

# 12.5.2018

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## No Coverage for Property Damage Caused by Tenant's Illegal Marijuana Growing Operation

The legalization of marijuana for medical use in 31 states and for recreational use in 9 states has opened up new lines of coverage for insurers. However, because marijuana remains a Schedule 1 banned controlled substance under the Comprehensive Drug Abuse Prevention and Control Act of 1970 (21 U.S.C. 801 et seq.), it remains "unlawful for any person knowingly or intentionally... to manufacture, distribute, or dispense, or possess with intent to distribute or dispense marijuana." 21 U.S.C. 841(a). Due to the lack of uniformity of federal and state laws, it is not yet clear how legalized marijuana will affect insurance coverage for legal businesses. A recent case involving an illegal grow operation, however, shows how the legalization of marijuana may impact coverage for property damage for a legitimate marijuana business owner.

On August 21, 2018, the U.S. Court of Appeals for the Sixth Circuit affirmed a District Court Order which granted summary judgment to an insurer, finding no coverage where the insured's tenant was involved in an illegal marijuana grow operation. On appeal, the tenant, KVG, contended the damage to the property was clearly "vandalism," which would be covered under the policy. The Court agreed finding that "the policy's insuring agreements cover the damage here, but [the insurer] has proven that the dishonest or criminal acts exclusion applies . . . ." Thus, the Court considered "whether the risks here are not covered because an exclusion takes them off the table."

In its analysis, the Appellate Court focused on the "Dishonest or Criminal Acts Exclusion." "Under this exception," the Court noted, "the core issue is whether the tenants committed a 'criminal act' within the meaning of the policy." The Court had little trouble inferring that the tenants had in fact committed such an act. Indeed, the Sixth Circuit concluded that "no reasonable jury could find that [the] tenants complied with Michigan law" under these factual circumstances. The Court further noted that, during eviction proceedings, the landlord "itself claimed, in Michigan Court, that its tenants violated the law." In other words, even though Michigan had legalized medical marijuana, the tenants were not in compliance with the Michigan Medical Marijuana Act. As such, the policyholder was not entitled to insurance coverage for the damage done to its rental units by the tenants because the "Dishonest or Criminal Acts Exclusion."

The Sixth Circuit's holding turned on the fact that the tenants were not acting in compliance with state law regarding marijuana. The outcome in KVG, however, may have been different if the tenants were in compliance with state law. In identifying the main issue before the Court - "whether the tenants committed a 'criminal act' within the meaning of the policy" - the Court aptly noted explained:

In the abstract, this is an interesting question." The court continued: "Cultivating marijuana is a crime under federal law ... but it is protected by Michigan law under certain conditions". As such, the Court observed that: "Under different circumstances, [the policyholder] might have a strong federalism argument in favor of coverage.

Thus, even though Michigan law had carve-outs under the Medical Marijuana Act for certain grow operations, the tenant's operation here was not protected under the Act. Additionally, at the time of the raid, the DEA was not conducting raids on entities protected under the Act, and KVG had alleged in its eviction complaint that the tenant's activity was "illegal."

The Sixth Circuit also noted:

In diversity cases, we act as faithful agents of the state courts and the state legislature...Since the [Michigan Medical Marijuana Act] was passed by ballot initiative, we would exercise even more care, lest we (as

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unelected judges) tread directly on the will of the People of the State of Michigan, who cannot easily correct any error we commit. Exercising the Michigan courts' common-law power to interpret public initiatives, we would hesitate before reading a Michigan insurance policy to bar coverage for a "criminal act" when Michigan law confers criminal and civil immunity for the conduct at issue ... But we need not face that difficult issue today, because no reasonable jury could find that [the] tenants complied with Michigan law.

Although the Sixth Circuit did not reach the question of whether the "Dishonest or Criminal Acts Exclusion" would have barred coverage had the tenants been acting in compliance with state law, the Sixth Circuit court appears to be suggesting that the outcome could be different if the tenant had been acting lawfully. The Court observed that, in such circumstances, the insured "might have a strong federalism argument in favor of coverage" and that the Court "would hesitate before reading [an] insurance policy to bar coverage for a 'criminal act' when [applicable state] law confers criminal and civil immunity for the conduct at issue."

Comment: The Sixth Circuit's decision suggests that an insurer may not be able to invoke the "Dishonest or Criminal Acts Exclusion" to deny insurance coverage to a cannabis-related business compliant with state law, even though cannabis remains illegal under federal law.

Although the Court focused on the dishonesty of the tenant rather than the violation of federal law, the burgeoning marijuana industry should be on the forefront of the insurance industry professional's minds. The marijuana cultivation process significantly increases the risk of property losses as marijuana operations require large amounts of water that increase the risk of water damage and humidity, which fosters growth. Thus, while the illegal acts exclusion was successfully used by the insurer in KVG, courts may not apply policy exclusions if the insurer is aware that the policyholder is legally engaged in the marijuana industry, and the act causing the loss is legal under state law.

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