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Finding the Right Independent Director

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The proliferation of independent directors in distressed situations has been a growing trend for many years. The field of professional independent directors has expanded materially, and independents now appear as fixtures in both routine and highly complex restructurings. Whether their presence gives creditors comfort that corporate decision-making is focused on value maximization; promotes transparency for stakeholders; mitigates concerns about conflicts or self-dealing; or introduces specialized distressed-situation expertise that a “regular-way” board may lack—one conclusion is clear: independent directors are here to stay and, when the right choice is made, can add significant value.

Every distressed situation is unique, however, and the optimal independent director can vary accordingly. The discussion that follows centers on selecting an independent director in a distressed private credit scenario for two primary reasons. First, market expectations—rightly or wrongly—suggest that private credit distress may increase, perhaps materially. Second, in our experience, the ideal candidate for a private credit workout often requires an additional skill set and unique temperament that differs from a candidate that is seeking an independent director role in a large or mega Chapter 11 case. Independent directors are not interchangeable, and careful selection is essential.

As a starting point, consider two contrasting fact patterns. The first is the large, “mega” distressed situation with multiple layers of debt totaling many hundreds of millions—or more. The second is the middle market private-credit distressed scenario, where funded debt is typically a few hundred million dollars or less and capital structures often involve a facility with a single lender, or a small club of lenders.

In the large mega case, independent directors—there are often more than one—typically have access to a full suite of professional advisors who provide data, analysis, and strategic solutions. Financial advisors, investment bankers, and specialized legal counsel bring substantial value to independents charged with maximizing enterprise value. Any gaps in an independent director’s expertise are usually filled by these professionals, whose deep benches can address virtually any issue that arises. Although the costs of these advisors are significant, the economic stakes are correspondingly high, and the expected return on professional services justifies the expenditure.

Large cases also tend to involve more companies with debt that is issued in the broadly syndicated loan market with an active secondary trading market. This, in turn can lead to opportunistic distressed investors buying into the structure and organizing with existing holders into ad hoc groups. It is also not unusual for these companies to have multiple facilities—whether an asset based loan, second lien secured loan, or a cash flow revolving facility (or all of the above).

The end result is that each of these stakeholders frequently retain their own restructuring advisors and explore potential solutions, which they engage in with the company's restructuring professionals. In these circumstances, independent directors can often serve as an audience for these potential restructuring proposals. The process becomes iterative as the company and its investors explore an out-of-court restructuring, sale, or a Chapter 11 proceeding. While no two cases are identical, certain themes commonly dominate: (i) value drives strategy where the “art of the possible” is shaped by financial realities; (ii) there is active participation by multiple stakeholders to craft potential solutions; and (iii) the relative leverage of competing stakeholders vis-à-vis one another and the company plays a central role in decision-making.

The private credit distressed situation, by contrast, often bears little resemblance to the large or mega case. Frequently, a single independent director is appointed without the economic justification—or available liquidity—to retain a bevy of advisors. In many private credit scenarios, the balance sheet is already severely impaired by the time the independent is installed, whether through a negotiated amendment or forbearance agreement, or through the lender's exercise of proxy or voting rights following a continuing event of default. Additional challenges often compound the situation: (i) the sponsor may be unwilling to put in equity capital; (ii) a refinancing of the defaulted (or soon to be defaulted) debt that once appeared viable has failed; (iii) the secured lender is unwilling to provide further financial support and wants to maximize its recovery; (iv) there is limited or nonexistent unencumbered collateral to support new third-party financing; and (v) the prohibitively high costs of a Chapter 11 filing makes that potential pathway challenging or impossible to implement. In such circumstances, an out-of-court solution may be the only realistic path forward.

On the day an independent director is appointed in a private credit distressed situation, the “art of the possible” can be both expansive and uncertain. While the fiduciary's objective remains focused on value maximization, the independent director in a private credit setting may be responsible for more day-to-day decision-making than in a large Chapter 11. In this way, the role resembles that of a Chief Restructuring Officer rather than an independent director. An investment professional seeking an independent director for the private credit distressed scenario would be well served to prioritize candidates with as many of the following attributes as possible:

- **Front-Line Distressed Experience**

There is no substitute for real-world experience. The independent director must be able to quickly sift through incomplete or imperfect information, understand what has transpired behind the scenes, and identify immediate priorities. A background in investing, whether in a principal capacity, or as a workout or turnaround capacity, is particularly valuable. This is not a role for the uninitiated; people—and their experience—really matter. Someone with this type of experience brings a lot of muscle memory, and the ability to think as a principal.

- **Willingness and Capacity to Engage Immediately**

Private credit distress often resembles a rapidly melting ice cube. Given the smaller capital structure and less extensive network of investors, customers and vendors to support the business, a middle market private credit borrower's fortunes can turn dramatically. The independent director must be prepared to “roll up their sleeves,” devote meaningful time on short notice, and stabilize operations quickly. Candidates with excessive professional commitments or limited bandwidth are ill-suited for this role. Early-stage delegation to others knowledgeable about distressed situations is frequently impossible; immersion in day-to-day matters is often required to drive a workable outcome.

- **Ability to Do More with Less**

The independent director may initially lack all of the financial, legal, or banking support the situation calls for, yet still be required to form and execute a credible restructuring strategy. Resources are typically constrained, and budgets for professionals may be meager. The director is thus forced to implement a targeted approach for tasks retained advisors are asked to complete, which requires a candidate to utilize his or her prior experience to know what is, and what is not, necessary. In this way, the director's role resembles that of a CRO—the end result is the need for a candidate that is comfortable making decisions with imperfect information, knows what inputs are essential, and who is not prone to paralysis by over-analysis.

- **High Emotional Intelligence and Stakeholder Management Skills**

Building trust with management is essential and often difficult. Management teams may be inexperienced in distress, surprised by the independent director's appointment, and understandably anxious about their futures. The independent director must balance authority with empathy, credibility with approachability, and decisiveness with diplomacy. Technical competence alone is insufficient; interpersonal skill is equally vital.

- **A Temperament Suited to Crisis Management, Problem Solving, and Constraint**

The most effective private credit independents often thrive in chaotic circumstances, excel at identifying and addressing the problems that need immediate fixing, and are spurred on by the challenges presented by resource constraints. These traits can be difficult to find in a candidate but are highly consequential to achieving consistent, favorable outcomes.

In sum, the ideal independent director for a private credit distressed situation is a multifaceted “Swiss Army knife”—a rare and valuable talent. The objective should be to identify candidates who embody as many of these characteristics as possible. Although the search can be challenging, it is manageable when the selection criteria are clear. For those without a ready roster of qualified professionals, consulting experienced restructuring counsel to develop one in advance is a prudent step. When the need arises—and it inevitably will—you will be grateful you prepared in advance.

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