Podcast: How does DeFi impact insurance, employment, and litigation?

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You may have heard things about cryptocurrencies and decentralized finance. How are these developments going to impact areas that range from insurance to employment to litigation?

Aaron Kouhoupt: My name is Aaron Kouhoupt, and I'm a Member in our Consumer Finance practice group. I work out of the Cleveland office of McGlinchey Stafford. I am excited to bring you the next episode of our Deep Dive series into DeFi, and I'm joined by colleagues from across the firm to discuss how DeFi may interplay with areas like insurance, employment, and, while we hope you don't find yourself there, litigation. I'm going to start with my partner Lauren Ybarra, who is an insurance regulatory attorney working out of Austin, Texas. She's going to talk a little bit today about DeFi in the insurance space.

Lauren Ybarra: Thanks, Aaron.

Aaron Kouhoupt: Thank you for being with us today, Lauren. We've been talking a lot about how DeFi works in the financial services industry. Really what you hear about, primarily, is crypto coins and all of these other things. What we're interested in today is how does that impact insurance. And is there a future where this is in the insurance realm?

Lauren Ybarra: So when people think of DeFi insurance, they can refer to either blockchain-based insurance as a replacement or traditional insurance as we know it, or it could be insurance that covers DeFi-related activity. For decentralized insurance, it is a new area of "parametric" or what we're calling "smart insurance," which completely eliminates all claims. It's interesting because this insurance is not yet regulated in the traditional sense of stock insurance companies as we know it. It's more in the surplus lines areas. So for decentralized insurance to happen, there has to be a specified event that happens within a parameter of specified risk. And if anything were to happen within that parameter, a claim is paid automatically. And it thereby eliminates any kind of claim filing, claim adjustment. It's speed-to-market, and you get paid immediately upon the specified event happening. It's gone so far in the parametric realm that it can be done automatically through computers, detecting how fast winds happen, where tornados touch down. It also happens in the realm of flight delay insurance, a hurricane, or other natural perils. So that's one really interesting area where DeFi insurance is happening.

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Another interesting area is insurance that covers DeFi or crypto losses. The FTC estimated last year about $1 billion in losses. So, unstable parameters around DeFi regulation have created a lot of bad actors out there. So we're going to be seeing a big move in the insurance industry market covering these kinds of DeFi activities. So in totality, while I think there are DeFi risks that are already here, it's going to take some time for state regulators to create laws around this area. For the United States, insurance laws are adopted on a state-by-state basis, and as you can imagine, it's an extremely slow process. So while DeFi is here and the technology is moving fast, the insurance industry is going to have to catch up quickly in order to not be left behind.

Aaron Kouhoupt: Thanks, Lauren. So if I'm hearing you correctly, there are two different ways to think about this. One is whether or not you ever see the insurance industry move into a decentralized model, and the other is just to what extent does traditional insurance cover losses that might come out of working with cryptocurrencies or decentralized finance.

Lauren Ybarra: That's exactly correct. Yeah, there are definitely different options out there, but those are the two that I see as prominent happening as quickly as now.

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Aaron Kouhoupt: Thanks Lauren. So one thing that you just talked about that I don't think has gotten as much attention that I find really interesting. Ignoring for a second how insurance can move into a decentralized space, which could be very, very complicated to do. You talked a little bit about protecting yourselves and whether or not you can get insurance to cover losses that you might experience because you're involved with it, you're holding crypto or anything like that. I think that's really interesting. Could you just talk about that a little bit more?

Lauren Ybarra: Yeah, sure thing. So while I haven't seen an actual DeFi insurance company or an insurance company that's providing DeFi, what I have seen, interestingly enough, are technology-driven companies that are offering some kind of crypto or blockchain services. And they're offering a type of mutual risk pool arrangement, whereby they would pool together people that are providing the services and getting the services from this tech company, and pooling together their risk. What's interesting is that they are classifying themselves as a mutual, which is a type of risk-bearing insurance-related entity. They are not, in fact, from what I found, licensed as any kind of risk-bearing entity, which is alarming for state regulators. It's alarming in the realm of litigation. It goes on and on. And these, you know, risk pool "mutuals" are saying that they are using community voting to determine whether claims should be paid. And they have expert investigators that will determine whether claims should be paid. So I think there's a lot to be done in this space. Again, the word alarming comes to mind. But we will see globally decentralized protocols when it comes to this insurance, but we are just not there yet.

If you're subject to the FLSA, your employees must be paid at least the federal minimum wage for all hours worked, and overtime pay that is not less than one half the regular pay for all hours worked over 40 hours in a given work week.

Aaron Kouhoupt: Thank you, Lauren, that was really helpful. I appreciate it. We are also joined today by Chase Stoecker, who is Of Counsel in our Fort Lauderdale office. Chase does a variety of different things for the firm, but one of the things he does a lot of is employment law, in particular when it interplays with the financial services industry. Excited for you to be here with us today, Chase. And what I'd like to know is, it's kind of fun, and I think we all chuckle a little bit when we see things about athletes and celebrities that are choosing their salaries to be paid in cryptocurrency as opposed to just sort of a traditional salary. And without getting into how that impacts a salary cap, I'm curious as to whether or not this is feasible on a wide scale. Should we start seeing employees asking to be, negotiating their employment contracts to be paid in crypto?

Chase Stoecker: Aaron, that's a good question. Just from a 10,000 foot view, employers can violate federal and state law by paying their employees with what we call non-fiat or non-government issued currency, which would be this decentralized cryptocurrency. Now, there's an overarching law that governs payment of wages. It's called the Fair Labor Standards Act, the FLSA for short, and the FLSA governs minimum wage, overtime pay, and other wage-related issues for private and public sectors. Now the specific language in the FLSA states "required payments of prescribed wages including minimum wage and overtime compensation in cash or negotiable instruments payable at par." And this language is precise for a reason.

Now the first thing is not every employee is subject to the FLSA. So if you're fortunate enough to be an athlete or a celebrity, like your question posed, then you're likely not going to be subject to this law because your job duties and your salaries kind of take you outside of the FLSA. But employers, especially in the financial industry, really need to be concerned about the FLSA because a majority of employees are subject to this law. That means that if you're subject to the FLSA, your employees must be paid at least the federal minimum wage for all hours worked and overtime pay that is not less than one half the regular pay for all hours worked over 40 hours in a given work week. Again, that's most employees. Most employees are not your athletes or your celebrities, or your highly-paid individuals who would fall outside this law. So with that in mind, there are serious concerns regarding the payment of cryptocurrency for wages to an FLSA non-exempt employee.

If the value of the currency is less on the day the employee worked a regular shift versus overtime, let's say, a recalculation would be required. And then you're going to have to multiply this by dozens, hundreds, or maybe even thousands of employees across the workspace.

I'll just give you an example. The value of cryptocurrency fluctuates hour by hour, sometimes minute by minute. It's market-driven, right? So how does that translate then into hourly pay rate, overtime calculations, and calculating paid time off? If the of value the currency is less on the day the employee worked a regular shift versus overtime, let's say, a recalculation would be required. And then you're going to have to multiply this by dozens, hundreds, or maybe even thousands of employees across the workspace. Not only can these scenarios easily result in an inadvertent FLSA violation, which, if that's the case, comes with severe financial penalties. But even if you could get around the potential FLSA minefield, you have an administrative nightmare on your hands trying to comply with the law because you're trying to apply non-fiat currency payment to hundreds or thousands of employees.

Another big concern that we have is access to your wages. And then you have another issue. What about transaction fees? Because buying or selling, or exchanging cryptocurrency, there are transaction fees many times involved with that. And states require that wages be paid without a discount. So those fees couldn't be roped into the payment to the employee. That would have to be something the employer would have to take out of their end.

At the end of the day, compounding all this is states have their own wage-and-hour laws that complement and go further than the FLSA, so you just can't look at the FLSA. You have to look at the state-by-state analysis and say, okay, even if we could kind of slot this so that we're complying with the FLSA, what does the state that we're operating [in], do they have additional regulations or constraints that would apply to a decentralized currency? This does not mean an employer can never turn to cryptocurrencies as a form of payment, it just can't be used as a base payment. So the FLSA's "cash negotiable instrument" language only applies to the portions of compensation that are required under the statute or the base wage. If an employer decides to pay its employees amounts in addition to what the FLSA requires, and I'll give you an example, like a year-end bonus or some sort of incentive payment for performance, that "cash or negotiable instrument" rule under the FLSA would not apply. So, in a nutshell, bonuses can be paid in cryptocurrency, but I wouldn't recommend you pay wages in cryptocurrency.

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Aaron Kouhoupt: Thanks Chase. So it sounds to me like what you said at the end is key. It's possible, but probably like all other areas of DeFi and crypto, it's really going to take some federal or state interference to really make it feasible on a wide-scale basis.

Chase Stoecker: That's correct. At the Department of Labor, which enforces the FLSA rules, I don't see an appetite for coming in to regulate this at this time just because the FLSA is such a tightly regulated law and it's very specific. Maybe once there's been more widespread adoption of cryptocurrency, maybe they'll come and step in and start publishing scenarios, examples, and statements as they do from time to time. But at this point, I don't see that happening anytime soon.

Aaron Kouhoupt: Thank you, I appreciate it. We're going to turn at the end to Gregg Stevens, who's a partner in our Dallas office. Gregg does a lot of financial services litigation. I think what is interesting here, Gregg, is every time that you have a space that there's not a lot of regulation in it, there are some question marks around what's going to happen. There's this tendency to think of it as the wild west a little bit. And you know, no regulation. There are overarching laws that we've talked about, but they're so unclear right now. Do you think it's wise to sort of see this in that manner, or is the litigation aspect of all of this really the same as anything else that you're doing?

Gregg Stevens: Thanks, Aaron. I think, at the end of the day, litigation is litigation. So it's very similar to other litigation that I'm doing, including financial services litigation. For example, you need to make sure that you keep good records. You need to make sure that you have good customer service. If you have good customer service, you might be able to avoid litigation. But the reality is if you're running a business, you are going to end up in litigation. That's just a fact of life in 21st-century America, and it was probably a fact of life in 20th-century America. So, for example, if you get sued by a consumer, whether it's for breach of contract or you're trying to collect from a consumer, you need to make sure that you're complying with all state and federal laws in the collection context. For example, it may be under the FDCPA, although that usually does not apply if you're trying to collect your own debt, various state laws apply, like the Texas Debt Collection Act.

If you're running a business, you are going to end up in litigation. If you get sued by a consumer, whether it's for breach of contract or you're trying to collect from a consumer, you need to make sure that you're complying with all state and federal laws in the collection context.

In addition, you need to make sure you have good policies and procedures in place because that's usually the first thing the plaintiffs ask for. They want to know what policies and procedures you had in place that could have prevented the problem. In addition, I would assume, and hopefully, that's not a mistake, that when a consumer or somebody calls you to make a complaint, you have a strong and robust customer service department and that you're recording the calls. In addition, you need to have a procedure in place for litigation, whereas if you receive a litigation hold letter, what do you do? It's like any other piece of litigation that you have. You need to notify all the lines of business to preserve the emails, preserve telephone calls, preserve notes.

So I think in that context, the litigation is pretty much the same. In addition, you're going to want to take contemporaneous notes of what you did and memorialize the conversation because over time, usually, if an issue arises, it doesn't end up in litigation right away. It takes some time before it gets to litigation. So unless you take contemporaneous notes of what you did and what you tried to do to resolve the issue, you may have a higher level of litigation risk if you try to reconstruct previous conversations. So, you know, make sure your records are contemporaneous. Make sure your policies and procedures are strong. Make sure that if a litigation hold letter is received, you comply with the hold letter.

That's usually the first thing the plaintiffs ask for. They want to know what policies and procedures you had in place that could have prevented the problem.

In addition, you may end up receiving a subpoena. What do you do when you receive the subpoena? The same tenets apply. Make sure it gets routed to the proper department. Make sure that a thorough investigation is done to comply with the subpoena or retain outside counsel or in-house counsel to lodge whatever the appropriate objections are. So the reality is, although the subject matter may be a little different, litigation is litigation, and the same basic principles apply across the board.

Aaron Kouhoupt: Thanks Gregg. So I think what we've really heard today and listened to is that this is a space that everybody's excited about and trying to figure out exactly where to navigate the seas here. And whether it's trying to figure out how to protect yourself from losses via insurance or employees that suddenly come to you and start asking to be paid in crypto, these things are out there. They're things to be cognizant of, and there are some roadblocks that you need to think about so that you don't find yourself in the litigation context. And like everything else, just understanding that litigation is part of it and being prepared for what that looks like, no matter what you do. But trying to really understand the parameters and structuring something appropriately is the key.

Make sure your records are contemporaneous. Make sure your policies and procedures are strong. Make sure that if a litigation hold letter is received, you comply with the hold letter.

Gregg Stevens: At the end of the day, litigation is litigation. And I've never heard of a company yet that likes to hear from the litigation department or a line of business that likes to hear from the litigation department because it's usually not something that is good. However, by being proactive and having good procedures in place, you can minimize the risk. You can't eliminate it, but you can minimize it.

Chase Stoecker: Gregg raised a good point, and it kind of seeps into the employment side of things too. If you are intent on paying an employee in cryptocurrency, and you've decided that they fall outside of the FLSA: written policies. Write everything, memorialize everything. Make sure that there's an understanding between you and the employee that captures that relationship because you want to be proactive, and you don't want something like this to lead the litigation further down the line.

Aaron Kouhoupt: Thank you. This has all been great. I really appreciate everybody taking the time to be with us today. And as always, if anybody has any questions, you can reach out to any one of us. Thank you!

Gregg Stevens: Thanks, Aaron.

Chase Stoecker: Thanks a lot, Aaron.

Lauren Ybarra: Thanks, Aaron.

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