Weeding Through Operational Risks in the Cannabis Industry

More than half of U.S. states have legalized some form of medical or recreational marijuana. All six New England states have legalized the use of cannabis for medical purposes, and recreational marijuana is legal in Connecticut, Maine, Massachusetts and Vermont. Despite conflicting state and federal laws, the demand for cannabis continues to grow and with it the need for coverage and risk management services. The vast majority of business is written by surplus lines carriers.

"The reality is that you can't drive a mile on the highway in Massachusetts or in our surrounding communities without seeing a billboard for the closest dispensary," said Eric McLaughlin, AAI, partner and executive vice president of C&S Insurance, which is headquartered in Mansfield, Mass. He discussed cannabis risk with members of the Central Massachusetts, New Hampshire and Rhode Island chapters of the CPCU Society at their recent I-Day event. McLaughlin made it clear that it is not "stereotypical stoners" who are running these businesses. The capital required to set up a cannabis business is a barrier for people with only a passing interest in marijuana. Many of the dispensary owners McLaughlin counts as clients are former chief executive or chief financial officers, certified public accountants, doctors and attorneys, with one commonality — high net worth.

"The people I currently work with are successful business entrepreneurs who are simply trying to take advantage of an opportunity to get involved in an industry that has the potential to absolutely skyrocket if and when the federal government legalizes cannabis."

As an example, one of McLaughlin's clients owns a cannabis dispensary in Mass. that has approximately $15 million in revenue annually coupled with a cannabis operation consulting company that generates another $5 million. He noted that his book of business continues to grow and that he is not seeing much claims activity right now.

Owner & Operator Hurdles

The owners and operators of cannabis businesses face numerous challenges, including funding their businesses, investing in technology and handling public scrutiny. To be considered for a dispensary license in Mass., a business needs to have $500,000 in cash in a bank account.[1] That is no small task given that banking institutions consider cannabis to be illegal. "There are no business loans out there. You can't go to your local bank. The money is either from personal funds or investors," explained McLaughlin.

The Massachusetts Cannabis Control Commission is "very deliberate" in its process. Commission members "don't move fast, and they don't overlook the details for the regulations that are in place," according to McLaughlin. As a result, the licensing process for owners seeking to establish a dispensary takes a considerable amount of time. "The process is slow and expensive, which is not a great combination for the owner. But the heartening thing to know is for the general population, the safeguards are in place to keep the community safe."

The Cannabis Control Commission requires insurance to be purchased before a license can be granted. Insurance for a fully operational dispensary is required to be in place to keep the licensing process moving forward. The inspection of the property is the last step in the process, which could take up to eight months, noted McLaughlin. He has seen situations where a dispensary owner anticipated having revenue of $1 million in the first year but licensing delays resulted in only $100,000. "The first year [with clients] is an absolute roller coaster. You need to be creative in managing exposures to avoid having the owners pay for insurance that they don't need."

Medicinal Versus Recreational Dispensaries

Today, business owners can opt to open a medicinal dispensary, a recreational dispensary or both. McLaughlin likened recreational dispensaries to liquor stores in that they sell a product that is purchased from a cultivator/wholesaler. It is more expensive for a consumer to buy products from a recreational dispensary, and the business is taxed at a higher rate than a medicinal dispensary.

Individuals need a prescription from a physician to purchase products from a medicinal dispensary. The prescription allows consumers to purchase larger quantities and stronger doses than they would receive at a recreational dispensary.

[1] The Massachusetts Cannabis Control Commission has developed an economic empowerment program to aid dispensary businesses in communities disproportionally harmed by the "war on drugs" to gain access and opportunity in the cannabis industry. There is also an opportunity for veterans to get involved on the medicinal marijuana side of the business. These two groups may be able to bypass the initial investment of $500,000 in cash.

The Controlled Substances Act

At the federal level, marijuana is classified as a Schedule I drug under the Controlled Substances Act of 1970. Schedule I substances, which include hallucinogen lysergic acid diethylamide (LSD) and heroin, are those the federal government deems to have "a high potential for abuse" with "no currently accepted medical use in treatment in the United States," that cannot safely be dispensed under a prescription.

States that have legalized recreational and/or medical marijuana are in direct conflict with federal law, which has created tension between states' rights and the authority of the federal government.

Insuring a Cannabis Operation

One of the major differentiators between the two types of dispensaries is that medicinal dispensaries have to grow their own product. From an underwriting perspective, the business needs to be insured for having a physical storefront as well as a crop.

Builders Risk Insurance: As with any new business venture, agents need to start by obtaining coverage with a builders risk insurance package. Some standard carriers will cover the builders risk phase, with a "very specific endorsement terminating coverage as soon as occupancy is granted and cannabis-related work commences."

The situation is complicated because the business is still trying to obtain a license from the cannabis commission, and although it has an occupancy permit, it may not be selling products for upwards of a year. In essence, the commercial insurance package is put into place long before any plants, soil, fertilizer or product is even in the building.

Lessors Risk & Excess Liability Insurance: Another common coverage for dispensaries is lessors risk insurance. In Central and Western Mass., numerous old warehouses and former industrial parks are being converted into large cultivation centers. McLaughlin is currently working on one that will have 125,000 square feet dedicated to cultivation, equating to roughly 90,000 plants.

Like many other types of businesses, cannabis operations find that excess liability insurance is "extraordinarily hard to obtain," noted McLaughlin. "More often than not, you're better off purchasing a $5 million straight liability limit as opposed to a traditional $1 million or $2 million with excess insurance because you currently can't get it."

To highlight the significant investment of cannabis operations, McLaughlin noted that the statement of values for a large cultivation risk can easily exceed $75 million — and that figure could be "on the low side." Only two of the carriers that underwrite property for cannabis operations have the ability to have a $40 million limit. "So, when you're talking about a minimum of $75 million with a large-scale crop, layering becomes a process. The two [carriers] I have can't work together, and the rest can only put up $10 million … [The challenge] is to get to the full limits without having coinsurance issues."

Layering is difficult for two reasons — the small pool of carriers and reinsurance. The reinsurance pool is even smaller than that of the primary carriers, noted McLaughlin. If reinsurers insure multiple primary carriers in the cannabis market, reinsurance treaties will prevent layering the carriers with each other. "That makes it very difficult to build a tower. You have to be aware of who works best with whom."

Other statutory requirements in Mass. include having workers compensation insurance (the all-encompassing class code for cannabis risks is **Classification 0035**) and having a surety bond in place. The surety bond is to cover the taxes should a dispensary become insolvent. "They want some type of guarantee that they will recover the taxes owed to them for the sales of that particular year," said McLaughlin.

Beyond these coverages, McLaughlin recommends that his clients obtain some type of professional liability coverage. Similar to bartenders, dispensaries have budtenders who offer recommendations to customers, have knowledge of the store's inventory and can describe the differences between various products or strains. "I always recommend that they get some type of professional coverage, just in the event that somebody comes back and says, 'You told me it was going to do this, and it definitely didn't do that.'"

For cultivators, McLaughlin recommends purchasing product recall insurance. The insurance is much less expensive than the cost to recoup the product off the shelves.

The Underwriting Process

Carrier availability for cannabis operations is limited at best. "To put it into context, Lloyd's of London — which insures anything — doesn't even entertain cannabis risks," said McLaughlin. He believes that little will change in the market unless or until the federal government legalizes cannabis. Until then, there will be few carriers from which to choose. Some carriers are monoline writers, while others write both the liability insurance and the property insurance. All of the carriers that write cannabis operations are accessible through wholesalers.

"The underwriting process is remarkably slow. The wholesalers are fantastic. They do a great job, and they know how to get it done, but the amount of detailed information that it takes to compile together for an underwriter is painstaking. It takes a long time."

McLaughlin explained that every application includes supplemental forms and more than one supplemental form is often needed. A universal application "that checks the box for everybody" does not exist.

Carriers want to know if the cannabis operation is a cultivation risk, a retail risk, a medicinal or recreational risk or a combination of all four. Some cannabis businesses offer delivery services. McLaughlin cautioned that a delivery option is problematic in that even fewer carriers have an appetite for it. "It's risky business, and carriers just don't like it yet."

One of the most time-consuming parts for McLaughlin is that property carriers require a detailed statement of values with an itemized schedule for any industry-specific equipment like extraction and trimming machines. Another challenge is that carriers assign a specific value for each plant during different phases of development from a seed to a fully mature plant. "Each carrier has a different methodology for their evaluation process, so the property really becomes the biggest challenge in putting these risks together."

McLaughlin explained that some carriers reimburse in the case of a loss at wholesale value while others reimburse at retail value. Still others treat the loss as an expense reimbursement for the expenses associated with growing a plant. "So there's really no blanket solution other than layering and working with that list of carriers. It becomes a challenge to manage each layer to make sure that it's following that primary form."

The good news is that property liability coverage is straightforward — it is rating basis and sales. "Really the trickiest part about the liability is getting that first year correct. After that, as it grows, you just adjust, so it's really no different than a manufacturing risk," said McLaughlin.

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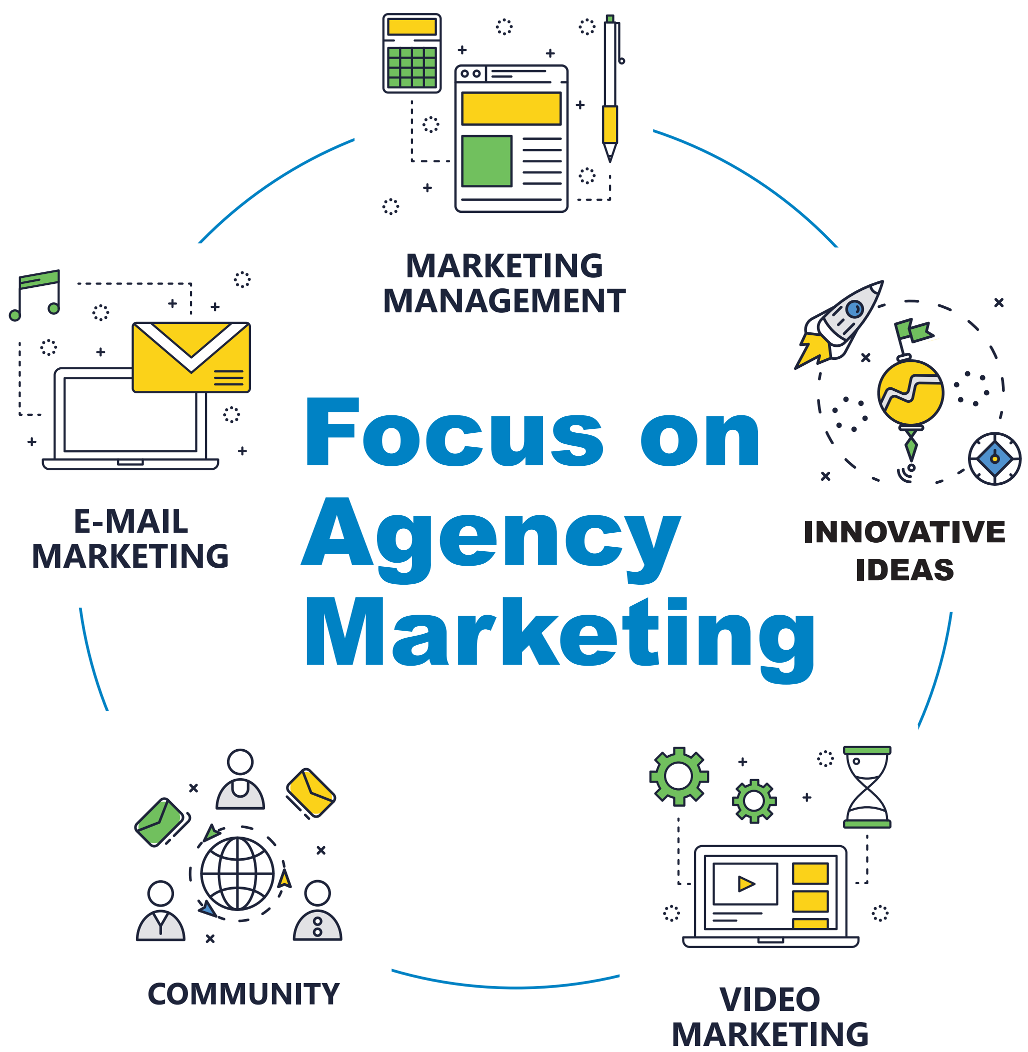

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What does an average premium look like for these policies? For small retail shops that have revenue between $2.5 million and $5 million, the premium could range from $15,000 to $22,000. Large cultivation facilities could pay over $1 million. Up until now, there has not been a lot of loss activity; however, if there is another harsh winter like New England experienced in 2015, there could be large crop losses, which would drive premiums up.

Emerging Concerns

Carriers that offer coverage for cannabis operations have been "tweaking" their forms for HVAC systems to make sure that they are appropriately covering cannabis crops. For example, if there is an HVAC system outage that creates temperature issues that lead to crop failure, is there coverage? It depends on why the system failed, according to McLaughlin. "Equipment breakdown is a very difficult coverage to obtain right now because that has become such a hot, sticky topic."

Crime coverages are expensive as well. Although McLaughlin is not seeing much crime activity from employees or consumers, he suspects that there will be in the future, particularly as the licensing process may not be able to keep up with demand. Supply shortages could lead to potential assault and battery situations as patrons' tempers flare while waiting in line.

Cannabis operations often have a lot of cash on hand, although debit card payments are accepted. While banks will not conduct business with cannabis businesses, some credit unions will. It is not uncommon for cannabis business owners to make multiple daily deposits to a credit union in an effort to eliminate the amount of cash on the premises.

With so few carriers in the market, capacity is another issue facing the industry. Accounts for small retail storefronts are not a problem, but any business that includes cultivation and extraction is going to face capacity challenges, according to McLaughlin.

Legalization at the Federal Level

Without the legalization of cannabis at the federal level, agents will continue to work with a small group of carriers, and premiums will continue to increase, which McLaughlin said is not necessarily a bad situation.

If cannabis is legalized by the federal government, he thinks more carriers would enter the market and that there would be significant consolidation, much like there was in the tobacco industry.

"I think we'll see a huge influx of private-equity money coming in, and we'll see a lot of consolidation. Those people who jumped in — like my client eight years ago — will realize the American dream. They'll make some money."

McLaughlin's last prediction is that the smaller retail locations — the liquor store-type operations — will go out of business. "Here in Massachusetts, we have a liquor store it seems every 30 feet on the street, but I do believe that the cannabis industry is different. There might not be enough product to meet the demand. So I envision that the smaller guys are going to get flushed out, and the larger guys will really be the ones that will make a run for the long haul." ■

In Tumultuous Times the Insurance Industry Turns to the E&S Market for Solution

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market, insureds that have historically suffered losses, in addition to challenging classes — including residential and habitational risks, demolition, roofing, and scaffolding — could see fewer interested carriers, tougher pricing and lower-than-desired limits. For these risks, carriers in this hardening market will likely include more restrictive terms, such as limits on wrap projects and on the number of units in high-rise projects," said AM Best.

In response to the collapse of the Champlain Towers South in Miami in June 2021, residential high-rise risks could become less appealing to insurers and require more detailed informational on inspections, repairs and recertifications than in previous years. It could result in retailers turning to wholesalers and surplus lines insurers.

Space Tourism: While still in its infancy, space tourism is another area that the E&S market will play a role in as activity evolves. Space X is developing fully reusable rockets, and Virgin Galactic and Blue Origin are considering space tourism. These innovations would present challenges for traditional insurers and could add to market growth in E&S in the future, according to Fitch Ratings.

Looking Toward 2022

The global economic recovery and the reopening of businesses, combined with harder market conditions yielding higher premiums, should add to the momentum for direct premium growth that continued through the first half of 2021, according to AM Best.

For 2022, AM Best expects market conditions to remain tight due to the ongoing impacts of COVID-19. A decline in capacity owing to changes in company risk appetites, along with hardening rates for many commercial lines of coverage, creates an environment with a need for creative market and product-oriented solutions — hallmarks of E&S carriers. ■