

# Lawyer Insights

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## Cannabis Coverage Conundrum: Was This Property Claim Doomed?

by Michael S. Levine and Geoffrey B. Fehling

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The U.S. Court of Appeals for the Sixth Circuit recently upheld dismissal of KVG Properties Inc.'s claims under a first-party property policy arising from damage to KVG's office spaces due to tenants' use of cannabis-growing operations. [*K.V.G. Properties, Inc. v. Westfield Insurance Co.* (No. 17-2421, 6th Cir. Aug. 21, 2018)]

We have been tracking the KVG case closely and previously reported on KVG's initial appeal and Westfield's retort on why the district court correctly dismissed the claims. Although there was no coverage for KVG under the particular facts of this case, the Sixth Circuit's decision raises several important insurance issues for policyholders to consider and previews likely battlegrounds for future cannabis coverage disputes, many of which are precipitated by the variances in federal and state cannabis law.

### Sixth Circuit Decision

Although Westfield denied coverage under three exclusions, the Sixth Circuit resolved the issue and affirmed based solely on the criminal acts exclusion. At the outset, the court noted that the first step of its coverage analysis — whether KVG's claim falls within the policy's insuring agreement — “requires little discussion” because the insuring agreement was written broadly to cover all “Risks of Direct Physical Loss.” In fact, the court noted “one would struggle to think of damage *not* covered by this language,” but that the harder question is whether the particular risks at issue are excluded.

Westfield argued that the tenants' conduct was criminal under either state or federal law and that those acts caused KVG's loss. The Sixth Circuit agreed and affirmed the district court's dismissal based on this exclusion.

As was the case on summary judgment, the central issue on appeal was whether the tenants committed a “criminal act” under the policy. Cultivating cannabis is a federal crime but is protected in certain situations under Michigan law. Although the court recognized that, under different circumstances, KVG may have had a “strong federalism argument” in favor of coverage, there was no coverage for the particular claims at issue because no reasonable jury could find that KVG's tenants complied with Michigan law.

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Even though it remained Westfield's burden to prove all facts necessary to demonstrate that the criminal acts exclusion applied, the court looked no further than KVG's own admissions in the proceedings below that its tenants "illegally grew marijuana." Likewise, it was undisputed that federal Drug Enforcement Administration agents raided the KVG property "as part of a criminal investigation," which suggested that the tenants were not in compliance with Michigan law. Federal guidance documents state that such raids occur only when officials believe the targets are not in "clear and unambiguous compliance with existing state laws." These facts were sufficient to support Westfield's prima facie burden of proving that application of the criminal acts exclusion applied.

In closing, the court rejected KVG's position that the criminal acts exclusion applied only when the tenants had been "convicted" of a crime. The court explained that the Westfield policy says criminal "act," not "crime" or "conviction," and "[a] fugitive from justice may properly be deemed a criminal by the person he harms, even though the State cannot prove it beyond a reasonable doubt." Predicting that the Michigan Supreme Court would not read such an "onerous" conviction requirement into a "standard" insurance contract, the Sixth Circuit declined to do so in KVG's appeal.

## Takeaways

- **Review coverage limitations.** The decision is a reminder to carefully review all coverage limitations closely to ensure that what may be a "generous insuring agreement" is not restricted by "a litany of exclusions," as occurred in *KVG*. For example, as the Sixth Circuit suggested, policyholders should look for narrower criminal acts exclusions—for example, those triggered only by a "crime" or "conviction"—that do not apply broadly to alleged "criminal acts." Absent admissions from the policyholder that acts were "illegal" (as was the case in *KVG*), a court would be required to interpret exclusions narrowly and in favor of coverage, which may have led to a different outcome in *KVG* notwithstanding the broader language in the exclusion.
- **Make alternative coverage arguments.** Do not abandon any alternative coverage arguments, especially given the insurer's burden of proof on exclusions, which requires that the insurer demonstrate that each aspect of the provision clearly and unambiguously applies to the loss at issue. In *KVG*, the court noted the potential for an argument that the criminal acts exclusion should not apply to tenants who, like *KVG's*, obtain "entrustment" by false pretenses. The *KVG* court declined to analyze this issue because *KVG* expressly chose not to discuss that element of the exclusion or argue it in favor of reversal. If possible, policyholders should adopt a "belt-and-suspenders" approach and consider raising all potentially applicable arguments to trigger coverage for a claim.
- **Hire coverage counsel early.** The decision underscores the importance of retaining coverage counsel early in any dispute, and certainly before any lawsuit is filed. Coordinating insurance and defense strategies can avoid arguments in underlying matters that may jeopardize positions in a later coverage action, as occurred in *KVG* as a consequence of statements made in the underlying eviction proceedings.
- **Be prepared for federal vs state law arguments.** The *KVG* decision previews "federalism" arguments that are likely to reappear in future cannabis coverage disputes when state law permitting all or limited use of cannabis conflicts with federal law. As the Sixth Circuit recognized, federal courts "act as faithful agents of the state courts and the state legislature," and federal courts sitting in diversity emulate state courts that will enforce applicable state law. Federal courts

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“exercise even more care” when citizens of a particular state have approved cannabis use through ballot initiatives. This deference to state law, including legislation or other initiatives legalizing cannabis usage, may result in different outcomes on “criminal acts” arising from different facts or applicable state law.

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