Cannabis Deregulation Raises Bankruptcy Access Questions

By **Michael Rosenblum, Jake Schwartz and Aleksandra Abramova** (April 25, 2025)

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Since the enactment of the Controlled Substances Act in 1970, cannabis has been designated as a Schedule I controlled substance, along with substances such as heroin, LSD and ecstasy.[1]

Schedule I controlled substances are federally regulated at the highest level and include felony criminal charges related to their production, distribution and use.[2] In recent years, however, public sentiment surrounding cannabis has significantly shifted in favor of deregulation, resulting in certain changes in federal law,[3] legalization in many states,[4] and efforts to reschedule cannabis from Schedule I to Schedule III.[5]

While cannabis remains a Schedule I controlled substance for now, it remains possible — if not inevitable — that the substance will be subject to further federal deregulation at some point in the future.

Rescheduling cannabis from a Schedule I to Schedule III controlled substance gives rise to a significant number of legal questions, including whether cannabis businesses will be permitted to avail themselves of the protections afforded by the federal bankruptcy code.

Put differently, if cannabis is rescheduled, will cannabis companies be eligible to file for bankruptcy? This article will explore why cannabis companies have been historically prohibited from filing for bankruptcy, certain exceptions to the general rule, and the potential effects of federal deregulation on such companies' bankruptcy eligibility.

Why Cannabis Companies Currently Cannot File for Bankruptcy

While cannabis companies are not expressly forbidden from filing for bankruptcy, courts have often denied them eligibility on various legal grounds, including that the bankruptcy filing itself furthers a violation of nonbankruptcy law, the filing violates the Bankruptcy Code's good faith requirements, and the related doctrine of "unclean hands."[6]

While a bankruptcy court may deny a debtor's petition for relief under the Bankruptcy Code sua sponte, the U.S. Trustee's Office is typically the party seeking to dismiss cannabis companies' bankruptcy filings.[7]

Section 1112 of the Bankruptcy Code provides that a bankruptcy case may be dismissed for cause.[8] While not expressly enumerated in the statute, cause for dismissal has been found based upon a debtor's failure to comply with applicable nonbankruptcy law.[9]

Violations of nonbankruptcy law may constitute cause for various reasons, including (1) findings that the debtor lacks good faith,[10] (2) findings of gross mismanagement[11] or

(3) violations of general principles applicable to bankruptcy judges' oath of office to uphold the law.[12]

Moreover, for a debtor to avail itself of the protections of the Bankruptcy Code, it must be capable of proposing a plan that meets the requirements of Section 1129, which include that a plan be "proposed in good faith and not by any means forbidden by law."[13]

Notwithstanding these prohibitions, whether cause exists for purposes of dismissal is a fact-specific analysis, subject to the discretion of the bankruptcy judge.[14] For example, bankruptcy courts have weighed various factors in determining whether dismissal is appropriate, such as whether violations of the law are ongoing, whether violations have occurred prepetition or postpetition, and the degree of connectedness as between the violations and the debtor's operations.[15]

The availability of alternative statutory mechanisms may also weigh against dismissal in certain circumstances, such as the appointment of a trustee or examiner, or sanctions.[16]

Rescheduling Cannabis' Effect on Federal Legalization

While many states have recently legalized cannabis, the federal government has yet to do so, even for medical purposes. If cannabis is ultimately rescheduled to a Schedule III controlled substance, medical usage of cannabis would likely become federally permissible, as Schedule III substances are deemed to have accepted medical benefits and moderate to low potential for physical and psychological dependence.[17]

Nevertheless, the current framework for manufacturing, distributing and selling cannabis contradicts the strict requirements imposed by the U.S. Drug Enforcement Administration with respect to Schedule III substances. Thus, as the industry currently operates, rescheduling would not eliminate criminalization for the sale, possession and distribution of cannabis from a federal perspective.

Implications for Access to Bankruptcy

Despite bankruptcy courts' historical reluctance to permit cannabis-related bankruptcy cases, certain courts have become more receptive in recent years under narrow circumstances, as seen in the U.S. Bankruptcy Court for the Central District of California's 2023 decision in In re: Hacienda Company LLC and the U.S. Bankruptcy Court for the Northern District of California's decision last year in In re: Callaway.[18]

In these and other decisions involving cannabis-related businesses or assets, the debtors have successfully established a degree of separation from the cannabis-related activities at issue by removing themselves from any direct operation of a cannabis business.

While bankruptcy courts appear to be inching toward a more permissive stance with regard to cannabis-related bankruptcies, they are not there yet. Courts still routinely dismiss bankruptcy cases where the debtor is directly engaged in, or deriving profits from, cannabis-related business activities.[19] As such, for so long as cannabis remains federally illegal under the CSA in any capacity, the U.S. Trustee's Office will likely continue to object to cannabis bankruptcy filings, and most bankruptcy courts are unlikely to change their stance on the issue, as the debtor will still be violating the CSA, albeit in less severity than if cannabis was a Schedule I substance.

While a rescheduling will likely not open the floodgates for cannabis bankruptcy filings or

otherwise cause a major shift in bankruptcy law with respect to cannabis companies, it may provide bankruptcy courts further comfort, however, where debtors are only tangentially related to cannabis-related activities.

Rescheduling may further alter public sentiment, which in turn may lead to further leniency. Moreover, to the extent rescheduling results in a company no longer engaging in cannabis-related activities that are considered federally illegal — e.g., for certain medicinal and research activities — a strong argument would exist that such companies should be permitted to file for bankruptcy.

A Rare Exception

Against the high burden facing cannabis companies seeking to file bankruptcy, certain exceptions have arisen, such as in Hacienda.[20] In Hacienda, a wholesale manufacturer and packager of cannabis products, operating under the name Lowell Farms, filed for bankruptcy in September 2022.

Months prior to its bankruptcy filing, however, Lowell Farms ceased operations in the U.S. and sold substantially all of its assets — valued at approximately $39 million — including its intellectual property, to a publicly traded Canadian company, Indus Holdings Inc., in exchange for $4.1 million in cash and 22,643,678 subordinate voting shares of Indus, constituting 9.4% of Indus' outstanding shares.[21]

The share consideration of the transaction was issued in a private placement transaction and Indus agreed to register the shares for resale in the U.S.[22] Indus then legally changed its name to Lowell Farms and continued to operate in the U.S., along with other countries, including Canada.

In bankruptcy, Hacienda, now a shell entity with the exception of its cash and shares in Indus-Lowell Farms, sought to propose a plan of liquidation whereby Hacienda would sell its newly owned shares of Lowell Farms on the Canadian Securities Exchange and distribute the funds received from the sale to its creditors on a pro rata basis.

The U.S. Trustee for Region 16 quickly objected to Hacienda's bankruptcy filing, asserting that Hacienda "previously operated a marijuana company and currently owns shares in Lowell Farms, Inc, a Canadian publicly traded marijuana company operating in California in violation of federal narcotics statutes," and arguing that "this unlawful conduct cannot form the basis of a successful reorganization, rendering this case a bad faith filing, which is cause to dismiss the case. Further, [Hacienda] intends to sell its stock of Lowell Farms, Inc. to fund its plan of reorganization."[23]

The Bankruptcy Court ultimately denied and overruled the U.S. Trustee's objection, finding that the U.S. Trustee failed to establish any ongoing or future violations of the CSA. Specifically, the Bankruptcy Court found that Hacienda's passive ownership of Lowell Farms, with the intent of liquidating such stock over time to pay creditors, was not a "conspirac[y] with intent to distribute cannabis" in violation of Section 856 of the CSA.[24]

So long as Hacienda did not "maintain its investment in [Lowell Farms] for too long a period of time," the Bankruptcy Court ruled that Hacienda did not have the necessary "intent to profit from an ongoing scheme to distribute cannabis" such that the bankruptcy case could proceed.[25] The Bankruptcy Court further found that liquidating shares in Lowell Farms did not constitute "investing" in cannabis-related enterprises in violation of Section 854 of the CSA.[26]

Finally, the Bankruptcy Court found that, even if the U.S. Trustee could establish a violation of the CSA by virtue of Hacienda's cannabis-related activities, such violation standing alone would not be sufficient to automatically warrant dismissal, explaining that "Congress did not adopt a 'zero tolerance' policy that requires dismissal of any bankruptcy case involving violation of the CSA."[27]

The court highlighted numerous policy concerns associated with implementing such a strict ruling of Section 1112 of the Bankruptcy Code, such as improperly limiting a significant percentage of companies access to bankruptcy based upon alleged violations of federal law.[28]

Additionally, the Bankruptcy Court found that the "unusual circumstances" exception to dismissal applied here by virtue of Hacienda's prepetition divestiture "of any direct involvement in the cannabis business" and "a very realistic possibility of substantial payment to creditors" through Hacienda selling its shares in Lowell, the now-Canadian company.[29]

While it permitted Hacienda's bankruptcy case to continue, the Bankruptcy Court cautioned that "nothing in this Opinion should be interpreted as condoning illegal activity" and such actions:

> [C]an be cause for dismissal in appropriate circumstances, both as a matter of interpreting Congress' directives in [Section] 1112(b) and, more generally, to preserve the integrity of the bankruptcy system and the bankruptcy courts that Congress has established.[30]

Following this ruling, the U.S. Trustee subsequently objected to Hacienda's proposed plan of liquidation. The Bankruptcy Court again overruled the U.S. Trustee and confirmed the plan, finding — along the same lines of its prior decision — that Hacienda's plan had been proposed in good faith as required by Section 1129(a)(3) and that:

> [Hacienda's] orderly liquidation of its stock in Lowell Farms, and distribution of the proceeds to creditors, is entirely consistent with the objectives and purposes of the Code ... [and Hacienda's] temporary retention of such stock, while divesting itself of that connection to cannabis, does not foster a single sale of any cannabis products, nor does it add a single dollar to any cannabis-related enterprise.[31]

The Future of Cannabis Companies and Bankruptcy Filings

Due to their federal illegality, cannabis companies lack access to traditional sources of capital and rely heavily on debt financing from private lenders. According to MJBizDaily, debt financing has eclipsed equity as the capital-intensive industry's preferred source of funding, and an estimate of at least $2 billion in debt is coming due in 2026.[32]

Loans to operators often feature onerous terms, such as exorbitantly high interest rates and substantial prepayment penalties, and the ability to refinance often depends on factors outside the industry's control, including regulatory developments at the federal and state level.

In the face of mounting debts and onerous regulations, cannabis companies will continue to face financial challenges which will require restructurings or complete liquidations.

For reasons previously explained, traditional bankruptcy filings will likely not be a viable

option for companies directly engaged in cannabis-related activities, even if cannabis is rescheduled from a Schedule I to Schedule III controlled substance. As such, cannabis companies looking to restructure or reorganize and continue operating will likely be forced to engage in private workouts, distressed mergers and acquisitions, and other out-of-court transactions permitted under state law.

For those entities forced into liquidation scenarios, however, a potential avenue exists to access the bankruptcy system and its corresponding benefits — such as invocation of the automatic stay, obtaining releases, rejecting burdensome contracts, and others — through a Hacienda-structured transaction whereby the entity sells its cannabis-related assets to another entity located in a jurisdiction where cannabis is legal, such as Canada, in exchange for stock,[33] and thereafter liquidates such stock in a U.S. bankruptcy and distributes the proceeds to creditors.

While the law is certainly not widely settled as to whether this bankruptcy structure is permissible, and U.S. Trustees are likely to continue to object, the decisions in Hacienda and Callaway provide a defensible basis for attempting such transactions under the rationale that the company is no longer engaging in cannabis-related activities and will not engage in, or profit from, any such activities in the future.

The company must commit to ceasing its operations on a go-forward basis and — as mandated by the court in Hacienda — seek to promptly liquidate or otherwise divest its holdings in any other companies currently engaging cannabis-related business.

In exchange, however, the company would be permitted to invoke the many rights and benefits associated with a bankruptcy filing. Generally speaking, in order to survive dismissal, the bankruptcy court must be convinced that the company is no longer engaged in actions deemed federally illegal under the CSA, and there is no risk of any future violations post-bankruptcy. Liquidations of stock appear to fit that criteria, at least in the eyes of the few courts that have addressed the issue.

Conclusion

As a general rule, for so long as cannabis remains federally illegal under the CSA, it is unlikely that companies engaged in cannabis-related businesses will be permitted to access the bankruptcy system, and such filings will be dismissed pursuant to Section 1112 of the Bankruptcy Code.

Rescheduling cannabis under the CSA from a Schedule I to Schedule III controlled substance may lead to ceratin exceptions to this general rule where a company is engaged in activities that are no longer deemed federally illegal, such as certain forms of medicinal usage or research, but otherwise, rescheduling will likely not change the status quo with respect to cannabis bankruptcies.

To the extent a company is seeking to fully liquidate its assets, however, and would prefer to pursue such liquidation as part of a structured bankruptcy process — with related benefits such as the automatic stay or potential releases — it might be permitted to do so by engaging in a transaction similar to that which was effectuated in the Hacienda bankruptcy case.

While there is limited case law addressing the subject, a supportable basis exists to assert that the liquidation of a passive ownership interest in a cannabis company, standing alone

and with no intention of holding such interest for an extended period of time, does not violate the CSA and is not cause for dismissal under the Bankruptcy Code.

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[1] 21 U.S.C. § 812, Schedule I(c)(10).

[2] 21 U.S.C. § 841.

[3] Examples include the Rohrabacher-Blumenauer Amendment (first passed in 2014, prohibiting federal interference with the implementation of state medical cannabis laws), and the Agriculture Improvement Act of 2018 ("descheduling" certain low-THC cannabis products, such as cannabinol (CBD), from the CSA).

[4] Currently, thirty-nine (39) states, three (3) territories, and the District of Columbia allow the medical use of cannabis products and twenty-four (24) states, three (3) territories, and the District of Columbia allow or regulate cannabis for recreational use. See National Conference of State Legislatures, State Medical Cannabis Laws, NCSL (March 6, 2025), https://www.ncsl.org/health/state-medical-cannabis-laws.

[5] In August 2023, the U.S. Department of Health and Human Services recommended that cannabis be reclassified as a Schedule III substance. The Department of Justice subsequently initiated formal rulemaking, but as of April 2025, the process remains stalled pending final action by the Drug Enforcement Agency's acting administrator, Derek Maltz.

[6] See, e.g., In re Arenas, 535 B.R. 845 (10th Cir. B.A.P. 2015).

[7] 11 U.S.C. § 105(a).

[8] 11 U.S.C. § 1112(b)(1).

[9] In re Hacienda Company, 647 B.R. at 751.

[10] See, e.g., In re Leavitt, 171 F.3d 1219 (9th Cir. 1999).

[11] See, e.g., In re Rent-Rite Super Kegs West Ltd., 484 B.R. 799 (Bankr. D. Colo. 2012).

[12] See, e.g., In re Johnson, 532 B.R. 53 (Bankr. W.D. Mich. 2015).

[13] See 11 U.S.C. § 1129(a)(3).

[14] See In re Burton, 610 B.R. 633, 640 (9th Cir. B.A.P. 2020).

[15] See, e.g., id. at 637-638; see also Garvin v. Cook Investments NW, SPNWY LLC, 922 F.3d 1031, 1036 (9th Cir. 2019).

[16] See, e.g., 11 U.S.C. § 1104; Fed. R. Bankr. Pro. 9011.

[17] 21 U.S.C. § 812(b)(3).

[18] See Garvin v. Cook Inc. NW, SPNWY, LLC, 922 F.3d 1031 (9th Cir. 2019) (confirming chapter 11 plan that derived indirect support from rental income from a lessor engaged in a marijuana growing business); In re Hacienda Company, L.L.C., 647 B.R. 748 (Bankr. C.D. Cal. 2023) (permitting bankruptcy filing structured around liquidation of cannabis company stock); In re Callaway, 663 B.R. 109 (Bankr. N.D. Cal. 2024) (permitting individual debtor to liquidate membership interest in LLC engaged in marijuana business).

[19] See, e.g., In re Blumsack, 657 B.R. 505, (BAP 1st Cir. 2024); In re Johnson, 532 B.R. 53 (Bankr. W.D. Mich. 2015); Arm Ventures, LLC, 564 B.R. 77 (Bankr. S.D. Fla. 2017); In re Way to Grow Inc., 597 B.R. 111 (Bankr. D. Colo 2018); In re Rent-Rite Super Kegs West Ltd., 484 B.R. 799 (Bankr. D. Colo. 2012); In re Mayer, 2022 WL 18715955 (Bankr. D. Ariz. Jan. 31, 2022); In re Kittrell, 2020 WL 6821720 (Bankr. D. Ariz. Oct. 6, 2020).

[20] In re Hacienda Company LLC, 647 B.R. 748 (Bankr. C.D. Cal. 2023).

[21] Indus Holdings, Inc., Indus Holdings, Inc. Announces the Acquisition of Lowell Herb Co. (Feb. 25, 2021), https://ir.lowellfarmservices.com/news-events/press-releases/detail/55/indus-holdings-inc-announces-the-acquisition-of-lowell.

[22] Id.

[23] Notice of Motion and Motion under 11 U.S.C. § 1112(b) to Dismiss Case, Declaration of Dare Law in Support Thereof, In re The Hacienda Company, No. 2:22-bk-15163-NB, at ECF No. 53 (Bankr. C.D. Cal. Nov. 29, 2022).

[24] In re Hacienda Company, 647, B.R. at 753. The Bankruptcy Court acknowledged the U.S. Trustee's alternative characterization of the facts as Hacienda "effectively conspiring to continue carrying on its California-based cannabis business indirectly, through its ownership interest in a Canadian company operating under [Hacienda's] former name" but ultimately chose not to adopt the U.S. Trustee's conclusions.

[25] Id.

[26] Id.

[27] Id. at 754.

[28] Id. (noting "[s]ome of the largest bankruptcy cases, like those of Pacific Gas & Electric Co. of "Erin Brockovich" fame, Enron Corporation, and Bernie Madoff, involve alleged criminal activity. Should those cases have been dismissed?").

[29] In re Hacienda Company, 647 B.R. at 756-57.

[30] Id. at 757.

[31] Memorandum Decision Confirming Debtor's Amended Plan, In re The Hacienda Company, No. 2:22-bk-15163-NB, at ECF No. 200 (Bankr. C.D. Cal. Sept. 20, 2023).

[32] Chris Roberts, Cannabis Debt Crisis Looms as Billions in Loans Come Due in 2026, MJBizDaily (Jan. 14, 2025), https://mjbizdaily.com/cannabis-debt-crisis-looms-as-billions-in-loans-come-due-in-2026/.

[33] This article expresses no opinion as to the legality of any sale of cannabis-related assets under U.S. or foreign law. Indeed, the court in Hacienda noted that the prepetition stock transaction "appears to be legal and feasible under Canadian law" but expressed no further opinion on it. In re Hacienda Company, 647 B.R. at 757.