New Dawn Risk

Understanding and opening up the US cannabis insurance market

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"In 2018 the US market saw an estimated $8 billion in legalized cannabis sales. This could rise to over $40 billion by 2025."

"In 2018 sales of medical and recreational cannabis in the U.S. were nearly nine times higher than Oreo cookies."

"The legal US cannabis industry would pay about $1 billion in annual premiums were it insured to levels normal for other businesses."

"Six in 10 Americans say the use of cannabis should be legalized."

"An estimated 70 percent of cannabis businesses have no relationship with a financial institution and thus use cash for all transactions, including salaries for employees."

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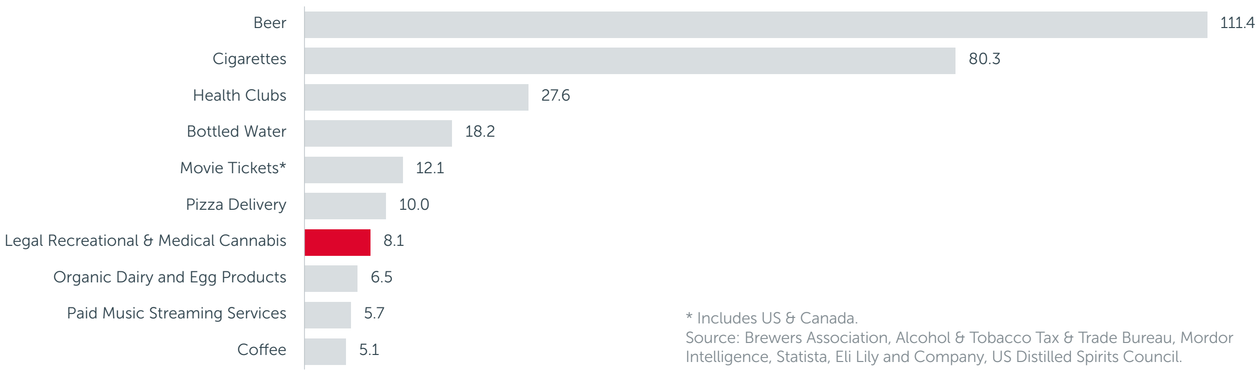
1. INTRODUCTION

Over the past seven years, the US legal marijuana market has expanded from zero to over $10.4 billion in 2018 with 250,000 jobs devoted to the handling of plants, according to New Frontier Data. Hundreds of thousands of businesses have been set up to service the industry. In Oregon alone there are 16,600 registered growers who are producing at 13,959 grow sites. This does not take account of the companies who retail the products, or who supply services such as packaging, processing, payroll and transport. To put this into perspective, more is spent annually in the legal marijuana market than on Netflix!

ANNUAL MARIJUANA SALES VS. OTHER INDUSTRIES, 2017
($ billions)



* Includes US & Canada.
Source: Brewers Association, Alcohol & Tobacco Tax & Trade Bureau, Mordor Intelligence, Statista, Eli Lily and Company, US Distilled Spirits Council.

As our report shows however, there are three critical factors when it comes to considering US cannabis. First, the industry is going to grow at pace, bringing significant opportunities. Second, there is an as yet unmet demand for insurance across a number of classes at every stage of the of the cannabis production and distribution process. And third, most significantly from the perspective of re/insurers, are the differences in regulation at federal and state level that will take years to be resolved. While cannabis is legal in a number of US states it remains illegal at a federal level. As a result, fear of government sanctions is causing reticence among insurers to get involved.

However, the insurance community – brokers, risk managers and underwriters alike – typically thrive on finding solutions to challenging problems. We have already seen evidence of this. In 2019 the US National Cannabis Risk Management Association (NCRMA) announced that it was setting up a member-owned insurance company to help it manage and transfer its risks.

Garnet Casualty Insurance Corporation (Garnet) will be fully owned by NCRMA policy-holding members and will operate separately from the association. It will employ a single managing general underwriter (MGU) and multiple managing general agents (MGAs) to service the membership. Appointed brokers, who have been vetted and approved by the NCRMA and Garnet, will work directly with the MGAs to deliver solutions.

We also believe that another solution could be for cannabis businesses to consider establishing self-funded captives domiciled in countries with more understanding regulatory regimes, to build up capital that is set aside to pay for losses as they arise. But this too would pose questions. Would a captive solution only work for single businesses or could a group of companies work together? How would a captive get reinsurance when appetite is severely restricted? And if an insurer is required to set up, run and manage the captive are they not restricted by the same rules as if they were underwriting cannabis themselves?

New Dawn Risk is committed to working with carriers and clients to share knowledge and insights and to help identify and deliver creative solutions. In just one example, we have already successfully placed cyber cover for a number of cannabis businesses. But we want to do more, especially in these uncertain times. The current global crisis has led to increased demand for cannabis in the US, but it will also make it tougher for producers to obtain insurance as providers further tighten terms and conditions and introduce exclusions, while insurers who may have been looking to enter the marker will put their plans on hold.

While we wait to see how the cannabis industry weathers the stresses of COVID-19, it is vital that we maintain the discussion around how best to prepare it for the future. Please do get in touch to find out how we can work together to tackle the challenges, deliver solutions and expand coverage in this exciting and fast-growing sector.

Max Carter
CEO, New Dawn Risk

2. SIZING THE PRIZE: HOW BIG COULD THE MARKET GET?

The first opening of the door to this huge industry came via the legalisation of medical marijuana in California in 1998. In a medical marijuana facility, cannabis can be obtained under strict dispensing regulations at carefully screened locations, with variances in the exact nature of the restrictions state by state.

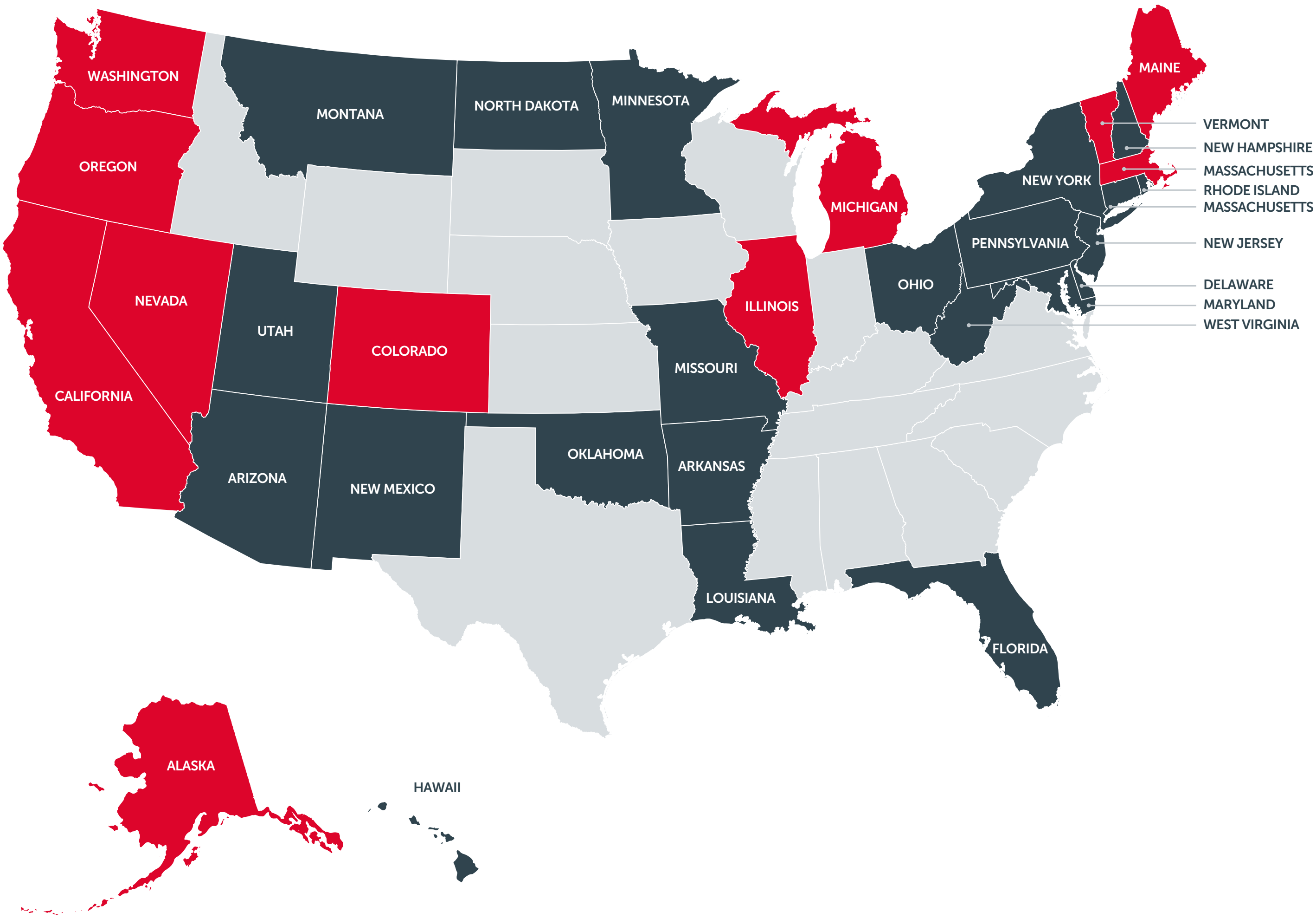
Following the success of this initiative, in 2012, Colorado and Washington became the first states to legalize recreational use of cannabis. Both instituted regimes that regulated cannabis in a way which is similar to alcohol, allowing possession of up to an ounce for adults ages 21 and older. Both allowed for commercial cultivation and sales, subject to regulation and taxes.

By March 2020, a total of eleven states in the US had taken steps to legalise the recreational use of cannabis and a further 21 had legalised the use of medical marijuana (see map below).

"32 US states have legalized cannabis for medical or recreational use."

STATES WHERE MARIJUANA IS LEGAL

Legalized recreational and medical marijuana   Legalized medical marijuana



HEMP: A GROWTH CROP

Hemp is a variant of the cannabis plant and, if grown correctly, can be legally be farmed following the 2018 Farm Bill which removed it from the Controlled Substances Act. It must be harvested with less than 0.03% (THC) content, meaning that it does not have mood-altering properties.

Hemp is often farmed in order to make CBD oil – thought to ease the symptoms of diseases such as epilepsy; but it is a versatile plant (hemp was used for many materials in the 19th century, including sails for ships) , and farmers use hemp crops to produce commercial fabrics, textiles, paper, construction and insulation materials, cosmetic products, animal feed, food, and beverages. Hemp is rapidly becoming an insurable crop, as its legal status becomes clearer and Brightfield Group says the hemp CBD market can reach as much as $22 billion by 2022.

THE CANNABIS DOTCOM BOOM

The multiple uses and growing market for hemp, cannabis and cannabis-related products, such as CBD, has created an investor boom across the USA and Canada. Investors have poured money into the sector and marijuana companies raised $13.8 billion in funding in 2018, according to cannabis industry research firm Viridian Capital Advisors. This was four times the amount raised in 2017.

LEGAL AT A STATE LEVEL, BUT ILLEGAL UNDER FEDERAL LAWS

The but, and it is a big one, is that, while many states have legalised the drug, cannabis remains illegal under US federal laws as a Schedule 1 drug. As a result, no part of any marijuana-related business can cross state lines, even if it is between two states that share a border and have both legalised recreational cannabis use.

Furthermore, marijuana companies cannot access any suppliers outside their states, as the payments to these companies would violate money-laundering laws. This means that virtually all insurance for cannabis-related businesses is supplied at a local level by smaller state-based insurers. Covers are limited and products are basic, while conversely premiums are high. Cannabis firms, as a result, tend to buy only the cover that they are forced to have under law (eg workers' compensation insurance).

Companies that invest in cannabis producers have different and other specific issues, given the rapidity of the industry's growth, the proximity of highly active black markets alongside the legal market, and the fact that most of the expertise in the industry comes from a historic counter-culture of illegality. The risks for those who sit on their boards, supply management, accounting and financial services are high (see case study right).

However, because cannabis business transactions violate federal laws, most existing professional liability and D&O insurance would be technically invalid, which makes it hard for accountants and other firms to deal with cannabis businesses. There is a clear need for the provision of a specific professional liability or D&O insurance wording that gives affirmative cover. This would mean that proper professional accounting, legal and other professional services could be supplied by known third parties, helping to raise business standards and improve the reputation of this large part of the US economy.

CASE STUDY

Folium Biosciences and Australis

A TALE OF UNREGULATED CORPORATE MISMANAGEMENT

The US SEC and Canadian CSE are both currently looking into multiple management and product failures at two linked companies, Folium Biosciences and Australis, with lawsuits filed additionally by both investors and former employees.

The issues investigated include an astonishingly wide range of legal problems and lift the lid on exactly how poor the management culture can be in early-stage cannabis companies.

Issues being investigated (in early 2020) include:

- Unexplained payments to family members from company accounts
- Product contamination through the use of hemp sprayed with unauthorised metal pesticides
- Questionable press releases about possibly non-existent new products issued in order to drive up the Australis stock price before a planned merger between Folium and Australis
- Unequally allocated investor payouts that did not match equity values or agreed remuneration.

The full story of the investigation into Folium and Australis can be read here.

"While many states have legalised cannabis, it remains illegal under US federal laws as a Schedule 1 drug."

3. THE LAWS AND RULINGS THAT IMPACT CANNABIS COVER

Those directly and tangentially involved in the cannabis industry need insurance that addresses the specific needs of young companies and a high-risk, rapidly evolving market. But many carriers are reluctant to get involved because of the conflicting state and federal laws. They also lack data for claims information, and the lack of transparency across states means that it is almost impossible to collect any such information, or apply it at a national level.

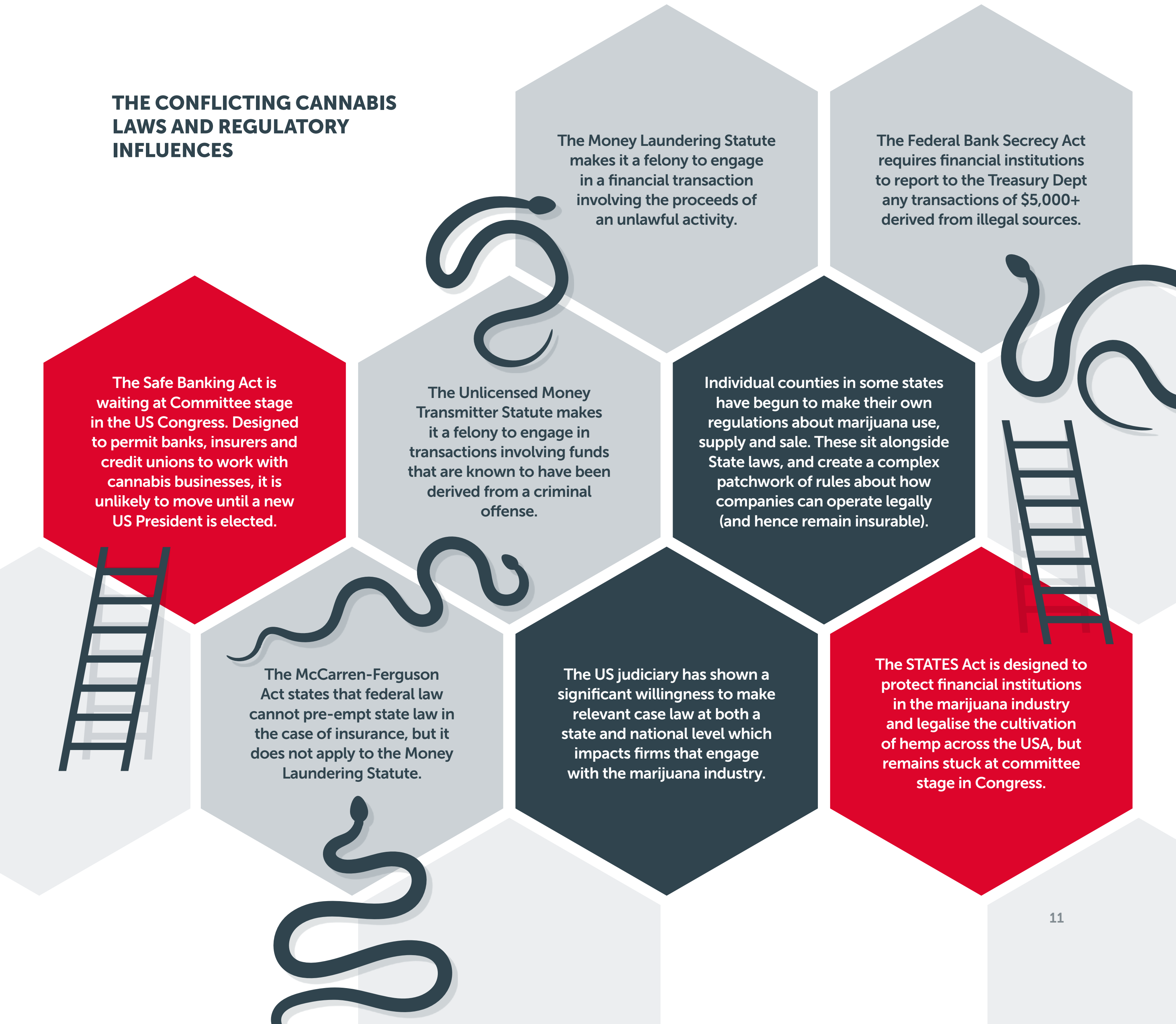
Overall, the sector faces strong headwinds that could stifle growth. Though the US government has taken no action against insurers that serve the cannabis industry, there have been active moves against banks that have served cannabis firms, and experts say insurance carriers are unlikely to jump into the market until marijuana is decriminalised at the federal level and banking regulations change.

The likelihood of any legislation being passed that could protect financial services firms in this market was already low in early 2020, due to the upcoming US election. Subsequently the economic and political shocks of the COVID-19 pandemic have now further reduced the possibility that legislative time and attention will be allocated to the legalisation of cannabis at any time in the near future.

The legalisation of cannabis in some states has created a highly complex legal picture, and one which changes rapidly. The graphic below shows the significant laws and factors which insurers must take into account when considering whether to insure firms in the cannabis supply chain.

"The legalisation of cannabis has created a highly complex and rapidly changing legal picture."

THE CONFLICTING CANNABIS LAWS AND REGULATORY INFLUENCES



4. PERSPECTIVES FROM BUYERS

"Lack of insurance for the industry adds layers of unnecessary risk and exposure for all market participants."

NAIC report, "Understanding the cannabis marketplace" [1]

Cannabis cultivation has had something of a gold-rush air about it for the last few years. Thousands of firms have set up to grow, process, test or distribute cannabis-based products. However, legitimacy has brought about a need to put in place normal business processes and protections. States such as California and Massachusetts now require proof of insurance, such as a general liability policy, for cannabis business applicants seeking licensure from state and local jurisdictions.

But buyers find that their insurance premium costs are inflated because of the nature of their business. A Californian cannabis farmer interviewed for this study reported that he knew of only two insurers who would provide the general liability policy that is required for any firm to legally operate in California. As a result, he is forced to pay the price that is offered, as a penalty for doing business in that state.

"Buyers find that their insurance premium costs are inflated because of the nature of their business."

The farmer's business would also like to buy crop insurance, having suffered a $70,000 flood loss in the last two years, which was uninsured. However, at present he cannot find an insurer who will provide the cover.

INSURERS ARE HARD TO FIND

Because of federal laws, insurers and brokers do not advertise their services as being accessible to cannabis-related businesses, and this means that insurance (along with banking services) is mainly sourced by word of mouth through local communities. Some brokers are beginning to attend industry conferences, but overall, for buyers, access is limited and also subject to regular change. Many cannabis businesses will need to pay annual premiums in cash, and any serving brokers or insurers need to be prepared for this, which requires a radically new approach to security and banking. This further limits the opportunities for buyers.

"Insurance markets such as Lloyd's have shied away from cannabis-related cover, and only a few firms are willing to consider underwriting such risks."

Smaller cannabis insurance buyers are conditioned to believe that they can only use in-state providers, and do not tend to look outside their home state for insurance support, on the basis that buying out of their home state will violate federal laws.

To a large extent this is true – insurance markets such as Lloyd's have shied away from cannabis-related cover, and only a few firms are willing to consider underwriting such risks. It is also challenging for offshore players, such as Bermudans, to reach into the medium to small-size market. It is here that the role of the broker could become key, uniting local markets to international underwriting capital to provide critical services to both.

Larger firms understand the wider picture of international insurance markets, but still struggle with higher costs and availability. Kyle Kazan, chief executive of Glass House Group, which is one of the largest cannabis companies in the US, says that his cultivation facilities in California pay double the insurance premiums required for his non-cannabis farms (Source FT.com). He found it an ongoing challenge to find insurers who understand the industry. "You don't want your local State Farm agent doing this," he said – recognising the complexity of the purchases that he needs to make.

PERSPECTIVES FROM THE SECOND TIER OF BUYERS

One further group of buyers to consider are the investors, advisors and suppliers of professional services to cannabis businesses. Accountants, lawyers, venture capitalists and angel investors are all vulnerable to the accusation that they are violating the Money Laundering Regulations by taking payments from cannabis industry clients; and as it stands, doing so will invalidate many of their professional liability and D&O covers. There is a significant demand for policy wordings that will protect this group of secondary suppliers. A recognised protective umbrella would be likely to go a long way to opening up the market and allowing many of these businesses to begin to do legitimate business with the cannabis industry, without their management team fearing punitive litigation as a result.

"As it stands investors, advisors and suppliers of professional services will invalidate many of their professional liability and D&O covers by taking payments from cannabis industry clients."

5. CLASSES AND CATEGORIES OF INSURANCE: THE CHALLENGES FOR CARRIERS AND BROKERS

"Nothing the cannabis world does is any different than the normal world when you think about classifications. The product is just a widget. Whether you're growing that widget, manufacturing that widget, selling that widget or testing that widget, it's just a widget. The risk is not the product; we're not insuring nuclear waste."

Mike Aberle,
Senior Vice President,
CannGen Insurance Services [2]

Cannabis represents a significant missed opportunity for the insurance industry which could issue over 100,000 policies, were insurers to sell only a single policy to each active marijuana business in the US. Neil Hitchcock, chief executive of Bermuda-based insurance broker Skyfront, recently told the Financial Times that he believed the legal US cannabis industry would pay about $1bn in annual premiums were it insured to levels normal for other businesses – with policies split across the types of business and activity shown in the table below.

"The legal US cannabis industry would pay about $1bn in annual premiums were it insured to levels normal for other businesses."

Segment	
Cultivation	Business that handle marijuana along the supply chain, including indoor, outdoor and mixed business that cultivate, process, harvest, text, package and transport cannabis for sale and consumption
Dispensaries and retailers	Retail outlets or stores when most consumers can purchase medical or recreational marijuana product. Cash management is often vital to these businesses.
Infused products	Wide variety of products including cannabis beverages, beauty and skin care, edibles or capsules
Landlords	Business to business services such as testing labs, packaging firms, marketing, real estate owners etc.
Suppliers of business and professional services	Accountants, lawyers, medicare providers, venture capitalists, and other professional services.

ISSUES ABOUND

There are currently only six large insurers offering cannabis cover and currently most insurers who are entering the market are offering a core set of policies that usually consist of the following:

- Commercial and general liability with limits of $1m per occurrence / $2m aggregate
- Property damage, with limits of $1m per occurrence / $2m aggregate
- Product liability, with limits of $1m per occurrence / $2m aggregate

One issue is that although legal side products such as CBD oil and hemp should be straightforward to cover under typical policies, there is still a reluctance from some insurers to provide cover for these products too. Aside from a lingering sense of 'guilt by association', CBD oil does have some similarities to pharmaceuticals, with similar large-scale exposures possible from claims arising from CBD producers claiming users can use their products to treat the side effects of cancer treatment for example.

Overall insurers looking at the cannabis and hemp markets struggle with a number of specific issues that make it hard for them to price and administer policies. Some of the wider legal issues that deter insurers from entering the market have been covered already in this report, but other problems are specific to underwriters and the provisions of the actual policies.

The biggest risk the cannabis industry faces is uncertainty. Not only is there uncertainty around regulation, but there also is uncertainty around the nature of the lawsuits that could arise. There has already been a high level of white-collar crime among companies raising money to invest in the space from the VC community, with several lawsuits directed from investors at cannabis company officers and directors. [3] In addition, there is a growing body of complaint about the verified strength and varied mixes of different CBD oils, some of which are designed to target different illnesses, such as epilepsy or asthma. Medical malpractice and misrepresentation claims both seem likely as the industry becomes more mainstream.

"The biggest risk the cannabis industry faces is uncertainty. Not only around regulation, but around the nature of the lawsuits that could arise."

The second big problem is data. Insurers need greater access to quality statistics on actual losses. Both personal and commercial lines insurers need to study early claims (frequency and severity) in states where marijuana has been legalised to help determine their risk appetite. However, the 'word of mouth' nature of the business, the state-by-state fragmentation, and the rapidity of changes make it almost impossible for insurers to access any kind of reliable data on the specific risks that exist within this industry.

One of the most glaring issues for all parties is the low policy limits across all areas, including cyber. As firms grow, more and more of insureds need limits up to $5 million or $10 million, if not more, while many carriers are currently uncomfortable extending high limits right now. As an emerging market, most insurers believe that their risk in these businesses is best managed by keeping low limits on policies to cap the risk.

"One of the most glaring issues for all parties is the low policy limits across all areas."

Meanwhile, there are also individual issues that impact certain types of coverage. The US National Association of Insurance Commissioners has set up a working group on cannabis, which has identified the most important insurance needs for the industry. Below is a short summary of the individual challenges associated with each type of cover required.

D&O LIABILITY

Without doubt the lack of capacity for directors' and officers' liability within the US cannabis industry is a major challenge. In an industry where there is a significant amount of investment money being channelled into young businesses, and some high revenue forecasts, the business risks for senior officers have proved to be extensive. Malpractice has been exposed in a number of areas and, as an example, there have already been three class action lawsuits in Canada against firms accused of misleading investors by overstating likely revenue and issuing misleading forecasts. [4]

"With a significant amount of investment money being channelled into young businesses, and some high revenue forecasts, the business risks for directors and officers have proved to be extensive."

Risk also comes from employees inside the company. Many cannabis firms need to develop proper HR policies and upscale to treat employees properly. The current haphazard approaches of many firms also bring challenges around workers compensation, with many staff working against the clock.

In addition, there is a need for D&O coverage for supplementary businesses like dispensaries, testing facilities and manufacturers to protect owners from mismanagement of the product.

Alongside D&O, cyber risk is a related issue, and this is dealt with separately below.

CYBER

Because licensed cannabis businesses are required to collect customer information, they are particularly vulnerable to cyber attacks.

Dispensaries might need cyber and privacy liability coverage as they may have patient information in their records. Cannabis entities are at a higher risk of data loss than similar entities in other parts of the economy. If a buyer walks into any licensed cannabis facility, they are required to supply a state identification card, which the dispensary scan. Dispensaries also have high quality video surveillance, which is often accessible live to regulators online. This, of course, means it's also accessible to hackers. The cannabis seed-to-sale tracking systems, which are part of the track-and-trace programs the regulatory bodies use, are also accessible to regulators.

Cannabis firms are therefore at a high risk for data loss. At the same time, many do not appreciate it because, as start-ups their eye is elsewhere, with a focus on compliance and other risk management issues. Meanwhile, the insurance markets are extremely limited for cyber cover for this type of business, which is an additional incentive for firms to park cyber cover as being out of reach.

"Many cannabis firms are start-ups and therefore are focusing on compliance and other risk management issues. But these businesses are at a high risk for data loss and they need to be aware of cyber threats."

PRODUCT LIABILITY

Product liability insurance is something that the larger cannabis businesses all know they need to access. There is a great deal of experimentation by cannabis product suppliers in terms of the mixes and level of THC in different products, both medical and recreational.

Already product labelling and marketing are two areas generating early lawsuits. There have been claims over products that could appeal to minors or claims that product claims “purest” or “strongest”, as well as numerous examples of labels that contain incorrect information on the cannabinoid panel.

WORKERS' COMPENSATION

This is the most straightforward of any insurances for the cannabis industry. It is a requirement in many states for businesses to have employers' liability insurance before they can legally operate. As a result, numerous small brokers have begun to supply this at a state level. Although prices are high, and choice of insurer is limited, companies can source the cover, and it is, currently, the least challenging of all the covers to get hold of.

CASH AND CONTENTS INSURANCE FOR PREMISES

While cannabis farms, manufacturers and dispensaries may be at high risk for theft because they carry a lot of cash and valuable products, they almost all have extensive security in place. State regulators have been very prescriptive in their requirements for cannabis businesses, down to the pixellation of surveillance cameras and the fire ratings of safes and vaults.

In this area there have been some attempts to find unique solutions, with one cannabis bank which wanted to insure its cash looking at buying a bankers blanket bond for vault risk and crime.

CROP INSURANCE

Crop insurance is difficult to find, and many cannabis farmers assume they will not be able to get it, so don't bother to look. However, losses can be large, especially in a state that has, in recent years, seen large numbers of wildfires, mudslides and earthquake activity. The value of the crop also causes a challenging gap between cover requirements and availability, particularly for larger farmers. Put simply, in a business where a one-acre crop can have a value of $3m, many crop insurances do not have high enough limits.

"In a business where a one-acre crop can have a value of $3m, many crop insurances do not have high enough limits."

FLEET AUTO AND CARGO

Some of the larger cannabis farms and distributors have reported significant challenges finding fleet auto cover and cargo insurance. For fleet auto, it seems the challenge is an assumption by insurers that drivers might be likely to partake of the crop they work with, and hence become a higher accident risk.

For cargo, the issues are different, and centre around the high value of the crops that are being transported, and the temptations for hijack and theft. Cannabis crops cannot cross state lines legally, as this would also invalidate the cargo insurance.

A linked issue is the need for cannabis businesses to transport large amounts of cash on a regular basis, which can create a unique cash-theft / hijack risk, which is hard to quantify for insurers. On the one hand, many cannabis businesses use state trooper patrols and have high security in place, simply because of their levels of cash on the premises. On the other, there is a clear risk, and little data in place to disprove the theory that it is vulnerable to theft.

CONCLUSION

In conclusion, the insurance requirements for cannabis, hemp and CBD farming, production and sales are large and complex. It must be acknowledged that the market will take some time to unknit and solve each individual issue for each line of cover required. The challenge, however, needs to be addressed, because the industry opportunity is large and the needs are real. Insurers and brokers will have to work together, but the results can bring real benefits to a new part of the economy, as well as providing an engaging new opportunity for those who provide cover.

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