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Corporate Governance Group

Client Alert

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DELAWARE SUPREME COURT PROVIDES GUIDANCE ON INTERPRETATION OF "BOILERPLATE" INDENTURE PROVISIONS

Proposed corporate splitoff not sufficiently tied to previous transactions to require aggregation under bond indenture's "successor obligor provision"

In *Bank of New York Mellon Trust Company, N.A. v. Liberty Media Corp.*,[1] the Delaware Supreme Court recently considered whether the Court of Chancery properly determined that a series of four divestitures – taking place over the course of seven years along with various asset acquisitions and swaps – should be aggregated for purposes of determining whether a corporation had sold "substantially all of its assets" under a bond indenture's successor obligor provision.[2] While affirming the Court of Chancery's conclusion that the four divestitures were not sufficiently connected to warrant aggregation, the Supreme Court also found that the Court of Chancery's adoption of the "step-transaction doctrine" as an analytical tool for determining whether a series of transactions should be aggregated for purposes of a bond indenture's successor obligor provision was not necessary, limiting the precedential impact of the Court of Chancery's decision. The Supreme Court also took the opportunity to provide some useful guidance concerning the interpretation of so-called "boilerplate" language when used in a bond indenture.

Background

Liberty Media Corporation, led by cable TV giant John Malone, is a major distributor of entertainment, sports and other television programming. Liberty was created in 1991 by Tele-Communications, Inc. in reaction to a threat by federal regulators to separate its programming assets from its cable systems. After a series of corporate transactions engineered by Malone, Liberty emerged in August 2001 as an independent, publicly-traded corporation.

[1] No. 284, 2011, C.A. No 5702 (Del. Sup. Ct. Sept. 21, 2011).

[2] For a more detailed discussion of the Delaware Court of Chancery's decision, please *see* our prior Client Alert titled "*Delaware Court Declines To Aggregate Four Corporate Splitoff Transactions For Purposes Of Indenture's Successor Obligor Provision*," dated June 7, 2011.

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At that time, Liberty held assets characterized by the Court of Chancery as "a 'fruit salad' of assets, consisting mainly of minority equity positions in public and private entities." In addition, Liberty was party to an indenture for outstanding bonds containing a "successor obligor provision." This provision prohibited Liberty "from selling, transferring, or otherwise disposing of 'substantially all' of its assets unless the entity to which the assets are transferred assumes Liberty's obligations under the indenture.…" Notably, the bond indenture, which is governed by New York law, does not define the term "substantially all."

Because many of Liberty's assets were minority investments that did not generate cash flow, Liberty management sought to acquire controlling interests in those businesses. If the path to control was blocked, management would "evaluate[ ] all possible alternatives for the asset." In furtherance of this strategy, Liberty "engaged regularly in acquisitions, dispositions, [and] complex swaps," as well as the following dispositive transactions:

1. *LMI*: In 2004, management engineered the spinoff to Liberty stockholders of a subsidiary, Liberty Media International, Inc., which removed $11.79 billion in assets from Liberty's balance sheet, representing 19% of Liberty's book value as of March 31, 2004.

2. *Discovery*: In 2005, Liberty dividended to stockholders its minority interest in the joint venture that owns the Discovery cable channel, removing $5.825 billion in assets from its balance sheet, or 10% of Liberty's book value, as of March 31, 2004.

3. *LEI*: In 2009, Liberty split off its interest in DirectTV (as well as certain other businesses) into a new entity called Liberty Entertainment, Inc. ("LEI"), removing $14.2 billion in assets from Liberty's balance sheet, or 23% of Liberty's book value, as of March 31, 2004.

4. *Capital Splitoff*: Finally, in June 2010, Liberty announced the "Capital Splitoff," pursuant to which it would split off its Capital and Starz Groups into a new public entity, removing $9.1 billion in assets from Liberty's balance sheet, or 15% of Liberty's total assets, as of March 31, 2004.

After learning of the Capital Splitoff, a lawyer acting for an anonymous bondholder sent a letter to Liberty claiming that it was pursuing "a 'disaggregation strategy' designed to remove assets from the corporate structure against which the bondholders have claims and shift the assets into the hands of Liberty's stockholders." Completion of the Capital Splitoff, the letter asserted, would result in a sale by Liberty of "substantially all of its assets." Accordingly, unless Liberty simultaneously arranged for the successor entity to assume its obligations under the bond indenture, Liberty would be in violation of the bond indenture's successor obligor provision. On this basis, the lawyer's letter threatened Liberty with a declaration of an event of default under the bond indenture.

Faced with this threat, Liberty sought declaratory and injunctive relief in the Court of Chancery against Bank of New York Mellon in its capacity as Trustee under the bond indenture.

The Court of Chancery's Analysis

The Court of Chancery recognized that the "threshold question is … whether the Capital Splitoff should be aggregated with the prior spinoffs of LMI and Discovery and the splitoff of LEI." Applying the

Second Circuit's decision in *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*,[3] the Court of Chancery found that the independent transactions engaged in by Liberty over a seven-year period – and not pursuant to any specific plan – should not be aggregated.

Turning to the question of when multiple transactions will be treated as a single transaction for purposes of "determining whether a transaction constitutes a sale of all or substantially all of a corporation's assets," the Court of Chancery adopted the "step-transaction doctrine" articulated by the Court of Chancery in *Noddings Investment Group, Inc. v. Capstar Communications, Inc*.[4] Under *Noddings*, the Court of Chancery explained, the various "steps" in a series of formally separate but related transactions will be treated as a single transaction if any one of the following tests is satisfied:

1. Under the "*end result test*," the doctrine will be invoked "if it appears that a series of separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result."

2. Under the "*interdependence test*," separate transactions will be treated as one if "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."

3. The "*binding commitment test*" requires "a series of transactions [to be] combined only if, at the time the first step is entered into, there was a binding commitment to undertake the later steps."

Employing each of the "three lenses of the step-transaction doctrine … as a doctrinal tool" to bring the picture created by the evidence at trial "into sharper focus," the Court of Chancery saw no basis to support invocation of the step-transaction doctrine to Liberty's four dispositive transactions.

The Trustee then appealed to the Delaware Supreme Court, challenging not only the Court of Chancery's conclusion that the transactions should not be aggregated under *Sharon Steel*, but also its use of the step-transaction doctrine as an analytical tool in this context.

The Supreme Court's Analysis

Court of Chancery Correctly Applied Sharon Steel

At the outset, the Supreme Court agreed with the Court of Chancery's framing of the threshold issue,[5] as well as its reliance on *Sharon Steel* and acknowledgement that "as a theoretical matter, a series of transactions can be aggregated for purposes of a 'substantially all' analysis." Next, the Supreme Court affirmed the Court of Chancery's application of the *Sharon Steel* principles to the Liberty divestitures, noting that "the Court of Chancery carefully assessed whether the trial evidence demonstrated that Liberty had developed a plan or scheme to dispose of its assets piecemeal with a goal of liquidating nearly all its assets…" Crediting the Court of Chancery's conclusion that the evidence at trial did not establish a plan on the part of Liberty to engage in

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[3] 691 F.2d 1039 (2d. Cir. 1982).

[4] Del. Ch. Mar. 24, 1999.

[5] In framing the threshold question on appeal, the Supreme Court noted that, "The answer ... involves the construction of a boilerplate successor obligor provision in an indenture governed by New York law .... The question presented has not been addressed by the New York Court of Appeals, nor, to our knowledge, by any lower New York state court. In the past, we have certified questions of first impression under New York law to the New York Court of Appeals. In this case, certification is not realistically possible because the parties have requested a decision within one week of the oral argument before this Court. Consequently, as did the Court of Chancery, we must predict what the law of New York would be on this important question of first impression."

a series of distributions that would evade the bondholders' claim, the Supreme Court upheld the Court of Chancery's "legal conclusion rest[ing] on its factual finding that aggregating the four transactions is not warranted because each transaction was the result of a discrete, context-based decision and not as part of an overall plan to deplete Liberty's asset base over time."

Application of Step-Transaction Doctrine Not Necessary

The Supreme Court was not prepared, however, to support the Court of Chancery's "second layer of analysis" incorporating the *Noddings* step-transaction doctrine. Rather, because of the "near absence of any authoritative New York case law," the Supreme Court held that the Court of Chancery should have ended its analysis when it determined that Liberty's various dispositive transactions should not be aggregated under *Sharon Steel*. On this basis, the Supreme Court concluded that it was unnecessary for it to decide whether a New York court would adopt the step-transaction doctrine to determine whether to aggregate a series of transactions in a "substantially all" analysis. "Given the Court of Chancery's factual findings," the Supreme Court explained, "even if the Court of Chancery had not utilized '[t]he three lenses of the step-transaction doctrine,'" its ultimate conclusion "would have been the same under its independent reading of *Sharon Steel*."

"Market-Facilitating Boilerplate Language" Requires "Uniform Interpretation"

The Supreme Court's opinion also provides important guidance concerning the interpretation of so-called "boilerplate" language used in an indenture – in this case, the successor obligor provision. The Supreme Court explained that "[c]ourts endeavor to apply the plain terms of such provisions in a uniform manner to promote market stability." Under such circumstances, "courts will not look to the intent of the parties, but rather the accepted common purpose" of non-negotiated boilerplate provisions. With respect to the Liberty indenture's successor obligor provision, the Supreme Court noted that the indenture "was executed many years after … *Sharon Steel*. There is no evidence that the … language was included for any reason other than to clarify that the Successor Obligor Provision should be interpreted in the same manner as the one at issue in *Sharon Steel*."

The Supreme Court also noted that "the Successor Obligor Provision was never a subject of negotiations between the parties … ." As such, the Supreme Court pointed out that "[h]ad the parties to the Indenture intended to create an asset disposition covenant with a broader scope than the standard, boilerplate successor obligor covenant, it was incumbent upon them to include it in a separate, negotiated covenant." Quoting two commentators on the subject, the Supreme Court explained that if parties to an indenture intend to change the meaning of a commonly used provisions, such provision must "be not only explicit but also distinct from boilerplate provisions. Modifications to common indenture provisions will unlikely yield additional rights as courts will not look to the intent of the parties, but rather the accepted common purpose of such provisions."[6] The reason for this seems straightforward enough: in the words of the Supreme Court, "[i]t is important to the efficiency of capital markets that language routinely used in indentures be accorded a consistent and uniform construction."

Continuing with this theme, the Supreme Court recognized that, if they so desired, the drafters of the Liberty indenture could have availed themselves of "more rigorous model provisions available that explicitly required consideration of prior asset dispositions in determining the legal effect of a later disposition of any substantial part of an issuer's assets." The Liberty indenture contained no such

[6] In an interesting reference to a recent Supreme Court decision interpreting a corporate charter provision establishing a classified, or "staggered," board of directors, the Supreme Court noted that under *Airgas, Inc. v. Air Products and Chemicals*, 8 A.3d 1182 (Del. 2010), "practice and understanding in the real world are relevant and persuasive when interpreting similar language in a contractual provision." For a more detailed discussion of the Delaware Supreme Court's analysis, please *see* our prior Client Alert titled "*Delaware Supreme Court Rejects Stockholder-Proposed Bylaw Amendment Accelerating Date of Annual Meeting*," dated December 1, 2010.

provisions. The Supreme Court also referenced the Court of Chancery's observations that the indenture contained "no covenant 'requiring Liberty to maintain a particular credit rating, a minimum debt coverage ratio, or a minimum asset-to-liability ratio,'" nor "any provision directly addressing dividends and stock repurchases, which are the corporate vehicles to effectuate a spinoff (stock dividend) and a splitoff (stock redemption)." Given that "this Court has consistently held that the rights of bondholders and other creditors are fixed by contract …, it would be inconsistent with the concept of private ordering to expand the scope of the Successor Obligor Provision by rewriting the Indenture contract to include by implication additional protections for which the parties could have – but did not – provide by way of a covenant separate and apart from the boilerplate successor obligor provision."

Conclusion

The Supreme Court's opinion in *Liberty Media* provides helpful guidance to drafters of bond indentures on several levels:

First, although the determination whether and when separate corporate dispositions should be aggregated for purposes of a successor obligor provision is inherently fact-specific, it is clear that the temporal proximity or similarity of the transactions in question will not be determinative under a *Sharon Steel* analysis.

Second, the Supreme Court rejected the Court of Chancery's attempt to impose a perhaps more sophisticated doctrinal approach to the determination whether transactions of this nature should be aggregated. Especially in view of the fact that the Liberty indenture is governed by New York law and the only precedent available was the Second Circuit's opinion in *Sharon Steel*, the Supreme Court was not prepared to support the Court of Chancery's incorporation of the step-transaction doctrine into the analysis.

Third, the *Liberty Media* opinion reinforces the proposition that non-negotiated boilerplate indenture provisions will be given the accepted meaning in the market. When it comes to interpreting such language, the actual words used, or the intent of the parties, appear to be of little significance. Rather, they simply serve as a marker signaling that the prevailing market meaning should be applied, absent the negotiation of "explicit" and, more important, "distinct" contractual language that provides otherwise.

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