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Seeing Through the Haze: Ninth Circuit Affirms Plan of Reorganization for Marijuana Grower's Landlord

By Jonathan I. Levine, Brian J. Lohan, and Ginger Clements*

Although a U.S. Court of Appeals for the Ninth Circuit decision paved the way for the debtors in the case to confirm a plan of reorganization, it does not necessarily eliminate the risks associated with the ability of marijuana-related companies to avail themselves of Chapter 11. This article examines the decision.

The U.S. Court of Appeals for the Ninth Circuit affirmed confirmation of the plan of reorganization of five real estate holding companies (the "Debtors").[1] One of the debtor real estate holding companies leased property to a company that used the property to grow marijuana. The U.S. Trustee ("Trustee") objected to the plan of reorganization on the basis that the lease violated current federal drug law, rendering the plan unconfirmable under Section 1129(a)(3) of the Bankruptcy Code, which requires a plan not be proposed by means forbidden by law. The Ninth Circuit held that Section 1129(a)(3) looks only to the means of a plan's *proposal*, not its substantive provisions, and thus, affirmed the confirmation of the plan, finding it was not proposed by any means forbidden by law. The decision by the court highlights the tension between a state-level push to legalize marijuana use (including in states such as Illinois) and existing federal drug laws.

As discussed below, while the Ninth Circuit's decision paved the way for the Debtors in this case to confirm a plan of reorganization, it does not necessarily eliminate the risks associated with the ability of marijuana-related companies to avail themselves of Chapter 11.

BACKGROUND

One of the Debtors, Debtor Cook Investments NW, DARR, LLC ("Cook

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[1] *Garvin v. Cook Investments NW, SPNWY, LLC (In re Cook Investments NW, Spnwy, LLC),* 922 F.3d 1031 (9th Cir. 2019).

DARR"), owns commercial real estate in Darrington, Washington, and leased the property to two tenants, one of whom, N.T. Pawloski, LLC ("Green Haven"), used the property exclusively to grow marijuana (the lease for such, the "Green Haven Lease"). The court noted that Green Haven appears to be in compliance with Washington state law, but that the Green Haven Lease is in violation of the federal Controlled Substances Act.[2]

The Debtors' plan of reorganization provides for repayment of all creditors' claims in full and for the Debtors to continue as a going concern. The plan rejected the Green Haven Lease and was structured in a manner that would pay the Debtors' monthly obligations without revenue from Green Haven.[3]

Prior to confirmation of the Debtors' plan, the Trustee filed a motion to dismiss the Cook DARR Chapter 11 case, asserting that the Green Haven Lease constituted gross mismanagement and thus cause to dismiss under Section 1112(b) of the Bankruptcy Code.[4]

The bankruptcy court denied the Trustee's motion without prejudice to raise the issue at the plan confirmation hearing. The Trustee was the only objector to the Debtors' plan of reorganization. However, the Trustee did not renew its motion to dismiss at the confirmation hearing.

On appeal, the U.S. District Court for the Western District of Washington affirmed confirmation of the plan and affirmed the denial of the motion to dismiss Cook DARR's case.

ANALYSIS OF ISSUES

On appeal to the Ninth Circuit, the court first concluded that the Trustee waived its argument for "gross mismanagement" under Section 1112(b) when it failed to renew its motion to dismiss. Thus, the only issue considered by the court was the Trustee's argument that the plan violated Section 1129(a)(3)'s requirement that a plan be proposed in good faith and not by any means forbidden by law. Framing its analysis of this issue, the court noted that the "appeal rests on a straightforward question of statutory interpretation rather

[2] The Controlled Substances Act prohibits "knowingly . . . leas[ing] . . . any place . . . for the purpose of manufacturing, distributing, or using any controlled substance." 21 U.S.C. § 856(a)(1).

[3] The Debtors' other tenants were to pay their rent directly to the Debtors' prepetition lender, and rents from Green Haven were paid directly to Cook DARR.

[4] Section 1112(b) provides that the court may dismiss a case under Chapter 11 for "cause," which is defined to include "gross mismanagement of the estate," among other things. *See* 11 U.S.C. § 1112(b)(1), (4)(B).

than on any conflict between federal and state drug laws."

SECTION 1129(a)(3)

A plan of reorganization must satisfy the requirements of Section 1129(a) of the Bankruptcy Code in order to be confirmable by the court, including the requirement set forth in Section 1129(a)(3) that "the plan has been proposed in good faith and not by any means forbidden by law."[5]

The Trustee argued that because Cook DARR receives rent from Green Haven (and such payments provides at least indirect support for the plan), the plan was "proposed . . . by . . . means forbidden by law" in violation of Section 1129(a)(3). Thus, the key issue as to the plan's confirmability "depend[ed] on whether § 1129(a)(3) forbids confirmation of a plan that is *proposed in an unlawful manner* as opposed to a plan with *substantive provisions that depend on illegality*, an issue of first impression in the Ninth Circuit."

The court concluded that Section 1129(a)(3) directs courts to look *only to the proposal of a plan*, not the terms of the plan. In reaching this conclusion, the court reasoned this reading aligns with both the statutory text and with persuasive authority on the matter. Indeed, the U.S. Bankruptcy Appellate Panel for the First Circuit reached the same conclusion in a case before it in 2013.

The court observed that the phrase "*not by any means forbidden by law*" modifies "*the plan has been proposed*" in the text. The court reasoned that the Trustee's interpretation rendered the words "*has been proposed"* meaningless and was contrary to the statute's clear meaning. The court also noted that such an interpretation (a) would require the court to "rewrite the statute completely" and (b) make other provisions of Section 1129(a) redundant.

The court acknowledged that some bankruptcy courts have accepted the Trustee's interpretation of Section 1129(a)(3)[6] but notes that such decisions ignore the statute's focus on the manner of the plan's *proposal*.

The court's decision solely addresses (and narrowly interprets) Section 1129(a)(3), and specifically does not consider (a) any conflict between federal and state drug laws, or (b) the issue of whether the Green Haven Lease constituted "gross mismanagement" constituting cause to dismiss the case

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[5] Section 1129(b) provides certain exceptions if one of Section 1129(a)'s requirements, namely, Section 1129(a)(8), cannot be satisfied. However, the plan of reorganization in this case enjoyed full creditor support and, thus, was subject to Section 1129(a).

[6] Specifically referencing *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. 799 (Bankr. D. Colo. 2012).

under Section 1112(b). The court stated that it does not believe its interpretation will result in bankruptcy proceedings being used to facilitate illegal activity, highlighting (y) that bankruptcy courts may consider gross mismanagement issues under Section 1112(b) and (z) confirmation of a plan does not insulate debtors for criminal activity (even if the activity is part of the plan).

COMPARING *DARR* TO *RENT-RITE*

In another marijuana-related Chapter 11, the debtor, Rent-Rite, derived approximately 25 percent of its revenues from leasing warehouse space to tenants who were engaged in the business of growing marijuana.[7] While legal under Colorado law, Rent Rite's business similarly violated the federal Controlled Substances Act.

Rent-Rite's secured creditor VFC Partners 14 LLC ("VFC") sought dismissal of the case under the "clean hands doctrine" and argued that Rent-Rite's activities, which the U.S. Bankruptcy Court for the District of Colorado (the "Rent-Rite court") found to be illegal under federal law, made it unworthy of the equitable protection of the bankruptcy court. In addition, VFC argued that the case was filed in bad faith and should be dismissed on that basis.

In a particularly harsh decision, the Rent-Rite court made several findings related to Rent-Rite's conduct, including:

- [Rent-Rite] has knowingly and intentionally engaged in conduct that constitutes a violation of federal criminal law . . . ; Because [Rent-Rite] is committing an ongoing criminal violation that is punishable by a prison sentence of more than one year, the forfeiture statute comes into play . . . under 11 U.S.C. § 362(b)(b)(4), the automatic stay does not enjoin governmental entities against actions that constitute an exercise of governmental police powers;[8] and
- *[E]very day that [Rent-Rite] continues under the [c]ourt's protection is another day that VFC's collateral remains at risk.*

The Rent-Rite court found gross mismanagement, and therefore "cause" for dismissal or conversion under Section 1112(b). In considering the best interests of creditors and the estate on the issue of whether to dismiss or convert the case to a Chapter 7 case, the Rent-Rite court focused on the ability of a Chapter 7

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[7] *In re Rent-Rite Super Kegs W. Ltd.,* 484 B.R. 799 (Bankr. D. Colo. 2012).

[8] In a footnote, the Rent-Rite Court acknowledged that it may be a harsh result that a statute known as the "crack house statute" is written so broadly that it encompasses Rent-Rite's conduct noting that there is no evidence that Rent-Rite's activities have anything in common with the activities the forfeiture statute was intended to combat.

trustee to administer an estate where a major asset is the location of ongoing criminal activity subject to forfeiture. The Rent-Rite court scheduled a further hearing on the issues, and the case was ultimately dismissed.

CONCLUSION

While the Ninth Circuit addressed whether a plan for a marijuana-related debtor could be confirmed in the face of an objection under Section 1129(a)(3), it specifically did not address issues such as Section 1112(b) and other issues raised by the Rent-Rite court. As was stated by the Rent-Rite court, "[u]nless and until Congress changes that law, the Debtor's operations constitute a continuing criminal violation of the [Controlled Substances Act] and a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime."[9]

Thus, despite the changes at the state-level, until there is a change in the federal legislation, risks still exist for marijuana-related companies contemplating Chapter 11.

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[9] Although not the subject of this article, the Rent-Rite Court analyzed issues of preemption relating to the Colorado legislation legalizing marijuana.