

DAVIES

Issue 7

Insolvency Now

Financial Gloom and the Increase
in Insolvency Filings

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Bursting the Crypto Bubble and the Financial Turbulence Ahead

With the FTX Group's recent Chapter 11 filing, on the heels of the recent Celsius Network LLC Chapter 11 filing, we have entered what could be described as a "Lehman Brothers moment" for the crypto industry. This observation, together with the recent awarding of the Nobel Prize in Economics to former Federal Reserve chair Ben Bernanke and professors Douglas Diamond and Philip Dybvig for their pioneering research on banks and financial crises, has caused some of us to experience a déjà vu moment.

As many will not forget, in September 2008, Bernanke allowed Lehman Brothers to file for bankruptcy. However, when a full-blown financial crisis erupted, he encouraged Congress to bail out the biggest banks while creating new money to pour into the financial system. This policy, which was repeated at the start of the pandemic, has proved effective in quelling financial panic. However, economics professors Raghuram Rajan and Viral Acharya warn that the approach has left many actors in the financial sector "dependent on easy liquidity," placing monetary policy-makers "in a very difficult position." To bring down inflation, central banks need to withdraw money from the economy and raise interest rates, increasing the likelihood of another financial earthquake.

In Canada, Q2 insolvency data portend the beginning of a similar financial earthquake with the expected increase in insolvency filings that many observers have been predicting and preparing for since the start of the pandemic. We saw an increase in most types of insolvency filings other than receiverships this past quarter.

In this issue of Davies Insolvency Now, we first highlight the significant data points in these rising filing rates. Next, we provide a Canadian lens on the digital asset marketplace. With recent drops in crypto prices severely affecting several digital asset lenders and exchanges, we explore what this could mean in the Canadian context – in particular, what could be in store for the key players in a cryptocurrency exchange insolvency.

Davies Insolvency Now is a quarterly publication authored by [Natasha MacParland](#), [Robin B. Schwill](#) and [Stephanie Ben-Ishai](#) that analyzes key trends and developments in the insolvency and restructuring community.

Insolvency Data for Q2 2022: Highlights

CCAA FILINGS

The number of CCAA (*Companies' Creditors Arrangement Act*) proceedings in 2022 grew significantly from four in Q1 to nine in Q2. Manufacturing and retail trade had the most CCAA filings in Q2 2022. Contrary to historical trends, British Columbia experienced an unusually high number of CCAA filings in Q2 2022 (five). Ontario had three filings in that quarter.

BUSINESS BANKRUPTCIES AND PROPOSALS

The number of business insolvencies in Q2 2022 was similar to that in Q1 2022. However, the total number of business insolvencies in July 2022 was 45% higher than the total number of insolvencies in July 2021. Business insolvencies for the 12-month period ending in July 31, 2022 increased by 20.2% over the 12-month period ending July 31, 2021. In addition, there were 303 *Bankruptcy and Insolvency Act* (BIA) proceedings in June 2022, the highest month since February 2020.

When we break down the number of business insolvencies into bankruptcies and proposals, we note that proposals in Q2 2022 decreased slightly from Q1 2022 whereas bankruptcies in Q2 2022 experienced a small increase from Q1 2022.

The sectors that registered the biggest increases in insolvencies were construction, accommodation and food services, and transportation and warehousing. The sectors with the biggest decreases in insolvencies were mining and gas extraction, and management of companies and enterprises.

The provinces with the most business insolvencies were Ontario, Québec, Alberta and British Columbia, consistent with historical trends.

CBCA ARRANGEMENTS

The number of arrangements under the *Canada Business Corporations Act* (CBCA) for the three-month period from May to July increased significantly year over year, with 18 arrangements reported in 2022 compared with three arrangements over the same period in 2021.

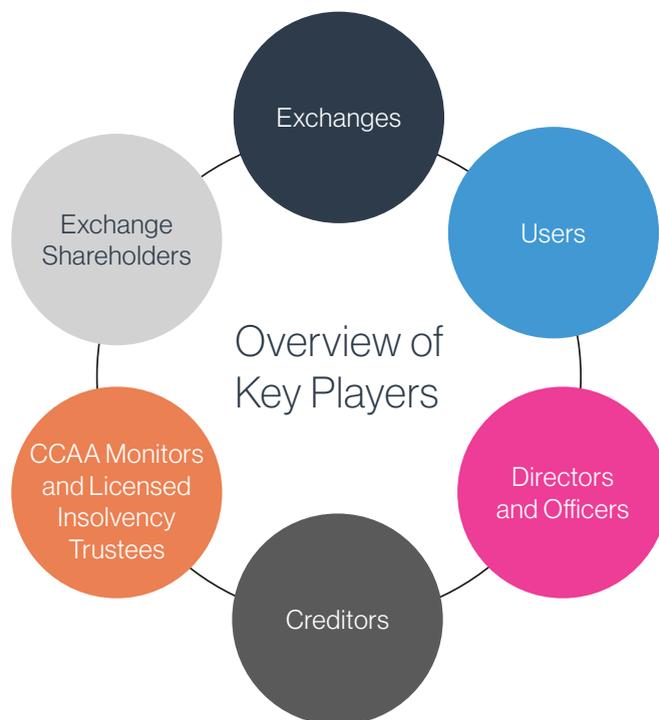
RECEIVERSHIPS

Receivership activity has remained low to this point in 2022. There were fewer receiverships in each month of 2022 compared with 2021. The declared assets of receiverships in 2022 have maintained a similarly low level to that in 2021.

Cryptocurrency Exchange Insolvency

OVERVIEW OF KEY PLAYERS¹

Since the beginning of 2022, the total value of cryptocurrencies in the [global] market has plummeted from US\$3 trillion to less than US\$1 trillion. This sharp downturn had profound effects on cryptocurrency trading and lending firms, with major players such as Three Arrows Capital, Voyager Digital and Celsius Network suspending user withdrawals and filing for bankruptcy. These bankruptcy cases present novel questions regarding the treatment of cryptocurrency assets and the relief available to different stakeholders in insolvency proceedings. This infographic surveys the key players involved in the bankruptcy of cryptocurrency exchanges.



¹ Please see:

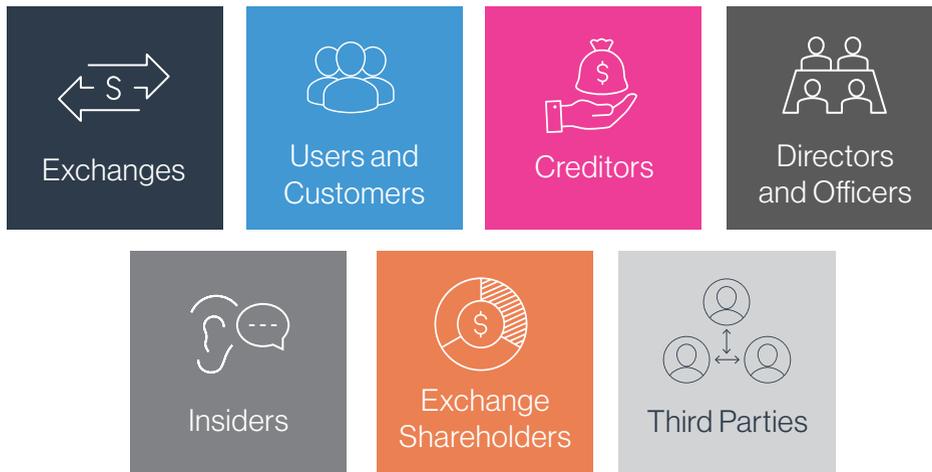
<https://www.forbes.com/advisor/investing/cryptocurrency/best-crypto-exchanges/>

<https://laws-lois.justice.gc.ca/eng/acts/c-44/page-14.html#docCont>

<https://scc-csc.lexum.com/scc-csc/scc-csc/en/item/2184/index.do>

TREATMENT OF KEY CRYPTOCURRENCY PLAYERS UNDER CANADIAN INSOLVENCY LAW²

Click icons to learn more about how each of the key cryptocurrency players is treated under Canadian insolvency law.



CRYPTOCURRENCY EXCHANGE INSOLVENCIES: SUMMARY OF CANADIAN CASE LAW

The Canadian insolvency and bankruptcy system is well-suited to deal with the failure of cryptocurrency exchanges. In *Quadriga*, the Ontario Superior Court of Justice recognized cryptocurrency as “property” for the purposes of the BIA. Section 67(1)(c) of the BIA mandates that in the case of bankruptcy, cryptocurrency that has monetary value should go into the estate of the bankrupt. *Quadriga* illustrated that if a LIT can locate and take possession of the cryptocurrency, it is an asset for the purposes of a bankruptcy liquidation.

² Please see:

<https://documentcentre.ey.com/api/Document/download?docId=33444&language=EN>

<https://www.canlii.org/en/bc/bcsc/doc/2018/2018bcsc1709/2018bcsc1709.html>

<https://www.abi.org/newsroom/daily-wire/new-york-judge-splits-with-colleagues-on-redaction-of-crypto-customers'-names>

https://www.osler.com/en/resources/regulations/2022/the-chilling-effect-of-crypto-winter-on-directors-and-officers#_ftn5

https://uncitral.un.org/en/texts/insolvency/modellaw/cross-border_insolvency

For valuing claims denominated in cryptocurrency, the LIT uses the date of bankruptcy and can convert claims to dollars using the prevailing exchange rate as of the date of bankruptcy. Cryptocurrency claims may be analogous to debts in a currency other than Canadian dollars, and thus section 215.1 of the BIA states that the currency should be converted as of the date of bankruptcy.

In *Quadriga*, Justice Hailey further found that the principles of efficiency and economy support valuing cryptocurrency as of the date of bankruptcy to reduce the administrative burden and cost to the estate. For distribution purposes, all unsecured creditors who were affected users ranked *pari passu* in *Quadriga*. No affected user of the exchange opposed the ranking scheme, and Justice Hailey endorsed it.

A security interest may exist in cryptocurrency, which would allow a secured creditor to realize the asset upon insolvency. Cryptocurrency does not fall into an established asset category under provincial personal property legislation in Canada, but it can be argued that it should qualify as an “intangible” under Ontario’s *Personal Property Security Act* (PPSA). As set out by the Supreme Court of Canada in *Saulnier v Royal Bank of Canada* (*Saulnier*), the PPSA is ultimately designed to facilitate the creation of a security interest both to enable holders of personal property to use it as collateral and to enable lenders to accurately predict the priority of their claims against the assets in question.

In an international context, cryptocurrency’s digital characteristics also create uncertainty over the appropriate jurisdiction in which secured lenders should register their security interests. Moreover, the leading case of *Saulnier* held that a non-enumerated asset was an intangible capable of perfection by registration, but that case dealt with “an interest created by statute.” Here, cryptocurrency may not satisfy the test in *Saulnier*. Even where a security interest can exist in cryptocurrency, it will impose two further requirements on the disposition of cryptocurrency assets in insolvency: the sale of the intangible asset must have the secured lender’s consent, and the purchaser of cryptocurrency may not be certain of clear title without a court-issued sale approval and vesting order (where lender’s consent would no longer be required).

We are continuing to monitor the response to the [U.K. Law Commission’s July 2022 consultation paper](#), which contains provisional law reform proposals to “[ensure that the law recognises and protects digital assets \(including crypto-tokens and crypto-assets\) in a digitised world.](#)” The consultation paper proposes the explicit recognition of a new category of personal property that would allow for a more nuanced consideration of new, emergent and idiosyncratic objects of property rights called “data objects.”

Finally, on administration of the exchange estate, the recent decision in *British Columbia Securities Commission v Einstein Capital Partners Ltd.* raises questions concerning the estate not having the resources to pursue an intensive investigation into missing assets. The exchange owed \$16 million in a mix of cryptocurrency and cash, and there were [ongoing investigations](#) into anti-money laundering and improper use of customer assets. The interim receiver found that an effort to sell the assets of the estate would outweigh any recovery and applied for an order to discharge its duties as interim receiver. The interim receiver’s application was granted by the Supreme Court of British Columbia, but questions remain over navigating the administration of a debtor exchange’s estate when there is a significant shortfall in funds or allegations of fraud. In the future, this may be an area worth exploring through third-party litigation funding.

What's Next?

In addition to exchange users' claims over cryptocurrency deposits, there are potential claims against a debtor relating to trading. Specifically, a failure to execute a transaction due to an intervening insolvency or the suspension of the user access to one's account may detrimentally affect the cryptocurrency value. These claims could cover losses resulting from an inability to transact with the cryptocurrency held in the custodial wallet until the value is returned. Cryptocurrency exchanges may mitigate the risk of such claims by excluding liability contractually when users sign up for the exchange's services. In any case, service agreements should clearly state the impact of insolvency on a customer's title to deposited cryptocurrency assets.

Cryptocurrency exchanges may consider fully segregating the exchange's operating capital from customer deposits. This would reduce uncertainty in determining the value of customer deposits as well as the value of losses due to hacking or theft. In fact, because exchanges (especially growing platforms) operate with few staff and cybersecurity professionals, hacking or theft has sometimes depleted cryptocurrency exchanges' assets, harming all stakeholders.

For example, in a high-profile case in 2021, Bitmart announced that hackers withdrew almost \$200 million from the company's account. Unfortunately, most exchange hackers are not caught, especially when the cryptocurrency is stored in "hot wallets" and thus connected to the Internet, which offers relatively easy access. Experts also agree that even though the blockchain is public, investigators face obstacles tracing transactions to their ultimate destination and beneficiaries. Even during an insolvency proceeding, without careful advice, the monitor or LIT could see substantial loss of assets due to hacking; this could reduce the likelihood of a successful restructuring or reorganization.

In summary, the digital asset marketplace generally, and cryptocurrency exchange insolvencies specifically, raise novel legal questions. As highlighted, each stakeholder needs to make a complex assessment on how and when to react to an exchange that is nearing insolvency. In general, all stakeholders should remain vigilant as market conditions and case law are changing rapidly. Looking ahead, we will continue to monitor developments related to other digital assets, including the market for non-fungible tokens (NFTs) – another novel and flexible legal structuring tool that is creating increasing interest and may give rise to insolvency issues and challenges.

Key Contacts

Across novel sectors, Davies has deep expertise in applying our data-driven approach to provide the most appropriate tools for recovery and resolution. Whether providing an early-stage overview or advising on a range of remedial options, we work with you to navigate your unique circumstances and reach your business goals. Please contact any of the individuals listed below or visit our website at www.dwpv.com.



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