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Taxing Legal Marijuana: A Hazy Issue for Municipalities Seeking Relief in Chapter 9

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Date Created: Tue, 05/17/2016 - 12:27

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Editor's Note: The following article, "Taxing Legal Marijuana: A Hazy Issue for Municipalities Seeking Relief in Chapter 9," won the prize for second place in the Eighth Annual ABI Bankruptcy Law Student Writing Competition. Ms. Lewis is a recent graduate of the University of Michigan Law School in Anne Arbor, Mich. She is currently a student attorney in the university's Environmental Law Clinic, and will begin working in New York as an associate in Weil Gotshal & Manges' Business Finance & Restructuring group this fall.

The past 25 years have marked a growing trend toward the legalization and decriminalization of marijuana. Twenty-three states have legalized the drug's medical use, with four states and Washington, D.C., going a step further by peri recreational use for adults over the age of 21. [1] Despite the actions taken by those states and our nation's cap federal government's position regarding the use of marijuana remains clear: Possession, cultivation or distributio drug constitutes a criminal offense under federal law. [2]

As the number of states where marijuana is legal continues to rise, this glaring tension between state and federal law has begun to manifest itself outside the criminal justice system, namely in U.S. bankruptcy courts. A host of bankruptcy courts have recently ruled that state law-compliant marijuana businesses are barred from federal bankruptcy protection due to the criminal nature of their business in the eyes of federal law. [3] Not only are businesses directly handling the drug precluded from bankruptcy, so too are businesses with income more remotely derived from marijuana-related activity. [4]

In addition to their unsettling implications for business owners, these holdings may pose a serious problem for fiscally distressed municipalities looking for relief in chapter 9 — specifically municipalities that currently tax marijuana sales or those hoping to incorporate such a tax into a chapter 9 plan for readjustment. This article contends that recent case law on the issue, as well as the architecture of chapter 9's plan confirmation requirements, support the conclusion that such municipalities may be precluded from the benefits of federal bankruptcy protection.

Setting the Stage: Marijuana Businesses Barred from Bankruptcy

Marijuana businesses run and operate like any other type of business. They purchase supplies, sell goods, compete for customers, buy and rent property, pay for utilities, hire employees and borrow money from creditors. They are also subject to the same economic forces and market conditions that can steer a business into financial trouble. Unlike other businesses, though, recent case law confirms that bankruptcy relief is not an option for struggling debtors in this field of work. [5]

Arenas v. U.S. Trustee (In re Arenas)

In a prominent recent case, Frank and Sarah Arenas owned a two-unit property in downtown Denver; they operated one unit of the property as a marijuana-cultivation business and leased the other unit to a marijuana dispensary. [6] When the Arenas' business fell on hard financial times in 2014, they filed a chapter 7 petition. [7] The U.S. Trustee promptly filed a motion to dismiss the case "for cause" pursuant to § 707(a) of the Bankruptcy Code, arguing that a panel trustee would be unable to administer the estate's assets without violating the CSA and that a bankruptcy court should not aid the violation of federal law.

In response, the Arenas moved to convert their chapter 7 case to a chapter 13 case, which would not involve trustee administration of the business. The bankruptcy court denied the motion to convert and dismissed the case, noting that although "the Debtors' business operations and ownership and operation of their property are not illegal under the laws of the state of Colorado … the Debtors' activity of leasing space to a marijuana dispensary and Mr. Arenas' cultivation of marijuana on the property makes the Debtors liable for criminal penalties under the CSA." [8]

The Arenas appealed the decision to the Tenth Circuit Bankruptcy Appellate Panel (BAP). [9] In analyzing whether the Arenas' marijuana business, legal under Colorado state law but illegal under federal law, constituted sufficient cause to dismiss, the BAP concluded that bankruptcy relief is unavailable to debtors whose business activities violate federal law. [10]

Affirming the bankruptcy court's holding, the BAP agreed that a panel trustee could not administer the estate's assets without violating the CSA. The court thus concluded that the inability to lawfully administer the Arenas' bankruptcy estate under chapter 7 constituted cause for dismissal under § 707(a).

Moreover, relying on *Marrama v. Citizens Bank of Mass.*, [11] the BAP similarly found that the Arenas' petition was ineligible for conversion to chapter 13. The court held that good faith is an affirmative requirement for plan confirmation under § 1325(a)(3) and that a debtor whose plan payments would be financed with the proceeds of criminal activity did not meet the Code's standard that a plan be proposed "in good faith" and "not by any means forbidden by law." [12] In the court's words, the court could not "confirm a reorganization plan … funded from the fruits of federal crimes." [13]

Arenas' Impact on Municipal Debtors

The *Arenas* holding suggests that a municipality that encourages and taxes marijuana sales, such as the Arenas' hometown of Denver, [14] may be similarly ineligible for bankruptcy protection under chapter 9. The Code imposes plan confirmation requirements on municipal debtors similar to those it imposes on individual or business debtors. Specifically, a chapter 9 adjustment [15] plan must be filed in "good faith" and the municipality must not be "prohibited by law from taking any action necessary to carry out the plan." [16] If a municipality were to encourage illegal marijuana sales and incorporate those tax revenues into a plan for readjustment, a federal court would be "administering the fruits and instrumentalities of federal criminal activity" — the precise reason that the Arenas' case was not eligible for conversion to chapter 13. [17]

One may attempt to distinguish the Arenas' situation from that of a municipal debtor by pointing out that, in contrast to the Arenas, a municipality would not typically be *directly* involved in the possession, cultivation or sale of marijuana; [18] however, *Arenas*' companion cases suggest that a debtor with a material connection to marijuana income, either direct or indirect, may face heavy scrutiny under the "clean hands" doctrine during plan confirmation.

The "Clean Hands" Doctrine

In *In re Rent-Rite Super Kegs West Ltd.*, a debtor owned a warehouse and leased space to tenants engaged in the cultivation of marijuana. [19] The debtor derived 25 percent of its income from the tenants' lease but had no direct involvement with the drug business. The court found that the debtor's lease relationship was sufficient to dismiss the petition under the "clean hands" doctrine, noting:

> "[O]ne's misconduct need not necessarily have been of such a nature as to be punishable as a crime or as to justify legal proceedings of any character. Any willful act concerning the cause of action which rightfully can be said to transgress equitable standards of conduct is sufficient cause for the invocation of the [clean hands] maxim by the chancellor." [20]

Because § 856 of the CSA prohibits property owners and managers from knowingly and intentionally leasing or making available space to individuals for the purpose of unlawfully manufacturing, storing or distributing a controlled substance, the court found that the debtor had unclean hands and was not eligible for bankruptcy relief. [21]

While the activity in *In re Rent Rite* clearly falls under the purview of the clean-hands doctrine, the court in *In re Medpoint Management* rea similar conclusion despite the debtor's connection to marijuana-related activity at the time of the petition's filing being much more tenuous. *Medpoint*, the debtor owned a marijuana products trademark that it licensed to another company, generating the debtor's sole source of r [22] While the debtor had at one point in time owned a medical marijuana business, the debtor did not directly own any marijuana, marijua products or dispensaries at the time of the petition's filing, nor did the debtor lease or rent space for the purpose of advancing marijuana-related activity. Nevertheless, the court dismissed an involuntary petition that had been filed against the debtor because it found all of its assets to be "marijuana-related," and the petitioning creditors nonetheless had knowingly entered into contractual relationships with the debtor." [23] Furthermore, the court observed that the debtor's IP and IP Licensing Agreement helped to *facilitate* the sale of marijuana and that aiding in the facilitation of the drug's sale constituted sufficient cause to dismiss under the unclean-hands doctrine. [24]

In both of the aforementioned cases, the debtors' income was either in whole or in part derived from marijuana-related activity; however, neither debtor had any direct relationship with the cultivation, sale or distribution of the drug. Despite the indirect nature of the debtors' relationships with marijuana, the courts found that the Code's good-faith filing requirement had not been met and dismissed the debtors' bankruptcy proceedings. While the court's dismissal in *In re Rent-Rite* was clearly justified under the clean-hands doctrine, *Medpoint* suggests that a municipal debtor that taxes marijuana could find itself barred from chapter 9 under the unclean-hands doctrine if a court were to find that the municipality helped to facilitate the cultivation or sale of the drug. The architecture of chapter 9's plan-confirmation requirements lends further support to this conclusion.

The Structure of Chapter 9

Before analyzing the structure of chapter 9, it is important to understand its early history. Prior to the creation of chapter 9 bankruptcy, the options for fiscally distressed municipalities and their creditors were limited to those available under state law. [25] When a municipality was unable to pay its debts, its creditors' primary remedy was to bring a *mandamus* action against the municipality to compel it to exercise its taxing or levying powers to generate funds for debt-repayment. [26] During the Great Depression, however, this approach proved inadequate, and by January 1934, at least "2019 municipalities, counties and other governmental units were known to be in default." [27] In May 1934, Congress responded to the escalating situation by amending the Bankruptcy Act to extend to municipalities.

Shortly after enactment, the Supreme Court declared the law unconstitutional under the Tenth Amendment in *Ashton v. Cameron County Water District*. [28] A revised version of the act remedying its constitutional deficiencies was passed again by Congress in 1937 and codified as chapter X of the Bankruptcy Act (later redesignated as chapter IX). [29] Despite its revisions, the law's constitutionality was challenged again in *United States*

v. Bekins. [30] This time, however, the Supreme Court upheld the law, stressing that congressional reports demonstrated a concerted effort not to "impinge upon the sovereignty of the State." [31] The court also emphasized that the Code requires a state to consent to its municipalities' use of chapter IX, thus augmenting rather than impairing the powers reserved to states under the Tenth Amendment. [32]

In light of its early history, the federal bankruptcy process as applied to municipalities has evolved to reflect a need for constitutional balance. The Code recognizes this delicate constitutional balance by placing limits, both express and implied through omission, on a bankruptcy court's powers over a municipal debtor. For example, many of the debtor oversight provisions found in chapters 11 and 13 are notably absent from chapter 9. A bankruptcy court may not appoint a trustee or examiner, [33] nor does it have the authority to interfere with a municipality's power to use property, raise taxes or make expenditures in the ordinary course of its governmental affairs. [34] These differences, among others, highlight a deference to municipal debtors that is not extended to individual or business debtors under the Code.

Should Deference Make a Difference?

While chapter 9's history and structure make it clear that Congress intended deference toward states' traditional government functions throughout the bankruptcy process, it remains unclear to what extent the constitutional balance should impact the Code's plan-confirmation requirements. Municipal bankruptcy remains relatively rare, with fewer than 700 filings nationwide since municipal bankruptcy entered federal law in 1934. [35] With so few filings, chapter 9 confirmation requirements have not benefitted from the same judicial scrutiny as the confirmation requirements in other chapters. [36] Consequently, we are largely left to speculate the extent to which deference toward states' rights would impact a court's interpretation of chapter 9's good-faith requirement.

In the absence of judicial guidance, examining the architectural structure of chapter 9's confirmation requirements may provide a clue as to where deferential consideration was or was not intended when interpreting chapter 9. For example, some of chapter 9's confirmation requirements are *expressly stated* in § 943, while others are *imported* through reference to chapter 11. Specifically, both the best-interests and feasibility requirements are expressly stated in § 943(a)(7), whereas the good-faith requirement is imported through reference to chapter 11. [37] But why?

Chapter 11, like chapter 9, requires debtors to meet both a best-interests and a feasibility test for plan confirmation. [38] What is the reason, then, that the drafters chose to expressly state those two requirements rather than import them through reference, as they did with the good-faith requirement? Perhaps the reason is that the good-faith requirement was intended to be interpreted uniformly throughout the Code. This view lends further support to the conclusion that municipalities that tax marijuana are precluded from bankruptcy.

Closing Comments

Given the relative rarity of municipal bankruptcy, a bankruptcy court may not face this curious question of first impression before growing national support for federal legalization of marijuana renders it a moot issue. In the meantime, though, it is worthwhile to think about the various practical arguments that have helped catalyze the trend toward legalization and consider their attractiveness from a municipal debtor's perspective.

Key among them is marijuana's demonstrated potential to create jobs and boost tax revenue. According to the Colorado Department of Revenue, the state brought in almost $70 million in tax revenue from marijuana sales in 2015, eclipsing its alcohol tax revenues by over $25 million. [39] Given its huge potential to boost income, municipalities experiencing financial distress may encourage marijuana-related industries and celebrate the ability to incorporate a marijuana tax in a plan for adjustment — assuming, of course, they are permitted to do so.

[1] *See* "23 Medical Marijuana States and DC: Laws, Fees, and Possession Limits," ProCon.org, *available at* medicalmarijuana.procon.org/view.resource.php?resourceID=000881 (last updated Jan. 1, 2016, 10:23 a.m.); *see also* Debra Borchardt, "U.S. Legal Adult-Use Marijuana Sales Grow 184% in One Year," *Forbes* (Feb. 1, 2016), *available at* www.forbes.com/sites/debraborchardt/2016/02/01/marijuana-sales-grow-184-...

[2] *See* Controlled Substances Act (CSA), 21 U.S.C. § 841 (2012).

[3] *See, e.g.*, *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012) (dismissing debtors' case "for cause" because debtors' business derived a quarter of its income from leasing space to tenants growing marijuana in violation of the CSA).

[4] *See In re Medpoint Management LLC*, 528 B.R. 178, 182 (Bankr. D. Ariz. 2015) (holding that debtor was precluded from bankruptcy protection because all of its assets were "marijuana-related," likely in violation of the CSA).

[5] *See, e.g.*, *In re McGinnis*, 453 B.R. 770 (2011).

[6] *See* "Marijuana Grower's Bankruptcy Hopes Go Up in Smoke," 27 *BNA Bankruptcy Law Reporter* No. 34 (Aug. 27, 2015).

[7] *See In re Arenas*, 514 B.R. 887 (Bankr. D. Colo. 2014).

[8] *Id*. at 889.

[9] *See Arenas v. U.S. Trustee* (*In re Arenas*), 535 B.R. 845 (B.A.P. 10th Cir. 2015), *aff'g*, 514 B.R. 887 (Bankr. D. Colo. 2014).

[10] *See id.*

[11] *Marrama v. Citizens Bank,* 549 U.S. 365 (2007).

[12] *See In re Arenas*, 535 B.R. at 847.

[13] *In re Arenas*, 514 B.R. 895.

[14] Business Taxes, Denver Treasury Division, *available at* www.denvergov.org/content/denvergov/en/treasury-division/business-taxes.... (last visited Feb. 27, 2016) (stating Denver's tax of 7.15% on the sale of retail/recreational marijuana and 3.65% on medical marijuana, effective Jan. 1, 2015).

[15] A plan of adjustment is the chapter 9 counterpart to the chapter 11 plan of reorganization. *See* 11 U.S.C. § 941.

[16] *See* 11 U.S.C. § 943(b) (incorporating § 1129(a)(3) through reference to § 901).

[17] *In re Arenas*, 514 B.R. at 890.

[18] In March 2015, the town of North Bonneville, Wash., opened a marijuana dispensary called The Cannabis Corner. The Cannabis Corner is owned and operated by the municipality. As a result of the municipality's direct handling and distribution of marijuana, the author of this article believes North Bonneville would be precluded from seeking bankruptcy protection under *Arenas* and its companion cases. *See* Conrad Wilson, "First Government-Run Pot Shop to Open in Washington State," *OPB* (Mar. 6, 2015), *available at* www.opb.org/news/article/first-government-run-pot-shop-to-open-in-washin...

[19] *See In re Rent-Rite Super Kegs West Ltd.*, 484 B.R. 799 (Bank. D. Colo. 2012).

[20] *See id.*

[21] *See* 21 U.S.C. § 856.

[22] *See Medpoint Mgmt LLC*, 528 B.R. at 188.

[23] *See id.* at 182.

[24] *See id.* at 185 ("The Court observes, without deciding, that it is quite possible that Medpoint's IP and the IP licensing revenues could be seized or forfeited, and that Medpoint could be or could have been guilty of facilitation of a crime under the CSA. *See* Deputy A.G. James M. Cole, U.S. DOJ, Memorandum at 2 (June 29, 2011) ("Persons who are in the business of cultivating, selling or distributing marijuana, and those who knowingly facilitate such activities, are in violation of the Controlled Substances Act, regardless of state law.")).

[25] Kenneth N. Klee, *A Short History of Municipal Bankruptcy* (2012), *available at* cumberland.samford.edu/files/Short%20History%20of%20Municipal%20Bankruptcy.pdf (last visited Feb. 29, 2016).

[26] *Id.*

[27] *See Ashton v. Cameron County Water District*, 298 U.S. 513, 533 (1936) (Cardozo, J., dissenting).

[28] *See id.*

[29] *See* Act of Aug. 16, 1937, ch. 657, 50 Stat. 653 (current version codified in scattered sections of 11 U.S.C.).

[30] *See United States v. Bekins*, 304 U.S. 27 (1938).

[31] *Id.* at 51.

[32] *See* Juliet M. Moringiello, *Chapter 9 Plan Confirmation Standards and the Role of State Choices*, 37 Campbell L. Rev. 71, 76 (2015).

[33] 11 U.S.C. § 901 (2012) (omitting §§ 363 and 1104 from chapter 9).

[34] *See* 11 U.S.C. §§ 903 and 904.

[35] *See* Moringiello, *supra* note 26, at 72; *see also* Francis Lawall & J. Gregg Miller, *Debt Adjustments for Municipalities Under Chapter 9 of the Bankruptcy Code: A Collier Monograph*, § 1 at 5 (2012) (reporting that between 1934 and 2012, fewer than 650 municipalities had filed for bankruptcy).

[36] Moringiello, *supra* note 26, at 71.

[37] 11 U.S.C. § 943(b) (incorporating § 1129(a)(3) through reference to § 901).

[38] *See* 11 U.S.C. § 1129(a)(7) and (a)(11).

[39] *See* Debra Borchardt, "Colorado Now Reaping More Tax Revenue from Pot than from Alcohol," *Forbes* (Sept. 16, 2015), *available at* www.forbes.com/sites/debraborchardt/2015/09/16/colorados-pot-tax-revenues-are-higher-than-alcohols/#60d2137b716b.

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