CANNABIS BUSINESS CONTRACTUAL INDEMNITY/RISK TRANSFER STRATEGIES

National Cannabis Industry Association

FINANCE AND INSURANCE COMMITTEE

CONTRACTS SUBCOMMITTEE

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Somewhere in America, a tourist walks into an adult-use dispensary for the first time. After a conversation with an experienced budtender, the tourist purchases a chocolate bar containing 100 mg of THC, divided into 10 sections/servings, each with 10 mg of THC. The tourist eats two pieces of the bar, hops into the rental car, and proceeds to get into a single-car accident. A month later, the chocolate bar's manufacturer, the distributor that delivered the product to the dispensary, and the dispensary are all served with a lawsuit alleging that the accident was caused by a cannabis overdose. A year-and-a-half later, a jury finds all three defendants are liable for the tourist's injuries and awards $2 million in damages.

As more and more states throughout the country legalize adult-use cannabis, scenarios like the one above will become more and more common. Cannabis operators have long avoided these sorts of suits largely by virtue of the fact that it would never have occurred to most folks to sue their dispensary for a bad batch. Nonetheless, the attention that the industry is beginning to receive from mainstream media outlets will almost certainly catch the eyes of plaintiffs' attorneys throughout the country. More mature recreational markets like Colorado have already started to see this phenomenon. As these suits begin to trickle in, many cannabis operators will be examining a question of critical importance to their businesses: Who is going to pay for this?!?

The answer to this question is likely to come down to the contractual relationship between the cannabis operators. If the parties have been well-represented by legal counsel, liability for events like the one described above will likely have been allocated in advance and clearly spelled out in the parties' contract(s). This is accomplished through what are commonly referred to as "indemnity provisions" or "contractual risk transfer provisions." Understanding the way that these provisions operate and using them strategically could turn out to be a critical component in determining whether a cannabis business will survive a serious lawsuit.

What Are Contractual Risk Transfer Provisions?

Fundamentally, the object of indemnity/risk transfer provisions is to shift risks to other parties. In the absence of such provisions, liability is generally shared among parties found liable for a plaintiff's injuries. This sharing may be in proportion to each party's relative culpability or each may be liable for the full judgment, depending on the state in which the businesses operate. So, the manufacturer, distributor, and dispensary in the hypothetical above each likely pay some portion of the jury's award to the tourist. Likewise, where there are losses to products at various stages of the supply chain, contractual risk transfer provisions can eliminate the finger-pointing and legal maneuvering that may otherwise result when the question of who bears the loss is presented squarely.

Risk transfer provisions take allocation issues out of the hands of uncertainty in litigation and establish clearly who will be responsible for a financial loss under particular circumstances. Utilizing such tools can reduce the likelihood of ancillary litigation between co-defendants and allow all parties to more effectively mitigate their overall exposure to risks.

This risk allocation is most commonly accomplished through indemnification provisions in which one party agrees to assume the liability of another in the event of a claim or loss. A related but distinct risk transfer device is the "hold harmless" agreement, through which one party agrees in advance not to pursue any legal action against the other in the event that things go wrong. Contracts often also provide that one party will defend another against claims and suits, which is significant given the high cost of litigation.

Who Indemnifies Whom?

There are a number of factors that play into decisions to indemnify, hold harmless, and/or defend another party to a contract. Much of the equation, however, boils down to bargaining power.
For example, many, if not most, cannabis operators who lease property from commercial landlords will find indemnification provisions in their leases. Commercial property available for cannabis activity is at a premium, so property owners can often include any number of favorable terms, including full indemnity and defense obligations for any third-party claims.

Increasingly, cannabis operators will likely be negotiating risk transfer provisions in their supply contracts as well. For a craft grower or edible manufacturer, getting product onto the shelves of one of your state's largest dispensaries is a business coup. Often times, however, these relatively tiny companies will need to agree to accept the risks of their distributor *and* the dispensary in order to make that happen. So, it is likely that the distributor and dispensary against whom our hapless tourist prevailed would both turn to the product manufacturer to cover *the entire $2 million judgment and pay for their legal fees* based on the risk transfer provisions in their contracts.

Where bargaining power is more even, parties are more likely to agree to reciprocal risk transfer provisions. Such agreements provide that each party will indemnify the other against their own negligence. So, a cultivator and extract manufacturers to whom they sell their flower, might agree to assume sole responsibility for any claims arising out of issues they ultimately caused. If it turned out, for instance, that the cultivator sold the manufacturer tainted product, ultimately resulting in an adverse reaction to an end consumer, the cultivator could be responsible for indemnifying and defending the manufacturer against a suit by the consumer. But if it were instead determined that the manufacturer negligently contaminated perfectly good flower in the extraction process, it would be the cultivator that is entitled to defense and indemnity.

As is likely clear from the above example, reciprocal risk transfer provisions do not offer contracting parties the same certainty and efficiencies as unilateral indemnity and defense agreements. Nonetheless, they may be far preferable for a company without substantial market power.

What Risks Can Be Transferred?

One piece of good news for parties with less than complete negotiating leverage is that many states limit the extent to which parties may agree to indemnify each other in certain circumstances. These limitations typically protect parties from finding themselves on the hook for damages caused by their contractual partner's negligence.

In California, one party (the indemnitor) can generally contract to indemnify another party (the indemnitee) for the indemnitee's own actively negligent acts so long as the agreements does so

through “sufficiently specific language.”[1] Without such clarity, an indemnity agreement shall be construed to extend only to passive negligence by the indemnitee. What is the difference between active and passive neglect? Simply put, it is the difference between taking an action that causes harm (active negligence) and causing harm through a failure to take action (passive negligence). In Colorado, this distinction is less critical, as any indemnification against another party’s own negligence requires “clear and unequivocal language.”[2] And, contrary to both California and Colorado, Massachusetts has abandoned its specificity requirements for such indemnity language.[3]

What are the practical differences in these differing state standards? Well, let us return to the scenario from the introduction: Say that a budtender at the dispensary accidentally spilled some cannabis oil onto the wrapped chocolate bar. The budtender had attempted to wipe all of the oil off the wrapper, but the distributor had used the wrong packaging material, and some seeped through, coating the bar. As a result, the tourist received far more than 20 mg of THC when eating those two pieces of the bar. A contract between the two operators requires the distributor to indemnify the dispensary against all liability whatsoever related to their transactions, without breaking out any particular type of potentially culpable conduct. In California, this provision would not likely be enforced against the distributor, as the contract does not employ specific language as to indemnity for the dispensary’s active negligence. In Colorado, the question would be whether the provision is sufficiently clear and unequivocal as to permit the dispensary to be indemnified for its own negligence. And, in Massachusetts, the indemnity agreement would almost certainly be enforced.

Limits on what risks are permissible to indemnify can also go well beyond the clarity of language used for indemnifying another against their own negligence. California, for instance, precludes parties from indemnifying another’s fraud or willfully harmful conduct,[4] as well as liability for punitive damages.[5] Further, distributors in California will be delighted to learn of the State’s prohibition on indemnification against liability for bodily injury or property damage stemming from another party’s sole negligence in any trucking or cartage contract.[6] Not only that, any provision that purports to do so is “void and unenforceable” under the law. And, in Massachusetts, most cannabis operators have to like the fact that landlords cannot require their tenants to provide indemnity against the landlords’ own negligence.[6]

[1] E. L. White, Inc. v. City of Huntington Beach, 579 P.2d 505, 511 (Cal. 1978).
[2] Williams v. White Mountain Construction Company, Inc., 749 P.2d 423, 426 (Colo. 1988).
[3] Shea v. Bay State Gas Co., 418 N.E.2d 597 (Mass. 1981). See also Post v. Belmont Country Club, 805 N.E.2d 63 (Mass. App. Ct. 2004).
[4] Cal. Civ. Code § 1668.
[5] PPG Indus., Inc., v. Transamerica Ins. Co., 975 P.2d 652, 658 (Cal. 1999).
[6] Cal. Civ. Code § 2784.5.
[7] MASS. GEN. LAWS ch. 186, § 15.

Insurance and Indemnity

Ideally, regardless of which party is responsible under a contract for covering a particular liability or loss, the cost of remedying it will be covered by insurance. Indeed, most commercial liability insurance policies cover liability for bodily injury and property damage assumed by contract, and state laws generally permit parties to contractually require their counterparts to purchase insurance and to make contractual partners additional insureds under such insurance. Parties may even agree to limit their liability to one other to the extent of available insurance proceeds.

Deliberate use of insurance provisions can be of great use to the cannabis industry. Rather than relying exclusively on its own liability policy, for example, a dispensary doing business with dozens of distributors and selling products from hundreds of suppliers can better protect itself against potential liability by requiring that distributors make it an additional insured on the distributor's liability policy.

It is critical, however, to be cautious when employing contractual strategies related to insurance coverage. Insurance policies often contain provisions that preclude some of the contractual insurance strategies above. For example, liability insurance policies often transfer all of the policyholder's rights to pursue other responsible parties to the insurer, thereby allowing the insurer to recover what it has paid on the policyholder's behalf from another party also responsible for the same harm. Because of this, if a policyholder has, without its insurer's consent, waived rights to pursue its contractual partners, the entire policy may be rendered void. Similarly, a distributor's agreement to add a dispensary to its policy as an additional insured is only of practical benefit to the dispensary if 1) the distributor follows through on this agreement, and 2) if the policy in question actually covers the liability the parties are likely to incur.

Insurers will typically work with policyholders on provisions like the ones discussed above. It is important to keep in mind, however, that insurance for the cannabis industry is far more constrained than that in most any other industry in America. Supply is far shorter than in other industries and, not surprisingly, coverage provided tends to be much narrower. For this reason, it is important for cannabis companies not to over-commit to a contractual partner with regard to the insurance that they will purchase, lest they end up breaching their contracts, their insurance policies, or both.

Conclusion

In sum, strong risk management for cannabis businesses likely includes the employment of some or all of the contractual risk transfer devices discussed above. Like any tools, however, failing to take appropriate care in the way you use them can result in catastrophe. For this reason, it is advisable to partner with attorneys and insurance brokers who are familiar with both the cannabis industry and best practices in risk management more generally.