UNDERSTANDING THE ROLE OF THE INDEPENDENT DIRECTOR IN BANKRUPTCY

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In recent years, more and more distressed companies have appointed independent directors onto their boards to support the restructuring process, from the initial contingency planning through to plan confirmation and emergence from Chapter 11. Consequently, because it is now more likely that professionals in the turnaround industry will be working with independent directors or may have the opportunity to assume an independent director position themselves, restructuring professionals can benefit from a more comprehensive understanding of this role, as well as the genesis behind it and how independent directors may impact the corporate restructuring process.

The Basis for Appointing an Independent Director

Regardless of solvency, the appointment of independent directors and special committees is considered good corporate governance and, for public companies, a mandatory part of their listing requirements. A primary reason—and one of the most important benefits of appointing independent directors—is to enable the board of directors to avail

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itself of the business judgment rule if a transaction or decision is challenged. The business judgment rule protects a board's decisions, and courts will generally give deference to such decisions and are unlikely to question them, so long as the board members were clearly disinterested, acting in good faith, and acting in an informed manner. The business judgment rule provides officers and directors with their best line of defense if faced with breach of fiduciary duty claims brought by shareholders and/or creditors.

If a party challenging a board's decision can prove a lack of independence of the board members or that the decision-makers breached their fiduciary duties, the board loses the protection of the business judgment rule and the court will apply the "entire fairness" standard. This rule shifts the burden of proof onto the company to demonstrate that the challenged transaction was fairly priced and/or the result of a fair process. The entire fairness standard is much more exacting and significantly increases both the scrutiny of and the burden on the officers and directors.

Although public companies often have independent directors in place, private companies often do not, and the lack of an independent board member could be detrimental to the company if a transaction or board decision is challenged. As a general practice, therefore, private companies should consider appointing independent directors so the board's decisions, if later challenged, will be protected by the business judgment rule.

The appointment of an independent director is particularly warranted for companies that are both in the zone of insolvency and owned by private equity firms.

The best corporate practice is to appoint independent directors before an issue or concern with respect to liability or insolvency arises. If a company appoints an independent director on the eve of bankruptcy, for example, the board members risk scrutiny that they waited too long to take action, which could increase the likelihood of an investigation by creditors into the board's conduct prior to the appointment. In this scenario, the independent director may be viewed by creditors as unable to act in an objective manner and instead beholden to those who appointed him or her.

Independent directors are also important for portfolio companies of private equity funds. The boards of these portfolio companies are typically appointed by the private equity fund itself. Because these directors often hold positions at the private equity fund or are investors in the fund, they may be perceived to be acting in the best interests of the fund rather than the company, so their allegiance to the company may be scrutinized. The use of independent directors solves this issue.

Requisite Qualifications for Independent Directors

Whether a professional is tasked with advising on the appointment of an independent director or considering taking on the role themselves, understanding the requirements for the position is crucial, which usually will depend upon the circumstances and needs of the company. Fundamentally, independent directors should have a solid understanding of the company's business, as well as demonstrated experience with the potential transactions to be undertaken.

It is common for company board members and management to lack experience with bankruptcy and restructuring. In these situations, an independent director with corporate restructuring experience can deliver significant value and provide a stabilizing effect on the board and company in a time of crisis. Bringing in someone familiar with the restructuring and bankruptcy process and who speaks the language can provide significant benefits. The independent director's understanding of the process enables them to know which levers certain creditors and other constituents may pull and can coordinate and handle the communication with the company's stakeholders. This skill can be very valuable in allowing the company to avoid the noise and better understand how the process will play out.

From a practical standpoint, many independent directors are appointed to boards of companies that have never faced the challenge of needing to restructure their company—a situation that can be daunting and intimidating to a board. An independent director with corporate restructuring experience can help to stabilize the situation and provide many benefits to the company as it moves through the process. Furthermore, an experienced independent director can help alleviate the burdens of restructuring from the board and management, so they can focus their attention where it's needed most and continue to do their day jobs.

Whether the decision is made by legal counsel or the board, the selection of independent directors should be a robust, transparent process. In selecting an independent director, the board is bound by the company's organizational documents, procedures, and bylaws. The process will likely

involve seeking out and interviewing multiple candidates and choosing the appropriate candidate based on the company's needs and the challenges it faces. Within a restructuring process, the decision to appoint an independent director may be highly scrutinized by creditors, which underscores the importance of following best practices to minimize any potential concerns or challenges that may be raised.

The Roles & Responsibilities of Independent Directors

Companies typically establish a charter for the independent director(s) that outlines what they are intended to accomplish. The scope of this charter gives independent directors the ability to hire their own advisors at the company's cost, including legal counsel, financial advisors, and investment bankers. This capability is essential to the independent directors' ability to do their jobs effectively. It is also necessary to preserve, maintain, and protect the attorney-client privilege in situations where the independent director may be investigating the board and company's actions. Confidentiality must be kept between any special committees, independent directors, and legal counsel.

The primary fiduciary duties of directors and officers, including independent directors, involves both the duty of care, which requires directors to conduct business with a level of care expected from a conscientious and prudent director, and the duty of loyalty requiring directors to act in good faith with the intention and belief that their actions and decisions are in the company's best interest.

Within the restructuring process, independent directors have a variety of roles and responsibilities, including leading restructuring negotiations on behalf of the company with various stakeholders, potentially testifying in Chapter 11 proceedings regarding general restructuring matters, and investigating, prosecuting, and/or settling claims that the company may have against insiders and others.

There are several different claims that independent directors can be tasked with investigating/pursuing, including:

1 Preferences and fraudulent conveyances.

2 Dividend payments and dividend recaps.

3 "Liability management" spin-off transactions that may benefit a sponsor or former parent.

4 Conflicts of interest where directors and officers benefit at the company's expense.

5 Breaches of duty and other claims that may be released in a plan of reorganization.

6 Failed business strategies and transactions.

7 Misconduct by company personnel and other lawsuits against the company.

Upon the confirmation of a plan, independent directors typically conclude their duties and are discharged, as the reorganized company constitutes a new board. As any good officer and director knows, it is important that a tail D&O policy is put into place to ensure that they continue to have insurance coverage for the role they played after confirmation.

Independent directors can play an integral role in guiding companies through the restructuring process. While creditors and other stakeholders may have concerns regarding their appointment, professionals can minimize potential scrutiny by following best practices in the selection process. Despite potential pitfalls and considerations in how they can balance the needs of the company and their duties to remain objective, the benefits of appointing an independent director far outweigh the challenges they may face in fulfilling their duties. ■

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