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# Otten Johnson Alert -

## Federal Bankruptcy Courts No Safe Haven for Marijuana Producers – Or Their Landlords

The approval by Colorado voters of medical marijuana in 2000, and recreational marijuana in 2012, has created a burgeoning legal marijuana industry in our state. Not only have marijuana growing operations and dispensaries flourished, but they have provided new leasing opportunities for landlords.

Of course, marijuana is still a Schedule I controlled substance and, as such, remains illegal under the federal Controlled Substances Act (the "CSA"). The U.S. Justice Department has stated that it is unlikely to expend prosecutorial resources on individuals and businesses that operate within the regulatory and enforcement system of states in which certain types of production, distribution and possession of marijuana have been legalized.

But the federal government's soft assurance – that it won't likely prosecute those who operate within the regulatory framework of a state with legal marijuana – goes only so far. What happens when those people and businesses seek affirmative benefits provided under federal law, like bankruptcy protection? A couple of cases addressing that question in the District of Colorado provide little encouragement.

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Colorado Real Estate Blog—Otten Johnson hosts a blog about development, financing and other property news in Colorado. Our attorneys are posting information and commentary on legal issues and business developments related to the real estate industry in Colorado and the West. Check it out: rockymountainrealestatelaw.com.

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*Rent-Rite*

The first case is *In re Rent-Rite Super Kegs West Ltd.*, in the U.S. Bankruptcy Court for the District of Colorado. The debtor in *Rent-Rite* owned a warehouse in northeast Denver, and it leased about 25% of its space to a marijuana growing business. When the debtor filed a Chapter 11 bankruptcy petition, its mortgage lender filed a motion to dismiss the bankruptcy case under the "clean hands" doctrine.

The Court in *Rent-Rite* determined that the debtor was violating the "crack house statute" in the CSA, which makes it a federal crime to intentionally rent a place for manufacturing, storing, distributing or using controlled substances. The fact that the debtor was unlikely to be prosecuted for that federal crime did not sway the judge: "[T]he fact that a violator is never charged, tried or convicted does not change the fact that the crime has been committed."

The Court found sufficient cause to dismiss the Chapter 11 case or convert it to Chapter 7 liquidation, due to "gross mismanagement of the [bankruptcy] estate." Specifically, the Court concluded that renting premises to a marijuana business subjected the debtor and its mortgage lender to forfeiture of the warehouse property. The Court further concluded that the debtor could not reorganize successfully in Chapter 11, since one of the requirements for confirming a reorganization plan is that the plan be "proposed in good faith and not by any means forbidden by law."

Before the Court determined whether dismissal of the case or conversion to Chapter 7 was appropriate, the debtor and the mortgage lender stipulated to the entry of an order for relief from the bankruptcy stay allowing the mortgage lender to pursue its remedies, including foreclosure. But in its opinion, the Court raised the question whether conversion to Chapter 7 was even possible, since "[t]he [Chapter 7] trustee who is appointed in the case would have responsibility for a site where continuing criminal conduct is taking place."

*Arenas*

The same Court confronted that question directly in the

later case of *In re Arenas*. The Chapter 7 debtors in that case, a husband and wife, owned a property in downtown Denver comprising two units. In one unit, the debtors operated a marijuana growing and distribution business. They leased the other unit to a marijuana dispensary. The United States Trustee (a division of the Justice Department that participates in bankruptcy cases) filed a motion to dismiss the case. The Debtors filed a separate motion to convert their case to Chapter 13 (wage-earner reorganization).

While the Court noted that "the Debtors' business operations and ownership and operation of their Property are not illegal under the laws of the state of Colorado," it concluded that both "the Debtors' activity of leasing space to a marijuana dispensary and Mr. Arenas' cultivation of marijuana on the property makes the Debtors liable for criminal penalties under the CSA."

The Court was not unsympathetic to the debtors' situation, but concluded that the case must be dismissed. First, the Court concluded it could not allow the case to move forward under Chapter 7 because that would require a Chapter 7 trustee to act as a landlord to the dispensary and to liquidate the debtors' inventory of marijuana – both "ongoing criminal violation[s] of the CSA." The Court also concluded that converting the case to Chapter 13 was impossible, because the debtors' reorganization "would be funded from profits of an ongoing criminal activity under federal law," and would require the Chapter 13 Trustee to distribute those funds to creditors.

The *Arenas* debtors filed an appeal of the Bankruptcy Court's ruling, which is still pending. The Bankruptcy Judge agreed to stay his ruling pending the appeal. In doing so, the Judge noted the contradiction between (a) the Justice Department's election not to prosecute most marijuana activities that are legal under Colorado law, and (b) its motion (through the United States Trustee) to dismiss the debtors' bankruptcy case for precisely such activities. The Court urged federal legislative action, stating that it "understands the dilemma faced by state citizens whose conduct does not violate state drug laws but who may find themselves denied bankruptcy relief because their conduct does violate the CSA."

*The Takeaway*

Prospective marijuana business owners, and property owners that may lease space to them, must evaluate their own comfort level with the federal government's pronouncements that most persons who operate businesses in compliance with a state legal-marijuana regulatory system are unlikely to be prosecuted. For the time being, without new federal legislation on this issue or appellate decisions reversing cases like *Rent-Rite* and *Arenas*, that evaluation should not assume that relief or protection from the federal Bankruptcy Courts will be available to them.

***Otten Johnson's attorneys have substantial experience with helping clients navigate business issues like those highlighted in this alert. For more information, or for help evaluating your current situation, contact any of the attorneys in the Bankruptcy & Troubled Loans practice group.***

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