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Delaware Chancery Court Finds Absence of Controlling Stockholder Does Not Eliminate Possibility for Adequately Pled Corporate Overpayment Claims

August 2, 2018

On July 26, 2018, Vice Chancellor Glasscock of the Delaware Court of Chancery denied in part and granted in part Defendants' motion to dismiss in *Sciabacucchi v. Charter Communications Corporation et al.* We discussed the Court's prior ruling in this action here. In brief, the action challenged certain transactions between Charter Communications, Inc. and its largest stockholder, Liberty Broadband Corporation, which owned approximately 26% of Charter's outstanding common stock and had the right to designate four of ten directors on Charter's Board. In particular, a Charter stockholder challenged a voting proxy agreement between Charter and Liberty and two stock issuances worth $5 billion made by Charter to Liberty, allegedly as a part of the "financing" of Charter's $78.7 billion merger with Time Warner Cable and its purchase of Bright House Networks, LLC. Ultimately, 86% of Charter stock not affiliated with Liberty voted, in a single vote, to approve (i) the share issuances and the voting agreement, (ii) the merger with Time Warner Cable and (iii) the purchase of Bright House. Both third-party transactions were conditioned on Charter stockholders' approval of the share issuances to and voting agreement with Charter.

According to Plaintiff, the defendant directors breached their fiduciary duties in approving the Liberty-Charter transactions because: (i) Liberty was paying $173/share for the $700 million in newly issued Charter stock, which represented a discount to Charter's market price at the time; (ii) Charter's $4.3 billion issuance of stock to Liberty in connection with the Time Warner Merger was unfair because that price purportedly failed to take account of the project value of the combined companies following the merger; (iii) Charter's decision to allow only Liberty to receive all stock for its Time Warner shares (whereas other Time Warner shareholder received a mix of cash and stock) was unfair because it gave Liberty a tax benefit not available to all other stockholders; and (iv) the grant of a 6% voting proxy to Liberty by Advance/Newhouse Partnership, the then-owner of Bright House), such that Liberty's voting power post-closing of the Bright House transactions would be at least 25.01% (thereby allowing Liberty to "escape regulation" under the Investment Company Act of 1940), unfairly transferred voting power from public stockholders to Liberty by permitting Liberty to maintain its pre-transaction voting power notwithstanding that post-transaction it only owned approximately 20% of the combined entities.

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Defendants moved to dismiss on the ground that the stockholder votes approving the transaction had a "cleansing effect" under *Corwin v. KKR Financial Holdings LLC*, thereby subjecting the transaction to deferential business judgment review. Under *Corwin*, a fully informed, uncoerced vote of the majority of disinterested stock results in business judgment review attaching to the transaction so approved, leading to dismissal absent an adequate pleading of waste. The Court held that the vote was structurally coercive because stockholders were left with "a simple choice: accept (disloyal) equity issuances to the Company's largest stockholder, and an agreement granting that stockholder greater voting power, or lose two beneficial transactions."

Despite determining that *Corwin* therefore did not apply so as to give cleansing effect to the stockholder vote, the Court held that the briefing was insufficient for a determination on the remaining grounds in Defendant's motion to dismiss and ordered additional briefing on the motion. In its most recent decision following supplemental briefing, the Court found that the Plaintiff's claims were derivative in nature, and therefore dismissed the direct claims. But as to the derivative claims, the Court found that the complaint adequately pled that demand on the Charter board was excused, and that entire fairness rather than deferential business judgment rule review applied, because a majority of the Charter directors who approved the challenged Charter-Liberty transactions were beholden to John Malone, a Charter director who was interested in the transactions by virtue of his ownership of 47% of the voting power of Liberty. As a result, the derivative claims survived.

Key Takeaways and Analysis

Corporate Overpayment Claims Cannot Be Both Direct and Derivative in the Absence of a Controlling Stockholder

Plaintiff's complaint asserted both derivative and individual claims relating to "corporate overpayment" – *i.e.*, Charter overpaid Liberty by "issuing it stock for allegedly unfair consideration" and receiving "inadequate consideration from Liberty in exchange for agreeing to grant it the 6% voting proxy." Defendants argued that these claims were derivative only and sought dismissal of the direct claims. The Court agreed.

Under the rule announced in *Gentile v. Rossette*,[1] the Delaware Supreme Court held that a corporate overpayment claim may be both direct and derivative where (1) a controlling stockholder causes a corporation to issue excessive shares of its stock in exchange for assets of the controlling stockholder that have a lesser value and (2) the exchange causes a dilution of the voting rights of public stockholders **and** a decrease in those shares' economic value. The Supreme Court revisited the issue in *El Paso Pipeline GP Co., LLC v. Brinckerhoff*,[2] where it rejected the Plaintiff's claim that

[1] 906 A.2d 91 (Del. 2006).

[2] 152 A.3d 1248 (Del. 2016).

a direct and derivative claim existed where a corporate overpayment resulted in the extraction of strictly economic value. Instead, the *El Paso* Court held that absent any proof of dilution of Plaintiff's voting rights plus the extraction of economic value, the claim is derivative only.

Vice Chancellor Glasscock observed that two Court of Chancery decisions since *El Paso* have held that a controlling stockholder must exist prior to the challenged transaction. In *Carr v. New Enterprise Associates, Inc.*, Chancellor Bouchard wrote, "the *Gentile* paradigm only applies when a stockholder *already possessing majority or effective control* causes the corporation to issue more shares to it for inadequate consideration."[3] Relying upon his earlier opinion in this action holding that Malone and Liberty Broadband were not controlling stockholders, the Court found that Plaintiff could not assert a dual direct and derivative claim in the current case under *Gentile* and *El Paso*. Notably, Vice Chancellor Glasscock lamented that relying upon *El Paso* and not applying *Gentile* to "conflicted board non-controller dilution cases . . . is, as matter of doctrine, unsatisfying."

Material Outside Business Relationships, Public Comments on an Interested Director's Influence, and an Interested Party's Sway Over a Director's Full-Time Employment Continue to Be Indicia of a Lack of Independence at the Pleading Stage

The Court found that the Complaint had adequately raised a reasonable doubt that at least half the ten-person Charter board could fairly consider a demand due to their ties to an interested director, John Malone, thereby excusing demand. Defendants conceded the lack of independence of two of the four Liberty-designated directors, Malone and Gregory Maffei. As to the other three directors the Court analyzed and found to lack independence:

- Balan Nair, another Liberty designee, served as Executive Vice President and Chief Technology Officer of Liberty Global plc, in which Malone held a 25% stake and was Chairman of the Board of Directors. According to the Court, absent some "unusual fact" such as "inherited wealth," when "a director is employed by or receives compensation from other entities, and where the interested party who would be adversely affected by pursuing litigation controls or has substantial influence over those entities, a reasonable doubt exists about the director's ability to impartially consider a litigation demand." Here, Malone's ownership interest in Liberty combined with his role as Board Chairman put him "in a position to exercise considerable influence over Nair."

- Thomas Rutledge had served as Charter's CEO and as a board member since 2012. Not only was Rutledge a full-time Charter employee in a situation where Liberty (in which Malone owned a 47% stake) controlled 26% of Charter's stock, but in public comments Rutledge conceded Malone's influence. In an interview with the *New York Times*, Rutledge "did not deny Malone's influence, stating '[w]hen he talks, I listen. And he is a significant talker."

[3] 2018 WL 3388398 (Del. July 11, 2018) (emphasis added)

- Eric Zinterhofer had been Chairman of the Charter Board since 2009 and a founder of Searchlight Capital Partners, LLC, a private equity firm that in 2012 acquired a Puerto Rican cable company in a joint venture with Liberty Global. Two years later, Liberty Global and Searchlight announced a joint venture to purchase another Puerto Rican cable company – the combined entity is the largest cable company in Puerto Rico. Therefore, as the complaint alleged, "Zinterhofer is a current business partner with Liberty Global and Malone in corporate enterprises worth almost $1 billion." The Court found that, at the pleading stage, "it is reasonable to infer that joint ventures of this size are important to their principals, even if those principals have high net worth," and that the joint ventures are "material to the firms involved, even absent details regarding the size of those firms' investment portfolios." While the Court recognized that allegations of a "mere outside business relationship, standing alone," are insufficient to undermine a presumption of independence, a "pleading-stage inference of beholdenness may arise" where, as in this case, there are allegations that a director's business relationship with an interested party is material to the director.

Delaware Courts Remain Open to Considering Public Statements Made by a Director Regarding an Interested Party's Influence

As noted above, the Court considered statements by Rutledge to the New York Times in concluding that Plaintiffs had raised a reasonable inference that he was beholden to Malone. The Court's consideration of such statements is not an isolated event. For instance, in *In re Tesla Motors, Inc. Stockholder Litigation*, decided earlier this year, the Court of Chancery relied on prior public statements by Tesla and Elon Musk, Tesla's Chairman, CEO and owner of 22.1% of its outstanding stock, in considering Mr. Musk's status as a controlling stockholder. Tesla's SEC filings, for example, included various statements regarding Mr. Musk's importance to the Company, including disclosure regarding Mr. Musk's role in "recruiting executives and engineers, contributing to the Tesla Roadster's engineering and design, raising capital for us and bringing investors to us, and raising public awareness of the Company," as well as a risk factor providing that "[Tesla is] highly dependent on the services of Elon Musk, [who is] highly active in [the Company's] management, [and if Tesla were to lose his services, it could] disrupt our operations, delay the development and introduction of our vehicles and services, and negatively impact our business, prospects and operating results as well as cause our stock price to decline." Moreover, Mr. Musk often referred to Tesla as "my company," published two "Master Plans" in which he described his strategic direction for Tesla, and previously stated that had he not become CEO of Tesla "the company wasn't going to make it."

The Independence of the Full Ten-Person Charter Board Determined Whether the Business Judgment Rule Applied Even Though Only the Six Non-Liberty Designees Voted on the Challenged Charter-Liberty Transactions

Because the Court found that at least half the Charter Board lacked independence, not only was demand excused but also the business judgment rule would not apply, and the transactions would

be assessed under the entire fairness standard. Defendants argued, however, that only the six non-Liberty designees approved the challenged transactions and a majority of these directors were independent, such that business judgment rule review was warranted. The Court disagreed. It found that the four Liberty designees, along with the rest of the board, "approved the acquisitions of Time Warner and Bright House, and the structure whereby those deals would not close unless the challenged transactions received stockholder approval. Thus, by signing off on the structurally coercive terms of the acquisitions, the Liberty designees helped 'strong arm[]' the stockholders into voting for the [challenged] transaction[s] 'for reasons outside of the economic merit' of the decision." Accordingly, to rebut the business judgment rule, Plaintiff was required to call into question the independence of at least five members of the ten-person board, not four of the six non-Liberty designees.

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