

The Cannabis Industry & Insurance

Understanding coverage in the most rapidly evolving industry



Defining the industry

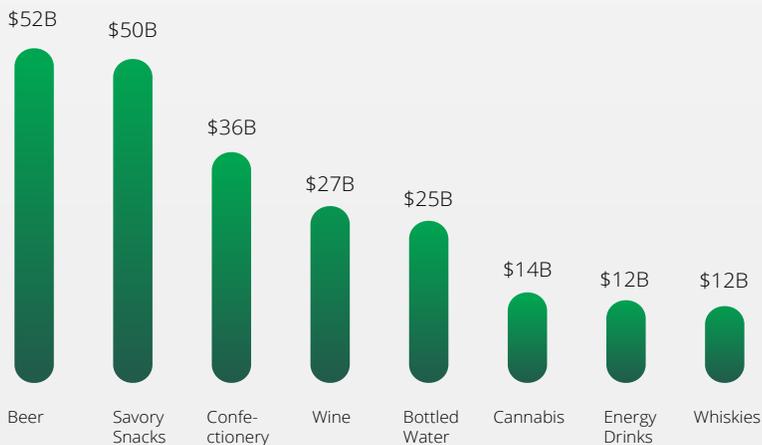
What is the cannabis industry? Is hemp cannabis? Is marijuana cannabis? Where does CBD come from?

These are all questions that have caused some confusion for those who are not directly in the cannabis industry, leading to legal and business complications for cannabis companies. With the growth of the cannabis industry, these questions have also found their way into the insurance industry. We will look to provide a high level overview of the various aspects of the cannabis industry which affect the insurance purchasing for a given company.

Recreational Use

Estimated 2019 U.S. Consumer Goods Sales

Compared to other consumer products, we believe legal cannabis product sales could rival other consumer goods.



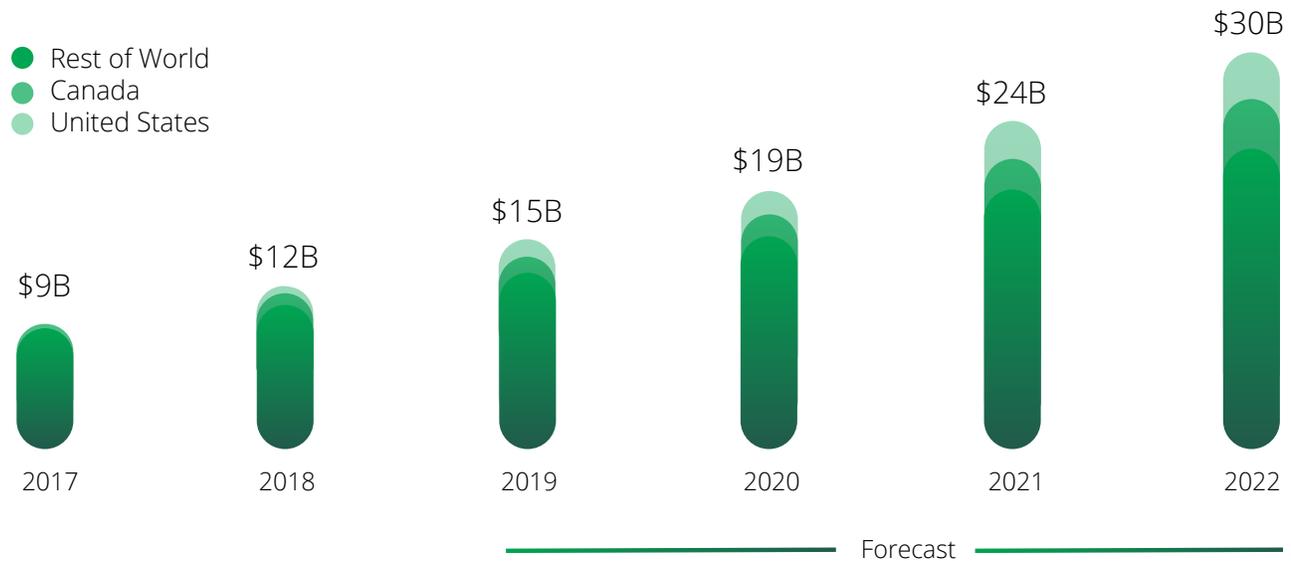
Source: "Estimated 2019 Select US Consumer Goods Sales," Bloomberg. Data as of 11/27/18



Global Cannabis Market

Global Spending on Legal Cannabis

Legal cannabis spending is anticipated to grow to \$30 billion by 2022



Source: "The CBD Effect: The Growth and Future of Legal Cannabis and Cannabinoids," BDS Analytics, 4/30/19.

Global spending projections are not indicative of future investment performance.

Cannabis:

Cannabis is a genus of plant in the Cannabaceae family, with three different species; sativa, indica and ruderalis, with each of these species having varying effects on the human body due to the differing amounts of specific chemical compounds present in a given plant. While medically and commercially produced products can vary in which species is used, the goal of this white paper is to focus on the difference between hemp and marijuana and how each is defined.

While there are a number differences between hemp and marijuana, currently in the US, the classification really boils down to the amount of THC (the psychoactive aspect) produced in the plant itself.

Hemp:

Hemp, by current US laws for the "cannabis industry", is defined as containing 0.3% THC or less (although some hemp plants can contain higher amounts). Products that test at this level are federally legal across the US via the 2018 Farm Bill.

Marijuana:

Marijuana on the other hand is classified as plants producing more than 0.3% THC (in some cases up to 30%). While a number of states have passed local legislation as to its legality, the products that fall above this key testing percentage threshold are still considered federally illegal and classified as a Schedule 1 drug.

THC and CBD:

The cannabis plant is composed of hundreds of chemical compounds, which create a variety of effects. For the medical and recreational subcategories of the cannabis business, the two main drivers of effects stem from the THC (tetrahydrocannabinol) and CBD (cannabidiol) compounds.

While THC has a number of medicinal uses (helping with pain, nausea, relaxation, sedation, etc), because it also produces the euphoric or “high” sensation, it has been deemed to be a Schedule 1 drug in the US. CBD on the other hand typically leads to a clear headed, and non-intoxicated effect on human users, allowing its products to be more widely accepted. The CBD compound has been used to manage a wide range of symptoms ranging from epilepsy and seizure disorder to standard pain management.

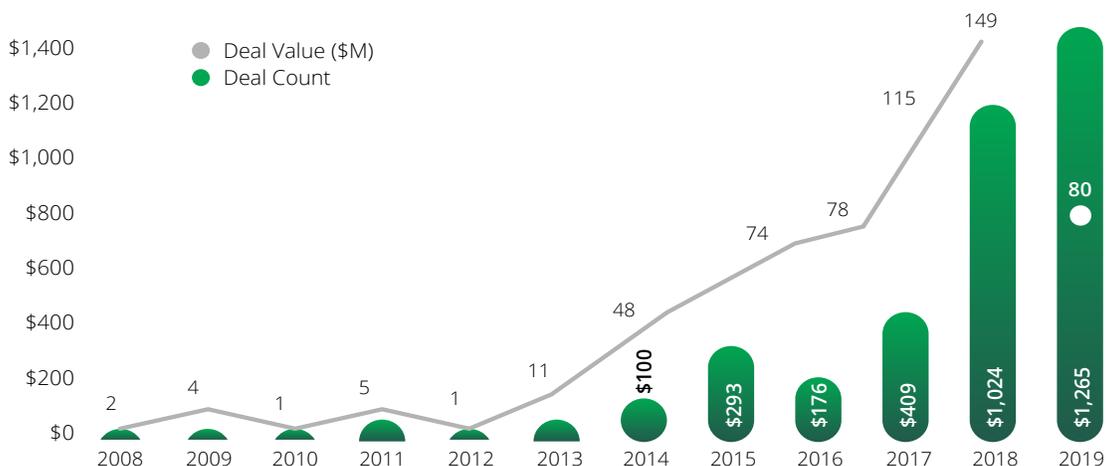
As mentioned above, for a hemp product to be deemed legal at a federal level, the plant (and product itself) must test at or below the .3% THC level. While CBD is a compound found in both marijuana and hemp products, the CBD products extracted from hemp have been accepted on a broader basis.

How the insurance market views the industry

With the overall confusion of hemp versus marijuana, insurance companies (as with many others) have a murky view of both types of products which can lead to differing underwriting guidelines and varying premium levels. As the insurance market currently stands, hemp derived products, with high CBD levels and THC levels below 0.3% is more easily accepted by underwriters, due to the current legislation surrounding them. This leads to a more competitive and open marketplace, keeping premiums at a lower level.

For marijuana products on the other hand, even those with high levels of CBD, underwriters follow the federal guidelines meaning less insurance companies are open to providing coverage for companies selling and producing these products, creating higher premiums and more stringent underwriting guidelines.

VC cannabis deal activity



Source: PitchBook

Region: US & Canada
*Data as of 5/15/2019

Legal Environment

The legal environment for the cannabis industry is ever changing and can vary from a national to municipal standpoint. Hemp products, as mentioned above, have been made federally legal since the adoption of the 2018 Farm Bill.

This has led to a less challenging legal environment for companies focusing solely on the cultivation and production of these products, at least in relation to its cousin marijuana. Due to the fact marijuana is still federally illegal, the laws and regulations companies must follow depend on where your business is operating.

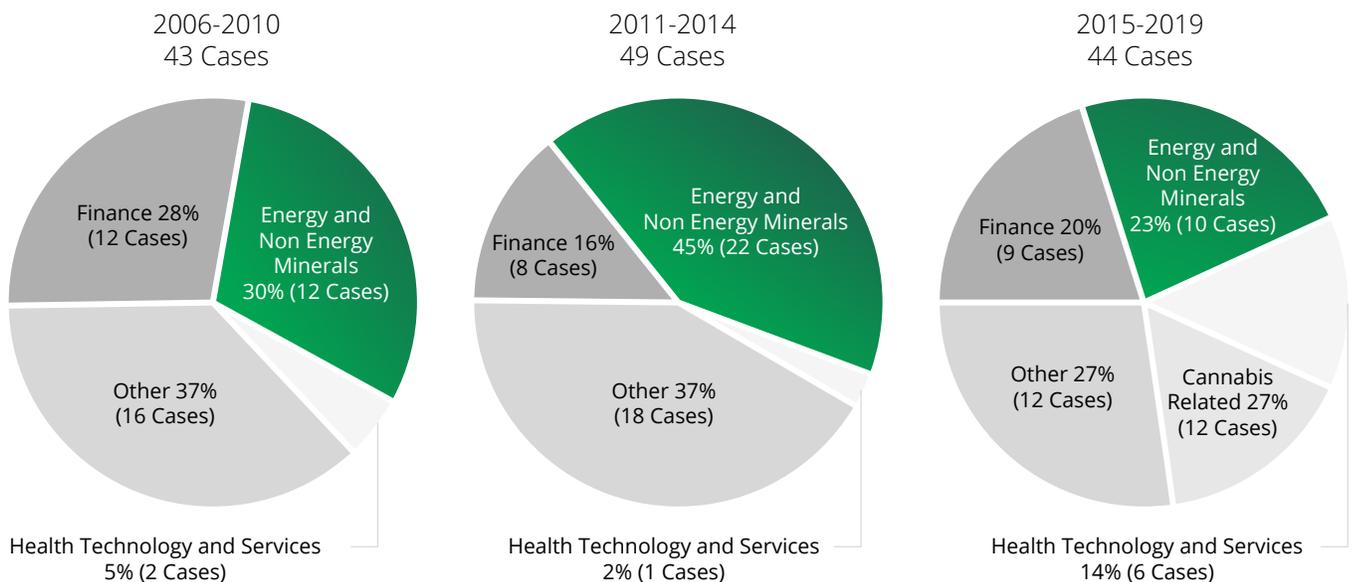
As of January 1st, 2020, there are 11 states who have legalized the use of marijuana products for adults over the age of 21 with another 33 making the use of these products for medicinal purposes. Within each of these states, however, municipalities and towns have their own rules and regulations which can make operating a business centered around the cultivation, production and sale of these products very difficult. It is important to

understand your local governments licencing and regulatory guidelines as you start and operate your business.

The most wide ranging rule across state and municipal lines come from the product testing itself. The 0.3% threshold for “hemp” products is the national rule, which can cause problems for companies focused on the production and cultivation of products.

There have been a number of instances where companies have had to stop production and even burn their crop because the plants test above the threshold, putting them in noncompliance with their licensing requirements. This can lead to the obvious operational issues as well as pave the way for a large D&O lawsuit.

As with all businesses, it is important to adhere to the rules and regulations of your industry, and understand how insurance can be an invaluable investment should something go not as planned.



Business & Industry Risks

Non-Compliance & Licensing

Due to the legal landscape of the industry, obtaining the proper license for your business and maintaining compliance with national, state and local regulations is of utmost importance. Without doing so, you leave the business open to the possibility of destroying crops, halting operations until you are compliant, or having to permanently shut your doors.

Financing

The core issue when it comes to financing a cannabis business stems from the legal system surrounding the industry. . With the inability or desire of many large traditional financial institutions to support the industry, smaller and more localized financing have become the financial backbone of the industry.

As with any new venture, securing funding and the proper financing partners comes with its own set of challenges. Debt funding, which is a staple of the startup world, can be extremely tricky to navigate due to the federal regulation in the cannabis industry. Many large, traditional financing institutions are not willing or completely unable to work with companies in the space.

Because of these challenges, cannabis companies have turned to local credit unions or looked towards newly developed companies who take the financing issue head on.

In a similar vein to debt financing, equity

funding can look a bit different in the cannabis industry. Larger more well known VC's and PE shops have not jumped with both feet into the industry, however, there have been a number of firms created with the specific focus on the cannabis space. There has also been an uptick in firms looking into adding cannabis / hemp companies to their portfolio as a diversification play.

Getting your funding in order is paramount to any new venture regardless of what industry a company is in. The cannabis industry may present its own legal and functional hurdles to secure funding, however, like the industry itself, the funding options will only continue to grow.

Weather

As with any commodity, crop yields are greatly affected by the weather patterns in a given region. While there are a number of producers who utilize greenhouses, which does limit this risk, weather can play a massive role in a company's yield.

Product Claims

As with any industry that produces consumer goods, the risk of injury or sickness caused by a company's product is a huge concern. Given the legal nature of the industry in general, this is something cannabis companies should be even more cognizant of.

Insurance Landscape

“A combination of a highly regulated industry that is the cannabis space and severely limited insurance capacity has produced one of, if not the most, hard insurance markets. Both reinsurance treaties and corporate strategies have led to restrictive coverage and high premiums, making it even more imperative that insureds find a broker specializing in the space” - **Drew Taylor, Lead Broker, AlphaRoot**

Similar to the volatility in the legal and regulatory landscapes of the cannabis industry, the insurance landscape is also constantly changing. AlphaRoot has seen carriers enter the space aggressively only to non-renew business and leave the industry altogether. This volatility can be found across all lines of coverage in both the Property & Casualty and the Management / Professional liability spaces.

It's important to note that this insurance landscape overview is what we at AlphaRoot believe is important from a holistic risk management approach for all companies in the Cannabis space. However, some of these coverages vary depending on company industry and operations so it's important to review with a broker who specializes in this space.

Insurance coverages in the cannabis space are similar to that of the traditional insurance marketplace; however, there are tailored forms to properly cover the exposure at hand. As such, you'll notice many of these coverages are familiar. We've also included a key exclusion per coverage type, but it's important to review with a broker specializing in the space to understand if these exclusions will apply to your business:

Property and Casualty Coverages

General Liability: Premises Specific

General Liability is often packaged with product liability in the traditional insurance space. However, many carriers offering 3rd party liability coverage in the cannabis space, depending on size of risk, prefer to write the premises coverage separate form. This 3rd party liability coverage is still important, especially if you own or lease property. This will step in to cover customer slips, trips, falls on your property. If you're a dispensary with customers in and out all day, this coverage becomes that much more important. In that same example of being a dispensary, especially one that allows consumers to



use your product on premises (i.e. smoke lounge), one key exclusion to look out for is a “On-Premises Consumption Exclusion”. This exclusion would preclude any claims arising from consumption. Product Liability:

As noted above, carriers in this space, depending on operations and size, tend to split this out of the General Liability coverage. Aside from Directors & Officers liability coverage, this line of coverage is arguably the most limited in terms of market capacity. This 3rd party liability coverage will cover claims arising from the use of your product. This coverage is extremely important to carry if you are anywhere in the supply chain, even those that are white-labeling the end product.

In an effort to provide a key exclusion, let’s imagine your business sells cartridges and vapes; however, your policy excludes batteries from China. With that exclusion, the battery powered vapes would not be covered, nor would the cartridges if they were used in connection with the battery powered vapes.

Property and Crop Coverage:

Property and Crop covers are both 1st party coverages, meaning they cover your belongings / items you own (i.e. buildings, equipment, seeds, plants, etc.) Property and Crop coverage can either be written on the same form or on separate forms, depending on the insurer.

Similar to traditional property coverage, this coverage will respond to make you whole again by replacing the property values that were lost on an actual cash value or replacement cost basis, depending on policy language.

Worker’s Compensation:

Workers’ Compensation and Employers Liability (a portion of the WC cover) are both intended to cover injuries that employees sustain during the course of their work and are typically required by state law. Workers’ Comp. in the cannabis space is the most similar coverage to the traditional insurance marketplace in terms of coverage with the key difference in this space being that only a handful of markets will entertain MSO risks, as many cannot write across state lines. Therefore, it is important to have proper insurance in place as companies look to grow and scale in multiple states to avoid a lapse or complications of coverage.

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Management and Professional Liability Coverages

Directors & Officers

Directors & Officers insurance or D&O insurance as it’s commonly referred to as is intended to cover the directors and

officers from investor lawsuits involving mismanagement of company funds, misrepresentation, etc. The 3 sides of this coverage (Side A, B, and C) intend to indemnify the Ds and Os or the company in the following circumstances:

Side A: Indemnifies the D&Os in the event the company is unable to either in the event of insolvency or not permitted by law

Side B: Indemnifies or reimburses the company after they have indemnified the D&Os

Side C: Entity or Balance Sheet protection coverage for the company as this side indemnifies the company. For public companies, this is for securities claims while private companies are offered more coverage assuming the claim is covered.

As previously stated, the D&O insurance marketplace is extremely limited and we have only seen one carrier in the space payout losses. Most carriers offering coverage will do so with a cannabis regulatory exclusion or regulatory endorsement which will preclude any claims arising from cannabis, which, if you are operating as a cannabis company, is not exactly ideal.

Employment Practices Liability:

Employment Practices Liability or EPL insurance is a labor law coverage which responds to claims arising from invasion of privacy, wrongful termination, sexual harassment, etc. In the current legal landscape we recommend it as a standard coverage for companies with any number of employees. This coverage is not specific to the cannabis industry.

Cyber Liability:

Cyber Liability is both a 1st and 3rd party liability cover as it responds when there is a breach of data to notify individuals that their data may have been compromised and cover liability associated with such a breach. However, there can also be a 1st party cover in that it will respond to cover Business Interruption and/or Extra Expense associated with a data breach. To date, there is only one carrier writing coverage for true cannabis companies.

Marketplace

As mentioned above in the coverage reviews, it's apparent that the marketplace in the Cannabis space is severely limited. For companies operating solely in the Hemp space, the market opens up their capacity. However, those in the CBD space are viewed to be operating as a cannabis company, for the most part, in the eyes of the insurance market. And finally, those that have products that classify as marijuana and MSO's are having the hardest time securing affordable insurance coverage that will respond appropriately during the time of loss.

More so in the cannabis space than other industries, it is important to have specialized brokers review and place coverage to ensure that coverage does respond. As RT Pro-Exec Executive Vice-President, Kevin Lacoix, harps on, "the most expensive policy is the one that doesn't provide coverage when it should" and this statement could not be more true in this challenging industry.





About AlphaRoot:

AlphaRoot is a subsidiary of Founder Shield, utilizing its technological tools to provide whiteglove insurance brokering services to the Cannabis Industry.

Our goal is to educate the cannabis companies about the risks associated with their business and take the stress out of buying insurance for innovative businesses. We're on a mission to take a broken and confusing experience and create the most seamless and informative insurance purchase process available.

We partner with the leading cannabis insurance carriers to craft tailored risk management programs that allow you to focus on the things that matter, growing your business

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