2021-2022

# CICA STUDENT ESSAY CONTEST

## Using Captive Insurance Solutions to Address Coverage Gaps


Fox School of Business
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## AMERICAN CANNABIS ASSOCIATION


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American Cannabis Association - Group Captive Solution

Matia Daskalos and Vincent Palmieri

**Introduction**

The American Cannabis Association (ACA) is an excellent candidate for implementing a captive insurance company. The cannabis industry is growing at an extraordinary rate and is on track to expand at a compound annual growth rate of 26.7% between 2021 and 2028 (*Grandview Research)*. Notwithstanding the cannabis industry's significant growth, marijuana is still considered an illegal Schedule I drug under the Controlled Substance Act of 1970. However, 18 states and Washington D.C. have made the recreational use of marijuana legal, and 19 states have made the medical use of marijuana legal, as illustrated in *Exhibit 1*. The inconsistencies between federal and state regulations across the country have created many challenges for the insurance companies to meet the risk needs of the cannabis industry. There is hesitation from commercial carriers to write or participate as a front in fear of having premiums or collateral taken as well as the fear of being prosecuted for aiding a federal felony. Despite traditional insurance companies' fears, cannabis businesses remain uninsured across all production and distribution stages including cultivators, transporters, and retailers.

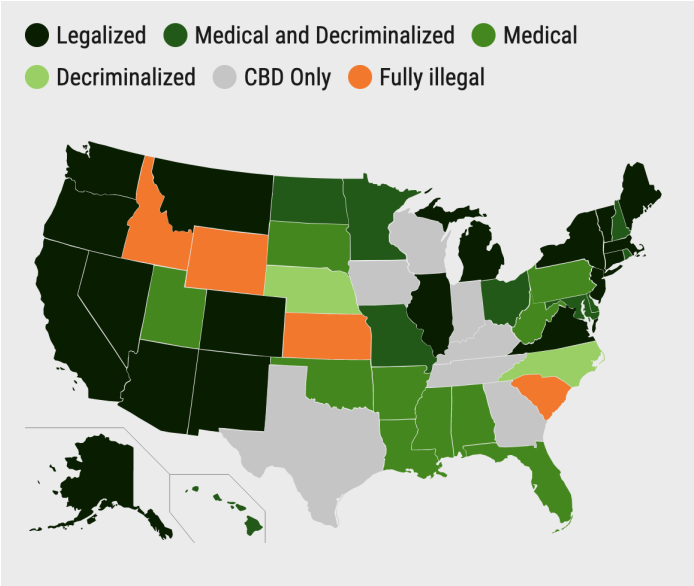



*Exhibit 1: Legalization of Marijuana in the United States*

The cannabis industry is in a position where it can handle significant losses under a well-managed captive insurance company. In 2021, the cannabis industry reached USD$250 million in premiums, and if properly insured with sufficient capacity, this figure could increase to USD$1 billion(Delaney). This essay will discuss limited insurance coverage options currently available within the cannabis industry, how the formation of a group captive insurance company could help meet the risk management needs of the cannabis sector, and how the ACA membership base could establish and operate its own group captive.

**Current Insurance Landscape**

Because of federal laws, it is no surprise that the cannabis industry struggles to conduct business with insurers, banks, and other third-party service providers. Perception and reputation are on the line for companies that form relationships with cannabis businesses. Insurance companies generally avoid the cannabis industry because of federal illegality. Banks avoid dealing with cannabis retailers because they are influenced by the Federal Government through regulations and also influenced by the Federal Deposit Insurance Corporation. The most significant bill pending in Congress today is the Secure and Fair Enforcement (SAFE) Banking Act. This act protects banks and financial institutions who decide to conduct business with the cannabis industry from federal penalties. If SAFE were to be passed by Congress it would create major shifts for insurers and banks when deciding to take on cannabis-related risks. Looking to the future, a rise in interest rates will pose yet another challenge for cannabis businesses making it harder for them to raise capital for future growth.

**Risks for Cannabis-related businesses**

Cannabis-related businesses face numerous risks across the entire supply chain. Cultivators face risks surrounding the growth of cannabis plants. If cultivators have an outdoor farm, it is subject to severe weather conditions. Crop insurance is one way to transfer risk to insurers, although the biggest problem with crop insurance is that the value of one acre of cannabis can reach a million dollars which is much higher than what crop insurance is designed for. Many cannabis farmers assume they will not qualify for traditional crop insurance, causing them to forgo the coverage. After the growing process, the product goes through a manufacturing plant which faces risks of cross-contamination and product liability exposures.

Transporting products across states is not possible because of individualized state laws. Cannabis businesses are subject to theft while transporting products and without proper risk management controls in place, these businesses could face significant losses. A way to transfer risk is by utilizing theft, fleet auto, and cargo insurance.

An outstanding 70% of dispensaries operate strictly in a cash-only environment which leaves them subject to high risks of theft, fraud, and violent crimes (NAIC). There is a lack of law enforcement to help protect business owners from these violent crimes. Increasing the amount of law enforcement will help prevent losses and theft insurance will transfer the risk.

Cannabis retailers are also susceptible to cyber crimes such as data breaches and ransomware attacks because of the amount of data involved. Any given customer must present a valid identification that is scanned in dispensaries and stored in a database that could be susceptible to hackers. The current insurance market offers cyber liability policies including kidnap and ransom coverages, although those who purchase these should be cautious of the

"banned substances" and "Schedule One" exclusions. If a cannabis business fails to negotiate this language out of the contracts, their loss or coverage could be denied.

Every step of the cannabis supply chain faces risks that are currently unmet. Forming a captive allows a tailored approach to insurance and enables legal cannabis business owners to get the basic coverage they need, including general liability, product liability, and workers compensation. A captive can also help provide more individualized coverage such as crop, auto, and cyber coverage.

**Advantages and Disadvantages of a Group Captive**

*Advantages:* Member-owned group captives provide its members greater control of premiums, claims, and coverage. Group captives are wholly-owned and controlled by their members who are also insureds; their primary purpose is to insure the risks of their owners regardless of premium size. Each member is an equal owner in their insurance company which entitles each member to have one seat and one shareholder vote. This diversity across all types of cannabis-related businesses establishes a large pool of industry-specific knowledge that acts as a resource to prevent and decrease the frequency and severity of future losses. Group captives incentivize members to develop workplace cultures that exemplify best safety and loss prevention measures. Another advantage to a member-owned group captive is that it eliminates all of the unpleasant surprises with premium rate increases because it is not subject to the rise and falls of the traditional insurance market. Captives create capacity by allowing direct access to the reinsurance market. Members benefit from the group captive by receiving investment income earned on unused loss funds, capital, and cash collateral. The most significant advantage

of a captive is that it provides coverage that would otherwise be unavailable in the commercial insurance market

*Disadvantages:* The captive industry is a heavily regulated market which poses its own disadvantages. As a result, it can be difficult to get a captive approved in a domicile with certain sources of risk that the captive will be insuring. Once approved, captive insurance companies must comply with their domicile's regulations, and if they don't it can lead to liquidation or shutdowns. However, once a captive is approved to do business, adhering to the regulations is a transparent and straightforward process. Another disadvantage of creating a captive is the high sensitivity to losses. A high variation between actual and expected losses can increase future premiums and raise required capital from captive owners. The third disadvantage would be the high start-up and implementation costs.

**Group Captive Structure**

First, we need to know how many members will be a part of the ACA group captive. There are around 24,000 registered growers and retailers across the United States. We assume about 10% of these business owners will choose to become a member of the ACA group captive. Our homogenous group captive will contain approximately 2,400 cannabis business owners, including growers, transporters, and retailers across many different states, creating a diverse demographic. Establishing certain criteria for members to meet prior to joining the Captive will help mitigate losses to some degree. Ideally, interested businesses would have to report better than average losses in the industry, but since the cannabis industry is relatively new, the criteria will start out as simply not having any abnormally large losses. As data is collected, members

will be able to prove their financial stability in order to remain in the captive. Additionally, regular attendance to shareholder meetings will be required so members stay up to date. As of today, finding a suitable domicile is challenging with cannabis being a Schedule I drug. However, Nevada is currently the most accommodating location to establish the captive's domicile.

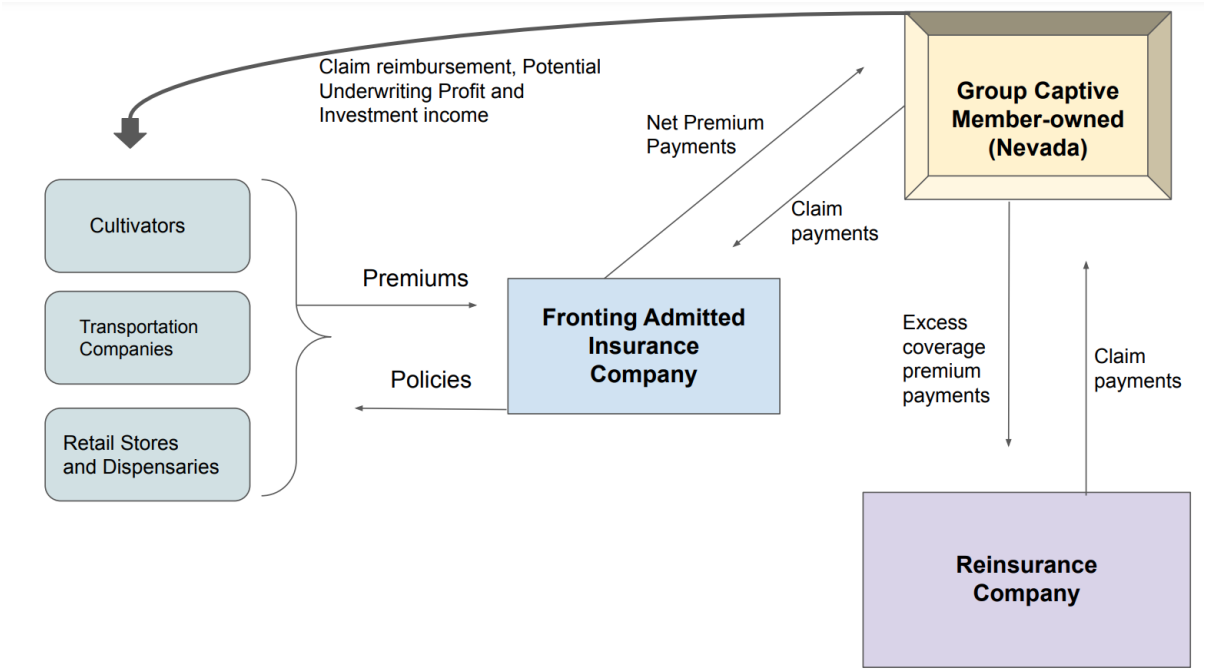



*Exhibit 2: Group captive structure*

**Group Captive Operations**

A commercial fronting company will be beneficial for underwriting services. The fronting company will charge around a 5% fee of the total premiums since they will be obligated to pay out claims if the captive fails to indemnify them. Captives are unlicensed insurers, so many states make a fronting arrangement a requirement in order to comply with domicile regulations. Utilizing a fronting company is a form of reinsurance with the captive remaining as

the main bearer of risk. This is done by the captive and fronting company signing a fronting agreement which transfers the risk back to the captive. Even if the domicile does not make it a requirement, viewing the fronting company as strictly a form of reinsurance allows the captive to shift some risk over to the fronting company. This admitted insurer will be able to provide policies such as general liability and workers' compensation coverages. In the event the captive fails, the fronting company will take over claims. With cannabis being a schedule 1 drug, this is something we strongly suggest. Lastly, the bonus of the fronting company is that it allows the insured to be in a favorable situation when it comes to tax deductions. Although this should not be the primary motivator, it is an additional result of using this tool.

Before operations begin, a feasibility study would be conducted to decide if forming this captive will be the best action to take. Immediately after, we will develop a cost allocation to create transparency in the captive, so every member knows how their money is distributed. The following is how gross premiums will be allocated: 60%, 35%, 5% towards claim payments, basic expenses, and fronting fees respectively (*Exhibit 3*).

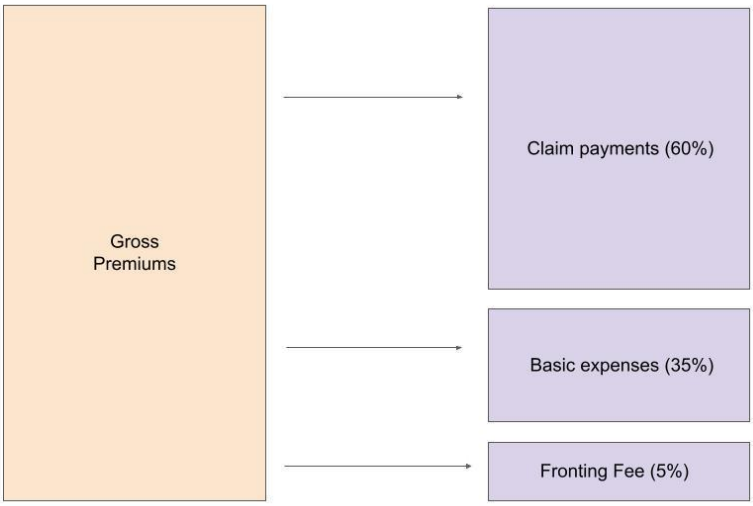
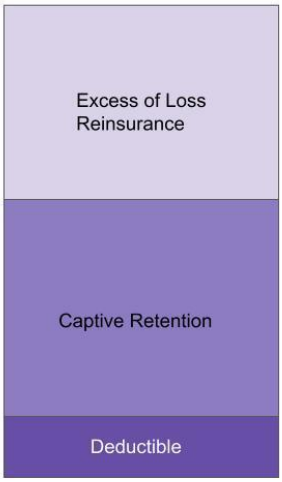



*Exhibit 3: Gross premium distribution*

**Risk Treatment**

*Exhibit 4*




Loss prevention is a risk treatment that creates a physical action plan to prevent and control losses. Workplace safety throughout the entire cannabis supply chain is critical to lowering costs of risk for each business and in turn means fewer workplace injuries. A small portion of each member's premium will be allocated towards loss prevention services as part of basic expenses (*Exhibit 3*). This will fund risk control workshops for members and provide at-risk members a consultant to enhance their loss prevention practices. The captive will be the most viable option to transfer risk from each business. A way to reduce the probability of severe losses is by diversifying the size and type of cannabis businesses that are in the group captive. A crucial way to retain risk is by holding reserves, which allows the captive to set funds aside for future claim payouts.

**Package Policy**

Our ACA group captive will have a customizable package policy with base coverage including general liability, product liability, workers compensation. In the first two years of establishing the group captive, only the base coverages will be offered. After the captive has matured, additional specialty coverages will be offered depending on the specific business needs. Cultivators receive crop insurance, transporters receive auto insurance, and dispensaries receive cyber insurance.

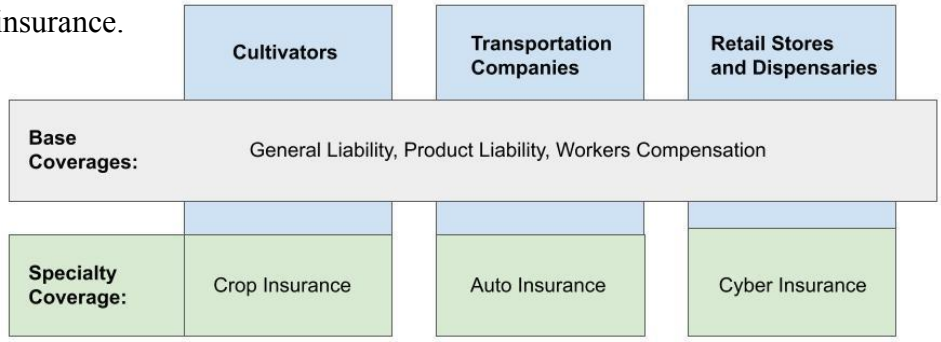



*Exhibit 5: Packaged policy*

**Premium Development**

Our captive will be partnering with an actuarial service company. In order for the actuaries to calculate accurate premiums, each member will need to submit their loss history over the past five years or if it is a new company the losses since operations began. The actuarially determined premium will be based on the expected claim losses plus operating expenses. The benefit of our captive is that even if members overpay, any unused premiums will remain internal. This allows the actuary to have a conservative approach when setting premium rates that will sufficiently cover claims. The first year of establishing our captive, all members will have to pay a membership fee which will be used for start-up costs as well as act as a security fund that will not be subject to the 5% fronting fee. If actual losses exceed expected losses in the first year, the membership fees will support these payouts. The more data is collected, the more accurate the actuarial estimates become.

**Profit Utilization**

When the actual claims in any given year are less than the expected claims the captive earns a profit. In order to make decisions easier, a threshold will be set to decide the amount at which we will start distributing dividends to members. Any amount of total equity under this threshold will be strictly used for investment income.

| | | |
|---|---|---|
| **Profit Utilization** | A > E | Profit = zero |
| | A < E given C < T | Profits are invested |
| | A < E given C > T | Profits over T yields dividends |

Key:
A: Actual losses
E: Expected losses
C: Capital (Total Equity)
T: $X threshold set

**Conclusion**

The cannabis industry faces numerous challenges stemming from its legal status in the United States. A perfect alternative to the commercial insurance market for cannabis businesses is a group captive which will fill gaps in coverage, mitigate overall costs of insurance, and increase a tailored approach to preventing future losses.

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