ARIZONA STATE UNIVERSITY

CORPORATE AND BUSINESS LAW JOURNAL FORUM

VOLUME 1 | NOVEMBER 2019 | NUMBER 9

COMMENTARY

NETFLIX FACES STOCKHOLDER DERIVATIVE SUIT AFTER FAILING TO MEET QUARTERLY GOALS

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On November 6, 2019, Plaintiff Gerald Lovoi, derivatively on behalf of Netflix, Inc. ("Netflix"), brought a stockholder derivative complaint against the company's board of directors (the "Board") and executive officers.[1] A stockholder derivative suit is brought by a stockholder on behalf of the corporation, if the stockholder believes that the corporation's board of directors, officers, or a third party is guilty of harming the corporation. In the complaint, Mr. Lovoi accuses the Board and executive officers for breaching their fiduciary duties and for violating Section 14(a) of the Securities Exchange Act of 1934 ("Exchange Act").[2] Mr. Lovoi alleges the violations occurred in a series of announcements made by the Board and executive officers between April 2019 and October 2019.[3]

On April 16, 2019, Netflix issued a letter to its stockholders announcing financial results for its first quarter of 2019.[4] The letter noted revenues of $4.5 billion, and an increase in global streaming paid memberships from 139.26 million in the fourth quarter of 2018 to 148.86 million in the first quarter of 2019.[5] Netflix announced that it was forecasting global streaming paid memberships to increase by 5 million to 153.86 million in the second quarter of 2019, even though the Board decided to increase the subscription price for U.S. consumers.[6]

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1 Complaint at 2, *Levoi v. Netflix, Inc.* (U.S. District Court Cal. Northern Dist., San Jose Division, 2019, No. 5:19-CV-07303.

2 *Id.*

3 *Id.* at 2-3.

4 *Id.* at 6

5 *Id.*

6 *Id.*

A few months later on July 17, 2019, the Board issued a letter that disclosed Netflix had added only 2.7 million new subscriptions, not the 5 million it had previously forecasted in April.[7] The stock market did not appreciate the missed forecast. In the days after issuing the letter, Netflix stock price dropped from $362.44 a share at close on July 17, 2019 to $315.10 a share at close on July 19, 2019.[8] The July letter also revealed subscription projections were missed more in regions with price increases.[9] Despite the missed forecast, Netflix projected it would add 7 million subscriptions in the third quarter of 2019.[10]

On October 16, 2019, the Board finally admitted that the company was having issues enrolling new subscribers.[11] The Board acknowledged that "retention ha[d] not yet fully returned on a sustained basis to pre-price-change levels, which ha[d] led to slower US membership growth."[12] One of the named defendants, Spencer Neumann, the company's Chief Financial Officer, went even further and admitted that new subscriptions in the U.S. had dropped from the year before, noting that the gap in new subscriptions was almost entirely in the U.S. and that it was "really on the back of the price increase."[13]

The complaint alleges the statements made in the April 16, 2019 stockholder letter and by the CFO in the conference call that day were false and misleading.[14] Specifically, the complaint alleges the Board's statements did not disclose that Netflix would have issues enrolling new subscribers and did not disclose that a recently implemented price increase would increase churn in U.S. subscribers.[15] When the missed forecast was disclosed on July 17, 2019, the complaint claims that the Board continued to make false and misleading statements that attributed the lower subscription numbers to "seasonality," "timing of the content slate," and other past performance metrics being higher than expected.[16]

As officers and directors of Netflix, the leadership team owes Netflix duties of good faith, loyalty, and candor, and is required to use their utmost ability to control and manage Netflix in a fair, just, honest and equitable manner.[17] The complaint accuses the Board and executive officers of knowingly or recklessly violating their obligations to Netflix.[18] Mr. Lovoi asserts that the alleged false and misleading statements by the Board have damaged the company.[19] Between April 18, 2019 and October 18, 2019, Netflix's stock dropped 23.6%, a loss of $37.2 billion in market share.[20] During the same period, Netflix faced two other securities class actions claiming the statements made on April 16, 2019 were false and misleading that Netflix would be able to gain the expected number of new subscribers.[21] The lawsuits exposed Netflix to millions of dollars in

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7 *Id.* at 7.
8 *Id.* at 9.
9 *Id.* at 7.
10 *Id.*
11 *Id.* at 11.
12 *Id.*
13 *Id.*
14 *Id.* at 10
15 *Id.*
16 *Id.*
17 *Id.* at 11
18 *Id.* at 11-12.
19 *Id.* at 11.
20 *Id.*
21 *See* Venkatachalapathy v. Netflix, Inc. et al, Case No. 5:19-cv-4395 (N.D.Ca.); *see also* Wallerstein v. Netflix, Inc. et al, Case No. 5:19-cv-4195 (N.D.Ca.)

legal fees and potential damages.[22] The complaint also asserts that the Board's statements damaged Netflix's credibility and reputation.[23]

In addition to claiming the Board violated its fiduciary duties, Mr. Lovoi claims the Board caused or allowed Netflix to file false and misleading statements with the Securities and Exchange Commission (the "SEC").[24] As officers and directors of a publicly-traded company whose common stock was registered with the SEC pursuant to the Exchange Act, the Board had a duty to not effect the dissemination of inaccurate and untruthful information with respect to Netflix's financial condition, performance, growth, operations, financial statements, business, products, management, earnings, internal controls, and present and future business prospects.[25] The complaint bolsters this claim by stating the Board failed to maintain adequate internal controls and compliance with applicable regulations and therefore violated its fiduciary duty in regards to its reporting requirements.[26]

Mr. Lovoi faces an uphill battle in convincing the court that he, a shareholder, is better situated than the Board to bring a claim on behalf of Netflix. As a general rule, management of a corporation, including decisions concerning prosecution of actions, is vested in its board of directors.[27] When the board refuses to enforce corporate claims, however, the shareholder derivative suit provides a limited exception to the rule that the corporation is the proper party plaintiff.[28] In deference to the managerial role of directors in order to curb potential abuse, the shareholder asserting a derivative claim must make a showing that he or she made a pre-suit demand on the board to take the desired action.[29] Moreover, the plaintiff must plead with particularity the attempts that were made to secure board action before bringing suit, or, alternatively, the factual basis upon which the plaintiff believes that a demand on the board would have been futile.[30]

Although the complaint addressed the relevant elements, the District Court has yet to rule on the matter.

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[22] Complaint at 11, *Levoi v. Netflix, Inc.* (U.S. District Court Cal. Northern Dist., San Jose Division, 2019, No. 5:19-CV-07303.
[23] *Id.*
[24] *Id.* at 15.
[25] *Id.*
[26] *Id.* at 21-22.
[27] *Apple, Inc. v. Superior Court*, 18 Cal.App.5th 222, 231-232 (2017)
[28] *Id.* at 232
[29] *Id.*
[30] *Id.*