Growing Medical Marijuana, Problematic in Bankruptcy, and Out

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Frank Arenas is licensed in Colorado to grow and dispense medical marijuana. He and his wife own a building, half of which is used for the cultivation and the other half of which is leased to a marijuana dispensary. These activities are legal in Colorado, but, despite then Attorney General Eric Holder's expressed willingness to work with Congress[i] to reschedule marijuana and remove it from the Schedule I (high potential for abuse) drug list[ii], 21 U.S.C. § 856(a) has not been amended. Thus, knowingly opening, renting, using or maintaining any place, even temporarily, for the purpose of manufacturing, distributing or using any controlled substance is a federal crime. Similarly, 21 U.S.C. § 841(a)(1) makes it unlawful for any person knowingly or intentionally to manufacture, distribute, or dispense or possess with intent to do so, a controlled substance.

When Mr. Arenas tried to evict his tenant but lost the effort and, instead, suffered a judgment that Arenas could not pay, he and his wife filed Chapter 7.[iii] They listed their nonexempt marijuana plants with a value of $6,250 and their building as worth $262,725 but as over-encumbered with liens. The trustee filed a notice of no distribution but after he received some indication that a purchaser would take the property, he withdrew that notice and consulted with the United States Trustee ("UST") to determine whether he could administer the property. The UST said no and filed a motion to dismiss the case for cause because the property could not be administered without violating federal law. In response, the Debtors moved to convert their case to Chapter 13. The bankruptcy court denied the motion to convert and dismissed the case. Debtors appealed to the Tenth Circuit Bankruptcy Appellate Panel ("BAP").

In analyzing whether engaging in marijuana trade, legal under Colorado state law but illegal under federal law, constituted cause to dismiss the bankruptcy for lack of good faith, the BAP concluded that bankruptcy relief is unavailable to debtors whose business activities violate federal law.[iv] Relying on *Marrama v. Citizens Bank of Mass.,* 549 U.S. 365 (2007), the BAP opined that good faith is an affirmative requirement for confirmation of a plan under 11 U.S.C. § 1325(a)(3) and that a debtor whose plan payments would be funded with proceeds of a criminal activity could not meet the standard that the plan be proposed in good faith and not by any means forbidden by law. Moreover, a Chapter 7 trustee could not administer these assets without running afoul of the Controlled Substances Act.>[v] Thus, Debtors could not fund a plan and could not stay in Chapter 7

The BAP noted that Debtors had never asked the bankruptcy court to require the Chapter 7 trustee to abandon the marijuana assets if he could not administer them. But even if they had, this estate had no ostensible means of producing a dividend to creditors other than the marijuana business. Allowing Debtors a discharge would permit them to keep the marijuana assets through the abandonment while being protected from collection activities. The BAP concluded that such a result "strikes us as prejudicial delay that amounts to cause for dismissal." [vi]

The tension between state law authorizing a marijuana trade and federal law prohibiting it should make lenders wary of involvement in this type of business. Unfortunately, that same tension means that a person searching for a lending facility to start or maintain this trade encounters difficulties approaching traditional lenders for funds. Who, then, will lend the money?

In February, 2014, the U.S. Department of the Treasury, through the Financial Crimes Enforcement Network ("FinCEN"), [vii] the agency primarily responsible for administering the Currency and Foreign Transactions Reporting Act of 1970 (commonly referred to as the Bank Secrecy Act ("BSA")),[viii] issued a Guidance to clarify BSA expectations for financial institutions seeking to provide services to marijuana-related businesses.[ix] Notwithstanding the effort, the restrictions identified in the Guidance were substantial for financial institutions that may want to participate in the lending market for these transactions. Among others, the lending institution was not relieved of the obligation to file suspicious activity reports ("SAR"), although a limited report was authorized in some circumstances.[x] As noted in the Guidance: "Financial institutions shall file with FinCEN, to the extent and in the manner required, a report of any suspicious transaction relevant to a possible violation of law or regulation. A financial institution may also file with FinCEN a SAR with respect to any suspicious transaction that it believes is relevant to the possible violation of any law or regulation but whose reporting is not required by FinCEN regulations."[xi]

Some of the activities on the "watch list" were described in the FinCEN report as follows:

The Cole Memo provides guidance to DOJ attorneys and law enforcement to focus their enforcement resources on persons or organizations whose conduct interferes with any one or more of the following important priorities (the "Cole Memo priorities"):

- Preventing the distribution of marijuana to minors;
- Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;
- Preventing the diversion of marijuana from states where it is legal under state law in some form to other states;
- Preventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;
- Preventing violence and the use of firearms in the cultivation and distribution of marijuana;
- Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
- Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and
- Preventing marijuana possession or use on federal property.[xii

It remains to be seen whether nontraditional, legitimate lenders will provide substantial financing for marijuana businesses authorized by state law but acting in violation of federal law. One concern must be that financing activity that the federal government views as a crime would constitute aiding and abetting, also in violation of federal law. Prudent bankruptcy counsel may want to consider these issues when advising their clients regarding extending cash collateral or making DIP loans for debtors engaged in the marijuana trade, and, in light of *Arenas,* question the likelihood that a court would approve of either.

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[i] See Ryan J. Reilly,"Eric Holder Would Be 'Glad To Work With Congress' To Reschedule Marijuana," Huff Post Politics, Aug. 4, 2014.

[ii] Schedule I includes ecstasy, heroin and LSD.

[iii] In re Frank Anthony Arenas, et al. Debtors, Bankruptcy No. 14-11406 (District of Colorado).

[iv] Frank Anthony Arenas and Sarah Eve Arenas, Appellants, v. United States Trustee, Appellee, BAP No. CO-14-046 (B.A.P. 10th Cir., Aug. 24, 2015) ("Opinion").

[v] 21 U.S.C. § 801 et seq.

[vi] Opinion, note iv, *supra,* typescript at 16.

[vii] “FinCEN’s mission is to safeguard the financial system from illicit use and combat money laundering and promote national security through the collection, analysis, and dissemination of financial intelligence and strategic use of financial authorities.” See FinCEN Welcome page, *available at* http://www.fincen.gov.

[viii] The BSA is the law by which U.S. financial institutions must assist federal agencies to detect and prevent money laundering by keeping records of cash transactions over $10,000. The question of what reports were required when a business was authorized by state law but involved marijuana arose. The government stepped in to provide guidance through the February, 2014 FinCEN report.

[ix] **FIN-2014-G001, Guidance, “BSA** Expectations Regarding Marijuana-Related Businesses” (Feb. 14, 2014), *available at* http://www.fincen.gov/statutes_regs/guidance/html/FIN-2014-G001.html.

[x] “A financial institution providing financial services to a marijuana-related business that it reasonably believes, based on its customer due diligence, does not implicate one of the Cole Memo priorities or violate state law should file a ‘Marijuana Limited’ SAR. The content of this SAR should be limited to the following information: (i) identifying information of the subject and related parties; (ii) addresses of the subject and related parties; (iii) the fact that the filing institution is filing the SAR solely because the subject is engaged in a marijuana-related business; and (iv) the fact that no additional suspicious activity has been identified. Financial institutions should use the term “MARIJUANA LIMITED” in the narrative section.

A financial institution should follow FinCEN’s existing guidance on the timing of filing continuing activity reports for the same activity initially reported on a “Marijuana Limited” SAR. The continuing activity report may contain the same limited content as the initial SAR, plus details about the amount of deposits, withdrawals, and transfers in the account since the last SAR. However, if, in the course of conducting customer due diligence (including ongoing monitoring for red flags), the financial institution detects changes in activity that potentially implicate one of the Cole Memo priorities or violate state law, the financial institution should file a ‘Marijuana Priority’ SAR.” *Id.* (footnotes omitted).

Note that the Cole Memo was issued by U.S. Department of Justice Deputy Attorney General James M. Cole to all United States Attorneys providing updated guidance to federal prosecutors concerning marijuana enforcement under the CSA to deal with the fact that 20 states and the District of Columbia had legalized certain marijuana-related activity. The Cole Memo guidance applies to all of DOJ’s federal enforcement activity, including civil enforcement and criminal investigations and prosecutions, concerning marijuana in all states. *See* James M. Cole, Deputy Attorney General, U.S. Department of Justice, *Memorandum for All United States Attorneys: Guidance Regarding Marijuana Enforcement* (August 29, 2013), *available at* http://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf. As stated in the FinCen Guidance, The Cole Memo reflects “Congress’s determination that marijuana is a dangerous drug and that the illegal distribution and sale of marijuana is a serious crime that provides a significant source of revenue to large-scale criminal enterprises, gangs, and cartels.”

[xi] See note 5 of the FinCEN report, citing, e.g., 31 CFR § 1020.320.

[xii] **FIN-2014-G001, Guidance, “BSA** Expectations Regarding Marijuana-Related Businesses” (Feb. 14, 2014), *available at* http://www.fincen.gov/statutes_regs/guidance/html/FIN-2014-G001.html.

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