Volume 7 | Issue 2

ViewPoint

Analyzing Industry Issues from an Independent Perspective

SILENT CRYPTO

Cryptocurrency as Property Exposure

14% of the US population own cryptocurrency, as estimated in May 2021 by Gemini, a cryptocurrency exchange. But, despite the increasing popularity of cryptocurrency among both individuals and institutions, US regulatory guidance has been limited on the legal classification of cryptocurrency. *Kimmelman v. Wayne Insurance Group* highlights how this limited regulatory guidance may have created a new property risk for insurers: cryptocurrency as property exposure, particularly in homeowners policies.

Regulatory Uncertainty On Cryptocurrency

Currently, there is no consensus from regulators on how to treat cryptocurrencies, which can vary significantly in terms of features, governance, purpose, etc.

As a Security. In 2018, SEC Chair Jay Clayton noted the following:

- He did not think Bitcoin and Ethereum were securities, but
- Some cryptocurrencies that were created via ICO (Initial Coin Offering) should be considered securities.

The new SEC Chair Gary Gensler agrees that many cryptocurrencies are securities, but has not commented on exactly which cryptocurrencies he believes are securities. He has further stated that the SEC is facing a lack of resources for regulating cryptocurrencies.

Further clarity may arise with the SEC's current lawsuit against Ripple, which alleges that Ripple raised over $1.3 billion through an unregistered digital asset securities offering.

> **The SEC is facing a lack of resources for regulating cryptocurrencies.**
>
> *-SEC Chair Gary Gensler*

As a Commodity. In its "Bitcoin Basics" literature, the Commodity Futures Trading Commission (CFTC) says that virtual currencies, including Bitcoin, are "deemed to be commodities under the Commodity Exchange Act (CEA)." CFTC Commissioner Brian Quintenz recently tweeted that Ethereum is a "non-security commodity."

As Property. At present, the clearest guidance on treating cryptocurrencies is from the IRS. IRS Notice 2014-21 states that all virtual currency is considered property for federal income tax purposes.

Since further guidance from other regulatory bodies may continue to be delayed due to complexity and/or lack of skilled resources, the IRS's treatment of cryptocurrencies may have significant implications for the insurance industry.

KIMMELMAN V. WAYNE INSURANCE GROUP

To date there has been only one major published property insurance court decision on cryptocurrency as property. The *Kimmelman v. Wayne Insurance Group* case is a significant court case on treating cryptocurrency as property. This case brought to light the lack of regulatory guidance and has now introduced the potential for a new silent exposure for homeowners insurers.

The Claim. James Kimmelman submitted a claim to Wayne Insurance Group in August of 2017. He reported that approximately $16,000 of his Bitcoin was stolen. In assessing the claim, Wayne Insurance Group determined that Bitcoin was money, and was therefore subject to a $200 sublimit under the policy. Kimmelman sued his insurer, arguing that Bitcoin should be considered property.

The Finding. The court agreed with him, and stated:

> *[T]he only authority the Court can rely on in determining the status of BitCoin is the Internal Revenue Service Notice 2014-21. Under Notice 2014-21, the IRS states, "For federal tax purposes, virtual currency is treated as property." Accordingly, the Court finds BitCoin, although termed "virtual currency," is recognized as property by the IRS and shall be recognized as such by this Court.*

Some of the details of the case are unknown, such as how the Bitcoin was stored when it was stolen. It may be relevant if Kimmelman maintained control of his private keys, or if his Bitcoin was stored with a third party and he did not own his private

> **For federal tax purposes, virtual currency is treated as property.**
>
> *-IRS FAQ Page on Virtual Currency*

keys. Regardless, this case demonstrates that courts may lean on IRS Notice 2014-21 when asked to determine how to treat cryptocurrency.

If all cryptocurrency is considered property, then large hacks have the potential to create catastrophe-like events for homeowners insurers.

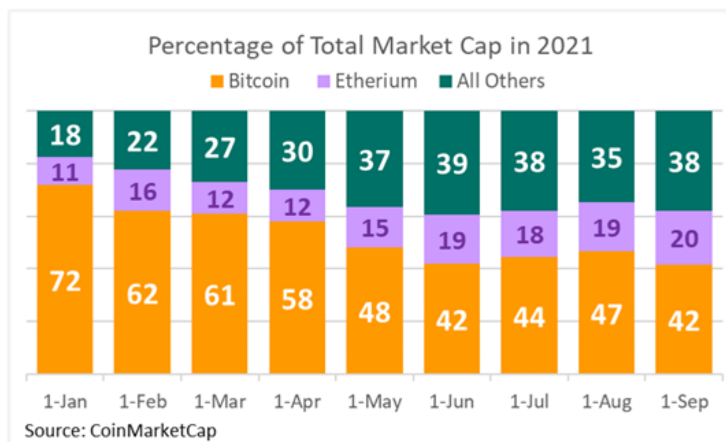
Understanding the Size of Silent Crypto Exposure

Cryptocurrencies have grown tremendously in popularity. Exchanges like Coinbase (NASDAQ:COIN) and Gemini, in addition to payment services like PayPal and Square's Cash App, have fueled this growth in crypto ownership by making it as easy to buy cryptocurrency as it is to buy stocks. Leveraging this ease of use, El Salvador just became the first country to adopt Bitcoin as legal tender.

The total market cap of all cryptocurrencies has more than doubled in the first quarter of this year, and now sits at around $2 trillion dollars.

Source: CoinMarketCap

And while Bitcoin remains the largest in market cap, other cryptoassets have grown in size significantly throughout 2021, now representing more than 50% of total market cap.



Source: CoinMarketCap

With this much value at stake, hacks and exploits in the blockchain/cryptocurrency world highlight the vulnerability of these platforms. Although blockchains like Bitcoin and Ethereum have never been compromised, less secure blockchains have been attacked, exchanges are subject to attack, and users can also lose tokens in self-custody.

Blockchains are hackable. One type of attack that has been successfully implemented by hackers is a "51% attack." If one entity controls more than 51% of the computing power of a proof-of-work blockchain, they can control certain transactions. There have been three separate 51% attacks on the Ethereum Classic blockchain, resulting in the theft of millions of dollars of cryptocurrency. Although these 51% attacks did not have a broad impact on the general population of cryptocurrency owners, it demonstrates that an entire blockchain may be hacked, even impacting those with self-custody (e.g., stored on a hardware wallet inside a policyholder's home).

Projects on Blockchains are hackable. In addition to blockchains being hackable, projects that are built on top of blockchains may also be hacked. Poly Network, a decentralized protocol that is used to swap cryptocurrencies across

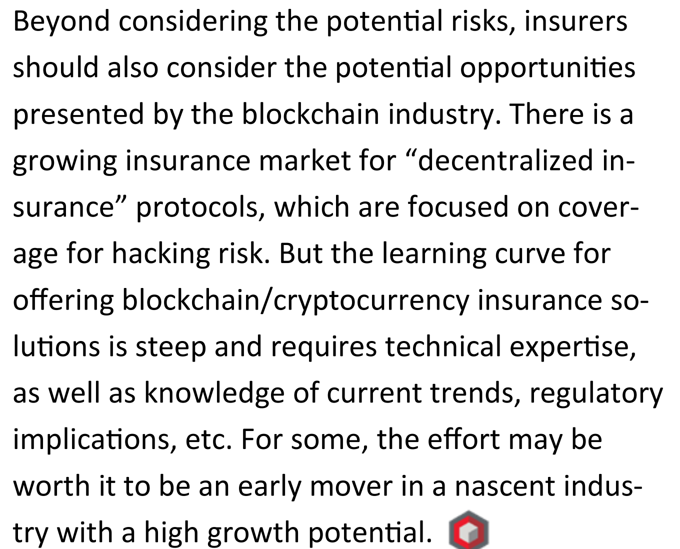
different blockchains, was recently hacked for $600 million dollars. Fortunately for those affected, the funds were returned (and the hacker was offered both a reward and a job). While this was a more unique situation, it provides further evidence that large hacks are possible, putting the consumer (and policyholder) at risk of losing their cryptocurrency.

> **TIP: You don't need to be a cryptocurrency expert, but you should know how to respond to a policyholder making a claim for stolen Bitcoin.**
>
> *-American Bar Association 49-FALL Brief 8*

Conclusion

There may be a large, and growing, silent crypto exposure for homeowners insurers if cryptocurrencies are treated as property like in the *Kimmelman v. Wayne Insurance Group* case. To mitigate this risk, a 3-prong approach should be considered:

- Add cryptocurrency exclusions or sublimits to your policy forms. Some specialist cyber insurers have already started to specifically address cryptocurrency in their policy forms to eliminate any ambiguity in coverage.
- Incorporate this emerging risk in your Enterprise Risk Management risk register, stress testing and risk mitigation.
- Closely consider other lines of business outside of homeowners that may have exposure, such as commercial property, professional lines, or cyber.



Beyond considering the potential risks, insurers should also consider the potential opportunities presented by the blockchain industry. There is a growing insurance market for "decentralized insurance" protocols, which are focused on coverage for hacking risk. But the learning curve for offering blockchain/cryptocurrency insurance solutions is steep and requires technical expertise, as well as knowledge of current trends, regulatory implications, etc. For some, the effort may be worth it to be an early mover in a nascent industry with a high growth potential.

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