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LEGALIZED MARIJUANA AND INSURANCE LAW

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Background

In 1996 California voters approved Proposition 215, which made it legal under California law for individuals of any age to use marijuana for medical purposes.

In 2003 the Legislature legalized medical marijuana collectives. These collectives are nonprofit organizations that grow and provide marijuana to their members.

The US Supreme Court held in 2005 that federal agencies could continue under federal law to prosecute individuals who possess or use marijuana for medical purposes, even if legal under a state law.

In 2012, Colorado and Washington became the first states to vote to legalize marijuana for recreational purposes. Six more states have legalized recreational use of marijuana. Washington DC voted to allow possession, growing, and gifting. But sales for recreational use are not allowed.

In 2013, the U.S. Department of Justice ("USDOJ") issued a memorandum stating its general policy not to interfere with the medical use of marijuana pursuant to state laws, provided the state tightly regulates and controls the medical marijuana market. Memorandum from James M. Cole, Deputy Attorney General, to All United States Attorneys, Guidance Regarding Marijuana Enforcement (August 29, 2013) ("Cole Memorandum"). The Cole Memorandum does not override federal law enacted by Congress or grant immunity to individuals or businesses from federal prosecution.

According to the AG summary of Proposition 64, the DOJ chooses not to prosecute most marijuana users and businesses that follow state and local laws if those laws are consistent with federal priorities. Those priorities include preventing minors from using marijuana and preventing marijuana from being taken to other states.

In 2016 California voters approved Proposition 64. Prop 64 makes it legal under California law for individuals 21 years of age or older to use marijuana for recreational purposes. This proposition also allows commercial manufacture and sale starting in 2018. It imposes state taxes on sales and cultivation. It provides for licensing the industry. It establishes standards for marijuana products.

However, under Federal Controlled Substances Act, 21 U.S.C. section 841, it is illegal to manufacture, distribute or dispense marijuana. Marijuana is classified as a Class 1 substance – meaning it has no medical value and poses a high risk of abuse. 21 U.S.C. section 812.

Ethics Issues

One issue that lawyers must consider is legal ethics. Lawyers need to understand exactly what they are allowed to do in counseling marijuana-related businesses. There have been varying opinions around the country.

California Rules of Professional Conduct, Rule 3-210 **Advising the Violation of Law** provides that "A member shall not advise the violation of any law, rule, or ruling of a tribunal unless the member believes in good faith that such law, rule, or ruling is invalid. A member may take appropriate steps in good faith to test the validity of any law, rule, or ruling of a tribunal."

And California Business & Professions Code section 6068(a) states that it is an attorney's duty to support the Constitution and laws of the United States and this state."

ABA Model Rule 1.2(d) provides:

> (d) A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

This rule is broader than the California rule in the additional prohibition on *assisting* a client. Los Angeles County Bar Association Opinion No. 527.

Comment 9 to the ABA model rule makes this distinction: between presenting an analysis of the legal aspects of questionable conduct – and – recommending the means by which a crime might be committed with impunity.

Some argue that there is a need for representation of persons using or selling marijuana under state laws. e.g. Bar Association of San Francisco Opinion 2015-1.

(Without legal representation, those who want to engage in transactions related to medical marijuana may not fully understand their rights, duties, and liabilities. If, as a matter of ethics or policy, the bar were to refuse to represent people regarding medical marijuana, then non-lawyers would be deprived of essential legal representation.) The argument is that if lawyers do not assist clients on these issues, this will create a risk of non-compliance and invite the potential for abuse.

Some state bars have found that such services by a lawyer would violate the Rules of Professional Conduct. Parties in those states seek to amend their rules to allow such activities. For example, the Ohio Board of Professional Conduct determined that advising clients on the federal law and the consequences of establishing a medical marijuana business is ethical. BUT, providing other services in aid of the business is not.

The syllabus of the Ohio opinion, Supreme Court of Ohio, Board of Professional Conduct, Opinion 2016-6, issued August 5, 2016 states that **"**A lawyer may not advise a client to engage in conduct that violates federal law, or assist in such conduct, even if the conduct is authorized by state law. A lawyer cannot provide legal services necessary for a client to establish and operate a medical marijuana enterprise or to transact business with a person or entity engaged in a medical marijuana enterprise. A lawyer may provide advice as to the legality and consequences of a client's proposed conduct under state and federal law and explain the validity, scope, meaning, and application of the law."

The San Francisco Bar Association opinion provides the following summary: "A California attorney may ethically represent a California client in respect to lawfully forming and operating a medical marijuana dispensary and related matters permissible under state law, even though the attorney may thereby aid and

abet violations of federal law. However, the attorney should advise the client of potential liability under federal law and relevant adverse consequences and should be aware of the attorney's own risks."

And the San Francisco Bar opinion offers this important warning:

> In addition, the lawyer should counsel the client about limitations on confidentiality. One of the duties of a California lawyer is to "maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client." Bus. & Prof. Code § 6068(e)(1). The lawyer should warn the client that their communications may not be privileged in the event of litigation. The "crime fraud" exception to the attorney-client privilege applies if the lawyer's services are obtained to help the client to plan or to commit a crime. Evid. Code § 956. The client's mere disclosure of his or her intent to commit a crime is privileged. *People v. Clark* (1990) 50 Cal.3d 583, 621-23. But where the client seeks legal assistance to plan or to perpetrate a crime, the privilege is eviscerated. *Id*. Thus, the lawyer should warn the client that, if the client becomes involved in civil or criminal litigation, there is a risk that the communications between them will not be held to be privileged and thus be subject to disclosure in testimony.

Third parties face legal issues as well, and their lawyers. Landlords who lease property, banks who lend to or provide banking services to, security companies and armored car companies who provide such services to marijuana-related businesses, have to consider the impact of this conflict in federal and state law.

Insurance Cases

There have been a few insurance cases concerning the medical and recreational marijuana industries. Most of these cases have focused on first party property losses, and not on third party liability claims.

First Party Coverage

One of the first issues to come up is "insurable interest" in the property – marijuana plants and marijuana – and the effect of federal public policy on potential recovery for loss of marijuana plants and marijuana.

In California insurable interest is defined. "Every interest in property, or any relation thereto, or liability in respect thereof, of such a nature that a contemplated peril might directly damnify, is an insurable interest." Cal. Ins. Code § 281 This does not mention illegality of property or contraband. But there is a Ninth Circuit case that applied such a concept. In *Ariasi v. Orient Ins. Co.* (9th Cir. 1931) 50 F.2d 548 wine that was not legally possessed pursuant to the National Prohibition Act was not "property" for which recovery could be had under a fire policy. However, given California law on medical marijuana and recreational marijuana, and the policy behind those laws, California courts could find an insurable interest in such property.

In *Green Earth Wellness Ctr., LLC v. Atain Specialty Ins. Co.*, 13-CV-03452-MSK-NYW, 2016 WL 632357 (D. Colo. Feb. 17, 2016) the court held that Federal public policy did not invalidate a first-party policy issued to a medical-marijuana retail operation. Growing plants and harvested marijuana were damaged by smoke from a wild fire. The smoke overwhelmed the ventilation system, intruded into the plants and eventually damaged the plants. The court held that the growing plants exclusion applied. It

held that crops include indoor greenhouse crops. But the harvested marijuana was inventory and therefore covered as "stock" under the policy.

The policy excluded loss of "Contraband, or property in the course of illegal transportation or trade." The court found that this was rendered ambiguous by the difference between the federal government's *de jure* and *de facto* policies regarding state-regulated medical marijuana.

The court noted with regard to the federal public policy argument, that the federal government had expressed ambivalence about enforcing the Controlled Substances Act in circumstances where a person or entity's possession and distribution of marijuana is consistent with well-regulated state law.

This suggests the question of what happens if the government position changes with a new administration. If the "ambivalence" is removed by a new policy, does the coverage suddenly change?

Finally the court refused to provide "assurances" to the parties about the legality of paying the loss. It just interpreted the contract as written.

It made the following observation, which suggests due diligence that insurers might conduct. "The Court assumes that Atain obtained legal opinions and assurances on these points from its own counsel before ever embarking on the business of insuring medical marijuana operations." [footnote omitted].

In *Tracy v. USAA Cas. Ins. Co.*, 2012 WL 928186, (D. Hawai'i 2012) the loss was theft of marijuana plants from insured homeowner. The policy covered trees and shrubs up to $500 per plants, which was significantly less than the value ascribed to the plants by the insured in submitting this loss to the insurer.

The homeowner argued that she had the plants for medical marijuana use, permitted under Hawai'i law. But there were more plants than permitted for one person. But two others living in the home also were qualifying patients. The court held that if plaintiffs exceeded the "adequate supply" restriction of Hawai'i law, there would be no coverage, but this was a question of fact.

The court held that a qualifying patient had an insurable interest in the plants under Hawai'i law. But because possession violated federal law, to require the insurer to pay for the loss would violate federal law. Therefore the insurer did not breach the policy by refusing to pay.

In *Barnett v. State Farm General Ins. Co.*, 200 Cal. App.4th 536, 132 Cal.Rptr.3d 742 (2011) the court held that seizure of medical marijuana pursuant to facially valid search warrant was not "theft" covered under homeowner's insurance. The insured argued that the officer obtaining the warrant had been misleading about prior information available to the police department. But the court found that this was not a theft and not covered.

In *Bowers v. Farmers Ins. Exch.*, 99 Wash. App. 41, 991 P.2d 734 (2000) the insured landlord's home suffered mold damage. This was caused by tenant's marijuana growing operations. This was held caused by an insured risk (vandalism and malicious mischief), and not excluded by the mold exclusion.

In *Hyunh v. Safeco Ins. Co. of America*, 2012 WL 5893482, (N.D.Cal. 11-23-12) the court held than an illegal growing of plants exclusion applied to damage to landlord's premises caused by an illegal growing operation of tenant. The language of the exclusion is important to this result.

There is the issue of loss caused by government seizure of marijuana, marijuana plants or other associated business assets. The Department of Justice may seek civil forfeiture of property from the owner, landlord, mortgage holder or other person or entity who has an interest in property connected with an illegal activity. *See*, *e.g.*, 21 U.S.C. § 881.

The ISO commercial property policy does not cover seizure or destruction of covered property as an act of a governmental authority. For example, the ISO Causes of Loss – Special Form, CP 10 30 10 12, excludes "**c. Governmental Action.** Seizure or destruction of property by order of governmental authority..."

Third Party Coverage

On the liability side, the ISO homeowner's policy contains a controlled substances exclusion. It reads:

> ISO HO 00 03 05 11
>
> 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 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.

Some policies have additional language on this exclusion. In *Prudential Prop. & Cas. Ins. Co. v. Brenner*, 350 N.J. Super. 316, 321, 795 A.2d 286, 288 (App. Div. 2002) the exclusion added certain exceptions including:

However, this exclusion does not apply to:

> ***
>
> (2) The insured's [sic] who have no knowledge of the involvement with a controlled substance(s).

An insured's knowledge of such involvement must be shown by us by competent evidence of such knowledge.

Commercial liability policies such as the ISO business owners policy and the ISO commercial general liability policy, generally do not have such an exclusion.

There have been a number of cases litigating this exclusion in the personal insurance context. One was in a business context. All of these involved drugs other than marijuana. But marijuana is a Schedule 1 drug, 21 U.S.C. section 812, and so within the exclusion.

In *Westfield Nat'l Ins. Co. v. Long*, 811 N.E.2d 776 (2004) the victim's death was caused by methamphetamine being placed in her drink. The court held that the controlled substances exclusion applied as to the individual accused of placing the drug in the drink.

In *Forman v. Penn*, 945 N.E.2d 717, 719 (Ind. App. 2011) the injury arose out of an individual's use of methadone. The court held that this triggered the controlled substances exclusion. In that case, a son's guest ingested some of the mother's methadone. She had a prescription. The court held that the homeowner's policy did not apply because the loss was excluded by a controlled substances exclusion. The homeowner argued that the mother had a prescription so that the exclusion should not apply (because "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.") But the court held that the use by the guest was not under a prescription, and that the exclusion applied to use by "any" person of a controlled substance.

In *Prudential Prop. & Cas. Co. v. Brenner*, 795 A.2d 286, 287 (N.J. 2002), a drug dealer was shot and killed when the perpetrators' "whole purpose" in going to the dealer's home was to acquire marijuana. The court found a "substantial nexus" between the drug dealer's death and the perpetrators' attempted purchase of a controlled substance.

In *Massachusetts Prop. Ins. Underwriting Ass'n v. Gallagher,* 75 Mass. App. Ct. 58, 911 N.E.2d 808 (2009) a homeowner's overnight guest died, from an apparent suicide by ingesting an overdose of prescription medication that the homeowner allegedly had negligently left in a place accessible to the guest. The policy contained a controlled substances exclusion. The insured argued that this arose out of homeowner's legitimate use of a prescription drug when following the orders of a licensed physician. Thus the insured argued it was within the exception to the exclusion for legitimate use of prescription drugs by a person following the lawful orders of a licensed health care professional. But the court disagreed finding that the guest's own use of the medication was not prescribed, and so the death did not arise from guest's legitimate use of a prescription drug when following the orders of a licensed physician.

The court in *Gallagher* held that the fact that other causes for an injury also may exist does not preclude a determination that the injury arises out of activities excluded from coverage under the insurance policy.

But another court disagreed with this reasoning. *Am. Nat'l Prop. & Cas. Co. v. United Specialty Ins. Co.*, No. CV 11-1137 LFG/RHS, 2012 WL 12549878, at *8 (D.N.M. Sept. 24, 2012), rev'd and remanded sub nom. *Am. Nat. Prop. & Cas. Co. v. United Specialty Ins. Co.*, 592 F. App'x 730 (10th Cir. 2014). In that case, De La Paz was driving a Navigator, while in the course and scope of employment with Endeavor. He crossed the centerline and collided head-on with Judson. Both drivers died. De La Paz tested positive for methamphetamine. Cooper owned the Navigator.

ANPAC issued a personal auto and commercial umbrella policy to Cooper, who owned the Navigator. Great West issued commercial auto coverage to Endeavor, and United Specialty issued excess coverage to Endeavor.

ANPAC's umbrella policy excluded "bodily injury arising out of the use, ... or possession by any person of a controlled substance." ANPAC asserted that the controlled substance exclusion applied. United

Specialty, the excess insurer of Endeavor, argued that the accident occurred about 50 miles into De La Paz's trip. De La Paz had driven, without accident, for some length of time, or at least from 25 to 50 miles before the accident. United Specialty argued that under these circumstances, there were other possible

contributing causes for the accident. It argued that immediately prior to the accident, De La Paz's attention could have been diverted for reasons other than his drug use. The District Court agreed with these arguments.

But on appeal the 10th Circuit found that the exclusion was clear and unambiguous and that it applied. The court held that the ANPAC umbrella policy exclusion for damages "arising out of" use of controlled substances was not ambiguous as applied to the accident as De La Paz was under the influence of methamphetamine, and the police report identified "driver inattention" as contributing factor in the accident.

Beyond this there are exclusions that apply to all businesses, and which may be of particular concern to marijuana cultivation and manufacturing operations.

With medical marijuana, there is a complication as to the exception for prescription 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."

A doctor may not prescribe marijuana because it is a Schedule I drug. However, a doctor may recommend use of marijuana and discuss treatment options with patients, even though that might lead to illegal conduct. *Gonzales v. Raich* (2005) 545 U.S. 1, 14-15. While methadone and other drugs discussed in the case law above can be prescribed for medical use under federal law, the same is not so for marijuana. Arguably then, medical marijuana it is not a use of a "prescription drug" following "lawful orders of a licensed health care professional".

These controlled substances exclusions are typically not found in business policies. The concerns for a business will be more oriented to exclusions that affect all businesses. One that has been mentioned is the pollution exclusion given the nature of growing operations. Another concern is some broad language in one part of the liquor liability exclusion, which excludes injury or damage by reason of "causing or contributing to the intoxication of any person", though the title arguably suggests a more limited focus of this language.

Another area of interest may be advertising injury coverage. A marijuana business cannot obtain a federal trademark on marijuana and marijuana products. But they may assert claims based on unfair competition. Insured marijuana businesses may assert that such claims are covered under the advertising injury provisions of a policy, depending upon the definition of advertising injury and the offenses that comprise advertising injury.

Most published cases, and most claims arising from medical and recreational marijuana businesses have related to first party coverage and not to third party coverage. Marijuana businesses will not start operating in California until 2018. There is much to anticipate.

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