

Client Update

Chesapeake Energy Loses \$1.3 Billion Bond Redemption Appeal: Will a Few Missing Words Cost \$400 Million?

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Chesapeake Energy has lost the latest battle in the long-running lawsuit over its attempt to use a special redemption provision to repay \$1.3 billion of its bonds without any premium. A federal appeals court has ruled that the indenture provision was clear and that the redemption notice given by Chesapeake was too late, reversing an earlier lower court decision that came out in Chesapeake's favor. The decision raises a number of considerations for deal sponsors, corporate borrowers and financing arrangers, as discussed below.

The redemption provision was unusual. It allowed the company to redeem the bonds at any time during a Special Early Redemption Period "from and including November 15, 2012 to and including March 15, 2013," without having to pay any penalty or premium. It went on to say that the company "shall be permitted to exercise its option to redeem" the bonds under that provision "so long as it gives the notice of redemption" in accordance with the indenture "during the Special Early Redemption Period." After March 15, 2013, the bonds would only be redeemable at an expensive "make-whole" premium.

The indenture required the notice to be given 30 to 60 days in advance of the redemption date. The company gave the notice on the last day of the Special Early Redemption Period. Although the indenture did not permit notice to be given conditionally, the notice provided that it was given solely under the special provision and was otherwise null and void. The bondholders and trustee disputed the notice, contending that because the redemption would occur after the end of the Special Early Redemption Period, the special provision did not apply and, as a conditional notice was improper, the bonds had to be redeemed at the make-whole premium.

Under New York law, which governed the bond indenture, a court first looks at a contract provision to determine whether it is clear and unambiguous on its face. If it is, the court will not consider any external evidence of the intent of the

parties to the contract. In this case, that evidence clearly showed that the company and the underwriter that offered the bonds both intended for the company to be able to use the special redemption feature so long as the notice was given during the Special Early Redemption Period, even if the redemption took place after the end of that period. That intention, however, was never clearly communicated either to the investors who purchased the bonds or to the indenture trustee – even though it would have only taken a handful of additional words in the disclosure document to do so.

The lower court decision, in May of 2013, found that, though not well drafted, the provision was unambiguous and should be read in the company's favor, and if it were found to be ambiguous, should be similarly interpreted based on the clear evidence of what the company and underwriter intended.

The appeals court, in a 2 to 1 decision, also found the language unambiguous – but in favor of the bondholders and trustee rather than the company. It held that the second sentence limited the first, and thus that both the notice must be given and the redemption must occur during the Special Early Redemption Period. It gave short shrift to the company's argument that this interpretation effectively cut the period from four months to three, and because it found the provision unambiguous, ignored the external evidence of what the company and the underwriter intended the provision to say. The court ruled that the company's notice was too late and remanded the case to the lower court to consider whether the notice operated to require redemption at the approximately \$400 million make-whole premium.

The dissenting judge found the language ambiguous, but would have required the lower court to reassess the external evidence, stating that less weight should be given to discussions between the underwriter and the issuer that were not communicated to investors and more weight to other evidence that in that judge's view would have provided significant support for the trustee's position. The dissent thus might not have come out any differently on the ultimate result.

The case presents a number of practical lessons:

- The conditional redemption feature that we introduced to the high yield bond market some years ago, which allows a redemption notice to be given on a conditional basis, can save a company from significant economic risk.
- An understanding between a company and the financing arranger about the meaning of the financing agreement will not necessarily prevail, if it has not been communicated to investors.

- Under New York law, which commonly governs financings in U.S. markets, if a court finds contract language unambiguous, it will ignore external evidence of the parties' intent, however clear. Moreover, a court might find wording unambiguous even if its meaning is disputed and appears subject to multiple interpretations.
- The description of material terms in a bond disclosure document should be drafted and negotiated with a similar level of care as the indenture that governs the bonds.
- Borrowers, arrangers and their counsel should take special care to make the terms of financing agreements clear, particularly where the investors are not party to the negotiations.

Overlooking a few words can make hundreds of millions of dollars' worth of difference.

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Please do not hesitate to contact us with any questions.