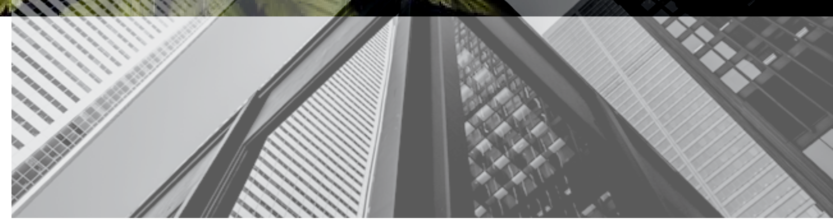
BUDDING BOARDS

There has never been a business like it. The cannabis industry, seemingly overnight, has seized the imagination of entrepreneurs, governments and, of course, investors – who have driven into the stratosphere the valuations of stocks in the sector.

With medical cannabis already legal, and recreational pot likely to follow later this year, Corporate Canada is jockeying for position in a multibillion-dollar business that is in the process of being repatriated from the bikers and criminals who ran it in the past. Corporate governance in the sector is struggling to keep up with the dizzying changes, but oversight is crucial if conflicts of interest, scandal, fraud and legal hassles are to be avoided.

For decades, Canada's recreational marijuana trade has been controlled by criminals. Now, as dozens of private and public companies move in to the soon-to-be legitimized sector, a new kind of oversight is required. Richard Blackwell explores the challenges of governance in the cannabis industry



UNCHARTED TERRITORY

To make sure governance is strong, cannabis company boards need energetic and independent directors. But in a classic chicken-and-egg situation, many potential directors are hesitant to join boards until they are confident the business has established a legitimate reputation, oversight is strong and downside risks are mitigated.

Part of the problem is that there is no precedent for the creation of the cannabis industry in the public markets, said Richard Leblanc, a law professor at York University in Toronto who specializes in governance. Even the dot-com bubble in the late 1990s was slower moving and less volatile. Indeed, the rise of cannabis is more like a gold rush, he said, with investors and participants scrambling to get in on a piece of the action as quickly as possible.

In one respect, however, the cannabis business is analogous to junior mining or high-tech, Leblanc said. Many of the companies were created by entrepreneurs who are "used to running their own show," he said. These owner-operators brought in angel investors, who often joined the entrepreneurs on their boards. When these kinds of companies go public, it can be wrenching to replace the board members with independent directors. The problem is exacerbated by rapid-fire growth and volatile stock prices.

Ideally, public cannabis companies need independent board members with expertise in finance, legal and regulatory compliance, distribution, regulatory change, and mergers and acquisitions, Leblanc said. And these directors "need to have gravitas, so the entrepreneurs on the board will listen." Those kind of people can be hard to find, especially when some potential board members may be concerned about their reputations because of the dodgy past of the prelegal cannabis industry.

Currently, the four biggest public Canadian cannabis companies – Aphria Inc., Aurora Cannabis Inc., Canopy Growth Corp., and MedReleaf Corp. – have boards ranging in size from five to seven members, and each has a majority of independent directors. All except Canopy have at least one female director. But there are dozens of smaller players, with boards that range widely in size and quality.

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>
> *John Bell*
> *Canopy Growth board*

IMAGE PROBLEM

While the cannabis sector is now going mainstream, there are still many people in the business community who are hesitant to get involved, and others who will raise their eyebrows at those who have taken the plunge. One person who is highly experienced in director selection, but who did not want to be identified, said individuals taking director positions at cannabis companies "are akin to people who join the board of a tobacco company. [I have] real question marks about their judgment."

That kind of attitude may be on the wane, however. The reputation of the sector received a small boost in early in 2018 when the big banks revealed they are now on board. The breakthrough came when Bank of Montreal co-led a $200-million stock sale for Canopy Growth. It was the first time a big bank had acknowledged its participation in a major cannabis financing. A further stamp of approval came from the bank's corner office when BMO CEO Darryl White told Bloomberg News that he considered Canopy a "bona fide business operating within the boundaries of the law."

Soon after the BMO announcement, Canadian Imperial Bank of Commerce revealed it had led a $20-million credit facility for medical marijuana seller MedReleaf. And around the same time, the Liquor Control Board of Ontario – the agency that will handle that province's distribution of recreational cannabis – announced that respected former Toronto-Dominion Bank CEO Ed Clark is taking over as LCBO chair, bringing a further sense of respectability to the cannabis sector.

Deborah Rosati, an entrepreneur, accountant and director in Toronto, said she certainly considered her image when she was offered a board seat at MedReleaf. "I did take a pause," she said. "I looked at my overall portfolio and my current work and thought: 'Would there be an impact from a reputation perspective?'" But she also realized just how much potential growth there was in medical cannabis, and that she could bring her expertise to the emerging industry. "I got past the reputation issues very quickly," she said.

Rosati, who is also the CEO of Women Get on Board, an organization that promotes gender diversity in the boardroom, noted that cannabis sector boards are heavily male dominated. (MedReleaf is unusual in that two of its five directors are women.) But there are lots of qualified women – especially ones with experience in consumer goods, packaging, retail pharma and health care – who could serve on boards of cannabis companies, she said.

Another concern Rosati had before becoming a MedReleaf director was whether she had the time to devote to an active board in an industry that has essentially risen out of nowhere. With rapidly evolving regulatory and compliance issues, a need to raise financing, and possible M&A activity, these boards will be very busy. Rosati noted, however, that she is an entrepreneur with an appetite for risk, so that helped her decide to jump in. "I've been in a lot of high-growth, early-stage emerging companies," and cannabis matched that profile. "I thought, it is going to be one of those things where either I get in now or watch everybody else get in."

Rosati said Ed Clark's move to take on the LCBO chairmanship is a "huge statement" that will make others consider taking on board positions in the cannabis sector. The big banks' willingness to get involved in financing the sector will also help to legitimize it, she added.

Bruce Linton, founder, chair and CEO of Canopy Growth, said that four or five years ago, the reputation issue made it very tough to recruit directors. At that time, some potential directors who considered joining his board had to give up the idea when their other boards vetoed it because they were concerned about "image cascade." Now there is less hesitation, Linton said, partly because the business is so interesting and dynamic, and the stock performance of companies in the sector has been so extraordinary.

SKILLS CHALLENGE

Another issue in recruiting directors early on, Linton said, was determining what kind of skills were useful on a cannabis company board. While many people assumed the industry needed people from the agricultural or pharmaceutical sector, "there was actually more of a crossover with entrepreneur-driven public companies that had grown rapidly and had global ambitions." That meant individuals from fast-moving, capital-intensive tech companies most closely fit the bill.

Now, the cannabis industry is evolving into a business that will sell a packaged consumer product, so Linton would like to add a director with skills in branding and finished goods. He is also conscious that there are no women on his board, and he would like to change that. Still "male or female, the best fit is going to be someone who has been a leader in an entrepreneurial environment that went from $1-million [in sales] to a few billion rapidly, and has had other professional experiences."

Linton is both CEO and chair at Canopy – a situation governance critics say is less than ideal – but he said that will not likely change for another few years. At the moment, it is crucial that both the CEO and the board chair be immediately aware of the rapidly changing business and regulatory environment, he said, and the only way to do that is for him to take both roles. In the meantime, the company has an independent lead director to lend some outside perspective.

That lead director is John Bell, CEO of investment manager Onbelay Capital Inc. He also serves on the board of the Royal Canadian Mint. Bell, who is helping Linton look for new directors to expand Canopy's five-member board, is adamant that new recruits should have an entrepreneurial bent, rather than a single-minded focus on rules and restrictions. "I don't need organizational skills, I need creative energy," Bell said. "A governance zealot could cripple us by slowing us down. [We don't need] bank governance in what is an early-stage company."

For instance, he said, it would make no sense for the Canopy board to take time to establish formal "key performance indicators" to determine Mr. Linton's compensation, a process that is common in many large, established companies. There's no need for that kind of system to motivate the CEO, Bell said. "He's fully committed."

While the need for entrepreneurial and capital markets skills is clear, it is also crucial that cannabis boards have some members with experience in selling a highly regulated, potentially dangerous substance, said Michael Watts, a lawyer at Osler Hoskin & Harcourt LLP who advises clients in the sector. Cannabis companies will be "selling a product where the risk of harm is not really understood," he said. Just because Health Canada has approved cannabis, that's not a defence against liability if there is harm caused by it – something the tobacco industry learned decades ago.

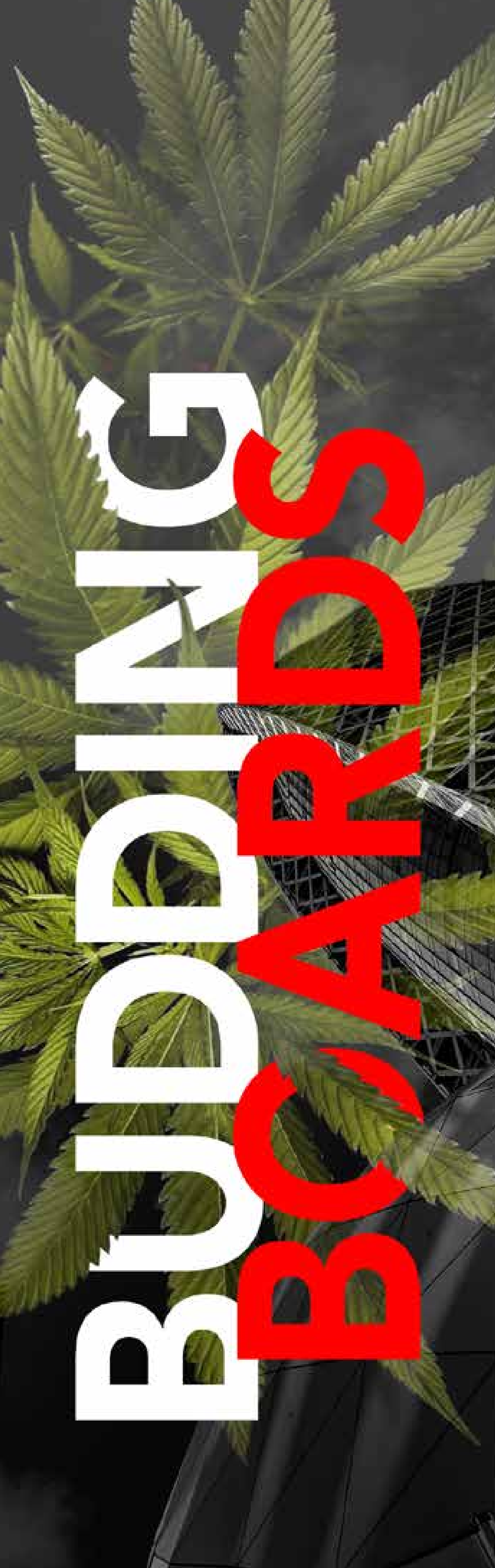
Consequently, cannabis company boards need people with experience selling prescriptions and over-the-counter drugs, alcohol or tobacco, not just any packaged product, Watts said. And that should include some knowledge of the importance of warning consumers about the health effects, he added.

One thing is certain: Directors riding the cannabis roller coaster are going to have an exciting time, even if the ups and downs might make them a bit queasy in the process. ■

RICHARD BLACKWELL is a former business reporter at the Financial Post and The Globe and Mail. Over three decades, he covered many sectors, including technology, financial services, media and energy.

DIRECTORLENS

- The legitimization of the recreational cannabis business in Canada opens uncharted territory. As investors pour tens of billions of dollars into marijuana startups, professional corporate oversight will be crucial to avoid conflicts of interest, scandal, fraud and legal problems.
- The criminal history of the prelegal cannabis industry leaves some experienced directors hesitant to join the new sector out of concern for their own reputations. But the recent involvement of some of Canada's most respected financial institutions is helping bring respectability to the field.
- The best skills for cannabis boards are still being determined, but directors from fast-growing, entrepreneur-driven public companies, who are willing to commit significant amounts of time, are a good fit.



BEFORE YOU JOIN A CANNABIS BOARD

So you've been approached to join the board of a nascent public cannabis company, and it looks like a pretty attractive offer. The chance to make a significant financial gain as a shareholder or option holder looks impressive. And the CEO looks like a real player with the skills and drive to make it work. Should you take the plunge?

As you would when considering any board seat, you need to think about whether you have the skills needed to make a contribution. In the case of cannabis companies, experience in finance, marketing and even packaging will probably be valuable, as would a background in highly regulated industries, the pharmaceutical business or agribusiness

Then ask yourself, are you confident in management and the other directors around the table? Is the board diverse enough to get a broad range of perspectives?

This is a fast-growing, highly volatile business and you will need to set aside more time than you would on a more traditional board. Don't expect monthly meetings – they will likely be much more frequent. And there will be middle-of-the-night calls if there is M&A action. "We're talking about big time commitments," said Cheryl Reicin, a partner at Torys LLP and chair of the firm's life sciences practice. "There are so many things happening on a weekly basis." At some point, she added, directors might have to make tough decisions on who is going to manage the company. It may not be pleasant to usher the founder out of the CEO's office.

Is there adequate directors and officers (D&O) insurance? While liability issues are similar to other businesses, "when there is a lot of volatility in an industry, there is more potential liability," Reicin said. This is also an industry selling a product with health effects that are not yet fully studied. And it is possible the company may get caught up in legal tangles, especially if it has any operations in the United States, where federal law still deems cannabis illegal.

And then there is your reputation. Are you on other boards where some members might balk at your participation on a cannabis board? Attitudes are changing, but don't expect everyone to be enthusiastic if you decide to take the plunge.

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