WINSTON & STRAWN LLP

ARTICLE

Oxbow: Alignment Is Key In Put Valuation Processes

FEBRUARY 15, 2019

This is the third in a series of articles devoted to a study of the recent Oxbow Carbon Unitholder Litigation. Our first article summarized the facts of the case and the relevant Delaware decisions. Our second article discussed potential misalignments created by a mandatory quarterly cash distribution and the put/forced-sale provisions.

In this article, we review common put valuation processes and the problems that arise. We then discuss the Oxbow valuation and the alignment mechanism that resulted in them working reasonably well, even in a highly adversarial relationship.

Common Valuation Approaches

The Formulaic Approach

One approach to determine value is to use a contractual formula. By agreeing up front how to value the company, parties try to decrease the likelihood, as well as the time and monetary cost, of a dispute. Even so, it can be difficult to foresee the variables that can dramatically impact future valuation, particularly in the heat of a deal.

This risk is illustrated by PECO Logistics LLC v. Walnut Inv. Partners LP,[1] where the transaction documents provided that an appraiser would determine valuation assuming a hypothetical sale. However, layered on top of a customary valuation formula was the limitation that total enterprise value could not be (1) less than a 6.5 multiple of trailing earnings before interest, tax, depreciation and amortization, or (2) more than a 7.5 multiple of trailing EBITDA.[2]

These collars were likely imposed because the parties believed they represented appropriate multiples for the industry. They contractually limited the ability to apply alternative valuation methodologies, such as a discounted cash flow, in a manner that would result in a valuation outside the agreed range. The appraisal firm conducted both a discounted cash flow analysis and a comparable company analysis. Its valuation ascribed an enterprise value that significantly exceeded the cap and, accordingly, the top-line value was reduced to the cap.

This appears to have occurred, at least in part, because PECO incurred indebtedness to fund growth. Debt incurrences are immediate, but investments take time to convert into EBITDA. Discounted cash flow incorporates future growth, but trailing EBITDA multiples do not. As a result, the EBITDA cap limited the value of growth investments. The put party was, however, penalized on a dollar-for-dollar basis for indebtedness, because total equity value is derived by subtracting indebtedness from total enterprise value.[3] As a consequence, the put party enjoyed little or none of the benefits, but suffered all of the consequences, of the debt incurrence. The resulting valuation represented a significant discount to the value of PECO based on other valuation methodologies and resulted in litigation.

When formulas fail to accurately reflect value, a party often believes it is being mistreated, regardless of contractual terms. These sentiments damage relationships and often lead to litigation. Formulas may increase predictability, but may do so at the cost of accuracy and disputes.

Formulas that properly account for all variables are necessarily complex. Complex provisions increase the risk of disputes because:

Transcription Errors

Business professionals prepare equations in Excel and are not accustomed to embodying equations in the words of a contract. Business expectations may diverge from the contractual language.

Deal Team Turnover

The professionals who negotiated the deal may no longer be around when it is time to apply the formula. This can create interpretive uncertainty on complex provisions. If the parties are aligned and the relationship amicable, these uncertainties may be easily resolved. In less cordial circumstances, uncertainties can collapse into litigation.

Imperfect Memory

Human memory is imperfect. It can be difficult to recall the intent of various aspects of a complex formula. Words that seemed obvious when the contract was drafted may be ambiguous in hindsight. Well-intentioned parties can reach differing interpretations when attempting to reconstruct intent and there is a natural inclination to recall intent in a way most favorable to ourselves.

If these risks arise, it undermines the virtues of a formula. There are two customary ways these interpretive disputes are resolved, neither of them ideal:

Valuation Firm

A valuation firm can be retained to apply the formula or arbitrate disputes. In PECO, the court held that the valuation firm’s interpretation will generally be binding, unless the contract provides otherwise. The courts will not second-guess reasonable interpretations of an independent appraiser acting in good faith.[4] The practical consequence is that, absent bad facts, there is no forum to review parole evidence on intent.

Judicial Review

The arbitrator’s valuation and decisions can be subject to judicial review, or the agreement can bypass valuation firms altogether and go directly to the courts. Judicial review is often the longest and most expensive way to obtain resolution and, as such, does not accomplish the objective of minimizing time and monetary expenditures necessary to obtain valuation.

The Shotgun Approach

Another approach is the “shotgun” construct that applies economic forces to discipline the parties in setting value. These provisions generally follow two formulations, with equally colorful names: (1) Russian Roulette, and (2) the Texas Shoot-Out.

Russian Roulette

A Russian Roulette provision requires one of the parties to submit a valuation at which it is both a willing buyer and a willing seller. The party that receives the offer then elects whether, based on such valuation, it is a buyer or a seller.[5]

Texas Shoot-Out

A Texas Shoot-Out provision requires both parties to submit a sealed valuation. The valuations are opened simultaneously and the party with the highest valuation must buy the equity interests of the other party.

The appeal is simplicity. Rather than complex formulas applied in the distant future, these provisions rely on economic incentives at the exercise time to induce rational behavior in setting fair value. The problem is that a party can rationally believe it has leverage to manipulate valuation because the other party is unlikely to be a buyer.

Even in the case of well-capitalized strategics, it is rarely safe to assume that in the far-off future both parties will be equally inclined or able to be buyers or sellers. These provisions are particularly susceptible to gamesmanship when the amounts at issue are large and defending value is capital intensive.

Furthermore, constraints intrinsic to private equity funds may make these provisions a particularly poor fit for sponsors. The issues a private equity sponsor may have with shotgun provisions include:

- The exercise period is often outside a fund's permitted investment period. Assigning purchase rights to a subsequent fund, even if theoretically possible, can create difficult governance and fiduciary issues for the general partner.
- A fund is looking for participation in a control premium. Shotgun provisions mean incurring risk that basic liquidity objectives will be frustrated.
- Concentration limitations may restrict the ability to be a buyer.
- Control investments may require more time than a minority investment. Available time can be as much of a limitation as capital.
- Electing to buy may require involvement of debt financing sources in order to obtain (1) additional indebtedness to fund the purchase, or (2) consent for a change-in-control.
- If management is aligned with the seller, the sponsor will be subject to either finding a new management team or engaging in negotiations to motivate the existing team.

The Oxbow Approach

Once the put was exercised, Oxbow's operating agreement specified a process to determine Oxbow's fair market value. Crestview Partners LP and Oxbow were each required to retain an appraisal firm to determine value on "a going concern basis." If the valuations were within 10 percent of each other, then fair market value would be the average of the two. If the valuations differed by more than 10 percent, a third valuation firm was to be retained. The median valuation would be the binding valuation.

Conceptually, the operating agreement deferred to the appraisal firms to determine relevant factors in setting their valuation. Vice Chancellor J. Travis Laster articulated one of the weaknesses of this approach, when he stated in In re Appraisal of Dell Inc.[6] that the "obligation to make a single determination of a corporation's value introduces an impression of false precision."[7]

For example, when bankers advise boards in a sales process, they look at a number of different ways to model value and present value ranges (but not a precise value). Similarly, when a private equity sponsor evaluates a transaction, it will model a "base case" for the deal (i.e., the return profile based on financial assumptions the sponsor believes are most realistic) and alternate outcomes based on differing assumptions. The sponsor will also consider the likelihood of deviation from the base case (e.g., by conducting a sensitivity and/or scenario analysis). After the sponsor has analyzed the alternative cases, impacts on IRR and the likelihood of those varying outcomes, it will determine whether the transaction is attractive and, importantly, how much to pay for the investment.

These examples illustrate a few key points:

- Fair market value is not the “true value” of a company. In the real world, there’s no such thing as true value.
- There are many different ways to value a company. The application of different methodologies can result in divergent outcomes.
- Valuations and deal models are only as good as the assumptions that feed them.

When parties hire an appraisal firm, they understand the valuation will not represent the true value of the company. Similar to bankers advising a board, the appraisal firm will typically run the company through a number of different valuation methodologies, based on certain assumptions, in order to triangulate toward valuation. When an appraisal firm delivers that valuation, all it is delivering is a best estimate based on the assumptions it believes are most reasonable.

That the Oxbow operating agreement contemplated the retention of three valuation firms (which is not uncommon) illustrates the trepidation with which parties approach this high-stakes game. Even in the best-case scenario, where the valuation firms are operating free of influence, valuations can diverge dramatically.

Parties believe the assumptions feeding into valuations can be subtly influenced, or even worse, fundamentally results-driven. This is a concern shared by the Delaware Chancery Court.[8] The statutory appraisal process following a merger has similar dynamics as a put valuation process, where one party desires a higher valuation and the other party wants a lower valuation. In that context, the Delaware Supreme Court has characterized the valuations presented to the courts as “wildly divergent.”[9] In the Dell opinion, Laster cited studies substantiating this anecdotal experience, noting that experts hired by companies defending against appraisal actions provided median and mean valuations 16 percent and 22 percent below merger price, respectively. Conversely, experts hired by parties seeking to improve on merger price provided median valuations 78 percent above merger price and means 186 percent above.

In other words, there is a widespread belief, supported by data, that valuations can be manipulated. Agreements utilizing the Oxbow approach are susceptible to widely divergent valuations, accusations of manipulation and disputes over the selection of valuation firms. All these flashpoints materialized in Oxbow.

First, the initial appraisals came back dramatically different: (1) Crestview at $256.6 per unit; and (2) Koch at $145 per unit. Koch believed Crestview manipulated its valuation by providing its valuation firm stale financials. When the parties went to hire a tie-breaking valuation firm, this too triggered problems. Koch alleges Crestview “improperly and in bad faith interfered with the selection of the third investment bank” by vetoing suggestions made by Oxbow’s valuation firm and vetoing an investment bank mutually agreed to by the valuation firms of Koch and Crestview. While we do not know the basis for Crestview’s objections, agreements commonly require that a valuation firm meet certain specified criteria, which typically entails both independence and a specified level of sophistication.[10] It is likely Crestview was objecting under this criteria.

These kinds of disputes can meaningfully slow down the process and frustrate negotiated rights. In Am Gen. Holdings LLC v. Renco Grp., Inc.,[11] the parties bickered for a year over the third appraisal firm, ultimately asked the Delaware Chancery Court to choose for them and then continued litigating over whether the firm selected by the Delaware Chancery Court was actually independent.

A third valuation firm was finally agreed upon by Oxbow and Crestview. It delivered a tie-breaking valuation of $169 per unit. The parties appear to have peaceably accepted this valuation and moved on to other fights.

This presents an interesting question: in a deal where the parties couldn't agree on the color of the sky, why did they move past flashpoints without litigating and achieve an agreed valuation? The reason is likely because of how the valuation interacted with the forced-sale provisions.

The put valuation also operated as a threshold for a forced-sale. No forced-sale could be consummated unless it exceeded the valuation. This created alignment. Each of the parties had an incentive to reach a reasonable valuation. Koch had an interest in control not being sold at too low a price and the minority members had an interest in the put valuation not being unreasonably high and blocking a forced-sale.

Interestingly, during negotiations, Crestview tried to strip the fair market value threshold out of the forced-sale provision. Alignment may have been more the result of chance than design. As an alternative to the FMV threshold, the parties could have employed "baseball arbitration," where the tie-breaking valuation firm has to choose one of the valuations submitted by the parties, but no other valuation. While baseball arbitration has its pitfalls, its premise is that since there is no such thing as true value, valuation processes shouldn't be designed to get the "right" number, but instead to reduce the likelihood initial valuations will be manipulated and "wildly divergent." In other words, baseball arbitration seeks to create alignment, reduce valuation gaps and, as a result, decrease litigation risk.

Oxbow demonstrates how important it is to create alignment in some fashion. In the absence of an alignment mechanism, it appears likely that Oxbow would have collapsed into litigation at the valuation stage. Parties should be thoughtful about which valuation process they employ. They all have dangers. But, most importantly, parties need to consider whether there is a way to create alignment on setting value. It is the most effective way to reduce the risk of litigation.

---

[1] PECO Logistics LLC v. Walnut Inv. Partners LP, CV 9978-CB 2015 WL 9488249 (Del. Ch. 2015)

[2] PECO rents pallets to third parties, which requires significant capital expenditures to buy and store pallets and to replace lost or damaged pallets. In both instances, EBITDA was reduced for maintenance capex (generally speaking, the cost of replacing lost pallets), which represented the cost of doing business.

[3] This issue was also compounded because (1) growth capex, unlike maintenance capex, was not backed-out of EBITDA, and (2) measurement dates did not align (i.e., EBITDA caps were measured as of the end of FY 2013, but the indebtedness measurement date was interpreted to be mid-year 2014). With different facts, the misalignment on timing could have cut the other way.

[4] It is worth noting that the PECO provisions provided that the valuation firm's findings would be "final and binding" on the parties. This is fairly customary language.

[5] Anyone with children has likely done this at home when splitting the last piece of cake — let one child slice the cake and the other child gets to choose which half to eat.

[6] C.A. No. 9322-VCL (Del. Ch., 2016)

[7] Although Laster's decision in Dell was reversed, his opinion is a worthwhile read. It provides detailed background on how a company is valued and the variables that can impact valuation.

[8] See, e.g., Hexion Spec. Chemicals v. Huntsman Corp., 965 A.2d 715 (Del. Ch., 2008); see also Fox v. CDX Holdings, Inc., C.A. No. 8031-VCL (Del. Ch., 2015).

[9] Golden Telecom Inc. v. Glob. GT LP (Golden Telecom II), 11 A.3d 214, 217-18 (Del. 2010).

[10] Independence criteria may be left undefined or may be specified (e.g., no retention by either of the parties in the

past three years). Agreements can widely vary on the level of requisite sophistication. Some agreements may accept regionally recognized valuation firms or investment banks, nationally or internationally recognized valuation firms or, most stringently, internationally recognized investment banks experienced in selling comparable companies.

[11] Am Gen. Holdings LLC v. Renco Grp., Inc. C.A. No. 7639-VCN (Del. Ch., 2015)

10+ Min Read

Related Locations

Chicago

Related Topics

Law360

Related Capabilities

Transactions

Mergers & Acquisitions

Related Regions

North America

Related Professionals

Kyle Gann