

Battling moguls take the stand

Diller, Malone face off in court over IAC control

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John Simons

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(Fortune) -- Think of it as the corporate divorce of the century. On Monday, Liberty Media's John Malone spent nearly four hours on the stand in a Delaware courtroom attempting to convince a judge that he should be allowed to wrest control of Internet conglomerate IAC/Interactive Corp. away from its CEO, Barry Diller.

The heated legal battle pits two of Big Media's most notoriously hardnosed dealmakers in war of words, and dueling lawsuits. The case, being heard at the Delaware Chancery Court in Wilmington, revolves around the complex agreements both Diller and Malone entered into after Diller transformed a broadcast media company that featured Home Shopping Network as its centerpiece into a collection of e-commerce businesses.

The dustup comes at a bad time for IAC (IACI, Fortune 500), whose vast holdings include HSN, Ticketmaster, LendingTree, Match.com, and Ask.com. According to a June 2007 Nielsen/NetRatings report, IAC is the largest buyer of online advertising in the United States. But while the conglomerate's overall 2007 revenue grew 8%, to \$6.4 billion, the company was forced to take a massive writedown on LendingTree's losses. IAC shares have fallen 59% over the last five years.

Malone controls 61% of the voting power because Liberty is the sole owner of IAC's class B common stock (which entitles the holder to 10 votes per share, as opposed to the one vote per share that comes with ownership of IAC's common stock). Liberty, however, owns just a 30% financial stake in IAC. Under a proxy agreement between Diller and Malone forged in August 2005, Malone gave Diller the right to exercise Malone's 60% voting authority.

Malone and Diller's proxy voting arrangement went swimmingly until Diller, last year, proposed to split the conglomerate into five businesses. Malone agreed with the plan in principle, with one key exception: he opposed the introduction of a new voting structure.

Diller's proposed blueprint for the four spun-off entities included plans to dilute Malone's control by reducing Liberty Media's voting rights to 30% for each of the newly formed companies. In late January, Malone filed suit, demanding his proxy vote back from Diller in order to stop the spinoff scheme from being implemented.

In his testimony and cross-examination Monday, Malone was even-tempered and rather matter-of-fact about his answers to lawyers' questions. Attorneys for both the plaintiff and the defense peppered Malone with questions that tried to get at his understanding of proxy voting agreement he set up with Diller. They were also interested in the sequence of events that led Malone to seek remedy in the courts.

One exchange between Malone and Diller at a Jan. 16, 2007, IAC board meeting came up many times in the day's questioning. In the meeting, Malone says that he urged Diller to put the spinoff proposal up for a shareholder vote. Malone insists that Diller said he would do so but that he would vote Liberty's proxy. Malone and another IAC director, William Berkman, took Diller's statement to mean that the spinoff plan and its single tier voting structure was inevitable. "There was no conditionality to the statement," said Berkman, when he was being cross-examined. "This was a classic challenge situation."

In contrast to Malone's serenity on the stand, Berkman, who was placed on IAC's board by Malone as a Liberty designee, was more combative. He bristled when asked to remember and characterize long-ago exchanges between Malone and Diller. Berkman was considerably more blunt in communicating his dislike for Diller's spinoff proposal. "I fundamentally don't think it's fair," he said.

Malone charges that Diller's reasons for fashioning the spinoff voting structure are somewhat sinister. Liberty's filed complaint alleges that "in 2006, Diller began to focus on avenues that would permit him to end his relationship with Liberty and create independent companies led by his hand-picked managers that could operate free of Liberty's influence," reads Liberty's complaint. It continues: "In connection with an article published on October 26, 2006, Diller told a reporter from the Wall Street Journal that 'he eventually wants to end IAC's relationship with Liberty... to preserve his own legacy.' ...Diller apparently also said that he wants the company to be independent."

Many observers of the legal melee never thought this case would come to trial. Rumors circulated in the financial press that the two parties might settle. But that never came to pass.

There's no telling when the court might resolve the dispute. The case is on the chancery court's schedule for the entire week. One bright spot: This particular venue is known for hearing and deciding cases swiftly.

Legal experts who are familiar with the case have a difficult time predicting the outcome. But they agree that the presiding judge is likely to see a great deal of testimony from the main players, Malone and Diller. "This case will hinge on the testimony," says Lucian Bebchuk, director of Harvard Law School's Program on Corporate Governance. "When the court tries to interpret a situation like this, they look at communications between parties, and the reasonable expectations the parties had. The court will get that from the testimony."

Bebchuk shies away from speculating who has the stronger case. He does find it "puzzling that two sophisticated parties didn't take the steps to resolve the ambiguity in their proxy agreement. The language that was used is open ended and the parties didn't make more of an effort to prevent disputes of this kind," Bebchuk notes.

Says Harry Hu, professor of corporate and securities law at University of Texas School of Law: "I think it's an uphill fight for Malone. One of the key principles here is that Diller's fiduciary duty is owed to the shareholders - the entire body of shareholders rather than any particular

shareholder. And the spinoffs generally make sense from a shareholder wealth maximization standpoint."

Hu also notes that the proxy agreement between Malone and Diller is rare. "It's unusual for parties to hand over that kind of super-proxy voting right," he says, also noting that the proxy agreement is vague.

"Maybe the relationship between Malone and Diller was so close that they didn't think everything had to be air tight," Hu guesses. "It's like when people get married, they should have a pre-nup, but no one's thinking about divorce at the time."