Will U.S. Cannabis Companies Find Grass Is Greener in Canada for Restructuring?

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Recreational cannabis use became legal in Canada on October 17, 2018. Canada is now the second country in the world—and the first G-7 nation—to authorize a national cannabis market.[1] The passage of Bill C-45, otherwise known as the Cannabis Act, marks a historical moment for advocates of cannabis legalization.

In the United States in 2018, cannabis supporters celebrated smaller victories, with nine states and the District of Columbia now allowing for recreational cannabis use and 30 states allowing for medical cannabis use. Yet cannabis remains illegal in the United States at the federal level.

The uncertainty and conflict surrounding the legality of cannabis in the United States have not stunted the substantial investments that continue to flow into the burgeoning international cannabis industry. In August 2018, for example, Constellation Brands, the public company behind Robert Mondavi wine and Corona beer, announced a $4 billion investment in Canopy Growth Corporation, a Canadian public company and leading provider of medicinal cannabis products. This latest investment increased Constellation Brands' stake from 9.9 percent to 38 percent, with an option to purchase shares sufficient to increase its stake to more than 50 percent.

Similarly, in May 2017, ScottsMiracle-Gro, the lawn and garden products leader, announced that it was selling its international business in Europe and Australia and investing $150 million of the proceeds into growth areas like hydroponics and soilless gardening, both often used in marijuana cultivation. In yet another example, in 2015, Pax Labs, a manufacturer of portable vaporizers, raised $46.7 million from established investors, including Fidelity Investments.

This appetite for risk in the United States is not surprising considering the projected growth in the cannabis industry. In California, where recreational cannabis became legal on January 1, 2017, legal cannabis sales are expected to reach $3.1 billion in 2018 and grow to $7.6 billion by 2022. In the United States, legal cannabis sales are expected to reach $24.1 billion by 2025, up from $6.6 billion in 2016.[2]

Notwithstanding the industry's projected growth, business failures, whether from insufficient capital, natural disasters, or plain old-fashioned bad management, are inevitable. Traditionally, companies that fail or face financial distress in the United States can file bankruptcy, which allows for either a financial or operational reorganization or the orderly liquidation of assets to maximize value for stakeholders. However, cannabis companies are effectively prohibited from filing bankruptcy in the United States.[3]

Bankruptcy Courts generally dismiss cannabis-related cases on grounds that either (1) a bankruptcy trustee cannot administer the assets without violating federal law or (2) a Chapter 11 or Chapter 13 bankruptcy plan cannot comply with the good faith requirements of Section 1129 of the Bankruptcy Code because such a plan would necessarily seek to violate federal law, *i.e.*, the Controlled Substances Act.[4]

This result—the unfortunate byproduct of U.S. states allowing conduct that the federal government does not—is causing substantial challenges for restructuring professionals. Traditionally, bankruptcy serves as a storm shelter for distressed companies, but its protections are not available to the myriad cannabis companies expanding under the hope of full legalization.

In other words, cannabis companies—and their creditors—are left exposed at a time when a distressed storm is gathering on the horizon for them. The projected growth of the legal cannabis industry is attracting sophisticated investors, whose investments are driving a robust industry consolidation in search of economies of scale. There will inevitably be losers—but with access to U.S. Bankruptcy Courts effectively shut off to cannabis companies, how will these distressed companies effectively restructure or liquidate?

Assignments for the benefit of creditors (ABCs) and state court receiverships may be viable options, but each has its drawbacks. Specifically, an ABC does not stay litigation, and litigious creditors can frustrate a potential sale of the company. In addition, the assignee of an ABC is generally selected by the company and lacks the power or ability to conduct a fulsome forensic investigation, something investors may want to pursue if they suspect mismanagement of funds. State court receivers generally are not authorized under applicable receivership statutes to recover preferential payments to creditors or insiders that occurred prior to the receivership.

Chapter 15 – Comity vs. Public Policy

A creative option exists for U.S. cannabis companies with a presence in Canada looking to effectuate a restructuring or orderly liquidation: a Canadian insolvency proceeding coupled with a Chapter 15 proceeding in the United States.[5] Though this scenario remains untested, it is established that Canada allows cannabis companies to institute insolvency proceedings. For example, in the context of its restructuring process under the Bankruptcy and Insolvency Act, Peloton Pharmaceuticals Inc. sold its assets to Aurora Cannabis Inc., a publicly traded company listed on the Toronto Stock Exchange. The transaction was done through a proposal providing for a reorganization of Peloton's share capital, allowing creditors to be paid in full.

Further, this option has the potential to apply to a great many cannabis companies. Established cannabis companies based in the United States are no stranger to Canada. In fact, there is a growing trend of stateside companies tapping the Canadian capital markets. For example, MedMen Enterprises Inc., a vertically integrated cannabis company with cultivation, manufacturing, and dispensary operations, operates in California, New York, and Nevada, and recently listed its shares publicly on the Canadian Securities Exchange with an approximate $1.75 billion market cap.

Unlike common Chapter 7 or Chapter 11 plenary insolvency proceedings, Chapter 15 cases are specialized ancillary proceedings intended to provide effective mechanisms for dealing with cases of cross-border insolvency. Importantly, cases commenced under Chapter 15 also provide many of the protections afforded to companies in Chapter 7 or Chapter 11, including a stay of all pending litigation and collection efforts to provide a distressed company with breathing room to restructure. 11 U.S.C. Sections 1501(a) and 1520.

However, there are several key differences between an ancillary Chapter 15 case and a plenary Chapter 7 or Chapter 11 case. In the context of distressed cannabis companies, the key relevant difference is that, unlike a plenary case, an ancillary Chapter 15 case does not create an estate under Section 541(a) of the Bankruptcy Code.[6] Accordingly, the hypothetical concerns of the United States Trustee regarding administering cannabis assets are not applicable.

Nevertheless, any debtor seeking Chapter 15 recognition of a Canadian insolvency proceeding should be prepared for the United States Trustee to dispute the filing. The United States Trustee can reasonably be expected to argue that the public policy exception applies such that a U.S. Bankruptcy Court should refuse to recognize the foreign reorganization of a cannabis business as "*manifestly contrary to the public policy of the United States*." 11 U.S.C. Section 1506 (emphasis added).

But hope for future cannabis debtors is not lost. The public policy exception of Chapter 15 was adopted from the model law put forth by the United Nations Commission on International Trade Law (UNCITRAL). Thus, UNCITRAL's interpretation of the public policy exception is instructive. Member countries of UNCITRAL have historically viewed the exception as limited to issues of a constitutional nature and for narrow construction in an international context. UNCITRAL added the word "manifestly" to its model law to make this intended narrow scope clear on the face of the statue.[7]

Further, there is case law from U.S. Bankruptcy Courts to support the limited public policy exception in Section 1506. In *RSM Richter Inc. v. Aguilar*, the court noted that the legislative history of Section 1506 limits its use to "the most fundamental policies of the United States" and ruled that certain claims resolution mediation procedures implemented by the Ontario Superior Court were fair and impartial and not manifestly contrary to the public policy of the United States.[8]

In *In re Metcalfe & Mansfield Alternative Investments*, the Bankruptcy Court considered whether enforcing non-debtor releases contained in a Canadian order would be manifestly contrary to the public policy of the United States and noted that the releases and the Canadian lower court's jurisdiction to grant them had been approved by the Canadian Court of Appeals.[9] The Bankruptcy Court also noted that the Section 1506 public policy exception was to be narrowly construed, that "[t]he relief granted in the foreign proceeding and the relief available in a U.S. proceeding need not be identical," and that comity should be granted to the Canadian orders.[10]

In contrast, the court in *In re Qimonda* took a more expansive approach to the exception on remand, ultimately declining to defer to the German law that permitted the administrator to terminate patent licenses. The *Qimonda* court found that failure to apply Section 365(n) of the Bankruptcy Code would undermine the public policy of the United States of promoting technological innovation.[11]

While controversial for its broader interpretation of the public policy exception, the decision in *In re Qimonda* is at least arguably consistent with the widely accepted understanding that the exception should be limited to "the most fundamental policies of the United States;" the promotion of technological innovation is commanded by the U.S. Constitution itself. Article I, Section 8, Clause 8.

Prior to remand, the District Court in *In re Qimonda* espoused the following three principles to guide courts in applying the public policy exception:

1. The mere fact of a conflict between foreign law and U.S. law is not sufficient to support a public policy exception

2. Deference should not be afforded to a foreign proceeding if its procedural fairness is in doubt and cannot be cured

3. An action should not be taken in a Chapter 15 proceeding where it would frustrate a U.S. court's ability to administer the Chapter 15 case or would severely impinge a U.S. constitutional right.[12]

Applying these factors, a U.S. Bankruptcy Court may legitimately conclude that the recognition of a Canadian plenary proceeding involving cannabis assets is not contrary to public policy. First, as recognized in *Qimonda*, a conflict between foreign law and U.S. law is not sufficient to support the public policy exception. Second, there is nothing to suggest that Canadian insolvency proceedings are inherently unfair, as they are consistently recognized in the United States. Third, recognition of a Canadian cannabis proceeding would not frustrate the U.S. court's ability to administer a Chapter 15 case or infringe on U.S. constitutional rights. To the contrary, recognition of a Canadian cannabis proceeding would provide a forum for U.S. creditors to adjudicate their claims in a fair and equitable manner.

Conclusion

Until cannabis becomes legal on a federal level in the United States and companies and their creditors operating in the space are able to access the country's Bankruptcy Courts, a Canadian plenary proceeding coupled with a Chapter 15 ancillary proceeding may be a practical and creative solution. This idea may face staunch opposition, but practitioners should welcome the challenge and strive to forge a new path.

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1. Uruguay legalized cannabis in 2013, although legal retail sales did not begin until 2017.
2. The State of the Legal Marijuana Markets, 6th Edition, produced by Arcview Market Research & BDS Analytics.
3. *In re Arenas*, 514 B.R. 887 (Bankr. D. Colo. Aug. 28, 2014) (marijuana grower's Chapter 7 case dismissed because the trustee could not administer the business without violating federal law); *In re McGinnis*, 453 B.R. 770 (Bankr. D. Or. 2011) (the Bankruptcy Court denied confirmation of a Chapter 13 plan on feasibility, stating the sale and cultivation of marijuana is illegal under federal law).

4. A plan must be proposed in good faith. Courts have held that a plan proposed by a debtor that is involved in an illegal enterprise is not in good faith, even where the debtor does not have a subjective bad motive. *Arenas v. U.S. Trustee (In re Arenas)*, 535 B.R. 845, 852-53 (10th Cir. BAP 2015); *In re Rent-Rite Super Kegs W., Ltd.,* 484 B.R. 799, 809-10 (Bankr. D. Colo. 2012). Moreover, some courts have concluded that a debtor engaged in an illegal business who seeks bankruptcy relief comes into court with unclean hands and is not eligible for relief. *Id.* at 807; cf. I*n re Medpoint Mgmt., LLC,* 528 B.R. 178, 184-87 (Bankr. D. Ariz. 2015) (petitioning creditors who knew the debtor was engaged in the cannabis business had unclean hands and could not seek relief from the Bankruptcy Court).
5. In the event a cannabis company is accessing Canadian capital markets without a presence in Canada or by a non-Canadian entity, it may be worthwhile to establish a Canadian holding company with a presence in Canada.
6. *In re JSC BTA Bank,* 434 B.R. 334, 341 (Bankr. S.D.N.Y. 2010).
7. Guide to Enactment of Model Law of 1997, ¶¶ 87–89. The Guide to Enactment was revised in 2013.
8. *RSM Richter Inc. v. Aguilar (In re Ephedra Products Liability Litigation)*, 349 B.R. 333 (S.D.N.Y. 2006).
9. *In re Metcalfe & Mansfield Alternative Investments*, 421 B.R. 685 (Bankr. S.D.N.Y. 2010).
10. *Id.* at 697-98.
11. *In re Qimonda AG*, 462 B.R. 165 (Bankr. E.D. Vir. 2011), certified for direct appeal, 470 B.R. 374 (E.D. Va. 2012), aff'd, *Jaffé v. Samsung Elecs. Co.*, 737 F.3d 14 (4th Cir. 2013).
12. *In re Qimonda AG Bankr. Litig.,* 433 B.R. 547, 570 (E.D. Va. 2010).

About The Author

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