No. 11-18034

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

IN RE: ONLINE DVD RENTAL ANTITRUST LITIGATION,

ANDREA RESNICK; BRYAN EASTMAN; AMY LATHAM; MELANIE MISCIOSCIA; STAN MAGEE; MICHAEL OROZCO; LISA SIVEK; MICHAEL WIENER,

Plaintiffs-Appellants,

—v.—

NETFLIX, INC.; WAL-MART STORES, INC.; WALMART.COM USA LLC,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

BRIEF OF DEFENDANT-APPELLEE NETFLIX, INC.

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CORPORATE DISCLOSURE STATEMENT PURSUANT TO FRAP 26.1

Pursuant to Federal Rule of Appellate Procedure 26.1, Defendant-Appellee Netflix, Inc. certifies, through the undersigned counsel, the following:

Netflix, Inc. has no parent corporation.

No publicly held corporation owns 10% or more of Netflix, Inc. stock.

Dated: April 24, 2012

/s/ Jonathan M. Jacobson
Jonathan M. Jacobson

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TABLE OF ABBREVIATIONS

Netflix	Netflix, Inc.
Walmart	Defendants Wal-Mart Stores, Inc. and Walmart.com, LLC, collectively
Walmart.com	Defendant Walmart.com, LLC
PA	The May 2005 Promotion Agreement
VC	A video clip deposition excerpt viewable in question by clicking on the hyperlink on the CD-ROM version of this document
1C (or 2C)	One-at-a-time (or two-at-a-time) DVD rental subscription plan capped at 2 (or 4) DVDs per month
1U, 2U, 3U, 4U	Unlimited DVD rental subscription plans with one-out, two-out, three-out, or four-out at a time, respectively
DVDR	Online DVD rental
ER.	Plaintiffs' Record Excerpts
SER..	Netflix's Supplemental Record Excerpts
App.-Br..	Brief for Plaintiffs-Appellants

PRELIMINARY STATEMENT

Plaintiffs advanced below one theory, and one theory only, of injury-in-fact. They argued that, but for Walmart's exit from online DVD rental, Netflix would have reduced the price of its "three-out unlimited" subscription plan from $17.99 per month to $15.99 no later than May 19, 2005, and that this move would have been accompanied by lower subscription prices on all of Netflix's other plans too. That Plaintiffs relied only on this one theory was no accident. Having procured class certification, they had to prove *classwide* injury – that *all* persons who had Netflix subscriptions at any time from May 19, 2005 through September 30, 2010 suffered injury. The argument that Netflix would have reduced prices to all its subscribers by May 19, 2005, was the only route they advanced for doing so.

The problem Plaintiffs faced, however, was that their one theory of injury was preposterous. Netflix's major competitor at the time was Blockbuster, with an online rental share of 20% and growing rapidly. Blockbuster's comparable 3U plan was priced at $14.99, well below Netflix's, and even included two free in-store rentals. Notwithstanding that intense competition, Netflix elected to stay at $17.99. Walmart, in contrast, had just a 1.5% share, and its inferior online DVD rental service was dwindling rapidly. Its 3U price of $17.36 was much higher than Blockbuster's and not very different from Netflix's. In its retreat, moreover, Walmart was no longer even accepting new 3U subscriptions and had cancelled all

expansion plans. Plaintiffs' theory was that, even though Netflix declined to reduce its price in the face of a $14.99 price from a large and growing competitor, it would have reduced its price well below the $17.36 price of a tiny and shrinking rival, had that rival not exited.

The district court properly rejected Plaintiffs' theory. It "conclude[d] that no reasonable juror could believe that Netflix would have lowered its 3U price to $15.99 in response to continued competition from Walmart, whose 3U price was set at $17.[36] – particularly when [the undisputed] facts demonstrate that Netflix chose *not* to lower its price in the face of Blockbuster's $14.99 price cut." ER28 (emphasis in original). Tellingly, there is no attempt to support Plaintiffs' theory, or to challenge the district court's reasoning rejecting it, anywhere in Plaintiffs' 65-page brief. Plaintiffs' failure to raise a triable issue as to the fact of injury was manifest, as their inability to defend their one theory here confirms.

Plaintiffs' case on antitrust violation was wholly insufficient as well. There was no "market allocation," just a joint promotion agreement with a simple acquisition by Netflix of Walmart's subscriber base. And there was certainly no harm to competition. Prices declined, output increased, and quality and service all improved. Walmart's exit had no effect. It had but a 1.5% share, never had more than 60,000 subscribers, never led any competitor to respond in any way after it

entered, and had made an independent decision to exit (as confirmed by a formal accounting reserve taken on its books) *prior* to any agreement with Netflix.

Walmart's impact was so trivial that Netflix felt compelled to issue a press release alerting the public that their agreement was not a material event for investors. And the consequent lack of any potential harm to competition led the Federal Trade Commission and, later, two state attorneys general to abandon any investigation of the transaction. This, then, appears to be the first case in history to challenge a transaction not only deemed benign by government antitrust officials, but specifically announced to the investing public as immaterial.

The ruling below granting summary judgment was correct and should be affirmed.

COUNTERSTATEMENT OF THE CASE

STATEMENT OF FACTS

The evidence is of course viewed in the light most favorable to the Plaintiffs; and they are given the benefit of all reasonable inferences. Here, however, Plaintiffs have gone far beyond what the law allows. Many of their arguments are not only at odds with the uncontroverted evidence; they are often contrary to the very evidence they cite – and in some cases reflect supposed facts that are simply made up. The following counterstatement, in contrast, is based on facts that are either undisputed or uncontroverted on the record.

Initial years. Netflix was founded in 1997 as an online service to deliver movies and other video entertainment to consumers. SER1557/¶¶ 2-3; SER970, 973. Initially, Netflix offered DVD-by-mail rentals under a pay-per-rental model, and sold DVDs as well. SER1557/¶ 3. At first, Netflix was not successful, leading its co-founder, Reed Hastings, to assume the role of Chief Executive Officer in late 1998. *Id.* One of Hastings' first actions as CEO was to cease selling new DVDs; he had concluded that Netflix needed to focus its business on developing and offering a quality online DVD *rental* business. *Id.* ¶ 4; *see also* SER313-14/34:14-35:3 (VC). Hastings also believed that DVD sales would be a distraction in an area in which Netflix had no competitive advantage and faced formidable and larger competitors, such as Amazon. SER1557/¶ 4. Netflix discontinued new DVD sales in 1999, and also changed to a subscription rental model rather than pay-per-rental. *Id.* ¶ 5. Netflix eventually became popular with consumers and began experiencing robust growth.

After deciding to stop selling new DVDs, Netflix entered into promotional arrangements with some major sellers of new DVDs and DVD players to help expand its rental business. SER1558/¶ 6. In 1998, when Netflix was still a small startup, it entered an agreement with Amazon for promotion of Netflix on the Amazon website; Netflix, in turn, agreed to promote DVD sales by Amazon. *Id.* When that agreement terminated, Netflix entered into an agreement with

Musicland providing for Musicland's promotion of rentals through Netflix and Netflix's promotion of DVD sales by Musicland. *Id.* In 2001, Netflix entered into a similar arrangement with Best Buy. *Id.*; SER975-1001. After termination of the 1998 Amazon agreement (which specifically precluded new sales), there was no contractual impediment to the sale of new DVDs by Netflix. SER1558-59/¶ 7. Nor did Netflix ever have any informal understanding with anyone that Netflix would not sell new DVDs. *Id.* Since 1999, however, Netflix's senior management has continuously held the strong belief that Netflix should not be in the business of selling new DVDs, and, although the subject has come up from time to time, Netflix has never seriously reconsidered that decision. *Id.*; SER324-29/319:8-321:13 (VC), 327:2-329:22.

Walmart enters. In June 2003, Walmart launched its own online DVD rental service. SER1003. The price for Walmart's 3U plan was $18.76/month, lower than Netflix's 3U plan, which was priced at $19.95/month. SER944. Although well-feared before it actually entered, it quickly became apparent that Walmart was having no competitive impact. Netflix did not lower prices in response, and, in fact, Netflix's first price change thereafter was to *increase* its 3U plan to $21.99 in June 2004. *Id.*; SER1559-60/¶¶ 9-11. Netflix executives observed consistently that Walmart's DVDR service was insignificant and not a threat. Walmart had inadequate service levels and catalogue depth, and Netflix's

analysis of its cancellation data confirmed that Walmart was not a factor in subscribers' decisions to cancel their Netflix service. SER1559/¶ 9; SER1005 (Walmart's "[c]ustomers state[d] they would rather pay the $1 or $2 more a month with Netflix and get the guaranteed 1 to 2 day delivery turnaround" and found the site "not customer friendly"); SER1008-12; SER1024; SER339-41/174:19-176:8.

Blockbuster and the threat of Amazon entry. In August 2004, Blockbuster entered the online DVD rental business, offering a 3U plan at $19.99 that also included two free coupons monthly for in-store rentals. SER1097-99. In October 2004, concerned by seemingly reliable reports that Amazon.com was also about to enter DVDR, Netflix slashed its price for the 3U plan from $21.99 to $17.99. SER1100-07; SER1560-61/¶¶ 13, 16. Shortly thereafter, Walmart lowered its 3U price to $17.36, and Blockbuster lowered its price to $17.49. SER944. Walmart was not a factor in Netflix's decision to reduce price. All of Netflix's internal decision-making documents, as well as the relevant testimony, established beyond dispute that the price reduction was due to the competition from Blockbuster and the threatened entry of Amazon. *See, e.g.*, SER1100-07; *see also* SER1561/¶ 15.

October 2004 meeting. On October 27, 2004, Hastings met with John Fleming, the CEO of Walmart.com, in pursuit of an alliance to improve Netflix's ability to compete against Amazon. SER1562-63/¶¶ 17-19; SER1111. Hastings believed that Walmart could see that its online DVD rental service was not gaining

traction, and he suggested developing an arrangement that would help Walmart to compete with Amazon in sales of DVDs, while helping Netflix to compete against Amazon in online DVD rentals. SER1562/¶ 17; SER1111. Hastings also sought to gauge whether Walmart might be looking for a suitor to acquire its rental subscriber base. SER1562/¶ 17; SER316-17/170:18-171:21 (VC). However, Fleming informed Hastings at that meeting that Walmart was not interested in pursuing any transaction with Netflix. SER317-18/171:22-172:6 (VC). No agreement was reached, and there was no plan for follow up. *Id*; SER492/78:3-17; SER1562-63/¶ 19. During the course of that meeting, the subject of new DVD sales by Netflix never came up. SER1562-63/¶ 19; SER364-65/20:5-21:6 (VC).

Walmart decides to exit. In late 2004, and following the October meeting, Walmart was pursuing a different partnership – one with Yahoo! Walmart understood that its online DVD rental business was failing. SER394-95/121:16-122:12; SER402/14:3-15 (VC). Its subscriber base had never even reached 60,000 subscribers – compared to over 2,000,000 for Netflix and over 400,000 for Blockbuster – and was in decline. SER924-25/¶¶ 23, 32, 41. In addition to the Yahoo! arrangement, it was also considering just exiting the business. SER416-17/127:12-128:8.

On December 22, 2004, Blockbuster announced a dramatic price cut, reducing its 3U price to $14.99. SER1113-14. Already a fast-growing competitor,

Blockbuster hoped that the lower price would increase its subscriber growth even more. SER437-38/194:20-195:8. Netflix, however, chose to keep its 3U plan price at $17.99. SER944; SER66; SER51-53. Walmart was not a factor in either Blockbuster's decision or Netflix's. SER51-53; SER1116; SER1120; SER442/347:3-14.

The Blockbuster price cut was devastating to Walmart.com. As CEO Fleming put it, the price cut "changed the world for us" by "[taking] all the economics out of it," and became "the tipping point for we gotta get out of this." SER382-84/249:15-251:20 (VC). It effectively ended Walmart's ability to consummate the marketing partnership it had been negotiating with Yahoo! by rendering that proposal unprofitable for both sides. SER403/16:10-24 (VC); *see also* SER1179-85; SER1184-85. And with or without Yahoo!, *all* of Walmart's projections indicated sharp reductions in both subscribers and revenue, with heavy financial losses. SER1187-88.

In January 2005, Walmart.com made the decision to exit the online DVD rental business. SER366/23:4-9 (VC), 30:8-11 (VC); SER1190; SER405/24:17-19 (VC); SER431-32/121:11-122:12 (VC). It elected not to match Blockbuster's $14.99 3U price but, instead, to keep its 3U price at $17.36 and to eliminate new sign-ups for its 3U and 4U plans. SER1190. It lowered its 2U price to $12.97 in order to hold on to enough customers to have a business to sell, but decided not to

promote the new price point. *Id.* As one of the steps in the shutdown, Walmart decided to "have conversations with BBI [Blockbuster] and NFLX to figure out what subs are worth and disc salvage value is." *Id.*

Walmart made the shutdown decision independently, and not as a result of any discussions or agreements with Netflix. SER371/33:2-11. In fact, at the time of the shutdown decision, there were no discussions between Netflix and Walmart. SER1564-65/¶¶ 23-24; SER365/21:7-16, 37:10-14; SER493/79:6-13. Walmart formalized the decision by recording a financial reserve on its books to cover the losses from the closure; the reserve was effective January 31, 2005 (the end of its fiscal year). SER370-71/32:6-33:1; SER1192; SER406/26:1-13. No one from Netflix knew. SER373-75/36:13-38:2 (VC).

Promotion Agreement. After the brief October 2004 meeting, the next substantive communication between Hastings and Fleming was on February 9, 2005. SER1565/¶ 24; SER365/21:7-16, 37:10-14. Hastings renewed his approach to Fleming notwithstanding Fleming's prior rejection because he believed that recent changes in the business might lead Walmart to change its mind. SER1564/¶ 23. During their February 9 meeting, in order to preserve bargaining leverage, Fleming did not inform Hastings that Walmart had already decided to leave the business. SER373-75/36:13-38:2 (VC); SER1194-96. No agreement was reached

during that meeting, but Fleming expressed willingness to continue discussions. SER1565/¶ 25.

By March 17, 2005, Hastings and Fleming reached a verbal agreement in principle. SER1566/¶ 27; SER1201. The agreement provided that Walmart DVD rental subscribers would be transitioned to Netflix, if they so chose, at the same price as their Walmart subscription, and Netflix would import their rental selection "queues." SER1566/¶ 27. Netflix would pay Walmart for each subscriber that elected to transfer or who was referred through promotions on the Walmart website. *Id*. Finally, Netflix would provide some limited promotion for Walmart DVD sales. *Id.*; SER1201. There was nothing regarding sales of DVDs by Netflix. There were no covenants not to compete. SER1566-67/¶¶ 28-29; SER1201. Walmart remained free to re-enter online DVD rentals at any time. SER1566-67/¶ 29; SER305/§ 3.14; SER378/43:3-20. Importantly, the agreement provided a "soft-landing" for Walmart subscribers. SER376-77/39:19-40:15; SER353/53:9-22; SER321/240:7-12. Rather than be left with nothing upon Walmart's exit, they had the option of continuing with an objectively superior service at their pre-existing price.

The final written agreement mirrored the terms of the verbal agreement: there were no covenants not to compete; nothing in it even addressed (much less prohibited) new DVD sales by Netflix; and nothing restricted Walmart from

offering an online DVD rental service. SER301-10; SER1566/¶ 27; SER348-50/127:19-129:20. Netflix agreed to pay a 10% revenue share to Walmart for each subscriber who transferred, and a $36 bounty for each new subscriber gained through Walmart referrals. SER305/§§ 3.12, 4.2. The Promotion Agreement ("PA") was publicly announced May 19, 2005. SER1203-04. Later the same day, Netflix issued a separate press release warning investors that the PA was not material to its financial performance due to the small number of Walmart subscribers. SER1572-73.

Shortly after the announcement of the PA, the Federal Trade Commission conducted a preliminary inquiry to determine whether there were grounds for a formal investigation. SER1539-40/¶¶ 3-5. The FTC decided not to issue a civil investigative demand, and took no further action. *Id.* Later, in 2009, after this action was filed, Netflix received communications from the attorneys general of Florida and West Virginia seeking additional information. SER1540-41/¶¶ 6-14. After learning the facts concerning the absence of any market allocation or competitive impact, these agencies likewise declined to pursue investigations. *Id.*

When Walmart exited in mid-2005, Netflix did not increase its prices. Its 3U price remained at $17.99 from November 2004 (well before Walmart's exit) through July 2007, when it decreased the price to $16.99 following a similar price reduction by Blockbuster. SER944. Over time, Netflix's prices all decreased, led

by its new, low-cost ($9.99) 1U plan, which became (by far) its most popular. At the same time, Netflix significantly increased the value provided to its subscribers by adding the functionality of "Watch Instantly" video streaming over the Internet for no extra charge. SER925-27/¶¶ 24-25, SER940-41/¶ 138. Today, Netflix is primarily a streaming company; its subscribers watch more hours of video streamed over the Internet than they do on DVDs sent through the mail. SER1568/¶ 36; SER1206; SER1210; SER1212-13. One of Netflix's competitors is Walmart, which in February 2010 acquired Vudu.com, a service that offers movie rentals to consumers through Internet streaming. SER422-23/111:3-112:13; SER1566-67/¶ 29.

PROCEEDINGS BELOW

The initial complaint in this MDL was filed on behalf of a putative class of Netflix subscribers on January 2, 2009. SER1771-93. Several other essentially identical complaints were filed, and the JPML centralized the cases in the court below. The consolidated amended complaint, filed May 27, 2009, alleged violations of Sections 1 and 2 of the Sherman Act, all based on the May 19, 2005 PA between Walmart and Netflix. ER1480-507. In May 2009, the same Plaintiffs' counsel filed more complaints, advancing the same allegations, on behalf of a putative class of Blockbuster subscribers. SER1742-70.

To make the case expensive to defend, Plaintiffs' discovery strategy was no-holds barred, and massive discovery ensued. SER1731-37; SER245-61. Netflix alone produced well over 15 million pages of documents. Forty-three depositions were taken. Walmart succumbed and settled right before the class certification hearing. SER1738-41. On December 23, 2010, the court certified a class of all Netflix subscribers from May 19, 2005 to September 30, 2010. SER1712-30. On April 29, 2011, the court granted summary judgment for Netflix against the putative Blockbuster class for lack of standing due to the unduly speculative nature of the injuries alleged. SER1610-25. Plaintiffs appealed that ruling, but later dismissed the appeal in return for forgiveness of court costs. SER1-3; SER7-9.

During the course of 2011, Plaintiffs submitted their expert reports. The report of their economist, Dr. Beyer, asserted damages on behalf of all Netflix subscribers from May 19, 2005 to September 30, 2010, in a range from $493.5 million to $654.2 million (or $1.48 billion to $1.96 billion after statutory trebling). SER653. All damages were premised on the conclusion that "Netflix would have lowered its 3-out unlimited plan price to $15.99" by May 19, 2005. SER609-10/¶ 93. No equitable relief was sought.

Netflix moved for summary judgment, arguing that Plaintiffs had failed to raise any issue of fact as to (i) a violation of the antitrust laws, or (ii) injury-in-fact. Netflix also moved to exclude the testimony of Plaintiffs' experts under FED. R.

EVID. 702. The court (i) held there was no per se violation, (ii) declined to reach the rule of reason; and (iii) granted summary judgment for failure to raise a triable issue as to fact-of-injury. ER13-30. As to the experts, the court concluded that, "[b]ecause Netflix has taken the opportunity to challenge the factual assumptions underlying [economist] Beyer's report, and the lack of evidence in the record to support those assumptions, it is not necessary to exclude the report." ER32. The court reached the same conclusion as to Plaintiffs' marketing expert, Dr. Gundlach. *Id.*

This appeal followed.

SUMMARY OF ARGUMENT

1. The one theory of injury-in-fact Plaintiffs asserted below was that, if Walmart had not exited, Netflix would have lowered its prices on all its subscription plans no later than May 19, 2005. This was the only theory they advanced to suggest the *classwide* injury-in-fact that Plaintiffs' class action status required. The theory, however, had no support in the evidence. It presupposed that, even though Netflix did not lower prices in response to the $14.99 price of Blockbuster, a large and growing competitor, it would have lowered prices in response to the continued presence of Walmart, a company with a rapidly-declining 1.5% share. That theory made no sense; was properly rejected below; and is not even defended by Plaintiffs in their brief on this appeal.

2. The judgment should be affirmed as well on the additional ground that there was no issue of fact as to any antitrust violation.

(a) As the district court correctly held, there was no per se illegal "market allocation" agreement. This was a joint promotion agreement, with output-enhancing attributes that preclude per se condemnation. There was, moreover, no evidence that Netflix agreed not to sell new DVDs; and the uncontroverted evidence was that Walmart's decision to exit was independent and made *before* any agreement with Netflix was reached.

(b) The evidence also demonstrated beyond genuine dispute that there was no harm to competition and, thus, no basis for any claim of illegality under the rule of reason. It was undisputed that: prices declined; output increased dramatically; and the levels of service, quality, and innovation all improved. Walmart's exit from DVDR was competitively irrelevant. Plaintiffs' own economic expert conceded "that there [was] no competitive response in terms of price change, plan change, quality change or anything else that Netflix did that's attributable to any action taken by Wal-Mart while it was in the online DVD rental space." SER507/184:6-16 (VC). Walmart's share was trivial and declining, and its decision to exit was independent and unilateral – made after having concluded that its prospects for expansion were poor, that it would

continue to lose subscribers, and that any effort to stay in the business would generate many millions of dollars of additional losses.

3. Plaintiffs' effort to add a new theory that Netflix's early agreements with Amazon, Musicland, and Best Buy were illegal fails on both procedure and substance. The theory was not raised in the complaint, and appeared for the first time after the close of fact discovery – precluding Netflix from any opportunity for discovery. This Court's decisions forbid evasion of summary judgment by asserting new theories not alleged in the complaint. The theory, moreover, is substantively meritless. The agreements were entered into long before any alleged relevant "DVDR market" existed; and they were plainly lawful as standard joint promotion arrangements.

ARGUMENT

I. NO INJURY-IN-FACT

A. PLAINTIFFS HAD TO PROVE CLASSWIDE INJURY

There was no antitrust violation in this case. But even if there had been one, Plaintiffs were also required to prove injury-in-fact on *each* of their claims – and they did not do so. As this Court held in *Rebel Oil Co. v. Atlantic Richfield Co.*, 51 F.3d 1421 (9th Cir. 1995), "causal antitrust injury . . . is an element of all antitrust suits brought by private parties." *Id.* at 1433; *accord, e.g.*, *J. Truett Payne Co. v. Chrysler Motors Corp.*, 451 U.S. 557, 562 (1981). And while a plaintiff is entitled

to some leeway in estimating the *amount* of the damages, the *fact* of injury must be proven "with reasonable certainty." 2A P. AREEDA & H. HOVENKAMP, ANTITRUST LAW ¶ 392, at 332 (3d ed. 2007); *accord, e.g.*, *Nw. Publ'ns, Inc. v. Crumb*, 752 F.2d 473, 476-77 (9th Cir. 1985); *In re Coordinated Pretrial Proceedings in Petroleum Prods. Antitrust Litig.*, 691 F.2d 1335, 1341 & n.7 (9th Cir. 1982). The violation "need not be the sole cause of the injury, but it must be a material and a substantial cause" and, in any event, the *existence* of the claimed injury itself must be established. ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS 756-57 (7th ed. 2012).

This case, moreover, is not brought by a single plaintiff alleging harm only to itself. It is brought by a class of some 33 million Netflix subscribers over the course of a five-year period. SER1627. Certifying a class of that magnitude allowed Plaintiffs to wield the threat of a massive treble-damage judgment, but it also imposed a critical requirement: specifically, Plaintiffs had to establish *classwide* injury-in-fact. *E.g.*, *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2554-56 (2011) (requiring proof that "all the individual . . . decisions" were unlawful); *In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305, 311-12 (3d Cir. 2009) (proof of injury at trial must be "common to the class rather than individual to its members"); *In re New Motor Vehicles Canadian Export Antitrust Litig.*, 632 F. Supp. 2d 42, 56, 58 (D. Me. 2009) (summary judgment granted where plaintiffs

failed to "provide evidence that *each transaction sales price* was affected by the agreement" and thus failed to prove that "*all* class members paid a higher price").

Common proof of injury in this case was inherently difficult. There were but three million subscribers on May 19, 2005, the start of the class period, SER654-63, but 15 million by the end of the period, September 30, 2010. *Id*. And while the total number of Netflix subscribers – the class members – grew dramatically, there was constant attrition as well. Netflix gained subscribers overall but still suffered thousands of cancellations every day. *E.g.*, ER1071. As a result, by September 2010, the total number of class members, including both current subscribers and the many who had cancelled at some point after May 2005, was some 33 million. SER1627.

To demonstrate classwide injury, Plaintiffs needed to use a methodology that would allow them to claim that a subscriber on May 19, 2005 who cancelled, say, a month afterwards, paid higher subscription prices for that brief period; and that, as another example, a subscriber who might have joined four years later also incurred the same harm. And since Netflix offered multiple subscription plans, Plaintiffs had to show that all subscribers to all plans paid higher prices as a consequence of Walmart's exit. SER1645-47/¶¶ 25-29; SER650-63. Plaintiffs were not required to prove the precise amount of the predicted price effects, *cf.* App.-Br. 41 n.7, but they were required to offer legally sufficient evidence that prices to all 33 million

class members would have been reduced in some amount by May 19, 2005. *See Gerlinger v. Amazon.com Inc.*, 526 F.3d 1253, 1255-56 (9th Cir. 2008) (Amazon took over Borders' online sales, challenged as "market allocation"; case dismissed for failure to prove that prices increased as a result).

The *only* method for proving classwide injury put forth by Plaintiffs was a theory (i) that Netflix would have reduced its 3U price from $17.99 to $15.99 no later than May 19, 2005 (the date of the PA); (ii) that Netflix would have reduced prices on all plans at the same time; and (iii) that Netflix's prices on all plans would have continued to be lower at all times through September 30, 2010. SER595-609/¶¶ 66-92; SER710-21/¶¶ 80-102; ER241-45. This was the theory that Judge Hamilton considered and properly rejected as unreasonable and contrary to the undisputed facts. ER22-29.

B. PLAINTIFFS' $15.99 THEORY WAS PROPERLY REJECTED

The idea that Netflix would have reduced its 3U price to $15.99 (or at all) by May 2005 had no basis in reality.

The undeniable truth is that Netflix chose *not* to lower its $17.99 price even in the face of Blockbuster's $14.99 price, two free rentals, and aggressive marketing – all at a time when Blockbuster's subscriber share was 20% and growing. There was nothing to suggest why the continued presence of *Walmart* in DVDR would have had an impact on *Netflix's* pricing by May 2005 given the

undisputed facts that (i) Walmart's share was 1.5% and declining (SER935-36/¶ 76 & Chart 4), (ii) Walmart's 3U price was $17.36 (not $14.99 or even $15.99) (SER944); (iii) Walmart was no longer allowing customers to sign up for its 3U and 4U plans (SER1190); (iv) Walmart had cancelled all expansion plans (SER489-90/40:25-41:7 (VC)); (v) Walmart's projections for the future indicated millions of dollars of losses and no prospect of gaining meaningful market share (SER1263; SER496-97/116:18-117:19); (vi) Walmart took a reserve for closing its DVDR business effective January 31, 2005 (SER426-28/121:11-123:9); (vii) Netflix had never lowered price in response to Walmart even when Walmart was trying to grow (SER507/184:6-16 (VC)); and (viii) none of Netflix's contemporaneous documents considering a 3U price decrease gave Walmart (as opposed to Blockbuster and Amazon) any consideration. SER1116; SER46-58.

In arguing that an early 2005 price decrease was "likely," Plaintiffs ignore the fact that *none* of the documents they cite *even mentions* Walmart as a factor in Netflix's consideration of a lower 3U price. App.-Br. 12, 29 (citing ER445-46, 988-89, 995, 997, 998-99, 1007, 1390). Instead, *all* of the documents they cite, and *all* other contemporaneous documents, reflect that lower price points on the 3U plan were considered *only* because of the BBI $14.99 price and, to a lesser extent, the continued concern over potential competition from Amazon. *See also* SER1116; SER46-58. And Plaintiffs just ignore the plainly undisputed fact that,

notwithstanding Netflix's serious concerns over the impact of BBI's $14.99 price, a 3U plan price reduction was *rejected* – again for reasons having nothing to do with Walmart. *E.g.*, SER1116; SER46-53; SER66. Netflix concluded that its "only shot at profitability for [2005] is to stay at $18," and therefore decided to "[s]tay at $18 unless we are going to miss [the 2005 year-end goal of four million] subs materially" (a prospect that never materialized). SER53; *see* SER66.

Plaintiffs try to make much of internal January 2005 comments that Netflix "would 'find some way to make lemonade from having to go to $16'" if it had to and, from one executive, that she thought a price decrease was '"more likely than not.'" App.-Br. 29 (quoting ER988-89, 1007). But none of these statements had anything to do with Walmart. As Judge Hamilton pointed out correctly, "the internal Netflix discussion over whether to lower its price to $15.99 following Blockbuster's price drop, even if substantial, was (1) in response to Blockbuster (not Walmart); (2) always couched in terms of possibility; and (3) never actually occurred." ER28. There is just no evidence to suggest that Walmart played any role when Netflix was considering a lower 3U price point, or that its continued presence would somehow have made a difference.

The one document Plaintiffs cite in this time period that even mentions Walmart pricing is an email from Mr. Hastings noting Walmart's reduction of its 2U price to $12.97. App.-Br. 11 (citing ER982). But noting that fact is all the

email does. There was no suggestion there, or anywhere else, that Netflix respond in any way. Before Walmart's move, Netflix already had a lower price point ($11.99) for its 2C plan (SER944), which authorized four discs a month, comparable to the 4.3 disc average usage on Walmart's 2U plan (SER70). So, on comparable plans, Netflix was already priced lower. There is no evidence – not a single document or testimony – that Netflix paid the $12.97 2U price *any* attention in considering its competitive strategy.

C. PLAINTIFFS' ARGUMENTS ARE MISDIRECTED

Other than passing references to the price reduction Netflix considered in response to Blockbuster, App.-Br. 12, 29-30, 41-42 & n.7, Plaintiffs never address the core holding of the court below – that the one theory of injury Plaintiffs advanced had no grounding in reality.

Plaintiffs argue at length that the PA was "a material cause" of "at least some" injury. *E.g.*, *id*. 41 n.7, 44. They assert that Walmart was a nontrivial competitor, that it might have grown to be significant at some undetermined future point, that the PA resulted in a less competitive "two-firm" market, that Netflix had an "intent to harm competition," and that their experts reasonably concluded that injury was incurred. *Id.* 25-45. None of this is even close to correct for reasons explained below. But even if it were, Plaintiffs do not address their problem.

Having secured class certification, it became Plaintiffs' burden to raise a genuine issue of material fact as to *classwide* injury. The one theory they advanced in that respect was that, if Walmart had continued DVDR operations, Netflix's 3U price would have been reduced to $15.99 by May 2005 and all other plans reduced then as well. No other theory was before the court below.

Plaintiffs' brief never even addresses that point. They make no effort to explain why, if Netflix chose not to reduce its 3U price in response to the very serious threat from the much lower ($14.99) price of its largest and growing rival (Blockbuster), it would ever lower its $17.99 price because of the $17.36 price of a tiny and shrinking rival. The fact of injury must be proven with "reasonable probability," not speculation. *Petroleum Prods.*, 691 F.2d at 1341 & n.7; *see, e.g.*, *Greater Rockford Energy & Tech. Corp. v. Shell Oil Co.*, 998 F.2d 391, 404 (7th Cir. 1993). Here, the argument was not just speculative; it was absurd. Plaintiffs' effort to bury it serves only to confirm the correctness of the ruling below.

II. NO VIOLATION OF THE ANTITRUST LAWS

Plaintiffs' Sherman Act claims required them to demonstrate a violation under either the "per se rule" or the "rule of reason." *Texaco Inc. v. Dagher*, 547 U.S. 1, 5 (2006); *Paladin Assocs., Inc. v. Mont. Power Co.*, 328 F.3d 1145, 1154-56 (9th Cir. 2003). The district court held correctly that there was no per se violation, ER13-16, but declined to reach the question whether there was sufficient

evidence to support a claim under the rule of reason, ER20-22. For the reasons stated here, there was no evidence to suggest a violation under either analysis, and the judgment may appropriately be affirmed on that alternative ground.

A. No Per Se Violation

Plaintiffs argue that the PA was a horizontal division of markets and, on that basis, illegal per se. The court below correctly held otherwise.

1. Requirements for Per Se Illegality

Netflix is aware of no case, and Plaintiffs cite none, holding a joint promotion agreement to be illegal per se. Indeed, as the Supreme Court has made increasingly clear over the past 35 years, the scope of per se illegality is narrow. Per se analysis applies only where the "practice facially appears to be one that would always or almost always tend to restrict competition and decrease output" rather than "one designed to 'increase economic efficiency and render markets more, rather than less, competitive.'" *Nw. Wholesale Stationers, Inc. v. Pac. Stationery & Printing Co.*, 472 U.S. 284, 289-90 (1985) (citations omitted); *Broadcast Music, Inc. v. CBS, Inc.*, 441 U.S. 1, 19-20 (1979) ("*BMI*"); *Paladin*, 328 F.3d at 1154-55. Moreover, "[p]er se treatment is proper only '[o]nce experience with a particular kind of restraint enables the [c]ourt to predict with confidence that the rule of reason will condemn it.'" *Cal. ex rel. Harris v. Safeway, Inc.*, 651 F.3d 1118, 1133 (9th Cir. 2011) (en banc) (citations omitted). If

the arrangement is "'"not a naked restraint of trade with no purpose except stifling of competition,'" the rule of reason applies. *Id.* at 1137 (quoting *BMI*, 441 U.S. at 19-20). And any "'departure from the rule-of-reason standard must be based upon demonstrable economic effect rather than . . . upon formalistic line drawing.'" *Harris*, 651 F.3d at 1134 (quoting *Leegin Creative Leather Prods., Inc. v. PSKS, Inc*., 551 U.S. 877, 887 (2007)).

These principles apply with equal force whether the agreement is characterized by plaintiff as "market allocation" or something else. As this Court recently held in *Harris*, per se condemnation is confined to "classic" horizontal market division agreements, which "are ones in which 'competitors at the same level agree to divide up the market for a given product.'" 651 F.3d at 1137 (quoting *Metro Indus., Inc. v. Sammi Corp*., 82 F.3d 839, 844 (9th Cir. 1996)). "But where, as here, 'the conduct at issue is not a garden-variety horizontal division of a market, we have eschewed a *per se* rule and instead have utilized rule of reason analysis.'" *Id.* (citation omitted).

A ruling that joint promotion agreements between actual or potential competitors are illegal per se would have far-reaching implications. These agreements are common. Microsoft promotes Facebook in return for Facebook's use and promotion of Microsoft's "Bing" search. ABC produces TV shows shown on CBS, and the two rivals promote those shows. The arrangements are used so

frequently, in fact, that contract forms for their drafting are widely available. *E.g.*, docs.biztree.com/templates/checklistdrafting-joint-promotion-agreements/5216/. Yet per se condemnation would outlaw them all. Plaintiffs, unsurprisingly, cite no authority for the proposition that joint promotion agreements are "market allocations" and illegal per se.

2. Output-Enhancing Efficiencies

The agreement here was no "garden-variety division of markets." On the contrary, its features were output-enhancing. The very first conception of the PA, an internal email from Mr. Hastings, captured its ultimate focus. It said: "[C]an we help [Walmart] sell more against amazon if they help us rent more against amazon?" ER945. All the subsequent evidence is consistent with that output-enhancing objective; and Plaintiffs have offered no contrary evidence.

As the district court pointed out, ER17-19, the PA here had features designed to increase output in both online DVD rentals and DVD sales, precluding any characterization as a "market division" with no redeeming virtues. *Leegin*, 551 U.S. at 886; *BMI*, 441 U.S. at 19-20. Output in rentals was increased by Walmart's promotion of the Netflix service, and by providing a "soft landing" for Walmart subscribers – a major consideration for a consumer-focused company. SER373-77/36:10-40:15; SER353/53:9-22; SER321/240:7-12. Walmart customers were allowed seamlessly to join Netflix at the same price they had paid previously;

to maintain their rental queues; and to enjoy Netflix's service levels – rather than abruptly losing their accounts and service. The arrangement therefore left no subscriber worse off, and provided added value to those who elected to switch.

On the DVD sale side, the agreement increased output through the parties' options to promote DVD sales through Walmart. Once the agreement was entered into, Netflix promoted Walmart DVD sales through a banner on its website and advertising copy on its ubiquitous DVD-mailer envelopes, SER102-08, thus expanding DVD output by enhancing Walmart's sales.

These consumer benefits could not have been achieved without the agreement and preclude per se treatment. *Nw. Wholesale Stationers*, 472 U.S. at 293-95; *Northrop Corp. v. McDonnell Douglas Corp.*, 705 F.2d 1030, 1050-53 (9th Cir. 1983) (agreement that restricted Northrop to selling one type of aircraft and McDonnell Douglas to another had procompetitive merit).

3. Plaintiffs' Contrary Arguments Are Meritless

Plaintiffs' per se argument has two parts: first, that Netflix agreed not to sell new DVDs in return for Walmart's promise to exit DVDR; and second, that Walmart's exit from DVDR alone was illegal per se. App.-Br. 45-61. In light of the considerations just discussed, none of these points would justify per se condemnation in any event. But even on their own terms, the arguments do not hold up.

No quid-pro-quo. The evidence that Netflix did *not* agree to refrain from new sales is uncontroverted. Plaintiffs' own expert expressly admitted the lack of evidence of any commitment by Netflix to Walmart to refrain from selling new DVDs. SER486-88/29:12-31:18 (VC). The testimony is unequivocal from both Walmart and Netflix that the subject was *never even discussed* and, in the millions of the documents produced, there is nothing remotely hinting otherwise. SER1562-63/¶¶ 19, 28-29; SER364-65/20:5-21:6 (VC), 43:3-20; SER1201; SER305/§ 3.14; SER394/121:1-15, 126:17-127:14; SER407-09/36:22-38:2 (VC).

Plaintiffs have no answer to that point, and so they have made one up. They assert that, at the February 9, 2005 Hastings-Fleming meeting, "[a]t a minimum, Hastings communicated to Fleming that, as part of an agreement, Netflix would not resume selling new DVDs." App.-Br. 13. The argument is pure fabrication. Plaintiffs cite no evidence, and there is no evidence, to support it. All the evidence is to the contrary.

Plaintiffs' supposed "direct" evidence of an agreement by Netflix to refrain from new sales is the PA itself and related documents, including the companies' joint press release, touting the fact that Walmart agreed to promote Netflix and Netflix, in turn, agreed to promote Walmart DVD sales. App.-Br. 13, 46-47, 52 (citing, *e.g.*, ER1128 ("we are the rental business, they are the sell-through business")). This is direct evidence of *a promotion agreement*, not an agreement

by Netflix to refrain from new sales. *See Toscano v. Prof'l Golfers' Ass'n*, 258 F.3d 978, 983-85 (9th Cir. 2001). It is difficult to imagine how one could have a joint promotion agreement without documents using the same terms and descriptions upon which Plaintiffs rely. There is no "direct evidence" that Netflix agreed not to sell new DVDs. *Abraham v. Intermountain Health Care Inc.*, 461 F.3d 1249, 1258-59 (10th Cir. 2006). Indeed, even if the subject had been discussed, which it was not, evidence of discussions, without more, does not establish conspiracy. *In re Citric Acid Litig.*, 191 F.3d 1090, 1103 (9th Cir. 1999).

Plaintiffs' next assert incorrectly that Netflix was obligated to "clear" with Walmart its sales of *used* DVDs out of excess rental inventory. App.-Br. 55 (citing ER1176, 1179); *but see* SER100-01/158:4-159:8. To the same effect, they point to an earnings call where Netflix CFO McCarthy was asked whether there was "a way Wal-Mart could prohibit you from selling DVD[s] on your site," and responded by inquiring whether the question related to new or used sales, ER1173, an obviously reasonable inquiry since Netflix had just decided to dispose of old discs by selling them. Sales of old DVDs by Netflix in fact began a short while later, ER1176, and no one ever suggested that anything in the PA would inhibit that activity. Nothing in the documents cited addresses the sale of new DVDs; and nothing in them even arguably tends to exclude the possibility of independent action. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 588

(1986) (circumstantial evidence must "ten[d] to exclude the possibility" of independent action).

Plaintiffs ignore the most relevant evidence – the consideration (and, once again, rejection, consistent with management's views since 1999) of new DVD sales by Netflix on several occasions *after* the PA was signed, including November 2005, just a few months afterwards. SER1238; SER1566-67/¶ 29. If new DVD sales had been prohibited through an understanding with Walmart, the subject could never have come up. Plaintiffs' economist had to concede that very point, agreeing that there was no "indication when the issue arose [after May 2005] that there was anything that Netflix had committed to that would inhibit it from selling new DVDs, had it chosen to, at that time." SER486-88/29:12-31:18 (VC).

Plaintiffs attack the district court for relying on the plain text of the PA to support the conclusion that there was no quid-pro-quo arrangement by which Netflix would refrain from new DVD sales. App.-Br. 54. That is a strange argument indeed given Plaintiffs' own reliance on the same text. The fact that the PA contained no covenants not to compete in either DVD sales or DVD rentals, SER301-10, was plainly relevant and the district court was quite correct to consider it. ER15-16.

Walmart's exit alone. Plaintiffs alternatively argue a "*per se* single market allocation theory." App.-Br. 48-50. The argument is that any agreement pursuant

to which one rival exits a business is illegal per se, irrespective of output-enhancing efficiencies. That is not the law.

Every merger or acquisition of a competitor necessarily "eliminates" an actual or potential competitor in a single market. The law is as clear as can be, however, that horizontal mergers are not illegal per se. *E.g.*, *United States v. Gen. Dynamics Corp.*, 415 U.S. 486, 498 (1974). The aspect of the PA that Plaintiffs complain about was the functional sale by Walmart of its subscriber base to Netflix in return for a bounty for converting subscribers, and Walmart's concomitant exit – the precise circumstance one encounters in *every* merger or acquisition. There is no authority, and Plaintiffs cite none, suggesting that this kind of agreement is illegal per se.

What separates the typical acquisition (and consequent exit of the acquired firm) from "market allocation" is a lack of any output-enhancing efficiencies and the parties' *reciprocal* agreement (or quid-pro-quo) to *divide* their markets. *Harris*, 651 F.3d at 1137 ("'Classic' horizontal market division agreements are ones in which 'competitors at the same level agree to divide up the market for a given product.'") (quoting *Metro Indus.*, 83 F.3d at 844); *United States v. Brown*, 936 F.2d 1042, 1045 (9th Cir. 1991). The point was underscored by the Plaintiffs' economist. He admitted that his opinions on harm to competition "no longer holds" absent proof that Netflix agreed not to sell new DVDs, and that, absent such

proof, an acquisition of Walmart's subscriber base would "[p]resumably" be "within the law." SER484-85/12:16-13:20, 134:16-135:14 (VC).

The case on which Plaintiffs rely is *In re Cardizem CD Antitrust Litigation*, 332 F.3d 896 (6th Cir. 2003). App.-Br. 47, 50. That case involved an agreement by a branded drug maker to pay $40 million a year to the sole generic drug maker simply to stay out of the market for the drug. *Cardizem*, 332 F.3d at 900. The court's holding – that the conduct was a naked restraint with no plausible efficiency justification, and therefore illegal per se – is irrelevant here. *Cardizem* involved an arrangement that prevented low-cost entry, harming price and output, and did *nothing else*. The case has no application to a cooperative arrangement designed to increase the output of both contracting parties, as in the case here.

Plaintiffs also criticize the district court's reliance on Walmart's prior independent decision to exit DVDR. App.-Br. 49-50. They attack the fact that the PA's language confirming that preexisting fact "was inserted by *Netflix's* attorneys," *id.*, as if the drafting of a legal agreement by lawyers was particularly sinister. For all the reasons just given, even an explicit agreement that Walmart would exit would not convert the PA into a per se violation. But even so, the district court's reliance on this uncontroverted fact was entirely legitimate. As the court correctly pointed out, Walmart's prior, independent decision confirmed that

the PA was not "a blatant agreement to eliminate Walmart from [DVDR] as a form of market allocation." ER16.

B. NO VIOLATION UNDER THE RULE OF REASON

An agreement will be found to restrain trade unreasonably only if its actual or probable effect is to raise prices, restrict output, reduce quality, or otherwise harm consumers in a significant way. *NCAA v. Bd. of Regents*, 468 U.S. 85, 98-100 (1984); *NYNEX Corp. v. Discon, Inc.*, 525 U.S. 128, 139 (1998); *R.C. Dick Geothermal Corp. v. Thermogenics, Inc.*, 890 F.2d 139, 151-52 (9th Cir. 1989) (en banc) (finding no effect on prices or output); *Sterling Merch., Inc. v. Nestle, SA*, 656 F.3d 112, 121-22 (1st Cir. 2011) (dismissal for "lack of evidence of antitrust injury in the form of either increased consumer prices or reduced output"); *Bhan v. NME Hosps., Inc.*, 929 F.2d 1404, 1414 (9th Cir. 1991). "The core question in antitrust is output. Unless a contract reduces output in some market, to the detriment of consumers, there is no antitrust problem." *Chi. Prof'l Sports Ltd. P'ship v. NBA*, 95 F.3d 593, 597 (7th Cir. 1996). As explained below, it is beyond genuine dispute that the PA did not reduce competition in any significant way.

1. Consumer Welfare Improved on Every Measure

The objective facts are that, in the more than five years between the PA and the end of the class period, output of online DVD rental increased, prices declined, and service, quality, availability, and innovation all improved.

Output. In applying the rule of reason, "the primary inquiry is whether the restraint tends to reduce marketwide output." 11 P. AREEDA & H. HOVENKAMP, ANTITRUST LAW ¶ 1912a, at 347 (3d ed. 2011). Here, the number of online DVD rental subscribers – marketwide output – increased dramatically, from 5.1 million in 2005 to 21 million by the end of the class period. *See* SER924-25/¶¶ 23, 32. Plaintiffs advanced below no suggestion that there would have been greater output had the PA not been signed; and their own damages theory assumed that the PA had no effect on output. *See* ER1359-68.

Prices. From May 2005 through the end of the class period, DVDR prices declined. No Netflix plan was increased. Several new and popular low prices points were introduced, including the plan that became Netflix's most popular, the 1U. That plan was introduced in May 2005 at $9.99, and was reduced to $8.99 two years later. SER944. Netflix also introduced a popular 1C plan in July 2006 at just $5.99, and dropped its price to $4.99 just a few months later. *Id.* Netflix's average price per movie shipped or streamed declined from $3 to $1. SER940-42/¶ 138 & Charts 6-7.

Service and quality. Service and quality increased significantly. The median time of shipment declined so that more and more subscribers have been able to get their DVDs the very next day after shipment. *See* SER110; SER117. The number of titles and disc copies also increased substantially, so that consumers

became better able to get the title they want when they want it. SER217/¶¶ 3-4. From the end of the first quarter of 2005 through the end of the class period, the number of discs increased by more than 169 million, and the number of titles increased by more than 47,000. *Id.*; *see also* SER925-26/¶ 24. Netflix also made many improvements to its website, making selection of the "right" movie easier and easier. SER119-29; SER60-62.

Innovation. Innovation is one of the most important competitive criteria of them all, for innovation is the source of the most powerful market growth. *E.g.*, *Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407 (2004). Here, Netflix has become the pioneer in next generation video content consumption through the online streaming service it introduced in 2007 and improved consistently since that time. SER115-16; SER925-26/¶ 24 & Charts 1-2.

2. Walmart Unilaterally Decided to Exit

The PA had no effect on whether Walmart stayed in the business or not. The evidence is uncontroverted that Walmart made an independent decision to exit online DVD rentals in January 2005 – at a time when there were no discussions occurring between Netflix and Walmart. Plaintiffs' own economic expert conceded that a conclusion that Walmart decided independently to exit in January 2005 means that competition was not harmed. SER484-85/12:25-13:20.

In late 2004, Walmart.com's business was on a negative trajectory, losing subscribers in the face of substantial growth by Netflix and Blockbuster. SER924-25/¶¶ 23, 32, 41. Walmart.com went from tiny (56,852 subscribers in September 2004) to tinier (49,686 subscribers in December 2004). *Id.* ¶ 32. In the same period, Netflix increased its subscribers from 2.2 million to 2.6 million, and Blockbuster went from 1.2 million to 1.3 million subscribers. *Id.* ¶¶ 32, 41.

In an effort to save its failing DVDR business, Walmart.com pursued an alliance with Yahoo!. SER1247-53; SER416-17/127:16-128:8. However, when Blockbuster cut its price for its 3U plan to $14.99 on December 22, 2004, Walmart realized that the financial assumptions essential to the Yahoo! deal could no longer be achieved. SER418-19/141:19-142:18 (VC); SER1255 ("the economics no longer work"); SER1184-85; SER1257; SER1180-81. The Yahoo! term sheet included a provision allowing either party to terminate in the event the average selling price (ASP) of Walmart's DVDR subscriptions went below $16.90. SER1251. On December 10, 2004, the Walmart ASP was approximately $17.18, already very close to the termination trigger. SER937 n.138. When Blockbuster went to $14.99 on December 22, 2004, any material price reduction undertaken by Walmart would push its ASP below the $16.90 threshold and thereby activate the termination provision. SER937/¶ 85. Yet, without a price reduction, Walmart would have no platform to increase its subscriber base to 50,000, as Yahoo!

expected. SER1259. The proposed Yahoo! agreement thus fell through and was never signed. SER418-19/141:19-142:18 (VC); SER403/16:10-24 (VC).

Nor was staying in business alone an option. In evaluating the price changes required in order to respond to Blockbuster's price cut, Walmart projected a number of different scenarios. SER1187-88; SER1261. All showed continued significant subscriber decreases, well below 50,000, as well as short and long term financial losses. SER1187-88; SER1263; SER404/20:13-23. Plaintiffs assert that Walmart's 2U plan was "profitable," App.-Br. 11, but the argument is misleading. When accounting for the relevant costs, that plan too indisputably was losing money. SER383-84/250:17-251:20 (VC).

Therefore, in January 2005, Walmart.com made an internal decision to shut down the DVDR business. SER1265; SER1190; SER405/24:17-19 (VC); SER431-32/121:11-122:12 (VC); SER366/23:4-9 (VC), 30:8-11 (VC). The steps leading up to the shutdown included: (i) lowering the 2U price to $12.97 (above the $11.99 Netflix was charging for its 2C plan, but low enough to keep *some* customer base to sell); (ii) discontinuing the 3U and 4U plans for new sign-ups; (iii) terminating all network expansion plans; and (iv) beginning conversations with Blockbuster and Netflix about "what subs [subscribers] are worth and disc salvage value." SER1190; *see also* SER1267-68. This shutdown plan was kept strictly confidential. SER1190. Importantly, Walmart set up a formal impairment

reserve on its books for the closure of the business as of January 31, 2005, the end of its fiscal year. SER370-71/32:6-33:1; SER494/110:2-6; SER1192; SER426-28/121:11-123:9.

There is no evidence whatsoever that any communication with or from Netflix had anything to do with Walmart's decision to exit DVDR and set up the reserve. *See* SER371/33:7-11. The subsequent agreement that Netflix would take over willing subscribers upon Walmart's exit was a *result* of Walmart's independent determination to exit, not a cause.

Contrary to Plaintiffs' arguments (App.-Br. 56), the district court did not say there was an issue of fact as to the independent nature of Walmart's exit, just that Plaintiffs argued there was one – and that the court need not resolve it. ER22. And, in fact, the record is beyond genuine dispute that Walmart's decision to exit was made independently. Plaintiffs' opposing arguments are based on a few internal Netflix documents that refer to an "agreement" with Walmart that it would exit DVD rentals. App.-Br. 14. But those documents simply reflect the fact that Netflix did not know about Walmart's prior, independent decision to exit. At the February 9, 2005, meeting, Mr. Hastings had suggested an arrangement under which Netflix and Walmart.com would be positioned side-by-side, with Netflix as a "premium" service and Walmart as a "value" service (and, thus, that Walmart would *not* exit). SER1564-65/¶¶ 23-26; SER1245. Netflix's CMO, Leslie

Kilgore, however, expressed the view that this approach would leave the impression with consumers that Netflix was expensive, which was likely to harm its business. SER1565/¶ 26; SER342-45/179:17-182:11. Accordingly, the Netflix representatives later sought an arrangement under which there would be just one surviving service, Netflix's, not Walmart's; and that contemplated Walmart's exit. None of this negates the unequivocal evidence that Walmart had made a *prior*, wholly independent decision to exit the business. "Agreement" on Walmart's exit served only to reconfirm that previously-determined fact.

3. No Competitive Harm Regardless of Why Walmart Exited

Plaintiffs' central argument on this appeal is that, if Walmart had not exited, prices to DVDR customers would have declined. But Plaintiffs advanced no evidence that Walmart's continued presence would have made the slightest competitive difference. Even if Plaintiffs could show that Walmart exited online DVD rental only as a result of an agreement with Netflix, rather than independently – an assertion contrary to all the evidence – there was still no evidence to create a triable issue of competitive harm.

Wal-Mart Stores provided Walmart.com insufficient resources. In January 2005, Walmart's subscriber share was 1.5% and declining rapidly. SER935-36/¶ 76 & Chart 4. One of the reasons for Walmart.com's inability to gain traction was the failure of Wal-Mart Stores to provide resources for DVDR, in large part

because it saw other online businesses as being more profitable. SER1275 (1/25/05: "right now the payback for [a DVDR] investment versus other investments the company can make is not as compelling"); SER1277-79. The online DVD rental business had only three full-time salaried employees who worked solely on that business. SER412-13/43:12-44:16. It devoted only $2.525 million in marketing expenditures in contrast to some $325 million for Netflix over the same period. SER1282-93. Undisputed evidence confirmed the many other severe resource constraints under which the DVDR business operated, including technology and distribution. SER361-63/15:21-17:2 (VC); SER400-02/12:20-13:15 (VC), 14:3-15 (VC); SER414-15/121:20-122:17 (VC); SER1284; SER1286-87. Notwithstanding the media puffery cited by Plaintiffs, App.-Br. 6, 28, Walmart understood that its offering was inferior, with quality and service levels far below par in every respect. *See, e.g.*, SER1005-09.

Netflix viewed Walmart as insignificant. Walmart's lack of serious commitment to the online DVD rental business was evident to outside observers. As early as September 2003, Netflix's board minutes noted that Walmart had "very little traction in the DVD rental space, primarily due to their inferior service and lack of word-of-mouth." SER1011. A presentation from the same board meeting indicated that Netflix had felt "no impact" from Walmart's service, and that it was not likely Walmart's service would impact Netflix's business going forward.

SER1025. The irrelevance of Walmart's DVDR business persisted through the duration of its existence. Cancellation data showed that Walmart was not a factor for customers deciding to leave Netflix's service. SER339-41/174:19-176:8; SER1559/¶ 9. As a result, Netflix viewed Walmart's service as "absolutely inconsequential." SER339/174:15-18. Even the lead Plaintiffs in this case who became Netflix subscribers while Walmart's service was available conceded that they too did not consider Walmart as a viable alternative; in fact, they had never even *heard* of Walmart's service. SER473/53:12-14; SER476-77/30:14-16, 82:13-23; SER480-81/23:24-24:3.

Consequently, Walmart had zero impact on how Netflix competed in online DVD rental. Plaintiffs' own economic expert conceded "*that there [was] no competitive response in terms of price change, plan change, quality change or anything else that Netflix did that's attributable to any action taken by Wal-Mart while it was in the online DVD rental space*." SER507/184:6-16 (VC) (emphasis added).

Other market participants viewed Walmart as insignificant. The same was true with respect to the next largest market participant, Blockbuster. As Plaintiffs' economic expert conceded again, there was "no competitive response by Blockbuster to anything that Wal-Mart ever did." SER505-06/182:19-183:1 (VC). Every Blockbuster executive testified that "Wal-Mart didn't impact our pricing

decision." SER442/347:7-14; *see also* SER436/76:3-11; SER451-53/94:6-20, 95:22-96:6; SER456-62/98:12-101:5, 101:20-102:9, 106:16-107:1. Blockbuster's reaction to Walmart's decision to shut down was that it was "logical" that Walmart would exit, because "[Walmart's] distribution network wasn't in place. Title count wasn't there. I mean, the service levels weren't in a position to compete." SER446-48/394:22-396:6. Similarly, when Amazon.com was researching the online DVD business in preparation for possible entry, it did not view Walmart as a threat. SER466-70/205:2-6, 232:17-233:4, 233:17-234:4, 234:16-235:9; SER1301-11.

The <u>objective</u> facts are that Walmart had no competitive significance. When Walmart entered in June 2003, Netflix did not lower its 3U price in response to the lower price charged by Walmart. To the contrary, Netflix kept its 3U price the same, and then the very next price change Netflix implemented was to *increase* its 3U plan to $21.99 in June 2004. SER944. The introduction of Walmart's tiny, poorly-implemented service exerted no competitive pressure on Netflix. When Walmart exited in mid-2005, Netflix did *not increase* its 3U price, but instead kept it the same level – further demonstrating that the exit of Walmart was a non-event that had no effect on competitive conditions. *Id.* Netflix's next price change on the 3U plan, in mid-2007, was a price *decrease*. *Id.*

Furthermore, Netflix often acted as a price leader downwards by introducing new, inexpensive subscription plans. While Plaintiffs focus almost exclusively on prices for the 3U plan, in fact there were numerous plans available at different price points. In December 2004, Netflix lowered the price of its 2C plan to $11.99, which was then the lowest priced plan available from any service. *Id*. In May 2005, Netflix introduced an even less expensive subscription for $9.99 (the 1U plan), again giving it the lowest price of any service. In July 2006, Netflix began offering a $5.99 subscription (the 1C plan), which also became the lowest-priced plan available in the market. *Id*. Netflix's price decreases occurred both before and after Walmart's exit, demonstrating that the presence or absence of Walmart as a nominal competitor did not affect Netflix's price-leading behavior.

Netflix issued a press release advising that the PA was immaterial. The insignificance of Walmart as a competitor in DVDR was so pronounced that Netflix concluded that it had a securities-regulatory obligation to issue a press release to advise investors that the PA was immaterial to Netflix's financial performance. SER140-41; SER186-87; SER196-215; SER1567/¶ 31 & Ex. A. Walmart's subscriber base was so small that the number of additional subscribers Netflix stood to acquire under the PA had no material effect on Netflix's results. SER140-41; SER186-87; SER196-215; SER1567/¶ 31 & Ex. A. Instead, Netflix considered the benefits of the PA to be in the form of promotion on the Walmart

website, and the public relations benefit of being able to characterize Netflix as having succeeded in a space where the world's largest retailer had not. SER140-41; SER186-87; SER196-215; SER1567/¶ 31 & Ex. A.

Comments about Walmart in the media raise no issue of fact. Plaintiffs rely on a report of an interview of Mr. Hastings on CNBC in October 2004, in which he remarked that online DVD rentals were "heating up a lot faster than we thought it would. Blockbuster is coming in, Amazon is coming in, Wal-Mart has been in the market for two years," adding further that Netflix was cutting prices as a result. ER934; App.-Br. 10. Assuming the report to be accurate, the statement was no more than an acknowledgment that Walmart was one of the firms in the DVDR arena. It was not a contradiction of all the company's internal documents that Walmart was not an effective competitor. Plaintiffs simply ignore Mr. Hastings' other contemporaneous public comments; asked if Netflix had "noticed any sort of impact on growth or customer acquisition" from Walmart.com, he responded by saying that "Wal-Mart is not very active in the market . . . . I just think it's a fairly minor initiative for them." SER1299; SER1568-69/¶ 37.

Plaintiffs also rely on an earnings call in April 2005, after agreement in principle had been reached between Walmart and Netflix, in which Mr. Hastings remarked that "[i]f there are only two ***major*** players, Blockbuster and Netflix, the profitability may be substantial . . . . If on the other hand Amazon, Wal-Mart,

Blockbuster and Netflix are all ***major*** competitors in online rental, then profits would likely be small." ER407 (emphasis added); App.-Br. 53. But he also made clear in the very next sentence that Walmart was *not* a "major" competitor. Nothing in Mr. Hastings' remarks suggested that Walmart mattered. SER1568-69/¶ 37.

Plaintiffs' other document snippets raise no issue of fact. Plaintiffs cite a number of documents they claim show that Walmart was perceived as an effective competitor. App.-Br. 7-9. But Plaintiffs' characterizations are not evidence, and all the evidence is to the contrary.

Most of the documents Plaintiffs cite (ER571-72, 686-87, 703-04, 726-27) reflect statements made *prior to Walmart's actual entry* and, thus, prior to the reality of its actual performance. One, ER704, cautioned against a price increase while Walmart was "lurking." App.-Br. 9 (citing ER704). But Plaintiffs persist, as they did below, in omitting the comment on the same page stating that Netflix expected that Walmart would "eventually kill [its] service" if it did not get "momentum," defined as "probably 300,000 subs." ER704. Walmart never got even a fifth of that number. In similar fashion, Plaintiffs cite the testimony of Mr. Hastings (in a different case) that he viewed Walmart as a threat – not disclosing that he was discussing 2002, long before Walmart actually entered. App.-Br. 8 (citing ER727). In 2004, *after* Walmart's entry quickly had proven to be a failure,

Netflix reacted to *Blockbuster*'s 2004 entry as "Competition, *Finally*." SER184 (emphasis added). And the Netflix email that Plaintiffs pretend expressed concerns about Walmart in July 2004, App.-Br. 8-9, in fact circulated a "[g]reat deep report on BBI and NFLX," not Walmart. ER709.

The remaining documents fall largely into a category of planning for the unlikely. *See* SER264 ("Worrying is our specialty and it keeps us healthy -- without worry what is there?"). The risk that "Wal-mart decides to spend big on marketing dvd rental," which Plaintiffs portray as an actual concern, App.-Br. 11, is expressly described as a *10%* longshot. ER441; ER715 (similar analysis, 2%-25% likelihood); *see also* ER1427, 982 (cited at App.-Br. 11) (listing "threats" as Blockbuster and Amazon in bold, Walmart in regular type).

4. 3-Firm Competition Fallacy

Although there were several other small players as well, SER934/¶ 45, Walmart can be described as a "third firm" in online DVD rental. Plaintiffs say that makes a difference.

Plaintiffs argue, first, that Netflix's economists indicated that "going from a three-firm to a two-firm market" resulted in less competition. App.-Br. 16-31. Plaintiffs misstate that evidence. Netflix's experts made absolutely clear that the "three-firm" competition they were talking about was three *significant* competitors, and that Walmart – with a dwindling 1.5% share and zero competitive impact –

was *not* a significant competitor. SER151-53/166:22-168:15; SER156-59/67:17-68:21, 150:22-151:10. Plaintiffs deceptively omitted those portions of their testimony. They cite no legal or economic authority that there is anything to be made from the exit of a firm with a declining 1.5% share and no history of affecting rival pricing or other competitive decisions. Nor do they explain how Walmart's presence as a "third firm" ever mattered, or how the "three-firm" competition they trumpet was in any way different from competition without Walmart, from just Netflix, Blockbuster, and the threat of Amazon.

Second, Plaintiffs assert that Netflix "admitted" that the PA "increased [market] concentration." App.-Br. 31. To the contrary, as Netflix pointed out below, Plaintiffs' own data demonstrated that, for the first three years after the PA, concentration *declined* – the result of Blockbuster gaining share at Netflix's expense. SER236 (citing ER1281/¶ 28).

Because Walmart had no meaningful competitive significance, the case law is clear that the PA was not an unreasonable restraint of trade. *Gen. Dynamics*, 415 U.S. at 509-10 (acquisition not unlawful where acquired firm would not "compete on a significant scale"). Plaintiffs had to show that Walmart itself had some impact in the market, or that *its* contribution to "three-firm" competition was meaningful, so that its removal made a difference. *See United States v. Oracle Corp.*, 331 F. Supp. 2d 1098, 1166-73 (N.D. Cal. 2004) (elimination of PeopleSoft

as independent competitor was not likely to lessen competition substantially in light of continued competition from SAP and others); *F.T.C. v. Arch Coal, Inc.*, 329 F. Supp. 2d 109, 147 (D.D.C. 2004) (approving acquisition where acquired firm "does not lead or even influence pricing in the market, does not compete aggressively, and does not have a history of [aggressive] bidding on contracts" such that it was "unlikely that [the acquired firm] will become any more competitive in the marketplace than it is right now"); Statement of Chairman Pitofsky et al., *The Boeing Co./McDonnell Douglas Corp.*, File No. 971-0051 (F.T.C. July 1, 1997) (approving Boeing acquisition of McDonnell Douglas where "the absence of any prospect of significant commercial sales, combined with a dismal financial forecast, indicate[d] that Douglas Aircraft is no longer an effective competitor"), *available at* www.ftc.gov/opa/1997/07/boeingsta.shtm. There is no evidence to that effect in the record.

This Court's decision in *Gerlinger*, relied on by the district court, confirms the absence of any antitrust violation. In that case, very much like here, Amazon took over Borders' online book sales and was charged with "market allocation." The plaintiff argued the same theory advanced here, that the reduction of competitors from three-to-two – Barnes & Noble was the third – sufficed to show that prices were likely to rise. Brief for Appellant at 33-44, *Gerlinger v. Amazon.com Inc.*, 526 F.3d 1253 (9th Cir. 2008) (No. 05-17328). But the case was

dismissed because prices remained the same or decreased, negating any suggestion of consumer harm, notwithstanding the plaintiff's argument that, had Borders remained independent, prices would have been even lower. *Gerlinger*, 526 F.3d at 1255-56. The Court's rationale was that there was no injury to consumers and, therefore, no *standing*. *Id.* That same rationale means equally that there was no consumer harm of the sort a *violation* of the Sherman Act requires. Plaintiffs try to distinguish *Gerlinger* as a case of insufficient evidence. App.-Br. 40. But that is no distinction. It is the identical failure that warrants affirmance here.

5. The PA Did Not Eliminate Any Significant Potential Competition

Nor was there any evidence that the PA eliminated significant *potential* competition. An acquisition cannot be condemned on the basis that it eliminates potential competition absent proof, among other things, that the competition in question was probable and significant. *United States v. Marine Bancorporation*, 418 U.S. 602, 602-04 (1974). Those requirements have not even arguably been satisfied here.

Walmart's prospects at the time of its exit were dismal. At the close of 2004, Walmart predicted nothing but steady losses. SER1187-88; SER1260-63. Its contemporaneous projections showed that, if it maintained the same level of investment, it would have much less than 1% of online rentals in four more years, after having incurred substantial additional losses. SER496-98/116:18-118:13.

The projections also showed that investing more to grow its business would result in even larger losses, and that it would never exceed 5% of online rentals in even the most optimistic scenario. *Id*. at 117:3-19; SER1262; SER938-39/¶ 86 & n.141.

In addition, nothing in the PA inhibited Walmart from reentering online DVD rental at any time. If Walmart were in fact a significant potential competitor in May 2005, then allowing Netflix to attract less than 50,000 subscribers (in return for financial compensation for each one who transferred) in no way precluded it from launching a new online DVD rental business of equal potential competitive significance as soon as the next day. The PA did nothing to eliminate any potential competition. In fact, Walmart did later re-enter online movie rental with its acquisition of Vudu.com in February 2010. SER422-23/111:3-112:13.

6. District Court Concerns

The district court concluded correctly that there was no adverse effect on prices as a result of the PA. ER28-29. Nevertheless, the court referred to Plaintiffs' arguments concerning "Netflix's discussions about decreasing movie title count, and its institution of a 28[-day] delay on . . . new releases," and declined to reach the issue of competitive harm under the rule of reason based on concerns that these arguments might suggest "lower output and unresponsiveness to consumer preference." ER22. Unfortunately, the court was misled by

Plaintiffs' arguments. On the actual record, there was no conceivable consumer harm, and the court should have resolved the rule of reason issue in Netflix's favor.

28-day window. Plaintiffs claimed that the 28-day window that began in 2010 on certain new releases was an anticompetitive act of Netflix's. The argument was false. The 28-day window was imposed by the motion picture studios on Netflix, not the opposite, as Plaintiffs' own exhibit made clear. ER1100-01 ("none of the Warner offers is palatable"); *see also* SER130-38. The studios imposed the same restriction on the leading DVD rental kiosk provider, Redbox, which responded by suing them. *See Redbox Automated Retail LLC v. Universal City Studios LLP*, No. 08-766, 2009 WL 2588748, at *5 (D. Del. Aug. 17, 2009) (denying motion to dismiss). Plaintiffs' own exhibit demonstrated that Netflix was considering launching litigation of its own. ER1101 ("I am advocating suing at this time"). The 28-day window came in almost *five years after the PA*. Netflix viewed it as unpalatable. To argue that it was an anticompetitive effect of the PA was insupportable.

"Trimming" title count. Plaintiffs' argument about title count was equally deceptive. The objective facts were that Netflix's title count and disc inventory both increased *every* quarter since the time of the PA. SER217/¶ 4. Recently, the DVD rental arena has begun shifting away from physical discs and towards streaming over the Internet. SER274-76/¶ 31 & Chart 2; SER1206. That reality

means that, as subscriber demand for streaming rises, demand for physical discs will decline. And so Netflix is developing plans for the inevitable reduction in disc inventory that will come. The 2009 document Plaintiffs cited is one that looks at the "Core 10 Year Challenge Ahead." SER269. Yet this possible plan for physical disc reduction in the future, SER270, is one that Plaintiffs incorrectly cited *as a present effect*. ER298.

7. Plaintiffs' Experts Did Not Create Any Triable Issue of Fact

Plaintiffs point to the district court's denial of Netflix's *Daubert* motions. They argue that the district court "ignored" the opinions of Drs. Beyer and Gundlach, and that, had it not done so, it would have found that they establish injury-in-fact and harm to competition. App.-Br. 35-37. But the district court did not "ignore" their opinions; it determined that it was "unnecessary" to exclude them because they failed to raise any issue of fact. "[T]he factual assumptions underlying" the expert's opinions had been challenged, and the court had already addressed "the lack of evidence in the record to support those assumptions." ER32. That is hardly the ringing endorsement Plaintiffs would have this Court believe.

Neither expert's testimony raised an issue of fact. Dr. Gundlach was called to testify, contrary to the evidence, that Walmart really did not decide to exit independently and would have become a significant competitor in DVDR.

SER753-54/¶¶ 9, 71. That testimony as to the *facts* (about which this "expert" had no knowledge) was properly disregarded. *See El Aguila Food Prods., Inc. v. Gruma Corp.*, 301 F. Supp. 2d 612, 619-24 (S.D. Tex. 2003) (excluding Dr. Gundlach's testimony as to alleged anticompetitive effects where it was not based on facts of case), *aff'd*, 131 F. App'x 450 (5th Cir. 2005).

Dr. Beyer's testimony was no better. He advanced the $15.99 price reduction theory that, as discussed above, had no basis in reality. He also asserted that "going from a three firm market to a two firm market . . . allowed Netflix to participate in a duopoly and avoid a price decrease." ER26. That opinion, however, ignored the reality that Walmart's share was 1.5% and dropping, and he was unable to cite any economic literature suggesting that the exit of such a small and declining firm could ever matter. His one attempt to do so was a misinterpretation of a model that was itself thrown out on *Daubert* grounds in *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039, 1057 (8th Cir. 2000). SER509-10/189:4-190:12. He also tried relying on the "Bertrand Model," SER599-600/¶¶ 75-76, but failed to recognize that, under that model, only two firms – here, Netflix and Blockbuster – are all that is needed to keep prices at the competitive level. SER1373 ("[T]he Bertrand equilibrium is counterintuitive: So long as there are at least two firms, the Bertrand price is the competitive price (marginal cost)."). *See generally, e.g.*, *Blue Cross & Blue Shield United v.*

Marshfield Clinic, 152 F.3d 588, 593 (7th Cir. 1998) (Posner, J.) (finding Dr. Beyer's damages analysis "worthless"); *Lantec, Inc. v. Novell, Inc.*, 306 F.3d 1003, 1025-26 (10th Cir. 2002) (rejecting Dr. Beyer).

This Court's holding in *Rebel Oil*, on which the district court relied, ER28-29, provides the complete answer to Plaintiffs' arguments:

> When an expert opinion is not supported by sufficient facts to validate it in the eyes of the law, or when indisputable record facts contradict or otherwise render the opinion unreasonable, it cannot support a jury's verdict. Expert testimony is useful as a guide to interpreting market facts, but it is not a substitute for them. . . . "[E]xpert opinion evidence . . . has little probative value in comparison with the economic factors" that may dictate a particular conclusion.

Rebel Oil, 51 F.3d at 1436 (quoting *Brooke Grp. Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 242 (1993)).

8. Rule of Reason Summary

There was no evidence presented in the court below to create an issue of fact that the PA was an unreasonable restraint on competition. Walmart's exit was competitively meaningless and the objective facts established that consumer welfare improved on every measure. Given the absence of any harm to competition, the district court should have concluded that there was no antitrust violation. The judgment may be affirmed on that alternative basis.

C. NO SECTION 2 VIOLATION

Section 2 claims, whether based on allegations of conspiracy to monopolize, attempt to monopolize, or actual monopolization, all require proof of anticompetitive conduct. *Trinko*, 540 U.S. at 407; *Rebel Oil*, 51 F.3d at 1433. The only conduct alleged here to be anticompetitive, however, is the conduct leading to the PA and Walmart's exit.

As demonstrated above, the PA had no negative effects on competition. Where an agreement is found not to be anticompetitive in violation of Sherman Act § 1, there is likewise no basis for a monopolization claim under Section 2. *Nova Designs, Inc. v. Scuba Retailers Ass'n*, 202 F.3d 1088, 1092 (9th Cir. 2000); *Sicor Ltd. v. Cetus Corp.*, 51 F.3d 848, 856 (9th Cir. 1995); *Williams v. I.B. Fischer Nev.*, 999 F.2d 445, 448 (9th Cir. 1993). Plaintiffs do not argue otherwise.

III. THE DISTRICT COURT PROPERLY REJECTED PLAINTIFFS' NEW THEORY OF SECTION 2 VIOLATION

The one and only theory of antitrust liability alleged in Plaintiffs' complaint was the theory that Netflix subscribers paid supracompetitive prices as a result of Walmart's exit following the PA in May 2005. *See* ER1481-82. After Netflix's motion for summary judgment effectively disposed of that theory on the multiple grounds explained above, Plaintiffs invented an entirely new theory of antitrust liability – that Netflix violated Section 2 of the Sherman Act based on a combination of a 1998 agreement with Amazon, a 1999 agreement with

Musicland, and a 2001 agreement with Best Buy. ER318-21. This new theory was not alleged in the amended complaint, which never mentioned these agreements and never referred to Best Buy or Musicland at all. ER1480-1520, *passim*. Nor was it included in Plaintiffs' October 2010 (post-discovery) interrogatory answers, SER952-67, or even in Plaintiffs' January 2011 expert report, SER556-665. Netflix was thus denied any ability to seek discovery from Musicland, Best Buy, or (on these issues) Amazon; to examine Plaintiffs' expert on the subject; or to provide expert testimony in rebuttal.

The district court correctly rejected Plaintiffs' new theory of liability on the grounds that "none of these agreements were expressly pled as a basis for unlawful conduct in the operative consolidated amended complaint." ER7 n.3. While Plaintiffs' argue on appeal that "notice pleading principles" permitted them to "advance a new legal theory" on summary judgment based on the Amazon, Musicland, and Best Buy agreements, App.-Br. 63, Plaintiffs fail to identify any allegations in their complaint factually sufficient to put Netflix on "notice" of this "new legal theory."

In fact, when the district court specifically challenged Plaintiffs' counsel to identify language in the complaint relating to this new theory, counsel was unable to do so. ER266-67. The best he could do was point to paragraph 67(f), which simply alleges that one question common to all members of the putative class was

"[w]hether the alleged contract, combination, and conspiracy and other conduct violated Section 2 of the Sherman Act." *Id.*; ER1500/¶ 67(f). Aside from the vague reference to "other conduct" in this allegation, Plaintiffs' counsel could not identify anything relating to alleged injuries other than those allegedly resulting from Walmart's exit.

This Court has long recognized that "adding a new theory of liability at the summary judgment stage would prejudice the defendant who faces different burdens and defenses under this second theory of liability." *Coleman v. Quaker Oats Co.*, 232 F.3d 1271, 1292 (9th Cir. 2000). Accordingly, the Court has repeatedly rejected attempts by plaintiffs to oppose a motion for summary judgment by relying on new theories not pleaded with the requisite factual support in the complaint. *Trishan Air, Inc. v. Fed. Ins. Co.*, 635 F.3d 422, 435 (9th Cir. 2011); *La Asociacion de Trabajadores v. City of Lake Forest*, 624 F.3d 1083, 1089 (9th Cir. 2010); *Navajo Nation v. U.S. Forest Serv.*, 535 F.3d 1058, 1080 (9th Cir. 2008); *Wasco Prods., Inc. v. Southwall Techs., Inc.*, 435 F.3d 989, 992 (9th Cir. 2006); *Pickern v. Pier 1 Imports (U.S.), Inc.*, 457 F.3d 963, 968-69 (9th Cir. 2006).

"'Simply put, summary judgment is not a procedural second chance to flesh out inadequate pleadings.'" *Trishan Air*, 635 F.3d at 435 (quoting *Wasco*, 435 F.3d at 992). For a theory to be considered on summary judgment, "'[t]he necessary factual averments are required with respect to each material element of

the underlying legal theory.'" *Trishan Air*, 635 F.3d at 435 (quoting *Wasco*, 435 F.3d at 992). Consequently, new theories cannot prevent summary judgment even if fully "'briefed at summary judgment by all parties and presented at oral argument." *Navajo Nation*, 535 F.3d at 1080 (citation omitted).

Nor can Plaintiffs rely on discovery exchanges, as they argue here, because no sufficient notice was provided during discovery, *see* SER16-20, and because the complaint – not discovery exchanges – defines the scope of the claims to be adjudicated. *See Oliver v. Ralphs Grocery Co*., 654 F.3d 903, 908-09 (9th Cir. 2011) (unlawful conduct identified only in discovery and not in the complaint could not be used to oppose summary judgment). If Plaintiffs were aware of their new theory during discovery, they should have "proceeded by filing a timely motion to amend the complaint." *Pickern*, 457 F.3d at 968-69.

Plaintiffs' theory has no substantive merit in any event. The three agreements in question were entered into in 1998, 1999, and 2001. Netflix has assumed, *arguendo*, the existence of an online DVD rental "market" for purposes of this appeal. But it is undisputed that no such relevant "market" existed in the 1998-2001 period, and so there was no market to "allocate." Plaintiffs' expert opined only that a DVDR "market" had come into existence by May 2005, SER567-68/¶ 16, and he conceded in his deposition that there was no such market in Netflix's early years. SER194-95/173:12-174:21. Agreements entered into

prior to the emergence of a relevant market and that help to create the market cannot violate the antitrust laws. *See Fraser v. Major League Soccer, L.L.C.*, 284 F.3d 47, 69-71 (1st Cir. 2002). Nor was there any possible injury-in-fact from these agreements; and Plaintiffs assert no theory of injury from these agreements in their brief.

Plaintiffs' characterization of the agreements throughout their appeal brief, moreover, is wrong. As the district court correctly recognized, the Amazon agreement from 1998 precluded Netflix from new sales, but the Musicland and Best Buy agreements did not. ER7. They had provisions preventing Netflix from promoting DVD sales from *other retailers*, but neither said nor implied anything about Netflix's own sales. ER470; ER482/§ 1.7; ER485/§ 3.6. Plaintiffs' own expert concurred; he acknowledged that there was nothing that impeded Netflix from engaging in new sales before the PA (or afterwards). SER486-88/29:12-31:18 (VC). And, yet, even if all these agreements had in fact precluded Netflix from selling new DVDs, there would have been nothing remotely unlawful. A covenant not to compete ancillary to an output-enhancing joint venture cannot be assailed as anticompetitive. *See, e.g.*, *Northrop*, 705 F.2d at 1050-54; *Rothery Storage & Van Co. v. Atlas Van Lines*, 792 F.2d 210, 224-30 (D.C. Cir. 1986); *Polk Bros. v. Forest City Enters.*, 776 F.2d 185, 189-90 (7th Cir. 1985).

CONCLUSION

As this Court held in *Bhan*, "an appropriate award of summary judgment may save the parties and the courts from unnecessarily spending the extraordinary resources required for a full-blown antitrust trial." 929 F.2d at 1409. And since *Matsushita*, 475 U.S at 592-94, it has been clear that "any presumption against the granting of summary judgment in complex antitrust cases has now disappeared." *In re ATM Fee Antitrust Litig*., 554 F. Supp. 2d 1003, 1010 (N.D. Cal. 2008); *see also PepsiCo, Inc. v. Coca-Cola Co*., 315 F.3d 101, 104 (2d Cir. 2002) (Kearse & Newman, JJ.) ("summary judgment is particularly favored" in antitrust cases). This case has been without any basis from the start, but has cost the parties many millions in wasteful litigation costs while occupying substantial amounts of court time. It should be brought to a definitive end.

The judgment below dismissing the case on summary judgment should be AFFIRMED.[1]

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[1] The Court is undoubtedly aware of media reports in 2011 of Netflix's plan to separate its DVD-by-mail service from online streaming. Netflix implemented price decreases for both DVD-by-mail and online streaming, but a price increase for those continuing to take both. Significant subscriber cancellations and a precipitous drop in the company's stock price ensued. All this might suggest that Netflix lacks market power. But the relevant time period here ends September 30, 2010, and neither 2011 events nor the question of market power are at issue on this appeal.

Dated: April 24, 2012

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STATEMENT OF RELATED CASES PURSUANT TO NINTH CIRCUIT RULE 28-2.6

Pursuant to Ninth Circuit Local Rule 28-2.6, Defendant-Appellee Netflix, Inc. certifies, through the undersigned counsel, that the following related cases are or have been pending before this Court:

Daniel Kaffer, et al. v. Netflix, Inc., No. 11-16415 (docketed on June 6, 2011) (Blockbuster Subscribers appeal from the Order Granting Motion for Summary Judgment, dated April 29, 2011) (voluntarily dismissed on July 29, 2011).

Daniel Kaffer, et al. v. Netflix, Inc., et al., No. 11-17228 (docketed on September 20, 2011) (Blockbuster Subscribers appeal from the Order Granting Motion for Summary Judgment, dated April 29, 2011, and the related Stipulation and Order re Application to Claims Against Wal-Mart Defendants of Order Granting Summary Judgment to Netflix Inc., dated August 15, 2011) (voluntarily dismissed on February 13, 2012).

Theodore H. Frank, et al. v. Netflix, Inc., et al., No. 12-15705 (docketed on March 30, 2012) (Appeal from the Court's Final Order and Judgment Approving Wal-Mart Settlement and Order Awarding Attorneys' Fees, both entered on March 29, 2012).

Jon Zimmerman, et al. v. Netflix, Inc., et al., No. 12-15889 (docketed on April 18, 2012) (Appeal from the Court's Final Order and Judgment Approving Wal-Mart Settlement and Order Awarding Attorneys' Fees, both entered on March 29, 2012).

Dated: April 24, 2012

/s/ Jonathan M. Jacobson
Jonathan M. Jacobson

CERTIFICATE OF COMPLIANCE

Pursuant to Federal Rule of Appellate Procedure 32(a)(7)(C) and Ninth Circuit Rule 32-1, the undersigned hereby certifies:

1. Exclusive of the portions exempted by Federal Rule of Appellate Procedure 32(a)(7)(B)(iii), the brief contains 13,848 words.

2. The brief complies with the type size and typeface requirements of Federal Rule of Appellate Procedure 32(a)(5)-(6). The brief has been prepared in proportionally spaced typeface using Microsoft Word 2007 in 14 point Times New Roman font.

As permitted by Federal Rule of Appellate Procedure 32(a)(7)(C)(i), the undersigned has relied upon the word count feature of this word processing system in preparing this certificate.

Dated: April 24, 2012

/s/ Jonathan M. Jacobson
Jonathan M. Jacobson

CERTIFICATE OF SERVICE
CM/ECF FILING/SERVICE

U.S. Court of Appeals Docket No.: 11-18034

I, Nadia Oswald-Hamid, hereby certify that on April 24, 2012, I electronically filed the foregoing Brief of Defendant-Appellee Netflix, Inc. with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system.

Participants in the case who are registered CM/ECF users will be served by the appellate CM/ECF system.

I further certify that four of the participants in the case are not registered CM/ECF users. We have mailed the foregoing document by Federal Express Next Business day delivery to the following non-CM/ECF participants:

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