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12

13 UNITED STATES DISTRICT COURT

14 NORTHERN DISTRICT OF CALIFORNIA

15 CITY OF ROYAL OAK RETIREMENT)
SYSTEM, Individually and on Behalf of All)
16 Others Similarly Situated,)

17 Plaintiff,)

18 vs.)

19 NETFLIX, INC., REED HASTINGS, DAVID)
B. WELLS, THEODORE A. SARANDOS,)
20 LESLIE J. KILGORE and NEIL D. HUNT,)

21 Defendants.)

No.

CLASS ACTION

COMPLAINT FOR VIOLATION OF THE
FEDERAL SECURITIES LAWS

DEMAND FOR JURY TRIAL

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1 **INTRODUCTION**

2 1. This is a securities fraud class action on behalf of all persons who purchased the
3 common stock of Netflix, Inc. (“Netflix” or the “Company”) between December 20, 2010 and
4 October 24, 2011, inclusive (the “Class Period”). This action is brought against Netflix and certain
5 of its officers and/or directors for violations of the Securities Exchange Act of 1934 (the “1934
6 Act”).

7 2. Netflix is an Internet subscription service that streams television shows and movies.
8 The Company’s subscribers can watch unlimited television shows and movies streamed over the
9 Internet to their televisions, computers and mobile devices, and in the United States, subscribers can
10 also have DVDs delivered to their homes.

11 **SUMMARY OF THE ACTION**

12 3. During the Class Period, defendants issued materially false and misleading statements
13 regarding the Company’s business practices and its contracts with content providers. Specifically,
14 defendants concealed negative trends in Netflix’s business. As a result of defendants’ false
15 statements, Netflix’s stock traded at artificially inflated prices during the Class Period, reaching a
16 high of almost \$300 per share on July 13, 2011. While Netflix stock was inflated (partially by
17 Netflix buying back its own stock), Company insiders were selling 388,661 shares of their own
18 Netflix stock for proceeds of \$90.2 million.

19 4. On September 15, 2011, Netflix issued a press release announcing an update to its
20 third quarter 2011 guidance. Netflix revealed that it had lost a million subscribers upon its price
21 increases becoming effective. On this news, Netflix stock collapsed nearly \$40 per share to close at
22 just under \$170 per share on September 15, 2011, a one-day decline of nearly 19% on volume of 21
23 million shares. The stock fell further when defendants were forced to announce on September 19,
24 2011 that, in an effort to offset skyrocketing costs and rapidly defecting customers, the Company
25 would begin charging separately for its two services and had raised prices as much as 60%. The
26 streaming service would retain the Netflix name, while the DVD service would be renamed
27 Qwikster. Netflix stock dropped to \$130 per share on this news, a nearly 44% decline from early
28 September 2011.

1 **BACKGROUND**

2 24. Netflix is an Internet subscription service that streams television shows and movies.
3 The Company’s subscribers can watch unlimited television shows and movies streamed over the
4 Internet to their televisions, computers and mobile devices, and in the United States, subscribers can
5 also receive DVDs delivered to their homes. The Company is organized into two operating
6 segments: United States and International. The Company obtains content from various studios and
7 other content providers through fixed-fee licenses, revenue sharing agreements and direct purchases.
8 The Company markets its services through various channels, including online advertising and broad-
9 based media, such as television and radio, as well as various partnerships.

10 25. Netflix’s fastest growing and most important segment was its streaming business.
11 This business depended upon Netflix having an adequate amount of content available for its
12 customers. In October 2008, Netflix had acquired rights to stream Starz Encore; in July 2010,
13 Netflix obtained the rights to Relativity Media; in August 2010, Netflix had obtained the rights to
14 EPIX; and in September 2010, Netflix obtained the rights to Nu Image/Millennium. These rights
15 were expensive but insiders knew the rights were about to get a lot more expensive.

16 26. At the beginning of the Class Period, Netflix was facing increasing competition for
17 streaming business and content providers were exploring new ways to distribute their content and/or
18 maximize their licensing fees. For example, in early March 2011, Warner Brothers announced it
19 would offer select movies through Facebook, bypassing companies like Netflix altogether. Cable
20 companies were also dramatically increasing their digital offerings. Obviously, such developments
21 caused investors to be concerned that Netflix would be unable to maintain its profit margins. Thus,
22 defendants’ statements about Netflix’s ability to secure content and maintain profit margins were
23 crucial to investors’ evaluation of Netflix. Rather than fully disclose the devastating cost increases
24 which were then threatening Netflix’s entire business, defendants talked about its ability to grow.

25 27. The defendants frequently referred to Netflix’s *three virtuous cycles* of subscriber
26 growth:

- 27 – Increasing numbers of subscribers leads to higher revenue, making it possible
28 for Netflix to acquire more content, attracting more subscribers.

1 however, it is the reverse: ESPN3 charges consumer ISP networks like Comcast for
2 the privilege of transporting the ESPN3 data to the ISP's consumers (in essence,
3 Comcast and peers are forced to share some of the revenue of the \$45 per month
4 broadband package with ESPN3). We don't have any plans to go the ESPN3 route,
5 but *the odds of material negative Netflix P&L impact from broadband pricing
6 trends in 2011 are very low.*

7 Moving to more interesting angles, Whitney documents our recent decreased
8 FCF conversion due to us paying for content earlier than we had in the past. With
9 this angle, Whitney does draw a little blood. Our new CFO David Wells and our
10 content team are all over our need to get more consistent about pay-by-quarter for
11 content going forward rather than pay-by-year, even if it means we'll pay a little
12 more. We will be working to improve the FCF conversion trend in 2011. On a long
13 term basis, FCF should track net income reasonably closely, as it has in the past, with
14 stock options as an offset against small buildups in PPE and prepaid content. Nearly
15 all of our computing is through Amazon Web Services and CDNs, which are pure
16 opex.

17 Next in the litany of Whitney threats is market saturation. In 2011, this is
18 unlikely to affect us. Streaming is growing rapidly; it is propelling Hulu, YouTube,
19 Netflix and others to huge growth rates. Streaming adoption will likely follow the
20 classic S curve, and we're still on the first part (acceleration) of the S curve. Since we
21 expanded into streaming, Netflix net subscriber additions have been 1.9m in 2008,
22 2.9m in 2009, and over 7m this year (estimated). While saturation will happen
23 eventually, given the recent huge acceleration of our business specifically, and
24 streaming generally, saturation seems unlikely to hit in the short term.

25 * * *

26 Moving on to the widely-discussed issue of increased content costs, it is true
27 that we are paying more for any given piece of content than we were two years ago,
28 and that in two years, we'll pay more than we pay today. Part of our goal as a
business is to make money for content producers and to become one of their largest
and best revenue sources. *Fortunately, our subscriber base is growing fast enough,
and DVD shipments are growing slow enough, that we can afford to pay for the
existing streaming content we have, and also get more content.* We try not to
comment on specific deals, like the Starz renewal, as that rarely helps us get deals
done.

Investors sometimes see the content cost threat as an issue around our
margins. But *we have no intention of overspending relative to our margin
structure, and there is no specific content that we "must have" at nearly any cost.*
In our domestic business we spend 65-70% of revenue on COGS (which is mostly
content and postage). So if content costs rose faster than we expected, then in
practice we'd have less content than otherwise, rather than less margin. *This would
ultimately show up in less subscriber growth than we wanted from a not-as-good-
as-it-would-otherwise-be service; it would not likely show up as a sudden hit to
margins. Management at Netflix largely controls margins, but not growth.*

Turning to competition, there is a legitimate short thesis in the unknown of
who enters directly against us and when. Some offerings like Hulu Plus have some
content we do not, but we are making progress on that gap. In the near term, some of
our subscribers will also subscribe to Hulu Plus, but very few will quit Netflix
because we have lots of streaming content that Hulu Plus does not. For a competitive
firm to materially hurt our growth, they have to have some positive differentiator

1 (price, additional content, integration, etc.), and then they have to market their
2 service effectively. This wild-card of major new competitor offering great content
3 and marketing aggressively is the single best near-term short thesis, but no one
4 knows if it will happen in 2011.

5 The core competitive barrier for direct competitors is brand/subscriber-
6 evangelism. Our large subscriber base is very happy with Netflix, and tells their
7 friends about Netflix. That means that the cost of acquiring the incremental 1m
8 subscribers is lower for us than for a competitor, and thus our net additions are
9 higher. There are also lots of other smaller competitive barriers, but the happy
10 subscriber base is the big one.

11 * * *

12 To wrap up, I have to agree with my friend Whitney that there are many risks
13 ahead for Netflix, that our valuation is substantial, and that it is possible that one
14 could make money shorting Netflix today. *But shorting a market leading firm as it
15 is driving a huge new market is a very gutsy call.* On balance, I would rather have
16 my co-philanthropists on the long side of this particular bet.

17 32. Following this unusual communication by a CEO, Netflix's stock price jumped,
18 increasing \$8.19 per share, or 4% in one day to close at \$186.24 per share on December 21, 2010.

19 33. On January 26, 2011, Netflix issued a press release announcing its fourth quarter and
20 year-end financial results for the period ended December 31, 2010. The Company reported net
21 income of \$47 million, or \$0.87 diluted earnings per share ("EPS") for the fourth quarter of 2010.
22 The Company reported 20 million subscribers and net subscriber additions of 3.08 million for its
23 fourth quarter 2010, and a growth of 7.7 million net subscriber additions for 2010, up from its
24 forecast at the start of 2010 of net additions of 3.6 million. Regarding the Company's business
25 outlook, the release stated in part:

26 **Business Outlook**

27 Going forward we are providing more detail in our guidance for the current
28 quarter by breaking out domestic versus international and by providing operating
income guidance. Our business is so dynamic that we will be doing less calendar
year guidance than in the past.

Our domestic guidance for Q1 2011 is:

- Subscribers between 21.9 million and 22.8 million
- Revenue between \$684 million and \$704 million
- Operating Income between \$98 million and \$116 million

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Our global guidance for Q1 2011 is:

- Net Income between \$49 million and \$62 million
- EPS between \$0.90 and \$1.13

For the year 2011:

- We expect to operate domestically at approximately a 14% operating margin
- We expect domestic subscriber net additions to continue to grow in 2011
- We expect our Canadian operations to have a positive operating margin in Q3
- We expect to have approximately \$50 million in operating losses in international in 2H of 2011 as we expand beyond Canada

34. The release also stated in part:

In November last year we introduced our \$7.99 per month pure streaming plan, and we increased the prices on our combination plans, which include streaming and unlimited DVD rentals. As you can see from our strong Q1 subscriber guidance, our pure streaming plan has a great deal of consumer appeal. More than one third of new subscribers are signing up for the pure streaming plan, and we expect that percentage to grow over time. The balance of new subscribers primarily takes our \$9.99 1-DVD combination plan. Very few of our existing subscribers are downgrading to the pure streaming plan.

Our three virtuous cycles of subscriber growth are:

1. More subscribers means more money to license content with, *which drives more subscriber growth*
2. More subscribers means more word-of-mouth from subscribers to those who are not yet subscribers, *which drives more subscriber growth*
3. More subscribers means we can increase R&D spend to improve our user experience, *which drives more subscriber growth*

* * *

Streaming Content

We continue to expand our selection of movies and TV shows available to watch instantly. Our Epix deal just completed its first full quarter of current studio releases and great catalog movies. We also closed an expansive new deal with ABC/Disney that includes all previous seasons of “Lost,” “Desperate Housewives,” and “Brothers and Sisters” from ABC and “Phineas and Ferb,” “Good Luck Charlie” and a host of other popular shows and original movies from the Disney Channel.

1 Our unique direct deals with independent producers and distributors have
2 made it possible for us to bring all five of the just-announced 2011 Academy
3 Awards-nominated Best Documentary Feature films to our growing streaming
4 library. Two of those films – “Exit Through the Gift Shop” and “Restrepo”– are
5 available to stream now. “Waste Land” is coming on March 29 and “Gasland” and
6 “Inside Job” will be coming soon through existing deals.

7 Our interest in television shows is high. Our primary strategy is to offer
8 complete previous seasons of shows rather than offering those shows the day of, or a
9 few days after, broadcast, during the critical ratings and revenue window. This is in
10 the best interest of content owners and is consistent with our desire to offer a very
11 low-cost service for consumers. As with theatrical ticket sales, VOD and the 28-day
12 DVD sale window, this allows studios to capture the market for those most interested
13 in seeing content right away. You will occasionally see us offering shows day after
14 broadcast, as we do with “Saturday Night Live,” or 15 days after broadcast, as we do
15 with Disney Channel programs, but it doesn’t represent a change in our overall TV
16 strategy.

17 * * *

18 Operating Margins

19 Managing to a target operating margin has proven to be effective for us, and
20 we plan to continue to do so. For the next few quarters we will target a domestic
21 operating margin of about 14%, which we believe is a good balance of growth and
22 earnings. The variable costs of DVD shipments, and the seasonal nature of big DVD
23 releases, contributed to material expense seasonality in the past. While this remains
24 true of DVD, this expense seasonality will smooth out as streaming becomes the
25 majority of our content expense. Seasonality of subscriber growth will remain, but
26 the domestic margin structure going forward should be less seasonal than in the past.
27 Occasionally, we will have the opportunity to close a big streaming content deal, and
28 our margins will dip temporarily, *but most of the streaming deals are less lumpy,
and we will be able to manage close to the domestic 14% target.*

35. After releasing its 2010 fourth quarter and year-end financial results on January 25,
2011, Netflix hosted a conference call with analysts, investors and media representatives, during
which defendant Hastings represented the following:

[ANALYST:] Do you believe it will get harder to acquire incremental films and TV
shows from major Hollywood studios? And, where are you in quantity today and
where would you hope to be in a few years?

[HASTINGS:] Doug, no it’s not gotten harder, it’s gotten easier as we pay
more. Three, four years ago, when we couldn’t pay much, it was very hard, and, *now
because we’ve got significant dollars to spend, we’ve got people coming to us and
that makes perfect sense.* So, while [sic] *we’re feeling great about both our ability
to make content owners a lot of money and to get deals done and continue to fill
out and improve our selection.*

1 36. On February 18, 2011, Netflix filed its Form 10-K with the SEC for the year ended
2 December 31, 2010, in which it discussed the impact of possible changes with content distributors.
3 The Form 10-K assured investors about Netflix's margins:

4 *We believe that the streaming content we make available to our subscribers is*
5 *sufficiently diversified, such that we will not be forced to pay licensing fees for*
6 *content in excess of our desired operational margins.* We believe that any failure to
7 secure content will manifest in lower subscriber acquisition and retention and *not in*
8 *materially reduced margins.* Nonetheless, given the multiple-year duration and
9 largely fixed nature of content licenses, if we do not experience subscriber
acquisition and retention as forecasted, our margins may be impacted by these fixed
content licensing costs. During the course of our license relationship, various
contract administration issues can arise. To the extent that we are unable to resolve
any of these issues in an amicable manner, our relationship with the studios and other
content distributors or our access to content may be adversely impacted.

10 37. This disclosure concealed the extent of the price increases then being demanded by
11 content providers as alternative streaming venues also competed for content.

12 38. On April 25, 2011, Netflix issued a press release announcing its first quarter 2011
13 financial results. The Company reported net income of \$60 million, or \$1.11 diluted EPS, and
14 revenue of \$718 million for the quarter ended March 31, 2011. The Company further reported
15 strong quarterly growth in subscribers of 23.6 million globally. Additionally, Netflix provided its
16 outlook for the second quarter of 2011, stating in part:

17 **Business Outlook**

18 **Guidance**

19 **Domestic Q2 2011:**

20	Subscribers	24.0m to 24.8m
21	Revenue	\$762m to \$778m
21	Operating Income	\$100m to \$116m

22 **International Q2 2011:**

23	Subscribers	900k to 1,050k
24	Revenue	\$16m to \$20m
24	Operating Loss	-\$14m to -\$10m

25 **Global Q2 2011:**

26	Net Income	\$50m to \$62m
27	EPS	\$0.93 to \$1.15

28 39. The release also stated in part:

1 content investment, what is the rationale of buying back stock? Given the multiple
2 you get for subs, wouldn't you generate more value by investing in adding subs
versus buybacks?

3 * * *

4 [WELLS:] So we have three legs, basically, of investment. One is our
5 streaming content investment. One is our marketing. And one is our earnings target,
6 basically putting money towards – back to investors. And setting that 14% operating
7 margin – domestic operating margin target allows us to set basically a content spend
8 and a marketing spend. And so how we think about cash relative to the buyback is
independent of how much we spend on marketing. And I'd say how we approach the
buyback is what could we do with that cash as an alternative use? Should we hold it
as an insurance policy, or should we return it to shareholders and a buyback is the
most efficient way to do that.

9 47. On September 1, 2011, following the market close, Starz announced it was pulling its
10 content from Netflix as a result of failed negotiations. Starz had represented some of Netflix's most
11 valuable content.

12 48. Netflix's stock dropped \$20.16 per share on this news.

13 49. On September 15, 2011, Netflix issued a press release announcing an update to its
14 third quarter 2011 guidance. Netflix lowered its third quarter 2011 domestic subscriber estimates,
15 expecting to end the third quarter with 21.8 million domestic streaming subscribers and 14.2 million
16 U.S. DVD subscribers, down from its prior forecast of 22 million and 15 million, respectively. More
17 significantly, Netflix lost a million subscribers almost immediately upon its price increases
18 becoming effective.

19 50. On this news, Netflix's stock collapsed \$39.46 per share to close at \$169.25 per share
20 on September 15, 2011, a one-day decline of nearly 19% on volume of 21 million shares.

21 51. The stock dropped even further when the Company announced on September 19,
22 2011, that it would begin charging separately for the two services and raised prices as much as 60%,
23 a move that was poorly received among subscribers. The streaming service would retain the Netflix
24 name, while the DVD service would be renamed Qwikster

25 52. Netflix's stock dropped to \$130.03 per share on this news, a nearly 44% decline from
26 early September 2011.

27 53. On October 24, 2011, Netflix issued its third quarter 2011 shareholder letter in which
28 it reported a net loss of 810,000 U.S. subscribers, translating into a cumulative loss of 5.5 million

1 subscribers. The subsequently filed Form 10-Q revealed that Netflix's obligations for content over
2 the coming years had skyrocketed to \$3.5 billion, with \$2.8 billion due within three years.

3 54. These disclosures caused Netflix's stock to collapse from \$118.84 per share on
4 October 24, 2011 to \$80.86 per share on October 27, 2011, on volume of 76 million shares over
5 three days.

6 55. The true facts, which were known by the defendants but concealed from the investing
7 public during the Class Period, were as follows:

8 (a) Netflix had short-term contracts with content providers and defendants were
9 aware that the Company faced a Hobbesian choice to renegotiate the contracts in 2011 at much
10 higher rates or not renew them at all;

11 (b) Content providers were already demanding much higher license fees, which
12 would dramatically alter Netflix's business;

13 (c) Defendants recognized that Netflix's pricing would have to dramatically
14 increase to maintain profit margins given the streaming content costs they knew the Company would
15 soon be incurring; and

16 (d) Netflix was not on track to achieve the earnings forecasts made by and for the
17 Company for 2011.

18 56. As a result of defendants' false statements, Netflix's stock traded at inflated levels
19 during the Class Period. However, after the above revelations seeped into the market, the
20 Company's shares were hammered by massive sales, sending them down 73% from their Class
21 Period high.

22 **LOSS CAUSATION**

23 57. During the Class Period, as detailed herein, the defendants made false and misleading
24 statements and engaged in a scheme to deceive the market and a course of conduct that artificially
25 inflated the price of Netflix common stock and operated as a fraud or deceit on Class Period
26 purchasers of Netflix common stock by misrepresenting the Company's business and prospects.
27 Later, when the defendants' prior misrepresentations and fraudulent conduct became apparent to the
28 market, the price of Netflix common stock fell precipitously, as the prior artificial inflation came out

1 of the price over time. As a result of their purchases of Netflix common stock during the Class
2 Period, plaintiff and other members of the Class suffered economic loss, *i.e.*, damages, under the
3 federal securities laws.

4 **NO SAFE HARBOR**

5 58. Netflix's verbal "Safe Harbor" warnings accompanying its oral forward-looking
6 statements ("FLS") issued during the Class Period were ineffective to shield those statements from
7 liability.

8 59. The defendants are also liable for any false or misleading FLS pleaded because, at the
9 time each FLS was made, the speaker knew the FLS was false or misleading and the FLS was
10 authorized and/or approved by an executive officer of Netflix who knew that the FLS was false.
11 None of the historic or present tense statements made by defendants were assumptions underlying or
12 relating to any plan, projection or statement of future economic performance, as they were not stated
13 to be such assumptions underlying or relating to any projection or statement of future economic
14 performance when made, nor were any of the projections or forecasts made by defendants expressly
15 related to or stated to be dependent on those historic or present tense statements when made.

16 **CLASS ACTION ALLEGATIONS**

17 60. Plaintiff brings this action as a class action pursuant to Rule 23 of the Federal Rules
18 of Civil Procedure on behalf of all persons who purchased or otherwise acquired Netflix common
19 stock during the Class Period (the "Class"). Excluded from the Class are defendants and their
20 families, the officers and directors of the Company, at all relevant times, members of their
21 immediate families and their legal representatives, heirs, successors or assigns and any entity in
22 which defendants have or had a controlling interest.

23 61. The members of the Class are so numerous that joinder of all members is
24 impracticable. The disposition of their claims in a class action will provide substantial benefits to
25 the parties and the Court. Netflix has over 52.5 million shares of stock outstanding, owned by
26 hundreds if not thousands of persons.

- 1 (a) employed devices, schemes and artifices to defraud;
- 2 (b) made untrue statements of material facts or omitted to state material facts
- 3 necessary in order to make the statements made, in light of the circumstances under which they were
- 4 made, not misleading; or
- 5 (c) engaged in acts, practices and a course of business that operated as a fraud or
- 6 deceit upon plaintiff and others similarly situated in connection with their purchases of Netflix
- 7 common stock during the Class Period.

8 69. Plaintiff and the Class have suffered damages in that, in reliance on the integrity of

9 the market, they paid artificially inflated prices for Netflix common stock. Plaintiff and the Class

10 would not have purchased Netflix common stock at the prices they paid, or at all, if they had been

11 aware that the market price had been artificially and falsely inflated by defendants' misleading

12 statements.

13 **COUNT II**

14 **For Violation of §20(a) of the 1934 Act**

15 **Against All Defendants**

16 70. Plaintiff incorporates ¶¶1-69 by reference.

17 71. The Individual Defendants acted as controlling persons of Netflix within the meaning

18 of §20(a) of the 1934 Act. By virtue of their positions with the Company, and ownership of Netflix

19 stock, the Individual Defendants had the power and authority to cause Netflix to engage in the

20 wrongful conduct complained of herein. Netflix controlled the Individual Defendants and all of its

21 employees. By reason of such conduct, defendants are liable pursuant to §20(a) of the 1934 Act.

22 **PRAYER FOR RELIEF**

23 WHEREFORE, plaintiff prays for judgment as follows:

- 24 A. Declaring this action to be a proper class action pursuant to Fed. R. Civ. P. 23;
- 25 B. Awarding plaintiff and the members of the Class damages, including interest;
- 26 C. Awarding plaintiff reasonable costs and attorneys' fees; and
- 27 D. Awarding such equitable/injunctive or other relief as the Court may deem just and
- 28 proper.

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JURY DEMAND

Plaintiff demands a trial by jury.

DATED: January __, 2012

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