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ARTICLE

Freedom Of Contract Is Fundamental To Delaware Law

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In its recent decision in In re Oxbow Carbon LLC Unitholder Litigation, the Delaware Supreme Court reversed a Chancery Court decision that applied the implied covenant of good faith and fair dealing to modify (1) how proceeds could be distributed in connection with a forced sale of Oxbow Carbon LLC, and (2) as a result, the circumstances in which minority unitholders of Oxbow could force a sale under the terms of the LLC Agreement of Oxbow, or the LLCA. The Delaware Supreme Court's decision reaffirms that freedom of contract is a bedrock principle of Delaware law and, accordingly, the implied covenant is only to be applied with judicial restraint in limited circumstances.

This case deals with "put" and "forced sale" provisions, providing deal-professionals ring-side seats to observe the battles and mistakes that can occur on the path to liquidity. Since liquidity rights are one of the most important features in a deal, the practical lessons to be learned are as important as the law of this case.

This is the first in a series of articles devoted to Oxbow. This article details the key facts and reviews the decisions of both the Chancery Court and the Delaware Supreme Court. The following articles discuss deal lessons to be learned.

Factual Background

William Koch founded the Oxbow group in 1983. Oxbow's primary business is the sourcing, production, marketing and distribution of refinery byproducts and solid carbon fuel. While contemplating two acquisitions in 2006, Oxbow solicited financing from private equity investors. On May 8, 2007, Crestview Partners LP and Load Line Capital LLC (collectively, the minority members) consummated an investment into Oxbow, for respective amounts of $190 million (and 23.48 percent of the equity) and $75 million (and 9.27 percent of the equity). Koch and affiliates held the remainder of the equity.

The minority members were entitled to seats on Oxbow's board. In addition, the minority members obtained a "soft put," exercisable on the seventh anniversary of their investment. Oxbow could reject the put. If it did so, the minority members could, subject to certain conditions, force a sale of Oxbow. The three relevant conditions were:

- The sale proceeds must be greater than the fair market value of the Oxbow equity (determined through a valuation process).
- Every member would sell equity on the same terms and conditions.
- Each of the members receive 1.5x cumulative returns on their capital contributions.

The seeds of discord were sown in 2011 when, in connection with another acquisition, Oxbow issued equity to executives of the target and members of Koch's family (collectively, the small holders). The total investment was $30 million,[1] which, because of improved performance, priced at $300 per unit (a $200 premium to the 2007 closing). The small holders received 1.4 percent of Oxbow's equity and invested through vehicles controlled by Koch.

Although governance formalities weren't followed (e.g., complying with preemptive rights and affiliate transaction approvals), the Oxbow board, including the designees of the minority members, unanimously approved the issuance. The proceeds were not needed for the balance sheet and were distributed (the minority members received $11.4 million). However, at the time, no one seriously considered implications of this issuance on an exit sale. As fate willed, it mattered.

By 2013, Koch was nervous about the pending "put" and forced sale rights of the minority members. Koch had two primary concerns:

- Based on prior experience, he was uninterested in being a minority investor. Short of a 100 percent sale, a sale of a controlling stake was not appealing.
- He believed it was the wrong time in the business cycle to sell.

To address his concerns, the minority members agreed to an amendment to the LLCA, which postponed the exercise date for the put. The put was postponed three additional times and Crestview even extended its fund life to accommodate their continuing position in Oxbow.

As liquidity delayed, tensions mounted. Many eyes studied the "1.5x clause"; few understood it. The confusion stemmed from two potentially conflicting provisions. An exit sale was defined as a transfer of all (but not less than all) of the equity or assets of Oxbow. However, the 1.5x clause was far from clear. It stated (emphasis added):

> "provided, that the Exercising Put Party may not require any other Member to engage in such Exit Sale unless the resulting proceeds to such Member (when combined with all prior distributions to such member) equal at least 1.5 times such Member's aggregate Capital Contributions through such date."

Because the LLCA also required quarterly distributions, each of the members (other than the small holders) had received the requisite 1.5x return and, in fact, had received that return prior to the admission of the small holders. To satisfy the small holder's return threshold, an exit sale required a $4.5 billion enterprise value (roughly double the anticipated valuation).

The parties struggled to understand what it meant that the small holders were not required to participate in a 100 percent sale unless the 1.5x return was satisfied. Three interpretations emerged:

- The small holders could choose to participate or be left behind.
- The small holders had a right to a preferential return.
- The small holders could block an exit.

Perhaps because it represented the middle-path, Koch and each of the minority members—at least initially—appeared to settle on the second interpretation.

In September 2015, Crestview exercised its put, valuing Oxbow's equity at $256.6 per unit. In October, Oxbow solicited bids on minority investments. None exceeded $120 per unit. Koch contested Crestview's valuation and valued Oxbow at $145 per unit. Due to this divergence, a third party was engaged and set a value of $169 per unit.

This valuation was binding under the LLCA for both the put price and the exit sale FMV threshold.

Koch believed the FMV threshold would not be satisfied and declined the put. On Jan. 20, 2016, Crestview exercised its rights to force an exit. On March 16, 2016, a private equity firm submitted a term sheet that satisfied the FMV threshold by valuing Oxbow's equity at $176.59 per unit.

A week later, Koch's counsel suddenly discovered a provision in the LLCA that required sale proceeds to be distributed pro rata. For years the parties had operated under the shared belief that the small holders could not block a sale. Now, Koch argued preferential returns were impermissible and, as a result, the small holders could block an exit.

Litigation ensued and the private equity bidder bowed out because it didn't want to buy a lawsuit.

The Chancery Court Decision

Plain Meaning

Vice Chancellor J. Travis Laster sided with Koch's new theory and determined the plain meaning of the LLCA provided that (1) the small holders were entitled to a 1.5x return in an exit sale, and (2) proceeds from an exit sale were required to be allocated on a pro rata basis among the members. Accordingly, the small holders could block the exit.

While he acknowledged some inherent ambiguity in the 1.5x clause, when read in the context of the entire LLCA, the plain language did not permit a "leave behind" of, or preferential treatment to, the small holders. In reaching this conclusion, he reviewed a number of provisions in the LLCA, including:

- The definition of an exit sale (requiring a sale of 100 percent of Oxbow's equity or assets). He noted a "leave behind" option was not a viable reading of the 1.5x clause in light of the flexibility to structure an exit sale as an asset transaction.
- Provisions relating to distribution of proceeds (including that sale proceeds be distributed on a pro rata basis). This confirmed the LLCA lacked flexibility to (1) "leave behind" the small holders, or (2) allocate a preferred return to the small holders.
- The "tag-along" provisions, which, unlike the exit sale provisions, did provide a mechanic for members to opt-out of a transfer.

Invalid Issuance

Laster also addressed the argument that the issuances to the small holders were void. He was concerned by the lack of process surrounding the issuances. However, compared to corporations, the same strict formalities are not required for issuances by LLCs. Further, the LLCA did not provide that failure to follow specified procedures voided issuances (and the board had the power to issue equity under the LLCA). Accordingly, while the issuance was voidable, it was not void. The distinction is that a voidable issuance is subject to equitable defenses. Laster concluded the doctrine of laches,[2] which is an equitable defense born from the maxim that "equity aids the vigilant, but not those who slumber on their rights," prevented voiding these issuances.

Implied Covenant of Good Faith and Fair Dealing

Laster appeared troubled by the consequences of his findings, which would provide Koch a block on an exit sale, thwarting the exit sale rights for which the minority members had bargained. Laster was also influenced by:

- The lack of formality surrounding the issuances to the small holders, which may have resulted in the minority members not evaluating consequences under the LLCA with appropriate care.
- Alleged bad behavior by Koch, ranging from exorbitant expenses, to suppressing projections, to terminating employees (in an attempt to derail the sale).

Facing these facts, it is unsurprising a court might stretch to avoid an inequitable outcome. There is a reason for the adage, "Bad facts make for bad law." This is what the Delaware Supreme Court appears to think happened next. Although Laster had already determined the issuances were valid, he circled-back and applied the implied covenant to reform the terms of that issuance. In doing so, he reviewed provisions governing issuances:

> Upon the approval of the Directors, additional Persons may be admitted to the Company as Members and Units may be created and issued to such Persons as determined by the Directors on such terms and conditions as the Directors may determine at the time of admission. The terms of admission may provide for the creation of different classes or series of Units having different rights, powers and duties.

He determined this standard provision paradoxically created an "intentional gap" which, as a result of the Oxbow board's lack of specificity on the terms of the issuance, remained unfilled. He found this gap empowered him to apply the implied covenant and reform the agreement to what the parties would have negotiated for at the time of issuance (i.e., a preferred return to the small holders). Accordingly, Laster determined that Koch could not block an exit sale.

The Delaware Supreme Court Decision

The Delaware Supreme Court upheld Laster's determinations with respect to plain meaning. It also characterized Laster's analysis of laches as "well-reasoned" and upheld the issuances to the small holders. However, the court was skeptical that, where a litigant was barred from contesting the validity of an issuance under one equitable principle (laches), it should be entitled to relief under another equitable principle (the implied covenant).

In oral arguments, Chief Justice Leo Strine crystallized this paradox, "If you can't challenge their status as Members, and you can't deny to them the contractual rights they have under these exit sale provisions, how can the court then imply a gap and then, basically, ignore its own laches rulings and give your clients' relief? I don't get it."

The court's opinion was no less forceful, stating (emphasis added): "*At a minimum*, the trial court's reliance on the same factual predicate to bar one claim but to serve as a basis for another creates an untenable tension…we conclude that the implied covenant claim is *meritless*."

The court also disagreed with Laster's determination that an intentional gap existed in the LLCA, holding that, "Conferring discretion to the Board was a contractual choice to grant authority to the Board — not a gap." It focused on the permissive language, emphasizing that equity may be issued on such terms as the board "may determine at the time of the admission" and that the board "may provide for the creation of difference classes". However, the board was not obligated to vary the terms of issuances. Thus, "Absent the Board's imposition of different rights for newly issued units, the definition of 'Member' suggests that use of that term in the LLC Agreement, including the Exit Sale Right, applies to subsequently admitted Members."

Although the court acknowledged the process for the issuances was "hardly a model of good corporate governance," it believed that, "the Minority Members were highly sophisticated entities with three Board members who were capable of reading the LLC Agreement and bargaining for the rights they now seek through litigation." Accordingly, the court found Laster's process concerns unpersuasive and held that, "The parties' sloppiness and failure to consider the implications of the Small Holders' investment in 2011 did not equate to a contractual gap."

The court concluded by first focusing on what the implied covenant of good faith and fair dealing is not: "an equitable remedy for rebalancing economic interests after events that could have been anticipated, but were not, that later adversely affected one party to a contract." It is "a limited and extraordinary legal remedy" that is only applied when "the contract is truly silent."

Properly understood, the court's decision is not a vindication of Oxbow or Koch. It is a reaffirmation of the freedom of contract. The importance of this principle is fundamental to Delaware law and may require courts to enforce a contract that provides uncommercial windfalls to a party. The court's decision drives home that, while the implied covenant is an equitable remedy, it is not a remedy to be utilized merely because contracts have an inequitable result.

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[1] The opinion of the Delaware Supreme Court states that the investment amount was $35 million and the opinion of the Court of Chancery states that the investment amount was $30 million. We have utilized the number stated in the opinion of the Court of Chancery.

[2] These elements are: (1) knowledge by the claimant (i.e., the Minority Members), (2) unreasonable delay in bringing the claim, and (3) prejudice to the defendant (i.e., the Small Holders).

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