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Important Lessons From 'In re Oxbow Carbon' for Drafting Joint Venture Exit Provisions

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The Delaware Court of Chancery recently issued an opinion that offers useful guidance for parties seeking to draft joint venture exit provisions. In *In re Oxbow Carbon Unitholder Litigation*, C.A. No. 12447-VCL (Del. Ch. Feb. 12, 2018), the court invoked the implied covenant of good faith and fair dealing to resolve a dispute over whether certain minority members of Oxbow Carbon LLC (Oxbow) had a contractual right under Oxbow's limited liability company agreement (the LLC agreement) to force Oxbow to engage in an "exit sale." The decision highlights the need for parties to devote special attention when drafting joint venture exit provisions.

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The dispute arose when two minority members of Oxbow, both of which were owned by the private equity fund Crestview Partners L.P. and together owned approximately one-third of the outstanding equity of Oxbow, sought to enforce a contractual right under the LLC agreement to force Oxbow to engage in an exit sale.

The LLC agreement contained an exit sale provision which provided that, beginning on the seventh anniversary of Crestview's investment (May 2014), Crestview had the right to force Oxbow to engage in an exit sale. The LLC agreement defined an "exit sale" as a "transfer of all, but not less than all, of the then-outstanding equity securities of [Oxbow] and/or all of the assets of [Oxbow]." The exit sale provision also stated that the exercising party "may not require any other member to engage in such exit sale unless the resulting proceeds to such member equal at least 1.5 times such member's aggregate capital contributions through such date."

The dispute centered on two small holders of Oxbow securities, both of which were controlled by the CEO, founder and majority member of Oxbow, William Koch. Notably, when the small holders were admitted as members of Oxbow in 2011 and 2012, respectively, Oxbow (controlled by Koch) failed to follow the procedures required by the LLC agreement and did not obtain the requisite approvals for the admission of the new members. In connection with the admission of the small holders, the existing members should have been asked to waive their pre-emptive rights; because it was a related party transaction, the admission of the s mall holders should have been approved by a supermajority vote of the existing members; and the small holders should have delivered counterpart signature pages to the LLC agreement. None of these items occurred, except that signature pages

were delivered after the commencement of litigation. Nevertheless, the other members (including Crestview) treated the small holders as members and did not raise the defects in their admission until the dispute regarding the exit sale arose.

Under the terms of Crestview's proposed exit sale, the small holders would not receive the 1.5 times return on investment required by the terms of the exit sale provision. As a result, Koch and the small holders brought suit seeking a declaratory judgment from the Court of Chancery that, absent a 1.5 times return on investment for all members of Oxbow, Crestview did not have the right to force the proposed exit sale. The small holders argued that if an exit sale does not satisfy the 1.5 times requirement for any member, and that member chooses not to participate, then exit sale cannot go forward because it no longer would involve "all, but not less than all, of the then-outstanding equity securities of [Oxbow]." The court referred to this argument as the "blocking theory."

In contrast, Crestview argued that if an exit sale does not satisfy the 1.5 times requirement for any member, then that member can choose to participate in the exit sale, but cannot be forced to sell, and the exit sale can proceed without such member. The court referred to this argument as the "leave behind theory." Crestview also argued that, assuming the court adopted the small holder's blocking theory and assuming the exit sale would not satisfy the 1.5 times requirement for the small holders, the exit sale should still be able to proceed if the small holders receive additional funds sufficient to satisfy the 1.5 times requirement—i.e., if the small holders are provided with an additional amount of the sale proceeds such that they receive the 1.5 times return on investment required by the exit sale provision. The court referred to this argument as the "top off theory." The small holders responded to Crestview's top off theory argument by citing the equal treatment provision in the LLC agreement which stated that an exit sale must treat all members equally by offering "the same terms and conditions" to each member and allocating proceeds "by assuming that the aggregate purchase price was distributed" pro rata to all unitholders and that the unequal distribution proposed by the top off theory would violate such requirement.

The court held that the plain language of the LLC agreement foreclosed Crestview's arguments in favor of the leave behind theory and top off theory. The court noted that in interpreting contract language, the court must construe the agreement as a whole and give effect to all of its provisions. The court pointed out that while the language of the exit sale provision in isolation could be interpreted as supporting Crestview's leave behind theory, the leave behind theory was inconsistent with the definition of "exit sale," which did not contemplate a partial exit, and Crestview's top off theory was inconsistent with language in the LLC agreement requiring payments in an exit sale be made on a pro rata basis.

Crestview also contended that the smal holders were not properly admitted as members because the required approvals had not been obtained and required procedures had not been followed in connection with their admission. As a result, according to Crestview, because the small holders had not properly been admitted as members, the dispute over the 1.5 times return on investment was moot. The court rejected this argument based the equitable defense of laches—that Crestview had known about the admission of the small holders as far back as 2011 and had not objected until this dispute arose.

Notwithstanding the rejection of Crestview's arguments based on the contractual language and the defective admission of the small holders, the court nevertheless invoked the implied covenant of good faith and fair dealing to allow the exit sale to proceed. The court noted that the implied covenant ensures that the parties' contractual expectations are fulfilled in unforeseen circumstances, and the implied covenant supplies terms to fill gaps in the contract. In this case, the court determined that, while the LLC agreement clearly contemplated the possibility of adding additional members, the LLC agreement did not specify the rights that later-admitted members would have. Instead, the LLC agreement empowered Oxbow's board to determine such rights when additional members were admitted. However, when the small holders were admitted, Oxbow failed to follow required procedures, which resulted in the board of Oxbow not

determining the rights of the small holders. Consequently, there were gaps as to how the LLC agreement and the 1.5 times return on investment requirement were intended to apply to the small holders. Ultimately, the court held that the 1.5 times requirement did not give the small holders a blocking right. In reaching this decision, the court appeared sympathetic to Crestview, particularly in light of the fact that the failure of the board to determine the rights of the small holders arguably stemmed from failures of Oxbow (as controlled by Koch), and stated that an alternative finding would have "produce[d] a harsh result by effectively blocking an exit sale." The court further determined that, had the parties considered the rights of the small holders at the time of their admission, Crestview never would have agreed to a re-set of the 1.5 times clause.

This decision highlights the need for parties to devote special attention when drafting joint venture exit provisions in limited liability company agreements and to take care when admitting new members to ensure that such admission does not create unintended consequences for the forced sale or other provisions in the agreements. As a starting point, parties should be careful to address how any minimum return on investment requirement, such as the LLC agreement's 1.5 times requirement, will apply to members who are admitted as members at different times. The parties should also consider whether, in the case of a minimum return requirement, they desire to have the flexibility of a topping off option or if the minimum return requirement may only be satisfied upon pro rata and equal distribution of an exit sale's proceeds.

In addition, the parties should be explicit about what type of exit sale a joint venture partner can force. That is, parties should consider whether such provisions should be limited only to equity sales, changes of control or sales of assets, and they should think through how a sale of assets would be accomplished if a holder is entitled to stay behind and not participate in a sale.

Further, parties should be extremely careful when using defined terms that also apply to other provisions because such overlapping usage may incorporate concepts not intended to be applied to an exit sale. For example, in the LLC agreement, the definition of "exit sale" also applied to the drag-along provision, and the equal treatment provision applied to the drag-along and other provisions. While the definition and the equal treatment provision made sense in the context of the drag-along provision, they raised issues in the context of Crestview's right to force a sale because they effectively granted the small holders a blocking right.

If the exit provision includes a minimum return on investment requirement, the exit provision language should make clear whether the minimum return on investment requirement creates a blocking right or a leave behind right. If the leave behind concept applies, the parties should be explicit about how such leave behind would work in the event of a sale of all the assets of the company.

In sum, parties should take care to address all potential contingencies in drafting exit provisions and, in particular, should ensure they do not inadvertently create a blocking right over a forced sale. Pressure testing the exit provisions under hypothetical scenarios can be helpful in making sure the provision is tightly drafted and avoids unintended consequences.

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