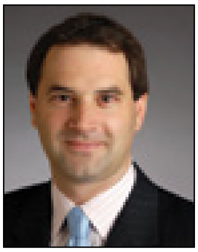
Captives could be a solution for cannabis insurance

Marijuana businesses often face higher insurance rates

By Marshall Gilinsky and Jerry S. Goldman



The complicated legal status of marijuana production and sale can make it difficult for cannabis businesses to insure certain risks. Despite the participation of several commercial insurance companies in the cannabis space, cannabis businesses are typically charged higher rates than traditional businesses for common insurance products.

The abrupt withdrawal of Lloyd's from the market in mid-2015 did not help.

The phrase "grow your own" is a longstanding tradition in cannabis culture, but it may also point toward a solution for insurance. For decades, businesses faced with higher priced or unavailable insurance have turned to captive insurance to meet their risk transfer needs.

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 for manuscripted insurance policies tailored to the parent company's needs. Captive insurance may be an appealing option for some cannabis businesses seeking better pricing and broader coverage than they can find in the commercial marketplace, including crop insurance, liability insurance, auto insurance, workers' comp, armored car insurance and other lines of insurance that a cannabis business might need.

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. A captive insurance company may insure or reinsure the risks of a corporate parent and other entities.

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, as well as surpluses and profits, if the policyholder's loss experience is favorable. As long as the captive's underwriting is sound and the loss experience acceptable, the captive retains the investment income and profits that would otherwise be retained by the commercial insurance company.

While the risk of large losses also resides with the captive, 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 is typically much less than retail insurance, captives can be 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; some even expand to the point of 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 more than 1,000 captives, while Bermuda and the Cayman Islands remain the most common domiciles worldwide.

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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:

• Certain types of coverage are either too expensive or unattainable in the commercial insurance market, and a captive can often 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 be comfortable with.

• The very existence of a captive can give a parent company negotiation leverage with the commercial insurance market.

• A captive can use market-based premium quotes to set rates on an "arm's length" basis for its policyholder-parent. Generally, 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 are typically able to provide insurance services at a lower cost.

• 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 funding higher retention levels when necessary or advantageous.

• A captive can create heightened loss potential awareness in an organization and can help develop more efficient loss prevention program.

• Finally, captives offer a superb man-

THE USE OF A CAPTIVE DOES NOT INCREASE THE POLICYHOLDER PARENT'S RISK OF PROSECUTION

agement tool for high-frequency, low-severity risks.

Given current market conditions, these benefits may be particularly well-suited to the marijuana industry. The limited number of commercial insurance companies competing for cannabis businesses is apparently 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.

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. The use of a captive, therefore, does not increase the policyholder-parent's risk of prosecution.

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 therefore will be regulated as one. Prior to the implementation of a captive program, a company or consortium should contact the regulators in the proposed domicile. It is also essential to prepare a detailed feasibility study and business plan specifically tailored to the particular captive arrangement, in order to ensure that a captive proposal makes sense for the corporate parent or group.

Businesses in many industries have found that integrating a captive into their risk management program can have significant benefits. Current market conditions make this especially true for the cannabis industry and, as a result, many of the larger players are likely to consider the benefits that a captive can provide for them.

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