A Problem with the Code? Third Circuit rules appointment of an Examiner mandatory: is it time to amend the Statute?

Written by:
John D. Demmy
Saul Ewing LLP, Wilmington, Delaware
www.saul.com

The Third Circuit has a reputation as being a "plain meaning" court—meaning that it strictly construes and applies the words of a statute. Its January 19, 2024, opinion in *In re FTX Trading Ltd.*, No. 23-2297 (3rd Cir. Jan. 19, 2024) ("*FTX*") is an example. The relevant facts in the "highly complex" *FTX* bankruptcy were few and straightforward as related to the question before the court: "whether 11 U.S.C. § 1104(c)(2) ("§ 1104(c)(2)") mandates the Bankruptcy Court to grant the U.S. Trustee's motion to appoint an examiner to investigate FTX's management." *Id.*, Slip. Op. at 3.

Section 1104(c)(2) provides, in relevant part, as follows:

> [O]n request of a party in interest or the United States trustee, . . . 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—
>
> * * *
>
> (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.

11 U.S.C. § 1104(c)(2) (emphasis supplied).

"[G]iven both the statute's plain text and Congress's expressed intent in enacting this portion of the Bankruptcy Code," the Third Circuit's holding was equally simple and straightforward. *See FTX*, Slip Op. at 3. It held that appointment of an examiner was mandatory upon request in any case involving $5 million or more in unsecured claims, and the Bankruptcy Court lacked discretion to deny the appointment. *Id*.

The collapse of FTX's business, the bankruptcy filing and the alleged misconduct of FTX's management contributing to the collapse and resulting bankruptcy has been widely reported and does not require repetition here. Soon after the bankruptcy

filing, the U.S. Trustee moved for the appointment of an examiner under § 1104(c)(2). The FTX Debtors, the unsecured creditors committee, and others objected to the request, arguing that appointment of an examiner was discretionary (not mandatory), relying in part on the language "as is appropriate" in §1104(c)(2). Although the U.S. Trustee argued there were non-statutory justifications supporting its request for appointment of an examiner—including uncovering the "wider implications" of the FTX collapse for the cryptocurrency industry and relieving the FTX Debtors' post-bankruptcy management of investigatory burdens to allow them to focus on reorganization efforts—the Third Circuit did not rely on such and instead focused on the statutory requirements of a request having been made where unsecured debts exceeded $5 million.

The Third Circuit's decision emphasized use of the word "shall" in the statute, which it termed an obligatory word that is "impervious to judicial discretion," (citing *Lexecon Inc. v. Milberg Weiss Bershad Hynes & Lerach*, 523 U.S. 26, 35 (1998)), the abandonment of which would require abandonment of "plain meanings altogether," (quoting *Litgo N.J. Inc. v. Comm'r N.J. Dep't of Env't Prot*., 725 F.3d 369, 397 n.17 (3d Cir. 2013)). It also concluded the words "as is appropriate" in the statute refer only to the nature of the examiner's investigation not to the appointment of the examiner. *FTX*, Slip. Op. at 11. The Third Circuit also held that interpreting § 1104(c)(2) as discretionary would disregard direct evidence of Congressional intent: that § 1104(c)(2) is among the Bankruptcy Code provisions enacted to ensure special protections in "large cases having great public interest." *Id.* at 12.

Relatedly, the Third Circuit rejected arguments that an examiner's work would be duplicative of investigatory work by the FTX Debtors (which could be impacted by the input of pre-bankruptcy management personnel) and the unsecured creditors' committee, as neither was disinterested in the same manner in which an examiner must be, neither must answer to the bankruptcy court as is an examiner, and neither had an obligation to make the results of their investigations public as does an examiner. *Id.* at 15–17. Nevertheless, the Third Circuit noted that the Bankruptcy Court retains discretion to shape the scope of an examiner's duties. *Id.* at 14.

The Third Circuit's decision is consistent with the only other circuit court to have ruled on the issue, *In re Revco*, 898 F.2d 498 (6th Cir. 1990). The *FTX* decision, in effect, reverses Delaware Bankruptcy Court precedent holding that appointment of an examiner lies within the discretion of the bankruptcy court (assuming the $5 million unsecured claim threshold is satisfied) (*see e.g., In re Spansion, Inc.*, 426 B.R. 114, 128 (Bankr. D. Del. 2010) (holding the bankruptcy court had discretion and appointment of an examiner was not appropriate because an examiner would be

costly and duplicative of another investigation)), and is contrary to similar decisions of other influential bankruptcy courts (*see e.g.*, *In re Residential Cap., LLC*, 474 B.R. 112, 121 (Bankr. S.D.N.Y. 2012) (holding the bankruptcy court had discretion and that appointment of an examiner was appropriate under the facts of the case); *In re PG&E Corp.*, No. BR 19-30088-DM, 2020 WL 9211190, at *3 (Bankr. N.D. Cal. July 6, 2020) (holding the bankruptcy court had discretion, but appointment of an examiner was not appropriate because the examiner would be costly and duplicative of another investigation)).

Given the language of the statute and applying it as written, it is difficult to argue that the Third Circuit's *FTX* decision is statutorily incorrect. But perhaps it is time for Congress to re-visit what is now, in respect of the $5 million financial threshold, a nearly 50-year-old provision of the Bankruptcy Code that has not been amended since its enactment in 1978. A case with general unsecured claims of $5 million—which may have been a large case in 1978—has not been considered a "large case" for many years in many jurisdictions. Should the financial threshold in § 1104(c)(2) be increased? Of course, the number that strikes the right balance between "small" and "large" cases in which a mandatory examiner appointment upon request is required is certainly open for debate and may very well be difficult to determine.

Perhaps the amendment to consider in respect of § 1104(c)(2) is simply to make appointment of an examiner in every situation explicitly at the discretion of the bankruptcy court based on all the facts and circumstances of the case, and not just an arbitrary amount of unsecured claims. At least in the Third Circuit, opposition to appointment of an examiner likely will now focus more on the discretion that a bankruptcy court has to limit the scope of the examiner's investigation, and, instead of opposing an appointment that is considered unwarranted, litigants likely will ask bankruptcy courts to limit the examiner's duties (perhaps to an immaterial or illusory level), which itself might spawn disagreement and further litigation. In the words of the Delaware Bankruptcy Court in exercising its discretion, prior to *FTX*, to deny a requested appointment, appointment of an examiner "with no meaningful duties strikes [the court] as a wasteful exercise, a result that could not have been intended by Congress." *Spansion*, 426 B.R. at 127. Amending the statute to expressly make the appointment of an examiner discretionary based on the needs of the case (as advocated by the parties and determined by the bankruptcy court) would eliminate the need for any financial threshold. Instead, the bankruptcy court could determine when an examiner is needed, whether in a "small" or "large" case as measured by

the aggregate amount of claims (priority, secured or unsecured), the number of creditors (priority, secured or unsecured), or otherwise. The needs of the case, rather than an arbitrary unsecured claim amount, should control whether an examiner is needed and can be afforded by the estate.