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Client Alert

Cannabis Law

Way to Grow gets 'no go' from bankruptcy court

At a Glance…

Virtually all bankruptcy courts faced with the question of whether growers or dispensers of cannabis and cannabis products can take advantage of the protections afforded by the federal bankruptcy laws have said, no, they cannot. Recently a federal district court in Colorado decided that even an entity that supplies equipment and consulting services to cannabis growers (in this case hydroponic gardening equipment and advisory services) and whose revenues are largely derived therefrom is likewise ineligible to use the Bankruptcy Code to reorganize or liquidate, especially when the business plan is dependent upon continuing to service these same customers. In this case, as in many others, the cannabis companies involved are operating legally under applicable state laws.

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Background

The case of *In re Way to Grow, Inc.*, Case No. 18-14330-MER, Dkt. No. 379 (Bankr. D. Co. Dec. 14, 2018) involved three debtors, whose business was the sale of equipment for indoor hydroponic gardening as well as consultative services. The debtors sold their equipment to growers of all types of crops but many of their customers were growers of cannabis. Further, the debtors' business plan and future expansion was predicated upon sales to growers of cannabis.

Cannabis remains a schedule 1 drug under the Controlled Substances Act, 21 U.S.C. § 101, *et seq.* (the "CSA"), which means that growing and dispensing cannabis is a federal crime, regardless of whether the grower/dispenser is in compliance with applicable state laws.

The *Way to Grow* decision is extremely comprehensive in that the court analyzes and summarizes virtually all bankruptcy court decisions involving debtors in the cannabis business or in businesses that rely heavily upon customers in the cannabis industry. When it comes to businesses that grow or sell cannabis, courts uniformly agree that such entities may not take advantage of federal bankruptcy law, even if they intend to liquidate. This is because after filing their bankruptcy cases, such entities are in continued violation of federal law by virtue of growing or selling their products, or if they are liquidating, a trustee or debtor in possession is in violation of federal law when it sells cannabis products.

The more difficult decision arises when debtors whose products are not illegal supply products to cannabis growers or distributors for the purpose of enabling such entities to produce or distribute cannabis.

The court pointed out that a debtor involved in a business that does not "touch the plant" sells or leases property to a business that does touch the plant and continues to do so following a bankruptcy filing is violating federal law by enabling another to violate the CSA.[1]

The court summarized the prevailing rule as follows: first, a party cannot seek bankruptcy relief from a federal court while continuing to violate federal law; second, a bankruptcy case cannot proceed where the court, the trustee or a debtor in possession will necessarily be required to possess and administer assets that are either illegal under the CSA or constitute proceeds of activity criminalized by the CSA; and third, the focus of the court's inquiry should be on the debtor's marijuana related activities during the bankruptcy case and not necessarily before the case." *Way to Grow*, Case No. 18-14330-MER, Dkt. No. 379, at 9.

In this case, debtors were in the business of providing products to cannabis growers. Those products were not themselves illegal and could be used by growers of crops other than cannabis. The court noted that because the debtors were not growers or dispensers of marijuana, its inquiry needed to focus upon whether the debtors had a specific intent to enable their customers to engage in an illegal activity. The court found that while the debtors were not violating the CSA through complicity in criminal activity by their marijuana growing customers, another provision of the CSA produces violations based upon a lesser *mens rea* of simply knowing how ones' products will be used.[2] *Id.* at 20. To counter this argument involving the debtors' knowledge and intent, the debtors argued that while their products were used by some cannabis growers, they were also used by other entities growing

crops that are not controlled substances.

In a case from the Tenth Circuit, which the court in this case was obligated to follow, the court noted the applicable scienter requirement. The court in this case found that debtors had actual knowledge that they were selling equipment used to manufacture a controlled substance. The equipment at issue – hydroponic supplies – is related to marijuana cultivation. The debtors' former principal testified that meeting the needs of cannabis growers is essential to the debtors' success. Further, one of debtors' products was specifically used to make "water hash," a concentrated marijuana derivative. Other key witnesses also testified about the use of the debtors' products in producing cannabis and in selling cannabis products. *Id.* at 22-25.

In its finding of illegal conduct by the debtors, the court said that "considering the abundant evidence, debtors efforts to distance themselves from knowledge of their customers' use of their products is simply not credible." *Id.* at 26. Further, "Debtors certainly know they are selling products to customers who will, and do, use those products to manufacture a controlled substance in violation of the CSA … There is no evidence this business model has materially changed post-petition." *Id.*

The court also found that the debtors would not have a viable business without their clientele in the cannabis industry. Ridding themselves of cannabis producer clients would cause the debtors to lose a substantial portion of their revenue, which was unlikely to be made up from other legal sources. *Id.* The court concluded that the debtors' business model and execution thereof fundamentally violates section 843(a)(7) of the CSA. *Id.* These violations continued post-petition and consequently the court was compelled to order a dismissal of the cases.

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1. Specifically, the CSA makes it a federal crime to "manufacture" or "distribute" "any equipment, chemical, product or material which may be used to manufacture a controlled substance …
2. Under federal law, those who provide knowing aid to persons committing federal crimes, with the intent to facilitate the crime, are themselves committing a crime. See 18 U.S.C. § 2.

If you have questions or would like additional information on the material covered in this Alert, please contact the author – listed below – or the Reed Smith lawyer with whom you regularly work.

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