a borrower's corporate governance is an overlooked area of potential risk in the underwriting process, and is even more of a possible problem when things get tough. Lenders can be proactive in this area, benefitting both the borrower and themselves.

The vast majority of middle-market borrowers are privately held companies. A publicly held borrower with sales of less than $250 million is a relative rarity, especially if the company is an ABL borrower. So the typical loan underwriting process pays little attention, if any, to the corporate governance structure of the borrower. The borrower entity must be a corporation or LLC in good standing in the state in which it was established, and bank counsel in handling the UCC filings will ensure that the corporation's name is correctly listed. Perhaps the lender will even note whether the corporate officer positions required under applicable state law are filled, as well as list the names of corporate directors (or LLC members).

Has anyone ever heard of a loan underwriter asking to see the borrower's corporate minute book, in order to make sure that the trappings of corporate existence are being observed? Why should it matter? The shareholders are probably personal guarantors anyway, right? Wrong! If the corporation's existence as a separate entity is not being properly maintained, then a secured lender's position could minimally become more complicated—if not unfavorably affected—by the "corporate veil" evaporating, especially in the face of other creditors' claims.

Furthermore, sloppiness in the area of maintaining good corporate governance with timely and regular shareholder and Board meetings, evidenced by written minutes, could be a sign of sloppiness elsewhere, perhaps in the inventory or accounts receivable accounting. Once upon a time, a basic training military commander explained to me the reason behind the myriad picayune rules that basic trainees were required to follow: "If you can't follow these simple rules, how can we trust you with an airplane, a tank, or the lives of other soldiers?"

Rarely does a loan underwriter think about the independence of the Board directors, or lack thereof. Indeed, it is widely assumed that the shareholders of the typically privately owned and closely held middle-market company will automatically put themselves on the Board. But the presence of independent Board members is more important than is commonly understood. As long as business is good and there are no defaults, a borrower whose Board is populated with non-independent members may be less cause for concern. However, "You only find out who is swimming naked when the tide goes out," Warren Buffet said. Once a company is having problems, the value of independent Board members becomes evident. Who is going to make sure that a borrower in the "zone of insolvency" is considering the interests of creditors? Even if the Board is instructed by its counsel about its fiduciary duties, the Board members' lack of independence is still a source of risk for the lender. In most cases, the non-independent Board members are not replaced until a decision to file bankruptcy is imminent and it is contemplated that those Board members may be buyers in a §363 sale.

It would reduce a lender's risk for there to be independent members—perhaps even a majority—appointed to the Board—as soon as there is a sign of trouble. Lenders should consider making this one of the terms of forbearance agreements, covenant waivers, etc. Corporate minutes should become one of the documents regularly shared with the lender. Lenders might let prospective borrowers know that having independent Board members makes a borrower a more attractive credit. Might that even be worth a few basis points on loan pricing?

As every lender knows, "It's all about risk." A borrower's corporate governance is an area of risk that is seldom recognized, and which represents an opportunity for risk reduction. TSL

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