

Podcast: Cannabis and Bankruptcy, Ep. 3: Considerations for Lenders

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This is the third installment in our three-part series: “Exploring Issues in Cannabis and Bankruptcy.” In this final episode, we’ll explore what the two recent decisions in *Blumsack* and *Hacienda* mean for creditors in the cannabis industry and also what rights are available to lenders and marijuana financiers in the bankruptcy context.

Heidi Urness: I’m Heidi Urness, chair of McGlinchey’s Cannabis Practice Group and resident in Seattle. Joining me today are two of my firm colleagues in our New Orleans office. Timothy Bird is a commercial litigator with bankruptcy experience, and Rudy Cerone brings more than 40 years of experience in all sides of bankruptcy law. So, even though all of the parties in *Hacienda*, it sounds like, wanted the matter to remain in bankruptcy court, *Hacienda* doesn’t necessarily stand for that proposition. In fact, *Hacienda* seems to make clear that bankruptcy is not going to be available to most cannabis businesses because of their ongoing conduct in the industry. If that’s the case, what are the alternatives to creditors of this industry?

One option for a secured creditor dealing with a distressed cannabis company is to attempt to restructure that obligation, which makes sense to the creditor and would allow money to be paid over a longer term...Another option is for the secured creditors to go after the secured assets, foreclose, and dispose of them.

Timothy Byrd: In terms of creditors dealing with a distressed cannabis company, it’s important to note that creditors do not want to hold collateral. They don’t want to foreclose on property if it can be avoided. One option for a secured creditor dealing with a distressed cannabis company is to attempt to restructure that obligation, which makes sense to the creditor and would allow money to be paid over a longer term. This is just a negotiation, and all of the different debt covenants or payment terms are fair game in that negotiation.

Another option is for the secured creditors to go after the secured assets, foreclose, and dispose of them. If there are any deficiencies, typically, there’s a guarantor on those contracts, and the creditor can go after the

guarantor for any deficiency amount. In the negotiation process, a cannabis company, as we've talked about earlier, is most likely not going to have the threat of declaring bankruptcy, which would invoke the automatic stay and prevent creditors from taking action. Creditors understand that in the negotiation, and will likely need to take aggressive action and race to the courthouse.

Heidi Urness: If a creditor knows that a marijuana company can't take advantage of the benefits of bankruptcy, there will be a race to the courthouse. The regulations in cannabis can present some unique challenges to these creditors. And they're not totally unique to the cannabis industry. They apply to a lot of highly regulated industries. For example, in cannabis, we can't secure the marijuana inventory because only people who possess marijuana licenses from the state are allowed legally to possess that amount of commercial cannabis. What do we do in the case of creditors who can't secure all of the assets of a certain business in a highly regulated industry?

A very important strategy on the front end to prevent this would be for a creditor to specifically negotiate in the contract, where they loan money to the cannabis company, for a first lien on the valuable operating assets. This would give you a first lien above the other creditors.

Rudy Cerone: Heidi, we do have some experience along those lines. In the late '90s and early 2000s, there was a wave of casino bankruptcies, and think about it, casinos have licenses from the state in order to operate. Only they can possess gaming equipment, mainly slot machines. So if a creditor is a secured creditor to a casino and wants to realize on its collateral, you've got a problem with owning and taking possession of gaming devices.

There are options available under state law, such as assignments for the benefit of creditors and receiverships, where the collateral can be sold only to persons entitled to possess them. In the case of casinos, it was other casinos that you would sell the whole building along with all of the assets in the building to another licensee. I would think the same thing can happen in the cannabis space. There are other licensees, and there can be a list of potential licensees.

If I were advising the secured creditor, I'd advertise to all of those particular companies and say, "You're qualified. Do you want to bid on the foreclosure of these particular assets?" Therefore, the creditor doesn't have to get involved with possessing and then disposing of things that they're not licensed under state law to do.

Heidi Urness: It presents an interesting issue in cannabis as well because, in addition to not being able to secure the inventory, we have issues over who can "control" the business and make management decisions. I think this is going to be a really interesting area of contention. We may see some sort of analysis similar to what we saw in *Hacienda* where we say, "As long as we are disposing of all of these assets to exit the industry, we will allow this temporary control by creditors of these assets and these activities."

An additional protection that is normally made in regular lending decisions to small businesses, assuming that we're talking about relatively small businesses, is to get personal guarantees from the principals of the business. Normal trade creditors, those that are doing business with them on open account, usually don't have access to guarantees from the principals of the business. Therefore, lenders with more leverage can extract a personal guarantee and put pressure on the business owners as a result of that guarantee.

Rudy Cerone: There may be a gap in the state regulations that creditors in the cannabis industry and trade groups might want to propose to state regulators and state legislators. They could suggest that, in order to maximize the availability of secured credit to this particular industry, there has to be an off-ramp, an exit in the event that the business doesn't make it. Please make it easier for us to dispose of this type of collateral to other licensees, but make it easier for the creditors to exercise their state law rights.

Heidi Urness: If these interactions of bankruptcy, other federal laws, and state laws result in a sort of race to the courthouse for creditors, is there anything that creditors can do to protect themselves or even empower themselves when dealing with marijuana businesses?

Timothy Byrd: If you know a business cannot declare bankruptcy, then it's just going to be a race to the courthouse. The first creditor to seize assets is likely going to win and take all the funds from the disposition of that collateral. The bankruptcy code specifically prevents this race to the courthouse because it inherently leads to inequitable treatment among creditors and can destroy the value of the business.

Now, a very important strategy on the front end to prevent this would be for a creditor to specifically negotiate in the contract, where they loan money to the cannabis company, for a first lien on the valuable operating assets. This would give you a first lien above the other creditors in a hypothetical race to the courthouse, but would also give you significant negotiating leverage when it comes down to having restructuring talks with the cannabis company.

Rudy Cerone: An additional protection that is normally made in regular lending decisions to small businesses, assuming that we're talking about relatively small businesses, is to get personal guarantees from the principals of the business. Normal trade creditors, those that are doing business with them on open account, usually don't have access to guarantees from the principals of the business. Therefore, lenders with more leverage can extract a personal guarantee and put pressure on the business owners as a result of that guarantee.

One option is to use whatever state they're incorporated or domiciled in and utilize that state law mechanism called an assignment for the benefit of creditors. It's similar to a Chapter 7 bankruptcy proceeding, where the debtor's assets are liquidated in an orderly fashion to maximize value, but it's not governed by the bankruptcy code.

Heidi Urness: As most folks are aware, there are certain pockets of the cannabis industry that, despite its growth, are experiencing a certain level of distress at this time. Tim, what would you say to these cannabis industries that are in distress? What are their options if it doesn't look like Chapter 11 bankruptcy from *Hacienda* is going to be an option for them?

Timothy Byrd: One option is to use whatever state they're incorporated or domiciled in and utilize that state law mechanism called an assignment for the benefit of creditors. It's similar to a Chapter 7 bankruptcy proceeding, where the debtor's assets are liquidated in an orderly fashion to maximize value, but it's not governed by the bankruptcy code. Each state typically has its own assignment for the benefit of creditor statutes, and they have specific rules. So you need to consult your state's laws, but it can be an option and give some bankruptcy-type relief when the company is not eligible to file under the federal bankruptcy laws.

Heidi Urness: And Rudy, on the other side of that coin, what would be your message to lenders during this time in the industry?

Rudy Cerone: Well, Heidi, as you mentioned at the beginning, I've been practicing bankruptcy law for over 30 years. However, I also get involved with advising creditors, lenders, and prospective lenders on what to do upfront when they're considering making loans. We will advise on what particular types of remedies and default options are available in their loan documents. As Tim mentioned previously, the most important aspect is to secure the loan with collateral that can be disposed of in an efficient manner and also to obtain personal guarantees of the principals of the debtor. This maintains the ability to realize on the collateral and get paid on its debt.

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Heidi Urness: It sounds like we've come full circle from the very beginning of our conversation, and there is a glimmer of hope. Hope is not all lost for either distressed cannabis businesses or their secured or unsecured creditors. Thank you both very much for your insights into both lenders in this space and cannabis businesses as well. We very much appreciate your insights and, of course, your years of experience. While these issues are new to a lot of participants in the industry, they're certainly not new to either of you. We very much appreciate all of your time and insights on this topic.

Rudy Cerone: Thank you, Heidi. It was very interesting. Thanks.

Timothy Byrd: Great. Thanks, Heidi. I appreciate it.

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