Skarzynski | Marick

Skarzynski Marick & Black LLP
One Battery Park Plaza, 32nd Floor
New York, New York 10004
P 212.820.7700 | **F** 212.820.7740
skarzynski.com

The FTX Meltdown: Insurance Issues Arising From the FTX Collapse

Topic presented live at the IADC 2023 Professional Liability Roundtable, New York, NY - May 18, 2023

Moderator: **Sarah Voutyras**, Partner, Skarzynski Marick & Black LLP, *Los Angeles, CA*

Speakers: **Brock Dahl**, Head of US Fintech, Freshfields Bruckhaus Deringer LLP, *Washington, DC*
Maria Fazzolari, Vice President, Head of Claims, Specialty and Professional Claims, Nationwide, *New York, NY*
Kristy Littman, Partner, Willkie Farr & Gallagher LLP, *Washington, DC*

Whitepaper Authors: **Sarah Voutyras** & **William Accordino**, Skarzynski Marick & Black LLP, *New York*

The collapse of FTX in November 2022 was widely seen as a harbinger of doom for the crypto industry. Not only did spectators suspect that FTX was undone by its minting and trading cryptocurrencies, which until recently seemed to have incredibly generated billions of dollars of profits for its participants, but also its collapse shook the volatile crypto market as a whole, which immediately lost billions in value. However, a close review of the alleged fraud at FTX suggests that it was not the company's exposure to crypto that caused its collapse, but rather standard financial fraud, akin to that perpetrated by Enron and Bernie Madoff. Nonetheless, FTX's collapse has caused a cascading effect that has shaken both the cryptocurrency and broader financial markets and enflamed the already increased push for, and fight over, regulation in the cryptocurrency space.

Background

Valued at $32 billion in the beginning of 2022, Bahamas-based FTX operated the fourth largest cryptocurrency trading platform in the world, facilitating more than $15 billion in daily trades. Founded in 2019 by Sam Bankman-Fried and Gary Wang, FTX quickly gained popularity among crypto traders and investors due to its innovative features and user-friendly interface -- FTX allowed ordinary users to easily connect their digital wallets, place trades, exchange digital currencies, enter into derivatives contracts, and buy and sell non-fungible tokens (NFTs). FTX also apparently offered customers yield bearing accounts (YBAs) that were allegedly portrayed as "savings accounts" guaranteed to yield returns on customer assets, whether they were held as USD, legal tender, or cryptocurrency.

Sam Bankman-Fried, known by many as "SBF," quickly vaulted to celebrity in his quest to make FTX a household name. For a time, SBF was crypto's golden boy, viewed as an approachable, friendly billionaire eager to deploy his wealth for good, and one for whom the best was still yet to come. In December 2021, Forbes reported that SBF's fortune was as high as $26.5 billion; and he was referred to by the renowned investment firm Sequoia as a "future trillionaire." Known for his unconventional and unkempt appearance, the 30-year old billionaire was born and raised in California and cut his teeth working as a trader at Jane Street Capital on Wall Street, a trading shop specializing in ETF arbitrage. To most, SBF presented an aura of genius with a philanthropic tint. Potential employees of FTX were told that SBF started the firm partly so he could give away some of its profits as effective altruism, a movement that declares the aim of directing donations to where they can do the most good.

SBF joked about the actual functionality of crypto assets on numerous occasions and made many trips to Washington, D.C. to advocate for Congress to regulate crypto. SBF contributed $5.2 million to the 2020 presidential campaign. And he even extended loans to competing crypto firms facing collapse in the beginning of the so-called "crypto winter" in May 2022[1]. FTX had prominent paid sponsorships, including the naming rights to a professional sports arena in Miami, celebrity endorsements and a 2022 Super Bowl commercial that touted FTX as "the safest and easiest way to buy and sell crypto."

Unbeknownst to its customers, FTX was apparently siphoning customer deposits into SBF's privately held hedge fund, Alameda Research LLC ("Alameda"), which Alameda then poured into high-risk investments such as esoteric cryptocurrencies and crypto-related startups. SBF co-founded Alameda in 2017 for the purpose of taking advantage of an arbitrage opportunity related to the price of bitcoin in Japan. At the time, traders who were able to navigate the complexities of the crypto scene there – which SBF apparently was able to navigate by coining his firm as a "research institute" so that Japanese banks would be more willing to do business with it – could profit by buying Bitcoin elsewhere and selling it to Japanese buyers for more. Sources suggest that Alameda made between $10 million and $30 million in profits before the price gap closed in early 2018. In 2019, riding the wave of his Alameda success, SBF founded the derivatives-friendly crypto exchange FTX. He stepped down from Alameda's helm in 2021 after FTX raised $420 million from high-profile investors in a round of funding that valued FTX at $25 billion, placing Caroline Ellison into the chief executive position at Alameda.

Sources suggest that Alameda made over $1 billion in profits in 2021; however, during that year cryptocurrencies of all kinds soared, even ones created as a joke.[2] While outsiders assumed Alameda was continuing to win big, in reality Alameda's assets quickly declined, and with no outside investors (SBF owned 90%), nor applicable regulations, Alameda was not required to report to any outside investors about its financial performance.[3]

FTX executives are alleged to have created features in the underlying code for the FTX exchange which apparently allowed Alameda to maintain an essentially unlimited line of credit on FTX deposits and provided Alameda with a quicker execution times and a "secret exemption" from the platform's publicly touted auto-liquidation risk management process. This meant that Alameda could carry a negative balance with FTX without its collateral being automatically sold if its balance declined to a specific floor (as it would with other customers). Records from FTX's bankruptcy proceedings appear to show that FTX funneled some $9.3 billion in customer funds to Alameda, which were then placed into overvalued and illiquid assets, including FTX's digital token FTT.

[1] The period of negative gains in the value of cryptocurrency is commonly referred to as crypto winter, similar in concept to a "bear market" when used in the traditional financial market sense. Beginning in May 2022, a series of events triggered a domino effect of financial losses throughout the crypto markets, including the sudden decline in value of a number of popular cryptocurrencies. The "crypto winter" is said to be ongoing at this time.

[2] For example, Dogecoin, a digital currency that was created as a joke to poke fun at some of the wild speculation in cryptocurrencies, skyrocketed and became the world's 10th largest cryptocurrency in February 2021 after Tesla CEO Elon Musk tweeted about it and the popular online forum Reddit exploded in discussion about it.

[3] Alameda did have debt facilities in place with third party crypto lenders and its financials, although not audited, were disclosed to such lenders.

In turn Alameda, by then one of the largest traders in crypto, fueled FTX's growth by serving as the exchange's primary market maker, meaning that it was always available to buy and sell if other traders wanted to; sources report that Alameda sometimes would take the losing side of a trade in order to attract customers to the FTX exchange. SBF and other FTX executives are also alleged to have taken hundreds of millions of dollars in "loans" from Alameda that they used to purchase luxury real estate and property for themselves and/or family members, make political donations, and for other unauthorized uses. None of this was disclosed to or known by FTX customers.

FTX's house of cards began tumbling on November 2, 2022, when prominent digital asset news website CoinDesk published a report questioning the financial health of both FTX and Alameda and noting that Alameda held a significant portion of its $14.6 billion in assets in FTX's digital token FTT. Following that revelation, Changpeng Zhao, the billionaire founder of rival crypto exchange Binance, announced that Binance would sell all holdings of the token, worth at least $580 million. This caused FTX customers to panic and begin selling FTT, causing its price to plummet and withdrawing their funds in large quantities. When FTX was unable to meet the demand for customer withdrawals, Binance signed a letter of intent to acquire FTX following due diligence. Binance withdrew from the proposed rescue deal the next day, citing reports of mishandled customer funds and U.S. agency investigations.[4] Shortly thereafter, SBF resigned and on November 11, 2022, FTX filed a Chapter 11 bankruptcy petition.

The Fallout

On December 12, 2022, SBF was arrested in The Bahamas. Since then, federal prosecutors in Manhattan have charged SBF with criminal counts including wire fraud, commodities-fraud conspiracy and securities-fraud conspiracy and, most recently, with violations of the FCPA in connection with the alleged payment of $40 million in bribes to Chinese government officials in response to an investigation by the Chinese government commenced in 2021 into a "particular Alameda trading counterparty." The US Securities & Exchange Commission (SEC) charged SBF with orchestrating a scheme to defraud investors in FTX under the anti-fraud provisions of the US Securities Laws, and on the same day, the Commodity Futures Trading Commission (CFTC) charged SBF, FTX, and Alameda for violations of the Commodity Exchange Act (CEA) on the basis that their activities caused a "significant negative price impact on the value of commodities in interstate commerce in the United States, including Bitcoin and Ether spot and futures prices."

Other civil litigation by FTX customers have followed, including, among others: (1) against SBF, FTX insiders, and FTX brand ambassadors including NFL quarterback Tom Brady, Gisele Bundchen, Shark Tank star Kevin "Mr. Wonderful" O'Leary, NBA all-star Stephen Curry and the Golden State Warriors, NBA star Shaquille O'Neal, comedian Larry David, and countless others; (2) against prominent VC firms Sequoia, Thoma Bravo, and Paradigm for promoting FTX as credible and trustworthy in connection with their $550 million investments in FTX; and (3) against banks such as Silvergate Bank and Signature Bank for accepting deposits from FTX investors and permitting those deposits to be transferred to Alameda. While many commentators have noted that it seems unlikely any of the FTX promoters actually participated in the fraud at FTX, they must all still respond to the subsequent litigation. Given the SEC's actions alleging that many crypto assets are "securities"

[4] On March 27, 2023, the CFTC filed a complaint against Binance for engaging in the trading of commodities without registering with the CFTC.

which require more extensive promotion disclosures than ordinary consumer goods, celebrity touting of crypto assets is fertile ground for SEC enforcement actions.[5]

The collapse of FTX also immediately sent shockwaves through the cryptocurrency market, with many traders and investors reeling from the news. A sharp drop in the value of several digital assets, including Bitcoin, Ethereum, and Dogecoin, followed immediately after the platform's sudden shutdown. The broader market has also taken a hit, with many other cryptocurrency exchanges reporting a drop in trading volume and investor confidence.

Impact on Efforts to Regulate the Crypto-Currency Space

While the unique features and volatility of digital assets may have played a role in FTX's downfall, it should be noted that the fraud itself generally presents as a classic Ponzi scheme whereby the FTX entities shuffled customer funds between their opaque affiliated entities and used new investor funds and loans to pay interest to the old ones in an attempt to maintain the appearance of liquidity when in reality they were unable to meet their financial obligations. Bankruptcy filings show that FTX's creditors are owed more than $3 billion. And as with the Enron and Madoff scandals, the victims who have been hit the hardest are ordinary consumers – consumers that put their personal savings into the custody of FTX in the hopes of cashing in on the crypto boom, and who risk never recovering their assets from FTX. Federal prosecutors have called the stunning collapse of FTX "one of the biggest financial frauds in American history" and have charged SBF with defrauding investors while enriching himself – charges that would be the same whether he dealt in securities, commodities, cryptocurrencies, or plain old cash.

Nonetheless, the collapse of FTX has certainly highlighted the risks associated with investing in cryptocurrency and the need for stronger regulation and oversight of digital assets and the exchanges that they are traded on. It has also raised questions about the reliability and transparency of cryptocurrency trading platforms. It may be argued that if FTX had been subject to the extensive regulations that govern other trading platforms, there may have been more regulator oversight and checks and balances that revealed the scheme earlier, or even stopped it before it started.

At this time, federal regulators including the SEC, the CFTC, and the Department of Treasury along with a number of states are all wrestling with how best to oversee crypto (to name just a few) while simultaneously debating the legal identity of the different assets that exist in the space. The SEC, which is charged with regulating traditional securities such as equities, debt instruments, and investment contracts as defined in the US Supreme Court's 1946 decision in *SEC v. Howey*, has claimed that investment contracts involving crypto are under its jurisdiction, such that persons and entities issuing such products must comply with applicable securities laws and SEC rules just as if they were issuing ordinary securities. The SEC has been increasingly active in bringing enforcement actions against several issuers of cryptocurrencies or other digital tokens for engaging in unregistered securities offerings. SEC Chairman Gary Gensler has been vocal in his position that most tokens are securities under the Supreme Court's *Howey* test and that the SEC should be the primary regulator for the crypto markets. Consistent with Commissioner Gensler's public comments, following the collapse of FTX, the SEC has initiated a number of high-profile enforcement actions which some speculate may

[5] For example, a number of celebrities, including singer Lindsay Lohan, YouTube influencer Jake Paul, and other musicians including Soulja Boy, Ne-Yo, and Akon have been charged by the SEC with securities violations for illegally promoting cryptocurrencies without disclosing that they were being compensated for doing so.

be geared towards sending a message to the market and industry as a whole regarding the SEC's intentions for regulating cryptocurrencies,[6] and in March 2023 it issued an Investor Alert and Bulletin urging investors to be cautious if considering an investment involving crypto asset securities, noting that those dealing in "crypto asset investments" may need to register with the SEC or other self-regulatory organizations such as FINRA. And in February 2021 the SEC proposed rule changes that would amend the Commission's custody rule under the Investment Advisers Act of 1940 to govern adviser custody over client funds and securities and *any* other client asset, including crypto assets.

The CFTC on the other hand, which has plenary jurisdiction over commodity transactions and derivatives involving commodities, has established that Bitcoin and other cryptocurrencies are commodities—like wheat, gold, and certain financial products—and that the CFTC's rules apply equally to derivatives transactions referencing such cryptocurrencies. The CFTC Chairman Rostin Behnam has supported proposed legislation that would give his agency oversight of trading in certain cryptocurrencies, including Bitcoin and Ether ("ETH") in addition to other digital assets that would be classified as "commodities" within the purview of the CFTC. Some skeptics have however questioned CFTC's relationship with FTX, as prior to its collapse SBF was heavily lobbying for oversight of crypto by the CFTC.

For cryptocurrencies, the lines can sometimes be blurred between those two asset classes – for example, crypto assets may satisfy the *Howey* test when first issued by an entity but, on the secondary market when users are betting on volatility not tied to the issuer's actions they may be traded more like virtual currencies or commodities. The SEC did recently succeed in convincing a court in New Hampshire that the LBC digital tokens sold by the company LBRY qualified as "securities" subject to SEC regulation on the basis that the value of the tokens were tied to LBRY executives' efforts managing the company (as the value of common shares in a company might be). The SEC is currently attempting to convince a New York court of that same proposition with respect to the blockchain developer Ripple Labs and its XRP token.

Ultimately, the regulation of digital assets will likely require a coordinated effort among legislators and multiple regulatory bodies. The goal should be to establish a balanced and flexible regulatory framework that can adapt to the rapidly evolving nature of the digital asset industry, while also protecting investors and promoting innovation.

Implications on Management Liability Insurance

So far, many D&O insurers have been avoiding the crypto space given the lack of clarity on regulation and the significant level of litigation surrounding crypto. However, the fallout from the FTX debacle highlights the possibility of "silent crypto" exposure for insurance carriers.

Most public and private companies purchase Directors & Officers and Company liability insurance coverage, known as "D&O" and/or Management Liability Insurance. Such policies typically provide defense and indemnity

[6] For example, in January 2023 the SEC brought charges against the crypto exchange Gemini and crypto lender Genesis for trading unregistered securities. And in February 2023, the SEC announced a settlement with Kraken, a crypto exchange, over a crypto-based rewards program offered by Kraken. In addition, in March 2023 the SEC issued a Wells notice to Coinbase, the largest crypto exchange in the U.S., regarding potential violations of the Securities Act of 1933 and the Securities Exchange Act of 1934.

coverage for litigations against the entity and/or its D&Os for conduct related to the management of the company.

With respect to public companies, while such coverage is broadly available to the D&Os for any acts, errors, omissions, and the like in connection with the management of the company, coverage for the company itself is generally limited to "Securities Claims," i.e., lawsuits against the company alleging violations of the U.S. securities laws and any other similar law regulating the purchase, sale or offer of securities of the company. Thus, while coverage could potentially be available for individual D&Os for their involvement in the issuance of tokens or in alleged crypto fraud, subject of course to exclusions for fraud, disgorgement, and the like, there may be an issue of whether some of the claims against entities qualify as "Securities Claims," given that it is not at this time decided whether (or when) a digital token qualifies as a "security". To use FTX as an example, it is alleged to not only have dealt in unregistered securities, but it is also alleged to have made misstatements related to the YBAs, which apparently operated more like savings accounts than "securities." The fact that FTX is alleged to have siphoned off customer deposits to fund Alameda trading activity also begs the question of whether a "Securities Claim" is involved. Of course, the bankruptcy proceedings result in a stay of any litigation against FTX and Alameda specifically; however there may be other entities that face liability as a result of this conduct, including the Bahamian entity FTX DM, which is alleged to have received fraudulent transfers from FTX prior to the bankruptcy. As of the date of this writing, SBF's request to access two D&O policies in order to put up an "effective defense" in 16 separate cases remains pending before the court presiding over FTX's bankruptcy proceedings, with FTX's new leadership responding that while it could not oppose outright SBF's demand for at least some of the insurance proceeds, it did object to allowing the former crypto CEO to "drain" the policies "for his sole benefit" and urging the court to ensure that the D&O insurers are able to pay *all* Insureds, rather than solely SBF, "according to a fair and equitable distribution of those insurance proceeds." FTX's Official Committee of Unsecured Creditors has objected to SBF's request to lift the bankruptcy stay to allow SBF to access the policies, which belonged to West Realm Shires, the legal name of FTX's U.S. arm.

Conversely, with respect to private companies, management liability policies typically exclude coverage for lawsuits arising out of the purchase or sale of securities in the company. In the case of an exclusion, the uncertainty surrounding the classification of cryptocurrencies as "securities" becomes even more interesting. Specifically, in many states, an insurer's duty to defend or advance defense costs is determined based on the allegations in the complaint. To the extent private companies stand accused of engaging in the unregistered sale of securities (like Ripple and FTX), there could be an issue as to whether the securities exclusion in their private company management liability policies applies, or whether there exists a "possibility" of coverage given that the issue of whether a digital token qualifies as a security remains undecided.

NOTE: The discussions of legal and insurance issues set forth in this article are solely for illustrative purposes and is not intended to provide an official opinion or legal advice regarding any of the topics discussed herein.