

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

LAW DEBENTURE TRUST COMPANY)
OF NEW YORK, AS INDENTURE)
TRUSTEE FOR KCS ENERGY, INC.)
7 1/8 % SENIOR NOTES DUE 2012,)

Plaintiff,)

v.)

PETROHAWK ENERGY CORP., and)
KCS ENERGY, INC.,)

Defendants.)

C.A. No. 2422-VCS

MEMORANDUM OPINION

Date Submitted: May 3, 2007

Date Decided: August 1, 2007

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STRINE, Vice Chancellor.

I. Introduction

The plaintiff, an indenture trustee, represents a group of “Noteholders” who hold “Notes” issued by KCS Energy, Inc. In July 2006, KCS merged with Petrohawk Energy Corp. (the “Merger”). Petrohawk was the surviving entity. The Noteholders claim that the Merger triggered a “Change of Control” within the meaning of the “Indenture” governing the Noteholders’ rights. If a Change of Control occurred, Petrohawk would be required, under the terms of the Indenture, to redeem the Notes at 101% of face value. Petrohawk insists that there was no Change of Control and has refused to redeem the Notes. In this opinion, I conclude that no Change of Control occurred within the meaning of the Indenture and grant summary judgment in favor of Petrohawk.

The two lines of arguments the Noteholders make in support of their claim that a Change of Control occurred are both based on overly-technical contentions and raise concerns that are outside the scope of the rights granted to the Noteholders by the Indenture. First, the Noteholders contend that the Merger triggered a Change of Control under the Indenture provision that required the former KCS stockholders to hold a majority of voting shares in any post-Merger entity (the “Majority Share Provision”). The former KCS stockholders owned 50.06% of the post-Merger shares — a small, but clear, majority. The Noteholders contend, however, that certain shares of preferred stock that Petrohawk redeemed before the Merger should be included in the post-Merger share count, giving the former KCS stockholders only 49.88% of the total post-Merger shares.

But the Noteholders do not allege that those preferred shares were in fact outstanding at the time of the Merger or that the redemption did not occur. Rather, they take issue with

the manner in which the redemption was carried out, claiming that the redemption did not comply with either the redemption procedures provided in the Certificate of Designation applicable to the preferred stock or with SEC rules applicable to tender offers. But although those contentions may give rise to claims by Petrohawk's preferred stockholders against Petrohawk, or might raise enforcement issues for federal regulators, the Noteholders have not explained why they have standing to raise those issues here. More important, the Noteholders' arguments do not change the facts that the preferred shares were redeemed and that the former KCS stockholders held 50.06% of the outstanding post-Merger shares. Thus, even if the Noteholders' contentions regarding the allegedly non-compliant redemption were correct, no Change of Control would have occurred.

For their second argument, the Noteholders claim that there was a Change of Control under the Indenture's "Continuing Director Provision," which, in general terms, triggers a Change of Control upon a change in the majority composition of the board, unless the incumbent board approves the change. Specifically, the Continuing Director Provision required that a majority of the post-Merger directors be "nominated for election or elected to [the] Board of Directors with the approval of" a majority of the pre-Merger KCS board. The Noteholders do not dispute that the pre-Merger KCS board unanimously approved the make-up of the post-Merger board, which consisted of four pre-Merger KCS directors and five pre-Merger Petrohawk directors. Instead, they raise a number of unpersuasive arguments that, when closely considered, do not reflect a commercially reasonable reading of the Indenture grounded in the actual meaning or purpose of the Continuing Director Provision. Rather, the Noteholders are attempting to exploit imprecise contract drafting and

irrelevant corporation law technicalities to allow them to redeem their Notes early, in a situation — a friendly merger of equals approved by all pre-Merger directors — where the Indenture clearly contemplates no such right. The Noteholders’ arguments ignore the ordinarily accepted meaning of change of control provisions of this type, which, as courts have routinely recognized, require approval of successor directors by the incumbents. That approval was expressly and indisputably given, and, as a result, no Change of Control occurred.

II. Factual Background¹

A. The Indenture

On April 1, 2004, KCS issued \$275 million in aggregate principal amount of the Notes. The Notes carry a 7.125% interest rate and mature in 2012, about five years from now. They were issued pursuant to a lengthy, heavily-negotiated Indenture that consists of more than 100 pages of text, including several exhibits and appendixes. The Indenture contains, as is customary, a number of protective covenants. This lawsuit focuses on one of those covenants, the “Change of Control Covenant,” and particularly on the definition of a Change of Control.

Because this dispute is about the effect of the Merger on the rights of the Noteholders under the Indenture, it is useful to begin by noting that the Indenture expressly contemplated that a merger of the type involved here might occur and that such a merger would not necessarily require redemption of the Notes. Section 5.1 of the Indenture provides that “[t]he Company may not . . . merge with or into another Person” unless a number of

¹ The facts are not in material dispute.

conditions are met, including: (1) either the Company is the surviving entity or the entity surviving the merger is an entity organized under the laws of the United States, any state thereof, or the District of Columbia; (2) the entity surviving the merger assumes all of the obligations of the Company under the Indenture; and (3) the surviving entity meets certain financial criteria.² Failure to comply with § 5.1 is an Event of Default under the Indenture that would allow the Noteholders to accelerate the Notes, making them immediately due and payable. But a merger in compliance with § 5.1 does not otherwise affect the rights of the parties under the Indenture, and the Noteholders do not contend that the Merger violated § 5.1.

But regardless of the Merger's compliance with § 5.1, the Change of Control Covenant set forth in § 4.11 of the Indenture provided additional protections to the Noteholders. It provides that "if a Change of Control occurs, each [Noteholder] will have the right to require the Company to repurchase all or any part of that Holder's [Notes] . . . for 101% of the aggregate principal amount of the [Notes] to be repurchased plus accrued and unpaid interest thereon."³ Petrohawk does not dispute that if a Change of Control occurred, it is required to offer to repurchase the Notes from the Noteholders.

The Indenture lists five circumstances that give rise to a Change of Control, and the Noteholders make arguments that two of them came to pass as a result of the Merger. First, under the Majority Share Provision, a Change of Control occurs if following a merger, the former KCS stockholders do not hold a majority of the outstanding voting shares of the

² Indenture at § 5.1.

³ Indenture at § 4.11.

surviving entity. Second, under the Continuing Director Provision, a Change of Control occurs “the first day on which a majority of the Board of Directors of the Company are not Continuing Directors.”⁴ The Indenture defined a “Continuing Director” as

any member of the Board of Directors of the Company who (1) was a member of such Board of Directors on the [date the Notes were issued]; or (2) was nominated for election or elected to such Board of Directors with the approval of a majority of the Continuing Directors who were members of such Board at the time of such nomination or election.⁵

The Indenture defined the “Company” as KCS and did not include a provision, common to many Indentures of this type, providing that the definition of the “Company” shall include successor entities.⁶

B. The Merger

On April 20, 2006, KCS entered into the “Merger Agreement” with Petrohawk. The Merger Agreement provided that each issued and outstanding share of KCS would be converted into the right to receive \$9.00 in cash and 1.65 shares of Petrohawk common stock. The Merger was consummated on July 12, 2006.

The parties to the Merger structured the transaction carefully to avoid running afoul of the Majority Share Provision. In order to avoid triggering a Change of Control, immediately following the Merger, the former KCS stockholders needed to hold a majority of the combined entity’s voting shares. Based on the respective number of voting shares of each company outstanding at the time the Merger Agreement was executed, the transaction

⁴ *Id.* at § 1.1.

⁵ *Id.*

⁶ *See, e.g.*, AMERICAN BAR ASSOCIATION, REVISED MODEL SIMPLIFIED INDENTURE at §§ 1.01, 5.02 (2000) (noting the common inclusion of such a provision).

would have resulted in the former KCS stockholders only holding 49.88% of the post-Merger voting shares. To place a majority of voting shares in the hands of the former KCS stockholders, before the Merger closed, Petrohawk therefore redeemed 590,271 shares of its preferred stock (the “Preferred Share Redemption”) so that those shares would not be counted in determining the post-Merger ownership percentages of the stockholders of the two formerly separate companies.

It is unclear when the decision to embark upon the Preferred Share Redemption was made. Initially it appears that KCS and Petrohawk believed that the Merger would, in fact, trigger a Change of Control and that, after the Merger, Petrohawk would redeem the Notes and refinance the debt. Indeed, KCS’s Chief Executive Officer, Jim Christmas stated in an investor conference call on April 21, 2006 that the Merger would trigger a Change of Control under the Indenture.

At some point, however, the Preferred Share Redemption was begun, and by July 10, 2006, two days before the Merger, all of the preferred shares had been redeemed. After the Merger was consummated, the combined Petrohawk entity had 167,471,125 voting shares outstanding, of which the former KCS stockholders held 83,828,085, or 50.06%.

Notably, a number of KCS executives had employment contracts, under which they were entitled to substantial change of control benefits unless the former KCS stockholders held 51%, rather than simply a majority, of the shares of any post-merger entity. Thus, although the 50.06% figure did not trigger a Change of Control under the Indenture, it did trigger a change of control under the KCS executives’ employment contracts, and those executives collected an aggregate of about \$15 million in change of control payments.

The parties to the Merger also took care to avoid a Change of Control under the Indenture's Continuing Director Provision. Before the Merger, KCS had a seven member board of directors. Petrohawk had a nine member board. There was no overlap among directors of the two companies. The Merger Agreement provided that after the Merger, Petrohawk would continue to have a nine member board. It further provided that five members of the post-Merger board would be designated by Petrohawk (the "Petrohawk Designees") and four would be designated by KCS (the "KCS Designees"). In the joint "Proxy Statement" submitted by Petrohawk and KCS to their respective stockholders, the two companies identified by name the nine individuals (the "Post-Merger Directors") that they had designated to serve on the post-Merger board. The Post-Merger Directors consisted of four pre-Merger KCS directors and five pre-Merger Petrohawk directors.

The Merger Agreement provided that immediately following the effective time of the Merger, Petrohawk would take all corporate action necessary or advisable to cause the election or appointment of a board consistent with a disclosure letter to the Merger Agreement. That disclosure letter specified the conditions for a post-Merger board, conditions met by the Post-Merger Directors. The Proxy Statement named the nine Post-Merger Directors and stated that "[w]hen the merger is consummated, it is anticipated that four members of Petrohawk's board of directors will resign and the remaining Petrohawk board members will appoint [the four KCS Designees] to the Petrohawk board."⁷

In order to avoid triggering a Change of Control, following the Merger, at least five of the directors of the combined entity needed to be Continuing Directors within the

⁷ KCS Energy, Inc., Proxy Statement (Schedule 14A), at 108 (June 6, 2006).

meaning of the Indenture. But only four of the former KCS board members would continue as directors of the post-Merger entity. Therefore, at a KCS board meeting on July 7, 2006, the KCS board unanimously adopted a resolution “confirm[ing] and approv[ing] the nomination and election of each of the [Post-Merger Directors] as the members of the Board of Directors of the surviving corporation.”⁸ On July 6, 2007, the pre-Merger Petrohawk board adopted an identical resolution. The close manner in which the language of that resolution tracks the language of the Indenture’s Continuing Director Provision is notable and indisputably demonstrates that the KCS board intended for that resolution to cause all of the post-Merger board members to be Continuing Directors.

On the morning of July 12, 2006, Petrohawk held its annual stockholders meeting, at which the Petrohawk stockholders voted on two pertinent matters. First, as Petrohawk had a classified board that required election of three directors each year, and the outcome of the Merger vote could not be assumed, the Petrohawk stockholders re-elected the three Petrohawk directors whose terms had expired, including two of the directors who had been designated to serve on the post-Merger board, and one who had not. The Petrohawk stockholders also voted on, and approved, the Merger.

Also on the morning of July 12, 2006, KCS held a special stockholders meeting, at which the KCS stockholders voted on, and approved, the Merger. The closing of the Merger happened shortly thereafter. At 3:02 p.m. of that day, a Certificate of Merger was filed with the Secretary of State’s office, making the Merger effective as of that time.

⁸ Letter from Jon E. Abramczyk to the court (May 3, 2007), Ex. R.

The Certificate of Merger identified the nine Post-Merger Directors by name and stated that “[t]he directors of the surviving corporation shall be [the Post-Merger Directors] until their successors are duly elected or appointed and qualified or until their earlier death, resignation, or removal in accordance with the Certificate of Incorporation and Bylaws of [Petrohawk].”⁹ In other words, the Certificate of Merger, unlike the Proxy Statement and the Merger Agreement, did not contemplate that any additional corporate formalities were required in order to seat the Post-Merger Directors on the post-Merger board.

Indeed, no other formal corporate action was taken to vest the Post-Merger Directors with their board positions. The four pre-Merger Petrohawk directors who did not continue as directors following the Merger, including the one who was re-elected to office that morning, did not sign a resignation statement other than the implicit one represented by their prior approval of the Certificate of Merger, which clearly indicated who would compose the post-Merger board once the Merger became effective. Thus, once the Merger was completed, the departing directors simply ceased to act as directors and their replacements simply took office in their place. No board meeting occurred on July 12, 2006, the day of the Merger. But on that afternoon, the Post-Merger Directors acted by unanimous written consent, identifying each of those nine individuals as the members of the Petrohawk board, placing them in the various classes of the classified board, and designating the committees on which they would serve, among other routine Merger-related matters.¹⁰ The first post-Merger Petrohawk board meeting occurred on August 8, 2006. The same nine Post-Merger

⁹ *Id.*

¹⁰ *See id.* at Ex. V.

Directors attended that meeting and acted as the Petrohawk board of directors in a routine manner.

III. The Procedural And Contract Law Framework

Petrohawk initially moved to dismiss the Noteholders complaint under Rule 12(b)(6) for failure to state a claim. In doing so, Petrohawk submitted materials not incorporated into the pleadings that could not properly be considered on a motion to dismiss. Moreover, at oral argument on the motion to dismiss it became clear that a minor factual issue remained as to the manner in which the Post-Merger Directors were seated in office. As a result, I allowed the Noteholders to take limited discovery, and the parties to submit supplemental papers, on that discrete issue in order to develop an appropriate factual record for resolution of this case.¹¹

I now consider the additional submissions of the parties and treat Petrohawk's motion as one for summary judgment. The motion is therefore governed by the familiar Rule 56 standard under which judgment will be granted when a movant demonstrates that there are

¹¹ Another procedural aspect is worth noting. Although Petrohawk's opening brief on its motion to dismiss did not raise an argument under Rule 12(b)(1), at oral argument, a question was raised regarding this court's subject matter jurisdiction. The Noteholders attempted to invoke this court's traditional equity jurisdiction by styling its claim as one for specific performance of Petrohawk's obligation to offer to redeem the Notes. I am skeptical that such a request, which is essentially one seeking a simple monetary payment, can properly be considered an equitable claim for specific performance. Rather, it seems that the Noteholders are advancing legal contract claims and are seeking an exclusively legal, monetary remedy. Nonetheless, resolution of this case requires me to interpret and apply the Delaware General Corporation Law. As a result, this court has jurisdiction under 8 *Del. C.* § 111(b), which provides that "[a]ny civil action to interpret, apply, or enforce any provision of this title may be brought in the Court of Chancery," as well as under 8 *Del. C.* § 111(a), which provides that "[a]ny civil action to interpret, apply, enforce, or determine the validity of the provisions of . . . [a]ny agreement or certificate of merger . . . [m]ay be brought in the Court of Chancery."

no genuine issues of material fact in dispute and that it is entitled to judgment as a matter of law.¹²

Resolving this motion requires me to interpret the terms of the Indenture, which provides that it is governed by the laws of New York. Under New York law, as in Delaware, “[t]he construction and interpretation of an unambiguous written contract is an issue of law within the province of the court.”¹³ The interpretation of an unambiguous contract is appropriate for determination by the court on summary judgment.¹⁴

In New York, “the essence of proper contract interpretation . . . is to enforce a contract in accordance with the true expectations of the parties.”¹⁵ With regard to standardized agreements like the Indenture, determination of those expectations must be done by examining the language of the agreement itself because “[b]oilerplate 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.”¹⁶

In interpreting contract language, New York contract law instructs courts ordinarily to give the words and phrases employed their plain and commonly-accepted meanings.¹⁷ Moreover, a proper interpretation can only be done by examining the contract as a whole

¹² *E.g.*, *Scureman v. Judge*, 626 A.2d 5, 10 (Del. Ch. 1992).

¹³ *Estate of Hatch v. NYCO Minerals, Inc.*, 666 N.Y.S.2d 296, 298 (N.Y. App. Div. 1997); *see also Klair v. Reese*, 531 A.2d 219, 222 (Del. 1987).

¹⁴ *Marinas of the Future, Inc. v. City of New York*, 450 N.Y.S.2d 839, 843-44 (N.Y. App. Div. 1982).

¹⁵ *Reiss v. Fin. Performance Corp.*, 715 N.Y.S.2d 29, 34 (N.Y. App. Div. 2000).

¹⁶ *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1048 (2d Cir. 1982).

¹⁷ *Laba v. Carey*, 29 N.Y.2d 302, 308 (N.Y. 1971).

and “giving effect and meaning to every term of the contract.”¹⁸ That is, “[p]articular words should be considered, not as if isolated from the context, but in light of the obligation as a whole.”¹⁹

IV. The Merger Did Not Trigger A Change Of Control Under The Indenture

A. No Change Of Control Occurred Under The Majority Share Provision

Under the Majority Share Provision, a Change of Control did not occur so long as the former KCS stockholders held a majority of voting shares in post-Merger Petrohawk. As a result of the Preferred Share Redemption, the former KCS stockholders held 50.06% of the post-Merger voting shares, a clear majority.

The Noteholders do not dispute that fact, but instead raise a technical argument regarding the manner in which the Preferred Share Redemption was carried out. They do not now contend that the Redemption did not occur or that the preferred shares were actually outstanding at the time of the Merger.²⁰ Rather, they contend that “based upon everything we can glean and infer from [KCS’s and Petrohawk’s] public filings,” the Preferred Share Redemption “was not done properly.”²¹ The argument the Noteholders

¹⁸ *Niagara Frontier Transportation Authority v. Euro-United Corp.*, 757 N.Y.S.2d 174, 176 (N.Y. App. Div. 2003).

¹⁹ *Kass v. Kass*, 91 N.Y.2d 554, 566 (N.Y. 1998) (quotations omitted); *see also id.* at 567 (explaining that where the terms of the contract, taken as an entirety, make the overarching meaning clear, “courts examining isolated provisions should then choose the construction which will carry out the plain purpose and object of the agreement.”).

²⁰ *See* Transcript of Oral Argument (“Argument Tr.”) at 70-71 (reflecting counsel for the Noteholders’ concession in response to the question of whether the Noteholders are alleging that the preferred shares were not in fact redeemed: “I’d say . . . At this point I’d say no, I’m not going to allege that . . .”).

²¹ *Id.*

make is essentially to contend that Petrohawk's decision to redeem the preferred shares came too late.

The Noteholders first highlight the fact that KCS's CEO admitted a few months before the Merger that the Merger would cause a Change of Control. They then point to public filings from as late as June 28, 2006, about two weeks before the Merger, which they contend suggested the preferred shares would not be redeemed. The reason, the Noteholders say, is that the June 28 disclosure presents pro forma financial statements reflecting a combined entity in which the preferred shares would be outstanding. The Noteholders then contend that, based on the timeframe of that disclosure, any last-minute decision on the part of the two merging companies to redeem the preferred shares could not have complied with either: (1) the Certificate of Designation for the preferred shares, which required Petrohawk to give 30 days notice to the holders of the preferred stock of its intent to redeem the preferred shares; or (2) Securities and Exchange Act Rule 14e-1, which requires all tender offers to be held open for a minimum of 20 days, and which Petrohawk would have to have complied with had it not validly redeemed the preferred shares in accordance with the Certificate of Designation.

The Noteholders' arguments in this regard fail for a number of reasons, the first of which is that the public disclosures to which the Noteholders point do not suggest at all that Petrohawk did not comply with the redemption procedures outlined in the preferred shares' Certificate of Designation. In fact, the June 28 disclosure to which the Noteholders point did not contain any statement to the effect that KCS or Petrohawk believed the preferred shares would remain outstanding after the Merger. The pro forma financial statements

contained in that disclosure did not purport to reflect the actual results of the Merger on July 12, 2006, but rather to reflect “how the combined financial statements of [Petrohawk] and KCS may have appeared had the businesses actually been combined *as of March 31, 2006*.”²² It would have been misleading for the preferred shares not to be included in those financial statements because those shares were outstanding on March 31. But that does not mean they were outstanding, or intended to be outstanding, on July 12. Petrohawk had plenty of time after March 31 to effect a valid Redemption, and the Noteholders have not alleged any facts to suggest they did not. Moreover, the fact that KCS’s CEO stated in a conference call *in April* that he believed a Change of Control would occur does not aid the Noteholders. Regardless of their initial belief, KCS and Petrohawk later figured out a way to structure the Merger so that the former KCS stockholders would hold more than 50% of the post-Merger shares, and they complied with the unambiguous letter of that Provision.

The more important reason the Noteholders’ Majority Share arguments fail, though, is simply that even if there were technical defects in the way the preferred shares were redeemed, those defects would be completely irrelevant to the Noteholders’ claims. The Noteholders fail to explain why Petrohawk’s failure to redeem the preferred shares in compliance with the Certificate of Designation or federal securities regulations changes the fact that the allegedly non-compliant redemption did in fact occur. Regardless of any such compliance or non-compliance, the Noteholders admit that the preferred shares were redeemed and were not outstanding post-Merger. The issues the Noteholders raise are therefore beyond the province of the Indenture, which is the only source of rights that the

²² Petrohawk Energy Corp., Current Report (Form 8-K), at 1 (June 28, 2006) (emphasis added).

Noteholders have.²³ The Noteholders do not even begin to explain why they have standing to assert rights under either the Certificate of Designation or the federal securities laws directed at the protection of the preferred shareholders or, even if they did, how that would change the fact that the former KCS stockholders had majority voting control in post-Merger Petrohawk. The Noteholders do not point to any provision *in the Indenture* that required Petrohawk to comply with the notice provisions contained in the preferred shares' Certificate of Designation, and even if they did, that still would not matter because the allegedly non-compliant redemption was carried out by *Petrohawk*, not KCS, before the Merger, at a time when Petrohawk was not a party to the Indenture and had not yet assumed any obligations under it.

In this same vein, it is also irrelevant that a change of control was triggered under the KCS executives' employment agreements, which allowed them to collect substantial monetary sums as a result of the Merger. The Noteholders complain that KCS's management sold control of KCS to Petrohawk in exchange for \$15 million in change of control benefits. But the fact that the KCS executives held different contract rights entitling them to those benefits does not change the unambiguous and more-limited contract rights held by the Noteholders. Not only that, the Noteholders have not alleged how they might have been injured by payment of the change of control benefits, as they do not contend that payment of those benefits has rendered Petrohawk unable to meet its obligations under the

²³ *E.g.*, *Katz v. Oak Industries, Inc.*, 508 A.2d 873, 878 (Del. Ch. 1986); *Harff v. Kerkorian*, 324 A.2d 215, 221-22 (Del. Ch. 1974), *rev'd on other grounds*, 347 A.2d 133 (Del. 1975).

Notes. Indeed, Petrohawk continues to make its debt service payments on the Notes in a timely manner.

Issuers of corporate debt do not breach their contractual obligations by structuring transactions to avoid triggering a mandatory redemption provision in favor of Noteholders.²⁴ That is all that happened here. The Noteholders do not contest that, under the Indenture, 50.06% was a sufficient majority of shares for the former KCS stockholders to hold in order to avoid triggering a Change of Control under the Majority Share Provision, and that is precisely what the Noteholders admit the former KCS stockholders had.

B. No Change Of Control Occurred Under The Continuing Director Provision

Under the Continuing Director Provision, the Merger triggered a Change of Control unless a majority of the Post-Merger Directors were Continuing Directors. A Continuing Director is:

any member of the Board of Directors of the Company who (1) was a member of such Board of Directors on the [date the Notes were issued]; or (2) was nominated for election or elected to such Board of Directors with the approval of a majority of the Continuing Directors who were members of such Board at the time of such nomination or election.²⁵

As stated, only four out of the nine Post-Merger Directors were former KCS board members. Petrohawk relies on the fact that the pre-Merger KCS board expressly approved the post-Merger board's composition in contending that all of the Post-Merger Directors are Continuing Directors.

²⁴ See, e.g., *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1515 (S.D.N.Y. 1989) (noting that in order to ensure the efficient functioning of capital markets, issuers of corporate debt must be allowed to rely strictly on the terms of protective covenants).

²⁵ Indenture at § 1.1.

In support of their contention that the Merger triggered a Change of Control under the Continuing Director Provision, the Noteholders make a number of complex contractual arguments based on the literal text of the Indenture. The arguments can be separated into two categories, with the first based on the contractual definition of the “Company,” and the second focusing on the fact that the manner in which the Post-Merger Directors were seated in office did not involve an “election” in the strict corporate law sense. I address each category separately.

1. The Noteholders’ Arguments Contending That Petrohawk Is Not The “Company”

The Noteholders’ first series of arguments begins with the notion that the Indenture defined the “Company” as referring only to KCS and did not include a provision, common to many indentures, providing that the word “Company” will refer to successor entities. Then, the Noteholders point out, the Continuing Director Provision required that the Petrohawk Designees be elected to the Board of Directors of the “Company,” i.e., to the KCS board. But the five Petrohawk Designees were never KCS board members. As a result, the Noteholders contend that they cannot be Continuing Directors.

The issue therefore is whether the term “Company” as used in the Continuing Director Provision includes Petrohawk as the successor to KCS. Despite the fact that the Indenture does not contain an express provision to the effect that the “Company” includes its successor entities, when read as whole, the Indenture clearly implies as much, at least as that term is used in the Continuing Director Provision. For one thing, the Noteholders do not point to any provision in the Indenture which contemplates that the “Company” will disappear following a merger in which KCS is not the surviving entity. For another, the

Noteholders, having sued Petrohawk seeking to force a redemption of the Notes, are clearly treating Petrohawk as the primary obligor under the Notes, i.e., as the “Company” under the Indenture. According to the Indenture, a Change of Control only occurs when “a majority of the board of directors of the “Company” are not Continuing Directors.”²⁶ If Petrohawk is not the “Company,” then it is irrelevant under the Indenture whether its directors are Continuing Directors. And under the Change of Control Covenant, only the “Company” is required to offer to redeem the Notes if a Change of Control occurred. If Petrohawk is not the “Company,” it has no such obligation. In other words, the Noteholders cannot have it both ways. If they want to treat Petrohawk as the Company under the Change of Control Covenant, they must also treat Petrohawk as the Company under the Continuing Director Provision.

Moreover, the Noteholders’ reading of the word “Company” as failing to include successor entities is expressly contradicted by Exhibit E to the Indenture, which is titled “Form of Supplemental Indenture to Be Delivered by Future Guarantors,” and which defines the “Company” as KCS “*or its permitted successor.*” Petrohawk and the Indenture Trustee executed a Supplemental Indenture consistent with that form on the date of the Merger, which expressly defines Petrohawk as the “Company.” Having executed the Supplemental Indenture, naming Petrohawk as the “Company,” the Noteholders cannot now

²⁶ Indenture at § 1.1.

be heard to challenge Petrohawk's status as the "Company" under all of the terms of the Indenture.²⁷

The fact that Petrohawk must be treated as the "Company" under the Continuing Director Provision is actually highlighted by a clear flaw in another argument the Noteholders make. The Noteholders point out that to be a Continuing Director in the first place, one must be "a member of the Board of Directors of the *Company*."²⁸ The Noteholders then contend that because only directors of the "Company" (i.e., KCS) can be Continuing Directors and because KCS ceased to exist after the Merger, none of the Post-Merger Directors were directors of KCS and thus none were Continuing Directors — not even the four pre-Merger KCS directors who the Noteholders admit were Continuing Directors up until the moment of the Merger.

But that interpretation of the Continuing Director Provision is obviously wrong because it would result in a Change of Control in any merger in which KCS was not the surviving entity. The Indenture expressly contemplated in § 5.1 that such a merger might

²⁷ The Noteholders' contention that Petrohawk did not *become* the "Company," but merely succeeded to KCS's obligations as the "Company" under the Indenture is also unconvincing, even absent the Supplemental Indenture. The surviving entity following a merger succeeds not only to the liabilities and contract obligations of the non-surviving entity, but also to its "rights, privileges, powers, and franchises." 8 *Del. C.* § 259. Not only did Petrohawk succeed to the obligations of KCS as the "Company," but also to its rights under the Indenture, which include allowing Petrohawk to be treated as the "Company" under the Continuing Director Provision. As this court explained in *Western Airlines, Inc. v. Allegheny Airlines, Inc.*, 313 A.2d 145 (Del. Ch. 1973), although parties to contracts are free to provide that contractual rights and obligations will not survive a merger, they must do so in clear and unambiguous terms, and the absence of a "successors and assigns" clause will not suffice for that purpose. That is, the failure to include successors in the definition of the "Company" does not preclude a successor from being treated as such. *See id.* at 153-54 ("If the agreement does not specifically state it is not applicable to successors and assigns, the policy of the law is so clear that survival should be taken as the normal course of events. Contracts must be written and construed in light of generally accepted legal principles.").

²⁸ Indenture at § 1.1 (emphasis added).

occur and that in certain circumstances, the Notes would remain outstanding with no change in the Noteholders' rights. To accept the Noteholders' arguments would therefore essentially read the safe harbor for certain mergers in § 5.1 out of the Indenture entirely. A Change of Control subjects the surviving entity to an even more ominous remedy than if an event of default occurs under § 5.1. In the case of the latter, the Noteholders would be able to accelerate the debt and force the surviving entity to pay it off immediately with accrued interest. If a Change of Control occurred, the surviving entity would have to pay that same amount plus an additional 1%.²⁹ Because the Indenture contemplates that it is possible to have a merger in which KCS is not the surviving entity without the survivor having to pay off the entire debt, Petrohawk, the surviving entity in the Merger, must be treated, in the post-Merger period, as the "Company" under the Continuing Director Provision.³⁰

2. The Noteholders' Arguments Regarding The Lack Of A Formal Corporate Election

The Noteholders' final argument contending that a Change of Control occurred is based on the manner in which the Post-Merger Directors were seated on the board. Because the five Petrohawk Designees constituted a majority of the Post-Merger board and because none had served as directors of KCS before the Merger, a Change of Control would have occurred following the Merger unless at least one of those five directors was "nominated for election or elected to [the post-Merger board] with the approval of" a majority of the pre-

²⁹ In this vein, the Noteholders' attempts to differentiate between an event of default entitling the Noteholders to accelerate the debt and the obligation to redeem the Notes under the Change of Control covenant have no substance. Although it is true that the Noteholders could choose not to accept an offer to redeem the Notes, they could also choose to waive an event of default caused by a violation of § 5.1, with the end result being the same.

³⁰ See *Kass*, 91 N.Y.2d at 566-67 (explaining that contract provisions should be interpreted in a manner that best allows all the terms of a contract to fit together in a consistent manner).

Merger KCS board members.³¹ For purposes of this argument, the Noteholders concede that the KCS Designees remained Continuing Directors following the Merger because they were directors of KCS at the time the Notes were issued.³²

The Noteholders do not dispute that the pre-Merger KCS board approved each of the nine Post-Merger Directors. Indeed, on July 7, the KCS board adopted a unanimous resolution providing that “the [KCS] Board hereby confirms and approves the nomination and election of each of the individuals set forth in . . . the Certificate of Merger as the members of the Board of Directors of the surviving corporation identified in such Certificate of Merger.”³³ As stated, the Certificate of Merger identified, by name, each of the nine Post-Merger Directors. The argument the Noteholders make is that the Post-Merger Directors were never “nominated for election or elected” in the strict corporate law sense, which, the Noteholders say, is a prerequisite to being deemed a Continuing Director. The Noteholders contend therefore that the approval given by the KCS board was ineffective.

This argument, like the Noteholders’ prior one, is a technical argument based on concerns that do not bear on the substantive rights of the Noteholders. To give them their due, the Noteholders are correct in noting the roundabout way the merging parties went about seating the Post-Merger Directors. In the Merger Agreement itself, the parties provided that Petrohawk would take whatever action was necessary to seat a nine-member board in conformity with a disclosure letter to the Merger Agreement. That disclosure letter

³¹ Indenture at § 1.1.

³² See Argument Tr. at 74 (explaining that only one of the Petrohawk Designees would need to be a Continuing Director to avoid triggering a Change of Control).

³³ Letter from Jon E. Abramczyk to the court (May 3, 2007), Ex. R.

did not precisely identify the nine members. In the Proxy Statement, the nine members who had been agreed upon by the merging parties — and expressly approved by the KCS board — were identified. But the Proxy Statement suggested that the seating of the nine Post-Merger Directors would be accomplished by the resignations of four pre-Merger Petrohawk board members and the appointment of the KCS Designees in their place.

As we now know, the merging parties took another route toward seating the post-Merger board. Both boards — including the KCS Board — adopted resolutions approving the nomination and election of the Post-Merger Directors as set forth in the Certificate of Merger. After these resolutions were adopted and after the stockholders of both corporations approved the Merger Agreement, a Certificate of Merger was filed that simply identified the nine Post-Merger Directors as the Petrohawk board. No further action was taken to seat that board and it is undisputed that only the Post-Merger Directors have ever served as the board of post-Merger Petrohawk.

The Noteholders contend that this was not a proper way to compose the post-Merger board. They claim that a Certificate of Merger is simply an administrative convenience that permits merging parties, and the Secretary of State, to avoid the burdens that come from filing the full merger agreement.³⁴ The Noteholders argue that it was an improper technique for the merging parties to utilize a Certificate of Merger as a device to seat a new board.

³⁴ See 8 *Del. C.* § 251 (“In lieu of filing the agreement of merger or consolidation required by this section, the surviving or resulting corporation may file a certificate of merger or consolidation . . . which” describes the key aspects of the merger); DREXLER, BLACK & SPARKS, DELAWARE CORPORATE LAW AND PRACTICE § 35.04[5] (2006) (“Allowing the short form to be filed rather than the entire merger agreement “serve[s] the dual purpose of avoiding the expense of filing a lengthy merger agreement and avoiding public disclosure of all the merger terms.”).

Instead of that technique, the Noteholders say that the incumbent Petrohawk board majority should have appointed the KCS Designees to the post-Merger board once four of the pre-Merger Petrohawk directors had resigned, as Petrohawk and KCS said would happen in the Merger Proxy Statement.³⁵ The Noteholders contend that if that process had been followed, it would be clear that the five Petrohawk Designees would not be Continuing Directors because no corporate action of any kind, much less an election, would have occurred to seat the Petrohawk Designees on the post-Merger Petrohawk board.³⁶ They simply stayed on the Petrohawk board and continued serving as they had done before the Merger.

In addressing this confusing and gray matter grinding argument, it is helpful to begin by noting the internal inconsistency of the argument itself, which is that although the Noteholders challenge the manner by which the KCS Designees were seated on the post-Merger Petrohawk board, it is the Petrohawk Designees that the Noteholders contend are not Continuing Directors. As stated, for purposes of this argument, the Noteholders concede that the KCS Designees are Continuing Directors. Moreover, as is easy to grasp, the Noteholders' argument is one that no stockholder of either KCS or Petrohawk would or has asserted. It is entirely technical, and has no substantive or equitable basis. The Noteholders do not contend that the merging parties seated a board contrary to that which the merging parties had agreed upon and disclosed to their stockholders in the Proxy Statement. Rather,

³⁵ 8 *Del. C.* § 141(b) (“Each director shall hold office until such director’s successor is elected and qualified or until such director’s earlier resignation or removal. Any director may resign at any time upon notice given in writing . . .”).

³⁶ See 8 *Del. C.* § 211 (“All elections of directors shall be by written ballot unless otherwise provided in the certificate of incorporation . . .”).

the Noteholders question the method by which that board was seated. Their purpose for doing so is to use a technicality to trigger a right of redemption.

The problem for the Noteholders is that these technical arguments do not properly lie in their mouths.³⁷ As a matter of contract interpretation, the key issue is whether the post-Merger board was comprised of a majority of directors whose service was approved by the incumbent KCS board. Whether or not the use of a Certificate of Merger was a proper way to seat the Post-Merger Directors as a matter of Delaware corporate law, the action of the KCS board in approving the service of the Post-Merger Directors was sufficient as a matter of New York contract law to vest the Post-Merger Directors with the status of Continuing Directors. That unilateral, voluntary act by the KCS board fulfilled the key function of the Continuing Director Provision, which was to provide the Noteholders with a limited contractual protection against hostile acquisitions. That is, the Continuing Director Provision turned the Notes into a form of “poison debt,” which made a hostile acquisition more difficult by requiring the Notes to be paid in full with a 1% premium if the incumbent board did not sign off on the transition. The import of the Provision was to give the incumbent board the power to determine whether a transaction would trigger a Change of Control or not. Implicit in that was the notion that so long as the other provisions of the Indenture were complied with, the incumbent board could freely authorize a friendly

³⁷ See 8 Del. C. § 225 (providing that in cases to contest the validity of a corporate election, the only parties with standing are stockholders, directors, and officers whose titles to office are contested); see also 8 Del. C. § 221 (providing that holders of corporate debt have no voting rights unless expressly provided for in a certificate of incorporation).

transaction.³⁸ Indeed, the “nominated for election or elected” language that appears in the Continuing Director Provision is commonly used in contract provisions of this kind, and the Noteholders do not point to a single case in which any court has considered that aspect of the provision to require a formal corporate election process. Rather, case law in this area focuses on whether a transaction causing a change in board composition was approved by the incumbent board.³⁹

Here, it is indisputable that every member of the post-Merger board was expressly approved by the pre-Merger KCS board in a resolution expressly contemplating the filing of a Certificate of Merger that would have the effect of seating the Post-Merger Directors immediately upon the effective time of the Merger. Moreover, it is undisputed that the Post-Merger Directors took office immediately after the Merger with no further action.

Although there is, I suppose, a colorable argument that the merging parties’ use of a Certificate of Merger to seat the Post-Merger Directors was improper as a matter of corporate law,⁴⁰ that argument is irrelevant. The key question is not whether the method

³⁸ *California Public Employees’ Retirement System v. Coulter*, 2005 WL 1074354, at *4 (Del. Ch. 2005) (explaining that when parties insert a continuing director provision like the one involved here in a contract, they choose, “as a matter of contract, to allow the incumbent directors, in effect, to determine if there had not been a change of control” and that new directors can be deemed continuing directors so long as the existing directors vote to approve them).

³⁹ *See, e.g., Miracle v. Networth, Inc.*, 2000 WL 1073611, at *3 (Tex. App. 2000) (finding that no change of control occurred under a continuing director provision that required a new director’s “initial election or initial nomination for election” to be approved by the incumbent board based solely on the fact that the incumbent directors approved the transaction that altered the board’s composition).

⁴⁰ Although I decline to decide this question, the Noteholders’ argument that the method used was foreclosed by the DGCL is hardly overwhelming. Although the merging parties could have used a different approach, the one that they did use was substantively consistent with the terms of the Merger Agreement and seated a board of exactly the kind the stockholders expected to govern the post-Merger entity. Indeed, the identity of the Post-Merger Directors was disclosed in the Merger

used to seat the post-Merger board was proper under the Delaware General Corporation Law, the key question is whether the post-Merger board was comprised of a majority of Continuing Directors as a matter of contract. In this regard, it is notable that § 5.1 of the Indenture did not preclude a merger in which the surviving entity could be domiciled in a state other than Delaware. That reality emphasizes that the crucial issue is one of substantive contract interpretation, not technical corporate law.

In New York, the primary goal of contract interpretation is to give effect to the reasonable expectations of the parties to the agreement.⁴¹ In that regard, both the language and clear purpose of the Continuing Director Provision in the Indenture were fulfilled by the

Proxy Statement. Section 5.12 of the Merger Agreement expressly indicated that Petrohawk would take all corporate action necessary to seat a board consistent with the disclosure letter — i.e., the Post-Merger Directors — immediately after the Effective Time, i.e., when the Certificate of Merger was filed and the Merger became effective. The Certificate of Merger expressly indicated that the directors of the post-Merger entity would be the Post-Merger Directors, giving them that status as soon as the Merger became effective. As Petrohawk notes, §§ 251(b)(6), 251(c), and 251(d), when read together, can rationally be read as permitting merging parties to use a Certificate of Merger to seat a board of directors so long as that board is, as was the case here, consistent with the expectations of the voting stockholders. Even if this method of seating the Post-Merger Directors was different than the Proxy Statement suggested would be used, the method was agreed upon by both boards. Both boards had retained the power to make amendments to the Merger Agreement that were consistent with the limits set forth in § 251(d), and the change in method was a technical change permissible under § 251(d) because it did not alter any substantive expectation or right of the merging entities' stockholders. In fact, because § 5.12 was not specific as to method, the use of the Certificate of Merger was consistent with the Merger Agreement as written. Although the Noteholders gripe about Petrohawk's failure to secure official resignations from four of its pre-Merger directors, and its failure to officially appoint the KCS Designees, the unanimous resolution of the Petrohawk board approving the nomination and election of the Post-Merger Directors to the post-Merger board as set forth in the Certificate of Merger rationally can be read as a resignation by the four directors who would not continue and the appointment of the KCS Designees in compliance with § 223 of the DGCL. Likewise, it can be read as authorizing and requiring whatever temporal minuet of resignations, appointments, or reappointments as was necessary to seat all the nine persons approved as Continuing Directors on the post-Merger board.

⁴¹ E.g., *Sutton v. E. River Sav. Bank*, 55 N.Y.2d 550, 555 (N.Y. 1982) (explaining that when interpreting a contract, "the aim is a *practical* interpretation of the expression of the parties to the end that there be a realization of their reasonable expectations") (emphasis added).

action of the KCS board in approving the Post-Merger Directors. The Merger resulted from arms-length bargaining between KCS and Petrohawk. As part of that process, Petrohawk secured concessions regarding the composition of the post-Merger entity's board of directors. The post-Merger board that was seated by the Certificate of Merger was comprised entirely of individuals "approv[ed]" by the KCS board. The language of the Continuing Director Provision does not require that Continuing Directors be "nominated or elected" by a vote of KCS stockholders. Rather, the Continuing Director Provisions simply requires that a majority of the incumbent KCS board "approv[e]" the nomination or election of new directors if those new directors are to qualify as Continuing Directors. Furthermore, it is obvious that the Provision does not use the term "election" in any formal sense tied to the DGCL.⁴² Rather, the term election must be read to have been used more colloquially to refer to the process by which a director is seated to hold office.⁴³ Otherwise, the term would exclude from the status of Continuing Directors persons appointed by the KCS board incumbents to fill vacancies, an unreasonable result serving no legitimate purpose for the Noteholders.⁴⁴ The critical requirement of the Continuing Director Provision is that the incumbent KCS board "approv[e]" any director before she takes office, by whatever means

⁴² See, e.g., *Laba*, 29 N.Y.2d at 308 (explaining that New York contract law instructs courts to give the words and phrases employed their plain and commonly-accepted meaning).

⁴³ See THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 574 (4th ed. 2000) (defining the verb "elect" as "to select by vote," and "to make a choice or selection"); MERRIAM-WEBSTER'S ONLINE DICTIONARY, available at <http://mw1.merriam-webster.com/dictionary/elected> (same). That meaning encompasses other methods by which a director might attain office, in addition to a formal shareholder election by written ballot. See 8 Del. C. § 223 (providing that vacancies and newly created directorships can be "filled by a majority of directors then in office").

⁴⁴ See, e.g., *Superb General Contracting Co. v. City of New York*, 833 N.Y.S.2d 64, 64 (App. Div. 2007) ("A contract should not be interpreted to produce a result that is absurd, commercially unreasonable or contrary to the reasonable expectations of the parties.") (internal quotation omitted).

of selection. It is undisputed that the election in that sense of the nine post-Merger Directors was “approv[ed]” by the pre-Merger KCS board.

As a temporal matter, it is also clear that there was never a time when the entity responsible for honoring the Noteholders’ rights was governed by a board not comprised of Continuing Directors. Before the Merger, KCS was governed by a seven-member board comprised entirely of Continuing Directors, and these were the sitting directors who “approv[ed]” the election of the Post-Merger Directors to govern the post-Merger entity. As soon as the Certificate of Merger became effective, the entity responsible for honoring the Noteholders’ rights became Petrohawk, and its board was comprised entirely of Continuing Directors who had been “approv[ed]” by the pre-Merger KCS board.

As a matter of substance, it is equally plain that the Noteholders have no claim. They acknowledge that the pre-Merger KCS board knew exactly which nine individuals would be the Post-Merger Directors and approved every member, including the Petrohawk Designees. No substantive expectation of the Noteholders was thwarted. In fact, the Noteholders implicitly admit that their argument is a wholly-technical, “gotcha” argument, as they suggested at oral argument that there were methods by which the same Post-Merger Directors could have been seated that would not have triggered a Change in Control. According to the Noteholders, everything would have been peachy if, before the Merger, KCS had adopted a by-law expanding its board by one member and held a special election electing one of the Petrohawk Designees to sit momentarily on the soon-to-be-defunct KCS

board.⁴⁵ By that cumbersome means, the Noteholders say that the election requirement in the Indenture would have been satisfied with respect to that director, along with the four KCS Designees, and five of the nine post-Merger directors would have been Continuing Directors. Yet, because the Noteholders believe that the merging parties' transactional planners blew it by not taking that formalistic step and by using an allegedly inappropriate method to seat the Post-Merger Directors that they contend is not sanctioned by the DGCL, they claim that some version of strict contractual liability dictates a ruling in their favor.

I conclude otherwise because both the language and the clear purpose of the Continuing Director Provision, when sensibly read, were satisfied by the KCS board's unanimous approval that the Post-Merger Directors be installed in office as soon as the Merger became effective. Having negotiated at arms' length a Merger Agreement that involved the seating of a compromise board of directors, having expressly informed both companies' stockholders of the identity of the Post-Merger Directors and the intent that Petrohawk would do whatever was necessary to promptly seat them on the post-Merger board, and having expressly adopted resolutions "approving" the seating of all the Post-Merger Directors via a Certificate of Merger, the failure of the KCS and Petrohawk boards to engage in the gymnastics now suggested by the Noteholders is understandable. Whether they were correct or not about how they went about things, there is no doubt that the Post-Merger Directors were seated with the prior approval of the KCS board and that the continuation of the five incumbent Petrohawk directors was the result of a decision of the KCS board. The fact that four Petrohawk directors departed as a result of that bargaining

⁴⁵ Argument Tr. at 74, 81, 96.

process highlights a corresponding fact, which is that the five incumbents were only able to continue service on the Petrohawk board after the Merger because of the KCS board's prior approval in the Merger Agreement and its resolution of July 7, 2006. The KCS board clearly understood all of the Post-Merger Directors to be deriving their legitimacy as members of the post-Merger board from the Certificate of Merger, which in turned derived its legitimacy from its consistency with the Merger Agreement that was approved by both companies' stockholders. That is, the resolutions of the boards in July both reflected an understanding that the Post-Merger Directors would be installed in office — i.e., "elected" within the meaning of the Indenture — as a result of the Certificate of Merger. Any corporate law flaw in this method does not implicate any legitimate interest of the Noteholders. It would only implicate interests of the stockholders, and not one of them has complained.

Indeed, the Noteholders' concession that the four KCS Designees are Continuing Directors is an implicit admission of the Noteholders' strained reasoning on this point. Absent the Certificate of Merger, these four directors would never have joined the Petrohawk board. The Certificate of Merger approved by both boards, in conformity with the Merger Agreement, is what installed those KCS Designees in office on the Petrohawk board. If their seating by that means did not disentitle them to Continuing Director status, on what rational basis does the seating of the five incumbent Petrohawk directors on the post-Merger board disentitle those directors to Continuing Director status? I can perceive none.

V. Conclusion

For the reasons stated, I grant summary judgment in favor of Petrohawk on all counts and dismiss all of the Noteholders' claims. IT IS SO ORDERED.