GRR

THE ART OF THE AD HOC

THIRD EDITION

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

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Publisher's Note

Welcome to *The Art of the Ad Hoc* – part of the Global Restructuring Review technical library.

GRR, for anyone unfamiliar, is the online home for all professionals who specialise in high-stakes restructuring and insolvency, with a particular focus on cross-border aspects. We tell our readers everything they need to know about all that matters, wherever it takes place.

As well as guides such as this, GRR readers get access to our daily news, surveys and features; GRR Live events; and innovative tools and know-how products.

The origin of this volume lies in an observation that there was a gap in the literature. No book yet systematically covered all aspects of the institution known as the ad hoc committee.

The Art of the Ad Hoc fills that gap and has all the answers. In plain English, it guides you through how to work successfully with these committees, illuminating an activity that is, at its core, 'an art'.

This is our third edition, which has been updated to keep pace with changes in practice. We once again benefit from the collective wisdom and real-life experiences of 18 distinguished practitioners from eight firms. We are confident you will find it an essential desktop reference work.

I would like to convey my personal thanks to these authors and my LBR team for their sterling work. And to the editors, for their energy and vision.

If you have suggestions for this, or other GRR guides, please do not hesitate to get in touch at insight@globalrestructuringreview.com.

Contents

Editors' Preface

It is pleasing that *The Art of the Ad Hoc* is now in its third edition. We are most grateful to the expert authors who contribute to the book.

James Peck's introduction to the second edition follows this preface. We cannot better it as a cogent overall perspective on the book's subject matter, explaining its key commercial and legal context. As, at the time of writing, the global economy appears to be on the verge of a profoundly testing time for businesses, the role and importance of ad hoc committees is only going to be more extensive and of greater consequence. Ad hoc committees enable clarity and help to structure an organised response to a company's financial problems. Out of the clamour of increasingly anxious voices raised when a company runs into distress, an ad hoc committee can focus the creditor case, enable effective communication and progress towards the goal of restructuring. There is the art element, assembling a committee, organising and creating a working relationship with the debtor and its advisers. The work of an ad hoc committee is done within a framework of legal rules from a variety of sources, some of great rigour, and practice, ways of doing things whose familiarity to the participants helps the crucial work of negotiation.

Therefore, this book is not simply a legal text but the product of the insights of specialists in a practical field that is informed by a variety of legal disciplines.

We want to thank, again, the authors of the following chapters and the publisher, GRR, and its production team, especially Georgia Goldberg and Hannah Higgins.

Howard Morris and Sonya Van de Graaff
Morrison & Foerster LLP | Katten Muchin Rosenman LLP
September 2022

Part I

Formation and Organisation of an Ad Hoc Committee in a Restructuring

CHAPTER 3

Selection and Organisation of Members and the Process of Formation

Yen Sum and Hugo Bowkett[1]

Introduction

The primary purpose of an ad hoc committee is to engage in potential restructuring or capital structure amendment discussions and negotiations with the debtor and, where applicable, other stakeholders (e.g., shareholders and other creditors). The ad hoc committee will provide the perspective of the class of creditor informally represented by that committee. A restructuring proposal may be formulated by the debtor or the ad hoc committee but, in any event, will be negotiated between them and, in an ideal scenario, result in an agreed plan being presented to the whole creditor class for approval or support.

Engagement with an ad hoc committee that is representative of a particular constituency of creditors provides a forum for discussion and provides assurance for both the debtor and the creditors that an orderly process is being undertaken. The fact that a representative group of influential creditors is leading discussions is likely to assist other creditors in the class, particularly if the committee members are representative of the types and sizes of institutions constituting the broader class of creditors, and if the members have extensive experience and expertise of restructuring.

Therefore, it is important that the committee is broadly representative of the applicable syndicate of creditors and, if possible, holds sufficient debt to provide or build momentum towards the necessary consents to implement a restructuring.

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1 Yen Sum is a partner and Hugo Bowkett is an associate at Latham & Watkins LLP.

In consensual restructurings where the creditor group and the debtor are aligned, an ad hoc committee composed of creditors with sufficient debt holdings, restructuring expertise and the ability to provide new money within the required timescale provides a helpful platform for agreeing a deal. A representative committee brings several benefits to the process: giving the debtor confidence in the committee's ability to act as a legitimate sounding board and to persuade other creditors in that class to agree on the restructuring plan; providing confidence to the remainder of the syndicate that their position in the capital structure will be represented in the restructuring discussions; and giving the debtor (and, where relevant, other stakeholders) a degree of confidence in the ability to execute the restructuring.

If the creditor group and the debtor are not in agreement about the proposed restructuring path, the ad hoc committee will seek to speak on behalf of the wider syndicate (without assuming any fiduciary duty to any other creditor or person) in discussions with the debtor or with other stakeholders, with the objective of ensuring that the views and aims of that class are fairly represented and taken into account.

How many committees?

In a multi-layered capital structure, one of the first questions to arise is the number of committees that will be required.

In practice, the number of committees will ultimately reflect what is necessary in the circumstances and will be influenced by a number of factors, such as:

- valuation assumptions (affecting views on where the value breaks and determining the key fulcrum creditors);
- the economic convergence or divergence between different creditor groups;
- the relative rights and obligations of the different creditor groups;
- the proposed treatment of the different creditor groups as part of any restructuring; and
- the relative strength of the negotiating position of the various stakeholders, including the debtor, shareholders and other classes of creditors.

In addition, the debtor will be mindful that the formation of multiple committees will increase restructuring costs and may hinder swift implementation, because of the need to discuss and agree the restructuring proposal with each committee separately. Accordingly, the debtor may advocate consolidation across various syndicates into a limited number of committees.

The appetite of creditors to consolidate will also be heavily influenced by the available valuation evidence and which creditors are thought to be 'out of the money'. It would be highly unusual for 'in the money' creditors to be represented in the same committee as creditors whose debt (based on market assumptions) is 'out of the money' (i.e., unlikely to be able to be repaid through a sale of all the business and assets of the obligors and a distribution of the proceeds of that sale).

Broadly, creditors will need to be satisfied that they are grouped in a committee with creditors with whom they share equivalent or similar rights, so they can meaningfully consult together and there is no apparent conflict of interest. This is likely to be most straightforward with a syndicated facility agreement governing one class of debt. It may also be possible for creditors who, for example, share the same security package on a *pari passu* basis to form one committee (even if their rights are governed by separate credit agreements). Sometimes, creditors in the same class of debt form a separate group because certain creditors in that class have significant cross-holdings in a different tranche, while others hold the entirety of their claim in one tranche of debt, as their interests may not be aligned.

How is a committee formed?

Committee formation is not a rigid process and will vary with the particular situation, although there are recurring themes and general principles. Given the relatively informal nature of ad hoc committees, the selection and formation process is often similarly informal. The initial impetus for creditors to coalesce into a committee may be driven by a request from the debtor (whether formal or informal) or by proactive initiation by one or more creditors monitoring the situation (or a combination of the two).

Legal or financial advisers, or both, may be part of the formation process or may be appointed following the coalescing of one or more creditors. Once legal and financial advisers have been selected, the ad hoc committee will typically approach the debtor or shareholder and inform them of their status and seek engagement with the debtor or shareholder, or both, as applicable.

Typical considerations informing the decisions to admit institutions to a committee include: the size of the debt holdings of the individual committee members, as well as the aggregate position across the committee as a whole; the number of members and how that may affect the responsiveness and functioning of the committee; and diversity in the type of members and whether the group is representative of the creditor syndicate as a whole (as well as whether any particular creditor has a significant relationship with the debtor already).

The ad hoc committee (together with advisers) will often also discuss whether a *de minimis* level of debt holding should be required for membership and whether there should be any restriction on committee members with cross-holdings.

Committee members, or those wishing to join the committee, should expect to disclose their holdings to the advisers, who may (on request) keep the individual figures confidential while updating members on the aggregate holdings of the committee, to inform membership discussions.

Who should join?

Size and number

There is an inherent tension between ensuring that the committee represents a meaningful proportion of the syndicate while also enabling efficient functioning of the committee. Time is often of the essence, so an agile committee that is able to move quickly on key decisions will serve everyone's interests. As mentioned above, it may be necessary to determine a minimum debt holding for members to be accepted or remain in the committee, particularly where there is significant creditor appetite to join. Although the exact number depends on the circumstances and composition of each syndicate, three to five institutions as members is typically a helpful and manageable number in a standard committee. As a restructuring progresses, often the composition of the committee will alter as trading occurs and, as a result, the debt may consolidate into the hands of a smaller number of key creditors driving the restructuring.

The aggregate amount of the committee members' holdings will need to be reasonable as a proportion of the amount of total debt within the class of creditors represented by the ad hoc committee and, therefore, will affect the number of committee members needed. In a small syndicate, where the debt is concentrated in the hands of a limited number of institutions, the committee members' holdings are likely to be significant by value and by number of institutions. When the debt is more widely held (as in the case of a diverse and large bondholder group), a smaller committee holding may have to be sufficient to create a committee in the first place.

As a general principle, it is helpful to have the largest holders of the debt as members of the committee, given that those lenders have proportionately more to gain or lose in real terms from any restructuring and that their votes will have the greatest effect on reaching the relevant threshold to implement the restructuring. Their membership also adds to the committee's standing and legitimacy in the eyes of the debtor and other creditors.

Type

As noted above, it is generally advantageous for a committee to be both material in aggregate holdings across a class of creditors as well as representative of that class – this may require the committee to include different types of creditors, such as banks, funds, par lenders, distressed investors, mark-to-market investors and non-mark-to-market investors. However, this can lead to divergent approaches to the restructuring because of differing outlooks between different creditor types owing to different 'buy-in' prices, economic hurdles, structuring requirements and internal policies. The natural tension in strategy and desired restructuring outcome between different groups may need to be weighed up by institutions and advisers against the consequences of excluding a material creditor or creditor constituency who may feel aggrieved at being left out. In the worst case, an excluded member may pursue a competing strategy or vote down a fully formed proposal, resulting in potential delay and greater expense or even (in extreme cases) prevent a proposal from being implemented. Divergent interests may arise where distressed investors favour a restructuring that significantly deleverages a debtor's balance sheet, which may result in control of the business transferring to creditors (e.g., an enforcement or debt for equity), whereas some par creditors may be satisfied with a solution whereby the current shareholder retains control, and the debt terms are amended and maturities extended to give the debtor additional time to address any debt refinancing and servicing issues.

What are the obstacles to joining for individual members?

Actual or perceived conflict of interest

In some cases, a significant holder of debt may be excluded from an ad hoc committee if that holder is affected by an actual or perceived conflict of interest. This might arise if, for example, the creditor is affiliated with the debtor or shareholder and may have greater access to better information than the other creditors. Alternatively, a creditor may have significant debt holdings in a different tranche or another part of the capital structure (with different rights and obligations) or a creditor could also hold credit default swaps (CDS) in respect of their position, each resulting in a different negotiating position or interest. Therefore, the inclusion of committee members with cross-holdings across the capital structure or members who hold CDS can be a sensitive matter, given the potential for conflicts of interest between holders of the different tranches of debt or equity.

These conflicts (whether actual or perceived) may be managed, in certain circumstances, by information barriers within the creditor institution (strengthened by the positions in the different tranches being managed by different investment teams or investment committees), or a limit on cross-holdings that are permitted while being a member of the committee. The potential for conflicts should be addressed early and, ideally, there should be an open dialogue among the creditors in the syndicate on any issues.

Public and private information

Increasingly, at least in the early stages of discussions when the debtor's restructuring options are still being explored, many creditors will be keen to ensure they remain recipients of information that is either public, or not considered to be price sensitive, so that they may continue to trade in the debt in the secondary debt market. This relates particularly to public securities where insider dealing and market manipulation laws and regulations apply. However, even in the private loan market, institutions regulated by the UK Financial Conduct Authority and the US Securities and Exchange Commission and similar financial regulatory bodies may take a cautious view – while some are willing to trade their debt on 'big boy' letters, other creditors prefer not to do so and are cognisant of conduct obligations imposed by regulators as well as applicable Loan Syndications and Trading Association (LSTA) and Loan Market Association (LMA) guidelines.

Naturally, this needs to be balanced against the potential need of the debtor to share private information with the members of the ad hoc committee to advance the restructuring discussions and demonstrate the debtor's liquidity constraints.

Creditors have become more alive to the potential for their trading to be restricted once they join an ad hoc committee given the approach outlined in the LSTA and the LMA guidelines. These suggest that committee members are likely to be in receipt of debtor confidential information that is not available to the syndicate as a whole (thereby curtailing the committee members' ability to trade).

These concerns can be dealt with by instructing the debtor to provide material non-public or price-sensitive information to the advisers in the first instance. The advisers then act as an information barrier and only share public information with the committee. This approach is often adopted in the early stages of a deal where creditors will seek a steer from the advisers when to opt to receive private information and become restricted.

If creditors agree to become restricted, they will seek to agree a disclosure or 'cleansing' mechanism whereby the committee will agree to receive private information for a limited period, following which the debtor will be obliged to release the private information to the market and, if not, the committee members may be able to release the information publicly themselves. The effect of such a disclosure is to 'cleanse' the committee members of that information so they are no longer 'insiders'. Following cleansing, the committee members cannot be accused of trading on material non-public information (MNPI) of which their trading counterparty is unaware. Disclosure mechanisms are typically heavily negotiated. Committee members are often unwilling to be in possession of MNPI for a significant period, and the debtor is likely to be unwilling to release potentially commercially sensitive (and, in the opinion of management teams, value destructive) information publicly before a restructuring has been agreed, or at all (if there is a possibility that the information could fall into the hands of industry competitors). One solution may be for any particularly commercially sensitive information to be shared only with advisers on the basis that it will never be disclosed publicly.

The concerns about sharing information that may constitute MNPI should be addressed early with the debtor to ensure the debtor understands the issue and will manage the information flow appropriately. Committee members need to be comfortable that the debtor will not inadvertently provide them with MNPI without prior warning (e.g., unsolicited emails or written documents, or disclosure by management on diligence calls or trading updates).[2]

Sub-participation and elevation

If creditors hold their debt through sub-participation and have not been elevated to the status of lender of record (e.g., because the debtor has a consent right and refuses to elevate the creditor, or the creditor is unable for operational reasons to step into the shoes of a fronting bank), this can create additional issues in certain jurisdictions if a sub-participating creditor holds a meaningful stake and wishes to form part of the committee. For example, this could be problematic in France where only the lenders of record are entitled to take part in, or receive information in relation to, confidential proceedings such as conciliation or *mandat ad hoc*.

The benefit: being in the driving seat

Despite these potential obstacles and the degree of work involved for an institution (where a small investment team may be tasked with managing a number of different portfolio investments), membership of an ad hoc committee is still an attractive path for certain creditors. This is particularly so if they hold a significant investment that they wish to manage proactively and use their position to drive the restructuring discussions.

2 For further discussion about public and private information, see the chapter on the insider/outsider conundrum.

When is the right time?

When the need for a restructuring becomes apparent, creditors should be proactive in organising and approaching the debtor early with a view to opening a constructive dialogue and shaping the restructuring discussions. Early engagement is important, not only because the debtor itself may be under timing constraints – for example, if liquidity is severely constrained or a waiver is needed urgently – but also because it will take some time for the committee itself to organise. This is especially the case if the committee decides to document its appointment or existence (see further below). The timing of the committee's formation will also be affected by the size of the creditor syndicate – whereas a small loan syndicate can organise relatively quickly, the organisation of a large bondholder syndicate may require longer.

Despite these legitimate timing concerns, the debtor may seek to delay formation of, or engagement with, the ad hoc committee. There may be for various reasons for this:

- the debtor may simply want to buy itself time to evaluate its situation and formulate its own restructuring plan without creditor input or distraction. Debtors will often be cognisant of the heavy diligence burden and the effect on management time that accompanies engagement with committees (but it may be time well spent);
- the debtor may wish to manage liquidity demands by avoiding a formalised committee incurring adviser costs that the debtor will ultimately be asked to pay;
- the controlling shareholder of a debtor may influence the debtor to engage as late as possible with creditors to give the creditors less time to react to a proposal, particularly if the shareholder wishes to retain control of the process;
- the credit agreements may specify that it is a default to commence negotiations with creditors (thereby requiring the debtor to approach creditors for a waiver); and
- similarly, the announcement of the formation of an ad hoc committee with a view to commencing restructuring discussions may have a public relations impact. It may adversely affect commercial contracts (e.g., by triggering termination rights or a renegotiation of contract terms), lead to customer and supplier attrition and trade credit or insurance issues, or draw the scrutiny of any relevant regulator or other stakeholders (e.g., pensions trustees).

If the debtor has no need to engage with the creditors at the current point in time (because there are no liquidity issues or forthcoming debt maturities that cannot be refinanced, no waivers are required and no event of default is expected), the creditors will be hard-pressed to force the formation or recognition of an ad hoc committee on the debtor. This may become a familiar situation given the proliferation of covenant-lite term loan B and high-yield incurrence-style covenants in credit terms and documentation in the European capital markets and European private debt markets. In such a situation, creditors may be well advised to remind the debtor of the benefits of a pre-formed sounding board if any negotiations or waivers are likely to be required in the future (e.g., if the group seeks to make an acquisition as a means of improving operating profits) or to ensure that the company does not fall into severe distress before restructuring discussions are commenced so that value may be preserved for all stakeholders.

Documenting the committee's formation

As the committee is forming, its members will need to determine (with the assistance of advisers) how far they wish to document their relationship. In the case of more formal coordinating committees, in the past, the documentation has consisted of:

- (most commonly) a letter with the company to provide for (among other matters) recognition of the ad hoc committee, fee coverage, exclusion of liability, indemnities, and confidentiality and disclosure (though confidentiality and cleansing may be covered in a separate non-disclosure agreement);
- (sometimes) a protocol among the members of the committee to govern, for example, decision-making, confidentiality, information-sharing, cross-holdings and eligibility to remain on the committee. Some regulation of dealings within the ad hoc committee, in terms of composition, conflicts, minimum debt holdings, cross-holdings and decision-making processes, may be included in adviser engagement letters; and
- (now almost non-existent) a letter with the rest of the creditor syndicate to provide for indemnity coverage and exclusions of liability in favour of the committee.

The key concern for ad hoc committees is to ensure that they are able to access independent advice to help formulate and evaluate any proposals. Therefore, some form of documentation is beneficial to the committee as a means of ensuring that, at a minimum, their costs and expenses are covered. It is usually advisable to also address non-disclosure of confidential information and cleansing concerns. Exclusions of liability are also likely to be included in any relevant transaction documents (e.g., lock-up or restructuring support agreements and implementation documentation).

Despite the benefits of formalising these arrangements, the committee may decline to put formal documentation in place and may instead prefer to rely on more informal, verbal or ad hoc arrangements. This approach may be adopted if, for example, timing or costs are tight and the committee needs to dive straight into the substantive restructuring discussions. Alternatively, committee members may wish to remain at arm's length as an informal working group, with a fee arrangement only with the debtor and the individual committee members bound by their own adviser engagement letters.

Next steps

Once the initial ad hoc committee is formed, the committee should formally approach the debtor, putting the debtor on notice of the committee's existence and of the amount of debt it represents. Depending on the confidentiality of the negotiations with the debtor, the ad hoc committee may also consider informing the applicable creditor class of its formation so that any views on or enquiries about the capital structure and restructuring process from the class may be directed to the committee.

The debtor should now have the benefit of a cohesive group representative of its creditor constituency to smooth the path for any waivers, consents or agreements that may be required, and to act as an informal proxy through which the applicable creditor class conducts restructuring discussions. The creditors in the relevant class should have the benefit of a working group towards which it may direct queries, suggestions and feedback on the potential restructuring.

APPENDIX 1

About the Authors

Yen Sum

Latham & Watkins LLP

Yen Sum has built a top-tier UK and European restructuring and special situations practice and leads a team of 30 professionals. She has more than 20 years of experience in advising senior management, private equity sponsors, credit funds and hedge funds on financial and operational restructurings, special situations and alternative investments across the capital structure. She also advises on associated mergers and acquisitions and buyouts, acquisition finance and fund investments.

Yen is particularly focused on cross-border structures, or those requiring new or innovative thinking and multifaceted solutions across corporate balance sheets, as well as managing divergent stakeholder interests. She has led or has been involved in a number of notable and prominent transactions, including investments within multi-layered capital structures, public and private securities, schemes of arrangement, security enforcements, UK administrations and company voluntary arrangements, US Chapter 11, and in and out-of-court proceedings in France, Germany, Luxembourg, the Netherlands, Spain and Switzerland, and equivalent processes in other jurisdictions.

She also spent several years as a banking professional in Barclays Capital's leveraged finance business, where she was involved in numerous buyouts, refinancings and recapitalisations.

Hugo Bowkett

Latham & Watkins LLP

Hugo Bowkett has wide experience in acting for various stakeholders on finance, special situations and restructuring matters. He advises on complex, multi-jurisdictional transactions that often entail negotiating and managing the interests of different stakeholders throughout the capital structure.

Latham & Watkins LLP
99 Bishopsgate
London, EC2M 3XF
United Kingdom
Tel: +44 20 7710 1000
yen.sum@lw.com
hugo.bowkett@lw.com
www.lw.com

With changes in credit markets, traditional steering committees – now seen as too slow and unwieldy – have fallen from favour in restructurings. Enter the ad hoc committee. It takes less time to set up, is more flexible and can achieve better results.

Understanding the rules that govern these committees and their inner workings is essential. *The Art of the Ad Hoc* has all the answers. In plain English, it provides a comprehensive guide to how to work successfully with these committees, an activity that Judge James M Peck says in the Introduction is rightly described as 'an art'.

The Art of the Ad Hoc draws on the collective wisdom and actual experiences of 18 distinguished practitioners from eight firms to cover several angles and perspectives – particularly those of committee members and debtors. It is an essential desktop reference work.

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