

Delaware Court of Chancery Rules in Favor of Simpson Thacher Client Petrohawk Energy Corp. in Bond Indenture Suit Arising from Merger

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Issuers of corporate debt have recently confronted claims by noteholders and their representatives that corporate transactions breach various restrictive covenants in indentures, thereby triggering a right to early redemption of the notes at a premium. In an important decision applying New York law, on August 1, 2007, the Delaware Court of Chancery rejected one such attempt. In *Law Debenture Trust Company of New York v. Petrohawk Energy Corp.*, Vice Chancellor Leo E. Strine, Jr. granted summary judgment dismissing all claims asserted by an indenture trustee against Petrohawk, holding that noteholder rights are created and limited by the indenture governing the debt, and that unambiguous language in indentures must be enforced in a strict, commercially reasonable manner. The court further held that issuers of corporate debt permissibly may structure transactions to purposely avoid triggering mandatory debt redemption provisions.

BACKGROUND

KCS Energy, Inc. issued 7.125% Senior Notes due 2012 pursuant to an indenture between KCS and an indenture trustee. The indenture included a common provision, which provided that in the event of a "Change of Control," as defined in the indenture, noteholders would be entitled to redeem the notes at 101% of their face value. The indenture enumerated five circumstances that constitute a Change of Control, two of which were at issue in the litigation. First, a Change of Control occurs if, following a merger, KCS shareholders do not hold a majority of the outstanding voting shares of the surviving entity. Second, a Change of Control occurs if a majority of the members of the board of directors of the company are not Continuing Directors. The Indenture defined "Continuing Directors" to include any board member who was a board member on the date the notes were issued or who was nominated for election or elected to the board with the approval of the then-serving "Continuing Directors."

In July 2006, KCS merged with and into Petrohawk, which assumed KCS's obligations under the indenture. The indenture trustee, who was appointed by a group of noteholders seeking redemption of the notes, sued Petrohawk, KCS and directors of both companies in the Delaware Court of Chancery shortly after the effective date of the merger, asserting various contract and tort claims in an effort to require Petrohawk to repurchase immediately at 101% of face value the \$275 million in aggregate principal amount of the notes - more than five years ahead of schedule. After the defendants filed their brief in support of their motion to dismiss, the indenture trustee filed an amended complaint in which it abandoned its claims against the directors and its tort claims against Petrohawk and KCS. The amended complaint purported to allege claims for specific performance,

breach of contract and breach of the implied covenant of good faith and fair dealing, premised on the assertion that the merger triggered a Change of Control – and the right to redeem the notes at a premium.

The noteholders asserted that the merger triggered two sections of the Change of Control provision. First, the noteholders claimed that the merger triggered a Change of Control under the voting stock provision. While the noteholders acknowledged that former KCS shareholders owned more than 50% of the voting stock of the post-merger company, they argued that certain previously redeemed shares of Petrohawk preferred stock should be included in the share count because the redemption allegedly did not comply with the shares' certificate of designation or SEC tender offer rules. Second, although it was undisputed that the pre-merger KCS board unanimously approved the composition of the post-merger board (five individuals designated by Petrohawk and four by KCS), and the shareholders of both companies approved the merger agreement after receiving a joint proxy statement that identified the nine members of the post-merger board, the noteholders asserted that the directors of the post-merger company were not "Continuing Directors" because they were not elected in the formal sense under Delaware corporate law.

Simpson Thacher moved to dismiss the amended complaint on behalf of Petrohawk, arguing that the unambiguous language of the indenture compelled the conclusion that the merger did not trigger the Change of Control provision. Following oral argument on the motion, the Court of Chancery permitted the noteholders limited discovery, targeted at the question of whether and how the directors of the post-merger company had been seated. Following supplemental submissions by the parties, the court converted the motion to one for summary judgment.

SUMMARY OF THE DECISION

In a thoroughly reasoned 31-page opinion, the Court of Chancery granted summary judgment to Petrohawk and dismissed the action in its entirety. The court commenced its analysis by noting that "standardized agreements" such as indentures must be interpreted by examining the language of the agreement itself because common provisions are "not the consequences of the relationship of particular borrowers and lenders and do not depend upon particularized intentions of the parties to an indenture."

Addressing the claims based on the voting stock provision, the court stated that the undisputed fact that former KCS shareholders held a "clear majority" of the post-merger company's voting shares was dispositive. Noteholders, the court held, lack standing to assert arguments relating to the manner in which other securities were redeemed. That is, even if there were technical defects in the way the preferred shares were redeemed (and the court concluded there were not), "those defects would be completely irrelevant to the Noteholders' claims." Significantly, the court also held that the fact that a separate change of control provision in the employment contracts of certain KCS executives was triggered had no bearing on whether the terms of the indenture were breached.

The Court of Chancery also rejected the noteholders' "Continuing Directors" argument. The noteholders focused on the "entirely technical" claim that the directors of the post-merger board were not elected in the formal sense under Delaware corporate law. Whether the board was seated in strict compliance with Delaware corporate law was irrelevant, the court held, because "it is obvious that the provision does not use the term 'election' in any formal sense tied to" Delaware corporate law. Thus, the "key issue" under the indenture was whether the KCS board approved the composition of the post-merger board. Because merger-related documents unambiguously demonstrated that the pre-merger KCS board unanimously approved the composition of the post-merger board, the court held that there was "no substantive or equitable basis" for the noteholders' claim.

IMPLICATIONS

The Court of Chancery's decision is an important precedent because it decisively rejects efforts by noteholders to declare an event of default - and thereby accelerate debt or trigger rights to note redemption - through rewriting unambiguous indenture provisions to conform to a noteholder's subjective interpretation. The decision squarely holds that noteholders' rights are limited to the protections bargained for and memorialized in an indenture, and asserted technicalities that do not violate the plain language of an indenture provision will not constitute a default. Equally importantly, the decision recognizes that issuers of debt are free to structure corporate transactions in a manner that purposely seeks to avoid triggering restrictive covenants in indentures.

For further information about this decision, please feel free to contact members of the Firm's Litigation Department, including:

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