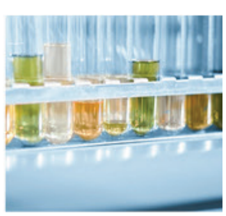
# A Primer for U.S. Cannabis Companies Contemplating Going Public in Canada

## Accessing the Canadian Cannabis Ecosystem

2019



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# THE BUSINESS CASE

The business case is straightforward — Canada is the world's top source of public venture and growth capital for cannabis companies. Under current circumstances, the listing of a U.S. cannabis company in Canada will provide a higher valuation than remaining private in the United States, will lead to greater access to capital and will provide a currency with which to acquire other U.S. and Canadian cannabis companies. Please refer to the Cassels Brock Presentation "Advantages of the Canadian Public Capital Markets in the Cannabis Space" which identifies many of the advantages of becoming part of the Canadian Cannabis Ecosystem. Additional benefits of the Canadian Cannabis Ecosystem, include: access to investment bankers and analysts, executive talent, experienced independent directors and legal and accounting professionals knowledgeable in the space.

The purpose of this Primer is to take a complex subject and simplify it so that entrepreneurs and their advisors can preliminarily determine whether to investigate the feasibility of taking their cannabis companies public in Canada. The link to this Primer may be found at "Accessing the Canadian Cannabis Ecosystem." This Primer makes reference, throughout, to more in-depth materials to provide the reader with a more complete picture of the process to gain a deeper understanding of the subject matter. Embarking on this investigation will likely require the active participation of other Canadian Cannabis Ecosystem participants, to whom we can facilitate introductions, to assist in the assessment of timing, costs and feasibility. A number of these participants have been involved in the preparation of this Primer or authored the more in-depth material which is referenced herein. These participants are prepared, as are we at Cassels Brock, to be consulted prior to being retained to assist in the determination of the feasibility of the endeavour.

# GOING PUBLIC IN GENERAL

Going public involves a layer of complexity, investment of time and expenses, and governance and management changes with which entrepreneurial private company management may or may not be familiar. Examples include: a likely requirement to broaden the management team; retaining an executive with responsibility for investor relations; educating senior members of the management team on the myriad of regulatory requirements involved in becoming and being a public company; designing an appropriate and informative website; organizing, and in some instances upgrading (or even completing), the company's key corporate and business documents and affairs so that third parties can conduct their due diligence; completing and auditing financial statements if they do not already exist; retaining a Canadian accounting firm; recruiting independent directors to the board of directors; crafting an appropriate compensation regime; and so forth.

Most sophisticated entrepreneurs will have a general understanding of what's involved in being public and while this process is not terribly daunting, the entrepreneur should be prepared for what's involved. It will come as no surprise that Cassels Brock is well-equipped to provide advice and guidance in this regard. A public company in Canada is referred to as a **Reporting Issuer** and in the attached link you will find a memorandum entitled "Reporting Issuer and Related Securities Obligations Overview for CSE-Listed Issuers."

# ADDITIONAL STEPS REQUIRED BEFORE A U.S. COMPANY CAN BE TAKEN PUBLIC IN CANADA

There are several significant regulatory advantages to being public in Canada versus the United States and reference is made to the Dorsey CSE Guide defined and described below. However, a Reporting Issuer that proposes to continue to be principally run out of the U.S. will need to be restructured in order to take advantage of these benefits. Simplistically, the restructuring exercise involves both **corporate** and **tax** planning aspects.

The **corporate restructuring** is likely to require the incorporation of a new Canadian company with two classes of shares, common shares and compressed shares, convertible under certain circumstances into common shares. This share structure will allow U.S. resident shareholders to own more than 50% of the equity of the Canadian public company, while owning less than 50% of the number of voting shares. The Canadian incorporation, combined with the dual class share structure, should provide the Reporting Issuer with the benefits of being a **Foreign Private Issuer**. This topic is comprehensively covered in the Dorsey & Whitney Presentation entitled "U.S. Emerging Company Guide to Listing on the Canadian Securities Exchange" contained in The Dorsey CSE Guide. It should be noted that the Toronto Stock Exchange will not list the shares of cannabis companies with U.S. operations, hence the focus in the Primer is on the CSE.

The **tax planning** aspect, because it is so fact dependent and variable from state-to-state, requires a much more in-depth analysis. To assist U.S. companies wishing to assess the feasibility of embarking on this relatively complicated process, we felt it would be helpful to identify certain fact situations into which a U.S. company might find itself, allowing the reader to focus on the applicable example. The examples provided below are ordered in their level of complexity.

1. The simplest fact situation is where the U.S. company is in start-up mode and has few shareholders. In this instance, it may be possible for the shareholders to enter into a simple agreement and contribute their shares to a newly incorporated Canadian company and to receive, in a tax free exchange, compressed shares. As mentioned above such shares will be convertible into common shares upon certain circumstances, including disposition. The newly incorporated company may be taken public by clearing a prospectus in Canada or by completing a reverse takeover with a reporting issuer. Please see the section below: Going Public in Canada by Filing a Prospectus versus By Way of Reverse Takeover.
2. The next simplest fact situation is where the U.S. company is being acquired by a larger Canadian public or private company that has had an active trade or business in Canada for three years prior to such acquisition. In this fact situation, if the U.S.

shareholders will own 50% or less of the equity shares of the combined or successor corporation, they may receive, on a tax free rollover basis, compressed shares. In this fact situation, the successor corporation will be a Canadian taxpayer and will not be "inverted" for U.S. purposes. Please refer to the Dorsey CSE Guide for a discussion on tax inversions. If the U.S. company is being acquired by a public Canadian company at this stage it will be public and if it was acquired by a private company it can either file a prospectus or complete a reverse takeover to become public.

3. In the fact situation where the U.S. company is being acquired by a Canadian company that has not been active for a three year period if the U.S. shareholders will own over 80% of the successor corporation without taking into account shares issued to investors in a related offering, the same tax free rollover into compressed shares may be available, with the proviso that the successor company will be "inverted" for U.S. tax purposes and will be treated as a U.S. taxpayer. Again, reference is made to the Dorsey CSE Guide. In this fact situation, it is assumed that the Canadian company is a Reporting Issuer.
4. The next fact situation is one in which the U.S. company is being acquired by a Canadian company that has not been active for a three year period and where the U.S. shareholders will own less than 80% of the shares of the successor corporation without taking into account shares issued to investors in a related offering. This is a difficult fact situation to structure around and exchangeable shares may be required to provide the selling shareholders with a tax-free rollover, with the only good news being that compressed shares may not be required to be a Foreign Private Issuer. The successor company will be inverted for U.S. tax purposes.

As indicated above, the above four fact situations provide an overly simplified picture of what is required in terms of tax assessment and planning. The discussion does not address the U.S. securities exemptions required to be identified to issue the shares of the Canadian company to the selling shareholders of the U.S. companies, nor does the discussion take into account the U.S. Federal and State cannabis regulations.

# GOING PUBLIC IN CANADA BY FILING A PROSPECTUS VERSUS BY WAY OF REVERSE TAKEOVER

Most of the cannabis companies that have gone public in Canada have done so by way of a reverse takeover (an "RTO") of an existing "public shell" Reporting Issuer. Unfortunately, as a result of the large number of cannabis companies choosing to go public by way of RTO, the demand for these public shell companies has skyrocketed. This has at least two consequences: (i) the dilution to existing shareholders on the RTO can be substantial — whereas it has historically been as low as 3%, we are seeing it as high as 13%; and (ii) the negotiations to effect the RTO are often lengthier because of the enhanced negotiating position of the public shell and may involve their ask for additional cash fees to be paid and/or the ask by the shell for some form of participation in the successor corporation.

We take the position in this Primer that going public by filing a prospectus (an "IPO") is the preferred route to pursue. The traditional view is that RTOs require less work and can be effected on a faster timeline than proceeding by way of an IPO, and, because each method has numerous steps, reference is made to the memorandum "Initial Public Offerings vs Reverse Takeovers" which discusses in more detail the pros and cons of pursuing an RTO versus an IPO. In summary, in light of the shortage of shells, the time required to negotiate an agreement with a shell, and the likely requirement to hold a shareholder meeting, we are of the belief that the conventional view that an RTO requires less time to complete than an IPO doesn't hold true in the current environment. There are additional advantages to an IPO, including the fact that a properly marketed IPO will provide stronger retail distribution, will avoid the issue of inheriting any historical liabilities of the shell and is considered a more professional way of going public. The only possible negative is the vagaries of the public markets and there are ways to mitigate this risk working closely with a quality underwriter and being well-enough capitalized going into the IPO.

In closing on this topic, we also point out that the perception that the disclosure required on an RTO can be less comprehensive than in a prospectus is again misleading. Upon the completion of an RTO, the public company's filings are subject to review by the Canadian Securities Administrators and the regulator can require corrective or additional disclosures. In addition, when the newly minted issuer wishes to access the public market, raising money by way of a short form prospectus, the prospectus will be reviewed by the Canadian Securities Administrators and to the extent that the existing public disclosure is deficient, clearing the prospectus could cause issues in completing the public offering in a timely manner and may put the issuer off-side of timelines set out in the underwriting agreement.

# CONCLUDING REMARKS

A number of industry participants have been involved in the preparation of this Primer or authored the more in-depth material which is referenced herein. These participants are prepared, as are we at Cassels Brock, to be consulted prior to being retained to assist in the determination of the feasibility of the endeavour. Please do not hesitate to seek out this assistance, which we are all happy to provide.

If you are interested in a sampling of Cassels Brock cannabis related transactions, please review our flyer "Cannabis: Evolving Opportunity in an Emerging Industry" and visit our Cannabis & Life Science Law Blog.