NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research
CIPR newsletter

Insuring the Commercial Cannabis Industry

By Anne Obersteadt, CIPR Senior Researcher

The author is grateful to Ian Stewart of Wilson Elser for his contributions to the article and help improving it with his insightful comments and background information.

◆ Introduction

The rapid expansion of the cannabis industry is bringing a host of unique needs and complex risks to be insured. More than two-thirds of states have legalized cannabis in some form. The District of Columbia and 10 states now allow adult consumption of cannabis for recreational use. There are other states that have passed laws which specifically legalize the use of cannabis-derived products, such as cannabidiol (CBD) oil. The number of cannabis-related businesses will undoubtedly grow as more states move to legalize it in the future. In fact, sales of legal cannabis are projected to double over the next four years, reaching $20 billion.[1]

Insurers looking to provide commercial cannabis insurance to this budding market should understand its rapidly shifting landscape. They must contend with legal uncertainty, evolving regulations, lack of data and developing business practices. Insurers will also need to understand how the cannabis industry's first- and third-party coverage needs are unique from other industries. To support this, the NAIC Cannabis Insurance (C) Working Group was formed last year. Members of the Working Group will collaborate to better understand the industry's insurance coverage gaps and regulatory issues. They will also develop best practices for state insurance regulators to help them address these insurance needs. As part of this process, the Working Group anticipates releasing a white paper in 2019.

◆ Insurance Availability

The cannabis industry has evolved in sophistication over the last decade. This once illicit market, characterized by tie-dyes and Birkenstocks, has given way to suits and boardrooms. Cannabis operations now involve farmers, chefs, scientists, laboratory technicians, engineers, security personnel and accountants. Additionally, the once loosely regulated industry must now conform to robust regulations. Such regulations support the insurability of the industry.

Demand for cannabis-related insurance products will continue to grow as more states legalize the drug. Additionally, coverage needs will become more complex as cannabis-related businesses respond to evolving state regulations. Despite this, only a limited number of insurers and brokers serve the market. There are a few large carriers, but most are small specialty insurers. Coverage is primarily written in the surplus lines market due to the specialized hard-to-place risks inherent in cannabis operations.

Recently, however, there have been a handful of admitted carriers entering the market. This is largely attributed to insurance regulatory outreach efforts. Most notably, Golden Bear Insurance became California's first admitted carrier in November 2017. Since then, the California Department of Insurance has approved admitted insurer Continental Heritage and four additional admitted carriers. It also approved the first Cannabis Business Owners Policy (CannaBOP) form for business lines of insurance.[2]

Insurance regulators in states where cannabis has become legal are examining the insurance and insurance regulatory needs of this new industry. This is in line with state insurance regulators' charge to ensure insurance availability and affordability in their markets.

◆ Barriers to Entry

So, what is keeping carriers on the sidelines? Inconsistencies between federal and state laws are likely the most significant obstacle to insurers' willingness to enter the market. Cannabis is now legal for medical and/or recreational use in more than half of U.S. states. However, its listing as a Schedule 1 drug under the federal Controlled Substances Act (CSA) makes it a federally illegal substance. This contradiction creates legal risks because insurance policy provisions exclude illegal operations and criminal acts. The risk is particularly relevant to large multistate insurers with concerns over federal anti-money laundering laws.

To provide some clarity on this issue, the U.S. Department of Justice (DOJ) issued non-enforcement policies in 2014 related to cannabis transactions in states where the drug is legal. Despite this, Lloyd's of London ceased insuring the U.S. cannabis industry in June 2015, citing legal uncertainty. It should be noted many of the policies were subsequently picked up by other insurers, most notably Hannover Re.[3]

Another barrier is the lack of data available for pricing and underwriting such a nascent industry. Additionally, in states where cannabis is legal, state insurance regulators are moving rapidly to erect regulatory structures. This means insurers must contend with an industry where standard business practices are still evolving. Moreover, most states license at

(Continued on page 3)

the local and state level. As such, carriers must keep pace with new and frequently changing requirements at both levels in each jurisdiction where they operate.

The complexity of cannabis-related operations presents another difficulty to be navigated. This requires specialized employee education and training. Policy submissions are typically lengthy and intricate. Carriers must be able to identify standard and unique risks and align them with the appropriate insurance coverage. They must also understand what is needed to effectively mitigate risk and manage claims. The following sections take a closer look at how these apply to the commercial cannabis industry and each phase of its supply chain.

◆ COMMERCIAL INSURANCE NEEDS

Most commercial businesses have exposure to first-party property losses and third-party commercial general liability (CGL) and product liability claims. Cannabis-related businesses are no exception. Commercial property insurance indemnifies against physical loss to property from fire, theft and certain weather perils. Property includes contents, equipment, fixtures and owned property. Most policies also cover losses related to business interruption from a covered peril. This coverage replaces lost earnings and expenses during the time operations are disrupted. It can also provide protection against delays from operation disruptions further down the supply chain.

Commercial property insurance should often have higher limits for cannabis-related businesses compared to other businesses of similar size. Theft of inventory (cannabis and related products) and cash is a significant risk for this industry. Many banks, which are federally regulated, are hesitant to accept deposits from the cannabis industry due to federal law. This leaves cannabis-related businesses heavy in cash. Employee dishonesty and crime coverage is needed to cover the risk of theft from first and third parties. In addition to theft, excessive cash also brings a higher risk for kidnap, ransom or extortion.[4] It should be noted some of these coverages may be sold as standalone policies.

Insurers typically mitigate against theft risks by requiring use of sophisticated security systems, fencing and security personnel. Cash is often required to be stored in fireproof safes. This has the added benefit of protecting against losses from fire. Fire damage to high-value cannabis crops and products and expensive equipment have the potential to generate large property damage losses. As such, automatic fire suppression systems and proper ventilation are also frequently required.[5]

Cannabis-related businesses also have extensive legal exposure tied to their products. Liability from a defective product claim can extend to every business in the supply chain.[6] As such, it is important products liability coverage be included in CGL policies. A stand-alone product liability policy may be needed if the CGL policy excludes this coverage. Additionally, insureds should be made aware of any coverage limitations. For example, CGL and product liability policies may have shared limits for both coverages, non-stacking endorsements and no duty to defend. There may also be exclusions for illegal acts, smoking product, health hazard, mental or physical impairment, and vape cartridges.

Products liability exposure is high, in part, because a claimant only needs to demonstrate a product is defective to establish strict product liability.[7] Negligence is not a consideration. Additionally, product contamination and impairment can occur at any part of the supply chain. The wide range of cannabis potency and strains and infused-products also increases exposure. Aside from product damage and bodily injury, claims of failure-to-warn, deceptive adverting and defective labeling may arise.

Most states with robust regulatory regimes require sophisticated track and trace software. This software allows a product to be traced as it moves through the supply chain from "seed to sale." By doing so, every party along the supply chain can be easily identified and potentially added to a product liability lawsuit, regardless of "fault."

The risk of cyber threats in this industry should not be ignored. Track and trace software brings together numerous data points, many of which are required to be provided to regulators online. Cannabis-related businesses also often store personal and medical information on their customers. Unfortunately, the availability of cannabis-specific cyber coverage is limited.[8]

◆ RESPONDING TO SPECIFIC OPERATIONAL RISKS

Cultivation

Insurance needs can vary based on the risks specific to where cannabis-related businesses operate in the supply chain. The supply chain starts with cultivation. Cultivators include growers of plants and nurseries producing seeds and seedlings. Commercial cannabis cultivation activities include planting and growing the plant, harvesting the buds, and then drying, curing or trimming them. The can-

(Continued on page 4)

nabis bud is considered a product. As such, cultivators have product liability exposure from potential injury claims. For instance, a consumer could file a claim after becoming ill from ingesting a product originating from a grower using non-approved pesticide.

Cultivating cannabis can be done outdoors in a field or indoors in a grow facility. Pesticide drift is a major problem for outdoor growers. Cultivating cannabis outdoors also carries the same exposures as other crops.[9] This includes natural disasters such as hail, drought or floods and loss of revenue from price fluctuations. While crop insurance covers losses from insects, natural disaster and mold, it is usually not available to outdoor cultivators.[10] Also, coverage of saleable cannabis and crop are two distinct coverages.

Indoor cultivating often relies on high-wattage lights to grow crops. This increases the risk of losses from fire and power outages. Mold can be an additional risk of growing indoors. Property damage limits for cultivators is frequently higher to address these risks. The remaining risks are in line with outdoor cultivation operations. All plants are subject to issues from water supply, insects and climate. The controlled atmosphere does offer greater control of these risks. It also provides a greater yield by allowing year-long growing. For these reasons, many licensed growers choose to cultivate indoors.[11]

Manufacturing

Manufacturing is the next step in the supply chain. In some business models, processing the cannabis after harvest is done in this step, separate from the grow operations. This includes processing, drying, curing, packaging and labeling the cannabis product. Manufacturing can also include extraction, infusion and compounding processes, and the storing of components and ingredients. Manufacturers produce cannabis-derived or infused products in the form of edibles, vape oil, topical applications, wax, beverages, tinctures and capsules. They also produce accessories, such as papers, pipes and vape pens.

Manufacturers of cannabis products face many unique risks. Cannabis-infused products rely on cannabis extract. Extraction operations use chemical solvents to extract the active ingredients from the cannabis flowers. These solvents are usually flammable and can have explosion hazards, bringing the need for higher-limit property damage coverage.[12] As stated earlier, cannabis-infused edibles are exposed to heightened product liability, mislabeling and false advertising hazards. Accidental over-consumption is more likely with edibles. Infusing cannabis into food can result in uneven dosage. Additionally, there is a significantly delayed psychoactive effect when consuming versus smoking cannabis.

Contamination risk also exposes manufactures to potential CGL, products liability, false advertising and property hazards. Improper product handling or issues involving pests, molds, bacteria and pesticides can result in contamination. For instance, bakeries producing edibles carry all the standard food preparation risks.[13] Should inventory become contaminated, it, and potentially the equipment used to process it, would need to be disposed or recalled, resulting in product and equipment losses. Product recall insurance would reimburse for any costs involved in recalling defective product from the market. However, this coverage can be expensive and difficult to obtain.

The oil used in the production of vape pen cartridge concentrates can also contain contaminates. The most common are pesticides, heavy metals and toxins. One 2015 study found pesticides were detected in one-third of the study's concentrate samples.[14] Vape pens are used to heat and vaporize the cannabis oil, which is then inhaled through the pen. Certain solvents or additives may produce health risks when heated. Vape pens may also not heat evenly or may be used in a way which increases risk. Many vape pens are manufactured in China and may not conform to newly issued regulations. Some pens have been falsely labeled as being from ceramic, which heats differently from glass or metal.[15]

Retail/Wholesale

Retail shops, dispensaries and wholesale outlets are the final step in the supply chain. Wholesalers can serve as an intermediary between manufactures and retailers. Product is received from manufactures or wholesalers and is often already tested, labeled and packaged. A dispensary provides cannabis and related products to medical cannabis patients. Access to the dispensary may require a medical recommendation and/or a medical marijuana card. Retail shops serve recreational users and tend to focus more on branding and packaging for public appeal. They also tend to have wider product selection. Sales are made by bud tenders who provide dosage and product suggestions.[16]

(Continued on page 5)

Retailers, dispensaries and wholesalers ("retailers") face risks from property exposure to fire, vandalism and theft. They also have CGL exposures from slips and falls, security failures and crime. Theft and crime risks are elevated for retailers due to their public accessibility. Dispensaries not anticipating the needs of disabled clients have higher exposure to claims of negligence.[17] As with the rest of the supply chain, retailers have exposure to product liability hazards related to their products. For instance, a consumer may sue for personal injury from an ingested edible.

Retailers who sell products infused with CBD face much legal uncertainty. CBD is an extract of hemp or cannabis and has no psychoactive effects. Bolstered by its purported health benefits, CBD-infused oils, topical treatments and food products have become popular. A provision in the 2018 Farm Bill is anticipated to remove hemp from the list of Schedule 1 controlled substances.[18]

As such, the U.S. Drug Enforcement Administration (DEA) will not consider hemp-derived CBD a controlled substance subject to the CSA. However, the U.S. Food and Drug Administration (FDA) has concluded CBD from any source is a drug, not a dietary supplement or an allowable additive to food. As such, CBD-infused products require FDA approval prior to being sold to the public.[19]

Companies continuing to sell hemp-sourced CBD should understand they face potential regulatory fines and civil litigation. As the FDA's jurisdiction pertains to interstate commerce, this is particularly true for those selling across state lines. The FDA has warned many online sellers of CBD-infused products against making impermissible health claims. Adding to the complexity, some states (such as California) also prohibit hemp-derived CBD in food products. Thus, CBD-infused products could be the subject of class-action lawsuits alleging adulteration or misbranding under consumer protection laws.[20]

Insurance carriers need to understand the risks presented by potential violations of U.S. food and drug laws. This represents the more important long-term problem for the industry. Legal experts warn carriers are more likely to pay defense and indemnity dollars as a result of violating food and drug laws, as opposed to losses arising from the legal status of CBD under the CSA or the Farm Bill.[21]

Laboratories

Laboratories test for potency, pesticides, mold, residual solvents and other contaminants. They are also usually required to perform sampling and validate consistency in products such as extracts, concentrates and edibles. Most states with legal cannabis require laboratory testing to ensure safety. However, not all states have accreditation requirements to ensure the quality of the lab's testing procedures. Improper testing can result in product liability losses from bodily injury claims. It can also lead to professional liability losses from negligence claims. Additional risks are typical of all testing laboratories.

Distribution

Cannabis distributors transport cannabis, cannabis-related products and cash between the various operators in the supply chain. Transporting in the cannabis industry is a specialized process with many risks. States frequently impose strict regulations on the transportation of cannabis. Because cannabis is illegal under federal law, the product is constrained to intrastate transportation.

It is important for commercial auto insurance to be tailored to the unique transportation risks and methods of the cannabis industry. The transport of large volumes of high-value product and cash requires excessive means to ensure safety. This is especially true when transporting to retail locations because of their greater visibility and public access. For this reason, transporting usually involves armed military trained drivers taking varied routes in armored and unmarked vehicles.[22]

It should be noted a standard auto policy may not cover employees driving personal vehicles for business purposes. These policies provide accident coverage and rental reimbursement. However, they do not typically cover the transport of cannabis.

Landlord

Landlords who lease their owned building or property to cannabis-related businesses have unique risks. Many commercial property and GCL policies exclude coverage for tenants operating in the cannabis industry. Thus, a specialized lessor's risk liability policy may be needed to protect the owner from lessee or third-party bodily injury or property damage claims.

(Continued on page 6)

◆ CONCLUSION

The explosive growth potential of the industry offers insurers new business opportunities. Nevertheless, insuring cannabis-related businesses is complicated and requires extensive knowledge of the industry. There are many legal uncertainties, unique hazards and emerging risks involved. Robust state regulations support the insurability of this market by setting standards. This is tempered somewhat by the increased potential for class-action litigation alleging noncompliance with narrower rules. Efforts to remove inconsistencies between federal and state laws in the new year could reduce the legal hazard. Ultimately, the decision on whether to enter the market is a business risk decision to be made by each insurer.

ABOUT THE AUTHOR

Anne Obersteadt is a researcher with the NAIC Center for Insurance Policy and Research. Since 2000, she has been at the NAIC performing financial, statistical and research analysis on all insurance sectors. In her current role, she has authored several articles for the CIPR Newsletter, a CIPR Study on the State of the Life Insurance Industry, organized forums on insurance related issues, and provided support for NAIC working groups. Before joining CIPR, she worked in other NAIC Departments where she published statistical reports, provided insurance guidance and statistical data for external parties, analyzed insurer financial filings for solvency issues, and authored commentaries on the financial performance of the life and property and casualty insurance sectors. Prior to the NAIC, she worked as a commercial loan officer for U.S. Bank. Ms. Obersteadt has a bachelor's degree in business administration and an MBA in finance.

ENDNOTES

[1]*Walsh, Chris, 2018. "Annual Marijuana Fact Book," Marijuana Business Daily Ed. 6, accessed at https://mjbizdaily.com/wp-content/uploads/2018/05/Factbook2018-ExecutiveSummary.pdf.*

[2]*Dixon, Camille, 2018. Interview, California Department of Insurance.*

[3]*Dreibus, Tony, 2015. "Lloyd's of London to Exit U.S. Cannabis Insurance Industry," Marijuana Business Daily, accessed at https://mjbizdaily.com/exclusive-lloyds-of-london-to-exit-u-s-cannabis-industry/.*

[4]*Chaney, Fiona, and Woods, Pamela, 2017. "A Look At 1st-Party Insurance Coverage for Cannabis," Law360, accessed at www.law360.com/articles/925337/a-look-at-1st-party-insurance-coverage-for-cannabis.*

[5]*American Bar, n.d. How High: The Buzz on Emerging Issues in Coverage for Cannabis Operations, accessed at www.americanbar.org/content/dam/aba/administrative/litigation/materials/regionals-materials/2018-2019/win/8-Coverage-for-Cannabis-Operations/WIN-How-High-The-Buzz-on-Emerging-Issues-in-Coverage-for-Cannabis-Oper.pdf.*

[6]*Jackson, Stacey, 2018. Oral Presentation, NAIC Fall National Meeting, Cannabis Insurance (C) Working Group Meeting.*

[7]*Ibid.*

[8]*Ibid.*

[9]*Ibid.*

[10]*Weidenback, Lindsey, 2018. "Cannabis Businesses: Insurance Needs 101," Jefferson, Danielson, Sonn & Aylward, P.S. Blog, accessed at www.jdsalaw.com/blog/2018/5/30/cannabis-businesses-insurance-needs-101.*

[11]*Jackson, Stacey, 2018. Oral Presentation, NAIC Fall National Meeting, Cannabis Insurance (C) Working Group Meeting.*

[12]*Ibid.*

[13]*Ibid.*

[14]*Rabber, Jeffery, Sytze, Elzinga, and Charles Kaplan, 2015. "Understanding Dabs: Contamination Concerns of Cannabis Concentrates and Cannabinoid Transfer During the Act of Dabbing," The Journal of Toxicological Sciences, 40(6):797-–803.*

[15]*Richards, Kathleen, 2018. "Is Vaping Cannabis Safe?," East Bay Express, accessed at www.eastbayexpress.com/oakland/is-vaping-cannabis-safe/Content?oid=14356874.*

[16]*Oleinic, Alex, 2018. "A Marijuana Store and a Cannabis Dispensary: What's the Difference?," Benzinga, accessed at www.benzinga.com/markets/cannabis/18/11/12569406/a-marijuana-store-and-a-cannabis-dispensary-whats-the-difference.*

[17]*Jackson, Stacey, 2018. Oral Presentation, NAIC Fall National Meeting, Cannabis Insurance (C) Working Group Meeting.*

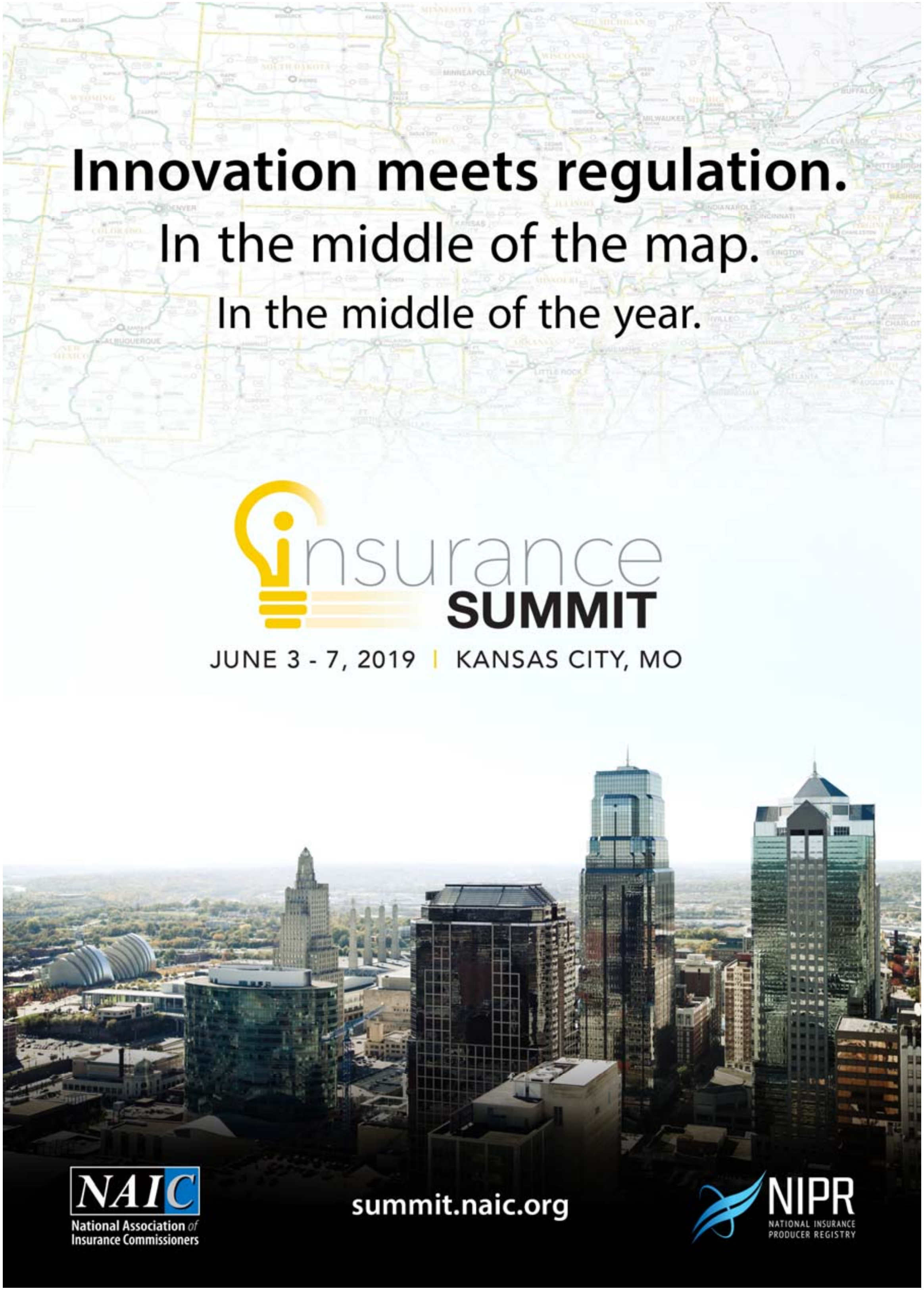
[18]*Mundhal, Erin, 2018. "New Farm Bill Makes Hemp Federally Legal in the U.S.," Inside Sources accessed at www.insidesources.com/legal-cannabis-is-closer-than-you-think/.*

[19]*Stewart, Ian, and Neill Willner, 2018. "Hemp-Derived CBD in Food Products, a Legal Rabbit Hole," Wilson Elser, accessed at https://www.wilsonelser.com/news_and_insights/attorney_articles/3185-hemp-derived_cbd_in_food_products_a_legal_rabbit.*

[20]*Ibid.*

[21]*Stewart, Ian 2018. Interview. Wilson Elser.*

[22]*Guillot, Craig, 2018. "Cannabis Transport Risk," Risk & Insurance, accessed at http://riskandinsurance.com/cannabis-transport-risk/.*


Innovation meets regulation.
In the middle of the map.
In the middle of the year.
insurance
SUMMIT
JUNE 3 - 7, 2019 | KANSAS CITY, MO
NAIC
National Association of Insurance Commissioners
summit.naic.org
NIPR
NATIONAL INSURANCE PRODUCER REGISTRY

NAIC Central Office
Center for Insurance Policy and Research
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197
Phone: 816-842-3600
Fax: 816-783-8175

http://www.naic.org http://cipr.naic.org

To subscribe to the CIPR mailing list, please email CIPRNEWS@NAIC.org.