Global Restructuring Review

The Art of the Ad Hoc

Editors
Howard Morris, James M Peck and Sonya Van de Graaff

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Status and relationship of an ad hoc committee with indenture trustees

The relationship between an ad hoc committee and the indenture trustee can be a delicate one, subject to a range of pressures and tensions, depending on the debt issuer's circumstances, the composition of the pool of noteholders and the identity of the particular trustee.

A trustee is normally a financial institution (such as a trust company or a bank) who is appointed by the issuer of the notes and given fiduciary powers. It is ultimately a representative of the noteholders, although its fees and expenses may be paid by the issuer. A crucial fact that underpins the ad hoc committee and the trustee's relationship is that the trustee, at all times, should act in the best interests of all noteholders it represents, regardless of whether they are members of the ad hoc group, are 'original' noteholders who bought in at issue or subsequently purchased the notes on the secondary market. The trustee will also not be concerned about whether a noteholder purchased the notes at par, or at a significant discount; provided that the noteholder acquired the voting and information rights attached to the notes, it will treat all such noteholders equally.

The trust indenture or deed (as is commonly used under English law), along with the offering memorandum, will set out all relevant procedures (e.g., for convening noteholder meetings) and the circumstances under which the trustee and noteholders can call an event of default and accelerate maturity of the bonds (i.e., require immediate payment of principal and interest). Under the terms of the notes, there will be a number of restrictions on the issuer, such as negative pledges (restricting encumbrance of certain assets), restrictive covenants (restricting disposal of certain assets or incurrence of additional indebtedness, save for permitted indebtedness), and events of default (breaches of certain obligations, such as non-payment or breach of conditions, or anticipatory breaches, such as cross-default, insolvency, administration and distress proceedings). These conditions are intended to generally

1 Ben Klinger is a partner and Sabina Khan is an associate at Brown Rudnick LLP.

preserve the issuer's creditworthiness and, in turn, protect the noteholder's investments. It is the trustee who monitors the issuer's compliance with these conditions and ensures relevant information flows back to noteholders.

As indicated above, the duties owed by the trustee to the noteholders, and by extension, to the ad hoc committee, are of a fiduciary nature, subject to common law[2] and statutory duty of care – this entails, among other things, exercising reasonable care and skill,[3] avoiding conflicts of interest, acting in the beneficiaries' interests, and acting in good faith and with honesty and integrity. In practice, the trustee's role is usually an administrative one during much of the pre-distress/default stage – its duties include distributing coupons and principal payments, maintaining a list of registered noteholders, monitoring the terms and conditions of the notes, and potentially holding and managing the security if the debt is secured. The trustee–noteholder relationship at this stage is, therefore, almost mechanical in nature, and not dissimilar to the role of an agent bank, although its precise duties will be dictated by the terms of the notes. Trustees will, however, at various stages need to exercise their discretion. Trustees do not have unfettered discretion and there is an implied duty for trustees to exercise their discretion in a rational manner. *Socimer International Bank v. Standard Bank* [2008] EWCA Civ 116 clarified that trustees will, to some extent, be bound by 'concepts of honesty, good faith, and genuineness, and the need for the absence of arbitrariness, perversity and irrationality'.[4] When and how this discretion is used can impact noteholders' recovery in the event of the issuer's restructuring or liquidation; therefore, opening communication channels early on and forming a relationship with the trustee can be very helpful in manoeuvring them in a direction that is more favourable to the ad hoc committee.

One should be mindful that trustees are traditionally paid quite low fees; however, they will often need to discharge their duties in a careful manner, whereby they protect noteholders, and at the same time avoid incurring personal liabilities (as well as minimise their reputational and commercial risks). Stemming from the liability issues and concerns faced by indenture trustees, in practice, a trustee will rarely take action on its own volition, and will always take instructions, either from the requisite percentage of noteholders (which may be a majority or super-majority of the noteholders) as prescribed under the terms of the notes, or, if appropriate, seek directions from the court.

Ad hoc committees can form at any point; for example, at the first sign of a problem with one or more levels of the issuer's debt, or further down the workout timeline when it is more apparent that the issuer is in distress and value preservation is necessary. Timing will also depend on the nature and goals of the ad hoc committee and whether they are 'activist' and wish to agitate the situation or have a strategy or endgame that they wish to implement. Ultimately, for most ad hoc committees, the course of action they take will often be commensurate with the risk of winding up, and having carried out a cost-benefit analysis between 'holding out' and taking a more proactive role. As outlined above, the ad hoc committee allows a platform for the relevant noteholders to communicate with the trustee with 'one voice' and create a relationship whereby the trustee can take into account the concerns of a particular collective of the noteholders and also provide information to and from the issuer.

2 *Learoyd v. Whiteley* (1887).

3 Section 1 Trustee Act 2000.

4 [2008] Bus. L.R. 1304, [66].

At times of the issuer's distress, there are a number of concerns an ad hoc committee may have; for example, decisions relating to payment of coupons or breach of covenant waivers. The trustee formally represents the interests of all noteholders, but the motivation behind the formation of an ad hoc committee is usually to give the group a voice with, and be able to influence, the trustee. In this way, the committee members can avoid being prejudiced by actions of the trustee driven by the decisions made by other, potentially larger, creditors whose agenda, for whatever reason, diverges from the ad hoc committee's goals.

One of the hurdles noteholders can face is getting the trustee to act upon their instructions. This issue may be exacerbated by single institutional noteholders (e.g., large 'activist' private equity or hedge funds) who hold a major position in the notes, and by virtue of their holdings, can 'sway' the trustee. The agendas of these institutions may not necessarily be aligned with smaller noteholders; this is particularly the case if such institutions are invested in multiple tranches of the debt, have certain goals (e.g., to acquire the issuer), or have other investments (e.g., a credit default swap) in their portfolio that stand to benefit from the issuer's default. This is where ad hoc committees can, *inter alia*, wield greater influence on the trustee and, in turn, the issuer, through having a say on a reorganisation plan or pressing for more formal action. The trustee is more likely to perceive the ad hoc committee as a credible or substantial threat than if such noteholders were each acting in their individual capacity.

Ad hoc committees will maintain regular dialogue with and usually be heavily reliant on the trustee, particularly in relation to communication with the issuer. These 'pressure groups' (especially when unified or aggressive) can exert significant influence. It may not be possible or permissible for the trustee to disregard the demands of an ad hoc group (for example, to call a meeting of noteholders) where such committee together represents a substantial slice of the debt in the relevant tranche. The trustee will also be particularly alert to cases where the representative value of notes held by the ad hoc group is a 'critical mass' that gives the committee the power to block (or delay) certain transactions proposed by the issuer (e.g., where 75 per cent of creditor consent is required to approve a transaction, and the ad hoc group represents over 25 per cent of noteholders). Also, the constitution of the ad hoc committee may mean that any requisite quorum required to call or hold noteholder meetings, or to pass certain resolutions, are more likely to be met.[5]

Trustee's communications with ad hoc committees

The trustee will regularly communicate with ad hoc committees via its advisers, send notifications and help bridge the communication channels with the issuer. However, it should be noted that trustee–noteholder communications are not necessarily afforded the cloak of confidentiality as, for example, attorney–client communications. In the US case *Finisar Corp v. US Bank Trust NA*, the communications between trustee and noteholders were not deemed to be privileged. Therefore, where default is likely, privileged information ought to be communicated in a careful manner – a common interest privilege agreement should be drawn up between the ad hoc committee and the trustee and their respective counsel.

5 The difficulty for an ad hoc committee will be proving that its members represent a particular size of holdings in the notes.

The information shared between trustees and ad hoc committees can be instrumental to formulating recovery strategies and shape the next course of action. If the trustee feels that the ad hoc committee is exploring issues that are of benefit to itself and the noteholders as a whole, it is likely to pay close attention. In limited circumstances, the trustee may even cover the expenses incurred by an ad hoc committee (via the issuer) if such legal and financial expenses of the ad hoc group related to services that were beneficial to the trustee and wider class of creditors under the trust deed. This commercial approach was sanctioned by the courts in *UBS AG, London Branch v. Glas Trust Corporation Limited*.[6]

Issuer's distress stage

Under the terms of the notes, the trustees will usually have fairly wide discretion, including determining whether the terms of the notes have been breached by the issuer, whether such breach is 'materially prejudicial' to the interests of the noteholders and tantamount to an event of default, or if the relevant event is minor or capable of remedy (and if such event should be authorised or waived). However, how and when the trustee should exercise this discretion is not always clear cut, and the trustee's views may not always align with an ad hoc committee's views (*Satinland*[7] is one such example). A key difficulty the trustee has when dealing with one or more ad hoc committee is balancing the interests and demands of the ad hoc committees with the interests of all relevant noteholders, and ensuring that any action it takes does not prejudice or invite complaints from other noteholders who are not members of the ad hoc groups.

Issuer's default stage

Ad hoc committees are often formed in a distress or default scenario, as the committee members normally want to influence how the restructuring will play out, or ensure that enforcement action is taken. Upon the issuer's default, under a trust structure, the trustee will generally have an exclusive right to accelerate the notes (either of its own volition, upon assessment that an event of default has occurred that is materially prejudicial to the noteholders or upon the instruction of a certain percentage of noteholders). Noteholders themselves have no power to accelerate or take enforcement action. This prevents arbitrary or tactical acceleration, which can be harmful to the issuer as well as to other noteholders and creditors. The exception to this position is where the trustee has been properly instructed by the requisite percentage of noteholders to accelerate, yet has failed to do so within a reasonable period of time.

Noteholders' relationships with the indenture trustee are particularly tested during times of the issuer's stress. The trustee, being an independent party and having a relationship with the issuer and most of the noteholders, occupies a unique and (generally) more informed position than the noteholders. Trustees are not obliged to inform noteholders where an event of default has occurred (save for specific types of defaults, such as a payment default); indeed, in some cases the trustee may feel that it is in the interests of the noteholders to refrain from

6 *UBS AG London Branch v. Glas Trust Corporation Ltd* [2017] EWHC 1788 (Comm).

7 *Satinland Finance Sarl & Anor v. BNP Paribas Trust Corporation UK Limited and Irish Nationwide Building Society* ([2010] EWHC 3062 (Ch)).

releasing such information. For example, the trustee may take the view that enforcement action is premature and could potentially and unnecessarily force the issuer into insolvency, which might result in less recovery for the noteholders (particularly if they sit lower in the capital hierarchy), as opposed to going down an out-of-court restructuring route.

In practice, trustees will take a very measured approach and seldom step outside of their comfort zone without noteholder ratification or court direction, for fear of opening themselves up to various liabilities. The relationship between the trustee and ad hoc group is crucial at this stage as the trustee will often require 'instructions' from the noteholders before it takes specific action. The key issue for an ad hoc committee is whether it carries sufficient weight in order to be able to deliver instructions to the trustee and drive forward its agenda, or alternatively to object to other noteholders' instructions or agenda. It is important to note that although the trustee will be conscious that it is dealing with an ad hoc group, it will ultimately seek instructions from each and every noteholder, as opposed to the committee's representative.

Breakdown of relationship between trustee and ad hoc committee

The trust indenture includes provisions that allow for noteholders to remove and replace the trustee (usually without the need for the issuer's consent). Removal of trustee provisions serve as an important solution to dealing with a difficult or uncooperative trustee, or one who the ad hoc group perceives to be too 'pro-borrower'. This course of action also potentially allows the ad hoc committee to drive the appointment of a new trustee who would be more amenable to taking the actions that the group requires. However, in practice, changing and replacing a trustee can be a lengthy and cumbersome process, especially in a time-sensitive context.

Ad hoc committees' relationships with agent banks

Syndicated loans will generally use an 'agent bank' or a 'facility agent' that acts as a representative for the borrower and lender. Debt securities can also be issued using a fiscal agency structure (although in certain cases a trustee is mandatory), particularly in more 'vanilla' issues of debt; however, in this context, an agent bank is usually a representative of the issuer. In each case, like a trustee, the agent bank is interposed between the issuer and the noteholders and lenders, however, the agent bank's role is almost entirely administrative in nature and (subject to the terms of the agreement) restricted to a limited number of duties, such as managing communications and funds flow between relevant parties, informing lenders where events of default have occurred, maintaining records and registers of lenders, publishing notices, acting as a depositary of information for inspection (e.g., annual no-default certificates), and redeeming or replacing securities.

Ad hoc committees are likely to find their relationship with an agent bank more muted than with a trustee, given the limitations inherent in an agent's role. This approach was supported by the courts in *Torre*,[8] where the agent (RBS) failed to pass along certain information to the investor in relation to financial reporting. The information would have revealed breaches of various covenants the borrower was subject to, which would have permitted the investor (Torre) to call in its loans and enforce its security at that stage. The borrower

8 *Torre Asset Funding v. RBS* [2013] EWHC 2670 (Ch).

subsequently defaulted and went into administrative receivership. The court found that the contractual duties assumed by RBS as agent were tightly defined and limited in scope, and it would be commercially unrealistic to import any additional duties under the common law of agency. The court also found that there was no duty to pass on information that does not fall within the ambit of the documents that need to be relayed under the terms of the agreement. Accordingly, the relationship between an ad hoc committee and an agent bank will normally be tightly defined by the parameters of the agent's role, as expressly set out in the overarching agreement. The general presumption is that no duties or discretion exist beyond this.

Lenders and ad hoc committees will generally need to take an active role and proceed with as much caution as they would were the facility a bilateral arrangement; for example, the onus is usually on the lender to appraise and investigate the risks involved in its commitment. However, the wording of the facility agreement will need to be closely reviewed, as certain agents may assume a more extensive role, for example, they may agree to provide certain commentaries and analyses.

Ad hoc groups will be aware that agent banks generally do not have the same discretionary powers as trustees (and even where they may be given limited discretionary powers, they will be reluctant to use this and almost always require instructions from majority lenders). Unlike trustees, agents usually cannot make any amendments to terms and conditions of the notes, grant certain waivers or authorisations, determine whether an event is material or immaterial, or consider if acceleration is the best course of action. Given that an agent bank does not assume a relationship of agency or trust with the noteholders (indeed, under LMA terms, any fiduciary or trustee duties are normally expressly excluded), noteholders need to take a more pragmatic and vigilant role.

The dynamics of an ad hoc committee's relationship with the agent bank is generally more simplistic, in that there is no need to persuade or sway the agent in a particular way. The agent will act upon the instructions of the majority of the lenders (acceleration per the LMA facility agreement is a majority lender decision; i.e., lenders holding one-third of the loan commitments). Provided that the ad hoc committee carries sufficient weight, it will be able to deliver necessary instructions to the agent, which the agent will act upon (e.g., to accelerate the loan or take enforcement action). In practice, the bigger challenge tends to be assembling an ad hoc committee comprising lenders who share the same consensus and have sufficient firepower to instruct the agent – this can be particularly difficult if the debt is trading on the secondary market and swapping hands at a fast pace. Further, it should be noted, once the ad hoc committee has given the agent instructions, there is a need to 'maintain' this consensus among lenders. This was an issue encountered in *Charmway Hong Kong Investment*,[9] where a group of lenders (representing a majority of lenders) initially instructed the facility agent to commence enforcement action against the borrower's assets. As a result of numerous secondary trades thereafter, the majority lender group changed along with the instructions to take enforcement action against the borrower.

Enforcement works in a different manner under the agency structure because each lender or noteholder has the right to accelerate with respect to its own commitments only (as opposed to the acceleration of an entire commitment or series). However, as indicated

9 *Charmway Hong Kong Investment v. Fortunesea (Cayman) Ltd & Ors* [2015] HKCU 1717.

above, initiation of enforcement proceedings is a majority lender decision, so therefore, lenders would still need to proceed through the collective action mechanism of instructions via the facility agent.

Liabilities and indemnities

Under a trust indenture, the trustee is given various indemnities. However, before accelerating the notes, a trustee may want an additional, wider or more substantial indemnity from noteholders covering its costs, expenses and potential damages, which may result from taking specific action. Such an indemnity may cover predecessor trustees and usually extends to all losses, liabilities and expenses of the trustees. The trustee is generally not required to take any action unless it is appropriately indemnified or pre-funded. Under English law (and often by virtue of the terms of the indenture itself) it is not possible to exempt or seek an indemnity against liability for negligent acts, negligent failure to act, or wilful misconduct, however, in certain cases there may be carveouts for errors in judgement otherwise made in good faith.

In practice, agreeing to an indemnity to the satisfaction of all parties concerned can be challenging, and especially more so given that negotiations may take place during a time-sensitive period where the issuer is showing signs of distress or may have already defaulted (hence the need to act quickly). On the one hand, the trustee will want the indemnity to cover as many eventualities in order to protect its own funds, whereas on the other, noteholders will want to limit their exposure and impose monetary caps on their liability. Noteholders will likely also be conscious that if the issuer goes down the insolvency or restructuring route, they may already be out of the money to an extent before any trustee indemnity potentially kicks in.

This tension was apparent in *Concord*,[10] where the Court of Appeal considered whether a trustee was entitled to call for a €1 billion indemnity from noteholders prior to accelerating the notes. The trustee in *Concord* was concerned that the issuer disputed that an event of default had occurred and intimated that it would challenge any acceleration notice. The trustee's view that it may face a substantial claim for damages by the guarantor of the notes was not shared by the House of Lords, which declared that if there was indeed no event of default, then the acceleration of the notes would have no legal effect, so although the Court accepted the trustee was contractually entitled to seek an indemnity to cover the cost of the proceedings to determine the validity of the acceleration notice, it could not extend the indemnity to cover damages for loss caused by the giving of an invalid notice.

The *Concord* decision is helpful because:

- It clarifies that where conditions to accelerate payment under a trust deed have been satisfied, the trustee must serve a notice of acceleration where requested by noteholders: 'As between the Trustee and the bondholders it was not open to the Trustee to argue that an Event of Default had not happened, or might not have happened, or that anything more needed to happen before the mandatory obligation on the Trustee . . . to give the notice of acceleration arose.'[11] From a practical perspective, this makes sense given the delays, costs and administrative burden that noteholders would need to bear if trustees and agents needed to obtain directions from the court before triggering acceleration.

10 *Concord Trust v. Law Debenture Trust Corp Plc* [2005] UKHL 27.

11 Lord Scott of Foscote (para. 27).

- The burden is on the issuer, not the trustee, to challenge the occurrence of the alleged event of default, and consequently, the validity of the acceleration notice. If the issuer succeeds, then the acceleration notice can be ignored, since it was not valid and, therefore, ineffective.
- The decision also gives some comfort to trustees and agents that the acceleration of bonds on the basis of an incorrect assessment that a default had occurred, does not give rise to contractual or tortious causes of action against the trustee or agent (and potentially also extends to the noteholders and banks they represent).

Noteholders will want their liability to fall away in the event that they sell their noteholdings. In terms of releasing the noteholders from an indemnity, the trustee will require the purchaser of the relevant notes to provide a back-to-back or similar indemnity. Alternatively, if the trustee refuses to release the noteholder from the indemnity (for example, it may not be satisfied with the creditworthiness of the potential purchaser), the noteholders may find themselves in an undesirable position where the notes have been sold on to a third party (therefore, essentially relinquishing control of the asset), with the seller of notes remaining liable under the indemnity.

In terms of syndicated loan agreements, these will often contain very wide exclusion of liability provisions that protect the agent from anything beyond its pre-agreed duties. Indeed, one of the main reasons behind the agent bank's limited administrative and mechanical role is to shield it from unwanted liabilities. The agent is normally protected from any liability whatsoever (including for negligence), unless there is actual loss that emanates from its action or inaction, as the case may be. The agent will also benefit from a range of indemnities, including the indemnity given to all finance parties, and an indemnity from the borrower's parent company for any cost, loss or liability incurred in the discharge of its duties as agent (except for any losses that arose as a result of the agent's own gross negligence or wilful misconduct). Lenders are also required to indemnify the agent. To the extent the borrower's indemnity does not cover the agent, the lenders' indemnity will kick in to reimburse the agent.

Conclusion

The relationship between an ad hoc committee and a trustee is an important one, which can be beneficial to both sides. For ad hoc groups, the trustee is their independent and prudent watchdog and spokesperson who looks after their interests and acts for their benefit. However, at times of the issuer's distress, or when there is friction or a divergence of opinions between noteholders, the relationship between an ad hoc group and the trustee can be used as a platform to allow smaller noteholders to exert influence and be heard, and in turn, steer the issuer or block institutional noteholders. Trustees will use ad hoc committees to gain insight into how the noteholder pool is leaning and thinking. As set out above, although the trustee has a certain amount of discretion, it is very unlikely to use this discretion where there is risk to noteholders' investments, or where it is aware that noteholders may not share its views, for fear that this may attract unwanted liabilities and put its personal assets at risk. Ultimately, the relationship between the trustee and the ad hoc committee can help each side to consider the various options at hand and make a more informed decision as to the best course of action.

Although it is important for the trustee to take into account ad hoc committees, the trustee will no doubt be mindful of its overarching duties to the noteholders as a whole. Balancing the interests of ad hoc committees and noteholders generally (who may be silent or, conversely, may have formed other ad hoc committees) can present its own set of challenges. The extent to which an ad hoc committee will influence and sway the trustee will often depend on its representative value and the composition of the noteholders in the group, and their relative firepower and goals. However, if the trustee is not satisfied that the correct approach is being proposed, it can apply to court for directions in order to fully protect itself before taking any action.

The trustee and ad hoc committee relationship is dependent on a range of factors, but will mainly stem from the particular noteholders and their approaches (i.e., aggressive, proactive or passive), and also the type of trustee that is in place (whether it is pro-issuer or pro-noteholder). Depending on the trustee's skills and experience, the ad hoc committee may trust and buy into its approach, or seek to replace it with a more amenable or appropriate trustee.

As stated above, the relationship between an ad hoc committee and an agent bank is more mechanical in nature and will turn on whether the ad hoc committee represents a sufficient majority of the amounts outstanding to either instruct the agent bank to take action or block instructions from others.

Appendix 1

About the Authors

Ben Klinger LLP
Brown Rudnick

Ben Klinger is a partner in the bankruptcy and corporate restructuring practice in London.

Ben has broad experience advising corporates (including large multinational groups), insolvency practitioners, institutional lenders and other creditors. He also has experience in relation to workouts/restructuring of distressed structured finance transactions along with leveraged and syndicated loans. Additionally, he has extensive experience advising in relation to security and insolvency law aspects of structuring new commercial, structured and leveraged finance transactions.

Ben was recognised in *The Legal 500* in the area of corporate restructuring and insolvency, with clients praising his 'ability to understand the economic, commercial and business points of a deal'.

Prior to joining Brown Rudnick, Ben was a partner at Sidley Austin LLP.

Sabina Khan LLP
Brown Rudnick

Sabina Khan is an associate in Brown Rudnick's bankruptcy and corporate restructuring team in the London office. Sabina's practice focuses on restructuring, finance, insolvency and debt trading matters. She acts for a range of clients including private equity funds, hedge funds, sovereign entities, creditors, debtors and corporates. Sabina is experienced with asset sale agreements, finance and security documentation, leases and guarantees. She also regularly advises in relation to the sale and purchase of distressed debt throughout Europe.

Prior to joining Brown Rudnick, Sabina spent over six years in investment banks, including JPMorgan and Deutsche Bank, working in the debt capital markets and derivatives space.

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The Art of the Ad Hoc – published by Global Restructuring Review – is a guide on how to work successfully with ad hoc committees. To borrow from Hon. James M Peck in his introduction, 'art' is the right word for a discipline driven as much by 'creativity, improvisation, intuition and occasional inspiration' as by 'dry logic'. *The Art of the Ad Hoc* draws on the collective wisdom and real life experiences of 20 distinguished practitioners from 10 different firms to illuminate this art.

Part I explains an ad hoc committee's formation and organisation; Part II, its activities and powers; and Part III, what trading committee members may undertake. There is an emphasis on the practical throughout.

Published digitally at GlobalRestructuringReview.com and updated annually, the editor and publisher hope that, over time, the guide will codify best practice in this area. *The Art of the Ad Hoc* is the first title in the GRR Guides series.

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