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# An Illustrative Lesson In Make-Whole Litigation

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On Nov. 25, 2014, a panel of judges on the U.S. Court of Appeals for the Second Circuit issued a decision in Chesapeake Energy Corp. v. Bank of New York Mellon Trust Co., holding that Chesapeake Energy failed to timely give notice of a special redemption for a series of notes that would have allowed Chesapeake to redeem the notes at par, plus accrued interest, with no make-whole or other premium. This decision overturned a lower court ruling by Judge Paul Engelmayer of the United States District Court for the Southern District of New York, which found that Chesapeake timely redeemed the notes, allowing Chesapeake to take advantage of the special redemption price.

**Background**

In February 2012, Chesapeake issued $1.3 billion in senior notes due in 2019, with a rate of 6.775 percent (the "Notes"). Bank of New York Mellon was named trustee to the Notes under the indenture (as supplemented, the "base indenture"), which governs the terms of the Notes. The base indenture, was executed in 2010, and governed both the Notes and other notes issued by Chesapeake. The supplemental indenture was executed along with the Notes in 2012 and applied to them only.

At dispute in the case was the timing for redemption at the non-make-whole rate during what the supplemental indenture calls the "special early redemption period." During the special early redemption period, Chesapeake could redeem the Notes at 100 percent of the principal amount, plus interest accrued at the date of redemption. If the Notes were redeemed subsequent to the special early redemption period, Chesapeake must also pay a make-whole premium in connection with any such redemption. This was, as the district court noted, $400 million more than would be required if Chesapeake redeemed the Notes during the special early redemption period.

As discussed in the district court opinion, Chesapeake set out to issue the Notes in 2012 in order to provide the company with short-term liquidity needed in advance of the completion of certain asset sales that Chesapeake anticipated would close shortly prior to or during the special early redemption period. Chesapeake and the underwriter of the notes, Bank of America, negotiated the length and timing of this period, and filed a prospectus with the U.S. Securities and Exchange Commissionstating that the Notes could be redeemed at the lower price so long as notice was given during the then agreed four-month special early redemption period of Nov. 15, 2012, through March 15, 2013.

However, the supplemental indentures that governed the Notes, executed after the prospectus was filed, gave rise to two potential interpretations of the required timing and procedures for a special redemption. The supplemental indenture defined the special early redemption period as the four-month period between Nov. 15, 2012, and March 15, 2013, but then referred back to the redemption notice requirements set forth in the base indenture. Under such notice requirements, Chesapeake was required to provide 30 to 60 days advance notice of any redemption. The language of Section 1.7(b) of the supplemental indenture, which was at issue in the case, is:

At any time from and including November 15, 2012 to and including March 15, 2013 (the "Special Early Redemption Period"), the Company, at its option, may redeem the Notes in whole or from time to time in part for a price equal to 100% of the principal amount of the Notes to be redeemed, plus accrued and unpaid interest on the Notes to be redeemed to the date of redemption; provided, however, that, immediately following any redemption of the Notes in part (and not in whole) pursuant to this Section 1.7(b), at least $250 million aggregate principal amount of the Notes remains outstanding. The Company shall be permitted to exercise its option to redeem the Notes pursuant to this Section 1.7 so long as it gives the notice of redemption pursuant to Section 3.04 of the base indenture during the special early redemption period. Any redemption pursuant to this Section 1.7(b) shall be conducted, to the extent applicable, pursuant to the provisions of Sections 3.02 through 3.07 of the base indenture. [Emphases added by the Second Circuit.]

The potential ambiguity created by Section 1.7(b) of the supplemental indenture is whether the redemption itself must be accomplished during the special early redemption period (therefore requiring that the notice of redemption be given at least 30 days prior to March 15), or alternatively, whether Chesapeake had until March 15 to provide the notice of redemption.

The controversy began on Feb. 20, 2013, 23 days prior to March 15, when Chesapeake notified BNY Mellon that it intended to redeem the Notes at the lower special early redemption period price. After various noteholders contacted BNY Mellon, and communicated that in their view the special early redemption period had expired, BNY Mellon refused to redeem the Notes at the lower price. BNY Mellon shortly thereafter told Chesapeake that it was considering treating Chesapeake's notice as instead triggering a redemption requiring payment of the full make-whole premium. Chesapeake nonetheless issued a notice of redemption on March 15, 2013, stating that the redemption at the lower price would occur on May 15, 2013.

**The District Court Opinion**

Shortly before issuing the formal notice of redemption, Chesapeake sought a declaratory judgment on an expedited basis from the Southern District of New York that the notice was given within the necessary time to allow Chesapeake to redeem the Notes with no make-whole, or in the alternative, prevent BNY Mellon from deeming the make-whole due. Judge Engelmayer conducted a trial on the issue in April 2013, hearing from 10 witnesses, and issued his opinion and order on May 8, 2013, one week prior to the proposed redemption date.

Judge Engelmayer, reading the base indenture and the supplemental indenture together, found that Chesapeake should be allowed to redeem at the lower special early redemption period price. While Judge Engelmayer stated that the base indenture and the supplemental indenture were less than perfectly drafted, the best reading of the relevant provisions would be to allow Chesapeake to give notice of a redemption up to March 15. The judge relied upon the canon of contractual interpretation that specific terms should control when in conflict with general terms and so he found that the period set out in the supplemental indenture should trump the general notice provision referenced in the base indenture. Because the supplemental indenture defined the special early redemption period as the four months between February and March, the more general notice requirement should not contradict that period by effectively shortening the period by a month. Therefore, the judge ordered that Chesapeake had given notice within the special early redemption period by giving notice before March 15, 2013.

In making his ruling, Judge Engelmayer found that the relevant provisions were not ambiguous, and should be enforced without reference to evidence beyond the indenture itself. However, he also found in the alternative that the evidence from outside the text of the supplemental indenture itself favored Chesapeake's interpretation. As numerous witnesses testified, Chesapeake and its underwriter negotiated for the period in which the redemption notice could be provided to last the full four months, as reflected in the prospectus for the Notes. While BNY Mellon introduced evidence of contemporaneous descriptions of the Notes by other parties which were contrary to Chesapeake's interpretation, the judge dismissed each such description as either vague or likely drafted without care or full information. Given that he found Chesapeake to be entitled to redeem at the lower special early redemption period price, the judge did not consider if the notice instead triggered redemption at the full make-whole price. Following Judge Engelmayer's ruling, BNY Mellon appealed to the Second Circuit.

**The Second Circuit Opinion**

The Second Circuit panel's majority opinion, issued on Nov. 25, 2014, reversed the district court. While the majority agreed that the special early redemption period provisions were not sufficiently ambiguous such that extrinsic evidence was required to interpret them, in a 2-1 decision, the panel came to the opposite conclusion from the district court, ruling that the redemption of the Notes was required to be completed during the special early redemption period, and that submission of the notice during such period was not sufficient to take advantage of the non-make-whole price.

Unlike the district court, the panel found that the notice provision in the base indenture was not in conflict with the supplemental indenture, but instead was a proviso, limiting the language of the special early redemption period. The panel emphasized the use of the word "redeem" in the indentures, which according to legal, financial and broad-use dictionaries, means the specific act of returning securities to the issuer, and not providing notice or beginning a process of redemption. Thus to actually redeem the Notes, that is return them to the issuer, during the special early redemption period as required by the supplemental indenture, Chesapeake had to comply with the notice requirements of the base indenture, and provide notice at least 30 days before March 15, 2013. The fact that Chesapeake thus in effect had only three months to give notice of its redemption was only a limitation on the special early redemption period, and did not conflict with the terms of the period.

Finding that the supplemental indenture was unambiguous, the panel chose not to address any of the findings made by the district court as to extrinsic evidence, but relied on the text alone in overturning the district court. The panel remanded back to the district court to determine if Chesapeake's notice had triggered a redemption at the full make-whole price. In a dissenting opinion, Judge Katherine Failla noted that the relevant provisions were in fact ambiguous, citing the fact that the district court and the majority of the panel came to different conclusions as to the indentures "unambiguous" meaning. Judge Failla recommended remand to the district court to further consider extrinsic evidence to reconcile the ambiguity.

## Observations

As a frequently litigated topic, the Chesapeake case is illustrative of the need for precision and clarity in the drafting of make-whole provisions. Moreover, it strongly counsels that clients' interests are really only protected with a holistic approach to the legal practice. Specifically, it is not enough for a leveraged finance or high-yield professional to draft or negotiate a loan agreement in a silo. Bankruptcy, litigation and a host of other colleagues need to be consulted because these other practice areas will view the documents and transaction through their own, different lens. This approach, which includes myriad subject matter expertise and experience, ensures that a client's interest is protected across a variety of circumstances not easily anticipated during the initial negotiation.

Additionally, many lawyers start each document with a form agreement. Not only is this the most practical approach, but it is also the most efficient and frankly best method from every perspective. That said, it must be a launching point and not the end game. The law surrounding make-whole provisions is simply more mature today than it was five years ago. Practitioners must regularly review and update their forms or risk leaving their clients exposed to recent changes in the law.

Finally, in the context of make-whole it is impossible to overstress the importance of specificity and clarity in drafting. Generally courts are willing to uphold make-whole provisions, but only if the specific circumstance giving rise to the make-whole was contemplated by the document and drafted unambiguously by the lender and agreed to by the borrower.
Another important lesson from Chesapeake that applies both to the legal and investing profession is that the operative agreement trumps the prospectus. While we are all familiar with integration clauses and the primacy of the governing document, it is always easier to read a prospectus than the actual document. Unfortunately, the prospectus sometimes describes the intent of the parties without capturing accurately the language of the operative agreement. Parole evidence teaches us that intent may be relevant but the four corners of the document are more important. Particularly with respect to economic provisions like make-whole, it is never enough to review the prospectus without confirming the language in the operative document. In pricing debt, it behooves the investor to focus more on the language of the agreement rather than the prospectus.

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