

The Cannabis Captive

Captive insurance for cannabis could be a viable option.

By Alex Wright

Estimated to be worth \$20 billion by 2025 and to employ tens of thousands of people, the rapid growth of the cannabis industry is driven by states such as Colorado, Oregon and Washington. With California the latest state to legalize and 12 more considering following suit, that growth will only increase.

However, problems exist. Cannabis is illegal under federal law, despite being legal to cultivate and sell medical marijuana in 29 states and recreational marijuana in nine. Many large players, including Lloyd's of London, have pulled out of the market.

Added to that are the tough safety and regulatory measures and a lack of historical loss data. The end result for cannabis growers and dispensaries has been scarcity or prohibitively high costs of traditional insurance market coverage.

That lack of coverage was laid bare by last September's hurricanes, which devastated cannabis operations in Florida and Puerto Rico, and the wildfires that swept through Northern California a month later.

But for those savvy cannabis entrepreneurs, a new solution is emerging. Closely-held captives, licensed in more than 30 states, can plug the coverage gap.

"This is the greatest captive opportunity of the 21st century," said Matthew Queen, general counsel, CCO, Venture Captive Management.

"Captives and risk retention groups are uniquely positioned to provide value to the cannabis community because of the unique and unknown cannabis exposures."

REGULATORY AND SAFETY RISKS

Cannabis regulation is a gray area because of differences in federal and state laws. Many carriers, particularly those that operate in multiple states, deny coverage because of the drug's illegal status.

"This is a real challenge, because the large commercial carriers generally refuse to provide coverage for a federally illegal substance," said Queen.

"Regardless of the merit of the federal government's position, this means that every individual operating in the cannabis space is either liable for violating the CSA or aiding and abetting the commission of a felony."

Worse still, in May 2015, Lloyd's of London, one of the cannabis industry's biggest specialist insurers, instructed its underwriters to cease coverage until marijuana is decriminalized at the federal level.

The ban had a far-reaching effect, extending to crop, property and liability insurance, as well as cover for banking-related services provided to these operations.

LACK OF COVERAGE

The problem for cannabis businesses or landlords is that insurance can be inadequate, expensive or unavailable. Then, even with coverage, carriers will often challenge cannabis-related claims and many courts will side with them.

Marshall Gilinsky, shareholder, Anderson Kill's New York office, who practices in the firm's insurance recovery and commercial litigation departments, said there is anecdotal talk that insurers are hiking up premiums due to reputational and criminal risks. Because loss ratios on cannabis are often lower than those of mainstream crops, carriers can rake in larger profits, he added.

"Pricing for cannabis plants is no different than, say, soya beans. But insurance companies are adding a ticker because of the risk they could get indicted for aiding and abetting or even money laundering."

"Another problem is that brokers mistakenly sell the wrong type of coverage that excludes cannabis," said Jeffrey Rosen, president, Tailored Benefits.



The burgeoning cannabis industry will require creative risk transfer solutions, including the use of captives.



Matthew Queen, general counsel, CCO, Venture Captive Management

CAPTIVE SOLUTION

A potential solution is captive insurance, or more specifically, closely-held captives (CICs). Cannabis companies can be a fit due to their strong capital position, risk appetite and entrepreneurial spirit.

Typical risks include: auto, BI, casualty, crop, commercial, cyber, general and product liability, property, surety, workers' compensation and even armored car insurance. A captive's coverage can extend to product recall, intellectual property, legal defense, crime and employee theft. Landlords can self-insure their property risks through a captive.

CICs are licensed insurance companies allowed, under special provisions, to sell cover to affiliated businesses but not to the general public, making them more efficient to form and operate than traditional insurance companies. They provide

businesses with greater control over insurance and claims handling practices and allow them to retain underwriting profit and put it back into the business.

"Captives provide absolute control of the terms and conditions of the coverage and remove any questions about the enforceability of insurance contracts. Moreover, the absence of the largest commercial carriers creates a market opportunity for smaller players," said Queen.

Dave Provost, deputy commissioner, Vermont's Captive Insurance Division, was more skeptical. He said that until cannabis becomes legal at the federal level, it won't find much of a niche in the captive market.

"If and when it does become legal, an alternative market 'solution' is unlikely to be necessary," he said.

"There may be opportunities for group programs in the future, but my guess is that the traditional market will be ready to step in the day after it becomes legal." &

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SUMMARY

- **Cannabis crops** in Florida and Puerto Rico were devastated by hurricanes.
- **Some think captives** and the cannabis industry are made for each other.
- **Some regulators** are still skeptical about the risk transfer options for cannabis.