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December 2019

## CANNABIS DEBT FINANCINGS: CURRENT MARKET SNAPSHOT AND CONSIDERATIONS FOR LENDERS, INVESTORS AND UNDERWRITERS

### Industry Overview

The global cannabis industry has experienced exponential growth over the last several years. The steady trend towards legalization across North America and Europe has significantly expanded market opportunity not only in the cannabis retail sector, but also in the leveraged finance space. While cannabis businesses are looking to access loan markets and debt capital markets more frequently to finance operational build-outs and M&A activity, the heavily regulated and novel nature of the sector presents uniquely complex compliance challenges to lenders, underwriters, investors, and other financial institutions looking to participate in this burgeoning industry.

### Regulatory Backdrop<sup>1</sup>

#### Canada

Medicinal use of cannabis has been legal in Canada since 2001, but it was the legalization of cannabis for recreational purposes in October 2018 that radically changed the nature of the Canadian cannabis market. As the second country in the world (after Uruguay) and the first G7 and G20 nation to formally legalize the cultivation, possession,



distribution and consumption of cannabis for both medicinal and recreational purposes, the cannabis market in Canada earned a head start over other markets that have followed or may be considering following suit. The Canadian regulatory landscape has also fostered the growth and expansion of ancillary cannabis companies (businesses that don't "touch the plant"), including consultancies, software platforms, data analytics providers and independent research firms. Although cannabis remains heavily regulated by various levels of the Canadian government, and notwithstanding the fact that Canadian cannabis equity markets experienced declines over the course of 2019, the industry as a whole remains widely expected to experience significant growth over the long term.

#### United States

The regulatory backdrop in the United States is more complex, as marijuana is differentially regulated at both a federal and state level. At present, eleven states and the District of Columbia have legalized marijuana for recreational use and thirty-three states have legalized marijuana for medicinal use. However, the possession, use and sale of marijuana remains illegal under U.S. federal law, as marijuana remains a Schedule I drug under the Controlled Substances Act of 1970 (the "Controlled Substances Act"). Under U.S. law, federal law trumps state law and the fact that an act may be legal under state law is not a defense to a federal prosecution. As a result, lenders and other capital providers continue to shy away from potential investment opportunities in states where marijuana debt financing activity is legal under state law.

However, there has been recent movement in federal marijuana regulation in the U.S. For example, in November 2019, the House Judiciary Committee approved the Marijuana Opportunity Reinvestment and Expungement Act (the "More Act") that would, if passed into law, remove marijuana from Schedule I of the Controlled Substances Act and thereby end prohibition of marijuana at the federal level. However, the More Act still requires approval in the House of Representatives and the Senate before it can become law.

Separately, in September 2019, the House of Representatives passed the Secure and Fair Enforcement Banking Act which, if approved by the Senate, would provide federally-regulated banks with a legal safe harbour to provide banking services, including bank accounts, credit cards and loans, to marijuana companies that operate in compliance with state law. The Congress is also considering various other legislative proposals, such as the STATES Act, which would, if passed, immunize state compliant marijuana businesses from federal prosecution. However, the prospects for passage of any of these reform bills are uncertain given the current political situation in the United States.

In 2018, Congress removed "hemp", defined as cannabis products having less than .3% THC on a dry weight basis, from the definition of marijuana under the Controlled Substances Act. This opened up opportunities for financing hemp businesses, including those involved in the manufacture and production of cannabidiol ("CBD"). However, these opportunities have been somewhat dampened by the fact that the CBD market and the regulatory framework around CBD are still evolving.

### ***United Kingdom***

The use of cannabis for medicinal purposes was legalized in the United Kingdom in November 2018. However, in contrast to the regulatory environment in Canada and certain U.S. states, recreational cannabis remains illegal in the United Kingdom. As a result,

lenders and investors operating from the UK risk committing breaches of the UK Proceeds of Crime Act 2002 ("POCA"), the UK's principal anti-money laundering legislation, by financing cannabis producers and cannabis-related companies to the extent their business activities are associated with recreational cannabis use. Notably, and subject to certain exceptions, POCA can have extraterritorial effect in that conduct that is legal under the laws of the country in which it occurs may still constitute "criminal conduct" for purposes of POCA, with the proceeds of any such criminal conduct thereby comprising "criminal property" under POCA, if it would have been unlawful had it occurred in the UK. This means that UK lenders and investors will need to carefully consider their position under POCA before facilitating the financing of cannabis companies abroad, even if their business activities are legal in their home jurisdiction.

### ***Europe***

The regulatory approach to cannabis varies dramatically between European countries and the market is in relatively early stages, but Europe looks to be a high-potential region. A substantial number of European nations now have a legal medicinal cannabis market including Germany, Italy, Spain and Portugal, among others. While a select group of European countries have decriminalized recreational cannabis, to date, none have formally legalized it. However, this appears to be changing, as Luxembourg has declared its

intention to legalize recreational cannabis by 2021 (medicinal cannabis has been legal in Luxembourg since 2018 and personal possession of recreational cannabis has been decriminalized since 2001). This development will undoubtedly impact the views of other European governments, and we may continue to see a gradual relaxation on cannabis prohibitions across the continent.

### **Financing Activity in the Cannabis Sector**

The bulk of capital raising activity across the cannabis sector has taken place in the form of equity issuances and convertible securities offerings. Nonconvertible debt financings have, by comparison, so far been substantially less frequent. However, the Canadian market has started to see a shift towards more traditional forms of debt financing as an alternative non-dilutive means of raising capital.

Previously reluctant to step into the sector, several major Canadian banks have begun accepting mandates to provide financing to cannabis firms predominantly in the form of secured term loans and revolving credit facilities. For example, Aurora Cannabis, one of the largest cannabis firms in the world, has entered into a CAD360 million secured credit facility with three of Canada's biggest banks which is one of the largest nonconvertible credit facilities currently in place in the cannabis industry. Nonconvertible debt securities issuances by cannabis companies



have also been limited, but we are now beginning to see cannabis issuers test the waters on this front in the international debt capital markets. One notable example is a recent issuance of non-convertible secured debenture and warrant units by a U.S.-based cannabis issuer listed on a major Canadian stock exchange. Though the terms of the debt securities offered were not governed by New York law, they included a full set of high yield style incurrence covenants. Units were offered for sale to Canadian subscribers under a prospectus, to U.S. "qualified institutional buyers" as defined in Rule 144A under the United States Securities Act of 1933, as amended and to certain additional international subscribers. While not a typical Regulation S/Rule 144A New York law-governed high yield bond issuance, this offering suggests the market for high yield cannabis bonds could be opening up. A continuation of the 2019 slump in Canadian cannabis equity markets and ongoing concerns about the refinancing of convertible debentures may motivate further non-convertible debt securities issuances.

U.S. banks, on the other hand, remain reluctant to service cannabis clients in light of the fact that marijuana is still a federally-prohibited narcotic controlled substance. Financing of cannabis and cannabis-related businesses in the UK and elsewhere in Europe also remains several steps behind what has been observed to date in Canada, as these markets remain less established than their North American counterparts. In our experience, regulated banks operating from the UK have adopted a wait-and-see approach

with respect to lending to or otherwise facilitating debt-raising activities by Canadian cannabis firms that are operating in compliance with applicable local law, in large part due to the risks associated with possible exposure to recreational cannabis and the corresponding risk of inadvertently breaching POCA. Financing of medicinal cannabis businesses that may now operate legally in the UK or in certain other European countries remains in a state of relatively early development.

Notably, smaller boutique investment firms, credit unions and other alternative capital providers have found success as cannabis financiers, particularly in markets where cannabis has been legalized but incumbent institutional banks remain reluctant to participate. This is most likely due to the relatively lower level of regulatory scrutiny to which smaller, local lending entities are exposed, as well as what may be a larger appetite for reputational risk, as further discussed below.

### Key Considerations for Market Participants

Potential lenders, investors or underwriters that may be looking to participate in debt financings with cannabis and cannabis-related borrowers and issuers will want to consider more than merely the black letter of the law. A multitude of factors will be relevant to a lender, investor or underwriter's decision to enter the cannabis debt financing space, including (but not limited to) the following:

- **Cross-border elements:** In light of the discrepancies in approach to cannabis

regulation between countries worldwide, and in particular the extraterritorial application of POCA and other anti-money laundering legislation, financial institutions will want to turn their minds to whether the cross-border elements of a proposed financing are likely to trip up the cannabis laws to which they are subject. Lenders, investors and underwriters should in particular query whether the borrower has subsidiaries, assets or operations in other jurisdictions that have not legalised its cannabis-related business activities, and whether the activity in question would be considered illegal in the jurisdiction in which the lender or underwriter operates.

- **Dealings with ancillary cannabis businesses:** As cannabis markets continue to develop, we expect there will be increasing opportunity to provide debt financing to ancillary cannabis companies that provide secondary services to cannabis producers or sit further up the supply chain. We also expect it will become increasingly difficult to determine whether involvement in any financings for such companies is likely to constitute a breach of applicable criminal and/or anti-money laundering law. For example, consider a scenario in which an investment bank domiciled in the UK is considering underwriting an international securities offering by a hydroponics technology developer based in Canada that primarily services cannabis producers. The development of hydroponics technology is not, in and of itself, criminal conduct, but where it is designed primarily to facilitate



cannabis cultivation, the question of whether any fees generated from such an underwriting mandate would constitute "criminal property" for purposes of POCA becomes a less straightforward one. In the U.S., knowingly financing an ancillary business that is designed to support a marijuana business could be considered aiding and abetting narcotics trafficking. These issues will need to be considered carefully on a case-by-case basis in conjunction with experienced legal advisors.

- **Overall risk appetite:** Finally, lenders, underwriters and other capital providers will need to consider their own internal risk appetite, including the following:
  - **Legal risk:** Is the financing in question likely to fall afoul of anti-money laundering laws or criminal laws in any applicable jurisdiction, and relatedly, is there ambiguity in the interpretation of the law? The financier will require advice from experienced transactional and regulatory legal advisors, including lawyers with expertise in criminal law, across what is likely to be a number of implicated jurisdictions. Whether the financier is more inclined to accept a conservative or liberal read of the relevant legislation will probably be informed by any concomitant credit and reputational risk considerations, as well as relevant legal precedent and enforcement practices.
  - **Regulatory risk:** Regulatory regimes affecting the cannabis industry have been developed recently and remain in flux. Financiers may wish to obtain jurisdiction-specific advice regarding regulations and government relations, including the likelihood of significant changes following

elections or government policy shifts. Regulatory risk profiles may vary significantly between sub-segments of the cannabis industry and lenders should treat both pure-play and diversified companies accordingly.

- **Credit risk:** A financier going to credit committee will want to consider the credit risk associated with the debt financing at issue, including in particular the strength of any collateral package. Taking security over the assets of a cannabis producer presents a number of challenges that are unique to the sector - for example, the collateral package may include specialized production equipment that may have limited resale value, and a lender's ability to enforce its rights in the collateral in a default scenario may be significantly restricted by regulation and courts' reluctance to enforce illegal agreements. Obtaining security over a cannabis producer's rights in any real property, if possible, would usually be advantageous from a credit risk perspective.
- **Reputational risk:** Even if the financing in question is legal, the legalization of cannabis in some jurisdictions is a relatively new development and cannabis remains an illegal substance in a number of key global economies. Consequently, many potential financiers are put off by the reputational risk that accompanies business dealings with cannabis companies. This tends to be a particularly important consideration within large multinational investment banks with stringent compliance functions that rely heavily on their international brand and/or are publicly

traded. Private funds or smaller credit unions that operate solely in jurisdictions where cannabis regulation is more relaxed may not be subject to the same level of public scrutiny.

## Looking Ahead

Cannabis debt financings remain difficult to navigate from a regulatory perspective, and the Canadian cannabis equity markets experienced some high-profile downturn over the course of 2019. Moreover, while we may continue to see marijuana reform at the state level in the U.S., we think significant federal reform is unlikely in light of the current political climate. Nevertheless, we think the future in select markets looks promising. Cannabis businesses are particularly capital intensive and we expect that demand for debt financings and other sources of liquidity will continue to increase as these companies expand their operations and become more acquisitive. To date, this has created a niche opening for alternative capital providers that have benefitted from a first-mover advantage in markets where more traditional, incumbent sources of financing have thus far been unable or unwilling to take part. With cannabis legalization moving up the political agendas in certain European countries, we expect that cannabis-friendly legislative reform in these jurisdictions will serve to broaden the scope of players in the leveraged finance market that are able to participate in European cannabis debt financings going forward.

For further industry insights, please visit our global cannabis compliance blog at <https://globalcannabiscompliance.bakermckenzie.com/>.

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\*This section contains only a high-level overview of the legal status of cannabis in certain key international markets and is not intended to be comprehensive. We note that the regulatory regimes summarized here are quite nuanced and complex—for example, in a jurisdiction where we refer to cannabis as having been "legalized," the acts of cultivation, distribution, sale, marketing, possession and consumption (among others) may be regulated differently, permitted only in part and/or subject to strict limitations.

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