

Bankruptcy and State Alternatives for Marijuana Businesses
By Tom Downey and John E. Jennings

Can a struggling marijuana business seek bankruptcy protection?

No, bankruptcy protection is not available to marijuana businesses. Bankruptcy has its genesis in the Constitution. Article I, Section 8 grants Congress the power to enact uniform bankruptcy rules. Congress has done so in the form of Title 11 of the United States Code. Because bankruptcy is created by federal law and because marijuana remains illegal under federal law, marijuana businesses cannot seek bankruptcy protection.

What if the marijuana business operates solely in a state like Colorado that has a legalized commercial marijuana system?

This is a good example of the tension that may exist between federal and state law. The usual resolution of this tension results in federal law preempting state law. In the case of commercial marijuana, the federal government has chosen not to interfere with commercial marijuana businesses as long as they remain in compliance with the strict regulations established by Colorado. While the federal government is not interfering, that does not mean federal courts, including bankruptcy courts, are available to marijuana businesses.

If bankruptcy is not an option, are there any alternatives available to a failing marijuana business?

There are three alternatives available to a failing marijuana business. The first is to informally wind up the business. Alternatively, a marijuana business could seek a state court receiver or an assignment for the benefit of creditors, a so-called "ABC." The latter two alternatives involve the liquidation of the business by a third party. None of these three alternatives contemplate a restructuring of the business as is available under Chapter 11 of the Bankruptcy Code.

Does a failing marijuana business have an obligation to pursue non-bankruptcy alternatives?

When a business is solvent, officers and directors owe a duty to the owners or shareholders to operate the business for their benefit. Traditionally, when a business becomes insolvent, the duty shifts to the business's creditors. While there is no specific duty to utilize a receivership or an ABC, doing so can address creditor concerns regarding propriety of the methods used to liquidate the business's assets and hopefully avoid later challenges.

Why would a marijuana business consider non-bankruptcy alternatives as opposed to an unsupervised sale of its assets?

As a business begins to fail, promised payments are missed, collection calls are avoided, and creditors become concerned. As their confidence deteriorates, creditors lose faith in management and worry management is favoring certain creditors, particularly insider creditors, over less favored creditors. By conducting the liquidation through a receivership or ABC, creditors' suspicions can be allayed because the receiver or assignee is an unrelated third party and the process is transparent.

Do these alternatives offer a marijuana business the same protections as bankruptcy?

The bankruptcy protection most notably missing is the protection of the automatic stay and the ability to resolve disputes in a single forum. Having said this, since all of the assets of a marijuana business are "transferred" to the receiver or assignee both of which operate under state court supervision, even if a judgment were obtained against the marijuana business, any collection efforts would need to be addressed in the receivership or ABC setting. A significant aspect missing in a receivership or ABC is the ability to "reject" leases which in a bankruptcy case permits a bankrupt tenant to end a lease and cap the damages associated with an early termination. Outside of bankruptcy, some of the avoidance actions employed by a bankruptcy trustee are simply not available. For example, the preference action which permits a bankruptcy trustee to recover monies paid to creditors in the three months before the bankruptcy filing or one year if the transfer is to an insider is only available in a bankruptcy case. Finally, you might think the inability to get a bankruptcy discharge would be a significant shortcoming, however, only individuals may receive a Chapter 7 bankruptcy discharge; entities are not entitled to a discharge. For this reason, the lack of a discharge is irrelevant.

How do these alternatives differ from bankruptcy in terms of the participants, cost and length of the process?

The two alternatives are likely quicker and less expensive. For example, under Colorado law, the ABC must be wound up in a year unless the supervising court allows for additional time. Moreover, the fee to be paid to a receiver or an assignee may be negotiated; in a bankruptcy case, the trustee's fee is established by statute. Finally, there is an ability to operate the business to preserve the going concern which is more limited in a Chapter 7 bankruptcy case.

Why would a marijuana business consider an assignment for the benefit of creditors versus a receivership?

Probably the biggest advantage to an ABC over a receivership is the ability to choose the assignee. A receivership is usually a creditor remedy, i.e., a creditor seeks the appointment of a receiver. When seeking a receivership, a business may propose a receiver and usually the court will appoint that person unless there are challenges by the creditors. With an ABC, the assets are simply transferred to the assignee. The other advantage is the duration of an ABC. As mentioned earlier, an ABC needs to be wound up in a year; there is no such time limitation for a receivership.

What are the disadvantages of an assignment for the benefit of creditors and a receivership?

Probably the biggest disadvantage is the inability to have everything resolved in a single judicial forum. If a business has assets located outside of Colorado, a Colorado court's jurisdiction over those assets is limited. Similarly, out of state creditors may not be subject to the state court's jurisdiction. As mentioned above, the ability to recover transfers to insiders is limited because there are no state law preference claims.

How are secured and unsecured creditors of a marijuana business involved in these non-bankruptcy proceedings?

In both the receivership and the ABC contexts, the business provides a list of all the creditors and these creditors receive a notice of the receivership or the assignment. Secured creditors will address issues with their collateral by foreclosing their interest, reaching an agreement with the receiver or assignee to have the collateral turned over to them, or allowing the receiver or assignee to sell their collateral and receiving payment out of the proceeds from the sale. Unsecured creditors will be paid a pro rata share of any monies generated from the sale of the assets.

What unique issues might arise with the disposition of collateral of a marijuana business?

The treatment of marijuana-related collateral presents novel issues for courts, regulators and lenders. Bankruptcy courts have barred marijuana businesses from seeking bankruptcy protection in part because bankruptcy trustees cannot be in the position of committing a federal crime by possessing or controlling the marijuana-related property or inventory of a debtor business. Regulators will often search Uniform Commercial Code public records to determine if collateral of a licensed marijuana business, such as equipment used to grow or process marijuana, is subject to any liens. Finally, lenders to marijuana businesses face the prospect of their collateral being subject to seizure or forfeiture by law enforcement agencies.

Are creditors and lenders allowed to take security interests in all assets of a marijuana business?

Typically, a lender may take a security interest in a broad range of assets of a business, including inventory. For a commercial marijuana business, inventory of marijuana plants and products will likely be its most valuable asset. A marijuana business, however, can only sell or transfer inventory to adult recreational consumers, medical patients, or other licensed marijuana businesses in compliance with a state-regulated system. A lender cannot legally seize or possess a marijuana business's inventory in the event of default on a loan, and therefore cannot take a security interest in such inventory.

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