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IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

) Case No. 12-00225 SC
)
) In re NETFLIX, INC., SECURITIES) ORDER GRANTING MOTION TO
) LITIGATION) DISMISS
)

I. INTRODUCTION

Plaintiffs Arkansas Teacher Retirement System and State-Boston Retirement System ("Plaintiffs") bring this putative securities class action against Netflix, Inc. ("Netflix"); Netflix Co-Founder, Chairman of the Board, and CEO Reed Hastings ("Hastings"); current Netflix CFO David Wells ("Wells"); and Barry McCarthy ("McCarthy"), Netflix's CFO until December 10, 2010 (collectively "Defendants"). Now before the Court is Defendants' Motion to Dismiss Plaintiffs' Consolidated Class Action Complaint ("CCAC"). ECF No. 91 ("MTD"). The motion is fully briefed, ECF Nos. 94 ("Opp'n"), 97 ("Reply"), and is suitable for determination without oral argument, Civ. L.R. 7-1(b). For the reasons set forth below, the Court GRANTS Defendants' Motion to Dismiss and DISMISSES the CCAC with leave to amend.

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1 **II. BACKGROUND**

2 Netflix is a public corporation that purports to be the
3 leading Internet subscription service for viewing movies and
4 television shows (collectively "movies"). ECF No. 89 (CCAC) ¶ 20.
5 Netflix currently allows consumers to watch movies either by
6 streaming them over the Internet directly to their televisions,
7 computers, or mobile devices, or by receiving DVDs sent to their
8 homes. Id.

9 Netflix provided no streaming services -- only DVDs by mail --
10 from 1999 to 2007. Id. ¶¶ 38-49. In 2007 Netflix began to allow
11 its subscribers to stream movies via the "hybrid plan," the only
12 plan it offered at the time, which allowed subscribers both to
13 stream movies and to receive DVDs. Id.

14 In November 2010, as part of its plan to develop its streaming
15 services further, Netflix decided to offer its subscribers a
16 standalone streaming plan in addition to the hybrid plan. Id. ¶
17 76. The hybrid plan cost \$9.99 per month, and the new streaming-
18 only plan cost \$7.99 per month. See id. Shortly before this
19 change, in October 2010, Defendants explained the "virtuous cycle"
20 that would drive Netflix's transition to a streaming-focused
21 company: "[A]s Netflix gained subscribers, it could afford to
22 license more streaming content, which would increase its appeal,
23 and therefore, allow [Netflix] to acquire more subscribers, and the
24 cycle would thus continue." Id. ¶ 65. The cycle was important
25 because Netflix's library of streaming content, unlike Netflix's
26 DVD library, demanded continuous licensing negotiations and would
27 require Netflix to continually increase its subscriber base in
28 order to acquire and maintain streaming content. See id. ¶¶ 50-65.

1 Netflix planned to offset some of the increasing content costs by
2 decreasing DVD-related expenditures. See id.

3 From June 2010 to July 2011, Netflix's subscriber count
4 steadily increased each quarter. Id. ¶ 91. Its stock price
5 followed suit, rising from a closing price of \$153.15 on October
6 20, 2010 to a high of \$298.73 on July 13, 2011. Id. ¶¶ 70, 73-74.

7 On July 12, 2011, however, Netflix announced that effective
8 September 1, 2011 for existing subscribers and immediately for new
9 ones, it would no longer offer its hybrid plan. Id. ¶ 351.
10 Instead, it would offer separate DVD-only and streaming-only plans,
11 both for \$7.99 per month. Id. ¶¶ 351, 407. Subscribers who
12 previously had access to both DVD and streaming services for \$9.99
13 per month under the hybrid plan would now have to pay \$15.98 to
14 subscribe to the new, separate plans. See id. ¶¶ 350-51.
15 Netflix's subscribers were unhappy, and Netflix experienced a net
16 loss in customers for the first time in years. Id. ¶¶ 377-78.

17 Netflix's fortunes fell further in September 2011. First, on
18 September 2, the cable channel Starz announced that it would not
19 renew its streaming contract with Netflix effective February 28,
20 2012. Id. ¶ 372.

21 Second, on September 15, Netflix reported that it expected to
22 lose one million subscribers during the third quarter of 2011 --
23 the first quarter in years that would close with a net loss in
24 subscribers. After the announcement, Netflix's stock price dropped
25 by \$39.46 to close at \$169.25. Id. ¶¶ 376-79. Plaintiffs state
26 that "the investing public understood that the subscriber drop-off
27 was due, in large part, to the price increases in July 2011." Id.
28 ¶ 378. Nevertheless, Netflix stood behind its decision as "the

1 right choice." Id. ¶ 380.

2 Third, on September 19, 2011, Netflix announced that it
3 planned to spin off its DVD services into a new subsidiary called
4 "Qwikster." Id. ¶ 152. Netflix planned to continue to provide
5 streaming services via its own subscription plans and website,
6 separately from the Qwikster subsidiary. Id. Netflix's customers
7 again recoiled from this change, and Netflix lost still more
8 subscribers. ECF No. 93 (Request for Judicial Notice) ("RJN") Ex.
9 3, at 15.¹ Netflix soon abandoned the Qwikster idea, but continued
10 its planned separation of the DVD-only and streaming-only plans,
11 thereby doing away with the hybrid plan altogether. CCAC ¶¶ 148,
12 149, 154.

13 Shortly thereafter, on October 24, 2011 in documents related
14 to the fourth quarter of 2011 ("4Q11"), Netflix began to report
15 segmented financial information for the now-entirely-separate DVD-
16 only and streaming-only plans -- information that had previously
17 been unavailable. Id. ¶ 225. Before 4Q11, Netflix reported its
18 financial results under the single "Domestic" segment, which
19 included customers on the hybrid plan and those on the newer
20 streaming-only plan, but did not provide segmented financial
21 information for the then-intertwined DVD and streaming services.

22 _____
23 ¹When ruling on a motion to dismiss, a court may consider documents
24 whose contents are incorporated by reference in a complaint or upon
25 which a complaint necessarily relies when authenticity is not
26 contested, and matters subject to judicial notice. Metzler Inv.
27 GMBH v. Corinthian Colls., Inc., 540 F.3d 1049, 1061 (9th Cir.
28 2008) (citing Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551
U.S. 308, 322 (2007)). The Court takes judicial notice of the
exhibits attached to the RJN because Plaintiffs refer to the
documents included in those exhibits, thereby incorporating them by
reference, and Plaintiffs did not object to the RJN.

1 See id. ¶¶ 149, 151, 407; RJN Ex. 4 at 71.

2 In its 4Q11 reports, Netflix announced that its "contribution
3 margin for domestic streaming [would] be low in 4Q11 at around 8%
4 . . . due to [its] increasing content spend," whereas Netflix's DVD
5 business had a contribution profit of 50-52%. Id. ¶¶ 382-85.
6 Netflix continued to stand by its decision to offer the DVD and
7 streaming subscription plans as separate services with separate
8 prices, but admitted that it had made the change too quickly,
9 compounding the problem "with [a] lack of explanation about the
10 rising cost of the expansion of streaming content, and steady DVD
11 costs." Id. ¶ 389. Netflix stated further that more long-term
12 members canceled their subscriptions in response to the pricing
13 changes than expected, thereby making Netflix's 4Q11 profits and
14 revenues lower than predicted, though Netflix would remain
15 profitable overall. Id. ¶ 390. After this announcement, Netflix's
16 stock price fell \$41.47 per share to close at \$77.37 per share on
17 October 25, 2011. Id.

18 Plaintiffs, Netflix shareholders, now sue Defendants for
19 alleged violations of the federal securities laws. Their claims
20 are all based on the theory that, between October 20, 2010 and
21 October 24, 2011, inclusive (the "Class Period"), Defendants misled
22 investors about the prospects of the new streaming-focused model,
23 thereby artificially inflating Netflix's stock price and leading to
24 a stock drop of almost 67 percent after the alleged falsity of
25 those statements was revealed. See id.

26 Plaintiffs allege that all Defendants violated Section 10(b)
27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and
28 Securities Exchange Commission ("SEC") Rule 10b-5; that the

1 individual Defendants violated Section 20(a) of the Act; and that
2 Hastings violated Section 20A of the Act. Id. ¶¶ 418-23.

3
4 **III. LEGAL STANDARD**

5 **A. Motion to Dismiss**

6 A motion to dismiss under Federal Rule of Civil Procedure
7 12(b)(6) "tests the legal sufficiency of a claim." Navarro v.
8 Block, 250 F.3d 729, 732 (9th Cir. 2001). "Dismissal can be based
9 on the lack of a cognizable legal theory or the absence of
10 sufficient facts alleged under a cognizable legal theory."
11 Balistreri v. Pacifica Police Dep't, 901 F.2d 696, 699 (9th Cir.
12 1988). "When there are well-pleaded factual allegations, a court
13 should assume their veracity and then determine whether they
14 plausibly give rise to an entitlement to relief." Ashcroft v.
15 Iqbal, 556 U.S. 662, 679 (2009). However, "the tenet that a court
16 must accept as true all of the allegations contained in a complaint
17 is inapplicable to legal conclusions. Threadbare recitals of the
18 elements of a cause of action, supported by mere conclusory
19 statements, do not suffice." Id. (citing Bell Atl. Corp. v.
20 Twombly, 550 U.S. 544, 555 (2007)). A court's review is generally
21 "limited to the complaint, materials incorporated into the
22 complaint by reference, and matters of which the court may take
23 judicial notice." Metzler, 540 F.3d at 1061 (citing Tellabs, 551
24 U.S. at 322).

25 **B. Section 10(b)**

26 Section 10(b) of the Exchange Act makes it unlawful "[t]o use
27 or employ, in connection with the purchase or sale of any security
28 registered on a national securities exchange . . . any manipulative

1 or deceptive device or contrivance in contravention of such rules
2 and regulations as the [Securities and Exchange] Commission may
3 prescribe" 15 U.S.C. § 78j(b). One such rule prescribed
4 by the Commission is Rule 10b-5, which states that "[i]t shall be
5 unlawful for any person . . . [t]o engage in any act, practice, or
6 course of business which operates or would operate as a fraud or
7 deceit upon any person, in connection with the purchase or sale of
8 any security." 17 C.F.R. § 240.10b-5(c). Plaintiffs must plead
9 five elements to establish a violation of Rule 10b-5: "(1) a
10 material misrepresentation or omission of fact, (2) scienter, (3) a
11 connection with the purchase or sale of a security, (4) transaction
12 and loss causation, and (5) economic loss." In re Daou Sys., 411
13 F.3d 1006, 1014 (9th Cir. 2005).

14 Plaintiffs must also meet the heightened pleading standards of
15 Federal Rule of Civil Procedure 9(b) and the Private Securities
16 Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-4. The
17 PSLRA requires plaintiffs to "specify each statement alleged to
18 have been misleading [and] the reason or reasons why the statement
19 is misleading." 15 U.S.C. § 78u-4(b)(1). Additionally, the
20 complaint must "state with particularity facts giving rise to a
21 strong inference that the defendant acted with the required state
22 of mind." Id. § 78u-4(b)(2). The "required state of mind" for
23 establishing securities fraud is the knowing, intentional, or
24 deliberately reckless disclosure of false or misleading statements.
25 See Daou, 411 F.3d at 1014-15. "The stricter standard for pleading
26 scienter naturally results in a stricter standard for pleading
27 falsity, because falsity and scienter in private securities fraud
28 cases are generally strongly inferred from the same set of facts,

1 and the two requirements may be combined into a unitary inquiry
2 under the PSLRA." Id. at 1015 (internal quotation marks omitted).

3
4 **IV. DISCUSSION**

5 **A. Plaintiffs' Section 10(b) Claim**

6 Plaintiffs allege that Defendants made materially false and
7 misleading statements about (1) Netflix's accounting practices, (2)
8 the virtuous cycle, (3) streaming's profitability relative to that
9 of the DVD business, (4) Netflix's statements about its price
10 changes, and (5) Defendants' statements to the SEC. Defendants
11 argue that Plaintiffs have failed to adequately plead falsity or
12 scienter. The Court agrees that Plaintiffs have failed to show
13 that Defendants' statements were materially false or misleading,
14 and accordingly need not address the issue of scienter.

15 **1. Defendants' Alleged Accounting Fraud**

16 Plaintiffs allege that Defendants materially misstated
17 Netflix's financial statements in violation of Generally Accepted
18 Accounting Principles ("GAAP") and SEC disclosure rules. See,
19 e.g., CCAC ¶¶ 41-56, 283, 331, 360. Defendants argue that they
20 were not required to implement segment reporting until 4Q11, when
21 they began to do so. MTD at 8.

22 **a. GAAP**

23 Plaintiffs state that the GAAP rule governing segment
24 reporting, Accounting Standards Codification § 280 ("ASC 280"),
25 requires a business component to be considered a separate operating
26 segment for financial reporting purposes if:

27 "(a) it engages in business activities from
28 which it may generate revenues and incur
expenses . . . (b) its operating results are
regularly reviewed by the Company's upper

1 management . . . in order to assess the
2 segment's performance and make decisions about
3 resources to be allocated to the segment . . .
and (c) its discrete financial information is
available."

4 Id. ¶ 191.

5 Plaintiffs allege that Defendants violate GAAP by failing to
6 provide segment reporting before 4Q11. See id. ¶¶ 193-221. This
7 allegation is not plausible because there is no indication that
8 Netflix had discrete financial information for its streaming and
9 DVD components until 4Q11. Plaintiffs claim that streaming
10 generated "its own revenues and incurred its own expenses separate
11 and apart from those of the DVD business," but in doing so
12 Plaintiffs massage the fact that the "DVD business" at that time
13 was financially inseparable from the streaming component of the
14 hybrid plan -- therefore this information was not "discrete." See
15 CCAC ¶¶ 194-195. Defendants may have had information about the
16 prospects of streaming generally, or the performance of the
17 streaming-only subscription plan, but this is not the same as
18 having information about streaming as a discrete component of
19 Netflix's overall service offerings.

20 Confronting this fact, Plaintiffs "formulate approximations"
21 of their own devising of how the DVD and streaming components of
22 the hybrid plan could have been financially separated, which
23 Plaintiffs say "strongly suggest[s]" that discrete financial
24 information was available to satisfy ASC 280. See id. ¶¶ 212-14.
25 Plaintiffs' allocation is premised on their estimation that
26 Netflix's streaming revenue must have been \$7.99, because that was
27 the price of the streaming-only plan after Netflix split its plans.
28 See id. ¶ 211-212 & nn. 6, 7. This kind of hypothesized allocation

1 does not plausibly show that Defendants actually had discrete
2 financial information available to them, because Plaintiffs do not
3 show that such an allocation was required or even possible given
4 the hybrid plan's unity of services and Netflix's statement that
5 until 4Q11, "revenues were generated and marketing expenses were
6 incurred in connection with the subscription offerings as a whole."
7 RJN Ex. 4 at 71.

8 Plaintiffs' argument that Netflix should have reported
9 segments in its domestic financial reports because it did so abroad
10 is also unavailing. Plaintiffs' pleadings do not explain what
11 kinds of plans Netflix offered abroad, which is a critical fact in
12 determining whether Netflix's domestic accounting practices were
13 inappropriate relative to what it did elsewhere. The Court cannot
14 agree that Netflix erred in not reporting its United States and
15 international financial data in the same way without evidence that
16 the facts were the same in the United States and abroad.

17 The Court finds that Plaintiffs have not pled any false or
18 misleading statements related to Defendants' accounting under GAAP.

19 **b. SEC Regulation S-K Item 303**

20 Plaintiffs also argue that Netflix violated SEC Regulation S-K
21 Item 303, which requires companies to "describe any other
22 significant components of revenues or expenses that . . . should be
23 described in order to understand the registrant's results of
24 operations." CCAC ¶ 222 (citing 17 C.F.R. § 229.303(a)(3)(i)-
25 (ii)). These disclosures include "any known trends or
26 uncertainties that have had or that the registrant reasonably
27 expects will have a material favorable or unfavorable impact on net
28 sales or revenues or income from continuing operations." Id.

1 Plaintiffs' allegations on this point are not plausible. "It
2 is well established that violation of an exchange rule will not
3 support a [Section 10(b) or Rule 10b-5] claim." In re VeriFone
4 Holdings, Inc. Secs. Litig., 11 F.3d 865, 870 (9th Cir. 1993). In
5 any event, Plaintiffs' pleadings do not actually show that
6 Defendants withheld information about a known trend or uncertainty
7 in the streaming market, since Defendants repeatedly stated that
8 success in the streaming market depended on multiple factors,
9 especially Netflix's ability to keep its subscriber base large and
10 happy. See, e.g., RJN Ex 1 at 16; Ex. 5 at 27; Ex. 16 at 24.
11 Plaintiffs' allegations regarding Item 303 are therefore
12 insufficient to state a claim for a violation of Section 10(b) or
13 Rule 10b-5.

14 **2. The Virtuous Cycle**

15 According to Defendant Hastings: "[By way of the virtuous
16 cycle, Netflix would] acquire more streaming content, which helps
17 grow [Netflix's] subscriber base and lessen[s] [Netflix's] DVD-by-
18 mail expense, which in turn provides [Netflix] with greater
19 financial resources to acquire more streaming content, improve the
20 user interface, and continue to grow the subscriber base." CCAC ¶
21 64.

22 In December 2010, defendants Hastings and McCarthy stated
23 further:

24 [Defendant Hastings:] [W]e are on that
25 virtuous cycle of more subscribers
26 It means that we can write bigger checks and
27 get more content, and that, in turn,
28 attracts more subscribers. And we are going
round and round that loop as we go
[Defendant McCarthy]: And so to be
explicitly clear, the benefit of paying less
on DVD is not higher profit margins. In the
alternative, it creates an opportunity for

1 us to re-task that money with our studio
2 partners in the licensing of streamed
3 content, which accelerates the virtuous
cycles that we had already spoke about.

4 Id. ¶¶ 293-94. On other occasions, Netflix made similar
5 statements affirming its reliance on the virtuous cycle to drive
6 its business growth, so long as Netflix's subscriber base continued
7 to grow and decreases in DVD-related expenditures allowed Netflix
8 to offset some of the increases in streaming-related costs. See,
9 e.g., id. at ¶¶ 293-94, 303-05, 325-26. Indeed, the virtuous cycle
10 seemed to work as Netflix had planned until, for the first time in
11 years, Netflix posted a loss in subscribers after its announcement
12 that it would increase prices. See id. ¶¶ 163, 377-78.

13 Plaintiffs allege that Defendants touted Netflix's turn toward
14 a streaming focus as a positive development, even though Defendants
15 allegedly knew that shifting to a streaming-focused model would be
16 unprofitable and unsustainable, thereby rendering Defendants'
17 explanations of and statements about the virtuous cycle false or
18 misleading. See, e.g., id. ¶¶ 277, 279. Defendants argue that
19 Plaintiffs' allegations do not prove that any statement about the
20 virtuous cycle was false or misleading. See MTD at 17.

21 The Court agrees with Defendants. The statements that
22 Plaintiffs allege to have been false or misleading appear to be
23 accurate descriptions of a business model that worked exactly as
24 Netflix said it would, until Netflix began to lose subscribers
25 after announcing its price increases and DVD-business spinoff. See
26 CCAC ¶ 377-78. Plaintiffs do not show, for example, that when
27 Defendants made public statements about the virtuous cycle, any of
28 the Defendants knew that the virtuous cycle was unsustainable but

1 pursued it as a strategy anyway; that any of Defendants' other
2 actions negatively impacted the virtuous cycle's operation; that
3 Defendants misrepresented the strength of the virtuous cycle at any
4 point; or that any of these statements did anything but confirm
5 Netflix's reliance on a model that worked as Defendants described
6 and failed due to circumstances Netflix had warned investors about
7 in earlier disclosures. For example, on February 18, 2011, Netflix
8 warned its investors of the virtuous cycle's reliance on subscriber
9 growth: "We must continually add new subscribers . . . If too many
10 of our subscribers cancel our service, or if we are unable to
11 attract new subscribers in numbers sufficient to grow our business,
12 our operating results will be adversely affected." RJN Ex. 5 at 4.
13 This statement and others like it showed that Netflix warned
14 investors about the virtuous cycle's reliance on subscriber growth.

15 Accordingly, the Court finds that Plaintiffs have failed to
16 plead that any of Defendants' statements about the virtuous cycle
17 were materially false or misleading.²

18 **3. Profitability**

19 Plaintiffs also allege that Defendants' statements about the
20 prospects of the streaming business were materially false or
21 misleading because Defendants hid facts about streaming's
22 disparately low profitability relative to Netflix's DVD component,
23 and because Defendants misrepresented the prospects of streaming
24 for the future of Netflix's business.

25 Defendants made several statements in SEC filings and
26

27 ² Defendants also argue that their statements were non-actionable
28 statements of optimism or forward-looking statements. Since the
Court finds the challenged statements are not false, it need not
and does not address this argument.

1 conference calls indicating that Netflix would shift its business
2 focus to streaming. See, e.g., CCAC ¶¶ 62, 267, 277, 279. For
3 example, Netflix stated in a press release on October 20, 2010 that
4 it had become "by every measure . . . primarily a streaming company
5 that also offers DVD by mail." Id. ¶ 62. Further, during an
6 earnings call on that same day, defendant Hastings said that
7 "[Netflix's] evolution to a streaming company has just been
8 phenomenal," based on year-over-year subscriber growth of 52
9 percent and rising, more content, more device partnerships, and
10 Netflix's entry into Canada. Id. ¶ 66.

11 Hastings also told investors that increasing costs associated
12 with acquiring streaming content would be offset by the declining
13 costs of the DVD business (e.g., postage for DVDs), and that
14 "[Netflix] would like to keep [the long-term margin structure]
15 between 30% and 35% gross margin." Id. ¶ 278. McCarthy confirmed
16 this principle, stating that the target margins could be sustained
17 by new content deals replacing postage. Id. ¶ 279. Plaintiffs
18 characterize these statements as being part of a discussion about
19 "relative profitability" of DVD and streaming segments. See id. ¶¶
20 278-79. However, as Defendants note, Hastings specifically refused
21 to speculate about comparative long-term margins without more
22 knowledge of future market competitiveness. RJN Ex. 7 at 8.

23 Plaintiffs' main contention as to these statements and others
24 like them is that Defendants misled investors as to the
25 profitability of its streaming component, because after Netflix
26 began segment reporting for the separate streaming and DVD plans in
27 4Q11, it revealed that the separate streaming plan had a
28 contribution profit of only about 8 percent compared to the DVD

1 plan's 50-52 percent. CCAC ¶¶ 275-370, 384-385. Plaintiffs allege
2 that Defendants knew the streaming business would be less
3 profitable than Netflix's DVD component, but concealed this from
4 their investors, and, further, that Defendants had an obligation to
5 reveal such discrete data once they had emphasized streaming's
6 importance to Netflix's future business goals. See id. ¶¶ 281,
7 315, 328, 356.

8 Defendants argue that Plaintiffs fail to plead a false or
9 misleading statement regarding the streaming service's
10 profitability, because "Plaintiffs do not allege facts reflecting
11 that Netflix ever made an affirmative public statement regarding
12 streaming's profitability," and because Plaintiffs do not plead
13 "any facts reflecting that the allegedly-omitted information was
14 known to Defendants at the time of the challenged statements." MTD
15 at 14-16. Plaintiffs respond: "That Defendants did not explicitly
16 reference the streaming segment's profitability [in its SEC
17 disclosures and other statements about its shift to streaming] is
18 beside the point." Opp'n at 10. Plaintiffs cite to Matrixx
19 Initiatives, Inc. v. Siricusano, 131 S. Ct. 1309, 1321-22 (2011),
20 and Brody v. Transitional Hospitals Corp., 280 F.3d 997, 1006 (9th
21 Cir. 2002), for the proposition that disclosure is required where
22 failure to disclose would render statements misleading in light of
23 the circumstances in which they were made. See Opp'n at 1-2, 10-
24 11. Contrary to Plaintiffs' suggestions, Matrixx and Brody do not
25 hold that a defendant's statement is misleading merely because it
26 is complete or because a defendant could have said more. See
27 Matrixx, 131 S. Ct. at 1321-22; Brody, 280 F.3d at 1006.

28 In the instant matter, Plaintiffs have not shown that

1 Defendants possessed information at odds with the state of affairs
2 they presented to investors, such that restatement or additional
3 disclosure was required. For Defendants' statements about
4 profitability to have been misleading, Defendants must have
5 actually known specific information about the allegedly disparate
6 profit margins of separate DVD and streaming segments. They did
7 not until 4Q11, because streaming was never wholly separate from
8 the DVD component until that point. Further, Plaintiffs'
9 allegation that Defendants touted the profitability of the
10 streaming business is not convincing: the statements quoted by
11 Plaintiffs do not actually refer to the profitability of streaming,
12 but rather the interrelationship of the streaming and DVD
13 businesses contributing to one overall margin. See CCAC ¶¶ 278-79.

14 Further, Defendants made clear throughout the Class Period
15 that the success of a streaming-focused business model was
16 contingent on other factors, primarily the growth and retention of
17 Netflix's subscriber base, suggesting that Defendants did not omit
18 any information or warnings in a way that would be misleading under
19 Rule 10b-5. See, e.g., RJN Decl. Ex 1 at 16; Ex. 5 at 27; Ex. 16
20 at 24; Ex. 5 at 27.

21 None of what Plaintiffs plead therefore shows that Defendants
22 made any false or misleading statements about the profitability of
23 the streaming business.

24 **4. Defendants' Communications with the SEC**

25 Plaintiffs further argue that Defendants made false or
26 misleading statements in a series of letters exchanged between
27 Defendants and the SEC. See CCAC ¶¶ 341-47.

28 Plaintiffs point first to July 2009 correspondence between

1 Netflix and the SEC in which the SEC urged Netflix to discuss the
2 "types of plans that [it offers], the price per plan, the cost per
3 plan, [and] the total revenues by plan type." Id. ¶ 116. Netflix
4 did not supply that information in its response or subsequent
5 filings. Id.

6 Later, on April 28, 2011, the SEC asked Netflix to provide
7 more information about its changing business, "such as the number
8 of subscription streaming-only plans, streaming and DVD by mail
9 plans, and DVD by mail only plans," so that investors could observe
10 and analyze that data. Id. The SEC also requested that Netflix
11 consider adding "any other operating statistics that [it believed]
12 would be useful to investors, which may include rates of churn or
13 any other statistics that would better enable investors to
14 understand [Netflix's] business." Id. ¶ 343. Netflix responded on
15 May 20, 2011, that though it did not think some of this information
16 would help, it would add more disclosures, giving the following
17 paragraph as an example:

18
19 We believe that the DVD portion of our
20 service will be a fading differentiator
21 given the rapid growth of streaming, and
22 that in order to prosper in streaming we
23 must concentrate on having the best possible
24 streaming service. As a result, we are
25 beginning to treat them separately in many
26 ways. Nonetheless, we believe that the
27 evolution of our business model in this
28 manner does not change, except as otherwise
disclosed in this MD&A, our expectations in
terms of impact or trend to our operating
results. As we continue to focus on
streaming, we expect to continue to grow our
number of subscribers, revenues, operating
income and free cash flows. Specifically in
fiscal 2011, we expect our domestic
operating margin to increase as compared to
fiscal 2010.

1 Id. ¶ 346. However, in its subsequent SEC filing, Netflix omitted
2 the portion of that paragraph beginning "Nonetheless" Id.
3 ¶ 347. In that same letter, Netflix also stated that it would
4 cease to provide certain operating metrics in 2012, namely gross
5 subscriber additions, subscriber acquisition costs, and churn (a
6 measurement of customer cancellations). Id. ¶¶ 117, 344. In June
7 2011, the SEC again wrote to Netflix asking it to reconsider its
8 decision not to provide these metrics, but Netflix did not do so.
9 Id. ¶ 118. In none of these letters did the SEC specifically ask
10 for segmented financial information. Id. ¶¶ 117-18, 344.

11 Plaintiffs allege that Netflix's choice not to include some
12 requested information in its public filings, as well as the
13 information that it did disclose in response to the SEC, prove that
14 these statements were misleading. Id. ¶¶ 341-49. Defendants
15 respond that Netflix's choice not to include certain information is
16 irrelevant because the exchanges between the SEC and Netflix are
17 public. Defendants reason that they put the public on notice as
18 soon as the letters were published regardless of whether Netflix
19 repeated their contents in subsequent statements. MTD at 18-19.
20 Defendants also point out that the SEC's 2009 correspondence with
21 Netflix could not possibly have concerned a streaming-only plan, as
22 none existed at that time. Id. at 9 (citing CCAC ¶ 76).

23 The Court agrees with Defendants that the exchange between
24 Netflix and the SEC in 2009 does not show that Defendants'
25 statements about streaming were false or misleading. The SEC asked
26 about metrics like subscriber information for Netflix's different
27 plans and other operating statistics, not about specific segmented
28 financial information for DVDs and streaming segments. See CCAC ¶¶

1 341-45. Moreover, Netflix did not offer standalone streaming plans
2 when the SEC sent its 2009 letters. The 2009 correspondence is
3 therefore irrelevant to Plaintiffs' claims and appears to serve
4 only as innuendo relating to Defendants' dealings with the SEC.

5 Further, since Defendants' correspondence with the SEC was
6 public, Plaintiffs' allegation that Netflix somehow hid information
7 from investors while simultaneously filing these letters with the
8 SEC hold no weight. Netflix's decision not to reiterate the same
9 statements it made to the SEC in subsequent filings does not
10 indicate that Defendants misled investors. Plaintiffs do not
11 otherwise allege that Netflix misled the SEC.

12 The Court finds that Netflix's statements to the SEC do not
13 support a 10b-5 claim.

14 **5. Defendants' Statements About Price Increases**

15 In July 2011, Netflix posted on its official blog that it
16 would begin to offer a DVD-only plan in addition to its streaming-
17 only plan, but would phase out the hybrid plan. CCAC ¶ 351. Both
18 new plans, the streaming-only and DVD-only plans, would be \$7.99
19 per month -- \$15.98 for both -- effective immediately for new
20 subscribers and September 1, 2011 for current ones. Id. ¶¶ 350-51,
21 407. Netflix explained the reasoning behind these changes: "Given
22 the long life we think DVDs by mail will have, treating DVDs as a
23 \$2 add-on to our unlimited streaming plan neither makes great
24 financial sense nor satisfies people who just want DVDs. Creating
25 an unlimited DVDs by mail plan (no streaming) at our lowest price
26 ever, \$7.99, does make sense and will ensure a long life for our
27 DVDs by mail offering." Id. ¶ 351.

28 Plaintiffs argue that Netflix's announcement about price

1 changes was false and misleading because "it failed to disclose
2 and/or misrepresented the reason that Netflix increased its prices,
3 namely, that Netflix was suffering from decreased liquidity and was
4 unable to afford the growing costs associated with its businesses."
5 Id. ¶ 352. Defendants' primary response is that Plaintiffs'
6 allegation about decreased liquidity is unfounded because Netflix
7 had more than \$375 million in liquid assets as of June 2011.
8 Plaintiffs did not respond to these arguments in their opposition.

9 The Court finds that the blog post about price increases was
10 not false or misleading. Plaintiffs do not plead specific facts
11 indicating that the real reason Netflix changed its prices had to
12 do with decreased liquidity or other concerns related to what
13 Plaintiffs claim is a faulty business model. They state only a
14 conclusory allegation that Netflix lied about its reason for
15 changing its pricing structures and subscription plans. In the
16 same documents on which Plaintiffs rely in their CCAC, Netflix
17 disclosed its cash, cash equivalents, and short-term investments as
18 of June 30, 2011. Plaintiffs do not point to any of those numbers
19 or other disclosures as indications of Netflix's lack of liquidity.
20 See RJN Decl. Ex. 1 at 4.

21 **B. Plaintiffs' Remaining Claims**

22 Absent an underlying violation of the Exchange Act, there
23 can be no control person liability under Section 20(a). Paracor
24 Fin., Inc. v. Gen. Elec. Capital Corp., 96 F.3d 1151, 1161 (9th
25 Cir. 1996). Because Plaintiffs have not pled a violation of
26 Section 10(b), their control person claim is also DISMISSED. See
27 Shurkin v. Golden State Vinters, Inc., 471 F. Supp. 2d 998, 1027
28 (N.D. Cal. 2006). Likewise, there can be no insider trading

1 liability under Section 20A without an underlying violation of
2 Section 10(b). See In re VeriFone, 11 F.3d at 872. Plaintiffs'
3 Section 20A claim is therefore DISMISSED.

4

5 **V. CONCLUSION**

6 For the foregoing reasons, the Court GRANTS Defendants Reed
7 Hastings, David Wells, Barry McCarthy, and Netflix, Inc.'s Motion
8 to Dismiss. Plaintiffs Arkansas Teacher Retirement System and
9 State-Boston Retirement System's Consolidated Class Action
10 Complaint is DISMISSED WITH LEAVE TO AMEND. Plaintiffs may file an
11 amended complaint within thirty (30) days of this Order's signature
12 date. Failure to do so will result in dismissal of this action
13 with prejudice.

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15 IT IS SO ORDERED.

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17 Dated: February 13, 2013

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UNITED STATES DISTRICT JUDGE

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