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Third Circuit – Chapter 11 Examiner Appointment Now Mandatory

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Although Chapter 11 of the Bankruptcy Code allows existing management of a debtor to remain in control of its business, it imposes several oversight mechanisms to help ensure the integrity of the process. Two of the most common include the Office of the United States Trustee and an Official Committee of Unsecured Creditors. In addition, the Code calls, under certain conditions, for the appointment of an independent examiner whose role can run from the very broad to extremely limited. Some Courts interpret the Code's examiner appointment provisions to be mandatory if the statutory requirements are met, while many others do not. The now infamous Chapter 11 bankruptcy case of FTX Trading Ltd. ("FTX"), once a multibillion-dollar cryptocurrency company, has reemerged in a dispute over this very important issue. On appeal, the Third Circuit recently held that the plain text of Section 1104(c)(2) mandates the appointment of an examiner under the specified conditions set forth. *In re FTX Trading Ltd.,* No. 23-2297, 2024 U.S. App. LEXIS 1279 (3d Cir. Jan. 19, 2024). As a result, in the Third Circuit, and likely other jurisdictions, the *FTX* decision will carry significant implications for large and medium sized bankruptcy cases.

As background, Samuel Bankman-Fried ("SBF") was the founder and majority owner of both FTX, a cryptocurrency exchange platform, and Alameda Research, a cryptocurrency hedge fund. Since its formation in 2019, FTX had grown to a staggering $32 billion valuation in just a few years. In early November 2022, however, questions emerged alleging a conflict of interest between the two ostensibly independent companies, and investors began cashing out at an alarming rate after discovering that Alameda Research had used funds from FTX customers to inflate its own balance sheet, among other questionable activities. On November 11, 2022, following a massive liquidity crisis that saw customers collectively lose billions of dollars in investments and put the legitimacy of the entire cryptocurrency industry in question, FTX filed for bankruptcy and SBF appointed John J. Ray III as replacement CEO for FTX and its affiliates. Mr. Ray's own investigations of the company confirmed "unacceptable management practices" including "the use of software to conceal the misuse of customer funds," and ultimately "located and secured only a fraction of the digital assets."

In the bankruptcy court, the U.S. Trustee ("US") filed a motion to appoint an examiner to investigate FTX's management, citing 11 U.S.C. § 1104(c)(2), which, according to the UST, mandates the appointment of an examiner if requested by the UST or a party in interest, and if "the debtor's total fixed, liquidated, unsecured debts" exceeds $5 million. The UST stated its belief that "a public report of the examiner's findings could reveal the 'wider implications' that FTX's unprecedented collapse had for the cryptocurrency industry." The opposing parties, including the Unsecured Creditors' Committee and the Debtor in Possession, argued that the phrase "as is appropriate" in Section 1104(c) indicates the appointment of an examiner is a permissive duty, subject to the bankruptcy court's discretion. They argued that granting the UST's motion would be "highly inappropriate" in this case, given that further investigation would "create an unjustifiable cost for creditors, interfere with their efforts to stabilize FTX Group, duplicate their findings of management wrongdoing, and pose a security risk to cryptocurrency codes."

The Bankruptcy Court agreed, denying the UST's motion for an examiner by interpreting the statute to give it discretion over whether such an appointment is made. 11 U.S.C. § 1104(c) reads as follows (emphasis added):

[O]n request of a party in interest or the United States trustee, and after notice and a hearing, the court **shall** order the appointment of an examiner to conduct such an investigation of the debtor **as is appropriate**, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor, if—

(1) such appointment is in the interests of creditors, any equity security holders, and other interests of the estate; or

(2) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000.

The UST appealed the bankruptcy court's decision, insisting that the appointment of an examiner is not only mandatory under these circumstances per the statute, but also backed by "clear legislative history that conveys Congress's intent to guarantee an independent investigation into any large-scale bankruptcy." Reversing the bankruptcy court's decision, the Court of Appeals held that the plain text of Section 1104(c)(2) mandates the appointment of an examiner under the specified conditions. The Court noted that the use of the word "shall" in the statute indicates a command, without discretion. The Court further pointed out that the phrase "as is appropriate" in the statute refers to the nature of the investigation, not the appointment of the examiner itself.

The Court then referred to legislative history to support its interpretation. In the enactment of the "compromise bill," through which the Bankruptcy Code was passed by both houses in 1978, the Senate floor manager explained on the record that the "business reorganization chapter" ensures "special protection for the large cases having great public interest," enforced by an "automatically appointed" examiner. Still, the Court recognized certain limitations that Congress created on the "mandatory nature of subsection 1104(c)(2)" via two mechanisms. First, the request to have an examiner be appointed is initially dependent upon a motion of the UST or other interested party. Second, the phrase "as is appropriate" indicates that the court "'retains broad discretion to direct the examiner's investigation' including its scope, degree, duration, and cost." The discretion contemplated here allows courts to ensure, to the point of the parties opposing the UST's motion, that investigatory efforts are not duplicative or burdensome to the debtor's reorganization.

While the bankruptcy court had found that the new CEO, Mr. Ray, was "completely independent" from other former FTX members, the Court here found that the examination called for under the Bankruptcy Code is sure not to be duplicative of any efforts by Mr. Ray, since the examiner is "disinterested," "answers solely to the court" and, crucially, must make its findings available to the public—none of which can be required of Mr. Ray. In closing, the Court confirmed that this case would benefit from “much-needed elucidation,” and that further investigation into FTX’s prepetition practices had the potential to reveal further undisclosed mismanagement that could continue to affect the public upon confirmation of FTX’s reorganization plan.

The Court of Appeals’ decision underscores the importance of the legislative intent behind the Bankruptcy Code. The code was designed to protect the public interest in large bankruptcy cases, and the Court’s interpretation of 11 U.S.C. § 1104(c)(2) reinforces that intent.

While the court’s decision provides clarity on the interpretation of 11 U.S.C. § 1104(c)(2), it also highlights the broad discretion that a bankruptcy court retains in directing the examiner’s investigation. This discretion allows the court to set the parameters of the investigation, ensuring that it does not unnecessarily disrupt the reorganization process or duplicate the efforts of other parties. This balance between mandatory appointment and discretionary direction underscores the nuanced approach of the Bankruptcy Code in dealing with larger Chapter 11 cases.

Looking ahead, the *FTX* decision will likely have significant implications for future bankruptcy cases, particularly those involving large and medium sized debtors. By clarifying the mandatory nature of an examiner’s appointment, the Third Circuit has set a precedent that will help shape the course of future investigations and influence the strategy of debtors and creditors alike. Moreover, given the importance of the Third Circuit with respect to bankruptcy issues, the FTX decision may well be followed in other jurisdictions.

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