

Corporate Litigation:

Preclusion in Derivative Litigation: New Uncertainty

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The dismissal of a putative stockholder derivative complaint for failure to make pre-suit demand has long been understood to have preclusive effect against attempts by different stockholders to relitigate the demand issue in another court. These decisions recognize that because a stockholder derivative plaintiff sues in the name of the company, privity for preclusion purposes exists between the plaintiffs in the first and subsequent actions making similar allegations because in both the company is the real party in interest. In a recent decision with truly far-reaching ramifications, Vice Chancellor J. Travis Laster in [*Louisiana Municipal Police Empl. Ret. Sys. v. Pyott*](#)¹ rejected these authorities, announcing a rival approach to preclusion predicated on Delaware's internal affairs doctrine rather than full faith and credit principles.

As an independent basis for withholding preclusive effect from a prior federal court judgment, Vice Chancellor Laster announced a Delaware law presumption that a "first-filing stockholder with a nominal stake" who sues derivatively without conducting meaningful pre-suit investigation has not provided adequate representation to the company and its stockholders. *Louisiana Municipal* has introduced substantial uncertainty into an area that requires predictable results. The Delaware Supreme Court has accepted an interlocutory appeal from the decision, and will be asked to provide important guidance not only on recurring representational and preclusion questions in multi-forum stockholder litigation, but on constitutional matters of federal and state sovereignty and comity.

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Pre-Suit Demand and Preclusion

Derivative claims are property of the corporation, which is why a stockholder must make a demand on the company's board or adequately allege demand futility to pursue derivative claims on the company's behalf. To prevent abuse of the derivative form of suit, as a precondition to seeking to enforce a right of a corporation a stockholder must demonstrate that the corporation refused to proceed as requested after suitable demand, unless demand is excused because particularized allegations establish reasonable doubt that a majority of the board could impartially consider a demand. Chancery Court Rule 23.1 provides that the complaint in any derivative suit must, among other things, "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort."

Parallel lawsuits regarding the same allegations are a familiar dynamic in stockholder litigation. In derivative litigation, recent Delaware decisions have sought to curb fast-filed, inadequately investigated complaints by emphasizing that when stockholders sue in Delaware in a representative capacity, first-to-file does not control which plaintiff and their counsel will be granted the leadership role. When the suits are filed in more than one forum, a key strategic objective for defendants is avoiding the burden and expense of litigating the same issues in multiple jurisdictions. Once the first final decision on demand-related allegations is rendered, preclusion doctrine protects these interests.

A request that one court give preclusive effect to a judgment entered in another court invokes constitutional full faith and credit principles. As the U.S. Supreme Court has recognized, "[r]egarding judgments...the full faith and credit obligation is exacting."² The preclusive effect of a judgment is determined by the law of the forum in which the judgment was rendered. Accordingly, the Delaware Court of Chancery "gives the same preclusive effect to the judgment of another state or federal court as the original court would give."³ In the U.S. Court of Appeals for the Ninth Circuit (the rendering jurisdiction in *Louisiana Municipal*) a party seeking to invoke issue preclusion (a/k/a collateral estoppel) must show that (1) an identical issue was necessarily decided in the previous proceeding, (2) "the first proceeding ended with a final judgment on the merits," and (3) "the party against whom collateral estoppel is asserted was a party or in privity with a party at the first proceeding."⁴

Privity, for purposes of issue preclusion, requires a relationship between two parties that is sufficiently close to bind them both to an initial determination. Outside the context of a certified class action, preclusion generally cannot be applied against entities that themselves did not have an opportunity to litigate in the initial action. In the derivative suit context, issue preclusion and demand futility law plainly bar the same stockholder who unsuccessfully litigates whether pre-suit demand was excused as futile from attempting to file a second putative derivative action again alleging demand futility.

Virtually every court to consider the question also has recognized that privity exists between the original and subsequent stockholder derivative plaintiffs because both sue on behalf of the corporation, asserting claims belonging not to them as individuals, but to the corporation. That is, because the claim belongs to the corporation, that the stockholders seeking to press the claim are different is irrelevant.⁵ Accordingly, the overwhelming weight of authority holds that once the issue of demand futility is litigated and decided against a stockholder who adequately represented the interests of the corporation and other stockholders, issue preclusion bars all subsequent stockholder plaintiffs from relitigating demand futility.

‘Louisiana Municipal’

Allergan, Inc. announced a settlement with the Department of Justice under which it pled guilty to criminal misdemeanor misbranding of Botox arising from its past marketing of Botox for off-label use. The settlement entailed \$600 million in fines and related civil penalties. Within days of announcement of the settlement and relying solely on publicly available materials, stockholders filed putative derivative suits in the Delaware Court of Chancery and California federal court on behalf of the company against Allergan’s board.

Two months later, another stockholder served a books and records demand on Allergan and moved to intervene in the Delaware action. The Delaware plaintiff opposed the proposed intervention as threatening to delay adjudication of its claims. The Court of Chancery denied intervention without prejudice, but postponed a hearing on defendants’ motion to dismiss pending completion of the books and records process.

Meanwhile, in the California action, the court twice granted motions to dismiss for failure to plead demand futility, the second time with prejudice after the California

plaintiffs amended their complaint to incorporate information obtained from Allergan's books and records production. Defendants then supplemented their Delaware motion to dismiss with collateral estoppel arguments, asserting that the California dismissal precluded the Delaware suit.

Vice Chancellor Laster held that the suit was not precluded, concluding that a stockholder who unsuccessfully alleges demand futility or demand refusal never obtains authority to assert the company's claims and therefore has not litigated in the name of the company. The court acknowledged that full faith and credit principles required it to give the California judgment the same preclusive effect it would receive in California. Issue preclusion in California (and elsewhere) requires that the party against whom preclusion is sought was party to or in privity with a party to the prior action.

The court considered and rejected as incorrectly decided *LeBoyer v. Greenspan*,⁶ a California federal court decision that "applied collateral estoppel to hold that a California state court's dismissal with prejudice of one stockholder plaintiff's derivative action pursuant to Rule 23.1 barred a different stockholder plaintiff from suing derivatively." He also expressly parted ways with [*In re Career Educ. Corp. Deriv. Litig.*](#)⁷ in which Vice Chancellor Donald Parsons Jr. explained that "differing groups of stockholders who can potentially stand in the corporation's stead are in privity for purposes of issue preclusion" because the corporation is the real party in interest in a derivative suit.

Reasoning that determination of whether a stockholder has authority to sue on behalf of the company is a matter of substance, not procedure, Vice Chancellor Laster ruled that whether successive stockholders are sufficiently in privity with the company to warrant preclusion is governed not by California collateral estoppel law, but by Delaware law and its internal affairs doctrine. Though Vice Chancellor Laster noted the "legal truism" that a derivative plaintiff sues in the name of the company, he asserted that courts invoking this principle to preclude subsequent plaintiffs from relitigating demand futility "miss that as a matter of Delaware law, a stockholder whose litigation efforts are opposed by the corporation does not have authority to sue on behalf of the corporation until there has been a finding of demand excusal or wrongful refusal." That is, unless and until demand-related allegations are successful, the derivative suit asserts only a stockholder's right to seek to compel the company to sue. While a prior decision rejecting demand futility or demand refusal allegations may be persuasive authority, under Vice Chancellor Laster's approach it does not preclude a different stockholder from making the

exact same demand-related allegations because the prior stockholder had not obtained authority to proceed on the company's behalf and therefore bind it.

Having ruled that dismissal of a stockholder derivative suit does not preclude other stockholders from relitigating demand futility, the court advanced an independent basis to deny preclusion: The California plaintiffs did not adequately represent Allergan. Adequate representation by the prior claimant in any representative action is the linchpin to binding other claimants in privity with the prior claimant. Expressing a view that derivative suits hastily filed by stockholder plaintiffs frequently are dismissed because they were inadequately prepared, Vice Chancellor Laster announced a presumption under Delaware law that "a fast-filing stockholder with a nominal stake, who sues derivatively after the public announcement of a corporate trauma in an effort to shift the still-developing losses to the corporation's fiduciaries, but without first conducting a meaningful investigation, has not provided adequate representation."

The court discussed at length the economic incentives it perceived will motivate stockholder plaintiffs' counsel to file as soon as possible after announcement of adverse company news. "Motivated by first-to-file pressure," the court observed, "plaintiffs' firms rationally eschew conducting investigations...fearing that any delay would enable competitors to gain control of the litigation and freeze-out the diligent lawyer. No role, no result, no fee." This economic imperative, Vice Chancellor Laster contended, creates "the dynamics of a lottery ticket," and in most cases the fast-filing plaintiff "will not have pled a derivative action that can overcome Rule 23.1."

The court described an "idealized" derivative lawsuit, in which both managers and stockholders should want potential plaintiffs and their counsel to conduct a thorough investigation through a books and records request, then make a pre-suit demand on the board, and (if the demand is refused) seek further books and records regarding the denial, before filing a fully informed derivative action. According to the court, corporate law's pursuit of this idealized course counseled adoption of a presumption that fast-filing stockholders cannot represent the company.

The court saw the litigation sequence that followed Allergan's Justice Department settlement as exemplifying the first-filer problem. It concluded that the federal plaintiffs sued "without first conducting a meaningful investigation," and therefore "provided inadequate representation for Allergan." The court acknowledged that

the federal plaintiffs had amended their complaint with the benefit of books and records originally demanded by the would-be Delaware intervenor but determined that their inadequacy was irretrievable.

Post-filing work and amendments “did not transform the fast-filing plaintiffs into adequate representatives” because “in [the court’s] view, the fast-filing plaintiffs already had shown where their true loyalties lay,” which the court saw as maximization of potential attorney fees. Having determined that the federal dismissal did not preclude relitigation of the demand futility issue by a different stockholder, the court rejected the federal courts conclusion and ruled that demand was excused because plaintiffs had alleged a substantial threat of liability against a majority of the board.

Conclusion

The rule giving preclusive effect to the first final decision on demand-related allegations is fair, efficient and promotes vital interests of respect for judicial rulings, finality and prevention of relitigation of issues decided. Until the Delaware Supreme Court provides definitive word, managers and stockholders of Delaware corporations must make strategic decisions based on conflicting guidance on whether the law of the first jurisdiction to decide demand issues will govern whether successive stockholders seeking to relitigate demand allegations are in privity with the first stockholder.

The standards of adequate representation for derivative plaintiffs need clarity too. The effect of the fast-filer presumption is a new, judicially created element to the demand requirement: Stockholders may need to seek corporate books and records or risk being a presumptively inadequate representative. A presumption that shareholders who file derivative suits without first making a books and records demand may be overbroad; in certain circumstances, enough public information about a company’s actions is available that a books and records demand is unlikely to change the outcome of a court’s demand futility determination.

Moreover, the Delaware Supreme Court has already provided guidance on how to discourage race-to-courthouse complaints. In [*King v. VeriFone Holdings, Inc.*](#),⁸ the Delaware Supreme Court last year reversed a trial court adoption of a bright-line rule that the filing by a stockholder of a putative derivative action is an “election” that bars the stockholder from pursuing a subsequent books and records action on the subject of the derivative litigation. The Supreme Court suggested three non-

exhaustive measures available to courts when a derivative complaint is filed without adequate investigation: (1) “deny the plaintiff lead plaintiff status;” (2) “dismiss the derivative complaint with prejudice and without leave to amend as to the named plaintiff”; and (3) “grant leave to amend one time, conditioned on the plaintiff paying the defendants attorney fees incurred on the initial motion to dismiss.”

Endnotes:

1. 46 A.3d 313 (Del. Ch. 2012).
2. [*Baker v. General Motors Corp.*](#), 522 U.S. 222, 233 (1998).
3. [*W. Coast Mgmt. & Capital, LLC v. Carrier Access Corp.*](#), 914 A.2d 636, 642-43 (Del. Ch. 2006)
4. *Kona Enterprises, Inc. v. Estate of Bishop ex rel. Peters*, 243 Fed. App’x 274, 278 (9th Cir. 2007).
5. [*In re Sonus Networks, Inc., Sholder Deriv. Litig.*](#), 499 F.3d 47 (1st Cir. 2007); [*Harben v. Dillard*](#), 2010 WL 3893980, *6 (E.D. Ark. 2010) (“Collateral estoppel prevents the issue of pre-suit demand futility from being relitigated” by other stockholders); *LeBoyer v. Greenspan*, 2007 WL 4287646, *3 (C.D. Cal. 2007) (according prior state ruling on demand futility issue preclusive effect against federal derivative plaintiffs, concluding “[t]he differing groups of stockholders who can potentially stand in the corporation’s stead are in privity for the purposes of issue preclusion” and “[w]ere the demand futility issue not final and on the merits it could be infinitely litigated in subsequent suits by successive individual plaintiffs suing in a derivative capacity”); [*Henik v. LaBranche*](#), 433 F.Supp.2d 372, 380 (S.D.N.Y. 2006) (under both res judicata and collateral estoppel, judgment on demand futility in derivative suit has preclusive effect for corporation and stockholders, including stockholders who did not bring prior action).
6. 2007 WL 4287646 (C.D. Cal. 2007).
7. 2007 WL 2875203 (Del. Ch. 2007).
8. [*King v. VeriFone Holdings, Inc.*](#), 12 A.3d 1140 (Del. 2011).

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