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9th Cir. Affirms Ch. 11 Plan Indirectly Supported by State-Legal Marijuana

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To save a successful chapter 11 restructuring from, in the words of the Ninth Circuit Court of Appeals, going "up in smoke," the Ninth Circuit recently affirmed a bankruptcy court's order confirming a commercial landlord's chapter 11 plan that received "at least indirect support" from a tenant in the marijuana business.[1] The tenant in question, doing business as "Green Haven," used the premises that it leased from the debtor to grow marijuana, and its lease provided that Green Haven would use the premises "exclusively as a marijuana establishment."[2]

This decision marks another significant step toward allowing access to the bankruptcy courts for marijuana businesses that are operating in accordance with state law despite the fact that the growth, processing and sale of marijuana continues to be illegal under federal law — specifically the federal Controlled Substances Act (CSA).[3] This decision follows a series of cases in which each successive decision expands access to the bankruptcy courts by participants in the marijuana industry.[4]

In *Cook Investments*, there was no dispute about the fact that Green Haven appeared "to be [operating] in compliance with Washington law."[5] Instead, the appeal was brought to the court by the U.S. Trustee, who argued that confirmation of the debtor's chapter 11 plan should be reversed because it violated of one of the 16 requirements for confirmation set forth in the Bankruptcy Code, namely 11 U.S.C. § 1129(a)(3). Section 1129 requires for confirmation that the plan (1) "has been proposed in good faith" and (2) "not by any means forbidden by law."[6] The U.S. Trustee's objection focused on the second prong of that phrase as it argued that the plan, which contemplated using income generated from a business that is illegal under federal law, violated the injunction against "any means forbidden by law," because payments to the debtor were to be made by a tenant that was operating in violation of the CSA. The Ninth Circuit disagreed and affirmed the district court,[7] which, in turn, had affirmed the bankruptcy court.

As if anticipating the inclination to read more than intended into the decision, the court framed the dispositive issue presented as one of narrow statutory construction, namely whether § 1129(a)(3) "forbids confirmation of a plan that is proposed in an unlawful manner as opposed to a plan with substantive provisions that depend on illegality."[8] This, the court wrote, was a question of first impression within the Ninth Circuit.[9]

The court's analysis began with its conclusion that "the phrase 'not by any means forbidden by law' modifies the phrase '[t]he plan has been proposed.'"[10] The Court's analysis then concluded that the plan was "proposed" by legal means (*i.e.*, "consistent with the objectives and purposes of the Bankruptcy Code").[11] The significance of the court's holding is highlighted by the fact that, pre-petition, the debtors had chosen to rent property to a tenant engaged in a business that is itself explicitly a crime under the CSA.[12]

An overview of the factual circumstances at issue in *Cook Investments* is instructive for understanding the contours of the court's ruling, including the potholes in the road to chapter 11 restructurings that might derail other landlords who rent to marijuana businesses. In *Cook Investments*, the debtor had operated several commercial real estate holding companies that were consolidated. The debtor's chapter 11 plan was confirmed over the objections of the U.S. Trustee. Although the U.S. Trustee had filed a motion to dismiss the cases for "cause" under 11 U.S.C. § 1112(b) on the grounds of alleged "gross mismanagement" for renting to a marijuana business, the bankruptcy

1 *Garvin v. Cook Invs. (In re Cook Invs., et al.)*, Case No. 18-35119, 2019 WL 1945280, *1 (9th Cir. May 2, 2019) (McKeown, CJ).
2 *Id.* at *1.
3 The CSA is codified as 21 U.S.C. §§ 801-971. Marijuana is presently legal for medicinal purposes in 33 states and Washington, D.C.; 10 of those states and Washington, D.C., also have laws allowing marijuana for "recreational" purposes (Alaska, California, Colorado, Maine, Massachusetts, Michigan, Nevada, Oregon, Vermont, Washington and Washington, D.C.). *See* "Legality of Cannabis by U.S. Jurisdiction," Wikipedia, *available at* en.wikipedia.org/wiki/Legality_of_cannabis_by_U.S._jurisdiction (unless otherwise specified, all links in this article were last visited on May 22, 2019) (cited by Alexander G. Malyshev, "Despite the Trend Towards Legalization, Challenges Remain for Investors Considering Investment in State-Legal Cannabis Industries," Carter Ledyard & Milburn LLP (March 26, 2019), *available at* clm.com/publication.cfm?ID=5647, at n.1).
4 *See* G. David Dean and Katherine M. Devanney, "Marijuana's Journey from Greenhouse to Courthouse: Can Cannabis Debtors Seek Bankruptcy Protection?," XXXVIII *ABI Journal* 5, 30-31, 64, May 2019, *available at* abi.org/abi-journal (chronicles recent cases that have involved cannabis operations).
5 *Cook Invs.* at *1.
6 11 U.S.C. § 1129(a)(3).
7 *Geiger v. Cook Invs., et al. (In re Cook Invs. NE, et al.)*, Case No. 3:17cv5516 (W.D. Wash.).
8 *Cook Invs.* at *3.
9 *Id.*
10 *Id.*
11 *Cook Invs.* at 4 and n.3 (citing *In re 431 W. Ponce de Leon LLC*, 515 B.R. 660, 673 (Bankr. N.D. Ga. 2014) (stating test for whether chapter 11 plan is proposed in good faith)).
12 21 U.S.C. § 856(a)(1) (prohibits "knowingly ... leas[ing] ... any place ... for the purpose of manufacturing, distributing, or using any controlled substance") (cited in *Cook Invs.* at *1).

court denied that motion "with leave to renew" the motion at the confirmation hearing.[13]

However, the U.S. Trustee failed to renew its motion to dismiss at the confirmation hearing.[14] Before confirmation, and in response to the U.S. Trustee's motion to dismiss, the debtor had amended its plan to provide for the rejection of the Green Haven lease in an effort to "cure" and thereby address the U.S. Trustee's mismanagement argument.[15]

The debtor's chapter 11 plan was a resounding success from the public policy perspective of the Bankruptcy Code:[16] The plan was supported by the creditors and provided for all creditors' claims to be repaid in full. The creditors voted to accept the plan, and since there was no stay pending appeal, the debtor performed and the unsecured claims were paid in full by the time the appeal was argued to the Ninth Circuit.[17] The "amended plan," as confirmed, also provided that the secured creditor would be paid directly by various tenants that were not in the marijuana business; the secured creditor did not receive any payments from Green Haven, and the plan's funding came from sources other than Green Haven's rent. Despite the fact that the amended plan provided for the rejection of the Green Haven lease, and that the plan's funding did not depend on income from Green Haven, the Ninth Circuit acknowledged that the debtor would continue "to receive rent payments from Green Haven, which provides *at least indirect support for the Amended Plan*."[18]

Against the backdrop of a successful restructuring that paid creditors' claims in full, the court considered — and rejected — the U.S. Trustee's request "that the Amended Plan go up in smoke because one of the Cook companies leases property to [Green Haven,] which uses the property to grow marijuana."[19] The Ninth Circuit emphasized that the U.S. Trustee had not renewed its motion to dismiss at the confirmation hearing, which resulted in a waiver of the argument on appeal.[20] In addition, the court indicated that it did not "believe that [its decision] ... will result in bankruptcy proceedings being used to facilitate legal violations."[21] The Court also noted that "confirmation of a plan does not insulate debtors from prosecution for criminal activity, even if that activity is part of the plan itself."[22]

Notwithstanding the court's implicit remonstration that its decision was not passing judgment on the legality of the marijuana business, which had provided "at least indirect support"[23] for the plan, and the corollary that the court's decision should not be read as opening the door to the marijuana trade as such, some would argue that it is obvious that the legality of the marijuana business under applicable state law provided at least a quantum of the thread woven into the fabric of the court's decision affirming the plan's confirmation. It would equally strain credulity to suggest that the court would have been prepared to affirm confirmation of a chapter 11 plan that was supported, even indirectly, by an enterprise engaged in child sex-trafficking or operation of a meth lab, for example. Thus, common sense dictates that the court's conclusion that "Green Haven appears to be in compliance with Washington law"[24] was a material factor, if not a determinative factor, underpinning the court's decision to affirm the confirmation order.

A compelling public policy argument may be made for taking into account that the activity in question, while illegal under federal law, is legal under applicable state law.[25] In public policy debates across the U.S., these issues are being addressed in numerous contexts as states continue to expand and develop their cannabis jurisprudence against the backdrop of the seemingly inert federal ban by way of the CSA. In this context, on the premise that such state-legal businesses deserve to receive the benefit of legal counsel, even state bar associations have weighed in.[26] These bars have issued ethical and practical guidance to lawyers that advise clients who are participants in the cannabis industry. Nevertheless, "proceed with caution," and strictly in compliance with applicable state law, would be the prudent lessons to take from the Ninth Circuit's *Cook Investments* decision. As long as marijuana remains a crime under federal law in light of the extant CSA, uncertainty and risks of potential prosecution cannot be ignored or eliminated.[27] abi

13 Bankruptcy courts have dismissed chapter 11 cases for "cause" under 11 U.S.C. § 1112(b) for the debtor's lease of property to a marijuana business. *See In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799, 811 (Bankr. D. Colo. 2012) (cited in Dean and Devanney, *supra* n.4 at fn.10).

14 *Cook Invs.* at *2.

15 The notion of "curing" the defects upon which a motion to dismiss might be brought is addressed briefly by the court's discussion of 11 U.S.C. § 1112(b)(2) ("[E]xception to dismissal for unusual circumstances applies if, *inter alia*, the cause for dismissal 'will be cured within a reasonable period of time.'"). *Cook Invs.* at *2. The prospect of dismissal from bankruptcy due to the debtor's participation in the marijuana industry underscores the appropriateness of taking into account the possible use of state law remedies to effect the restructuring and liquidation of financially distressed businesses, including receiverships and assignments for the benefit of creditors. *See generally* Dean and Devanney, *supra* n.4 at 64.

16 One of the primary public policy objectives of chapter 11 is to achieve a restructuring of a debtor's indebtedness for the benefit of creditors. *See* H.R. Rep. No. 595, 95th Cong., 2d Sess. 340 (1977) (cited in *In re W.R. Grace & Co.*, 475 B.R. 34, 158 (D. Del. June 11, 2012) ("[T]he underlying public policy in federal bankruptcy law [is] that a debtor's bankruptcy estate should be maximized for the benefit of both the debtor and all of its creditors.")).

17 *Cook Invs.* at *2.

18 *Id.* at *3 (emphasis added).

19 *Id.* at *1.

20 In ruling that the U.S. Trustee had waived the "bad faith" argument on which the motion to dismiss was premised, the court cited *Walsh v. Nev. Dep't of Human Res.*, 471 F.3d 1033, 1037 (9th Cir. 2006), for the proposition on waiver, where "a claim raised in the complaint was waived when it was not re-raised in response to a motion to dismiss." *Cook Invs.* at *2.

21 *Id.* at *4.

22 *Id.* (citing *In re Food City Inc.*, 110 B.R. 808 812 (Bankr. W.D. Tex. 1990)).

23 *Id.* at *3.

24 *Id.*

25 For the avoidance of doubt, analysis of any marijuana business that is assumed to be operating in accordance with applicable state law includes the conclusion (subject to verification) that the particular activity at issue is in fact legal under, and is being conducted in strict compliance with, the operative state law. Many states where marijuana is legal under state law, including California and Colorado for example, have comprehensive legal frameworks at both the state and local levels that govern and regulate the cultivation, production and sale of marijuana and its derivative products. *See, e.g.*, Cal. Bus. & Prof. Code §§ 26000-26231.2 (implementing Proposition 64); Colo. Const., art. 18, § 16 (adopting Amendment 64).

26 *See* Cal. Sup. Ct. Adin. Order 2018-09-26-01 (Sept. 26, 2008) (approving State Bar of California's proposed Rule 1.2.1 of the California Rules of Professional Conduct, including Comment [1] ("The fact that a client uses a lawyer's advice in a course of action that is criminal ... does not of itself make a lawyer a party to the course of action."); State Bar of Arizona Ethics Opinions 11-1 (Feb. 2011) ("[W]e decline to interpret and apply [Arizona's ethics rule] 1.2(d) in a manner that would prevent a lawyer who concludes that the client's proposed conduct is in 'clear and unambiguous compliance' with state law from assisting the client in connection with activities expressly authorized under state law, thereby depriving clients of the very legal advice and assistance that is needed to engage in the conduct that the state law expressly permits."); Ethics Opinion 1024, "Counseling Clients in Illegal Conduct; Medical Marijuana Law, New York State Bar (Sept. 29, 2014), *available at* nysba.org/CustomTemplates/Content.aspx?id=52179 ("[T]he New York Rules permit a lawyer to assist a client in conduct designed to comply with state medical marijuana law."); Ian A. Stewart and Sehreen Ladak, "The Legal Ethics of Advising the Cannabis Client," *National Law Review* (Sept. 19, 2017), *available at* natlawreview.com/article/legal-ethics-advising-cannabis-client ("Colorado, Connecticut, Ohio, Oregon, Nevada, Illinois and Washington have all amended their rules of professional conduct to permit attorneys to advise and assist their clients on cannabis business law issues, including state and local licensure."); *but see* David L. Hudson Jr., "Lawyers Advising Clients on Marijuana Laws May Run Afoul of Ethics Rules," *ABA Journal* (Jan. 1, 2017), *available at* abajournal.com/magazine/article/marijuana_legal_ethics_rules (upon legalization of recreational marijuana, Colorado Supreme Court adopted Comment 14 to rule 1.2 promulgated by Colorado Bar Association Ethics Committee; "The U.S. District Court ... which had adopted the state ethics rules, proceeded to opt out of the operative parts of Comment 14, leaving open the possibility that it may discipline federal practitioners for advising clients on marijuana-related matters.").

27 *See* 18 U.S.C. § 2 ("Whoever ... aids, abets, counsels ... induces or procures" a federal crime, or "causes" federal crime to be committed, "is punishable as a principal"); 18 U.S.C. § 3 (accessory after fact); 11 U.S.C. § 371 (conspiracy). *See also* Malyshev, *supra* n.3.