SIMPSON THACHER

SECURITIES LAW ALERT

APRIL 2013

This month's Alert addresses a Seventh Circuit decision affirming dismissal of a securities fraud action against Boeing for failure to allege scienter. We also cover two rulings from the Southern District of New York: one dismissing an ERISA stock drop action against Pfizer based on the *Moench* presumption of prudence for fiduciaries of employee stock ownership plans; and another dismissing a securities fraud suit against Research In Motion on the grounds that the complaint alleged only "corporate mismanagement, not malfeasance."

Finally, we discuss a Delaware Supreme Court decision holding that a California federal court's dismissal of a derivative suit brought by shareholders of Allergan for failure to plead demand futility collaterally estopped a similar derivative action brought by a different group of Allergan shareholders.

Save the Date for Our Annual CLE Program

On Monday, June 24th at 4:00 p.m., we will host our annual CLE panel discussion on recent decisions, emerging trends and breaking developments in securities and corporate litigation. Cocktails to follow. Please RSVP for this event by contacting Emma Rotenberg at erotenberg@stblaw.com or 212-455-3529.

Seventh Circuit Affirms Dismissal of a Securities Fraud Action against Boeing for Failure to Allege Scienter

On March 26, 2013, the Seventh Circuit affirmed dismissal of a securities fraud action against The Boeing Company and two of its executives for failure to allege scienter with respect to statements concerning the rollout of Boeing's new 787-8 Dreamliner airplane. *City of Livonia Employees' Ret. Sys. v. The Boeing Co.*, 711 F.3d 754 (7th Cir. 2013) (Posner, J.). The Seventh Circuit also remanded the action for the district court to consider imposing Rule 11 sanctions[1] based on the Seventh Circuit's finding that plaintiffs' counsel had failed to conduct a reasonable

1. Rule 11(c)(1) of the Federal Rules of Civil Procedure provides that "the court may impose an appropriate sanction on any attorney, law firm, or party" that violates Rule 11(b). Rule 11(b)(3) provides in relevant part that "[b]y presenting to the court a pleading … an attorney … certifies that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances … the factual contentions have evidentiary support."

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inquiry before amending the complaint to include confidential witness allegations that were ultimately recanted by the alleged confidential witness.

Background

On April 21, 2009, Boeing's new 787-8 Dreamliner airplane failed a stress test on its wings. On May 3, 2009, Boeing announced that "'all structural tests required on the static airframe prior to first flight are complete.'" The term "First Flight" "denotes the first time a new model of an airplane flies" and represents "an important milestone in the development of a new model."

In mid-May, Boeing conducted another stress test on the new Dreamliner after making some modifications to the design. The Dreamliner failed the stress test again. However, Boeing's CEO W. James McNerney, Jr. publicly expressed his belief that the Dreamliner would make its First Flight as scheduled in June. Scott E. Carson, the head of Boeing's commercial aircraft division, later stated to *Bloomberg* that the Dreamliner "'definitely will fly'" in June.

On June 23, 2009, Boeing announced that the Dreamliner's First Flight had been canceled because of an "'anomaly'" revealed by the stress tests. Boeing also stated that the First Flight's cancellation would result in delivery delays for the Dreamliner, which a number of airlines had already ordered. In the two days following these announcements, Boeing's share price fell by over ten percent. Plaintiffs subsequently filed a putative class action in the Northern District of Illinois asserting claims under Section 10(b) and Rule 10b-5.

Plaintiffs' first amended complaint alleged that "internal emails" made it clear that McNerney and Carson knew that the Dreamliner would not be ready for its First Flight in June 2009 at the time they made the statements at issue. Although the reference to "internal emails" suggested that plaintiffs may have obtained their information from a confidential witness, plaintiffs did not identify a source in the complaint. The Northern District of Illinois could not verify the existence of the alleged "internal emails" and therefore dismissed the complaint without prejudice for failure to allege scienter.

Plaintiffs then filed a second amended complaint that provided details concerning the alleged confidential source. Specifically, the complaint alleged that a "'Boeing Senior Structural Analyst Engineer and Chief Engineer'" had worked on the Dreamliner's wing-stress tests and had "'direct access to, as well as first-hand knowledge of'" Boeing's 787-8 stress test files. The complaint further alleged that those files included "'copies of internal electronic communications to defendants McNerney and Carson … informing'" them that the stress tests had failed and that this might impact the timing of the Dreamliner's First Flight. Based on these new allegations, which in turn were purportedly based on the plaintiffs' investigator's interview notes, the Northern District of Illinois denied defendants' motion to dismiss the second amended complaint.

The alleged confidential source was later revealed to be Bishnujee Singh, an engineer who had been employed by a contractor for Boeing rather than Boeing itself. When deposed by defendants' counsel, Singh stated that he had never worked on the Dreamliner 787-8 and claimed to have no "knowledge of or access to internal Boeing communications

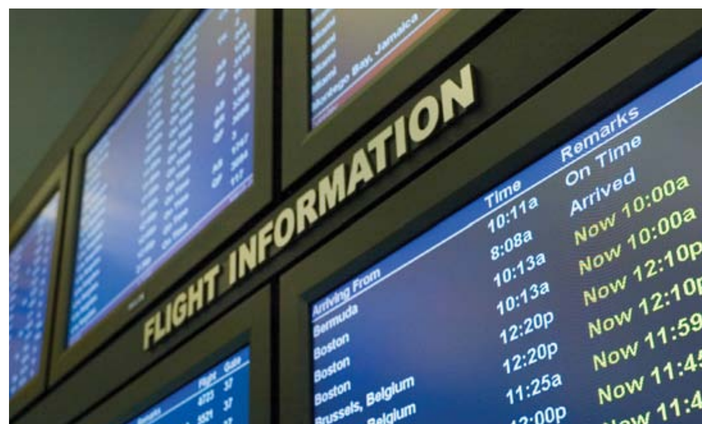
regarding the tests on the 787-8." Defendants subsequently moved for reconsideration of the denial of their motion to dismiss the second amended complaint based on Singh's deposition testimony. On March 7, 2011, the Northern District of Illinois dismissed the second amended complaint with prejudice. *City of Livonia Employees' Ret. Sys. v. The Boeing Co.*, 2011 WL 824604 (N.D. Ill. Mar. 7, 2011) (Conlon, J.).[2] The court found it significant that plaintiffs' counsel did not meet with or even speak with Singh until six months *after* filing the second amended complaint, and had made no attempt to verify the investigator's findings.

Plaintiffs appealed the district court's decision. Defendants cross-appealed based on the district court's failure to consider imposing Rule 11 sanctions on plaintiffs' counsel.

Seventh Circuit Finds the Complaint Fails to Raise a Strong Inference of Scienter

The court found that following defendants' deposition of Singh, plaintiffs determined that Singh would not be a witness at trial. "Either he had told the investigator the same thing he said in his deposition, which would be of no help to the plaintiffs and would expose the investigator as a liar, or he had made opposite assertions on the two occasions, in which event *he* was the liar, which wouldn't help the plaintiffs either." The Seventh Circuit found plaintiffs' "abandonment of their sole confidential source" "fatal" to their case. Without Singh, plaintiffs could point to no "source of access to a Boeing database alleged to contain emails" informing McNerney and Carson that the Dreamliner's stress "test results compelled cancellation of the First Flight."

The Seventh Circuit determined that the remaining allegations in the complaint "did not indicate whether McNerney, Carson, or anyone else who had made optimistic statements about the timing of the First Flight knew that their optimism was unfounded." The court explained that the allegations were "not inconsistent with the defendants' having had a realistic hope that the defects … revealed by the [wing] tests could be eliminated quickly, without requiring postponement" of the Dreamliner's First Flight. "Time may have been needed to digest the information produced by the tests and conclude from it that the First Flight would have to be delayed."



The Seventh Circuit found "[a] more plausible inference than that of fraud is that the defendants, unsure of whether they could fix the problem by June, were reluctant to tell the world 'we have a problem and maybe it will cause us to delay the First Flight and maybe not.'" The court emphasized that "[t]he law does not require public disclosure of mere *risks* of failure." "If a mistaken prediction is deemed a fraud," then corporations will be reluctant to make predictions, even "ones that are well grounded." The Seventh Circuit also underscored that "[t]here is no duty of total corporate transparency" under the securities laws. Not every "hitch or glitch … in a company's operations must be disclosed in 'real time.'"

Here, the court found that Boeing's customers were well aware that there might be delays in production and delivery of the new Dreamliner. "Any sophisticated purchaser of a product that is still on the

2. Please click here to read our discussion of the district court's decision in the March 2011 edition of the Alert.

drawing boards knows … that its market debut may be delayed, or indeed that the project may be abandoned before it yields salable product."

Seventh Circuit Remands the Case for Consideration of Rule 11 Sanctions

Plaintiffs contended that there was no appellate jurisdiction with respect to the issue of Rule 11 sanctions because defendants had never moved for sanctions. The Seventh Circuit determined that "this argument founders" under 15 U.S.C. § 78u-4(c)(1) which provides that "upon final adjudication of the action, the court shall include in the record specific findings regarding compliance by each party … with each requirement" of Rule 11(b) and "impose sanctions" (15 U.S.C. § 78u-4(c)(2)) in the event of non-compliance. The Seventh Circuit found "no requirement" in the statute "that the defendant have asked for the imposition of sanctions." Rather, the Seventh Circuit stated that it was the district court's "duty … to determine whether to impose sanctions." The district court's "failure to do so made the final judgment … vulnerable to challenge by the defendants."

The Seventh Circuit explained that "[r]epresentations in a filing in a federal district court that are not grounded in an 'inquiry reasonable under the circumstances' or that are unlikely to 'have evidentiary support after a reasonable opportunity for further investigation or discovery' violate Rules 11(b) and 11(b)(3)." The court also found it significant that plaintiffs' counsel had been "described in two other reported cases as having engaged in similar misconduct." The Seventh Circuit remanded the action for the district court to determine "whether to impose Rule 11 sanctions … and if so in what amount."

Southern District of New York Relies on the *Moench* Presumption of Prudence to Dismiss an ERISA Stock Drop Action against Pfizer

On March 29, 2013, the Southern District of New York granted defendants' motion to dismiss a putative ERISA stock drop class action against Pfizer Inc., Pharmacia Corporation, and certain of their committees, committee members, and directors.[3] *In re Pfizer Inc. ERISA Litig.*, 2013 WL 1285175 (S.D.N.Y. Mar. 29, 2013) (Swain, J.) (*Pfizer II*). The court found that plaintiffs could not overcome the presumption of prudence for fiduciaries of employee stock ownership plans set forth in *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995) and adopted by the Second Circuit in *In re Citigroup ERISA Litig.*, 662 F.3d 128 (2d Cir. 2011).

Background

In June 2006, plaintiffs filed a consolidated class action complaint on behalf of a putative class of participants in defined contribution plans sponsored

3. Simpson Thacher, together with DLA Piper, represented all defendants in the action.

by Pfizer, Pharmacia, and Warner-Lambert alleging, *inter alia*, breach of fiduciary duty claims under §§ 502(a)(2) and (a)(3) of ERISA. Plaintiffs contended that defendants "either knew or should have known that Pfizer and Pharmacia were engaging in marketing and communications activities" with respect to Celebrex and Bextra, two drugs used for the treatment of arthritis and/or acute pain management, "that artificially inflated the value of Pfizer and Pharmacia securities and rendered them imprudent and inappropriate investments." Plaintiffs further alleged that defendants knew that Celebrex and Bextra "presented cardiovascular and gastrointestinal risks of which the market was unaware." Plaintiffs claimed that defendants were "liable to the Plans under ERISA for losses suffered by the Plans on their holdings of Pfizer and Pharmacia stock."

Defendants initially moved to dismiss the complaint on September 29, 2006. On March 20, 2009, the Southern District of New York dismissed certain claims but permitted plaintiffs' breach of fiduciary duty claims to proceed. *In re Pfizer Inc. ERISA Litig.*, 2009 WL 749545 (S.D.N.Y. Mar. 20, 2009) (Swain, J.) (*Pfizer I*). The court found it "inappropriate" to consider the *Moench* presumption of prudence at the motion to dismiss stage.

Second Circuit Adopts the *Moench* Presumption of Prudence and Rules That the Presumption May Be Considered at the Pleading Stage

On October 19, 2011, the Second Circuit adopted the *Moench* presumption of prudence for fiduciaries of employee stock ownership plans. *Citigroup*, 662 F.3d 128. In *Moench*, the Third Circuit held that a fiduciary of an employee stock ownership plan "who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision." The Third Circuit further ruled that a plaintiff may only "overcome that presumption by establishing that the fiduciary [had] abused its discretion by investing in employer securities."

In *Citigroup*, the Second Circuit held that "only circumstances placing the employer in a 'dire situation' that was objectively unforeseeable by the settlor could require fiduciaries to override plan terms" and divest the plan of company stock. Courts "cannot rely, after the fact, on the magnitude of [a] decrease in the employer's stock price" when evaluating a fiduciary's conduct. Instead, courts "must consider the extent to which plan fiduciaries at a given point in time reasonably could have predicted the outcome that followed."

Notably, the Second Circuit rejected the argument that "the *Moench* presumption should not apply at the pleading stage." The court explained that the *Moench* presumption "is a standard of review applied to a decision made by an ERISA fiduciary" rather than "an evidentiary presumption." "Where plaintiffs do not allege facts sufficient to establish that a plan fiduciary has abused his discretion," the Second Circuit held that "there is no reason not to grant a motion to dismiss."

Since the *Citigroup* ruling, the Second Circuit has addressed the *Moench* presumption in five more decisions: *Gearren v. McGraw–Hill Cos.*, 660 F.3d 605 (2d Cir. 2011); *Fisher v. JP Morgan Chase & Co.*, 469 F. App'x 57 (2d Cir. 2012) (summary order); *In re GlaxoSmithKline ERISA Litig.*, 494 F. App'x 172 (2d Cir. 2012) (summary order); *Slaymon v. SLM Corp.*, 2012 WL 6684564 (2d Cir. Dec 26, 2012) (summary order); and *Taveras v. UBS AG*,

708 F.3d 436 (2d Cir. 2013).

Defendants again moved to dismiss the amended complaint in light of the recent Second Circuit guidance.

The *Pfizer II* Court Finds the *Moench* Presumption Applies to the Plans at Issue

The *Pfizer II* court explained that in determining whether the *Moench* presumption of prudence applies, a court "must look first to the language of the relevant plans and consider whether the plan documents require or, at least, 'strongly favor' investment in employer securities." If that is the case, then "the presumption will apply." "Here," the *Pfizer II* court found that "the Plans' stated purposes include providing employees with investments in company stock." For example, the governing documents for the 2004 Pfizer Savings Plan provide that it was "designed to invest primarily in shares of [Pfizer] common stock." The governing documents for the other plans at issue "include similar statements of purpose."

Plaintiffs argued that "the company stock fund provisions are … discretionary" and claimed that the *Moench* presumption does not apply "because the Plans give the fiduciaries power to eliminate the company stock fund investment option." The *Pfizer II* court rejected this argument, explaining that "an elimination provision does not … preclude application of the *Moench* presumption."

The court noted that in *Taveras*, 708 F.3d 436, "the Second Circuit found that the *Moench* presumption applied to a plan that explicitly permitted the investment committee to eliminate the company stock fund as an investment option." The Second Circuit held that "despite the fund elimination provision, the plan sufficiently required its fiduciaries to provide plan investors the option to invest in a

company stock fund so as to trigger the presumption of prudence." In this case, the *Pfizer II* court found that the Plans' governing documents "include fund elimination language that is similar to the language [of the elimination provision at issue] in *Taveras*."

The *Pfizer II* court concluded that when "considered as a whole, the Plans 'strongly favor' employee investment in the Pfizer and Pharmacia Company Stock Funds and do not grant fiduciaries 'unfettered discretion' whether to offer company stock." Accordingly, the court determined that "the *Moench* presumption applies" and defendants' "company stock acquisition and retention decisions are entitled to a presumption of prudence."

The Complaint Fails to Allege That Defendants Abused Their Discretion in Investing the Plans' Funds in Pfizer and Pharmacia Stock

"Once the *Moench* presumption applies," the *Pfizer II* court explained that a "fiduciary's action is subject to review [only] for abuse of discretion." Courts must "look[ ] to the overall economic situation of the company at the time of the challenged decision" to determine whether the fiduciaries knew or should have known that the company was in a "dire situation." The *Pfizer II* court observed that "[i]n each case in which the Second Circuit has assessed whether such

'dire circumstances' were present, it has examined whether the drop in the company's stock price occurred under circumstances indicative of a near-catastrophic threat, not merely to a product line or operating division, but to the company as a whole." While a plaintiff does not have to "demonstrate the prospect of impending collapse," the court stated that "mere stock fluctuations, even significant downturns, are not sufficient to establish 'dire circumstances' indicative of abuse of discretion in the retention of investments."

Here, plaintiffs attempted to overcome the *Moench* presumption by alleging, *inter alia*, that defendants knew or should have known that the safety issues involving Celebrex and Bextra "gave rise to significant undisclosed business risks." The court held that "[a] llegations that defendants should have known of potential risks are insufficient to rebut the *Moench* presumption."

The court found similarly "insufficient" allegations that the Pfizer defendants "should have recognized the risk that Pfizer could lose large sums of money due to diminished sales and the threat of civil or criminal liability." Even if defendants "could have anticipated the worst-case scenarios as to Celebrex and Bextra," the court determined that "none of the facts pleaded demonstrates that Pfizer (or Pharmacia) would have been in a 'dire situation,' given Pfizer's market capitalization and the fact that Celebrex and Bextra were only two of several 'blockbuster' drugs contributing to Pfizer's revenue stream." The court further held that Pfizer's 52% drop in stock price during the class period did "not amount to the sort of catastrophic decline necessary to rebut the [*Moench*] presumption," particularly because "Pfizer's stock price never fell below $20 per share."[4]

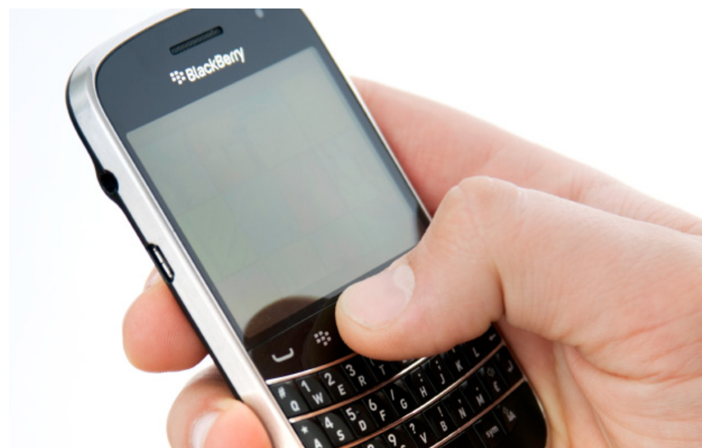
As to plaintiffs' alternative theory that the Pfizer defendants had "breached their duty of prudence by permitting the purchase of Pfizer stock at artificially inflated prices," the court found this argument "unavailing" because the *Moench* presumption of prudence "applies to both the 'acquisition' and the 'holding' of qualifying employer securities" in a company stock fund.

Since plaintiffs "failed to allege facts sufficient to rebut the *Moench* presumption," the court dismissed claims that defendants had breached their duty of prudence by allowing the Plans to purchase and/or retain Pfizer and Pharmacia stock during the class period. The court also dismissed plaintiffs' remaining claims as derivative of the prudence claims.

4. The court noted that the complaint was "devoid of any allegations that, prior to its 2003 acquisition by Pfizer, Pharmacia was in a 'dire' situation." The court therefore held that plaintiffs "fail[ed] entirely to state a claim" for breach of the duty of prudence as to the Pharmacia defendants.

Southern District of New York Dismisses a Securities Fraud Suit against Research in Motion, Finding That "Corporate Failings Alone Do Not Give Rise to a Securities Fraud Claim"

On March 29, 2013, the Southern District of New York dismissed with prejudice a putative securities fraud class action against Research in Motion Limited



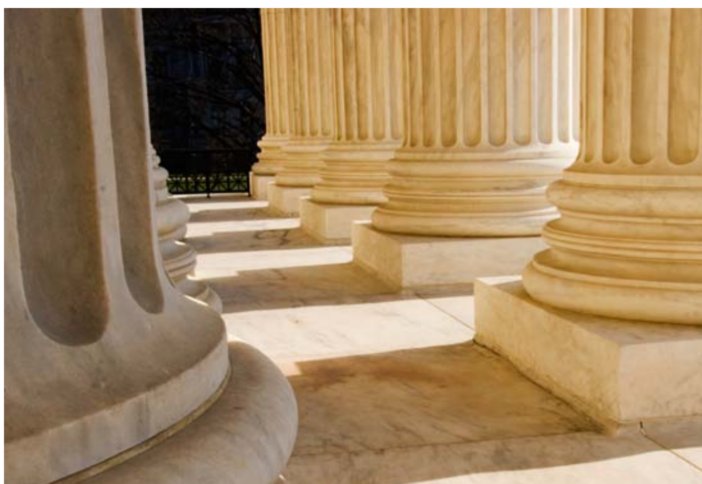
("RIM") and three of its executives (the "Individual Defendants") on the grounds that plaintiffs had failed to plead scienter or allege any material misrepresentations or omissions. *Shemian v. Research In Motion Ltd.*, 2013 WL 1285779 (S.D.N.Y. Mar. 29, 2013) (Sullivan, J.). The court found that the complaint simply catalogued "RIM's business errors, which, while serious," were "neither fraudulent nor actionable."

Background

RIM develops, manufactures and markets mobile communications technology, including the Blackberry. In the winter of 2010, RIM reported a 40% growth in revenues, a 58% increase in earnings per share, and a sound financial outlook. At the time, the company was developing QNX, a new operating system, and the PlayBook, RIM's first tablet device.

However, RIM suffered "a series of setbacks" in the following months, "including slowed sales on its aging product line, delays in releasing QNX, and a rushed introduction of the PlayBook that was marred by the tablet's glitches and lack of basic features." On June 16, 2011, RIM announced lower than forecast first quarter revenue figures and impending layoffs. RIM's share price "plummeted" from "a high of $69.86 on February 11, 2011" to "$27.25 … on June 17, 2011."

Plaintiffs subsequently brought suit under Section 10(b) and Rule 10b-5 alleging that RIM and three of its officers had "embarked on a scheme to issue materially false and misleading statements that lauded the company's condition and led investors to purchase RIM stock at inflated prices." Plaintiffs asserted that defendants had intended "to obscure the company's faltering market position as growing competition rapidly outpaced RIM's aging product line." Defendants moved to dismiss the complaint for, *inter alia*, "fail[ure] to plead scienter and any material misrepresentations or omissions."



The Court Finds the Complaint Alleges Only Mismanagement, Not Scienter

To establish "the requisite strong inference of scienter," plaintiffs in the Second Circuit may allege facts showing "either (1) that defendants had the motive and opportunity to commit fraud, or (2) strong circumstantial evidence of conscious misbehavior or recklessness." The court found that plaintiffs had "failed to identify any 'concrete and personal' benefit that would have motivated the Individual Defendants to engage in securities fraud." Plaintiffs had also "alleged no facts to support an inference" that the Individual Defendants had "engaged in … illegal or untoward behavior." The court therefore focused its analysis on whether plaintiffs had "adequately pled recklessness."

To plead recklessness, a plaintiff must allege that the defendants either "knew facts or had access to information contradicting their public statements, or failed to review or check information that they had a duty to monitor." Here, the court found no support for plaintiffs' claim that the Individual Defendants "had access to *specific* contradictory information *at the time* the allegedly fraudulent statements were made." Plaintiffs had instead "marshal[led] evidence from eleven low-level, confidential informants to loosely establish that a general atmosphere of delay

and lackluster delivery existed at RIM." However, "the informants never mentioned the Individual Defendants nor tied them personally to knowledge of the delays and product concerns."

The court held that the "absence of [direct] communication" between the confidential informants and the Individual Defendants "undermine[d] the inference that [the Individual] Defendants recklessly disregarded the truth." "[M]ere assertions that defendants *must* have been aware of informants' concerns are insufficient to establish that defendants *were* aware of those concerns."

Plaintiffs also attempted to establish scienter based on the Individual Defendants' high-ranking positions at RIM and "the fact that those positions required them to review and sign SEC filings and related documents." Rejecting this argument, the court explained that "accusations founded on nothing more than a defendant's corporate position are entitled to no weight." Moreover, the court found that "legal obligations" requiring the Individual Defendants to sign SEC filings "do not establish that the Individual Defendants were actually privy to, or failed to monitor, specific statements or reports contradicting their public statements."

Finally, plaintiffs "attempt[ed] to rely on the 'core operations' inference to support [their] allegations of scienter." Under this inference, "knowledge of the falsity of a company's … statements can be imputed to key officers who should have known of facts relating to the core operations of their company that would have led them to the realization that the company's … statements were false when issued." The court rejected this argument as well, finding that the "core operations" inference is not "independently sufficient to raise a strong inference of scienter" in light of the heightened pleading standards imposed by the Private Securities Litigation Reform Act.

Considering the scienter allegations holistically, the court found two possible inferences:

> [E]ither [the Individual] Defendants were aware or recklessly failed to realize that their statements understated RIM's serious deterioration, or, in the alternative, [the Individual] Defendants' statements, though potentially misleading, resulted from misplaced optimism or sloppy management, or both.

The court determined that "the more obvious, and less sinister, conclusion" is that the Individual Defendants "simply miscalculated and poorly executed on the development of new products in a fast-moving and highly competitive industry." Although this may be "a serious shortcoming in the management of a multibillion dollar company," the court held that "such deficiencies do not suggest, much less compel, an inference" that the Individual Defendants had acted with scienter.

The Court Finds the Complaint Fails to Allege Material Omissions

One of the plaintiffs' core contentions was that the Individual Defendants' "positive statements about the PlayBook were materially misleading" because they failed to disclose the PlayBook's alleged defects and shortcomings. As an initial matter, the court found

the "factual premise" of this claim "unsound" because defendants did in fact "make disclosures about the PlayBook's limitations."

The court further determined that none of the statements at issue "gave rise to a duty to disclose the defects in [the PlayBook's] design or production." Most were "too vague and inconsequential" for any duty to disclose to attach. Moreover, "to the extent [the Individual] Defendants praised the PlayBook, they did so in general terms … that did not create any legal duty to catalog the Play[B]ook's potential shortcomings." Finally, the court found that plaintiffs had "failed to allege sufficient facts regarding the existence and timing of [the Individual] Defendants' knowledge of defects to give rise to a duty to disclose."

The Court Concludes That the Complaint Fails to Allege Material Misstatements

Turning to the allegations concerning material misstatements, the court found that several of the alleged misrepresentations "in fact were true." The court determined that plaintiffs' "remaining allegations of misrepresentations fail[ed] on materiality grounds." "Those statements … were either puffery or forward-looking statements that bespoke caution, and thus they are not actionable."

The court noted that "investors were provided with substantial warnings that RIM's financial projections and other forward-looking statements, such as planned product launches and carrier partners, could be impacted by unforeseen circumstances." For example, the company cautioned investors that its "inability … to enhance, develop and introduce products and services in a timely manner, or at all, in response to changing market conditions or customer requirements could have a material adverse effect on [RIM's] business, operating results and financial condition or could result in its products and services becoming obsolete." The court found that "[n]o reasonable investor would read RIM's projections as certitudes when confronted with such warnings."

The Court Denies Plaintiffs' Request for Leave to Amend and Dismisses the Action with Prejudice

The court concluded that the allegations "support a finding of corporate mismanagement, not malfeasance." Because "corporate failings alone do not give rise to a securities fraud claim," the court determined that "additional attempts at amendment would be fruitless" and dismissed the complaint with prejudice.

Delaware Supreme Court Dismisses a Derivative Suit Brought by Allergan Shareholders on Collateral Estoppel Grounds

In June 2012, the Delaware Court of Chancery held that a California federal court's dismissal of a derivative suit brought by shareholders of Allergan, Inc. for failure to plead demand futility under Rule 23.1[5] did not collaterally estop a similar derivative action brought in Delaware state court by a different group of Allergan shareholders.

On April 4, 2013, the Delaware Supreme Court reversed the Chancery Court's decision. *Pyott v.*

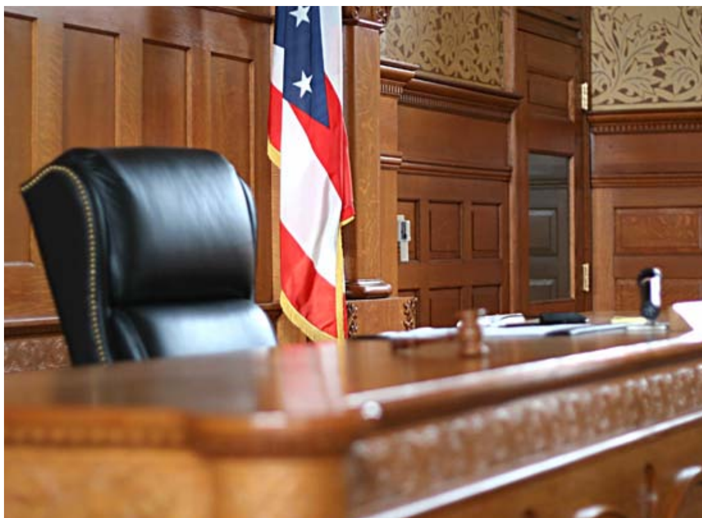
5. Rule 23.1 provides, *inter alia*, that a derivative complaint must "state with particularity" "any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members" or "the reasons for not obtaining the action or not making the effort." FED. R. CIV. P. 23.1(b)(3).

Louisiana Municipal Police Employees' Ret. Sys, 2013 WL 1364695 (Del. Supr. Apr. 4, 2013) (Berger, J.). The Delaware Supreme Court determined that under the full faith and credit doctrine, the California decision precluded the Delaware suit. The court also ruled that a derivative plaintiff who files suit quickly and without first bringing a Section 220 books and records action is not presumptively an inadequate corporate representative.

Background

Allergan manufactures Botox, a pharmaceutical that the FDA has approved for numerous therapeutic and cosmetic uses. The medical community also prescribes Botox for uses that the FDA has not approved (known as "off-label uses"). While it is not illegal to prescribe pharmaceuticals for off-label uses, it is unlawful to market pharmaceuticals for off-label uses.

In 2007, the DOJ launched an investigation into Allergan's alleged marketing of Botox for off-label uses. On September 1, 2010, Allergan announced that it had pled guilty to misbranding Botox and had agreed to pay $600 million in civil and criminal fines. Derivative suits against Allergan and its directors followed. On September 3, 2010, the Louisiana Municipal Police Employees' Retirement System ("LAMPERS") filed the instant action in the Chancery Court. In the ensuing weeks, other stockholders filed suit in the Central District of California; the California actions were consolidated on October 24, 2010.



Defendants moved to dismiss both the Delaware Action and the California Action for failure to plead demand futility under Rule 23.1. On January 17, 2012, the Central District of California dismissed the California Action with prejudice (the "California Judgment"). Defendants subsequently contended that the California Judgment mandated dismissal of the Delaware Action under the doctrine of collateral estoppel.

Chancery Court Finds the California Judgment Does Not Preclude the Delaware Action

On June 11, 2012, the Chancery Court denied defendants' motion to dismiss the Delaware Action. The court held that the California Judgment did not preclude the Delaware Action because the stockholder plaintiffs in the California Action were not in privity with plaintiffs in the Delaware Action. *Lousiana Municipal Police Employees' Ret. Sys. v. Pyott*, 46 A.3d 313 (Del. Ch. 2012) (Laster, V.C.).[6] The Chancery Court found the question of "[w]hether successive stockholders are sufficiently in privity with the corporation and each other" to be "a matter of substantive Delaware law governed by the internal affairs doctrine." Under 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." The Chancery Court therefore held that "an earlier Rule 23.1 dismissal does

6. Please click here to read our discussion of the Chancery Court's decision in the June 2012 edition of the Alert.

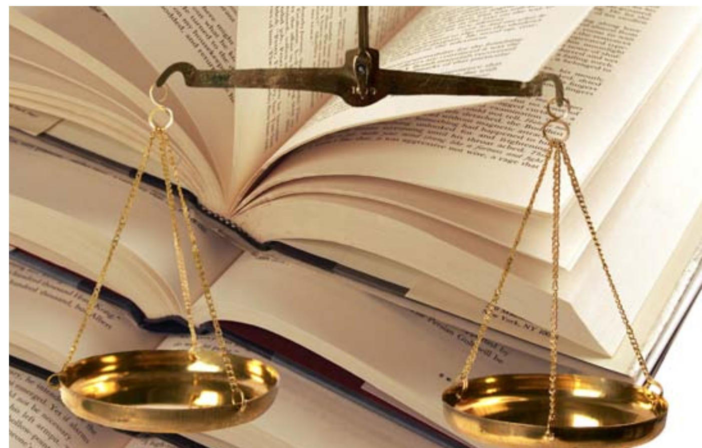
not have preclusive effect on a subsequent derivative action brought by a different plaintiff because, as the earlier Rule 23.1 decision itself established, the prior plaintiff lacked authority to sue on behalf of the corporation and therefore was not in privity with the corporation or other stockholders."

"As an independent basis for declining to give collateral estoppel effect to the California Judgment," the Chancery Court held that "the California plaintiffs did not adequately represent Allergan." The court adopted and applied a presumption that "a fast-filing stockholder with a nominal stake, who sues derivatively after the public announcement of a corporate trauma … but without first conducting a meaningful investigation, has not provided adequate representation." The court found that "[b]y leaping to litigate without first conducting a meaningful investigation, the California plaintiffs' firms failed to fulfill the fiduciary duties they [had] voluntarily assumed as derivative action plaintiffs."

Defendants appealed the Chancery Court's decision.

Delaware Supreme Court Reverses Chancery Court's Ruling Based on the Full Faith and Credit Doctrine

The Delaware Supreme Court began its analysis with the Full Faith and Credit Clause of the U.S. Constitution.[7] While this clause "does not explicitly apply when the 'rendering court' is a federal court rather than a state court, … the United States Supreme Court has held that a state court is required to give a federal judgment the same force and effect as it would be given under the preclusion rules of the state in which the federal court is sitting." The Delaware Supreme Court explained that under federal common law, a Delaware court must "give the California [ ] Judgment the same force and effect as it would be entitled to in the California federal or state courts under California's preclusion rules."



The Delaware Supreme Court found that the Chancery Court had erred in applying "demand futility law, under the internal affairs doctrine" rather than "the principles of collateral estoppel, under the full faith and credit doctrine" in determining whether the California Judgment precluded the Delaware Action. The Delaware Supreme Court explained that defendants' motion to dismiss "was about federalism, comity, and finality" and "should have been addressed exclusively on that basis."

"[R]ather than invoking the internal affairs doctrine to apply Delaware law to the issues of privity and adequacy of representation," the Chancery Court "should have applied California law or federal common law to analyze all elements of collateral estoppel." California law provides a five-factor test for determining whether the doctrine of collateral estoppel applies:

> First, the issue sought to be precluded … must be identical to that decided in a former proceeding. Second, the issue must have been actually litigated in the former proceeding. Third, it must have been necessarily decided

7. The clause provides as follows: "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State." U.S. Const., Art. IV § 1.

> in the former proceeding. Fourth, the decision in the former proceeding must be final and on the merits. Finally, the party against whom preclusion is sought must be the same as, or in privity with, the party to the former proceeding.

LeBoyer v. Greenspan, 2007 WL 4287646 (C.D. Cal. 2007).

The Delaware Supreme Court concluded that each of these requirements had been met here. In the Delaware Action, "[t]he issue sought to be precluded [was] whether, under Rule 23.1, the failure to make demand on the Allergan board [was] excused because such a demand would have been futile." The Delaware Supreme Court found that "[t]he California court [had] addressed that exact question" and had "entered a final judgment with prejudice … on the merits" in the defendants' favor. As to the question of privity, the court explained that "the real plaintiff in a derivative suit is the corporation" and therefore "differing groups of shareholders who can potentially stand in the corporation's stead are in privity for the purposes of issue preclusion."

Delaware Supreme Court Rejects the Presumption That a Fast-Filing Plaintiff Is an Inadequate Corporate Representative

The Delaware Supreme Court "reject[ed] the 'fast filer' irrebuttable presumption of inadequacy" adopted by the Chancery Court. While the court acknowledged that "there will be cases where a fast filing stockholder also is an inadequate representative," the Delaware Supreme Court found "no record support for the trial court's premise that stockholders who file quickly, without bringing a § 220 books and records action, are *a priori* acting on behalf of their law firms instead of the corporation." The Delaware Supreme Court explained that "remedies for the problems" created by fast-filers "should be directed at the lawyers, not the stockholder plaintiffs or their complaints."

Without the benefit of the "fast-filer" presumption, the Delaware Supreme Court found that "there was no basis" for the Chancery Court "to conclude that the California plaintiffs were inadequate."

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