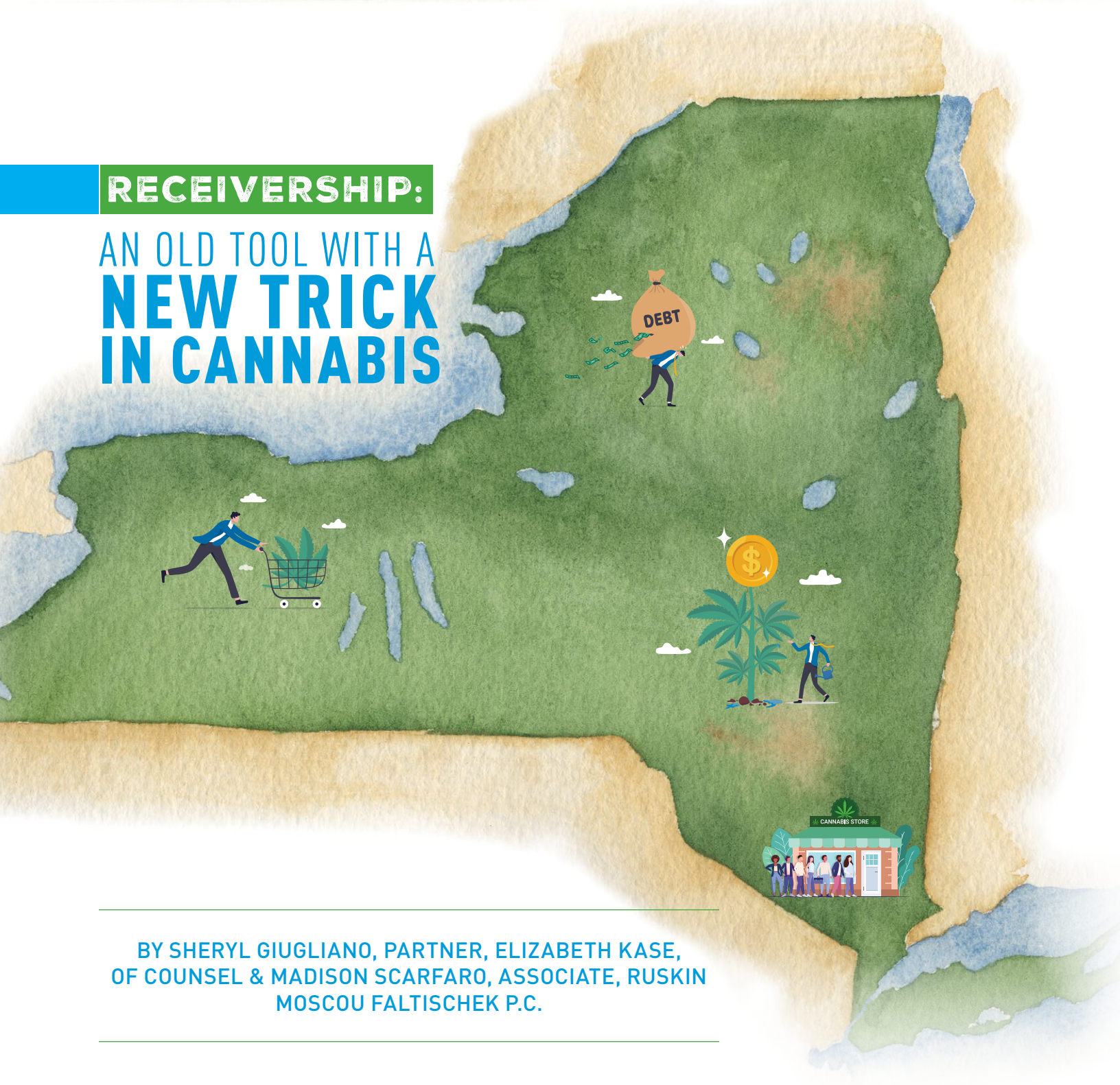
RECEIVERSHIP:

AN OLD TOOL WITH A NEW TRICK IN CANNABIS



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The cannabis industry in New York is one of the fastest growing industries. Rapid change means that innovative alternative ways to solve issues facing individuals or businesses involved with cannabis are required. Cannabis is currently classified as a Schedule I drug under the Controlled Substances Act, so cannabis and cannabis-ancillary businesses are generally unable to benefit from protections afforded by title 11 of the United States Bankruptcy Code. The U.S. Trustee Program, an arm of the U.S. Department of Justice, abides by an office-wide directive in which a trustee must not allow debtors to use bankruptcy to further ongoing commission of federal crimes. Accordingly, the U.S. Trustee will typically seek dismissal of any bankruptcy petition filed by a cannabis-related company.

Several recent decisions discuss whether cannabis and cannabis-related or cannabis-adjacent businesses should be offered bankruptcy protection. Many of the decisions turn on a key question: How dependent or involved is the business with cannabis and cannabis operations? The more involved a business is with cannabis, the less likely it is that a bankruptcy case will survive a motion to dismiss. Two recent court cases serve as examples:

- *In re Way to Grow, Inc.* upheld the bankruptcy court's decision to dismiss Chapter 11 cases where debtors knowingly sold equipment to cannabis growers.

Certain states that have legalized cannabis also have laws governing receiverships, including Arizona, California, Colorado, Illinois, Maryland, Nevada, Oregon and Washington. It is important to review applicable state law to see what is required for the appointment of a receiver in a particular jurisdiction.

- In *In re Rent-Rite Super Kegs W. Ltd.*, the court dismissed the case where the debtor knowingly perpetuated leases with cannabis growers.

Certain states that legalized cannabis allow it and related business (and their creditors) to utilize receiverships, including Arizona, California, Colorado, Illinois, Maryland, Nevada, Oregon, Washington, and, most recently, New York. Receivership is a state law-based resolution that provides a more structured insolvency option for cannabis and cannabis-related companies. Receiverships afford similar protections as those offered by bankruptcy for businesses who are looking to restructure, dissolve, or rehabilitate. Although state law receivership is a great option, most do not provide for an automatic stay, one of the most significant tools offered in a bankruptcy case. Of course, other non-bankruptcy alternatives are available, including assignments for the benefit of creditors, winding-up under state law, and remedies available to secured creditors under the Uniform Commercial Code. While not the focus of this article, they remain viable options.

Key Cannabis-Related Bankruptcy Decisions

As the legalization of cannabis becomes more common, the demand for restructuring options for cannabis and cannabis-related entities will necessarily increase. To that end, there has been a noticeable rise of prospective openness, specifically in the Ninth Circuit, in permitting cannabis-related businesses to remain in bankruptcy.

A 2023 decision gives new hope to cannabis and cannabis-related entities wishing to take advantage of federal bankruptcy laws. In *In re Hacienda Co.*, the United States Bankruptcy Court for the Central District of California denied a motion to dismiss by the U.S. Trustee. The debtor previously manufactured and packaged cannabis products and was ultimately able to proceed with a Chapter 11 plan of reorganization. In *Hacienda*, the bankruptcy judge held that the debtor, a company previously involved in cannabis, but which discontinued its manufacturing and packaging business pre-petition, was able to sell its ownership interest in the Canadian acquiring entity to pay its creditors. The debtor was a California-based company in the business of manufacturing and packaging cannabis products that ceased operations in February 2021 and transferred its assets to a Canadian company that grows and sells cannabis in Canada. The U.S. Trustee, in moving to dismiss, argued that the Hacienda Company was engaging in ongoing violations of the Controlled Substances Act by acting as a wholesale manufacturer of cannabis products. The bankruptcy court held that a company formerly involved in the cannabis industry is an eligible debtor in bankruptcy if it was not engaged in ongoing violations of the Controlled Substances Act.

Several other courts have discussed the issue of cannabis-related businesses and bankruptcy. By way of example, in 2019, in *Garvin v. Cook Investments,* the U.S. Court of Appeals for the Ninth Circuit affirmed a lower court's confirmation of a Chapter 11 plan pursuant to which the debtor would be supported by rental income from a tenant that dealt with cultivating cannabis. In 2020, in *In re Burton,* the Ninth Circuit Bankruptcy Appellate Panel similarly held that "the mere presence of marijuana near a bankruptcy case does not automatically prohibit a debtor from bankruptcy relief."

Last, in at least one case, *In re Medpoint Mgmt.*, a cannabis-related business asserted its violation of the Controlled Substances Act defensively to avoid bankruptcy, and successfully obtained dismissal of an involuntary Chapter 7 bankruptcy commenced against it by three creditors.

Two additional wrinkles to consider while navigating the highly complex cannabis space for businesses are:

1. The effects of rescheduling for medical marijuana.

2. The recent Supreme Court decision affecting the Chevron doctrine.

On May 21, 2024, the U.S. Department of Justice published a notice of proposed rulemaking that announced an intention to reschedule marijuana from a Schedule I to a Schedule III, which is a less restrictive schedule under the Controlled Substances Act. If this is finalized, rescheduling would relax certain restrictions and change the legal framework in which cannabis and cannabis-related entities operate their businesses. Notwithstanding this significant potential shift in the federal drug policy, cannabis-related activities permitted in various states would not suddenly become legal under federal law.[1]

Also, a recent decision from the United States Supreme Court could lean in favor of additional legal challenges to what have historically been restrictive interpretations of cannabis law from government agencies, including the Drug Enforcement Administration. The Supreme Court handed down a decision earlier this year that essentially upended the power that federal agencies held to

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interpret the laws they administer. In *Loper Bright Enterprises v. Raimondo*, the Supreme Court overruled the landmark 1984 decision in *Chevron v. Natural Resources Defense Council* that paved the way for the Chevron doctrine. This doctrine provided that if Congress had not directly addressed a question that was the object of a dispute, a court was required to defer to the agency's interpretation of the statute. The power to interpret an agency's potentially ambiguous laws is now seemingly in the hands of judges.

Receiverships Generally

Until bankruptcy is a reliable option for cannabis and cannabis-related entities, receiverships appear to be a viable alternative in states where cannabis is legal. In a receivership, a court-appointed fiduciary (or one appointed by private agreement) temporarily manages an entity's assets. The general concept is that a receiver as an independent fiduciary is in a better position to preserve the value of remaining property. Unlike a standard Chapter 11 bankruptcy case, receiverships may be less expensive because there are no U.S. Trustee fees, no required monthly operating reports, fewer reporting requirements, no committees, and usually fewer hearings. Unfortunately, there is generally no automatic stay either. However, the benefits of a receivership and the reality of there being no other alternative render receiverships a more appealing option. This article does not address federal receiverships governed by the Federal Rules of Civil Procedure, which are less common and would likely encounter the same issues as a bankruptcy case.

Certain states that have legalized cannabis also have laws governing receiverships, including Arizona, California, Colorado, Illinois, Maryland, Nevada, Oregon and Washington.[2] It is important to review applicable state law to see what is required for the appointment of a receiver in a particular jurisdiction. In New York, for example, Part 36 of the Rules of the Chief Judge governs receiverships. Businesses file papers with the court requesting the appointment of a receiver, which include reasons as to why receivership is necessary in their case. Serving as an equitable remedy, judges determine who should be the appointed receiver. In Colorado, a trial court has no jurisdiction to appoint a receiver where no action was pending against the party at the time of the appointment. The request for the appointment of a receiver may be the only claim for relief, but a complaint must be filed. Similarly, in Arizona, a superior court or a judge may appoint a receiver even if the action includes no other claim for relief. In California, the state receivership statutes specify which circumstances warrant the appointment of a receiver, specifically the California Code of Civil Procedure Sections 564 to 570 and the California Rules of Court, Rule 3.1175 to 3.1184. The courts in California have broad powers under those statutes and rules, so matters related to receiverships are in the discretion of trial courts.

Cannabis Receiverships

While most state court receiverships are industry agnostic, New York recently enacted a receivership option specific to cannabis and cannabis-related entities. This was a much-needed state endorsed program for cannabis and cannabis-related entities facing financial hardships as the New York cannabis industry has been slow to get going, and options for resolving financial distress (beyond liquidation) are extremely limited.

On September 27, 2023, the New York State Office of Cannabis Management (OCM) approved new regulations governing adult-use cannabis. Specifically, the title of Chapter II of Subtitle B of Title 9 of the Official Compilation of Codes, Rules and Regulations of the State of New York was amended, Part 16 was amended regarding definitions and conflicts or inconsistencies of law, and new Parts 118, 119, 120, 121, 123, 124, 125, and 131 were added to be effective upon publication of a Notice of Adoption in the New York State Register, titled, "Chapter II. Adult-Use Cannabis, Medical Cannabis, and Cannabinoid Hemp." Part 124.7 as an addition to the N.Y. Cannabis Law is specific to receiverships for cannabis and cannabis-related entities. N.Y. Cannabis Law § 124.7(a) discusses who may be appointed as a receiver. Once a receiver is appointed, the OCM requires the appointed receiver to receive express authorization from OCM before engaging in any cannabis-licensed activities. Currently, the procedure of appointing a receiver and getting approval for cannabis-licensed activities is discretionary. Likewise, once a receiver is appointed, he or she holds a fair amount of discretion in making decisions regarding the rehabilitation or restructuring of the cannabis business. The court continues to monitor and oversee the decisions and actions of the receiver, which hopefully balances the discretion afforded to the receiver in fulfilling his or her duties.

With § 124.7 in the N.Y. Cannabis Law in effect, cannabis and cannabis-related businesses in New York now have a state law-based solution that allows a receiver to assume control of operations and hopefully help businesses suffering from financial or other distress. Operating a receivership of a cannabis or cannabis-related entity will require patience and creativity. Receivers may need to be prepared for additional delays beyond typical court approval, because in a cannabis receivership, there are likely approvals needed from the state as well. Receivers (and their professionals) should also be prepared to encounter disorganized accounting and incomplete tax filings, and to verify reporting, among other unique hurdles in liquidating (or restructuring) a cannabis or cannabis-related entity.

New York professionals in this space looking for examples to follow may look to other states providing for cannabis and cannabis related entity receiverships. For example, in Oregon, where cannabis and marijuana are legal for recreational use, the state's administrative rules permit a receiver to operate a licensed cannabis business. However, the receiver's authority to operate the cannabis business is limited to "a reasonable period" and provides for the orderly disposition" of assets.

In 2022, CannaVer LLC was the first cannabis receivership in Missouri, relying upon the Missouri Commercial Receivership Act of 2016, §§ 515.500 through 515.665. The receivership arose when the company was unable to continue operating, but held three medical manufacturing licenses. The licenses were the most valuable assets (especially in a limited license state like Missouri), and as noted above, liquidating them took time due to required approvals.[3] In 2023, Skymint, one of Michigan's largest cannabis companies was placed in the control of a receiver as a result of significant unpaid debts. Skymint could not be placed into a bankruptcy, but in 2020, Michigan's laws were amended to allow for receiverships for cannabis companies. In April 2024, MM CAN

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USA Inc., a California corporation and wholly owned subsidiary of MedMen Enterprises Inc., a cannabis company with subsidiaries across the country, was placed into a receivership to effectuate an orderly dissolution of its California-based assets. The parent company, MedMen, was simultaneously placed into a bankruptcy proceeding.

Conclusion

Bankruptcy courts are still hesitant to allow cannabis or cannabis-related businesses to benefit from bankruptcy protections. But receiverships offer a viable alternative to rehabilitate, restructure, or dissolve cannabis and cannabis-related businesses. For example, lenders may feel more comfortable extending credit to cannabis or cannabis-related entities where a state sponsored receivership program is available, especially where the laws and rules are specific to cannabis. At the same time, receivers of these entities will need to exercise patience and be creative about dissolving assets for the benefit of creditors. It seems likely that New York-based cannabis and cannabis-related companies (and their creditors) can be expected to follow suit and take advantage of this new industry-specific receivership toolbox available.

Bankruptcy courts are still hesitant to allow cannabis or cannabis-related businesses to benefit from bankruptcy protections. But receiverships offer a viable alternative to rehabilitate, restructure, or dissolve cannabis and cannabis-related businesses.

[1] "DOJ Proposes Rescheduling Marijuana, But the Outlook for Finalization is Hazy," Ropes & Gray, May 29, 2024, https://www.ropesgray.com/en/insights/alerts/2024/05/doj-proposes-rescheduling-marijuana-but-the-outlook-for-finalization-is-hazy.

[2] "Alternatives to Bankruptcy for Cannabis Companies (Part 2)," Brent Salmons & Yuefan Wang, Cannabis Law Now, Sept. 1, 2023, https://www.cannabislawnow.com/2023/09/alternatives-to-bankruptcy-for-cannabis-companies-part-2/.

[3] "What are my options in cannabis when our company stumbles?," Eric Moraczewski, Greenway Magazine, https://mogreenway.com/2024/05/08/what-are-my-options-in-cannabis-when-our-company-stumbles/.