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By Kyle R. Kroll and Michael Petschel

Cannabis, Insurance, and the Federal-State Divide

As of Q3 2024, thirty-eight states have legalized cannabis in some form, whether for recreational use (twenty-four states) or medicinal use (fourteen additional states). Likewise, more than one-third of states permit home cultivation of cannabis. But despite continued legalization at the state level, cannabis possession, cultivation, and distribution remains illegal at the federal level under the Controlled Substances Act ("CSA")—though, this year's campaigns suggest this may change.

These converging, but diametrically-opposed, trends are placing ever-greater focus and attention on insurance coverage issues for both insureds and insurers. For example, cannabis's differing legal status gives rise to the question of whether federal courts can enforce insurance policies with respect to cannabis-related claims. And interesting questions regarding "compliance with law" exclusions and public policy on "insurable interest" abound.

As might be expected, the law is lagging behind the current momentum of cannabis legalization. Although some courts have addressed insurance coverage issues in this context (leading cases discussed below), there is a relative dearth of authority. But as Shakespeare wisely stated, "what's past is prologue," and states facing a new era of legality may draw upon these early cases while recognizing what has changed in public policy.

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Initially, Federal Courts Were Unfertile Ground for Cannabis Litigation

Prior to cannabis legalization, it was widely held that a person could not hold an insur-

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able interest in cannabis due to its illegality. Thus, if an insured made a claim for cannabis-related loss, courts reliably held that any policy that could be read to provide coverage was unenforceable as against public policy. This began to change in 2009, when the Department of Justice adopted a policy of non-enforcement under the CSA if the cannabis-related conduct in question was subject to well-regulated state legalization and enforcement.

But the change was not immediate. Despite the DOJ's forbearance, federal courts were reluctant to find coverage for cannabis-related policy claims. In 2012, the US District Court for the District of Hawaii confronted a dispute involving a claim for the loss of cannabis plants stolen from the insured's residence. *Tracy v. USAA Ins. Co.*, No. 11–00487 LEK–KSC, 2012 WL 928186 (D. Haw. Mar. 16, 2012). In this widely-cited case, the homeowner's policy included coverage for loss of "trees, shrubs, [and] plants" due to theft. At the time, Hawaii was one of the first states to decriminalize cannabis, and the court predicted that Hawaii courts would likely hold that a Hawaiian resident could have an insurable interest in cannabis. Nevertheless, the court dismissed the claim at summary judgment, holding the insurance policy was unenforceable as against federal public policy given cannabis's continued illegality under the CSA.

Tracy is the most notable early case analyzing coverage for cannabis-related loss in the context of state legalization but federal criminalization—and it continues to be cited as persuasive authority. But in the years since *Tracy*, courts have become increasingly more receptive to different arguments.

Equitable and Other Policy-Based Arguments Are Beginning to Flower

As time has passed and the Department of Justice's acquiescence continued, federal courts became more comfortable with cannabis coverage cases. In 2016, the US District Court for the District of Colorado, in a widely-cited decision, resolved a dispute between a cannabis business and insurer. *Green Earth Wellness Center, LLC v. Atain Spec. Ins. Co.*, 163 F. Supp. 3d 821 (D. Colo. 2016). The cannabis business suffered a loss of plants due to a wild fire, but the insurer denied coverage on the basis that cannabis is illegal under federal law. The federal court reasoned that whether cannabis is illegal under federal law is irrelevant to coverage, and that the court's responsibility was merely to determine whether there was a breach of contract. If so, the court was bound to follow federal law and remedy the breach.

Most notably, the court in *Green Earth* stated that because the insurer entered into the policy of its own will, knowingly and intelligently, it was obligated to comply with its terms or pay damages for having breached it. This opened the door to, and intimated at the potential persuasiveness of, equitable arguments not often raised in coverage disputes such as unjust enrichment. Additionally, the court questioned the degree to which cannabis actually violated federal public policy when the federal government has refused to enforce its own laws. The court ultimately decided that the business was entitled to coverage for its cannabis loss.

Two years later, the Sixth Circuit Court of Appeals became the first federal appeals court to address similar issues, but in a case in which both state and federal law prohibited the conduct at issue. *K.V.G. Properties v. Westfield Ins. Co.*, 900 F.3d 818 (6th Cir. 2018). The case involved a commercial property owner that leased space to a commercial tenant for a business unrelated to cannabis. The tenant, who was authorized to use the space only for "general office or light industrial use," instead set up an extensive marijuana growing facility. That facility eventually caused over $500,000 in structural damage to the property.

The Tenth Circuit affirmed denial of coverage on the merits of the policy terms—holding that coverage was barred under the policy's dishonest and criminal acts exclusion. The court held that the tenant was in violation of state cannabis law, and the tenant's conduct was, therefore, criminal. But the court did not stop there. In *dicta*, the Tenth Circuit suggested that the property owner, under different circumstances, would have a strong federalism argument—that in contract and state law matters, the federal courts "act as faithful agents of the state courts and state legislature[s]." Further, where state legalization of marijuana is effected by popular vote of the people, the federal courts will take even more care to avoid upsetting the will of the people.

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Federal Courts May Be Growing More Receptive to Cannabis Coverage

Although no federal court has held that a person can have an insurable interest in cannabis when it is illegal under state or federal law, the legal landscape appears to be shifting in a more insured-friendly direction. *See Bartch v. Barch*, 111 F.4th 1043, 1050 n.2 (10th Cir. 2024) (collecting contract cases, the majority of which have enforced contractual obligations). As legal cannabis continues to take root in more states, increased litigation can be expected.

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The early seminal cases cited above provide at least two key insights for practitioners when litigating cannabis-related policy disputes.

First, prepare to win on the merits. Given the limited cannabis-related insurance precedent, it is likely no longer sufficient to simply rely on a standard contraband or illegality provision. And there now exists case law that has reframed the question to whether the remedy (as opposed to the contract) violates state or federal law. Equity-based and other public policy arguments are likely to have more traction—such as the equitable avoidance of windfalls, unjust enrichment, and public policy favoring

insurance coverage. But such arguments wilt where policies directly and expressly address cannabis coverage, and courts need look no further than the four corners of the insurance contract and decide the case on the merits.

Second, know and understand not only the relevant state law but also the public policy underlying it. When a federal court is called upon to decide a contractual matter sitting in diversity, the court will see its duty to act as a faithful steward of state law—especially as the federal government continues to refuse to enforce its own law. Knowing both the state law and its policy rationale may present opportunities for new and creative arguments. The law is still very much under development. Thus, for example, if a state has fully legalized recreational use and created a regulated commercial cannabis industry, public policy may weigh in favor of coverage. However, if a state merely decriminalizes cannabis for the purposes of criminal justice reform, the underlying public policy may not be strong enough to carry the day.

Finally, practitioners should be aware of developments at the federal level. Recent legislative efforts such as the Secure and Fair Enforcement Regulation ("SAFER") Banking Act, S. 2860 (2023-2024), would provide cannabis businesses access to interstate banking services. These updates will further inform the public policy analysis.