

# Insurance Issues Raised by the Legalization of Recreational Marijuana

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**I**n the last two decades, states have embarked on an experiment in marijuana legalization. California became the first to authorize medical marijuana, in 1996, and 24 states and the District of Columbia have followed its lead. Since 2012, D.C. and four states—Washington, Colorado, Oregon, and Alaska—have legalized recreational use, and this November recreational marijuana will be on the ballot in several states, including California and Massachusetts.<sup>1</sup> Marijuana possession and use remain illegal under federal law,<sup>2</sup> but the Obama administration has generally declined to enforce that law in states that tightly regulate the drug.

Although still in its infancy, the legal recreational marijuana business is booming. In Colorado, legal marijuana sales this year are expected to reach \$1 billion,<sup>3</sup> and in Washington, total sales for the fiscal year ending June 30, 2016, exceeded \$970 million.<sup>4</sup>

With the growth in the legal marijuana business comes a need for both property and liability insurance. The drug's cultivation and sale pose substantial risks. Grow operations, for instance, are vulnerable to fires and flooding because of the irrigation, lighting, and other equipment necessary for cultivation. And theft is always a risk due to the drug's high value and portability. The tension between federal and state law, as well as the language of existing coverage forms, gives rise to several insurance coverage issues. A review of the case law and common insurance forms in this area highlights the insurance coverage issues likely to arise in the future.

### Is There an Insurable Interest in Marijuana?

The most salient issue for insurance carriers and policyholders is whether an interest in marijuana is insurable at all. While several states have legalized the drug, the federal Controlled Substances Act (CSA) continues to criminalize its possession, distribution, and sale.

The first case to address this issue, from the federal district court in Hawaii, found no insurable interest in cannabis.<sup>5</sup> The case began when Barbara Tracy sued her homeowners insurer, USAA, for failing to pay her claim for 12 stolen medical marijuana plants. USAA argued that the marijuana was not covered because a Hawaii statute required an insured's interest in property to be lawful, and the plant was not legal under state or federal law.<sup>6</sup> While the court held that Tracy had a lawful interest in the cannabis under Hawaii's medical marijuana statute, it determined that the insurance policy was unenforceable as to the cannabis because requiring USAA to pay for replacement of the plants would be contrary to federal law and policy.<sup>7</sup>

In a 2016 case, the Colorado district court reached a contrary result, based on the federal government's apparent de facto acceptance of state-regulated marijuana. *Green Earth Wellness Center, LLC v. Atain*

*Specialty Insurance Co.*<sup>8</sup> held that federal public policy did not invalidate a first-party policy issued to a medical marijuana retail operation. Green Earth operated a retail medical marijuana business and a growing facility in Colorado Springs. It applied for commercial property insurance with Atain, completing an application that asked several questions about its marijuana inventory. Atain issued the policy. Around the same time, smoke and ash from a nearby wildfire overwhelmed Green Earth's ventilation system, causing damage to its marijuana plants. After Atain denied the claim, Green Earth sued Atain for breach of contract, bad faith, and unreasonable delay in payment. The parties each filed dispositive motions.

Atain argued that the insurance contract was void as against public policy because the CSA made it a crime to possess marijuana for distribution. But the court observed that the federal government had publicly pronounced that it would likely decline to enforce the CSA if an entity's possession and distribution of marijuana was consistent with well-regulated state law such as Colorado's. Declining to follow *Tracy*, the district court noted that enforcing Atain's and Green Earth's agreement did not clearly violate public policy, given the "continued erosion of any clear and consistent federal public policy in this area."<sup>9</sup>

Courts are more likely to follow *Green Earth* than *Tracy*. While *Tracy* looks primarily to the federal de jure ban on marijuana, *Green Earth* recognizes that the federal government has in practice taken a hands-off approach to state-regulated marijuana—an approach that is unlikely to change anytime soon.<sup>10</sup> Moreover, in contrast to Hawaii law, some state laws expressly provide that contracts for marijuana are legal. The Oregon measure legalizing recreational marijuana provides that "[n]o contract shall be unenforceable on the basis that manufacturing, distributing, dispensing, possessing, or using marijuana is prohibited by federal law."<sup>11</sup> Similarly, a Colorado statute enacted after passage of Amendment 64 states 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 authorized by section 16 of article XVIII of the state constitution,"<sup>12</sup> the amendment legalizing recreational marijuana. (*Green Earth* did not cite this statute.) Courts may also be reluctant to hold that marijuana is uninsurable because it would disrupt the emerging multibillion-dollar market in legal marijuana.

Complicating the picture are municipal bans on marijuana in states where it is otherwise legal. In Colorado, a significant majority of municipalities opted out of allowing legal marijuana.<sup>13</sup> And Washington's medical and recreational marijuana statutes probably do not preempt local ordinances regulating or even banning marijuana businesses.<sup>14</sup> If marijuana is illegal under a



## TIP

If legal marijuana is here to stay, then insurers and policyholders must figure out how to navigate the effects of conflicting state and federal laws.

local ordinance, an entity may have no insurable interest in marijuana within that jurisdiction.

### Property Insurance Coverage

While the legality and insurability of marijuana is perhaps the most critical issue in this field, the language of existing first-party coverage forms raises additional coverage questions.

#### Exclusions for contraband.

Many first-party policies exclude from the definition of “covered property” “contraband, or property in the course of illegal transportation or trade,” including the Businessowners Coverage Form, the Building and Personal Property Coverage Form, and the Standard Property Policy.<sup>15</sup>

In *Green Earth*, the Colorado district court rejected the insurer’s argument that the marijuana buds and flowers were excluded contraband. The court noted that while the CSA does forbid marijuana possession, the federal government had expressed reluctance to prosecute any person or entity that possessed or distributed marijuana consistent with well-regulated state law, thereby rendering the contraband exclusion ambiguous.<sup>16</sup> In addition, the application and the insurer’s statements showed that it knew that the policyholder was operating a medical marijuana business and that marijuana buds and flowers would be covered. The court denied summary judgment for the insurer. Other

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courts are likely to follow *Green Earth* on this issue. An insurer cannot accept premiums from an entity it knows is in the marijuana field, while also denying coverage based on the contraband exclusion.

#### Coverage for growing plants.

*Green Earth* also addressed whether growing plants came within a policy’s coverage grant. The standard policy in that case covered, among other things, “stock,” defined as “merchandise held in storage or for sale, raw materials and in-process or finished goods, including supplies used in their packing or shipping.”<sup>17</sup> The policy did not, however, cover “growing crops.”<sup>18</sup>

In *Green Earth*, the insurer and policyholder disputed whether growing plants, rather than the harvested flowers or buds, qualified as “raw materials” and therefore stock.<sup>19</sup> Apart from dictionary definitions, neither party could point to extrinsic evidence of the meaning of the term. Citing government and university reports using “raw materials” to refer to agricultural products, the court concluded that there was a question of fact whether raw materials “can sometimes include an agricultural producer’s growing plants.”<sup>20</sup> *Green Earth* went on to hold, however, that the plants were “growing crops” and therefore not covered. Case law and dictionaries defined “growing crops” to include plants grown outdoors and indoors, and the insurer’s quote and binder specifically excluded coverage for growing plants.<sup>21</sup>

#### Limited coverage for outdoor plants.

Certain business property policies do not cover outdoor plants, unless special coverage is added. This optional coverage applies only if the loss is caused by certain perils—fire, lightning, explosion, riot or civil commotion, or aircraft—and only up to \$1,000 per plant for a total of \$2,500:

- c. Outdoor Property  
You may extend the insurance

provided by this policy to apply to your outdoor fences, radio and television antennas (including satellite dishes), signs (other than signs attached to buildings), trees, shrubs and plants, including debris removal expense. Loss or damage must be caused by or result from any of the following causes of loss:

- (1) Fire;
- (2) Lightning;
- (3) Explosion;
- (4) Riot or Civil Commotion; or
- (5) Aircraft.

The most we will pay for loss or damage under this Extension is \$2,500, unless a higher Limit of Insurance for Outdoor Property is shown in the Declarations, but not more than \$1,000 for any one tree, shrub or plant.<sup>22</sup>

The policy does not address indoor plants, which creates a substantial coverage gap because most marijuana plants are grown indoors.

A homeowners policy may provide additional coverage for plants caused by certain perils, including theft and fire, on the “residence premises”:

#### 3. Trees, Shrubs And Other Plants

We cover trees, shrubs, plants or lawns, on the “residence premises”, for loss caused by the following Perils Insured Against:

- a. Fire or Lightning;
- b. Explosion;
- c. Riot or Civil Commotion;
- d. Aircraft;
- e. Vehicles not owned or operated by a resident of the “residence premises”;
- f. Vandalism or Malicious Mischief; or
- g. Theft.

We will pay up to 5% of the limit of liability that applies to the dwelling for all trees, shrubs, plants or lawns. No more than \$500 of this limit will be paid for any one tree, shrub or plant.

We do not cover property grown

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for “business” purposes. This coverage is additional insurance.<sup>23</sup>

As noted above, the limit is \$500 per plant, or up to 5 percent of the policy limit for all plants. It also excludes plants grown for business purposes.

Setting aside the issue of insurability, the relatively low limits of these policies would leave most underinsured. In *Tracy*, for instance, the plaintiff valued mature plants at \$4,000 and others at \$3,200—far in excess of the per-plant limit. In addition, the plant coverage may not apply to the highly valuable bud or flower, especially after harvest.

**Criminal act exclusions.** At least one carrier excludes coverage for loss from the illegal growing of plants. A Safeco policy issued in 2011 excluded losses from:

16. Illegal Manufacturing, Production or Operation, meaning loss from:
  - a. the illegal growing of plants or the illegal raising or keeping of animals; or
  - b. resulting from the illegal manufacture, production, operation or processing of chemical, biological, animal or plant materials.

Such loss is excluded whether by vandalism or any other cause and whether or not within the knowledge or control of an *insured*.<sup>24</sup>

This exclusion applies to illegal marijuana grow operations.<sup>25</sup> Whether this would apply to operations that comply with state but not federal law raises the same issues addressed above in the discussion of *Tracy* and *Green Earth*. In addition, if the insured is growing more plants than is legally allowed under state

law, the insurance may cover only the amount that is allowed, rather than the entire crop.

**Business limits in homeowners policies.** Homeowners policies provide very limited coverage for business losses. The most common form has a special limit of liability of \$1,500 on business property away from the “residence premises” and \$2,500 on business property on the “residence premises”:

### 3. Special Limits Of Liability

The special limit for each category shown below is the total limit for each loss for all property in that category. These special limits do not increase the Coverage C limit of liability.

. . . .

- h. \$2,500 on property, on the “residence premises”, used primarily for “business” purposes.
- i. \$1,500 on property, away from the “residence premises”, used primarily for “business” purposes.<sup>26</sup>

Given this very limited coverage, no home-based marijuana business should rely on a homeowners policy for coverage.

**Employee dishonesty coverage.** Commercial property policies may provide coverage for acts caused by employee dishonesty or theft for an additional premium. The optional coverage grant usually reads:

### 3. Employee Dishonesty

- a. We will pay for direct loss of or damage to Business Personal Property and “money” and “securities” resulting from dishonest acts committed by any of your employees acting alone or in collusion with other persons (except you or

your partner) with the manifest intent to:

- (1) Cause you to sustain loss or damage; and also
- (2) Obtain financial benefit (other than salaries, commissions, fees, bonuses, promotions, awards, profit sharing, pensions or other employee benefits earned in the normal course of employment) for:
  - (a) Any employee; or
  - (b) Any other person or organization.<sup>27</sup>

Businesses in the marijuana industry face a heightened risk of theft losses, especially by employees, because the drug is easily concealed and most businesses deal in cash.<sup>28</sup> Any business in this industry should consider obtaining this coverage.

### Other first-party losses caused by marijuana grow operations.

Marijuana grow operations, whether legal or not, pose substantial risks to property. One of those risks is mold caused by condensation, which is typically an excluded cause of loss in first-party insurance policies. However, a Washington court has held as a matter of law that mold damage caused by an illegal grow operation amounts to covered vandalism.<sup>29</sup> In that case, Bethany Bowers rented her house to new tenants. Without her knowledge, they converted the basement into a marijuana hot-house, sealed the windows and doors, and diverted all heat to the basement, causing mold to proliferate elsewhere in the house. After police discovered the operation, Bowers file a claim with her homeowners insurer, Farmers, for the damage. Farmers denied the claim, citing an exclusion for “direct or indirect loss from . . . mold.” In the

insured's suit for repair costs and lost rent, the court held that the damage was caused by vandalism because the tenants intentionally disregarded the insured's rights. The court also held that the efficient proximate cause of the loss was vandalism and not mold. The efficient proximate cause rule provides that where a peril specifically insured against sets other causes into motion that, in an unbroken sequence, produce the result for which recovery is sought, the loss is covered, even though other events within the chain of causation are excluded from coverage. While the rule usually presents an issue of fact, the court held that Bowers was entitled to summary judgment because, as a matter of law, the tenants' vandalism, in an unbroken sequence, produced the loss.

#### Liability Insurance Coverage

While few courts have addressed first-party coverage for marijuana-related losses, case law addressing liability policies is even sparser. Those advising persons or entities in this field should be aware of three emerging issues: coverage for pollution, exclusions for controlled substances, and mandatory insurance.

**Pollution exclusion.** Marijuana businesses may face liability for odors emanating from their operation, which neighboring property owners or tenants might consider irritating or even offensive. For instance, the city of Pendleton, Oregon, recently declared marijuana odors to be a nuisance, and there are reports of litigation involving nuisance claims against marijuana businesses. If a business were to be sued for nuisance or trespass due to offensive smells, it might find itself without coverage due to the pollution exclusion. Those exclusions, which are found in nearly all commercial general liability (CGL) policies, typically apply to liability arising out of the

discharge or dispersal of pollutants, which include any gaseous irritant or contaminant.

While no appellate court has addressed whether marijuana odors are "pollutants," many have addressed odors from other sources. Generally, those from industrial operations such as composting facilities, sewage treatment plants, and rendering operations are considered to be pollutants, while odors from nonindustrial sources, such as restaurants, fall outside the definition.<sup>30</sup> Whether marijuana smells qualify as pollutants probably depends on

to cocaine, LSD, marijuana and all narcotic drugs. However, this exclusion does not apply to the legitimate use of prescription drugs by a person following the lawful orders of a licensed health care professional.<sup>31</sup>

The standard homeowners umbrella policy and a common farmers policy contain similar exclusions.<sup>32</sup> This bars coverage for nearly any losses relating to marijuana. Unlike the contraband exclusion, which *Green Earth* found to be ambiguous as applied to marijuana,

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their intensity, range, duration, and location. The occasional waft from a dispensary in a commercial district may not be a pollutant, while a wide-ranging, intense stench in a residential neighborhood may be.

**Exclusion for controlled substances.** The liability and medical payments coverage in homeowners policies excludes coverage for losses arising out of the use, sale, manufacture, delivery, transfer, or possession of controlled substances under federal law, including marijuana:

E. Coverage E – Personal Liability And Coverage F – Medical Payments To Others  
Coverages E and F do not apply to the following:

...  
8. Controlled Substance  
"Bodily injury" or "property damage" arising out of the use, sale, manufacture, delivery, transfer or possession by any person of a Controlled Substance as defined by the Federal Food and Drug Law at 21 U.S.C.A. Sections 811 and 812. Controlled Substances include but are not limited

this exclusion identifies marijuana by name and cites the CSA. This specificity makes it more likely to be enforceable. The exception for "the legitimate use of prescription drugs by a person following the lawful orders of a licensed health care professional" could, however, allow for coverage of losses arising from the use of medical marijuana.

**Mandatory liability insurance.** Washington requires all recreational marijuana businesses to carry at least \$1 million in CGL insurance for bodily injury and property damage arising out of licensed activities, with the state and its employees, agents, and volunteers identified as an additional insured.<sup>33</sup> Failure to carry the insurance can result in fines and suspension or cancellation of a license.<sup>34</sup>

While the Alaska Alcohol Control Board considered a regulation requiring a \$1 million CGL policy for marijuana establishments, the final regulations do not include any insurance requirement.<sup>35</sup> Colorado's constitutional amendment, implementing statute, and Department of Revenue regulations do not

mandate insurance for those in the marijuana industry,<sup>36</sup> and Oregon's recreational marijuana rules only require that vehicles transporting marijuana be insured at or above existing legal requirements.<sup>37</sup> The District of Columbia only allows growth and consumption of a small amount for personal use, rendering business insurance moot. ■

## Conclusion

As businesses in the legalized marijuana industry continue to grow, their need for insurance will expand. Agents, brokers, and attorneys advising businesses and insurers in this field must stay current with the rapidly changing legal landscape.

## Notes

1. Charlie Baker, Maura Healey & Martin J. Walsh, *Mass. Should Not Legalize Marijuana*, BOS. *GLOBE*, Mar. 4, 2016; Patrick McGreevy, *Initiative to Legalize Recreational Use of Pot in California Qualifies for November Ballot*, L.A. *TIMES*, June 28, 2016.

2. In August 2016, the DEA announced that it will not reclassify marijuana from a Schedule I to a Schedule II drug, as requested by the governors of Rhode Island and Washington. See Denial of Petition to Initiate Proceedings to Reschedule Marijuana, 81 Fed. Reg. 53,688 (Aug. 12, 2016).

3. Carlos Illescas, *Marijuana Sales Tax Revenue Huge Boon for Colorado Cities*, DENVER *POST*, May 26, 2016.

4. *Weekly Marijuana Report*, WASH. ST. LIQUOR & CANNABIS BOARD (Aug. 24, 2016), <http://lcb.wa.gov/marij/dashboard>.

5. Tracy v. USAA Cas. Ins. Co., No. 11-00487 LEK-KSC, 2012 WL 928186 (D. Haw. Mar. 16, 2012).

6. *Id.* at \*2 (citing HAW. REV. STAT. § 431:10E-101).

7. *Id.* at \*13.

8. No. 13-cv-03452-MSK-NYW, 2016 WL 632357 (D. Colo. Feb. 17, 2016).

9. *Id.* at \*10.

10. Chauncey L. Alcorn, *If There's One Issue That Hillary Clinton and Donald Trump Agree on, It's This*, FORTUNE (July 12, 2016).

11. Or. Ballot Measure 91, § 12 (2014).

12. COLO. REV. STAT. § 13-22-601.

13. Clarissa Cooper, *Colorado Profits, but Still Divided on Legal Weed*, CENTER FOR PUB. INTEGRITY (Aug. 16, 2015), <https://www.publicintegrity.org/2015/08/16/17841/colorado-profits-still-divided-legal-weed>.

14. See Cannabis Action Coal. v. City of Kent, 351 P.3d 151 (Wash. 2015); Wash. St. Attorney Gen. Op. 2014 No. 2 (Jan. 16, 2014).

15. See Ins. Servs. Office, Inc. (ISO), Businessowners Coverage Form BP 00 03 01 10, reprinted in SUSAN J. MILLER, MILLER'S STANDARD INSURANCE POLICIES ANNOTATED (7th ed.); ISO Bldg. & Pers. Prop. Coverage Form CP 00 10 10 12, reprinted in MILLER, *supra*; ISO Standard Prop. Policy Form CP 00 99 10 12, reprinted in MILLER, *supra*.

16. Green Earth Wellness Ctr., LLC v. Atain Specialty Ins. Co., No. 13-cv-03452-MSK-NYW, 2016 WL 632357, at \*8 (D. Colo. Feb. 17, 2016).

17. *Id.* at \*4; see also ISO Bldg. & Pers. Prop. Coverage Form CP 00 10 10 12, reprinted in MILLER, *supra* note 15; ISO Standard Prop. Policy Form CP 00 99 10 12, reprinted in MILLER, *supra*.

18. *Green Earth*, 2016 WL 632357, at \*5; see also ISO Bldg. & Pers. Prop. Coverage Form CP 00 10 10 12, reprinted in MILLER, *supra* note 15; ISO Standard Prop. Policy Form CP 00 99 10 12, reprinted in MILLER, *supra*.

19. *Green Earth*, 2016 WL 632357, at \*5.

20. *Id.*

21. *Id.* at \*6-7.

22. ISO Businessowners Coverage Form BP 00 03 01 10, ¶ I.A.6.c., reprinted in MILLER, *supra* note 15.

23. ISO Homeowners 3—Special Form HO 00 03 05 11, ¶ I.E.3., reprinted in MILLER, *supra* note 15.

24. Huynh v. Safeco Ins. Co. of Am., No. C 12-01574-PSG, 2012 WL 5893482, at \*2 (N.D. Cal. Nov. 23, 2012).

25. *Id.* at \*2 (enforcing exclusion in policy issued to landlord where tenant was operating grow operation that damaged property).

26. ISO Homeowners 3—Special Form HO 00 03 05 11, ¶ I.C.3., reprinted in MILLER, *supra* note 15.

27. ISO Businessowners Coverage Form BP 00 03 01 10, ¶ I.G.3., reprinted in MILLER, *supra* note 15.

28. John Schroyer, *For Marijuana Companies, Biggest Security Concern Comes from the Inside*, MARIJUANA BUS. DAILY (May 26, 2015), <https://mjbizdaily.com/for-marijuana-companies-biggest-security-concern-comes-from-the-inside/>.

29. Bowers v. Farmers Ins. Exch., 991 P.2d 734, 736 (Wash. Ct. App. 2000).

30. E.g., Barney Greengrass, Inc. v. Lumbermens Mut. Cas. Co., 445 F. App'x 411, 414-15 (2d Cir. 2011) (“[W]e conclude that Lumbermens cannot meet its burden of showing that the restaurant odors constitute ‘pollution’ within the meaning of the exclusion[.]”); City of Spokane v. United Nat'l Ins. Co., 190 F. Supp. 2d 1209, 1219 (E.D. Wash. 2002) (“Migration of odors from a solid waste facility clearly constitutes contamination, or pollution, of the environment.”); Kruger Commodities, Inc. v. U.S. Fid. & Guar., 923 F. Supp. 1474 (M.D. Ala. 1996) (holding that odors from rendering plant, which caused customers of neighboring business to become physically ill, were “pollutants”); City of Bremerton v. Harbor Ins. Co., 963 P.2d 194 (Wash. Ct. App. 1998) (holding that fumes from sewage treatment plant were pollutants).

31. ISO Homeowners 3—Special Form HO 00 03 05 11, ¶ I.I.E.8., reprinted in MILLER, *supra* note 15.

32. ISO Pers. Umbrella Liab. Policy Form DL 98 01 10 06, reprinted in MILLER, *supra* note 15; ISO Farmers Pers. Liab. Form HO 24 73 05 11, reprinted in MILLER, *supra*.

33. WASH. ADMIN. CODE § 314-55-082.

34. *Id.* § 314-55-530.

35. See ALASKA ADMIN. CODE tit. iii, §§ 306.005-990.

36. See COLO. REV. STAT. §§ 12-43.4-101 to -1101; COLO. CODE REGS. § 212-2; Colo. Ballot Amendment 64 (2012).

37. OR. ADMIN. R. 845-025-7700(3) (b)(A).