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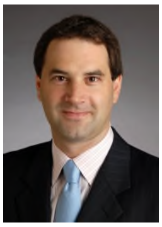


The Appeal of Captive Insurance Arrangements to Cannabis Business

By: Marshall Gilinsky and Jerry S. Goldman*

Insurance allows businesses to better manage and transfer risk. Businesses in the cannabis industry face risks, just like businesses in any other industry. But for a variety of reasons—some valid and others dubious—the risks associated with the cannabis industry are seen as somewhat unusual. In part because of this perception, cannabis businesses sometimes find it difficult to insure certain risks, and they typically are charged higher prices than traditional businesses for common insurance products.[1]

For decades, savvy insurance purchasers faced with overpriced or unavailable insurance have used alternative risk transfer strategies to meet their risk management needs. Foremost among these strategies is the use of captive insurance. A "captive" insurance company is a wholly owned subsidiary set up by the policyholder that operates as a true insurance company and charges actuarially sound premiums, in exchange for manuscripted insurance policies tailored to the parent company's needs. Although an active market exists through which cannabis businesses can access a wide array of commercial insurance products, captive insurance may be an appealing option for some cannabis businesses seeking better pricing and broader coverages compared with the current options in the commercial marketplace.

Insurance Needs of Cannabis Businesses Generally

Businesses in the cannabis industry use insurance to manage and transfer risks of loss associated with the normal operation of their businesses—just like any other businesses. In fact, cannabis businesses are actually required to purchase certain types of insurance in order to operate in certain states. For example, commercial general liability and products liability coverage with minimum limits of $1,000,000 are required in order to obtain and maintain a license in Washington State.[2]

Although some might perceive cannabis businesses as exotic risks, the insurance products they use are fairly standard and have been underwritten and sold in commercial insurance markets for decades (if not centuries). For example, a cultivation facility is wise to purchase crop insurance—just like any other agricultural producer—and the risks of loss faced by the facility are as easy for the underwriter to assess as the risks faced any farmer. As a general rule, cannabis businesses will want to purchase property and business interruption insurance to protect against risks of loss due to fire, flood, or hurricane, among many other ordinary perils. They will also need auto liability and workers' compensation insurance as required by law—just like any other business. Dispensaries and edible manufacturers will purchase general liability and products liability insurance to protect against lawsuits ranging from slip-and-fall accidents on their premises to allegations of personal injury arising from the use of their products. These risks and insurance products are basically the same as those commonly faced by businesses making and selling alcoholic beverages.

The fact that cannabis businesses have been forced to operate in cash might seem to place them at an unusually high risk of loss, but that risk commonly has been managed by policyholders in the automated teller machine and casino businesses through armored car or "specie" insurance. In fact, by developing business relationships with insurance companies (or reinsurers) that specialize in such risks, cannabis businesses access state-of-the-art strategies for minimizing the risk of loss from theft. Overall, cannabis businesses are wise to use commercial insurance and other time-tested alternative risk transfer tools to protect themselves from unexpected losses.

Federal Drug Laws and Their Impact on the Insurance Marketplace

For many decades, the Controlled Substances Act has made it illegal to "manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense" cannabis.[3] Even though the cultivation and sale of cannabis are now permitted under certain

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circumstances in many states, they are still a crime under federal law, as marijuana remains a Schedule 1 drug under the Controlled Substances Act[4]. The Supreme Court has confirmed that the federal government has the right to regulate and criminalize the sale and use of cannabis, even when state law permits the use for medical purposes.[5]

The illegality of marijuana under federal law affects not only the businesses directly involved in the cultivation and sale of cannabis products but also their suppliers and service providers—even though they do not "touch the plant." This is because federal law punishes not only those who actively commit crimes but also those who aid and abet or conspire with criminals.[6] Accordingly, anyone who "aids, abets, counsels, commands, induces, or procures" the commission of a federal crime by another is punishable as a principal, as though he or she had committed the offense.[7] Providing insurance to a cannabis business arguably constitutes aiding, abetting, and conspiring with that business with respect to its violation of the Controlled Substances Act—and subjects the insurance company to a risk of prosecution by the Department of Justice for such crimes.

Insurance companies also run the risk of being prosecuted for violation of federal money laundering laws based on their transactions with cannabis businesses. Under federal law, it is a crime to engage in a broad range of financial and monetary transactions involving the proceeds of a "specified unlawful activity"—including cannabis-related violations of the Controlled Substances Act.[8] The rationale for such broad anti-money-laundering laws is plain: They are designed to make the proceeds of a crime worthless and subject such funds to confiscation from those who knowingly receive them. Indeed, the legislative history states that the goal of the law is "to make the drug dealers' money worthless," and it goes on to observe: "You have outstanding businesspeople, who are otherwise totally moral, who are accepting these funds and profiting greatly from drug trafficking that is going on throughout this country, and this will put a stop to it."[9] By receiving premiums from cannabis businesses that are violating the Controlled Substances Act, insurance companies technically are in violation of various federal anti-money-laundering laws—and face a risk of prosecution by the Department of Justice and confiscation of premiums received, as well as criminal fines and penalties, including jail time.

Historically, federal prosecutors and courts have interpreted and enforced drug laws broadly, especially in the context of the crack cocaine epidemic of the 1980s and 1990s. The public's and government's tolerance of marijuana use today, however, is quite different from attitudes toward crack cocaine 30 years ago. Consequently, there have been significant changes in federal law enforcement policy in recent years, most notably through (1) administrative action summarized in non-prosecution guidelines published by the Department of Justice in 2013 and (2) recent congressional action that generally precludes the expenditure of certain federal funds for enforcement activities in the realm of cannabis.

The Department of Justice's current enforcement policy is reflected in a memorandum from Deputy Attorney General James Cole, dated August 29, 2013, to all U.S. Attorneys, entitled Guidance Regarding Marijuana Enforcement.[10] The Cole Memo states that the Department of Justice generally will refrain from prosecuting citizens whose activities are permitted under applicable state law, so long as that state law protects federal enforcement priorities:

1. preventing the distribution of marijuana to minors;
2. preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;
3. preventing the diversion of marijuana from states where it is legal under state law in some form to other states;
4. preventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;
5. preventing violence and the use of firearms in the cultivation and distribution of marijuana;
6. preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
7. preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and
8. preventing marijuana possession or use on federal property.[11]

If state enforcement efforts are not sufficiently robust to promote the federal priorities, however, the federal government may continue to bring individual enforcement actions, including criminal prosecutions, or even seek to challenge the regulatory structure itself.[12] In the two-plus years since the Cole Memo was published, few such enforcement actions have been taken, especially outside California. Moreover, the enhanced California regulations enacted this past October[13] should make that state "Cole-compliant" once the regulations are implemented and should significantly decrease the risk of federal enforcement actions there.

The Consolidated and Further Continuing Appropriations Act of 2015[14] and the Consolidated Appropriations Act of 2016[15] provide further assurance to industry participants in that they appear to prohibit the Department of Justice's use of federally appropriated funds to enforce federal law under certain circumstances, including in the medical marijuana field, where such activity is permitted under state law. Specifically, the Consolidated Appropriations Act of 2016 restricts the Department of Justice from using funds to prevent certain states from legalizing cannabis:

> None of the funds made available in this Act to the Department of Justice may be used, with respect to any of the States of Alabama, Alaska, Arizona, California, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Illinois, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, Washington, Wisconsin, and Wyoming, or with respect to the District of Columbia, Guam, or Puerto Rico, to prevent any of them from implementing their own laws that authorize the use, distribution, possession, or cultivation of medical marijuana.[16]

Taken individually or together, the Cole Memo and the appropriations acts have given cannabis businesses, their vendors, and their suppliers a large degree of comfort that, despite their violation of federal drug and money laundering laws, they will not be subject to prosecution, confiscation, fines, or penalties so long as such businesses operate in a state whose regulations protect the federal enforcement priorities and so long as they operate in compliance with such regulations.

That comfort, however, is not absolute. Due in part to the fact that marijuana continues to be illegal under federal law, many commercial insurance and reinsurance companies have been unwilling to sell insurance to cannabis businesses. Indeed, in a notorious about-face last May, a memorandum was issued by the director of performance management at Lloyd’s of London, declaring that

> unless and until the sale of either medicinal or recreational marijuana is formally recognized by the Federal government as legal (as opposed to subject to non-enforcement directives), syndicates at Lloyd’s should not insure such operations in any form (including crop, property, or liability cover for those who grow, distribute or sell any form of marijuana or the provision of banking or related services to these operations) in the United States.[17]

Despite the reluctance of some insurance markets to sell insurance to cannabis businesses, others see this emerging industry as a significant business opportunity and have established a fairly robust marketplace serving those businesses’ insurance needs. That said, market observers have noted that pricing for most insurance products sold to cannabis businesses is notably higher than sold to traditional enterprises.[18] Given the risk of federal prosecution faced by the insurance companies themselves, this price bump can be seen as an understandable response to the gross risk taken on in connection with cannabis accounts. But given the heightened scrutiny of the industry, and the resulting implementation of careful business practices and tight operational controls that most cannabis businesses adopt, there is good reason to believe that the loss ratios on these risks are actually quite low—and that the business is extremely profitable for the insurance companies that have entered into the market early.

The Appeal of Captive Insurance to Cannabis Businesses

A captive insurance company is an entity formed primarily to insure or reinsure the risks of the corporate parent, one or more other related entities, or even unrelated entities. Captive insurance companies insure the same risks that are covered by commercial insurance companies and often provide specialized coverage that can be hard to obtain in the retail insurance market—all tailored to the risk/potential loss profile of its affiliated policyholders.

Instead of paying premiums to a commercial insurance company, a policyholder with a captive pays its premiums to the captive insurance subsidiary, thereby retaining a degree of control over the investment of the premiums—subject to regulatory requirements—as well as the benefit of surpluses and profits, should the policyholder’s loss experience be favorable. Simply put, so long as the captive’s underwriting is sound and the loss experience acceptable, the captive retains the investment income and profits that otherwise are retained by the commercial insurance company. Of course, the risk of large losses also resides with the captive, but that risk generally can be managed or eliminated by ceding some or all of the risk to reinsurance companies either domestically or abroad. Because the cost of reinsurance generally is much less than the cost retail insurance, captives are seen as an effective way to access “wholesale” insurance markets that are not admitted to sell direct insurance in the United States.

With good underwriting and management, captive insurance companies can be very profitable and advantageous for their parent company, so much so that some even expand to the point that they begin selling insurance policies to non-affiliated entities. Today, there are nearly 6,000 captive insurance companies around the world. Vermont is the largest U.S. domicile—with over 1,000 captives—while Bermuda and the Cayman Islands remain the most common domiciles worldwide.

Although a captive insurance company often provides tax advantages for the parent company, the premise for the captive must be non-tax, such that the genesis of captive planning must be a legitimate business need other than tax savings. The benefits offered by a captive insurance arrangement include the following:

- There may be certain types of coverage desired by a parent or affiliated group that are either too expensive or unattainable in the commercial insurance market, and a captive often can fill that void. A captive even has the potential to develop new, advantageous insurance policy forms to cover novel risks in emerging markets that commercial insurance companies may not yet be comfortable with.
- The very existence of a captive can give a parent company negotiation leverage with the commercial insurance market because it shows the market that the parent (and affiliates) have expertise in the operation of an insurance company and the way coverage can be expanded, altered, or developed to fit the policyholder's insurance needs and that the parent has reliable insurance providers outside the retail insurance market.
- A captive insurance company can use market-based premium quotes to set rates on an "arm's length" basis for its policyholder parent. As a general rule, this means that a captive can accrue for loss expectancy for uncertain or unknown liabilities on a similar basis as a commercial insurance company even though captives typically are able to provide insurance services to a parent at lower cost. The additional surplus can be invested or otherwise put to use consistent with insurance company practice.
- Captives allow their parent companies to respond quickly to changes in the commercial insurance market. Whether the market firms up or softens, a parent company with a captive can respond to market conditions by having the capability to fund higher retention levels when necessary or advantageous.
- A captive's existence can create heightened loss potential awareness in an organization and can help create a more efficient loss prevention program among members of the captive's insured group.
- Finally, it is well known that captives offer a superb management tool for high-frequency, low-severity risks.

Given current market conditions, these benefits may be particularly well suited to cannabis businesses. For example, the limited number of commercial insurance companies competing for cannabis industry business apparently is yielding unusually high premium rates for most risks. Other risks are very difficult to insure in the commercial insurance market at any price. Captive insurance is a time-tested strategy for responding to such conditions and may be useful for certain cannabis businesses, depending on their risk profile and premium volume.

Captives also ought to be relatively unaffected by the risk of prosecution under federal drug or money laundering laws. Whereas concerns about such prosecution might prevent some commercial insurance companies from entering the market, cannabis businesses have already committed to the risk of prosecution. Thus, where insurance is arranged through a captive, there is no greater risk of prosecution than there was for the policyholder parent in the first place, and that risk generally will be of limited concern to the captive and should not be a barrier to entry into the insurance marketplace.

While a captive can provide the solution to many risk management problems, companies should realize that they are forming an entity that will operate as an insurance company and that will be regulated as one. Furthermore, the point of a captive is to finance risks and, it is hoped, to do so at reduced cost. Tax savings should not be the primary motive for creating a captive but certainly can be an important incidental benefit of doing so.

Prior to the implementation of a captive program, contact should be made with the regulators in the proposed domicile. It also is essential that a detailed feasibility study and business plan specifically tailored to the particular captive arrangement be prepared, in order to ensure that a captive proposal makes basic business sense for the corporate parent or group.

Conclusion

As savvy insurance purchasers in many other industries have found, the inclusion of a captive as part of a company's risk management program can have significant benefits. Current market conditions make this especially true for many cannabis businesses. As a result, many of the larger players in the cannabis industry are likely to consider the benefits that a captive can provide for them as well.

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[2] *See* Wash. Admin. Code § 314-55-082(1). The Washington regulations even require that the

Washington Liquor and Cannabis Board be added as an additional insured under the business's insurance policies. *See* Wash. Admin. Code § 314-55-082(3).

[3] 21 U.S.C. § 841.

[4] 21 U.S.C. § 812.

[5] *See Gonzales v. Raich*, 545 U.S. 1 (2005).

[6] *See* 18 U.S.C. §§ 2, 846.

[7] 18 U.S.C. § 2.

[8] *See* 18 U.S.C. §§ 1956–1957.

[9] H.R. Rep. No. 855, 99th Cong., 2d Sess., at 13–14 (1986).

[10] Memorandum from James M. Cole, Deputy Att'y Gen., U.S. Dep't of Justice, Guidance Regarding Marijuana Enforcement (Aug. 29, 2013)

[11] *See* Cole Memo, *supra* note 10, at 1–2.

[12] *See* Cole Memo, *supra* note 10, at 3.

[13] *See* Cal. Assem. B. 266; Cal. Assem. B. 243; Cal. S.B. 643.

[14] Consolidated and Further Continuing Appropriations Act, 2015, H.R. 83, § 538 (Dec. 16, 2014).

[15] *See* Consolidated Appropriations Act, 2016, H.R. 2029, § 542.

[16] Consolidated Appropriations Act, 2016, H.R. 2029, § 542.

[17] *See* Memorandum from Tom Bolt, Dir., Performance Management, Lloyd's (May 29, 2015), http://insuranceforcannabis.com/lloyds/.

[18] *See* "Insurance Companies Start Noticing the Legal Cannabis Industry," Forbes, July 5, 2015.

About Anderson Kill

Anderson Kill was founded in 1969 on the principles of integrity, excellence in the practice of law, and straightforward solutions to complex legal issues. The firm's attorneys approach engagements aggressively, and have earned a reputation for combining corporate polish with pugnacity. Based in New York City, the firm also has offices in Ventura, CA, Philadelphia, PA, Stamford, CT, Washington, DC and Newark, NJ, but the attorneys travel around the country and around the world to handle all types of matters. Anderson Kill attorneys work together, leveraging creativity and legal and business acumen to deliver cost-effective resolutions to clients' problems. Many of the firm's professionals are recognized experts in their practice areas, leaders and active participants in professional associations, and are frequently invited to speak to business organizations.

Anderson Kill clients include some of the nation's largest public and private entities, including companies in financial services, retail, oil/gas, telecommunications, construction, food supply, technology, pharmaceutical and life sciences, and utilities, municipalities and state governments, religious and not-for-profit organizations, small companies and individuals. Anderson Kill prides itself on attracting and retaining intelligent, personable and well-rounded attorneys. Smart attorneys with sharp skills, excellent client service, and a track record to prove it: that is the Anderson Kill difference.

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