

## Preventing Both Smoke and Fire: D&O Insurance for Cannabis Risks

By Lorelie S. Masters and Geoffrey B. Fehling

The recent actions of the federal government and the results of the November elections may signal a sea change for cannabis companies lobbying for federal cannabis legalization. President Biden recently granted a pardon to all individuals who have been convicted of simple marijuana possession under federal law. The President also urged the Secretary of Health and Human Services and the Attorney General to review expeditiously how marijuana is scheduled under federal law. In addition, two states, Maryland and Missouri, voted to legalize the recreational possession and use of marijuana bringing the total count to 21 states and the District of Columbia.

Despite these positive developments, given the disparate treatment of marijuana under state and federal laws, cannabis companies still face many obstacles. One critical obstacle is the appetite for insurance companies to insure the risk inherent with a federally-controlled substance as evidenced by low limits, exclusions of key coverages, and substantially higher premium rates and higher deductibles.

This is true even for several important lines of insurance, such as directors and officers liability (D&O) insurance. For these reasons, small and mid-size cannabis companies often forego purchasing D&O insurance. However, that can turn out to be a mistake. The security afforded by D&O insurance for growing cannabis companies and their directors and officers could have significant returns that more than justify the cost. In this article, we discuss just a few points cannabis companies should consider in making decisions about their D&O insurance.

### Litigation considerations

Recent cases involving cannabis businesses show that federal agencies and investors have taken action that could implicate coverage under D&O policies. For example, the SEC brought an action against two partners of a cannabis company for allegedly committing securities violations by using investor funds to pay debts and for personal luxuries. As part of its remedies, the SEC is seeking the return of all amounts that the two partners retained which they were not entitled to, which amounts to millions of dollars. In another case, investors of a cannabis company settled a lawsuit alleging that the company misled investors about the company's finances, including making false statements about purchasing millions of dollars of personal protective equipment during the COVID-19 pandemic.

Even small cannabis companies are not immune to regulatory scrutiny as a CEO of a penny-stock cannabis company found out. In that action, the SEC claimed that the CEO violated federal securities law

by falsely claiming that the company had plans to grow cannabis in parts of Africa, where it is illegal, and failing to disclose prior convictions of securities fraud. This is just one of many recent claims targeting small and mid-size companies for the same types of risks more commonly faced by larger companies. The difference is that, whereas a larger company may have the capital and assets to overcome a large judgment or settlement, that same judgment or settlement could have catastrophic consequences to small and mid-size companies. Questions may arise over whether the company can indemnify individual executives. Even if the company and its executives all escape liability, it may still be saddled with large defense costs that could easily reach into the six or even seven figures. D&O insurance could help, as those policies are precisely purchased to protect directors and officers (and in some cases the insured company) from allegations of breach of fiduciary duty, misrepresentation, and fraud, just to name a few.

Further, it is no secret that access to capital-raising mechanisms like investments from institutions and individuals are difficult to obtain because of the federal regulations and the stigma surrounding cannabis. Partly for that reason, cannabis companies often look to IPOs and mergers and acquisitions as a source to raise capital. However, these same sources of capital carry different risks that could ultimately lead to more D&O claims. Indeed, these types of lawsuits are often brought by investors alleging omissions or wrongful information or inaccurate disclosures, negligence by the board, and breach of fiduciary duties; claims that are generally covered under D&O policies.

#### Business considerations

Companies should also be aware of some business and financial considerations, present and future, that may impact the availability and scope of D&O insurance. First, one reason that premiums may be high for cannabis companies is the dearth of actuarial data, which creates uncertainty and thus can prevent insurance companies from having the confidence they seek in underwriting risks. As more and more cannabis companies purchase D&O policies, the more likely that market data will improve allowing for more certainty in pricing cannabis risks.

Second, D&O policies could be vital for a small and mid-size cannabis companies' growth. Great leadership can be crucial for the management and decision-making for emerging companies. But to attract high-caliber executives, they need to be reassured that they are protected. A D&O policy with sufficient limits could provide that assurance in the event of a claim, even where the company is unable or unwilling to indemnify the individual.

#### Current captive market for cannabis companies

Due to the narrow market for insuring cannabis, companies in this industry (and others) have turned to captives as a potential source for their insurance needs. Captives can offer flexibility in managing

emerging risks, offering insurance where the market is limited or has excluded certain key coverages. A key advantage that captive insurance can bring is the ability to tailor insurance to the specific needs of a company (or group of companies).

Generally, a captive is an insurance company that issues insurance to an entity that owns and controls the captive. As opposed to a traditional insurance company that collects the premium and retains the profits, a captive has the ability to manage, assign, and underwrite specific risks and pay claims. To be sure, captives are not without limitations. They must be capitalized and managed, and require significant effort, time, and expense to set up and administer and may not be suitable for all risks or all companies. Captives also may only be licensed in states or off-shore jurisdictions (Bermuda, Bahamas, etc.) with captive insurance legislation permitting their existence. Thus, this may create a dichotomy when a state has legalized cannabis in some form but not approved any legislation permitting captives to insure cannabis companies.

## Conclusion

With the new dialogue about reviewing federal law on cannabis, there may finally be some stability regarding regulations that could further decrease premiums and potentially make the common exclusion barring claims falling under federal regulation less concerning. These favorable terms in turn could lead to cannabis companies allocating the cost of D&O insurance into its yearly expenditures opening the door for new data and the boom of this specialized market.

But even if the change that small and mid-size cannabis companies are hoping for is far away, there is no better time than now to think about obtaining or renewing D&O insurance for their business, especially given the risk of costly litigation and business considerations. With the assistance of experienced coverage counsel, brokers, and other risk professionals, gaps in coverage could be identified and improvements could be made so that the policy responds as the policyholder expects.

Lorelie S. Masters is a partner in the Hunton Andrews Kurth LLP Insurance Coverage group in the firm's Washington D.C. office. A nationally recognized insurance coverage litigator, Lorie handles all aspects of complex, commercial litigation and arbitration. She can be reached at +1 (202) 955-1851 or [lmasters@HuntonAK.com](mailto:lmasters@HuntonAK.com).

Geoffrey B. Fehling is a partner in the Hunton Andrews Kurth LLP Insurance Coverage group in the firm's Boston office. Geoff represents corporate policyholders and their officers and directors in insurance coverage disputes involving directors' and officers' (D&O), errors and omissions (E&O), and other professional liability claims, cybersecurity and data breaches, representations and warranties, employee theft and fidelity claims, government investigations, breach of fiduciary duty, environmental liabilities and property damage. He can be reached at +1 (617) 648-2806 or [gfehling@HuntonAK.com](mailto:gfehling@HuntonAK.com).