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Case No. 2017-0402-JRS

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE FITBIT, INC. STOCKHOLDER DERIVATIVE LITIGATION	CONSOLIDATED C.A. NO. 2017-0402-JRS

NOMINAL DEFENDANT'S APPLICATION FOR CERTIFICATION OF INTERLOCUTORY APPEAL

1. Under Supreme Court Rule 42, nominal defendant Fitbit, Inc. ("Fitbit") respectfully requests this Court to certify to the Delaware Supreme Court an interlocutory appeal from this Court's December 14, 2018 Memorandum Opinion ("Opinion," Ex. A) and Order[1] denying Fitbit's motion to dismiss for failure to plead demand excusal under Rule 23.1 as to Plaintiffs' insider trading and breach of fiduciary duty claims.[2] (Op. 2.) Fitbit and its counsel have determined in good faith that this application meets the criteria in Rule 42(b)(iii).

PRELIMINARY STATEMENT

2. The Opinion decides substantial issues of material importance and should be certified for interlocutory review. The Opinion satisfies at least four of the eight factors under Rule 42(b)(iii), any one of which independently warrants

[1] Although no formal order has been entered, implicit in the Opinion is an order denying the motion to dismiss (the "Order").

[2] Defendants are James Park and Eric Friedman (the "Officer Directors"); Jonathan Callaghan, Steven Murray, and Christopher Paisley (the "Outside Directors" and together with the Officer Directors, the "Director Defendants"); and William Zerella, Fitbit's former CFO.

review. First, the Opinion unsettles decades of Delaware law recognizing the distinction between outside and inside directors and the heightened business judgment presumption afforded the former. Second, the Opinion creates new law, by holding that two Outside Directors face a substantial likelihood of liability on the insider trading claim, even though the operative complaint ("Complaint," Dkt. 18) does not allege that either Director personally sold any shares or benefited from any sales. Third, if the Court's Order were overturned, Plaintiffs' failure to adequately plead demand excusal would result in dismissal of the lawsuit. And fourth, interlocutory review will serve the interests of justice by properly balancing Plaintiffs' interests in pursuing derivative claims and the Board's prerogative of controlling litigation of Fitbit's claims and avoiding the costs of unnecessary litigation. The benefits of interlocutory review, therefore, far outweigh its costs.

BACKGROUND

3. The Complaint, filed on March 20, 2018, alleges that Fitbit made public statements claiming that its PurePulse™ heart-rate tracking technology was "highly accurate," even though Defendants allegedly knew that PurePulse™ did not provide accurate heart-rate readings. (¶¶ 40-41, 102.) The Complaint purports to state a *Brophy* claim of insider trading in Fitbit's "June 2015 IPO" and "November 2015 SPO." (¶¶ 205-211.) The Complaint also alleges a claim for

breach of fiduciary duty, challenging the Board's decision to waive lock-up agreements that would have prevented the challenged sales. (¶¶ 199-204.)

4. Defendants moved to dismiss the Complaint pursuant to Rules 23.1 and 12(b)(6). Following briefing and oral argument, the Court issued the Order denying Defendants' motion to dismiss.

5. The Court held that five of the seven-member "Demand Board"—two Officer Defendants and three Outside Directors—were not disinterested.[3] The Court held that Plaintiffs adequately pled that all five Director Defendants (including two Outside Directors) possessed material, nonpublic information and acted with scienter—despite having concluded that "the evidence mentioned in the SAC expressly identifies only [the Officer Directors] as having received the internal documents that recount the problems Fitbit was experiencing with the PurePulse™ technology." (Op. 40, 47.)

6. In so holding, the Court relied on the "core operations doctrine," to infer the Outside Directors' knowledge, "because the problems with PurePulse™ were profound and PurePulse™ drove the Company's bottom line." (Op. 40 & n.179.) Plaintiffs allege that three of Fitbit's products accounted for 79% of its revenue in 2015. (¶ 85.) PurePulse™ was a feature on two products. (¶¶ 41, 85.)

[3] The Demand Board also consists of two non-defendant directors: Laura Alber and Glenda Flanagan.

7. The Court also found that the Complaint adequately pled the Outside Directors' knowledge based on rulings in a related federal securities class action lawsuit that had survived a motion to dismiss. Although that action alleged claims under Section 10 of the 1934 Exchange Act and Section 11 of the 1983 Securities Act (Compl. Ex. B at 4), the Outside Directors were named as defendants only in the Section 11 claim. Knowledge is not an element of a Section 11 claim. (*Id.* at 19-20.)

8. The Court also held that two Outside Directors (Callaghan and Murray) face a substantial likelihood of liability on the *Brophy* claim, even though neither personally sold stock in the offerings. (Op. 35.) Callaghan's and Murray's affiliated investment funds sold shares, but the Complaint does not name those funds as defendants, nor does it contain any allegations that Callaghan or Murray personally benefited from those sales.

ARGUMENT

9. The Court may certify an interlocutory appeal where its ruling "decides a substantial issue of material importance that merits appellate review before a final judgment." Sup. Ct. R. 42(b)(i).

10. That is the case here. The Court granted Plaintiffs standing to sue Fitbit officers and directors on behalf of the company.[4] Plaintiffs' standing to sue

[4] *But see* Op. 3 n.4 (permitting discovery into Plaintiffs' stock ownership).

is a substantial issue of material importance to Fitbit, whose Board, under this ruling, would no longer have the authority to control whether to pursue claims on Fitbit's behalf. *See Gentile v. Rossette*, 2005 WL 3272361, at *2 (Del. Ch. Nov. 21, 2005) (order resolving standing to pursue claim "resolved a substantive legal issue" and a "substantial issue"); *see also Braddock v. Zimmerman*, 906 A.2d 776 (Del. 2006) (considering interlocutory appeal from decision granting plaintiff leave to file second amended complaint after dismissal on demand futility grounds). And the issue is of material importance to Delaware law more broadly, because the Opinion departs from a consistent line of Delaware cases on a key legal issue, and decides a novel issue of law.

11. Before certifying a decision for interlocutory review, this Court "should identify whether and why the likely benefits of interlocutory review outweigh the probable costs, such that interlocutory review is in the interest of justice." Sup. Ct. R. 42(b)(iii). Rule 42(b)(iii) identifies eight factors the Court should consider in deciding whether to certify an interlocutory appeal. Although satisfaction of even one factor is sufficient to warrant interlocutory review, *see Al Jazeera Am., LLC v. AT&T Servs., Inc.*, 2013 WL 5738034, at *2 (Del. Ch. Oct. 23, 2013), the Order here satisfies at least four.

I. THE OPINION CONFLICTS WITH "[T]HE DECISIONS OF THE TRIAL COURTS . . . UPON THE QUESTION OF LAW." (RULE 42(B)(iii)(B))

12. The Opinion creates a conflict with other trial courts on whether the "core operations" inference of *scienter* applies in considering an outside director's knowledge under Rule 23.1's heightened pleading standard.

13. Before the Opinion was issued, no Delaware case applied a core operations inference in the context of a 23.1 motion. Recognizing that, the Opinion frames its holding as relying not solely on the core operations inference, but also on "well-pled facts" that "management was keeping the Board apprised of the problems and efforts to address them" (Op. 41), and on a federal court decision denying dismissal of a related securities class action (*id*. 42-44). But no well-pled facts in the Complaint support the inference that the Outside Directors "knew of the alleged material, nonpublic information" (Op. 41 n.179), nor does the federal court decision in the related case.

14. First, the Complaint contains no particularized allegation even suggesting the Outside Directors had access to the alleged material, nonpublic information. Plaintiffs made no specific allegations regarding reports, studies, or analyses furnished to the Board, or Board meeting minutes from which it may be inferred that the Outside Directors had actual knowledge of the alleged nonpublic information. Plaintiffs' only allegation regarding Board knowledge is that one

presentation "*appears to have been* a presentation to Fitbit's Board." (¶ 118 (emphasis added).) That allegation fails to meet the particularity requirements of Rule 23.1, and the specific facts Plaintiffs do allege are to the contrary. Plaintiffs allege that the presentation was "emailed to Friedman" and that "both Defendants Park and Friedman reviewed" it. (*Id.*) Granting Plaintiffs the benefit of reasonable inferences cannot permit them to make allegations inconsistent with the very documents they cite. To allow that stands the well-established presumption of directors' good faith on its head.

15. Second, the Opinion's reading of the federal court decision denying dismissal of the securities class action—as holding that the facts alleged in the Complaint "supported an inference of knowledge not only for Park, Friedman and Zerella but also for all Defendants under a 'holistic review' of the pleading" (Op. 44)—is incorrect. The federal court did *not* address the Outside Directors' knowledge, because knowledge was not an element of the federal securities claim brought against them. The federal court addressed only the knowledge of Fitbit's *officers* (Park, Friedman, and Zerella). Only they faced a Section 10 claim, for which knowledge is an element.[5] (Defs.' Opening Br. ("DOB," Dkt. 21) at 40-41;

[5] For the same reason, the Opinion's citation to *Pfeiffer* (Op. 42) does not support its reading of the federal court's decision. Unlike here, all the director defendants in *Pfeiffer* were named as defendants to Section 10 fraud claims in the related class action. (Defs.' Reply Br. ("DRB," Dkt. 39) at 16); *Pfeiffer v. Toll*, 989 A.2d 683, 690 (Del. Ch. 2010) (citing parallel action alleging Section 10 claims.)

DRB at 15-16.) And the federal court did *not* find that the officers' knowledge could be inferred solely from a "'holistic review' of the pleading," without particularized allegations. Rather, the federal court explicitly relied on specific witness allegations. The full text of the federal court's holding cited in the Opinion reads: "Particularly given the contributions these devices made to Fitbit's revenue stream in 2015, *and the allegations by CW1 and CW2*, the Court finds that a holistic review of the allegations suffices to establish scienter" as to the Fitbit executives. (Pls.' Compendium Tab 2 (Dkt. 32) at 18 (emphasis in original but omitted from Opinion's quotation).)

16. At bottom, therefore, the Opinion rests on drawing an inference of the Outside Directors' scienter based solely upon the allegation that "the problems with PurePulse™ were profound and PurePulse™ drove the Company's bottom line." (Op. 41 n.179.) The one case the Opinion cites as support—*Pfeiffer*, 989 A.2d 683—is inapposite because it drew a core operations inference under the more "plaintiff-friendly Rule 12(b)(6) standard." *Id.* at 692. Courts have repeatedly distinguished *Pfeiffer* on that basis in refusing to apply the core operations inference in the context of Rule 23.1's heightened pleading standard. *See, e.g.*, *Sandys v. Pincus*, 2016 WL 769999, at *17 (Del. Ch. Feb. 29, 2016), *rev'd on other grounds*, 152 A.3d 124 (Del. 2016); *see also* DRB at 12. As those

courts have recognized, to do otherwise would eviscerate Rule 23.1's particularity requirement.

17. Other trial courts have also recognized that applying the core operations inference to establish *outside directors*' scienter in the demand futility context is especially problematic. That is so not only because of the heightened business judgment presumption for outside directors, but also because a derivative complaint must plead facts on a director-by-director basis. *See* R. Franklin Balotti, et al., *Del. L. of Corp. & Bus. Orgs.* § 4.19 (3d ed.) (2018 supp.) ("[T]he Delaware Supreme Court has held that the presumption of propriety afforded directors' decisions under the business judgment rule is 'heightened' when a majority of the members of the board of directors are independent, outside directors.") (citing Delaware cases); *Desimone v. Barrows*, 924 A.2d 908, 943 (Del. Ch. 2007) ("a derivative complaint must plead facts *specific to each director*" to demonstrate demand futility).

18. That the Complaint cannot allege that Fitbit's product issues had any impact on sales further underscores why no inference of knowledge can be drawn as to the Outside Directors. *See In re Forest Labs., Inc. Deriv. Litig.*, 450 F. Supp. 2d 379, 391 (S.D.N.Y. 2006). Here, the 220 documents incorporated into the Complaint show that Fitbit received relatively few complaints about the heart-rate tracking monitors on the PurePulse™ devices. By the time of the June 2015 IPO,

only "0.3% of Charge HR customers and 0.6% of Surge customers ha[d] filed a complaint of [heart rate tracking] accuracy." (Rohrer Aff. Ex. 56 (Dkt. 25) at 1434 (Dkt. 25); DOB at 39.)

19. If left uncorrected, the Opinion will be read to stand for the proposition that a stockholder need only allege that a product was key to a company's revenues to obtain the benefit of an inference that outside directors—who typically meet on a periodic basis and are not involved in the company's day-to-day operations—were privy to all company information about that product. That has never been the law in Delaware until now, and it is inconsistent with Rule 23.1's particularity requirement.

II. THE CASE "INVOLVES A QUESTION OF LAW RESOLVED FOR THE FIRST TIME IN THIS STATE." (RULE 42(B)(iii)(A))

20. Crucial to Plaintiffs' demand futility theory is their allegation that two outside directors—Callaghan and Murray—sold shares in the public offerings and are therefore liable under *Brophy*. (Compl. ¶¶ 192-93.) Yet Plaintiffs conceded that those directors did not personally sell shares. (POB at 12 n.47.) Rather, two investment funds, with which Callaghan and Murray are affiliated, sold shares.

21. Given this undisputed fact, the Opinion acknowledges that Plaintiffs' *Brophy* claim against these two Outside Directors was unprecedented: no previous Delaware case had held that "a fiduciary may be held liable on a *Brophy* claim for

trades that an entity or fund associated with that fiduciary executed in its name." (Op. 36.)

22. Although disclaiming a "basis or reason to state a hard and fast rule" resolving the question, the Opinion does state such a rule. The Opinion holds that "finding *ipso jure* that the True Ventures and Softbank trades cannot be attributed to Callaghan and Murray would frustrate the policy that animates *Brophy*," and that these Outside Directors could be held liable for their affiliated funds' trades. (Op. 37.) It further holds that because those Outside Directors "share voting and dispositive power over the Fitbit stock owned by their respective funds," allegations that those Directors sold through their funds "are sufficient at the pleading stage to allow a reasonable inference that Callaghan and Murray personally and materially profited from the challenged stock sales," (Op. 39), even though the Complaint itself alleges no personal benefit to them at all. Both holdings are unprecedented and mistaken as a matter of Delaware law.

23. First, the premise of a *Brophy* claim must be that a fiduciary abuses his fiduciary duty to a company "to his own profit." (Op. 37 (quoting *Brophy v. Cities Service Co.*, 70 A.2d 5, 8 (Del. Ch. 1949) ("[w]hen … a person 'in a confidential or fiduciary position, in breach of his duty, uses his knowledge *to make a profit for himself*, he is accountable for such profit.") (emphasis added)).) Holding that two directors who did not personally execute any trades are exposed

to *Brophy* liability unsettles the bedrock corporate law principle that a corporation and its owners and directors are separate actors. (DOB at 26; DRB at 10 n.9); *see also* 1 Fletcher Cyc. Corp. § 25, n.1. The same liability limitation applies to limited liability partnerships. Rev. Unif. P'ship Act § 201 (1994) (providing that a partnership is an entity distinct from its partners). The Opinion disregards this bedrock principle of legal separation, subjecting Callaghan and Murray to potential liability for sales of stock they did not own.

24. The Court expressed concern that enforcing the strict separation between a person and an affiliated fund would leave directors free "to trade on inside material information without consequence" (Op. 37). But as the Opinion recognizes, federal law provides a remedy if a plaintiff, or regulator, could prove that a fiduciary acted as a "tipper." (*Id*. 37-38 n.170). Even federal tipper liability requires a personal benefit to establish liability (*id*.), yet the Complaint lacks any allegations of personal benefit to Callaghan or Murray.

25. Second, there is no support for the ruling that it was permissible to infer that Callaghan and Murray would "profit from inside information" based solely on their alleged "ownership and control of their affiliated funds" (Op. 39). Again, the Complaint nowhere alleges that Callaghan or Murray benefited from their affiliated funds' sales. Drawing that inference without any such particularized allegations contravenes Rule 23.1's heightened pleading standard.

III. REVIEW OF THE OPINION "MAY TERMINATE THE LITIGATION." (RULE 42(B)(iii)(G))

26. The Court's Opinion determines the potentially dispositive issue of whether Plaintiffs could pursue their derivative claims, notwithstanding their failure to present a demand to Fitbit's Board. Had the Court granted the motion to dismiss, the litigation would have terminated.

IV. REVIEW OF THE OPINION "MAY SERVE CONSIDERATIONS OF JUSTICE." (RULE 42(B)(iii)(H))

27. A fundamental purpose of Rule 23.1's demand requirement is to protect the board's right to control the affairs of a company: "[T]he demand requirement of Chancery Rule 23.1 exists at the threshold, first to insure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits." *Aronson v. Lewis*, 473 A.2d 805, 811-12 (1984), *overruled on other grounds*, *Brehm v. Eisner*, 746 A.2d 244 (Del. Ch. 2000). Interlocutory review of the rulings in the Opinion will balance Plaintiffs' interests in pursuing derivative claims against the Board's legitimate prerogative in controlling litigation of Fitbit's claim and avoiding the costs of a possibly unnecessary and meritless lawsuit.

28. Because interlocutory appeals of decisions denying Rule 23.1 motions to dismiss can terminate litigation and otherwise serve the interests of justice, the Supreme Court has accepted review of such decisions and used such interlocutory

review to render foundational rulings on demand futility. *See, e.g.*, *Braddock*, 906 A.2d 776; *Aronson*, 473 A.2d at 807; *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

CONCLUSION

For the foregoing reasons, the Order should be certified for interlocutory review.

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