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M&A REPORT - A NEW TWIST IN THE *OXBOW* JOINT VENTURE SAGA: DELAWARE SUPREME COURT RULES THE COVENANT OF GOOD FAITH AND FAIR DEALING CANNOT SAVE THE DAY

To Our Clients and Friends:

The Delaware Supreme Court recently overruled a Court of Chancery opinion that had relied on the covenant of good faith and fair dealing to allow the minority owners in a joint venture to force an exit transaction. In its opinion, the Delaware Supreme Court offered useful guidance for parties seeking to draft joint venture exit provisions and indicated that parties should not expect to rely on the implied covenant of good faith and fair dealing to deliver them from a harsh outcome dictated by clear contractual language.

In *Oxbow Carbon & Minerals Holdings, Inc. v. Crestview-Oxbow Acquisition, LLC*, No. 536, 2018, 2019 WL 237360 (Del. Jan. 17, 2019), the Delaware Supreme Court refused to invoke 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 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.

The dispute arose when two minority members of Oxbow, both of which were owned by the private equity fund Crestview Partners L.P. ("Crestview") 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 (the "Small Holders") of Oxbow securities, both of which were controlled by the CEO, founder and majority member of Oxbow, William Koch ("Koch"). Notably, when the Small Holders were admitted as members of Oxbow in 2011 and 2012, respectively, Oxbow

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(controlled by Koch) failed to follow the procedures required by the LLC Agreement and did not obtain all 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 preemptive rights; because it was a related party transaction, the admission of the Small 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 conditions were satisfied, 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 in the LLC Agreement. 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 including the Small Holders, 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 the 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 of Chancery 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 of Chancery referred to this argument as the "Leave Behind Theory." Crestview also argued that, assuming the Small Holder's preferred Blocking Theory was adopted 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 of Chancery 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 of Chancery 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 of Chancery 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 of Chancery 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.

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Crestview also contended that the Small 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 of Chancery rejected this argument based on 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 of Chancery nevertheless invoked the implied covenant of good faith and fair dealing to allow the Exit Sale to proceed. The Court of Chancery 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 of Chancery 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, according to the Court of Chancery, 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 of Chancery held that the 1.5 times requirement did not give the Small Holders a blocking right. In reaching this decision, the Court of Chancery 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 of Chancery 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. Koch and the Small Holders appealed the Court of Chancery's decision to the Delaware Supreme Court.

On appeal, the Delaware Supreme Court agreed with the Court of Chancery's determination that the plain language of the LLC Agreement foreclosed Crestview's arguments in favor of the Leave Behind Theory and Top Off Theory. However, the Delaware Supreme Court disagreed with the lower court's conclusion that there had been any "gaps" in the LLC agreement. The Delaware Supreme Court held that the LLC Agreement conferred discretion on the board to determine the terms and conditions applicable to newly admitted members (such as the Small Holders) when they were admitted, and this deferral of determination until admission was a contractual choice and did not create a gap in the LLC Agreement. That is, the fact that the board had discretion to set the terms and conditions applicable to the Small Holders, but it did not require that the Small Holders be treated differently for purposes of determining whether an Exit Sale could proceed, did not create a contractual gap. Rather, the failure to set such terms and conditions resulted from Crestview's "sloppiness and failure to consider the implications of the Small Holders' investment." The Supreme Court pointed out that, while not every procedural formality in connection with the Small Holders' admission had been followed, Crestview approved the admission of the Small Holders, received a distribution based on the investment from the Small Holders and treated the Small Holders as members. Indeed, the Court of Chancery had held that the equitable defense of

laches foreclosed Crestview from arguing that the Small Holders had not been admitted. The Supreme Court noted that the Court of Chancery's determinations both that Crestview had approved the admission of the Small Holders (notwithstanding the failure to follow certain formalities for admission) and that a contractual gap exists resulting from such failure created "an untenable tension."

The Supreme Court further cautioned that use of the implied covenant of good faith and fair dealing is a limited and extraordinary legal remedy that does not apply when the contract addresses the conduct at issue. The Supreme Court agreed with the Court of Chancery that the plain language of the LLC Agreement foreclosed Crestview's arguments based on the contractual language.

This case 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, including how such provisions will apply to newly admitted members, and, in particular, should ensure they do not inadvertently create a blocking right over a forced sale. As demonstrated by the Delaware Supreme Court's opinion, courts are unlikely to use the implied covenant of good faith and fair dealing to rescue a party faced with "an extreme, harsh and unforeseen result arising from a plain reading" of the contract in question.



Gibson Dunn's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work or the following authors:

*Robert B. Little - Dallas (+1 214-698-3260, rlittle@gibsondunn.com)
Eric B. Pacifici - Dallas (+1 214-698-3401, epacifici@gibsondunn.com)*

Please also feel free to contact any of the following practice group leaders:

Mergers and Acquisitions Group:

*Barbara L. Becker - New York (+1 212-351-4062, bbecker@gibsondunn.com)
Jeffrey A. Chapman - Dallas (+1 214-698-3120, jchapman@gibsondunn.com)
Stephen I. Glover - Washington, D.C. (+1 202-955-8593, siglover@gibsondunn.com)*

Private Equity Group:

*Sean P. Griffiths - New York (+1 212-351-3872, sgriffiths@gibsondunn.com)
Ari Lanin - Los Angeles (+1 310-552-8581, alanin@gibsondunn.com)
Steven R. Shoemate - New York (+1 212-351-3879, sshoemate@gibsondunn.com)
Charlie Geffen - London (+44 (0)20 7071 4225, cgeffen@gibsondunn.com)
Scott Jalowayski - Hong Kong (+852 2214 3727, sjalowayski@gibsondunn.com)*

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