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# Delaware Supreme Court Issues Important Ruling Barring Re-Litigation Of Stockholder Derivative Suit Under Collateral Estoppel

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In a short but significant opinion with potentially wide-ranging implications for stockholder derivative law, on April 4, 2013, the Delaware Supreme Court unanimously ruled that: (1) a prior dismissal of a stockholder derivative suit for failure to allege demand futility precluded different stockholders from subsequently asserting similar derivative claims in Delaware; and (2) there is no irrebuttable presumption under Delaware law that "fast filing" derivative plaintiffs who commence suit without first seeking books and records are inadequate representatives for purposes of the collateral estoppel doctrine. *See Pyott v. La. Mun. Police Emps.' Ret. Sys.*, No. 380 (Del. Apr. 4, 2013). In so ruling, the Supreme Court reversed a controversial decision of the Delaware Chancery Court last year that upended a growing body of law governing preclusion in the context of multi-forum stockholder litigation. While the decision brings much-needed clarity to certain aspects of the law, the Supreme Court left open the full reach of collateral estoppel for another day.

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### Background

Allergan, Inc. ("Allergan") is a Delaware corporation that develops and markets Botox, a prescription neurotoxin regulated by the U.S. Food and Drug Administration. In 2010, Allergan announced that it had settled claims with the Department of Justice that it had illegally engaged in off-label marketing of Botox and paid $600 million in civil and criminal fines as part of the settlement. Within days of the announcement, stockholders commenced derivative actions in both Delaware and California, alleging (among other things) that Allergan's directors had breached their fiduciary duty by failing properly to oversee the company's operations.

The Allergan defendants moved to dismiss in both jurisdictions for failure to plead demand futility. In Delaware, the Court of Chancery postponed resolution of the motion to allow another stockholder to inspect Allergan's books and records under Section 220 of the Delaware General Corporation Law. Before argument on the motion in the Delaware action was heard, however, the California federal court dismissed the California action with prejudice on the grounds that plaintiffs had failed adequately to allege demand futility. The question before the Delaware Chancery Court was therefore whether the California judgment had preclusive effect such that the Delaware action was barred.

### Chancery Court Ruling

In a lengthy decision, Vice Chancellor J. Travis Laster held that collateral estoppel did not bar the Delaware action and denied the motion to dismiss.[1] This ran counter to a growing body of federal and state cases holding that dismissal of one stockholder derivative suit for failure to make pre-suit demand precludes other stockholders from later bringing similar demand-excused suits since stockholders of a corporation who sue derivatively do so as representatives of the corporation and, as such, are in privity with each other.[2] In taking the contrary view, Vice Chancellor Laster reasoned that, under Delaware law, stockholder plaintiffs do not have standing to bring a derivative suit *until* they establish that demand was

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futile or wrongfully denied.[3] Before that demonstration is made, the Vice Chancellor continued, the stockholder is merely suing in its own name for the right to represent the corporation and is not in privity with other stockholders.[4] Absent privity, the doctrine of collateral estoppel simply did not apply.

Vice Chancellor Laster went on to hold that the Delaware plaintiffs were not collaterally estopped in any event because the California plaintiffs were inadequate representatives. Echoing a long line of Delaware precedent strongly urging would-be derivative plaintiffs to first utilize the books and records demand procedures under Section 220, the Vice Chancellor scolded the California plaintiffs for "leaping to litigate without first conducting a meaningful investigation … "[5] In the Vice Chancellor's view, the California plaintiffs were thus presumptively inadequate because they sought to "benefit themselves by rushing to gain control of a case that could be harvested for legal fees" rather than acting for the benefit of Allergan.[6] The fact that the California plaintiffs subsequently amended their complaint with the benefit of the books and records obtained in the Delaware action "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."[7]

### Delaware Supreme Court Decision

In a terse 12-page decision, the Delaware Supreme Court disagreed with the Court of Chancery on both points and reversed the judgment denying defendants' motion to dismiss.[8]

With respect to the issue of estoppel, the Court held that Vice Chancellor Laster's analysis was predicated on a "mistaken premise."[9] The question was not, as the Chancery Court inaccurately held, whether a "stockholder in a Delaware corporation can sue derivatively after another stockholder attempted to plead demand futility" as a matter of Delaware demand futility law.[10] Rather, the issue was whether the California judgment precluded the Delaware action under California collateral estoppel law.[11] "Once a court of competent jurisdiction has issued a final judgment," the Court ruled, "a successive case is governed by the principles of collateral estoppel, under the full faith and credit doctrine, and not by demand futility law, under the internal affairs doctrine."[12] And under California law, privity was clearly not lacking: "because the real plaintiff in a derivative suit is the corporation, differing groups of shareholders who can potentially stand in the corporation's stead are in privity for the purposes of issue preclusion."[13] As a result, the Delaware plaintiffs were precluded from re-litigating the issue of demand futility in Delaware.[14]

Significantly, although the Court concluded that it could not address the issue of privity under Delaware law, it strongly hinted that the result would have been the same. While "we cannot address the merits" of the privity issue as a matter of Delaware law, the Court noted, "numerous other jurisdictions have held that there is privity between derivative stockholders."[15]

The Court also refused to recognize a "'fast filer' irrebuttable presumption of inadequacy."[16] Undoubtedly, the Court noted, "there will be cases where a fast filing stockholder is also an inadequate representative."[17] However, the Court found "no record support for the trial court's premise that stockholders who file quickly … are *a priori* acting on behalf of their law firms instead of the corporation."[18] While the Court was sensitive to the Vice Chancellor's "concerns about fast filers," the Court held that any "remedies … should be directed at the lawyers, not the stockholder plaintiffs or their complaints."[19] And in this case, at least, since the trial court had found that the Delaware complaint adequately stated a claim for relief and that the California and Delaware complaints were "so similar," the California complaint could not be so "grossly deficient" as to support a finding of inadequacy.[20]

### Conclusion

While the application of collateral estoppel in stockholder derivative cases is still developing, the Delaware Supreme Court's *Pyott* decision is rightly viewed as a welcome limit on the burdensome threat of multi-forum stockholder derivative litigation and a harbinger of further limits to come. For now, at least, the key takeaways are four-fold:

- Where the law of the predecessor court recognizes privity between derivative stockholders, a subsequent derivative plaintiff is collaterally estopped from re-litigating demand futility in Delaware under the Full Faith and Credit Clause.
- Where the law of the predecessor court is unresolved, the result is likely to turn on the application of complex choice of law principles and is therefore less clear. At least for Delaware corporations, however, this should not present much of an issue. Because the issue of stockholder privity concerns internal corporate affairs, its resolution should be governed by the law of the state of incorporation – i.e., Delaware. Although the Delaware Supreme Court felt constrained not to address the issue directly, it all but did so, strongly suggesting that, like "numerous other jurisdictions," Delaware will hold that there is privity between derivative stockholders.
- By rejecting the irrebuttable presumption of inadequacy for plaintiffs who "fast file" without conducting a pre-suit investigation, *Pyott* has narrowed the opportunity for dueling plaintiffs in multi-forum derivative litigation to avoid preclusion on collateral estoppel grounds.
- While acknowledging the problems created by "fast filers," the Delaware Supreme Court provided little guidance on an appropriate solution beyond repeating that any remedy should be directed at the lawyers responsible for those problems, not their clients. Absent a more concrete directive from the Supreme Court, *Pyott* provides little disincentive for the plaintiffs' bar to continue the race to the courthouse.

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1 *La. Mun. Police Emps.' Ret. Sys. v. Pyott*, 46 A.3d 313, 327-35 (Del. Ch. 2012).

2 *See id.* at 327.

3 *Id.* at 327-28.

4 *Id.* at 329.

5 *Id.* at 350.

6 *Id.* at 349.

7 *Id.* at 350.

8 *Pyott v. La. Mun. Police Emps.' Ret. Sys.*, No. 380, slip op. at 3 (Del. Apr. 4, 2013).

9 *Id.* at 6.

10 *Id.* at 6-7.

11 *Id.* at 3.

12 *Id.* at 7.

13 *Id.* at 9 (citation omitted).

14 *Id.* at 8.

15 *Id.* at 10.

16 *Id.* at 11.

17 *Id.*

18 *Id.*

19 *Id.* at 11-12.

20 *Id.* at 12.