Debtors' Operations that Violate Federal Law Preclude Access to Bankruptcy Court Relief

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A recent decision by the U.S. Bankruptcy Appellate Panel of the Tenth Circuit held that parties whose conduct violates federal law (in this case deriving income from the medical marijuana industry) are not eligible for relief under the Bankruptcy Code. See *Arenas v. U.S. Tr.* (In re *Arenas*), 2015 BL 270646, B.A.P. 10th Cir., No. CO-14-046, Aug. 21, 2015. While the facts of this decision may be unique, the holding may have potential significance in situations where federal enforcers, when faced with a bankruptcy filing by a debtor violating federal law, may wish to try to stop bankruptcy proceedings in connection with their prosecution of such violations.

In *Arenas*, debtors Frank and Sarah Arenas were licensed to grow and dispense medical marijuana in the state of Colorado, and they also leased a building to third parties who used it to dispense medical marijuana. The debtors brought an eviction action against their tenants that resulted in a $40,000 attorney's fees award in favor of the tenants. Unable to pay this judgment, the debtors filed a Chapter 7 bankruptcy petition in February of 2014.

Shortly after commencement of the case, the Office of the United States Trustee filed a motion to dismiss for cause, arguing that it would be impossible for the Chapter 7 trustee to administer the debtors' assets without violating federal law. The debtors objected to the motion to dismiss and moved to convert their case to Chapter 13, which is intended to allow individuals with regular income to restructure their finances through a plan that uses the debtor's income to pay some or all of its debts.

The bankruptcy court held an evidentiary hearing and acknowledged that although it is a violation of the Controlled Substances Act (CSA) to possess, grow or dispense marijuana (or to assist others in any of these activities), Colorado is one of over twenty states that has chosen to legalize and regulate medical marijuana activities. Despite the fact that the debtors' business operations were legal under Colorado state law, the court concluded that the debtors failed to meet the "good faith" requirement of the Bankruptcy Code because the administration of the estate's assets was forbidden by federal law. Accordingly, the bankruptcy court entered an order denying the debtors' motion to convert their case and granting the U.S. Trustee's motion to dismiss the debtors' Chapter 7 case. The debtors appealed this order directly to the U.S. Bankruptcy Appellate Panel of the Tenth Circuit.

The appellate panel addressed two issues and affirmed the bankruptcy court's ruling in both respects. First, the panel concluded that a debtor cannot move to convert its Chapter 7 proceeding to Chapter 13 if the debtor's Chapter 13 plan would depend on the proceeds of a state-licensed marijuana business. Second, the panel ruled that a debtor cannot be eligible for Chapter 7 relief if the nature of the debtor's business would require the trustee to administer and distribute the estate's assets in violation of federal law.

In reaching these conclusions, the panel emphasized several key points. First, any reorganization under Chapter 13 or distributions to creditors under Chapter 7 would be funded by activities that are forbidden by federal law. Because the debtors would be unable to comply with the Bankruptcy Code's requirement that any Chapter 13 plan be "proposed in good faith and not by any means forbidden by law," the appellate panel determined that this inability to confirm a plan represented a lack of good faith.

Second, the impossibility of administering the estate constituted cause for dismissal because any bankruptcy proceeding would be unreasonably prejudicial to creditors. In connection with this second point, the appellate panel rejected the debtors' argument that the trustee could simply abandon the debtors' marijuana-related assets and proceed to administer a bankruptcy estate consisting of the debtors' remaining assets. This would have provided the debtors with a windfall by allowing them to keep their primary assets while shielding the debtors' most valuable assets from creditors' collection efforts.

The order of the appellate panel has been stayed pending resolution of the debtors' appeal to the U.S. Court of Appeals for the Tenth Circuit. Although this is the first appellate level decision to address the issue, U.S. Bankruptcy Courts for the District of Arizona and the District of Colorado have issued similar decisions in the past. See *In re Medpoint Mgmt., LLC*, 528 B.R. 178 (Bankr. D. Ariz. 2015) (declining to enter an order for relief that would result in the Chapter 7 trustee necessarily violating the CSA in carrying out his or her duties under the Bankruptcy Code); *In re Rent-Rite Super Kegs West Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012) (holding that the debtor's business activities, which included leasing warehouse space to tenants that grew marijuana, constituted cause to dismiss or convert the debtor's chapter 11 proceeding).

In light of this precedent and the sound legal reasoning in the appellate panel's decision, it is unlikely that the decision will be overturned on appeal to the Tenth Circuit. However, reasonable arguments for a contrary conclusion do exist. For example, some parties, including the debtors in *Arenas*, have tried to argue that the concepts of "for cause" and "good faith" are equitable arguments that require a bankruptcy court to consider all of the relevant factors instead of focusing only on federal law. In addition, when analyzing Chapter 11's requirement that a plan be proposed "in good faith and not by any means forbidden law", a minority of courts and commentators have focused their analyses on the debtor's conduct in obtaining votes to confirm the plan and not necessarily on the substantive nature or means of implementation of the plan.

It has always been clear that a bankruptcy court will deny confirmation of a proposed plan if the plan seeks to restructure the emerging enterprise in a way that would violate federal law (e.g., federal antitrust laws). However, despite its unusual fact pattern, *Arenas* makes it clear that past business practices that are legal under applicable state law can also have adverse effects in bankruptcy court. As a practical matter, there are few debtors whose businesses are inextricably intertwined with unlawful activity, so the holding in *Arenas* is unlikely to apply very often. However, if a company's business model involves the violation of a federal law to the extent that a bankruptcy trustee would not be able to operate the business without violating the law, the government or another party in interest may seek to prevent that debtor from availing itself of the bankruptcy process. For example, if a hospital or other healthcare provider operated in violation of federal law and would not be able to alter its operations, the government or another party in interest could argue that the company was not entitled to bankruptcy relief on account of its conduct. Accordingly, healthcare providers whose businesses run afoul of federal law may encounter obstacles when seeking bankruptcy protection or a discharge of their debts.

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