American Bankruptcy Institute

When Boards Flip: Governance and Litigation Risk in Financial Distress

When a company undergoes financial distress, litigation rarely starts in the courtroom. The most consequential struggle begins earlier — in the boardroom.

A "board flip" — when lenders, investors or other stakeholders assume board control (or transfer board control to independent third parties) — can bring order by stabilizing the affairs of a company, aligning stakeholder incentives, and allowing the restructuring of outstanding liabilities. But it can also spark governance disputes, fiduciary duty claims and privilege battles that may determine the future of the company long before a bankruptcy filing. This type of governance transition is becoming both increasingly common and increasingly controversial as credit markets tighten.

What Makes Boards Flip in Today's Market

Rising interest rates and mounting distress among private credit portfolios have made governance control a central negotiating term. A board flip typically arises as a secured creditor remedy — an exercise of contractual rights embedded in credit agreements, pledge agreements or other security documents that grant lenders the authority to vote the equity of the borrower or its parent entity. When a borrower defaults, the secured creditor may exercise its proxy rights over pledged equity interests to replace the existing board with new directors that are aligned with the creditor's restructuring objectives. In some cases, these proxy rights are exercised to install independent directors rather than creditor affiliates, lending the transition an appearance of neutrality even when the practical effect is a shift in strategic control.

Separately, and sometimes in parallel, lenders and investors may negotiate for board seats, observer rights or appointment powers as conditions to new capital or forbearance. For lenders, these control measures are critical for preserving value while minimizing management drift. But from equity ownership's perspective, that same move may look opportunistic — a

quiet coup of convenience dressed up as "stewardship." This dynamic has fostered disputes over authority, process and motive.

The Fiduciary Pivot: Whose Interests Matter?

At the heart of a board flip is a battle about fiduciary duty. When a company enters the "zone of insolvency," directors often face competing demands from shareholders, creditors and new stakeholders. Courts have avoided a bright-line rule for insolvent companies that duties "shift" to creditors by emphasizing that directors owe duties to the enterprise collectively. Still, control transitions routinely give rise to claims that creditor-appointed directors prioritized the interests of their appointing creditors over the interests of the enterprise. Whether or not those claims have merit, the contemporaneous record often becomes the central battleground in subsequent litigation. A well-developed record of appointments, independence determinations and board process is crucial to mitigate any potential allegations of breach of loyalty or aiding and abetting in the future.

Litigation Flashpoints

Several recurring issues arise once a board flip occurs:

- *Authority and Process*. Challenges often turn on whether the reconstituted board was properly authorized under the company's charter, bylaws or shareholder agreements. Defects in notice, quorum or consent can invalidate the board flip, prompt injunction motions or result in an immediate bankruptcy filing in an effort to displace the new board.
- *Conflict and Control*. Equityholders may allege that creditor-appointed directors subordinated the interests of the company to the interests of their appointing creditor.
- *Valuation and Fairness*. If a board flip results in a subsequent restructuring or sale, equityholders may allege that the process unfairly favored creditors or chilled alternative bids or structures.

Strategic Moves

Restructuring counsel can mitigate exposure by focusing on process discipline and documentation.

Pre-Flip Preparation

- Conduct independence checks and analyze potential conflicts of interest before any change in board composition.

- Preserve written records of the business justification for and deliberative process supporting the flip.
- Marshal evidence of valuation that demonstrates that the incumbent equity ownership is "out of the money."
- Review organic corporate documents and applicable state law for procedural limitations and steps.
- Design (and document) a process to strictly adhere to applicable procedural, contractual and statutory requirements.

During the Transition

- Maintain detailed minutes and written consents confirming authority and directing action. Establish communication protocols to protect privilege and delineate roles between legacy and new directors.
- Expressly terminate authority of incumbent directors, advisors and, if applicable, employees.

Post-Flip Governance

- Reassess D&O coverage and indemnification provisions.
- Develop a litigation preparedness strategy in advance. Identifying likely claims, assembling a defense team, and considering whether a short standstill agreement with displaced stakeholders can prevent immediate court action and create space for a negotiated resolution.

Looking Ahead

Governance transitions are becoming the front line of distress litigation. What starts as a negotiated reorganization can rapidly turn into lawsuits for coercion, breach of fiduciary duties or implied covenant of good faith and fair dealing.

A board flip is not just a governance exercise; it is a pre-litigation event. Early inclusion of experienced restructuring counsel (*i.e.*, attorneys experienced in governance disputes and fiduciary duty claims) can help ensure that the process is defensible, the record is solid, and the strategic flexibility of the business is preserved.

Key Takeaways

- *Expect more flips*: Creditors and investors may assert control rights far earlier in the process amid mounting distress.
- *Process equals protection*: The best defense to challenges to a flip remains a properly authorized and documented process supported by independent analyses of value and fairness.
- *Plan for privilege*: Expect to determine who has rights to privileged communications once board control has changed.
- *Bring in experienced restructuring counsel early*: Transitions in governance with litigation strategy in mind are far less likely to be brought to litigation.

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