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A ‘growth industry’ for captive insurance?

Certain insurers are shying away from the legal marijuana industry, leaving a gap that could be filled by captives. Michael Schroeder of Roundstone Management examines the issues surrounding this controversial topic

One of the primary reasons a captive insurance company is formed is a lack of capacity in the traditional insurance market. Where traditional insurers raise their premiums, reduce their coverage or simply do not entertain the underwriting of certain risks, you are certain to find the captive insurance industry. Examples of past limitations in market capacity that led to an increase in captive formations include medical malpractice captives in the 1980s, professional liability coverage for nursing homes in the early 2000s and, more recently, trucking liability captives.

Captive insurers offer an alternative to the traditional market, especially when that market steps away from an entire class of business. This is what happened over the summer when Lloyd’s instructed its underwriters to cease issuing new policies and to not renew existing policies for businesses involved in the marijuana industry.

Thousands of dispensaries in California and Colorado were suddenly searching for new business operations coverage. Prior to its exit, Lloyd’s was the largest writer of marijuana-related business coverage. Opinions of industry participants maintain that they experienced favorable underwriting outcomes with outsized rates.

More than 20 US states have established medical marijuana regulatory regimes. Four have legalised marijuana under state recreational marijuana laws. Still, businesses involved in the production and distribution of marijuana in states where medical and recreational use is legal operate in a grey market because federal law does not yet

recognise the legality of such enterprises. Banking and insurance needs for these businesses pose substantial challenges, as both involve significant regulation on a state and federal level. Yet, these businesses have legitimate exposures that require coverage should a loss arise. What to do when insurers abstain or exit the space entirely? Many businesses are turning to the captive industry. If no one else will insure your business, then why not start your own insurance company? After all, the one requirement for forming a captive insurance company is capital and these businesses appear to have plenty.

The coverage

The coverages needed by marijuana-related businesses are not unique to the insurance industry. Coverage, such as general liability, property, surety, workers’ compensation and business interruption, are all relevant to a business producing, manufacturing, or distributing cannabis-related products. Any traditional insurance underwriter should be able to quickly assess and rate these risks. They do so for barbershops and manufacturers of widgets every day.

Companies selling into the marijuana industry also confront insurance challenges. What does a supplier of equipment, a landlord or finance company do when it discovers the purchaser of its goods or services is lacking basic insurance coverage? Captive insurance company solutions appear to be a viable alternative. After all, what vendor wants to place equipment with another business that is unable to show proof of insurance? What happens when a run-of-the-mill fire or theft

destroys the financed property that is not covered by the insurance of the business possessing the property? The answer is obvious—most vendors quickly look to obtain their own coverage, either through the traditional market or an alternative, such as a captive insurance facility. Captives that indemnify vendors for their uninsured exposures that arise when selling into the marijuana industry are growing. Imagine a process and coverage form similar to collateral protection insurance you see in the auto and home financing markets.

The feds

The marijuana industry presents many businesses with an interesting question: what can or should legitimate businesses do when confronted with the fact that a customer is operating in the state-legalised marijuana industry? While legal according to the state of the business’ domicile, the federal government maintains laws, namely the Controlled Substance Act, directly prohibiting the business’ operations (ie, marijuana production and sale). Legitimate service providers and suppliers of essential business tools, such as computers or garbage disposal, struggle to determine how to proceed. Likewise, insurance providers are confronted with the question of what they can or cannot do when they get a call from a business operating in the marijuana industry. Fortunately, the federal government recognised the quandary and offered some insight for businesses looking to maintain compliance with federal law when confronted with a state-legalised marijuana business customer. The state-federal conflict created by state marijuana laws has been the

subject of four different Department of Justice (DOJ) memoranda that date back to 2009. The memoranda articulate the DOJ's approach to the state-federal conflict by confirming marijuana remains a dangerous, illegal drug under federal law, but also indicating that the federal government will not pursue legal challenges against states so long as the state and local governments maintain strict regulatory enforcement controls.

The DOJ went further in its 2013 memorandum and instructed federal prosecutors not to consider the size or commercial nature of a marijuana business alone in determining whether to pursue enforcement of federal law.

Rather, the DOJ identified several factors that should be considered when deciding to pursue a civil or criminal enforcement action for violation of federal law.

The activities that are the priority or focus of federal enforcement include preventing:

- The distribution of marijuana to minors;
- The sale of marijuana to criminal enterprises, gangs, and cartels;
- The diversion of marijuana from states where it is legal under state law in some form to other states;
- State-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;

- Violence and the use of firearms in cultivation and distribution of marijuana;
- Drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
- The growing of marijuana on public lands and attendant public safety and environmental dangers posed by marijuana production on public lands; and
- Marijuana possession or use on federal property.

Additionally, because federal law continues to prohibit the deposit or withdrawal of proceeds derived from the distribution of marijuana and any other controlled substance, it is not surprising that state-legalised marijuana providers have historically experienced difficulty securing banking services.

Recently, however, the US Treasury has issued guidance to banks, incorporating the DOJ's enforcement priority memoranda and directing financial institutions that provide services to marijuana-related businesses to file specific transactional forms.

One of these is used when the institution determines, after the exercise of due diligence, that its customer is not engaged in any of the activities that violate state law, or that would implicate the DOJ's enforcement priorities listed above.

It would appear that the federal government has essentially given the 'green light' to banking institutions to handle the monies associated with the state-legalised marijuana industry, albeit not without strict, and arguably burdensome, regulations.

Is the above guidance enough to encourage the standard insurance market to participate in covering the marijuana industry? Will other markets after Lloyd's fill the void with policies sufficient to cover the real life exposures of a business producing or distributing cannabis products?

This remains to be seen, but no doubt the captive industry can offer solutions. **CIT**



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