Quarterly Review Spring 2023

By Ingrid Sapona | 15-minute read

In this issue of the Quarterly Review we look at two topics that have grabbed a lot of headlines over the past few years and that some clients may have questions about: Non-Fungible Tokens (NFTs) and the Benefits of Title Insurance.

NFTs: a Primer

NFTs are all the rage in the cryptocurrency space.

If that sentence is gibberish to you, it may comfort you to know that you're not alone in your confusion. This article will help decrypt (no pun intended) that sentence and will look at why NFTs are tricky to insure.

What are NFTs?

NFT stands for non-fungible token. Items that are fungible are freely interchangeable (the most common example is a loonie – loonies are fungible because they're equal in value and are fully interchangeable). Conversely, something that is non-fungible is a one-off. The token part of NFT refers to the fact that it represents something else – some other asset. The something else can be a digital asset or a physical asset. An important concept to keep in mind is that the NFT is separate from the underlying asset that it represents.

Conceptually, some analogize NFTs to shares in a publicly traded company, noting that, just as shares represent an ownership interest in the company and are not the actual company, NFTs represent an ownership interest and are separate from the underlying asset. Of course, the share analogy has its limitations, given that shares in public companies are fungible while NFTs are non-fungible.

An important concept to keep in mind is that the NFT is separate from the underlying asset that it represents.

NFTs really came into their own thanks to the growth in the market for digital art. Because such art can be so easily replicated, it became important to artists to find a

way of establishing ownership rights in such assets and NFTs do just that. Before creation of NFTs, ownership of a digital file (a digital work of art, for example) could not be proven because all copies of the digital file were identical to the original.

Though NFTs are not limited to the world of art, digital art is the area they are most popular, and it is what we will focus on here.

How NFTs Work

NFTs are said to be “minted” (created) using a smart contract, which is computer code stored on a blockchain. Artists who create digital artworks can, for example, mint an NFT associated with a piece of their art, allowing them to monetize their digital artwork by selling the NFT. The uniqueness (non-fungibility) of a NFT derives from the fact that is has a unique identifying code. The authenticity of the ownership of the underlying asset is, therefore, established by “immutable blocks of data on the blockchain”. Because NFTs are stored on a blockchain, when one is sold, that transaction is also recorded on the blockchain, along with the blockchain address of every digital wallet that has ever held that NFT.

In the case of digital artwork that an NFT represents, the digital artwork itself is generally not stored on a blockchain. The digital data in the NFT’s code includes a reference that, in effect, points to where the digital artwork is stored “off-chain”, the term used for things not on a blockchain.

Buying/Selling NFTs

With regard to digital artwork, it’s pretty easy to understand why someone interested in owning a particular piece of digital art would be interested in purchasing the NFT. Christie’s (the auction house) explains it this way: “…NFTs make it possible to assign value to the ownership of digital art, which opens a door to a sea of possibilities for a medium that is unbridled by physical limitations. As such, NFTs are paving a new way forward for the digital art market.”

But it isn’t just folks wanting to have ownership of the underlying asset that engage in buying/selling NFTs. Some see NFTs themselves as a digital collectable that they derive pleasure in owning – just the way folks collect baseball or Pokémon cards. Though it may be impossible for some to see the allure of NFTs in themselves, the point is many people are excited by them and there is a definite market – and marketplaces – for them.

Though records on the blockchain are unalterable, there have been reported hacking incidents that have resulted in the theft of cryptocurrency, for example, as well as attacks that exploit smart contract bugs. So, in addition to market risks, there are cyber risks associated with owning NFTs.

A digital wallet allows a wallet holder to transact on a blockchain. And, because NFTs are a type of crypto asset, in order to receive, access, or send NFTs, you need a digital wallet. Interestingly, NFTs are not actually stored in a digital wallet – instead, the wallet holds keys that allow the wallet owner to interact with a blockchain.

How prominent are NFTs?

While NFTs are not mainstream, over the years the dollar values associated with them has certainly garnered some press. Christie's is often credited with helping to bring NFTs – and digital artwork – to the mainstream (if one considers the type of assets Christie's deals in "mainstream"). In March 2021 Christie's sold the "First NFT based purely on a digital work of art offered by a major auction house." That auction was for an NFT for a digital piece called "Everydays – the First 5000 Days" by a artist known as Beeple (his given name is Michael Winkelmann) and it sold for U.S. $69,346,250. In fact, the Beeple NFT was not Christie's first NFT auction. In October 2020 it sold an NFT "as part of Robert Alice's Block 21 (which also included a physical painting) from the series Portraits of a Mind." In both cases, the NFTs were minted by the artist.

Since NFTs exist on a blockchain, some owners assume they can't be damaged or lost.

And, in terms of value, Christie's reports that the Beeple NFT sale was the third highest price for a work of art by a living artist. Sources have reported that the market for NFTs in 2021 was anywhere from U.S. $22 billion to U.S. $41 billion. By comparison, the conventional art market in 2020 was about $50 billion, so NFTs still lag, but they are inching closer to the traditional art market. The highest price paid for an NFT to date was U.S. $91.8 million – it was paid in December 2021 with Merge by digital artist Pak; the NFT was purchased by a collective that included nearly 30,000 collectors.

In March of this year the New York Times reported that the broader market for NFTs has experience a 97% decline in sales, but the drop hasn't stopped the "NFT industry" from turning a profit, nor has it discouraged digital artists from using NTFs as ownership records.

What about Insuring NFTs?

Since NFTs exist on a blockchain, some owners assume they can't be damaged or lost. And yet, NFTs have been stolen, so the question of whether – or how – they might be covered by insurance has been raised. In this section we'll look at some of the insurance issues related to risks and losses associated with NFTs. It's worth noting that though there is insurance for certain types of fungible digital assets (cryptocurrencies), to date there is no insurance coverage for NFTs.

Coverage of NFTs is not possible under a standard homeowner's policy because such policies are designed to cover losses related to physical assets, but NFTs are not physical assets. Similarly, a traditional fine art policy wouldn't provide cover for an NFT

because such policies are meant to cover physical loss or damage. Even if fine art policies were to include digital assets, valuation of NFTs would present a problem. With fine art, underwriters can use sales figures or purchase prices to value it; given the vast fluctuations in the market value for NFTs and cryptocurrency (which is often used to pay for NFTs), insurers would have a difficult time calculating the payout on a loss, which makes the underwriting difficult.

But, if an NFT owner suffers a loss due to theft or damaged to the NFT while it is in the custody of an auction house or art dealer, for example, third party coverage under the custodian's cyber policy may provide relief. If the custodian has a "well-structured cyber policy" that does not have language excluding or limiting coverage, unauthorized access and cyber crime that involves stealing, damaging, or altering an NFT may be sufficient.

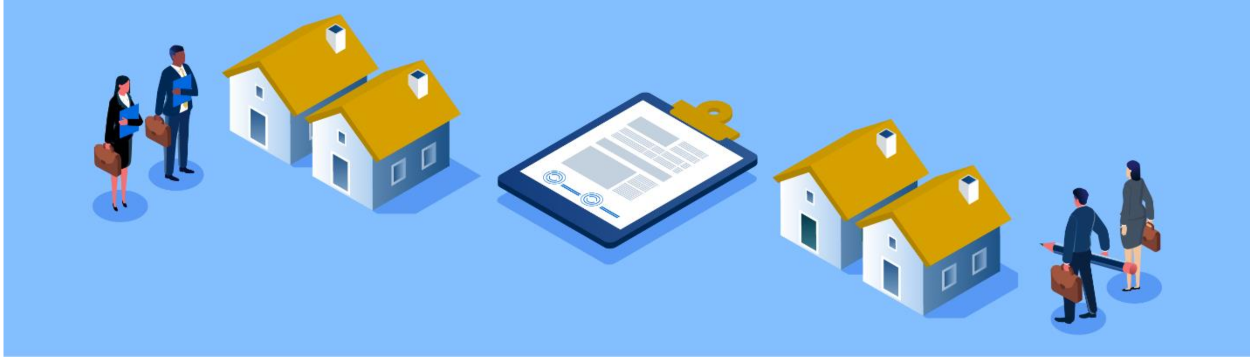
As noted earlier, there have been some losses as a result of problems with smart contracts. Some blockchain-based peer-to-peer networks are offering discretionary mutual coverage for claims made with respect to smart contract issues. Such coverage is not insurance per se, it is pools of funds contributed by participants to pay claims based on internal consensus of which claims are paid.

Non-insurance Risk Mitigation Techniques Should be Considered

Given the current unavailability of traditional insurance, NFT owners can best protect themselves by being knowledgeable about the potential risks. They should acquaint themselves with the different types of scams fraudsters have employed with respect NFTs, such as bidding scams, pump-and-dump scams, rug-pulling schemes, and so on. They should also understand how the blockchain and digital wallets work.

The most significant risks NFT owners face is from hackers that steal keys to cryptocurrency wallets. Hackers have used phishing attacks designed to get the wallet holder's private wallet key. Once they gain access, they can steal the NFTs. The wallet owner should understand the different types of wallets (so-called hot wallets and cold wallets) and the storage, custody, and security options available with respect to the wallet they choose. Though insurance is available with respect to crypto assets held in different types of wallets, such insurance covers crytpocurrencies and crypto tokens that are fungible, not the kind that are non-fungible.

As for the asset that the NFT is linked to, the owner should treat such assets as they would any other asset. So, if it is a physical, tangible piece of art, for example, the owner can insure it as such. If it is a piece of digital artwork for which there is no conventional insurance, the owner should store it "off chain". It is also a good idea to make identical copies of it, storing them in multiple places. A digital media file might also be insurable through a cyber policy that includes digital asset restoration.



The Benefits of Title Insurance

Over the past few years there have been many stories about fraudsters impersonating a homeowner and then taking out a mortgage on the property – or even selling it – and making off with the proceeds. Title fraud, as such schemes are called, is not common – but skyrocketing home prices have provided a lot of incentive for fraudsters. Such stories have also helped raise the profile of a unique insurance product: title insurance. Title insurance is available throughout Canada, but it is not mandated in any jurisdiction.

Title insurance is available for property owners, as well as for lenders. Lender policies indemnify lenders against actual loss if they are unable to enforce their priority on title to the land. Lender policies are not just for bank loans, they are available for private lenders, which are a growing share of residential real estate lending in Canada. Lender policies last for as long as the debt remains registered on title. Polices can include a variety of endorsements designed to meet the specific needs of the lender and the transaction.

The remainder of this article will focus on owner's policies.

What is Title?

Title is a legal term that signifies the legal ownership of property. Having title to real property carries with it a variety of rights, for example, the right to access the property; to mortgage it; to leave it to your heirs; and to sell it. Title is transferred by a title holder to someone else by way of a transfer that is registered in a government land registration system.

Title insurance is available throughout Canada, but it is not mandated in any jurisdiction.

Documents can be registered against title for things like mortgages, debts, unpaid tax, construction liens, claims related to breaches of municipal bylaws, restrictive covenants, and so on. As well, issues related to the physical footprint of the property, such as easements, rights-of-way, and the property's boundaries that can impact the title.

As a condition of closing, buyers expect to purchase clean title and so, in preparation for closing, the buyer's lawyer will do a title search of land registries going back many years. Title searchers will examine things like descriptions on deeds, the names of sellers and buyers, and so on. If the title search reveals title defects, they need to be addressed for the deal to close. For example, if there's an outstanding mortgage, it would have to be discharged.

What is Title Insurance?

Title insurance is an indemnity policy intended to protect property owners (residential and commercial) by insuring them against financial loss from defects – or clouds on title – that would make the title unmarketable. When title insurance was first introduced in Canada in the 1990s, there was some skepticism in the legal community about whether clients would find it beneficial. But, Garry Shapiro, of Shapiro Real Estate and Business Lawyers , says that title insurance has proven to be a very useful tool.

"Title searches sometimes turn up clouds on title such as old construction liens that were never perfected and that now are so old that the parties involved may no longer be around. But the lien exists so there is a cloud on title. In such a circumstance, we'd bring the matter to a title insurer to see if they would indemnify the buyer against it. The insurer may be willing to provide protection because they realize the chances of it becoming a problem are remote," explains Shapiro, who has been practicing real estate law in Toronto for over 40 years.

Another benefit of title insurance is that it covers issues that may not be revealed in a title search, such as outstanding property taxes or building zone issues. "If a client questions the expense of title insurance, I point out that if they don't want it, then we have to run additional off-title search for property taxes and building and zoning issues – and these all-cost money and take time. In the end, the cost difference is not that great and with title insurance, they are further protected against fraud," Shapiro says. Another benefit of title insurance is that if a title issue arises, rather than having to initiate a complaint or legal action against the professionals involved in the transaction, the insured makes a claim against the policy, which is a much simpler process.

Title insurance provides coverage for known defects specifically covered under the policy. It also protects the owner in the event of title fraud. Indeed, the fact that legal opinions do not protect against risks of title fraud, whereas title insurance does, is one of key benefits of title insurance. Shapiro says clients are very concerned about being protected against title fraud.

"Home buyers are now very attuned to fraud. They've been educated by news stories and so I would say that 99% of my clients purchase title insurance. In fact, for years we might get 10 calls a year from people who did not obtain title insurance and who are now interested in getting it long after they bought their property. Now we are getting 10 calls a month from uninsured homeowners who are worried about title fraud and are interested in getting it," he says.

Examples of Clouds on Title

Here are a couple examples of non-fraud types of title issues and how title insurance benefits unsuspecting owners:

-When an adjacent neighboring property was sold, the new owner had a survey done on their property. That survey disclosed that the insured's driveway encroached onto the neighbours' property. The new neighbour refused to allow the insureds to continue to have access to the driveway. The title insurer ended up reimbursing the insureds more than $9,000 for the costs to have a roadway developed so the owner would have access to their property.

-Municipal violations that incurred before the owner took title came to light after the owner took possession. A prior owner put an addition on the dwelling and to do so obtained a building permit. But the previous owner never had a final building inspection done by the municipality. Though the construction had been completed before the insured bought the property, after closing the municipality issued two work orders against the property. The title insurer hired an adjuster and engineer to determine the work required to have the property pass final inspection and ended up paying about $80,000 to indemnify the insureds for their losses.

As these examples show, clouds on title can be revealed at any time, not just when the owner goes to transfer their title.

Policies typically include exclusions or exceptions from coverage for things like risks known by the insured but not disclosed to the insurer, such as First Nations land claims, matters disclosed in condominium/strata property status certificates, mineral rights, and expropriation.

Because home prices have risen so rapidly over the past few years, there's quite a lot of money to be made from title fraud.

Unlike other types of insurance, which are meant to cover liability arising from future events, title insurance protects against losses caused by title problems that arose from past events. Title insurance premiums are not based on actuarial calculations. Instead, title insurers try to limit their potential losses by carrying out efficient, thorough title searching designed to minimize undetected title problems. The result is that only a fraction of premiums are used to pay losses.

Another non-traditional feature of title insurance is that it is not sold through brokers. It is primarily purchased through a lawyer (or notary), though in some cases a title insurer may provide a policy directly to an existing, uninsured homeowner.

Length and Amount of Coverage

An owner's policy protects the owner for actual losses related to title risks covered by the policy, including costs related to legal and/or notarial fees and expenses related to such losses. Insured's pay a one-time premium that is roughly based on the value of the property. Coverage lasts for as long as the insured owns the property. If the property is transferred to the insured's heirs, or to a spouse in the event of divorce, the coverage continues for as long as such transferees own it. As well, if an insured owner transfers the property to a child (or spouse) for a nominal amount, the coverage will continue while that transferee owns the property.

Owner policies are available for vacant land, residential dwellings, multi-unit dwellings (typically up to six units), cottages, condos, and coops. There is a one-time premium paid at the time the policy is issued. Owner policies are typically taken out at the time of purchase and provide coverage based on the value of the property. But an owner can obtain a policy after the purchase. In such cases the premium will be based on the current fair market value, assessed value, or appraised value, depending on the insurer.

Because real property tends to appreciate and tends to be held for a long time, coverage automatically increases with the value of the property up to a given percentage maximum (typically 200%). Given the rapid escalation in real estate values over the years, some insurers offer endorsements that increase the coverage. Wording on such endorsements vary, with some basically doubling the coverage (i.e., up to 400%), while others provide coverage up to the property's full fair market value at the time of a claim.

Such an endorsement can be purchased at any time, so that if a homeowner realizes their home has appreciated more than 200%, they can contact their insurer (typically through their lawyer) to purchase such an endorsement. The cost of such an endorsement depends on when the insured subscribes for it. If it is purchased at the time the policy is issued the cost is typically about 10% of the price of the title policy premium. If purchased at a later date, the cost is about 20% of the premium price (and subject to a minimum premium).

Title Fraud

Title frauds typically involve a fraudster assuming the identity of a property owner. Because home prices have risen so rapidly over the past few years, there's quite a lot of money to be made from title fraud, according to one insurance investigator. The perpetrators are often part of a sophisticated criminal organization, though the people who pose as the homeowners or tenants are not necessarily the ringleaders. Often such groups have a mortgage broker and a real estate lawyer or agent guiding them.

Examples of Title Fraud Claims

-A property owner who took a post overseas hired a property manager who leased out the property on the owner's behalf. The property owner sensed a problem when the property manager asked the homeowners to pay arrears owed. The property owner directed the property manager to collect it from the tenant. The property manager then discovered the people living in the house were not the tenants – they had purchased the house from fraudsters. Fortunately, the property owner had title insurance (though, given the appreciation in value from the time they bought, the 200% coverage did not cover their full loss property (or if they refinance).

-A couple used a mortgage broker when they purchased their home. The mortgage broker saved personal information about them and used it to impersonate the husband to take out a new mortgage from a private lender. The fraudster pre-paid six months on the loan so that it didn't go into default immediately. The homeowners had no idea the mortgage was issued on the property until they received a notice of foreclosure. The couple's title insurer paid the entire amount (about $450,000) related to the loan. (In its summary of this case the title insurer indicated it strongly believes the mortgage broker had connections.)

Measures to help prevent title fraud

Though title insurance provides protection in the event of title fraud, victims of title fraud have the burden of proving the fraud happened. Property owners might be able to save themselves time and hassle by taking steps to prevent falling victim to such fraud. For example:

- Take care with financial documents fraudsters could use to impersonate you. Regularly check credit card and bank statements and report anything that seems unusual. Retrieve your mail regularly. Shred financial documents, including utility bills; credit card statements; bank statements.
- Scammers prefer to target homes that are not occupied by the homeowner so they can have a realtor show it. Therefore, it's best not to leave property vacant. (This sounds obvious but think about how many cottages and vacation properties are unoccupied for weeks and months at a time.) If you do leave the property vacant, check on it regularly. Checking on the internet to see whether the property is listed for sale or lease is also a good idea.
- If you lease the property to a tenant, be sure you know who you are renting it to. Merely asking for photo identification is not enough; you should carry out comprehensive background checks on potential tenants, including looking on social media to see if they are who they purport to be.
- Because homes with no mortgages are generally more attractive to fraudsters, some advise that homeowners maintain a line-of-credit registered on the property. On this issue, however, Shapiro points out such a strategy is not without potential pitfalls or concerns. "If you have a line-of-credit registered on title that you don't use – maybe you've even forgotten you have it – and then you go to take out a mortgage, you may run into problems. You just have to be aware

of things like that," he says. Indeed, as Chicago Title notes, though fraudsters used to look for houses that were unencumbered, having a secured line of credit does not always deter them.

How do you know if you have title insurance?

Most owners' policies are issued at the time of purchase so the premium should be reflected on the closing documents you received from your lawyer or notary. Shapiro thinks best practice is for the lawyer to provide the client with a copy of the title insurance policy and, if there is a lender policy, they should provide the buyer with a copy of that too.

If you are in doubt about whether you have title insurance, ask your lawyer/notary, or contact the title insurance company directly. "Once in awhile we get a call from a non-client asking us if we can find out if they have title insurance. We tell them the best way to find out is to simply phone the four-or-so Canadian title insurers. The insurance companies can check their records based on the date of the transaction and the address," Shapiro says. "And if – in calling around – you find out you do have title insurance, you can ask them to send you a copy of the policy."

Reference and Resources

https://www.ahtins.com
https://robfreeman.com/nft-insurance
/en/cipsociety/information-services/advantage-monthly/1017-blockchain
https://www.iamagazine.com/markets/nft-insurance-understanding-the-challenges-and-solutions
https://www.christies.com
https://www.theverge.com/22310188/nft-explainer-what-is-blockchain-crypto-art-faq
https://opensea.io
https://rarible.com
https://www.technologyreview.com/2019/02/19/239592/once-hailed-as-unhackable-blockchains-are-now-getting-hacked
https://www.insurancebusinessmag.com/ca/news/breaking-news/how-can-we-appropriately-insure-nfts-260575.aspx
https://markets.businessinsider.com/news/currencies/nft-market-41-billion-nearing-fine-art-market-size-2022-1
https://www.dexerto.com/tech/top-10-most-expensive-nfts-ever-sold-1670505
https://www.nytimes.com/2023/03/21/arts/design-nft-quantum-lawsuit-dismiss-mccoy.html?smid=em-share
https://www.instech.co
https://eips.ethereum.org/EIPS/eip-1523
https://www.cloudwards.net
https://futurism.com/blockchains-unhackable-getting-hacked
Bryan Frye, Spears-Gilbert Professor of Law at University of Kentucky College of Law, The Digital Frontier: Navigating the Future of Law in the Age of AI, NFTs, and

Cybersecurity Symposium, Case Western Reserve University School of Law, March 31, 2023
https://macleans.ca/
https://financialpost.com/real-estate/mortgages/private-mortgage-risk-flagged-regulators-growth-shadow-banking
https://www.fsco.gov.on.ca/en/insurance/brochures/documents/undstitins.pdf
https://www.garryshapirolaw.com/
https://www.siskinds.com/title-insurance-your-title-fraud-security-blanket
https://www.stewart.ca/claims
https://microsites.fct.ca/property-owners/order-now
https://chicagotitle.ca
https://www.thestar.com/business/2023/01/30/be-on-high-alert-how-to-stop-criminals-from-selling-your-house-out-from-under-you.html