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Issue Preclusion in Multijurisdictional Shareholder Derivative Litigation

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If one court dismisses a shareholder derivative claim for failure to make pre-suit demand, are different shareholders free to press identical claims in other courts? There has been a surprising amount of litigation regarding that question in recent years. A new decision of the Supreme Court of Delaware, *Pyott v. Louisiana Municipal Police Employees' Retirement System*,[1] should serve to deter certain types of duplicative derivative litigation, although the case does leave open some questions that parties and courts are likely to focus on in the near future.

Shareholder Derivative Background Litigation

A shareholder derivative suit has a "two-fold" nature: "First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it"—often the company's own directors.[2] Shareholders face a very high burden, even at the pleading stage, to displace the authority of the board of directors to control corporate litigation. That burden is set forth both in procedural rules (Federal Rule of Civil Procedure 23.1, Delaware Court of Chancery Rule 23.1, or other state analogs) and in the substantive law of the state of incorporation.[3] Broadly speaking, a shareholder is required to make a pre-suit litigation demand on the board, or allege with specificity why its failure to do so should be excused because it would have been futile (*e.g.*, because a majority of the board would have been too conflicted to consider such a demand).[4]

Particularly in cases involving corporate "traumas"—financial or reputational harm such as accidents, regulatory fines, or business losses—many shareholders elect to sue without making a pre-suit demand and attempt to establish demand futility by showing that the directors are interested in the claims or lack independence from a director who is interested.[5] And derivative suits in such circumstances are often filed simultaneously (or nearly so) in multiple jurisdictions, with the various shareholder-plaintiffs asserting that the company's directors breached their fiduciary duties in permitting the trauma to occur.[6]

Although there are a variety of potential mechanisms available to address filings in

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multiple forums, they are often unavailing in the context of shareholder derivative litigation for a variety of reasons. One mechanism is to use the federal multidistrict litigation process, but that only works for cases that are in (or can be removed to) federal court. Another approach is for defendants to move to stay cases in deference to one "lead" case, but courts may deny such motions for a variety of reasons. Various plaintiffs' firms often compete for "lead plaintiff" status and typically resist any mechanisms that might slow their case relative to others because delay tends to reduce their chances of obtaining the bulk of any attorneys' fees that might ultimately be paid. Consequently, derivative defendants often are required to litigate parallel lawsuits, either simultaneously or in succession, in multiple forums. This has led to various reform proposals.[7]

Collateral Estoppel in Shareholder Derivative Litigation

Because of this multiple-forum issue, even if the derivative defendants win a final judgment of dismissal in connection with a specific corporate trauma, they may still face new or existing claims from the same or other shareholders in the same or other courts. Companies and their directors, and ultimately their shareholders, might naturally expect that if one court rules that making pre-suit demand would not have been futile (and that the board therefore remains in control of corporate litigation), then all similar suits based on the same corporate trauma should be precluded. That expectation has long been correct if the *same* shareholder files a successive case in the same or new court—this is known as "*res judicata*" or "claim preclusion." What has been hotly contested in recent years, however, is the question of whether *other* shareholders are also precluded—*i.e.*, whether there is "collateral estoppel" or "issue preclusion."

The legal standard for collateral estoppel is articulated in different ways in different jurisdictions, but it generally requires the following factor: For an issue to be barred from relitigation, it must be (1) identical to an issue that was (2) actually and (3) necessarily litigated and decided in a former proceeding that (4) resulted in a final judgment on the merits, and (5) the party to be precluded in the second proceeding must have been in "privity" with the party in the first proceeding.[8] Many jurisdictions also recognize exceptions to collateral estoppel; most notably, a second suit will not be precluded where the party in the first case provided inadequate representation.[9]

Where the first proceeding and successive proceedings occur in different jurisdictions, collateral estoppel takes on constitutional weight through the Full Faith and Credit Clause (and Full Faith and Credit Act).[10] In general, both state courts and federal courts are obligated to give a prior judgment of a state or federal court the same consequences—including preclusive effect—that the judgment would receive in the rendering court. In other words, the outcome should be identical if the second case is filed in the same court as issued the first decision, or in a different court.

Over the past decade, a series of cases, mostly in federal courts, applied these principles to bar relitigation of shareholder derivative cases that were substantively similar to claims by other shareholders that had been dismissed on the pleadings by other courts on demand futility grounds. These cases generally turned on the question of whether the shareholder in the first case was in privity with the shareholder in the second case (factor (5) above). And, most of the cases held that privity existed because, as the First Circuit has explained, the "real party in interest" is the corporation, individual plaintiffs are indistinguishable from each other, and the "question [of] whether demand on the board of directors would have been futile…is an issue that would have been the same no matter which shareholder served as nominal plaintiff."[11]

The Allergan Derivative Litigation

After announcing a $600 million settlement with the government, Allergan, Inc. and its directors were sued in the Delaware Court of Chancery, California federal court (the Central District of California), and California state court. Allergan attempted some of the above-mentioned consolidation and coordination techniques; the California state court plaintiffs agreed to stay their case, but the federal court plaintiffs refused and the federal court felt itself precluded from staying the case because the complaint also alleged federal securities law claims.[12] Allergan therefore proceeded to litigate the case in both the Central District of California and in the Delaware Court of Chancery.

Allergan ultimately obtained a final judgment of dismissal with prejudice in the Central District of California, which ruled that demand was not excused as a matter of substantive Delaware law.[13] Allergan then asked the Delaware Court of Chancery to dismiss the parallel case on the basis of collateral estoppel, citing the line of cases noted above.

The Court of Chancery refused to recognize any preclusive effect from the federal final judgment for two reasons.[14] First, although the court recognized that the preclusive effect of the earlier judgment was governed in broad terms by the collateral estoppel law of California, it held that the collateral estoppel element of privity should be resolved by Delaware law under the internal affairs doctrine.[15] The court then held that under its view of Delaware law, two shareholders are not in privity with each other for these purposes until and unless one of them has survived a Rule 23.1 motion. The court reasoned that a shareholder speaks only for itself, not for the company or other shareholders, until and unless a court rejects the board's authority to control the litigation.[16] Second, and independently, the court held that the California federal plaintiff was inadequate because it had rushed to file suit before conducting an investigation of the company's books and records (which it could have done under Delaware statutory law, 8 *Del. C.* § 220).[17]

The Allergan defendants sought an interlocutory appeal of the Court of Chancery's ruling, which the Supreme Court of Delaware granted.

The Supreme Court's Holding in *Pyott*

After full briefing and oral argument, the Delaware Supreme Court held that the *Pyott* case should have been dismissed under collateral estoppel principles. On the Court of Chancery's first ground for denying preclusion, the Supreme Court held that the lower court erred by using the internal affairs doctrine to resolve the privity question under the law of Delaware. Instead, "[t]he Court of Chancery should have applied California law or federal common law"—*i.e.*, the preclusion law of the rendering court—"to analyze all elements of collateral estoppel."[18] The Supreme Court's holding in this regard is unremarkable: the Restatement of Conflicts of Laws has long stated that "[t]he law of the state where a valid judgment is rendered determines who are in privity with the parties to the judgment."[19]

As the Court of Chancery recognized, the law in the rendering forum—the Central District of California—was clear. *LeBoyer v. Greenspan*, a case from that district, recognized privity for the same reasons as the many other cases cited above.[20] Because there was no justification for using the internal affairs doctrine to resolve the privity question under Delaware law, the Court of Chancery should have applied the law articulated by *LeBoyer* and found privity between the California federal plaintiffs and the Delaware plaintiffs.

On the Court of Chancery's second ground for denying preclusion, the Supreme Court held that a shareholder who files suit without first obtaining corporate books and records is not presumptively inadequate, and that the record in this case did not support a finding of inadequacy.[21]

Analysis and Open Questions

The *Pyott* decision should be welcome to derivative defendants—and the shareholders of companies involved in derivative suits—that wish to avoid the cost, time, and distraction of multi-forum litigation (and relitigation) of shareholder derivative claims. If the company and/or its directors secure dismissal of a derivative claim under Rule 23.1 then successive suits will, in general, be precluded (as long as the court rendering the judgment follows the majority rule in recognizing privity). Given the weight of authority and persuasiveness of reasoning of *Pyott* and the long line of federal cases that preceded it, other jurisdictions are likely to adopt the same approach.

The main question left unresolved by the *Pyott* case is the preclusive effect of a *Delaware* Rule 23.1 dismissal on relitigation in Delaware and elsewhere. The Supreme Court recognized that the Delaware Court of Chancery is divided about whether privity exists in those circumstances, but the Supreme Court did not resolve the conflict in the *Pyott* case because the relevant sources of law were California law and federal common law and thus Delaware law was not implicated.[22] The question of Delaware law on this point is of particular importance given another recent ruling by the Court of Chancery holding that boards of directors may, in general, adopt bylaws that require shareholder derivative suits to be brought exclusively in Delaware courts.[23] The exclusive forum ruling is likely to increase the number of demand futility decisions rendered by the Delaware Court of Chancery as compared to similar rulings made in other courts.

The Supreme Court in *Pyott* strongly hinted that it would recognize privity as a matter of Delaware law, stating that "numerous other jurisdictions have held that there is privity between derivative stockholders."[24] If Delaware were to reject this majority rule, companies would have a strong incentive to seek to stay Delaware cases in deference to cases in other jurisdictions, because dismissals in most other jurisdictions would lead to preclusion, while Delaware dismissals would be good only against a particular shareholder. It is unlikely that the Supreme Court would adopt a unique legal rule that would encourage companies to resist litigating in Delaware courts.

Nevertheless, following a dismissal by a Delaware court, a would-be successive plaintiff may point to Court of Chancery Rule 15(aaa) to avoid preclusion—an argument explicitly suggested by the Court of Chancery in *Pyott*.[25] Rule 15(aaa), adopted in 2001, states, in full (numbering added for clarity):

[1] Notwithstanding subsection (a) of this Rule [governing amendments to a pleading], a party that wishes to respond to a motion to dismiss under Rule 12(b)(6) or 23.1 by amending its pleading must file an amended complaint, or a motion to amend in conformity with this Rule, no later than the time such party's answering brief in response to either of the foregoing motions is due to be filed.

[2] In the event a party fails to timely file an amended complaint or motion to amend under this subsection (aaa) and the Court thereafter concludes that the complaint should be dismissed under Rule 12(b)(6) or 23.1, such dismissal shall be with prejudice (and in the case of complaints brought pursuant to Rule 23 or 23.1 with prejudice to the named plaintiffs only) unless the Court, for good cause shown, shall find that dismissal with prejudice would not be just under all the circumstances.

[3] Rules 41(a) [regarding voluntary dismissals], 23(e) [involving dismissal or compromise of a class action] and 23.1 [involving shareholder derivative litigation] shall be construed so as to give effect to this subsection (aaa).

The Court of Chancery in *Pyott* stated that "Rule 15(aaa) confirms that a dismissal pursuant to Rule 23.1 is 'with prejudice to named plaintiffs only.'"[26] By this, the court seemed to imply that Delaware courts should refuse to recognize privity between the "named plaintiffs" and other shareholders. But that is a strained reading of the rule that is contradicted by this unique rule's text, history, purpose, and statutory background.

First, by its plain text, the rule only applies to a narrow category of Rule 23.1 dismissals. Sentence [1] applies only when a plaintiff "wishes to respond to a motion to dismiss … by amending its pleading." Sentence [2], in turn, applies only when sentence [1] is satisfied, the plaintiff "fails" to file a timely amended complaint, "*and*" the court later renders a Rule 23.1 dismissal. Only when all of those conditions are met will the dismissal be with respect to the "named plaintiffs only." Thus, in the typical case in which the plaintiff "wishes" not to amend but to stand on its complaint, the "named plaintiffs only" clause of sentence [2] does not apply. And the canon of interpretation *expressio unius est exclusio alterius* implies that *typical* dismissals (where the conditions for sentence [2] are not met) are with prejudice with regard to *all* plaintiffs.

Second, the Court of Chancery's purpose in promulgating Rule 15(aaa) had nothing to do with privity or multiforum litigation. Instead, its purpose

> was to eliminate (or at least sharply curtail) instances in which [the Court of Chancery] is required to adjudicate multiple motions to dismiss the same action. Rule 15(aaa) is designed to accomplish that objective by requiring a party, when confronted by a motion to dismiss pursuant to any of Rules 12(b)(6), 12(c) or 23.1, to elect either to stand on its pleadings and respond to the motion or, instead, to amend or seek leave to amend its pleadings before the response to the motion is due.[27]

Absent such a rule, serial amenders can burden the courts by filing a "motion to re-plead" after every "successful motion to dismiss."[28] It would go entirely against the purpose of the rule, which is designed to protect parties (and courts) from the burdens of relitigation, to interpret it in a way that *encourages* relitigation by denying a finding of privity among shareholder derivative plaintiffs.

Finally, Rule 15(aaa) was adopted by the Court of Chancery pursuant to a rules enabling act, 10 *Del. C.* § 361, which (akin to its federal counterpart), states that "[t]he rules shall not abridge, enlarge or modify any substantive right of any party." To the extent that Delaware substantive law would otherwise recognize privity among shareholder derivative plaintiffs, thereby conveying a substantive right of finality on companies and their boards once they have refuted allegations of demand futility—a principle with ample support[29]—Rule 15(aaa) cannot be interpreted in a manner that would abridge that right, nor can it be used as authority to undermine that right.

Thus, notwithstanding any suggestion that under Rule 15(aaa) Delaware law does not recognize privity among shareholders in the demand-futility context, the Delaware Supreme Court is likely to hold otherwise, if and when it is presented with the question. In an appropriate case, the Supreme Court is likely to join the great majority of other jurisdictions that have recognized privity among shareholder derivative plaintiffs, thereby protecting directors and Delaware-chartered companies (and, ultimately, their shareholders) from serial relitigation over substantively identical claims.

Conclusion

The Delaware Supreme Court's *Pyott* decision embraces and enforces one means of minimizing duplicative litigation by giving preclusive effect to the first final judgment rendered by a court of competent jurisdiction on the question of demand futility. Although the court's ruling leaves open some important questions—involving the preclusive effect of a ruling by the Delaware Court of Chancery—it should help to reduce multijurisdictional derivative litigation, to the benefit of public companies, their directors, and their shareholders.

Notes

1. *Pyott v. La. Mun. Police Emps.' Ret. Sys.*, __ A.2d __, 2013 WL 1364695 (Del. Apr. 4, 2013).
2. *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).
3. *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 96-97 (1991).
4. *See, e.g.*, *Rales v. Blasband*, 634 A.2d 927, 933-34 (Del. 1993).
5. *See Stone v. Ritter*, 911 A.2d 362, 366-70 (Del. 2006); *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 968 (Del. Ch. 1996).
6. *See generally* Leo E. Strine, Jr. et al., *Putting Stockholders First, Not The First-Filed Complaint* (Harvard John M. Olin Center for Law, Economics, and Business, Discussion Paper No. 740, Jan. 10, 2013), available at *http://ssrn.com/abstract=2200499*.
7. *See King v. VeriFone Hldgs., Inc.*, 12 A.3d 1140 (Del. 2011) (reversing 994 A.2d 354 (Del. Ch. 2010)); *White v. Panic*, 783 A.2d 543, 549-50 (Del. 2001) (disapproving of legal standard articulated by 793 A.2d 356 (Del. Ch. 2000)).
8. *See Pyott*, 2013 WL 1364695, at *3; *see also* Restatement (Second) of Judgments §§ 27, 41, 59 & cmt. c, 62 & cmts. a & c (1982).
9. *See Pyott*, 2013 WL 1364695, at *4 & n.21; *see also* Restatement (Second) of Judgments § 42(1)(e).
10. *See generally Semtek Int'l Inc. v. Lockheed Martin Corp.*, 531 U.S. 497 (2001).
11. *In re Sonus Networks, Inc.*, 499 F.3d 47, 64 (1st Cir. 2007); *accord Arduini v. Hart*, No. 1:11-cv-255, 2012 WL 893874, at*3 (D. Nev. Mar. 14, 2012); *Carroll v. McKinnell*, No. 601879/06, 2008 WL 732834, at *7-8 (N.Y. Sup. Ct. Mar. 17, 2008); *In re Bed Bath & Beyond Inc. Derivative Litig.*, No. 06-5107, 2007 WL 4165389, at *7 (D.N.J. Nov. 19, 2007); *Hanson v. Odyssey Healthcare, Inc.*, No. 3:04-cv-2751, 2007 WL 5186795, at *5 (N.D. Tex. Sept. 21, 2007); *LeBoyer v. Greenspan*, No. CV 03-5603, 2007 WL 4287646, at *3 (C.D. Cal. June 13, 2007); *Henik v. LaBranche*, 433 F. Supp. 2d 372, 380 (S.D.N.Y. 2006).
12. *See Minucci v. Agrama*, 868 F.2d 1113 (9th Cir. 1989). The correctness of that approach is dubious, *see City and County of San Francisco v. United States*, 930 F. Supp. 1348, 1353-55 (N.D. Cal. 1996), but is beyond the scope of this discussion.
13. *In re Allergan, Inc. S'holder Derivative Litig.*, No. 10-1352, 2012 WL 137457 (C.D. Cal. Jan. 17, 2012).
14. *La. Mun. Police Emps' Ret. Sys. v. Pyott*, 46 A.3d 313, 323-50 (Del. Ch. 2012).
15. *Id.* at 325-27.
16. *Id.* at 329-35.
17. *Id.* at 335-50.
18. *Pyott*, 2013 WL 1364695, at *3.
19. Restatement (First) of Conflicts of Laws § 450 cmt. d (1934) (cited in *Cavalier Oil v. Harnett*, 564 A.2d 1137, 1141 n.3 (Del. 1989)); *accord* Restatement (Second) of Conflicts of Laws § 94 cmt. d (1971).
20. *Supra* note 11.
21. *Pyott*, 2013 WL 1364695, at *4. While the *Pyott* appeal was pending before the Delaware Supreme Court, the Vice Chancellor who denied preclusion in *Pyott* applied the same presumption of inadequacy to grant a Rule 23.1 motion to dismiss in *South v. Baker*, 62 A.3d 1, 22-26 (Del. Ch. 2012).
22. *Pyott*, 2013 WL 1364695, at *3 & n.20. The conflicting Delaware Court of Chancery decisions are *In re Career Education Corp. Derivative Litigation*, No. 1398, 2007 WL 2875203, at *10-15 (Del. Ch. Sept. 28, 2007) (granting a Rule 23.1 motion to dismiss based on the preclusive effect of a judgment against a different shareholder in the federal Northern District of Illinois), and *West Coast Management & Capital, LLC v. Carrier Access Corp.*, 914 A.2d 636, 643 (Del. Ch. 2006) (stating in dicta that "[e]quitable considerations render dubious the majority position" on preclusion of different shareholders).
23. *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, __ A.3d __, 2013 WL 3191981 (Del. Ch. June 25, 2013).
24. *Pyott*, 2013 WL 1364695, at *3.
25. 46 A.3d at 333-34.
26. *Id.* at 334.
27. *Lillis v. AT&T Corp.*, 2005 WL 5750582, at *5 (Del. Ch. Aug. 26, 2005) (internal quotation marks omitted).
28. *Stern v. LF Capital Partners, LLC*, 820 A.2d 1143, 1146 (Del. Ch. 2003).
29. *See, e.g.*, *King*, 12 A.3d at 1150 ("[I]t is wasteful of the court's and the litigants' resources to have a regime that could require a corporation to litigate repeatedly the issue of demand futility").