Insurers Should Beware Risks From Digital Asset Losses

By **Christopher Assise, Sean Commons and Raul Ruiz** (August 17, 2022)

Christopher Assise

Sean Commons

Raul Ruiz

Over the last several years, much digital ink has been spilled about whether various types of insurance policies cover the theft of digital currency such as bitcoin.

In 2018, a decision from the Court of Common Pleas, Franklin County, Ohio Civil Division, in Kimmelman v. Wayne Insurance Group upped the ante for personal lines insurers and generated considerable discussion of potential policy changes by holding that bitcoin was not currency and thus not subject to the currency sublimit in a homeowners insurance policy.[1]

But, four years later, most personal lines insurers do not appear to have taken steps to expressly address the issue, perhaps because the forecasted wave of claims and resulting coverage litigation has yet to materialize.

Moreover, insurers that have taken steps typically focused narrowly on digital currency, leaving open questions about losses involving other types of digital assets, such as in the burgeoning market over nonfungible tokens.

As this article explains, digital currencies are just one high-profile type of digital assets that have proliferated over the last few years with the increased adoption of blockchain technologies and growing interest from, and offerings for, individual investors.

Combined with the rapid expansion of state-sponsored hacking and online criminal gangs, the risk that individuals will experience digital losses grows daily.[2]

The absence of significant digital asset claims under personal lines insurance policies, however, may cause some insurers to underestimate both incurred and future exposure to digital asset losses.

To protect against a potential influx of claims of uncertain size, personal lines insurers, including those that have already added a digital currency exclusion, should strongly consider revising all of their policies that respond to theft or loss of personal property to include language broadly excluding coverage for digital assets generally.

Digital assets include more than just digital currency.

To date, virtually all discussion of insurance coverage for digital assets has focused on coverage for digital currencies such as bitcoin and Ethereum. This is for a good reason: Digital currencies are by far the most high-profile and widely held digital asset, and only digital currency losses have generated insurance coverage disputes to date.

But the world of digital assets is much broader than digital currency.

For example, NFTs are a flexible digital asset that can represent ownership of almost anything.[3] Christie's and Sotheby's, generally considered to be the two best known auction houses in the world, each sold over $100 million in NFTs in 2021, with a single NFT sale topping out at $69 million.[4] Industry analysts estimate that at least $44.2 billion was spent on NFTs in 2021 alone.[5]

Other types of digital assets with marketable economic value include utility tokens — a transferrable digital asset that provides the holder access to specific services or products — and digital card game collectables.[6] While less talked about, such digital assets present the same coverage issues as digital currency.

In addition, while some digital assets, such as NFTs consisting of digital artwork, may fall within existing policy sublimits, others may present challenges. Rather than litigating coverage disputes on an asset-by-asset basis, insurers should strongly consider taking a holistic view of digital assets that limits or eliminates exposure to this class of property risks in a more omnibus fashion.

Personal lines insurers may be underestimating their incurred and future exposure for digital asset losses.

The commercial insurance market has largely moved to exclude digital currency — although not necessarily digital asset — losses; the personal lines market has been slower to act.

The inaction suggests that carriers do not believe digital assets represent a material exposure — a position that is likely attributable to the fact that losses to date appear to be fairly small. But, historical loss information almost certainly underestimates the frequency of incurred losses and current underwriting practices, likely leaving many insurers in the dark about the potential severity of future exposure.

Evidence suggests that insureds' lack of awareness concerning potential coverage for digital asset theft may be artificially suppressing digital asset claim rates.

According to CNBC, an estimated $14 billion in digital currency was stolen in 2021 alone.[7] Experts estimate that over $2 billion has already been stolen in 2022 using a single tool.[8]

Indeed, a single attack earlier this year stole a total of $615 million from the blockchain project Ronin.[9] Many of these thefts may fall under commercial rather than personal lines policies, but the magnitude of the losses makes it likely that personal lines policyholders are sitting on hundreds of millions of dollars in digital asset losses that have not been reported.

One potential explanation for this disconnect between documented losses and the lack of claims is that insureds simply do not know that property insurance policies could cover digital asset theft. As time goes on, and losses mount, awareness of this potential coverage will only increase.

For example, litigation to recover customer funds from digital exchanges and wallets could easily transform into claims by insureds over remaining losses.[10]

As has occurred in other areas of litigation, carriers can reasonably assume that, at some point, attorneys will identify first-party property insurance claims as an easier, or at least concurrent, path to recovery, at which point carriers could face a wave of claims limited only by relevant state statutes of limitations and any policy claim filing deadlines.

The problem of assessing potential digital asset exposure is exacerbated by a lack

of meaningful underwriting information.

Prior to Kimmelman, property insurers likely believed their exposure for at least digital currency losses were capped at the currency sublimits contained in policies. While this is likely the better interpretation of most policies, Kimmelman makes clear that insurers cannot rely on such sublimits to cap exposure.

But in the absence of such policy sublimits, insurers lack any meaningful way to estimate their potential digital asset exposure, as personal lines insurers generally do not collect information about digital assets during underwriting. Even if such information is being collected, the wild fluctuations in the markets for digital assets mean that carriers' potential exposure can vary widely from month to month or even day to day.[11]

Absent policy reports, demographic changes will further increase carriers' exposure to digital asset losses.

As of November 2021, 16% of American adults said they had invested in, traded or used cryptocurrencies themselves.[12] Those figures appear to be steadily growing, as a 2022 poll found that 24% of American households have purchased cryptocurrencies or NFTs.[13] Moreover, ownership of digital assets skews toward younger adults, as almost one-third of Americans aged 18-29 have invested in cryptocurrencies.[14]

As property insurance rates are far lower for renters than homeowners,[15] the matriculation of these young adults from renters to homeowners — coupled with rising rates of digital asset ownership overall — means that personal lines property insurers' exposure to digital assets will only continue to grow over time.

Personal lines insurers should promptly consider several policy changes to protect against further exposure.

Given what is already known about the potential for future claims, personal lines insurers should carefully consider whether to implement broad policy exclusions and update underwriting practices to account for risks associated with known and future digital assets.

Even carriers that have added exclusions may not have implemented practices that account for the entirety of their exposure to digital assets.

For example, the Insurance Services Office issued a set of updated policy forms earlier this year with a virtual, digital or electronic currency exclusion. These new forms largely mirror an exclusion ISO added to its commercial crime program in 2015, which excluded loss involving virtual currency of any kind, by whatever name known, whether actual or fictitious, including, but not limited to, digital currency, crypto currency, or any other type of electronic currency.

However, such provisions do not carve out losses involving other types of digital assets commonly held by individuals and businesses.

The constantly evolving and growing digital asset landscape supports adopting a more forward-looking approach, rather than waiting for litigation to determine exposure.

The forms promulgated by ISO represent a good start, but personal lines carriers should evaluate whether to implement provisions that address all digital assets that may be stolen.

In settings where such exclusions may be difficult to implement, insurers should, at a minimum, consider whether to adopt new underwriting practices combined with policy forms that include sublimits for digital assets, defined broadly, while offering endorsements that allow insureds to schedule increased coverage for specifically identified digital assets.

Christopher M. Assise is counsel, Sean A. Commons is a partner and Raul A. Ruiz is an associate in Sidley Austin LLP.

[1] Kimmelman v. Wayne Ins. Grp., No. 18 CV 1041 (Ct. of Common Pleas, Franklin Cty. Sept. 25, 2018).

[2] https://go.chainalysis.com/rs/503-FAP-074/images/Crypto-Crime-Report-2022.pdf.

[3] https://www.forbes.com/advisor/investing/cryptocurrency/nft-non-fungible-token/.

[4] https://markets.businessinsider.com/news/currencies/christies-nft-sales-total-beeple-auction-crypto-cryptopunks-2021-12; https://www.coindesk.com/business/2021/12/15/sothebys-nft-sales-reach-100m-in-2021/.

[5] https://go.chainalysis.com/rs/503-FAP-074/images/Crypto-Crime-Report-2022.pdf.

[6] https://h41369.www4.hp.com/taw/article/ID/GB/TAW_002620 https://www.coindesk.com/markets/2019/09/23/gods-unchained-crypto-game-raises-15-million-from-naspers-galaxy/.

[7] https://www.cnbc.com/2022/01/06/crypto-scammers-took-a-record-14-billion-in-2021-chainalysis.html#:~:text=Cryptocurrency%20theft%20rose%20516%25%20from,%247.8%20billion%20worth%20of%20cryptocurrency

[8] https://www.cnbc.com/2022/08/05/crypto-startup-nomad-offers-10percent-bounty-after-190-million-hack.html.

[9] Id.

[10] E.g. Sarcuni v. bZx Dao, No. 22-cv-0618 (S.D. Cal.); Leidel v. Project Investors, Inc., No. 9:16-cv-80060 (S.D. Fla.); Leidel v. Coinbase Inc., No. 9:16-cv-81992-MARRA (S.D. Fla.).

[11] Bitcoin, for example, has experienced price changes as large as 39% in a single day. https://www.bankrate.com/investing/bitcoin-price-history/.

[12] https://www.pewresearch.org/fact-tank/2021/11/11/16-of-americans-say-they-have-ever-invested-in-traded-or-used-cryptocurrency/.

[13] https://www.shu.edu/business/news/1-in-4-american-households-have-purchased-or-

sold-crypto-nfts.cfm.

[14] Id.

[15] https://www.simplyinsurance.com/renters-insurance-statistics/; https://www.simplyinsurance.com/homeowners-insurance-statistics/.