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Board Flips in Distress Situations

Christopher K. Coleman, Moderator

King & Spalding LLP | Atlanta

Geoffrey M. King

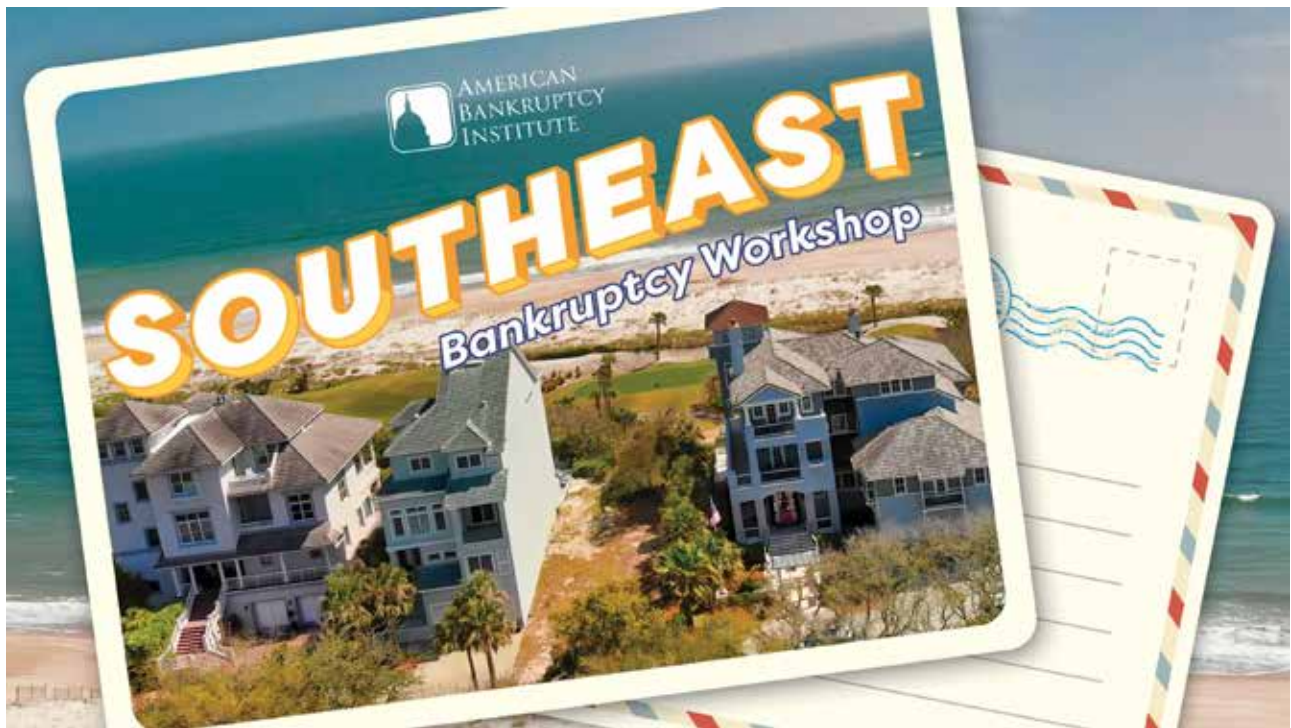
Paul Hastings LLP | Chicago

Reginald Sainvil

Moore & Van Allen PLLC | Charlotte, N.C.

Margaret R. Westbrook

K&L Gates LLP | Raleigh, N.C.



Board Flips in Distressed Situations

Exercising Voting Rights to Remove and/or Appoint Directors

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Geoff King

Paul Hastings LLP



Reggie Sainvil

Moore & Van Allen PLLC



Margaret Westbrook

K&L Gates LLP



Chris Coleman

King & Spalding LLP



Framing & Basics: What is a Board Flip?

A "board flip" (or "board sweep") occurs when lenders exercise contractual voting rights (sometimes called "proxy rights") to remove existing directors and appoint independent directors.

- Lenders may appoint restructuring professionals or other industry experts as independent directors instead of customary independent directorship firms.
- Appointing an independent director does not typically require replacement of senior management.
- Variations of this power include:
 - Appointing an independent director but not replacing other members;
 - Appointing an independent director with limited powers; or
 - Appointing the independent to director to serve on a special committee with a limited mandate.

When and why lenders pursue this path:

- Loss of trust and confidence in the existing board or management
- Conflicts of interest with current board members or management
- Remedy to control business rehabilitation or to direct a sale process
- Sponsor unwillingness to inject additional capital or cooperate on restructuring

Historically, regulated financial institutions have been reluctant to exercise this remedy for liability reasons while a much more common remedy with private credit and direct lenders.



Mechanics & Structural Constraints

LEGAL BASIS

Pledge agreements in secured financings include an equity pledge and a contractual proxy or power of attorney that together allow the secured party to exercise voting rights upon an Event of Default.

- The security agreement grants the secured lender the right to exercise all voting, consensual, and other powers of ownership pertaining to "Pledged Equity."
- Existing LLC agreement (or other organizational documents) should also permit the grant of proxy authority.
- Additional documentation: Independent Director Agreement, Special Committee bylaws/consents, D&O coverage arrangements.
- Organizational document amendments via proxy can range from moderate to aggressive (e.g., converting manager-managed LLCs to member-managed, purchasing additional D&O insurance, stripping sponsor protections).

General Steps for Execution:

01

Required Lenders execute a Direction Letter directing the Agent to deliver proxy notice and other documentation.

02

Agent sends the Borrower a Notice of Default / Notice of Acceleration.

03

Ensure commitment termination provisions align with underlying commitment documents.

04

Agent sends Notice of Proxy Exercise with written consents for removing/appointing directors and amended/restated corporate governance documents.

Key Limitations:

- No equity upside participation for the lenders
- Best used to effectuate a broader process where board is taking value-destructive actions
- Independent director will still owe fiduciary duties to all stakeholders
- Notice provisions must be read carefully
- Potential litigation or defensive bankruptcy filing by equity sponsor



Stakeholder Dynamics & Process

ROLE OF SPONSORS, LENDERS, INDEPENDENT DIRECTORS AND MANAGEMENT

- Communication and messaging to key stakeholders is critical to avoid business disruption
- Intercreditor considerations
- Exercising voting rights is not an end in itself

CONSENSUAL VS. NON-CONSENSUAL BOARD FLIPS

- Outcomes may be driven by liquidity pressures
- Sponsor willingness to inject additional capital
- Litigation/potential claims against the equity sponsor

ADVANTAGES OF EXERCISING VOTING RIGHTS:

- Provides an independent, sophisticated and disinterested board for negotiating a consensual restructuring.
- Decreases likelihood of an unexpected "free fall" Chapter 11 filing.
- Comparatively inexpensive as compared to other lender remedies.
- Provides access to critical information necessary for planning/executing a restructuring.

RISKS & DISADVANTAGES:

- The company may seek to invalidate voting rights through litigation or a parent entity bankruptcy filing.
- The company may file for bankruptcy regardless, leading to dismissal litigation.
- Proxy exercise can be disruptive to the business and management (change of control triggers, relationship management with senior team, etc.).



Fiduciary Duties & Litigation Risk

Exercising the proxy does not make the lender the owner. The equity still belongs to the borrower's equityholders, and the board's duties still run to the shareholders — and, once the company is insolvent, to its creditors, too.

- Courts have upheld voting rights exercised **PRIOR** to a bankruptcy filing by a parent.
- Assess litigation risks prior to a board flip, including pending litigation against the company.
- Fiduciary duties and conflicts that may arise during winddown or sale process — special committees, investigation of insider transactions, etc.

Common Litigation Themes:

1. Challenges to the exercise of voting rights by the existing boards and shareholders.
2. Equity sponsors may commence litigation (e.g., TRO, injunctive relief) or place the company into bankruptcy if voting rights are not exercised precisely in accordance with the loan documents.

Bankruptcy as a defensive measure by sponsors:

1. Section 362(a)(3) prohibits "any act to exercise control over property of the estate."
2. The automatic stay bars a creditor from exercising corporate governance rights over an entity the debtor owns (*In re Marvel Entertainment Group*, 209 B.R. 832 (D.Del. 1997)).
3. Bankruptcy does NOT deprive the secured lender of its rights with respect to economic rights derived from pledged equity.



Emerging Issues & Market Developments:

MARKET TRENDS

- As lender competition increases to win private credit deals, lenders have dropped many maintenance covenants, which are the early-warning tripwires that are used to flag trouble.
- With fewer tripwires, problems surface later, which makes board sweeps more likely.
- Increased use of advance notice provisions in credit (e.g., 5-business-day requirements).

SPONSOR DEFENSIVE TACTICS

- Rise of the "replacement independent director" and the mechanics to support swapping out successive independent directors.
- Preemptive governance reforms.
 - Early action to install an independent board member they know and are comfortable with.
- May leverage necessary services they provide to the business as a bargaining chip.

NEW CONTRACTUAL RESTRICTIONS

- New restrictions in credit agreements prohibiting lenders from signing cooperation agreements.
- "Disqualified Advisors" provisions allowing equity sponsors to block law firms or advisors from representing lenders.
- Equity sponsor threats arising out of tax considerations.



War Stories & Practical Lessons:

01

Selection of the right independent director is critical — Qualifications include turnaround strategy, industry expertise and communication skills.

02

Replacing the board/directors while retaining management is the optimal approach.

03

Investigation of insider transactions post-flip can uncover claims against sponsors.

04

Voting rights can also be used to amend organizational documents to prevent the parent/guarantor from circumventing the exercise.

05

Exercise of these rights can prevent the borrower from entering bankruptcy.

06

Even if not exercised, the potential for exercising voting rights under an equity pledge is a powerful tool in the secured lender's toolkit in workout scenarios.



Key Takeaways:

Board flips are a powerful but measured tool
They should be deployed strategically, not reactively.

The choice of independent director is critical
Industry qualifications, restructuring experience, cooperation, and situational dynamics matter.

Replacing the board is not the same as replacing management
In some cases, retaining management continuity while changing governance oversight is the optimal approach.

Careful attention is essential
To notice provisions, documentation and procedural compliance that withstand legal challenge.

Communication strategy is as important as the legal mechanics
Especially messaging to C-Suite management.

Consider all stakeholder dynamics
Sponsor defensive measures, intercreditor issues, cooperation agreements, and potential bankruptcy implications.

Investigation of insider transactions post-board flip
Can uncover claims against sponsors and former directors.

The exercise of proxy is not the end goal
It is a means to effectuate a broader restructuring, sale, or debt-to-equity conversion.



Panelists



Geoff King

Paul Hastings LLP



Reggie Sainvil

Moore & Van Allen PLLC



Margaret Westbrook

K&L Gates LLP



Chris Coleman

King & Spalding LLP

Faculty

Christopher K. Coleman is a senior associate in King & Spalding's Finance & Restructuring practice in Atlanta, where he represents private credit funds, financial institutions, private-equity sponsors, and private and public companies in all aspects of financial restructuring matters, both in- and out-of-court, including representing buyers and sellers in distressed M&A transactions. As a complement to his restructuring practice, he also represents private credit funds, financial institutions and corporate borrowers in a broad range of distressed and non-distressed secured lending transactions. Mr. Coleman regularly advises clients on a diverse selection of restructuring mandates, including distressed M&A transactions, commercial workouts, out-of-court restructurings and strategic wind-downs, as well as debtor-in-possession and special-situation financings. A former clerk for a federal bankruptcy judge, he routinely represents clients in complex bankruptcy cases, offshore liquidations, receivership actions and insolvency litigation. In addition to his restructuring practice, Mr. Coleman also represents clients at the origination stage, where he advises private-credit funds, financial institutions and corporate borrowers in nondistressed financings, including leveraged finance, commercial real estate finance and asset-based lending transactions. He received his B.A. in political science from Carson-Newman College, his M.Div. from Wake Forest University and his J.D. *cum laude* from the University of Tennessee College of Law.

Geoffrey M. King is a partner in the Financial Restructuring group at Paul Hastings LLP and is based in the firm's Chicago office. He represents lenders, equity sponsors, independent directors, special committees, distressed-asset purchasers and corporate debtors on complex in-court and out-of-court restructurings, special-situation matters and distressed transactions. Mr. King has significant experience advising clients on a wide array of restructuring-related matters, including distressed acquisitions, post-petition financing, independent investigations, liability-management transactions and cross-border restructurings. He received his B.S. *summa cum laude* from Miami University-Oxford in 2006, and his J.D. *cum laude* from Northwestern University Pritzker School of Law in 2009.

Reginald Sainvil is counsel in the Bankruptcy and Financial Restructuring practice at Moore & Van Allen in Charlotte, N.C., where he advises financial institutions, investors, indenture trustees, private credit funds, borrowers, and secured and unsecured creditors on complex domestic and international restructurings, distressed transactions, chapter 11 reorganizations, cross-border insolvencies, Article 9 foreclosures, workouts and related litigation. He represents clients across a range of industries, including media, energy, real estate and life sciences, and has helped preserve enterprise value and recover tens of millions of dollars in complex, multistakeholder restructurings. Mr. Sainvil is admitted to practice in Florida and Pennsylvania. His honors include recognition by *Chambers USA* for South Florida bankruptcy/restructuring as an associate to watch, and in *The Best Lawyers in America* as one of its Ones to Watch. He also received the National Conference of Bankruptcy Judges' Blackshear Presidential Fellowship, *Brickell Magazine's* Top 20 Under 40, the American Bar Association Business Bankruptcy Committee's 20/20 Partners Rising Young Leader Award, Diversity MBA's Top 100 Under 50 Emerging and Executive Leaders, and the Haitian American Chamber of Commerce of Florida's Top 20 Under 40 Young Professionals. Mr. Sainvil received his undergraduate degree in finance from the University of Miami in 2011 and his J.D. from the University of Pittsburgh School of Law in 2015.

Margaret R. Westbrook is a partner with K&L Gates LLP in its Raleigh, Charlotte and Research Triangle, N.C., offices, and currently serves as practice group coordinator for the firm's Restructuring and Insolvency Practice Group. She represents and litigates for secured and unsecured creditors in restructuring and insolvency matters both in and out of the state and federal courts in North Carolina, and in other jurisdictions including New York and Delaware. Ms. Westbrook advises transactional clients with respect to insolvency risks and debt restructuring. She represents purchasers and sellers of debt and assets from financially distressed companies in a variety of structures, including foreclosure sales, Article 9 sales and § 363 sales. She has extensive experience with agricultural cases, including chapter 12 proceedings, and with health care insolvency issues both in and outside of formal insolvency proceedings. Prior to joining the firm, Ms. Westbrook clerked for Hon. J. Rich Leonard of the U.S. Bankruptcy Court for the Eastern District of North Carolina from 1996-98. She chaired the Local Rules Committee for the Bankruptcy Court for the Eastern District of North Carolina from 2010-19, as well as the North Carolina Bar Association Bankruptcy Section Council from 2021-22, and she served as president of the Carolinas Chapter of the Turnaround Management Association from 2022-23. She previously served as a member of the Board of the *American Bankruptcy Law Journal* and has been recognized for her work on behalf of her clients and the bankruptcy bar in *Chambers USA*, *The Best Lawyers in America* and as a Fellow in the American College of Bankruptcy. Ms. Westbrook received her B.A. and J.D. with honors from the University of North Carolina at Chapel Hill.