

## E/Insuring the Marijuana Industry

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Peter Bernstein argues persuasively that our ability to calculate risk and plan accordingly is one of the hallmarks of the modern era.<sup>1</sup> It is inconceivable that a business venture of even moderate size could succeed without employing risk management strategies. This symposium considers many facets of the nascent industry of state-legal marijuana cultivation and sale. My article begins with the premise that the marijuana industry must manage a variety of risks in order to thrive as a commercial undertaking, and then focuses on the availability of effective commercial insurance as an important risk management tool. My thesis is that the marijuana industry can ensure its success only if it is able to insure itself effectively against risks.

Sophisticated businesses generally rely on a number of mutually reinforcing risk management techniques.<sup>2</sup> Some techniques are proactive; others are reactive. Consider an agricultural enterprise that intends to cultivate 10 acres of marijuana in a state that has legalized recreational use of marijuana.<sup>3</sup> Proactive efforts to

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1. PETER L. BERNSTEIN, *AGAINST THE GODS: THE REMARKABLE STORY OF RISK* at 1–3 (John Wiley & Sons, Inc., 1996). Bernstein explains:

The revolutionary idea that defines the boundary between modern times and the past is the mastery of risk: the notion that the future is more than a whim of the gods and that men and women are not passive before nature. Until human beings discovered a way across that boundary, the future was a mirror of the past or the murky domain of oracles and soothsayers who held a monopoly over knowledge of anticipated events.

This book tells the story of a group of thinkers whose remarkable vision revealed how to put the future at the serve of the present. By showing the world how to understand risk, measure it, and weigh its consequences, they converted risk-taking into one of the prime catalysts that drives modern Western society.

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The capacity to manage risk, and with it to take risk and make forward-looking choices, are key elements of the energy that drives the economic system forward.

*Id.* at 1-3.

2. Andrew Blackman, *Effective Risk Management Strategies*, ENVATO TUTS+ (Jan. 5, 2015), <https://business.tutsplus.com/tutorials/effective-risk-management-strategies--cms-22887> (on file with *The University of the Pacific Law Review*).

3. The potential value of marijuana as a commercial product has been estimated to be as high as \$100 billion dollars. Luke Scheuer, *The “Legal” Marijuana Industry’s Challenge for Business Entity Law*, 6 WM. & MARY BUS. L. REV. 511, 529 (2015) (citing Steve Hargreaves, *Marijuana Dealers Get Slammed by Taxes*, CNN (Feb. 25, 2013, 3:17 PM), <http://money.cnn.com/2013/02/25/smallbusiness/marijuana-tax/index.html>, [archived at <http://perma.cc/7GDB-U4L6>] (on file with *The University of the Pacific Law Review*)). The hypothetical in the text may seem like small potatoes, but if one is willing to put faith in calculations published by “theweedbusiness.com” seven years ago, marijuana plants can produce \$1.625 million per acre of retail value (\$325/ounce) product. <http://theweedbusiness.com/mass-producing-marijuana/> (May 11, 2010). Our hypothetical ten-acre farm would require sophisticated risk management to protect the \$16 million in product retail value that it will generate each year. Of course, with legalization there will be much more intense competition, and the price of marijuana already is plunging. In response, growers will need to cut their

minimize risk include strategies such as carefully screening employees to ensure they are skilled at their jobs and that they are honest and will not abscond with the harvest.<sup>4</sup> Proactive efforts to reduce the severity of the loss include strategies such as building an irrigation system that can be used in case of drought, and entering contracts with future buyers to fix the sales price in case there is a depressed market at the time of harvest.<sup>5</sup> Reactive efforts to reduce the severity of a loss include actions such as using pesticides to address an unexpected beetle infestation,<sup>6</sup> using cash reserves to deal with unforeseen costs or losses,<sup>7</sup> and purchasing insurance to provide compensation for certain contingent events.<sup>8</sup> Although this article will focus on the purchase of commercial insurance products, it is important to remember that the marijuana industry has recourse to other risk management techniques to lessen the risk of, and severity of, various losses.<sup>9</sup>

It is commonplace to say that insurance plays a vital role in the modern economy.<sup>10</sup> In this article I consider potential difficulties that the marijuana industry will face as it attempts to use commercial insurance products, regularly

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production costs to maintain the healthy profit margins. See Jack Kaskey, *As Pot Prices Plunge, Growers Scramble to Cut Their Costs*, BLOOMBERG (Jan. 17, 2017, 2:00 AM PST), [https://www.bloomberg.com/news/articles/2017-01-17/as-pot-prices-plunge-growers-scramble-to-cut-production-costs?ex\\_cid=SigDig](https://www.bloomberg.com/news/articles/2017-01-17/as-pot-prices-plunge-growers-scramble-to-cut-production-costs?ex_cid=SigDig) (on file with *The University of the Pacific Law Review*).

4. See William F. Hauswirth, *Risk Management and Background Checks—When It Comes To Your Business, You Cannot Afford To Take Chances*, INTELLICORP (Apr. 1, 2009), <https://www.intellicorp.net/marketing/RiskManagement1.aspx> (on file with *The University of the Pacific Law Review*).

5. David Kahan, *Managing Risk in Farming*, FOOD AND AGRICULTURE ORGANIZATION OF THE UNITED NATIONS at 32 (2008), available at: <http://www.fao.org/uploads/media/3-ManagingRiskInternLores.pdf> (on file with *The University of the Pacific Law Review*).

6. *Id.*

7. *Id.* at 20.

8. *Id.* at 68.

9. See Josh Harkinson, *The Secret of El Chapo's Success: Diversification*, MOTHER JONES (Jan. 12, 2016, 11:00 AM), <http://www.motherjones.com/politics/2016/01/el-chapo-marijuana-sinaloa-cartel/> (on file with *The University of the Pacific Law Review*) (examining the efforts of one of the largest Mexican syndicates to protect its revenue stream through diversification as marijuana production in the United States grew). Indeed, when marijuana was illegal for all purposes the business entities involved in its production and distribution used a wide variety of risk management techniques that did not, and could not, include commercial insurance products. For example, one of the key business strategies to avoid risk is to diversify the scope of one's business activities. As marijuana production in the United States grew, one of the largest Mexican syndicates sought to protect its revenue stream through diversification. *Id.*

10. Robert H. Jerry, *What is Insurance?*, 1 NEW APPLEMAN ON INS. L., LIB. ED. §1.02 (Jeffrey E. Thomas and Francis J. Mootz III Eds., LexisNexis 2009) (“By any measure, at the beginning of the Twenty-first Century, the insurance industry is one of the most important industries in this country and, indeed, the world.”); 1 STEMPER, LAW OF INSURANCE CONTRACT DISPUTES §3.15[d] (2d Ed., 1999; Supp. 2004) (“[A] major rationale for commercial insurance is to facilitate economic activity and growth by providing risk management protection for economic actors. . . .”). Courts essentially take judicial notice of this fact. See, e.g., *Pilington North America, Inc. v. Travelers Cas. & Surety Co.*, 861 N.E. 2d 121, 135 (Ohio 2006) (Pfeiffer, J., concurring in part and dissenting in part) (“[T]he insurer’s role in providing coverage for former wrongs is a very important one for long-term economic activity. The predictability of liability coverage is essential for businesses to move forward.” (quoting STEMPER, *supra* note 10)); *Silver v. Garcia*, 760 F.2d 33, 36 (1st Cir. 1985) (“There can be no doubt that insurance and occupations in the insurance industry are important to the national economy.”).

used by other businesses, to minimize its risks. Generic insurance products suitable for many businesses are not well suited to the emergence of a legal marijuana industry, given the legacy of many decades of federal and state prohibitions and the current situation in which the business remains illegal under federal law. Surplus lines insurers have emerged to fill the need of the new industry by providing specially drafted policies and underwriting strategies to deal with the special needs of the marijuana industry.<sup>11</sup> This article traces some of the issues that will confront the marijuana industry as commercial insurance providers adjust to the unique circumstances of this business.

This article unfolds in two parts. In Part One, I sketch the historical background against which coverage issues will be determined. When marijuana cultivation and sale were illegal under both state and federal law, losses incurred were often expressly excluded by insurance policy terms and also under general public policy principles. This background sets the stage for coverage complications in an environment in which cultivation and sale are legal under state law but illegal under federal law. In Part Two, I describe how some of these complications are now playing out in insurance coverage litigation. The legacy of

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11. As Professor Jerry explains,

The *surplus lines* market is a part of the insurance market for risks that licensed companies are unwilling to insure or only willing to insure at a very high premium, or with many exclusions, or with high deductibles, or with some combination of these constraints. . . . Surplus lines insurers are not unregulated, but they are typically subjected to less regulation than licensed, admitted insurers. Surplus lines companies sell more coverage when capacity in the admitted markets is reduced, and such companies often play a niche role in markets where coverage is more difficult to obtain.

Jerry, *supra* note 10, at §1.06[8].

This pattern of evolution is a common story in insurance. Consider the situation facing businesses in the late 20th century when employment-related liabilities expanded dramatically. The typical commercial insurance products differentiated worker's compensation and certain other employment liabilities, and were not structured appropriately to address the breadth of the new risk facing businesses. First, employers sought coverage under standard commercial insurance products through creative coverage litigation, then surplus lines carriers developed stand-alone products to address employment practices liability risks (EPL), and eventually EPL was offered as an endorsement as part of a comprehensive insurance program. *See, generally*, Francis J. Mootz III, *Foreword, Symposium: Employment Practices Liability Insurance and the Changing American Workplace*, 21 W. NEW ENG. L. REV. 245 (1999); Francis J. Mootz III, *Foreword, Symposium: Insurance Coverage of Employment Disputes*, 18 W. NEW ENG. L. REV. 1 (1996). There were particularly difficult issues regarding employment discrimination liabilities that underscored the need for this evolution. *See* Francis J. Mootz III, *Insurance Coverage of Employment Discrimination Claims*, 52 U. MIAMI L. REV. 1 (1997). After years of coverage cases and the development of new products, the insurance of employment-related liabilities has become a standard feature of commercial insurance. *See*, L.D. Simmons and Lowndes C. Quinlan, *Chapter 28: Employment Practices Liability Insurance*, 4 NEW APPLEMAN ON INS. L., LIB. ED. (Jeffrey E. Thomas and Aviva Abromovsky Eds., LexisNexis 2016).

One may expect a similar evolution in the provision of effective insurance coverage of business risks related to marijuana cultivation and sale. This article addresses the inevitable bumps in the road to establishing coverage for this business. A large bump occurred in the summer of 2015 when Lloyd's, underwriter of the "vast majority of insurance policies for cannabis businesses nationwide," decided to exit the market because, in the wake of regulatory uncertainty, "it just can't properly price the risk of its potential liability." Robert McVay, *Marijuana Insurance in the Wake of Lloyd's Exit*, CANNA LAW GROUP (June 2, 2015), <http://www.cannalawblog.com/marijuana-insurance-in-the-wake-of-lloyds-exit> (on file with *The University of the Pacific Law Review*).

complete illegality, and the continuing illegality under federal law, pose the risk that insurance coverage might be an unreliable part of the risk management strategies adopted by new businesses.

## I. TRADITIONAL INSURANCE COVERAGE AND MARIJUANA

Commercial property casualty insurance is a ubiquitous product, with well-established principles regarding policy interpretation. Insuring provisions in policies are interpreted broadly in favor of coverage, and exclusions from coverage are interpreted narrowly. These principles amount to a very strong form of *contra proferentem*, recognizing that insurance policies are complex agreements and that the forms are adhesion contracts between parties who usually have substantially asymmetrical levels of knowledge, experience, and sophistication.<sup>12</sup> As a result, ordinary contract principles are applied to insurance policies in a manner that favors coverage as a matter of public policy.<sup>13</sup> As a leading scholar wryly noted, judges “in insurance cases not only make insurance law; sometimes they also make insurance.”<sup>14</sup>

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12. See generally Jeffrey E. Thomas, *Chapter 5: Insurance Policy Interpretation*, 1 NEW APPLEMAN ON INS. L., LIB. ED. (Jeffrey E. Thomas and Francis J. Mootz III Eds., LexisNexis 2009). As Professor Thomas explains, courts began to use the doctrine of reasonable expectations aggressively in a manner that appeared to go beyond a strong version of *contra proferentem*, but over time most courts have either rejected the doctrine of reasonable expectations outright or have conflated the analysis with the principle of *contra proferentem*. See *id.* at §5.05.

13. Courts generally emphasize the public policy in favor of insurance coverage in the context of cases involving mandatory insurance under automobile statutes, but application of the strong principle of *contra proferentem* evidences a more general public policy. See generally Francis J. Mootz III, *The Sounds of Silence: Waiting for Courts to Acknowledge that Public Policy Justifies Awarding Damages to Third-party Claimants When Liability Insurers Deal with Them in Bad Faith*, 2 NEV. L. J. 443, 474-75 (2002). See, e.g., *Imperial Cas. & Indem. Co. v. Chicago Housing Auth.*, 987 F.2d 459, 463 (7th Cir. 1993) (“Illinois public policy favors construing insurance policies in favor of coverage . . .”); *Nielson v. TIG Ins. Co.*, 442 F. Supp. 2d 972, 979 (D. Mont. 2006) (“... public policy and case law clearly favor insurance companies providing coverage ...”); *Lifespan/Physician Prof. Serv. Org., Inc. v. Combined Ins. Co. of America*, 345 F. Supp. 2d 214, 222 (D. R.I. 2004) (“In the case of ambiguous policy language, it is black letter law that insurance policies are interpreted against the drafter (*contra proferentem*) and in favor of the insured, in order to achieve the public policy goal of providing insurance coverage for consumers ...”); *First Alabama Bank v. First State Ins. Co., Inc.*, No. 83-G-2082-S, 1988 WL 192452, at \*21 (N.D. Ala. May 26, 1988) (The public policy of Alabama favors insurance policies affording coverage coextensive with the insured’s legal liability ...”); *State Sec. Ins. Co. v. Burgos*, 583 N.E.2d 534, 547 (Ill. 1991) (In the case of liability policies, “public policy considerations . . . dictate that a liberal construction in favor of coverage be applied as the recovery of an injured party is involved ...”); *Kennedy v. Wash. Nat. Ins. Co.*, 401 N.W.2d 842, 844 (Wis. App. 1987) (“Public policy favors finding coverage where the insurance policy terms permit it ...”); *O’Connor v. Proprietors Ins. Co.*, 696 P.2d 282, 285 (Colo. En Banc 1985) (“Public policy does not favor the forfeiture of insurance coverage based on the insured’s technical violation of the insurance policy . . .”); *State Farm Mut. Auto. Ins. Co. v. Zurich Am. Ins. Co.*, 299 A.2d 704,710 (N.J. 1973) (There is “a strong public policy of this State for liberal construction of liability insurance to effect the broadest range of protection ...”).

14. KENNETH S. ABRAHAM, *DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY* 101 (Yale University Press 1986).

For example, one court read the coverage provision broadly to protect a landlord who suffered a loss when the tenant's conversion of the property to a grow house caused mold damage.<sup>15</sup> The policy covered "vandalism," but it also specifically excluded losses caused by "mold" under a provision that begins with "wear and tear."<sup>16</sup> The carrier argued that the house was altered intentionally to establish a grow house, and therefore was not "vandalized."<sup>17</sup> Additionally, the carrier argued that the exclusion for losses caused by "mold" was unambiguous.<sup>18</sup> However, reading the policy in favor of coverage, the court held that the tenants committed vandalism by acting in disregard of the integrity of the property, and that this vandalism caused the loss, with the mold being a secondary effect.<sup>19</sup>

Against this strong policy of interpreting policies in favor of coverage, courts also hold that insurance coverage is not permitted when it violates a strong public policy. As a general principle of contract law, courts refuse to enforce contracts that have an illegal object (e.g., a murder for hire agreement) or which contravene public policy (e.g., an agreement that requires a party to act tortiously). This principle is so strong that courts generally do not even afford relief under restitution principles, leaving the parties without any judicial remedy. For example, a person who pays an illegal bribe to another clearly may not obtain specific performance of their agreement, but that person often is also precluded from recovering the illegal payment. This doctrine is deeply embedded in insurance law, as exemplified by the legislative reaction in eighteenth century England against the emergence of life insurance being used as a form of a wager on the lives of third persons.<sup>20</sup> Thus, insurance has been permitted only within

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15. *Bowers v. Farmers Ins. Ex.*, 991 P.2d 734 (Wash. App. 2000).

16. *Id.* at 737.

17. *Id.*

18. *Id.*

19. Courts often justify the application of strong *contra proferentem* with the rationale that sophisticated insurers can protect themselves by using clear and specific language to exclude undesirable risks from coverage. For example, another case arising out of property damage caused by a tenant creating an illegal grow house had a far more explicit exclusion for "damage caused directly or indirectly by . . . [d]ishonest or criminal acts by anyone to whom [D entrusts] the property for any purpose." *United Specialty Ins. Co. v. Barry Inn Realty, Inc.*, 130 F. Supp. 3d 834, 837 (S.D.N.Y. 2015). The court granted summary to the insurer on the ground that the landlord "entrusted" the property to the lessee, whose illegal activities caused damage, and therefore no coverage was available. In this case the exclusion unambiguously shifted the risk of losses caused by illegal activities to the landlord, who presumably is in the best position to avoid these types of losses by carefully selecting a tenant and monitoring the property. *Id.*

20. *See generally* GEOFFREY CLARK, *BETTING ON LIVES: THE CULTURE OF LIFE INSURANCE IN ENGLAND, 1695-1775* (Manchester University Press 1999). Clark makes the case that life insurance was permitted to emerge in England despite its impiety because the Protestant clergy had to think about caring for their families. Other European countries would not countenance the practice because insuring against the risk of an untimely death was deemed an affront to God's will. However, there soon developed a culture in England of using life insurance to wager on the lives of third persons, a practice that Parliament forbade in the Life Assurance Act of 1774, which required that a policyholder have an "insurable interest" in the life insured. This is the basis of the modern rule that insurance must be distinguished from mere wagering in order to serve the public interest. *See generally id.*

carefully drawn parameters of public policy; however, once insurance is deemed appropriate, the policy is read broadly to promote coverage.

Courts deploy these principles more stringently in the insurance setting, seeking to avoid the “moral hazard” that arises if an insured can insulate itself from losses that result from behavior that is illegal or that violates public policy.<sup>21</sup> For example, courts have prohibited an insured from obtaining indemnification for a punitive damages award despite the lack of an express exclusion, reasoning that permitting recovery might encourage bad behavior and also would undermine the punitive effect of the award by holding the wrongdoer harmless.<sup>22</sup> A leading commentator concludes, in perhaps an overly cautious manner, that “in those areas of insurance law that are infused with significant public policy concerns the courts seem more inclined to utilize their discretion in a way that is consistent with the public policy in that area.”<sup>23</sup>

A Pennsylvania case provides a good example of the court overcoming apparent coverage through the application of the public policy doctrine.<sup>24</sup> A drug dealer sold heroin to a woman who subsequently overdosed in his house.<sup>25</sup> The homeowner’s insurance policy lacked an exclusion for liability for injuries arising out of the use of a controlled substance, but the court nevertheless held that

recovery is precluded for damages that arise out of an insured’s criminal acts regarding a Schedule I substance, as a matter of overriding public policy. Therefore, in situations when an insured commits a criminal act, with respect to a Schedule I controlled substance, and unintended or unexpected injuries or losses occur as a result, whether by accident or negligence, public policy will not allow coverage under the contract of insurance.<sup>26</sup>

Two dissenting justices argued that the court was “rewriting” the policy terms, but of course this is the very nature of the public policy doctrine.

During the period when marijuana cultivation, sale, and use were illegal under both federal and state law, it is likely that (sometimes unstated) public policy considerations shaped how courts read insuring clauses and exceptions. In short, the strong public policy against engaging in the narcotics trade (as expressed through stringent criminal prohibitions) likely trumped the customary

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21. Courts hold that the strong public policy against insuring intentional wrongdoing overrides the general public policy in favor of insurance coverage. *See, e.g., Wilshire Ins. Co. v. S.A.*, 224 Ariz. 97 (Ariz. App. 2010) (public policy against insuring intentional criminal acts overrides the public policy favoring coverage so as to provide compensation to the victim of the sexual assault).

22. *See, e.g., City Products Corp. v. Globe Indem. Co.*, 88 Cal. App. 3d 31, 40–41 (1979).

23. Thomas, *supra* note 12, at §5.06(2)(b).

24. *Minnesota Fire and Cas. Co. v. Greenfield*, 579 Pa. 333 (2004).

25. *Id.* at 336.

26. *Id.* at 352.

judicial practice of interpreting policies in favor of coverage. This dynamic is evidenced in cases involving coverage for small aircrafts used by drug smugglers. A federal appeals court case interpreted a property policy to read the exclusion for “conversion” broadly.<sup>27</sup> The owner had leased the plane under a contract that prohibited the lessee from using the plane to carry cargo or to engage in illegal activity.<sup>28</sup> Nevertheless, the lessee attempted to smuggle marijuana from the Bahamas, and the plane was damaged by law enforcement authorities who removed various electronic equipment.<sup>29</sup> The innocent owner filed a claim, but the carrier argued that an exclusion of “loss or damage due to conversion [including] any loss or damage during or resulting therefrom,” precluded coverage.<sup>30</sup> The Court held that the loss occurred during an ongoing conversion while the plane was used in an unauthorized manner.<sup>31</sup> Subsequent cases read the exclusion even more broadly.<sup>32</sup>

In a similar vein, an insured was denied coverage under a homeowner’s policy when the policyholder’s son was involved in an attempt to steal marijuana that resulted in the death of the drug dealer.<sup>33</sup> The juvenile knew generally that the group was planning to steal marijuana from the dealer, but there was no specific plan to murder him.<sup>34</sup> The carrier denied coverage under an exclusion in the policy for injuries that arise “out of the use, sale, manufacture, delivery, transfer or possession by any person of a Controlled Substance,” including marijuana.<sup>35</sup> The court held that the policy excluded coverage under the clear terms of the exclusion, reading “arising out of” broadly:

[The juvenile] was in [the dealer’s] home only to obtain marijuana and [the dealer’s] death was solely connected with and incident to an ill-conceived plan to obtain marijuana which went wildly and sadly awry. The language employed unmistakably encompasses more than the

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27. *Swish v. Manhattan Fire & Marine Ins. Co.*, 675 F.2d 1218 (11th Cir. 1982).

28. *Id.* at 1219

29. *Id.*

30. *Id.*

31. *Id.* at 1221.

32. *See Nat’l. Union Fire Ins. Co. of Pa. v. Carib Aviation*, 759 F.2d 873 (11<sup>th</sup> Cir. 1985) (citing *Swish* in holding that when the lessee rented a plane to fly from Miami to Orlando, but instead flew to the Bahamas to pick up marijuana, it “converted” the plane; the owner was denied coverage for loss that resulted from a crash over the ocean); *Gelder v. Puritan Ins. Co.*, 100 N.M. 240 (1983) (citing *Swish* in holding that a crash after dropping off marijuana was not covered because the lease precluded use of the plane to violate controlled substances laws; the lessee’s use constituted an excluded “conversion” even though the conversion did not directly cause the loss). Of course, these “innocent owners” cases are different from cases in which the insured operates a plane in an illegal manner, subjecting the loss to a clearly worded exclusion. *See Middlesex Mut. Ins. Co. v. McCoy*, 106 Cal. App. 3d 282 (1980) (insured owner crashed while carrying 541 kilos of marijuana in the plane).

33. *Prudential Prop. & Cas. Ins. Co. v. Brenner*, 350 N.J. Super. 316 (2002).

34. *Id.* at 287–88.

35. *Id.* at 289.

completed act of manufacture, use or transfer of a controlled dangerous substance.<sup>36</sup>

The court exhibited, at best, an ordinary reading of the policy language; more plausibly, it offered a pro-carrier reading that was likely informed by the juvenile's involvement with illegal drugs.

Finally, an appellate reversal reveals how trial courts may have been disposed to rule against coverage in situations involving illegal marijuana use.<sup>37</sup> An umbrella insurer denied coverage when a teenager was involved in an auto accident, citing the police report that the teen "had glassy eyes and appeared very disorderly," and that a bag of marijuana was found in the car.<sup>38</sup> The trial court determined that coverage was precluded by an exclusion of "bodily injury . . . arising out of the use . . . of a controlled substance [including marijuana]."<sup>39</sup> However, the Court of Appeals emphasized that there was no evidence in the record to sustain this verdict.<sup>40</sup> In particular, there was no medical evidence that the teen had ingested marijuana, no smoking paraphernalia was found in the car, and there was no other testimony suggesting use of marijuana before the accident.<sup>41</sup> Perhaps most important, the teen was unconscious when the police arrived at the scene of the accident, undoubtedly explaining his later disorientation.<sup>42</sup> On appeal, the carrier expressly referred to public policy, arguing that coverage should be denied when drug possession laws were being violated at the time of the accident.<sup>43</sup> This argument likely articulated the basis of the trial court's ruling, but the Court of Appeals rejected the argument because Indiana does not accept a public policy exception that overcomes the coverage afforded by a policy.<sup>44</sup> Even if state law endorsed the public policy doctrine, it would have been an extraordinary (which is to say, deeply problematic) result to deny coverage for "bad behavior" that had nothing to do with the accident.

As these cases demonstrate, courts read insurance coverage narrowly when the loss is related to the business of marijuana. When illegal under both state and federal law, activities directly relating to the marijuana trade obviously were uninsurable. The scope of the public policy against providing insurance for illegal activities extended further, with courts reading policies against landlords, homeowners and other innocent insureds who suffered a loss caused by the illegal behavior of third parties. This historical context is likely to continue to

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36. *Id.* at 290.

37. *Keckler v. Meridian Sec. Ins. Co.*, 967 N.E.2d 18 (Ind. Ct. App. 2012).

38. *Id.* at 20.

39. *Id.* at 23.

40. *Id.* at 25.

41. *Id.*

42. *Id.*

43. *Id.* at 26.

44. *Id.*

shape coverage decisions even after a state has made marijuana legal for some purposes or has entirely decriminalized the manufacture and possession of the drug.

## II. COVERAGE PROBLEMS IN THE CURRENT LEGAL ENVIRONMENT

An increasing number of states are permitting the sale and use of marijuana for certain medical purposes, and some have decriminalized the entire industry.<sup>45</sup> At the federal level, in contrast, marijuana possession, distribution and sale is prohibited under the federal Controlled Substances Act, and marijuana is classified with drugs such as heroin, LSD, and peyote.<sup>46</sup> Although the Obama administration signaled its intent not to deploy federal enforcement against individuals acting in conformity with state legalization,<sup>47</sup> the election of President

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45. See John Schroyer, *States with the Best Chance to Legalize Cannabis in 2017?*, MARIJUANA BUS. DAILY (Jan. 25, 2017), <http://mjbizdaily.com/which-states-have-best-chance-to-legalize-cannabis-in-2017/> (on file with *The University of the Pacific Law Review*).

46. Under the Controlled Substances Act, marijuana is a Schedule 1 drug. 21 U.S.C. § 812(c)(10). Schedule 1 drugs are defined as:

- (A) The drug or other substance has a high potential for abuse.
- (B) The drug or other substance has no currently accepted medical use in treatment in the United States.
- (C) There is a lack of accepted safety for use of the drug or other substance under medical supervision.

21 U.S.C. § 812(b)(1). The serious criminal penalties for violating the CSA with regard to Schedule 1 drugs are set forth in 21 U.S.C. § 844(a).

47. Soon after President Obama took office, his administration recognized the need for uniform guidance from the Justice Department regarding the conflict between state medical marijuana laws and federal law. In the “Ogden Memorandum,” the Department reinforced its “commitment to the enforcement of the Controlled Substances Act in all states,” but also signaled its “commitment to making efficient and rational use of its limited investigative and prosecutorial resources.” In balancing these commitments, the Department concluded as “a general matter, pursuit of [the Department’s priority of targeting drug trafficking networks] should not focus federal resources in your States on individuals whose actions are in clear and unambiguous compliance with existing state laws providing for the medical use of marijuana. . . . On the other hand, prosecution of commercial enterprises that unlawfully market and sell marijuana for profit continues to be an enforcement priority of the Department.” See Memorandum from U.S. Deputy Attorney General David W. Ogden to U.S. Attorneys (Oct. 19, 2009), available at <https://www.justice.gov/sites/default/files/opa/legacy/2009/10/19/medical-marijuana.pdf> (on file with *The University of the Pacific Law Review*).

As states begin passing even broader laws permitting the use of marijuana under state law, the Obama administration clarified its priorities with regard to the marijuana trade within such states. In the “Cole Memorandum,” the Department of Justice reaffirmed the Ogden Memorandum, but noted that there had been an increase in the scope of commercial cultivation, sale, distribution and use of marijuana for purported medical purposes. . . . The Ogden Memorandum was never intended to shield such activities from federal enforcement action and prosecution, even where those activities purport to comply with state law. Persons who are in the business of cultivating, selling or distributing marijuana, and those who knowingly facilitate such activities, are in violation of the Controlled Substances Act, regardless of state law. Consistent with resource constraints and the discretion you may exercise in your district, such persons are subject to federal enforcement action, including potential prosecution.

See Memorandum from U.S. Deputy Attorney General James M. Cole to U.S. Attorneys (June 29, 2011), available at <https://www.justice.gov/sites/default/files/oip/legacy/2014/07/23/dag-guidance-2011-for-medical-marijuana-use.pdf> (on file with *The University of the Pacific Law Review*).

Trump may result in a change of enforcement priorities.<sup>48</sup> Regardless, it is clear that federal law criminalizes the sale and use of marijuana for any purpose, and that this criminalization cannot be superseded by state law.<sup>49</sup>

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These statements of enforcement priority are non-binding, and even on their face provide little reassurance to commercial entities planning to operate large-scale operations in states that have legalized recreational use. Obviously, they are subject to change by the Trump administration. The United States Congress also provided relief by prohibiting the federal government from spending funds in a manner that interferes with state medical marijuana programs, and this prohibition recently was extended until April 28, 2017. See *Key Federal Marijuana Protection Extended through April*, MARIJUANA BUS. DAILY (Dec. 12, 2016), <http://mjbizdaily.com/key-federal-marijuana-protection-extended-through-April/> (on file with *The University of the Pacific Law Review*). Some courts have acknowledged that this appropriations rider can be enforced by defendants if they are arrested for a federal crime for activities that are fully compliant with state law regarding medical marijuana. See *U.S. v. McIntosh*, 833 F.3d 1163 (9<sup>th</sup> Cir. 2016); *U.S. v. Silkeutabay*, No. 15-30392, 2017 WL 766985 (9<sup>th</sup> Cir. Feb. 28, 2017). In addition to being limited to the medical marijuana context, this restriction on funding can be eliminated at any time by the Republican congress, with the potential for reaching behavior that occurred before the reversal of funding policy.

The federal government can prosecute [federal marijuana] offenses for up to five years after they occur. See 18 U.S.C. § 3282. Congress currently restricts the government from spending certain funds to prosecute certain individuals. But Congress could restore funding tomorrow, a year from now, or four years from now, and the government could then prosecute individuals who committed offenses while the government lacked funding. Moreover, a new president will be elected soon, and a new administration could shift enforcement priorities to place greater emphasis on prosecuting marijuana offenses.

*McIntosh*, 833 F.3d at 1179, n. 5.

Rob Mikos provides a comprehensive overview of the risks in relying on the non-enforcement memoranda or appropriations riders in Robert A. Mikos, *A Critical Appraisal of the Department of Justice's New Approach to Medical Marijuana*, 22 STAN. L. & POL'Y REV. 633 (2011).

48. The Trump administration's Attorney General, Jeff Sessions, has long been on record as opposing state-legalization of marijuana, but he has also signaled that limited resources may be better spent in the war on drugs, resulting in even more uncertainty among industry participants. See Tom Huddleston, Jr., *What Jeff Sessions Said About Marijuana in His Attorney General Hearing*, FORTUNE (Jan. 10, 2017), <http://fortune.com/2017/01/10/jeff-sessions-marijuana-confirmation-hearing> (on file with *The University of the Pacific Law Review*); Melissa Hoffman, *With Eyes on Trump, Legal Marijuana Warily Rolls Along*, NAT'L L. J. (Jan. 27, 2017), <http://m.nationallawjournal.com/?sreturn=20170128220238#/article/1202777859611/With-Eyes-on-Trump-Legal-Marijuana-Warily-Rolls-Along?> (on file with *The University of the Pacific Law Review*); Barber, *Jeff Sessions Says He'll Review "Effectiveness" of DOJ's Marijuana Guidance*, N.Y. L. J. (Jan. 27, 2017), <http://www.newyorklawjournal.com/id=1202777850184/Jeff-Sessions-Says-Hell-Review-Effectiveness-of-DOJs-Marijuana-Guidance> (on file with *The University of the Pacific Law Review*).

The White House Press Secretary increased the uncertainty by stating early this year that he expects increased federal enforcement with regard to state-legal recreational marijuana. See Sadie Gurman, *White House Expects Justice Crackdown on Legalized Marijuana*, THE ASSOCIATED PRESS (Feb. 24, 2017), <https://apnews.com/da972733ba854ae98b99433857aaffb7/white-house-expects-justice-crackdown-legalized-marijuana> (on file with *The University of the Pacific Law Review*).

In February, the Attorney General convened a Task Force on Crime Reduction and Public Safety, presumably to generate a recommendation that the federal government actively enforce laws against adult use of marijuana. However, preliminary leaks of the draft recommendations suggest that the task force may recommend maintaining the Obama-era policies. Political observers believe that the Attorney General may nevertheless initiate a crackdown on adult use. See Mark Joseph Stern, *Sessions' Marijuana Crackdown May Still Be Coming*, SLATE (August 7, 2017), [http://www.slate.com/articles/news\\_and\\_politics/jurisprudence/2017/08/jeff\\_sessions\\_will\\_probably\\_crack\\_down\\_on\\_legal\\_marijuana\\_despite\\_his\\_experts.html](http://www.slate.com/articles/news_and_politics/jurisprudence/2017/08/jeff_sessions_will_probably_crack_down_on_legal_marijuana_despite_his_experts.html)

49. *Gonzales v. Raich*, 545 U.S. 1, 29–33 (2005) (holding that state legalization of marijuana cannot restrict Congress's plenary power under the Commerce Clause to regulate marijuana with criminal and civil law).

Much attention has been devoted to the problems that federal criminal laws pose for the marijuana industry operating within a state that has legalized it due to federal banking regulations.<sup>50</sup> Banks generally have refused to provide services to the industry because of the risk that they might be liable under federal law for fostering a criminal enterprise, creating a serious impediment to the development of the industry. Little attention, however, has been devoted to the problem of ensuring that business entities have effective insurance coverage available to manage their risks.

*A. Reading Coverage Narrowly in the Absence of Full Compliance with State Law*

At a minimum, it is likely that courts will not hesitate to read coverage narrowly and exclusions broadly when the underlying activity fails to comply fully with state law. In a California case, the court held that an exclusion for the “illegal growing of plants” eliminated coverage for a landlord when the tenant was operating an illegal grow house in the building that caused damage to the structure.<sup>51</sup> At this time, California had legalized possession by persons using marijuana for medicinal purposes, but the tenant failed to comply with those laws.<sup>52</sup> In this case, the court treated the coverage question just as courts had done when marijuana was illegal under both state and federal law. Although understandable in this case, it might be reasonable to fear that a good faith failure to comply with the state regulatory structure in a merely technical manner may provide the basis for a denial of insurance coverage.

For example, consider a scenario in which a homeowner is cultivating marijuana for personal use in accordance with a state-issued license. If a thief steals the plants, the homeowner might legitimately expect that the loss would be covered under the policy provision insuring against theft of plants. However, if the homeowner has unwittingly violated state law in some manner, such as by having one too many plants in cultivation or by forgetting to renew her license in a timely fashion, the carrier might seek to avoid liability by asserting that failing to fully comply with state law renders the loss uninsurable under public policy

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50. See Julie Andersen Hill, *Marijuana, Federal Power and the States*, 65 CASE W. RES. L. REV. 597 (2015) (comprehensive review of federal laws, regulations, and guidance that would need to be changed to permit state banking cooperatives to satisfy the needs of the industry); Rachel Cheasty Sanders, *To Weed or Not to Weed? The Colorado Quandary of Legitimate Marijuana Businesses and the Financial Institutions Who Are Unable to Serve Them*, 120 PENN ST. L. REV. 281 (2015) (detailing the many legal issues and the inability of state cooperatives to replace the full services of a bank); Brittany Cohen, *Marijuana Dispensaries Not Feeling So High: Financial Institutions Close Their Doors to State-Legalized Marijuana Businesses*, 35 REV. BANKING & FIN. L. 72 (2015) (state-legal marijuana businesses will be unable to obtain access to financial institutions without federal legislation); and James A. Kohl, *Nascent Marijuana Industry Struggles for Access to Normal Financing*, 23 NEV. L. 16 (2015).

51. *Huynh v. Safeco Ins. Co.*, No. C 12-01574-PSG, 2012 WL 5893482, at \*1 (N.D. Cal. Nov. 23, 2012).

52. *Id.*

principles. Although the coverage provisions are read broadly and the exclusions are read narrowly, the existence of coverage for marijuana-related claims could effectively be narrowed by strictly reading state law requirements.

*B. Reading Coverage Narrowly Even When State Law is Followed Strictly*

It is also likely that courts will tend to construe policies more narrowly even if the marijuana business is conducted in full compliance with applicable state law, reflecting a continuing disapproval of what has been historically deemed to be dangerous and unfit behavior. Consider a recent case involving a claim under a homeowner’s policy for loss of marijuana plants seized under a search warrant and then destroyed by the police.<sup>53</sup> The policy covered “theft and loss of property,” including “plants . . . on the residence premises,” but the insurer denied coverage because a warrant had been (wrongfully) issued, and the plants were later destroyed pursuant to a (procedurally improper) official order.<sup>54</sup> The court concluded that there was no “theft” because the authorities had no criminal intent to steal, even if they acted improperly.<sup>55</sup> This narrow reading of the policy, despite the wrongful taking that caused the insured to suffer a loss, may indicate that some courts will be informed by the illegal legacy of marijuana.

Similarly, the carrier prevailed against a homeowner in a recent case by invoking a general exclusion for losses that occur while an insured has increased the risk of hazard.<sup>56</sup> The co-insured wife submitted a claim for fire loss caused by her husband’s use of a butane extraction method in the cultivation of marijuana for himself and other medical marijuana patients in his capacity as a licensed patient and caregiver.<sup>57</sup> Initially, Nationwide provided a payment of \$160,209.50 for the loss, but—as the trial court prosaically described in its opinion on the motion for summary judgment—“after learning the fire was caused by Mathews’s marijuana lab, Nationwide wants the money back.”<sup>58</sup> In fact, the Nationwide letter declining coverage stated that it had determined that Mathews was operating an “illegal” facility in the basement.<sup>59</sup> As the Court of Appeals summarized, Nationwide declined coverage upon discovering that the husband had allegedly been “operating an illegal marijuana and THC manufacturing facility in the basement,” which directly caused the fire.<sup>60</sup>

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53. *Barnett v. State Farm Gen. Ins. Co.*, 200 Cal. App. 4th 536, 539 (2011).

54. *Id.* at 539–40.

55. *Id.* at 543–44.

56. *Nationwide Mut. Fire Ins. Co. v. McDermott*, No. 14–1623, 603 Fed. Appx. 374, 379 (6th Cir. Feb. 24 2015).

57. *Id.* at 375–376.

58. *Nationwide Mut. Fire Ins. Co. v. McDermott*, No. 12-11863, 2013 WL 3732874, at \*1 (E.D. Mich. July 15, 2013) (order on motion for summary judgment).

59. *Nationwide*, 603 Fed. Appx. at 376.

60. *Id.*

Given that the matter before the court was a motion for summary judgment, there had been no adjudication of the disputed fact regarding the husband's declaration that he acted in full compliance with state law.<sup>61</sup> In an effort to support denial of coverage, Nationwide adopted a traditional scattershot approach, alleging that the policy could not cover an "illegal" facility or "wrongful conduct;" that the loss was not an accident but rather the result of intentional actions of the husband; and that the marijuana lab was an "increased hazard" and the insured had an obligation to provide notice of this change of use, and failing to do so constituted a concealment or misrepresentation.<sup>62</sup>

The District Court addressed only two of these arguments, finding them both dispositive. It entered summary judgment on the grounds that the loss was not an "accident" because it was the result of the butane extraction process, and also because the insureds had failed to notify Nationwide of this new use of the home that created an increased hazard.<sup>63</sup> The first ground is a surprising departure from mainstream approaches to loss by fire when an insured's intentional behavior (using butane to perform extraction) accidentally leads to property damage. First, Nationwide's investigator concluded as a matter of fact that the fire was the result of an accident.<sup>64</sup> Second, while the hoary doctrine of loss caused by "friendly fire" versus "hostile fire" is far from simple, its application by the court in this case is quite surprising and unsupported by relevant analogies to other cases.<sup>65</sup> On reconsideration, the district court rejected the insured's claim that the statutorily mandated fire policy language was being read too narrowly, but the only case it cited involved the court denying recovery to insureds who had criminally destroyed the insured property by arson!<sup>66</sup> Similarly, to consider this loss to be the result of intentional behavior flies in the face of the many decisions that protect homeowners every day from their incredibly irresponsible behavior that leads to property loss and personal injury.<sup>67</sup> The point is not to belabor

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61. *Nationwide*, 2013 WL 3732874 at \*1–2.

62. *Nationwide Mut. Fire Ins. Co. v. McDermott*, No. 14–1623, 603 Fed. Appx. 374, 376–77 (6th Cir. Feb. 24 2015).

63. *Id.* at 377.

64. *Nationwide Mut. Fire Ins. Co. v. McDermott*, No. 12-11862, 2014 WL 1464418, at \*1 (E.D. Mich., Aug. 15, 2014) (orders on motions for summary judgment) (the investigator concluded "on the information obtained by myself, reconstruction of the scene, and fire patterns analyzed, this fire is an accidental fire.").

65. One might briefly summarize the doctrine as precluding coverage when fire causes damage to property in the course of its intended presence (e.g., paper money accidentally falling into a burning fireplace would not be covered for loss by fire) as opposed to a fire breaking free of its intended boundaries and causing damage (e.g., the insured in *Nationwide* was using a flame to heat the product when the flame accidentally ignited a nearby source of butane). See *Nationwide*, 2013 WL 3732874 at \*1–2.

66. *Nationwide Mut. Fire Ins. Co. v. McDermott*, No. 12-11863, 2013 WL 4833553, at \*2 (E.D. Mich., Sept. 10, 2013) (order on motion for reconsideration).

67. It would be both tedious and depressing to attempt to catalog the cases that support the statement in the text. One case easily analogized to *Nationwide* is *Rockingham Mut. Ins. Co. v. MacHardy*, 48 VA. CIR. 389 (1999). In *Rockingham* the homeowner was working on a car in a one-car garage in February. He used a kerosene heater to warm the garage, but didn't open a window or door to provide ventilation. While he was working, a friend delivered a tank of acetylene gas and a tank of oxygen, which were placed in the garage. The

aspects of insurance law doctrine, but rather to suggest that the carrier's claims and the court's decision appear to reflect a strong negative bias against what apparently could have been a legal use of the property.

Perhaps recognizing that the weakness of the district court's conclusion as a matter of law that the fire loss was not accidental, the court of appeals ignored that ground and affirmed solely on the basis that the risk was increased by a change of use of the property by the insured without giving proper notice to the insurer. The policy excluded any losses "occurring while the hazard [was] increased by a means within the control and knowledge of an insured."<sup>68</sup> The co-insured had a "duty to notify [Nationwide] as soon as possible of any change which may affect the premium risk under th[e] policy," including "changes . . . in the occupancy or use of the residence premises."<sup>69</sup> The court noted that this clause is invoked in cases such as a homeowner moving out of the property and turning off the heat, leading to damage caused by frozen pipes two years later.<sup>70</sup> Why the insureds should have placed the carrier on notice that the husband was engaged in legal, noncommercial cultivation and preparation of marijuana in the basement is unclear at best. The court suggested that the scope of the marijuana operation was critical,<sup>71</sup> but the loss stemmed from negligent behavior that could have resulted if only one plant was being cultivated. Just as one would assume that homeowners might not think to place the carrier on notice that the husband had built an extensive metalworking and woodworking shop in the basement with multiple sources of potential fire, a legal marijuana operation that slowly came to involve the butane extraction method would not strike most people as triggering an obligation to notify their carrier.<sup>72</sup> Generally, courts note that the

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garage already contained two or three bales of hay, a three gallon can of gasoline, a large tank of propane and several smaller tanks, and various cans of paint and paint thinner. The insured removed the gas tank from the car as part of his work, which was promptly ignited by the kerosene heater. The garage ultimately exploded, injuring a third person. It is interesting to note that there was no question that the loss fell within the scope of coverage under the homeowners' policy. The court held that the exclusion for personal injuries arising out of the maintenance of a vehicle did not apply, because the injury was sustained as a result of many other non-automotive causes which contributed more significantly and directly to the explosion.

68. *Nationwide Mut. Fire Ins. Co. v. McDermott*, No. 14-1623, 603 Fed. Appx. 374, at 376 (6th Cir. Feb. 24, 2015).

69. *Id.*

70. *Id.* at 377.

71. In response to the insureds' argument that this reading of the policy would place an unreasonable burden on homeowners, the court concluded that the application of the notice requirement made sense on these facts.

Far from merely adding one houseplant, at the time of the fire, Mathews had approximately 28 marijuana plants growing in the basement. Two rooms in the basement had been converted into growing rooms. . . . Thus, because McDermott failed to report the change in use of the premises to Nationwide—a change in use that would have had a great impact on the premium risk—she cannot recover under the policy. To hold otherwise would make Nationwide liable for a risk it did not assume.

*Id.* at 378-79.

72. Nor is it beyond the pale for unwise decisions made by homeowners. *See Rockingham*, 48 Va. Cir. at 4.

insurer is perfectly capable of protecting itself through the careful drafting of exclusions, such as an exclusion for losses resulting from the use of gasoline, butane, etc., within the premises.

The *McDermott* case reveals how problematic coverage cases might be even if the insured is engaged in legal marijuana trade. Insurance policies generally have exclusions that are broad on their face, such as the “increased risk” exclusion, but are generally read narrowly so as not to undermine the insured’s reasonable expectations of coverage. The cases suggest that insureds seeking to recover for a loss that in some way involved the marijuana industry face a different burden for securing coverage. Undoubtedly drawing from previous cases that offset ordinary interpretation of insurance policies with the public policy against insuring illegal behavior, these new cases pose a threat to the activities of those who engage in the legal marijuana trade.

*C. Reading Coverage Narrowly to Effectuate Federal Public Policy*

The most difficult problem arises when courts consider the continuing federal ban on the production, sale, and use of marijuana as evidencing a strong public policy that overcomes the otherwise available insurance coverage. Two recent cases illustrate the competing arguments that will only intensify if the Trump administration takes a harder line enforcing the federal criminalization of all uses of marijuana.

A federal court in Hawai’i concluded that an insured complying with state law in growing marijuana could not recover under a homeowners policy because the public policy evidenced by federal criminalization trumps the express terms of the insurance policy.<sup>73</sup> In *Tracy*, the insured was growing 12 marijuana plants at her home in accordance with state medical marijuana law.<sup>74</sup> When the plants were stolen, she filed a claim under the policy, which covered the theft of “trees, shrubs, plants or lawns, on the residence premises.”<sup>75</sup> The carrier moved for summary judgment, arguing that the state medical marijuana law only provided an affirmative defense to state criminal charges, and therefore the insured had no legitimate insurable interest in the property because of the federal prohibition.<sup>76</sup> The carrier argued that enforcing coverage would violate federal public policy because it “presupposes that the insured will purchase, sell, and/or distribute marijuana plants with insurance proceeds.”<sup>77</sup>

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73. *Tracy v. USAA Ins. Co.*, No. CIV. 11-00487 LEK-KSC, 2012 WL 928186 (D. Haw. Mar. 16, 2012), appeal dismissed (9th Cir. 12-16015, June 14, 2012).

74. *Id.*

75. *Id.* at \*6.

76. *Id.* at \*2.

77. *Id.*

The Court found this rationale persuasive.

The rule under Hawai'i law that courts may decline to enforce a contract that is illegal or contrary to public policy applies where the enforcement of the contract would violate federal law. . . . The Court therefore assumes, for purposes of the instant motion, that the "Trees, Shrubs and Other Plants" provision of the Policy covered the loss of Plaintiff's medical marijuana plants. Even in light of that assumption, this Court cannot enforce the provision because Plaintiff's possession and cultivation of marijuana, even for State-authorized medical use, clearly violates federal law. To require Defendant to pay insurance proceeds for the replacement of medical marijuana plants would be contrary to federal law and public policy. . . . The Court therefore CONCLUDES that, as a matter of law, Defendant's refusal to pay for Plaintiff's claim for the loss of her medical marijuana plants did not constitute a breach [of] the parties' insurance contract.<sup>78</sup>

Despite the assumed legality of the insured's cultivation of the marijuana plants under state law, and the absence of any policy exclusion for this loss, the federal district court found that continued federal criminalization of marijuana precluded enforcement of the applicable insurance policy.

In contrast, a Colorado federal court enforced insurance coverage despite an exclusion for illegal contraband.<sup>79</sup> The court acknowledged that federal law criminalized the marijuana industry, but concluded that the federal position was rendered ambiguous in light of the Obama administration's decision to defer enforcement in states that have legalized aspects of the marijuana trade. As the court explained:

Other than pointing to federal criminal statutes, Atain offers no evidence that the application of existing federal public policy statements would be expected to result in criminal enforcement against Green Earth for possession or distribution of medical marijuana, nor does Atain assert that Green Earth's operations were somehow in violation of Colorado law. In short, the Policy's "Contraband" exclusion is rendered ambiguous by the difference between the federal government's *de jure* and *de facto* public policies regarding state-regulated medical marijuana.<sup>80</sup>

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78. *Id.* at \*13.

79. *Green Earth Wellness Center, LLC v. Atain Specialty Ins. Co.*, 163 F. Supp. 3d 821, 833 (D. Colo. 2016).

80. *Id.*

The insurer, Atain, responded to this analysis by seeking “some direction and assurances from this Court,” leading the court to conclude that the “unarticulated sub-text to this argument appears to be a request that the Court declare the policy unenforceable as against public policy.”<sup>81</sup> This argument fell flat, given that the surplus lines policy was written specifically to provide coverage to the insured for its state-legal marijuana business.

Atain chose to insure Green Earth’s inventory, without taking any apparent precautions to carefully delineate what types of inventory would and would not be covered. Atain’s newfound concerns that writing such a Policy might somehow be unlawful thus ring particularly hollow and its request for an advisory opinion appears somewhat disingenuous.<sup>82</sup>

Even if there was a public policy that precluded enforcement of the policy, the Court indicated that it would be inclined to award expectation damages to the policyholder for unjust enrichment since the insurer had accepted premiums for the disputed coverage.<sup>83</sup> The court specifically rejected the *Tracy* rationale, given the “continued erosion of any clear and consistent federal public policy,” and the significance that the carrier expressly assumed the risk of a marijuana business “of its own will, knowingly and intelligently.”<sup>84</sup>

One can explain the differing results in *Tracy* and *Green Earth* by recalling that the public policy defense to insurance coverage is a particular application of a general principle of contract law. The ability of marijuana businesses to enforce simple contracts is cabined by the continuing illegality of the business under federal law. For example, if a retailer paid a \$50,000 deposit for a \$250,000 purchase from a grower, the retailer could not compel the grower to follow through with the contract because the requested remedy would amount to a court order that the grower violate federal law.<sup>85</sup> *Tracy* represents this more traditional

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81. *Id.* at 834. The court’s equivocal language is surprising, given the clearly stated basis for Atain’s motion for summary judgment: “(i) Whether, in light of [Colorado’s Medical Marijuana Act], federal law, and federal public policy, it is legal for Atain to pay for damages to marijuana plants and products, and if so, whether the Court can order Atain to pay for these damages . . .” *Id.* at 824.

82. *Id.* at 834 n.8.

83. *Id.*

84. *Green Earth Wellness Center, LLC v. Atain Specialty Ins. Co.*, 163 F. Supp. 3d 821, 835 (D. Colo. 2016).

85. This principle represents a massive challenge for those engaged in the marijuana industry, given that it will prevent them from enforcing simple contracts that effectuate their business planning. For example, a trial court refused to enforce a commercial loan agreement intended to finance a state-legal medical marijuana facility, finding that the agreement was void because the stated object of the contract was illegal under federal law. *See Hammer v. Today’s Health Care II, Co.*, Nos. CV2011-051310, CV2011-051311, 2012 WL 12874349 (Ariz. Super. Trial Order, Apr. 17, 2012). Because the loan agreement specified that the proceeds were to be used “for a retail medical marijuana sales and grow center” the court determined that the loan agreement was “void and unenforceable,” and that the lenders could not recoup the loan amount in restitution. *Id.* at \*2.

If the contract claim is grounded in federal law rather than state common law, courts are likely to be even

approach that refused to enforce contracts relating to any manner of illegal activity, subject to narrow exceptions.<sup>86</sup> From this perspective, it makes no sense for a court to order payment under an insurance policy to provide a party with the resources to violate federal criminal law.

But this is not the only manner in which the doctrines of illegality and public policy are deployed. In another sales agreement case, the court held that the seller of a consulting business and hydroponics grow center could recover the unpaid balance of the purchase price because the contract did not mandate the violation of federal law.<sup>87</sup> This would also be true of all insurance contracts, which are aleatory in nature rather than bilateral. An insurance agreement requires a payment upon the happening of an uncertain event, and there is no obligation under the policy to spend the proceeds in any particular manner. This certainly fits with the reasoning in *Green Earth*. The court followed a newer approach, articulated in the Restatement Second of Contracts, that provides for a wide-ranging balancing test to determine the scope of a public policy prohibition on contract enforcement. The court's seemingly curious reference to the federal government's non-binding decision to refrain from interfering with state law through contradictory enforcement of federal criminal law makes perfect sense as an effort to assess the strength of the federal policy. The Restatement provision reads in full:

§ 178 When a Term Is Unenforceable on Grounds of Public Policy

- (1) A promise or other term of an agreement is unenforceable on grounds of public policy if legislation provides that it is unenforceable or the

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more strict. *See, e.g.*, *Staffin v. County of Shasta*, No. 2:13-cv-00315 JAM-CMK, 2013 WL 1896812, at \*4 (E. D. Cal. May 6, 2013) (rejecting challenge under federal statutory law because “all three contracts relate to distribution or cultivation of medical marijuana. However, marijuana is contraband under federal law. ... Therefore, under federal law for the purposes of Contract Clause analysis, no valid agreement exists.”).

86. *See, e.g.*, *Karpinski v. Collins*, 252 Cal. App. 2d 711 (1967) (holding that milk producer could recover illegal rebate paid to creamery because the producer's violation of the statute occurred only because he was particularly vulnerable to the economic pressure exerted by the creamery).

87. In *Mann v. Gullickson*, No. 15-cv-03630-MEJ, 2016 WL 6473215 (N. D. Cal. Nov. 2, 2016), the purchaser moved for summary judgment, arguing that the sales contract was void *ab initio* because it related to activities illegal under federal law, given that the parties anticipated that the note would be paid by revenues generated by operating the medical marijuana businesses. The court noted that at “its core, this case consists of a simple breach of contract claim [under state law]. But to decide whether the parties' business agreement is enforceable, the Court must navigate the conflict created by the prohibition of medical marijuana under federal law and the legalization of medical marijuana under California law.” *Id.* at \*1. Citing *Green Earth*, the court observed that the strength of the federal policy had grown weaker since the *Tracy* decision, but nevertheless it reaffirmed that a contract may not be enforced by a court if doing so would require a party to violate federal law. *Id.* at \*4–6. However, the court held that requiring the purchaser to pay for the businesses in that case would not require the purchaser to engage in the marijuana trade, even if that was the assumption of the parties underlying the sale. “Having reviewed the materials in the record, the Court finds it could grant relief in this case that does not require [the purchaser] to violate the CSA. [The seller's] suit seeks [the purchaser's] full payment for the businesses he sold to her. Mandating that payment does not require [the purchaser] to possess, cultivate, or distribute marijuana, or to in any other way require her to violate the CSA.” *Id.* at \*7.

interest in its enforcement is clearly out weighed in the circumstances by a public policy against the enforcement of such terms.

- (2) In weighing the interest in the enforcement of a term, account is taken of
  - (a) the parties' justified expectations,
  - (b) any forfeiture that would result if enforcement were denied, and
  - (c) any special public interest in the enforcement of the particular term.
- (3) In weighing a public policy against enforcement of a term, account is taken of
  - (a) the strength of that policy as manifested by legislation or judicial decisions,
  - (b) the likelihood that a refusal to enforce the term will further that policy,
  - (c) the seriousness of any misconduct involved and the extent to which it was deliberate, and
  - (d) the directness of the connection between that misconduct and the term.<sup>88</sup>

Although the *Green Earth* court did not expressly reference this balancing test, it supports the court's decision and provides a principled basis for distinguishing the *Tracy* case.

First, with respect to the factors favoring enforcement of the insurance policy, *Green Earth* adjudicated a policy specifically underwritten to provide protection to a state-legal marijuana business, whereas *Tracy* involved a general homeowner's policy under which marijuana plants were not specifically contemplated. As the *Green Earth* court concluded, "Atain chose to insure Green Earth's inventory, apparently without taking any apparent precautions to carefully delineate what types of inventory would and would not be covered. Atain's newfound concerns that writing such a Policy might somehow be unlawful thus ring particularly hollow and its request for an advisory opinion appears somewhat disingenuous."<sup>89</sup> In short, Atain assumed this risk "of its own will, knowingly and intelligently."<sup>90</sup>

It is certainly the case that Green Earth had justified expectations of coverage in light of the insurer's express assumption of the risk of losses suffered by a state-legal insurance business. In contrast, Tracy did not expressly bargain for coverage of her plants as part of the general homeowner's coverage. Additionally, Green Earth paid insurance premiums specifically for its marijuana business, and so would have suffered a forfeiture if the policy was not enforced,

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88. RESTATEMENT (SECOND) OF CONTRACTS § 178 (AM. LAW. INST. 1981).

89. *Green Earth Wellness Center, LLC v. Atain Specialty Ins. Co.*, 163 F. Supp. 3d 821, 834 n.8 (D. Colo. 2016).

90. *Id.* at 835.

subject only to the willingness of the court to return all premiums in restitution. In contrast, Tracy arguably received the full benefit of the homeowner's policy because coverage was afforded for numerous risks. Finally, Colorado has expressed a special public interest favoring the marijuana industry in a statute that provides that it "is the public policy of the state of Colorado that a contract is not void or voidable as against public policy if it pertains to lawful activities" under Colorado law.<sup>91</sup> In contrast, the medical marijuana scheme in *Tracy* simply exempted persons from state criminal prosecution.

These interests supporting enforcement are weighed against the public policy against enforcement of the insurance policy. In *Tracy*, the court acknowledged the serious federal criminal penalties that attach to marijuana. In contrast, the court in *Green Earth* detailed the "continued erosion of any clear and consistent federal public policy" since the *Tracy* decision, notwithstanding the continuing CSA Schedule I classification of marijuana.<sup>92</sup> Although the articulation of federal public policy might shift dramatically under President Trump, the current balancing of equities properly takes into account articulated federal enforcement policy that signals a weak public interest, at least with respect to state-legal medical marijuana activities.<sup>93</sup>

It is likely that refusing to enforce insurance contracts would further the federal public policy against marijuana, given the importance of risk management to commercial entities that likely would be the target of federal interest. Additionally, there is a direct connection between the insured activity and the public policy, and the insured is intentionally engaging in that activity. However, *Green Earth* effectively makes the case that the misconduct in question, despite the continued stringent federal penalties, is not considered as serious misbehavior in light of changing attitudes and actions taken by state legislatures.

On balance, at the moment there is a strong case to be made for state courts to enforce insurance coverage of state-legal marijuana activities. Insureds often remove cases to federal court, where one might expect a more solicitous treatment of the federal public policy. Of course, the issue will be raised only if

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91. COLO. REV. STAT. ANN. § 13-22-601 (West, Westlaw through May 24, 2017 legislation of 2017 Reg. Sess.).

92. *Green Earth Wellness Center, LLC v. Atain Specialty Ins. Co.*, 163 F. Supp. 3d 821, 835 (D. Colo. 2016).

93. This shift from a crude "illegality" model to a more nuanced "balancing of interests" model of decision making is also seen in the enforcement of general contracts, including enforcement actions in federal bankruptcy proceedings. See Luke Scheuer, *Are "Legal" Marijuana Contracts "Illegal"?*, 16 U.C. DAVIS BUS. L.J. 31, 53 (2015) ("In addition to the public policy goals of states that drove them to legalization, courts should also consider the negative effects of enforcing the public policy defense against marijuana businesses. If marijuana businesses cannot rely upon contracts, they will be forced even further into the world of illegal businesses."); Steven Mare, *He Who Comes Into Court Must Not Come With Green Hands: The Marijuana Industry's Ongoing Struggle with the Illegality and Unclean Hands Doctrines*, 44 HOFSTRA L. REV. 1351, 1379 (2016) (drawing from the Restatement balancing test to propose a method for bankruptcy courts to award, at a minimum, restitution with regard to state-legal marijuana contracts).

the carrier disputes coverage in some manner, but the uncertainty that would have been generated if the court in *Green Earth* had absolved the insurer of its contract obligations would have reverberated broadly and deeply throughout the industry.

*D. Reading Coverage Narrowly in Response to Market Segmentation*

Participants in the marijuana industry may find that the segmentation of the insurance market makes finding comprehensive coverage more difficult. Although courts read insurance provisions broadly, they respect the ability of insurers to create different policies for different risks. For example, the average person has two forms of liability insurance: her homeowner's or renter's policy, and her automobile policy. Each policy will exclude the risks properly covered by the other policy, and courts generally will respect this market differentiation even if policy language could be read more broadly.<sup>94</sup> The marijuana industry faces a significant risk in that growing crops can be damaged by a variety of natural events, but traditionally crops are excluded from property casualty policies and farmers must seek a crop insurance policy through a program underwritten or reinsured by the federal government.<sup>95</sup> In *Green Earth*, the policy contained the usual exclusion for "growing crops," and so the insured's immature plants that had not been cultivated were outside of the coverage provided for the

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94. See, e.g., *Penn. Nat. Ins. Co. v. Costa*, 198 N.J. 229 (2009), in which the court held that the homeowner's policy provided coverage when a third person walked over to assist the homeowner changing a tire, slipped on ice, and severely injured himself when his head hit the car jack. The court concluded that the accident did not "arise out of" the use of the automobile. It is possible that both policies could be triggered if there are independent acts of negligence. See, e.g., *Kalell v. Mut. Fire and Auto Ins. Co.*, 471 N.W. 2d 865 (Iowa 1991), in which the homeowner cut partially through a tree limb, tied a rope around the limb, and then used his pickup truck to pull the rope, leading to a third person being struck in the head by the limb. The court concluded that using a rope in this manner could be found to be negligent regardless of the source of the pulling, and also that choosing to use an automobile in this manner could be an independent negligent act. *Id.*

95. The history of the Federal Crop Insurance Program was helpfully summarized in a recent case.

Due to the inherent risks of insuring crops, insurance companies in the early 1900's refused to write multi-peril crop insurance. In order to remedy this problem, Congress enacted the Federal Crop Insurance Act (FICA). The Act was enacted in 1938 and its purpose was to "promote the national welfare by improving the economic stability of agriculture through a sound system of crop insurance. . . ." To carry out this purpose, Congress created an agency within the Department of Agriculture known as the Federal Crop Insurance Corporation. The Federal Crop Insurance Corporation assists in carrying out the goals of the FCIA by providing crop insurance to farmers by 1) selling insurance through private insurance agents; 2) reinsuring private insurance companies that provide crop insurance; and 3) providing crop insurance directly to the farmer.

Under the original scheme of the Federal Crop Insurance Act, only the Federal Crop Insurance Corporation issued crop insurance policies and handled claims. However, when the Federal Crop Insurance Act was amended in 1980, Congress authorized the utilization of private insurance companies to provide crop insurance to the nation's farmers. These private insurance companies sell and service crop insurance policies and are reinsured by the Federal Crop Insurance Corporation. As a result, under the current scheme, the Federal Crop Insurance Corporation both insures farmers directly and reinsures private companies to ensure [sic] farmers.

*Bullinger v. Trebas*, 245 F. Supp. 2d 1060, 1063 (D.N.D. 2003) (citations omitted for clarity).

inventory.<sup>96</sup> Given that the policy was written specifically for a retail medical marijuana business, the court found that it would have certainly added crop coverage if the intent was to cover growing plants in addition to stock for retail sale.<sup>97</sup> This decision reflects a clear segmentation of the market and the failure of the insured to purchase the appropriate crop insurance product if it desired that coverage.<sup>98</sup>

Insuring growing crops presents a special problem for the marijuana industry because the federal crop insurance program that writes or reinsures all crop insurance in the country does not provide coverage for marijuana, or even for hemp which is also classified as a Schedule I drug under the CSA. Indeed, the crop insurance application seeks to ensure that the farmer has not “in the last five years been convicted under federal or state law of planting, cultivating, growing, producing, harvesting, or storing a controlled substance.”<sup>99</sup> Without access to the federal crop insurance program, surplus lines carriers will have difficulty underwriting crop loss if they have large exposure because the pricing will likely be prohibitive. The simple reason is that the federal crop insurance program amounts to a massive taxpayer subsidy of agricultural producers rather than a traditional, economically self-sustaining insurance program.<sup>100</sup> Although some

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96. *Green Earth Wellness Center, LLC v. Atain Specialty Ins. Co.*, 163 F. Supp. 3d 821, 828–32 (D. Colo. 2016). The court found that the growing plants might possibly be within the scope of “stock” covered by the policy, and that the question could not be resolved by summary judgment. *Id.* at 828. However, the policy excluded “growing crops,” and Green Earth was unable to prevail on its argument that marijuana plants grown indoors were not “growing crops.” Moreover, the pre-policy documents expressly excluded growing crops, and there was no evidence that coverage for growing crops was discussed with the broker. *Id.* at 831.

97. *Id.* at 828–32.

98. In these situations the insured is unlikely to persuade a court to read a policy so broadly that it encompasses risks that are separately underwritten, but the insured might be able to recover for its lack of insurance if the agent or broker was negligent in designing and placing the insurance program requested by the insured. See Douglas Richmond, *Agents and Brokers*, in 1 *NEW APPELMAN ON INS. L.*, LIB. ED. 2-27, § 2.05 (Jeffrey E. Thomas and Francis J. Mootz III eds., LexisNexis 2009).

99. See Amy Martyn, *Razed California Crops Expose Blind Spots in Insurance and Regulation*, CONSUMER AFFAIRS (Oct. 13, 2017), <https://www.consumeraffairs.com/news/california-wildfires-show-the-need-for-cannabis-growers-to-get-insurance-coverage-101317.html> (showing the absence of “growing crops” coverage for cannabis in the October 2017 Northern California wildfires).

100. As two critics summarize in the abstract to their article:

Federal crop insurance is the largest federal property-casualty insurance program. Nominally, it is portrayed as a typical form of private property insurance. However, closer examination reveals that its structure departs significantly from conventional insurance principles and practices that are employed in private insurance markets. In reality, it is a greatly flawed and heavily subsidized wealth transfer program, costing taxpayers \$3-4 billion a year. Also, its flawed structure creates substantial adverse selection and moral hazard problems, encouraging farmers to make economically unsound investment and production choices with rippling effects for farm economies and the environment.

Robert W. Klein & Gregory Krohm, *Federal Crop Insurance: The Need for Reform*, 27 J. OF INS. REG. 23 (2008).

If surplus lines carriers undertook the risk of insuring growing crops, it likely would not run afoul of the Federal Crop Insurance program. Courts generally have held that the FCIA does not preempt state law regulating insurance. *Alliance Ins. Co. v. Wilson*, 384 F.3d 547, 553 (8th Cir. 2004); *Meyer v. Conlon*, 162 Fed. 3d 1264, 1268–70 (10th Cir. 1998); *Bullinger v. Trebas*, 215 F. Supp. 2d 1060, 1066 (D. N.D. 2003); *Halfman*

carriers have touted their willingness to offer “growing crop” coverage,<sup>101</sup> anecdotal evidence suggests that carriers are limiting their exposure to the more manageable risks of crops that are cultivated indoors.<sup>102</sup>

*E. The Uninsurable Risk of Federal Law Enforcement Action*

Under the public policy doctrine, it is a truism that parties cannot insure themselves against losses caused by law enforcement activity. At least one insurer has promoted its coverage for losses sustained by government raids, but the coverage only pertains to raids by state and local officials when the insured is fully compliant with state law, and does not (nor could it) provide coverage for raids by federal agencies.<sup>103</sup> The risk of having one’s plants and inventory seized by law enforcement authorities is significant, with the potential for severe losses. As described above, even with express policy coverage, courts may be hesitant to enforce the policy in situations where state officials conduct a raid if the insured is not wholly in compliance with all technical requirements under state law.<sup>104</sup> Perhaps more important, if the federal government conducts a raid on a business that it suspects is engaged in the illegal narcotics trade, even if the facts establish that the business is wholly compliant with state law, the damages caused by the raid will be uninsurable. There are certain risks inherent in the marijuana industry that will remain uninsurable until federal law changes.

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v. USAG Ins. Serv., Inc., 18 F. Supp. 2d 714, 720–21 (N.D. Tex. 2000); Dailey v. Am. Growers Ins., 103 S.W. 2d 60, 65 (Ky. 2003).

In the absence of a federal law specifically prohibiting insurance for marijuana as a growing crop, then, it is legally possible to insure this risk although it may be difficult to price the coverage accurately and affordably.

101. In a news report, one broker touted the availability of coverage for crops: “we cover your living plants.” Bruce Kennedy, *Insurance Brokers Reach Out to Marijuana Inc.*, CBS Money Watch (Feb. 13, 2014), <http://www.cbsnews.com/news/insurance-brokers-reach-out-to-marijuana-inc/> (on file with *The University of the Pacific Law Review*).

102. For example, a one-page brochure prepared by Bozzuto & Co. Ins. Svcs., Inc. touting its coverage for the cannabis industry lists the coverage for “Crop” to include “Indoor Plants In-Process.” See Brochure on file with author; confirmed in personal conversation with Gene Bernkrant of Bozzuto on September 21, 2017.

103. This coverage obviously is designed to insure against the losses suffered by the insured in *Barnett v. State Farm General Insurance Co.*, 132 Cal. Rptr. 3d 742, 744 (Cal. Ct. App. 2011). See *Medical Marijuana Insurance Specialist Offers Pot Raid Coverage*, MMD INS. BLOG (Feb. 4, 2011), <http://www.mmdinsurance.com/medical-marijuana-insurance-specialist-offers-pot-raid-coverage> (on file with *The University of the Pacific Law Review*). In a more recent story a California broker noted that carriers are offering coverage for state law enforcement raids, but not federal raids. “When you talk about federal, you can’t cover federal because it’s illegal . . . We’d all go to jail for insuring an illegal operation.” Kennedy, *supra* note 67. Of course, his carriers are insuring an operation that is illegal under federal law, but they are just choosing not to insure against federal law enforcement actions.

104. See *infra* Part II.A.

III. CONCLUSION.

It is difficult to conclude a story that barely has begun. The uneasy status of the nascent marijuana industry is only now coming into full view. With so many important issues confronting the industry, the question of available and effective insurance products might seem to be a minor matter, best left to the specialists after the important work has been done to resolve the quandary of state-legal activity that is heavily punished under federal criminal law. But, the commercial world works only because of insurance, and so insurance coverage in fact is a pressing question. This article has taken a first step by describing the terrain and the pitfalls. Creative solutions and strategies must await another day.