



IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE  
IN AND FOR NEW CASTLE COUNTY

BEVERLY PFEFFER,  
individually, and on behalf of all others similarly  
situated,

Plaintiff,

v.

SUMNER M. REDSTONE, GEORGE S.  
ABRAMS, DAVID R. ANDELMAN, JOSEPH  
A. CALIFANO, JR., WILLIAM S. COHEN,  
PHILIPPE P. DAUMAN, ALAN C.  
GREENBERG, JAN LESCHLY, SHARI  
REDSTONE, FREDERIC V. SALERNO,  
WILLIAM SCHWARTZ, PATTY  
STONESIFER, ROBERT D. WALTER,  
NATIONAL AMUSEMENTS, INC., JOHN F.  
ANTIOCO, RICHARD J. BRESSLER, JACKIE  
M. CLEGG, MICHAEL D. FRICKLAS, LINDA  
GRIEGO, JOHN L. MUETHING and CBS  
CORP. (f.k.a. VIACOM, INC.),

Defendants.

C.A. No. 2317-VCL

**PLAINTIFF'S ANSWERING BRIEF IN OPPOSITION TO  
DEFENDANTS' MOTIONS TO STAY OR DISMISS**

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## INTRODUCTION

This case is about Blockbuster Inc.'s ("Blockbuster") spin-off from its parent company Viacom Inc. ("Viacom"). At the time of the spin-off, Blockbuster was a chain of over 9,000 video rental stores and Viacom owned the movie studio Paramount Pictures, as well as numerous cable networks. ¶¶32, 36.<sup>1</sup> According to statements made by both Viacom and Blockbuster, both companies would be better off if they pursued their goals independent from each other. ¶37. However, in reality, the spin-off was structured to benefit solely Viacom, and its majority shareholder National Amusements Inc. ("NAI"), a closely held company controlled by Sumner Redstone, the Chairman and CEO of both Viacom and NAI. ¶8.

To effect the spin-off, Viacom executed a strategy that refunded to Viacom a substantial portion of its capital investment in Blockbuster, and then cashed out Viacom's equity holdings, leaving Blockbuster's public investors holding stock in a financially crippled company. *First*, Viacom, through its appointed directors on Blockbuster's board, caused Blockbuster to borrow \$950 million and pay a \$5 special dividend to all of its shareholders, which paid Viacom \$738 million (the "Special Dividend"). ¶¶38-40. *Second*, having extracted the cash out of Blockbuster and causing the company to incur a huge debt, Viacom liquidated its equity interest in Blockbuster by offering Viacom's minority shareholders the chance to exchange their Viacom shares for Viacom's Blockbuster shares purportedly at a purported premium (the "Exchange Offer"). ¶43. However, unbeknownst to Viacom's shareholders, but known to Redstone, NAI, and Viacom's directors and officers, after issuing the Special Dividend, Blockbuster was essentially a crippled company. It was unable to pay its debt and finance its publicly announced business plans, which included expanding its business to rent videos online. When the truth finally became known, remaining Blockbuster shareholders were left with a stake in a severely

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<sup>1</sup> The Amended Class Action Complaint will be cited to as ¶ \_\_.

impaired company, which was unable to compete in a challenging business environment. Further it became evident that Viacom's minority shareholders who participated in the Exchange Offer paid a vastly inflated price for Blockbuster stock.

Of note, Redstone and NAI, Viacom's majority shareholder, did not participate in the Exchange Offer. ¶46. Therefore, Redstone benefited directly from the spin-off as the Exchange Offer reduced his economic interest in Blockbuster as well as reducing Viacom's public float and further consolidating his control at the company. Viacom also benefited because, through deception, it was able to sell its Blockbuster stock at a vastly inflated price.

Plaintiff Beverly Pfeffer ("Plaintiff") asserts claims on behalf of a class of Viacom's minority shareholders who tendered Viacom shares in the Exchange Offer against the Viacom Directors,<sup>2</sup> alleging that they breached their fiduciary duties to Viacom's minority shareholders under Delaware law. Specifically, Plaintiff alleges that the Viacom Directors breached their duty of disclosure and their duty of loyalty to Viacom shareholders by failing to disclose material facts about the poor financial health of Blockbuster. The Viacom Directors, however, argue: (1) all material risks were disclosed in the Exchange Offer Prospectus<sup>3</sup>; (2) to the extent that certain facts were not disclosed, such facts were not material; and (3) Plaintiff has failed to plead that the Viacom Directors knowingly failed to disclose material information to minority shareholders.

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<sup>2</sup> The directors of Viacom at the time of the Exchange Offer were Sumner M. Redstone ("Redstone"); George S. Abrams ("Abrams"); David R. Andelman ("Andelman"); Joseph A. Califano, Jr. ("Califano"); William S. Cohen ("Cohen"); Philippe P. Dauman ("Dauman"); Alan C. Greenberg ("Greenberg"); Jan Leschly ("Leschly"); Shari Redstone; Frederic V. Salerno ("Salerno"); William Schwartz ("Schwartz"); Patty Stonesifer ("Stonesifer"); and Robert D. Walter ("Walter") (collective "Viacom Directors"). ¶¶8-20.

<sup>3</sup> Unless otherwise noted, "Prospectus" refers to the registration statement published September 8, 2004 in connection with the Exchange Offer.

Viacom Br. at 20-28.<sup>4</sup> In fact, Plaintiff has adequately pled that Viacom minority shareholders were not fully informed of all material facts concerning the Exchange Offer, including, *inter alia*, (1) that Blockbuster's reported cash flow was inflated by 58% in the Prospectus (¶61), and (2) that Blockbuster did its own internal cash flow analysis, which showed that Blockbuster could not afford to pay the Special Dividend and meet its business plan (¶62). These facts were material because they showed that Blockbuster did not have the resources to execute its ambitions business plan as outlined in the Prospectus. The misstatement regarding Blockbuster's cash flow alone, which was admitted in the context of Blockbuster's subsequent restatement, is sufficient to defeat Defendants' Motion to Dismiss.

Further, Plaintiff alleges that NAI, Viacom's majority shareholder, breached its duty of loyalty and good faith to minority shareholders by knowingly failing to disclose the above material information about Blockbuster. In addition to arguing that all material information about the Exchange Offer was disclosed, NAI argues that it had no fiduciary duty to minority shareholders in relation to the Exchange Offer. Viacom Br. at 31-34. NAI's argument is wrong as a matter of law. NAI, through the appointment of its agents on Viacom's board and installation of Redstone as Viacom's CEO, was the architect and primary beneficiary of the Exchange Offer. Thus, under Delaware law, it had a duty to disclose all material facts in its control about the Exchange Offer Scheme.

Plaintiff Pfeffer also asserts breach of fiduciary duty claims on behalf of a class of minority Blockbuster stockholders who held stock at the time the Special Dividend was issued ("Blockbuster Class"). Plaintiff asserts claims against both Viacom and the Blockbuster

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<sup>4</sup> Brief in Support of Viacom's Defendants' Motion To Stay Or Dismiss is cited as Viacom Br.

Directors<sup>5</sup> for issuing the crippling Special Dividend and misleading the public about the viability of Blockbuster. Viacom appointed its agents and persons interested in Viacom, on Blockbuster's board. These persons caused Blockbuster to issue the Special Dividend, which enriched Viacom by \$738 million, and misled the public about the viability of Blockbuster. ¶121. This deception enabled Viacom to sell its shares in the Exchange Offer at an inflated price, while depriving minority shareholders of the chance to sell their shares based on the undisclosed negative information.

### **STATEMENT OF FACTS**

#### **A. BACKGROUND ON BLOCKBUSTER, NAI, AND VIACOM**

Redstone, as majority shareholder, chairman, and CEO of NAI, was able to use his control over NAI to execute the Exchange Offer Scheme. NAI owned shares representing 71% of the voting power of all classes of Viacom's Common Stock (¶33), and Redstone used this power over Viacom to install himself as Chairman and CEO of the company (¶8). Additionally, Redstone appointed agents of NAI on Viacom's board. Specifically, (1) Defendant Abrams was a director of both NAI and Viacom; (2) Defendant Dauman was a director at both NAI and Viacom; and (3) Defendant Shari Redstone, daughter of Defendant Redstone, was Executive Vice Chairman of Viacom's board of directors and also President of NAI. ¶¶8-20.

Indeed, Viacom admitted that NAI had control over many of Viacom decisions in its 10-K for 2005:

NAI, through its beneficial ownership of the Company's Class A common stock, has voting control of the Company. Sumner M. Redstone, the controlling shareholder of NAI, is the chairman of the board and chief executive officer of the Company, and Shari Redstone, president of NAI, is a director of the

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<sup>5</sup> At the time of the Special Dividend, Redstone, Dauman, John F. Antioco ("Antioco"), Richard J. Bressler ("Bressler"); Jackie M. Clegg ("Clegg"); Michael D. Fricklas ("Fricklas"); Linda Griego ("Griego"); and John L. Muething ("Muething") were directors of Blockbuster at the time the Special Dividend was issued.

Company. **NAI is in a position to control the outcome of corporate actions that require shareholder approval, including the election of directors, issuance of securities and transactions involving a change of control.**

(emphasis added). ¶34.

Viacom, in turn, owned 95.9% of the total voting power of Blockbuster, and used its power over the company to elect directors with substantial financial ties to Viacom and/or NAI. ¶36. Specifically Viacom elected (1) Dauman, who was a director of NAI and Viacom; (2) Redstone, who was the chairman and CEO of Viacom and NAI; (3) Bressler, who was Senior Executive Vice President and Chief Financial Officer of Viacom; (4) and Fricklas, who was Executive Vice President, General Counsel, and Secretary of Viacom. ¶¶8-29, 71. Thus, four of eight Blockbuster directors had an interest in or were employed by Viacom and/or NAI.

In and around 2004, Redstone and his closely held company, NAI, were looking for a way to divest Viacom of its underperforming subsidiary, Blockbuster. At the time, Blockbuster was struggling. ¶¶3, 37. The company was facing intense competition from companies that allowed customers to rent movies online. Instead of selling Blockbuster to a third party buyer, however, Defendants NAI and Redstone devised and executed a scheme to unload the company on Viacom's minority shareholders. The scheme had three parts: (1) cause Blockbuster to issue a crippling \$5 Special Dividend (¶38); (2) mislead the public about the continued ability of Blockbuster to execute its business plan after issuing the Special Dividend (¶¶48-71); and (3) orchestrate the Exchange Offer, where Viacom shareholders could tender their shares of Viacom for Blockbuster shares owned by Viacom at a price inflated by false and misleading statements (collectively the "Exchange Offer Scheme") (¶39). Because NAI did not tender its Viacom shares in the Exchange Offer, the scheme had the effect of ridding Viacom and NAI of Blockbuster at a tremendous profit and further solidifying NAI's control over Viacom. ¶46.

Prior to the Exchange Offer, Viacom was Blockbuster's controlling shareholder, owning 82.3% of the company's total equity, and approximately 95.9% of the voting power of the corporation. ¶36. After the Exchange Offer, Viacom's interest in Blockbuster was reduced to zero.

## **B. THE EXCHANGE OFFER SCHEME**

On February 10, 2004, Viacom, at the behest of its controlling shareholder, NAI, announced that it was planning to spin off Blockbuster. Defendants claimed that Viacom and Blockbuster would be more competitive if the companies separated. On that day, Viacom issued a press release justifying the decision to split "based on the conclusion that Blockbuster would be better positioned as a company completely independent of Viacom." ¶37.

### **1. Blockbuster's Special Dividend**

The Special Dividend, which depleted Blockbuster of the resources to compete in a challenging business environment, was the first step in the Exchange Offer Scheme. In a June 18, 2004 press release, Blockbuster and Viacom explained the nature of the Exchange Offer to investors, informing the public that Viacom's split from Blockbuster would be preceded by Blockbuster's payment of a Special Dividend of \$5 per share. ¶38.

To finance the Special Dividend, however, Blockbuster had to borrow \$950 million. ¶40. On August 20, 2004, Blockbuster issued the Special Dividend and Viacom received its pro rata share, \$738 million. ¶39. While enriching Viacom, the Special Dividend left Blockbuster crippled, as it could not pay down its debt while financing its ambitious and publicly disclosed plans to stay competitive in a changing marketplace. Despite the weakened state of Blockbuster, Defendants had to convince minority Viacom shareholders to participate in the Exchange Offer.

## **2. Deception of Blockbuster and Viacom Minority Shareholders**

Defendants then misled the public about the viability of Blockbuster after the issuance of the Special Dividend. Although the amount of Blockbuster's debt was public knowledge, Defendants never publicly disclosed that Blockbuster was wholly unable to execute its business strategy. Indeed, they kept secret or obfuscated important indicators that would have alerted investors to Blockbuster's precarious state. Specifically, as set forth more fully below, Defendants misled shareholders about Blockbuster's cash flow to give the appearance that Blockbuster could pay for the Special Dividend and execute its business plan. Only after the restatement, did minority shareholders learn the whole truth about Blockbuster's crippled finances.

Such cash flow information was especially crucial because Blockbuster was attempting a resource-intensive overhaul to transform itself. Facing both competition from companies that rented videos online and pressure caused by the lower sale price of videos, the Prospectus outlined an ambitious business plan stating that Blockbuster planned to transform itself "from a place where you go to rent a movie to a brand where you go to rent, buy or trade a movie or game, new or used, pay-by-the-day, pay-by-the-month, in-store or online." ¶47. This transformation would take enormous resources because Blockbuster had to integrate its in-store operations with its new online business. ¶58. Further, to enable customers to trade videos, Blockbuster had to institute the same record-keeping requirements that governed pawnshops, requiring that Blockbuster keep records of who was trading (and how much was being traded). These regulations varied from state to state, and Blockbuster did not have adequate systems to collect the necessary data (and, thus, ensure compliance in each relevant jurisdiction). ¶59. Thus, to make an informed choice about tendering shares, Viacom stockholders needed complete and accurate information about Blockbuster's ability to execute its new business plan.

Defendants, however, repeatedly misrepresented the financial status of Blockbuster. On the day that the Special Dividend was announced, Blockbuster and Viacom issued a joint press release, quoting John Antioco, Blockbuster's chairman and CEO, stating: "We are pleased to be moving forward with our split-off from Viacom, and we believe that by becoming a separate company we will be better able to pursue our retailing strategy. Additionally, we believe issuing a special cash distribution will offer value to our stockholders without inhibiting us from executing our business plan." ¶48. Defendants made similar statements about Blockbuster's ability to adapt in a challenging business environment; the Prospectus stated: "Blockbuster and Viacom are united in the belief that a split off of Blockbuster from Viacom will enable each company, respectively, to better focus its managerial and financial resources." ¶48. Furthermore, Defendants made the following predictions of how Blockbuster would thrive after the Exchange Offer.

- An August 11, 2004 a Blockbuster Press Release predicted that Blockbuster's new online venture would help the company "develop a substantial share of the online rental business by the end of next year" through "aggressive[] marketing, pricing and combining our online program and in-store capabilities." ¶41.
- The Prospectus stated that Blockbuster planned to transform itself "from a place where you go to rent movies to a brand where you go to rent, buy or trade a movie or game, new or used, pay-by-the day, pay-by-the month, in-store or online." ¶47.
- The Prospectus incorporated a letter from Antioco ("Antioco Letter") that stated that Blockbuster would "be a multi-dimensional, highly differentiated and highly profitable home entertainment brand." ¶48.
- The Anticoco Letter stated: "As for renting movies online, we see this as a sizable opportunity that can contribute to our long-term profitability." ¶50.
- The Anticoco Letter stated that "movie and game trading represent[ed] a significant source of future incremental revenues." The Prospectus further stated that Blockbuster intended to "have movie and game trading available in more than 2,000 of [its] U.S. stores and all of [its] 700-plus U.K. stores, by the end of 2004." ¶52.

These assertions, however, simply were not true. Defendants were hiding crucial information about Blockbuster to induce Viacom's minority shareholders to participate in the Exchange Offer.

*First*, Defendants misrepresented the true status of Blockbuster's cash flows, thus concealing the inability of that company to meet its projected business plans. In evaluating a particular company's abilities to sustain its business plan, a company's operational cash flows are vitally important. This is true because the company's reported cash flow from operations is a good indicator of the company's ability to meet its operational expenses and achieve its business plan. In Blockbuster's case, however, the company inflated its reported cash flow from operations by improperly classifying its rental library as a non-current asset. ¶42. To explain, because the bulk of Blockbuster's retail library assets are new releases, those acquisitions should have been classified as current assets on Blockbuster's financial statements. Blockbuster, however, classified its acquisition of new releases as non-current, investment-related assets. ¶42. As a result, Blockbuster accounted for the *expense* of acquiring its inventory of new releases as a *capital* (*i.e.*, investment-related) expense rather than an *operational* expense. By so doing, Blockbuster materially inflated its reported net cash flow from operations. ¶42.

To understand why Plaintiff and the Class attach such importance to *operational* cash flow as opposed to cash flow from investment activities, it is necessary to define the difference between the two cash flow metrics. The former consists of “[c]ash receipts from sales of goods or services, including receipts from collection or sale of accounts and both short- and long-term notes receivable from customers arising from those sales.” *See* Statement of Financial Accounting Standards No. 95 at ¶22a. Thus, operational cash flow is derived from Blockbuster conducting its normal business activities. Cash flow from investment activities, however, is derived from “disposing of debt or equity instruments and property, plant, and equipment and other productive assets, that is, assets held for or used in the production of goods or services by

the enterprise.” See Statement of Financial Accounting Standards No. 95 at ¶15. Thus, this cash flow is derived from selling *productive* assets.

If Blockbuster did not have sufficient cash flow from operations to pay off its debts, it likely would have had to sell important assets, borrow more money, or refinance debt on less favorable terms. Indeed, this very risk was made explicit in a subsequent 10-K for the year ended 2006, which stated:

*If we are unable to generate sufficient cash flow from operations in the future to service our indebtedness and to meet our other commitments, we will be required to adopt one or more alternatives, such as refinancing or restructuring our indebtedness, selling material assets or operations or seeking to raise additional debt or equity capital. We cannot assure you that any of these actions could be affected on a timely basis or on satisfactory terms or at all, or that these actions would enable us to continue to satisfy our capital requirements.*

Blockbuster, Inc. Form 10-K (filed March 15, 2006), at 28-29 (attached as Exhibit A to the accompanying Declaration of Michael J. Barry in Opposition to Defendants’ Motions to Dismiss (“Barry Decl.”)).<sup>6</sup>

It is now beyond dispute, however, that Blockbuster materially inflated its cash flow from operations by improperly accounting for its rental library. On March 9, 2006, Blockbuster announced that following discussions with the Securities Exchange Commission (“SEC”), it was forced to restate its reported cash flows for 2003 through 2005. For the reported period prior to the Exchange Offer, cash from operations in 2004 went from \$1.215 billion to \$417 million, and for 2003 from \$1.43 billion to \$593.7 million. See ¶78. For the nine months ended September 30, 2004, cash flow went from the reported \$757.8 million to \$220.9 million. The results were

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<sup>6</sup> Plaintiff’s Amended Class Action Complaint alleges the materiality of Blockbuster’s admitted overstatement of its cash flows from operations. See ¶60. In their motions to dismiss, however, Defendants challenge the materiality of this error. Plaintiff offers Blockbuster’s 2006 Form 10-K, in which Blockbuster itself specifically highlights the materiality of its cash-flow from operations, as an admission that flatly rebuts Defendants’ argument in this regard.

even more disheartening for the nine months ended September 30, 2005, where positive cash flow of \$492.4 million was transformed into a *negative* cash flow of \$146.1 million:

<b>Year</b>	<b>Reported Cash Flow From Operations</b>	<b>Restated Cash Flow From Operations</b>	<b>Difference (% Overstatement)</b>
Nine Months Ended September 30, 2005	\$492.4 million	(\$146.1 million)	\$638.5 million (129.67%)
Fiscal Year 2004	\$1.215 billion	\$417 million	\$798 million (65.68%)
Fiscal Year 2003	\$1.43 billion	\$593.7 million	\$836.3 million (58.48%)

¶78.

*Second*, Defendants failed to disclose that Blockbuster had conducted its own cash flow analysis, estimating future cash flow, and found that Blockbuster could *not*, in fact, pay off the debt it had incurred in connection with the Special Dividend while simultaneously executing its announced business plan. ¶62. Specifically, Julie Mingus, a treasury department manager at Blockbuster, performed a cash flow analysis in February or March of 2004 – *prior* to the announcement and payment of the Special Dividend -- concluding that *Blockbuster could not meet its new business objectives*. According to an employee who worked in the company’s treasury operation department, the purpose of the analysis was to evaluate Blockbuster’s cash flow over 12 to 18 months to determine whether money from newly incurred debt and operating income would be sufficient to both fund the Special Dividend and help Blockbuster adapt its business plan. The cash flow analysis concluded that the Special Dividend would leave Blockbuster without the financial resources required to implement its ambitious strategic plan. Specifically, this analysis revealed that core in-store rental operations would not generate sufficient cash flow to fund Blockbuster’s investment in “new initiatives.” ¶62. Although the cash flow analysis was distributed to senior management of Blockbuster, it was never disclosed in the Prospectus. Indeed, Mary Bell, Senior Vice President of Investor Relations and Treasurer of

Blockbuster (“Bell”), specifically told subordinates not to disclose the analysis to analysts or investors. ¶63.

Notwithstanding their knowledge that Blockbuster lacked the necessary cash flow to meet its current obligations, the very Prospectus that Defendants used to promote the Exchange Offer highlighted the importance of *operating* cash flow (the very metric that Blockbuster had materially overstated) for Blockbuster to achieve its business objectives:

This focus on profitability played a central role in our efforts to transform Blockbuster, as the *steady operating cash flow from our core rental business has provided us with the ability to invest in new initiatives*. Specifically, these new initiatives are rental subscription programs (both in-store and online), movie and game trading, and video game concepts.

Prospectus at 1 (emphasis added); *see also* ¶47.

### **3. The Exchange Offer**

The Exchange Offer was designed to allow Redstone and NAI to divest their entire holdings in Blockbuster while keeping both Blockbuster’s public shareholders, and Viacom’s minority shareholders in the dark about Blockbuster’s true financial condition. Prior to the Exchange Offer, Viacom owned 82.3% of Blockbuster’s total equity: 100 percent of Blockbuster’s Class B shares and 78 percent of its Class A shares. Because Class B Common Stock had five votes compared to one vote for Class A Common Stock, Viacom controlled approximately 95.9% of the total voting power of Blockbuster. ¶36.<sup>7</sup>

On June 18, 2004, the same day that Blockbuster announced the Special Dividend, the company issued a preliminary prospectus detailing the nature of the Exchange Offer, which contained the omissions and obfuscations concerning Blockbuster’s financial health discussed

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<sup>7</sup> Redstone, through NAI’s ownership of Viacom stock, had a 9.3% economic interest in Blockbuster.

above. The Prospectus announced that Bear Stearns and Goldman Sachs Co. were co-dealer managers of the Exchange Offer. Prospectus at 20; *see also* ¶71.

On September 8, 2004, Blockbuster issued a press release detailing the final terms of the Exchange Offer. The Exchange Offer gave Viacom shareholders an opportunity to exchange their shares for Viacom's Blockbuster shares. Under the terms of the offer, each holder of Viacom Class A Common Stock and Viacom Class B Common Stock received 5.15 shares of Blockbuster stock -- consisting of 2.575 shares of Blockbuster Class A Common Stock and 2.575 shares of Blockbuster Class B Common Stock -- in exchange for each Viacom share tendered. The press release announced that the Blockbuster shares were being offered to Viacom shareholders at a 19.2 percent premium. ¶45.

In addition to mischaracterizing the financial health of Blockbuster, the Prospectus failed to disclose important information about the structure of the Exchange Offer. Specifically, the Prospectus never disclosed how the exchange ratio was calculated, except in the most vague and general terms. The Prospectus stated that "among other things," Viacom considered: (1) recent and historical prices of Viacom and Blockbuster common stock, and (2) information from co-dealer managers as to what price would induce Viacom shareholders to tender their shares. It never stated precisely what factors Viacom took into account when determining the exchange ratio, and as such, never informed investors that Defendants believed that the value of Blockbuster stock was inflated. ¶70.

While the Prospectus disclosed that a special committee of the Viacom Directors had authority to approve the Exchange Offer, the Prospectus did not disclose who was on this committee. This information was important because many of the Viacom Directors had disabling conflicts. Defendants Greenberg and Salerno were affiliated with Bear Stearns, which was a co-deal manager of the Exchange Offer. Further, as discussed above, Redstone, Shari Redstone,

Abrams, and Dauman were affiliated with NAI, which did not tender its shares in the Exchange Offer and had an interest in offering the lowest possible exchange ratio to Blockbuster shareholders. ¶71.

The scheme worked as planned. The Exchange Offer was oversubscribed and Viacom accepted 9.55% of the tendered shares, or 27,961,165 shares of Viacom common stock, in exchange for 144 million shares of Blockbuster common stock. ¶80; *see also* Viacom Form 10-Q for the quarter ended September 30, 2004, at 6 (Barry Decl. Ex. B). Therefore, through the Exchange Offer, Viacom completely divested itself of Blockbuster. Before the Exchange Offer, Viacom owned 82.3% of the equity, and 95.9% of the voting power of Blockbuster. After the Exchange Offer, Viacom’s interest was zero. ¶36.

	<b>Position in BBI</b>	
	<b>Before Exchange Offer</b>	<b>After Exchange Offer</b>
<b>Viacom’s Holdings in BBI</b>	144,000,000 (82.3% of BBI) or \$1,137,600,000	0
<b>NAI’s Equitable Interest in BBI through Viacom<sup>8</sup></b>	9.3% (11.41% of Viacom) or \$132,977,238.46	0

#### **4. The Truth Becomes Known**

After the Exchange Offer, the truth eventually became known: The Special Dividend crippled the company and Blockbuster was wholly unable to execute its business plan. From October 27, 2004 to March 9, 2006, the company gradually admitted that softness in the rental market would substantially diminish profitability to a level significantly less than represented in the Prospectus. As it became clear that Blockbuster, saddled with debt, was foundering, its debt

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<sup>8</sup> In addition, as of September 2004, NAI owned approximately 3.5 million shares of Blockbuster independent of Viacom. Plaintiffs do not have information regarding whether, or when, NAI liquidated its independent holdings, but given Redstone’s intent to divest himself completely of Blockbuster, Plaintiff presumes that NAI did, in fact, sell its Blockbuster shares at a healthy profit and expects to obtain such information through discovery.

was downgraded. By November 2005, the company warned that it may have to seek bankruptcy protection. ¶76. By November 9, 2005, Blockbuster shares were trading at \$4.11 per share, down 45% since the date of the Exchange Offer. Thus, once the truth about Blockbuster became known, it was evident that the exchange ratio offered to Viacom minority shareholders did not constitute a 19.2 percent premium as Defendants stated, but rather *a discount of over a 39 percent*. ¶31.<sup>9</sup> The following chart demonstrates the before and after impact on investors who tendered their Viacom shares in the Exchange Offer, ignorant of the true state of affairs at Blockbuster:

Value of Viacom Stock as of 9/7/04		Offer As Represented			Economic Reality of Offer		
		BBI as of 9/7/04	Implied Offer Per Share at 5.15 Exchange Ratio	Premium / (Discount) over Viacom as of 9/7/04	True Value of BBI After Disclosure	Implied Value Per Share at 5.15 Exchange Ratio	Premium / (Discount) over Viacom as of 9/7/04
Class A	\$34.60	\$7.90	\$40.685	17.6%	\$4.11	\$20.47	(40.83%)
Class B	\$34.13	n/a	\$40.685	19.2%	\$3.84	\$20.57	(39.73%)

By liquidating its shares of Blockbuster stock in the Exchange Offer before the truth of Blockbuster's cash flow problems became known, therefore, Viacom was able to dump 144 million shares on the market at a price of almost \$1.14 billion, and therefore avoid a loss of well

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<sup>9</sup> The Amended Complaint contains a mathematical error that incorrectly calculated the post-disclosure discount at just 34.5%. As the above chart demonstrates, however, the economic realities of the situation were actually worse.

over half a billion dollars that it would have suffered had the truth of Blockbuster's finances been disclosed.<sup>10</sup>

Further, the bad news about Blockbuster did not stop. The SEC forced Blockbuster to downwardly restate its operating cash flow. Specifically, the SEC pointed out that Blockbuster had improperly inflated its operating cash flow by not counting expenditures on its rental libraries as an operating cash outflow. ¶78. As discussed above, as a result of this misclassification, expenditures on the rental library were not booked as an operational expense, and Blockbuster thus artificially inflated its reported operational cash flow. In other words, shareholders were given the false and misleading impression that Blockbuster was generating more cash from its operations than the company really was. Not only were these misrepresentations made to Viacom's minority shareholders in an effort to induce their participation in the Exchange Offer, but they were also made to Blockbuster's minority shareholders in an effort to prevent them from dumping their stock at the time Viacom was trying to liquidate its investment in what it, and the Defendants, knew to be a deeply troubled and cash-strapped company.

Thus, Viacom profited from the Exchange Offer Scheme through receipt of the Special Dividend. Redstone and NAI benefited from the influx of money to Viacom from the Special Dividend and also because the Exchange Offer reduced Viacom's public float and consolidated NAI's control over Viacom. Redstone and NAI further benefited because the Exchange Offer enabled them to divest themselves of Blockbuster, an underperforming subsidiary. Minority shareholders of Viacom, however, were hurt because they tendered their Viacom shares for

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<sup>10</sup> Prior to the Exchange Offer, Viacom converted 72 million shares of its 144 million shares of Blockbuster Class A stock into 72 million shares of Class B stock. The economics impact of Viacom's liquidation of its interest in Blockbuster in the Exchange Offer may be calculated as follows:

Value as of 9/7/04:	$144,000,000 \times \$7.90 = \$1,137,600,000$
True value:	$(72,000,000 \times \$4.11) + (72,000,000 \times \$3.84) = \$572,400,000$
Loss Avoided by Viacom:	$\$1,137,600,000 - \$572,400,000 = \$565,200,000$

shares of Blockbuster, which, at the time, were trading at a vastly inflated price. Further, minority shareholders of Blockbuster were harmed even though they received a *pro rata* share of the Special Dividend. Unlike Redstone and NAI, who knew to dump their stock based on non-public information concerning Blockbusters' cash flow, minority shareholders still believed that Blockbuster could meet the challenges of a changing business environment post-merger. ¶40.

### **C. PROCEDURAL HISTORY**

On August 3, 2006, Plaintiff Pfeffer filed the original Complaint in this action. The Complaint asserted claims against the Viacom Directors alleging that they breached their fiduciary duties in connection with undertaking the Exchange Offer. In response, the Viacom Directors filed a motion to dismiss and stay on October 27, 2006 and an opening brief in support of their motion to dismiss on November 28, 2006. Plaintiff Pfeffer then amended her complaint to add claims on behalf of Blockbuster stockholders who held stock at the time the Special Dividend was issued. Plaintiff also added NAI, Viacom, and the Blockbuster Directors as Defendants. The Amended Class Action Complaint asserts the following claims:

- |           |                                                                                                                                                                                                                                                                                                                                                                                                                                               |
|-----------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Count I   | Claim for Breach of the Fiduciary Duty of Disclosure (Against Viacom Director Defendants on behalf of the Viacom Class);                                                                                                                                                                                                                                                                                                                      |
| Count II  | Claim for Breach of the Fiduciary Duties of Loyalty and Good Faith (Against the Viacom Director Defendants on behalf of the Viacom Class);                                                                                                                                                                                                                                                                                                    |
| Count III | Claim for Breach of Fiduciary Duty seeking to void the Exchange Offer as an interested transaction under Section 144 of the Delaware General Corporation Law, and for approving and/or acquiescing to the Exchange Offer at a price that was unfair to Viacom's minority shareholders and that unfairly benefited Viacom's controlling shareholder, NAI, and Redstone (Against the Viacom Director Defendants on behalf of the Viacom Class); |
| Count IV  | Claim for Breach of the Fiduciary Duties of Loyalty and Good Faith relating to the Exchange Offer (Against NAI on behalf of the Viacom Class);                                                                                                                                                                                                                                                                                                |

- Count V            Claim for Breach of the Fiduciary Duties of Loyalty and Good Faith for elevating the interests of Viacom over the interests of Blockbuster’s minority shareholders in connection with the Special Dividend (Against the Blockbuster Director Defendants on behalf of the Blockbuster Class); and
- Count VI            Claim for Breach of the Fiduciary Duties of Loyalty and Good Faith for causing Blockbuster to declare and pay the Special Dividend as an interested transaction without disclosing the true financial ramifications of the payment on Blockbuster’s finances (Against Viacom on behalf of the Blockbuster Class).

**D.        OTHER ACTIONS INVOLVING VIACOM AND BLOCKBUSTER**

On September 16, 2004, a shareholder of Viacom sued Viacom to enjoin the Exchange Offer. *See Joseph Sepulvado v. Viacom, et al.*, No 707-N. However, because the true effect of the Viacom Directors’ wrongdoing was not known at that time, the Court denied the preliminary injunction for a failure to sufficiently allege irreparable harm.

On November 10, 2005, a securities class action (“Federal Securities Action”), was filed in the United States District Court for the Northern District of Texas alleging violations of the Securities Act of 1933 (“Securities Act”) and the Exchange Act of 1934 (“Exchange Act”). *See Congregation Ezra Shalom v. Blockbuster Inc., et. al.*, No. 3:05 CV 2213-N (N.D. Tex). On May 25, 2006, pursuant to the Private Securities Litigation Reform Act of 1995 (“PSLRA”), the court appointed Nicole Lawrence, John E. Rohan, Mark F. Ott, Janice and Ronald Drisgill, and the Inkster Policemen and Firemen Retirement System lead plaintiffs (collectively “Inkster Group”), represented by Milberg Weiss LLP. On October 20, 2006, the Inkster Group filed its Second Amended Class Action Complaint (“PSLRA Complaint”) (Barry Decl., Ex. C), asserting claims under Sections 11, 15 and 12(a)(2) of the Securities Act, and Sections 10(b) and 20(a) of the Exchange Act, on behalf of a class consisting of former Viacom shareholders who acquired Blockbuster shares traceable to the Exchange Offer, and on behalf of all those who purchased

Blockbuster stock on the open market between September 8, 2004 and August 9, 2005, inclusive. PSLRA Complaint at ¶¶1, 130-55.

The defendants recently have filed motions to dismiss arguing, among other things, that the Inkster Group lacks standing to assert claims under Section 11 and Section 12(a)(2). *See* Viacom Defendants’ Motion To Dismiss And Supporting Brief (“Viacom Securities Brief”) and Blockbuster Defendants’ Motion to Dismiss Second Amended Complaint And Supporting Brief (“Blockbuster Security Brief”), both filed in *Congregation Ezra Sholom v. Blockbuster, et al.*, No. 3:05-CV-2213-N (N.D. Tex.) (Barry Decl., Exs. D and E, respectively).

On November 16, 2005, a participant of the Blockbuster Investment Plan (“BIP”) filed a class action on behalf of Plan members alleging violations of the Employee Retirement Securities Act (“ERISA Complaint”). On August 18, 2006 the ERISA complaint was consolidated with the securities action in the Northern District of Texas.

## **ARGUMENT**

### **A. THIS CASE SHOULD NOT BE STAYED**

Defendants’ argument that this case should be stayed in favor of the Federal Securities Action is wholly without merit. Under *McWane Cast Iron Pipe Corp. v. McDowell-Wellman Engineering Co.*, 263 A.2d 281, 283 (Del. 1970), a Delaware court has the discretion to stay an action where “there is a prior action pending elsewhere, in a court capable of doing prompt and complete justice, involving the same parties and the same issues.” While the Delaware Supreme Court has held that courts should freely exercise its discretion to stay a case in favor of a previously filed action, “a Delaware action will not be stayed as a matter of right by reason of a prior action pending in another jurisdiction... .” *Id.* Defendants argue that this case should be stayed because it involves the same parties, it involves the same underlying facts, and the Federal

Court in the Northern District of Texas is in a position to provide complete justice. Viacom Br. at 10-9.

Plaintiff admits that both cases involve the same underlying wrongdoing and, of course, cast no aspersions on the District Court for the Northern District of Texas. Nevertheless, Defendants' arguments that this case should be stayed is wholly without merit. As set forth below, the case, in fact, involves different plaintiffs and different defendants. Each factor alone is sufficient to defeat Defendants' motion to stay the case.

**1. This Case Involves Different Plaintiffs Than Previously Filed Actions**

It is indisputable that this case involves different parties. First, the case involves a class of plaintiffs not even represented in the Federal Securities Action. The proposed class in the Federal Securities Action case purports to represent persons "who purchased Blockbuster shares on the open market between September 8, 2004 and August 9, 2005, inclusive" for claims brought under the Exchange Act, and former Viacom shareholders who acquired Blockbuster shares "pursuant to or traceable to" the Exchange Offer under the Securities Act. PSLRA Complaint ¶34. However, this case involves not only a class of former Viacom shareholders who tendered their Viacom shares for Blockbuster shares in the Exchange Offer (which admittedly purports to be represented in the Federal action), but also a class of plaintiffs who owned Blockbuster stock at the time the Special Dividend was issued, on August 20, 2004. ¶1. These persons are simply not represented in the Federal Class Action and a stay would only serve to delay their ability to vindicate their rights under Delaware law. Therefore, the Viacom Directors' citation to *Schnell v. Porta Systems Corp.*, 1994 WL 148276, \*5 (Del. Ch.), a Delaware case that was stayed in favor of an earlier filed New York action, is wholly inapposite.

In that case, the class in the Delaware action consisted of persons who "purchased additional shares during the period from March 10, 1992, to April 1, 1993." *Id.* However, in that

case, “[t]he putative class in the [previously filed] New York Action would include all purchasers of Porta common stock during the exact same period.” *Id.* Therefore, the court held that plaintiffs in the New York action “would necessarily include the class contemplated in the Delaware Action.” *Id.* Unlike, *Schnell*, in the present case, there is a class of persons – shareholders who held Blockbuster stock when the Special Dividend was issued – who *will not* recover under the Federal Action.

Further, this case is unlike *Citrix*, cited by Viacom Defendants, where the later-filed Delaware action sought to “invalidate shareholder votes on two proposals conducted during the proposed class period March 27, 2000 to June 9, 2000.” *Louisiana State Employees' Retirement System v. Citrix Systems, Inc.*, 2001 WL 32638, \*1 (Del. Ch.). The plaintiffs in the earlier filed action purported to represent a class who purchased stock between October 20, 1999 and June 9, 2000. The court held: “I find that regardless of these differences, the two proposed classes for the purposes of the McWane analysis describe substantially the same groups of plaintiffs as the similarities in the composition and interests between the federal class and the Delaware class easily outweigh their differences.” *Id.* at \*2. In this case, however, Plaintiff seeks monetary damages on behalf of a class of plaintiffs not represented in the Federal Securities Action, not merely injunctive relief to invalidate a vote. If this action is stayed, holders of Blockbuster stock at the time the Special Dividend was issued will be unduly delayed in seeking a remedy against the Blockbuster Directors and Viacom.

## **2. The Standing Defense Unique to Federal Securities Action Plaintiffs Should Defeat A Stay**

Blockbuster argues both the Federal Securities Action and the present action name all the Blockbuster Directors, and, therefore, this court should exercise its discretion to stay claims against the Blockbuster Directors. This argument is the height of hypocrisy. At the same time Blockbuster is arguing that the Court should stay this action in favor of the Federal case,

Blockbuster is arguing in the Federal case that the plaintiffs in that action *lack standing to assert their claims*. Blockbuster can't have it both ways. It simply cannot be permitted to argue that this case should be stayed in favor of the Federal action if the Federal plaintiffs lack standing to prosecute the case.

The Inkster Group in the Federal Securities Action brought claims under Section 11 and Section 12(a)(2) against all of the Blockbuster Directors, and claims against Antioco under Section 10(b) and Rule 10b-5 of the Exchange Act. Although it is true that the Inkster Group in the Federal Securities Action named all the Blockbuster Directors as defendants, Blockbuster argued in their briefs that the Inkster Group did not have standing to bring claims under Section 11 and 12(a)(2) because plaintiffs did not purchase shares in the Exchange Offer. Barry Decl. Ex. D at 10-12, 26-28, Barry Decl., Ex. E at 7-10. Therefore, Plaintiff's claims against the Blockbuster Directors may not be vindicated in the Federal Securities Action because, according to the Defendants, the Inkster Group does not have standing.<sup>11</sup>

For this reason – *i.e.* one representative plaintiff may be more adequate to bring claims against defendants than another – Delaware courts have been reluctant to stay a later filed class

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<sup>11</sup> Although Delaware courts have held that the addition of outside directors in a later filed Delaware action will not, by itself, weigh in favor of a stay, this case is distinguishable. This is not a case where plaintiffs in the Federal Securities Action decided that there was no merit to federal claims against outside directors. *Cf. Citrix Systems*, 2001 WL 32638, at \*3 (“[T]he absence of the outside directors as defendants to the Federal Action will not interfere with the Federal Court’s ability to do ‘complete justice’ nor does there appear to be any reason why the outside directors could not be added as defendants to the Federal Action should there be any truly viable claim against them.”); *Schnell*, 1994 WL 148276, at \*5 (holding the fact that outside directors are not named in securities action is not material where there appears to be no “reason why the outside directors cannot be named as defendants in the New York action, if there is any truly viable claim against them”). This is a case where plaintiffs in the Federal Securities Action believed that there were claims against outside directors, tried to bring them, but face the very real possibility that they will not be able to bring such claims because they do not have standing to do so.

action in favor of a first filed class action. As the court in *In re Topps*, 2007 WL 1491451, \*5 (Del. Ch.) held:

*McWane* most clearly applies when an individual plaintiff sues a defendant in a convenient forum and is then met with a responsive suit by the defendant in another forum. In that circumstance, the first-filing plaintiff is rightly given primacy, assuming that her chosen forum is a convenient one that can do substantial justice between the parties.

In the representative action context, *McWane* has far less bite and for good reason. A first-filing plaintiff has no legitimacy to “call forum” for all the other stockholders of a corporation, as if their rights turned on a schoolboy playground convention. What is most important is not that the filing plaintiff get her way, but that the stockholders she seeks to represent have their legitimate expectations upheld.

Thus, because the lead plaintiffs in the Federal Securities Action do not have standing to bring claims against outside Blockbuster directors, they are not adequate representatives to assert claims on behalf of the class represented here. For this reason alone, Defendants’ motion to stay should be denied.<sup>12</sup>

### **3. The PSLRA Plaintiffs Have Not Brought Claims Under Delaware Law**

The fact that the Inkster Group has not amended its complaint in the Federal action to add Delaware state law claims also weighs against staying this case. In *Citrix*, the Court held that “plaintiffs have repackaged federal securities law claims as Delaware fiduciary duty claims.” *Citrix*, 2001 WL 32638, at \*4. However, the court only stayed the claim “on the condition that the Federal Action is amended to specifically include this claim.” *Id.* In this case, however,

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<sup>12</sup> In *Derdiger v. Tallman*, 773 A.2d 1005, 1012 (Del. Ch. 2000), the court stayed a class action in favor of an earlier filed federal class action where under the PSLRA “the District Court has already determined that the lead plaintiff and his lawyers are adequate class representatives.” However, this case is distinguishable from *Derdiger* because Defendants in this case have argued that lead plaintiffs in the Federal Action do not have standing to bring claims against most Blockbuster directors. Although picked as lead plaintiff, there is a very real possibility that Federal Security Plaintiffs will be denied standing to assert their claim against outside Blockbuster directors. Plaintiff in this action indisputably has standing to bring her claims against outside Blockbuster directors.

Plaintiffs in the Federal Securities Action amended their complaint after Plaintiff filed her class action and *did not* add Delaware state law claims. See PSLRA Complaint (Barry Decl., Ex. C). Thus, because plaintiffs in the previously filed action have not added Delaware state law claims to their complaint, this present action should not be stayed.

**B. PLAINTIFF’S CLAIMS SHOULD NOT BE DISMISSED**

**1. The Viacom Directors Breached Their Duty of Disclosure**

Plaintiff has adequately pled that the Viacom Directors breached their fiduciary duty of disclosure. There is no dispute between the parties that the Viacom Directors had an affirmative duty to ensure that Viacom shareholders were fully informed of all material facts when tendering their shares in the Exchange Offer. See *Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 987 (Del. Ch. 2000) (“Directors are required to provide stockholders with all information that is material to the action being requested and to provide a balanced, truthful account of all matters disclosed in the communications with stockholders.”) (quotation omitted); see also *In re Netsmart Technologies, Inc. Shareholders Litig.*, 924 A.2d 171, 203 (Del. Ch. 2007) (“Once a board broaches a topic in its disclosures, a duty attaches to provide information that is ‘materially complete and unbiased by the omission of material facts.’”). Further, to survive a motion to dismiss, Plaintiff must “plead facts identifying (1) material, (2) reasonably available, (3) information that, (4) was omitted from the proxy materials.” *Turner*, 846 A.2d at 987. Plaintiff has met this burden.

The Viacom Directors, however, argue: (1) all risks of investing in Blockbuster were fully disclosed; (2) specific omissions highlighted by Plaintiff were not material; (3) the undisclosed information was unknowable; and (4) the Viacom Directors had no duty to disclose how the exchange ratio was calculated and who was on the committee that approved the

Exchange Offer. Viacom Br. at 20-28. As set forth below, these arguments are wholly without merit.

Because the Viacom Brief so confuses Plaintiff's duty of disclosure claim, it is necessary to summarize Plaintiff's arguments before dealing with the Viacom Directors' specific points. Viacom's minority shareholders were told numerous times in the Prospectus and in other public statements that Blockbuster was positioned to be profitable in a changing business environment. As detailed above, Viacom shareholders were told, *inter alia*, that (1) minority shareholder were given the opportunity to tender their Viacom shares at a 19.2 percent premium (¶30); (2) Blockbuster would be better able to compete independent of Viacom (¶37); (3) the company would be able to execute its business plan despite taking on a large amount of debt to pay for the Special Dividend (¶56); and (4) Blockbuster could transform itself to compete in a challenging business environment (¶56).

However, Viacom shareholders were not given truthful and accurate information to evaluate these predictions. Specifically, as detailed above, minority shareholders were not told: (1) Blockbuster's reported cash flow from operating activities was inflated by 58% at the time of the Exchange Offer (¶61) and (2) a negative cash flow analysis showed that Blockbuster would be unable to execute its new business plan (¶62). As a result of this failure to disclose these facts concerning Blockbuster, Viacom minority shareholders were simply not able to learn that Blockbuster had inadequate cash flow to both pay its debt and execute its ambitious business plan. The restatement regarding Blockbuster's operational cash flows is itself sufficient to demonstrate that the disclosures made in the Prospectus were materially misleading and incorrect. *See e.g., In re FirstEnergy Sec. Litig.*, 316 F. Supp. 2d 581, 594 (N.D. Ohio 2004) (“[T]he purpose of a restatement is to correct an error in a previously-issued financial statement. By definition then, a restatement says that the prior financial statement was false.”).

Further, beyond the specific breaches of the duty of disclosure concerning the fiscal health of Blockbuster, the Viacom Directors failed to disclose crucial information concerning the Exchange Offer. Specifically, Viacom did not disclose whether the committee approving the Exchange Offer was interested in the transaction – many Viacom directors had relationships with NAI or Bear Stearns -- and did not disclose exactly how the exchange rate was calculated. ¶71.

## **2. Defendants Failed To Disclose Crucial Information Concerning Blockbuster**

Despite the fact that Plaintiff has pled that minority shareholders were misinformed about Blockbuster’s cash flow, the Viacom Directors argue that all risks of the Exchange Offer were fully disclosed because the Prospectus warned numerous times that Blockbuster’s cash flow may be inadequate. In reality, the disclosures in the Prospectus only highlight the importance of truthful, accurate cash flow information; they do not negate the need for the Viacom Directors to furnish such information. The following warnings in the Prospectus, quoted by the Viacom Directors, illustrate the crucial nature of Blockbuster’s cash flow:

- “[F]inancial results, including cash flows, will . . . be adversely impacted by the investment of approximately \$90 million of incremental operating expenses and approximately \$100 million of additional capital investments associated with the development and launch of its key growth initiatives, as well as by the anticipated continued weakness in the rental industry.”
- “Blockbuster’s debt service obligations with respect to this new debt will have an adverse impact on its earnings and cash flow for as long as the indebtedness is outstanding.”
- “[Blockbuster] may not have sufficient cash flow from operations to make its scheduled debt payments.”

Viacom Br. at 21-23.

The disclosure of so-called “risks” does not relieve the defendants of their affirmative obligations to disclose *facts* of which they knew. To wit, these general warnings concerning cash flow are simply not sufficient when the Viacom Directors *knew* that Blockbuster was effectively a crippled company after the Special Dividend was issued. *See Credit Suisse First Boston Corp. v.*

*ARM Fin. Group*, 2001 WL 300733, at \*8 (S.D.N.Y. 2001) (“[W]arnings of specific risks like those in [defendants’] Prospectus do not shelter defendants from liability if they fail to disclose hard facts critical to appreciating the magnitude of the risks described.”); *In re Prudential Sec. Inc. Ltd. P’ships Litig.*, 930 F.Supp. 68, 72 (S.D.N.Y. 1996) (“The doctrine of bespeaks caution provides no protection to someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away.”). Therefore, because Plaintiff has pled specific, negative cash flow information that was not disclosed to the public, Defendants cannot avoid liability by showing that the Prospectus included boilerplate speculation that cash flow *may* in the future be inadequate.

### **3. The Viacom Directors’ Mis-statements and Omissions Were Material**

The Viacom Directors argue that the misstatements and omissions enumerated in the Amended Complaint are not material as a matter of law. They are wrong. Delaware courts have held:

An omitted fact is only material if there is a substantial likelihood that it would be considered important in a reasonable shareholder’s deliberation and decision making process before casting his or her vote. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.

*In re Netsmart Technologies*, 924 A.2d at 199 (internal quotations omitted). Furthermore, “materiality ... is an inherently fact-sensitive inquiry not readily susceptible to dismissal.” *Acker v. Transurgical, Inc.*, 2004 WL 1230945, at \*4 (Del. Ch.). In this case, Plaintiff has identified information critical to a reasonable shareholder in deciding whether to participate in the Exchange Offer that was wholly omitted or misstated in the Prospectus, including the following: (1) Blockbuster’s operational cash flow (¶42); (2) a negative cash flow analysis prepared by high-level Blockbuster management (¶62); (3) the method by which the exchange offer was calculated

(¶70); and (5) the names of the Viacom directors who made the decision to engage in the Exchange Offer (¶71). This information is highly relevant to a reasonable investor because such information is necessary for him or her to determine if Blockbuster had the resources to execute its business plan, and also to gauge whether the Exchange Offer was structured to benefit Viacom and NAI over minority Viacom shareholders.

(a) Cash Flow Misstatements And Omissions Were Material

Overstating operational cash flow by 58% percent is a material misstatement. Delaware courts have held that accurate cash flow information is crucial to enable shareholders to make informed decisions. *See In re Netsmart Technologies*, 924 A.2d at 177 (“A reasonable stockholder deciding how to make these important choices would find it material to know what the best estimate was of the company’s expected future cash flows.”). At the time of the Exchange Offer, investors were told that operational cash flow was \$1.43 billion in 2003. In reality, as restated in 2006, Blockbuster’s cash flow from operations was only \$593.7 million. ¶78. At a minimum, this is an issue of fact that cannot be decided at the motion to dismiss stage. As this Court in *Albert v. Alex. Brown Mgmt. Servs., Inc.*, 2005 WL 2130607, at \*2 (Del. Ch.) held:

*The determination of materiality is a mixed question of fact and law that generally cannot be resolved on the pleadings. Therefore, the court cannot (and does not) make any final findings on the materiality of these alleged disclosure allegations. However, on a Rule 12(b)(6) motion, the court must determine whether, under the facts alleged in the complaint, these disclosure (or non-disclosure) allegations support a reasonable inference of materiality.*

(emphasis added).

At the very least, overstating operating cash flow by 58% supports a reasonable inference of materiality, as the importance of cash from operations was highlighted time and again by Defendants themselves. The SEC has found misstatements in financial statements that quantitatively were much lower to be material. *See In re Oxford Health Plans, Inc.*, SEC

Administrative Proceeding File No. 3-10845, 2002 WL 1688400, at \*3 (2002) (finding that overstatement of net income by 12.9% was material).

Further, because of Blockbuster's debt and its need for cash to change its business plan, operating cash flow was particularly important to investors. As the Prospectus (at 1) stated: "This focus on profitability played a central role in our efforts to transform Blockbuster, as the steady *operating cash flow* from our core rental business has provided us with the ability to invest in new initiatives. Specifically, these new initiatives are rental subscription programs (both in-store and online), movie and game trading, and video game concepts." (emphasis added).<sup>13</sup>

Defendants, however, argue that the overstatement of operational cash flow and the corresponding understatement of cash flow from investments was a misclassification, merely shifting "money amounts from one cash flow category" to another. Viacom Br at 27-8. This argument ignores the fundamental difference between cash flow from operations and cash flow from investments, which was explained above. *See supra* at 9. Indeed, reporting on Blockbuster's restatement, the WALL STREET JOURNAL specifically the efforts of Blockbuster's CFO to downplay the importance of the misclassification of the Company's cash flow, observing that "when professional investors look at cash flow, it is almost always the operating figure they focus on, because that's the one that reflects the money a company is bringing in from its everyday business, as opposed to sideline investments." Michael Rapoport, *Moving the Market – Tacking the Numbers/Outside Audit: Closer Look at Blockbuster's Results Changes Picture*, THE WALL STREET JOURNAL, 3/14/06 at C3 (Barry Decl., Ex. F). *See also*, Charles W. Mulford and Eugene E. Comiskey, *Creative Cash Flow Reporting, Uncovering Sustainable Financial*

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<sup>13</sup> The Viacom Brief quotes liberally from portions of the Prospectus not referenced in the Amended Complaint. If the Court determines it appropriate to entertain the references selectively quoted by Defendants, it should also consider the remainder of the Prospectus as well, which directly refutes statements made in the Viacom Defendants' Brief, such as Defendants' assertion that the overstatement of cash flow from operations was immaterial.

*Performance* (publisher: John Wiley & Sons, Inc.), at 56 (commenting on the difference between operating and investing cash flows, the authors observe: “Because they are derived from less sustainable sources, investing cash inflows are not valued as highly as operating cash inflows.”) (Barry Decl., Ex. G).

Moreover, by restating its financial results, Blockbuster has conceded the materiality of the very misstatements at issue here. The SEC only requires restatements of past filings if they contain *material* errors. See *In The Matter of Huntington Bancshares, Inc.*, 85 S.E.C. Docket 1433, 2005 WL 1307747, at \* 10 (“Huntington’s restatements are admissions of material error in violation of GAAP, which requires restatement only for material misstatements.”); see also 17 C.F.R. § 210.4-01(a)(1) (“Financial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided.”). Blockbuster, therefore, already has conceded that the inflation of operational cash flow was material.<sup>14</sup> See *In re FirstEnergy*, 316 F. Supp. 2d at 595 (“[T]he purpose of a restatement is to correct an error in a previously-issued financial statement. By definition then, a restatement says that the prior financial statement was false.”). At the very least, this admission precludes the court from accepting Defendants’ argument that Blockbuster’s inflated cash flow was an immaterial error as a matter of law. See *Chalverus v. Pegasystems, Inc.* 59 F. Supp. 2d 226, 233 (D. Mass. 1999) (“[A] plaintiff may rely on the defendant’s own disclosures about a

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<sup>14</sup> In this regard, this case is distinguishable from *In re U.S. Robotics Corp. S’holders Litig.*, 1999 WL 160154, \*13 (Del. Ch. 1999), where the court noted that a restatement did not necessarily constitute an admission that financial information contained in a particular 10-Q was false when filed. In that case, however, the restatement was necessitated not because of any error in its original reporting, but to make the financial data comparable to historical data of the company subsequent to a merger. *Id.* at \*4. Indeed, the court noted: “[The] March 1997 results themselves have never been restated at all.” *Id.* at \*13 n.4. In stark contrast, Blockbuster *admitted* that its operating cash flow was inflated in its restatement.

revenue restatement to allege that previously-made statements about revenue were materially false or misleading.”). Therefore, Defendant’s motion to dismiss based on the alleged non-materiality of restated operational cash flow is without merit.

In addition, the Viacom Directors’ failure to disclose that Blockbuster conducted its own cash flow analysis that found that Blockbuster could not pay the Special Dividend and execute its business plan was itself a material omission. The Viacom Directors, however, argue that they did not have to disclose this negative analysis because they disclosed the analysis of two financial advisors. Viacom Br. at 26. But the Delaware Supreme Court rejected this exact argument in *Lynch v. Vickers Energy Corp.*, 383 A.2d 278, 281 (Del. 1978), which held:

[W]hen . . . management was in possession of two estimates from responsible sources one using a ‘floor’ approach defining value in terms of its lowest worth, and the other a more ‘optimistic’ or ceiling approach defining value in terms of its highest worth it is our opinion that complete candor required disclosure of both estimates. If management believed that one estimate was more accurate or realistic than another, it was free to endorse that estimate and to explain the reason for doing so; but full disclosure, in our view, was a prerequisite.

In that case, Vickers Energy Corp. (“Vickers”), a majority shareholder of TransOcean Oil, Inc. (“TransOcean”) offered to purchase remaining shares of TransOcean in a tender offer. TransOcean stated that its net asset value was “not less than \$200,000,000.” *Id.* at 280. However TransOcean and Vickers failed to disclose that an estimate done by a TransOcean employee valued the company’s net assets at \$250.8 million. The court held that by not disclosing the higher estimate to minority shareholder of TransOcean, director defendants from Vickers and TransOcean breached their duty of disclosure. *Id.* at 280. In this case, even though the Prospectus discussed, in general terms, that Blockbuster may not be able to afford the debt used to pay the Special Dividend, such discussion is simply not a substitute for disclosure of an analysis that supports that point. *See id.* at 281 (holding that although Prospectus may be

technically accurate in its statements, “generality is hardly a substitute for hard facts when the law requires complete candor”). Therefore, failure to disclose the cash flow analysis was material.

Further, the fact that Plaintiff has pled that a Blockbuster manager in the treasury department prepared the negative cash flow analysis is sufficient at this stage to show that it has come from a “responsible source[]” as required by the Delaware Supreme Court in *Lynch*. *Id.* at 281. In that case, the estimate similarly came from an employee of the company subject to the tender offer. *Id.* Additionally, in *R.S.M. Inc. v. Alliance Capital Mgmt. Holdings L.P.*, 790 A.2d 478, 502 (Del. Ch. 2001) the court refused to dismiss a claim where plaintiffs alleged that defendants failed to disclose internal projections showing that the company would have received greater fees if shareholders did not support a reorganization than if it did. The court held: “At this stage, I feel constrained to give the plaintiffs the benefit of a pleading doubt that the omitted information was in fact of sufficient reliability and comparability to fairly bear on the question.” *Id.* Therefore, Plaintiff has adequately pled that the failure to disclose the internal cash flow projection was a material omission.<sup>15</sup>

(b) Misstatements Concerning the Structure of the Exchange Offer  
Are Material

The Viacom Directors wrongly argue the methodology in which Viacom calculated the exchange ratio is irrelevant as a matter of law. Delaware courts have held the exact opposite. The court in *In re Pure Resources, Inc. S’holders Litig.*, 808 A.2d 421, 449 (Del. Ch 2002) held:

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<sup>15</sup> Defendants claim that the omitted cash flow analysis was stale. Viacom. Br. at 29. However, the cash flow analysis was done over 3 months *after* one of the independent analyses of the Special Dividend was commissioned and only 3 months before that analysis was complete. Further, it was completed only five months before the second independent analysis touted by Viacom Directors was completed. Thus, the case is distinguishable from *In re PNB Holding Co. Shareholders Litig.*, 2006 WL 2403999, \*16 (Del. Ch.), where undisclosed projections were found to be not material where they were two years old. Further, to the extent that Blockbuster Defendants argue that conditions at Blockbuster changed subsequent to the analysis, but before the Exchange Offer, such argument at best raises an issue of fact that cannot be decided at the motion to dismiss stage.

The real informative value . . . is not in its bottom-line conclusion, but in the valuation analysis that buttresses that result. . . . [A] Pure minority stockholder engaging in the before-the-fact decision whether to tender would find it material to know the basic valuation exercises that First Boston and Petrie Parkman undertook, the key assumptions that they used in performing them, and the range of values that were thereby generated.

Thus, it would be vitally important for a shareholder to know *exactly* how Viacom calculated the exchange ratio in deciding whether or not to tender shares in the Exchange Offer as “failure to disclose the information . . . deprive[d] the stockholders of information material to making an informed decision whether the exchange ratio is favorable to them.” *Id.* at 450; *see also Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1145 (Del. Ch. 1987) (“Shareholders are entitled to be informed of information in the fiduciaries’ possession that is material to the fairness of the price.”). Thus, shareholders were entitled to know how the Viacom Directors calculated the price of the Exchange Offer. Further, it was highly misleading for Blockbuster to claim that the Exchange ratio was based on, *inter alia*, the historical market price of Blockbuster. As shown above, the price of Blockbuster stock at the Exchange Offer was artificially inflated through Defendants’ material misstatements and omissions.

*Frank v. Arnelle*, 1998 WL 668649 (Del. Ch.), *aff’d*, 725 A.2d 441, (Del. 1999) (table), cited by the Viacom Directors for the proposition that the Viacom Directors need not disclose how the exchange ratio was calculated, does not bear on this case as its holding was limited by the Delaware Supreme Court. Viacom Br. at 25-27. In that case, defendant company conducted a Dutch auction whereby they offered to purchase company stock between \$30 and \$35. *Id.* at \*2.<sup>16</sup> The Court held that how a company came to a valuation of the stock was immaterial because:

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<sup>16</sup> In a Dutch auction, the company “determines the lowest price at which it can purchase the number of shares it needs, and buys at that price, on a pro rata basis if necessary, all shares tendered at or below that price.” *Id.* at \*1.

In a Dutch auction, the stockholder's decision to tender shares is driven by the differential between the price range offered and the stock's market value. So where a stockholder is provided an opportunity to tender his shares in a Dutch auction, and after he has determined to sell rather than hold the stock, there is a single inquiry: Will I make a profit if I tender shares in the Dutch auction instead of selling them in the open market? Accordingly, only those facts that relate either to the terms of the Dutch auction self-tender offer, or the stock's market price (current and historical) would affect the total mix of information that a reasonable stockholder would consider in deciding whether to tender shares, and to what extent, in a Dutch auction

*Id.* at \*3. In affirming the decision, however, the Supreme Court noted a flaw in the Chancery Court's reasoning; holding: "We agree that this statement may be misleading. A stockholder faced with a Dutch auction tender offer must first decide whether to dispose of his shares or to retain them. In making the initial decision to sell or retain shares, a stockholder needs to know the relevant material information available as to that decision." *Frank*, 725 A.2d at 441 ("If the Court of Chancery intended to imply that there was no obligation by the directors to disclose information that would have been material to a stockholder's decision to hold or dispose of shares, that holding would be incorrect."). In that case, which was at the summary judgment stage, the Supreme Court held that there was no evidence that the company was valued higher than the auction range, and thus, how the price was actually calculated was not material. *Id.* In this case, whether or not the Viacom Directors took into account the negative cash flow analysis and the true cash flow of the company in valuing Blockbuster's stock would indisputably be material to stockholders in deciding whether or not to participate in the Exchange Offer.

Further, the Viacom Directors are wrong in their argument that the names of members on the Viacom committee with authority to approve the Exchange Offer was not material. *See Zoren v. Genesis Energy, L.P.*, 836 A.2d 521, 521 n.22 (Del. Ch. 2002) ("[The complaint] alleges that the proxy statement failed to disclose the identities of the two members of the special committee who recommended Restructuring. This is, of course a surprising omission. . . . [T]he materiality of the omission from the proxy statement would be a matter to resolve on a complete factual

record.”). As stated above, NAI, which did not tender its shares, would benefit the most if Viacom minority shareholders tendered their shares; NAI’s majority owned company, Viacom, would be rid of an underperforming subsidiary, and NAI’s controlling interest in Viacom would be increased. Directors who were affiliated with NAI, therefore, had potential conflicts of interest that independent directors would not have. Thus, it would be material for a stockholder to know who was on the special Viacom committee and whether they were independent of NAI or Bear Stearns, co-deal managers for the Exchange Offer.<sup>17</sup>

Again, this case is distinguishable from *Frank*, cited by Viacom Defendants for the proposition that names of board members on the Viacom special committee is not relevant. Viacom Br. at 26-7. In *Frank*, unlike in this case, there was no allegation that some members of the board had interests that differed from other members of the board. *See Frank*, 1998 WL 668649, at \* 5. Here, it would be of crucial importance for Viacom minority stockholders to learn whether only NAI and/or Bear Stearns affiliated directors approved the Exchange Offer.

(c) The Truth About Blockbuster was Reasonably Available To The Viacom Directors

Notwithstanding the falsity of the Prospectus, Defendants argue that the Viacom Directors were not in a position to know that the Prospectus contained material omissions and false statements about Blockbuster. Viacom Br. at 23-4. They are mistaken. Under Delaware law, the Viacom Directors have a “duty to disclose fully and fairly all material information within the board’s control when it seeks shareholder action.” *In re Freeport-McMoran Sulphur, Inc. Shareholder Litig.*, 2005 WL 1653923, \*14 (Del. Ch.) (quotations omitted). Plaintiff has pled sufficient facts to show that the Viacom Directors had control over financial information of Blockbuster and such information was “reasonably available” to the Viacom Directors. *Turner*,

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<sup>17</sup> Viacom correctly points out that Shari Redstone’s affiliation with NAI was disclosed in the Prospectus. Viacom Br. at 26.

846 A.2d at 987. Viacom was the majority shareholder of Blockbuster. ¶5. The Viacom Directors, including Redstone and Dauman, were also directors of Blockbuster. ¶71. Thus, it is simply incorrect for the Viacom Directors to argue, as a matter of law, that they did not have access to omitted and misstated Blockbuster cash flow information.

The Viacom Directors' argument that the above information is unknowable is wholly without merit. Thus, their citation to *Iotex Commc'n, Inc. v. Defries*, 1998 WL 914265, \*4 (Del. Ch. 1998) is inapposite. In *Iotex*, the court held:

where pleading a claim of fraud or breach of fiduciary duty that has at its core the charge that the defendant knew something, there must, at least, be sufficient well-pleaded facts from which it can reasonably be inferred that this 'something' was knowable and that the defendant was in a position to know it.

In that case, the plaintiffs conclusorily pled that defendant directors knew "a party negotiating a contractual arrangement with the corporation did not intend to perform its obligations under the contract[.]," yet provided no basis for the conclusory statement. *Id.* The court held: "Speculative conclusions unsupported by fact do not allege breaches of fiduciary duty." *Id.* In this case, however, Plaintiff has pled the existence of concrete information in the control of the Viacom Directors, including relevant cash flow information about Blockbuster, that the Viacom Directors had a duty to disclose. Similarly, such information was also in the control of Redstone and NAI as they controlled Viacom's Board.

#### **4. The Viacom Directors Breached Their Duty Of Loyalty By Failing To Disclose Material Information To Shareholders**

Plaintiff has adequately pled that the Viacom Director Defendants breached their duty of loyalty to minority Viacom shareholders. The Viacom Directors wrongly argue that their duty of loyalty is not implicated because (1) the Exchange Offer was offered to everybody on equal terms; (2) Plaintiff has not pled that the Viacom Directors benefited from the Exchange Offer; and (3) Plaintiff has not pled the extent to which NAI benefited from the Exchange Offer.

Viacom Br. at 30-31. Again, Defendants are wrong. The Viacom Defendants can be liable for breaching their duty of loyalty for elevating the interests of Redstone and NAI over Viacom's minority shareholders.

Under Delaware law, a failure to disclose can implicate both the duty of care and the duty of loyalty. As the court in *In re Tyson Foods, Inc.*, 919 A.2d 563, 597 -598 (Del. Ch. 2007) held:

Disclosure violations may, but do not always, involve violations of the duty of loyalty. A decision violates only the duty of care when the misstatement or omission was made as a result of a director's erroneous judgment with regard to the proper scope and content of disclosure, but was nevertheless made in good faith. Conversely, where there is reason to believe that the board lacked good faith in approving a disclosure, the violation implicates the duty of loyalty.

To state a claim at the motion to dismiss stage, Plaintiff must "plead[] facts sufficient to support the inference that the disclosure violation was made in bad faith, knowingly or intentionally" *O'Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 915 (Del. Ch. 1999). Here, facts suggest that the Viacom Directors, in bad faith, falsely and misleadingly misrepresented the financial status of Blockbuster in order to enable Viacom to divest its interests in Blockbuster at an inflated price. This benefited NAI (and thus Redstone) directly, who, as the controlling shareholder of Viacom, was able to rid the company it controlled of an underperforming asset at the direct expense of the minority shareholders.

In this regard, NAI's and Redstone's control over Viacom (and thus Blockbuster) cannot be ignored. Where a controlling shareholder expresses such interest in consolidating control over the company, Delaware courts have recognized that it may act as an "800-pound gorilla whose urgent hunger for the rest of the bananas is likely to frighten less powerful primates like putatively independent directors who might well have been hand-picked by the gorilla (and who at the very least owed their seats on the board to his support)." *In re Pure Resources, Inc., S'holders Litig.*, 808 A.2d 421, 436 (Del. Ch. 2002). Not only did the Special Dividend with the subsequent Exchange Offer benefit NAI and Redstone through their control over Viacom, but it

also benefited them directly as well. Indeed, the fact that NAI did not participate in the Exchange Offer, coupled with Redstone's well-publicized interest in reducing the public float of Viacom, gives rise to an inference of Redstone's design to consolidate control over Viacom. ¶69. The fact that the Viacom Board acquiesced to such a plan gives rise to an inference of bad faith, and thus a breach of the duty of loyalty. *In re Pure Resources*, 808 A.2d at 436; ¶2. Therefore, the Viacom Directors' argument that NAI did not benefit from the Exchange Offer is without merit.

Indeed, because the overall transaction – the declaration of the Special Dividend followed immediately by an Exchange Offer that hid the true impact that the Special Dividend had on Blockbuster's finances – was plainly interested, it should be subject to review under an "entire fairness" standard. In *Feldman v. Cutaita*, 2006 WL 920420, at \*6 (Del. Ch.), for example, the Court held that where "allegations with respect to the repurchase suggest that the self-tender offer was an interested transaction," such repurchase is "subject to the entire fairness standard of review." *Feldman*, 2006 WL 920420, at \*6. In that case, directors of a company offered to purchase company stock at \$10 per share. *Id.* at \*4. In addition to stock, the company offered to purchase warrants and options, of which directors of the company owned 89 percent. Plaintiffs argued that the offering price of the tender offer was inflated, to ensure that the directors would profit from "otherwise underwater options and warrants." *Id.* at \*1. Just as the Viacom Directors argued here, defendants in that case argued that "the repurchase is not an interested transaction because all security holders can participate in the transaction on equal terms." *Id.* at \*6. This Court, however, rejected that argument and held: "[T]aken as true, the particularized allegations of fact in the complaint support a reasonable probability that a majority of the Telex directors were financially interested in the repurchase and stand to receive a financial benefit not equally shared by the company's stockholders." (emphasis in original). Similarly, in this case, Plaintiff has pled facts giving rise to the inference that directors on the committee to approve the Exchange

Offer had a stake in NAI and priced the Exchange Offer to benefit NAI over minority Viacom shareholder. As such, the transaction is subject to review under the “entire fairness” standard, and Defendants’ motion to dismiss should be denied on this basis as well.

#### **5. NAI Breached Its Duty Of Disclosure To Viacom’s Minority Shareholders**

NAI also breached its duty of loyalty and disclosure to Viacom’s minority shareholders. Defendants dispute this point, arguing (1) because Viacom, not NAI acquired Viacom shares, NAI had *no* duty to minority shareholder and (2) all material facts about the Exchange Offer were disclosed. Viacom Br. at 31-34. As an initial matter, as discussed above, all material facts concerning the Exchange Offer most certainly were *not* disclosed to shareholders. *See supra* at 7-14, 24-32. And Defendants are simply incorrect in their assertion that NAI does not have a duty to minority shareholders.

“It is well settled law that only a ‘controlling stockholder’ owes fiduciary duties to other stockholders. A stockholder can meet this ‘control’ test in one of two ways. First, ownership of more than 50% of the voting power of a corporation satisfies the ‘control’ test. Alternatively, a stockholder stands as a fiduciary if it ‘exercises control over the business and affairs of the corporation.’” *In re Primedia Inc. Derivative Litig.*, 910 A.2d 248, 257 (Del. Ch. 2006). Here, it is undisputed that NAI is a majority shareholder of Viacom. It is also beyond dispute that Redstone, through his control of NAI, and through his positions as CEO and Chairman of Viacom, exercised control over the business and affairs of Viacom. As a result, NAI – by virtue of Redstone’s control over the business of Viacom -- owed fiduciary duties to Viacom’s minority shareholders.

It is also undisputed that when a majority shareholder itself purchases shares through an exchange offer or tender offer, it has “a fiduciary duty to plaintiff which require[s] ‘complete candor’ in disclosing fully ‘all of the facts and circumstances surrounding the “tender offer.”” *See*

*Lynch*, 383 A.2d at 279. It is logical to extend this reasoning where a controlling shareholder causes a company to purchase shares to help it consolidate control over the company, which is precisely what happened here. Defendants do not dispute this logic, but argue that Plaintiff has not pled that NAI in any way caused Viacom to engage in the Exchange Offer. This is absurd.

To plead control, Plaintiff “need not demonstrate that [the controlling shareholder] oversaw the day-to-day operations of [the corporation]. Allegations of control over the particular transaction at issue are enough.” *In re Primedia Inc.*, 910 A.2d at 257. In *Primedia*, the court found that the plaintiff adequately pled that the controlling shareholder exercised control over a transaction in which its company called preferred stock, owned by the shareholder, at its full redemption price, years before the corporation was contractually obligated to do so. *Id.* at 250. The court found control where (1) the proxy stated that the controlling shareholder was an influential force behind the transaction; (2) the controlling shareholder appointed associates on the company’s board; (3) there was no evidence to suggest an independent committee of directors considered the transaction; and (4) the shareholder had a financial stake in the transaction. Here, many of the same indicia of control are present: (1) Redstone, NAI and Viacom’s chairman and CEO, publicly stated an interest in reducing the public float of Viacom to increase NAI’s share of the company, (2) NAI appointed its affiliates on Viacom’s Board, including Redstone and his daughter Shari Redstone; (3) no evidence suggests an independent committee of Viacom board members considered the transaction (indeed, one of the important items the Prospectus failed to disclose is who structured the deal); and (4) NAI had an interest in the transaction because the Exchange Offer caused its ownership stake in Viacom to increase. Thus, Plaintiff has adequately pled that Redstone (and thus NAI) caused Viacom to engage in the Exchange Offer.

This case is clearly distinguishable from *Cinerama, Inc. v. Technicolor, Inc.*, 1991 WL 111134, \*20 (Del. Ch.), *aff’d in part, and rev’d in part*, *Cede & Co. v. Technicolor, Inc.*, 634

A.2d 345 (Del. 1993), cited by NAI, for the proposition that it does not owe a duty of disclosure to Plaintiff. Viacom Br. at 32-33. In that case, a third party acquiring company negotiated a deal with a company's board in which it would initiate a tender offer to acquire a majority of the company's shares and then effect a second step cash out merger. After the tender offer, the third party acquiring company effected the second step merger as previously negotiated at arms length with the board prior to the tender offer. *Id.* at \*20. Thus, in that case, because the details of the second step merger were negotiated prior to the time that defendant became a majority shareholder, the court held that the majority shareholder did not use its control over the company to set the terms of the merger. *Id.*

The facts in *Cinerama* could hardly be more dissimilar to the facts presented here. Sumner Redstone, and thus his company NAI, is far more than an outside investor of Viacom. He runs the Company. ¶8. As Viacom's Chairman and CEO – and in the express absence of any suggestion that either he or his appointees on the Viacom Board had anything to do with causing or structuring the Special Dividend and Exchange Offer (because the Viacom Defendants have refused to reveal this information – it is a reasonable inference that Redstone had his fingers in every aspect of the transaction. Because Redstone's role was central to the deal, NAI – the company he controlled and through which he exercised his control over Viacom's Board -- had a duty to disclose material information within its control.

#### **6. The Blockbuster Directors Breached Their Duty Of Loyalty to Blockbuster's Minority Shareholders**

Plaintiff also adequately has pled that the Blockbuster Directors breached their duty of loyalty to minority Blockbuster shareholders by failing to disclose the true crippling effect of the Special Dividend. Although duty of disclosure claims typically arise where directors make “statements to the corporation's stockholders in connection with a request for stockholder action,” where no stockholder action is requested, courts “have been willing ... to allow plaintiffs

to plead fraudulent disclosures under the rubric of the duty of loyalty.” *Orloff v. Shulman*, 2005 WL 3272355, at \*14 (Del. Ch.). To plead such a duty of loyalty claim, Plaintiff must plead that she relied on false information that Defendants “knowingly disseminate[d].” *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998). In deciding not to sell her shares, Plaintiff has alleged that she has relied on Blockbuster’s statements in the Prospectus, set forth above, affirmatively representing that Blockbuster could execute its business plan in a challenging business environment and pay off the debt incurred to finance the Special Dividend. ¶7.

In this case, the Exchange Offer Scheme clearly benefited Viacom, who dumped its shares at an inflated price, over minority shareholders, who were not privy to the true financial status of Blockbuster and did not know to sell. Because Plaintiff has pled that 5 of the 8 Blockbuster directors were financially interested or beholden to majority shareholder of Viacom, Plaintiff has successfully rebutted the business judgment rule. *See Orman v. Cullman*, 794 A.2d 5, 22 (Del. Ch. 2002) (“As a general matter, the business judgment rule presumption that a board acted loyally can be rebutted by alleging facts which, if accepted as true, establish that the board was either interested in the outcome of the transaction or lacked the independence to consider objectively whether the transaction was in the best interest of its company and all of its shareholders.”) (emphasis in original).

Plaintiff clearly has pled that five directors either profited directly from the Exchange Offer Scheme, or were beholden to Viacom: (1) Redstone directly profited from the Exchange Offer Scheme because as Chairman and CEO of Viacom and NAI, and controlling shareholder of NAI, Redstone directly profited when Viacom unloaded its Blockbuster shares on minority Viacom shareholders at an inflated price; (2) Antioco was Blockbuster’s CEO, and therefore owed his livelihood to Viacom, which as Blockbuster’s controlling shareholder could remove him at any time; and (3) Bressler, Dauman, and Fricklas were officers of Viacom and also owed their

livelihood to Viacom. See *In re MAXXAM, Inc.*, 659 A.2d 760, 774 (Del. Ch. 1995) (finding plaintiffs had adequately pled directors were beholden to majority shareholder where directors “were employed as highly paid officers of or consultants” of entity controlled by shareholder). Thus, Plaintiff has pled that a majority of the board at Blockbuster was interested or beholden to NAI in the Exchange Offer Scheme.<sup>18</sup>

The Blockbuster Directors’ claim that the Special Dividend and the Exchange Offer were not part of a unified plan to rid Viacom of Blockbuster stock at an inflated price is wholly without merit. The Blockbuster Directors argue: “[T]he Special Dividend was declared on August 20, 2004 – almost three weeks before Viacom issued its press release announcing the terms of the Exchange Offer on September 8, 2004.” Blockbuster Br. at 20. The Blockbuster Directors, however, have neglected to inform the Court that the Prospectus clearly discloses that Blockbuster’s special committee approved the Special Dividend on June 16, 2004. See Prospectus at 55. The very next day, June 17, 2004, Viacom and Blockbuster entered into an agreement where Blockbuster agreed to register shares to be offered in the Exchange Offer and Viacom agreed to use “commercially reasonable efforts” to dispose of its Blockbuster stock if Blockbuster issued the Special Dividend. Prospectus at 106. Thus, the Special Dividend and the Exchange Offer were part of the scheme to divest Viacom of Blockbuster at an inflated price.

Further, Plaintiff’s has adequately pled that the Blockbuster Directors knew that Blockbuster was not in a position to execute its business plan, even though the Prospectus

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<sup>18</sup> While Blockbuster Directors argue that a committee of independent directors approved the Special Dividend, evidence suggest that such directors were not fully informed. See *Teachers’ Retirement System of Louisiana v. Aidinoff*, 900 A.2d 654, 669 -670 (Del. Ch. 2006) (“Approval of a conflict transaction by an independent board majority remains an important cleansing device under our law and can insulate the resulting decision from fairness review under the appropriate circumstances. For that device to be given credit, however, the board majority must have acted in an informed manner.”) As the Prospectus makes clear, the financial advisors relied on data provided by Blockbuster. As discussed above, Blockbuster’s reported cash flow was inflated by 58 percent, indicating that financial advisors and the special committee were not fully informed.

represented that Blockbuster had a chance to succeed. As a general matter, “scienter in a fraud claim, may be averred generally.” *See Anglo American Sec. Fund, L.P. v. S.R. Global Intern. Fund, L.P.A.*, 829 A.2d 143, 149 (Del. Ch. 2003) (citing Ct. Ch. R. 9(b)). In any case, Plaintiff has provided specific information, within the control of Defendants and withheld from investors, that would have shown that Blockbuster was a crippled company: (1) Blockbuster’s cash flow was inflated by 58%; (2) Blockbuster could not accurately calculate GAAP cash flow; and (3) a reliable future cash flow analysis showed that Blockbuster could not execute its business plan. As directors of Blockbuster, Defendants were certainly in a position to know such basic financial information of the company. Thus, Plaintiff has sufficiently alleged that the Blockbuster Directors knowingly made false statements about Blockbuster’s finances.

#### **7. Viacom Breached Its Duty Of Loyalty To Blockbuster’s Minority Shareholders**

Viacom, a majority shareholder of Blockbuster, breached its duty of loyalty to minority Blockbuster shareholders. As a majority shareholder, Viacom owed minority shareholders the duties of a fiduciary. *In re Primedia Inc.*, 910 A.2d at 257. Viacom breached its fiduciary duty of loyalty by causing Blockbuster to pay the Special Dividend and issue a false and misleading Prospectus. Plaintiff has adequately pled control as they have alleged that (1) a majority of the Blockbuster Directors had a financial interest in the Exchange Offer transaction or were beholden to Viacom; (2) Redstone, who controlled Viacom and NAI, repeatedly expressed an interest in reducing public float of Viacom; and (3) Viacom caused Blockbuster to enter into a contract, whereby Blockbuster would undertake actions to facilitate the Exchange Offer, including issuing the Prospectus. *See* Prospectus at 52.

Further, the Amended Complaint adequately pleads that Viacom had actual knowledge that Blockbuster could not be a viable company. As a majority shareholder, with a majority of the Blockbuster board beholden to it, Viacom clearly had access to the cash flow data showing

Blockbuster could not be a viable company after incurring debt to finance the Special Dividend. Rather than disclosing this information to minority shareholders, Viacom cashed in, by spinning off Blockbuster at a vastly inflated price.

#### **8. Claims Against The Blockbuster Directors and Viacom are Direct**

Plaintiff's claims against both the Blockbuster Directors and Viacom are direct. Under Delaware law, whether a claim is direct or derivative "depends solely upon two questions: '(1) who suffered the alleged harm (the corporation or the suing stockholders individually); and (2) who would receive the benefit of the recovery or other remedy (the corporation or the stockholders, individually).'" *Gentile v. Rossette*, 906 A.2d 91, 97 (Del. 2006). Defendants accurately point out that, generally speaking, excessive grants of pro rata dividends are considered derivative claims, as the company is harmed if the directors have committed waste. Blockbuster Br. at 10-12. But Plaintiff does not make a claim for waste. Plaintiff's claims on behalf of the Blockbuster Class against Viacom and the Blockbuster Directors (Counts V and VI) are based on the fact that they elevated the interests of Viacom over the interests of Blockbuster's minority shareholders in order to permit Viacom to cash out its equity interest and leave Blockbuster's minority shareholders holding the proverbial bag. Plaintiff and the Blockbuster Class were directly harmed by the Blockbuster Directors' affirmative misrepresentation concerning Blockbuster's cash flow and the Company's ability to execute its business plan. In essence, the Exchange Offer Scheme prevented Blockbuster's minority shareholders from taking advantage of the same opportunity that Blockbuster's board of directors handed to Viacom on a silver platter – the opportunity to cut and run following the payment of the Special Dividend that left Blockbuster financially crippled and unable to fund the "new initiatives" that were necessary to the Company's ongoing operations. Delaware courts have held that such claims are direct. In

*Anglo American Sec. Fund*, a general partner left a partnership without promptly informing the limited partners. The court held that limited partners could sue directly because

plaintiffs allege that at least one effect of the two-month delay in disclosing to the limited partners that the general partner had bailed out of the Fund was to deprive the limited partners of the same opportunity to “cut their losses” promptly before the value of the Fund's investments declined further.

829 A.2d at 153. Similarly, in this case, had the true effect of the Special Dividend been disclosed, Plaintiff could have cut her losses and sold her shares – just like Viacom. Thus, Plaintiff’s claim against the Blockbuster Directors and Viacom are direct.

### CONCLUSION

For the forgoing reasons, Plaintiff respectfully requests that this Court deny Defendants’ motions to stay and dismiss.

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Respectfully submitted,

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