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**COMMENTARY**

*“This Situation is Unprecedented” : Examining the Legal Challenges  
in the Bankruptcy of FTX*

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John J. Ray III has guided companies through bankruptcy before, including the liquidation of Enron Corporation’s assets.<sup>1</sup> Yet, after being appointed the new CEO of FTX Trading LTD (“FTX”), Ray claimed, “Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information has occurred here...this situation is unprecedented”.<sup>2</sup> Filing for bankruptcy in the Bankruptcy Court for the District of Delaware, Ray laid out the dire situation of the FTX cryptocurrency exchange.<sup>3</sup> The company did not keep reliable financial records, and funds were used personally by the management under co-founder Sam Bankman-Fried.<sup>4</sup>

FTX collapsed seemingly overnight when it came to light that the crypto exchange lent billions of dollars of customer assets to an affiliated trading firm, Alameda Research, to fund risky investments.<sup>5</sup> This resulted in many customers

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<sup>1</sup>Alexander Saeedy & Soma Biswas, *FTX’s New CEO Faults Lax Oversight in Bankruptcy Filing*, WALL ST. J. (Nov. 17, 2022), [https://www.wsj.com/articles/ftxs-new-chief-says-complete-failure-of-oversight-contributed-to-firms-downfall-11668696069?mod=Searchresults\\_pos10&page=1](https://www.wsj.com/articles/ftxs-new-chief-says-complete-failure-of-oversight-contributed-to-firms-downfall-11668696069?mod=Searchresults_pos10&page=1).

<sup>2</sup> Decl. of John J. Ray III in Supp. Of Chapter 11 Pet. and First Day Pleadings, <https://s.wsj.net/public/resources/documents/FTXFILING.pdf>.

<sup>3</sup> *Id.*

<sup>4</sup> See Saeedy & Biswas, *supra* note 1.

<sup>5</sup> Vicky Ge Huang, Alexander Osipovich, & Patricia Kowsmann, *FTX Tapped into Customer Accounts to Fund Risky Bets, Setting up Its Downfall*, WALL ST. J. (Nov. 11, 2022), <https://www.wsj.com/articles/ftx-tapped-into-customer-accounts-to-fund-risky-bets-setting-up-its-downfall-11668093732>.

quickly moving to withdraw their assets from the platform.<sup>6</sup> Quickly, FTX found itself eight billion dollars in the hole.<sup>7</sup> The company then filed for Chapter 11 bankruptcy.<sup>8</sup> A Chapter 11 bankruptcy is done to reorganize business's debt, while allowing it to keep operating. The collapse of FTX will bring about many legal developments, from criminal charges to new regulations. However, the bankruptcy proceeding itself will have several unique challenges.

FTX and related entities' bankruptcy was filed on an emergency basis in Delaware due to an extreme liquidity problem.<sup>9</sup> FTX Trading has many related entities under its corporate umbrella. FTX trading and more than one hundred and thirty were part of the Delaware bankruptcy filing.<sup>10</sup> However, there is a single related company, FTX Digital Markets, which is headquartered in the Bahamas, that was not a part of the Chapter 11 filing.<sup>11</sup> While primarily a U.S. company, the co-founder and staff largely operated out of an office in the Bahamas.<sup>12</sup> FTX Digital Markets had begun a liquidation in a court in the Bahamas, the day before the Chapter 11 filing.<sup>13</sup> Following the Delaware filing, the Bahamian court-appointed liquidators then filed for a Chapter 15 bankruptcy case in the Southern District of New York, alleging that the Chapter 11 filing was not authorized.<sup>14</sup> A Chapter 15 filing allows foreign nationals to file for bankruptcy in the U.S. Courts when there are assets or business in multiple countries, and can be done after insolvency procedures have begun in the foreign country.<sup>15</sup> The Chapter 15 filing was made so that the Bankruptcy Court will recognize the Bahamian insolvency laws.<sup>16</sup> The Bahamian liquidation procedure does not have an absolute priority rule like the United States, and the U.S. system allows for more access by creditors.<sup>17</sup> Another concern when determining who should administer the bankruptcy is judicial competence in running a bankruptcy this large. The Delaware Court is very

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<sup>6</sup> Elizabeth Napolitano, Brian Cheung, & Jason Abbruzzese, *Sam Bankman-Fried and the FTX Collapse, Explained*, NBC NEWS (Nov. 18, 2022), <https://www.nbcnews.com/tech/crypto/sam-bankman-fried-crypto-ftx-collapse-explained-rcna57582>.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> Vince Sullivan, *FTX Bankruptcy to Start with International Clash for Control*, L. 360 (Nov. 18, 2022), <https://www.law360.com/bankruptcy/articles/1551031/ftx-bankruptcy-to-start-with-international-clash-for-control>.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

experienced in large Chapter 11 cases, and some worry that the level of difficulty of this case could prove to be beyond the ability of the Bahamian Court.<sup>18</sup>

The determinative factor in deciding jurisdiction is where the company's center of main interest lies.<sup>19</sup> Proponents of the Chapter 11 approach will argue that the United States is in control of most of the debtors. The Bahamian side will argue that FTX was headquartered in the Bahamas and that most of the employees were stationed there.<sup>20</sup> Until the jurisdiction issue gets resolved, the bankruptcy cannot move forward.

Another major concern with any bankruptcy is when and how much creditors will be able to recover. The investments made by crypto investors will likely be treated as unsecured claims without collateral rights.<sup>21</sup> These investments will be incredibly hard to recover, and, if anything, will be pennies on the dollar. However, on the debtor side, FTX will be looking to claw back funds that were transferred out of the company before the bankruptcy filing.<sup>22</sup> Payments to creditors right before bankruptcy are known as preferences, and they can be returned to the debtor upon a judge's approval.<sup>23</sup> The question will be if the digital assets that customers scrambled to pull right before the bankruptcy will count as preferences. The Court will have to determine whether the withdrawals were conducted in the ordinary course of business.<sup>24</sup>

However, a safe harbor exception could apply.<sup>25</sup> A bankruptcy safeguard allows assets like securities to continue to be traded on an exchange without being able to be clawed back as preferences.<sup>26</sup> Furthermore, the Court will listen to the argument that the cryptocurrency withdrawn by the customers was their property, not a payment by the company.<sup>27</sup> The Court's determination on this issue will have implications on all future bankruptcies involving cryptocurrencies.

In conclusion, these are just some of the many challenges going forward in the fall of FTX. The bankruptcy will likely set new precedent in how the U.S.

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<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> Caitlin Ostroff, Vicky Ge Huang, & Alexander Gladstone, *FTX Files for Bankruptcy, CEO Sam Bankman-Fried Resigns*, WALL ST. J. (Nov. 11, 2022), [https://www.wsj.com/articles/ftx-files-for-chapter-11-bankruptcy-11668176869?mod=Searchresults\\_pos18&page=1](https://www.wsj.com/articles/ftx-files-for-chapter-11-bankruptcy-11668176869?mod=Searchresults_pos18&page=1).

<sup>22</sup> James Nani & Daniel Gill, *FTX Looks at Years of Lawsuits to Recover Billions from Customers*, BLOOMBERG L. (Nov. 18, 2022), [https://www.bloomberglaw.com/login?target=https%3A%2F%2Fwww.bloomberglaw.com%2Fbloomberglawnews%2Fbankruptcy-law%2FBNA%2520000001848695d966ab9dc795c2a60001%3Fbna\\_news\\_filter%3Dbankruptcy-law](https://www.bloomberglaw.com/login?target=https%3A%2F%2Fwww.bloomberglaw.com%2Fbloomberglawnews%2Fbankruptcy-law%2FBNA%2520000001848695d966ab9dc795c2a60001%3Fbna_news_filter%3Dbankruptcy-law).

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

Courts view cryptocurrencies and exchanges. In addition, Congress will likely look to new regulations for the crypto market. The legal world will be paying close attention to the outcomes in the case, and it is only getting started.