

CLIENT MEMORANDUM

Delaware Chancery Court Guides Interpretation of Typical Indenture Change of Control Provision

December 21, 2015

AUTHORS

William Hiller | Michael Schwartz | Cristopher Greer | Joseph Minias | Weston Eguchi | Gabriel Brunswick

Typical change of control provisions in high yield indentures require an issuer to offer to purchase notes upon a “Change of Control,” which includes, among other things, a transaction that results in a person, or group, becoming “the Beneficial Owner” of more than a certain percentage threshold of voting stock of the issuer or a related company. Beneficial ownership, in turn, is usually defined by reference to Rule 13d-3 under the Securities Exchange Act of 1934, as amended (“Rule 13d-3”).

In *Wilmington Savings Fund Society v. Foresight Energy LLC*,¹ the Delaware Court of Chancery recently interpreted these types of indenture provisions in a manner that is broadly protective of noteholders, holding that Foresight Energy LLC (together with its affiliates, “Foresight”) had breached its obligations by failing to offer to purchase \$600 million in notes upon the company’s acquisition by Murray Energy Corporation (“Murray”).

Issuers and investors alike should take note of the decision when considering the consequences of a potential change of control. First, the Court held that veto rights over the disposition of securities may confer shared investment power for the purposes of deeming a party a beneficial owner. Perhaps more interestingly, however, the Court applied the anti-evasion provisions of Rule 13d-3(b) to set aside what the Court viewed as the parties’ attempts to contract around the change of control requirements, looking instead to the substance of the transaction to reach the conclusion that a change of control had, in fact, occurred.

Delaware Chancery Court Guides Interpretation of Typical Indenture Change of Control Provision

Continued

A. The Foresight Notes

In August 2013, Foresight and Foresight Energy Finance Corporation (collectively, the “Issuers”) issued \$600 million in notes (the “Notes”). The Issuers’ parent was controlled by Foresight Energy GP, LLC (the “General Partner”), which, in turn, was ultimately controlled by Foresight’s founder, Chris Cline (“Cline”).

Under the terms of the indenture governing the Notes (the “Indenture”), upon a “Change of Control,”² the Issuers were required to offer to redeem the Notes for 101% of the principal amount (the “Redemption Requirement”). Essentially, a Change of Control would occur if, among other events, a party other than Cline and his affiliates became “the Beneficial Owner” of more than 35% of the voting stock in the General Partner. The Indenture defined a “Beneficial Owner” by reference to Rules 13d-3 and 13d-5 of the Securities Exchange Act of 1934.

B. The Murray Transaction

In March 2015, Foresight and Murray announced that Murray would purchase a controlling share of Foresight. Under this original deal, bondholders agreed to waive the Redemption Requirement in exchange for a \$48 million fee. However, the deal was abandoned after Murray and Foresight were unable to acquire sufficient financing.

Murray and Foresight subsequently closed a revised deal in April 2015 (the “Revised Deal”). Under the Revised Deal, in addition to a 77.5% economic interest, Murray acquired a 34% voting interest in the General Partner, which was specifically designed to avoid triggering the 35% threshold in the Change of Control provision.

Additionally, Murray received a five-year option to acquire an additional 46% voting interest in the General Partner (the “Option”). However, Murray could exercise the Option only if Foresight successfully refinanced its outstanding indebtedness to avoid triggering any Change of Control provisions, and Murray gave Foresight 61-days’ advance notice of exercise. Both of these terms were designed to prevent Murray from being deemed “the Beneficial Owner” of the additional 46% voting interests. Under existing case law, if the fulfillment of a material condition to the exercise of an option lies beyond the option holder’s control (such as the refinancing by Foresight), the holder lacks the right to acquire the shares until the condition is fulfilled. Additionally, Rule 13d-3 generally provides that a person is a Beneficial Owner if it has the right to acquire the security within 60 days, so that Foresight would not become a Beneficial Owner until one day after actually giving notice of exercise.

Finally, under the Revised Deal, Murray received a number of governance rights through an amended operating agreement for the General Partnership. Among other things, Murray obtained the right (directly or through a Murray-appointed director) to block a number of significant corporate actions (the “Blocking Rights”), including the disposition of any shares of the General Partner still held by Cline and his affiliates (the “Cline Shares”), and the removal, replacement, or diminishment in duties of the CEO. As part of the Revised Deal, an officer of Murray was appointed as the CEO of the General Partner.

Delaware Chancery Court Guides Interpretation of Typical Indenture Change of Control Provision

Continued

With the Revised Deal in place, Foresight took the position that no Change of Control offer was required under the Indenture. In May 2015, Wilmington Savings, as indenture trustee (the “Trustee”), commenced this litigation on behalf of the noteholders to enforce the Redemption Requirement. Both sides moved for judgment on the pleadings.

C. The Chancery Court Decision

In ruling for the Trustee, the Court found that Murray was the Beneficial Owner of more than 35% of the General Partner’s voting shares as a result of two specific provisions of Rule 13d-3.³

1. Murray Was the Beneficial Owner of Voting Stock Whose Disposal Was Subject to Its Veto Rights

As Murray had directly acquired a 34% voting interest under the transaction, the Court first addressed whether Murray’s right to veto the disposition of the Cline Shares under its Blocking Rights also deemed Murray “the Beneficial Owner” of the Cline Shares, thereby triggering the 35% threshold under the Change of Control provision. Under Rule 13d-3(a)(2), a Beneficial Owner includes any person who “directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has *or shares*, . . . (2) [i]Investment power which *includes* the power to dispose, or to direct the disposition of such security” (emphasis added). Persuaded by Rule 13-d3’s reference to “share[d]” investment power, and relying on a leading treatise and an SEC no-action letter, the Court was persuaded that Murray’s Blocking Right to veto any disposition of the Cline Shares was sufficient to render Murray a Beneficial Owner, even though it shared such control with Foresight.

The Court also rejected Foresight’s argument that the Indenture’s reference to “*the* Beneficial Owner” (as opposed to “a” or “one of the”) overrode Rule 13d-3 because it suggested that only one person could hold beneficial ownership at any time. In addition to noting that the SEC’s own Rule 13d-3 regulations use the phrase “the Beneficial Owner” to refer to circumstances involving shared voting or investment power, the Court concluded that ordinary English understanding of the phrase did not support Foresight’s reading.⁴

Moreover, the Court concluded that its interpretation of the Change of Control provision gave effect to the provision’s underlying purpose, which was to ensure that Cline remained “basically in charge” of Foresight. As a result of the transaction, the Court concluded, “[b]y any reasonable reading of the [new operating agreement], Cline is no longer basically in charge. Murray Energy is now basically in charge.”

2. The Anti-Evasion Provisions of Rule 13d-3(b) Rendered Murray the Beneficial Owner of the Shares Under the Option

As an alternative basis for its decision, the Court also held that Murray was the Beneficial Owner of the shares under the Option regardless of the parties’ efforts to contract around the literal terms of the beneficial ownership definition under Rule 13d-3. The Court concluded that, by incorporating the “anti-evasion” provisions of Rule 13d-3(b),⁵ any person

Delaware Chancery Court Guides Interpretation of Typical Indenture Change of Control Provision

Continued

attempting to evade the literal terms of the Beneficial Owner definition would also be deemed a Beneficial Owner. The Court observed:

In the abstract, efforts to structure a transaction to avoid tripping the terms of an indenture are perfectly permissible. . . . But contract drafters can respond. In an ever-evolving contractual arms race, sophisticated parties can anticipate efforts to evade the terms of the agreement. One means of responding is by expanding the literal terms. Another is through provisions triggered by efforts to evade the literal terms.

As Foresight conceded, the terms of the Option and the Revised Deal were structured to avoid triggering the Change of Control provision. However, the Court concluded, the economic reality of the transaction indicated that Murray had acquired *de facto* control over Foresight. In addition to vesting practical control through the Blocking Rights, the appointment of the CEO and a management services agreement, the Court was persuaded by the fact that the exercise price of the Option (\$25 million) reflected the difference between the original deal (for 80% of the voting units) and the Revised Deal (for 34% of the voting units), which, under Foresight's interpretation, would result in a "preposterous" control premium of only 1.8%. Based on the substance of the transaction, the Court found that Rule 13d-3(b)'s anti-evasion provisions had, in fact, been triggered. The Court reached this conclusion even though there had been no attempt at concealment — which it acknowledged was the express purpose of Rule 13d-3 — since the Indenture was principally concerned with whether other parties gained influence over Foresight rather than concealment.

The Court found that because a Change of Control occurred upon the closing of the Revised Deal, the Issuers were required to offer to redeem the Notes and that since they failed to do so, the Trustee was entitled to an order compelling the Issuers to perform their obligations under the Indenture.⁶

Following the decision, Foresight announced that it had received a written notice from the administrative agent of its credit agreement claiming that Foresight is in default under the credit agreement as a result of the decision. Subsequently, Foresight filed a motion with the Chancery Court requesting reargument and reconsideration of the decision, which motion was denied by the Chancery Court on December 16, 2015.

D. Observations

Based on our review of a sample of high-yield indentures for notes issued in 2015, the overwhelming majority (over 90%) contain change of control provisions that, like the Change of Control provision in *Foresight Energy*, define beneficial ownership with reference to Rule 13d-3.⁷ Although most of these provisions further refine the beneficial ownership definition in a manner that qualifies Rule 13d-3's contours,⁸ none of the indentures we reviewed exclude the anti-evasion provisions of Rule 13d-3(b). It is not unheard of, however, for indentures to leave the term "beneficial ownership" undefined or, instead, to define a change of control by reference to another term (such as "control"), which, in turn, is defined without reference to Rule 13d-3.

Delaware Chancery Court Guides Interpretation of Typical Indenture Change of Control Provision

Continued

The decision is a noteworthy reminder that courts may look through the form of a transaction to its substance in interpreting contract provisions. The Court concluded that the drafters of the Indenture had intended to adopt a broadly protective Change of Control provision, and achieved that goal by incorporating an expansive “beneficial ownership” definition from the securities regulatory framework, including the anti-evasion provisions thereunder.

If you have any questions concerning the foregoing or would like additional information, please contact William E. Hiller (212-728-8228, whiller@willkie.com), Michael A. Schwartz (212-728-8267, mschwartz@willkie.com), Cristopher Greer (212-728-8214, cgreer@willkie.com), Joseph G. Minias (212-728-8202, jminias@willkie.com), Weston T. Eguchi (212-728-8881, weguchi@willkie.com), Gabriel Brunswick (212-728-8163, gbrunswick@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

December 21, 2015

Copyright © 2015 Willkie Farr & Gallagher LLP.

This memorandum is provided by Willkie Farr & Gallagher LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum may be considered advertising under applicable state laws.

¹ Case No. 11059 (Dec. 4, 2015) (Laster, V.C.).

² Specifically, the Indenture defined a “Change of Control” in relevant part as:

the consummation of any transaction (including, without limitation, any merger or consolidation), in one or a series of related transactions, the result of which is that any — person (as that term is used in Section 13(d)(3) of the [Securities Exchange Act of 1934]), excluding the Qualified Owners [Cline and his affiliates], becomes the Beneficial Owner, directly or indirectly, of more than 35% of the Voting Stock of [the General Partner], measured by voting power rather than number of shares, units or the like

³ Given that determination, the Court did not address the Trustee’s arguments that two other provisions of Rule 13d-3 had also been met, or that Foresight had breached the implied covenant of good faith and fair dealing.

⁴ As the decision points out, “A person may be called ‘the owner,’ even if that person is not necessarily ‘the sole owner.’ George Steinbrenner was often referred to as ‘the owner’ of the New York Yankees, when in fact he was one of the owners.”

Delaware Chancery Court Guides Interpretation of Typical Indenture Change of Control Provision

Continued

⁵ Rule 13d-3(b) provides:

Any person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or *any other contract, arrangement, or device with the purpose or effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership* as part of a plan or scheme to evade the reporting requirements of section 13(d) or (g) of the [Securities Exchange Act of 1934] *shall be deemed* for purposes of such sections *to be the beneficial owner* of such security.

17 C.F.R. § 240.13d-3(b) (emphasis added).

⁶ The Trustee was also awarded reasonable costs and expenses (to be established at a later date).

⁷ Many, but not all, of the indentures we reviewed also refer to Rule 13d-5 as well.

⁸ For example, over half of the indentures we reviewed not only defined beneficial ownership with reference to Rule 13d-3, but further qualified that a person or group would be deemed to have beneficial ownership of all shares that it has a right to acquire, “whether such right is currently exercisable or is exercisable only after the passage of time” or, alternatively, “whether such right is currently exercisable or is exercisable only upon the occurrence of a subsequent condition.” Indentures may also provide that beneficial ownership does not include securities that are the subject of a stock purchase agreement, merger agreement or similar agreement until consummation of the contemplated transaction, and/or that a person or group will be deemed to beneficially own voting stock held by a parent corporation if such person or group beneficially owns a majority of the voting power of such parent corporation.