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UNITED STATES DISTRICT COURT  
CENTRAL DISTRICT OF CALIFORNIA

In re DREAMWORKS ANIMATION  
SKG, INC., SECURITIES  
LITIGATION

Case File No. CV 05-03966 MRP  
(VBKx)

ORDER GRANTING DEFENDANTS'  
MOTION TO DISMISS PLAINTIFFS'  
CONSOLIDATED AMENDED CLASS  
ACTION COMPLAINT

I. Introduction

Lead Plaintiff Nextra Investment Management S.G.R. S.p.A.  
and additional plaintiffs Elim T. Moy and Charles C. Moy  
(collectively, "Plaintiffs") bring this action against defendants  
Dreamworks Animation SKG, Inc. ("Dreamworks"), its Chief  
Executive Officer, Jeffrey Katzenberg ("Katzenberg"), its  
Chairman, Roger Enrico ("Enrico"), its Vice President and General  
Counsel, Katherine Kendrick ("Kendrick"), its Chief Financial  
Officer, Kristina M. Leslie ("Leslie"), and Director and  
controlling shareholder, Paul Allen ("Allen") (collectively, the  
"Defendants"), alleging violations of Sections 11, 12(a)(2) and  
15 of the Securities Act of 1933 (the "Securities Act"), 17  
U.S.C. §§77k, 77l and 77o, and separately of Sections 10(b) and

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1 20(a) of the Securities Exchange Act of 1934 (the "Exchange  
2 Act"), 15 U.S.C. §§78j(b) and 78t(a), and Rule 10b-5 promulgated  
3 thereunder, 17 C.F.R. §240.10b-5. Defendant Dreamworks is a  
4 company that develops and produces computer generated animated  
5 feature films for release at the box office and in the home video  
6 market. In October of 2004, Dreamworks undertook an initial  
7 public offering of its Class A common stock (the "IPO"). In  
8 November of 2004, just days after the IPO, Dreamworks released  
9 the home video version of its feature film *Shrek 2*, which had  
10 been a box office success. The DVD went on to become the top  
11 selling home video of 2004 and one of the highest selling home  
12 videos of all time. Despite its strong performance, however, the  
13 *Shrek 2* DVD apparently did not sell as well as anticipated, and  
14 in May of 2005 Dreamworks announced that it would miss its  
15 earnings estimates for the first quarter of 2005, due in large  
16 part to higher than anticipated returns of *Shrek 2*. In July of  
17 2005, Dreamworks announced that it would not meet its revised  
18 guidance numbers for the second quarter of 2005, again due  
19 primarily to higher than anticipated returns of *Shrek 2*. Each of  
20 these announcements was followed by a substantial decrease in the  
21 price of Dreamworks stock. The allegations in Plaintiffs'  
22 Consolidated Amended Class Action Complaint (the "Amended  
23 Complaint"), filed on December 22, 2005, principally relate to  
24 various material misstatements and omissions allegedly made by  
25 Defendants in connection with the *Shrek 2* home video release.

26 Defendants filed a Motion to Dismiss Plaintiffs'  
27 Consolidated Amended Class Action Complaint on February 3, 2006.  
28 The Court heard oral argument from both parties with respect to

1 Defendants' Motion to Dismiss on April 5, 2006, and the motion  
2 was taken under submission.

3  
4 **II. Standards for Motion to Dismiss**

5 Dismissal for failure to state a claim under Rule 12(b)(6)  
6 is appropriate if it "appears beyond doubt that the Plaintiff can  
7 prove no set of facts in support of his claim which would entitle  
8 him to relief." *Homedics, Inc. v. Valley Forge Ins. Co.*, 315  
9 F.3d 1135, 1138 (9th Cir. 2003) (quoting *Conley v. Gibson*, 355  
10 U.S. 41, 45-46 (1957)). When evaluating a Rule 12(b)(6) motion,  
11 the court must accept all material allegations in the complaint  
12 as true and construe them in the light most favorable to the  
13 non-moving party. See *Barron v. Reich*, 13 F.3d 1370, 1374 (9th  
14 Cir. 1994) (citation omitted). However, the plaintiff bears the  
15 burden of pleading sufficient facts to state a claim. *Richards*  
16 *v. Harper*, 864 F.2d 85, 88 (9th Cir. 1988). Conclusory  
17 allegations of law and unwarranted inferences are insufficient to  
18 defeat a motion to dismiss for failure to state a claim. *In re*  
19 *Verifone Sec. Litig.*, 11 F.3d 865, 868 (9th Cir. 1993) (citation  
20 omitted).

21 If the court chooses to dismiss the complaint or a portion  
22 thereof, it must then decide whether to grant leave to amend.  
23 Generally, leave to amend is denied only if it is clear "that the  
24 deficiencies of the complaint could not be cured by amendment."  
25 *Noll v. Carlson*, 809 F.2d 1446, 1448 (9th Cir. 1987).

26 **III. Plaintiffs' Claims Under Sections 11, 12(a)(2) and 15 of**  
27 **the Securities Act**

28 Plaintiffs allege (1) violations of Section 11 of the

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1 Securities Act by all Defendants, (2) violations of Section  
2 12(a)(2) of the Securities Act by defendants Dreamworks and  
3 Allen, and (3) violations of Section 15 of the Securities Act by  
4 defendants Katzenberg, Enrico, Kendrick, Leslie and Allen  
5 (collectively, the "Individual Defendants"). To state a claim  
6 under Section 11, 12(a)(2) or 15 of the Securities Act, a  
7 plaintiff must allege, *inter alia*, a misstatement or omission of  
8 material fact in an offering document. 15 U.S.C. §§ 77k,  
9 771(a)(2); *In re Verifone*, 11 F.3d at 868. Here, Plaintiffs  
10 point to a number of statements made in the prospectus issued in  
11 connection with the IPO (the "Prospectus") relating to the strong  
12 box office performance of *Shrek 2*, the historical correlation  
13 between box office success and home video success, the historical  
14 success on home video of animated films vis-a-vis live action  
15 films, and the rapid growth of the home video market since the  
16 late 1990's. Although each of these statements was and is  
17 literally true, and although the Prospectus contains cautionary  
18 language making clear that Dreamworks could not guarantee that  
19 such trends would continue, Plaintiffs nevertheless contend that  
20 these statements are misleading insofar as they paint a rosy  
21 picture of the video market for animated films while failing to  
22 disclose a "sea change" in the home video market about which the  
23 management of Dreamworks was or should have been aware - namely a  
24 shortening of the retail window during which DVDs are purchased  
25 by consumers upon their release. According to Plaintiffs, the  
26 home video market has evolved in recent years to more closely  
27 mirror the performance of films at the box office in that a much  
28 higher percentage of total sales are achieved in the first week

1 after release. In reaction to this trend, Plaintiffs allege that  
2 Dreamworks "flooded the market" with copies of the *Shrek 2* DVD,  
3 in turn creating the risk that ultimate sales would be affected  
4 by a high number of returns from retailers, which in fact  
5 happened. It is this risk that Plaintiffs contend was material  
6 to investors and should have been disclosed along with the  
7 positive market trends highlighted in the Prospectus.

8 In support of its allegations that this change in the home  
9 video market had occurred and was understood by the Defendants  
10 such that it should have been disclosed in the Prospectus,  
11 Plaintiffs rely on a series of articles published in late 2004  
12 and 2005, mainly in trade publications, that describe this trend  
13 in varying degrees of detail. However, upon examination, these  
14 articles cited by Plaintiffs do not suggest the existence of a  
15 clear trend that would have been well understood at the time of  
16 the IPO. Of these articles, only two were published prior to the  
17 IPO, one in July of 2004 and the other in September of 2004. In  
18 the Amended Complaint, Plaintiffs focus particularly on the  
19 September 2004 article, in which an executive of Dreamworks SKG  
20 (Dreamworks' parent company prior to the IPO) notes that DVD  
21 titles are now garnering more of their total sales in the first  
22 week or even the first weekend after release. What Plaintiffs do  
23 not point out, however, is that this same article goes on to note  
24 that this is mainly a concern for "a smaller title" and that  
25 "major theatrical blockbusters like *Shrek 2* and *Spider-Man 2*  
26 won't be affected." (Supp. Decl. In Support of Plaintiffs' Motion  
27 to Dismiss, Ex. 1). The July 2004 article cited by Plaintiffs,  
28 while noting the trend toward a shorter market window for DVDs,

1 also notes the overall increase in the DVD market. A November  
2 2004 article cited by Plaintiffs for the proposition that  
3 Plaintiffs would have known about this trend because *Finding*  
4 *Nemo*, a comparable animated film released on DVD the prior year,  
5 sold 57% of its total sales during the first week after release,  
6 goes on to point out how successful *Finding Nemo* was both in  
7 absolute terms and relative to its own box office performance -  
8 thus exemplifying the market trends described by Dreamworks in  
9 the Prospectus. The most detailed discussion of this trend cited  
10 by Plaintiffs is a May 2005 article in the Wall Street Journal,  
11 published more than 6 months after the IPO, that uses *Shrek 2* as  
12 its main example of the trend and bears the subtitle "Fast-  
13 Changing Market Led Studio to Overestimate Demand for 'Shrek 2.'" (Decl. In Support of Plaintiffs' Motion to Dismiss, Ex. F).  
14 This very article notes that "it wasn't unreasonable to have high  
15 hopes for "*Shrek 2.*" " *Id.*

17 As the examples above illustrate, rather than pointing  
18 toward the existence of a clear material risk that Defendants  
19 knew about and failed to disclose, the handful of articles  
20 selectively quoted by Plaintiffs, when reviewed in full, actually  
21 describe a fast-changing DVD market in which the trend at issue  
22 here was not well understood at the time of the IPO and in which  
23 market insiders, including the Defendants, were generally  
24 surprised by the lower than expected performance of the *Shrek 2*  
25 DVD. "[W]e are not required to accept as true conclusory  
26 allegations which are contradicted by documents referred to in  
27 the complaint." *Steckman v. Hart*, 143 F. 3d 1293, 1295 (9<sup>th</sup> Cir.  
28 1998). As interpreted by the Ninth Circuit, Item 303(a)(3)(ii)

1 of Regulation S-K of the Securities Act requires that an offering  
2 document disclose an adverse trend only when that trend is  
3 reasonably likely to occur and to have a material impact. *Id.* at  
4 1297. Even taking as true the allegation that Defendants were  
5 aware of the trend, the documents cited by Plaintiff in the  
6 Amended Complaint undermine the contention that Defendants knew  
7 or should have known that this trend would have a material impact  
8 on the sales of the *Shrek 2* DVD.

9 Plaintiffs further argue that Defendants' alleged strategy  
10 of "flooding the market" with an excess supply of *Shrek 2* DVDs  
11 supports the contention that Defendants were aware of the trend  
12 in question and were acting in order to counter it. In *Steckman*,  
13 the court specifically rejected allegations of "channel  
14 stuffing" - the artificial inflation of sales in one quarter with  
15 the knowledge that such sales will subsequently drop while excess  
16 supply is depleted - as an indicia of a duty to disclose a known  
17 material trend, calling such an allegation "speculation made in  
18 hindsight." *Steckman*, 143 F. 3d at 1298. Furthermore, based on  
19 information contained in the Amended Complaint itself, the number  
20 of units shipped cannot be viewed as excessive. Plaintiffs  
21 allege at different points in the Amended Complaint that  
22 Dreamworks initially shipped either 25 million or 30 million  
23 copies of the *Shrek 2* DVD. According to the Amended Complaint,  
24 the *Finding Nemo* DVD, released a year before *Shrek 2*, sold 31.35  
25 million units in the first 90 days after its release. Given that  
26 *Shrek 2*, according to Plaintiffs' own sources, had outperformed  
27 *Finding Nemo* at the box office, an initial shipment of 25-30  
28

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1 million units does not appear inconsistent with the trends and  
2 expectations set forth in the Prospectus.

3 Plaintiffs also allege that Defendants failed to disclose in  
4 the Prospectus the important role of return rights granted by  
5 Dreamworks to retailers. However, as Defendants point out, the  
6 Prospectus states that retailers are granted return rights of up  
7 to 100%, provides a detailed explanation of how returns are  
8 estimated, and cautions investors that such estimates are subject  
9 to ongoing readjustment based on actual sales that could have a  
10 material impact on future operating results. Plaintiffs'  
11 allegations that these disclosures understated or did not  
12 adequately describe the risks that in fact materialized with  
13 respect to the high level of *Shrek 2* returns rests on the premise  
14 that Defendants knew the effect that the new trends in the home  
15 video market would have and failed to disclose them. However, as  
16 Plaintiffs' own sources contradict this premise, their claim that  
17 Defendants' statements in the Prospectus regarding return rights  
18 failed to adequately disclose known risks are merely conclusory.

19 Plaintiffs make similar claims concerning material  
20 misstatements made in the Prospectus with respect to Defendants'  
21 revenue recognition policies and internal controls. However, as  
22 each of these allegations is also dependent on the proposition  
23 that Defendants knew of the trend at issue and knew that it would  
24 be material, these allegations are rendered conclusory as well.

25 Finally, with respect to Plaintiffs' 12(a)(2) claim against  
26 defendant Allen, in addition to finding that the claim is  
27 unsupported by any material misstatement or omission in the  
28 Prospectus, the Court also finds that the claim fails for the



1 reason that Allen is not a "seller" under Section 12(a)(2). A  
2 "seller" within the meaning of Section 12(a)(2) is a person that  
3 either "(1) passes title to the securities to the plaintiff, or  
4 (2) solicits the purchase, motivated in part by financial gain."  
5 *In re Infonet Servs. Corp. Sec. Litig.*, 310 F. Supp 2d 1080, 1100  
6 (C.D. Cal. 2003); see also *Moore v. Kayport Package Express,*  
7 *Inc.*, 885 F.2d 531, 535 (9<sup>th</sup> Cir. 1989). Plaintiffs do not make  
8 any allegations that Allen is liable under either prong of this  
9 test, instead incorrectly asserting that Allen's financial  
10 interest in the transaction alone is sufficient to create  
11 liability under Section 12(a)(2).

12 Accordingly, the Court must conclude that the Amended  
13 Complaint fails to state a claim under Sections 11, 12(a)(2) and  
14 15 of the Securities Act.

15 **IV. Plaintiffs' Claims Under Section 10(b) and 20(a) of the**  
16 **Exchange Act**

17 Plaintiffs further allege that all Defendants are liable  
18 under section 10(b) of the Exchange Act, and that the Individual  
19 Defendants are also liable under Section 20(a) of the Exchange  
20 Act, for alleged misstatements and omissions relating to sales  
21 and returns of the *Shrek 2* home video made in various press  
22 releases, earnings calls and filings with the Securities and  
23 Exchange Commission ("SEC") made after the IPO, between December  
24 of 2004 and March of 2005. To state a claim under Section 10(b)  
25 of the Exchange Act and Rule 10b-5 promulgated thereunder,  
26 plaintiffs must allege: (1) a misrepresentation or omission of a  
27 material fact; (2) scienter; (3) causation; (4) reliance; and (5)  
28 damages. *Livid Holdings Ltd. v. Salomon Smith Barney, Inc.*, 403

1 F.3d 1050, 1055 (9<sup>th</sup> Cir. 2005). In addition, plaintiffs must  
2 satisfy the heightened pleading requirements of the Private  
3 Securities Litigation Reform Act ("PSLRA") and the particularity  
4 requirements of Rule 9(b). *Id.*

5 Defendants argue that Plaintiffs have not adequately alleged  
6 scienter. To plead scienter under the PSLRA, plaintiffs "must  
7 plead, in great detail, facts that constitute strong  
8 circumstantial evidence of deliberately reckless or conscious  
9 misconduct." *In re Silicon Graphics Se. Litig.*, 183 F. 3d 970,  
10 974 (9<sup>th</sup> Cir. 1999). A "strong inference" of deliberately  
11 reckless conduct requires plaintiffs to plead with particularity  
12 "facts that come close to demonstrating intent" and revealing  
13 more than "simple recklessness or a motive to commit fraud and an  
14 opportunity to do so." *Id.* Where pleadings are not sufficiently  
15 particularized or where, taken as a whole, they do not raise a  
16 strong inference of scienter, a Rule 12(b)(6) dismissal is  
17 proper. *Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1035 (9<sup>th</sup>  
18 Cir. 2002). Plaintiffs here attempt to plead scienter by  
19 alleging that (1) Defendants had detailed knowledge of actual  
20 sales and returns of the *Shrek 2* DVD throughout the relevant  
21 period and recklessly reported false sales figures in press  
22 releases, earnings calls and SEC filings and (2) Defendants had  
23 knowledge of the alleged trend in the DVD market toward a shorter  
24 retail window and engaged in an undisclosed strategy of "flooding  
25 the market" with *Shrek 2* DVDs in an attempt to counter it.

26 In support of the first of these two claims, that Defendants  
27 had knowledge of actual sales and returns of the *Shrek 2* DVD and  
28 recklessly reported false sales figures, Plaintiffs make four

1 additional allegations. First, they allege that Defendants had  
2 access to and closely monitored "a wealth of information" and  
3 "constant updates" on *Shrek 2* sales performance. However,  
4 Plaintiffs provide no information as to what kind of sales data  
5 the Defendants allegedly had access to or when they had it, nor  
6 do they make any specific allegations that such information was  
7 inconsistent with Defendants' public statements. The only  
8 evidence offered in support of this allegation is a general  
9 statement by a "confidential witness," an unidentified employee  
10 of Blockbuster, Inc., that his supervisor communicated  
11 Blockbuster sales data to a representative from Dreamworks on a  
12 daily basis and that "everybody...is able to obtain sales figures  
13 either in real time or by the next morning and that these figures  
14 are communicated to the studios daily." (Am. Comp. at ¶¶124,  
15 125). Without information identifying internal reports of sales  
16 data and the contents of those reports, "we cannot ascertain  
17 whether there is any basis for the allegations that the officers  
18 had actual or constructive knowledge" of the relevant trend "that  
19 would cause their optimistic representations to the contrary to  
20 be consciously misleading." *Lipton*, 284 F.3d at 1036, quoting *In*  
21 *re Silicon*, 183 F. 3d at 985. Absent particularized information  
22 related to the identity and content of the alleged sales reports,  
23 this general statement of an unidentified witness does not give  
24 rise to a strong inference of scienter.

25 Second, Plaintiffs argue that Defendants' knowledge of  
26 actual sales inconsistent with their public statements is  
27 demonstrated by the fact that Dreamworks took "corrective action"  
28 to respond to sagging sales by offering discounts to retailers on

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1 the *Shrek 2* DVD only 30 days after release. However, the trade  
2 publication article that the Plaintiffs cite in the Amended  
3 Complaint in support of this proposition notes that 30 day  
4 discounts to retailers are increasingly common in the DVD market.  
5 The fact that *Shrek 2* was discounted 30 days after release, by  
6 itself, does not give rise to a strong inference of scienter.

7 Third, Plaintiffs allege that a discrepancy between year end  
8 sales figures announced on March 17, 2005 (37 million units) and  
9 the financial year-end number reported in the 10-K filed on March  
10 28, 2005 (33.7 million units) gives rise to an inference that  
11 Plaintiffs were recklessly reporting false sales figures.  
12 However, as defendant Leslie, Dreamworks' CFO, explained on both  
13 the December 8, 2004 and the March 17, 2005 earnings calls,  
14 Dreamworks distinguishes between actual numbers of units sold and  
15 units recognized for financial reporting purposes (which allows  
16 for a reserve for returned units). The discrepancy highlighted  
17 by the Plaintiffs was plainly explained on the March 17 call.  
18 Plaintiffs are incorrect when they suggest that scienter can be  
19 inferred from this discrepancy.

20 Fourth, Plaintiffs allege that Defendants' knowledge of  
21 actual sales inconsistent with their public statements is  
22 demonstrated by their own admission that they receive routine  
23 sales information. Plaintiffs point to a statement made on an  
24 August 11, 2005 analyst conference call during which a Dreamworks  
25 employee stated that Dreamworks does receive sales information,  
26 and states that some of this is received on a daily or weekly  
27 basis. However, this statement was made well after the relevant  
28 period and says nothing in relation to any particular sales data

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1 reviewed by Defendants. Like the comments of Plaintiffs'  
2 confidential witness, this kind of statement could be taken as  
3 generally true, but does not give rise to a strong inference of  
4 scienter as required under the PSLRA.

5 Plaintiffs also seek to show scienter by pointing toward  
6 Plaintiffs' alleged knowledge of trends in the home video market  
7 toward a higher percentage of total sales in the initial days and  
8 weeks after release, as well as toward its alleged "flood-the  
9 market" sales strategy. As discussed above, however, the sources  
10 cited in the Amended Complaint do not support of the existence of  
11 such a trend or Defendants' awareness of it during the relevant  
12 time period. At most, based on these sources, the market trends  
13 described by Plaintiffs were only emerging at the time Defendants  
14 allegedly made material misstatements, and cannot form the basis  
15 of a strong inference of scienter under the PSLRA's heightened  
16 pleading requirements.

17 Finally, the Court finds that the Amended Complaint fails to  
18 make any specific scienter allegations with respect to the  
19 Individual Defendants. The only scienter allegations against  
20 defendants Katzenberg and Enrico, other than general references  
21 to Katzenberg's experience in the entertainment field, are  
22 allegations of motive and opportunity that do not, on their own,  
23 give rise to a strong inference of scienter. See *In Re Silicon*,  
24 183 F.3d at 979. No specific scienter allegations are made with  
25 respect to defendants Kendrick and Leslie. With respect to  
26 Allen, the only allegations are that he signed the 10-K and had a  
27 financial motive to artificially inflate the stock price. These  
28 wholly conclusory allegations do not give rise to a strong

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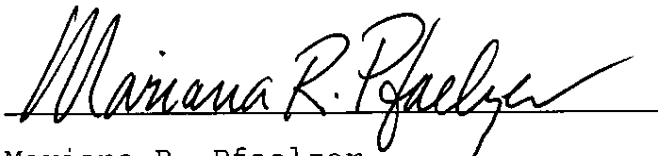
1 inference of scienter as required under the PSLRA. See *In re*  
2 *Infonet Servs. Corp. Sec. Litig.*, 310 F. Supp 2d 1080, 1105 (C.D.  
3 Cal. 2003).

4  
5 **V. Conclusion**

6 For the foregoing reasons, the Court GRANTS Defendant's  
7 Motion to Dismiss Plaintiffs' Consolidated Amended Class Action  
8 Complaint. Because the Court finds that the sources cited by  
9 Plaintiffs in support of their allegations under Sections 11,  
10 12(a)(2) and 15 of the Securities Act in fact contradict the  
11 claims made in the Amended Complaint, amendment with respect to  
12 these claims would be futile. Accordingly Counts I, II and III  
13 are dismissed *with prejudice*. The Court also finds that  
14 Plaintiff has failed to meet the heightened pleading requirements  
15 of the PSLRA and Rule 9(b) with respect to its claims under  
16 Sections 10(b) and 20(a) of the Exchange Act, and accordingly  
17 Counts IV and V of the Amended Complaint are dismissed *without*  
18 *prejudice*. Plaintiffs are granted leave to amend the Amended  
19 Complaint with respect to Counts IV and V only. The Plaintiffs  
20 shall file their amended pleading within sixty days from the date  
21 of this order.

22  
23 IT IS SO ORDERED.

24 DATED: April 12, 2006



Mariana R. Pfaelzer  
United States District Judge

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