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Commercial Banking, Collections and Bankruptcy

The newsletter of the Illinois State Bar Association's Section on Commercial Banking, Collections and Bankruptcy

You cannot go bankrupt selling marijuana!

BY THOMAS E. HOWARD

Since marijuana was prohibited by federal law in 1937, it has never been more legal and accepted. A Gallup poll from October 2015 found that 58 percent of Americans support legalizing recreational marijuana.[1] The legal marijuana industry routinely draws puns of being budding, or growing like a weed, with sky high profits, as it blossoms into a legitimate business enterprise. Not everything in the marijuana industry is as the puns make it seem. Some of the marijuana industry stinks.

Marijuana businesses face tough competition. As a result, prices fall and profits are slashed and taxed away. State laws impose barriers to entry and

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BY MICHAEL L. WEISSMAN

Unnecessary Disclosure in a UCC Financing Statement Did Not Violate the Right to Financial Privacy Act

In *Brackfield & Associates Partnership v. Branch Banking and Trust Company*, 2015 WL 5177737 (U.S.D.C. E.D. Tenn September 4, 2015) the issue was whether the bank had incurred liability by making unnecessary disclosures about Brackfield in UCC Financing Statements filed with Tennessee Secretary of State and the Knox County Recorder

The bank granted Brackfield a line of credit on the condition that Brackfield provide periodic reports on its financial condition. The line of credit was secured by a security interest in all Brackfield's non-real estate assets.

To perfect its security interest, it filed a UCC-1 financing statement with the

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operation in the cannabis marketplace. Marijuana businesses cannot access financial services, and so must operate as cash only.[2] Many tax deductions are off limits to marijuana business. With all these hurdles to clear, some quasi-legal marijuana businesses fail.

In 2014, one such business filed for bankruptcy in Colorado, where it is legal to sell marijuana as a form of highly regulated recreation. *See*, *In re Arenas*, 514 B.R. 887 (Bankr. Colo. 2015). The debtors, a state licensed grower and dispenser of marijuana and his wife, leased a building to a third party, who used it to sell marijuana to retail customers. The wife fell ill with a stroke and became disabled. After litigation with the tenants, the Arenas had a state court judgment entered against them. As often happens, the bankruptcy petition followed entry of the judgment.

Marijuana is an asset that cannot be administered for the benefit of creditors. Administering the marijuana assets is a criminal violation of federal law. It probably constitutes a 'continuing criminal enterprise' under the Controlled Substances Act ("CSA"). This crime is be punishable by imprisonment of not less than twenty years and up to life imprisonment. 21 USC 848. The trustee would also be criminally aiding and abetting the manufacture, distribution and dispersion of marijuana. 18 U.S.C. 2\. No trustee in bankruptcy is going to administer a marijuana related estate and risk mandatory imprisonment of at least twenty years.

The debtors listed a net monthly income of seven dollars on their schedules. They listed their only nonexempt assets as 25 marijuana plants, valued at $6,250, and the rental property. The trustee sought guidance from the United States Trustee ("UST") regarding administering the bankruptcy estate. The UST promptly filed a motion to dismiss for cause under Section 707(a) of the United States Bankruptcy Code (the "Code").

In its motion to dismiss, the UST alleged that it would be impossible under federal law for a trustee to administer the bankruptcy case. Therefore, the bankruptcy filing lacked the requisite good faith. Any administration of the case required the trustee to violate federal law and engage in criminal activity so heinous that the federal government can lock you up and throw away the key.

In response to the UST's motion to dismiss, the debtors filed a motion to convert their case to a Chapter 13. The bankruptcy court denied the debtors' motion to convert the case and granted the UST's motion to dismiss. The court acknowledged that while the debtors' conduct complied with Colorado law, it violated the CSA, which equates and regulates marijuana the same way as heroin. Any possession, or manufacture is criminal. The sale of such substance is so criminal that mandatory minimum sentences have filled prisons to capacity.

The debtors appealed to the Bankruptcy Appellate Panel ("BAP") of the Tenth Circuit, who affirmed the dismissal. *In re Arenas,* 535 BR 845 (B.A.P. 10th Cir. 2015). The BAP agreed with the bankruptcy court's opinion that while the debtors did not engage in evil conduct, they cannot obtain bankruptcy relief because their marijuana business operations are federal crimes.

In its opinion, the BAP highlighted Section 1325 of the Code that requires a plan to be proposed in good faith and not by any means forbidden by law. The only method to fund the debtors' Chapter 13 plan was through the sale of marijuana to pay for their rental income. As a result, the BAP affirmed the bankruptcy court's dismissal.

Meanwhile, a recent Michigan bankruptcy court case may offer some guidance for a failed marijuana business. *In re Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015). The Chapter 13 debtor in the *Johnson* case was a 66-year-old man that made approximately half of his income from Social Security, and the other half from state-law compliant marijuana sales.

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This bankruptcy court did not grant the trustee's motion to dismiss the case.

Instead of dismissal, the bankruptcy court required the debtor to cease all marijuana business operations. Further, the bankruptcy court ordered all of the debtor's marijuana assets be abandoned. While the court denied the trustee's motion, it did so without prejudice and set an evidentiary hearing to determine the debtor's compliance with the order enjoining him from marijuana sales and disposal of his marijuana inventory or farm products.

The Bankruptcy Code is a federal statute, just as the CSA is. The only way for a marijuana business to obtain relief under one is to violate the other. The Code was codified in 1978, and has not seen a major revision since 2005. On the other hand, Congress passed the CSA in 1970, legislating marijuana to be equivalent to heroin by placing both drugs in the same regulatory schedule. Since 1970, 23 states and the District of Columbia have passed medical marijuana laws, or legalized it all together. In that time, not one person has died from a marijuana overdose, while heroin overdoses killed more than 10,000 Americans in 2014 alone.[3] Who knows what Congress was smoking in 1970 when it regulated the two drugs the same way. ■

1. <http://www.gallup.com/poll/186260/back-legal-marijuana.aspx>.

2. See, Order dismissing the case of *Fourth Corner Credit Union, The v. Federal Reserve Bank of Kansas City*, 1:2015cv01633-RBJ, [Doc. 46] (D.C. Colo. 2016).

3. <http://www.drugabuse.gov/related-topics/trends-statistics/overdose-death-rates>.

Recent cases

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Tennessee Secretary of State, and a UCC-2 with the Knox County Register. Each contained a complete listing of assets and liabilities of Brackfield.

When it discovered the unnecessary financial data in the filed UCC financing statements, Brackfield notified the bank. The bank filed an amended financing statements with the Tennessee Secretary of State and Knox County Recorder.

Brackfield claimed the bank had violated the Right to Financial Privacy Act ("RFPA") by disclosing its financial condition to the entire world including all government agencies. The bank responded that since it did not disclose Brackfield's financial condition directly to a "government authority" it had no liability. The court agreed.

The RFPA prohibits a financial institution from providing "any government authority access to, or copies of, the information contained in the financial records of a customer unless it believes it has "information relevant to possible violation of a statute or regulation." 12 U.S.C. 3403.

Viewing the record in its totality, the court said that Brackfield did not claim that its financial data had been disclosed to the government, nor had it shown that the government was actually in possession of its financial data. And, finally, the court concluded "It would be purely 'hypothetical' to surmise that [Brackfield's] financial information has been disclosed or accessed by any government agency."

What's the point? Barring direct disclosure to the government, an inadvertent or accidental disclosure of a bank customer's financial information in a UCC filing will not generate liability for the disclosing bank.

Duty to Investigate Imposed by Inquiry Notice Abrogates Bank's Security Interest

On January 8, 2016 the Seventh Circuit United States Court of Appeals, in an opinion by Judge Posner, ruled on whether a secured creditor lost its secured status by its failure to act on inquiry notice of its borrower's misuse of funds entrusted to it and pledged to the secured creditor as collateral. *In re Sentinel Management,* (No. 15-1039 U.S. Ct. Appls. 7th Circuit).

Sentinel was a cash management firm. It received cash from its customers and invested the money in liquid, low-risk securities. It also traded for its own account using funds borrowed from Bank of New York Mellon Corp. and Bank of New York (collectively "BNYM").

Sentinel borrowed from BNYM. BNYM, for its part, required Sentinel's loan to be secured. Lacking the necessary security, Sentinel pledged securities it had purchased for its customers to BNYM. But Sentinel had contractual arrangements with its customers that required their securities to be held in segregated accounts wholly apart from Sentinel's assets. What Sentinel did was in violation of the contracts and federal law.

By June 2007, Sentinel's loans from BNYM aggregated $573 million. In August 2007, Sentinel experienced heavy trading losses that prevented it from maintaining adequate collateral with BNYM as well as satisfying demands from its customers for the redemption of securities it had purchased for them.

Having no choice, Sentinel filed for bankruptcy protection and a bankruptcy trustee was appointed.

BNYM advised Sentinel's trustee that the pledged securities would be liquidated because Sentinel's loan had not been repaid. In response, the bankruptcy trustee asserted that BNYM should not be treated as a creditor because the transfer of customer securities to secure Sentinel's loans were fraudulent transfers.

Judge Posner stated that the bank would be "in the clear" if it had accepted the securities "in good faith," citing U.S.C. 3548(c), but would not be acting in good faith if it had accepted them with "inquiry notice." Inquiry notice connotes an awareness of suspicious facts that would have induced a reasonable firm, acting