Garvin and its Aftermath: The Ninth Circuit Upholds a Bankruptcy Plan Contemplating Income From a Cannabis-Related Source and Several Bankruptcy Courts Quickly Weigh In

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In May, the United States Court of Appeals for the Ninth Circuit issued a much anticipated decision in *Garvin v. Cook Investments NW, SPNWY, LLC*, 922 F.3d 1031 (9th Cir. 2019), upholding the confirmation of a reorganization plan in a bankruptcy involving a debtor that leased land to a marijuana farmer in accord with state law but in violation of federal drug law.[1] Although the Ninth Circuit's decision represents a spark of hope for cannabis companies' ability to participate in federal bankruptcies, the case was ultimately decided narrowly and on a discrete matter of bankruptcy law—limiting its future application beyond the court's specific holding.

Indeed, in the short time since the Ninth Circuit's decision, two bankruptcy courts, the United States Bankruptcy Court for the Eastern District of Michigan and the United States Bankruptcy Court for the District of Nevada (within the Ninth Circuit), have considered *Garvin* yet dismissed bankruptcy cases in which the debtors were involved in marijuana-related activities.[2]

The Ninth Circuit *Garvin* Case

In *Garvin*, five real estate holding companies (collectively, "**Cook**") sought to reorganize under the Bankruptcy Code after defaulting on a loan secured by Cook's property.[3] Prior to the bankruptcy, one of the holding companies, Cook Investments NW, DAAR, LLC ("**Cook DAAR**"), had leased its property to Green Haven, which used the property to grow marijuana.[4] Although farming marijuana is legal under Washington state law[5] (and many other states' laws), the federal Controlled Substances Act, 21 U.S.C. §§ 801-971, prohibits "knowingly . . . leas[ing] . . . any place . . . for the purpose of manufacturing, distributing, or using any controlled substance [including marijuana]." *See id.* § 856(a)(1).

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[1] *Garvin*, 922 F.3d at 1035.

[2] *See In re Basrah Custom Design, Inc.*, 600 B.R. 368, 370 (Bankr. E.D. Mich. 2019), *reconsideration denied*, No. 18-56801, 2019 WL 2521122 (Bankr. E.D. Mich. June 18, 2019); *In re CWNevada LLC*, No. 19-12300-MKN, 2019 WL 2420032, at *21 (Bankr. D. Nev. June 3, 2019).

[3] *Garvin*, 922 F.3d at 1033.

[4] *See, e.g.*, *id.* at 1033 ("The lease with Green Haven . . . provides that Green Haven will use the Darrington Property exclusively as a marijuana establishment.").

[5] *See, e.g.*, *id.*

During the bankruptcy, the United States Trustee filed a motion to dismiss Cook DAAR's bankruptcy[6] on the basis that the lease to Green Haven had been "gross mismanagement" of the property, and cause to dismiss existed under 11 U.S.C. § 1112(b).[7] The bankruptcy court denied the motion to dismiss, but invited the Trustee to refile at plan confirmation.[8] Notably, the Trustee did not do so. After submission of an amended plan,[9] the bankruptcy court confirmed the debtors' plan over an objection by a sole objector, the Trustee, who asserted that it violated § 1129(a)(3)'s requirement that a plan be "proposed in good faith and not by any means forbidden by law" because the lease violated federal law.[10]

On appeal to the district court, because the Trustee did not renew the § 1112(b) motion at plan confirmation, the court determined that the Trustee failed to properly preserve the

[6] The U.S. Trustee Program has, according to news reports, "ramped up enforcement and began a concerted effort to uncover bankruptcy filers receiving income from marijuana and expel them from court . . . ." Jonathan Randles, *Marijuana Ties Are Hurting More Filers in Bankruptcy Courts*, Wall St. J. (June 22, 2019), https://www.wsj.com/articles/marijuana-ties-are-hurting-more-filers-in-bankruptcy-courts-11561208400. Indeed, Clifford J. White III, Director of the United States Trustee Program, issued a directive instructing that "[i]n cases involving marijuana assets or income, the United States Trustees will file a motion to dismiss and other pleadings as appropriate." *A Time to Reform: Oversight of the Activities of the Justice Department's Civil, Tax, and Environment and Natural Resources Divisions and the U.S. Trustee Program: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law Comm. of the H. Comm. on the Judiciary*, 115th Cong. 4-5 (June 8, 2017) (statement of Clifford J. White III, Dir. Exec. Office for U.S. Trustees, U.S. Dep't of Justice), https://docs.house.gov/meetings/JU/JU05/20170608/106076/HHRG-115-JU05-Wstate-WhiteC-20170608.pdf. Director White also stated that funding a plan from income derived from marijuana would be a means forbidden by law. *Id.* The Ninth Circuit rejected this view in *Garvin*.

[7] *Garvin*, 922 F.3d at 1033. Section 1112(b) provides, *inter alia*, that "(1) Except as provided in paragraph (2) and subsection (c), on request of a party in interest, and after notice and a hearing, the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause unless the court determines that the appointment under section 1104(a) of a trustee or an examiner is in the best interests of creditors and the estate" and that "cause" includes "(B) gross mismanagement of the estate."

[8] *Garvin*, 922 F.3d at 1033.

[9] The debtors proposed an amended plan that "rejected the Green Haven lease and structured the plan so that his monthly obligations would be paid without revenue from Green Haven." *Id.* at 1034.

[10] *Id.* at 1033-34. The full text of the relevant portion of 11 U.S.C. § 1129(a)(3) is "(a) The court shall confirm a plan only if all of the following requirements are met . . . (3) The plan has been proposed in good faith and not by any means forbidden by law."

argument that the plan violated § 1112(b).[11] The Trustee then appealed confirmation of the plan to the Ninth Circuit.[12]

As explained by the Ninth Circuit, "[b]ecause it appears that Cook continues to receive rent payments from Green Haven . . . the Trustee asserts [the plan] was 'proposed . . . by . . . means forbidden by law.'"[13] The Ninth Circuit, however, rejected the theory that § 1129(a)(3) precludes confirmation of a plan that conflicts with federal drug laws, finding that the "plain text of § 1129(a)(3) . . . directs bankruptcy courts to police the means of a reorganization plan's proposal, not its substantive provisions."[14] The court described the appeal as a "straightforward question of statutory interpretation rather than on any conflict between federal and state drug laws."[15] Under the plain language of the statute, the phrase "not by any means forbidden by law" modifies the phrase "[t]he plan has been proposed." The court reasoned that adopting the Trustee's position would require rewriting the statute entirely to mean that the plan must comply with all applicable law, rendering the statute's separate requirement that the plan comply with the provisions of the Bankruptcy Code redundant.[16]

The Ninth Circuit's precise holding was that the plan was not "proposed . . . by . . . means forbidden by law," as precluded by § 1129(a)(3), because, although it upheld a lease of real property to a company that used the land to grow marijuana, a violation of federal law, *the plan itself was not proposed in an illegal manner*.[17] In adopting this interpretation of § 1129(a)(3), the Ninth Circuit followed other courts that have held that the provision directs courts to look only to the proposal of a plan, not the terms of the plan.[18] The court specifically rejected decisions holding that § 1129(a)(3) precludes confirmation of a plan that relies in any part on income derived from a criminal activity.[19]

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[11] *Id.* at 1034.

[12] The United States Trustee asserted that the plan violated § 1129(a)(3) and also challenged the bankruptcy court's refusal to dismiss the bankruptcy under § 1112(b) for "gross mismanagement." Notably, the Ninth Circuit agreed with the district court that the § 1112(b) argument was waived. *Id.*

[13] *Id.* at 1035.

[14] *Garvin*, 922 F.3d at 1033.

[15] *Id.*

[16] *Id.* at 1034.

[17] *Id.* at 1034-35.

[18] *See id.* at 1035 (*citing Irving Tanning Co. v. Me. Superintendent of Ins.* (*In re Irving Tanning Co.*), 496 B.R. 644, 660 (1st Cir. B.A.P. 2013); *In re Gen. Dev. Corp.*, 135 B.R. 1002, 1007 (Bankr. S.D. Fla. 1991) ("Courts addressing the issue have uniformly held that Section 1129(a)(3) does not require that the contents of a plan comply in all respects with the provisions of all nonbankruptcy laws and regulations." (internal quotation marks omitted))).

[19] *See id.* (footnote omitted) (citing *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799, 809 (Bankr. D. Colo. 2012)).

Moreover, the Ninth Circuit was not troubled by arguments that its interpretation would lead to bankruptcy being used to legitimize operations illegal under federal law, noting that "confirmation of a plan does not insulate debtors from prosecution for criminal activity, even if that activity is part of the plan itself" and that "absent waiver, as in this case, courts may consider gross mismanagement issues under § 1112(b)."[20]

A number of lower courts have, in fact, found cause to dismiss or convert a bankruptcy case under § 1112(b) when a significant portion of the debtor's revenues are generated from activities that violate federal drug laws. *See, e.g.*, *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012);[21] *In re Arm Ventures, LLC*, 564 B.R. 77 (Bankr. S.D. Fla. 2017);[22] *In re Way to Grow, Inc.*, 597 B.R. 111 (Bankr. D. Colo. 2018).[23]

As noted above, since *Garvin*, two bankruptcy courts—including a court within the Ninth Circuit—have dismissed bankruptcy cases involving substantial proceeds from marijuana sources, finding that *Garvin* had no bearing on the particular legal issues before the courts.[24]

In *Basrah Custom Design*, the bankruptcy court stated that it was "aware" of *Garvin*, but noted that it does not address dismissal for cause under § 1112(b), and was not binding.[25] The bankruptcy court expressed its respectful potential disagreement with "the *Garvin* court's holding about § 1129(a)(3)" and stated that it found the Ninth Circuit's affirmance "by a *federal*

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[20] *Garvin*, 922 F.3d at 1035 (citing *In re Food City, Inc.*, 110 B.R. 808, 812 (Bankr. W.D. Tex. 1990)) (upholding confirmation of a plan that may have violated securities laws because, *inter alia*, the confirmation order would not prevent the SEC from enforcing securities laws with respect to the violation arising out of the plan).

[21] In *Rent-Rite Super Kegs W. Ltd.*, the creditors sought to dismiss a voluntary Chapter 11 case filed by the owner of a warehouse because twenty-five percent of the debtor's revenues came from the medical marijuana industry. The bankruptcy court found that "cause" existed under § 1112(b) due to gross mismanagement and application of the unclean hands doctrine to dismiss the case, but because the majority of the debtor's revenues were not derived from the marijuana tenants, scheduled a further hearing to determine whether conversion or dismissal would be in the best interests of creditors. 484 B.R. at 810-11.

[22] 564 B.R. at 86 (finding that a plan could not be confirmed when a debtor proposed a plan that provided that a portion of its property would be leased to generate income from medical marijuana, but allowed the debtor time to come up with an alternative before conversion).

[23] In the recent Colorado bankruptcy case, *In re Way to Grow, Inc.*, 597 B.R. at 132, the bankruptcy court held that "cause" existed to dismiss the case under § 1112(b) because the debtors' activities were in violation of federal law in a case where the debtors sold equipment used for growing marijuana.

[24] *See Basrah Custom Design*, 600 B.R. 368 (dismissing for cause under § 1112(b)); *CWNevada LLC*, 2019 WL 2420032 (court found it appropriate to abstain under 11 U.S.C. § 305(a)(1) when debtor company engaged in the cultivation and distribution of marijuana was subject to multiple state court actions brought by creditors clamoring to enforce their claims against limited assets).

[25] 600 B.R. at 381.

court, of the confirmation of a Chapter 11 plan under which a debtor would continue to violate *federal* criminal law under the CSA" questionable.[26]

In *CWNevada LLC*, the Nevada bankruptcy court found that under the circumstances of that case, where no plan had been proposed, and no objections had been made, the "decision in *Garvin* is informative, but neither procedurally nor factually apposite."[27] Although *Garvin* would control when a good faith objection to plan confirmation is raised under § 1129(a)(3), the court emphasized that there was no plan and no such objection before the court.[28] The court further said that the Ninth Circuit's decision "offers no guidance on whether dismissal under section 1112(b)(1) on the basis of mismanagement under section 1112(b)(4)(B), or any other ground, would be appropriate in the present case."[29] Finally, the court found it of the upmost importance that "the *Garvin* decision does not address whether dismissal independently based on abstention under Section 305(a) is appropriate."[30] The debtor in *CWNevada LLC* was subject to multiple state court actions brought by creditors clamoring to enforce their claims against limited assets. On that basis, the court found it appropriate to abstain under § 305(a), and did not reach the question of dismissal for cause under § 1112(b).[31] Importantly, the court refused to hold that all bankruptcy cases should be dismissed on the basis of unclean hands, and noted that there may be "cases where Chapter 11 relief is appropriate for an individual or a non-individual entity directly engaged in a marijuana-related business."[32]

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The Ninth Circuit's decision to uphold the bankruptcy plan in *Garvin*, albeit on a narrow ground, forecloses a statutory ground for objection to plans for debtors that derive income from marijuana-related activities within that circuit, and may reflect a shift by courts to be more open-minded about cannabis companies and access to federal bankruptcy law. The *CWNevada LLC* court's suggestion that there may be cases where relief is appropriate for debtors that generate income from marijuana-related activities supports this view. But the numerous cases dismissing bankruptcy cases involving cannabis for cause, along with the United States Trustee Program's position, are stark reminders that cannabis activities have generally led to a closed door at the

[26] *Id.*

[27] 2019 WL 2420032, at *9-10.

[28] *Id.*

[29] *Id.* at *9. Also relevant was the obvious factual distinction in that the debtor was engaged in the cultivation, production and distribution of marijuana; unlike in *Garvin*, where marijuana derived proceeds would provide merely "indirect support" for a confirmed plan.

[30] *Id.* at *10

[31] *Id.* at *21.

[32] *Id.*

bankruptcy courthouse. Nevertheless, this remains a ripe area for growth and further examination by the Circuit Courts and, perhaps, eventually the Supreme Court.[33]

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[33] At the time of publication, the United States has been granted an extension of time to file a petition for rehearing before the Ninth Circuit or rehearing *en banc*. Order, *Garvin v. Cook Invs. NW, SPNWY, LLC*, No. 18-35119 (9th Cir. June 11, 2019), ECF No. 45.