

MARKETS IN FOCUS

CANNABIS

Insurance Pricing &
Market Update
Q4 2021





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Introduction

The pandemic was a boon for the cannabis industry.¹ U.S. sales in 2021 hit \$25B (a 40% YoY increase) and are expected to grow annually at a rate of 15% for the next five years.² Cannabis is legal for recreational use in 18 states and the District of Columbia, decriminalized in 13 others and available for medical use in 36. Polls indicate that American support for legalization sits between 60%³ and 68%,⁴ and a further 31% favor legalization for medical purposes. In places where it is not fully legal, Attorneys Generals are declining to prosecute cannabis possession cases,⁵ while other prosecutors and governors are working towards expedited sentencing relief⁶ and pardons for prior convictions.⁷ This sea change of attitudes is manifesting in the workplace as well, exemplified by Amazon's 2021 decision to stop testing for cannabis in pre-employment drug tests.⁸ A nationwide legalization of cannabis would have an appreciable impact on calculations of American GDP⁹, and California now collects \$50M in monthly revenues from cannabis sales and production.¹⁰



The biggest open questions for the industry in 2022 will be political. At the federal level, the SAFE Banking Act, which allows state-licensed cannabis-related businesses to engage freely in relationships with banks and other financial institutions, has passed the House five times, but not yet passed the Senate;¹¹ a number of other bills intended to decriminalize and normalize cannabis have stalled as well.¹² Despite a gridlocked congress, individual states continue to lead the way in medical cannabis expansions, recreational usage, equity and licensing.¹³ Relatedly, some states typically thought of as pro-business rather than pro-cannabis are nevertheless creating attractive conditions for cannabis companies, leading to an explosion of entrepreneurship in places like Oklahoma,¹⁴ while more visibly pro-cannabis places like California struggle.¹⁵

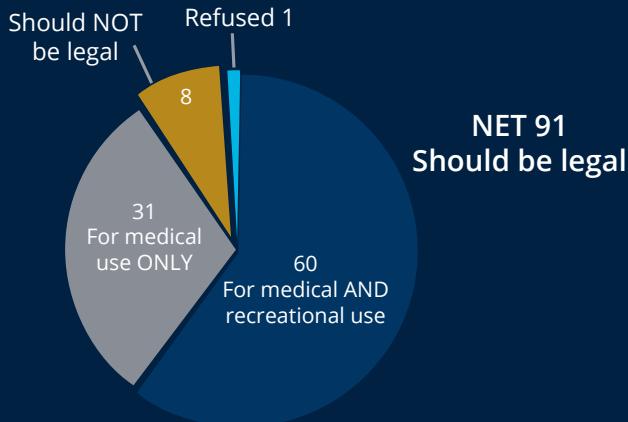
How firms navigate these legislative issues will determine who gets what share of the pie, but one thing is for certain: the pie is going to get substantially larger this coming year.

Top Ten U.S. Contributors to Growth (in billions)



Source: BDSA Forecast, as of February 2021

Fewer than 10% of U.S. adults say cannabis should not be legal at all
% who say cannabis...



Source: Survey of U.S. adults conducted April 5-11, 2021
Pew Research Center

Legislation Update: Federal

SAFE Banking Act

The Secure and Fair Enforcement (SAFE) Banking Act is intended to reduce frictions for the cannabis industry by prohibiting any federal banking regulator from “penalizing a depository institution for providing banking services to a legitimate cannabis-related business,” including a prohibition on “asset forfeiture for providing a loan or other financial services to a legitimate cannabis-related business.”¹⁶ The bill would make it much easier to fund growth, de-risk the industry and make cannabis businesses more appealing to insurers by reducing the threat of robberies, embezzlement and employee theft. A lack of access to regular banking adds substantial costs to cannabis businesses, and many have hired armed guards and armored trucks to deal with the difficulty of transporting revenue safely.¹⁷

Important passages from the bill, which has passed the House of Representatives five times, were slated to be included in the 2022 National Defense Authorization Act, but ultimately were dropped. Senate Majority Leader Chuck Schumer (D-NY) has argued in the past that banking provisions should come after broad criminal justice reform for cannabis convictions;¹⁸ Senate Banking Committee Chairman Sherrod Brown (D-OH) agrees, arguing that cannabis legislation has “been too much about Wall Street and not enough about housing, not enough about rural and urban affairs and people’s everyday economic lives.”¹⁹ The fate of the SAFE Banking Act remains unclear, but its proponents remain committed to its passage.

CLAIMS Act

The Clarifying Law Around Insurance of Cannabis (CLAIM) Act of 2021 aimed to ban criminal prosecution of insurers who work with state-legal cannabis businesses.²⁰ At present, the majority of coverage for the industry is being found in the costly Surplus Lines and Managing General Underwriters/Agencies markets. Capacity is generally limited but has improved slightly over the last few years. Considering many states require cannabis companies to obtain **General Liability, Property and Workers' Compensation** insurance to obtain business licenses, additional costly insurance poses a real challenge to the bottom line.

Ultimately, language from the CLAIMS Act was included in the SAFE Banking Act, whose current iteration (as of February 2022) states that “an insurer that engages in the business of insurance with a cannabis-related legitimate business or service provider...may not be held liable pursuant to any Federal law or regulation... solely for engaging in the business of insurance.”²¹ Thus, the fates of the two bills are intertwined.

MORE Act

The Cannabis Opportunity Reinvestment & Expungement (MORE) Act aims to remove cannabis from the list of scheduled substances under the Controlled Substances Act, which has been in place since 1970.²² It would also expunge many cannabis related convictions and prohibit the denial of federal benefits on the basis of cannabis convictions.²³ A version of it passed in the House in December 2020, while its Senate iteration — sponsored by Kamala Harris — has stalled,²⁴ and its passage is unlikely to be a priority for either the Senate leadership or the Biden Administration.

Cannabis Administration and Opportunity Act

Sponsored by Democratic Senators Chuck Schumer, Corey Booker and Ron Wyden, this act would recognize cannabis legalization by states and would remove cannabis and THC from the Controlled Substances Act.²⁵ The public comment period ended in September 2021, and though its current fate is unclear, the fact that it was co-sponsored by the Senate Majority Leader shows how far the movement has come.

States Reform Act

This act was introduced to Congress in November 2021 and would remove cannabis from the list of Controlled Substances; its distinctive feature is that it was sponsored by six Republicans (spearheaded by Nancy Mace of South Carolina's 1st Congressional District). Its fate in the Democratic-controlled chamber is unclear, but it signals increasing bipartisan support for the act.





Legislation Update: Local

More than 70 bills and initiatives were introduced around the country regarding cannabis in 2021, many in states that have already partly or fully legalized cannabis production or usage. There have been a few important liability-related developments in Michigan, which are detailed at length below; also briefly covered are developments in other key states.

Michigan

Three laws in various states of effect are worth mentioning.

- + Public Act 55, which became law in October 2021, amends a law prohibiting the sale of cannabis to children or visibly intoxicated persons by mandating that cannabis retailers and micro sellers maintain insurance "provided by a licensed and admitted insurance company in Michigan."²⁶ (Laws in this category are sometimes called "Gram Shop Laws" because of the affected parties.²⁷)
- + The Medical Marijuana Facilities Licensing Act has been modified to require that all in-state cannabis shops acquire insurance against a few different categories of bodily injury "from a licensed insurance company or licensed captive insurance company in this state."²⁸
- + Senate Bill 461 requires that all cannabis "growers, processors, provisioning centers, secure transporters and safety compliance facilities" acquire a "liability insurance policy" from a "licensed insurance company or licensed captive insurance company in this state for at least \$100,000 PER LICENSE HELD."²⁹

Prior to these laws, cannabis businesses were able to meet their liabilities through evidence of cash on hand, unencumbered securities, an approved insurance policy or a constant value bond executed by a surety company (regardless of the number of licenses held). However, the legislature argued that "some policies issued by insurers to licensees contain certain policy exclusions that could be interpreted by courts as precluding coverage for a claim relating to that exclusion," and thus there was a need to "close loopholes...and clarify standards for insurers who offer liability insurance products to medical cannabis licensees."³⁰

The issue with these laws is that cannabis retailers, suppliers and operations shops have typically met their insurance obligations with policies from non-admitted carriers, which can cover risks not typically covered by admitted carriers. These surplus line carriers are sometimes called the "safety valve" for the insurance industry because they can "react to evolving risks and market conditions by quickly changing forms;" further, policies from the non-admitted carrier market often evolve into those provided by admitted carriers, as the non-admitted carriers are effectively gathering risk and price data about what constitutes viable policies.³¹ However, there are very few, if any, admitted carrier options in most states, which causes consternation for Michigan operators. Industry analysts will be watching this situation closely, as one potential outcome is that rising compliance costs will make it harder for Michigan's legitimate cannabis businesses to compete with the black market, as some have argued is happening in California (see below for more information). Hopefully the CLAIMS act, or a version of it, passes and allows for more admitted market capacity.

We will be monitoring the situation closely to see if this regulation spreads to other states.

Elsewhere

A few highlights from states that have not fully legalized as of 2022:

- + **Idaho**, in which cannabis is (with minor exceptions) illegal, has outstanding bills to legalize both medical cannabis³² and recreational usage³³
- + In **Kansas**, a medical cannabis bill passed the House of Representatives and is “alive for consideration” in the Senate³⁴
- + **Texas** expanded access to medical cannabis³⁵ and has a bill pending in the Senate to decriminalize generally³⁶
- + **Wyoming** has a pending bill to permit medical cannabis³⁷ and outstanding ballot initiatives for full decriminalization³⁸
- + **Kansas, Mississippi, Nebraska and South Dakota** lawmakers are currently considering bills that would shield workers’ compensation insurers from reimbursing injured workers for using medicinal cannabis³⁹

Operating a Cannabis Business: The State-by-State Landscape

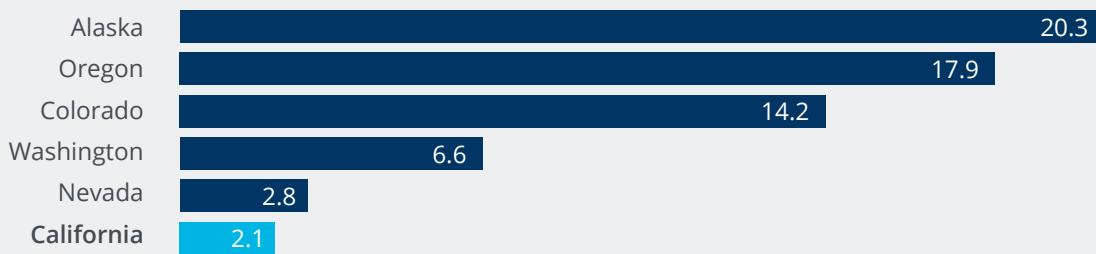
Many states in which cannabis is legal are nevertheless difficult environments in which to start a cannabis business. Politico cites “local government opposition, high taxes and competition from unlicensed businesses” as three reasons why California’s illegal cannabis market does \$8B in sales annually, twice the size of the legal market. California has 823 brick and mortar cannabis shops, for a population of nearly 40 million, whereas there are 817 dispensaries for Colorado, with only a population of 5.8 million. In Connecticut, cultivation licenses can cost \$50M, and a dispensary can cost \$10M, due to enforced scarcity by the state.

Contrast this with Oklahoma — which, in 2014, sued the state of Colorado over an influx of cannabis into its borders⁴⁰ — which has become a hotbed of cannabis entrepreneurship. In October 2021, it surpassed California in grow operations (over 9,000) due to low starting costs and comparatively lax oversight from officials.⁴¹ A new license for a grow facility costs just \$2,500 in the Sooner State, compared to \$100,000 in neighboring Arkansas.⁴² Nearby Arizona recorded over \$1B in sales in 2021, with no signs of slowing growth.⁴³

Overall, for states to reap the benefits of this growing market, legalization alone is not enough; they must also ensure that the regulatory and licensing landscape do not handicap legal businesses relative to existing illegal operations.

California lags behind other states in cannabis shops per capita

Dispensaries per 100,000 residents in Western states with recreational sales, October 2021



Note: Arizona not included due to a lack of publicly available data

Chart: Alexander Nieves / POLITICO | Source: State licensing databases

Per <https://www.politico.com/news/2021/10/23/california-legal-illicit-weed-market-516868>



2022 Cannabis Insurance Market Outlook

Many of the factors that led to increased pricing pressure in 2021 have continued into 2022. The U.S. remains in a low interest rate environment (which makes it hard for insurance companies to offset losses with investment income), traditional inflation and social inflation continue to increase the cost of claims and natural disasters continue to plague the U.S. and Europe. Additionally, another tough 2021 wildfire season for the mountain states, Western Canada, California and the Pacific Northwest (which culminated with the Marshall Fire in suburban Denver that destroyed 1,000+ homes on 12/31/2021) has made property underwriters weary of exposing capacity to high fire risk areas. As such, carriers will continue to place an emphasis on disciplined underwriting and reshaping their portfolios to maximize profitability.

+ **Property** – In general, there continues to be sufficient capacity in the **Property** market, but availability and pricing are dependent on risk perception and rate. Placing **Property** risk remains a challenge, particularly in the gulf coast states given their catastrophic storm ("CAT") exposure, litigious nature and questions raised around quality control such as the Surfside, Florida condo collapse. Another challenging wildfire year is also impacting pricing and capacity for western states, particularly California, Oregon, Washington, Utah, Idaho and Colorado. Areas that were traditionally not seen as "wildfire risks" by underwriters are now being viewed as such, which is a break from traditional risk modeling. Many carriers in the property market are also concerned about the ongoing nationwide shortage of building materials and labor that is having an inflationary impact on property claims. Carriers continue to struggle with the gap between what is reported as replacement value when underwriting the policy versus the actual cost to repair when a claim occurs.

– Wind and hail coverage has also become a challenge to obtain in certain states, particularly Oklahoma. Many carriers have started to add wind and hail sublimits or are not even offering coverage for certain states.

+ **Crop Insurance** – **Crop Insurance** is available and covers all three stages of a crop's life (living plant material (including seeds), harvested plant material that is drying and curing and finished stock ready for sale) from various perils such as lightning, fire, theft, hail, smoke, vandalism and even water damage from plumbing or air conditioning leaks. Capacity and carriers willing to write the coverage for cannabis industry are limited for this product and coverage may come with sublimits. However, since hemp was removed from the list of Schedule 1 controlled substances with the passage of the 2018 Farm Bill, there is generally more capacity and better terms for these operators. Important to note is damage to crops and finished product inventory is not covered by traditional **Property** insurance, which is where these policies can fill a coverage gap.

- + **Builder's Risk** – Like other markets, **Builder's Risk** policies are seeing increases in pricing and retentions not only due to significant losses as a result of large fires but also an increased frequency of smaller claims. Large wood frame, modular construction and renovation projects continue to be the most challenging projects to place. Overall, rate increases are becoming more common given the current demand and price for building materials and labor. Additionally, due to delays in projects as a result of labor shortages and supply chain issues, many insureds are seeking extensions, which can be problematic for carriers as their risk models may not accurately capture pricing for these extensions.
 - Many Builder's Risk carriers are also assessing specific deductibles for water damage and water intrusion, which can be \$100k or greater.
- + **Casualty** – Capacity in the **Casualty** market has improved for the cannabis space. Many cannabis operators are able to find the traditional \$1 or \$2M in **General Liability** limits, but **Umbrella/Excess** carriers are only willing to expose \$5M within the first \$10M of excess limits. Underwriters are, however, focusing on the **Product Liability** portion of **General Liability** policies for cannabis companies, which is driving overall rates for **General Liability**. As it stands, a lack of **Casualty** capacity isn't the problem for many cannabis operators, instead it is pricing having a much larger impact on limit selection.
- + **Product Recall Liability** – Since many **Product Liability** coverage forms only offer an "expense only" sublimit that typically has very limited coverage, many carriers are providing standalone **Product Recall Liability**. Additionally, many General Liability forms differ in what is covered in these sublimits, which can also add problems for insureds when they switch carriers. The **Product Recall Liability** policy is designed to provide limits for re-testing costs, loss of income, costs associated with notifying customers and other expenses connected with a product recall that are most likely not covered by the Product Liability sublimits. These limits can come in handy when state legislatures mandate product recalls, for example Michigan ordering a recall after identifying "inaccurate and/or unreliable results of products tested in laboratories.⁴⁴"

- + Many **General Liability** carriers are also concerned with the **Products Liability** portion of coverage for the cannabis industry – especially for operations that make or sell vaping products, edibles or beverages. Carriers are still concerned with how appealing these products are for children and the expensive judgments that could result from lawsuits relating to underage consumption.
- + **Commercial Auto – Excess/Umbrella** underwriters, like **General Liability** underwriters, are also very concerned about nuclear verdicts and if an insured's loss history is indicative of a potential large loss. This is especially true for companies with large auto fleets, as **Auto** continues to be a loss leader for carriers and is also starting to impact **Umbrella/Excess** pricing. As such, underwriters are requiring a longer history of loss information as well as more details related to losses and any subsequent changes made to mitigate future loss. For companies looking to invest more into delivery services to customers or simply support growth via transportation of product between facilities, elevated Auto rates should be planned for and budgeted appropriately.
- + **Workers' Compensation** – Despite some states' legislative pressure on **Workers' Compensation** claims related to medical cannabis, pricing and capacity continue to remain favorable with rates typically remaining flat for those with positive loss history and experience modifiers.

Executive Liability Update & Outlook

+ D&O

Though **D&O** pricing saw a significant uptick in late 2019 and in 2020, market conditions have generally improved due to a decline in **D&O** litigation trends, case dismissal rates remaining elevated and new capacity entering the market. However, **D&O** rates for the cannabis industry continue to remain elevated due to the fact that 1) federal bankruptcy protection laws don't apply to the cannabis industry (which means that losses are difficult to predict), 2) market participation continues to be limited as cannabis did not see the influx of capacity that other industries saw and 3) the industry is relatively young and lacks solid risk modeling data. These factors continue to perpetuate a very hard market for cannabis **D&O** insurance. Rate increases up to 50% continue to be commonplace and finding capacity for limits exceeding \$10M remains a challenge. Insureds are having to consider changing their purchasing strategy and looking at **Side A** only coverage (which only covers the directors and officers on a dollar for dollar basis when the company is unable or unwilling to indemnify and does not provide any protection for the company) or participating in captives in order to achieve desired limits. Unfortunately, until circumstances change at the federal level, it appears the industry will continue to see elevated pricing compared to the overall market.



+ Cyber

With cyberattacks on the rise, cannabis business owners and operators would be prudent to consider a **Cyber Insurance** policy. However, as more and more high-profile attacks make news headlines, the market has responded by increasing rates, diminishing capacity and requiring sophisticated cyber security controls just to receive a quote. For example, many carriers are focused on and are asking many questions around Multi-Factor Authentication ("MFA") protocols, offsite backup facilities, breach response planning and endpoint detection and response ("EDR") software. If responses to questions around control factors are not met with satisfactory responses, underwriters are simply declining submissions.

+ Crime

Given the fact that approximately 90% of financial losses in the cannabis industry can be attributed to employee theft⁴⁵, there are now over 400,000 people employed by the U.S. cannabis industry and because of the cash-heavy nature of the industry, owner operators would be prudent to consider a **Crime** policy. Aside from employee theft, **Crime** policies can also provide coverage for third-party theft, money in transit, counterfeit currency fraud and forgery. Underwriters are still weary of exposing significant amounts of capacity to the cannabis sector due to the elevated risk profile and will typically ask a lot of questions around cameras, security systems, what firms are being used to transport cash, etc.



Navigating 2022

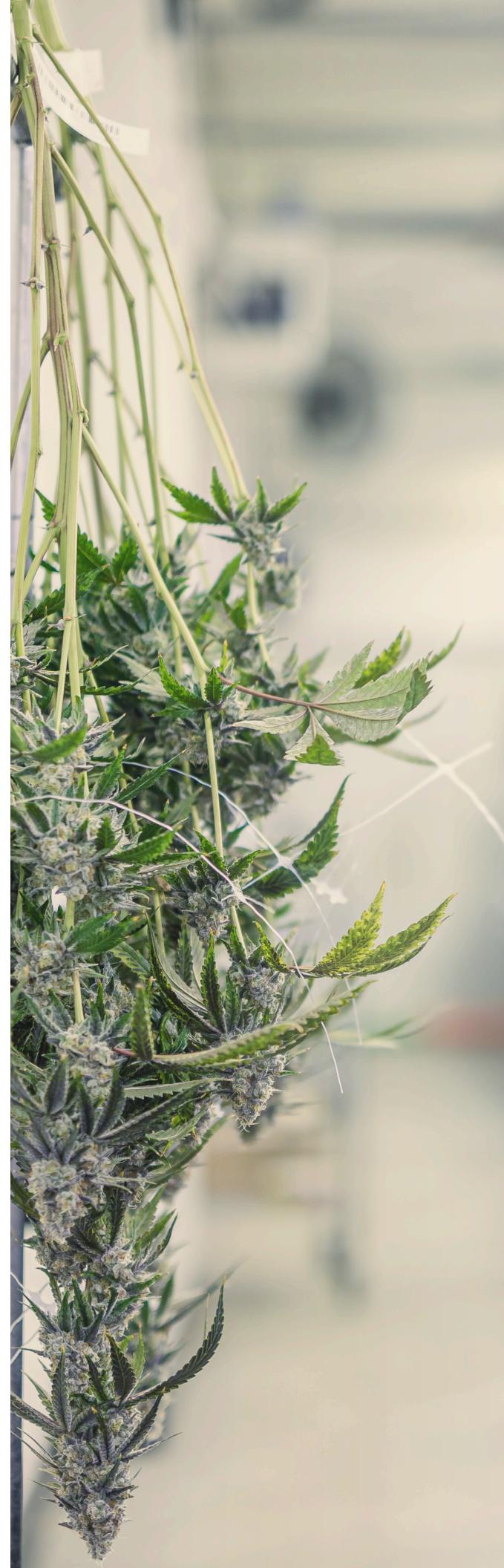
- + **Building Valuations** – As mentioned previously, construction costs continue to fluctuate, and insureds should evaluate if their limits can adequately cover a total loss and rebuild in the current cost environment. To aid in confirming if values are being reported on a replacement cost basis, indices detailing cost trends by geographic area and type of occupancy are available, providing a cost trend factor to apply based on the current age of the property currently scheduled or the original value of that asset.
- + **Permitting** – As legalization continues to spread across the country and the industry looks to expand, it will be important for companies to stay up to date with permitting requirements and if Michigan's licensing insurance requirements spread to other states.
- + **Captive Switching Costs** – Should there not be adequate pricing, limits or policy language available in the admitted or surplus markets and a captive must be considered, insureds need to remember that there are additional considerations. For example, when joining a group captive, prospective insureds go through a vetting process by the members of the group captive to make sure that the risk aligns with those of the captive. This can be a very invasive and time-consuming process depending upon the captive. Additionally, group captives may have high collateral requirements and will be subject to the ebbs and flows of the reinsurance market as these costs are split among the captive.



Keys To Success In 2022

- + **Begin the Renewal Process Early** – The **General Liability, Excess/Umbrella, D&O, Cyber and Property** markets have become constrained and more difficult to navigate in the hard market. Additionally, many carriers in the cannabis space are offering less capacity and more carriers are being required to then achieve desired limits. Due to general price increases across all lines of coverage and all industry sectors in the hard market, underwriters are being inundated with submissions as brokers and insureds look to minimize these additional costs. As such, turnaround times for quotes are increasing. **In order to achieve the best results, insureds should begin their renewal processes earlier than usual to allow for brokers to successfully canvass the market, work diligently with underwriters in detail, negotiate the best terms or potentially enter a captive.**
- + **Partner with Industry Experts** – The cannabis industry presents a unique set of challenges and risks and it is important to work with a broker who truly understands the business and the market for placing the risk. With the challenges insureds are facing in the hard insurance market, it is paramount to have a team that can best represent your risks, offer risk control service to improve processes and has strong, reliable carrier relations. **Having operated in the Colorado, California and Oregon markets for many years and working with many different clients in the cannabis space, we have gained a significant level of industry expertise.**
- + **Look to Partner with Carriers When Possible** – Strong relationships with key trading partners are always important, but even more so in difficult times. This business philosophy also applies to insureds' relationships with carriers. Where possible, insureds should look to meet, even virtually, with their current and prospective carriers. **This interaction not only builds rapport and allows them to put a face (or voice) to a submission by telling their company's story; it also allows for insureds to control the narrative of their risk versus letting underwriters decide.** This is particularly true if there have been losses and insureds are then able to explain what happened and use the opportunity to discuss lessons learned and what new practices have been implemented, as opposed to underwriters simply reading a loss run.
- + **Product Recall Liability** – Make sure to understand what exactly is covered in the **Product Liability** product recall sublimits or consider purchasing a **Product Recall Liability** policy if the desired coverages are not met by the sublimits. Your service team can also assist in making this decision.

- + **Highlight Cybersecurity** - With cyber policies becoming more expensive and difficult to place for cannabis clients, it will be important for insureds to highlight the specificity of their cybersecurity programs. **It is vital to start the process 120 days in advance of your renewal and to highlight any additions in cybersecurity staffing or upgrades to programs as well as lessons learned from any previous attacks.**
- + **Highlight Safety** - Carriers are always looking to analyze EH&S practices, but underwriters will add more scrutiny to workplace safety in the hard market. If there have been claims in the past, it will be important to explain to carriers what the lessons were learned and how the company is working to not have repeat incidents. **Additionally, our Client Advantage EH&S and risk control professionals can help strengthen policies, provide training based on the latest regulations or provide on-site audits.**
- + **Contracts** - Carriers are becoming more and more interested in indemnity language in contracts. Many underwriters are even asking for samples of contracts to review as part of their renewal process to see what insureds are agreeing to indemnify. **Our Client Advantage attorneys can help tighten indemnity language and give feedback on current contracts to help protect clients and make the risk more attractive to underwriters.**



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More Than Just Insurance

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Editor-in-Chief

JOHN SEEGER, *Director of Marketing, Market Intelligence & Insight*

Markets in Focus Contributors

MIKE HENNESSEY, *National Cannabis Practice Leader*

DANIEL MIZE, *Vice President, Commercial Lines Leader*

DANIEL DIONNE, *Account Executive Property & Casualty*

RYLEE GALE, *Account Executive*

SETH GREEN, *Writer*

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