A Few Early Takeaways on Startup Investing in the Wake of FTX

Joseph B. Allen

WILLCOX SAVAGE

The bankruptcy of FTX, the large, privately held cryptocurrency exchange that had raised hundreds of millions of dollars in venture capital funding, has been a top story in the financial press the past week. Although investigations are still in their early stages, a few practice tips can be identified from initial news reports.

On Tuesday, November 8, news broke that FTX, previously one of the largest cryptocurrency exchanges in the world, was in the midst of a liquidity crisis after experiencing customer withdrawal requests estimated at $6 billion in the span of 72 hours[i]. Another large crypto exchange purportedly entered into a non-binding letter of intent to buy a substantial portion of FTX's operations, but subsequently withdrew its offer[ii]. On Friday, November 11, FTX filed for Chapter 11 bankruptcy protection in Delaware, and it's unclear whether FTX customers will be able to recover all of their funds that they deposited on FTX's platform.

This turn of events represented an extremely fast downfall for a company that just a few months ago reportedly raised $500 million from very prominent investors at a $32 billion valuation[iii], and some of those investors are now valuing their investments in FTX at zero[iv]. Given the company's abrupt decline, many have wondered why these issues weren't spotted earlier. It's likely that more information will come to light once investigators have had more time to review and assess the situation. However, when viewing the FTX situation as an opportunity to learn and improve startup investing practices from a legal perspective, a few practice tips can be seen in the initial reports.

Look Closely at Related Party Transactions

Although more details may be forthcoming, several news reports have stated that a source of FTX's financial distress resulted from FTX loaning a significant amount of money to Alameda Research, which was also experiencing distress[v]. FTX and Alameda Research were both founded by the same individual, Sam Bankman-Fried, who also reportedly owned significant equity stakes in both firms.

In most private investments, the startup will make several representations and warranties to investors about its business. One common warranty is that the startup is not a party to any undisclosed transactions or contracts with related parties, including entities that are directly or indirectly owned or controlled by the startup's owners, management, or relatives of the foregoing. This is an important representation, as in many cases related party transactions are conducted on terms that are very different from those that unrelated third parties would agree to when negotiating on an arm's length basis. It's unclear how much investors knew about FTX's relationship with Alameda Research before making the decision to invest.

Don't Always Follow Brand Names

Many news reports have noted the many prominent, brand-name investment firms and angel investors that reportedly invested significant funds in FTX[vi]. Many of those investors have long track records of successful investments in the past, and no investor or investment firm will be able to achieve a 100% success rate.

However, it's worth noting that even the most successful investors can miss or overlook significant issues in an investment target. Some investors, when considering a new investment in a startup, will look at the startup's cap table, see names of other prominent investors, and be tempted to skimp on diligence or skip over asking probing questions of the startup's management on the assumption that the existing prominent investors must have already conducted thorough diligence. The FTX situation is a reminder of the importance of each investor conducting its own diligence and engaging in independent, critical thinking before giving the green light to a potential investment.

Negotiating Control and Information Rights

It's not uncommon for outside investors that are considering buying a significant equity stake in a startup to require one or more seats on the startup's board and extensive rights to information from the startup as conditions to closing the investment. Having a representative on a startup's board generally grants the investor greater access to information, a certain level of oversight over the startup's operations, and some influence over the strategic direction of the startup. In FTX's case, it appears that none of its venture capital firm investors required or obtained a seat on FTX's board[vii].

Private Investing is Risky

A final takeaway from the FTX situation is just that investing in private startups is inherently risky and uncertain. New, privately held firms such as FTX often do not have long operating histories, experienced management teams, or robust internal controls. For each startup failure such as FTX that becomes front-page news, there are many others that don't make it for one reason or another and whose failure does not become widely known. It's strongly recommended that any person considering an investment in a privately held startup both engage experienced legal counsel and other advisors to provide guidance as well as be sure that they are prepared, both financially and mentally, to take on the significant risk that is inherent in this field.

Joseph B. Allen
Willcox Savage
1775 Tysons Blvd, 5th floor
Tysons, VA 22102
jallen@wilsav.com
(757) 628-5648

[i] Kalley Huang, What Happened to FTX? Here's What to Know., N.Y. TIMES, Nov. 10, 2022, https://www.nytimes.com/2022/11/10/technology/ftx-binance-crypto-explained.html

[ii] MacKenzie Sigalos and Kate Rooney, Binance backs out of FTX Rescue, leaving the crypto exchange on the brink of collapse, CNBC, Nov. 9, 2022, https://www.cnbc.com/2022/11/09/binance-backs-out-of-ftx-rescue-leaving-the-crypto-exchange-on-the-brink-of-collapse.html

[iii] Erin Griffith and David Yaffe-Bellany, Investors Who Put $2 Billion Into FTX Face Scrutiny, Too, N.Y. TIMES, Nov. 11, 2022, https://www.nytimes.com/2022/11/11/technology/ftx-investors-venture-capital.html

[iv] Id.

[v] Dave Michaels, Elaine Yu, and Caitlin Ostroff, Alameda, FTX Executives Are Said to Have Known FTX Was Using Customer Funds, WALL STREET JOURNAL, Nov. 12, 2022, https://www.wsj.com/articles/alameda-ftx-executives-are-said-to-have-known-ftx-was-using-customer-funds-11668264238

[vi] Erin Griffith and David Yaffe-Bellany, Investors Who Put $2 Billion Into FTX Face Scrutiny, Too, N.Y. TIMES, Nov. 11, 2022, https://www.nytimes.com/2022/11/11/technology/ftx-investors-venture-capital.html

[vii] Antoine Gara, Harriet Agnew, Tabby Kinder, and Richard Waters, How Sam Bankman-Fried seduced blue-chip investors, FINANCIAL TIMES, Nov. 11, 2022, https://www.ft.com/content/67b1899f-4b1f-4676-b264-0d19e205d64e