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Board Resignations and Bankruptcy

Key Considerations When Determining Whether to Resign from a Board in Advance of a Bankruptcy Filing

Whether to resign from a board of directors at a time when a company is seriously considering filing for bankruptcy is one of the most difficult decisions most board members will ever face. Beyond the legal and business aspects, such a decision is also rife with difficult emotional considerations: Am I putting my personal needs before those of the company? Am I abandoning my colleagues at a difficult time? Am I increasing my personal exposure? What are the ramifications if I don't resign and the company proceeds to file for bankruptcy?

Each decision has its own unique set of facts and circumstances which need to be carefully scrutinized on an individual basis. However, any decision as to whether a board member should or should not resign is impacted by the following eight considerations:

1. There Are Occasions Which Dictate That a Board Member Should Resign: If the board member is aware that other members of the board, or management, are committing fraud and not willing to correct the problem, then the board member should resign. Failure to do so could result in that individual being considered a part of the fraudulent conduct. In these rare circumstances, the board member also needs to establish a record by voicing his or her concerns in a formal written letter prior to resignation.

2. Deciding to Resign Is Often Not in the Best Interests of the Company or the Board Member: In too many cases, the decision to resign from the board just prior to bankruptcy ends up being ill advised for both the board member and the company. For the company, the resignation represents a public affirmation that things are seriously amiss. For the individual board member, the problems that led to bankruptcy have, by and in large, already occurred, while the individual was a member of the board. Therefore, resigning will not void a director's history with the company or shield the individual from actions previously taken during his or her tenure. Rather, resignation denies the former director the opportunity to be involved in the decision-making process going forward, such as ensuring that proper steps are taken during the pre-bankruptcy planning phase. This may

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include hiring independent counsel and financial advisors, as well as implementing appropriate procedures to protect the interests of the shareholders and creditors.

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Resignation also denies former directors the ability to "steer the course" through involvement in subsequent discussions regarding liability and settlement. Finally, former directors lose the ability to insulate themselves from liability through bankruptcy court approval of business decisions made both before and after the bankruptcy filing.

3. The Decision to Resign Will Not Necessarily Provide Immediate Relief from Emotional Stress: It is undeniable that the decision to file for the bankruptcy, and the preceding period when the company is in serious financial dire straits, is extremely stressful for management and board members alike. Therefore, it is not surprising that some board members will consider resignation in an effort to lessen the emotional toll on themselves and their families. However, this decision is often shortsighted because it ignores both legal and business realities. For example, resignation does not protect a board member from being investigated. Furthermore, the circumstances surrounding the member's resignation are highly likely to be subject to discovery in the bankruptcy proceedings, including having the former board member testify under oath as to the reasons for the resignation and the extent of the board member's knowledge at the time of the resignation.

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Moreover, it is often not clear when potential negligent conduct by a board member begins. For example, management is sometimes more concerned about job retention than paying creditors. If a board member resigns, and then management later takes action unfair to creditors after the resignation, the board member may still be considered negligent if he or she was aware of or heard discussions about the possible conduct, even if the actual conduct took place after the resignation. Additionally, resigning from a board pre-bankruptcy filing can also result in "finger pointing," with the former board member taking a disproportionate share of the blame. It is unfortunately all too common, and easy, for a new board to blame the old regime for everything that went wrong.

4. Board Members Should Be Careful with Whom They Discuss Their Potential Resignation: Generally speaking, a board member's discussions regarding his or her potential resignation are subject to discovery and sworn testimony in legal proceedings, including broad provisions in the bankruptcy code. The most notable exceptions to this rule are discussions with the board member's personal lawyer and, in most cases, the board member's spouse. Presumably, most board members know better than to discuss the company's business with their best friend or the person sitting next to them at the ball game. But even a discussion between two concerned board members regarding the company's deteriorating financial situation is likely to be disclosed as part of the discovery process.

Additionally, directors should be aware that even discussions with the company's corporate counsel may not be protected after a bankruptcy filing. For example, post-bankruptcy filing, a trustee may be put in place to supervise the affairs of the corporation. Long-standing Supreme Court precedent has held that the bankruptcy trustee controls the corporation's attorney-client privilege and has the ability to waive that privilege on behalf of the company. Accordingly, board members considering resignation should limit their conversations regarding potential resignation to their personal attorneys and other individuals who can legally keep such discussions confidential.

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5. A Board Member Who Resigns Still Owes a Duty of Loyalty to the Company: On occasion, a board member resigns with the notion that he or she can now "tell it like it is" to stakeholders, the media, and others. This is a fundamental misunderstanding of the law and a director's ongoing obligations to the company, even after resignation. Generally, board members have an obligation to continue to honor confidential company information. Violations for breaching this duty of loyalty can be harsh and far-reaching.

6. Avoid Management's Attempts to Limit the Cost of D&O Insurance Coverage: As companies find themselves in financial difficulties, management will appropriately look for ways to reduce costs. Often, they will recommend curtailing the cost of the D&O insurance policies. Board members should be vigilant against this type of shortsighted cost saving. Practically speaking, it is nearly impossible for distressed entities to get director insurance. Therefore, companies should get robust coverage while the financial situation is strong and maintain that coverage even as the company becomes more financially distressed. This critical coverage will pay for the costs of protecting the interests of both current and usually former directors, as the company faces potential bankruptcy. In general, even if a company is fiscally strong, board members should consider resigning if the company is unwilling or unable to maintain adequate D&O insurance.

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7. *Assess the Media's Reaction:* In the past five years, media coverage of business in general, and what transpires at boardrooms in particular, have resulted in unprecedented scrutiny of board members' resignation decisions. Fueled by the social media with its tens of thousands of websites, blogs, sector analysis sites, and other forums, a board member's decision to resign, even from a relatively small company, is likely to be noticed and commented on by numerous sources. If a board member does ultimately decide to resign, especially from a well known or public company, he or she should discuss

with their lawyer the advisability of retaining a media consultant to assess and address the media's reaction to the resignation.

8. Hire a Lawyer Early: Trusted and experienced advisors, who have the board member's best interests at heart, and with whom a board member can confidentially discuss all aspects of the decision, are invaluable. The damage resulting from failing to consider a critical legal or practical point will likely dwarf the costs, in time and money, of hiring a lawyer to assist with a decision that has such potentially devastating consequences.

The decision by a board member to resign from a company that is facing bankruptcy is replete with complex legal, business, practical and emotional issues. However, having trusted and experienced advisors, as well as being fully informed as to key considerations of resigning from a board pre-bankruptcy, will help directors to successfully resolve the inherently difficult issues they need to address.