

Legalized Marijuana Sector Reaches New Highs: Safeguards for Investors and Creditors

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Financial Restructuring and Bankruptcy Alert

8.15.17

In recent years legalized marijuana businesses have seen sales increase and profits reach new highs. This new revenue stream has attracted not only investors but states willing to legalize marijuana for the associated tax revenue. Despite marijuana's nuanced legality, it is likely to continue its growth and investors and creditors alike will need to be prepared to address the risks involved. In 2016, the marijuana market posted \$6.7 billion in revenue in North America; a 30% increase over revenue in 2015. Tax revenue from the marijuana industry rose to over \$200 million in 2016 for Colorado alone. With growth levels skyrocketing, it is little wonder why 29 states and the District of Columbia have legalized marijuana in some form and investors and entrepreneurs are eager for a piece of the market. However, it isn't all positive forecasts. The marijuana industry is reported to have a failure rate of about 40% - slightly higher than the national average for new businesses. While not necessarily a bad sign for the industry or its potential, it should signal some measure of caution. Just because the industry is booming does not mean that every business will be a success.

Because marijuana remains illegal under federal law, there are certain legal protections for businesses and their investors that are not currently available to those involved in marijuana related businesses. This issue was most recently highlighted when Clifford White, Director for the United States Trustee Program, made clear the federal government's continued opposition to marijuana businesses by directing regional bankruptcy trustees to oppose any bankruptcy filed by a marijuana business or marijuana related business. Because the bankruptcy trustees serve as the "watch-dogs" of the bankruptcy process, this letter, together with the developing case law holding that the bankruptcy courts are not available to marijuana related businesses, effectively prevent any marijuana related business from using bankruptcy to reorganize or liquidate a failing business.

When a marijuana business finds itself in challenging financial straits, both investors and creditors can also find themselves in a difficult place. Usually a struggling business could restructure or liquidate by filing for bankruptcy. However, this is currently not an option for marijuana businesses. Director White's letter expressed concern over the "increase in the number of bankruptcy cases involving marijuana assets" and instructed trustees to object to any bankruptcy case that involved marijuana assets, which includes reliance on income from marijuana sales. Director White's letter had the stated goal of trying to ensure that trustees did not violate the Controlled Substances Act (CSA) 21 U.S.C. § 801 *et seq.* by administering assets related to a Schedule 1 drug. The Department of Justice has made clear that the prohibition applies to cases "in which the marijuana assets would leave the estate through exemption or abandonment." This not only creates problems for marijuana businesses, but is also a major buzz kill for investors, landlords, and other creditors connected to a marijuana business, because they lose the transparency and protections that federal bankruptcy law provides.

While the Bankruptcy Code does not explicitly prohibit a marijuana business from filing for bankruptcy, bankruptcy courts may dismiss cases for "cause." This dismissal occurs when continuing the case would require the trustee to manage assets in contravention of the CSA (as would be the case with marijuana) or if the debtor's plan relies upon income from the sale of marijuana.

Prior to Director White's letter, the courts addressing the availability of federal bankruptcy courts to marijuana related businesses have been uniform. They have held that debtors operating a marijuana business are barred from filing for bankruptcy. Other courts have held that those receiving income from marijuana businesses have also been barred. For example, cases involving landlords of marijuana businesses, owners of intellectual property (such as trademarks) licensed to a marijuana business, and even creditors filing an

involuntary bankruptcy case against a marijuana business have all been dismissed because the cases involved income from the sale of marijuana. Now that the Justice Department has officially weighed in, it seems clear that federal bankruptcy laws are not an option for marijuana related businesses in the current environment.

State court remedies may also be limited. Generally, state laws allow creditors the ability to foreclose or garnish assets of a debtor. They also permit businesses to effectuate an assignment for the benefit of creditors (ABC), which is a state law alternative to federal bankruptcy. However, states that have legalized the sale of marijuana have strict laws governing those companies that can lawfully grow, distribute and sell marijuana. Licensing requirements limit who can sell marijuana and most states do not allow the transfer of these licenses without review and authorization by the state. Consequently, investors and creditors may be unable to either foreclose on or sell inventory or the related license to pay debts or recoup their investment. While some states, such as California and Washington, either contemplate or specifically provide for the use of a receiver for liquidation, many states have not addressed the issue.

Despite the complications and risks created by the fact that marijuana remains illegal at the federal level, the growth of marijuana related businesses do not seem to be affected. While there are certainly risks, the benefits of being a part of one of the fastest and most lucrative fields continues to draw the attention and support of states and investors alike. For example, on June 20, 2017, Pennsylvania (for the first time ever) issued licenses to growers and attracted some prominent investors, including Jack Ham (former linebacker for the Pittsburgh Steelers) and Keith Morgan (heir to the Aamco transmission fortune). Pennsylvania has also issued 27 dispensary permits to date, including ten in the Southeast Region, which includes Philadelphia, Bucks, Chester, Montgomery, and Berks Counties. Similarly, on July 1, 2017, Nevada began sales of recreational marijuana. Sales quickly exceeded expectations and due to a glitch in Nevada's regulatory framework, dispensaries began to run out of product and faced closing shop. To avoid a loss in tax revenue, Nevada declared a state of emergency and eased regulations on transporting marijuana to increase the amount of product available to dispensaries.

Though states and investors are moving forward, the federal government is highly unlikely to legalize marijuana in the near future. Investors and creditors should take this into account before getting involved in this area. Investors should plan to have appropriate measures in place to protect their interests, including selecting the appropriate form of entity, which can affect control of the business and transfers of interest, and creating a proper exit strategy. Creditors, meanwhile, will need to consider the need for additional collateral to secure their interests, such as real estate, personal guarantees, and where possible the license or shares/interest in the business. Creditors, such as landlords or mortgagees, should also address their rights for termination and setoff against accounts.

If a business becomes financially insolvent, having the proper protections and understanding in place from the beginning will improve a party's recovery during the restructuring or liquidation of the business. Although there will still be issues that need to be resolved, careful planning at the outset can prevent your investment from going up in smoke.

Attorneys at White and Williams have been advising marijuana related businesses in the creation of business entities, addressing particular state requirements for operating in this sector, and advising investors and creditors of their options to ensure their rights are protected. If you have questions or would like additional information regarding specific points regarding state laws governing marijuana businesses, please contact Thomas Pinney (pinneyt@whiteandwilliams.com), Suzanne Prybella (prybellas@whiteandwilliams.com) or James Vandermark (vandermarkj@whiteandwilliams.com).

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