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Article

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To Co-Pack or Not to Co-Pack?

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In 2018, on the precipice of cannabis legalization in Canada, Deloitte published a report which surveyed Canadian attitudes and response to the legalization of cannabis. The survey found that 58% of likely consumers planned to purchase and use edibles (although at the time edible products were over a year away from legalization) and of those, 31% said they would be interested in trying cannabis infused beverages.

Fast forward to 2021 and the takeoff on beverages has not occurred in any material fashion, not yet any way. While there are arguably many reasons behind the failure of beverages to take off quickly, one of the major limitations, at least thus far, seems to be a lack of product offerings, with the major players reaping the benefit. That might be about to change.

As the costs necessary to construct and outfit a facility to produce cannabis infused beverages prove to be out of reach for many players, parties are looking to alternative solutions and in doing so they are looking to a well-known solution in the food and beverage sector, co-packing.

Co-packing refers to the process where Party A outsources the manufacturing and packaging of a product to Party B for a fee. We will refer to Party A as the “Brand” and Party B as the “Co-Packer.” In this article we will discuss a number of factors that both the Brand and the Co-Packer should be mindful of when negotiating a co-packing agreement in the cannabis sector.

Licencing Requirements

The cannabis co-packing relationship differs from that in other industries, in so far as the Brand in this case will likely not be licenced to handle its products, or at least some of the ingredients in such products, and as such must rely solely on the Co-Packer to not just manufacture and label the products, but to also store and sell the products to other licensees and/or provincial bodies. As such, both the Brand and the Co-Packer must be diligent in ensuring that the Co-Packing partner holds the appropriate licenses and license amendments to meet the Brand’s needs. Due diligence on the license that is held by the Co-Packer and what is permitted thereunder is fundamental.

Exclusivity and Products

Is the Co-Packer producing all of the Brand's cannabis infused products, or just a select few? The Co-Packer has an interest in tying up the Brand's entire portfolio for obvious reasons. However, the Brand may want some flexibility, also for obvious reasons. For these purposes, clarity is paramount.

Do certain products require ingredients or packaging that the Co-Packer's facility can't accommodate? Can the Co-Packer meet the Brand's timelines? Does the exclusivity granted cover only existing SKUs or all future SKUs brought to market as well? These are all discussions that need to occur before the relationship is solidified.

Under section 244 of the *Cannabis Regulations*, licensed processors must notify Health Canada of their intent to sell a cannabis product they have not previously sold in Canada. This Notice of New Cannabis Product ("NNCP") must be provided to Health Canada at least 60 calendar days before making the new cannabis product available for sale. This filing is done through the licence holders' portal, meaning, that if the Brand wants to switch co-packing partners, a new NNCP must be filed and the 60 day notice period will start again and could create supply chain issues for the Brand. As such, Brands need to give serious thought to their long term plans, and potential obstacles that may occur down the road at the outset to have contingency plans in place.

Term and Termination

How long will the relationship last? Under what circumstances can a party terminate the agreement? Bankruptcy and insolvency are standard, as is loss of the processing licence. Should a party be able to terminate if other terms of the contract are breached, like manufacturing standards, delivery terms or payments? Can the agreement address these breaches in some other manner, either through credits, discounts, or is the breaching party otherwise able to remedy the breach? It is imperative that termination provisions in co-packaging arrangements are given critical thought, given how catastrophic any pause in getting products to the market can be for the Brand.

Product Requirements and Specifications

It is important that the product requirements, formula, and ingredients are clear and specific. The product is required to comply with its NNCP submitted to Health Canada in all respects, that includes ingredients, labelling and final product specifications. If the product ultimately produced does not comply with those requirements, either due to fault of the Co-Packer or due to the specifications provided by the Brand, the product may not be saleable. Even if it is, failure to follow product requirements to the letter may result in harm to the Brand's reputation when the products hit store shelves and subsequently the mouths and bellies of consumers. As such it is an imperative interest to both parties that the specifications for the products be laid out fully and clearly to ensure that any deviation from those specifications are easily ascertainable and can result in appropriate remedies for the necessary party.

Forecasts and Delivery

How much will we need? How much will we sell? When will we need it? When do we need to tell you we need it? How much time do we need to make it? How early do we need to order ingredients? These are all critical questions that both the Brand and the Co-Packer need to address to ensure the relationship accommodates their respective needs.

Some relationships are as simple as the Brand issuing a purchase order to manufacture and waiting for the Co-Packer to complete production. In these situations the Brand is at the mercy of the Co-Packer, hoping they have the capacity to accommodate the Brand's needs in a timely fashion. In other relationships, the Brand will make rolling forecasts such that the Co-Pack can, and depending on the contractual terms, must, appropriately schedule timely production runs.

The appropriate relationship will depend on the capacities and cash flows of each party.

Payment

Always a key factor in any commercial relationship is how much is a party paying, how are they paying and when payment is due. Depending on the relationship this could also include pre-payments for ingredients.

Generally, until such time as the respective parties have built up enough trust, and more importantly enough good credit, you can expect the Brand to be required to prepay for the production costs of the products. Thereafter, since the Co-Packer will be the party actually selling the products to the respective boards and retail establishments, the Co-Packer will control the monies and the Brand will be chasing it for payment.

What the payment terms look like will depend on the relationship. Some relationships are built on a fixed cost per unit to the Co-Packer, with the balance of the sale proceeds going to the Brand. Others are structured royalty payments, with the Brand paying the Co-Packer a percentage of sales – whether that is net of manufacturing costs or inclusive of manufacturing costs – will again depend on the nature of the relationship of the parties and their respective negotiating power.

This is the area that will make or break you. With margins being razor thin, it cannot be stressed enough how diligent the parties must be in determining what payment structure is most appropriate.

Risk of Loss and Liability

In any commercial relationship apportioning liability and risk is a key factor. When apportioning risk and liabilities the parties should keep in mind a number of items including without limitation: transport, delivery, manufacturing errors, errors in specifications, deficiencies in ingredients and hardware, breaches of legal requirements. As each party will have different obligations under the contract it is key to apportion liability for a breach of those obligations appropriately.

Conclusion

When entering into a co-packing relationship there are a wide variety of business and legal terms that need to be given careful thought at the outset in order to ensure the subsequent relationship goes smoothly. A Co-Packer's failure to meet the Brand's needs can be catastrophic for the Brand in the cannabis sector given the dependency that the Brand will have on the Co-Packer to get the products to market and, in most cases, to remit revenue back to the Brand in a timely fashion to ensure acceptable (and predictable) cash flow. While the considerations are numerous, we hope that the few considerations we have outlined in this article provide some insight into the complexity that exists in a co-packing relationship in the cannabis sector.

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