

Cannabis Businesses in Bankruptcy – Pushing the Envelope

July 27, 2020

Client Advisory

As cannabis businesses continue to struggle with the restrictions – including the limitation on the right to reorganize in bankruptcy – that derive from the impact of federal criminal law, new developments should lead to the adoption of more precise guidelines for business that operate in the margins of the field. A recent bankruptcy filing in Colorado is set to provide the next step in this process.

United Cannabis Corporation filed a Chapter 11 case in April in the District of Colorado (*in re United Cannabis Corporation*, Case No. 20-12692). The initial filing, in obvious recognition of the judicially-enforced bar of the federal courts to companies having any relationship to the cannabis industry, contained a disclaimer that the company dealt exclusively in hemp rather than cannabis, and argued that since hemp has been removed by the 2018 amendments from the definition of banned controlled substances, there is no bar to its seeking relief under the Bankruptcy Code. Despite this, the bankruptcy court, *sua sponte*, immediately issued an order to show cause directing the debtor to explain why its case should not be dismissed under governing principles of law. The United States Trustee added its voice in support of dismissal, while the debtor's response, filed in mid-May, attempted to downplay its involvement in cannabis, as opposed to hemp, business.

However, a creditor filed a separate motion to dismiss, basing its argument on two principal grounds. The first, which raises issues that have been fought over in other cases, is that despite its protestations to the contrary, the debtor has had and continues to maintain substantial involvement in cannabis business. Some of these are passive – owning a substantial equity stake in a Canadian producer of Cannabis products, for example – while others are less so – offering consulting services to other cannabis producers and licensing a patent it owns for the extraction and preparation of cannabis.

The second issue, one not previously raised before as far as we can tell, is that even the hemp-based products which would arguably be legal under the Controlled Substances Act, were nevertheless illegal because they had not been approved by the Food & Drug Administration for public sale. Violations of the Food Drug & Cosmetics Act of 1938 also carry criminal penalties, so, the argument ran, selling unapproved drugs constituted a separate violation of federal criminal law which should require dismissal even if the debtor could prove it had not violated the CSA.

While this issue would likely have generated some interesting case law, it is no longer before the court. The creditor seeking dismissal of the case sold its claim in late May, and the purchaser withdrew the motion to dismiss in the first week of June. However, as of this writing, the court has not ruled on either its original order to show cause or the U.S. Trustee's joinder. In the interim, the bankruptcy case has continued to move forward, setting a deadline to file claims, rejecting a lease of real property, filing monthly operating reports, and taking other actions typical of an ordinary chapter 11 case. The available record discloses no indication of when, or even whether, the court will determine the applicability of the cannabis bar.

* * *

For more information concerning the matters discussed in this publication, please contact the author **Aaron R. Cahn** (212-238-8629, cahn@clm.com), or your regular Carter Ledyard attorney.

related professionals

Aaron R. Cahn / Counsel

D 212-238-8629

cahn@clm.com