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

BEVERLY PFEFFER, 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, and ROBERT D. WALTER, Defendants.	C.A. No. 2317-N

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

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INTRODUCTION

Defendants have filed a motion to stay this action in favor of a federal securities case pending in the United Sates District Court for the Northern District of Texas or, in the alternative, to dismiss this action pursuant to Court of Chancery Rule 12(b)(6). Defendants' motion to dismiss has been rendered moot with the filing of the Amended Complaint (filed January 12, 2006). Defendants' motion to stay should be denied for the reasons set forth in this memorandum.

On August 3, 2006, Plaintiff Beverly Pfeffer ("Plaintiff") brought suit against the directors of Viacom, Inc. ("Viacom" or the "Company"), on behalf of herself and all those former Viacom shareholders similarly situated (the "Viacom Class"), for favoring the interests of Viacom's controlling shareholder, National Amusements, Inc. ("NAI") at the expense of Viacom shareholders who tendered their shares for shares of Blockbuster, Inc. ("Blockbuster"), a subsidiary of Viacom, as part of the Blockbuster Split-Off Exchange Offer commenced on September 8, 2004 and completed on October 5, 2004 ("Exchange Offer"). Plaintiff asserted these claims against the Viacom board for violating their fiduciary duties to Viacom's minority shareholders.

On January 12, 2007, Plaintiff filed an Amended Complaint, in which she both refined the original claims asserted in her original pleading, added defendants, and added claims against certain present and former members of Blockbuster's Board of Directors arising from the breaches of their fiduciary duties to Blockbuster's minority stockholders in connection with an extraordinary dividend they caused Blockbuster to pay immediately preceding the Exchange Offer.

When Plaintiff filed her original complaint under Delaware law, a securities class action was pending in the Northern District of Texas asserting federal securities claims against Blockbuster, certain Blockbuster directors and executives, NAI and Sumner Redstone, Chairman and CEO of NAI, Chairman and Chief Executive Officer of Viacom, and a director of Blockbuster ("Federal Action"). Not named as defendants in the Federal Action were Viacom directors who were not also directors of Blockbuster. In seeking to stay this litigation, Defendants argue that the claims in the Federal Action are "substantively identical" to the claims asserted here, and therefore this action should be stayed under *McWane Case Iron Pipe Corp. v. McDowell-Wellman Eng'g Co.*, 263 A.2d 281, 283 (1970). Defendants are mistaken.

The factors relevant for consideration under *McWane* do not support the imposition of a stay on this action. As set forth below, there are crucial differences between this action and the Federal Action, namely, the two lawsuits involve different parties and different claims. Moreover, this action raises important issues of Delaware corporate law concerning the duties that directors and controlling shareholders owe to minority shareholders in connection with the declaration of dividends and the decision to spin-off a subsidiary which has undisclosed financial and operational problems. *See Louisiana State Employees' Retirement System v. Citrix Systems, Inc.*, Civil Action No. 18298, 2001 Del. Ch. LEXIS 2 (Del. Ch. Jan. 5, 2001) (holding that court need not stay actions brought under debated areas of Delaware law). Further, this action, through the Amended Complaint, also asserts claims against certain present and former directors of

Blockbuster that are completely distinct – and are in fact asserted on behalf of a completely different class of investors – from the claims asserted in the Federal Action.

Finally, in moving to stay this litigation in favor of the Federal Action, Defendants neglect to inform the Court that the defendants in the Federal Action have, in fact, moved to dismiss that case on the grounds that the plaintiff *lacks standing* to assert the federal claims at issue there. It is simply absurd for Defendants here to argue that this case should be stayed in favor of the federal action, while at the same time the defendants named in the Federal Action are challenging the standing of the plaintiff there to maintain the lawsuit in the first place.

Nevertheless, to the extent there is some overlap in the factual issues raised in this case and the Federal Action, the Plaintiff here recently has agreed to coordinate discovery efforts with the plaintiff in the Federal Action, and therefore any concern the Defendants may have regarding duplicative litigation is misplaced. Instead, discovery may proceed as if both cases are pending together, and discovery may be coordinated between the jurisdictions as has been done in many other cases pending before the Court of Chancery. *See, e.g.*, *American International Group, Inc. Consolid. Deriv. Litig.*, C.A. No. 769-N (Del. Ch.), *coordinated with In re American International Group, Inc.*, No. 04-CV-8141 (JES) (S.D.N.Y.), *and In re American International Group, Inc. Deriv. Litig.*, No. 04-CV-8406 (JES) (S.D.N.Y.).

STATEMENT OF FACTS

A. NATURE OF THE CLAIMS ASSERTED IN THIS ACTION

Plaintiff in this case asserts claims on behalf of two distinct classes of shareholders. First, Plaintiff asserts claims on behalf of a class of Viacom's minority shareholders who tendered Viacom shares into the Exchange Offer, alleging that Viacom's directors violated their fiduciary duties to Viacom's minority shareholders under Delaware law. *See* Counts I through IV. Second, Plaintiff asserts claims on behalf of a class of Blockbuster's minority shareholders who were injured as a result of the Blockbuster board's approval of the payment of a special dividend of $5 per share in which Viacom reaped $738 million in tax free profit ("Special Dividend") when the board *knew* that Viacom would then divest its holdings of Blockbuster and leave the minority shareholders with equity holdings in a company saddled with such an extraordinary amount of debt that would thereafter be unable to meet its business plans. *See* Counts V and VI.

1. Claims On Behalf Of The Viacom Class

Specifically, in Count I, plaintiff alleges that Viacom's directors failed to disclose a number of material facts which, if known to Plaintiff and the Viacom Class, would have affected the Viacom minority shareholders' decision of whether to tender into the Exchange Offer. Among other things, the Viacom directors did not disclose that Blockbuster was crippled by the debt used to finance the Special Dividend and did not have the means to achieve the business objectives outlined in the Exchange Offer Prospectus filed on September 2004 ("Prospectus"). For example, the Prospectus

claimed that Blockbuster would undergo dramatic changes "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." However, Viacom directors at the time knew that Blockbuster simply lacked the resources to undertake such a change in its business plan.

Further, the Viacom directors knowingly inflated Viacom's cash flow as reflected in Viacom's most recent financial statements at the time of the Exchange Offer. The 2003 financial statements showed Blockbuster with a robust cash flow – the very cash flow that the Prospectus expressly stated would fund the new business initiatives – of $1.43 billion for the year. In reality, that cash flow was overstated by an astounding 58% because Blockbuster was inappropriately classifying its rental library assets as non-current assets. Had Blockbuster been appropriately classifying those assets as current assets, its stated cash flow would have been a meager $593.7 million in 2003. The Viacom directors also failed to disclose the following material facts in the Prospectus:

- that, due to outdated equipment, Blockbuster was unable to integrate its in-store and on-line operations – a key element of its new business plan;
- that Blockbuster was experiencing difficulties launching its in-store DVD tracking system because it lacked adequate internal controls;
- that the Exchange Offer was not engineered to benefit or even be fair to tendering Viacom shareholders, but rather was designed to reduce Viacom's public float to further solidify the control of NAI and Redstone over Viacom;
- that the explanation of how the Exchange Ratio was derived was materially incomplete and misleading; and

- that critical information regarding the process by which Viacom's Board approved the Exchange Offer was omitted, namely, who served on the committee charged with the authority to approve the Exchange Offer.

The failure to disclose this material information constituted a violation of the Viacom directors' fiduciary duties under Delaware law.

In Count II, plaintiff alleges that the Viacom directors violated their fiduciary duty of loyalty and good faith to plaintiff and the Viacom Class by favoring the interests of NAI and Redstone over the interests of Viacom's minority shareholders by devising the Special Dividend/Exchange Offer scheme. Specifically, NAI (and NAI's controlling shareholder, Redstone) saw its Viacom holdings increase in both voting power and economic value through the Exchange Offer (which contracted the Viacom public float) and the Blockbuster Special Dividend (the overwhelming majority of which was paid to Viacom.

In Count III, plaintiff alleges that the Viacom directors breached their fiduciary duties of loyalty and care in approving and/or acquiescing to the Exchange Offer on terms that were unfair to Viacom's minority shareholders and unfairly benefited Viacom's controlling shareholder, NAI, and Redstone. Because NAI and Redstone were financially interested in the transactions at issue, it is defendants' burden to demonstrate that they complied with 8 *Del. C.* §144 in order to avoid liability and to keep the transactions from being voided. As the allegations of the complaint make clear, however, the Viacom directors cannot avail themselves of Section 144's safe harbor because they deliberately designed the transactions to be unfair to Viacom's minority shareholders and to favor the interests of NAI and Redstone.

In Count IV, plaintiff alleges that NAI, as the controlling shareholder of Viacom, breached its fiduciary duties to Viacom's minority shareholders. Specifically, NAI caused the Viacom board, which it controlled and dominated, to approve the Exchange Offer in order to benefit NAI at the expense of the Viacom minority shareholders. The Exchange Offer – in which NAI did not participate – left the Viacom minority holding shares in Blockbuster, a former Viacom subsidiary that Viacom (at NAI's direction) had left crippled with debt as a result of the Special Dividend.

2. Claims On Behalf Of The Blockbuster Class

In Count V, plaintiff, in her capacity as a Blockbuster shareholder at the time of the Special Dividend, alleges that the Blockbuster directors breached their fiduciary duties to the Blockbuster minority shareholders by declaring the Special Dividend to unfairly benefit Viacom, Blockbuster's controlling shareholder. The Blockbuster directors caused Blockbuster to take on crushing debt to fund the Special Dividend and then declared the Dividend when they knew that Viacom was about to divest its Blockbuster holdings. Thus, the Blockbuster directors knew that Viacom's interests were not aligned with those of the minority shareholders because Viacom was not going to continue as a Blockbuster shareholder and share the burden that the debt used to finance the Special Dividend caused Blockbuster.

Finally, in Count VI, plaintiff, again in her capacity as a Blockbuster shareholder at the time of the Special Dividend, alleges that Viacom, as Blockbuster's controlling shareholder, breached its fiduciary duties to Blockbuster's minority shareholders. Viacom, through its control and domination of Blockbuster's directors, caused those

directors to incur the debt and declare the Special Dividend which so unfairly benefited Viacom at the expense of the Blockbuster minority shareholders.

B. OTHER ACTIONS INVOLVING VIACOM AND BLOCKBUSTER

First, on September 16, 2004, a shareholder of Viacom sued Defendants 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.

Second, on November 10, 2005, the Federal Action, a securities class 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 an institutional investor as lead plaintiff ("Lead Plaintiff"). On October 20, 2006, the Lead Plaintiff filed its Second Amended Class Action Complaint ("PSLRA Complaint"), which brought claims against certain executives and the directors of Blockbuster for violations of Section 11 of the Securities Act. These Section 11 claims were based upon false and misleading statements in the Prospectus concerning the value of the Exchange Offer. *See* PSLRA Complaint at ¶¶130-135. The PSLRA Complaint also brought claims against Blockbuster and certain Blockbuster executives for making false statements under Section 10(b) and Rule 10b-5 of the Exchange Act that inflated the value of Blockbuster

stock before and after the Exchange Offer. *See* PSLRA Complaint at ¶¶148-153. The PSLRA Complaint asserted control person claims under Section 15 of the Securities Act and Section 20(a) of the Exchange against Redstone for controlling NAI, Viacom, and Blockbuster when they violated the Securities Act and Exchange Act; against NAI for controlling Blockbuster and Viacom when they violated the Securities Act and Exchange Act; and against certain Blockbuster executives and Viacom for controlling Blockbuster when it engaged in its underlying violations of the Securities Act and Exchange Act. ¶¶ 145-47, 154-55. Finally, the Lead Plaintiff brought a claim under Section 12(a)(2) of the Securities Act against all defendants for selling Blockbuster securities using a false and misleading prospectus. ¶¶136-144. The defendants named in this litigation recently have filed motions to dismiss arguing that the named plaintiff lacks standing to assert many of the claims asserted therein. *See* Viacom Defendants' Motion To Dismiss And Supporting Brief *and* Blockbuster Defendants' Motion to Dismiss Second Amended Complaint And Supporting Brief, both filed in *Congregation Ezra Sholom v. Blockbuster, et al.*, No. 3:05-CV-2213-N (N.D. Tex.) (attached to the Declaration of Michael J. Barry In Support Of Plaintiff's Answering Brief In Opposition To Defendants' Motion To Stay Or Dismiss, as Exhibits A and B, respectively).

Third, 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

Defendants argue that this action must be stayed in favor of the Federal Action in the Northern District of Texas under *McWane Case Iron Pipe Corp. v. McDowell-Wellman Eng'g Co.*, 263 A.2d 281, 283 (1970). Applying the *McWane* factors, defendants argue that the present case should be stayed because: (1) the Federal Action was filed first; (2) the Northern District of Texas is capable of prompt and complete justice; and (3) the case involves the same parties and issues. As set forth below, Defendants' argument fails because this action – a class action based upon the Delaware law of fiduciary duty – involves different parties and materially different issues. Moreover, this action involves important, perhaps even first impression, issues of fiduciary duty involving two layers of controlling shareholders which should be decided in the court system with the greatest interest and the system best equipped to render such decisions – the Delaware court system. Finally, the policy considerations which underlie *McWane* – that there not be wasteful duplication of judicial resources between courts of different jurisdictions – are not implicated here. Plaintiff here has entered into an agreement with the Lead Plaintiff in the Federal Action whereby plaintiff and the federal Lead Plaintiff will assist each other in the prosecution of their respective actions.

I. THIS ACTION INVOLVES DIFFERENT PARTIES THAN DOES THE FEDERAL ACTION

The first *McWane* factor is identity of the parties between the two actions. Complete identity of the parties between the actions counsels in favor of a stay. Here, however, the parties simply are not the same as are involved in the Federal Action. Out of the twenty one defendants in the present action, only ten were named as defendants in

the PSLRA Complaint. The primary difference between the two actions is that this action seeks relief on behalf of Viacom's former shareholders against Viacom's board of directors. Only two of those directors are named in the Federal Action, and the only reason they are named in that action is the fact that they also served as directors of Blockbuster. The Federal Action seeks no relief against the Viacom directors in their capacity as Viacom directors. The Federal Action also does not purport to assert any claims on behalf of the Blockbuster Class, which are alleged in this case.

Defendants incorrectly attempt to analogize this case to *Schnell v. Porta Sys. Corp.*, Civil Action No. 12,948, 1994 Del. Ch. LEXIS 47 (Apr. 12, 1994). *See* Def. Br. at 11. In that case a securities class action was filed against inside directors of a company for inflating the price of the stock under federal securities law. A later-filed Delaware action brought breach of fiduciary duty claims, naming all the same defendants as the securities class action and merely adding outside directors of the same board as additional defendants. *Schnell*, 1994 Del. Ch. LEXIS at *10. The Court held that "[t]he absence of the five outside directors . . . is not, however a material difference. Nor does there appear to be any reason why the outside directors cannot be named as defendants in the New York Action." *Id.* at *12. Unlike *Schnell*, however, the fact that the Federal Action does not name most of Viacom directors – and names none of them in their capacities as Viacom directors is a material difference. The Viacom directors were not merely left off the PLSRA Complaint; they are not proper defendants given the causes of action alleged in the Federal Action. As such, defendants have failed to satisfy this factor of *McWane*.

II. THIS ACTION INVOLVES DIFFERENT ISSUES – SIGNIFICANT ISSUES OF CORPORATE GOVERNANCE UNDER DELAWARE LAW – THAT SHOULD BE DECIDED IN THE DELAWARE COURT SYSTEM

Even if this Court finds that the parties are sufficiently identical (which they are not), this action involves significantly different issues and theories of liability than the Federal Action. First, the Federal Action does not assert a single fiduciary duty or Delaware corporate law claim – all of the claims asserted there are based upon the federal securities laws for purported material misstatements made by Blockbuster's board to Viacom's tendering shareholders. Second, the issues implicated in this action of the fiduciary duties of two layers of controlling shareholders and the fiduciary duties of the boards of a parent corporation and its subsidiary in the context of both an extraordinary dividend and a spin-off transaction have significant implications for Delaware corporate law. As such, they should (and, indeed, in this circumstance, must) be decided in the Delaware court system.

Delaware courts have a unique interest in important issues of Delaware law raised by this case. Delaware courts will refuse to stay a case where Delaware "has a paramount interest in the prompt resolution of a dispute that impacts the governance of a Delaware corporation." *Citrix,* 2001 Del. Ch. LEXIS at *11. In *Citrix*, the Court refused to stay a claim seeking resolution of a debated issue of Delaware law despite a previously filed action asserting similar claims against defendants in federal court in Florida. The Court held:

> Although I have no doubt concerning the ability and interest of the Southern District of Florida in providing complete justice in the Federal Action and I am mindful of the importance of protecting a litigant's choice of forum, I do not believe that either of these interests will be sacrificed if

> Claim I is allowed to proceed before this Court. In this action, LASERS asserts a claim attacking the Citrix board's decision to adjourn a vote and then reconvene the Annual Meeting. The propriety of defendants' actions implicates a recently elucidated aspect of Delaware law on an issue governing the internal affairs of a Delaware corporation. The nature of the claim, a challenge to an increase in the number of options available for distribution to employees, also counsels this Court that a prompt decision in this matter is required.

Id. at *11-12.

As in *Citrix*, the claims asserted in this action involve the internal affairs of not just one, but two Delaware corporations. To resolve plaintiff's claims, a court will have to decide whether a controlling shareholder can cause the board of the corporation to declare a dividend, that, while seeming to be otherwise permissible under the Delaware General Corporation Law, has the ultimate though not immediate effect of unfairly favoring the controlling shareholder. A court will also have to decide whether a different controlling shareholder can cause the board of its corporation to approve and recommend an exchange offer to the minority shareholders that harms the minority because of actions the board caused to be taken at the other corporation whose shares the minority received. These are issues that simply cry out for decision in the court system which has the greatest interest in regulating the internal affairs of Delaware corporations – and which has the most extensive body of caselaw in the area – the Delaware court system.

CONCLUSION

For all the foregoing reasons, Defendants' motion to stay this action in favor of the federal actions pending in the Northern District of Texas should be denied.

Dated: January 12, 2007

Respectfully submitted,

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