

HAS COVID-19 LIT THE FUSE ON INSOLVENCIES IN THE CANADIAN CANNABIS INDUSTRY?

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Novel corona virus and the global COVID-19 pandemic have had devastating impacts on financial markets and the economy generally as well as everyday life. All Canadian businesses now face challenges that were unimaginable even a month ago. Canadian corporations that entered 2020 with weak balance sheets and tightening access to capital, however, may find themselves standing at the precipice of difficult decisions.

In this respect, no industry sector had been watched more closely than the maturing Canadian cannabis industry. Until December 2019, only three Canadian cannabis companies had filed for creditor protection. Since the beginning of December 2019, however the number of filings has steadily increased, with two filings in December 2019, and six in the first quarter of 2020. By the end of 2020, the Canadian cannabis industry may well see significant consolidation with a handful of dominant market players. We anticipate that the current trickle of cannabis companies seeking creditor protection under the *Companies' Creditors Arrangement Act* [1] ("CCAA") or the *Bankruptcy and Insolvency Act* [2] ("BIA") will build to a steady flow.

We look at the most recent market analysis of the Canadian cannabis industry, as well as the unique regulatory constraints as we discuss the challenges for cannabis companies and their creditors alike in addressing the upcoming financial headwinds and obstacles.

Challenging Landscape

The highly regulated nature of the Canadian cannabis industry poses unique challenges. Many licensed producers faced an initial backlog of licensing applications. Provincial plans for licensing retail cannabis stores created an uneven market, with Ontario licensing only a limited number of cannabis retailers. Despite the stated public policy objectives of legalizing recreational cannabis in eliminating the illicit black market, 75% of cannabis-consuming Canadians continue to buy illicit products, which are aggressively priced. [3]

While the legalization of recreational cannabis in Canada in October, 2018 triggered an influx of market activity, from initial public offerings, debenture issues and to M&A transactions, the industry grappled with cash-flow issues, limited available capital and falling valuations. While M&A activity continued to increase from 2018 into the first two quarters of 2019, as compared to that of the previous year, [4] 2019 proved to be a year of ups and



downs with the number of transactions declining by the end of the year. [5] The last quarter of 2019 saw the total transaction value fall below \$1 billion for one quarter, first time since third quarter of 2017. [6] Public cannabis company EBITDA results fell short of expectations. [7]

The industry was encouraged by the fact that legal cannabis sales reached an all-time high of \$146.2 million by December 2019[8] and the cannabis companies' expectation of a positive EBITDA by 2021.[9] The monthly sales in January 2020 were up, at \$154.2 million which is an increase from \$54.9 million last year.[10] Some analysists expect 2020 sales to reach \$2.8 billion with the addition of new retail stores and cannabis 2.0 products[11] and sales to increase substantially by 2025.[12]

Cannabis companies' funding landscape has changed dramatically. Historically, companies in this industry have raised funds though issuing additional capital. Last year, though, the amount of capital raised declined 31% from 2018 to 2019 while debt financing increased 28%. [13] Current pandemic-related market challenges will no doubt make it even more challenging to raise capital and debt. Creditors who lose faith may force some cannabis companies to seek creditor protection (or face being placed into receivership). Others, especially those with cash on hand, are potentially the target of unsolicited takeover bids or targets of short selling campaigns which may accelerate their need to seek court protection from creditors.

The global COVID-19 pandemic places further stress on the industry. It is difficult to discern whether the increased cannabis sales were a result of consumers stock piling during the pandemic or will continue. [14] There are glimmers of hope – it is worth noting that cannabis is generally considered an essential service in those states in the United States that permit adult recreational cannabis use, as it is in most Canadian provinces. Even in Ontario, where retail cannabis stores are not considered essential services and were ordered closed as of April 4, 2020, an emergency order was made on April 7, 2020 that will temporarily allow licensed cannabis retailers to deliver cannabis and cannabis products to customer, or arrange for curb-side pick-up in order to curtail the illicit market. [15] In addition, the Business Development Bank of Canada and Export Development Bank announced that they will include the cannabis sector among the businesses entitled to access \$40 billion in new credit available as part of the Federal Government's COVID-19 Economic Response Plan. [16]

Trends and Signals from Current Restructuring Proceedings

The Canadian cannabis industry has already seen an uptick in the number of cannabis companies seeking protection under the CCAA or the BIA. Ascent Industries Corp. ("Ascent") filed for protection under the CCAA over a year ago, in the beginning of March 2019.[17] DionyMed Brands Inc.[18] ("DionyMed") and Curative Cannabis[19] were placed in receivership last year and Wayland Group[20] and AgMedica Bioscience Inc.[21] obtained creditor protection under the CCAA in December 2019. This year, so far, Invictus MD Strategies Corp.



sought creditor protection in February 2020,[22] Pure Global Cannabis Inc.[23] ("**Pure Global**") and CannTrust Holdings Inc.[24] in March 2020 and James E. Wagner Cultivation Corporation[25] ("**JWC**") in April 2020. In addition, Eureka 93 Inc.[26] ("**Eureka 93**") and Green Relief Inc.[27] filed notices of intention to make a proposal under the BIA (similarly staying creditors for 30 days in order to file proposals).

Challenges in Cannabis Restructuring

Successful restructuring in the cannabis space will require the usual elements of any successful restructuring: adequate financing through the restructuring process (debtor in possession or "**DIP**" financing), accessible liquidity, and support from key creditors. In addition, where a licensed producer intends to continue operating through the restructuring process, it must maintain its key employees in order to keep its licenses. Ultimately, though, licensed producers will face challenges. Regulatory restrictions and limited market growth likely means that, for now at least, there will be a limited number of strategic purchasers interested in acquiring either inventory or build-out or nearly completed grow and production facilities.

Realization of Cannabis Assets

Debtors, creditors and insolvency professionals must be aware of the concerns specific to the cannabis industry that may affect restructuring and insolvency proceedings. The legalization of cannabis was primarily a public health policy change, without any corresponding changes to insolvency legislation. As a result, gaps exist in how assets unique to cannabis industry are treated in insolvency proceedings.

The realization or recovery of assets in the cannabis industry can be particularly complex. The following specific issues may arise in any restructuring or insolvency proceeding involving cannabis assets.

Licensing

Canadian cannabis producers must hold valid licenses issued by multiple levels of government:

- Federal Health Canada [28] and Canada Revenue Agency ("CRA") licenses [29]
- Provincial retail licenses
- Municipal business permits

The federal licenses for cultivation and processing also require key employees obtain security clearances before Health Canada will grant the license to the cannabis producer. [30] These roles must be filled by individuals with security clearances or the producer risks the license being cancelled. Cannabis producers will typically have their federal licenses held by the operating corporation, with key employees obtaining the appropriate security clearances. [31] There is no provision in the *Cannabis Act* [32] or the regulations that permit the transfer or assignment of licenses. The federal CRA license also requires payment of prescribed security for cannabis duty



liability.[33]

Provincial licenses and municipal permits may require the payment of further fees and separate security clearances for key employees. The evolving nature of cannabis regulations in Canada's federal system means producers and retailers will have to meet different licensing and permitting requirements in each province and municipality. Such complexities may limit the marketability of cannabis assets in a restructuring or liquidation.

Valuation and marketability of cannabis assets is further complicated by the uncertainty around the ability to transfer or assign federal licenses under current legislation and regulations. At this time, it appears that such licenses are not transferrable. Accordingly, cannabis sector restructurings (as opposed to liquidations) will generally be debtor-led. The reorganization of share capital can effectively transfer cannabis assets and insolvency proceedings can be used to effect such reorganizations. For instance, proposal proceedings under the *BIA* can be used to effectively transfer cannabis assets to a purchaser through a reorganization of the debtor's share capital.[34]

Cannabis licensing poses particular concerns for practitioners in formal insolvency proceedings. To date, it appears insolvency practitioners will not be able to obtain temporary licenses from Health Canada in order to take possession of the debtor's property. Similar temporary licenses have been granted by provincial regulators when gaming or alcohol assets are involved. To address this limitation, the trend increasingly appears to amend the model initial orders in insolvency proceedings to authorize the receiver to deal with licensing issues under federal and provincial legislation (in the name of the name or as agent for the debtor) or to exempt the monitor from taking possession of assets subject to cannabis regulations. We note that in the Monitor in the Pure Global proceedings indicated that it was not prepared to act as a receiver because it would not be able to lawfully take possession of cannabis (in pre-packaged finished and bulk inventory, or as work-in-progress plan inventory). Teven if cannabis inventory remains in the debtor's possession, a receiver, in taking possession of the debtor's other property will require the assistance of key employees and cooperation with Health Canada and provincial regulators.

Key Employees and Technical Expertise

Specific expertise is necessary to safeguard organic products particularly when the corporate producer is undergoing restructuring or insolvency proceedings. This expertise is even more critical when the organic product is as heavily regulated as cannabis is. Insolvency practitioners will need to rely on key employees with technical expertise necessary to meet regulatory requirements as well as established contacts with federal and provincial regulators.

Insolvency practitioners themselves will need to develop their own relationships with key regulators as well. Early and frequent contact with Health Canada and provincial regulators will be necessary to safeguard



cannabis assets and complete recovery and realization.

Federal licensing regulations require that directors and officers, as well as key individuals on site obtain and maintain security clearances. These individuals include the head of security, master grower, quality assurance persons and the person with overall responsible for all activities conducted by the cannabis producer. Which individuals will require security clearances depends on the nature of activities conducted by the cannabis producer. [38]

The critical nature of key employees in cannabis production, particularly for maintaining licenses, means that practitioners should consider use of key employee retention plans ("**KERPs**") in cannabis insolvency proceedings. The early implementation and court approval of KERPs, including any priority charge necessary to fund the KERPs, is an important aspect of safeguarding cannabis assets.

Valuation

The vagaries applicable to valuation of organic products also apply to the valuation of cannabis assets. Determining the value of cannabis assets may include assessment of expected product yields, stage of growth, market price for finished product, selling costs, cost per gram, cost to complete and survivorship/wastage.[39]

Valuation of cannabis producers is complicated by the industry's recent emergence. Valuators are challenged to adequately assess risk profiles because of the short history of both the industry and individual producers, as well as the evolving regulatory oversight in each jurisdiction.[40]

Sales Process

The nature of cannabis assets will have significant effect on the sales process in insolvency proceedings. The regulatory requirements may limit the target market of potential strategic purchasers to those capable of approval at federal, provincial and municipal levels. The tight timelines in insolvency proceedings may limit the target market further to only those already holding relevant licenses[41] and who are in a position to obtain additional capital or debt to fund the purchase of assets in an insolvency. A perceived glut of both cultivation capacity and inventory of cannabis and cannabis products may further limit the value realized on these assets. Inventory that cannot be sold to another licensed producer, or that remains on-site after a licensed producer surrenders or loses its license, must be destroyed.

Accordingly, effective restructurings may involve the creative realization of assets associated with cannabis production, such as real property (either owned or leased) and equipment. While the sale of equipment will generally be targeted to other licensed producers or retailers, the willingness of producers to retrofit existing operations for new products during the COVID-19 outbreak may expand the target market to other innovators.



The uncertainty surrounding cannabis assets will likely lead to the use of stalking-horse bids in insolvency proceedings. Stalking horse bids, where the accepted purchaser sets the initial sale terms, provides parties with the certainty of an appropriate purchaser and the purchaser with comfort its due diligence will not be wasted particularly where break fees may compensate the stalking horse bidder. [42] In the recent filing of JWC, the company contemplates that the sale and investor solicitation process will include a stalking horse bid from its secured creditor who is also the DIP lender. [43]

Court approval of sales of cannabis assets may be complicated by the challenges of valuing cannabis assets and the limited target market. Insolvency practitioners must take care to satisfy the court that the proposed transaction is prudent in light of the circumstances. This will require evidence about the nature of the cannabis assets, the valuation and marketing of such assets and the challenges posed by cannabis regulations.

Cross-Border Operations

Several cannabis producers have operations in both Canada and the United States. The lack of federal legalization of cannabis in the United States poses unique challenges for cross-border restructurings.

There have been no cross-border insolvency proceedings regarding cannabis producers to date, although we note that there have been two insolvency proceedings to date involving cross-border issues. DionyMed was placed in receivership in British Columbia. As a Canadian holding company, it's revenues were primarily generated from United States subsidiaries. This is not a true cross border insolvency. Ascent also has a cross border aspect, but only as a consequence of Health Canada suspending and revoking licenses held by its Canadian subsidiaries. Ascent successfully sold its Canadian assets, leaving it with only its United States subsidiaries. Neither of these proceedings involved a reorganization of the United States subsidiaries or assets and it is unclear if proceedings to recognize Canadian insolvency proceedings would be permitted by US courts. American courts continue to grapple with the conflict between state-licensed cannabis activity and the criminalization of cannabis at the federal level which prevents protection under US insolvency legislation.

It is not clear that cannabis producers can seek protection under US insolvency legislation due to the illegal status of cannabis under US federal law. One US circuit court of appeals recently appeared to open the door to cannabis producers seeking protection under the federal Bankruptcy Code. The appellate court upheld lower courts' determination that the court will not sanction a plan proposed in an unlawful manner but that such restriction does not forbid approval of a plan that may depend on certain illegal elements. In this case, the plan involved a debtor that leased property to a licensed cannabis producer in Washington State. This decision, however, is already under attack from other US courts. [44]

Lessons So Far



It is too early to look for trends to predict which cannabis companies will need to restructure or those which will be able to do so successfully. There are perhaps some common themes for the first wave of cannabis companies seeking creditor protection or placed in receivership. Many of the early casualties had attempted to become vertically integrated cannabis producers without first generating positive cash-flow as a licensed producer. Often, these debtors quickly consumed capital or took on significant and often convertible debt in order to implement rapid expansion plans in the hopes of putting as many acres into production as quickly as possible. Some cannabis companies struggled to move from an entrepreneurial mindset to that of a highly regulated industry player responsible to Health Canada and securities regulators. While regulatory non-compliance is not necessarily fatal to a cannabis producer, if addressed promptly, persistent operational issues which threaten Health Canada licenses or delinquencies in meeting reporting obligations imposed under securities laws are symptoms of management's inability to deal with the multiple stressors on a start-up business in a heavily regulated and nascent industry.

Creditor support is critical and will likely only become more so, given the economic impact of COVID-19. In the last two months, creditors have opposed initial creditor protection for two producers. In the case of Eureka 93, creditors greeted the company's notice to make a proposal under the BIA on the grounds that its plans to obtain loans (which would rank in priority to existing secured creditors) to allow to complete its only operating facility, which creditors described in their court materials as only "aspirational". Pure Global's Debenture Holders[45] and other secured creditors did not support its restructuring plans. Pure Global sought creditor protection following its default under its debentures and vendor take-back mortgages on two Brampton properties (warehouse and production facilities) owned by its subsidiaries, which are its only significant assets. The court approved interim DIP financing of \$700,000 during the initial eight day stay, with an additional \$1 million (and a total DIP Charge of \$1.7 million) available through May 15, 2020. While the Monitor proposed to initiate a sales process of the business as a going concern, Pure Global's secured creditors saw no prospect of successfully restructuring Pure Global as a going concern. The Court agreed and after the initial eight-day stay, ordered Pure Global to cease operations. The CCAA stay of proceedings will continue until May 15, 2020 to allow Pure Global to dispose of or destroy its cannabis or cannabis products, in consultation with Revenue Canada and Health Canada. This restructuring process, where Pure Global remains in possession of its property, permits the Monitor to continue in its role and avoids the difficulties in appointing a receiver over cannabis and cannabis products. The secured creditors are free to seek the appointment of a receiver after the CCAA stay period expires.[46]

As with any company facing a liquidity crisis, successful restructuring depends on a number of factors. The most critical is a willingness of management and the board of directors to be proactive and maintain communication with key creditors and regulators in order to a credible plan in place and to make an orderly



transition into restructuring proceedings. Given the additional challenges posed by the highly regulated nature of the cannabis industry, the earlier the licensed producers and cannabis retailers plan for entering and exiting CCAA proceedings, the better the company's chances of successfully avoiding receivership and liquidation will be.

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- [1] RSC 1985, c C-36.
- [2] RSC 1985, c B-3.
- [3] Eva Koronois, "2020 Canadian Cannabis Industry Update" (February 3, 2020), online.
- [4] MNP Corporate Finance Inc, "Quarterly Industry Update: Cannabis Q4 2019" (February 10, 2020), online.
- [5] *Ibid*.
- [6] *Ibid*.
- [7] Ernst and Young, "EY Insights: Cannabis valuations" (October 2019), online.
- [8] Bringing the annualized run rate of cannabis sales to \$1.75 billion; BNN Bloomberg, "<u>Cannabis Canada</u>: <u>Annualized legal pot sales on track to hit \$1.75B</u>" (February 21, 2020), online.
- [9] Supra, note 7.
- [10] Ibid.
- [11] Vanmala Subramaniam, "<u>Canadians bought just \$1.2 billion worth of legal weed in 2019, but sales ended the year strong</u>" (February 21, 2020), online.
- [12] Supra, note 7.
- [13] Supra, note 4.
- [14] *Ibid*.
- [15] O. Reg. 128/20. The emergency order granted on April 7, 2020 initially lasts for 14 days but may be extended. See also AGCO, "<u>Information Bulletin: Temporary delivery and curb-side pick-up by authorized cannabis retail stores and burden reduction measures during the COVID-19 pandemic</u>" (April 7, 2020), online.
- [16] Colin Perkel, "Bars, cannabis sector eligible for \$40-billion credit program from government bank" (April 5, 2020), online.
- [17] Re Ascent Industries Corp., BCSC (Vancouver Registry), Court File No. S-192188, Sanction Order dated December 19, 2019..
- [18] GLAS Americas LLC v. DionyMed Brands Inc., BCSC (Vancouver Registry), Court File No. S191098, Receiver Order dated October 29, 2019 (Marchand J).
- [19] *Auxly Cannabis v 2368523 Ontario Ltd.*, ON SCJ [Commercial List], Court File No. CV-19-627308-00CL, Receiver Order dated September 19, 2019, (Hainey J).
- [20] Re Wayland Group, ON SCJ [Commercial List], Court File No. CV-19-00632079-00CL, Initial Order dated



December 2, 2019 (Hainey J).

- [21] Re AgMedica BioScience Inc., ON SCJ [Commercial List], Court File No. CV-19-00632052-00CL, Initial Order dated December 2, 2019 (Hainey J).
- [22] Re Invictus MD Strategies Court BSCS, [Vancouver Registry], Court File No. S-201708, Initial Order dated February 13, 2020 (Fitzpatrick J).
- [23] Re Pure Global Cannabis, ON SCJ [Commerical List], Court File No. CV-20-00638503-00CL] Initial Order dated March 19, 2020 granting an eight-day stay (Hainey J).
- [24] Re CannTrust, ON SCJ [Commercial List], Court File No. CV-20-00638930-00CL, Initial Order dated March 31, 2020 (Hainey J).
- [25] Re James E Wagner Cultivation Corporation et al, ON SCJ [Commercial List], Court File No.
- CV-20-00639000-00CL, Initial Order dated April 1, 2020 (Hainey J).
- [26] Re Eureka 93 Inc., 2020 ONSC 1482.
- [27] Re Green Relief Inc., ON SCJ [Commercial List], Court File No. CV-20-637735-00CL, filed on March 11, 2020 (Koehnen J set an April 8, 2020 come-back date).
- [28] Health Canada, "<u>Summary of Application requirements for cannabis cultivation, processing and medical sales licences</u>" (March 6, 2020), online.
- [29] Canada Revenue Agency, "<u>Cannabis duty Apply for a cannabis licence from the CRA</u>" (February 24, 2020), online.
- [30] Supra, note 28 at Appendix A, online.
- [31] Allen, Vanessa and Hutchison, Dean, "Asset Realizations in the New World Dealing with Cryptocurrency and Cannabis Assets", *Annual Review of Insolvency Law 2019*, ed. Professor Jill Corraini and The Honourable D Blair Nixon (Thomson Reuters Canada Limited: Toronto, 2020).
- [32] SC 2018, c 16.
- [33] <u>Supra, note 29</u>, online.
- [34] *Supra*, note 31.
- [35] Re AgMedica Bioscience Inc. et al, supra, note 21; Auxly Cannabis Group Inc. v. 2368523 Ontario Limited dba Curative Cannabis, supra note 19.
- [36] As is typically the case with respect to any property that may carry liability under environmental legislation.
- [37] Supra, note 23, First Monitor's Report dated April 2, 2020.
- [38] Supra, note 28 at Appendix A, online.
- [39] BDO Canada LLP, "Valuing Biological Assets in the Cannabis Industry" (September 19, 2019), online.
- [40] Chris Walsh, "<u>Appraising a Marijuana Business: Q&A with Valuations Expert Ronald Seigneur</u>" (September 10, 2014), online.
- [41] Supra, note 31.



- [42] *Ibid*.
- [43] Supra, note 25; Report of KSV Kofman, Inc. dated March 31, 2020.
- [44] Mark A. Salzberg, "Cannabis and Bankruptcy: 2019 in Review" (December 17, 2019), online.
- [45] McMillan LLP is counsel to certain Debenture Holders.
- [46] Supra, note 23, Amended and Restated Initial Order dated April 6, 2020.

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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