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The Need For Insurance Options To Protect NFTs

By **Richard Giller, Kirk Gandy and Chaz Hales** (July 12, 2021, 3:15 PM EDT)

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Winning a championship ring is everything. It can transform the careers of those who "couldn't win the big one," into professional athletes Jerry West, John Elway and Dirk Nowitzki — and maybe even the Phoenix Suns' Chris Paul into Chris Paul.

Not convinced? Right or wrong, just ask the Los Angeles Dodgers, who won 11 National League West titles between their 1988 and 2020 World Series championships and would likely have traded several of those division titles for more World Series championships. But, of course, not all rings are equal. Neither are sports collectibles.

Last year, a Mike Trout-signed Bowman rookie baseball card sold for $3.93 million, eclipsing the prior record — a 1906 Honus Wagner card, the so-called Mona Lisa of cards[1] — by $800,000.

And, whether it's a championship ring or a $4 million baseball card, the owner of those physical assets would be able to purchase an insurance policy in today's market to protect against damage to or loss of such a physical asset as the result of certain perils.

According to Mark Cuban, the owner of the NBA's Dallas Mavericks, there is another valuable sports collectible to chase on the horizon: nonfungible tokens, or NFTs. Described by Cuban as "just digital collectibles,"[2] NFTs are unique digital assets, or tokens, whose ownership is recorded on a blockchain.[3]

Each token is linked to an underlying, usually digital, asset, such as a piece of digital art, music, meme, collection of highlights or game-day ticket. The holder of the token owns some package of rights in the underlying asset, although exactly which rights often varies.

Broadly speaking, an NFT owner can usually display, trade or resell it, but the NFT owner probably cannot commercialize the digital asset on, say, a line of T-shirts. An NFT for a song could conceivably come with master recording rights, or it might just let the owner listen to the song, much like buying a single does.

Specific to sports, an NFT highlight package, known as moments in NFT jargon, is like a baseball card but with moving images. More practically, an NFT for a game ticket allows you entrance to a game, but it may also become a valuable souvenir, depending on the event, which has resale value well after the game has been played.

An authentic ticket to the U.S. versus Russia "Miracle on Ice" 1980 Olympic hockey game can sell for thousands of dollars. However, unlike current insurance products that protect physical assets, insurance policies for NFTs do not exist — at least not yet.

Although the concept of NFTs may seem unfamiliar at first, they are not entirely dissimilar to their physical counterparts. Fungible goods are interchangeable and can be replaced by any other identical item, which makes them a good candidate for use as money or making payments.

Physical cash, like the U.S. dollar, is the easiest example of a fungible commodity, much like early cryptocurrency tokens focused on payments.

When someone pays you $50 for your old bike at a yard sale, you don't care which $50 they give you. You only care that the total amount is correct. They could give you five $10 dollar bills, 50 singles or 5,000 pennies. If they had two stacks of 50 $1 bills, you likely wouldn't care which stack you received. In other words, dollars are fungible — even though they technically have unique serial numbers on them.

Physical goods in the real world, like NFTs in the digital world, tend to be nonfungible because of their uniqueness. Of course, we can still swap them for one another, but bartering requires negotiation on the relative value of the goods involved. Suppose someone showed up to your yard sale and, rather than paying $50 for your bike, they offered you a leather jacket in exchange. You could accept the jacket as payment, but, because you are not trading like-kind goods, the jacket and the bike are not assumed to have identical value.

In the sports world, even championship rings may not be fungible.

For example, no one outside of Houston would dispute that Lebron James' 2016 NBA championship ring, where he led the Cleveland Cavaliers to a title after being down 3 games to 1 against the Golden State Warriors, would command a higher price at an auction than Robert Horry's 1995 championship ring that he won in the Houston Rockets' 4-0 sweep of the Orlando Magic. Not only are these different rings, but the road to secure them was different, and the careers of the players are different.

However, not even similar 2016 NBA championship rings awarded to members of the same team are fungible. Would you pay the same amount to own James' championship ring from that year as you would for one awarded to the head athletic trainer? No. In short, noncommodity physical goods, such as real estate, art and collectibles, are generally nonfungible.

Similarly, NFTs are often one-of-a-kind items. Their uniqueness stems from the cryptographic technology underpinning their existence. As with cryptocurrencies, NFTs live on a blockchain, associated with their owners' public addresses. Owners use software called digital wallets to buy, sell and transfer NFTs using secret private keys to authorize such transactions.

Anyone may explore the blockchain record to, in most cases, view the underlying asset and, more importantly, verify the ownership of the NFT. But while others can publicly view the digital asset, only the holder of the NFT has the private key that verifies that she is the owner on the distributed blockchain ledger. The holder of the NFT is recorded as the owner unless and until the holder transfers the token to another person's digital wallet.

The sports world has taken notice of the money-making potential of NFTs and is looking for ways to monetize this technology. Some NBA, NHL and MLB teams are already accepting cryptocurrencies to pay for season tickets,[4] and Cuban's Mavericks will issue NFT-based tickets for basketball games next season.[5]

Meanwhile, all major American sports leagues have shown at least some interest in utilizing NFTs for sports collectibles.[6] The NBA has partnered with a Canadian company, Dapper Labs Inc., to make collectible digital assets for the league,[7] having sold a half-billion dollars of NFTs since July 2020.[8]

Developments like these have led Cuban to describe NFTs as a potential top-three revenue stream for the NBA over the next 10 years. Even sports collectible companies are joining the NFT revolution.

For example, this April, The Topps Company Inc. released its yearly baseball card collection for the very first time as NFTs, and the MLB has teamed up with Candy Digital to begin digitizing the enthusiasm of baseball card collectors.

The first offering was a single NFT of Lou Gehrig's July 4, 1949, "Luckiest Man" speech that was auctioned off beginning on the 72nd anniversary of that speech and purportedly sold for over $70,000 on July 8, 2021.[9]

The following day, MLB and Candy announced a unique combination of one-of-a-kind MLB collectibles and opportunities for auction, including the first-ever World Series NFT.

The package includes a high-definition, single edition NFT of the Los Angeles Dodgers' 2020 World Championship ring, together with a physical version of the ring —which consists of 232 diamonds and 53 sapphires — and the opportunity for the auction winner to throw out the first pitch at an upcoming Dodgers game.[10] The three-day World Series auction is scheduled to take place between July 12 and July 15.[11]

While blockchain technology suggests heightened security for these digital assets — because its distributed ledger records the identity of the owner of each NFT — one former CIA hacker explained there is nothing to prevent thieves from stealing NFTs like any other digital asset.[12]

Because owning an NFT requires a digital wallet, if hackers steal the password to that digital wallet or the phone on which it is installed, they can transfer NFTs from that wallet to their own digital wallets or to someone else's. Like the loss or destruction of a physical collectible, the theft of a NFT is irreversible because blockchain transactions are irreversible.

Even worse, there is a difference between an NFT and the actual digital collectible. While an NFT may be thought of as a digital certificate of ownership, the asset it represents is usually stored on the plain old World Wide Web. An NFT usually contains an embedded link that points to the storage location of the underlying asset.

As a result, if the company storing the asset represented by an NFT goes out of business, the owner of the token might be left with a token that links to a file that no longer exists.[13] Digital asset owners and NFT creators therefore would be well served to procure insurance coverage to protect against the risks of loss.

The problem is that, while insurance companies offer digital asset coverage for some digital assets, they currently do not offer it for NFTs.[14] The conspicuous lack of insurance coverage for NFTs has many explanations.

One is the comparative value of NFTs versus cryptocurrencies. The NFT market coverage capacity is only in the billions, whereas cryptocurrencies value in the trillions. Insurers may also not yet have enough information to understand how to price the risks associated with NFTs.

Digital sports collectibles are selling for what seems to be absurd amounts of money. For example, the digital rights to a 1988-1989 Michael Jordan trading card from Fleer Corp. recently sold for over $900,000; someone paid $1.08 million for an NFT consisting of five digital trading cards of A.C. Milan soccer players; and the exclusive, noncommercial rights to the only copy of a photograph of Lebron James dunking recently sold for $21.6 million.[15]

Despite the possible explanations for why insurers have not yet begun selling NFT-specific insurance policies, the absence of insurance coverage for these assets is nevertheless inexcusable. Insurance companies already know that physical collectibles and personal items are of great value to their owners, and many carriers offer art, jewelry and collectibles insurance to protect against damage to or the loss of such physical assets.[16]

While not every NFT owner has to worry about Danny Ocean stealing their one-of-a-kind meme, computer hackers have already successfully stolen digital artwork worth thousands of dollars.[17] In addition to lost passwords, digital theft and computer hacks, there are several other risks that are unique to NFTs and some that are also present in other settings.

Examples of some of the risks unique to NFTs include, for instance, something known as bit rot, where a digital file's quality decreases over time as technology improves, along with the general risks associated with ever-changing technological advancements. Imagine if you had invested in eight-track tape technology in the mid-1960s just to have that technology replaced by cassette tapes, and then CDs, and now by WAV and MP3 files.

Some other risks associated with NFT sales include whether the seller properly owned or procured the necessary intellectual property rights associated with the digital asset before the sale, misrepresentations during the transaction, and the financial stability of the various entities involved in the NFT transaction.

What happens if someone purchases an NFT where the creator or seller failed to secure or verify necessary trademark or copyrights and a lawsuit is brought against the seller or purchaser? Who bears the risk of loss in that type of situation?

Similarly, what would happen if a digital marketplace, storage wallet provider or a server farm involved in a NFT transaction were to file for bankruptcy, close its doors, or suffer a catastrophic service interruption that destroys the stored digital files? What happens to the digital image underlying a purchased NFT in those situations? Who bears the risks of this type of loss?

Although the insurance industry has been slow to respond to NFT risks, some pundits believe that reputable insurers will eventually figure out how to both craft insurance policies to protect NFTs and price both the unique and the not-so-unique risks involved.

The insurance industry and many carriers are very familiar with, and currently offer coverages that insure against many of the risks associated with NFT transactions, such as intellectual property protection, and insurance against misrepresentations, theft and bankruptcy, among others.

The challenge for insurers will be to take currently offered coverages, add insurance protection for risks unique to NFT transactions and participants, and then create NFT-specific insurance policies for NFT creators, NFT owners, digital marketplaces, storage wallet providers and server farms. Until that happens, the participants to NFT transactions are exposed to potentially significant risks for which there is no current insurance product.

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