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Corporate governance best practices should begin before IPO

By Richard S. Horvath, Jr.

Last month, in *In re Fitbit, Inc. Stockholder Derivative Litigation*, C.A. No. 2017-0402-JRS (Del. Ch. Dec. 14, 2018), Vice Chancellor Joseph Slights of the Delaware Court of Chancery issued an important decision denying a motion to dismiss this derivative litigation arising out of the June 18, 2015 initial public offering and the Nov. 13, 2015, secondary offering of Fitbit, Inc. While there is much in the decision that warrants consideration, of particular note is the cautionary tale offered for pre-public companies and their venture capital investors. The ruling again demonstrates the need for corporate governance best practices — specifically, the appointment of fully empowered independent directors — well before any IPO.

Background

The court's decision succinctly sets out the allegations. Only a brief summary is needed here.

At the time of the IPO, Fitbit was addressing difficulties with PurePulse, its wrist-based heart rate monitoring technology. Despite being used in products constituting 80 percent of Fitbit's revenue, PurePulse was allegedly inaccurate above low or resting heart rates. Allegedly knowing that technical fixes for PurePulse were not bearing fruit, Fitbit nonetheless failed to disclose problems with PurePulse in the offering documents.

The court also described three allegedly unusual aspects of the offerings.

First, both offerings allocated an unusually large percentage of stock to be sold by insiders, including venture capital funds affiliated with two Fitbit directors — up to 47 percent of the IPO shares and up to 85 percent of the secondary offering shares. While the Fitbit board appointed a three-member IPO Pricing Committee to determine the number of shares the insiders could sell in the IPO, two of the committee members were the directors affiliated with the venture capital funds.

Second, a month after the IPO, the Fitbit board began planning the secondary offering. The timing was unusual, as a Fitbit advisor informed the board that only a "small subgroup" of companies comparable to Fitbit had so quickly conducted a secondary offering.

Third, before the secondary offering, the Fitbit board lifted lock-up restrictions that prevented insiders from selling stock sooner than 180 days after the IPO. Because the lock-up would have expired during a trading blackout, the insiders would not have been able to sell any stock until March 1, 2016. With the lock-ups waived, the insiders allegedly sold 9.62 million shares in the secondary offering.

On Jan. 5, 2016, weeks after the secondary offering was completed, the problems with PurePulse came to light through a consumer class action filed in federal court. A securities class action, and this derivative action, followed. Fitbit settled the securities class action while the motion to dismiss the derivative action was pending.

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The *Fitbit* decision highlights the need for caution in any offering that is structured to enable large investors to sell an unusually large percentage of the offered stock.

The Court of Chancery's Holding in *Fitbit*

In the derivative complaint, the plaintiffs named the five directors on the Fitbit board at the time of the offerings and the company's CFO as defendants. The CFO and four of the directors allegedly sold stock in the offering. The complaint alleged claims for breach of fiduciary duty: (1) against the selling fiduciaries for selling their shares based on material, nonpublic information and (2) against all defendants for (a) allowing the insider sales and (b) waiving the lock-up restrictions.

While the court held that the plaintiffs waived their claim that the defendants allowed the insider sales, the court held that the claims related to the waiver of the lock-up restrictions and the insider sales themselves survived.

The court also held that the directors affiliated with the venture capital funds could be liable for the funds' sales even if the directors did not themselves sell any stock. Otherwise, a director could "trade on inside material information without consequence just because the director did not trade personally but rather passed the information to an entity with which he is affiliated (and over which he exercised control) to do the trading."

As to the waivers of the lock-up restrictions, the court held that the complaint alleged the "selling" directors personally benefitted from the waivers because, with the waivers, they could sell shares based on the nonpublic information about PurePulse. The court also held that claims were stated against the fifth director who did not sell stock because he facilitated the insider sales despite allegedly knowing of the problems with PurePulse.

Corporate Governance Takeaways

The court's decision highlights why both the boards of pre-IPO companies and their venture capital investors should be concerned with corporate governance best practices.

Independent directors, acting with due care, are at the heart of sound corporate governance. The *Fitbit* decision demonstrates the need for pre-public boards to have sufficient independent directors who can guide an IPO. Should there be any aspect of an offering that could place the interests of the company's founders or its large venture capital investors in conflict with other investors, independent directors can navigate the rocky shoals of that conflict. Moreover, often an alleged conflict comes down to how a transaction is portrayed in litigation years after the fact. That portrayal can be mitigated through unaffiliated directors who are empowered to retain advisors and act in the face of any potential conflicts.

As to venture capital funds and their board representatives, the decision highlights the need for caution in any offering that is structured to enable large investors to sell an unusually large percentage of the offered stock. In addition, combined with the Court of Chancery's earlier holding in *Lee v. Pincus*, C.A. No. 8458-CB (Del. Ch. Nov. 14, 2014), one can expect that the court will warily review waivers of lock-up restrictions — especially where there is a potential argument that insiders benefitting from the waiver stand differently from other investors in the company. Here again, vesting authority in independent directors to pass upon the structure of an offering or the waiver of lock-up restrictions could safeguard against any allegations of self-dealing.

The court's decision will not be the last word in the *Fitbit* litigation. Nonetheless, the decision should be taken as an opportunity for in-house counsel, outside counsel, and stakeholders to assess the governance practices in place at companies contemplating an IPO.

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