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Turnaround Topics

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Considerations for Structuring a Board of Directors When Pre-Petition Lenders Get Equitized

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With the current tight credit market conditions and high borrowing rates, distressed M&A markets are not nearly as accommodating or robust as they have been in recent years. Consequently, lenders of all types (*e.g.*, banks, collateralized loan obligations, private-credit funds and hedge funds) to a distressed business should be prepared to be equitized in a reorganization scenario, and to own and operate the business upon emergence. In these situations, new shareholders will need to constitute a new board of directors. There are some unique considerations to keep in mind when forming a board for a company that has just emerged from bankruptcy compared to other companies of the same relative size or industry, whether public or private, although there are many overlapping considerations.

The importance of this new board cannot be overstated. In most situations, companies that emerge from bankruptcy have already suffered from years of underperformance, underinvestment, key personnel departures and significant cost-cutting, largely to headcount. Operations are lean with limited redundancy and flexibility. Given this backdrop, recruiting new management can be challenging. The new board of directors should be seen as an actively engaged advisory committee and an extension of the senior management team. The new board should also have the capacity and skill sets necessary to lean in and work with the executive management team to increase the likelihood of a successful turnaround post-emergence.

What Skills Should Board Members Have?

When considering the skill set of each board member, new shareholders should look to (1) the operations of the business, (2) the key strategic initiatives that will need to be executed to drive the turnaround, and (3) the amount of time that new owners are willing to wait for a liquidity event, typically an exit transaction. Understanding the operations of the underlying business should be a straightforward requirement for lenders willing to be equitized. Using a relevant illustrative example,[2] let's look at a restaurant chain with revenue streams from traditional company-operated restaurants, franchises and a licensing business.

The restaurant chain's major expenses would include rent to landlords, food-purchasing and labor. A major driver of dining traffic and brand awareness will be the chain's marketing strategy. The finance department is responsible for the company's budgeting and financial reporting. The intent should not necessarily be that each board member has all-encompassing expertise in these areas or that each board member has only one area of expertise. Rather, the goal should be that all candidates collectively embody leadership positions in their respective industries with a track record of success in relevant strategic areas of focus for the business.

In this example, there are other relevant skill sets that could be important for a new board, including general business expertise and a career of general business success (even if not specific to restaurants

1 The views expressed herein are those of the author and not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, its affiliates or its other professionals. FTI Consulting, Inc., including its subsidiaries and affiliates, is a consulting firm and is not a certified public accounting firm or a law firm.

2 The author also has been an independent director of California Pizza Kitchen since its emergence from bankruptcy in November 2020.

or hospitality), turnaround experience and success, or information technology and cybersecurity expertise, among others. However, boards come at a cost. The experts that equity owners rely on to help guide management teams and provide strategic advice do not work for free, so in these situations, boards need to be highly effective but lean in size. New shareholders must decide how to prioritize the skills that they want their new board to have, working within the financial constraints and limited number of board seats they are willing to fund. Equitized lenders who have already written down their positions before taking ownership of a business will not operate these businesses with a blank checkbook. Board members need to be able to work collaboratively with each other and with management so that they can be highly effective in their limited size.

Why Is the Hold Period Important?

"Hold period" refers to the length of time that the majority holders of the new equity are willing to retain their ownership position before a liquidity event, typically a sale of their equity stake or an enterprise sale. Post-emergence, equity sometimes (but infrequently) trades on a secondary market, which typically is not a deep or liquid market. The hold period will influence or dictate the capital-allocation decisions of the management team and its board.

The chairperson's ultimate focus is highly influenced by the timing of a liquidity event. For example, shareholders who have a relatively short hold period will typically be cautious or reluctant to fund growth capex with medium-to-long payback periods, because they will be concerned that if the business is sold before these investments come to fruition, buyers will not give full credit for such investments and their projected returns.

What Is the "Right" Number of Board Members?

An article from the Harvard Law School Forum on Corporate Governance based on a 2022 survey from Compensation Advisory Partners notes that the typical private company board size ranges from five to eight directors, with a median of six directors.[3] An odd number of board members is generally preferred in case votes are split, but an effective chairperson who knows how to drive consensus and board members who work collaboratively should be able to reach unanimous consent on most issues with vigorous debate and critical analysis. The "right" number of directors is a balance of explicit cost, adequate representation of shareholder interests, and having the capacity and skill sets necessary to guide and work with the executive management team and the chief executive officer (CEO) and other board members.

In addition to the work of providing strategic advice to the CEO and management team, board members serve on oversight committees, the most common of which are audit, compensation and nominating/governance. These oversight committees are important and can require substantial time commitments. A small board will likely work together on key issues, with board members effectively serving on all committees, whereas a larger board will designate different board members to each committee.

An additional consideration is the mix of independent directors and non-independent directors. Independent directors do not have a material relationship with the company and are not current or former employees of the company. Non-independent directors are usually current or former members of the executive management team. Generally, the CEO is a member of the board of directors, although not necessarily chairman. Other non-independent directors would include the chief financial officer, former CEOs to the company and other members of the senior management team.

Giving current management a seat on the board allows them to play a larger role in the deliberation of strategy, instead of only executing on it. There is no set guideline for what the precise mix of independent and non-independent directors should be. Independent directors provide a check on management and will provide an outsider's perspective on critical issues, while non-independent directors should come with an insider's depth of knowledge about the business, its history and historical performance, and strategies that have been implemented, whether successfully or not.

Should the CEO Be Board Chair?

A 2019 article notes that as of 2005, 30 percent of chairperson and CEO roles at companies in the S&P 500 were split, according to Institutional Shareholder Services. That had increased to 53 percent by 2019.[4] The trend appears to be largely driven by shareholder activists who seek better governance and more control over CEO compensation, and who believe that separating these roles will improve performance. A 2016 article citing the Seven Myths of Boards of Directors notes "no statistical relationship between the independence status of the chairman and operating performance," "no evidence that a change in independence status (separation or combination) impacts future operating performance," and some evidence that "forced separation is detrimental to firm outcomes. Companies that separate the roles due to investor pressure exhibit negative returns around the announcement date and lower subsequent operating performance." They argue that the costs and benefits of requiring an independent chair depend on the circumstances, and quote former head of the Federal Deposit Insurance Corp. Sheila Bair: "Too much is made of separating these roles.... It's really more about the people and whether they are competent and setting the right tone and culture."[5]

The CEO oversees the day-to-day business operations, while the board chair is charged with overseeing the company's overall strategic direction. The board chair does not come to conclusions on strategic direction on their own; this occurs only after robust debate among the members of

3 Susan Schroeder, Bertha Masuda & Bonnie Schindler, "Private Company Board Compensation and Governance," *Harvard Law School Forum on Corporate Governance* (Oct. 11, 2022), *available at* corpgov.law.harvard.edu/2022/10/11/private-company-board-compensation-and-governance ("Governance Findings" section) (unless otherwise specified, all links in this article were last visited on June 28, 2023).

4 Jeanne Sahadi, "Should CEOs Double as Board Chairs? Increasingly S&P 500 Companies Are Saying No," CNN Business (Oct. 31, 2019), *available at* cnn.com/2019/10/31/success/ceo-board-chair-split-role/index.html.

5 Cydney Posner, "ISS Study Shows Board Leadership Structure Affects CEO Compensation," Cooley PubCo (March 14, 2016), *available at* cooleypubco.com/2016/03/14/iss-study-shows-board-leadership-structure-affects-ceo-compensation.

the board of directors, of which the CEO is almost always a member. The board chair should also be the person focused on the timing of a liquidity event once business performance and market conditions dictate.

The board chair is also responsible for facilitating the board's operations and deliberations, choosing the members of each committee and the committee chairs, influencing the amount of time and effort placed on any one issue, and overseeing "the hiring, firing, evaluating, and compensating the CEO,"[6] among others. Concentrating both operational and oversight control into one person can be controversial. Even well-regarded large public companies such as JPMorgan Chase and Berkshire Hathaway with executive (CEO) chairs have come under fire for not splitting the role of CEO and board chair. The arguments for splitting these roles tend to be around checks and balances, governance and oversight, and diverting the attention of the CEO, who should be focused on growing the business, the composition of the senior management team and executing on strategy.

Conclusion

Board composition should not be an afterthought. Lenders who become owners through a debt-to-equity conversion should deliberate on the aforementioned considerations, as there is no "one size fits all" approach. Each company will have different needs, as will shareholder groups.

This guidance is not meant to represent all possible considerations, but the critical ones applicable in most situations. For companies that have suffered through years of underinvestment, structuring a board that can guide and actively advise the senior management team is vital to increasing the probability of a successful turnaround and ultimately a positive return on investment for lenders-turned-shareholders. abi

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6 Linda Henman, "Should the Role of Chairman and CEO Be Split?," Henman Performance Grp., *available at* henmanperformancegroup.com/boards/should-the-role-of-chairman-and-ceo-be-split.