The Public and the Private of the FTX Bankruptcy

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Bankruptcy has a public and a private side. The reorganization of a private company in chapter 11 has implications for the public, and, in some reorganizations, the public interest is quite substantial. As Jay Westbrook has written, the assumption that chapter 11 bankruptcy "is entirely about negotiations among private commercial interests" is wrong. Rather, "[p]ublic interests should guide decisions in bankruptcy cases and often do." Indeed, the recent bankruptcy of the third largest crypto exchange in the world, FTX, represents the kind of corporate restructuring for which the public interest is front and center. Yet the public priority embedded in these proceedings has the potential to be overlooked. In this post, we aim to change that by shining light on the stakes, the costs, and the allocative decisions to be made in what will no doubt be described as one of the most consequential legal proceedings to happen in the world of crypto.

On November 14, 2022, the crypto giant FTX filed for bankruptcy. Facing an extreme liquidity crisis and the freezing of an affiliate company's assets by securities regulators in the Bahamas, senior management at FTX relinquished control to several independent directors and a new CEO, John J. Ray, III.

Since then, members of the original management team—including the company's 30-year-old owner and founder, Sam Bankman-Fried—have been investigated by lawmakers and regulators across many jurisdictions, including the Commodity Futures Trading Commission, the Securities and Exchange Commission, and the U.S. Attorney for the Southern District of New York. As of this writing, Bankman-Fried has been arrested and is awaiting trial, two members of his former executive team have pleaded guilty to federal fraud charges, and several others are rumored to be cooperating with the authorities.

Meanwhile, FTX continues to navigate what will likely be one of the most complex and expensive chapter 11 cases in recent history. In Ray's December testimony before the House Financial Services Committee, the newly appointed CEO summarized the challenges he and the company's management team face as they work to identify property of the estate and classify claims and interests: "[N]ever in my career have I seen such an utter failure of corporate controls at every level of an organization, from the lack of financial statements to a complete failure of any internal controls or governance whatsoever."

Ray began his testimony by acknowledging that his "one fundamental goal" was to "maximi[ze] value for FTX's customers and creditors so that we can mitigate, to the greatest extent possible, the harm suffered by so many." Later in the testimony, he highlighted his team's investigative work: "Our investigative and cyber security teams, led by the law firm Sullivan & Cromwell, are already well into the process of gathering the evidence that will provide us with an understanding of what led to this collapse. They are working in close coordination with U.S. and foreign regulatory and law

enforcement authorities." As part of these efforts, Ray's team is also "summarizing this information in a manner that will make the information useful, not only to the bankruptcy estate, but also to governmental and regulatory stakeholders in the U.S., including the House Financial Services Committee, and around the world."

The lack of appropriate controls, combined with the digital nature of many of the assets, have made asset identification and recovery more difficult. According to Ray, "[t]he scope of the investigation underway is enormous. It involves detailed tracing of money flows and asset transfers from the time of FTX's founding, and highly complex technological efforts to identify and trace crypto assets." Hinting at the significant costs of an investigation that may only be partially successful, he explained that the teams "are working around the clock to locate and secure…property of the estate, a substantial portion of which may be missing, misappropriated, or not readily traceable due to the lack of proper record keeping."

Ray's frank demeanor and his clear, straightforward responses to questions only served to confirm what his professional record already indicates: that he is more than qualified to take control of FTX and steer it through a bankruptcy process that will be part liquidation, part restructuring. Indeed, as of this writing, only Bankman-Fried has expressed public criticism of Ray's appointment or his actions to date.

And yet, the bankruptcy docket reflects some discontent—if not with Ray himself, then with the capacity in which he serves. Several parties—namely the U.S. Trustee and two state regulators—have requested the appointment of an independent examiner, and four U.S. Senators submitted a letter in support of this request. (See docket nos. 176, 263, 339, and 467).

Ordinarily, requests for an independent examiner in chapter 11 are akin to requests for the appointment of a trustee to take the reins from a debtor-in-possession: such demands usually stem from a lack of faith in the debtor's existing management, typically because of allegations of gross misconduct or real or perceived conflicts of interest.

But this is no ordinary chapter 11 case. And no one has even remotely suggested that Ray is unfit to lead FTX. In fact, in its motion, the U.S. Trustee conceded that "Mr. Ray and FTX's new management have done valuable preliminary work," adding that "the U.S. Trustee does not question the qualifications, competence, or good faith of Mr. Ray." (Docket no. 176, p. 3). In a similar way, the State of Wisconsin wrote that its decision to join the request was not intended to "in any way impugn Mr. Ray or the current corporate leadership." (Docket no. 263, p. 7-8).

To be sure, some stakeholders *have* complained that Sullivan & Cromwell is conflicted and thus unfit to serve as debtors' counsel. (Docket nos. 369, 467, 496). But the question of whether to approve professional appointments is normally separate and distinct from the question of whether to appoint an independent examiner.

It seems to us that the request to appoint an independent examiner—as well as the fuss raised over Sullivan & Cromwell's retention application—are proxies for a much bigger question in the FTX

bankruptcy: how best to manage the private versus public interests in the case. As the U.S. Trustee complained in its motion, "[Ray's] role in these cases is that of a fiduciary for the Debtors' estates with objectives that may not necessarily be aligned with those of all other interested parties," including the "public interest in transparency and accountability" given the extraordinary nature of the case and its implications for the growing crypto sector. (Docket no. 176, pp. 3, 21-22).

This latter objection suggests some frustration with the broader purposes—and limitations—of bankruptcy process. It also brings to mind Professor Jay Westbrook's proposal that bankruptcy courts should consider public interest factors in the cases before them, by showing "concern about the positive and negative effects of a [decision or policy] on most of the people in society." In developing his recommendations, Professor Westbrook is careful to distinguish public interests from the aggregated interests of individual stakeholders—including those interests that have tended to be neglected in the legal process. Instead, his focus is on broader societal interests, which are more than the sum of the various private interests, large and small, that are traditionally considered in bankruptcy proceedings.

The public interest in this case is more than simply getting to the bottom of the massive corporate failure and fraud allegations. It is also to answer several major questions about crypto that have up until now been left largely unanswered in the United States. First, we may learn more clearly what it means to actually hold crypto. In other words, if one holds a cryptoasset, is this akin to owning a piece of property? Or, alternatively, does one merely have a contract right against an exchange company or other intermediary? This question has been answered, at least in part, in some foreign jurisdictions but it has not yet received legal treatment in the United States. For example, in the 2019 case of *B2C2 Ltd v Quoine Pte Ltd*, the Singapore International Commercial Court held that crypto assets can be considered as a form of property and thus able to be held in trust. In *AA v. Persons Unknown*, an English court held that Bitcoin could be the subject of a proprietary injunction on the basis that it was a form of property.

Another question that has weighed heavily on the crypto market deals with the nature of how crypto assets are held by exchange companies. In other words, assuming that crypto assets are indeed a form of property, to whom does this property belong? Do they belong to the customer, with the exchange company merely acting as a custodian? Or do they belong to the exchange company, with the customer possessing a right to demand tender of the crypto assets, much in the way of a customer's relationship with a bank and money in a deposit account? Professor Adam Levitin has written about this legal quandary as to crypto exchange companies, as have other scholars in the context of the reserve assets held by certain issuers of stablecoins. The bankruptcy proceedings of the crypto lending platform Celsius have provided some indication of how certain firms hold crypto—in that case, the crypto assets were deemed property of the bankruptcy estate, much to the chagrin of customer-creditors. But the answer to this question of custody has yet to be determined in the U.S. for exchange companies, which are the all-important intermediaries of the crypto world. What role do the terms of service play (particularly when they are unclear, contradictory, or have changed over time) versus the expectations of the customers?

These questions are of great public interest. The answers will not only help settle the law in this area and infuse the crypto market with much-needed certainty and predictability; they will also help guide regulators and lawmakers as they continue their quest to craft and adopt the right laws and approaches to regulating and policing the crypto market.

But however important these questions may be to the broader public, the fact remains that FTX's bankruptcy is an exercise in scarcity. While recent requests for an independent examiner acknowledge the important public interests at stake, they sidestep the uncomfortable reality that FTX's customers and investors—who are already bearing the economic consequences of such a massive corporate failure—would shoulder these additional costs. This is because the costs would be borne by the estate, further reducing the value available for distribution. A central question then becomes whether the chapter 11 model that governs this process—one largely focused on expending limited resources to fairly and efficiently capture private value for *private actors*—is appropriate for a process that is so important to the *public interest*.