

Budding Considerations :: Cannabis-Related Insurance Issues

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Thirty states and the District of Columbia have legalized marijuana for medical purposes,¹ while recreational marijuana is legal in nine states and the District of Columbia.² Cannabis sales are skyrocketing, with an estimated \$9.7 billion in legal marijuana sales last year in North America.³ In June 2018, the U.S. Food and Drug Administration (FDA) approved a new drug for rare seizure disorders that contains a plant-derived, highly purified form of cannabidiol (or CBD),⁴ the first FDA-approved drug derived from marijuana.⁵ As of October 17, 2018, cannabis products are legal, although regulated, in Canada.⁶

However, under U.S. federal law, the cultivation, distribution, and possession of marijuana are prohibited by the Controlled Substances Act of 1970, which classifies the plant as a Schedule 1 substance and imposes criminal penalties for engaging in proscribed activities.⁷ Businesses in the cannabis sector therefore face potential federal prosecution and exposure to criminal penalties. The resulting uncertainties present significant hurdles for the cannabis industry and contribute to a risk profile that insurers approach with caution or avoid altogether.

A Risky Business

Marijuana-related businesses face both specialized risks associated with the product's potential illegality and psychoactive properties, as well as ordinary risks faced by other agricultural or manufacturing businesses. Because the product is an illegal controlled substance under federal law, businesses in the cannabis sector face limited access to banking services under federal regulations. In a recent *Forbes* piece on cannabis industry financing, contributor Julie Weed explained that "big banks won't open a checking account for [cannabis-related businesses], let alone lend them money, because cannabis production, processing and selling is still illegal at the federal level."⁸ As a result, cannabis-related businesses necessarily handle large sums of cash, subjecting them to a higher risk of theft.⁹ Edibles and other infused products present product liability and safety risks, such as potential claims arising from mislabeling or misrepresentations, impure or contaminated product, or the psychoactive effects of the drug.¹⁰

¹ Melia Robinson, Jeremy Berke & Skye Gould, "This Map Shows Every State That Has Legalized Marijuana," *Bus. Insider*, June 28, 2018.

² Robinson, Berke & Gould, *supra* note 1.

³ Robinson, Berke & Gould, *supra* note 1.

⁴ See Epidiolex (last visited Oct. 9, 2018).

⁵ Press Release, U.S. Food & Drug Admin., FDA Approves First Drug Comprised of an Active Ingredient Derived from Marijuana to Treat Rare, Severe Forms of Epilepsy (June 25, 2018).

⁶ See John Paul Tasker, "Trudeau Says Pot Will Be Legal as of Oct. 17, 2018," *Can. Broad. Corp.*, June 20, 2018.

⁷ See 21 U.S.C. § 812.

⁸ Julie Weed, "Legal Weed Entrepreneurs Finding New Funding Options," *Forbes*, Sept. 9, 2017.

⁹ Nat'l Ass'n of Ins. Comm'rs, Cannabis and Insurance (last updated Feb. 16, 2018).

¹⁰ Cannabis and Insurance, *supra* note 9.

Moreover, cannabis growers are particularly susceptible to the risk of fire, both wildfires and fires caused by internal sources. Fires may consume growing crops and inventory, while the resulting smoke and ash may contaminate the sensitive flowers, resulting in substantial losses.¹¹

As in any developing sector, cannabis companies also face potential exposure for misstatements and misrepresentations that induce investors to buy stock or to lend funds. In September 2018, two securities class action lawsuits were filed against Canadian-based Cronos Group (NASDAQ: CRON) arising from alleged misrepresentations regarding Cronos's distribution agreements in anticipation of Canada's legalization of marijuana for recreational use in October 2018. Cronos was subsequently accused of omitting key details regarding its distribution agreements and misleading the investing public regarding the agreements, which were reported to be "so small they could never justify the premium investors are paying for the stock."¹² In response to the report, Cronos's stock price dropped more than 28 percent and, predictably, litigation ensued.¹³

As the cannabis sector continues along its growth trajectory, businesses engaged in cannabis commerce and their investors will look increasingly to the insurance industry for products that are designed to protect their substantial investments.

Money Talks :: The Insurance Industry Response

Not surprisingly, the insurance industry is responding to the market demands of the booming cannabis sector. For the past year, California Insurance Commissioner Dave Jones has been working to clear the regulatory path, encouraging insurers to issue policies tailored to the legal cannabis industry.¹⁴ As a result, California has attracted and approved several new insurance products in recent months, including the following:

1. insurance coverage for commercial landlords that addresses risks specific to tenants operating cannabis-related businesses;¹⁵
2. product liability and product recall insurance for the cannabis industry;¹⁶ and
3. "CannaBOP"—the first business owners policy for cannabis-related businesses,¹⁷ "consisting of property and liability coverage for dispensaries, processors, manufacturers, distributors, cannabis storage facilities and other relative businesses operating in the state."¹⁸

¹¹ See Debra Borchardt, "California Fires Destroy Cannabis Crops at Harvest Time," *Forbes*, Oct. 11, 2017.

¹² Kevin LaCroix, "Plaintiffs Files Cannabis-Related Securities Class Action Lawsuits," *D&O Diary*, Sept. 17, 2018.

¹³ LaCroix, *supra* note 12.

¹⁴ See Mary Carreon, "Cannabis Industry and Insurance: California's Next Trend," *Forbes*, June 8, 2018.

¹⁵ See Press Release, Cal. Dep't of Ins., Office of Ins. Comm'r, Insurance Commissioner Approves First Coverage to Protect Property Owners Leasing to Cannabis Industry (May 1, 2018).

¹⁶ See Press Release, Cal. Dep't of Ins., Office of Ins. Comm'r, Commissioner Approves New Product Liability Program for Cannabis Industry (May 16, 2018).

¹⁷ See Press Release, Cal. Dep't of Ins., Office of Ins. Comm'r, California's Cannabis Insurance Marketplace Continues to Grow with Commissioner's Latest Approval (June 4, 2018).

¹⁸ Carreon, *supra* note 14.

While a handful of insurers have embraced the cannabis sector, others remain wary of the risks. Lloyd's of London, for example, instructed its syndicates to not write the industry because marijuana is still listed as a Schedule 1 drug under federal law.¹⁹ As the insurance market answers the cannabis sector's demand for insurance products and issues policies to cannabis-related businesses, coverage disputes are taking shape around the uncertainties in both the risks and the policies written to insure them.

In the Weeds :: Cannabis Coverage Disputes

Insurance disputes arising from the loss or use of marijuana-related products and from business risks associated with the production and distribution of cannabis products highlight several key issues. The conflict between federal law prohibiting and state laws permitting the production, possession, and use of cannabis for medical or recreational uses creates significant uncertainty for insureds and insurers alike.²⁰ Although the McCarran-Ferguson Act of 1945²¹ mandates that the insurance industry is governed by state law,²² insurers have had success using federal law as a basis for disclaiming coverage on illegality or public policy grounds, even in the absence of specific exclusions for criminal or unlawful conduct.²³

Against public policy

In one of the earliest marijuana-related coverage cases, the insured asked USAA Casualty Insurance Co. to pay \$45,000 for the loss of 12 legal medical marijuana plants stolen from her home.²⁴ The policyholder asserted that her homeowner's policy covered loss to "trees, shrubs, and other plants."²⁵

In support of its denial, USAA argued that the homeowner could not have an insurable interest in unlawful property, that Hawaii law prohibits the enforcement of illegal contracts, and that Hawaii's medical marijuana law is merely an affirmative defense to criminal prosecution that does not create an insurable interest in unlawful property.²⁶

While the court recognized the insured's insurable interest in the marijuana plants under Hawaii law,²⁷ it was persuaded by USAA's argument that providing coverage for the plants would be contrary to federal law and federal public policy.²⁸ Although state law authorized marijuana for medical use, the court agreed that

¹⁹ Stephen Pate, "No Longer Stuck in the Weeds: Marijuana Insurance Moves into the Mainstream," *Bus. Ins.*, Sept. 5, 2017.

²⁰ See *K.V.G. Props., Inc. v. Westfield Ins. Co.*, 296 F. Supp. 3d 863, 868 (E.D. Mich. 2017); *Green Earth Wellness Ctr., LLC v. Atain Specialty Ins. Co.*, 163 F. Supp. 3d 821, 826–35 (D. Colo. 2016); *Tracy v. USAA Cas. Ins. Co.*, No. 11-00487 LEK-KSC, 2012 U.S. Dist. LEXIS 35913 (D. Haw. Mar. 16, 2012).

²¹ 15 U.S.C. §§ 1011–1015.

²² See 15 U.S.C. § 1012.

²³ Compare *Tracy v. USAA Cas. Ins. Co.*, No. 11-00487 LEK-KSC, 2012 U.S. Dist. LEXIS 35913 (D. Haw. Mar. 16, 2012) (although a homeowner was legally growing marijuana in his home pursuant to state law, coverage for loss of marijuana plants was contrary to public policy), with *Green Earth Wellness Ctr., LLC v. Atain Specialty Ins. Co.*, 163 F. Supp. 3d 821 (D. Colo. 2016) (rejecting insurer's public policy defense to coverage for saleable marijuana inventory).

²⁴ *Tracy*, 2012 U.S. Dist. LEXIS 35913, at *1.

²⁵ *Tracy*, 2012 U.S. Dist. LEXIS 35913, at *1.

²⁶ See *Tracy*, 2012 U.S. Dist. LEXIS 35913, at *2.

²⁷ See *Tracy*, 2012 U.S. Dist. LEXIS 35913, at *10.

²⁸ See *Tracy*, 2012 U.S. Dist. LEXIS 35913, at *11–13.

enforcement of the policy to provide coverage for replacing “unlawful” marijuana plants was contrary to public policy based on federal law.²⁹

“Contraband”—and public policy, revisited

Four years later, a federal district court in Colorado considered the public policy argument again, rejecting it based on a lack of evidence that the insured faced any meaningful risk of federal prosecution. The Colorado court also considered various issues relating to insurance for cannabis-related business operations.

Green Earth Wellness Center operated a retail medical marijuana dispensary and an adjacent growing facility in Colorado. In 2012, smoke and ash from a wildfire outside Colorado Springs damaged marijuana plants in the growing facility and buds and flowers that had already been harvested and were being prepared for sale. Green Earth made a claim on its commercial property policy for the damaged product.³⁰

The policy covered “Stock”—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”—but excluded “growing crops.” Green Earth argued that the exclusion for “growing crops” applied only to plants growing in outdoor soil, such that the exclusion would not bar coverage for plants raised indoors in containers.³¹ The court disagreed, concluding that the policy excluded Green Earth’s loss arising from the damaged “growing” plants.³²

The court concluded that damage to the harvested flowers and buds was covered, however, rejecting the insurer’s arguments based on a “contraband exclusion” and public policy.³³ Although the policy excluded coverage for “Contraband, or property in the course of illegal transportation or trade,” the court found that the federal government’s “erratic” enforcement of federal laws criminalizing marijuana rendered the term “contraband” ambiguous:

In short, the [p]olicy’s “Contraband” exclusion is rendered ambiguous by the difference between the federal government’s *de jure* and *de facto* public policies regarding state-regulated medical marijuana.³⁴

The court noted that the insurer knew Green Earth was operating a medical marijuana business and knew (or should have known) that “federal law nominally prohibited such a business” when it issued a policy that unambiguously covered Green Earth’s inventory of saleable marijuana and did not undertake to exclude certain inventory from coverage.³⁵

Applying Colorado law to the policy, the court also rejected the insurer’s argument that the policy was unenforceable as against public policy in the absence of evidence that the application of federal public policy

²⁹ See *Tracy*, 2012 U.S. Dist. LEXIS 35913, at *12–13.

³⁰ *Green Earth Wellness Ctr., LLC v. Atain Specialty Ins. Co.*, 163 F. Supp. 3d 821, 823 (D. Colo. 2016).

³¹ See *Green Earth Wellness Center, LLC*, 163 F. Supp. 3d at 829.

³² See *Green Earth Wellness Center, LLC*, 163 F. Supp. 3d at 831–32.

³³ *Green Earth Wellness Center, LLC*, 163 F. Supp. 3d at 832.

³⁴ *Green Earth Wellness Center, LLC*, 163 F. Supp. 3d at 832–33.

³⁵ *Green Earth Wellness Center, LLC*, 163 F. Supp. 3d at 833.

would be expected to result in criminal enforcement action.³⁶ Because the insurer knew the nature of Green Earth's business when it issued the policy, along with "the peculiar legal concerns attendant to doing business in this sphere," the court rebuffed the insurer's "newfound concerns" regarding the unlawfulness of the policy.³⁷ If the contract was void as against public policy as the insurer argued, the court would permit Green Earth to amend its pleadings to allege the payment of premiums for "an illusory promise of insurance" and reliance on that promise in not seeking alternative coverage, prompting the court to exercise its equitable powers to award Green Earth its expectation damages.³⁸

Illegal acts exclusions

The illegality defense has also surfaced in cases involving policies that expressly exclude illegal or criminal acts. In *K.V.G. Properties, Inc. v. Westfield Insurance Co.*, the insurer raised the "illegal or dishonest" activity exclusion to avoid coverage under a commercial property policy for damage caused by marijuana-growing tenants.³⁹ The tenants caused significant damage to the property by adding heating, ventilation, and air conditioning units; tearing out walls; adding gas lines; and cutting holes in the roof.⁴⁰ The insured landlord argued that the damage was vandalism and covered under the policy.⁴¹

The insurer argued that the marijuana operations, while legal under Michigan law, were illegal under federal law.⁴² Apparently accepting this argument, the court declared that "the tenants' use of the units to grow marijuana was illegal or at the very least dishonest."⁴³ Accordingly, the court granted the insurer summary judgment on grounds that the landlord's losses were excluded under the illegal or dishonest acts exclusion.⁴⁴

Similarly, in *United Specialty Insurance Co. v. Barry Inn Realty Inc.*, a property owner entrusted insured property to a tenant who engaged in a marijuana-growing operation.⁴⁵ Pursuant to an exclusion barring coverage for damage caused by criminal acts of someone to whom the owner entrusted the property, the insurance policy did not provide coverage for property damage caused by the operation.⁴⁶ The court held that the insurer had no obligation to indemnify the property owner for damage to insured property caused by the tenant's illegal marijuana-growing operation.⁴⁷

Increased hazard—and failure to notify

In 2012, Kasey McDermott lost her Michigan home in a fire. Pursuant to McDermott's homeowner's policy, Nationwide Mutual Fire Insurance Co. paid \$160,000 for the claim.⁴⁸ The insurer later learned that the fire

³⁶ See *Green Earth Wellness Center, LLC*, 163 F. Supp. 3d at 832–34.

³⁷ *Green Earth Wellness Center, LLC*, 163 F. Supp. 3d at 834 n.8.

³⁸ *Green Earth Wellness Center, LLC*, 163 F. Supp. 3d at 834 n.8.

³⁹ *K.V.G. Props., Inc. v. Westfield Ins. Co.*, 296 F. Supp. 3d 863 (E.D. Mich. 2017).

⁴⁰ See *K.V.G. Properties, Inc.*, 296 F. Supp. 3d at 865.

⁴¹ *K.V.G. Properties, Inc.*, 296 F. Supp. 3d at 867.

⁴² *K.V.G. Properties, Inc.*, 296 F. Supp. 3d at 868.

⁴³ *K.V.G. Properties, Inc.*, 296 F. Supp. 3d at 868–69.

⁴⁴ *K.V.G. Properties, Inc.*, 296 F. Supp. 3d at 869.

⁴⁵ *United Specialty Ins. Co. v. Barry Inn Realty Inc.*, 130 F. Supp. 3d 834, 836 (S.D.N.Y. 2015).

⁴⁶ See *Barry Inn Realty Inc.*, 130 F. Supp. 3d at 839–42.

⁴⁷ *Barry Inn Realty Inc.*, 130 F. Supp. 3d at 842.

⁴⁸ *Nationwide Mut. Fire Ins. Co. v. McDermott*, 603 F. App'x 374, 374 (6th Cir. 2015).

was accidentally started by McDermott's then husband, who operated a butane "honey oil" lab in the basement to create a concentrated form of marijuana for his patients.⁴⁹ The fire started when he lit a sample for himself.⁵⁰ Although the policy "provided coverage for 'accidental direct physical loss to [the] property,'"⁵¹ it did not cover losses "caused by an intentional act of the insured or those 'occurring while hazard [was] increased by a means within the control and knowledge of an insured.'"⁵² The policy also required McDermott to notify Nationwide of any changes that would affect the premium risk.⁵³

Nationwide sued to avoid liability for the fire, advancing several arguments in support of its position—the manufacturing facility in the home was illegal, the insured misrepresented the use of the property, the cause of the fire fell under the increased hazard and intentional acts exclusions, and there was no accidental direct physical loss to property.⁵⁴ Notwithstanding policy provisions that might have precluded coverage based on the increased hazard, the court determined that McDermott's failure to notify Nationwide regarding the risks associated with using the basement for manufacturing and processing marijuana supported Nationwide's disclaimer of coverage.⁵⁵

Unspecified operations

The most recent decision regarding insurance for marijuana risks arises from the sale of synthetic marijuana by a gas station convenience store. Emily Bauer purchased synthetic marijuana from the store and suffered a massive stroke after ingesting the substance.⁵⁶ Bauer sued the store operator, Gulshan Enterprises, alleging that it negligently or intentionally allowed the sale of synthetic marijuana at its store, causing her injuries.⁵⁷ Admiral Insurance Company initially agreed to defend Gulshan against the Bauer lawsuit under its commercial general liability policy⁵⁸ but later sought a declaratory judgment that the policy did not provide coverage.⁵⁹

The policy contained a "Specified Operations" endorsement that limited coverage to bodily injuries caused by "wholesale gasoline sales" only.⁶⁰ Gulshan argued that there was a fact issue "as to what is included in the scope of 'wholesale gasoline sales,'"⁶¹ but the court disagreed. The court determined that the "plain language of the 'Specified Operations Endorsement' limits insurance coverage to only those accidents reportedly caused by Gulshan's 'wholesale gasoline sales.'"⁶² Because the sale of the synthetic marijuana

⁴⁹ See *McDermott*, 603 F. App'x at 374–75.

⁵⁰ See *McDermott*, 603 F. App'x at 375.

⁵¹ *McDermott*, 603 F. App'x at 376.

⁵² *McDermott*, 603 F. App'x at 376.

⁵³ *McDermott*, 603 F. App'x at 376.

⁵⁴ *McDermott*, 603 F. App'x at 376.

⁵⁵ See *McDermott*, 603 F. App'x at 377–79.

⁵⁶ *Admiral Ins. Co. v. Gulshan Enters., Inc.*, No. 4:16-CV-2837, 2017 U.S. Dist. LEXIS 199773, at *1 (S.D. Tex. Nov. 15, 2017).

⁵⁷ *Gulshan Enterprises, Inc.*, 2017 U.S. Dist. LEXIS 199773, at *1.

⁵⁸ *Gulshan Enterprises, Inc.*, 2017 U.S. Dist. LEXIS 199773, at *1.

⁵⁹ *Gulshan Enterprises, Inc.*, 2017 U.S. Dist. LEXIS 199773, at *1.

⁶⁰ *Gulshan Enterprises, Inc.*, 2017 U.S. Dist. LEXIS 199773, at *2.

⁶¹ *Gulshan Enterprises, Inc.*, 2017 U.S. Dist. LEXIS 199773, at *2.

⁶² *Gulshan Enterprises, Inc.*, 2017 U.S. Dist. LEXIS 199773, at *5.

was not directly linked to “wholesale gasoline sales,” the court held that the retail sale of synthetic marijuana was not covered and Admiral had no duty to defend or indemnify Gulshan in the Bauer lawsuit.⁶³

Roll-Up

Lessons learned from coverage litigation involving cannabis-related activities provide some guidance for insurers and insureds interested in understanding how risks are insured under policies issued to cannabis businesses. A candid discussion regarding the nature of the risks to be insured—and not to be insured—is necessary to ensure that the policy performs as intended. Policy provisions should be reviewed with cannabis-specific risks in mind *and* with an eye to the potential effect of illegality arguments. Exclusions for criminal, illegal, or hazardous conduct should be addressed and limited appropriately to avoid unexpected gaps in coverage if the parties intend to cover the production and distribution of cannabis products until the currently prevailing uncertainties are resolved.

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⁶³ See *Gulshan Enterprises, Inc.*, 2017 U.S. Dist. LEXIS 199773, at *4–6.