

DIRECTORS' AND OFFICERS' LIABILITY

PRECLUSION IN SHAREHOLDER DERIVATIVE LITIGATION

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The application of preclusion principles in shareholder derivative litigation has given rise to considerable disagreement in the courts. A plaintiff may file a derivative action only if it demonstrates that the corporation wrongfully refused, or would have wrongfully refused, to bring suit after suitable demand on the corporation's board of directors. If a plaintiff fails to make demand prior to filing suit, it must allege with particularity why demand would have been futile. If the issue of demand futility is litigated and decided against the shareholder, are different plaintiffs who seek to pursue derivative claims predicated on similar allegations in the same or other courts precluded from relitigating the futility of demand on the board? As recent case law demonstrates, the answer may depend on the preclusion doctrine of the jurisdiction in which the first suit is litigated.

Pre-Suit Demand and Preclusion

To prevent abuse of the derivative form of suit, equity courts established as a precondition for the suit that the shareholder demonstrate that the corporation refused to proceed as requested after suitable demand, unless excused by extraordinary circumstances. Fed. R. Civ. P. 23.1 provides (along with state analogs) that the complaint in any derivative suit must be verified and "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, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort." The pre-suit demand requirement safeguards the principle of corporate governance that the decisions of a corporation - including the decision to initiate litigation - should be made by the board of directors or a majority of shareholders.¹ The law of the corporation's state of incorporation governs whether the demand requirement may be excused as futile.² Under Delaware law, in order to show demand is excused, the plaintiff must plead with particularity that reasonable doubt exists either that: (i) a majority of the board is disinterested and independent; or (ii) the challenged transaction was a valid exercise of business

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judgment.³ To establish demand futility in a case challenging a course of conduct rather than a specific action of the board, the particularized factual allegations must create a reasonable doubt that, as of the time the complaint was filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand for suit.⁴

A request that one court give preclusive effect to a judgment entered in another court invokes full faith and credit principles. Under the Full Faith and Credit statute, [28 U.S.C. §1738](#), a federal court must give the same preclusive effect to a judgment entered in a prior action as would the courts of the jurisdiction in which the prior judgment was entered.⁵ While specific formulations of the requirements may vary somewhat, a party seeking to invoke issue preclusion (a/k/a collateral estoppel) generally must prove (1) the party against whom preclusion is asserted was a party to or is in privity with a party in the prior case; (2) the issues in both proceedings are identical; (3) a valid and final judgment was entered in the prior adjudication; (4) the issue was actually litigated and decided in the prior action; and (5) the issue was essential to the first judgment. The additional requirement found in older cases that the prior judgment be “on the merits” has been discarded by many jurisdictions, as it was in the Restatement (Second) of Judgments, or at least sidelined as confusing and a distraction from the core characteristics that determine the preclusive force of the prior judgment.⁶

Privity, for purposes of issue preclusion, requires a relationship between two parties which is sufficiently close to bind them both to an initial determination. Outside the class action context, preclusion generally cannot be applied against entities who themselves did not have an opportunity to litigate in the initial action. In the derivative suit context, however, privity exists between the original and subsequent shareholder 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 shareholders seeking to press the claim are different is irrelevant.⁷ Accordingly, the rule in federal court and New York is clear: once the issue of demand futility is litigated and decided against a shareholder who adequately represented the interests of the corporation and other shareholders, issue preclusion bars all subsequent plaintiffs from relitigating demand futility.

Recent Decisions

The First Circuit’s August 2007 decision in *In re Sonus Networks, Inc, Sh. Deriv., Litig.*,⁸ is now the leading federal case and merits close inspection. On the heels of a restatement by Sonus of its financial results for two fiscal years and commencement of an SEC investigation into the company’s financial reporting, certain Sonus shareholders filed two derivative suits in Massachusetts Superior Court alleging breaches of fiduciary duty relating to the company’s accounting practices and internal controls against certain officers and directors of Sonus. No pre-suit demand was made on the company’s board of directors. A few days later, different shareholders filed three derivative actions in Massachusetts federal court against six of the seven directors of Sonus, and several other Sonus officers. The federal shareholder derivative plaintiffs also made no pre-suit demand. The state court subsequently dismissed the state actions without leave to replead, finding that pre-suit demand was not excused under

applicable Delaware law. Defendants in the consolidated federal actions then moved dismiss on the ground that issue preclusion barred the federal plaintiffs from relitigating that demand on the board should be excused. The district court agreed, holding that (i) the prior state court ruling was a final judgment on the merits and “the equivalent of a dismissal for failing to state a claim or failing to plead with particularity,” (ii) for privity purposes Sonus was the real party in interest in both cases, and (iii) none of the “new evidence” relied on by the federal plaintiffs precluded the finding of identity of issues in the two proceedings required for issue preclusion.⁹

The First Circuit issued a lengthy opinion affirming the application of issue preclusion. The court began by noting the uncertainty under Massachusetts law as to what constitutes an “on the merits” determination for issue preclusion purposes. It concluded that the proper characterization of a dismissal for failure to adequately plead demand futility is a dismissal for failure to satisfy a precondition to suit, which is a failure that may be remedied by the time the second suit is filed. Nevertheless, dismissal for failure to satisfy a precondition to suit is an event which “precludes relitigation of the very same issues actually decided in the first litigation.” The court recognized that a dismissal for failure to state a claim is accorded claim-preclusive effect, but rejected defendants’ argument that the prior dismissal for failure to plead demand futility was an “on the merits” determination also entitled to claim preclusive (a/k/a *res judicata*) effect. Thus the court held that “the Massachusetts state court judgment was ‘on the merits’ in the sense that it is entitled to issue-preclusive effect,” but the Rule 23.1 dismissal was not “‘on the merits’” in the sense that no further suit could be brought on the same claim.”¹⁰ The distinction has significance. Applying claim preclusion to a dismissal for failure to plead demand futility would mean the defect in the precondition to suit could never be cured, regardless of new, post-adjudication events. Consequently, the court framed the “identity of issues” inquiry as whether there was any significant change in the futility issue from what was presented to the state court, and concluded that the subsequent plaintiffs’ allegations were not new facts that could not have been previously alleged, but only different from what had been alleged in the prior actions. The evidence was available to be used in the prior action, but was not. The court emphasized that the reason it distinguished between dismissals for failure to comply with the demand and futility pleading requirements and dismissal for failure to state a claim is that whether a precondition has been met is dynamic and may change. “This is a rationale for allowing a plaintiff (or his privies) to plead new events that happened after the first litigation was dismissed, but not for allowing him to plead facts that had already occurred and could have been pleaded in the first suit.” Applying this limitation, the court concluded that the “new” facts alleged by plaintiffs – purported “red flags” in Sonus’s SEC filings -- were cumulative and did not “transfigure” the demand futility issue to bar issue preclusion. This holding suggests that if the subsequent action alleges a sufficient number of important *and* previously unavailable facts, the change may preclude a finding that the issues in the two actions are substantially identical.

On the issue of privity, *Sonus* reaffirmed as black letter law that the plaintiff in a derivative suit represents the corporation, which is the real party in interest, and that the corporation is bound by the results of the suit in subsequent litigation, even if different shareholders bring the actions. Citing potential risks of collusion between a nominal plaintiff and defendants in derivative actions, however, the court acknowledged “the important

proviso” to issue preclusion in the derivative context that the prior shareholder must have adequately represented the corporation. As in other forms of representative litigation, courts tread carefully when asked to grant preclusive effect to a judgment in a prior derivative lawsuit, as they must ensure that the interests of the corporation and its shareholders were adequately represented in the prior action.¹¹ The *Sonus* court asserted that particular attention to the adequate representation requirement is warranted where preclusive effect is sought for a judgment that pre-suit demand was not excused because the adequacy of representation protections in derivative actions provided by [Federal Rule of Civil Procedure 23.1](#) and state analogs usually do not come into play before a motion to dismiss for failure to make pre-suit demand is considered. Thus, in *Sonus*, as would be expected, the adequacy of the plaintiffs’ representation in the prior suit was not litigated in either action. Of course, if adequacy of representation is litigated and determined, that finding is entitled to full preclusive effect and cannot be revisited by another court. Although not mentioned by the First Circuit, it should be noted that Rule 23.1 does not mandate the same protective mechanisms for shareholders that are offered to absent class members by Rule 23. Unlike in class actions under Rule 23, the district court in shareholder derivative actions is not required to make a preliminary, affirmative determination that the named plaintiffs will fairly and adequately represent the interests of other shareholders. Rather, because the rule provides only that a derivative suit may not be maintained if it appears that the named shareholder does not fairly and adequately represent the other shareholders, the burden of demonstrating inadequacy rests with the defendant.¹² The reversal of the burden regarding adequacy in derivative actions in no way suggests that the requirement is less important than in class actions.¹³

In order to address the federal plaintiffs’ assertion that the interests of the company were not adequately represented in the prior suit, the *Sonus* court considered, under a grossly deficient standard, whether the prior plaintiffs “were seriously remiss in failing to state the facts that are now included in” the federal complaint, informed by the substantive standard for pleading demand futility under Delaware law, discussed above. Because demand futility is examined as of the time suit is filed, events that occurred post-commencement are not considered when judging adequacy of representation unless the events illuminate facts that existed when the suit was filed. While acknowledging that the state plaintiffs could have strengthened their complaint by amending to allege the results of *Sonus* internal investigations revealing material weaknesses in internal controls, the court concluded that such an amendment would not have added material allegations establishing that a majority of the board was either interested or lacked independence such that they would be incapable of impartially considering demand. Consequently, issue preclusion barred the subsequent suit.

A similar approach is employed under New York law. In *Henik v. Labranche & Co.*,¹⁴ a federal court last year applied issue preclusion and claim preclusion to bar a shareholder derivative suit in federal court, based on a prior dismissal of a New York state derivative action brought by a different plaintiff for failure to make pre-suit demand. Justice Bernard Fried enforced the same principle last year in *Levin v. Kozlowski*,¹⁵ dismissing a derivative action on issue preclusion grounds where a New Hampshire federal court had previously dismissed a derivative action brought by different plaintiffs, which made similar allegations against the

same director defendants, for failure to adequately allege the requirements under applicable law to bring a derivative claim.

A decision of the Delaware Court of Chancery last year in *West Coast Management & Capital, LLC v. Carrier Access Corp.*,¹⁶ exhibited far more skepticism about the wisdom of precluding derivative litigation based on findings made against different shareholders. In June 2005, plaintiff filed a shareholder derivative action in Colorado federal court on behalf of Carrier against certain directors and officers of Carrier. Four months later, the same plaintiff served on Carrier a demand to inspect books and records relating to the claims asserted in the Colorado complaint, to which defendants objected as duplicative of discovery propounded in Colorado, and plaintiff did not pursue it further. In 2006, the Colorado federal court granted defendants' motion to dismiss for failure to adequately plead demand futility under the requirements of Delaware law. The dismissal expressly was entered without prejudice. Shortly thereafter, plaintiff served on Carrier a second books and records demand, identical in substance to its prior books and records demand, asserting that it sought the inspection to support a second derivative action based on the same allegations as the Colorado action. After Carrier refused the request, plaintiff filed a complaint in Delaware for inspection of books and records. Defendant moved for judgment on the pleadings, arguing that the inspection demand lacked a "proper purpose" as mandated by [8 Del. C. §220](#) because plaintiff could not bring a second derivative suit.

Turning to the full faith and credit analysis, the court noted that the law of the court in which the prior judgment was entered did not directly address whether the same plaintiff could replead demand futility in a second suit, but that recent federal case law, although "interpreting other states' law, goes even further and holds that collateral estoppel bars all subsequent plaintiffs from relitigating demand futility." The *West Coast* court concluded that issue preclusion barred the same plaintiff from relitigating demand futility. The only close question in the preclusion analysis, the court stated, was whether the prior federal court dismissal under Rule 23.1 was a final and valid judgment. Governing federal law, consonant with Delaware law, holds that any dismissal, even one without prejudice, is a final order, as long as it is not coupled with leave to amend within a fixed time. Because the plaintiff actually litigated and lost the issue of demand futility, issue preclusion barred the same plaintiff from pursuing a second derivative suit based on the same claims. Consequently, plaintiff lacked a proper purpose for its section 220 demand, and its complaint was dismissed. The import of the prior "without prejudice" dismissal, the court stated, was that the underlying claim belonging to the corporation was not adjudicated, permitting the possibility that the plaintiff could proceed by way of demand.

West Coast contains signs that Delaware courts may be more receptive to attempts by different plaintiffs to relitigate demand futility, at least if they are armed with new facts. First, the Court of Chancery observed that the usual practice in Delaware where allegations of demand futility are determined inadequate is to dismiss the derivative action with prejudice as to the named plaintiff *only*, but not as to the corporation or its other stockholders. The court then in *dicta* questioned the wisdom of the majority rule that issue preclusion bars subsequent

attempts by different plaintiffs to relitigate demand futility, contending that if a subsequent plaintiff “makes substantially different allegations of demand futility based on additional information, issue preclusion, from both a logic and fairness standpoint, would not apply.”¹⁷ The court did not, as *Sonus* did, limit the word “additional” by excluding facts that existed but were not used at the time the prior complaint was filed. Moreover, the court asserted, precluding subsequent plaintiffs who have obtained “additional information” through a section 220 demand from relitigating demand futility “would undercut the purpose of the statute and the policy” to encourage pre-derivative suit use of section 220. The court offered no guidance on what standard might be applied to gauge whether asserted additional information prevented application of issue preclusion.

¹ [Kamen v. Kemper Fin. Servs., Inc.](#), 500 U.S. 90, 101 (1991).

² [Henik v. LaBranche](#), 433 F. Supp. 2d 372, 377 (S.D.N.Y. 2006); [West Coast Management & Capital, LLC v. Carrier Access Corp.](#), 914 A.2d 636, 642 (Del. Ch. 2006).

³ [Aronson v. Lewis](#), 473 A.2d 805, 814 (Del. 1984), *overruled in part on other grounds by* [Brehm v. Eisner](#), 746 A.2d 244 (Del. 2000).

⁴ See [Rales v. Blasband](#), 634 A.2d 927, 934 (Del. 1993).

⁵ See [Matsushita Elec. Indus. Co. v. Epstein](#), 516 U.S. 367, 373 (1996).

⁶ See, e.g., [In re Sonus Networks, Inc. Sh. Deriv., Litig.](#), --- F.3d ---, 2007 WL 2325819, at *6-8 (1st Cir. 2007).

⁷ [Nathan v. Rowan](#), 651 F.2d 1223, 1226 (6th Cir. 1981) (“In shareholder actions arising under Fed. R. Civ. P. 23.1, parties and their privies include the corporation and all non-party shareholders.”); [Cramer v. Gen. Tel & Elec. Corp.](#), 582 F.2d 259, 266-67 (3d Cir. 1978) (judgment against shareholder in one derivative case precluded relitigation of the claim by other shareholders); [LeBoyer v. Greenspan](#), 2006 WL 2987705, at *3 (C.D. Cal. 2006) (according prior state ruling on demand futility issue preclusive effect against federal derivative plaintiffs, concluding “[t]he differing groups of shareholders 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 shareholders, including shareholders who did not bring prior action).

- ⁸ [---- F.3d ----, 2007 WL 2325819, at *9 \(1st Cir. Aug. 16, 2007\)](#).
- ⁹ [In re Sonus Networks, Inc. Sh. Deriv. Litig., 422 F. Supp.2d 281 \(D. Mass. 2006\), aff'd, ---- F.3d ----, 2007 WL 2325819 \(1st Cir. Aug. 16, 2007\)](#).
- ¹⁰ [In re Sonus Networks, Inc, Sh. Deriv., Litig., ---- F.3d ----, 2007 WL 2325819, at *9 \(1st Cir. Aug. 16, 2007\)](#).
- ¹¹ [Henik v. LaBranche, 433 F. Supp. 2d 372, 381 \(S.D.N.Y. 2006\)](#) (noting that “there may be grounds warranting [denial of preclusive effect] where the plaintiff shareholder in the first action is alleged to have inadequately represented the interests of all of the shareholders” but concluding that “there has been no showing nor contention by Plaintiffs here that the plaintiffs in [prior action] did not adequately represent the interests of the shareholders”); Restatement (Second) of Judgments, § 42(e) (“A person is not bound by a judgment for or against a party who purports to represent him if (e) The representative failed to prosecute or defend the action with due diligence and reasonable prudence, and the opposing party was on notice of facts making that failure apparent.”); [Ji v. Van Heyningen, 2006 WL 2521440, at *4-5 \(D.R.I. 2006\)](#) (noting that “a ruling against a shareholder in a derivative action is actually a ruling against the corporation” because “[t]he corporation is the real party in interest; the shareholder is at best the nominal plaintiff,” but declining to apply issue preclusion because the original plaintiff’s “[f]ailure to make demand or allege demand futility with sufficient particularity may well reflect the kind of feeble prosecution of the claim which would invoke fairness issues when it came time to bar subsequent suits by nonparty shareholders”).
- ¹² See [Powers v. Eichen, 229 F.3d 1249, 1254-55 \(9th Cir. 2000\)](#).
- ¹³ See [DeLeo v. Swirsky, 2002 WL 989526, at *4 \(N.D. Ill. 2002\)](#).
- ¹⁴ [433 F. Supp.2d 372 \(S.D.N.Y. 2006\)](#)
- ¹⁵ [13 Misc. 2d 1236\(A\), 831 N.Y.S. 2d 354 \(Sup. Ct. N.Y. Co. 2006\)](#).
- ¹⁶ [914 A.2d 636 \(Del. Ch. 2006\)](#).
- ¹⁷ *Id.* at 643.