implied ratification of the filing, and did not dismiss on these grounds. Id. at 9.

3. Legal Standard: The opinion provides a helpful overview of the authorities and legal underpinnings of "bad faith," and articulates the 3rd Circuit's overall standard: "…The Third Circuit . . . has focused on two fundamental inquiries: (1) whether the petition serves a valid reorganizational purpose; and (2) whether the petition is filed merely to obtain a tactical litigation advantage."

4. Special Circumstances Exception. The court articulated the following exception applicable when considering bad faith filings:

> . . . The court may not, however, convert or dismiss the case if unusual circumstances establish that dismissal or conversion would not be in the best interests of the estate and creditors. "A determination of unusual circumstances is fact intensive and contemplates facts that are not common to Chapter 11 cases." Additionally, the unusual circumstances exception only applies if: (1) there is a reasonable likelihood that a plan will be confirmed within a reasonable time;
> (2) the cause for dismissal or conversion is something other than a continuing loss or diminution of the estate with no reasonable likelihood of rehabilitation; and (3) there is a reasonable justification for the act or omission giving rise to the cause of dismissal or conversion that will be cured within a reasonable time.

Id. at 18 (footnotes omitted).

5. Did the facts indicate bad faith in this sufficient to constitute cause for dismissal under Section 1112? After extensive analysis of the facts and players in this case, including the allegedly duped mother whom the court found was likely a participant in the fraudulent scheme to hide true ownership of the debtor's assets for the purposes of obtaining a loan from the aggrieved secured lender, the Court found compelling evidence of bad faith sufficient for dismissal. The Debtor in this case had filed a plan to show that the filing was not futile or in bad faith. That gambit did not work. *Central to the court's analysis was the finding that the proposed plan and its cram-down of the secured lender's position would essentially constitute a continuation of the pre-petition fraudulent scheme.* The lack of other creditors (except property tax claimants) guided the court to dismissal rather than conversion to Chapter 7 or stay relief.

B. *In re Encore Prop. Mgmt. of Western N.Y., LLC*, 585 B.R. 22 (Bankr. W.D. N.Y. 2018). This is not a footnote that debtor's counsel wants to read in a decision dismissing a case on grounds of bad faith:

> *…A young attorney, looking for pointers on litigation best practices, would do well to study the "Response" filed in this case. . . . A finer example of what not to do as a litigator would be hard to find. This seems like a good opportunity for the Court to clarify its expectations of . . .: (1) motions or responses made by letter submissions are unacceptable; (2) written responses to motions are required to be submitted, by parties represented by counsel, 3 days before a hearing—the Court long ago "ordered otherwise" for purposes of Rule 9014(a) FRBP; and (3) a memorandum of law is to be submitted to support legal arguments where necessary—putting scraps of paper, bits of string, a lucky bottle cap, and an old red yo-yo in a cigar box doesn't cut it.*

Id. at p.6, n.3. An earlier footnote questions the same counsel's likely conflict acting as counsel for the debtor in possession given his involvement in prior litigation. Id., n. 1. The court's incredulous tone is evidenced throughout the opinion, in which the court found that bad faith was fully evident where the debtor's plan was to continue nine years of litigation over a property with a negative equity position of over $40 million dollars, and only one secured creditor comprising a classic two-party dispute. The court rejected an argument that debtor's intent was to protect individual bondholder participants comprising the secured creditor's interest, and rejected the suggestion that individual bondholders could vote on a reorganization plan. Creative advocacy appeared to cross the line on all fronts in this case.

C. *In re Hanna*, 2018 WL 1770960 (BAP 9th Cir. April 13, 2018) (unpublished). The Hannas filed their Chapter 11 case to admittedly accomplish certain goals as to longstanding pending litigation with their neighbors concerning land and sewage issues. Those goals included: (1) staying pending enforcement of a money judgment, and (2) avoiding the expense of posting a cash supersedeas bond to stay enforcement of the judgment pending appeal. On the facts of this case, the BAP upheld the bankruptcy court's finding that a bad faith dismissal was not warranted. Key to the decision was the filing of a plan appearing to treat the ultimate claim of the neighbors in accordance with confirmation requirements, and the timely pursuit of the appeal. Thus, the court found none of the facts alone constituted *ipso facto* bad faith and, taken together, all the facts demonstrated an allowable use of Chapter 11.

See also In re Hayden, 2015 WL 2148949 (Bankr. C.D. Cal. 2015) (Tighe, J.) (bad faith not found despite allegations that the filing was made solely as a litigation tactic by a solvent debtor in a two-party dispute). Notably, the court rejected the "two-party" dispute argument where the major creditor "made it so" by acquiring another major creditor's claim. Id at 4.

D. *In re Green*, 2016 WL 6699311 (BAP 9th Cir. November 9, 2016) (unpublished). In contrast to the preceding case, the Greens filed a Chapter 11 case on facially similar facts that was dismissed for bad faith and the dismissal was upheld on appeal. The Greens filed their Chapter 11 case before a final judgment for over $1.2 million could be entered against them by the state court in regards to their embezzlement of substantial assets from a decedent's estate. They admitted that the filing was made in lieu of an appeal. The court found that the filing was made solely as a litigation tactic. *See also*, *In re Prometheus Health Imaging*. The following factors were important in the court's analysis: (1) the Greens were otherwise solvent with little or no other debts, and (2) no feasible plan could be confirmed, as they only had unsecured debt and the largest debt holder would not vote for a plan. As an overall cause, the court determined that the Greens were attempting to "unreasonably deter and harass" the creditor, soley for delay.

The case also has a good discussion of the "unusual circumstances" exception to dismissal for bad faith, rejecting the debtor's assertions based on the 3-part test articulated in *In re Warren, 2015 WL 3407244, at *4 (9th Cir. BAP May 14, 2015):*

> …the debtor must also prove (1) there is a reasonable likelihood of plan confirmation within a reasonable time, (2) that the "cause" shown for conversion or dismissal was reasonably justified, and (3) that the cause for conversion or dismissal can be 'cured' within a reasonable time.

Green at 11. The court also noted that if "bad faith" was the cause shown, debtor's may not overcome the "reasonably justified" or "curable" requirements. Id.

E. *In re Arm Ventures, LLC*, 564 B.R. 77 (Bankr. S.D. Fla. 2017) (Isicoff, J.) This case will likely be discussed further in these materials regarding its treatment and disposition of a case in which the reorganization's success rests in large part on anticipated income from a marijuana sales-related facility.

However, the case contains an extensive discussion of "bad faith" filing factors and analysis, hinging on evidence demonstrating … "an intent to abuse the judicial process and the purposes of the reorganization provisions." Id. at 82. The debtor's case suffered from typical bad faith candidate maladies…single asset, appearance of a two-party dispute, litigation tactic timing, and the like. The tipping point for the court, however, seemed to be the likely inability of the debtor to confirm a plan given the federal laws governing sales of marijuana.

ETHICAL PITFALLS OF REPRESENTING CLIENTS WITH INTERESTS IN THE MARIJUANA INDUSTRY

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Representing clients engaged in the marijuana industry[1,2] requires an attorney to consider the ethical implications long before deciding whether a filing for relief under the bankruptcy code is an option for the potential client. The crux of the problem for those engaged in the marijuana industry is the conflict between state law – creating a framework for the legal cultivation and sale of marijuana – and federal law, which in the Controlled Substances Act still lists marijuana as a Schedule 1 substance and thus subjects legal marijuana business operators to the possibility of prosecution under federal drug and money laundering statutes.[3]

I. Is it ever permissible to represent a Cannabis Client?

Rule 1.2(d) of the American Bar Association's Model Rules of Professional Conduct (the "ABA RPC") provides that:

> A lawyer shall not counsel a client to engage, or assist a client, in ***conduct that the lawyer knows is criminal*** or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

(Emphasis Added). It is clear that discussing with a client the legal consequences of operating a dispensary and how it can affect the client's ability to reorganize using the Bankruptcy Code is permitted. What is less clear is whether the attorney automatically violates this rule by – for example – setting up a legal entity and drafting the governing documents for a dispensary. Technically, the attorney's actions – drafting and creating a business entity – are legal under both state and federal law. On the other hand, the very purpose of the entity is criminal under federal law.

Example – Transactional Work

A potential new client comes to you to form an LLC for the purpose of purchasing and operating a commerical property. What if the property is currently used as a cultivation facility for marijuana within the confines of applicable state law? What if the client plans on continuing to rent to the same tenant who will continue to use the property for the same purpose? Does assisting this potential Cannabis Client in purchasing the

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[1] Unless specifically state otherwise, this outline assumes that any marijuana operation used as an example herein is legal under applicable state law.

[2] For brevity, a "client engaged in the marijuana industry" will hereinafter be referred to as a "Cannabis Client".

[3] *See, e.g.*, 18 U.S.C. §§ 1956, 1957; 21 U.S.C. §§ 841, 856.) Note, even ancillary service providers such as doctors, bankers, investors, lawyers, landlords, real estate brokers, and vendors can be prosecuted under these same statutes as coconspirators or aiders and abettors. (18 U.S.C. § 2; 21 U.S.C. § 846)

property and forming the LLC constitute assisting the client in "conduct the lawyer knows is a crime"? In short, yes.

Realizing that this puts every attorney in every state that has legal marijuana in some form or another in an impossible position, a number of states have modified their Rules of Professional Conduct (the "RPC") to permit attorneys to counsel and/or assist clients assuming certain requirements are met.

TAKEAWAY

Before deciding whether to represent a Cannabis Client, check your state's Rules of Professional Conduct to find out your State Bar Association's position on the matter.

To the extent that state bar associations have issued comments or other guidance on this issue, ***all of them*** require that the attorney ***also*** advise the Cannabis Client regarding related federal and policy.[4] While the scope of this advice may be unclear / may not have been the subject of further guidance by your state bar or your local courts, ***create a process*** to ensure that you and all attorneys within your firm provide *any* potential Cannabis Client with the minimum advice regarding related federal law and policy. Then ***create a process*** that documents – *for permanent retention in your files* – when and how you complied with this requirement.

TAKEAWAY

What if your state's RPC are silent on this conflict of laws? In short, doing work for a Cannabis Client puts your license at risk as you will be in violation of one of the most fundamental tenets of lawyer ethics: "Thou shall not assist your client in committing a crime."

While maintaining one's good standing within the state's attorney bar association is of tantamount importance, there are other items to consider when deciding whether to represent a Cannabis Client, such as:

- Will your malpractice carrier cover all (any?) work done for the Cannabis Client? Liability insurance policies normally contain exclusions for criminal acts.
- Conversations with a Cannabis Client may not be privileged.

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[4] *See, e.g.* Illinois Rules of Professional Conduct R. 1.2(d)(3); Oregon Rules of Professional Conduct R. 1.2(d); *see also*, State Bar of Arizona Ethics Opinion 11-01; Washington State Bar Association Advisory Opinion 2232.

- *See, U.S. v. Zolin*, 2626, 491 U.S. 554, 562–63 (U.S. 1989)("The attorney-client privilege…ceases to operate at a certain point, namely, where the desired advice refers *not to prior wrongdoing,* but to *future wrongdoing*.")(Internal Citations and Quotations Omitted)(Emphasis as in original).

- How to get paid from the Cannabis Client
  - Civil forfeiture laws allow the government to take all of the assets involved in operating the marijuana business and any property traceable to proceeds of the business. (18 U.S.C. §§ 981, 983.)
    - The Cannabis Client from Example 1 therefore must be advised that the real property to be purchased its at a real risk of being taken over in a federal forfeiture action. *See, e.g.*, City of Oakland v. Lynch, 798 F.3d 1159 (9th Cir. 2015) (The action targeted Harborside Health Center, a retail marijuana store that distributes medical marijuana legally under state law but allegedly in violation of the Controlled Substances Act 21 U.S.C. §§ 841 and 856.)
  - Is it permissible to put funds from the Cannabis Client in your IOLTA account?

II. Representing a Cannabis Client

After careful consideration of the items discussed in *supra*, your firm decided to represent the Cannabis Client. Your transactional group created the LLC, assisted in the purchase of the property, and provided related legal support. A few years go by and the Cannabis Client returns to your office, this time for assistance in dealing with financial problems.

Example – A Financially Distressed Cannabis Client

Based in part on Arms Ventures, LLC[5,6]

The Cannabis Client finds itself facing foreclosure. After litigation between the Cannabis Client's entity (the "Cannabis Business") and the bank holding the first mortgage on the property (the "Cannabis Property") the state court ordered the sale of the Cannabis Property and entered a final judgment of more than $800,000 against the Cannabis Business. The Cannabis Business wants to retain you to help deal with its creditors. In addition to the $800,000 judgment it owes approximately $630,000 in undisputed non-insider non-priority unsecured claims and is generally unable to pay its debts as they come due.

[5] 564 B.R. 77 (Bankr. S.D. Fla. 2017)
[6] The example is *based on* the *Arms Ventures* case but simplifies some background facts that are immaterial to the outcome of the case or this analysis and modifies certain facts to illustrate various issues that may arise.

Is it ethical to file a bankruptcy for the Cannabis Client? Does the presence of non-marijuana related non-insider unsecured creditors and their best interest make a difference? Does it matter if your state's receivership laws provide a viable alternative[7]? How is your answer different (if at all) if the Cannabis Client comes to you ***after*** the Cannabis Client filed a petition for relief in the Bankruptcy Court?

UNITED STATES TRUSTEES' POSITION

It is policy 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 case trustees or other parties object on the same or different grounds.[8]

MARIJUANA AS THE SOLE ASSET/SOURCE OF INCOME

The Cannabis Client here has a single tenant – a marijuana cultivation facility and all income generated by the Cannabis Property is derived directly from a marijuana related activity. Thus, there is no doubt that filing a bankruptcy case for the Cannabis Client is objectively futile as its dismissal by the court is virtually guaranteed in this scenario. The question then becomes whether it is unethical to file a bankruptcy petition – even if it is solely to give the Cannabis Client a short breathing spell by invoking the automatic stay. The preamble to the ABA's Rules of Professional Conduct points out that:

> A lawyer's conduct should conform to the requirements of the law, both in professional service to clients and in the lawyer's business and personal affairs. A lawyer should use the law's procedures ***only for legitimate purposes***…

Here, you know filing a bankruptcy case will give your Cannabis Client a breathing spell from his creditors by virtue of the automatic stay. However, you also know that your Cannabis Client's case will be dismissed, that you nevertheless expect to be paid for your services, and that your client may end up owing more on the mortgage due to attorneys' fees incurred by the creditor in the bankruptcy. In other words, it is virtually certain that your Cannabis Client will end up in a worse position than if no bankruptcy had been filed.

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[7] For a discussion on using state receivership laws in lieu of seeking bankruptcy relief for a legal marijuana business operator, *see*, Andrew King, *Not Enough Green: Sticky Problems From Insolvency In The Marijuana Business*, The Arkansas Lawyer, Vol. 53/Summer 2018.

[8] *See*, Letter to Chapter 7 and Chapter 13 Trustees dated April 26, 2017 available on the Department of Justice's website at https://www.justice.gov/ust/file/marijuana_assets.pdf/download (last visited 9/30/2018); see also, Clifford J. White III and John Sheahan, *Why Marijuana Assets May Not Be Administered in Bankruptcy*, XXXVI ABI Journal 12, 34-35, December 2017.

TAKEAWAY

Facts Matter. Are you using the bankruptcy laws for a legitimate purpose if your client's sole asset and/or sole source of income is from a marijuana business, rendering the case objectively futile before it is even filed?

MARIJUANA AS ONE ASSET/SOURCE OF INCOME IN ADDITION TO OTHERS

Does it make a difference if the Cannabis Property has other tenants with businesses completely unrelated to the marijuana industry? After all, a finding of bad faith by the debtor does not automatically implicate ethical shortcomings on the part of debtor's counsel. The debtor in *Arm Ventures* had other sources of income by renting portions of the commercial property to businesses not related to the marijuana industry. However, that alone may not be sufficient to overcome a motion to dismiss.

As summarized in *In re Arm Ventures*:

- A Colorado bankruptcy court ruled it would dismiss or convert the debtor's chapter 11 case because the debtor derived 25% of its revenues from leasing space to a tenant who was engaged in growing marijuana in a business legal under state law, but which business did not have DEA approval. The court noted that even if there were no good faith requirement in section 1129, the court could not confirm a plan that relied on income derived from a criminal activity. *In re Arm Ventures, LLC*, 564 B.R. at 84 citing *In re Rent–Rite Super Kegs W. Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012).
- A Michigan bankruptcy court held that even though debtor's payments were from an "untainted" source, the debtor's continuing operation of a marijuana business, even if the income were segregated, would require the court, the trustee, and even the debtor (who under chapter 13 retains property of the estate) to violate federal law, which they could not. The court indicated that if the Debtor wished to remain in bankruptcy, he could stop operating the marijuana business, thereby avoiding a dismissal. *In re Arm Ventures, LLC*, 564 B.R. at 84 citing *In re Jerry L. Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015).
- The 10th Circuit's Bankruptcy Appellate Panel held that because "the debtors could not confirm a plan without the marijuana income, the debtors could not qualify to be debtors in a chapter 13 case." *In re Arm Ventures, LLC*, 564 B.R. at 84–85 citing *In re Arenas*, 535 B.R. 845 (10th Cir. BAP 2015).

The *Arm Ventures* decision did not dismiss the case at that juncture, finding that dismissal at that time was not in the best interest of the non-insider unsecured. The court did grant stay relief to the bank holding a lien on the Cannabis Property, and the case was dismissed shortly thereafter.

STATUTES RELATING TO RECUSAL AND DISQUALIFICATION

28 U.S.C. § 47 - Disqualification of trial judge to hear appeal

Disqualification of trial judge to hear appeal
No judge shall hear or determine an appeal from the decision of a case or issue tried by him.

(June 25, 1948, ch. 646, 62 Stat. 872.)

28 U.S.C. § 144 - Bias or prejudice of judge

Bias or prejudice of judge
Whenever a party to any proceeding in a district court makes and files a timely and sufficient affidavit that the judge before whom the matter is pending has a personal bias or prejudice either against him or in favor of any adverse party, such judge shall proceed no further therein, but another judge shall be assigned to hear such proceeding.

The affidavit shall state the facts and the reasons for the belief that bias or prejudice exists, and shall be filed not less than ten days before the beginning of the term at which the proceeding is to be heard, or good cause shall be shown for failure to file it within such time. A party may file only one such affidavit in any case. It shall be accompanied by a certificate of counsel of record stating that it is made in good faith.

(June 25, 1948, ch. 646, 62 Stat. 898; May 24, 1949, ch. 139, § 65, 63 Stat. 99.)

28 U.S.C. § 455 - Disqualification of justice, judge, or magistrate judge

Disqualification of justice, judge, or magistrate judge
(a) Any justice, judge, or magistrate judge of the United States shall disqualify himself in any proceeding in which his impartiality might reasonably be questioned.
(b) He shall also disqualify himself in the following circumstances:

(1) Where he has a personal bias or prejudice concerning a party, or personal knowledge of disputed evidentiary facts concerning the proceeding;
(2) Where in private practice he served as lawyer in the matter in controversy, or a lawyer with whom he previously practiced law served during such association as a lawyer concerning the matter, or the judge or such lawyer has been a material witness concerning it;
(3) Where he has served in governmental employment and in such capacity participated as counsel, adviser or material witness concerning the proceeding or expressed an opinion concerning the merits of the particular case in controversy;
(4) He knows that he, individually or as a fiduciary, or his spouse or minor child residing in his household, has a financial interest in the subject matter in controversy or in a party

to the proceeding, or any other interest that could be substantially affected by the outcome of the proceeding;

(5) He or his spouse, or a person within the third degree of relationship to either of them, or the spouse of such a person:

(i) Is a party to the proceeding, or an officer, director, or trustee of a party;

(ii) Is acting as a lawyer in the proceeding;

(iii) Is known by the judge to have an interest that could be substantially affected by the outcome of the proceeding;

(iv) Is to the judge's knowledge likely to be a material witness in the proceeding.

(c) A judge should inform himself about his personal and fiduciary financial interests, and make a reasonable effort to inform himself about the personal financial interests of his spouse and minor children residing in his household.

(d) For the purposes of this section the following words or phrases shall have the meaning indicated:

(1) "proceeding" includes pretrial, trial, appellate review, or other stages of litigation;

(2) the degree of relationship is calculated according to the civil law system;

(3) "fiduciary" includes such relationships as executor, administrator, trustee, and guardian;

(4) "financial interest" means ownership of a legal or equitable interest, however small, or a relationship as director, adviser, or other active participant in the affairs of a party, except that:

(i) Ownership in a mutual or common investment fund that holds securities is not a "financial interest" in such securities unless the judge participates in the management of the fund;

(ii) An office in an educational, religious, charitable, fraternal, or civic organization is not a "financial interest" in securities held by the organization;

(iii) The proprietary interest of a policyholder in a mutual insurance company, of a depositor in a mutual savings association, or a similar proprietary interest, is a "financial interest" in the organization only if the outcome of the proceeding could substantially affect the value of the interest;

(iv) Ownership of government securities is a "financial interest" in the issuer only if the outcome of the proceeding could substantially affect the value of the securities.

(e) No justice, judge, or magistrate judge shall accept from the parties to the proceeding a waiver of any ground for disqualification enumerated in subsection (b). Where the ground for disqualification arises only under subsection (a), waiver may be accepted provided it is preceded by a full disclosure on the record of the basis for disqualification.

(f) Notwithstanding the preceding provisions of this section, if any justice, judge, magistrate judge, or bankruptcy judge to whom a matter has been assigned would be disqualified, after substantial judicial time has been devoted to the matter, because of the appearance or discovery, after the matter was assigned to him or her, that he or she individually or as a fiduciary, or his or her spouse or minor child residing in his or her household, has a financial interest in a party (other than an interest that could be substantially affected by the outcome), disqualification is not required if the justice, judge, magistrate judge, bankruptcy judge, spouse or minor child, as the case may be, divests himself or herself of the interest that provides the grounds for the disqualification.

(June 25, 1948, ch. 646, 62 Stat. 908; Pub. L. 93–512, § 1, Dec. 5, 1974, 88 Stat. 1609; Pub. L. 95–598, title II, § 214(a), (b), Nov. 6, 1978, 92 Stat. 2661; Pub. L. 100–702, title X, § 1007, Nov. 19, 1988, 102 Stat. 4667; Pub. L. 101–650, title III, § 321, Dec. 1, 1990, 104 Stat. 5117.)

A court's determination of "whether a judge's impartiality might reasonably be questioned under [28 U.S.C. §] 455(a) is an objective standard designed to promote the public's confidence in the impartiality and integrity of the judicial process." *Davis v. Jones,* 506 F. 3d 1325, 1332 n. 12 (11th Cir. 2007)(internal citations omitted). The standard for recusal based on a claim of lack of impartiality is objective reasonableness. *Cheney v. U.S. Dist. Court for D.C.,* 541 U.S. 913, 924 (2004). The judge must "ensure that the matters before the court are decided by a judiciary that is impartial both in fact and in appearance." *In re Evergreen Sec., Ltd.,* 363 B.R. 267, 295 (Bankr. M.D. Fla. 2007). However, courts uniformly hold that moving for recusal as a tactic when a litigant is displeased with the court's rulings is an inappropriate use of recusal procedures. *Id.* At 296.

In order to establish grounds for disqualification under 28 U.S.C. §455(b)(1), the party moving for recusal must allege and then present evidence of a "negative bias or prejudice [which] must be grounded in some personal animus or malice that the judge harbors against him." The standard for finding actual bias is objective, and "it is with reference to the 'well-informed, thoughtful and objective observer, rather than the hypersensitive, cynical an suspicious person' that the objective standard is currently established." *In re Damerau,* 525 B.R. 799, 803 (Bankr. S.D. Fla. 2015)(citations omitted).