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Are the Bankruptcy Courts Available for the Cannabis Industry?

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Since 2012, ten states and the District of Columbia have legalized marijuana for adult recreational use.

Another 23 states have legalized some form of medical marijuana use. At the federal level, the Agriculture Improvement Act of 2018, or AIA, decriminalized hemp and hemp-derived cannabidiol ("CBD"), by removing both substances from the definition of "marijuana" under the Controlled Substances Act of 1972 ("CSA"). With these legal changes, businesses of all stripes – from growers, extractors, and dispensers to product manufacturers, lenders, insurers, and others that do not "touch the plant" – have entered the cannabis industry across the country. CBD is being touted as everything from a trendy additive to food and beverages – the new ginseng – to a miracle elixir, and products containing hemp-derived CBD are proliferating.

Like any other industry, some cannabis businesses will thrive, others will struggle, and still, others will fail. Many of these struggles are heightened for the cannabis industry due to unique regulatory challenges and difficulties obtaining insurance, banking services, merchant services, and access to capital. When businesses struggle or fail in the cannabis industry, will the doors to the bankruptcy court be

open to them – and their creditors – to reorganize their debts, liquidate their assets, and orderly pay claims?

Marijuana

In North Carolina, marijuana – and hemp if it contains too much delta-9 tetrahydrocannabinol ("THC") – is illegal. But in those states that have legalized medical and/or recreational marijuana use, the courts have consistently held that businesses in the marijuana industry cannot rely on the protections of the Bankruptcy Code.

Recently, in In re Way to Grow, Inc., a bankruptcy court in Colorado – where recreational marijuana use is legal under state law – dismissed a bankruptcy filing by three companies who sold equipment for indoor hydroponic gardening. The companies sold their equipment to growers of a variety of crops including marijuana, and their business plan and future expansion relied on continuing sales to marijuana growers.

The bankruptcy court pointed out that a party may not seek bankruptcy relief while violating or continuing to violate federal law. Despite Colorado law, marijuana remains a Schedule I drug under the CSA, and growing and dispensing marijuana is a federal crime. Therefore, businesses that grow or sell marijuana may not take advantage of bankruptcy, even to liquidate, because they violate federal law by growing or selling their products. If they liquidated, then a trustee or debtor in possession would violate federal law when it sold marijuana products.

According to the Way to Grow court, the prohibition on bankruptcy relief also extends to businesses who do not "touch the plant." In other words, it is no defense for a business to argue that it is not a grower or dispenser and that its products – like hydroponic gardening equipment – are not themselves illegal. If a business sells or leases property to a business that touches the plant and continues to do so during bankruptcy, it enables another to produce or distribute marijuana and violates federal law. The court found that the debtors knew their products were used to grow marijuana and they would have no viable business without their marijuana clients.

Hemp and Hemp-Derived CBD

The AIA left regulation of hemp and hemp-derived CBD to the United States Department of Agriculture, the Federal Food and Drug Administration ("FDA"), and, if they so choose, applicable state-level agencies. Simultaneous with the passage of the AIA, the FDA issued a non-binding press release. It signaled the FDA's intent to regulate hemp and hemp-derived CBD being used to produce food, cosmetic, and dietary supplement products. You can read more about the FDA's statement here.

And then in February, the North Carolina Department of Agriculture and Consumer Services, Food and Drug Protection Division (the "Division") disclosed its intent to issue CBD Advisory Warnings. The Division claims that under the Federal Food, Drug and Cosmetics Act, which has been adopted and implemented by North Carolina, (i) it is illegal to sell any human food or animal feed in North Carolina that

contains CBD because CBD is the active ingredient in an FDA-approved therapy, (ii) CBD cannot be considered a dietary supplement because of its inclusion in an FDA-approved drug, and (iii) any product that contains CBD and makes health-related claims must be approved by the FDA before sale.

The Division will issue warning letters to companies and retailers it believes violates these provisions. For now, the Division has signaled that it will take an "educate first" approach with the industry. But companies that ignore the Division's notices and demands may face additional future action, including product embargoes and seizures. You can read more about the Division's statement here.

For North Carolina businesses involved in the burgeoning market for edible and drinkable CBD products, there is uncertainty on how the bankruptcy courts will treat the positions of the FDA and the Division. Will it be enough for a potential debtor to establish that it does business in the now "legal" – according to the AIA – hemp or hemp-derived CBD business? Or will the FDA and Division's actions cause a bankruptcy court to treat certain CBD-related business activity as illegal – or illegal enough to deny it bankruptcy relief? Unfortunately, the law is unsettled right now, and it is impossible to answer these questions with certainty. Businesses should factor this uncertainty into their decisions.