FTX Bankruptcy Provides A Road Map For Crypto Regulation

By **Kimberly Black and Daniel Lowenthal** (December 1, 2022)

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On Nov. 11, FTX Trading Ltd. and approximately 130 of its affiliates filed voluntary Chapter 11 bankruptcy petitions in the U.S. Bankruptcy Court for the District of Delaware.

FTX operates the world's second largest cryptocurrency exchange and was valued earlier this year at $32 billion.

The FTX filing estimates the debtors' liabilities at between $10 billion and $50 billion. The filing also estimates that the number of creditors is over 100,000, but the actual number could be over one million.

This filing cannot be viewed in a vacuum. Earlier this year, as the values of major cryptocurrencies including bitcoin and ether began to tumble, Three Arrows Capital Ltd., Celsius Network LLC and Voyager Digital Holdings Inc. filed insolvency cases within weeks of each other.

The FTX filing is, therefore, part of the larger so-called crypto winter.

The FTX filing may push the crypto winter into a full-blown ice age by causing even more crypto companies to fail. In fact, on Nov. 28, another crypto business, BlockFi Inc., filed for bankruptcy in the U.S. Bankruptcy Court for the District of New Jersey. Still, some experts say the fallout may be more limited.

One thing is for certain — Voyager Digital's case has been derailed.

Just last month, the bankruptcy judge in Voyager Digital's case approved its sale to FTX, which formed the basis for Voyager Digital's proposed Chapter 11 plan. With FTX's filing, Voyager Digital has said this transaction will not occur.

FTX's bankruptcy is a freefall bankruptcy, meaning there is no immediate plan for FTX's exit from Chapter 11. This type of Chapter 11 filing has become less common over the last decade while prepackaged cases — where a debtor files Chapter 11 with a prenegotiated plan of reorganization — have become increasingly popular.

Prepackaged cases are preferred by would-be debtors because these cases are quicker, simpler and cheaper. Both the Celsius and Voyager Digital cases are also freefall bankruptcies.

FTX also did not immediately file many of the motions that debtors typically file on the first day of a case — aptly referred to as the first-day motions.

These motions often seek an array of emergency relief, such as the ability to use cash collateral or to continue paying employees, and the relief sought is often granted, at least on an interim basis, mere days after commencement of the case.

These motions, filed contemporaneously with the bankruptcy petitions, are often used by debtors to send a reassuring message to vendors, employees, clients and other interested parties. Beyond that, the larger purpose of these motions, and the relief sought, is to stabilize a debtor's business after the filing.

In the days following the petitions, FTX began to file some typical first-day motions. In one motion, FTX explained that the filing was done on an emergency basis and previewed that it would soon file requests for additional relief.

Further, emphasizing the emergency nature of this case, FTX also asserted that barely over a week before the filing it was one of the most respected companies in the crypto space.

FTX's sudden financial woes can be traced back to Nov. 2, when it was reported that a large number of FTX's native cryptocurrency tokens, FTT, were held by Alameda Research, a hedge fund run by FTX's co-founder and CEO Sam Bankman-Fried. The close financial ties between the two companies had not been previously disclosed.

This new information caused FTT's price to plummet while customer withdrawals from FTX's platform surged. Reports said that in just three days traders pulled approximately $6 billion from the platform. Customer withdrawals were frozen on Nov. 8.

This may sound like déjà vu since the rush of customer withdrawals followed by a freeze in customer accounts is eerily similar to what happened in this year's earlier crypto filings. For a brief moment, however, it seemed that FTX might escape bankruptcy through a sale to competitor Binance Holdings Ltd.

But that deal fell through at the due diligence stage — yet another sign that all was not well with FTX's business.

As more and more questions were raised regarding FTX's leadership, the company's CEO resigned. A new CEO, John Ray III, with vast experience running troubled companies in Chapter 11 cases, was appointed.

According to FTX's filings, the new CEO and the professionals he retained immediately began working around the clock put the FTX companies in bankruptcy.

FTX's new CEO has since filed a declaration describing the "complete failure of corporate controls" and "complete absence of trustworthy financial information" that apparently precipitated FTX's filing.

Since its filing, FTX has been in contact with the U.S. attorney's office, the U.S. Securities and Exchange Commission, the U.S. Commodity Futures Trading Commission, and other federal, state and international regulatory agencies.

For years, regulatory agencies around the world have struggled to create a regulatory framework to govern crypto transactions. The filings of Voyager Digital and Celsius triggered similar investigations into the circumstances surrounding their bankruptcies, but efforts to enact large-scale regulatory oversight are apparently still stalled.

In the U.S., the CFTC and the SEC have both tried to exercise some level of regulatory oversight, but there is still no definitive classification of crypto assets as either securities, commodities, foreign currencies or something else.

The burden of this regulatory shortfall has fallen on small, retail investors. After Voyager Digital and Celsius filed for bankruptcy, their court dockets received a deluge of letters written by mom and pop investors, some of whom could lose their entire life savings.

It's possible that FTX's creditors will also include these small, retail investors, and for them, regulatory investigations conducted after the company has already imploded may prove too little too late.

In short, FTX's collapse is another reminder that more regulation is needed in the crypto space. FTX's case provides an excellent outline of where proper government regulation is needed.

First, FTX's filings note the company did not have proper corporate governance, including disbursement controls that would centralize control of the company's cash.

At a Nov. 22 hearing, FTX's counsel revealed that many of the debtors' assets had either been stolen or are missing. Government regulatory action should establish some kind of oversight aimed at eliminating this kind of mismanagement.

Second, FTX's investors have sued a slew of celebrities for their roles in advertising FTX's platform.

Although these lawsuits may prove to be without merit, many retail investors were allegedly lured into investing in crypto through aggressive marketing that included promises of consistent and steady returns. Government regulation should crack down on such misleading marketing strategies.

Finally, as noted above, FTX's filing was immediately preceded by massive customer withdrawals, which is akin to a run on the bank. A century ago, runs on the bank commonly compounded financial woes when customers, fearful that a bank might become insolvent, rushed to withdraw their cash.

Ironically, this panic often turned the bank's failure into a self-fulfilling prophecy, as banks struggled to meet surging customer demands.

Fortunately, federal deposit insurance through the Federal Deposit Insurance Corporation has made runs on the bank largely a thing of the past.

In addition, traditional brokerage firms that become insolvent may rely on the Securities Investor Protection Corp. to arrange for the transfer of brokerage accounts to different securities brokerages, which provides similar comfort to brokerage investors.

In contrast, there is currently nothing in place to protect crypto investors. In fact, the regulatory space is so empty that courts have little guidance on how crypto investors should be treated in a bankruptcy filing. This uncertainty has undoubtedly increased investor panic.

Deposit protections or a clear bankruptcy framework may prevent future runs on crypto companies, which may in turn reduce additional bankruptcy filings or at least delay filings until a company can be fully prepared for a smooth landing into bankruptcy.

But until regulations are put in place for the crypto industry, investment losses will likely continue to be paid by those who can least afford it.

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