

Race to “get a foot in the door” of the recreational cannabis industry raises potentially legal issues

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Canadian cannabis producers are in a race to increase their size and gain capital ahead of Canada's planned recreational cannabis legalization in July 2018. The recent duelling takeover bids involving three domestic cannabis companies is proof of the jockeying that is currently going on in the industry.

As of November 30, 2017, Health Canada's website lists 76 authorized licensed producers (“LPs”) of cannabis for medical purposes, providing plenty of appealing takeover targets for existing players and new entrants to target.¹ For example, Alberta-based Aurora Cannabis Inc. announced its intention to launch a takeover bid for CanniMed Therapeutics Inc., a medical cannabis producer based in Saskatchewan. The all-stock hostile takeover attempt came just one week after Aurora proposed a friendly offer to CanniMed's board. In response, Cannimed has adopted a shareholder's right plan to defend itself.

There is a lot at stake for the early players in the industry. According to *Deloitte's Recreational Marijuana Insights and Opportunities, 2016*², with tax and licensing revenue totalling over USD \$52 million in Colorado for the last fiscal year (and Colorado's population being one-seventh the size of Canada's), it is obvious the opportunities in the Canadian recreational cannabis market are substantial.

Given the recent M&A activity and national press coverage, it is evident that the associated risk is not stopping the investors, underwriters and lenders who previously avoided the cannabis industry. In addition, established players who recognize the substantial opportunity that the recreational cannabis industry offers are likely to draw on experience from established industries such as tobacco, pharmaceuticals and alcohol, in order to leverage their existing assets.³ The rush to “get a foot in the door” of the market raises some potentially serious legal issues.

WeirFoulds LLP is prepared to help your business address these complex issues. As the cannabis industry continues to grow and mature, the wide range of complex issues will continue to evolve and require producers and their service providers to pay close attention to the changing landscape in which they operate.

Investment and Financing

As previously mentioned, the competition for capital prior to July 2018 is fierce, as access to financing is crucial for cannabis producers. Those in the industry have relied on alternative financing models such as private placements or small public offerings, without the support of the banks/global investment banks. Nevertheless, as we move forward into a system of recreational legalization, all potential avenues for investment and financing should be considered.

Protection of Intellectual Property, IT & Cyber Security

Intellectual property remains one of a producer's most valuable assets and can make an enormous difference to their bottom

line. [Patenting a plant is not generally permissible in Canada. However, it may be possible to protect newly-developed strains of cannabis under the *Plant Breeders' Rights Act*](#). Other issues may include information technology and cyber security, as the loss or unauthorized disclosure of this proprietary information could be catastrophic.

Product, Class Action and Director and Officer Liability

Insurance in the cannabis industry has had an interesting past. Coverage was a challenge as insurance companies did not fully understand the industry and its risks. As the industry matures, so does the need for insurance to cover labelling, product defects, including the use of pesticides and/or possible contamination. These can all lead to recalls that might lead to product liability class action lawsuits. Even prior to recreational legalization, there have been two publicized class action lawsuits which related to product recalls.

The board of directors for cannabis companies are motivated to get D&O insurance for the same reasons as the board of directors of any other company – for corporate and personal protection in case of litigation. The federal *Cannabis Act* will deem corporate directors, officers and agents to be parties to any non-criminal violations of the *Cannabis Act* that they authorized or to which they acquiesced, regardless of active involvement.

Provincial Regulation

The current regulatory regime governing the production and sale of cannabis in Canada is fragmented. First, there is a significant difference in the way that medical cannabis is regulated (under the federal Access to Cannabis for Medical Purposes Regulations) compared to the way recreational cannabis is intended to be regulated (the federal *Cannabis Act*). Second, post-recreational legalization, the federal government intends to largely let the individual provinces and territories create their own sets of rules governing the sale and consumption of recreational cannabis, with retail options so far ranging from privatized sales (Alberta) to government-run monopolies (Ontario). This fragmentation is expected to raise compliance costs.

Advertising and Branding

Currently, under the Access to Cannabis for Medical Purposes Regulations, branding and advertising of products is severely restricted. The intention under the federal *Cannabis Act* is that companies will be able to brand their products, but must avoid anything that could be construed as trying to appeal directly to youth (i.e. using animated characters, animals, or celebrity endorsements) in their advertisements. Companies may use factual information on their packaging, such as THC levels, that would assist consumers in their purchasing decisions. It is worth noting that the federal *Cannabis Act* has not yet been passed into law and there remain several opportunities (committees, and notably approval by the Senate) for significant revisions to the Bill before it becomes law. As the legislative requirements become more settled, their impact on business (both from a federal perspective and the need not to run afoul of any individual province's own laws on sale, as they may be more stringent than the federal law) should be a constant consideration. In addition, regarding production and distribution, only LPs licensed by Health Canada can grow and sell cannabis under the current medical regime; as we move into a recreational world, it becomes murkier as to who can produce and sell, and may vary somewhat by province.

Market Growth and Limitations

Several Canadian LPs have already expanded into Germany and Australia where the use of cannabis for medical purposes is permitted and regulated. International opportunities will continue to emerge as legalization spreads. However, exporting cannabis from Canada is currently restricted to medical or scientific purposes. Moreover, the most likely source of expansion for Canadian exports would be to the United States, although cannabis remains a Schedule 1 narcotic under the *American Controlled Substances Act*. Thus, due diligence by Canadian companies wishing to access markets in the 29 states that have legalized cannabis use in some form will have to

be extensive.⁴

Tax Considerations

There are a wide range of tax considerations that need to be addressed by existing players and potential entrants to the cannabis industry. British Columbia Premier John Horgan has stated that his provincial government should not "gouge" cannabis businesses with licensing fees if the province wants to eliminate the sizable black market.⁵

Federally speaking, on November 10, 2017, the Department of Finance released its proposed excise duty and GST/HST framework for cannabis products, which includes the application of excise duties and the imposition of licensing, stamping and reporting requirements. GST/HST will also generally apply in addition to the excise duties. The public is invited to submit feedback on the proposals by December 7, 2017. Under the proposals, excise duties (that are currently levied on spirits, wine and tobacco) will be levied on cannabis (both medical and recreational) at a maximum rate of the greater of \$1 per gram or 10 per cent of the sale price.

Further, cannabis producers will be required to obtain a license from the Canada Revenue Agency (CRA), in addition to a license issued by Health Canada. Obtaining a license will require the submission of a detailed application with supporting documentation (including a business plan) and the posting of security of \$5,000 to \$5,000,000, depending on the expected amount of duty payable. Cannabis licenses will be issued for a maximum of two years and will not be automatically renewed. A cannabis licensee will have to re-apply at least 30 days prior to the expiry of their license. All cannabis products will generally be required to be packaged in a container with an excise stamp, which stamp will be issued by the CRA.

All cannabis licensees will also be required to submit to the CRA a monthly duty and information return.

The cannabis excise duty framework is proposed to generally apply on the date that legal cannabis for non-medical purposes becomes accessible for retail sale.

In the Result

As July 2018 inches closer, each province and territory in Canada will continue to develop and implement its own regulatory framework, to be layered with the federal cannabis legislation. In this rapidly-developing marketplace, WeirFoulds LLP is eager to help you navigate the evolving commercial, regulatory, and legal landscapes and ensure that your business meets its legal obligations under federal and provincial laws.

[1]Geoff Zochodne (November 20, 2017) "Consolidation fever intensifies in Canada's cannabis sector" Financial Post, <http://business.financialpost.com/investing/consolidation-fever-intensifies-in-canadas-cannabis-sector>

[2]Deloitte, "Recreational Marijuana Insights and Opportunities" (2016).

[3]David Hodges, (November 20, 2017) "87 per cent of Canadian pot producers say industry consolidation is inevitable: survey" The Canadian Press/ CTV

News, <http://www.ctvnews.ca/business/87-per-cent-of-canadian-pot-producers-say-industry-consolidation-is-inevitable-survey-1.3686160>

[4]Deloitte, "Recreational Marijuana Insights and Opportunities" (2016).

[5]Mike Hager (November 22, 2017) "Horgan warns against overtaxing burgeoning cannabis industry", The Globe and Mail, <https://www.theglobeandmail.com/news/british-columbia/horgan-warns-against-overcharging-burgeoning-cannabis-industry/article37058020/>

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