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Lending to Cannabis Companies: No Bankruptcy, No Problem?

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Lending to companies directly or indirectly involved in the business of selling cannabis or cannabis-derived or -related products (collectively, "cannabis companies") can create complex issues for lenders in a workout or foreclosure scenario. Such companies might not have access to the protections afforded under chapter 11 (or chapter 7, for that matter) of the Bankruptcy Code due to the classification of "marihuana" as a Schedule I "controlled substance" under the Controlled Substances Act (CSA).[1]

Any such company that commences a case under the Code would probably have their case dismissed under § 1112(b) for "cause" on the grounds that it constitutes the debtor's "gross mismanagement of the estate" for operating a business that contravenes federal law or the unenumerated item of filing in "bad faith."[2] Although Congress is working on various legislation to remove cannabis and related products as "controlled substances" under the CSA,[3] at least for now federal illegality and lack of chapter 11 access remains the status quo for the majority of companies involved in "the marijuana industry."[4]

The inability of cannabis companies to access the chapter 11 process to effectuate a change-of-control restructuring or other distressed-sale transaction in a downside scenario may be viewed by potential creditor investors as a huge impediment toward loaning money to such companies. Chapter 11 ensures that a company will be able to reorganize its debts and maximize the value of its assets in an organized and predictable manner.

The benefits of chapter 11 are too numerous to list but include (1) imposition of the automatic stay, which prohibits a "race to the courthouse" by enjoining creditors and other parties from seizing assets and taking other actions adverse to the debtor (including revocation of regulatory licenses) and its stakeholders;[5] (2) facilitating the financing of new capital, the exchange or cancellation of existing debt and equity interests, and/or the sale of material assets with the benefit of Bankruptcy Code provisions, which largely eliminate the hold-up value of out-of-the-money stakeholders and minority-holdout stakeholders within any class of creditors "in the money";[6] and (3) judicial oversight over the management and governance over the debtor generally and court approval for non-ordinary course use, sale or lease of assets.[7] However, lenders to cannabis companies can negotiate certain provisions in intercreditor agreements with other lenders or agreements with equityholders that provide the same or similar benefits as the bankruptcy process, or at least mitigate the costs, delay and uncertainty of effectuating a change-of-control restructuring and/or distressed sale transaction and/or exercising remedies generally.

Contractual Arrangements with Other Lenders

Given the absence of bankruptcy protection, broad and detailed intercreditor provisions are essential to ensure a more predictable and orderly restructuring process. Although typically an intercreditor arrangement is only entered into by senior and junior secured creditors for purposes of determining their respective rights in the borrower's and other guarantors' (collectively, the "loan parties") collateral, lenders to a cannabis borrower should endeavor to negotiate intercreditor provisions with *all* funded debt credi-

1 *See generally* 21 U.S.C. § 801, *et seq.*, and 21 C.F.R. Part 1300, *et seq.* The term "marihuana" is defined in the CSA as all parts of the plant *Cannabis sativa L.*, whether growing or not; the seeds thereof; the resin extracted from any part of such plant; and every compound, manufacture, salt, derivative, mixture or preparation of such plant, its seeds or resin. However, certain derivatives of the plant (*e.g.*, fiber produced from mature stalks, oil made from the seeds) are expressly excluded. "Hemp" (*i.e.*, *Cannabis sativa L.* with a delta-9-tetrahydrocannabinol (THC) concentration of not more than 0.3 percent on a dry-weight basis), and compounds derived from "hemp," also are generally excluded from the definition. 21 U.S.C. §§ 802(16) and 812(c). Certain medications that are produced from cannabis are lawful under the CSA.

2 *See* Cameron Purcell, "Bankruptcy Courts Are Largely Unavailable to Cannabis-Related Debtors but Not Off Limits," 12 St. John's Bankr. Research Libr. No. 22 (2020) (citing 11 U.S.C. § 1112(b)(4)(B) and *In re Rent-Rite*, 484 B.R 799, 809 (Bankr. D. Colo. 2012) (holding that debtor's post-petition activity in violation of CSA constitutes gross mismanagement of estate)); *see also In re Arm Ventures LLC*, 564 B.R. 77 (Bankr. S.D. Fla. 2017) (finding that debtor's federal law violations constituted "bad faith" cause for dismissal).

3 A variety of legislation has been introduced that would affect cannabis regulation in the U.S. For example, the Medical Opportunity Reinvestment and Expungement (MORE) Act, H.R. 3617 (117th Cong., 2d Sess.) — passed by the House of Representatives on April 1, 2022 — would remove "marihuana" and THC from regulation as controlled substances; cease and expunge various criminal offenses; impose taxes on cannabis products produced in/imported into the U.S. and on cannabis business enterprises; and establish certain loan nondiscrimination and opportunity loan provisions. Other proposed legislation would require study and the development of recommendations for national cannabis regulation, establish governing regimes similar to alcohol or tobacco regulation, limit the Food and Drug Administration's potential authority, and clarify federal versus state roles. Certain banking- and finance-related bills also have been introduced.

4 *In re Way to Grow Inc.*, 610 B.R. 338, 344 (D. Colo. 2019) ("[A]s long as marijuana remains a Schedule I controlled substance, a Chapter 11 debtor cannot propose a good-faith reorganization plan that relies on knowingly profiting from the marijuana industry. And, in turn, inability to propose a good-faith reorganization plan is cause for dismissal under 11 U.S.C. § 1112(b)(1).").

5 *See* 11 U.S.C. § 362(a).

6 *See, e.g.*, 11 U.S.C. §§ 364 (authorizing debtor to obtain financing with superpriority and priming lien); 363(f) (allowing for asset sales free and clear, subject to certain conditions); 1129(b)(2) (requiring creditors to receive payment in full before holders of equity interests can receive or retain any property under reorganization plan (referred to as "absolute priority rule")).

7 *See, e.g.*, 11 U.S.C. § 363(b).

tors (including unsecured creditors) and negotiate more detailed and comprehensive provisions than typically negotiated in non-cannabis financings. There are several such intercreditor arrangements.

Broad Standstills

A provision requiring junior lenders to "stand still" and not take any action against the loan parties for a specified period of time to provide senior creditors with the exclusive right to exercise remedies. The term "action" should be broadly defined and, at a minimum, should prohibit lenders (and their collateral/admin agents, if applicable) from bringing lawsuits against or on behalf of the loan parties or exercising rights on collateral.

Release of Junior Liens and Claims

A separate provision requiring junior lenders to affirmatively cooperate in connection with senior lenders' efforts to effectuate a change of control through the equitization of its senior loan claims into equity (or a distressed asset sale transaction via credit-bid or to a third party) in the loan parties may also be appropriate, subject to appropriate limitations and parameters. Although standard intercreditor agreements require junior secured creditors to release their liens on collateral upon the senior secured creditors' exercise of remedies, such provisions are often not broad enough to ensure that senior lenders are equipped with the proper rights to effectuate an orderly change-of-control transaction. A release of claims is particularly important where the loan parties are involved in highly regulated industries, such as cannabis, as litigation brought by creditors against the company or its affiliates (*e.g.*, directors and officers) to recoup economic losses and/or for purposes of extracting hold-up consideration could jeopardize licenses, relationships with customers, vendors and other important counterparties, and generally harm enterprise value.

Thus, if possible, senior lenders should negotiate a full release of claims against all of the loan parties, the senior lenders and their respective affiliates should the senior lenders exercise remedies. In a scenario where senior lenders are not secured by liens on virtually all of the loan parties' assets and there is otherwise significant asset value *not* encumbered by such liens, junior lenders may view the economic implications of a broad-release-claims provision as untenable. Junior lenders should also insist on purchase-option rights, which would provide them with the right to purchase the senior obligations at par plus accrued interest and fees in full, in cash upon the occurrence of an event of default arising under the senior loan agreement. If the junior debt is payment subordinated, then a full release of claims is appropriate.

Specified Cooperation Covenants

Depending on the facts and circumstances, the loan parties and senior lenders may strongly prefer to effectuate the equitization of senior loans in a consensual manner, which could require the junior creditors to use commercially reasonable efforts to (1) negotiate and execute a restructuring-support agreement and/or other documents related to an out-of-court restructuring, or (2) support a sale process (including release of claims and liens in a nondefault scenario as part of a going-concern sale transaction, even if the sale price does not clear the junior debt).

Contractual Arrangements with Equityholders

In addition to intercreditor arrangements, lenders should also obtain from the loan parties' equityholders certain affirmative and negative covenants in their favor related to the lenders' exercise of remedies and efforts to effectuate a change-of-control restructuring transaction. In some respects, such provisions are *more* important than intercreditor provisions given that chapter 11 affords the debtors and creditor stakeholders various protections against out-of-the money equityholders using their control of the loan parties to extract additional consideration from creditors.

Further, if the loan parties are involved in a cannabis-related business requiring state or other government licenses, then the lender might not be able to effectuate a change-of-control transaction (including a stock or asset foreclosure) until it has obtained such licenses, and the cooperation of the loan parties and their controlling equityholders in obtaining such licenses may be extremely helpful, if not necessary.[8] There are several governance arrangements.

Sale Process/Sale Transaction

A provision requiring equityholders to support a sale process and agree to vote in favor of a sale transaction and release their equity interests in connection therewith if the independent director(s) vote in favor of the company entering into such sale transaction, even if the purchase price would not result in any recovery to equity.

Credit Bid/Foreclosure

A provision requiring equityholders to support, or refrain from impeding, a secured creditor's exercise of remedies or providing for a sale of the company to such secured creditor via a credit bid.

Standstill

A provision requiring equityholders to refrain from bringing an acting action, either directly or via the loan parties, seeking to enjoin or impede the secured creditor's exercise of remedies (including the exercise-of-proxy rights[9] and/or foreclosure of collateral) or otherwise obstructing a consensual change-of-control transaction with such secured creditor if approved by a majority of the board.

Release of Interests

A provision requiring the equityholders to agree to consensually surrender their interests in the loan parties and use commercially reasonable efforts to exchange mutual releases with the loan parties and the senior lenders taking ownership and control of the loan parties.

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8 State licensing requirements are detailed, vary by state and activity conducted, and may be restricted in number or region.

9 Exercising proxy rights with respect to pledged equity allows the creditor to exercise the rights of the holder of the pledged equity subject to the proxy rights, including the director designation rights.

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Note

Such covenants will have to comply with the state corporate law governing the loan parties, as well as applicable regulatory law. Further, to the extent that an affirmative and/or negative covenant requires an undertaking from an equityholder with respect to their seat on the loan parties' board of directors (or similar governing body), such provision will likely include a fiduciary duty qualifier (*i.e.*, equityholder will/will not do X, and will cause any of its director affiliates to vote in favor of or against X, subject to his or her fiduciary duties to the loan parties under applicable state law). While such governance provisions are far less typical than intercreditor arrangements, they may be essential when lending to a cannabis company, given the unavailability of bankruptcy to protect creditor interests.

Conclusion

Although credit investors may be wary to invest in a highly regulated and federally illegal industry such as cannabis without the ability to effectuate a restructuring or liquidation under chapter 11 (or chapter 7) of the Bankruptcy Code, there exists a suite of provisions that lenders can negotiate with junior lenders and equityholders to make a restructuring in a downside scenario more predictable and less value-destructive. Thus, until federal law is changed to allow for companies involved in cannabis-related businesses to restructure through chapter 11, such provisions are especially important when lending to cannabis companies. abi

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