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Emerging Coverage Issues in the Cannabis Industry

I. Cannabis Insurance and the Law

The Cannabis plant family includes many species including both hemp and marijuana. Despite being in the same family, hemp and marijuana have different purposes and uses that are often misunderstood. Hemp has an average THC content of 1%. The 2018 Farm Bill defines hemp as no greater than 0.3% THC yield. Cannabis has an average THC content of 10%.

In the early 1900s, cannabis and hemp were legal to grow and consume in all states. With the passage of the Federal Marijuana Tax Act in 1937, the federal government taxed marijuana so heavily that it was basically made illegal. In 1970, Congress enacted the Controlled Substances Act, which criminalized the “manufacturing, possession, sale, or use of marijuana is illegal under the Controlled Substances Act” (CSA) (21 USC § 801). Marijuana was placed on Schedule I, the most restrictive class of drugs regulated under the CSA.

The Rohrabacher Blumenauer Amendment was added in 2014 to a short-term spending bill (Rohrabacher-Farr), and has been annually renewed, presently set to expire on September 30, 2019. The amendment provides that federal funding cannot be used to prevent states from implementing laws that authorize “the use, distribution, possession or cultivation of medical marijuana”

The cannabis industry is expanding rapidly in the United States, even in the face of contradictory legal status on the federal level and among the fifty states. While use, sale and possession of cannabis remains illegal under federal law, more than two-thirds of states have legalized cannabis in some form, and at least ten states and the District of Columbia permit adult consumption of cannabis for recreational use. Many states also permit the sale of cannabis-derived products, such as cannabidiol (CBD) oil. Legal sales of cannabis-related products are anticipated to exceed \$20 billion nationwide by the early part of the next decade.

Federal Regulation

The cultivation, use, sale, and possession of cannabis and cannabis products containing over 0.3% THC are prohibited under federal law. Until the passage of the Agriculture Improvement Act of 2018, even cannabis products containing less than 0.3% THC were subject to the Controlled Substances Act of 1970, which classifies cannabis as a Schedule I drug. Schedule I drugs are described as having a high potential for abuse, having no currently accepted medical use in treatment in the United States, and lacking accepted safety for use under medical supervision.

Although there has been a proliferation of CBD products, they are not legal. The Farm Bill only allows hemp that is grown: (a) with a US Department of Agriculture license (which haven't been awarded); (b) under state or tribal program that is approved by the USDA (which have not yet been approved); or (c) under the existing 2014 existing industrial hemp pilot authority. Regulations have not yet been published but are expected in 2019.

The FDA maintains that the Farm Bill did not change FDA law to allow CBD (whether marijuana-derived or hemp-derived) to be added to edible products. As a result, FDA posture is that it is illegal to add CBD to food that will be in interstate commerce or to sell CBD products as being dietary products. The FDA did in 2019 approve as "general recognized as safe" hulled hemp seeds, hemp seed protein and hemp seed oil. This means that these products can be marketed in food. The FDA was clear that this did not change their existing position on CBD. FDA has not taken any enforcement actions on CBD to date.

Despite federal prohibitions, over the last decade enforcement of federal cannabis prohibition has been inconsistent. On October 19, 2009, the United States Department of Justice issued the "Ogden Memorandum", which instructed U.S. Attorneys to not focus federal law enforcement resources on individuals who complied with state laws providing for medical marijuana use. The Department of Justice then issued the "Cole Memorandum" on August 29, 2013, directing U.S. Attorneys to not prioritize enforcement of federal marijuana prohibitions in states that had legalized cannabis and implemented strong and effective regulatory and enforcement systems that were consistent with federal crime-prevention priorities. However, on January 4, 2018, at the direction of former Attorney General Jefferson Beauregard Sessions, the Department of Justice rescinded the Cole Memorandum, instructing U.S. Attorneys to follow federal prosecutorial principles. However, current Attorney General William Barr has recently stated his reluctance to go after businesses that have been relying on the Cole Memorandum, citing potential harm to the marketplace and investors.

State Decriminalization

In 1996, California became the first state to legalize medical cannabis use, and was swiftly followed by Washington, Oregon, Alaska, Nevada, and the District of Columbia. Today, it is legal to use cannabis for medical purposes in thirty-three states and the District of Columbia. An additional fifteen states permit cannabis use for medical purposes, subject to THC content restrictions. Many states also allow the sale of cannabis-derived products, such as cannabidiol ("CBD") oil.

In 2012, Washington and Colorado became the first states to decriminalize recreational use of cannabis. Since then, Oregon, Alaska, the District of Columbia, California, Nevada, Maine, Massachusetts, Michigan, Vermont, and Illinois have followed suit.

Cannabis Coverage Case Law

Due to the historic prohibition of cannabis, cannabis-related insurance coverage litigation is a relatively recent phenomenon. Cannabis's inconsistent legal status under federal and state law has led to inconsistent coverage outcomes. For instance, in *Tracy v. USAA Cas. Ins. Co.*, 2012 U.S. Dist. LEXIS 35913 (D. Haw. Mar. 16, 2012), a homeowner sought coverage for the theft of cannabis plants, which she legally possessed and cultivated for her own medical purposes under Hawaii law. The insurer initially paid the insured for the loss, but the insured claimed that the amount was insufficient, and sued for breach of contract and bad faith denial of her claim. The court held that, while the cannabis plants were insured under the subject homeowner's policy, the court could not force the insurer to pay proceeds to replace the cannabis plants as a matter of public policy, because to do so would be contrary to federal law as reflected in the Controlled Substances Act, and the Supreme Court's decision in *Gonzales v. Raich*.

Green Earth Wellness Ctr., LLC v. Atain Specialty Ins. Co.

In *Green Earth Wellness Ctr., LLC v. Atain Specialty Ins. Co.*, 163 F. Supp. 3d 821 (D. Col. 2016), a retail medical marijuana business and adjacent growing facility ("Green Earth") sought coverage for damage to its plants caused by entry of wildfire smoke and ash into the facility's ventilation systems. The insurer, Atain Specialty Insurance Company ("Atain") declined coverage. Green Earth sued, asserting claims for breach of contract, statutory bad faith, and unreasonable delay in payment. The parties filed dueling motions for summary judgment. Among other arguments, Atain asserted that Green Earth's claim for damages to potted marijuana plants was barred by the "growing crops" exclusion in the Policy. Atain also filed motions arguing that it was illegal under federal law and federal public policy for Atain to pay for damages to marijuana plants and products, that the court could therefore not order Atain to pay those damages, and that the Atain Policy's Contraband Exclusion precluded coverage for Green Earth's claim.

In its analysis, the court provided a detailed description of Green Earth's growing operation. "Mother plants" are used solely for producing a constant and reliable supply of genetically-identical "clones", and are not cultivated to produce useable marijuana. A "clone" is a portion of the mother plant that is cut off, planted, and grown to maturity. Green Earth kept mature clones in either a "vegetative" state, in which the plant was under near constant lighting to prevent it from flowering, or a "flowering" state, in which the plant was subjected to intermittent light and darkness for flower and bud production. The flowers and buds were then harvested, dried, and sold. Green Earth's claim consisted of damage to its mother plants and clones, as well as buds and flowers that had been harvested and were being prepared for sale.

The Atain Policy provided coverage for "Business Personal Property located in or on the [covered] building[s]," including "Stock," which the Atain Policy defined as "merchandise held in storage or for sale, raw materials and in-process or finished goods, including supplies used in their packing or shipping." While the parties agreed that the harvested buds and flowers qualified as "Stock", they disagreed as to whether

the mother plants and clones also came within that definition. The court concluded that the mother plants and clones qualified as “Stock”, relying upon certain authorities defining growing plants as “raw materials.”

However, the Atain Policy also contained an exclusion for “Land (including land on which the property is located), water, growing crops or lawns”, which Atain argued precluded coverage for the mother plants and clones, even if they qualified as “Stock.” The court agreed, rejecting Green Earth’s arguments that “crops” must grow in outdoor soil, and that “growing crops” should be limited to crops attached to the surface of the earth, rather than crops grown in pots. Accordingly, the “growing crops” exclusion precluded coverage for damages to the mother plants and clones.

Atain further argued that the Atain Policy’s exclusion for “Contraband, or property in the course of illegal transportation or trade” and public policy precluded coverage for Green Earth’s damaged flowers and buds. While the court agreed that the flowers and buds came under the common and ordinary meaning of “contraband”, and that their possession for distribution constituted a federal crime, the court nonetheless demurred, citing the federal government’s ambivalence towards enforcing the Controlled Substances Act where a person or entity’s possession and/or distribution of marijuana was consistent with state law. The differences between the federal government’s *de jure* and *de facto* public policies regarding state-regulated marijuana rendered the “Contraband” exclusion ambiguous and unenforceable. The court declined to follow *Tracy v. USAA Cas. Ins. Co.*, noting that any clear federal public policy had eroded in the intervening years, and refused to void the Atain Policy on public policy grounds. Further, in light of the parties’ explicit and mutual intentions that the Atain Policy provide coverage for Green Earth’s marijuana inventory, the court held that even if it were contrary to public policy to enforce the parties’ agreement, Green Earth would still be entitled to recover from Atain under a theory of unjust enrichment.

K.V.G. Props., Inc. v. Westfield Ins. Co.

In *K.V.G. Props., Inc. v. Westfield Ins. Co.*, 900 F.3d 818 (6th Cir. 2018), a commercial landlord sought coverage for damage to property caused by its tenant’s cannabis cultivation operation. After federal agents raided the property, the landlord evicted the tenants, and discovered that, in the course of the tenants’ cannabis cultivation operations, the tenants had removed walls, cut holes in the roof, altered ductwork, and damaged the property’s HVAC system. In seeking to evict the cultivation operation, the landlord had argued that its tenant was not operating legally. The insurer denied coverage, citing the policy’s criminal acts exclusion. The insured sued.

The court agreed that coverage was precluded by the policy’s criminal acts exclusion. Although lawful cultivation of cannabis for medical purposes was legal in Michigan, the court noted that the insured had argued that its tenants were in violation of the law in the underlying eviction proceedings. Further, federal agents raided the property as part of a criminal investigation, even in the face of the Ogden and Cole Memoranda, which the court assumed federal agents did not ignore in deciding whether to conduct the raid. Accordingly, the criminal acts exclusion applied. Notably, regardless of federal prohibition, the court expressed reluctance to enforce the criminal acts exclusion if the subject operation were in fact legal under Michigan law, citing federalism concerns.

II. The Cannabis Industry & Risk

General

The cannabis insurance market is limited by a small number of carriers with limited capacity for coverage. Pricing issues are caused by a lack of available data and a lack of insured loss histories. Cannabis licensees have difficulty obtaining liability insurance, workers' compensation insurance etc, and face numerous potential liabilities, including class action lawsuits, including consumer protection lawsuits and malpractice risks for doctors recommending or prescribing cannabis. RICO cases have been brought against cannabis businesses, alleging a coordinated illegal conspiracy. (Safe Street Alliance case, Horn case).

Traditional business loans are not available to the cannabis industry. If a bank is federally insured (regardless of whether state chartered), it is then subject to federal regulation and monitoring which prohibits deposits from cannabis company.

Financial institutions are subject to the federal Bank Secrecy Act and anti-money-laundering regulations. The US Dept. of Treasury's Financial Crimes Enforcement Network (FinCEN) acts as the regulators for the requirements of the BSA. Large cash transactions can trigger reporting requirements, and "SARs" reports which are for suspicious activity. If the bank knows that the business involves cannabis, and cannabis is a Schedule I narcotic, any transaction with a cannabis business should result in a SARs report, as these reports are compulsory. The BSA imposes potential criminal liability for infractions.

Despite the fact that most banks are opposed to accepting cannabis business deposits, FinCEN issued guidance in 2014 for accepting Marijuana Related Business (MRBs) deposits. This guidance cannot supersede the CSA and BSA, so it does not expressly authorize doing business with MRBs, but does provide some compliance points.

Cannabis businesses may be able to obtain capital from foreign sources, such as in Canada. The competitive application process requires applicants to be grossly overcapitalized. Reg. D Offering (SEC registration exempt). Medical marijuana is typically patients paying cash, and deposits are difficult. Traditional health insurance does not cover. Medicare/Medicaid does not reimburse or cover medical cannabis due to the CSA. The Veterans Administration permits usage, but does not cover the cost.

Because banks are hesitant to accept deposits from the cannabis industry due to federal prohibitions, cannabis businesses are relatively cash-heavy, giving rise to risks of theft (by employees and third parties), kidnapping, ransom, and extortion. Insurers therefore often require security systems, fencing and security personnel, that cash be kept in a fire-proof safe, and that automatic fire-suppression systems and proper ventilation be installed to protect crops.

Employment concerns include adverse employment action resulting from cannabis usage. In most states, the employee must be shown to have been impaired at work. There are emerging cases providing protection to employees under disability laws.

Drug Recognition Experts & Driving While Impaired – There is no acute toxicity test for cannabis, and THC can remain in system for days. DRE training based on studies from 1985, 1986 & 1994, and DRE accurate less than 50% in some tests. Reliability is frequently challenged.

Possession of cannabis at hospital or office is permitted under state law, but there are intersecting issue of hospital or office rules. Health care facilities often impose rules on consumption, banning smoking, but allowing self-administered cannabis (most health care providers do not administer cannabis). Under New Jersey law, only the patient and their caregiver can administer. Health care providers (and specifically hospitals) must be very careful not to administer cannabis due to the reliance on Medicare/Medicaid and the Schedule I status of cannabis. However, it is equally important for physicians and hospitals to be aware of any medicine brought to the hospital by the patient.

Product liability is also a risk, including claims for strict liability, negligence, failure to warn, deceptive advertising, and defective labeling arising from product contamination and customer impairment. Liability for a defective product can extend to every business in a supply chain, requiring products liability coverage from cultivation through retail. Special attention should be given for exclusions for illegal acts, smoking products, health hazards, mental or physical impairment, and vape cartridges.

The cannabis supply chain starts with cultivation, which includes planting and growing plants, and harvesting, drying, curing, and trimming the buds. Cultivating can be done outdoors or inside. Outside cultivation includes risks such as pesticide drift, hail, drought, and floods. Inside cultivation includes risks of loss from fire and power outages caused by high-wattage lights, and mold. All plants are at risk from water supply, insects, climate issues, and loss of revenue from price fluctuations.

Manufacturing includes processing, drying, curing, packaging and labeling the cannabis product, extraction, infusion, and compounding processes, and storage of components and ingredients. Manufacturers produce edibles, vape oil, topical applications, wax, beverages, tinctures, and capsules, as well as accessories such as papers, pipes, and vape pens.

Risks involved with manufacture are many. Cannabis extraction uses chemical solvents that are usually flammable and can have explosion hazards, necessitating higher property coverage limits. Edibles have heightened product liability, mislabeling, and false advertising hazards. Over-consumption is more likely with edibles, which may have uneven dosages, as well as a delayed psychoactive effect. Other risks include contamination from pests, bacteria, pesticides, or improper handling, as well as standard food-preparation risks. Contamination may also result in product or equipment losses. Oil used in vape pens may also contain contaminants, including pesticides, heavy metals, and toxins, and certain solvents or additives may cause health risks when heated. Vape pens themselves may also increase risk of bodily injury and property damage through burns and fire.

Retail shops, dispensaries and wholesalers are the final link in the supply chain. Wholesalers serve as intermediaries between manufacturers and retailers. A dispensary sells cannabis products to medical patients. Retail shops serve recreational users.

Retailers, dispensaries, and wholesalers face property risks from fire, vandalism, and theft, as well as CGL exposure from slips and falls, security failures, and crime. Retailers face elevated crime risk due to public accessibility, as well as product liability hazards. Products containing CBD oil are also subject to regulation by the U.S. Food and Drug Administration, which may give rise to potential regulatory fines and civil litigation.

Laboratories test for potency, pesticides, mold, residual solvents, contaminants, and are required by most states with legal cannabis to ensure product safety. Risks include product liability losses from bodily injury claims and professional liability losses from negligence claims.

Cannabis distributors transport cannabis products and cash between members of the supply chain. Transporting involves special risks associated with moving large volumes of product and cash and usually involves armed guards and unmarked vehicles.

Landlords who lease their buildings and property to cannabis businesses also face risks associated with their tenants and may require specialized lessor's risk liability policies that do not exclude coverage for cannabis industry tenants.

III. Coverage and the Cannabis Industry

Coverages needed by cannabis industry members include:

- Commercial Property
- General Liability
- Crop
- Worker's Compensation
- Surety Bonds
- Builder's Risk Coverage
- Products Liability
- Product Recall
- Commercial Auto
- Stock Throughput

Many types of coverages remain difficult for cannabis industry members to acquire, including Cyber Liability, Employment Practices, Professional Liability, D&O, Hired/Non-Owned Auto and Goods-in-Transit, and Event Insurance.

Policies issued to cannabis industry members commonly feature:

- Low limits (\$1/\$2m occurrence/aggregate are commonplace for GL and PL)
- High premiums
- Product liability premiums are generally 80% higher than for “analogue” products
- Minimum earned premiums of 25% to 50%
- Carriers are looking to offset initial costs of underwriting since licensees can and do quickly flip and companies can liquidate or be shut down
- Defense costs inside of limits
- Majority of policies include defense cost and containment within limits of the policy
- Numerous restrictive endorsements, including:
 - Territorial limitations—Coverage doesn’t extend beyond the state of insured’s operations
 - Noncompliance with laws—No claims arising out of non-compliance with any laws, regulations, ordinances, rules, etc.
 - Track & trace warranty—Claims excluded unless, as a condition precedent, track and trace system is functioning to the required level of specificity and all intermediaries in value chain are properly licensed
 - Government acts & criminal activities—Excludes claims resulting from investigations, fines, or prosecutions brought by the federal government
 - RICO—Claims brought under RICO or state laws that allow for property claims based on interference with the enjoyment of property
 - Mold, Fungi and Bacteria—Excludes claims resulting from viruses, fungi, mold, mildew or bacteria
 - Pesticides-Any claim based on exposure to pesticides
 - Carcinogens—Any claim based on exposure to carcinogens
 - Illness or Communicable Disease-Excludes claims involving cancer, cardiovascular diseases, prenatal injuries, depression, addiction or dependence
 - Banned Substance—Excludes any product that contains an ingredient banned by the FDA or a sports authority (e.g. NFL) (with the exception of cannabis)

“Hot Topics” for underwriters include:

- Unsubstantiated medical or health claims
- Class actions via state consumer protection laws
- Medical vs. adult-use: what’s the bigger risk?
- Medical customers covered under HIPAA?
- Inadequate, inaccurate packaging and labeling
- Products that appeal to children; Severe respiratory illness / vitamin E acetate
- Product contamination (solvents, pesticides, mold)
- Intoxicated driving (esp. when combined with alcohol)
- Correlation of heavy cannabis use and schizophrenia
- Vaping apparatuses and batteries