Crypto winter: Navigating signs of financial stress

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2022 showed us that a tumultuous downturn of the digital asset industry could be an opportunity for M&A. Continued financial challenges may also mean that an insolvency process or debt restructuring is the best path forward.

Background

For the past few years, the crypto markets have made consistent headlines. However, as the industry faces turbulence and price volatility, those headlines have begun to focus on the "crypto winter" and its impact across the industry.

A US$2 trillion crash in 2022 preceded multiple bankruptcies and insolvencies worldwide. Notably, Canadian crypto brokerage and lender Voyager Digital filed for Chapter 11 bankruptcy protection and sought recognition under Part IV of the Companies' Creditors Arrangement Act after market losses rendered the firm incapable of facilitating withdrawals for customers. In its filings, Voyager declared holdings of only US$1.3 billion of crypto assets on US$2.3 billion of retail deposits. On Oct. 21, 2022, the U.S. Bankruptcy Court for the Southern District of New York approved Voyager's asset purchase agreement with FTX US as part of a multi-step process. However, following the Chapter 11 filing by FTX Group, the bidding process was reopened. As of the time of writing, the U.S. subsidiary of Binance has been selected as the winning bidder.

Voyager's demise culminated from a perfect storm of debt, high leverage, collateral valuation issues and a bear market. When stablecoin TerraUSD collapsed in June, crypto hedge fund Three Arrows Capital (3AC) suffered heavy losses on trades connected to the coin. As a result, it defaulted on its US$670 million loan from Voyager as well as other multi-million dollar crypto loans. The broader collapse of loan portfolios led other firms, such as lender Celsius Network, to file for bankruptcy protection.

As the crypto winter continues, analysts predict that financial trouble lies ahead. Crypto companies may increasingly seek creditor protection, and their creditors will want to enforce their rights and remedies, including obtaining bankruptcy or receivership orders under the *Bankruptcy and Insolvency Act*.

Beyond these obvious financial troubles, recent global developments suggest that the digital asset sector is coming under increased and sustained regulatory scrutiny, with governments motivated by constituents to rein in the more unorthodox ("wild west") aspects of the digital asset industry.

Key warning signs

Despite the financial fallout of the crypto winter, debtors and creditors can work together to manage the challenges raised by the icy season. Below is a brief summary of some of the warning signs and issues that participants in this space should keep in mind. However, we note that it is difficult for most people in the industry to access some of the information needed to properly assess the warning signs referred to below:

- Business-specific issues, including the loss or insolvency of a major customer or supplier.
- Excessive counterparty risk, in particular with firms dealing with margined or leveraged positions on digital assets.
- Negative cash flow, whether caused by debt or investments in the business.
- Diminishing revenue or weak profits.
- Difficulty securing capital on favourable terms.
- Defaulting on payments or the inability to meet obligations in existing agreements.
- Regulatory changes that may diminish profitability. For example, the Canadian Securities Administrators (CSA) recently confirmed that platforms dealing with digital assets are subject to a number of business constraints that could severely limit profitability.

Not all warning signs may be present, but industry stakeholders should be vigilant to protect themselves from the effect of rapidly declining prices, reduced customer confidence (which may contribute to increased withdrawals) and overall declining investment.

Recommended practices

- Where practicable, companies that hold their own digital assets should hold their assets in "cold storage" (*i.e.* not connected to the internet or other network) rather than in hot wallets (*i.e.* connected to the internet or other network). This step, though more cumbersome to administer, will mitigate the risk of data compromise or theft of digital assets.
- Companies should carefully review audited financial statements of companies/firms they do business with, wherever possible. The digital asset industry is relatively new and many firms have yet to implement financial monitoring and record-keeping protocols that are typical of more mature industries. For instance, 3AC did not provide financial statements, which inhibited Voyager's ability to access the financial condition of 3AC and its general capacity to meet its financial obligations.
- Digital asset firms should consider the following steps:
    - Implement a strong corporate governance structure, with a board that includes independent directors and appropriate separation between management and the board.

- Maintain vigorous financial monitoring and record-keeping protocols, consistent with best practices of firms dealing with conventional financial assets.
- Monitor their competitors' performance, so that they can take advantage of potential acquisition opportunities prior to financial distress. Market distress can create opportunities, which we considered in our first article in the series, *Crypto winter can be a season for M&A opportunities*.
- Monitor the evolving regulatory environment, and anticipate changes that may affect business operations or profitability (whether by increasing availability of capital, reducing revenue streams, or increasing administrative/compliance costs). For example, in the United States, the incoming UCC Article 12 should make it simpler and more cost-effective for lenders to take security over cyprocurrencies and other digital assets, providing greater financing options to debtors in the digital asset space. See BLG's article on UCC Article 12 for more information.
- Markets are cyclical, and this is not the first crypto winter (nor will it be the last). The distress creates challenges, but for those that are prepared and proactive, it can also be an opportunity to emerge stronger.

Conclusion

As the crypto winter forges on, investors and other stakeholders should be vigilant and proactive. Current and complete financial information will allow companies to recognize potential issues early on, and devise strategies to mitigate or avoid such issues. Early involvement of financial and legal advisors can also improve outcomes, as the number of strategic options only decreases as a company's financial position deteriorates. Although the outcome of a bankruptcy or insolvency is always uncertain, a proactive approach to restructuring will help businesses to more effectively navigate the season's challenges.

How BLG can help

BLG is committed to helping our clients navigate the challenges and opportunities that 2023 may bring. Our team helps clients to assess their risks and options in order to improve their financial situation. This could include analyzing potential restructuring options or acquisitions of distressed entities and assets. We support our clients in a way that positions them to survive and thrive in the current financial climate by taking advantage of opportunities presented by distressed competitors.

For more information on the digital assets industry, reach out to any of the key contacts listed below.

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