BY HOWARD BROD BROWNSTEIN, CTP

Howard Brod Brownstein explains why lenders should pay closer attention to borrowers' corporate governance.

Corporate Governance An Overlooked Opportunity for Lenders

In my 25-plus years as a turnaround professional, alongside more than four decades as an independent corporate board member, I have seen first hand many occasions where, if a borrower had had stronger corporate governance, many problems would have been prevented or at least lessened, and the lender would have received greater repayment. And yet, during a lender's underwriting process – when they theoretically can see any records of the prospective borrower – lenders rarely, if ever, pay any attention to the borrower's corporate governance:

- Does the borrower have a real board of directors? Who's on it?
- Does it include anyone who is really independent of the company?
- How often does the board meet?
- Are there written minutes of board meetings, and can the lender see them?

These questions are seldom asked as the lending relationship begins. And then, on the "back-end", when there may have been issues concerning the borrower's performance. necessitating the lender to provide an extension, default waiver and/or forbearance agreement, seldom, if ever, does the lender include as one of its conditions that the borrower strengthen its corporate governance: e.g., assemble a real board, add truly independent board members, start keeping minutes of board meetings, etc.

Why is this such a blind spot for lenders? The senior lenders whom I contacted admitted that paying attention to a borrower's corporate governance had never occurred to them, nor had they ever heard of any lenders doing so. A few questioned whether inquiring into a borrower's corporate governance might possibly "cross the line" in terms of exposure to lender liability, equitable subordination, etc. And yet, lenders readily scrutinize other risk factors in the borrower's business during the underwriting process, as well as when an extension, waiver and/or forbearance agreement is required.

The problem is that lenders don't typically recognize the value of the borrower's corporate governance, i.e., that strong corporate governance potentially 1) reduces risk and 2) increases enterprise value. The academic literature from leading business schools covering larger companies readily demonstrates the correlation between governance and financial performance. Ironically, the lenders themselves likely have strong corporate governance – especially if they are regulated banks.

Everyone knows that publicly held companies must meet regulatory requirements, including having a specified number of board members who meet a stringent definition of independence. Regulators know that independent board members are likelier to "speak truth to power" and ask tough questions of management, which helps to reduce risk for investors. However, the vast majority of middle-market borrowers – who are likely to deal with asset-based lenders and factors – are privately held companies and not subject to such regulations. The typical ABL or factoring underwriting process ignores the corporate governance of the borrower, and just confirms that the borrower is a corporation or LLC in good standing in the state in which it was established and is correctly named, mainly to ensure that the lender's liens will stand up.

The state laws governing the fiduciary duties of corporate board members are typically no different for publicly held and privately owned corporations, and the regulations that apply to publicly held companies arise only at the federal and/or stock exchange level. Therefore, board members of privately held companies are required to fulfill fundamentally the same duties of care and loyalty as those of publicly held companies. The only differences are that publicly held companies are usually a lot larger, so

there is a lot more for board members to oversee and, as mentioned, have the overlay of regulatory requirements, but the dedication and diligence required of board members are the same for both public and private companies.

While many privately owned companies may have a board of directors in name only, composed entirely of insiders, there has nonetheless been a strong and growing trend among privately owned companies to take their corporate governance more seriously. One sees this especially among multi-generational family-owned companies that want to benchmark themselves against non-family-owned companies. The National Association of Corporate Directors (NACD) has over 18,000 members, many of whom are board members of privately-owned companies and nonprofits, and other organizations offer often sold-out conferences on private-company governance, which reflects the increasing seriousness with which corporate governance is taken at privately-owned companies.

What about the concern about possible exposure to lender liability and equitable subordination, which a few lenders mentioned to me as why they do not concern themselves with a borrower's corporate governance? This is a pure canard. Certainly, at the underwriting stage, the lender is entitled to inquire into anything, but may choose to provide no feedback at this point to the prospective borrower about how to reduce risk factors. This may be because the lender is in a competitive situation, and so may feel that it has to accept or reject the borrower "as-is", although I've heard that in some cases a prospective borrower might be advised, "If you will do A, B and C, we will do X, Y and Z." The point is, lenders could easily include during underwriting an inquiry into the borrower's corporate governance in their gathering of information, even if they make no comment upon it, and just note it for the file as a baseline.

But then, on the back-end, when there's been a loan maturity or default, and an extension, waiver and/or forbearance agreement are required, the lender is already listing a number of conditions required for continuing to provide support to the borrower. These might include a timetable for reducing an overadvance or out-of-formula condition, improving the turnover of inventory or receivables, reducing excessive concentration in the collateral, limiting compensation to management and shareholders, etc. Why not include a requirement that the borrower improve its corporate governance? Just add one or more truly independent board members. The lender would not dictate whom those new independent board members should be – instead, the lender could refer the borrower to a definition of independence like the SEC's (even though the borrower is privately owned). And, of course, the lender itself should not serve on the borrower's board. The idea is to include on the board individuals who – as with publicly owned companies mentioned above – "speak truth to power" and help reduce risk by asking tough questions.

Such strengthening of corporate governance will also increase enterprise value: picture a private equity fund that is valuing a prospective acquisition, and noting that the privately owned target has a real board of directors, which includes some genuinely independent members, and with orderly board meeting minutes that are available for the acquirer's due diligence. Would that not make the acquirer feel a bit more secure in terms of how the target company has been run, and the overall risks of the prospective acquisition? Conversely, it is a definite risk factor for both prospective lenders and acquirers if a company ignores its corporate governance. What else are they ignoring?

Borrowers may be concerned that having a real board, which includes independent directors, would be a cost problem, e.g., for board director fees, holding real meetings, etc. However, director fees are often less than might be expected, and are typically paid only to the non-executive independent board members. And companies can be creative in structuring board fees, perhaps basing a major part on company performance – a surrogate for handing out equity which might not be appropriate in a privately owned company, and better aligning board members' interests with the shareholders.

Considering a borrower's corporate governance during underwriting as well as portfolio management is, unfortunately. nearly always overlooked by lenders, but this is a readily available opportunity for lenders to help reduce risk and increase enterprise value – benefitting lender and borrower alike. TSL

Howard Brod Brownstein is a Certified Turnaround Professional, President of The Brownstein Corporation in Conshohocken, PA, and has served on the Governing Board of the CFA Education Foundation.