LEGAL & FINANCING INSIGHTS

Chronic Problems in Cannabis Lending

Navigating the Patchwork of Laws, Rulings and Regulations

BY RICHARD PAUL ORMOND

The only constant in the cannabis industry is change. This article provides an overview of the latest developments and points out that lenders need a deep understanding of the inconsistent patchwork of laws and regulations and the continuing conflict of law between the states and the federal government before entering this space.

Secured lending in the cannabis industry has evolved significantly over the past four years. What was recently left only to the "hard money" lenders or to lenders of "last resort" is now moving into mainstream lending. From factoring to bank-initiated secured real estate transactions, more and more lenders are now entering the cannabis industry and lending on (relatively) competitive terms to Cannabis Related Businesses (or "CRBs"). However, collateralization of these loans remains difficult without understanding the various moving parts of the industry, ever-changing regulations and conflicts of law. Lenders must be cognizant of laws and regulations at the local/municipal level, the state level and, of course, at the federal level to have any true protection and success. So, despite this quickly developing loan market, serious pitfalls and concerns continue to plague the industry for lenders.

A Brief Legal History

On January 4, 2018, only four days after California enacted the Adult Use of Marijuana Act (AUMA or Proposition 64),[1] then U.S. Attorney General Jefferson B. Sessions rescinded the Department of Justice's nationwide guidance relaxing certain types of enforcement in connection with the cultivation, distribution and possession of marijuana set forth in the Controlled Substances Act (CSA).[2]

This rescission under Attorney General Sessions included the revocation of the important 2013 memorandum issued by James M. Cole, Deputy Attorney General (referred to in the industry as the "Cole Memo") that provided that, if cannabis businesses operated legally within the "four corners" of their respective state's laws and complied with the eight primary directives listed in the Cole Memo, the Department of Justice would create a safe harbor, albeit a narrow one, for compliant cannabis business operators whereby federal officials would refrain from seeking enforcement of the CSA with respect to those operators.

RICHARD PAUL ORMOND
Ejudicate.com, Buchalter

A few weeks after the Cole Memo was rescinded, the U.S. Department of the Treasury declined to follow Mr. Sessions' lead. In a public letter dated January 31, 2018, sent to U.S. House Rep. Denny Heck, the Treasury Department reaffirmed that the Financial Crimes Enforcement Network ("FinCEN") would continue to follow the Cole Memo. In the FinCEN Memorandum, the Treasury Department agreed that the safe harbor from prosecution as set forth in the Cole Memo was necessary and laid out protocols for banks that do business with CRBs. The Treasury's announcement complicated the regulatory picture even further: CRBs (and Lenders) must contend with competing federal agencies and bureaucracies that don't necessarily agree with one another. The Biden administration has not taken any meaningful steps, thus far, to reinstate or update the Cole Memo and has remained mostly silent on the issue. These inconsistencies today create an environment where finance, banking, lending and creditors' rights face a mishmash of rules, restrictions and guesswork.

Adding to the complexity is the Rohrabacher–Farr amendment (also known as the Rohrabacher–Blumenauer amendment), which is duly passed legislation incorporated into the federal budget, approved by Congress, that prohibits the Justice Department from spending funds to interfere with the implementation of state medical cannabis laws.[3] It passed the House in May 2014, becoming law in December 2014 as part of an omnibus spending bill and it must be renewed annually. But it cannot and should not be relied on by lenders in this industry.

Risks To Lenders

Lending to a CRB is risk-inherent as any collateral secured by the lender may still be subject to Civil Asset Forfeiture, presenting a significant credit risk for banks that may otherwise want to provide services in this industry. Civil Asset Forfeiture may include "All real property, including any right title, and interest ... which is used ... in any manner or part to commit, or to facilitate the commission of [violation of the CSA] shall be subject to forfeiture."[4]

Recovery of seized property is possible, but a lender must satisfy the conditions of the "Innocent Owner" defense under the Civil Asset Forfeiture Reform Act[5], which has two key elements: (1) owner before illegal conduct giving rise to forfeiture occurs is an "innocent owner" if that owner was not aware of illegal conduct giving rise to forfeiture; or upon learning of such conduct, did all that reasonably could be expected under the circumstances to terminate the illegal use of property; and (2) an owner who acquires property after illegal conduct

occurs is an "innocent owner" if at time of acquisition it was a bona fide purchaser or seller for value; and did not know and was reasonably without cause to believe that the property was subject to forfeiture.[6] Thus, crafting loan documents in these circumstances requires precision and creativity to ensure that these defenses are preserved.

Federal Courts and Bankruptcy Courts are Closed for CRB Business

Because cannabis is a Schedule I drug pursuant to the CSA and thus, illegal, at the federal level, enforcement rights for lenders are curtailed by limited loan enforcement remedies. A federal court is unlikely to grant a writ of attachment on behalf of a lender seeking to attach assets that consist of or are derived from an illegal narcotic (at least for as long as the CSA remains on the books without mitigation). Also, if the nature of the collateral is unlawful, it may raise an illegality of contract issue in that the subject matter of the loan agreement (and its security) is illegal and thus the entire contract or loan itself is unenforceable under federal law.[7] Naturally, that's a nightmare scenario for any lender.

A critical issue for dealing with a marijuana-related bankruptcy is the inability, in many circumstances, to appoint a trustee or debt-or-in-possession and, even if appointed, what constraints he or she will have while operating a CRB or liquidating its "contraband" assets.

California, in anticipation of an illegality of contract defense being raised in its state courts, preemptively issued and signed into law Assembly Bill No. 1159, which was enacted as California Civil Code § 1550.5 and provides that "commercial activity relating to medicinal cannabis or adult-use cannabis conducted in compliance with California law and any applicable local standards, requirements, and regulations shall be deemed to be all of the following: (1) A lawful object of a contract[;] (2) Not contrary to an express provision of law, any policy of express law, or good morals[; and] (3) Not against public policy."[8] Lenders can thus rest assured, at least in California state courts, that their loan agreements will not be summarily deemed unenforceable by virtue of conflicting Federal law.

Adding to the complexity of creditors' rights is the fact that it is nearly impossible for a CRB to seek protection under the Bankruptcy Code, eliminating the many creditor protections available to a lender in a bankruptcy proceeding. A number of rulings from the Ninth Circuit and other federal courts effectively close the door to bankruptcy protection for struggling CRBs concluding that a lender cannot rely on its creditor rights that it would typically have in Bankruptcy Court. As one court firmly declared, bankruptcy courts "should not be 'a haven for wrongdoers.'"[9] If the activity of the debtor is illegal federally, then state law notwithstanding, the trustee or debtor-in-possession cannot violate that federal law.

A critical issue for dealing with a marijuana-related bankruptcy is the inability, in many circumstances, to appoint a trustee or debtor-in-possession and, even if appointed, what constraints he or she will have while operating a CRB or liquidating its "contraband" assets. Specifically, the case of *In re Arenas*[10] addresses this issue ruling that a Chapter 7 debtor could not operate his business legally under the CSA even though he possessed all of the required licenses and permits necessary for producing and distributing marijuana in the State of Colorado. The Court opined that "[f]or the Trustee to take possession and control of the Debtors' Property and marijuana inventory would directly involve him in the commission of federal crimes."[11] Further, the Court held that the inevitable illegality of the trustee's administration of illegal estate assets constituted cause to dismiss under section 707(a). [12]

In a Chapter 11 context, a number of practical concerns arise including the inability to open debtor-in-possession bank accounts and a restricted or complete lack of access to debtor-in-possession financing (commonly referred to as "DIP financing"). To further add to these inconsistencies, some Bankruptcy Courts have allowed Chapter 13 cases to proceed, despite the fact that creditors will be paid by cannabis-derived funds. So how does a lender navigate these pitfalls?

Looking Forward and Being Smart

Despite the restrictions and access to Bankruptcy Court, there are remedies available to creditors through different state law mechanisms, but these must come with the caveat that none of them is perfect. A lender is not precluded from seeking a receiver in state court to harbor and hold the obligor's assets in custodia legis and a lender may seek the authority for a receiver to liquidate such assets or sell them to a new operator.[13] The receiver needs to understand the conflict between state and federal law and the implied risks of that