IN THE COURT OF THE CHANCERY OF THE STATE OF DELAWARE

In re Yahoo! Shareholders Litigation	Cons. C.A. No. 3561-CC

PUBLIC VERSION -
DATED: JULY 17, 2008

SECOND AMENDED AND SUPPLEMENTAL CONSOLIDATED COMPLAINT

Plaintiffs Police & Fire Retirement System of the City of Detroit and General Retirement System of the City of Detroit (collectively "Plaintiffs"), by their undersigned counsel, on behalf of themselves and all other similarly situated public shareholders of Yahoo! Inc. (hereafter, "Yahoo" or the "Company"), and (to the extent any of the claims herein are not direct claims) derivatively on behalf of Yahoo, bring the following Second Amended and Supplemental Consolidated Complaint ("Amended Complaint"). The allegations of this Amended Complaint are based on the personal knowledge of Plaintiffs as to themselves and on information and belief (including the investigation of counsel, review of publicly available information and conduct of discovery) as to all other matters.

SUMMARY OF THE ACTION

1. In this action, the shareholders of Yahoo!, Inc. ("Yahoo" or the "Company"), seek relief from a pattern of inequitable conduct by Yahoo's Board of Directors (the "Board") and senior management in reaction to an unsolicited premium merger proposal from Microsoft Corporation ("Microsoft"). Rather than engage in a good faith exploration of Microsoft's interest, Yahoo's Board abdicated its fiduciary role and allowed the Company's response to be dictated by the constituency most pre-disposed against an acquisition – senior management. As a result, the Board processes

were tainted by management's withholding from the board of key information, and, in the end, the Board made decisions that protect management jobs (and their own incumbency) at the expense of shareholder interests.

2. Among other things, the facts (including evidence gathered through as yet incomplete discovery) show the following:

- In response to Microsoft's approach, Yahoo adopted poison pill severance plans that impose unprecedented uncertainty and costs on any potential acquirer or proxy contestent. The plans turn Yahoo's employees into a structural defense by incentivising all employees to quit in the aftermath of a change of control. The plans constitute an unreasonable response to a merger proposal that is wholly disproportionate to any arguable threat.

- In crafting the plans, management principally relied on the advice of advisors responsible for Yahoo's takeover defenses and withheld from the Board significant reservations voiced by the Company's compensation consultant, as well as comparative information prepared by that consultant underscoring the unprecedented nature of the plans. In its proxy materials, the Company misleadingly implies that the compensation consultants endorsed the severance plans.

- In opposing Microsoft's efforts, the Board approved a business relationship with Google, Inc. ("Google") that necessarily scuttles its pre-existing long-term strategy and imposes a disproportionate change-in-control termination fee.

- Recognizing that shareholders might seek to remove the Board for their handling of Microsoft's efforts, the Board deliberately coerced the shareholder vote by making the election of an insurgent slate a trigger for the defensive severance plans.

3. The dispute follows eighteen months during which Microsoft privately courted Yahoo to accept a friendly deal, culminating in a January 31, 2008, letter to Yahoo's Board proposing a merger in which Microsoft would pay Yahoo shareholders $31 in cash or Microsoft stock – a 62% premium over Yahoo's then-current market price.

4. From the outset, the Board handed Yang responsibility for direct negotiations with Microsoft, which he used to delay, to refuse to negotiate in good faith, and to erect roadblocks. Yang also threatened that if Microsoft dared nominate a competing slate of directors, Yahoo would implement a plan that would render an acquisition of Yahoo far less attractive, if not unfeasible, for Microsoft, and in the process abandon the cornerstone of Yahoo's pre-existing business strategy.

5. In order to further assure Yahoo's continued independence from Microsoft, Yang convinced the Board to adopt change-in-control employee severance plans that impose tremendous costs, burdens and uncertainties for both an acquirer or any shareholder-sponsored proxy contestant, throwing sand in the gears of Microsoft's plans for a smooth integration. These highly unusual – and in many material respects unique – severance plans reward every one of Yahoo's full-time employees with full equity acceleration and rich cash benefits if they are terminated or if they resign due to a "substantial adverse alteration" of their "duties or responsibilities" in the aftermath of a change in control. These plans deter both an acquisition and a proxy fight because any effort to fire, move or redeploy employees following a change in the composition of the Board exposes the Company both to large severance payments and to a potential mass employee walkout, since almost all employees are incented to, and able to, resign and make a credible claim for severance benefits following a change of control.

6. Yahoo's own compensation consultant, Compensia, advised management not to grant all employees the right to claim severance benefits based on a change in their "duties or responsibilities," and further advised that the severance benefits were very

aggressive. Management not only disregarded that advice, they withheld it and Compensia's comparability data from the Board and the Compensation Committee. Management's withholding of material information tainted the Board's process. Yahoo then disclosed publicly that Yahoo had been advised by Compensia, without disclosing that management had disregarded its advice and that the Board never heard critical advice and information provided by Compensia.

7. The Board was told (and accepted without question) that Microsoft was willing to spend $1.5 billion to encourage key employees to remain with the Company and that Microsoft's proposed expenditure justified Yang's plan to reward employees who choose to leave the Company after a change of control. The Board took no steps to verify this information or better understand the scope or structure of Microsoft's retention efforts – choosing instead to completely discount the proposal without analysis. Redacted

Redacted

Redacted

8. The severance plans also improperly entrench the Board against any shareholder-led proxy contest. Shareholder election of ***any*** insurgent slate of nominees irrevocably triggers the change in control employee severance plans (even if no actual change of control transaction takes place). This means that for the two years following a successful proxy contest, any effort by a new board to undertake any restructuring, reorganization, reduction in force, or strategic initiative will allow any affected employee,

or any employee whose duties or responsibilities are otherwise altered over the following two years, to resign and claim full severance benefits.

9. While Yahoo's Board and management claim the severance plans were adopted solely to calm employee concerns, the terms of the plans and the manner of their adoption betray an intent to frustrate an acquisition or proxy contest. The plans impose tremendous costs and burdens on an acquiror and they do nothing to aid retention in the absence of a change of control. The executive exodus following the withdrawal of Microsoft's merger proposal speaks volumes about the pretextual nature of the retention justification for the severance plans.

10. Under cover of a poison pill, Yang spent three months looking for a deal with anyone other than Microsoft. Yang previously considered a venture with Google but rejected it after finding it inconsistent with Yahoo's long term strategy. Nevertheless, backed by the Board, Yang was prepared to jettison that core value in order to make Yahoo unattractive to Microsoft. It is a small wonder that *The New York Times* reported that on the way out of a meeting with Yang "one of Mr. Ballmer's lieutenants whispered, '***they are going to burn the furniture if we go hostile. They are going to destroy the place.***'"

11. Finally, at a critical meeting on May 3, Ballmer met with Yang and Filo to discuss Microsoft's offer, which had been raised to $33. No Yahoo outside director or financial advisor attended and the presence of co-founder Filo, a non-director who shared Yang's anti-Microsoft bias, sent a powerful message. Yang and Filo, who combined own less than 10% of Yahoo's shares, set Yahoo's selling price at $37 per share, far above

what Microsoft was willing to pay and what Yahoo's largest shareholders had advised Yahoo they were seeking. Yang and Filo made clear that Yahoo would abandon its core strategy by outsourcing part of its search functions to Google if Microsoft took its offer directly to Yahoo shareholders.

12. Ballmer promptly withdrew Microsoft's offer, writing in his withdrawal letter: "after giving this week's conversations further thought, it is clear to me that it is not sensible for Microsoft to take our offer directly to your shareholders. . . . Our discussions with you have led us to conclude that, in the interim, you would take steps that would make Yahoo! undesirable as an acquisition for Microsoft." Yang and his loyalists reportedly celebrated with a round of "high fives."

13. Yang's defensive and self-interested conduct was grossly disproportionate to any threat arguably presented by Microsoft's proposal for a friendly merger. There was no question of Microsoft's ability to finance the transaction or its sincerity in seeking a negotiated acquisition. Yahoo's poison pill precluded a hostile bid. While Microsoft could deal directly with Yahoo shareholders by exercising its right to nominate a director slate at Yahoo's next annual meeting, Microsoft preferred a deal supported by Yang and the Board to avoid a costly, protracted and disruptive proxy fight.

14. Subsequent to Microsoft's withdrawal of its merger proposal, Carl Icahn launched a proxy contest with the express aim of reigniting merger negotiations with Microsoft and bringing value to Yahoo shareholders.

15. On June 12, 2008, Yahoo's Board approved a commercial relationship with Google that Yahoo claims will bring between $250-450 million in incremental

income in the first year following its implementation. However, Google has the right to terminate the contract and claim a $250 million termination fee if Yahoo enters into a major transaction with Microsoft. The prospect of paying a $250 million termination fee on a contract that may only generate that amount of cash flow in the first year and in any event may not survive regulatory scrutiny or bring benefits to Yahoo is itself a deterrent to electing a competing slate of directors (including Icahn's proxy contest).

16. Since it withdrew its merger proposal, Microsoft has indicated its willingness to negotiate alternative transactions (or potentially a new merger proposal), but only if Yang and the Yahoo Board are replaced. As described in a July 13, 2008 media article: ***"It's just impossible to deal with the Yahoo board or Yang,"*** said one source at Microsoft. ***"They have no intention of negotiating, so we're just going to do what we have to do."***

17. Plaintiffs seek invalidation of the severance plans and the termination fee in the Google agreement, curative disclosures, as well as all available recourse for Yang's disloyalty and the Board's bad faith indulgence of Yang's conduct, which cost Yahoo shareholders the opportunity to realize a 72% premium over the unaffected market price, and which coerces stockholders into voting to reelect the incumbent directors who deprived stockholders of that merger premium.

18. In self-congratulatory missives, Yahoo's Board and senior management profess that they followed a shareholder-centered strategy, which successfully induced Microsoft to increase its initial bid from $31 to $33. They fail to note, however, that in

the face of Yahoo's intransigence and dishonesty, Microsoft withdrew its bid, stating an unwillingness to treat further with the Company unless and until its Board is replaced.

THE PARTIES

A. Plaintiffs

19. Plaintiff Police & Fire Retirement System of the City of Detroit ("Detroit Police & Fire") is a public pension fund for the benefit of the active and retired police officers and firefighters of the City of Detroit, Michigan. Detroit Police & Fire is a shareholder of Yahoo, has been a shareholder of Yahoo at all material times alleged in this Complaint, and will continue to be a shareholder through its pendency.

20. Plaintiff General Retirement System of the City of Detroit ("Detroit General") is a public pension fund for the benefit of the active and retired public employees of the City of Detroit, Michigan. Detroit General is a shareholder of Yahoo, has been a shareholder of Yahoo at all material times alleged in this Complaint, and will continue to be a shareholder through its pendency.

B. The Director Defendants

21. The Yahoo Board is characterized by lavish compensation and interlocking business relationships with Yahoo and with each other.

22. Defendant Roy J. Bostock has served on Yahoo's board since 2003 and became Non-Executive Chairman of the Board on January 31, 2008. Bostock received compensation worth almost $650,000 for serving as a Yahoo director in fiscal 2006 and compensation worth $499,264 in fiscal 2007. As Non-Executive Chairman he receives an additional annual cash fee of $275,000.

23. Bostock is also Chairman of the Board of Northwest Airlines Corporation, having succeeded co-Yahoo-director Gary Wilson in 2007. Bostock and Wilson were roommates at Duke University, are both Trustees of Duke and members of the Board of Visitors of the Fuqua School of Business at Duke, and members of the Board of Directors of the NCAA Foundation. Bostock and Wilson also serve on the advisory board of NeoSpire Corporation, a managed hosting company co-founded by Wilson's son, Derek Wilson, and with which Yahoo has a relationship.

24. Defendant Ronald W. Burkle has served as a member of the Yahoo Board since November 2001. Burkle received compensation worth over $588,000 in fiscal 2006 and $482,046 in fiscal 2007 for serving as a Yahoo board member.

25. Defendant Eric Hippeau has served as a Yahoo director since January 1996. Hippeau received compensation worth about $606,000 in fiscal 2006 and $496,674 in fiscal 2007 for serving as a Yahoo board member. Between May 2000 and October 2007, Hippeau made almost $27 million by exercising Yahoo stock options and selling the related shares, according to data from Vickers. Hippeau has numerous business dealings with Yang and Yahoo. Hippeau is Managing Partner of Softbank Capital ("Softbank"), which holds a substantial stake in Yahoo's lucrative Asian operations: Yahoo! Japan and the parent of Alibaba.com. Yang is on the board of Alibaba.com and Yahoo! Japan. Yang and Hippeau also served together on the board of Ziff-Davis, Inc., of which Hippeau served as CEO and board Chairman from 1993 until at least 2000. In connection with Softbank's investments, Hippeau also serves on the board of directors of several companies that have business relationships with Yahoo,

including (a) PureVideo, a network of video websites; (b) Goodmail Systems, creator of a service for trusted e-mail delivery; and (c) Beliefnet, a web site devoted to spiritual beliefs.

26. Defendant Vyomesh Joshi served as a Yahoo director since July 2005. Joshi received compensation worth about $600,000 for serving as a Yahoo board member in fiscal 2006 and $520,000 in fiscal 2007. Joshi is Executive Vice President of Hewlett Packard Company, a company with which Yahoo has a long-standing business relationship.

27. Defendant Arthur H. Kern joined the Yahoo Board in January 1996, shortly before Yahoo became a publicly traded company. Kern received compensation of almost $500,000 for the fiscal year 2007 and over $600,000 for fiscal 2006 for serving as a Yahoo board member and committee chairman. Plaintiffs believe that much of Kern's wealth and success is linked to his affiliation with Yang. Kern has made some $113 million by exercising Yahoo stock options and then selling the related shares. In January 1996, Kern received an option to purchase 114,068 shares of Yahoo stock at an exercise price of $1 per share (not adjusted for subsequent stock splits). In addition, he received options to purchase 40,000 Yahoo shares under the Company's 1996 Directors' Stock Option Plan, once again not adjusted for splits. On a split-adjusted basis, those grants translated to options to purchase 3.69 million shares with a strike price of about five cents per share.

28. Defendant Robert A. Kotick has been a director of Yahoo since March 2003. Kotick received compensation of $492,774 for the fiscal year 2007 and over

$620,000 for 2006 for serving as a Yahoo board member. Kotick is Chairman and Chief Executive Officer of Activision, Inc., a company with which Yahoo does business.

29. Defendant Edward R. Kozel was a member of the Yahoo Board from October 2000 until his resignation on May 20, 2008. Kozel received compensation of $516,202 for the fiscal year 2007 and almost $620,000 for the fiscal year 2006 for serving as a Yahoo board member. Kozel is the Chairman and the former Chief Executive Officer of SkyRyder Inc., a company with which Yahoo does business. He is a non-employee director of two entities with which Yahoo does business: Network Appliance, Inc. and Reuters Group PLC. Yang and Kozel have been involved in multiple business ventures together for several years, and have served together on the boards of Cisco Corporation, American Internet Corp, Pipelinks Inc. and Combinet Inc. Yang and Kozel also both served in an executive capacity for Growth Networks Inc.

30. Defendant Gary L. Wilson has been a Yahoo Board member since November 2001. Wilson received compensation of over $482,000 for the fiscal year 2007, and about $588,000 for 2006 for serving as a Yahoo board member. Wilson has numerous ties to Defendant Bostock, as described above.

31. Defendant Mary Agnes Wilderotter was appointed a director by the Board on July 27, 2007. Wilderotter received compensation of $205,832 for her less-than-half year of service during 2007 as a Yahoo board member.

32. Defendant Jerry Yang has served as a member of the Board and an officer of the Company since March 1995. He is a co-founder of the Company and Chief Executive Officer.

33. In the last several years, the non-employee Yahoo directors have received a significant amount of Yahoo stock options. Over 80% of the value of the Individual Defendants' compensation in fiscal 2006 and over 70% in fiscal 2007 were in the form of options. Each non-employee director received 50,000 Yahoo options with an exercise price of $36.75 in May 2005, 15,000 options with an exercise price of $32.92 in May 2006, and 15,000 options with an exercise price of $27.05 in June 2007. If Yahoo had accepted Microsoft's $33 per-share offer, the 2005 and 2006 option grants would be worthless, and the 2007 grant would be worth about $90,000 per director. Similarly, the 100,000 options with a $32.94 exercise price defendant Joshi received when he joined the Board in July 2005 would be worthless. The strike prices of these stock option grants incentivized the Board to gamble imprudently on low-probability strategies to increase Yahoo's stock price beyond the level of Microsoft's merger proposals, even when the Company's stockholders would seek to monetize their investment. As a result of their compensation from Yahoo, their affiliation with institutions with ties to Yahoo and/or Defendant Yang, their deliberate use of the severance plans to entrench themselves in office by making the election of a replacement slate of directors a trigger for potentially billions in cash payouts to employees, and other factors, the non-employee directors are not independent and disinterested.

B. <u>Officer Defendant David Filo</u>

34. Defendant David Filo co-founded Yahoo in 1994, was a director until 1996 and has served as an officer since 1995. Filo, whose job title is "Chief Yahoo," reports directly to Yang and is involved in guiding Yahoo's vision, is involved in many

key aspects of the business at a strategic and operational level. Yahoo describes him as "a stalwart of the Company's employee culture and morale." On information and belief, Filo consulted and conspired with Yang about how to maintain Yahoo's independence in the face of Microsoft's merger proposal.

C. **Nominal Defendant Yahoo**

35. Nominal defendant Yahoo is a Delaware corporation with corporate headquarters in Sunnyvale, California. Yahoo is a top global internet brand that operates leading on-line website and services including search and advertising. As of June 3, 2008, there were 1,381,008,701 shares of common stock outstanding, trading under the ticker symbol YHOO. Filo and Yang together hold less than 10% of Yahoo's outstanding stock.

FACTUAL BACKGROUND

A. **Microsoft's Initial Friendly Approaches Are Rebuffed**

36. Microsoft has attempted since mid-2006, to court Yahoo and its top executives to support a friendly transaction. Internal Yahoo minutes and documents indicate that the Board received overtures in August 2006, October 2006 and early 2007. Internal documents also indicate approaches by an unnamed party, clearly Microsoft, in January and October 2007.

37. Yahoo's reaction has been consistent, rebuffing Microsoft's efforts towards a consensual deal, including a January 2007 acquisition proposal reportedly offering about $40 per share. The Board-authorized response to that approach was a letter from then-CEO Terry Semel rejecting "a broader strategic transaction at [that]

time," but professing a willingness to discuss "a commercial partnership arrangement." Discovery obtained by Plaintiffs gives no indication of serious discussions about any such commercial relationship.

38. Director Arthur Kern testified that the Board authorized rejecting Microsoft's acquisition efforts without finding out what price Microsoft was willing to offer. He claimed that since Yahoo was a company "in transition," the Board "wouldn't have been prepared to discuss price at that time."

39. During an October 5, 2007, meeting, Yang and the Board discussed "recent communications about a third party's interest in a transaction with the Company" and "the likelihood that a third party would make an offer to purchase the Company." Yang obtained approval to set the stage publicly for a rejection of any offer. A standby press release to be issued by Yang after consultation with select Board members stated, among other things, that "the Board will carefully consider the offer and is committed to acting in the best interests of shareholders in doing so," but that it had "very recently determined that it was not the right time for the company to seek to sell itself."

B. <u>Yang and the Board Embrace Project Panama</u>

40. Perceived as losing ground to the industry's dominant player, Google, Yahoo spent 2007 in search of a strategy that would satisfy its increasingly restive investors. In early 2007, it launched Project Panama, which Yahoo touted as a new search advertising platform that would allow the Company to better compete with industry leader Google.

41. By mid-year, CEO Terry Semel was facing a shareholder revolt. Semel resigned on June 18, at which time Yang assumed the CEO position and day-to-day control. Yang promised action — a "100-day plan" to re-define Yahoo's long-term strategy in a way that would allow it to adapt to brisk changes in consumer behavior on the Web and to counter Google. The reality was different. "He came on board, announced a 100-day strategic review and promised there would be no sacred cows," said Mark Mahaney, a Citigroup analyst. "One hundred days went by, and no cows were slaughtered."

42. During the fall of 2007, Yahoo announced, first internally and later externally, three "Big Bets" upon which Yang and his management team's success would be judged:

> [1] Making Yahoo the starting point for web users with the launch of new products, innovative new mobile offerings and premium partnerships with wireless and broadband providers;
>
> [2] Making Yahoo a "must buy" for the most advertisers by integrating Yahoo acquisitions Right Media and Blue Lithium into Yahoo's internally operating marketing system, improving targeting capabilities and expanding partnerships with publishers across the web; and
>
> [3] Creating open and industry leading platforms, including social networking, that attracts new developers.

43. Yang described Yahoo's Big Bets as "three big, multi-year strategic objectives that will be the core of everything we do at Yahoo for the next few years."

C. January 31, 2008: Microsoft Makes a Friendly $31 Per Share Offer

44. Shortly after 5:00 PM on January 31, 2008, Microsoft CEO Steve Ballmer emailed a letter to Yang and Bostock, offering to negotiate a $31 per share acquisition of

Yahoo (the "January 31 Offer"). The January 31 Offer recounted Microsoft's prior efforts to acquire Yahoo and noted that Microsoft had given Yahoo time to implement business strategies to turn the Company around. The letter made explicit Microsoft's desire for a consensual transaction and a smooth integration:

> Under our proposal, Microsoft would acquire all of the outstanding shares of Yahoo! common stock for per share consideration of $31 based on Microsoft's closing share price on January 31, 2008, payable in the form of $31 in cash or 0.9509 of a share of Microsoft common stock. Microsoft would provide each Yahoo! shareholder with the ability to choose whether to receive the consideration in cash or Microsoft common stock, subject to pro-ration so that in the aggregate one-half of the Yahoo! common shares will be exchanged for shares of Microsoft common stock and one-half of the Yahoo! common shares will be converted into the right to receive cash. ***Our proposal is not subject to any financing condition.***
>
> Our proposal represents a 62% premium above the closing price of Yahoo! common stock of $19.18 on January 31, 2008. The implied premium for the operating assets of the company clearly is considerably greater when adjusted for the minority, non-controlled assets and cash....
>
> *******
>
> Microsoft's consistent belief has been that the combination of Microsoft and Yahoo! clearly represents the best way to deliver maximum value to our respective shareholders, as well as create a more efficient and competitive company that would provide greater value and service to our customers. In late 2006 and early 2007, we jointly explored a broad range of ways in which our two companies might work together. These discussions were based on a vision that the online businesses of Microsoft and Yahoo! should be aligned in some way to create a more effective competitor in the online marketplace.
>
> In February 2007, I received a letter from your Chairman indicating the view of the Yahoo! Board that "now is not the right time from the perspective of our shareholders to enter into discussions regarding an acquisition transaction." According to that letter, the principal reason for this view was the Yahoo! Board's confidence in the "potential upside" if management successfully executed on a reformulated strategy based on certain operational initiatives, such as Project Panama, and a significant

> organizational realignment. A year has gone by, and the competitive situation has not improved.
>
> While online advertising growth continues, there are significant benefits of scale in advertising platform economics, in capital costs for search index build-out, and in research and development, making this a time of industry consolidation and convergence. ***Today the market is increasingly dominated by one player who is consolidating its dominance through acquisition. Together, Microsoft and Yahoo! can offer a credible alternative for consumers, advertisers, and publishers.***
>
> ******
>
> ***We would value the opportunity to further discuss with you how to optimize the integration of our respective businesses to create a leading global technology company with exceptional display and search advertising capabilities. You should also be aware that we intend to offer significant retention packages to your engineers, key leaders and employees across all disciplines.***

(Emphasis added)

45. On a January 31, 2008, telephone call captured by notes of an unidentified Yahoo participant, Ballmer told Yang that Microsoft much preferred to negotiate a deal in private but was prepared to disclose its offer publicly because of concerns that Yang would never support any deal, regardless of price. According to the notes (with emphasis added):

> -- if we want to make a counterproposal and in the ballpark then we don't go public and we push for an [agreement].
>
> *****
>
> -- if you guys can't get to a [point] of discussion in a couple of days -- then still going to go public -- and everyone can see what investors think
>
> -- if on the same page tonight then hold announcement but if not then we put it out there and its visible and we work through it
>
> *****

– if had a price and willing to sell the business and get that comfort from you and Roy then can hold it a couple of days

Jerry – you don't lose anything by waiting a week.

*****

Steve – if you really don't want to sell the biz then don't want to wait.

46. According to the notes, Ballmer stated that Microsoft "care[s] about employees," "want[s] employees to be OK," and was contemplating paying "$1.5b for retention of employees," in addition to the "$45b for deal."

47. Yang told Ballmer that Yahoo could not prepare a response to the proposal within two days. Ballmer made the letter public the following morning.

48. On January 31, Microsoft's General Counsel, Brad Smith, spoke separately with Yahoo's General Counsel, Michael Callahan. Smith explained that Microsoft had allocated a significant sum for the retention and severance of employees and was prepared to negotiate with Yahoo about the scope of the plan. Smith does not recall setting forth a fixed dollar amount. He recalls that the bottom end of the range was significantly lower than $1.5 billion, and that $1.5 billion may have been at the top end of the range of amounts discussed. Since Microsoft was analyzing retention and severance costs for employees at both companies, the allocated cost for severance payments to terminated Yahoo employees was far less than $1.5 billion. Neither Callahan nor any other Yahoo representative attempted to learn more about Microsoft's intentions following those initial calls.

49. The January 31 proposal made clear that Microsoft sought a friendly deal to acquire all shares on equal terms. Indeed, given Yahoo's poison pill, Microsoft could

not have closed a hostile deal. The offer was not contingent on outside financing, and in light of Microsoft's financial strength, there could be no serious concern about its ability to close. In addition, there could be no realistic concern that Microsoft was engaged in greenmail or had some other motive. Moreover, Microsoft's expressed willingness to negotiate the payment of significant sums for employee retention and employee severance eliminated any concern that Microsoft's merger proposal represented a threat to Yahoo's employees.

50. From January 31, 2008, onward, the Board was consistently advised and understood, based on comments from its advisors as well as backchannel communications through various sources, including Microsoft director Chuck Noski, that Microsoft preferred a friendly transaction, that integration was an important issue for Microsoft, and, therefore, the Board's cooperation in the deal was important in obtaining the maximum value for shareholders.

D. Yang's Personal Interests and Animus Towards Microsoft Were The Greatest Risk Facing Yahoo's Shareholders

51. The biggest threat to Yahoo and its shareholders was not from Microsoft's offer to negotiate a friendly deal. Rather, it was from the risk that Yang's hubris would lead him, co-founder Filo and their loyalists to thwart Microsoft's advances at shareholder expense.

52. Yang and Filo harbor strong emotional attachments to the Company. Yang and Filo created Yahoo in 1994 in a trailer at Stanford University, where they were graduate students. Initially, their site consisted of a list of recommended web pages and

was called "Jerry's Guide to the World Wide Web." It was renamed "Yahoo!" as the site gained popularity. They took the company public in 1996. By 2007, Yahoo had more than 14,000 employees and revenues approaching $7 billion.

53. Yang's ego drove him to strongly desire a future for Yahoo that could diverge from the best interests of shareholders – preserving independence from industry giant Microsoft. A former Yahoo executive quoted in an ABCNews.com article entitled "Yahoo CEO Hoping to Thwart Microsoft" described Yang as having always "envisioned building a company that would be around for 100 years, not just 14 years."

54. Yang also harbors a well-known antipathy for Microsoft. An article published by CNET News, entitled "No love lost from Jerry Yang when it comes to Microsoft," states:

> Yahoo may indeed agree to Microsoft's $44.6 billion bear hug, but it will be over Jerry Yang's dead body.
>
> People familiar with Yahoo's chief executive say he "can't stand" Microsoft, which can't come as a big surprise considering the decade-long rivalry between the companies.
>
> One former employee has been quoted as saying: "Jerry would rather give up his left pinky than see Microsoft wind up running this company."

55. According to the *New York Post*, at least some Board members were worried that "Yang and his loyalists . . . might act out of emotion rather than their fiduciary duty." That concern supposedly produced "friction on the board." The article quotes one source observing that "The emotional part of Yang would rather do anything but sell to Microsoft…."

56. The Board had an obligation to ensure that Yahoo's response to Microsoft's bid was directed at achieving the best outcome for Yahoo's shareholders, irrespective of the proclivities of the Company's founders. Consequently, the Board was obligated to conduct a process insulated from Yang's ego. Further, the Board should have protected shareholders from the obvious threat that Yang would obstruct any Microsoft bid for Yahoo, regardless of fairness or the opportunity presented. The Board had ample warning about this obligation, as Plaintiffs' initial complaint in this action, filed February 21, 2008, exposed each Board member to personal liability for failing to restrain Yang from harming shareholders.

57. Nevertheless, the Board put Yang and Filo in control of the most critical steps in the process. As discussed in a *The Wall Street Journal* postmortem on May 6, following Microsoft's withdrawal of its merger proposal, the Board ignored Yang's and Filo's disabling personal agenda, allowing them to act like controlling shareholders in orchestrating Yahoo's response to Microsoft, as if the 1996 IPO never happened:

> One thing Yang can do is invite the right people into his negotiations with Microsoft. ***So far, he and co-founder David Filo have been running the negotiations themselves, largely ignoring the suggestions of investment bankers and shareholders alike. One person close to the deal said Yang hasn't invited members of the board to take part in some of the major discussions. Yang and Filo can't create a clique of two to decide the company's future — at some point, they have to trust the board, employees and shareholders too.*** If [Yahoo's two largest institutional investors] Cap Re and Bill Miller aren't taking their concerns to management before they take them to the public, that's a harsh statement about trust. (Emphasis added)

E. Yang Overrules His Human Resource Executives and Yahoo's Outside Compensation Advisor and Obtains Immediate Board

Approval of An Unprecedented Change-in-Control Employee <u>Walkout Plan</u>

58. Yang knew Microsoft placed importance on the smooth integration and was interested in keeping much of the Yahoo workforce, as reflected in Ballmer's and Smith's statements to Yang and Callahan. Viewing employee retention as Microsoft's Achilles' heel, Yang engineered an ingenious defense creating huge incentives for a massive employee walkout in the aftermath of a change in control. The plan gives each of Yahoo's over 13,000 full-time employees the right to quit his or her job and pocket generous termination benefits at any time during the two years following a takeover, by claiming a "substantial adverse alteration" in job duties or responsibilities.

59. The day after Microsoft's offer, Yahoo's newly-hired Chief Technology Officer, Ari Balogh, the person to whom Yahoo's engineers report, told Yang that he disagreed with Yang's desire for immediate adoption of a broad employee retention plan. Balogh reasoned that Microsoft's offer:

> is likely hugely retentive for anyone who understands how these things go (and everyone will shortly as we prepare them for the dance). We should run the glue analysis on the key folks, and have set up a pool and leeway to move quickly based on senior management judgment, as necessary. After this settles in, we can make a decision on something narrow or broad or nothing.

60. As Balogh recognized, Microsoft's premium offer was "likely hugely retentive." It could even help solve Yahoo's pre-existing troubles with employee morale and retention. Employee dissatisfaction was one of the primary issues listed in an "All Hands Q&A" script prepared for a meeting on or around January 29, 2008, and numerous internal emails pre-dating Microsoft's offer recognized that in the absence of significant

changes, Yahoo faced a serious "flight risk" on account of widespread dissatisfaction with the then-existing path of Yahoo's senior management.

61. Redacted

Redacted

62. Yang chose not to educate Yahoo's employees about the retention benefits of Microsoft's premium offer and a negotiated merger. Instead, Yang kept employees in the dark and opportunistically manipulated the uncertainty of the situation to impose a plan that would frustrate Microsoft's desire for a smooth integration, drive up the cost of an acquisition, deter a proxy fight to change the composition of the Board, incentivize employees to quit after a change of control, and do nothing to benefit employees whose jobs may be terminated, or whose job duties may be restructured, prior to any change of control or as part of any alternative transaction.

63. Any change of control employee severance plan should have been recommended by the Board's Compensation Committee, and developed with the assistance of their independent compensation consultant. In order to insulate Yahoo from the conflicts of interest inherent when management is involved in compensation issues, the Compensation Committee's Charter places squarely in the hands of the Committee the responsibility and power,. "if the Committee deems it appropriate, [to] adopt, or recommend to the Board, the adoption of, new, or the amendment of existing, executive compensation plans[.]"

64. Yang ran roughshod over the Compensation Committee Charter. On February 1, the Committee held a regularly-scheduled meeting with its independent compensation consultant and counsel, as well as Yahoo's senior human resources executives. Neither Microsoft nor retention issues were raised while the advisors and human resources personnel were in the room. At the end of the meeting, Yang excused those with the most direct insight and responsibility for retention and compensation issues, called a "closed session" with Committee members only, and demanded and received authority for senior management to develop a broad employee retention plan in light of Microsoft's proposal. While the Compensation Committee's meeting minutes are silent on the topic, the handwritten notes of the meeting paint the picture of narrowly tailored plan that would seek retention even if Yang and the Board continued to control the Company:

- Identify key people
- Broad & simple, but scaled

- ***Reward regardless of what happens*** (emphasis added)

65. That afternoon, the Board was advised that the Compensation Committee had directed management to work with Yahoo's takeover defense counsel, Skadden Arps, Slate, Meagher & Flom LLP, to develop a broad retention plan that would be triggered by an employee loss of job following a change in control (known as a "double trigger"). The Compensation Committee's compensation consultant was not told about any retention plan proposal until several days later, after the key elements of the plan were set by Yang. The directive to place principal reliance on takeover counsel, not on the Company's employment consultant, speaks volumes on the true intent behind the plan – to convert Yahoo's employees into a structural defense to Microsoft's acquisition bid.

66. The plan's design was ostensibly put in the hands of Yahoo human resource executives, but they were given little time to do their job and their efforts were undermined by Yang's directives. The executives, primarily Vice President David Windley and Director of Compensation Carl Statkiewicz, were assisted by an outside consulting firm, Compensia. Compensia's advice was disregarded and Compensia ended up doing little more than running calculations based on assumptions and data provided by Yahoo management and providing comparative data that Yahoo managers withheld from the Board.

67. Compensia advertises that it "has developed substantial expertise with respect to advising companies as to what is market with respect to severance and change-in-control arrangements." In October 2007, Compensia's Tim Sparks advised the Compensation Committee of BEA Systems in connection with a change of control

severance plan adopted in light of a potential acquisition by Oracle. In that capacity Sparks advocated changes to the management proposal that reduced the amount of equity acceleration (from 100% to 50%) and the amount of cash benefits, and he advocated not having severance benefits triggered by changes to employee duties or responsibilities. BEA Systems tooks Sparks's advice. Sparks testified that he thought the BEA Systems plan was the most appropriate precedent for Yahoo's situation.

68. After initial consultation with Compensia, Yahoo human resources executives sent a proposed plan to Yang on February 3 that addressed the perceived retention concerns in three ways: (1) the amendment of stock options granted in August 2007 to about 700 executives to add a double trigger for accelerated vesting; (2) a pool of restricted stock units for "key employees," with accelerated vesting upon a double trigger; and (3) cash severance for employees terminated after a merger consistent with the amounts Yahoo was paying as part of its just-announced 7% reduction in force.

69. Yang and his takeover defense advisers insisted on a plan far more aggressive than that outlined by the human resources team. After Yang's review, the plan was expanded from amending only the August 2007 option grants to 700 key executives to providing full acceleration of all equity-based compensation ever granted to all employees.

70. Statkiewicz informed Compensia of Yang's insistence on expanding the coverage of the change-in-control rights to cover all equity held by full-time employees. Statkiewicz sought Compensia's views because the management proposal to accelerate equity of all employees was "extreme." Compensia provided "pushback," according to

Statkiewicz's handwritten notes. Statkiewicz confirmed in deposition that Compensia expressed reservations about the breadth of the program.

71. Nevertheless, Yang pushed the envelope further. On February 5, Yahoo's CFO, Blake Jorgenson, emailed Statkiewicz, directing him, "[b]ased on a call with Jerry and [Yahoo President] Sue [Decker] this morning," to prepare a plan that granted 100% acceleration of all outstanding equity rights of employees whose severance is triggered (as opposed to the one or two year acceleration previously contemplated).

72. Asked to run acceleration scenarios assuming 100% vesting of all outstanding equity, Compensia expressed surprise, writing an email asking Statkiewicz to "confirm that we're talking 100% acceleration for everyone (I think that's what you intended but I want to make sure)."

73. Compensia had calculated that the cost of partially accelerated equity for everyone (the most recent proposal by management prior to the proposal of full equity acceleration for everyone) would equal $1.5 billion, or 3.2% of the transaction price. In an internal email, Compensia President Tim Sparks wrote that "3.2% seems very high for a deal of this size, but I am guessing (hoping) that this assumes 100% double trigger activation?" (Ex. B) In an email one minute later, Sparks made clear his view of Yang's plan to provide 100% equity acceleration for all employees: ***"That's nuts."*** (Ex. C) (emphasis added)

74. Statkiewicz initially advised Jorgenson that Compensia would run "various acceleration scenarios." Jorgenson directed Statkiewicz to implement Yang's instruction, responding, "I would push Compensia to include the 100% scenario in their

mix." Before Compensia ran the 100% scenario, Compensia informed Statkiewicz that the cost of the plans, based only on partial acceleration, "***is a really big number in the aggregate and as a % of the deal.***" (Ex. D) (emphasis added)

75. Sparks advised Yahoo management that fully accelerating all of the equity owned by Yahoo's senior executives was "very aggressive." Statkiewicz confirmed learning that Sparks thought that the severance benefits for senior executives provided compensation beyond the amount needed for retention:

> Q. Did he [Sparks] express the view to you or indicate to you that it went beyond the necessary retention, in fact, was a rich plan?
>
> MR. WALTZER: Objection to form. You can answer.
>
> A. Beyond sufficient, yes.

76. On or about February 5, the severance plan proposal became even more aggressive. Instead of protecting only employees who Microsoft chose to fire, relocate or cut their pay or benefits, each Yahoo employee was given the right to quit and receive full acceleration of equity and above-market cash severance upon a voluntary resignation for "good reason" after a change in control, with "good reason" expansively defined as including any "substantial adverse alteration" in the employee's "duties or responsibilities" at any time during the two years following a change in control.

77. Sparks testified that prior to February 5, he told Yahoo management that, based on his prior experience advising acquirors, he was opposed to granting employees the right to resign and claim severance benefits based on changes to their "duties or responsibilities." Sparks told Yahoo management that in his experience, "those

provisions have troubling administrative elements to them." Sparks knew that acquirors find it difficult to fight severance claims based on such "duties or responsibilities" provisions, and that acquirors often taken the path of least resistance, which means interpreting the provision broadly and paying the severance claim.

78. In the context of the Yahoo severance plan, a "good reason" resignation triggered by a "substantial adverse alteration" in an employee's "duties or responsibilities" enormously increases the cost, burdens and uncertainties of the plan. It places a powerful weapon in the hands of employees, including those employees Microsoft has every intention to retain. As discussed in the accompanying Declaration of John Fox (Ex. E), the lucrative benefits afforded to an employee who resigns for "good reason" incentivizes thousands to leave -- or threaten to leave -- because virtually all Yahoo employees would be able to make a credible claim that they suffered a "substantial adverse alteration" in their duties or responsibilities within two years after a change of control.

79. Fox explains that the Yahoo severance benefits are "eye popping", even by Silicon Valley standards, and the grant of a right to severance benefits to any employee who has experienced a "substantial adverse alteration" in "duties or responsibilities" is exceedingly broad, and perhaps unprecedented. The prospect of acquiring a company whose entire workforce is incented to resign creates pressure on the acquiror to pay severance benefits to *all employees preemptively.* In effect, the acquiror converts the loose double trigger into a single trigger payable upon a change of control, so that employees are not incented to resign and pull the second trigger themselves.

Sparks himself acknowledged that paying severance benefits preemptively would be the path of least resistance.

80. Adoption of a "duties or responsibilities" trigger was raised by Yahoo management on a February 5 phone call that included Sparks and Compensation Committee Chairman Art Kern. Kern had requested in a prior email (Ex. F) that Sparks either be on the call or that management get Spark's input and share Compensia's "specific insights from their experience" in similar situations. But Compensia's Sparks was employed by Yahoo management, not by the Compensation Committee. Since Sparks had previously informed management that he was opposed to "duties or responsibilities" triggers, he held his tongue on February 5 when Kern and management discussed implementing a severance plan containing a "duties or responsibilities" trigger. Management did not inform Kern (or any other director) about Sparks's advice on that subject. Kern testified that he and the other Committee members would have liked to have known about Sparks's contrary advice: "we would expect to see an insight either from him or from the company that would have a bearing on the plan's prudence. If there was something imprudent that they were recommending, we would expect to hear that insight."

81. The potential cost and administrative difficulty of a severance plan triggered by a "substantial adverse alteration" to an employee's "duties or responsibilities" is compounded by the fact that Yahoo's thousands of engineers, known as "Technical Yahoos!," have detailed job responsibilities and qualifications, and those responsibilities can be expected to change repeatedly and as part of an integration. Fox

explains in his expert declaration that, given the nature of Yahoo's business, the large amounts of severance and the breadth of the "duties or responsibilities" trigger, Yahoo employees are incented and able to use the severance plans offensively to position credible demands for severance, even if they are otherwise planning to voluntarily terminate from Yahoo (such as for personal reasons) or otherwise inclined to stay but for the severance incentive.

82. As a consequence, Microsoft or any new board upon a change of control would not only be forced to pay severance benefits for employees it fired, the acquirer would also be saddled with:

(1) paying severance benefits for employees who were redeployed;

(2) paying benefits for employees whose duties changed in some way found by a California court to be substantially adverse;

(3) the costs of a potentially mass, unwanted employee exodus, and lost productivity of employees biding their time until they claim severance;

(4) friction and uncertainty as a result of potential disputes over the application of the plan terms; and

(5) the cost of administering a plan covering over 13,000 employees.

83. Nobody involved in developing or approving the severance plans analyzed the impact of giving every employee the incentive to claim a constructive termination based on changed duties or responsibilities. There was no analysis of the effect on an acquirer's ability to achieve a smooth integration, or of how many employees could be expected to claim constructive termination rights.

84. Shortly before the February 8 Board meeting at which the severance plan was being considered, Kozel sent an email to Kern asking that the Board be provided with the definition of "good reason" because "Acceleration without clearly outlined/understood conditions to encourage retention in a CIC scenario would not be in the shareholders interest." The definition of "good reason" was added to the presentation book, but the problem remained of a lack of "clearly outlined/understood conditions." Fox explains in his Declaration that the words "substantial adverse alteration" have no clear legal meaning and are exceedingly broad. Indeed, the contractual standard is broader than the safe harbor language in newly adopted regulations respecting Section 409A of the Internal Revenue Code, potentially exposing Yahoo employees who receive severance benefits to substantial tax penalties, calling into question whether the drafters of the plans were truly motivated by employee welfare.

85. Carl Statkiewicz was the person who worked the most on developing the board presentation and interacting with Compensia, and he was invited to the February 8 board meeting to answer any questions Board members might have. Yet he testified as follows:

> Q. Did you have a general discussion about how the substantial adverse change in duties and responsibilities language could, in fact, increase the number of, essentially, walkouts in the event Microsoft acquires the company?
>
> MR. WALTZER: Objection to form. You can answer.
>
> THE WITNESS: I don't recall focusing on that clause.

86. There was no exploration of the prevalence among other companies of conferring such constructive termination rights on all employees. The only comparative data assembled by anyone was a series of charts prepared by Compensia (Ex. G) that included a page describing three unsolicited takeover precedents that CFO Jorgenson had identified because they each provided generous severance benefits to terminated employees in the event of an impending hostile takeover (*i.e.*, BEA Systems, Siebel Systems and PeopleSoft). That chart showed that Yahoo's plan had the most aggressive benefits package.

87. Missing from the chart is comparative information about when employees can qualify for severance benefits – the most glaring and costly difference between the Yahoo plan and the identified "comparables." BEA Systems, a Compensia client advised by Sparks, had no "duties or responsibilities" trigger; Siebel Systems had no "duties or responsibilities" trigger for employees at the Vice President level or below; PeopleSoft only had a "duties or responsibilities" trigger for a handful of employees at the level of Group Vice President or above. Sparks testified that he did not provide comparative information about "duties or responsibilities" triggers because he was not asked to do so and he had already advised management he was opposed to including a "duties or responsibilities" trigger.

88. Compensia delivered the comparative charts in an email, writing "Here are some data points that you may want to throw in the Appendix of your presentation" to the Board. The charts were not provided to any Yahoo director.

89. The Board approved the change-in-control severance plan in concept on February 8 and delegated to the Compensation Committee the authority to adopt the specific terms of the plans. No independent consultant attended the Board meeting or provided an opinion on the plan's cost or scope. The management-prepared board book did, however, contain calculations showing that if Microsoft paid severance benefits to all employees, the cost of the plan at a $31 per share deal price would be ***over $2.1 billion*** and at $35 per share would be ***almost $2.4 billion***. (Ex. H) The calculations also showed that the great bulk of the expense was for potential severance payments, not for retention incentives to key employees in the form of new retention stock units with accelerated vesting.

90. Management advised the Board that the payment of benefits to just 15% of the workforce was the most likely scenario. Yahoo's David Windley testified that he made this determination based on Microsoft's public statement about maintaining much of Yahoo's workforce and his own guess of administrative overlap following a deal. Carl Statkiewicz testified that he expected a reduction in force range of between 15% and 30% represented the likely cost of the severance plans. In selecting a 15% reduction in force as the cost of the plan, Yahoo's management consciously ignored the effect of the easily pulled "duties or responsibilities" trigger, which greatly expands the pool of compensated employees.

91. No benchmark data or opinions about market terms or market costs for change in control severance plans were provided to the Board. Instead, the Board was told to evaluate the plan in light of the supposed statement of Microsoft's Brad Smith to

Yahoo's Michael Callahan that Microsoft had earmarked $1.5 billion for employee retention as part of the January 31, 2008 merger proposal. As shown, Callahan apparently misreported Smith's comment.

92. Moreover, the comparison is fatuous. Microsoft's goal was to incentivize key employees to stay with the company after a merger announcement. Severance payments to terminated employees would be on market terms and represent a fraction of the total allocated sum. Yahoo's severance plan overcompensates terminated employees and incentivizes all other employees to stay until the merger closes and then quit. Redacte

Redacted

93. Kern testified that Microsoft's proposed retention incentives were immaterial to his decision to approve the Severance Plans, principally because Microsoft was the source of the information. Yahoo management made no effort to discern for themselves or inform the Board about the nature and scope of Microsoft's retention plans or how, if at all, those plans could be meaningfully compared to the proposed Yahoo change in control employee severance plans. No Yahoo compensation consultant was told about the Microsoft retention proposal, much less asked to analyze it.

94. The Compensation Committee met on the morning of February 12, 2008, at which time it approved the plan. No compensation consultant attended the meeting or provided any opinion respecting the cost or scope of the plan.

95. Just prior to the meeting, Compensia replied to a last-minute email request for information on how to evaluate the cost of the plan. Compensia gave the following informal guidance (with emphasis added):

> We have looked at this many times for technology company transactions but (obviously) never for a deal of this magnitude. As you might imagine, the acceptable/market % is inversely related to transaction value. For what it is worth, ***the investment bankers usually have an opinion here*** and generally provide guidance to the Board as to what is acceptable/market. ***That said, I think the 1% level is acceptable/market (assuming the cost assumptions are reasonable) …***

(Ex. I) (emphasis added). Compensia provided no opinion on the reasonableness of the cost assumptions. No investment banker provided an opinion about the reasonableness of the cost of the severance plans.

96. If 15% of the employees received severance payments after a $31 per share deal – the very bottom of the range suggested by management (without consideration of the incentives created by the loose "good reason" trigger) – the cost of the plan exceeds $500 million (including a $45 million charge mistakenly omitted from the board book). That is more than 1% of the total deal value. Greater levels of employee attrition dramatically increase the cost in absolute terms and as a percentage of deal size. Only advance payment to all employees of the full $2.1 billion (or something close to a full payment) would remove the incentive for a mass employee walkout.

97. The terms of the severance plans adopted by the Compensation Committee have the effect of completely disabling the Board's ability to amend or rescind the plans so long as Microsoft's offer remained pending. Under the plans, no amendment or rescission of the plans can be made until thirty (30) days ***after*** the "Potential Change of Control" event – which Microsoft's offer clearly was – has been withdrawn or terminated. The Yahoo Board also disabled itself from amending the severance plans during the pendency of a proxy contest to replace at least a majority of the Board of Directors.

98. Compensia's Sparks testified that management wanted to be very careful in defining "Change of Control." Management did not want to trigger the enhanced severance benefits in the event that the Board approved an alternative transaction that kept Yahoo independent. Yahoo management and the Board used the pretext of employee uncertainty as a justification for plans that do nothing to benefit employees in the event of potential job loss from a reduction in force or a potential restructuring transaction, such as the outsourcing of the search function to Google. The incumbent Board reserved for itself the right to hire, fire and redeploy Yahoo employees at will, without triggering the possibility of severance payouts. Employees only get massive severance benefits if someone other than Yang and the current Board end up in control of the Company's affairs.

99. The highly conditional nature of the severance benefits means that the plans cannot fulfill the function of alleviating employee uncertainty. In the words of Sparks, the severance plans provide only a supposed "psychic benefit" to employees

worried about a potential termination in the absence of a plan-defined "Change of Control." As noted below, following Microsoft's withdrawal of its takeover offer and the Board's acceptance of a deal with Google that keeps Yang and the Board in control of the Company, numerous mid- and senior- level employees have quit their jobs. The fact that the Board and Compensation Committee were principally devoting funds to severance benefits, and not retention awards in the absence of a change of control, evidences the pretextual nature of severance plans that make a takeover or proxy fight as burdensome and costly as possible.

100. The entire Board was self-interested in the approval of the severance plans. "Change of Control" is defined broadly to include not just an acquisition but also the replacement of a majority of the Board in a proxy contest. This means that a new board majority elected by Yahoo's shareholders faces the risk of massive severance payouts as part of any reduction in force, reorganization or strategic alliance, or even from the natural attrition that would take place in a cutting-edge technology company such as Yahoo in which changes in job duties or responsibilities occur as a matter of course. Upon the election of a new slate of directors, any employee is incented to resign following a change of duties and make a credible claim for severance benefits.

101. This discrimination between how the incumbent Board can treat employees and how a new board must compensate employees who are either terminated or resign with "good reason" makes no sense as a human resources matter, but it does dissuade stockholders from electing a new board in a proxy contest. Yahoo shareholders are faced with the choice of whether to elect incumbent directors who have free rein in

the management of employees and electing a new board, and thereby triggering the severance plans.

102. At his deposition, Kern testified that the Board was well aware of the fact that it would not be able to terminate the severance plans in the event of a shareholder-led proxy fight and was also aware of how the plans would be triggered by a successful removal of the incumbent board. Kern attempted to justify the discrimination in the severance plans between the incumbent Board and a new board by testifying that an employee who has bought into the three-year strategic plan approved by the incumbent Board should "feel more stable in [his or her] job" if the incumbent Board is elected. This rationale is stunning considering that the same incumbent Board had just implemented a reduction in force and begun a search of strategic alternatives at the same time it approved the change in control employee severance plans. In addition, this justification ignores concerns predating the Microsoft merger proposal about low employee morale and that employees had lost faith in the current management team.

103. The Board was self-interested in structuring a costly retention plan that would serve to help entrench themselves in office in the event of a shareholder-led proxy contest. This entrenchment mechanism was adopted unilaterally by the Yahoo Board, and the Board members are the principal beneficiaries of defining "Change of Control" to authorize benefits for job losses that occur only after a successful proxy contest.

104. Yahoo employees quickly appreciated that the severance plans created perverse incentives. One vice president wrote (with emphasis added) that it is "a ***bizarre outcome*** if people who stick around make off worse financially than people who [are]

laid off." Yahoo's Senior Director of Integration & Corporate Development, Jonathan Dillon, recognized that the plan "***Will make things increasingly expensive for msft.***" (Ex. J) (emphasis added).

105. Dillon explained to Greg Mrva, Yahoo's Vice President of Mergers and Acquisitions, that a "good reason" termination trigger based on changed duties or responsibilities means that Microsoft would have to pay additional compensation to keep employees from pulling the good reason trigger:

> ... double trigger also covers change of role, etc. you know that is tough to take a hard line on if not waived at Close. And to waive at Close, they need to effectively buy us out with more retention. Or even continue both which [would] be the best. Just like we do when in the buying position.

106. Upon public announcement of summary terms of the severance plans, Microsoft quickly appreciated that the plans were clearly not in the shareholder interest. Nevertheless, Microsoft decided not to publicly criticize the adoption of the plans because Microsoft was then engaged in winning over both Yahoo shareholders and Yahoo employees. Additionally, in the absence of due diligence, Microsoft was unable to quantify the effect of the severance plans.

107. Subsequently, in an April 5, 2008, letter to Yahoos' Board, Microsoft's CEO made a veiled criticism of the severance plans, which he said "made any change of control more costly."

108. On June 7, 2008, *The New York Post* reported that "Sources close to Microsoft said the severance plan was a 'big issue' when deciding what price they could pay for Yahoo!"

109. The Board's adoption of Yang's proposed Severance Plans is both a standalone breach of fiduciary duty and is emblematic of the directors' general attitude towards the Microsoft merger proposal – ceding authority to interested director Yang to thwart Microsoft's integration objectives.

F. **The Board Changes Its Bylaws to Buy Time To Thwart Microsoft**.

110. Yahoo held its last annual meeting on June 12, 2007. Delaware law required Yahoo to hold an annual meeting within one year of that date. Under Yahoo's pre-existing bylaws, shareholders had until March 14, 2008 to nominate directors to the Yahoo Board. On January 31, 2008, just before Microsoft made its offer, the Board resolved to hold Yahoo's annual meeting on June 10, 2008.

111. Seeking to delay a proxy challenge by Microsoft, and buy more time to hatch additional takeover defenses, Yahoo amended its by-laws on March 5 to extend the nomination deadline until 10 days after the announcement of the date of the annual meeting. Section 2.5 was amended to provide that "with respect to the 2008 annual meeting, notice by the stockholder [of nominations of a slate of directors] must be so received not later than the close of business on the 10th day following the day on which such notice of the date of the [annual] meeting was mailed or such public announcement of the date of such meeting is first made, whichever occurs first. . . ."

G. **The Board Opens its Doors to Anybody But Microsoft**

112. Yahoo's board formally rejected Microsoft's $31 per share offer on February 11, 2008. While responding to Microsoft with a stiff arm, Yahoo opened its doors to discussions with any potential partner – other than Microsoft.

113. On March 5, 2008, *The Wall Street Journal* reported Yahoo and Time Warner had stepped up talks over creating an alternative to Microsoft's unsolicited offer that would fold Time Warner's AOL Internet unit into Yahoo, with Time-Warner taking a sizable minority stake in the combined entity.

114. On April 10, 2008, Reuters reported Yahoo was nearing a deal with Time Warner to fold AOL (excluding AOL's legacy dial-up Internet access operations) into a combined company. Because Yahoo would have received cash from Time Warner in exchange for only 20 percent of the combined Yahoo-AOL, the transaction would not have required shareholder approval. *The Wall Street Journal* reported that Yahoo would use the cash and other funds to buy back several billion dollars worth of Yahoo stock at a price somewhere in the middle of the range between $30 and $40 a share.

115. Analysts remained unimpressed. UBS analyst Ben Schachter wrote: "In our view Yahoo management would have a difficult time convincing a majority of its shareholders this deal is worth more than Microsoft's offer." The UBS analyst also stated: "Even if shares were repurchased at $35-plus a share, the shares likely would pull back once the buyback is done." *The Wall Street Journal* noted that an AOL deal could cause a shareholder revolt: "Yahoo has yet to commit to a deal with AOL and though talks between the two continue, Yahoo's board could risk a revolt by shareholders if it chose that path over a tie-up with Microsoft."

116. Yahoo also claims it engaged in discussions with News Corp. However, on March 10, 2008, News Corp. Chairman Rupert Murdoch said he was "not going to get into a fight with Microsoft; which has a lot more money than us." Far from challenging

Microsoft, on April 10, 2008, *The New York Times* reported that News Corp. was talking with Microsoft about a joint bid for Yahoo.

117. Yahoo's Board also took its case for independence to the public. On March 18, 2008, Yahoo publicly issued a rosy investor presentation setting forth strategic initiatives and a three-year financial plan. Yahoo claimed it would almost double operating cash flow over the next three years from $1.9 billion to $3.7 billion and would generate $8.8 billion in revenue, excluding traffic acquisition costs in 2010.

118. Even after being fully informed of Yahoo's optimistic outlook, investors remained focused on Microsoft's offer. On March 18, 2008, Sanford C. Bernstein & Co. analyst Jeffrey Lindsay characterized Yahoo's sales forecasts as "too bullish," because it was unlikely that "the steps outlined in the presentation will be able to achieve the projected growth rates." According to Lindsay, "[t]he best outcome for Yahoo shareholders is still to sell the Company to Microsoft."

119. Stanford Group analyst Clayton Moran concluded "[w]e believe Yahoo!'s options are dwindling. Talks with other potential suitors have not panned out. Public comparable valuations have dropped. And, economic indicators more clearly point to a recession. As such, Yahoo!'s aggressive forecast may be its last attempt to negotiate publicly with Microsoft."

H. Microsoft Grows Frustrated and Issues a Deadline

120. On April 5, 2008, Ballmer wrote to Yahoo's Board of Directors, setting a three-week deadline for Yahoo to negotiate and reach a deal or face a proxy fight and possible reduction in Microsoft's bid amount. In his letter, Ballmer complained that

"While there has been some limited interaction between management of our two companies, there has been no meaningful negotiation to conclude an agreement." Ballmer observed that while Yahoo was negotiating in search of alternatives, he had seen "no indication that you have authorized Yahoo! management to negotiate with Microsoft." Instead, he wrote, Yahoo's Board "adopted new plans … that have made any change of control more costly."

121. Ballmer warned that his patience was not endless. Absent "an agreement within the next three weeks, we will be compelled to take our case directly to your shareholders, including the initiation of a proxy contest to elect an alternative slate of directors for the Yahoo! board." In such an event, "that action will have an undesirable impact on the value of your company from our perspective which will be reflected in the terms of our proposal."

122. On April 7, 2008, Yahoo's Board once again rejected Microsoft, although it claimed Yahoo was open to a higher price.

I. Yahoo Plays the Google Card

123. As explained above, a critical part of Yahoo's core long-term strategy before Microsoft's offer has been the investment of huge resources into the development of improved search and search advertising capabilities in order to compete with the market leader, Google. As *The New York Times* recently observed, "before Microsoft made its offer, Mr. Yang and his team had repeatedly rejected the idea [of outsourcing to Google], saying search advertising was an essential part of the company's long-term

strategy. Instead, the company spent millions in improving its own search advertising system, called Panama, telling investors it was the right choice."

124. Despite short-term revenue benefits, Yang concluded that outsourcing the business to Yahoo's strongest competitor would undermine its ability to market its services as unique. Maintaining web-search-advertising as a company-controlled platform was a core assumption in the strategic initiatives Yahoo embraced after Yang's first 100 days – an assumption Yang readily jettisoned to stop Microsoft.

125. Yang's long-term strategy was wholly inconsistent with outsourcing search-advertising to Google. As explained by Yang during an analyst conference call announcing Yahoo's fourth quarter 2007 earnings, the "formula for" becoming a "must buy" for advertisers – the second of the "big bets" – "is based on the strategic decision we made last year to internally build the leading advertising network platform, supplemented by strategic acquisitions like Right Media and BlueLithium." Yahoo could not be a "must buy" if advertisers are really buying from Google.

126. A Yahoo Q&A prepared for a January 30, 2008 "all hands" internal meeting struck a similar chord. In response to a question about whether Yahoo would "consider outsourcing search to Google," the Q&A explained (with emphasis added):

> ***We are focused on long-term value creation rather than short-term gains (short-term analysis of the revenue potential of outsourcing monetization may not take into account the longer term impact on the competitive market if search becomes an effective monopoly).***

127. That, however, was the day ***before*** Microsoft made its friendly offer. According to *The New York Times*, on February 1, the day Microsoft's offer became

public, Google CEO Eric Schmidt called Yang and offered to help Yahoo fend off Microsoft. On April 9, consistent with its ABM (anyone but Microsoft) strategy, Yahoo effectively abandoned its long-term strategy, announcing that it had initiated a plan to test run Google's search technology. According to a *New York Times* article (with emphasis added), "[o]n Wednesday, ***Yahoo suggested that it might be willing to cede part of its core business to Google, an archrival, to remain independent.***"

128. *The New York Times* also reported that the Chair of the U.S. Senate Judiciary Committee's Subcommittee on Antitrust, Competition Policy and Consumer rights, "warned about the potential anticompetitive implications." On April 23, 2008, Reuters reported that the U.S. Justice Department was investigating the Google-Yahoo test:

> The Justice Department is concerned the test may violate antitrust law, the source said, adding that authorities "have initiated an investigation" of it.
>
> ***The source, who spoke on condition of anonymity, said some of the government's concern focused on a telephone call from Google Chief Executive Eric Schmidt to Yahoo Chief Executive Jerry Yang to offer help in thwarting Microsoft's bid worth around $44 billion.***
>
> ***The test was one of a series of efforts by Yahoo to fend off Microsoft's unwelcome bid.***
>
> A second source said the Justice Department was concerned about a longer-term deal between Google and Yahoo, and had an initial inquiry underway into the matter.

(Emphasis added)

129. Yahoo's largest investors recognized the Google outsourcing deal as a desperate ploy. Bill Miller, the renowned Legg Mason fund manager who is Yahoo's second-largest investor, with 92 million shares as of April 2008, was quoted as saying

that outsourcing to Google "vitiates the Panama platform" and "would destroy the ecosystem of search."

130. The real effect of a Google-Yahoo deal, however, is to erect insurmountable obstacles to Microsoft's bid for Yahoo. Even if a Yahoo-Google deal passed antitrust muster, any arrangement among Microsoft, Yahoo and Google would be impossible and any effort to undo a Yahoo-Google deal would be uncertain, prolonged and highly disruptive.

J. Microsoft Puts $5 Billion More On the Table and Yang Goes Scorched Earth

131. Yang and Filo did not negotiate with Microsoft in good faith. As described in an article published by the *Washington Post*:

> Microsoft executives and bankers often sensed that Yahoo chief executive and co-founder Jerry Yang was never interested in reaching a deal.
>
> The clearest indication came on April 15, 10 weeks into the process, during a meeting in Portland, Ore., a neutral site. Yahoo had argued that Microsoft's offer of $31 a share, or $44.6 billion, was too low.
>
> So what price, the Microsoft negotiators asked, did Yahoo want?
>
> "Yahoo said, 'We don't have a price,'" according to a source familiar with the negotiations. "Honestly, I think they just wanted the company to stay independent."

132. A person in the room at the time told *The New York Times* that on the way out of that April 15 meeting, one of Mr. Ballmer's lieutenants whispered, "***they are going to burn the furniture if we go hostile. They are going to destroy the place***."

133. On April 26, 2008, Microsoft's deadline for Yahoo to accept its original offer expired. Microsoft persisted in seeking a friendly deal, raising its offer. On April 30, Ballmer informed Yang he thought he could come up with "a couple more dollars."

134. On May 1, Ballmer informed Yang that he was "formally offering a couple dollars more." The next day, Microsoft's general counsel Brad Smith called Ronald Olson, outside counsel for the Yahoo Board, to confirm that Microsoft was increasing its offer by $5 billion, to $33 per share. This represented a $47.5 billion offer for Yahoo, and was a 72% premium to Yahoo's closing price of $19.18 per share on January 31, 2008, the day before Microsoft offered to acquire the Company.

135. On May 3, Yang and Filo met with Ballmer and Kevin Johnson, Microsoft's head of online operations, at a Seattle airport. As the Associated Press reported on May 7, "Filo's presence at this pivotal meeting has puzzled some investors and analysts because he isn't on the company's board." In response to Microsoft's $33 per share offer, Yang and Filo stated their shared view that Yahoo was worth $38 per share but said they would support the board's desire for $37 per share. There has been no evidence or indication that any independent financial advisor opined that a price below $37 per share would be inadequate or unfair, or that it would have been improper to allow Yahoo shareholders the opportunity to weigh Microsoft's $33 per share offer.

136. Yang's demanded $37 price was unacceptable to Microsoft, and Microsoft had no effective recourse. Yang's actions leading up to and during the May 3 meeting made clear to Ballmer that Yang was prepared to respond to any attempt to deal directly with the Company's shareholders by pursuing interim measures that would make Yahoo undesirable to Microsoft (such as a Yahoo-Google outsourcing tie-up). Yang's threats to alter Yahoo's business to Microsoft's detriment left any Yahoo acquisition by means of a proxy fight, coupled with protracted litigation, impracticable both as a regulatory matter

and in terms of implementing the smooth integration essential to the acquisition's success.

137. After the May 3 meeting failed to result in a deal, Ballmer sent a letter to Yang withdrawing Microsoft's offer. In this letter Ballmer states flatly that Yahoo's threat to outsource search to Google was the principal reason deterring Microsoft from pursing a "hostile" bid for Yahoo:

> Dear Jerry:
>
> After over three months, we have reached the conclusion of the process regarding a possible combination of Microsoft and Yahoo!.
>
> * * *
>
> I am disappointed that Yahoo! has not moved towards accepting our offer. I first called you with our offer on January 31 because I believed that a combination of our two companies would have created real value for our respective shareholders and would have provided consumers, publishers, and advertisers with greater innovation and choice in the marketplace. Our decision to offer a 62 percent premium at that time reflected the strength of these convictions.
>
> In our conversations this week, we conveyed our willingness to raise our offer to $33.00 per share, reflecting again our belief in this collective opportunity. This increase would have added approximately another $5 billion of value to your shareholders, compared to the current value of our initial offer. It also would have reflected a premium of over 70 percent compared to the price at which your stock closed on January 31. Yet it has proven insufficient, as your final position insisted on Microsoft paying yet another $5 billion or more, or at least another $4 per share above our $33.00 offer.
>
> ***Also, after giving this week's conversations further thought, it is clear to me that it is not sensible for Microsoft to take our offer directly to your shareholders. This approach would necessarily involve a protracted proxy contest and eventually an exchange offer. Our discussions with you have led us to conclude that, in the interim, you would take steps that would make Yahoo! undesirable as an acquisition for Microsoft.***

We regard with particular concern your apparent planning to respond to a "hostile" bid by pursuing a new arrangement that would involve or lead to the outsourcing to Google of key paid Internet search terms offered by Yahoo! today. In our view, such an arrangement with the dominant search provider would make an acquisition of Yahoo! undesirable to us for a number of reasons:

* First, it would fundamentally undermine Yahoo!'s own strategy and long-term viability by encouraging advertisers to use Google as opposed to your Panama paid search system. This would also fragment your search advertising and display advertising strategies and the ecosystem surrounding them. This would undermine the reliance on your display advertising business to fuel future growth.

* Given this, it would impair Yahoo's ability to retain the talented engineers working on advertising systems that are important to our interest in a combination of our companies.

* In addition, it would raise a host of regulatory and legal problems that no acquirer, including Microsoft, would want to inherit. Among other things, this would consolidate market share with the already-dominant paid search provider in a manner that would reduce competition and choice in the marketplace.

* This would also effectively enable Google to set the prices for key search terms on both their and your search platforms and, in the process, raise prices charged to advertisers on Yahoo. In addition to whatever resulting legal problems, this seems unwise from a business perspective unless in fact one simply wishes to use this as a vehicle to exit the paid search business in favor of Google.

* It could foreclose any chance of a combination with any other search provider that is not already relying on Google's search services.

Accordingly, your apparent plan to pursue such an arrangement in the event of a proxy contest or exchange offer leads me to the firm decision not to pursue such a path. Instead, I hereby formally withdraw Microsoft's proposal to acquire Yahoo!

* * *

I still believe even today that our offer remains the only alternative put forward that provides your stockholders full and fair value for their shares.

> By failing to reach an agreement with us, you and your stockholders have left significant value on the table.

(Emphasis added)

K. High Fives From Yang, Thumbs Down From the Market

138. Far from lamenting the shareholders' loss of an opportunity to sell their shares at a 72% premium, *The New York Times* website reported that "Yang and his team, who told Microsoft they would not sell for less than $37 a share, greeted Microsoft's decision as a victory. ***High-fives were exchanged Saturday afternoon when they learned Microsoft was backing down.***" (Emphasis added) In Yahoo's initial public statement about the withdrawal of Microsoft's offer, Yang dismissed the whole affair as a "distraction."

139. The market saw things differently. Following Microsoft's withdrawal of its offer, at the opening of trading on May 5, Yahoo's stock price immediately dropped about 20 percent, ultimately closing down $4.30 per share (15%) at $24.37, some 26% less than Microsoft's $33 per share offer to acquire the Company.

140. The Board claimed to have had shareholder support for rejecting Microsoft's bids. Apa rt from Yang and Filo, it is not apparent to whom they are referring. Gordon Crawford of the Capital Research Group, Yahoo's largest shareholder, owning about 16% of Yahoos shares through funds he manages, and one of the country's most respected media investors, told *The Wall Street Journal* and other sources that he is "extremely disappointed" by Yang's performance and is "even more disappointed in the independent directors who were not responsive to the needs of independent shareholders."

141. Similarly, on May 5, 2008, *The New York Times* reported that Legg Mason's Bill Miller, who, through the funds he manages, is Yahoo's second-largest shareholder, stated: "[p]ress reports that major shareholders would have been willing to take $35 are probably not far off the mark." (Emphasis added.) Both Miller and Crawford stated that $34 to $35 would have been acceptable, and informed Yahoo about their views on their target price in advance of Yang's $37 per share demand.

142. On May 5, 2008, *The Wall Street Journal* reported that "[t]he analyst community" was lowering price targets for Yahoo stock, and some had "downgraded shares entirely." One analyst explained a Yahoo downgrade as follows: "In our view, companies that ignore the best interests of shareholder in favor of the interests of other stakeholders (particularly management) deserve to (and typically do) trade at a significant discount to peers."

143. According to a May 3 Bloomberg Report, another analyst called Yang's conduct: "Unbelievable. This is management putting its employees and its job security ahead of current Yahoo shareholders' interest."

144. Similarly, despite the lip service Yang has given to employee retention, one Yahoo executive anonymously told *The New York Times*, "If the stock drops as far as I think it will, a lot of employees are going to be angry and many key employees could leave." That remarked was prescient, as numerous senior executives departed Yahoo within several weeks after Microsoft withdrew its merger proposal, and the stock price dipped to below $20 per share.

145. This exodus of Yahoo senior executives illustrates how the Microsoft merger proposal was itself retentive, and how the Yahoo severance plans were not true retention mechanisms. The Board determined to pay employees windfalls if they leave after a change of control. Once the prospect of a change of control faded, employees had no incentive to stay. Yahoo's pre-existing retention problems returned with a vengeance, as the severance plans could not possibly fulfill the objective of alleviating employee uncertainty regardless of the outcome of the Microsoft merger proposal.

146. A May 7 op-ed in *The Wall Street Journal* identified Yang's personal agenda and his conduct vis-à-vis Microsoft's offer as the reason why no deal was struck:

> In a fashion, [Yang] outsmarted not only Mr. Ballmer but his own Yahoo shareholders and board. Having discovered how much Yahoo was worth to Redmond (and no one else), he set about destroying that unique value by ceding Yahoo's position in search to Google through an outsourcing deal.
>
> ***All this so Jerry Yang can fulfill his dream of having an independent Yahoo whose halls he can continue to walk as the revered "founder."***

(Emphasis added)

L. Carl Icahn Initiates a Proxy Contest That Is Burdened By the Discriminatory Effect of the Severance Plans

147. On May 15, 2008, Carl Icahn announced his nomination of a slate of ten nominees. Icahn publicly disclosed a letter to Defendant Bostock, which stated in part:

> It is clear to me that the board of directors of Yahoo has acted irrationally and lost the faith of shareholders and Microsoft. It is quite obvious that Microsoft's bid of $33 per share is a superior alternative to Yahoo's prospects on a standalone basis. I am perplexed by the board's actions. It is irresponsible to hide behind management's more than overly optimistic financial forecasts. It is unconscionable that you have not allowed your shareholders to choose to accept an offer that represented a 72% premium over Yahoo's closing price of $19.18 on the day before the initial

Microsoft offer. I and many of your shareholders strongly believe that a combination between Yahoo and Microsoft would form a dynamic company and more importantly would be a force strong enough to compete with Google on the Internet.

During the past week, a number of shareholders have asked me to lead a proxy fight to attempt to remove the current board and to establish a new board which would attempt to negotiate a successful merger with Microsoft, something that in my opinion the current board has completely botched.

***

While it is my understanding that you do not intend to enter into any transaction that would impede a Microsoft-Yahoo merger, I am concerned that in several recent press releases you stated that you intend to pursue certain "strategic alternatives". I therefore hope and trust that if there is any question that these "strategic alternatives" might in any way impede a future Microsoft merger you will at the very least allow shareholders to opine on them before embarking on such a transaction.

148. Shortly after Icahn's announcement of his plans to nominate a competing slate of directors, John Paulson of the New York based hedge fund Paulson & Company, which owns 50 million Yahoo shares, announced support for Icahn's slate of directors.

149. Icahn's proxy campaign operates under a coercive disability – shareholders who contemplate voting for his slate need be concerned that the severance plans are irrevocably triggered by the election of a new slate directors, meaning that over the subsequent two years any Yahoo employee who is terminated is entitled to massive severance benefits, and an employee can pull the second trigger of the severance plans by claiming a "substantial adverse alteration" in his or her duties or responsibilities. Reelection of the incumbent directors does not trigger the severance plans.

150. The Compensation Committee approved severance plans that are not subject to alteration during the pendency of a proxy contest or by a new Board following

a successful proxy contest. Unless the severance plans are invalidated judicially, any effort by Icahn or any other shareholder proposing a new slate of directors to solicit votes based on an agenda of pursuing new business strategies is penalized by the associated cost of severance plan liability.

151. An influential commentator at www.alleyinsider.com warned stockholders of the severance-plan-created detriment of electing Icahn's slate, potentially dooming his chances. The article begins:

> **Icahn Win Triggers Yahoo (YHOO) Severance Bonanza. So When Will Carl Give Up and Sell?**
>
> Add this to the list of reasons we won't be voting for Carl Icahn's Yahoo (YHOO) slate: If he wins the proxy contest, this will trigger the massive severance-bonus plan Yahoo put in place to fight off Microsoft. This will ensure that whatever management moves Carl's new board makes will cost shareholders a ton of money and put Yahoo even more behind the eight ball.
>
> (Yahoo's executives can't just quit and take the package. But our understanding is executives can resign for "good reason," which leaves a lot of wiggle room. And, if nothing else, the package will make it more expensive for Carl's new CEO to fire a lot of Yahoos, which we suspect would be one of his or her first moves.)

Clearer evidence of how the severance plans improperly coerce stockholder voting is scarcely imaginable.

M. Yahoo's Proxy Statement Contains False and Misleading Disclosures Regarding the Severance Plans

152. Yahoo filed its definitive proxy statement on June 9, 2008 (the "Proxy"), for an annual meeting scheduled to occur on August 1, 2008. Page 38 of the Proxy falsely discloses that the severance plans were "designed, in light of the uncertainty caused by the Microsoft proposal, to help retain the Company's employees, maintain a

stable work environment and provide certain economic benefits to the employees in the event their employment is actually or constructively terminated in connection with a change in control of the Company."

153. In reality, the severance plans were designed to throw sand in the gears of Microsoft's desire for an orderly integration and to defend against a potential proxy contest. They provide no economic benefit to employees in the event of any reduction in force, reorganization or alternative transaction in lieu of a sale to Microsoft, and, as Fox explains, the plans are drafted so broadly that they can potentially trigger a huge tax liability for former employees who resign and receive severance.

154. The Proxy misleadingly states on page 39 that "Compensia advised the Company and F.W. Cook & Co. advised the Compensation Committee with respect to the terms of the plans."

155. The Proxy misleadingly omits that Yahoo management disregarded and withheld from the Board critical advice and information provided by Compensia. Compensia advised against allowing an employee to obtain severance benefits by claiming a change in the employee's duties or responsibilities following a change of control. Compensia advised that Yahoo management was compensating its senior executives very aggressively in a change of control, in an amount beyond what should be sufficient to retain those executives. Compensia advised that the 1% of deal value was a reasonable benchmark for the total cost of a severance plan, a level exceeded by the lowest of the unreasonably low cost estimates put forward by Yahoo management. Compensia provided management with comparative data showing that Yahoo was

proposing to compensate its employees to an extent far more lavish than is seen in even hotly contested takeover battles, much less typical change in control employee severance plans. Compensia did not attend any Board or Compensation Committee meeting relating to the severance plans or render any opinion on that subject for the benefit of Yahoo's directors.

156. Even though George Paulin of Frederic W Cook & Co. was the independent advisor to the Compensation Committee, and even though Paulin had recently testified before Congress about the importance Compensation Committees relying on independent advice, rather than relying on advisors beholden to management, Kern had left Paulin in the dark and turned to Compensia's Sparks for advice. Sparks did not disclose to Kern the advice and information he had given to the Yahoo management, because Compensia's client was Yahoo management, not the Compensation Committee.

157. On the morning of February 6, Paulin caustically commented to Kern, that "at this point I feel like I am functioning as a fifth wheel at Yahoo! anyway." His involvement was limited to advice given that day, after the principal terms of the severance plans had already been proposed by Yahoo senior management and before any calculation of the costs and projected financial impact of those terms.

158. Paulin limited his advice to how the proposed severance plans treated senior executives. He testified that he did not offer any advice or guidance or analysis related to lower level employees outside of the senior management group.

159. Nobody from Frederic W Cook & Co. attended any Board or Compensation Committee meeting regarding the severance plans, created any written

analysis of the plans for presentation to the Compensation Committee, or provided any form of opinion respecting the severance plans.

160. The Proxy omits that neither Compensia nor F.W. Cook & Co. attended any relevant meeting of the Board or Compensation Committee or rendered any opinion for the benefit of Yahoo's directors.

N. Yahoo Curtails Further Negotiations With Microsoft and Enters Into a Pact <u>with Google.</u>

161. On June 12, 2008, Yahoo announced that it had ceased discussions with Microsoft about a potential transaction that Microsoft believed would have delivered in excess of $33 per share to Yahoo stockholders. Yahoo further announced that it had entered into a pact with Google, pursuant to which Yahoo will send search queries to Google and Google will provide Yahoo with advertisements for display on websites and other applications owned and operated by Yahoo (the "Google Agreement"). Yahoo has publicly stated that it estimates that the Google Agreement is "[e]xpected to generate an estimated $250-$450 million in incremental operating cash flow in the first twelve months following implementation.."

162. In a Form 8-K filed the following day, Yahoo made it appear to its shareholders that all of the expected benefits from the Google Agreement can disappear if Yahoo shareholders dare to elect Icahn's director slate at the upcoming annual meeting. In fact, the Google Agreement only allows Google to suspend performance for a five month period in the event of the election of the Icahn slate. .

163. The Google Agreement also affords Google or Yahoo the right to "suspend performance" in the event of what is misleadingly labeled a "pending Change in Control of Yahoo! involving Microsoft," or other entities. For purposes of a Microsoft transaction, but not anyone else, a "Change in Control" will be "deemed to occur if Microsoft ... acquires directly from a party [*e.g.*, Yahoo] any equity or voting securities of that party representing (or having a right to receive in the aggregate) 5% or more of the total equity value of the party or 1% or more of the party's annual revenues on a consolidated basis[.]" In other words, Yahoo contracted with Google in a manner that is terminable by Google if a future Yahoo board wants to contract with Microsoft.

164. If Microsoft acquires 35% of Yahoo's stock, or enters into a transaction with Yahoo in which Microsoft receives 35% of Yahoo's stock, then Google can terminate the Google Agreement and demand a termination fee of up to $250 million. That termination fee is huge considering that in the first full year following implementation of the Google Agreement, Yahoo expects to generate only $250 million to $450 million in incremental operating cash flow. Unlike a termination fee in a merger agreement, which is paid by a higher bidding acquiror, the termination fee in the Google Agreement is payable by Yahoo and is paid to an entity that has not agreed to anything nearly as significant as the purchase of a company (typically after paying a control premium). Since the Google Agreement is not slated to be implemented until October, pending antitrust review, and Microsoft may enter into an agreement with Yahoo in the interim, Google stands to receive a $250 million payout without ever having to perform

any services under the contract. It is as if Yahoo agreed to pay Google $250 million to assist in impeding Microsoft.

165. On July 7, 2008, Microsoft issued a press release reflecting its frustration with Yang and the Board's prior refusal to negotiate the merger of the companies in good faith:

> Despite working since January 31 of this year, as well as in the early part of last year, ***we have never been able to reach an agreement in a timely way on acceptable terms with the current management and Board of Directors at Yahoo!. We have concluded that we cannot reach an agreement with them.*** We confirm, however, that after the shareholder election Microsoft would be interested in discussing with a new board a major transaction with Yahoo!, such as either a transaction to purchase the "Search" function with large financial guarantees or, in the alternative, purchasing the whole company. (emphasis added)

166. On July 11, 2008, Microsoft and Icahn jointly proposed a transaction whereby Microsoft would purchase Yahoo's search function and Icahn's slate would become the new directors of Yahoo. The Board rejected the offer on July 12.

CLASS ACTION ALLEGATIONS

167. Plaintiffs bring this action pursuant to Rule 23 of the Rules of the Court of Chancery, individually and on behalf of all other holders of Yahoo common stock (except defendants herein and any persons, firm, trust, corporation or other entity related to or affiliated with them and their successors in interest) who have sustained damages as a result of the Defendants' conduct complained of herein and who are or will be threatened with injury arising from defendants' wrongful actions, as more fully described herein (the "Class").

168. This action is properly maintainable as a class action.

169. The Class is so numerous that joinder of all members is impracticable. Plaintiffs believe there are thousands, if not hundreds of thousands, of beneficial holders of Yahoo stock, including investors spread around the world.

170. A class action is superior to other available methods for the fair and efficient adjudication of this controversy. The expense and burden of individual litigation make it impracticable for Class members individually to seek redress for the wrongful conduct alleged herein.

171. There are questions of law and fact which are common to the Class and which predominate over questions affecting any individual class member. The common questions include, *inter alia*, the following:

a. Whether Defendants have fulfilled, and are capable of fulfilling, their fiduciary duties to Plaintiffs and the other members of the Class, including their duties of loyalty, due care, and candor;

b. Whether Defendants have engaged and are engaging in self-dealing in connection with the offers from Microsoft for an acquisition transaction;

c. Whether the refusal by Defendants to consider and negotiate in good faith regarding the offers by Microsoft to acquire Yahoo is entirely fair to the members of the Class;

d. Whether defensive measures, including a poison pill, the adoption of severance plans applicable to all Yahoo employees, and the Google Agreement, implemented by Defendants and designed to make an acquisition transaction more difficult or costly for a potential acquirer are reasonable under the circumstances and/or fair to members of the Class;

e. Whether Plaintiffs and the other members of the Class would be irreparably damaged if the Defendants are not (1) compelled to redeem the poison pill and to revoke and/or rescind the Google Agreement and the severance plans covering all Yahoo employees as described further herein, and (2) enjoined from taking other unreasonable actions that are disproportionate to any cognizable threat that may be posed; and

f. Whether the members of the Class have sustained damages as a result of the conduct complained of herein, and if so, the proper measure of damages.

172. Plaintiffs anticipate that there will be no difficulty in the management of this litigation as a class action.

173. The Defendants have acted on grounds generally applicable to the Class with respect to the matters complained of herein, thereby making appropriate the relief sought herein with respect to the Class as a whole. To the extent Defendants continue to maintain and/or adopt defensive measures to make an acquisition more difficult or costly to Microsoft or any other potential acquirer, preliminary and final injunctive relief on behalf of the Class as a whole will be entirely appropriate.

174. Plaintiffs are committed to prosecuting this action and have retained competent counsel experienced in litigation of this nature. Plaintiffs' claims are typical of the claims of the other members of the Class and Plaintiffs have the same interests as the other members of the Class. Accordingly, Plaintiffs are an adequate representative of the Class and will fairly and adequately protect the interests of the Class.

175. The prosecution of separate actions by individual members of the Class would create the risk of inconsistent or varying adjudications with respect to individual members of the Class, which would establish incompatible standards of conduct for defendants, or adjudications with respect to individual members of the Class which would, as a practical matter, be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests.

DEMAND FUTILITY

176. Plaintiffs believe that all of the claims stated herein are direct claims, including claims based on improper coercion of shareholder voting rights, interference with the shareholders' opportunity to receive a premium offer for their shares, and false and misleading disclosures in proxy statements. To the extent any of the claims asserted are derivative in nature, demand on the Board is excused as futile.

177. As more specifically alleged herein:

a. the Board was self-interested in the approval of the severance plans because they serve as defensive mechanisms to help ward off an unsolicited merger proposal, thereby raising the "omnipresent specter" of self-interested director conduct in the course of a takeover fight;

b. the Board was self-interested in the approval of the severance plans because the consciously and deliberately defined "Change of Control" so as to operate in a discriminatory way even in the context of a shareholder-led proxy contest, thereby entrenching the incumbent Board by interfering with the possibility of a free and unfettered election of directors;

c. the Board was woefully uninformed with respect to the terms of the severance plans generally, including their unique nature, their true cost, and the way in which the "duties and responsibilities" trigger would actually operate to cost potentially billions in the event of a "Change of Control" event;

d. the Board was incentivized to gamble in a way that would allow them to realize value from stock options at high strike prices, and they acted improperly to thwart Microsoft and thereby maintain their own incumbency and the flow of extraordinary financial rewards that accrue to directors of Yahoo, including by relegating the lead role in negotiating with Microsoft to defendants Yang and Filo, the two people most likely to act to thwart Microsoft at the expense of Yahoo's shareholders; and

e. the Board faces a substantial likelihood of liability in connection with its responses to Microsoft's various merger proposals.

COUNT I
(Breach of Fiduciary Duty Against Yang and Filo)

178. Plaintiffs reallege each and every allegation above as if set forth in full herein.

179. Yang and Filo owe the Class the utmost fiduciary duties of due care and loyalty. Due to their personal interests in maintaining Yahoo's independence and their strong antipathy towards Microsoft, Yang and Filo failed to consider and respond in good faith to the acquisition offers by Microsoft to the detriment of Yahoo and its shareholders.

180. In addition, Yang and Filo used the threat of pursuing measures that make Yahoo an unattractive acquisition target, including the prospect of Yahoo abandoning its long-term business strategy in favor of a tie-up with Google that would make a Microsoft

acquisition a regulatory and litigation quagmire, as an improper means to thwart Microsoft's advances.

181. As a result of the foregoing, Yang and Filo breached their fiduciary duties to Yahoo and its shareholders, including the obligations of loyalty and due care, causing harm to Plaintiffs and the Class.

182. Plaintiffs and the Class have no adequate remedy at law.

COUNT II
(Breach of Fiduciary Duty Against All Individual Defendants Other Than Yang and Filo)

183. Plaintiffs reallege each and every allegation above as if set forth in full herein.

184. The Yahoo Directors owe the Class the utmost fiduciary duties of due care and loyalty. Encompassed in their duties is the duty to protect Yahoo and its shareholders from cognizable threats that are reasonably perceived, and to take reasonable measures to protect Yahoo and its shareholders from such threats.

185. Yang's and Filo's personal interests in maintaining Yahoo's independence and their strong antipathy towards Microsoft constituted a legally cognizable threat to Yahoo and its shareholders. The Yahoo Directors failed to take proper and reasonable steps to ensure that Yang and Filo would not act on their self-interest to thwart Microsoft's unsolicited acquisition proposal to the harm and detriment of Yahoo's shareholders.

186. In particular, the Yahoo Directors allowed Yang and Filo to negotiate directly with Ballmer without the presence of any disinterested director or independent

financial advisors. As a result, Yang and Filo were able to demand a price above Microsoft's $33 per share offer without determining appropriately, including through an outside financial advisor's "inadequacy opinion," whether the $33 offer could reasonably be presented to Yahoo shareholders for their consideration.

187. Further, Yang and Filo were able to use the threat of pursuing measures that make Yahoo an unattractive acquisition target, including the prospect of Yahoo abandoning its long-term business strategy in favor of a tie-up with Google that would make a Microsoft acquisition a regulatory and litigation quagmire, as an improper means to thwart Microsoft's advances.

188. The Board acted disproportionately in delaying and refusing to negotiate in good faith with Microsoft, even though Microsoft's offer presented a negligible, if any, threat to Yahoo and its shareholders.

189. As a result of the foregoing, the Yahoo Directors have breached their fiduciary duties to Yahoo and its shareholders, including the obligations of loyalty, good faith, fair dealing, and due care, causing harm to Plaintiffs and the Class.

190. Plaintiffs and the Class have no adequate remedy at law.

COUNT III
(Breach of Fiduciary Duty Against All Director Defendants)

191. Plaintiffs reallege each and every allegation above as if set forth in full herein.

192. The Yahoo Directors owe the Class the utmost fiduciary duties of due care and loyalty. To the extent the Board was aware of and authorized the conduct of Yang

and Filo, such authorization was a disproportionate and preclusive response to Microsoft's offer that effectively prevented it from exercising its rights to nominate a slate of directors and to pursue a premium merger proposal. Such conduct includes, but is not limited to, authorizing Yahoo to contract with Google to test outsourcing of web search and advertising functions and authorizing Yang and Filo to threaten Microsoft with the prospect of a long-term outsourcing contract with Google.

193. The Yahoo Directors also have a duty not to adopt, implement or maintain any defensive measures, such as the Severance Plans, the Google Agreement, or the poison pill, designed to make the acquisition of Yahoo unduly burdensome or expensive for a potential suitor or coercive to a potential or actual proxy contestant. They are obligated to refrain from entering into any agreements that would either harm the Company or its shareholders or inhibit their ability to maximize shareholder value.

194. Given the substantial premium offered by Microsoft, its unquestioned desire and ability to consummate a transaction on the terms proposed, and its own willingness to allocate significant sums to assure the retention of employees following a transaction with Yahoo, Microsoft's proposal provided no (or, at most, negligible) cognizable threat to Yahoo or its shareholders.

195. The Board's adoption of the change-in-control severance plans constitutes an unreasonable and disproportionate defensive measure in breach of their fiduciary duties. The Board was not adequately advised of alternative measures that would serve any legitimate corporate purpose and allowed Yahoo's self-interested management to

structure the plans so as to maximize the burden on Microsoft and any other potential proxy contestant rather than provide value to Yahoo and its shareholders.

196. The plans, which may cost over $2 billion at a $31 per share price and nearly $2.4 billion at a $35 deal price, represent an unduly expensive and unlawful transfer of wealth in any sale of control. In order to account for the plans, Microsoft would have reserved from any offer the potential cost of employee severance. The difference between the price Microsoft ultimately offered and the price Yahoo's largest shareholders have publicly said they would have accepted is similar in magnitude to the cost of the plans that the Board adopted in breach of their duties.

197. The Board also abdicated its ability to amend or redeem the severance plans while Microsoft's offer remained pending, or a future proxy contest remained pending, itself a violation of their fiduciary duties, as any friendly negotiated transaction could have accounted for any legitimate employee-related concerns while avoiding the cost, structural and integration harm that the severance plans imposed on Microsoft in any deal and imposed on Yahoo and its shareholders in a proxy contest.

198. The director defendants further breached their fiduciary duties in approving the Google Agreement, given the deterrent effect of an unreasonably high termination fee.

199. As a result of the foregoing, the Defendants have breached their fiduciary duties to Yahoo and its shareholders, including the obligations of loyalty and due care, causing harm to Plaintiffs and the Class.

200. Plaintiffs and the Class have no adequate remedy at law.

COUNT IV
(Breach Of Fiduciary Duty Of Disclosure Against All Director Defendants)

201. Plaintiffs repeat and reallege each and every allegation above as if set forth in full herein.

202. The Yahoo Directors are bound by their fiduciary duties to provide Yahoo shareholders with all information material to the shareholders' decision regarding the election of directors at the 2008 annual shareholders meeting.

203. The Yahoo Directors have breached those fiduciary duties by making false and misleading disclosures related to the severance plans, as explained above.

204. Plaintiffs and the Class have no adequate remedy at law.

RELIEF REQUESTED

WHEREFORE, Plaintiffs demand judgment as follows:

(a) Declaring this action properly maintainable as a class action;

(b) Declaring that the Defendants' conduct in refusing to consider and respond in good faith to offers to acquire Yahoo was in breach of their fiduciary duties of loyalty and due care;

(c) Preliminarily and permanently enjoining Defendants from entering into any contractual agreements that inhibit their ability to maximize shareholder value;

(d) Preliminarily and permanently enjoining Defendants from initiating any defensive measures which may effectively preclude the acquisition of the Company or are unreasonable and disproportionate to any cognizable threat posed by such potential acquirer;

(e) Ordering Defendants to rescind or redeem the poison pill and/or declaring the poison pill invalid;

(f) Invalidating the Severance Plans;

(g) Invalidating and/or modifying the Google Agreement to eliminate the termination fee provisions;

(h) Awarding compensatory damages in favor of Plaintiffs and the other members of the Class against all individual defendants for all damages sustained as a result of the individual defendants' violations of duty in an amount to be proven at trial, together with interest thereon;

(i) Ordering the director defendants to make corrective disclosures in connection with the 2008 annual meeting;

(j) Awarding Plaintiffs the costs and disbursements of this action, including attorneys', accountants', and experts' fees; and

(k) Awarding such other and further relief as is just and equitable.

/s/ Joel Friedlander
Andre G. Bouchard (Bar No. 2504)
David J. Margules (Bar No. 2254)
Joel Friedlander (Bar No. 3163)
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Co-Lead Counsel for Plaintiffs

OF COUNSEL:

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1285 Avenue of the Americas
New York, New York 10019
(212) 554-1400

Dated: July 14, 2008

Exhibit

A

REDACTED IN ITS ENTIRETY

Exhibit

B

From: Tim Sparks
Sent: Tuesday, February 05, 2008 1:06 PM
To: Michael Benkowitz; Tom LaWer
Subject: RE: Y!

What turnover assumption are you using? 3.2% seems very high for a deal of this size, but I am guessing (hoping) that this assumes 100% double trigger activation?

From: Michael Benkowitz
Sent: Tuesday, February 05, 2008 12:50 PM
To: Tom LaWer; Tim Sparks
Subject: RE: Y!

We're waiting on some more data to do the full acceleration, but based on what we discussed this morning (2 yrs accel for SVPs+ and 1 yr for others), the total cost of cash + equity acceleration is $1.5B which is 3.2% of the transaction price.

Sounds like it's in the range right? J

Michael I. Benkowitz
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415-302-7406 (cell)
mbenkowitz@compensia.com

From: Tom LaWer
Sent: Tuesday, February 05, 2008 12:39 PM
To: Michael Benkowitz
Subject: RE: Y!

I guess that is not surprising from the analysis they sent around for the other deals

Tom LaWer
Compensia
1731 Technology Drive, Suite 810
San Jose, CA 95110
Direct Dial: (408) 907-4309
Fax: (408) 907-4339
tlawer@compensia.com

From: Michael Benkowitz
Sent: Tuesday, February 05, 2008 12:36 PM
To: Tim Sparks; Tom LaWer
Subject: Y!

FYI,

I spoke with Carl trying to finalize this costing. Their latest proposal is to provide 100% equity acceleration for everyone

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Exhibit

C

From: Tim Sparks
Sent: Tuesday, February 05, 2008 1:07 PM
To: Michael Benkowitz; Tom LaWer
Subject: RE: Y!

That's nuts.

From: Michael Benkowitz
Sent: Tuesday, February 05, 2008 12:36 PM
To: Tim Sparks; Tom LaWer
Subject: Y!

FYI,

I spoke with Carl trying to finalize this costing. Their latest proposal is to provide 100% equity acceleration for everyone

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EXHIBIT 19 PLTF.
WITNESS Statkiewicz DEFT.
CONSISTING OF 1 PAGES
DATE 4/29/08
BEHMKE REPORTING & VIDEO SERVICES

Exhibit

D

From: Michael Benkowitz
Sent: Tuesday, February 05, 2008 3:18 PM
To: Carl Statkiewicz
Cc: Tim Sparks; Tom LaWer
Subject: Updated Doc

Attachments: YAHOO_RETENTION MODEL 0208.zip

YAHOO_RETENTIO
N MODEL 0208.zip..

Carl,

See attached. One more thing to note. You had about 800 people in your cash file that weren't in the equity file (assume these are new hires?).

Also, this (the cost) is a really big number in the aggregate and as a % of the deal. I'm not sure if you're trying to sell this at the meeting this afternoon or just present information, but Tim's not seen this yet and we may want to get back on the phone with him again before your meeting to make sure we're all on the same page regarding our position on this

mb

EXHIBIT 24 PLTF. DEFT.
WITNESS Statkiewicz
CONSISTING OF 1 PAGES
DATE 4/29/08
BEHMKE REPORTING & VIDEO SERVICES

Exhibit

E

IN THE COURT OF CHANCERY IN THE STATE OF DELAWARE

In Re Yahoo! Shareholders Litigation	Consolidated C.A. No. 3561-CC

DECLARATION OF JOHN C. FOX

COUNTY OF Santa Clara)
) ss.
STATE OF California)

JOHN C. FOX, being duly sworn, hereby deposes and says as follows:

1. I am a Partner in the Palo Alto office of the Los Angeles based law firm, Manatt Phelps & Phillips, LLP and chair its Employment and Labor Law Group. I have practiced Employment Law my entire career since graduating from law school in 1976. I have led large and complex litigation matters in state and federal courts, in cases involving trade secrets, wage-hour and discrimination class actions, wrongful termination, corporate investigations, and the use of statistics in employment matters. I also provide business and strategic advice for a wide range of companies nationwide relating to their employment practices and help build employment systems in a way designed to minimize legal risk. I have reviewed and drafted hundreds of severance, change of control and key employee retention bonus plans over my 30 plus years of practice. Moreover, especially during the decade plus period of time I was a Partner at Fenwick & West, LLP, I have worked with Corporate Group lawyers on severance and change of control agreements in the contexts of mergers and acquisitions and, typically, start-up technology companies. I also have extensive experience analyzing statutory and regulatory language and words of entitlement in employment agreements and

benefit contracts. This Court previously certified me as an expert witness on California Employment Law, without objection, in the case of In Re The Walt Disney Company Derivative Litigation, Consolidated C.A. No. 15452 (2004).

2. Plaintiffs' counsel have retained my services in the above-captioned action to advise the Court on certain "Change in Control Employee Severance Plans" (the "Severance Plans") that the Compensation Committee of Yahoo! Inc. ("Yahoo!") approved on February 12, 2008 and to place them in context against the background of federal and state laws which operate on employers of California employees, including as to the resulting custom and practices of companies in California.

3. For this Declaration, I relied upon various materials, including but not limited to: (i) the Yahoo! Change in Control Employee Severance Plan for Level I and II Employees; (ii) Yahoo! Change in Control Employee Severance Plan for Level III, IV and V Employees; (iii) a Yahoo! PowerPoint™ presentation titled "Retention Program" (February 12, 2008); (iv) Plaintiffs' First Amended Complaint and attachments; and (v) various news reports and publicly available information.

4. I have drawn the following preliminary conclusions from my review of the various above-referenced materials in this case and drawn from my personal experience and training:

OPINION #1: The Yahoo! Change in Control Employee Severance Plans for Levels I-V Employees are very unusual (unique unto Yahoo!, so much as I know) given:

i. their allowances for employees to vest the severance benefit:

- upon "termination" for "Good Reason" based on certain changes to employee "duties or responsibilities";

- upon a change which may be a mere "substantial adverse alteration" of the employee's duties or responsibilities (and need not be a substantial or material "diminution" of same) ; and

-that the severance benefits flow down globally to all Yahoos!; and

ii. that they are extremely financially generous severance compensation benefits, even by Silicon Valley standards, apparently amounting to approximately $2.4 billion, if fully paid.

<u>OPINION #2:</u> The Yahoo! Severance Plans do not appear to be tailored, as most change of control and severance plans are, to replace potentially lost wages only as a result of an employee's involuntary termination of employment or "constructive termination" of employment.

<u>OPINION #3:</u> The Severance Plans' use of the term "substantial adverse alteration" is language which is not a "term of art" in California or in federal employment or benefits law.

<u>OPINION #4:</u> Yahoo! has drafted its Severance Plans to be very broad as evidenced by their allowances for employees to take under the Severance Plans even if they are not involuntarily discharged (or constructively discharged) within the meaning of California law, even if their duties are not diminished (but have been subject to a mere "substantial adverse alteration") and even though the "substantial adverse alteration" trigger language goes beyond the so-called "Safe Harbor" of Section 409A of the

Tax Code and thus could subject employees receiving a severance payment to potential substantial tax penalties, calling into question whether employee welfare was indeed the motivating purpose behind the creation of the Severance Plans.

<u>OPINION #5:</u> Implementing and doling out potentially $2.4 billion of severance plan monies across potentially approximately 13,000 Yahoos!, employee by employee, would be a costly, burdensome, time consuming and expensive administrative nightmare.

<u>OPINION #6:</u> There is an active plaintiffs employment bar in Northern California currently racking up over approximately a billion dollars per year in employee compensation claims and which bar would undoubtedly be keenly interested to challenge denials of employee access to these lucrative compensation benefits.

<u>OPINION #7:</u> Given the uncertain and expansive language of the Severance Plan entitlements, even only moderately clever Yahoos! would be incented to use the at-issue Yahoo! Plans "offensively" to position credible demands on an acquirer for substantial severance payments, even if those employees were otherwise planning to voluntarily terminate from Yahoo! (for personal reasons, for example) or were otherwise inclined to stay but for the severance incentive.

<u>OPINION #8:</u> Acquiring companies face basically four major choices when faced with a "duties or responsibilities trigger" of a type and quality of the Yahoo! Plans, all of them fraught with substantial potential legal risk and/or costs.

OPINION #1: The Yahoo! Change in Control Employee Severance Plans for Levels I-V Employees are very unusual in my experience.

5. While I assume there must be more such plans in existence in the United States other than just the Yahoo! Severance Plans with the form of "duties or responsibilities" clause contained in the Yahoo! Severance Plans, I am aware of no other such duties or responsibilities clause, let alone such a clause with "top to bottom" global coverage across all employees. I am aware of no other Severance Plan which extends a "duties or responsibilities" clause to all, or even most, employees of the company, regardless of the specific content of the clause.[1]

Rather, Yahoo's! Severance Plans mark a major departure from conventional Change of Control Plans which typically grant severance for termination or "constructive discharge". Thus, Yahoos'! Severance Plans, set a true new "high water mark" among corporate severance plans since the Yahoo! Severance Plans uniquely allow all employees the benefit of a "duties or responsibilities" clause and thereafter allow employees to vest in the severance benefit upon a mere "substantial adverse alteration" of those "duties or responsibilities", and not only upon a substantial or material "diminution" of such duties or responsibilities.

While subtle on paper, this change in entitlement makes for a large difference as to how many eligible employees may vest, in fact, in the severance benefit. Extension of the "duties or responsibilities" clause to all employees renders eligible for the benefit substantially more employees than has historically been the case in typical Change of Control clauses. And, use of the "substantial

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[1] While I had earlier thought that three other companies (*Syntex, PeopleSoft* and *Greater Bay Bancorp*, a regional bank in California) had installed similar "duties or responsibilities" clauses extending to all employees, my subsequent review of their severance plans revealed that their plans did not extend the "duties or responsibilities" clause to all employees, but rather extended them to a very small handful of senior executives.

adverse alteration" language all but insures, as a practical matter, and especially in the fast changing world of the Internet, that almost all Yahoos! would take under the Yahoo! Severance Plan, as a practical matter, upon a Change in Control.

This virtually "global vesting" of the Yahoo! severance benefit then makes for a large multiplier when calculating the total costs of the Yahoo! Severance Plans, were they to be deployed. Indeed, unlike most Change of Control Plans which vest a severance benefit in a relatively small number of (typically senior) employees, the Yahoo! Plans are written in such a way to render virtually all employees eligible for the severance benefit and to vest in fact, through the subtle variation of the "duties or responsibilities" clause virtually any Yahoo! who wishes to avail herself or himself of the severance benefit.

While all "diminutions" of duties or responsibilities are "alterations", not all "alterations" are "diminutions". Thus, the Yahoo! Plans permit vesting broadly (whenever a mere substantial adverse "alteration" occurs). But, as I note below, the Yahoo! Severance Plans thus permit vesting of the vast majority of Yahoo! employees upon the occurrence of routine and merely commonplace events which will more likely than not occur eventually in the regular course of events at Yahoo! and regardless whether a new CEO and Board come into power, or do not, or whether there is a Change or Control, or not.

6. In my experience, Change of Control agreements, typically reach down only to employees in the Executive Suite, and occasionally, to senior managers, but only rarely do they historically and currently reach mid-level managers and almost never reach all of the employees of the company.

7. My experience has historically been, too, that drafters of Change of Control and Severance Agreements typically only cover senior executives and not

the entire company. Rather, the corporate objective historically has typically been to "economically cushion" those employees in the company-to-be-acquired who are more likely than not going to lose their jobs because of the acquisition. Typically, the acquiring company terminates the employment of many of the acquired company's senior employees, either because their positions are redundant (i.e., two CEOs; two CFOs; two COOs; etc.), or because the acquiring management wants (demands) loyalty and personal familiarity with its way of doing business. The lower down in the hierarchy of job titles and compensation one goes, the less concern there is typically in the minds of the acquiring company's management for either redundancy or disloyalty to occur as a result of the acquisition.

8. Indeed, typically, the Acquiring Company is concerned about keeping all or most of the "rank and file" managers and employees to continue on-going production, maintenance, sales, customer service and research and development. The concern for retention of the employees of acquired companies is typically especially acute in technology acquisitions because of the shortage of skilled engineers, and because of the often particularized research and development submarkets in which technology companies work to create unique and cutting edge intellectual property. As a result, most California technology companies which acquire other companies install various incentives to retain and motivate employees, usually in the way of various forms of financial bonuses.

<u>OPINION #2: The Yahoo! Severance Plan does not appear to be tailored, as most change of control and severance plans are, to replace potentially lost wages as a result of an employee's involuntary termination of employment.</u>

9. In the private sector in California, no federal or state law or regulation requires companies to pay severance pay to terminated employees. Nonetheless, many companies do have severance plans and do pay employees severance upon termination, other than for cause. These companies usually do so out of a concern for the welfare of their employees if laid off through no fault of the employee.

10. Typically, too, those companies awarding severance pay (whether in the context of a "Change in Control" or upon involuntary termination outside of a Change in Control) have done so as a "wage replacement" to "gap" any unemployment and loss of wage and benefits the company may cause the employee. The need for severance pay usually arises either because the company has momentarily economically stumbled in the marketplace and has needed, as a result, to reduce employee headcount to save payroll costs, or because it is abandoning a line of business no longer of interest to the company, or combining functions, even though the company may be simultaneously increasing profits and market share.[2] This concept of "wage replacement" guides both the notion, historically, of who "takes" under the Severance Plan, how long (i.e., one month?, three months?, six months?, 12 months?) and how rich the wage protection is (typically tries to predict a payment level close in value to the terminated employee's wages and to be paid until such time as replacement employment is

---

[2] See, for example, <u>Downsizing - Employee Rights or Employer Prerogative</u>, 2 Empl. Rts. & Employ. Pol'y J. 1, 4 (1998). ["Severance pay has long been considered delayed payment, of money earned while working, to assist employees terminated without fault to make a life adjustment."] and <u>The Second Circuit Review -- 1984-1985 Term: Labor Law: Commentary: Employment At-Will in the Second Circuit</u>, 52 Brooklyn L. Rev. 913, 945 (1986) ["[S]everance pay is customarily treated as a reward for past services -- a dismissal wage or unemployment benefit made by an employer to a long-term employee to soften the effects of unemployment."]

predicted to be achieved, on average). As a result, companies typically design severance packages as a function of the approximate length of time it may take employees to find alternative gainful employment and benefits.

11. The severance amounts to be paid under the at-issue Yahoo! Plans are especially economically generous relative to all other severance plans I have ever seen or heard of. *See* Retention Program PowerPoint™, p. 4 (Feb. 12, 2008), Bates Y0001195 (**Attachment 1** to this Declaration). That Attachment succinctly summarizes the severance allowances available under the two at-issue Yahoo! Plans. The number of months of benefits to be paid is "eye popping" by Silicon Valley standards and far exceeds the length of time most Yahoos! would need to find alternative gainful employment. (Indeed, Yahoo! continued to vigorously hire through the Spring of 2008, and Google and Microsoft have almost 5,000 open job requisitions in the United States alone between them at any given moment in time as reported on the public Jobs Boards (Monster/HotJobs, etc).) Even in involuntary layoffs—indeed, even in large scale reductions in forces ("RIFs") accomplished by wealthy companies perhaps only transitioning platforms with no economic duress driving the RIF--I have never seen severance allowances as generous as those available in the Yahoo! Plans.

For example, it is typical in Silicon Valley to see up to approximately three months severance pay for "rank and file" employees, typically including paid health and welfare benefits for the same period of time (and assuming their employer involuntarily terminated their services). Typically mid-level to senior managers would be entitled to three to six months severance and Executive Suite members (CEOs/CFOs/COOs/CTOs) would perhaps enjoy as much as 12 months severance and paid health and welfare benefits. Another formulation of severance benefits is to allow a stated number of weeks of severance for each year of service, typically capped at a stated number of weeks of severance accrual (typically capped at between six and 20 weeks, for example, depending on the employee's level of employment within the company). In setting these values, many companies simply call "headhunters" and ask about the approximate placement times for various job classifications. An alternative subset formulation of such a severance plan would be to offer a set amount of severance pay (expressed in terms of the value of X many week's worth of work: i.e. 20 weeks) and a supplement based on the at-issue employee's length of service (i.e. perhaps 1 week of pay per year of service up to a stated maximum number of years of credited service: i.e. up to a maximum of 5 years).

12. Since revision of the Generally Accepted Accounting Principles several years ago, it is also quite unusual to see accelerated vesting of stock options, as the Yahoo! Plans also permit (because of the resulting accounting charge to the company which would then attach). The acceleration feature is thus another way to potentially provide a Yahoo! employees more economic value, and thus provide him/her, as a practical matter, an even greater number of months of wage protection than through the severance payments initially calculated by reference to level of employment in Yahoo!

OPINION #3: The Severance Plans' use of the term "substantial adverse alteration" is language which is not a "term of art" in California or in federal employment or benefits law.

13. The Severance Plans' definition of "Good Reason" (*see* Level I-V Employee Plan, ¶ 1.13) allowing a covered employee to deem himself/herself "terminated" following a Change in Control (even in the absence of an involuntary termination; *see* Level I-II Employee Plan at ¶ 1.20; and Level III-V

Employee Plan at ¶ 1.21) relies first and foremost on a unique occurrence described in the Plans as a "substantial adverse alteration" in the Eligible Employee's "duties or responsibilities" from those in effect immediately prior to the Change in Control. This "substantial adverse alteration" language is not a legal "term of art" under California law.

Nor is it a term of a art under federal law. I am not aware whether the "duties and responsibilities trigger" language is a "term of art" under Delaware law (which choice of law this Agreement purports to apply), since I am not licensed to practice law in Delaware.

OPINION #4: Yahoo! has drafted its Severance Plans to be very broad and indeed to allow vesting even in the absence of a "constructive discharge" and to provide benefits which do not avail vested Yahoos! of Safe Harbor tax treatment under Section 409A.

14. The at-issue Yahoo! Severance Plans are broader than California law in that they permit Yahoo! employees to recover severance benefits even if they are not involuntarily terminated or are not involuntarily "constructively discharged". Under the Yahoo! Severance Plans, a Yahoo! could take under the Plans, if involuntarily terminated (*see* Yahoo! Severance Plans, sections 1.20 and 1.21, respectively) or in the alternative, if s/he suffered merely a "substantial adverse alteration" of his/her job duties or responsibilities. One form of involuntary termination, of course, is a "constructive" discharge but proving up a constructive discharge is difficult for former employees to prove up under California law.[3]

[3] "An employee cannot simply quit and sue, claiming he or she was constructively discharged. The conditions giving rise to the resignation must be sufficiently extraordinary and egregious to overcome the normal motivation of a competent, diligent, and reasonable employee to remain on the job to earn a livelihood and to serve his or her employer." Turner v. Anheuser-Busch, Inc., 7 Cal. 4th 1238, 1246 (1994). "...to constitute constructive discharge in California, the working conditions must be 'unusually aggravated' or amount to a 'continuous pattern' before the situation will be deemed intolerable." Id. "A single, trivial, or isolated act of misconduct does not amount to a constructive discharge." Id. Further, "a poor performance rating or demotion, even if

The breadth of the Severance Plans is also revealed by the realization that the "substantial adverse alteration" trigger language will cause any Yahoo! distributions of the severance benefit to fall outside the scope of the so-called "Safe Harbor" provision of Section 409A of the Internal Revenue Code. That section creates a presumption in favor of the distribution of deferred compensation, like severance monies, without substantial tax penalties if, among other things, severance pay is made to compensate, among other things, "material diminutions" of base compensation, job duties or responsibilities (but not mere "alterations" of job duties or responsibilities).[4]

15. The ease by which a Yahoo! could prove up entitlement under the Severance Plans can be understood by understanding the fluid nature of work at cutting-edge Internet-search engine companies like Yahoo! Technology jobs, especially at Internet-search engine companies, constantly change, including the essential functions of the job and the applications and research the engineer supports. One expects changes in job duties or responsibilities as a matter of

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accompanied by a reduction in pay, does not alone constitute constructive discharge." Id. (holding that plaintiff's poor performance ratings, his job reassignment, and a change in who he reported to, did not amount to constructive termination); *see also* King v. AC&R Advertising, 1994 U.S. Dist. LEXIS 2618 (C.D. Cal. 1994) (finding that a 50% reduction in compensation, a reduction in benefits, a demotion, and a removal from involvement in management, did not support a constructive discharge claim); Belliveau v. Thompson Financial, Inc., 2006 U.S. Dist. LEXIS 88233 (E.D. Cal. 2006) (holding plaintiff's receipt of a performance improvement plan and his allegations that he was being set up for termination did not amount to a constructive discharge); Cloud v. Casey, 76 Cal. App. 4th 895 (1999) (finding plaintiff was not constructively discharged when denied a promotion and excluded from operational meetings).

[4] Unless an employer satisfies certain statutory requirements, Section 409A of the federal Tax Code now requires amounts (including severance pay) deferred under a nonqualified deferred compensation plan to be includible in the employee's gross income unless such amounts are subject to a substantial risk of forfeiture. In addition, such deferred amounts are subject to an additional 20 percent federal income tax, interest, and penalties if the employer fails to meet Section 409A's requirements. California has enacted similar tax provisions and imposes an additional 20 percent state tax, interest, and penalties. Were Yahoo! to fail to comply with Section 409A and its California state law analog, a Yahoo! employee in the 40% marginal income tax bracket and receiving the at-issue Yahoo! severance benefit would face an 80% tax liability on the severance payment.

course, especially since Yahoo!, Google and Microsoft are going to places nobody has been to before. This reality and message is absolutely basic and critical to not only the recruitment schemes of the Internet-search engine companies, but it is vital to their product branding for consumers. Change and adoption of "cutting-edge" technology is the objective. Internet-search engine jobs change constantly by adding job duties, subtracting job duties and changing job duties.

For example, the Yahoo! employee would take in the following examples under the Yahoo! Plans but would apparently not be able to prove up a constructive termination within the meaning of California law to take under the involuntary termination clause.

a. Yahoo! employee is assigned more employees to manage after the Change in Control (i.e., while there is no reduction in duties, there is a "substantial adverse alteration" because managing more employees typically causes an increase in compensation (which is a strong signal that there has been a change in essential job duties sufficiently important to increase the manager's salary). Such an alteration could be "adverse" because managing more employees is burdensome, involves more performance reviews, requires the manager to navigate around different and varied personalities and causes the manager to expend a much greater commitment of his/her time to the job and to managing employees. Many engineers, in particular, feel "doomed" when "kicked up to management" and they are no longer working at their computers or benches to create new products and services. This example also points up one of the inherent ambiguities of the current

Severance Plans' language: Do they rely on a "subjective" or "objective" test, and is more money and more responsibility always necessarily "better"?

b. A Yahoo! employee is assigned a bigger budget to manage after the Change in Control (i.e., there is no reduction in responsibilities, yet a "substantial adverse alteration" almost always would exist because managing more and varied and/or bigger and more important projects typically causes an increase in compensation in recognition of the more taxing and challenging nature of the job. Such an alteration could be "adverse" because managing bigger projects is more burdensome and causes the manager to commit more of his/her time and intellect to the company, and to become more "stressed" and time pressured.

c. A Yahoo! employee is told after the Change in Control to no longer report to a local manager in Silicon Valley, but rather to now operate under a Seattle, Washington-based manager (no reduction in duties or responsibilities but reporting track altered yet a "substantial adverse alteration" exists because reporting to a distant manager without the ability to interface directly with him or her burdens communication and increases the challenge to build a relationship useful to business. Such an alteration could be "adverse" because few people like distant managers or enjoy the difficulties in communication and travel vicarious management often entails).

d. A Yahoo! engineer who is assigned to work on a "hot" new software platform the Acquiring Company is building and which is widely considered to be the next "big thing" (thus there is a "substantial adverse alteration" in duties perceived to be "adverse," but not a reduction in either duties or responsibilities). This could be a "substantial adverse alteration" because even supporting a "hot" new application on the Acquiring Company's platform, while abandoning the engineer's platform, is not typically a pleasant or desirable result, especially if there is antipathy to the Acquiring Company or its product lines).

16. Yahoo! is also a company in transition and is migrating market focus, jobs and job duties at a very high pace and volume. Thus, the potential for large numbers of Yahoos! to vest under the at-issue Yahoo! Severance Plans upon a Change of Control is very high because of the quickly evolving nature of the industry and Yahoos! place in the industry at this time in history, and especially as it scrambles to survive.

It is well known throughout Silicon Valley, for example, that Yahoo! has undergone a series of at least three major and wrenching re-organizations of its operating divisions, reporting assignments and business focus in the last 18 months alone (since December 2006, and then again in June 2007, and then again in June 2008). In addition, Yahoo! was reported to have planned to terminate approximately 1,000 employees (about 7% of the company) in February 2008. Moreover, Yahoo! has reportedly lost over one hundred managers through voluntary quits in the last year alone. Finally, Yahoo! was engaged in a major hiring spree during the Spring of 2008. Re-organizations and the hiring, firing and regretted loss of hundreds and hundreds of employees all necessarily force changes in job duties and assignments, even apart from the changes competition forces and the changes the rapid-paced and evolving use of the Internet forces.

As to Yahoos'! re-organizations, for example, marketingpilgrim.com reported on June 26, 2008 that President Sue Decker had:

-created three entirely new divisions reporting to her, among other things to centralize and execute common marketing strategies;

-announced an entirely new technology development organization "Cloud Computing & Data Infrastructure Group" to develop a "world class computing and storage infrastructure"; and

-assigned new managers to its tech organization Search and Advertising Groups.

Of course, these sweeping changes mean new work assignments for large numbers of Yahoos! and the assignment of new managers (i.e. new "Sheriffs in town") mean that work directions and pace will change for the subordinate employees.

Moreover, BusinessWeek reported two days later on June 28, 2008 that in the past year over 100 managers, including top managers, had resigned and voluntarily left Yahoo!. The departure of 100 managers means, of course, more changes to the duties and/or responsibilities of the subordinate employees now under the commands of new managers and new departments. Such large scale defections also underscore how fragile loyalties are in tech companies and how easily and freely managers come and go from tech companies, even absent a Change in Control, or new CEO and even absent a large financial severance incentive to leave upon a mere "substantial adverse alteration" in their "duties or responsibilities" (which duties and responsibilities are nonetheless constantly in flux as a matter of course at any rate).

In addition, the New York Times reported on January 30, 2008 that Yahoo! was going to "cut 1,000 jobs by mid-Feb. to reduce costs and narrow its focus to its most important businesses" and that some of those laid –off could even apply for other new jobs at Yahoo!. "Yahoo has begun narrowing the focus of its portal on a few key areas, including its front page, the personalized home page service MyYhoo, search mail, and properties like news, finance and sports....Meanwhile, the company has said it would de-emphasize or shut down a number of other services including photos, pod casts and a largely unsuccessful social network". Of course, work force reductions and the burial of entire work platforms force numerous changes to the job duties of surviving employees as jobs are consolidated and personnel are re-assigned to tackle new market opportunities amid shifting market priorities and the eruption out of the ground of entire new departments.

On June 18, 2007 marketingpilgrim.com reported a new sweeping re-organization and that, among many other changes, Jerry Yang would replace then Yahoo! CEO Terry Semel and Susan Decker would move from CFO to President.

On June 19, 2007 marketingpilgrim.com quoted new Yahoo! President Susan Decker as saying "the level of management that she was just promoted from will be no more. Much of their December reorganization will be undone and department heads will be done away with."

Of course, the work does not go away with reorganizations; other managers must merely divvy up and absorb the abandoned duties and accept responsibility for the employees who nonetheless remain even as their department head leaves or is re-assigned to other duties.

Finally, TechCrunch.com reported on December 5, 2006 about the first of the three major modern Yahoo! reorganizations and underscored that it was driven by the need to change the focus and work of the company because of the rapid pace of marketplace change:

> "News from today's Yahoo executive meeting confirms our earlier story that the company is getting a major reorganization in terms of structure and management. The company said in a press release that they will now align themselves around three key customer segments: "audiences, advertisers, and publishers."
>
> "The Internet is continuing to grow and evolve at a rapid pace, and we're reshaping Yahoo! to be a leader in this transformation, just as we did successfully five years ago," said Terry Semel, Yahoo chairman and CEO, in the release. "Our strategy capitalizes on big emerging trends and leverages our core strengths in search, media, communities and communications. We believe having a more customer-focused organization, supported by robust technology, will speed the development of leading-edge experiences for our most valuable audience segments."

Accordingly, Yahoos! routinely experience major changes in market focus and job assignments, approximately at least every approximately 4-5 months, and even absent a change in external control. Yahoos'! recent history has been that it's internal control and operational direction change often to keep pace with the marketplace (regardless of the threat of an externally imposed change of control or new CEO or new Board of Directors). Moreover, the evolving and ever-changing nature of the use of the Internet--which Yahoo!, of course, must navigate like a Mississippi ship captain navigates that mighty and ever-changing river--drives constant change to Yahoos'! market face, research and operational needs, and thus the job duties of its employees.

OPINION #5: Implementing and doling out potentially $2.4 billion of severance plan monies across potentially 13,000 Yahoos!, employee by employee, would be a costly, burdensome, time consuming and expensive administrative nightmare.

17. The administration of the language of the "Good Reason" clauses in the Yahoo Plans is potentially very problematic, as a practical matter, for any Human Resources department. The unique and undefined use of the "trigger" language ("substantial adverse alteration") is made more challenging given the inclusion of three "lawyer words" (i.e., "substantial," "adverse[5]," and "alteration[6]") and the need to review each employee's claim.[7] Because individualized consideration is required under the Plan for each employee who seeks recompense under the Plan, the Plan architecture calls for and anticipates a rather large expenditure of human and legal resources to properly deny any employee's claim for the generous severance benefit.

Moreover, the Severance Plans give Yahoo! the opportunity to seek to "cure" the "substantial adverse alteration".[8] This apparent "cure right" is largely

[5] There are numerous federal courts of appeals decisions debating and seeking to define the scope of the meaning of the term "adverse" within the meaning of our federal and state discrimination laws (i.e., a transfer is not "adverse," unless a "demotion," or is it?--if upward mobility is more difficult after transfer to a "dead end" job; Is it an "objective" or "subjective" test?).

[6] There are hundreds of Equal Pay Act case decisions alone trying to determine if two jobs are sufficiently "similar" to be compared (for purposes of whether men or women are paid more or less than the other), or how much change in job duties there must be for the two sets of job duties to be different and thus permit different levels of compensation.

[7] *See* Level I-V Employee Plans, ¶ 7.2 ("Denial of Claims") as to notification and review rights to each individual "applicant" as to whom the Plan Administrator has denied a claim. Paragraph 7.2 also calls for the Plan Administrator to provide a written notice of the specific reasons for the denial, specific references to the plan provision upon which denial is based and a description of any information and material that the Plan Administrator needs to complete its review.

[8] See para 1.13 of the Severance Plans. The plans define "Good Reason" for termination to mean, among other things, that the employee has given Yahoo! written notification of termination within

hollow, however, since the at-issue "substantial adverse alterations" are rarely occasioned by negligent corporate action. Rather, they are brought on, as Yahoo! has candidly admitted during each of its reorganizations, by the constant pace of rapid-fire change surrounding use of the Internet. Thus, Yahoo! consciously, purposely and continuously changes employee job duties in reaction to changing technologies and market forces and not because it "accidentally" or in a rash moment changed an employee's duties while not mindful of its actions. This forced change of job duties is especially evident in recent months as the company appropriately scrambles to survive in a difficult marketplace. Accordingly, the likelihood is slim of the Yahoo! Severance Administrator overriding a Yahoo! line manager's decision to undertake a "substantial adverse alteration" of an employee's job duties to save severance costs with respect to an employee who has already announced his/her departure from Yahoo!. Not only will the Yahoo! line manager explain that the job changes were thoughtful and necessary, the line manager will also explain that s/he does not have the discretion to return the employee to his/her former duties because they no longer exist since the work has migrated to the next level, or the next problem to solve, or the next tool to be built. Standing still in a technology company is death.

OPINION #6: There is an active plaintiffs employment bar in Northern California currently racking up over approximately a billion dollars per year in employee compensation claims and which bar would undoubtedly be keenly interested to challenge denials of employee access to these lucrative compensation benefits.

18. Because there does not appear to be any "fee shifting" entitlement in the Plan, presumably employees would have to shoulder the cost of even successful

---

90 days of the event giving rise to the claimed Good Reason and Yahoo! has failed to remedy its act or omission within 30 days of receiving the Good Reason notification.

litigation themselves. While at first glance, that may appear to be an impediment to employee claims, there is an active plaintiff's bar in Northern California which would take a case on contingency seeking to recover only 40% of one year of wages of a high-level technology company wage earner, and the associated equity acceleration. Moreover, it could reasonably be expected that a fair number of engineers would attempt to be their own lawyer and "Perry Mason" the file. More importantly, however, Northern California is a hot bed of class action litigation in recent years and Yahoo! could reasonably expect that class action lawyers would attempt to certify classes or subclasses of employees potentially "adversely" affected due to selected job "alterations" and denied the severance benefit.

19. Moreover, California (and federal) courts would more likely than not certify for class action treatment the definition of the term "substantial adverse alteration."[9] California courts would also more likely than not certify subclasses to determine whether employees would "take" under representative fact patterns (i.e. Yahoo! employee must now report to managers in another state; increased responsibilities; increased duties; moved less than 35 miles but also doing different work; maintaining an employee's principal place of employment but

[9] "[W]here there are significant factual or legal differences among classes, a court may certify a class with respect to particular issues." Rodriguez v. Gates, 2002 U.S. Dist. LEXIS 10654, *24 (C.D. Cal. May 30, 2002); Fed. R. Civ. P 23(c)(4). It is appropriate to "sever a single issue of a claim for class certification under Rule 23." In Re Activision Sec. Litig., 621 F. Supp. 415, 438 (N.D. Cal. 1985) (certifying a class of underwriters to litigate the single issue of material misrepresentations and omissions in offering materials); *see also* In re Computer Memories Sec. Litig., 111 F.R.D. 675, 681 (N.D. Cal. 1986) (giving class treatment to a section 12(2) claim only for the purpose of determining the issue of whether the registration statement and prospectus contained material misrepresentations or omissions); In re: Northern District of California Dalkon Shield IUD Prods. Liability, 526 F. Supp. 887 (N.D. Cal. 1981) (certifying an "issues-only" class action as to the question of the drug company's liability arising from the manufacture and sale of the Dalkon Shield).

nonetheless requiring the employee to drive more than 50% of his/her time to perform his/her work in a different location more than 35 miles away).

"Commonality is generally satisfied where a lawsuit challenges a system-wide practice or policy that affects all of the putative class members. Differences in the ways in which these practices affect individual members of the class do not undermine the finding of commonality."[10]

OPINION #7: Given the uncertain and expansive language of the Severance Plan entitlements, even only moderately clever Yahoos! would be incented to use the Yahoo! Plans "offensively" to position credible demands on an acquirer for substantial severance payments, even if those employees were otherwise planning to voluntarily terminate from Yahoo! (for personal reasons, for example) or were otherwise inclined to stay but for the severance incentive.

20. In the case of the Yahoo! Severance Plans, the Yahoo! Plan Administrator suffers a "conflict of interest" and thus Yahoo! would find itself in a position of having to carefully look behind the Plan Administrator's reason for denial to justify and uphold it. Because of the uncertainty of result in the somewhat arduous legal analysis needed to interpret vague and uncertain "trigger" language, many defense counsel would likely recommend caution to their acquiring company clients and simply "payoff" the severance claim across the board, or to at least err on the side of caution to pay meritorious individual claims.

[10] Kincaid v. City of Fresno, 244 F.R.D. 597, 602 (E.D. Cal. 2007); Armstrong v. Davis, 275 F.3d 849, 868 (9th Cir. Cal. 2001); Stevens v. Harper, 213 F.R.D. 358, 377 (E.D. Cal. 2002); Heffelfinger v. Elec. Data Sys. Corp., 2008 U.S. Dist. LEXIS 5296, *57 (C.D. Cal. Jan. 7, 2008) (finding commonality where company had a blanket policy that all IT workers were exempt from overtime); Dukes v. Wal-Mart, Inc., 509 F.3d 1168, 1177 (9th Cir. Cal. 2007) (finding commonality when Plaintiffs provided evidence of discriminatory company-wide corporate practices and policies); Kincaid v. City of Fresno, 244 F.R.D. 597, 602 (E.D. Cal. 2007) (finding commonality when a city had a regularly established practice that applied to all class members equally).

The Plan Administrator's review of any employee's application for the severance benefit, or for the Plan Administrator's review of its denial of the benefit, is made all the more problematic by the current uncertainty of the law surrounding the standard of review for denials of ERISA benefit plans. For example, the United States Supreme Court last month decided the case of Glenn v. Metropolitan Life Ins. Co., 554 U.S. ___ (2008) [No. 06-923; June 19, 2008]. The import of the Glenn decision is that a plan administrator's dual role of both evaluating and paying benefits claims, like Yahoos'! Severance Plan administrator, creates a conflict of interest which may affect its determination of whether to grant or deny the benefits. The Court therefore ordered trial courts reviewing denials of ERISA benefits claims to assess the significance of the conflict depending upon the circumstances of the particular case. This standard, of course, will now open to legal challenge, as a practical and legal matter, many more corporate denial of benefit claims than was previously the case. The decision also makes it much more inviting for Yahoos! to make claim for severance given the resulting uncertainty in the application of the new legal standard the Court has announced and given the opportunity for Yahoos! to argue that the Plan Administrator was motivated to deny the severance given its "bias" (i.e. "conflict").

The United States Court of Appeals for the Ninth Circuit, the federal jurisdiction within which most Yahoos! would presumably file their court claims challenging any denial of their severance benefits, properly anticipated the Supreme Court's decision in the Glenn case in a recent *en banc* decision.: Abatie v. All To Health and Life Ins. Co., 458 Fd. 3d 995 (9th Cir. 2006) (*en banc*). Even though decided prior to Glenn, because the Ninth Circuit properly anticipated the Glenn decision and it is an *en banc* decision and by chance addresses some of the "real world" issues of interest on remand of the Glenn decision, I believe many federal courts within the Ninth Circuit will give Abatie particular deference.

Specifically, the Abatie case decision provides practical guidance for Plan Administrators and illustrates the individualized inquiry a benefits administrator needs to deploy in response to each request for benefits. In so doing, the Abatie decision points up forcefully the burden associated with denying a severance benefit distribution of the type at-issue in the Yahoo! Severance Plans: In Abatie, Carla Abatie challenged All To Health and Life Insurance Company's denial of her claim for life insurance benefits. The Ninth Circuit held (pre-saging the U.S. Supreme Court's decision last month in the Glenn case) that an inherent conflict of interest existed as the Plan Administrator was also the funding source of the at-issue benefit. The Court stated that where a plan grants "discretion" to a conflicted administrator (as do the Yahoo! Plans), the "abuse of discretion" review standard applies, but a financial conflict of interest must also be weighed as a "factor" in reviewing a Plan Administrator's decision to deny benefits. A court is required to consider all the facts and circumstances and make the decision as to how much or how little credit to give the Plan Administrator's stated reason to deny coverage. Certain facts will increase or decrease the court's skepticism, such as inconsistent reasons for denying the claim, inadequate investigation of the claim and failure to ask the claimant for necessary evidence, among other things.

OPINION #8: Acquiring companies face basically four major choices when faced with a "duties or responsibilities trigger" like that in the Yahoo! Severance Plans, all of them fraught with substantial potential legal risk and/or costs.

21. These four major options are:

  a. Assume all employees of the acquired company take under the Plan and pay them off (*see*, in fact, **Attachment D** to the First Amended Complaint in this case: Email dated February 14, 2008, 1:46 p.m. from Jonathan Dillon to Greg Mrva (*see* Bates YE00003109): "Right, but double trigger also covers change of role, etc. You know that is tough to take a hard line on if not waived at close. And to waive at close, they need to effectively buy us out with more retention or even continue both which would be the best. Just like we do when in the buying position;" or

  b. Deny all employee claims seeking the severance benefit (and thus force individual victim-specific liability litigation and/or class liability litigation addressing specific similar factual scenarios and thereafter individualistic benefit distributions); or

  c. Pro-actively individually catalogue and pay all involuntary terminations and "substantial adverse alterations" on a case-by-case basis (involving thousands of human and legal resources hours to evaluate all claims); or

  d. Seek a waiver from all employees at the time of acquisition (but with the consequent difficulties that not all employees will waive their (in this case, substantial) severance benefits and that the acquirer will have to put up sufficient consideration to entice the employees of the acquired company to waive (as Mr. Dillon's February 14, 2008 email presciently points out).

22. I offer this Declaration under threat of perjury this 13th day of July, 2008.

John C. Fox, Esq.

Exhibit

F

From: Carl Statkiewicz
Sent: Monday, February 04, 2008 6:57:36 PM
To: Sheryl Fox
Subject: FW: Retention Program--Atty Client Priv

Sheryl

Compensia is going to pull together some #'s off of the data that I sent them by level. I should have a handle on when we can expect this tomorrow.

Thanks

-- carl

****
Carl Statkiewicz
Director, Compensation
Yahoo! Inc.
(408) 349 7795
carlstak@yahoo-inc.com

From: Art Kern
Sent: Monday, February 04, 2008 6:31 PM
To: Libby Sartain
Cc: Michael Callahan; Mindy Heppberger; Carl Statkiewicz; David Windley; Jerry Yang
Subject: RE: Retention Program--Atty Client Priv

Not necessary if you have their input and you can talk about specific insights from their experience in these situations, if they have some. A.

From: Libby Sartain
Sent: Monday, February 04, 2008 6:28 PM
To: Art Kern
Cc: Michael Callahan; Mindy Heppberger; Carl Statkiewicz; David Windley; Jerry Yang
Subject: RE: Retention Program--Atty Client Priv

A.

We had planned to get your input first, but would certainly have Tim on the actual comp committee call when we get everything fully baked. This was meant to be a preview for you. We have engaged Tim and firm to help us and Carl and David met with them today to review our thoughts. If you want them on the call tomorrow, we can ask them to join.

Lib

From: Art Kern
Sent: Monday, February 04, 2008 6:24 PM
To: Libby Sartain
Cc: Michael Callahan; Mindy Heppberger; Carl Statkiewicz; David Windley; Jerry Yang
Subject: RE: Retention Program--Atty Client Priv

I'll be in a car heading down to Woodside, 5P-6:30P.
Glad to call in. Glad you're this far along.
Will you have Tim Sparks on the line too?
A.

From: Libby Sartain

EXHIBIT
64

Sent: Monday, February 04, 2008 5:58 PM
To: Art Kern
Cc: Michael Callahan; Mindy Heppberger; Carl Statkiewicz; David Windley; Jerry Yang
Subject: Retention Program--Atty Client Priv

Hi Art,

We have been working the past couple of days on designing a broad based retention plan that retains our current and future hires for 12 to 18 months, motivates both performance and retention, and keeps people secure and focused during uncertain times with planned announcement ASAP and implementation by the end of the month. David Windley has been appointed project leader on this initiative and we gave a high level overview to members of the board working group today (Ron, Ed, Gary, Roy). Next steps will be to review this with the comp committee.

We are hoping to have a recommendation ready by the end of this week, but David and I would like to walk you through what we showed the group. We are hoping you might have some time at the end of the day tomorrow (5ish) for that purpose. Let me know if that works for you.

Libby

:onfidential

Y0003427

Exhibit

G

Market Assessment: Named Executive Officers Other than the CEO

Provision	Current Arrangement	Broad Industry Analysis[1]
Protection Period	24 months	Up to 24 months (21% have 24 month protection period; 64% have 12 month or less protection period)
Severance – Salary Multiple	2.0x	0 – 2.0x (37% of companies provide 1.0x, and 63% of companies provide 1.0x or less)
Severance – Bonus Multiple	None	0 – 2.0x (42% of companies provide no bonus; 28% of the total provide for a payment of 1.0x or less)
Benefits Continuation	24 months	Up to 24 months (37% of companies provide 24 months)
Equity Acceleration	Full vesting acceleration on a double-trigger	Full acceleration subject to double-trigger (58% of companies provide full acceleration on a double-trigger) Consider partial acceleration for performance awards, if any
Excise Tax	Best Results[2]	Best Results (68% of companies either provide for best results or do not have a provision)

Market = Severance + Bonus

1. Based on Compensia survey of technology companies with >$1billion of revenue for arrangements filed in 2007
2. A best results provision maximizes the company's ability to deduct change-in-control payments and maximizes the employee's after tax payments by reducing the payment amount in certain situations to avoid the 280G excise tax

Broad Based Benefits Comparison to Other Recent Transactions

	Payout			
	Proposed Yahoo US Severance (base salary only)	BEA Plan (base & target bonus or commissions)	PeopleSoft Plan (base salary only)	Seibel Plan (base & target bonus or commissions)
IC	4 months	3 Months	Paid based on length of service (8-18 weeks)	3 Months
Sr IC/Mgr/Sr Mgr	6 months	3 Months		3 Months
Dir/Sr Dir	12 months	6 Months		6 Months
VP	12 months	12 Months	12 Months	12 Months
SVP	18 months	12 Months	12 Months plus	18 Months
EVP	24 months	n/a	n/a	n/a
Additional Benefits	Full vesting acceleration of stock awards Continuation of health benefits equal to severance period Outplacement services with amount varying by level	50% vesting acceleration of stock awards Continuation of health benefits equal to the length of severance	Full vesting acceleration of stock awards Continuation of health benefits based on length of service (2 - 5 months)	Full vesting acceleration of stock awards Continuation of health benefits equal to the length of severance Legal fees to enforce agreement

We have summarized market data with respect to broad-based employee severance plans[1]

General Observations

- Severance payments for non-executive employee levels are typically determined, in whole or part, on years of service (e.g., 1 – 2 weeks of salary per year)
- Other factors may include title/level or salary grade, age or individual negotiations
- The majority of non-executive levels (e.g., professionals and administrative) are provided with up to a 3-month program
- When basing severance on years of service, companies typically establish minimum and maximum severance amounts in their policies
  - Minimum severance for non-executive levels is 1 month and maximum severance for non-executive levels is typically 6 months
- 22% of respondents provide enhanced severance benefits in a change-of-control context
- Severance payments generally made in lump-sum or in installments as salary continuation
- Medical benefits (e.g., Company-paid COBRA premiums) are often paid coterminous with the salary severance period (95% of respondents)
- Reasonable outplacement services are also often provided at all levels (approximately 70% to 80% of all or certain professional and administrative employees are eligible)

1. Source: Lee Hecht Harrison Severance & Separation Benefits Survey covering ~1,000 respondents in varied industries

We have summarized market data with respect to broad-based employee severance plans[1]

Severance by Industry – Media, New Media, Dot-coms and Entertainment Companies

- 64% of respondents have a formal, written severance policy for full-time employees at all levels
- 82% provide outplacement to all or some professional employees and 71% provide to all or some administrative employees

	Employee Classifcation			
Severance Element	Sr. Exec	Exec	Professional	Administrative
Minimum total severance (w eeks)	5	4	4	2
Maximum total severance (w eeks)	36	34	32	29
1 to 2 w eeks severance (per yr service)	70%	82%	70%	77%

1. Source: Lee Hecht Harrison Severance & Separation Benefits Survey.

Exhibit

H

Cost of CIC at 2/1/09 100%, 30%, 15%

Payment Type	100% RIF $31	100% RIF $35	100% RIF $40	30% RIF $31	30% RIF $35	30% RIF $40	15% RIF $31	15% RIF $35	15% RIF $40
Cash Severance	$822,738,684	$822,738,684	$822,738,684	$246,815,332	$246,815,332	$246,815,332	$123,411,356	$123,411,356	$123,411,356
Benefits Continuation	$188,450,124	$188,450,124	$188,450,124	$56,533,589	$56,533,589	$56,533,589	$28,267,646	$28,267,646	$28,267,646
Equity Acceleration - Current Awards	$744,494,640	$966,207,611	$1,261,332,689	$249,248,392	$326,962,283	$429,499,807	$143,124,196	$189,981,142	$251,249,903
Equity Acceleartion - 2008 Focal	$247,546,873	$279,488,405	$319,415,320	$74,264,062	$83,846,522	$95,824,596	$37,132,031	$41,923,261	$47,912,298
Retention RSUs	$130,500,000	$130,500,000	$130,500,000	$130,500,000	$130,500,000	$130,500,000	$130,500,000	$130,500,000	$130,500,000
Total CIC Payments	$2,133,730,321	$2,387,384,824	$2,722,436,817	$757,361,375	$844,657,726	$959,173,324	$462,435,230	$514,083,405	$581,341,204

Exhibit

I

From: Carl Statkiewicz
Sent: Tuesday, February 12, 2008 8:47 AM
To: Mindy Heppberger; David Windley
Cc: Libby Sartain
Subject: FW: CIC Valuation

**** ****************************

Carl Statkiewicz
Director, Compensation
Yahoo! Inc.
(408) 349 7795
carlstak@yahoo-inc.com

From: Tim Sparks [mailto:tsparks@compensia.com]
Sent: Tuesday, February 12, 2008 8:49 AM
To: Carl Statkiewicz
Cc: Michael Benkowitz
Subject: RE: CIC Valuation

Carl,

We have looked at this many times for technology company transactions but (obviously) never for a deal of this magnitude. As you might imagine, the acceptable/market % is inversely related to transaction value. For what it is worth, the investment bankers usually have an opinion here and generally provide guidance to the Board as to what is acceptable/market. That said, I think the 1% level is acceptable/market (assuming the cost assumptions are reasonable). For example, I am familiar with another transaction with a deal value of between $7B-$8B where the severance/CoC costs were estimated to be in the 2-2.5% range and the bankers (and the Board) were very comfortable with that. I will look for some of the market research we done in the past and see if I can get you something a little more concrete.

Tim

Tim Sparks
President
Compensia, Inc.
1731 Technology Drive, Suite 810
San Jose, CA 95110

EXHIBIT 40 PLTF. DEFT.
WITNESS Statkiewicz
CONSISTING OF 2 PAGES
DATE 4/29/08
BEHMKE REPORTING & VIDEO SERVICES

Confidential
YE00011251

(office) 408.876.4024
(fax) 408.907.4334
tsparks@compensia.com

From: Carl Statkiewicz [mailto:carlstak@yahoo-inc.com]
Sent: Monday, February 11, 2008 10:28 PM
To: Tim Sparks; Michael Benkowitz
Subject: CIC Valuation

Tim/Mike

Do you have any market data to validate the 1% of deal value is an "acceptable/market" level for severance/retention in situations that we are currently faced with? If no market data, are you comfortable with this figure? Trying to prepare for that question for our comp comm. meeting at 11am tomorrow.

As always, thanks for you support.

c

****

Carl Statkiewicz
Director, Compensation
Yahoo! Inc.
(408) 349 7795
carlstak@yahoo-inc.com

Exhibit

J

From: Jonathan Dillon
Sent: Thursday, February 14, 2008 1:46 PM
To: Greg Mrva
Subject: RE:

Right, but double trigger also covers change of role, etc. you know that is tough to take a hard line on if not waived at Close. And to waive at Close, they need to effectively buy us out with more retention. Or even continue both which wld be the best. Just like we do when in the buying position.

If I get to run the process I will be happy to address that with them and give them the benefit of our expertise!

If our execs really want to stay independent they wld make this a single trigger. Not sure re the legalities of that though at this stage in the process.

Good luck with your preso. I will be on webcast.

-----Original Message-----
From: Greg Mrva
Sent: Thursday, February 14, 2008 1:41 PM
To: Jonathan Dillon
Subject: Re:

Its double trigger. But yes. Also drops a lot of $ into our C level folks - which is usually the case.

You and I will be f'd as they will find a way to make us work for 2 more years.

----- Original Message -----
From: Jonathan Dillon
To: Greg Mrva
Sent: Thu Feb 14 13:38:49 2008
Subject: RE:

Smart move. I wondered whether they wld do that.
Will make things increasingly expensive for msft though.

-----Original Message-----
From: Greg Mrva
Sent: Thursday, February 14, 2008 1:36 PM
To: Jonathan Dillon
Subject: Re:

No its just tied to an acquisition if one happens.

Quick summary. Everything you own is now double trigger. The entire company

I think this will all be very public very soon.

----- Original Message -----
From: Jonathan Dillon
To: Greg Mrva
Sent: Thu Feb 14 13:33:03 2008

Δ π EXHIBIT 55
2 pg
Deponent Windley
Date 4-30-08 Rptr. MC
WWW.DEPOBOOK.COM

Subject: RE:

Interesting. So a Y! program regardless of the path being taken. What do you think they will share later as opposed to in the meeting?

Anything else from the meeting?

-----Original Message-----
From: Greg Mrva
Sent: Thursday, February 14, 2008 12:59 PM
To: Jonathan Dillon
Subject: RE:

Retention program. They will share publicly later today

-----Original Message-----
From: Jonathan Dillon
Sent: Thursday, February 14, 2008 12:18 PM
To: Greg Mrva; Gerald Horkan
Subject:

Hey, I missed the jerry call. Anything interesting?