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Cannabis Alert

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Blazing grass: Financial restructuring and bankruptcy issues in cannabis

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Cannabis companies experiencing financial insolvency must look at options beyond traditional bankruptcy and restructuring avenues to remain viable.



What's the Impact?

- / Despite a promising economic outlook, the current unavailability of bankruptcy relief for cannabis businesses must be considered when starting a business
- / Cannabis and cannabis-adjacent companies in distress can work with cannabis attorneys specializing in financial restructuring and bankruptcy issues to weigh bankruptcy alternatives

Recreational use of marijuana is currently legal in 19 states, Washington, D.C., and Guam. Medical use of marijuana is legal in about two-thirds of the states. As states continue to legalize the sale and use of medical and recreational cannabis, there has been and will be a proliferation of new cannabis businesses, both directly and indirectly involved, as well as economic activities driven by market demand and profit potential.

As with many startups in an expanding new market, supply and demand, pricing, competition, and other economic factors can result in a company over leveraged and in financial distress. A company directly engaged in the manufacture, distribution, or dispensing of cannabis products so distressed will adversely affect the companies adjacently involved who are owed money for goods and services. Early signs of financial distress can include late or missed payments and an increase in orders for goods or services by the company directly engaged in the cannabis business.

Resolutions and challenges

If a company directly engaged in the cannabis business cannot contain its losses, its options may be limited to selling its assets or liquidation. In most industries, the start-up company may seek Bankruptcy Code protection to take advantage of the automatic stay while it attempts to restructure or sell its business. The Bankruptcy Code provides a vehicle for the debtor to deal with all of its assets in one place and assures creditors of equal treatment by the debtor. In a bankruptcy case, the rights and remedies of the debtor and its creditors are relatively predictable and merit consideration by either a company considering doing business with a startup directly engaged in the cannabis sector or by the startup itself.

With cannabis still classified as a Schedule I controlled drug under federal law, bankruptcy protection is currently not a viable restructuring option for an entity directly engaged in cultivating, distributing, and/or possessing cannabis products. The Department of Justice (DOJ) has generally taken a “hands-off” approach to enforcement of these laws if the parties are otherwise in compliance with state law.

In most of the reported bankruptcy cases involving a person or entity directly engaged in the manufacture, distribution, or dispensing of cannabis products, the bankruptcy petitions have either been dismissed or the reorganization plans have been deemed unconfirmable. Bankruptcy courts are governed by federal law and the courts have consistently denied relief to debtors directly engaged in the cannabis trade on the basis that it is an ongoing criminal enterprise. The Office of the U.S. Trustee, which is part of the DOJ, has issued a policy statement on the subject stating that it will contest bankruptcy cases involving cannabis because (i) a business reorganization would constitute the ongoing commission of a crime and (ii) a bankruptcy trustee or a debtor in possession with the powers and duties of a trustee cannot administer illegal assets.

The lack of access to bankruptcy protection also extends to adjacent companies providing the ancillary goods and services to entities directly engaged in the sale of cannabis. Landlords who lease space to tenants and equipment suppliers selling hydroponic equipment to customers directly engaged in selling cannabis products have been denied bankruptcy protection simply based on the receipt of “illegally” generated revenues. In another example, an employee working for a cannabis dispensary could not confirm a Chapter 13 bankruptcy plan since the employee’s wages were traceable to the sale of illegal drugs.

Other solutions

There are non-bankruptcy alternatives to debtors and creditors involved in cannabis-related business activities that are legal under state law. These alternatives include traditional collection cases, receiverships, assignments for the benefit of creditors, U.C.C. Article 9 sales, wind-ups and dissolution under state law, work-out agreements, and foreign insolvency proceedings (e.g., the Canadian Companies' Creditors Arrangement Act).

Each of these alternatives have some advantages depending the jurisdiction, the debt structure, the parties involved, and timing and cost considerations. On the other hand, the non-bankruptcy alternatives do not enjoy the advantages available in a bankruptcy cases, such as the protection of the automatic stay, the benefits of a sale free and clear of liens, the claim objection procedures, and the remedies of avoidance and recovery of preferences and fraudulent transfers.

Path forward

The current unavailability of bankruptcy relief to persons and entities either directly engaged or adjacently involved in the cannabis sector is an important issue that should be considered when starting a business. Although the economic forecast may look promising, it is worth considering what options are available if the cannabis company experiences financial distress. In many cases, parties entering into new business relationships will negotiate terms in their contracts that deal with a future bankruptcy filing. The same consideration should be given to a situation where a bankruptcy filing is not an option. For these reasons, it is pivotal to consult with a cannabis attorney specializing in financial restructuring and bankruptcy issues before launching a startup where the business either directly and indirectly involves cannabis.

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