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Turnaround Topics

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Independent Directors for Private-Credit Borrowers: When and Why

Private credit lenders are increasingly turning to the appointment of independent directors to boards of troubled private credit lender borrowers (and the appointment of independent managers to boards of managers of limited liability companies) when circumstances dictate, such as unaddressed liquidity issues, lack of trust and credibility of a borrower's fiduciaries, potential for self-dealing by a borrower's fiduciaries and more. The reason and timing of such an appointment is the critical inquiry.

Why and when should private credit lenders require borrowers to maintain an independent director/manager on their boards? The short answer is this: Terms of forbearance should include the appointment of an independent director/manager to facilitate an orderly and value-maximizing "board flip," if ultimately necessary, and to provide incentive for the current board, management and (private equity) ownership to work with the lenders in the meantime to avoid that maneuver and accomplish a successful, consensual restructuring.

Borrowers are reluctant to embrace an independent director (at any point in time) for fear that the resulting loss of partial/full control of the borrower's corporate governance will favor resolutions that maximize enterprise value in the short term for the lender's benefit, with no regard for a longer-term strategy that might capture value for equity. Private credit lenders are also fearful of introducing the concept of "independent directors" at a loan's inception given the competitive pressures of the marketplace, whereby an otherwise-competitive set of loan terms becomes undesirable with the addition of an "independent director" requirement.

Effective Use of Independent Directors

It is rare that a private credit lender making a loan to a borrower that actively operates a busi-

ness (as opposed to an SPE borrower) requires the appointment of an independent director at the inception of the loan. More common is the lenders' exercise of proxy voting rights after default to appoint an independent director of the lender's choosing to replace the borrower's board of directors/managers.

Borrowers are typically fearful of a lender-recommended independent director/manager entering the corporate governance fray, particularly at the later stages of a workout or out-of-court restructuring, or in anticipation of a chapter 11 filing. These fears include inappropriate leaks of privileged or strategic information to lenders, the cost of the director/manager (a cost that is usually borne by the borrower on a monthly basis), and the negative perception of the borrower's employees of such an appointment, which could lead to departures of key personnel. These fears are exacerbated as a borrower's financial performance further deteriorates, and as "interested" directors/managers become more willing to "roll the dice" on risky, bet-the-company strategies to achieve "in the money" status for equity, rather than pursue more rational and reasonable value-preservation strategies that could monetize the enterprise sufficient to maximize the value of the lenders' collateral, but leave junior stakeholders with zero recovery.

Lenders are similarly concerned about the negative impact of requesting that the borrower appoint an independent director/manager, particularly if the borrower refuses. Lenders' fears include an over-reaction by borrowers who deem such a request a precursor to remedy enforcement by lenders, the cost of the director/manager (which could require additional funding by lender), and the loss of key personnel of the borrower. Lenders' fears also are, and for the same reasons as borrowers, exacerbated if a borrower's financial performance further dete-



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riorates. While these fears are not misplaced, the effective use of independent directors/managers, the timing of their appointment in the workout/restructure timeline and forecasting their costs, among other things, can generally mitigate these fears and result in a successful restructuring transaction or series of transactions.

Corporate Governance Considerations

Principles of corporate governance play a material role in understanding the usefulness of an independent director/manager to borrowers in distressed situations. Adding an independent director/manager who enjoys the lender's confidence, and who has troubled company and financial advisory expertise, can produce a "win-win" result for the borrower and the lender. The duties of independent directors/managers are no different than other members of the board. An important distinguishing factor is the independent director's/manager's "independence" from management and (private equity) ownership.

A board dominated by or exclusively comprised of members of management and ownership might eventually face decisions concerning the restructuring or workout of the borrower's capital structure and other decisions that directly impact the interests of those individuals serving on the board. Consequently, directors/managers of a corporation/limited liability company generally enjoy the protections of the business-judgment rule, which guards those individuals from liability for bad decisions in hindsight, as long as the decisions were made in good faith and in the reasonable business judgment of those individuals consistent with their respective duties of care and loyalty.

In a situation where the decision impacts the value of the board members' and/or management's economic interest in the company, without an independent director/manager, those "interested" directors'/managers' decisions will not be subject to the reasonableness standard of the business-judgment rule. Those decisions will be evaluated under the "entire fairness" standard of review, which requires a rigorous analysis of what each director considered and relied upon in making the decision, as well as the degree of self-interest such individuals have in the transaction(s) under consideration.

The appointment of an independent director/manager mitigates, if not completely alleviates, "interested" director/manager liability for self-interested decisions. Thus, the appointment and decision-making of an independent director/manager insulates management and ownership while giving lenders confidence that the decision is free from self-interest to the lenders' detriment. The question of when to introduce the appointment of an independent director/manager therefore becomes the critical question. There are a couple of natural points in the life of a loan where appointment of an independent director/manager may be considered.

When Is the Right Time to Appoint an Independent Director?

The first point in time where the appointment of an independent director/manager can occur is at the time

that the loan is made. This type of requirement is not marketplace competitive and is thus a nonstarter in the current marketplace. Even so, lenders typically negotiate for proxy/voting rights such that upon default, a lender can exercise those proxy/voting rights (sometimes with, and sometimes without, prior notice to the borrower) to "flip the board."

The exercise of proxy/voting rights and the subsequent/simultaneous board flip after default is another point in time to introduce an independent director/manager. At this juncture in the loan cycle, it is the last-resort remedy for lenders to legally influence borrower decision-making through an independent director/manager.

If including provisions in the loan agreement at the inception of the loan that address when an independent director/manager should be appointed is a nonstarter for the borrower, and installing an independent director/manager upon the exercise of proxy/voting rights to flip the board to accommodate the nonconsensual appointment of an independent director/manager is similarly suboptimal to the lender, then the middle ground is to require such an appointment in the first forbearance agreement between borrower and lender following a default. The loan agreement can include a provision that upon the occurrence of an event of default, a pre-identified "independent" individual will automatically become a member of the borrower's board (preferred, but difficult to require in the current marketplace), or such a requirement can be a condition to lender forbearance and included in a forbearance agreement. The rationale for this approach is the balance that it creates for borrower/lender arms'-length negotiations.

The borrower's board member insiders (management and ownership) are insulated from claims of breach of the duty of loyalty (and the duty of care) and can freely push self-interested positions, while the independent director/manager negotiates and (hopefully) ultimately agrees with lenders on restructuring details. Such a "set-up" would also allow for the borrower's current board members to remain in place, rather than being replaced by the lender's chosen independent fiduciary. The alternative — the "board flip" — removes the voice of equity from the restructuring conversations and decision-making, which might be detrimental to value-maximization for the benefit of equity.

From a borrower's perspective, the requirement of an independent director/manager appointment (without removal of the existing board members) upon default provides instant credibility with its lenders and gives borrowers access to a workout/restructuring-savvy professional to assist, as well as a direct independent, unconflicted line of communication (as needed) to the lender. A borrower's decision to embrace an independent director/manager upon default eases its lender's lack of trust in the borrower and could likely delay, if not alleviate, the need for a "board flip." The participation of an independent director/manager in restructuring negotiations and decisions has the added benefit of protecting interested/conflicted board members (management/ownership) from the scrutiny of an "entire fairness" review in favor of the more lenient business-judgment standard of review. The overall benefit to both borrower and lender of appointing an independent director/manager is improved means for communication

and avoidance of miscommunications that might otherwise lead to further dysfunction to the detriment of the enterprise and enterprise value.

Conclusion and Food for Thought

The appointment of an independent director/manager early in the restructuring process can be in the best interests of the borrower, and thereby in the best interests of all of the borrower's stakeholders, including its lender. It seems counterintuitive that a borrower and lender would even discuss — let alone negotiate — an independent-director provision in a loan agreement, as neither party is entering into the transaction believing that there will be difficulty in abiding by the terms of the loan agreement.

That being said, this might be exactly what the parties should do if problems do arise in the future, as the borrower has already negotiated the timing and terms of appointment and the identity, duties and role of the independent director, and the lender has the protection of pre-negotiated terms for the appointment of an additional or replacement fiduciary. The overall benefits to both borrower and lender of independent-director appointments sooner rather than later in the loan cycle might be to save an enterprise from a liquidation or distressed sale in favor of a consensual workout or restructuring. **abi**

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