

Collateral Matters

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A “Green Rush” for Debt Financing?

By Graham Topa and Timothy Jones¹

Canadian cannabis policy announcements over the past year have spurred investment in licensed cannabis producers and dealers (“**Licensed Producers**”), resulting in one of Canada’s newest growth industries. Deloitte projects the potential size of a legal, recreational retail cannabis market at \$9 billion.² Equity investors have responded with what is becoming known as the “green rush,” with medical marijuana companies raising more than \$466 million in Canadian capital markets in 2016.³

While it is high times for equity financing, there is far less buzz for debt financing of Licensed Producers. Indeed, the Chief Executive Officer of one leading Toronto Stock Exchange-listed Licensed Producer has gone on record to say that “debt financing is the principal absent business instrument for the [regulated cannabis] sector.”⁴

What is holding lenders back from a “green rush” of debt financing?

Setting aside potential reputational risk associated with cannabis, there are other risks involved with lending to Licensed Producers:

- **Risks of Lending to Non-Compliant Borrowers:** Since cannabis is currently a controlled substance,⁵ a borrower’s non-compliance with the *Access to Cannabis for Medical Purposes Regulations*⁶ could create major risks for a lender. Under the Regulations, in order for a Licensed Producer to be legally permitted to cultivate, produce and/or sell marijuana, it must have received the requisite licence(s) from Health Canada. Non-compliance with such regulations can result in the revocation of a licence and has the potential to attract criminal liability/charges for the Licensed Producer. Actual or suspected non-compliance could therefore lead to a Licensed Producer’s assets being forfeited to the Crown under civil forfeiture legislation;⁷ potentially resulting in a significant loss of a lender’s collateral.
- **Difficulties Ascertaining Compliance:** Production, shipping, packaging, record-keeping, client eligibility, product security and export of marijuana are all extensively regulated on an ongoing basis by Health Canada under complex rules. Lenders should carefully scrutinize the business operations and practices of a potential Licensed Producer. If credit facilities are

¹ A Student-at-law. The authors acknowledge the contributions of Andrew Biderman, Aaron Collins, Daniel Overall, Lorway Gosse, Donald Johnston, Jeremy Nemers and Kyle Plunkett to the various scenarios contemplated in this article.

² A 2016 Deloitte study suggests that the Canadian retail market for regulated recreational marijuana product is between \$4.9 billion and \$8.7 billion, with potential upside (including spinoff effects) exceeding \$22 billion. Available online at <<https://www2.deloitte.com/ca/en/pages/deloitte-analytics/articles/recreational-marijuana-market.html>>.

³ Sunny Freeman, “Why smaller banks take bigger slice of the growing medical marijuana business,” Financial Post, online: January 30 2017, <<http://business.financialpost.com/news/fp-street/why-smaller-banks-take-bigger-slice-of-the-growing-medical-marijuana-business>>.

⁴ Bruce Linton, CEO of Canopy Growth Corporation, quoted in Eric Lam, “This Canadian Marijuana Grower is Looking for a Loan,” Bloomberg, online: July 29, 2016, <<https://www.bloomberg.com/news/articles/2016-07-29/pot-grower-canopy-graduates-to-stock-big-leagues-now-seeks-loan>>. Linton went on to comment: “if I was producing tomatoes that yielded this margin in these buildings, I’d have a lineup of debt instruments available.”

⁵ *Controlled Drugs and Substances Act*, SC 1996, c 19.

⁶ SOR/2016-230 (the “Regulations”).

⁷ In Ontario, the applicable legislation is the *Civil Remedies Act, 2001*, S.O. 2001, c. 28. Several other provinces have comparable statutes.

provided, the lender should ensure that the borrower provides the appropriate monitoring compliance certificates (perhaps on a more frequent basis than in other industries) and that the lender is immediately provided with full details of any Health Canada concerns with respect to the borrower.

- **Inability to Collateralize Licences:** In some industries where licences are scarce (as is currently the case in the cannabis industry), licences are often a borrower's most valuable asset. However, only transferable and relatively stable licences are useful collateral. Currently there is no statutory or policy guidance on the transferability of Health Canada issued marijuana licences. Whether or not a Health Canada issued licence can be safely collateralized is an issue that lenders should be mindful of, as there is ministerial discretion to suspend such licences without notice⁸ and it is not clear whether such licences constitute "property" over which a valid security interest can attach.⁹
- **Difficult Inventory Enforcement:** When the inventory is cannabis, lenders are in the sticky situation of having a security interest in collateral that they are not legally permitted to possess or resell. Only a Licenced Producer is permitted to possess and resell cannabis and, in order to do so, the "senior person in charge," "responsible persons in charge" and other persons must themselves hold valid security clearances and authorizations from Health Canada in connection with the licence. As such, if a lender seeks to enforce and the borrower's employees with security clearances leave the business, successful liquidation would be jeopardized. A receiver would need to retain persons with the appropriate clearances, such as another Licenced Producer or perhaps certain of their staff, in order to deal with the regulated collateral.
- **Court Involvement:** In a security realization scenario involving cannabis collateral, it is unlikely that Health Canada would take a passive role. To add credibility and certainty to a security enforcement situation involving cannabis collateral, a court-ordered receivership would be the most prudent course of action. A draft receivership order would likely have to be tailored to the requirements of the regulatory context, and Health Canada should be served with materials. This approach could potentially reduce the likelihood of suspension or cancellation of the Licenced Producer's Health Canada issued licence, legitimize the sale of cannabis inventory and increase the chances of recovery.

- **Few "White Knights":** Although the Regulations permit resale to other Licenced Producers, the current scarcity of Licenced Producers means the number of potential purchasers is limited. Similarly, the equipment used by a Licenced Producer cultivating cannabis may be of limited value from a margining perspective, since the number of potential purchasers of this specialized collateral is low.

In light of these issues, how can lenders protect themselves? In addition to very careful pre-commitment diligence, lenders could increase their confidence by negotiating the following rights:

- i. conservative margining (particularly with respect to valuing intangibles and inventory collateral; Licenced Producers with valuable real property interests or transferable equipment would, of course, inspire greater lender confidence);
- ii. periodic monitoring rights;
- iii. periodic compliance reporting by the borrower;
- iv. borrower to immediately provide notice to the lender of any Health Canada concern of compliance issues;
- v. borrower covenants mirroring the demands of the Regulations; and
- vi. side agreements with one or more "senior person in charge," "responsible persons in charge" and other persons that hold a valid security clearance authorized and approved by Health Canada in connection with Health Canada issued licences that provide that persons will assist with and facilitate the enforcement of the lender's security in the event of a security realization scenario.¹⁰

In addition, an acknowledgment and consent from Health Canada regarding the lender's security could be requested, providing that Health Canada will cooperate with any court-appointed officer in the context of enforcement by the lender of its security, to facilitate realization or a sale to a Health Canada-approved purchaser. This process would be familiar for lenders operating in other regulated industries, such as mining or long-term care. Alternatively, a borrower could consider issuing a notice to Health Canada advising that the borrower has granted a security interest over its personal property, including cannabis inventory, to the lender, thereby putting Health Canada on notice of the lender's security interest.

⁸ The Regulations provide wide discretion to the Health Canada to cancel permits on public safety or other grounds (s. 40(1)), and provide that licences *must* be cancelled if the security clearances of any "responsible person in charge" lapse.

⁹ In several jurisdictions, non-transferable licences are defined in the relevant personal property security legislation as property over which a security interest can be taken. In others, including Ontario, this question is resolved on a notoriously uncertain common-law test, where analysis can sometimes end up in the weeds: see *Saulnier v. Royal Bank of Canada*, 2008 SCC 58.

¹⁰ The consideration and structuring of such agreements would need to be considered.

In light of these challenges, it is not surprising that institutional debt capital has been largely absent from the early days of the Canadian “green rush.” As policymakers contemplate future legislation, they should consider how to address the issues identified above and support the ability of secured lenders to realize on their security.

We encourage policymakers and commentators to think of debt capital as a necessary pillar of a responsible and safe cannabis legalization strategy. Property, plant and equipment improvements – the traditional domain of asset-based lending – are essential to establishing safe and compliant production and distribution facilities. Regulatory reform that stimulates debt financing could both blaze a trail for economic growth and close the trust gap for this budding industry.

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