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TREND-SPOTTING

Board Observers – spectators or participants – help or hindrance ?

With increased distress in the mid-market we may well see lenders using different tools to keep a closer eye on a company's financial performance. One of those tools is to appoint a board observer.

A board observer is not a member of the board and therefore has no right to vote on any matter being debated by the board and has no fiduciary duty to the company or its shareholders. He/she will have a right to attend all or certain meetings of the board of directors (and committees) and receive the same notice and the same information as directors. Lenders will often request the right to appoint a board observer in high credit risk situations where they do not either have any equity interest or do but it is very small and does not warrant a full board seat. It is also a useful tool in monitoring progress on implementing a restructuring plan or initiative.

The right to appoint a board observer is framed in contract (often in a side letter but occasionally in the credit agreement) and not pursuant to the articles of incorporation. Often the power to appoint is granted to the majority lenders and can be a personal right which falls away if the commitments of certain lenders fall below a specified level. It being a contractual arrangement means that the terms of the board observer appointment are subject to negotiation and there are several key points that the board observer letter should be clear on. One of those points is whether or not the board observer has the right simply to attend board meetings as a spectator or whether it can participate in discussions.

Traditionally board observers were mere spectators. Their role was to listen and report back to the lenders – giving the lenders material information quicker than they would under normal monthly/quarterly reporting. Depending on what level of detail the credit agreement reporting requires, the board observer may also obtain information that the lenders would not otherwise receive under usual reporting. So it can be a useful way of supplementing or enhancing credit agreement reporting. In larger more widely held deals the board observer may well be a third party who is seen as neutral. In more closely held deals e.g. unitranche, the board observer in the ordinary course may well be an employee of the sole or principal lender.

However, as we move into distressed scenarios a lender or group of lenders may see the grant of a board observer right as a means of appointing a specialist adviser who is experienced in work-out/restructuring situations. It is here that thought needs to be given by both sides as to whether the board observer in this situation can act as a spectator or as a participant.

From the lender perspective appointing a specialist as an observer adds analysis and guidance to merely the reporting back of factual information. Having the right to ask questions and participate in discussions would clearly enhance the performance and benefit of that role. In the right circumstances, this would likely improve the quality of dialogue between lender and borrower and may lead to quicker and more informed outcomes due to the quality of the information and advice the lenders receive.

However, the borrower should ensure that any such participation comes with strict limits. Even with participation rights the role of the board observer should not change fundamentally from one of principally listening. So even where the observer is permitted to ask questions and participate in discussions, the board observer should not be setting the agenda or leading or dominating discussions or be able to propose any motions or matters for the board to consider or vote on. The board observer should also not be allowed to use the forum for advancing lender interests. While the board observer may be a restructuring specialist or be someone with a restructuring background, it is not a CRO at the end of the day. A strong chairman is a must when board meetings at which a board observer is present take place to ensure that corporate governance is not disrupted or hijacked. Ultimately, how successful a specialist participating board observer is comes down to personalities and approach. Someone who is constructive and personable and builds personal relationships with the board has a much higher chance of deriving real benefit for lenders. A borrower may ultimately want to grant participation on a voluntary basis and be able to withdraw that right if the board observer becomes obstructive or disrupts corporate governance.

Lenders also must be pragmatic and recognise the practical issues and limitations imposing a board observer on a borrower may bring and it certainly cannot be considered any kind of silver bullet. Board observers are often seen by borrowers as a hindrance to corporate governance as a board meeting should be a forum in which important matters can be discussed openly and freely and a consensus course of action agreed upon. This is even more the case in distressed situations. With the presence of a lender representative, specialist or otherwise, open conversation can be replaced by guarded behaviour or even the failure to include certain matters on the agenda, sometimes forcing conversations to a darkened corner away from the earshot of the board observer. In addition, in distressed situations the board may well want legal counsel to attend meetings, and often any situation where attorney-client privilege may be waived if conducted in the presence of a board observer is usually grounds for the board observer to be excluded. Likewise the board observer should be excluded where the purpose of the meeting is to discuss either an actual or potential conflict with the lenders or to make or consider a proposal in relation to the debt or its terms.

As we enter a period of enhanced distress in the mid-market, being able to closely monitor financial performance and the implementation of any kind of restructuring plan will be key to lenders of distressed companies. A board observer, specialist or otherwise, may well be seen as an essential tool in that process, as will the rights that such board observer is afforded. Whether any such board observer is a spectator or participant requires careful consideration from both sides, since ultimately any company needs to function through its board and its board must be allowed to function.