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Why Legacy Insurance May Not Protect Adopters Of Bitcoin

By **Amy Kallal, Andrea Fort and Andrew Romano** (June 10, 2021, 1:41 PM EDT)

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On June 9, El Salvador became the first country to adopt a Bitcoin standard. The law passed by El Salvador's legislative body deems Bitcoin legal tender, meaning it can be used to satisfy any monetary debt, and means that the country will buy the digital asset for its treasury reserves.[1]

In the wake of President Nayib Bukele's announcing these plans at the Bitcoin 2021 conference in Miami on June 5, lawmakers from Paraguay, Panama, Brazil, Mexico, Argentina, Ecuador and Tonga expressed support for Bitcoin as legal tender and a treasury reserve asset.[2]

Despite a significant price correction last month, the price of Bitcoin has risen over 270% in the last year. The performance of the flagship digital asset[3] can be attributed to several factors, one being that institutions began embracing Bitcoin.

Months before the El Salvador announcement on June 5, multinational corporations like MicroStrategy Inc., Tesla Inc. and Square Inc. converted portions of their balance sheets from dollars to bitcoin.[4] A small but growing number of small- and medium-sized businesses, which are nimbler and can therefore be even more aggressive, are also converting excess cash reserves to bitcoin.

As society moves further along the adoption curve, there is an emerging need for insurance products that cover the risk of owning and holding bitcoin. This article analyzes some common legacy insurance coverages and explains why they may not cover losses arising out of the hacking or theft of bitcoin stored in a digital wallet.

Powered by the blockchain, a decentralized ledger technology, Bitcoin is a digital monetary network that serves as a store of value and also as a fast, low-cost and anonymous medium of exchange.

Although blockchain technology is less vulnerable to hacking than traditional centralized databases, any technology platform that utilizes the blockchain runs on a combination of hardware and software, which can always be hacked or destroyed.[5]

Just as an art museum purchases insurance in addition to hiring guards and installing high-tech security systems because it can never eliminate the possibility of a heist, insurance provides a necessary backstop for holders of bitcoin.

The digital asset insurance industry barely existed before early 2018, and though it has grown rapidly, the demand for this insurance continues to outpace supply.[6] As of the date of publication, it is estimated around 50 publicly traded companies have invested over $50 billion in bitcoin, with hundreds more across various industries accepting it as payment.[7]

Smaller businesses are also starting to plug into this new monetary network. Online merchants are using platforms like Etsy Inc. and Shopify Inc. to accept payment in bitcoin.[8] It is easy to imagine a dental practice or small law firm deciding to accept bitcoin from patients or clients, then sweeping additional excess dollar cash flows into a digital wallet on a monthly or quarterly basis.

These enterprises, however, generally do not have insurance designed to cover digital assets. If a hacker successfully infiltrated the business's digital wallet and sent bitcoin to an unknown bank account, that transaction would be irreversible, and the business would likely bring a claim under its commercial property insurance or commercial crime insurance policies.

Coverage for such a situation under a legacy commercial property insurance policy depends on several issues, including whether the stolen bitcoin are covered property and whether the loss constitutes direct physical loss.

A typical commercial property insurance policy provides coverage for "direct physical loss of or damage to Covered Property at the premises ... caused by or resulting from any Covered Cause of Loss." Covered property typically is separated into: "(a) Building; (b) Business Personal Property; and (c) Personal Property of others."[9]

The stolen bitcoin clearly would not fall under building or personal property of others, as it is digital and belongs to the business. Assuming the policyholder can show the wallet is company property, the analysis would shift to the direct physical loss requirement.

In an arguably analogous context, courts have held that an insured does not sustain a direct physical loss for losses resulting from fraudulent securities schemes.[10] In those cases, the policyholders suffered economic losses arising out of the use of fraudulent checks.

The courts reasoned that the funds in question did not have a physical existence and were therefore not susceptible to physical loss or damage. Because digital assets are similarly intangible, there is a strong argument that the direct physical loss requirement would not be satisfied in the event of a digital wallet hack.

If, on the other hand, the business brought a commercial crime insurance claim, coverage would depend in part on whether the theft of bitcoin triggers coverage and whether the stolen bitcoin is other property as defined in the policy. Commercial crime policies typically cover losses resulting from an occurrence taking place at any time, which is discovered by an insured during the policy period.

Most commercial crime policies provide coverage for computer fraud, meaning "[loss] of or damage to 'money,' 'securities,' and 'other property' resulting directly from the use of any computer to fraudulently cause a transfer of that property."

This invites the question of whether Bitcoin constitutes money, securities or other property. If none of those, coverage would be unavailable. Money is defined in many crime forms to mean: "a. currency, coins and bank notes in current use and having a face value; and b. travelers checks, register checks and money orders held for sale to the public."

If the hypothetical dental practice or law firm had been using the now-stolen bitcoin as a medium of exchange, meaning it was accepting payment and purchasing office supplies in bitcoin, it could plausibly argue that it is a form of currency and thus is money.

Indeed, in 2013, the U.S. District Court for the Eastern District of Texas classified Bitcoin as a currency or form of money for the purpose of certain securities laws in U.S. Securities and

Exchange Commission v. Shavers.[11] On the other hand, bitcoin is not in current use in the same sense as coins and bank notes.

Moreover, Shavers involved a defendant seeking to defeat charges that he violated federal securities laws arising from Bitcoin-related investment opportunities on the basis that Bitcoin is not money. The purpose of the underlying legislation, prosecuting fraud, makes the applicability of Shavers in the commercial crime insurance context unclear.[12]

The term "securities" is commonly defined in commercial crime forms to mean

> negotiable and nonnegotiable instruments or contracts representing either "money" or property and includes: a. tokens, tickets, revenue and other stamps (whether represented by actual stamps or unused value in a meter) in current use; and b. evidences of debt issued in connection with credit or charge cards, which cards are not issued by you; but does not include "money."[13]

Although there continues to be considerable debate about whether some cryptocurrencies constitute securities under criteria established by the U.S. Supreme Court in 1946 in SEC v. W. J. Howey Co.,[14] the SEC has confirmed that Bitcoin is not a security in part due to its decentralized protocol.[15]

If Bitcoin is neither money nor a security, commercial crime coverage is likely unavailable unless it meets the definition of "other property."

Other property is typically defined as "any tangible property other than 'money' and 'securities' that has intrinsic value but does not include any property excluded under this insurance."

In a 2018 decision by an Ohio state court, Kimmelman v. Wayne Insurance Group,[16] the court found Bitcoin to be property for insurance purposes because the IRS classifies it as such. But the key word in the "other property" definition is "tangible." Courts may be unwilling to treat virtual currencies as tangible property despite Kimmelman.

Although the specific policy language and circumstances of a particular loss must always be taken into account, whether legacy insurance covers the hacking of a digital wallet as a general matter is far from certain. The insurance industry is adapting to the emergence of a new monetary network with provisions expressly addressing cryptocurrency risks.[17]

Major global insurers are starting to offer protection against cryptocurrency theft, demonstrating the industry's willingness to embrace, rather than miss out on, this rapidly growing ecosystem.

As bitcoin's value surges, and as the adoption cycle causes businesses to consider incorporating bitcoin into their balance sheet or profit and loss strategies, the need for insurance protection and opportunities for the insurance industry will continue to grow.

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[1] @AsambleaSV, Twitter (June 9, 2021, 2:09 AM), https://twitter.com/AsambleaSV/status/1402508029564760064; @DocumentingBTC, Twitter (June 9, 12:32 AM), https://twitter.com/DocumentingBTC/status/1402481423379009537; see also Caitlin Ostroff, El Salvador Becomes First Country to Approve Bitcoin as Legal Tender, The

Wall Street Journal (June 9, 2021), https://www.wsj.com/articles/el-salvador-becomes-first-country-to-approve-bitcoin-as-legal-tender-11623234476.

[2] @NLW, Twitter, (June 8, 2021, 10:20 AM), https://twitter.com/nlw/status/1402630693251866633; see also Luke Conway, All the Countries Where Bitcoin Adoption Is Being Considered, TheStreet.com (June 8, 2021), https://www.thestreet.com/crypto/bitcoin/politicians-from-these-countries-have-called-for-bitcoin-adoption.

[3] "Digital asset" is an umbrella term encompassing tokens and cryptocurrencies. Tokens—also referred to as crypto tokens—are units of value that blockchain-based organizations or projects develop on top of existing blockchain networks. While tokens often share deep compatibility with the cryptocurrencies of that network, they are a wholly different digital asset class. A cryptocurrency is the native asset of a blockchain network that can be traded, utilized as a medium of exchange, and used as a store of value. It is issued directly by the blockchain protocol on which it runs. In many cases, cryptocurrencies are not only used to pay transaction fees on the network, but are also used to incentivize users to keep the cryptocurrency's network secure. Cryptopedia Staff, Digital Assets: Cryptocurrencies vs. Tokens, Cryptopedia (Mar. 23, 2021), https://www.gemini.com/cryptopedia/cryptocurrencies-vs-tokens-difference. Bitcoin is the most valuable cryptocurrency with a market capitalization in excess of $1 trillion as of April 2021.

[4] Square, Inc. has purchased $220 million of bitcoin since October 2020. Tesla, Inc. added $1.5 billion in bitcoin in February 2021. MicroStrategy, Inc., a NASDAQ-listed enterprise software company based in Virginia, began accumulating bitcoin in August 2020 and has since converted nearly eighty percent of its treasury to bitcoin. Microstrategy is the first publicly traded company to adopt bitcoin as its primary treasury reserve asset.SeeAvi Salzman, Bitcoin Was Supposed to Be A Way Around Corporate Gatekeepers. Now Big Companies Are Hopping on Board, Barron's (April 9, 2021),https://www.barrons.com/articles/more-companies-see-business-opportunities-in-bitcoin-51617990873.

[5] In 2019, a record high of twelve different crypto asset exchanges were hacked and over $4 billion of crypto assets were stolen or scammed worldwide. Recent scandals include South Korean exchange UpBit's loss of approximately $50 million worth of Ether in November 2019. A few days later all funds were frozen at Chinese exchange Idax when the CEO suddenly "went missing." New crypto exchange Altsbi was hacked in February 2020, just months after publicly launching its services.SeeAdam Zuckerman, Insuring Crypto: The Birth of Digital Asset Insurance, 2021 U. Ill. J. L. Tech. & Pol'y (forthcoming 2021), available athttps://papers.ssrn.com/sol3/papers.cfm?abstract_id=3756619.

[6] Justin Grensing, Cryptocurrency Insurance Market Shows Promise Despite Cautious Approach by Major Insurers, Am. Express, https://www.americanexpress.com/us/foreign-exchange/articles/cryptocurrency-insurance-market-shows-promise-with-caution/(last visited Apr. 15, 2021);see also Phillip Martin, A Unique Look Under the Hood of One of the World's Most Comprehensive Crypto Insurance Programs, The Coinbase Blog (Apr. 2, 2019),https://blog.coinbase.com/on-insurance-and-cryptocurrency-d6db86ba40bd(Because insurers entering a new market must be conservative, the most secure and sophisticated holders bitcoin and other currencies (think Coinbase) are the ones most likely to obtain insurance. As a result, just a few of the major players in this space have digital asset insurance policies with multi-hundred-million-dollar limits, and these policies make up much of the insurance coverage in the industry.); Zuckerman, supranote 3.

[7] Bitcoin Treasuries, Bitcointreasuries.org,https://bitcointreasuries.org/index.html(last visited Apr. 15, 2021).

[8] Amrita Khalid, What You Need to Know Before Accepting Bitcoin Payments, Inc. Technology (Mar. 8, 2021), https://www.inc.com/amrita-khalid/cryptocurrency-bitcoin-payments.html.

[9] ABA Insurance Services, Specimen Policies and Endorsements, Building and Personal Property Coverage Form CP 74 38 (Ed. 07/19),available athttps://www.abais.com.

[10] Schmidt v. Travelers Indem. Co. of America , 101 F. Supp. 3d 768 (S.D. Ohio 2015); Florists' Mut. Ins. Co. v. Ludy Greenhouse Mfg. Corp. , 521 F. Supp. 2d 661, 680 (S.D. Ohio 2007); see also Tschimperle v. Aetna Cas. & Sur. Co. , 529 N.W.2d 421, 425 (Minn. 1995) ("loss of [an] investment does not constitute damage to tangible property"); Levine, Hentschel, Dierssen-Morice, and Srail, Unchained and Decrypted: Coverage Issues Concerning Blockchain and Cryptocurrencies Explained, IRMI: Insurance Law Essentials 4-5 (Oct. 2019), available athttps://www.huntoninsurancerecoveryblog.com/wp-content/uploads/sites/27/2019/10/IRMI-Insurance-Law-Essentials-Coverage-Issues-Blockchain-and-Cryptocurrencies-Levine.Hentschel-10.2019.pdf.

[11] No. 4:13-CV-416, 2013 WL 4028182 (E.D. Tex. Aug. 6, 2013). Noting that bitcoin can be used as a medium of exchange and can easily be converted to dollars, the court held that bitcoin is a "currency" or form of "money" for the purpose of the applicable securities laws.

[12] Mark J. Krone, Emily M. Lukes, Chris McKibbin, Tales from the Crypt: Cryptocurrency Is Here-How Will Crime Insurers Respond?, 24 Fidelity L.J. 1, 58 (2018).

[13] See, e.g., McKee v. State Farm Fire & Cas. Co. , 193 Cal. Rptr. 745 (Ct. App. 1983) (collectable coins, though not in circulation, were "money" under homeowner's policy); De Biase v. Comm'l Union Ins. Co. of N.Y. , 53 Misc. 2d 45, 278 N.Y.S.2d 145 (Civ. Ct. N.Y. County 1967) ("'money' is any matter … which has currency as a medium in commerce").

[14] SEC v. W.J. Howey Co. , 328 U.S. 293, 301 (1946) (establishing criteria to determine whether an investment contract exists, stating that an investment contract is: (1) an investment of money; (2) in a common enterprise; (3) with the expectation of profit; (4) to be derived from the efforts of others).

[15] See@SquawkCNBC, Twitter (April 1, 2021, 7:27 AM), https://twitter.com/SquawkCNBC/status/1377583405819424770 ("'Where digital assets land at the end of the day–will be driven in part by regulation both domestic and international, and I expect that regulation will come in this area both directly and indirectly,' says Former SEC Chairman Jay Clayton on #bitcoin.").

[16] 18- CV-1041 (Court of Common Pleas, Franklin County, Ohio Sept. 25, 2018).

[17] Levineet al., Unchained and Decrypted: Coverage Issues Concerning Blockchain and Cryptocurrencies Explained, at 14.
