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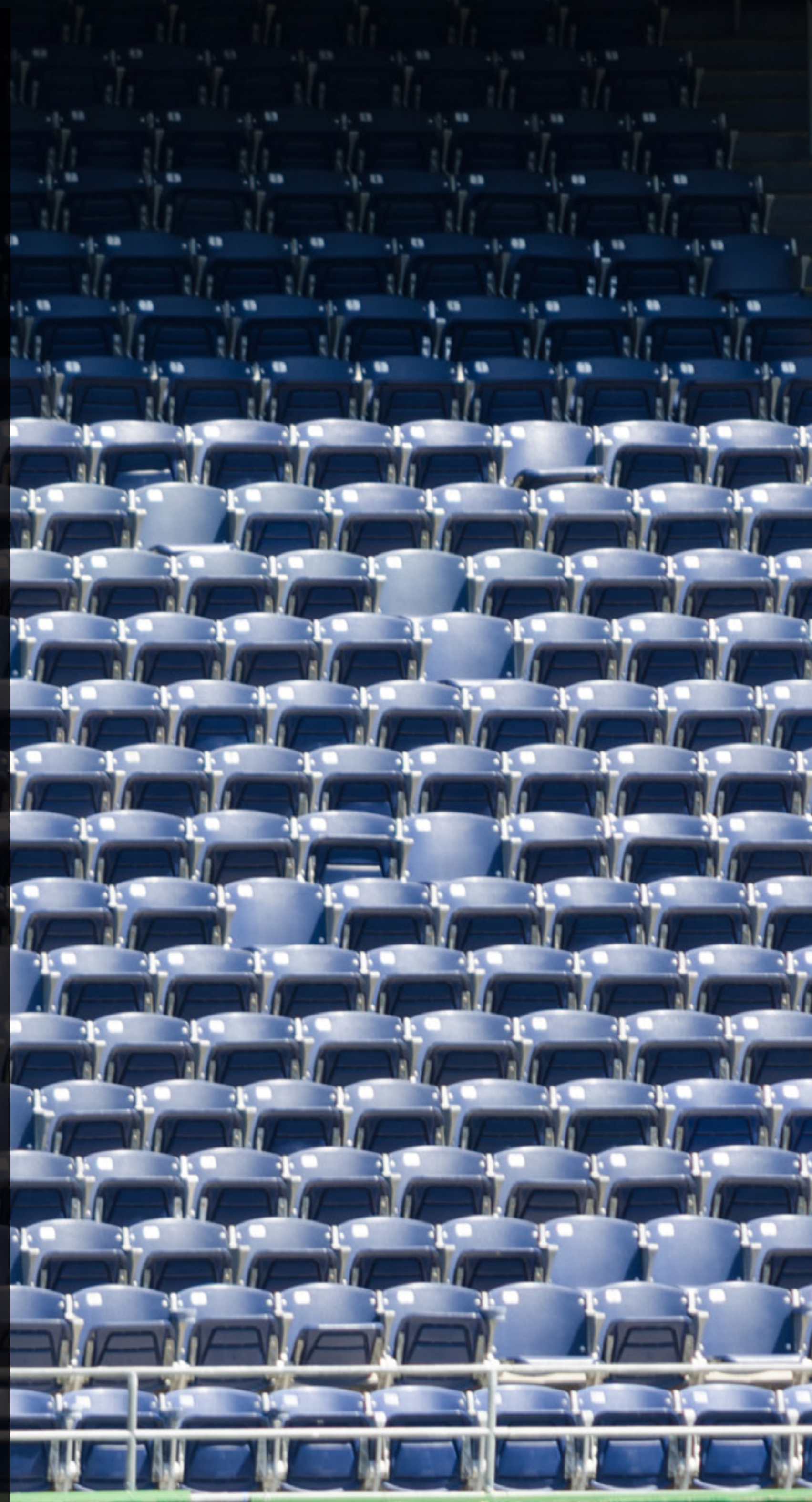

WHAT'S INSIDE

9TH Annual Energy Summit is going Virtual, September 16 & 23, 2020, more details coming soon to www.aira.org.

SUING YOUR SISTER, INVESTIGATING YOUR MOM: INDEPENDENT COUNSEL IN BANKRUPTCY

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Members of a corporate family often operate together as a unit. That corporate unity can remain intact, even in bankruptcy. Corporate families regularly file Chapter 11 bankruptcy petitions at the same time, functionally operate in the same manner as they did before bankruptcy, and receive guidance from the same restructuring advisors and counsel who may be providing a unified restructuring strategy. Sometimes, though, bankruptcy can drive the family apart. Corporate families stitched together through acquisition, for example, can find themselves with member companies that have different stakeholders, debt covenants, liquidity, and prospects. Insolvent family members owe duties principally to their specific creditors in bankruptcy, while solvent family members remain beholden to their parents and owners. If family members have different creditors, they also may face competing interests. Corporate children may need to investigate or take actions against their siblings, parents, and owners to maximize value for their own creditors.

These scenarios can generate a raft of potential conflicts for corporate directors, in-house counsel, and restructuring advisors and counsel. Generally, neither the directors of the corporate parent nor restructuring counsel for the family can represent all or multiple sides of these conflicts. Doing so risks challenges from competing stakeholders that might distract from—or worse, completely derail—the restructuring process. Here, it can make sense for companies to appoint disinterested, separate individual directors for the different affiliated entities. These independent directors owe their fiduciary duties to and can make decisions for the benefit of the entities they serve. This independence can help resolve questions of independence and perceived conflicts when dealing with intra-family matters. These independent boards and directors can retain independent counsel and other separate advisors to separately manage and respond to litigation and investigations at each entity.

This article presents a case study on the role that independent counsel (sometimes called conflicts counsel) can play in supporting disinterested directors as a part of the overall restructuring effort led by restructuring counsel. The bankruptcy of energy company Alta Mesa Resources, Inc. ("AMR") is the focus of the discussion.[1]

There, hard-fought intra-company litigation between two sister subsidiaries and comprehensive investigations of corporate affiliates and owners undertaken by two separate sets of independent counsel and advisors at the direction of disinterested directors were essential to securing the sale of the debtors' assets.

The "God Factor" Strikes

AMR was formed in 2018 based on a billion-dollar private equity bet on accelerated drilling for oil and gas in Oklahoma. Through a Byzantine corporate structure, AMR combined two pre-existing businesses: Alta Mesa Holdings ("AMH"), an "upstream" company that drilled wells and extracted oil and gas, and Kingfisher Midstream ("KFM"), a "midstream gatherer" for AMH and other producers that processed gas and moved oil and gas from the wells through local gathering pipelines to larger interstate pipelines.

Prior to the merger, AMH had been drilling oil and gas in Oklahoma and elsewhere as a privately held company. AMH was owned principally by its founder, CEO, other senior management, and two private equity sponsors through a holding company. KFM was created in 2015 and was owned by a combination of AMH's holding company, one of the private equity sponsors of AMH, and a third-party that operated KFM. Although separate companies, AMH and KFM were tied together through a series of "gathering agreements" that nominally committed AMH to use KFM to gather and process any oil and gas AMH produced from many of AMH's wells.

[1] *In re Alta Mesa Resources, Inc.*, No. 19-bk-35133 (Bankr. S.D. Tex.) (Isgur, J.) (bankruptcy petition filed Sept. 11, 2019).

AMH and KFM merged into AMR as part of an investment by a third private equity sponsor and through an initial public offering. The creation of AMR, the third private equity sponsor's investment, and the IPO were meant to finance a program to increase the density of wells operating on existing AMH mineral leases. The hope was that the new drilling program would increase production at lower drilling costs. That did not pan out. After early success with the drilling program, the "God factor struck," as AMR's chairman later testified, and production fell far below expectations.[2] Lower than expected production reduced the expected value of AMH's oil and gas reserves in the ground. Since AMH's credit was limited as a function of its oil and gas reserves, the drop in its reserves eventually reduced AMH's available credit and liquidity, and jeopardized AMH's financing. AMH, and thus AMR, and eventually KFM, were in trouble. In late 2018, AMR replaced many of its executives, and in 2019 it hired restructuring counsel.

As the restructuring process and negotiations with creditors unfolded, it became clear that AMH's creditors (a combination of secured bank debt and unsecured bonds), KFM's creditors (different secured bank debt), and AMR's three equity sponsors all had competing interests. One option on the table was a sale of all of AMH's and KFM's assets as part of a joint sale process. Although a joint sale of AMH's and KFM's assets was possible, AMH's creditors were mindful of the possibility that AMH's assets—principally its mineral rights—could be more valuable alone than with costly gathering contracts with KFM. KFM's creditors and equity sponsors wanted to keep KFM out of bankruptcy and to keep those contracts in place. Disinterested directors were brought in to manage AMH's and KFM's conflicting interests, and each entity retained independent counsel.

A "Gathering" Storm

AMH's and KFM's independent counsel played two roles: litigation and investigation. Litigation took center stage first. The day after AMR and AMH filed for bankruptcy, AMH's independent counsel, at the direction of AMH's disinterested director, sued KFM.[3] The goal: to terminate the costly natural gas and crude oil gathering agreements that were at the heart of the AMH-KFM business relationship before the AMR merger. AMH, supported by both secured and unsecured creditors, believed these agreements were overpriced and one-sided in favor of KFM, and AMH sought to reject the agreements in order to maximize the value of AMH's remaining assets. KFM wanted to keep those agreements in place.

Debtors in bankruptcy can reject executory contracts based on business judgment. But, KFM argued the agreements were covenants that ran with the land, meaning they were property rights that encumbered AMH's mineral interests (AMH's main assets), and, therefore, they could not be rejected. So, anyone who acquired AMH's assets would need to continue paying KFM's gathering rates. AMH argued these agreements did not run with the land, citing a favorable decision from a bankruptcy court in New York, *In re Sabine Oil & Gas*.[4] The *Sabine* court concluded similar agreements did not run with the land and permitted the debtor to reject them. AMH also challenged the contracts as fraudulent transfers and breaches of fiduciary duty executed by AMH's leadership prior to AMH's consolidation into AMR. They pointed to AMH management's stake in KFM at the time, which caused AMH to accept above-market agreements. AMH further alleged that KFM had breached the crude oil gathering agreement.

Complicating matters, the litigation was on the clock, and AMH had only four months to litigate the case. Why so fast? Because AMH's secured lenders required AMH to receive bids within four months of entering bankruptcy in exchange for AMH's lenders' agreement to allow AMH to use its cash collateral for operations. For the litigation to have an impact on AMH's sales price, it needed to conclude before the bids were received. So, the parties set a breakneck schedule for depositions, expert reports, summary judgment, and trial, all with a goal of obtaining a decision from the bankruptcy court on AMH's claims in time to inform any bidders that might be interested in acquiring AMH's assets separate from KFM's assets. If the agreements were terminated by the litigation, then AMH's assets might be worth more in a separate sale.

Eventually, the bankruptcy court concluded that the gathering agreements were covenants that ran with the land, and that they could not be rejected on that basis. But, the court denied KFM's motion for summary judgment on the other claims and sent the case to trial on the fraudulent transfer, breach of fiduciary duty, and breach of contract claims. In the meantime, initial bids for AMH's and KFM's assets continued to be received. After two days of testimony, stakeholders for AMH and KFM reached a temporary truce and agreed to negotiate a resolution based on the bids that had already been received. The litigation was over, but now the investigation took the stage.

2 Trial Transcript for Dec. 10, 2019 at 124-132, *Alta Mesa Holdings, LP v. Kingfisher Midstream, LLC*, No. 19-ap-3609 (Bankr. S.D. Tex.), ECF No. 212.

3 *Alta Mesa Holdings, LP v. Kingfisher Midstream, LLC*, No. 19-ap-3609 (Bankr. S.D. Tex.) (complaint filed Sept. 12, 2019).

4 *In re Sabine Oil & Gas Corp.*, 547 B.R. 66, 69 (Bankr. S.D.N.Y. 2016), *aff'd*, 567 B.R. 869 (S.D.N.Y. 2017), *aff'd*, 734 F. App'x 64 (2d Cir. 2018).

"Extreme" Investigations

While the litigation raced ahead and the overall bankruptcy process continued, the disinterested directors directed the respective independent counsel for AMH and KFM to investigate potential claims against related parties, including AMH's and KFM's claims against each other and affiliated parties. The investigations were intended to identify potential claims against affiliates and equity sponsors. They also aimed to determine the value of any releases that an affiliate or sponsor might seek as part of a bid by the affiliate or sponsor to purchase AMH's or KFM's assets. With those objectives in mind, independent counsel took the lead on the investigations, cooperating with the UCC, but avoiding the potential larger expense of an independent UCC investigation. In four months, independent counsel reviewed tens of thousands of documents, conducted interviews, deposed witnesses, and prepared comprehensive reports.

As the litigation wound down, bids came in. The leading bidders were AMH's unsecured bondholders and one of AMR's equity sponsors. When comparing the bids, AMH's disinterested director had to account for the value of potential claims against the equity sponsor–bidder, in part because the sponsor–bidder sought a release from claims by AMH as part of the sale. AMH's disinterested director, relying in part on the analysis by the independent counsel, determined the claims were of little value and that the equity sponsor's bid was superior for that and other reasons. The UCC, whose principal constituent was the unsecured bondholders, challenged the sale to the equity sponsor, and specifically the valuation of potential claims by AMH against the equity sponsor.

The court heard lengthy testimony at the sale hearing. The analysis provided in AMH's independent counsel's reports formed the heart of AMH's disinterested director's defense of his decision to recommend acceptance of the equity sponsor's bid. The KFM disinterested director likewise relied on KFM's independent counsel's analysis. Despite aggressive arguments and cross-examination by the UCC, the court approved the sale to the equity sponsor, citing the "extreme analysis" undertaken by independent counsel to vet potential claims against the equity sponsor–bidder.[5] AMH's and KFM's assets were sold jointly to the equity sponsor–bidder, and the proceeds were distributed amongst their creditors pursuant to a separate agreement between the creditors.

Considerations for Advisors to Debtors

The AMR bankruptcy was unusual, but it offers lessons for any corporate family that could find its corporate house divided and its restructuring process imperiled by conflicts.

- **Identify potential intra-company conflicts early.** In-house counsel, restructuring counsel, and restructuring advisors can be in the best position to watch for potential conflicts between family members, such as where family members have separate creditors, where intra-company agreements favor one family member over another, or where potential bidders in a sale of debtor assets are part of (or affiliated with) the corporate family. Designating disinterested directors and independent counsel from the outset can help avoid later accusations of conflicts. In the AMR case, the early appointment of disinterested directors and independent counsel who performed their own independent detailed investigations was key to the court's approval of the sale over the UCC's objections.
- **Maintain open lines of communication.** Management and restructuring counsel may find it disconcerting to hand over the reins for a portion of the restructuring process to disinterested directors and independent counsel. That is natural because disinterested directors and their counsel will need to act independently. They may need to sue or seek sensitive discovery from the management or company that hired restructuring counsel, or the disinterested directors and independent counsel may need to take steps that do not fit within restructuring counsel's overall plan. Thus, restructuring counsel and independent counsel can benefit from communicating often and with candor. That way, both sides can understand each other's objectives, allowing independent counsel to protect its client's interests while minimizing disruption to,

[5] Sale Hearing Transcript for Jan. 24, 2020 at 226-227, *In re Alta Mesa Resources, Inc.*, No. 19-bk-35133 (Bankr. S.D. Tex.), ECF No. 1035.

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and usually playing an essential part in, the overall restructuring goals that restructuring counsel is driving towards.

- **Cooperate to make the process efficient.** Independent counsel and restructuring counsel can work together to ensure that the litigation or investigation process is as efficient as possible. For instance, in the AMR litigation, the parties agreed to forego Rule 30(b)(6) corporate designee depositions when it became clear that any designee would be a shared employee of both sides and the parent company. Also, restructuring counsel managed document productions and facilitated witness interviews and depositions for both AMH and KFM. The parties also used Federal Rule of Evidence 502(d) agreements to avoid complex privilege fights and inadvertent privilege waivers. This sort of cooperation between independent counsel and restructuring counsel helped preserve limited debtor resources without compromising each counsel's separate objectives.
- **Prepare for disclosure of privileged investigations.** Disinterested directors may have to rely on privileged investigative reports prepared by independent counsel to inform their business judgment. If their decisions are questioned by a creditor or other party, the best defense may be waiving privilege and disclosing the investigative report. For example, the UCC's challenge to the AMH disinterested director's selection of the sponsor–bidder's offer was rebuffed, in part, by producing independent counsel's detailed reports to the court. That strategy works best if independent counsel prepares the investigative reports with an eye towards possible public disclosure to an audience other than the client. Protecting business information in the reports is another concern. Rule 502(d) agreements and protective orders can be used to avoid those disclosures causing broader waivers of privilege.

Bankruptcy is often a costly and stressful process for the debtor and its stakeholders, even when every member of the corporate family is rowing in the same direction. The idea that members of the corporate family might add to that expense and stress by hiring their own independent lawyers to sue and investigate each other can seem unfathomable. The AMR case shows that delegating authority to disinterested directors to manage intra-company disputes and hiring independent counsel to investigate and litigate those intra-company disagreements can be essential to the success of the overall bankruptcy. It also demonstrates that aggressive litigation and diligent investigations by independent counsel can avoid accusations of conflicts of interest that might otherwise distract from the restructuring process, and can be efficient when managed carefully and collaboratively by restructuring counsel and independent counsel.

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