

CLIENT ALERT

Delaware Supreme Court Affirms Preclusive Effect of Prior Demand Futility Dismissals in Stockholder Derivative Actions

January 29, 2018

AUTHORS

Tariq Mundiya | Martin L. Seidel | Mary Eaton | Sameer Advani | Jessica T. Sutton

On January 25, 2018, in a significant and highly anticipated opinion in the Wal-Mart Stores, Inc. derivative litigation,¹ the Delaware Supreme Court declined to adopt the Chancery Court's recommendation to limit the preclusive effect of decisions by out of state courts on demand futility to cases where the first derivative plaintiff survives a motion to dismiss. Instead, the high court affirmed the Chancery Court's original dismissal of Delaware stockholders' derivative claims against the directors of Wal-Mart as precluded by an earlier dismissal in a parallel derivative action in Arkansas federal court. In so holding, the high court adhered to the weight of federal and state precedent that granting preclusive effect to prior determinations of demand futility does not violate the Due Process rights of subsequent derivative plaintiffs where their "interests were aligned with and were adequately represented by the prior plaintiffs." This decision is an important reminder that early dismissal of parallel out of state or federal claims will cut off derivative claims brought by shareholders in Delaware courts.

The high court's decision arose from a series of consolidated derivative actions filed in Delaware and Arkansas relating to an alleged bribery scheme and cover-up perpetrated by executives at Wal-Mart's Mexican subsidiary. The Delaware plaintiffs demanded access to Wal-Mart's books and records under Section 220 in an effort to strengthen their case, and

¹ *California State Teachers' Retirement System v. Alvarez*, No. 295, 2018 WL 547768 (Del. Jan. 25, 2018). The Chancery Court opinions are *In re Wal-Mart Stores, Inc. Delaware Derivative Litigation*, 167 A.3d 513 (Del. Ch. 2017) and C.A. No. 7455-CB, 2016 WL 2908344 (Del. Ch. May 13, 2016).

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“vigorously pursued the books-and-records litigation, which took three years to resolve.” The Arkansas plaintiffs, by contrast, did not seek Wal-Mart’s books or records, or await the outcome of the Delaware action, and instead chose to proceed with their case based on publicly available materials. Before the Delaware plaintiffs had the chance to complete their Section 220 litigation and file an amended complaint, the federal district court in Arkansas dismissed the shareholders’ action for failure to adequately plead demand futility. The Chancery Court subsequently dismissed the Delaware shareholders’ claims on the ground that the Arkansas decision had preclusive effect. On appeal, the shareholders argued that affirming the lower court’s ruling could be the “death knell” of Section 220 actions, encouraging a race to the courthouse at the expense of proper investigation. The Delaware Supreme Court remanded the case, directing the Chancery Court to address whether, in a situation where dismissal by the federal court in Arkansas of a stockholder plaintiff’s derivative action for failure to plead demand futility is held by the Chancery Court to preclude subsequent stockholders from pursuing derivative litigation, the subsequent stockholders’ Due Process rights were violated. In evaluating that issue, the Chancery Court found that giving preclusive effect to the dismissal of a prior plaintiff’s derivative action on futility grounds does not violate the Due Process rights of subsequent derivative plaintiffs, so long as the prior representation was not inadequate. Nevertheless, the Chancery Court went on to recommend that the Delaware Supreme Court depart from the weight of authority and adopt the rule proposed in *dicta* in a prior Chancery Court decision, *EZCORP*,² that there should be no preclusive effect unless the first derivative plaintiff survives a Rule 23.1 motion to dismiss, since that would better safeguard the Due Process rights of stockholder plaintiffs and “go a long way to addressing the fast-filer problems” inherent in multi-forum derivative litigation.

While appreciating the Chancery Court’s “thoughtful deliberations on this difficult matter,” the Supreme Court rejected the Chancery Court’s recommendation. Although the court recognized Delaware’s “interest in governing the internal affairs of Delaware corporations,” it noted that this interest must “yield to the stronger national interests that all state and federal courts have in respecting each other’s judgments.” Therefore, in declining to adopt the Chancery Court’s approach, the Supreme Court held that the federal Due Process inquiry for non-party issue preclusion applied, which requires a two-prong analysis: (1) whether the nonparty had the same interests as someone who was a party, and (2) whether those interests were adequately represented. With respect to the first prong, the court found that the Delaware plaintiffs’ interests were the same as those of the Arkansas plaintiffs inasmuch as both sought “to prosecute claims by and in the right of the same real party in interest – *i.e.*, as representatives of—the corporation.” As to the second prong, the court found that all of the required elements were likewise satisfied: (1) the interests of the party and non-party plaintiffs were aligned; (2) the Arkansas plaintiffs understood that they were acting in a representative capacity and that the federal court’s decision would have a preclusive effect; and (3) the Delaware plaintiffs had notice of the Arkansas action. In analyzing adequacy, the court specifically noted, echoing views previously expressed in its 2013 decision in *Pyott*,³ that although the Arkansas plaintiffs’ decision to forego a Section 220 demand may have been “a tactical error,” it did not “rise

² *In re EZCORP Inc. Consulting Agreement Derivative Litigation*, 130 A.3d 934 (Del. Ch. 2016).

³ *Pyott v. La. Mun. Police Emps.’ Ret. Sys.*, 74 A.3d 612 (Del. 2013). For more information, please see our client alert entitled “Delaware Supreme Court Issues Important Ruling Barring Re-Litigation of Stockholder Derivative Suit Under Collateral Estoppel” (April 5, 2013), available [here](#).

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to the level of constitutional inadequacy.” The court, therefore, concluded there was no violation of the Delaware plaintiffs’ Due Process rights and affirmed dismissal of their action.

In declining to alter Delaware precedent on preclusion in the case of shareholder derivative actions, the Delaware Supreme Court’s decision reinforces longstanding precedent that preclusive effect may be given to other courts’ decisions on demand futility, and suggests that courts will not be inclined to find any Due Process violation absent extreme circumstances. The result is welcome news for defendants, who frequently face duplicative derivative suits in multi-forum litigation, and would otherwise be required to re-litigate the same futility issues repeatedly had the Delaware Supreme Court decided otherwise. While we do not anticipate the *Wal-Mart* decision will lead to a meaningful reduction in the number of Section 220 demands made by prospective Delaware derivative plaintiffs, given the strong admonition of the Delaware courts to use such “tools at hand,” the severe consequences faced by the Delaware plaintiffs in *Wal-Mart* will likely spur future shareholders to take more active steps, including seeking intervention, in parallel non-Delaware litigation to protect their rights.

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

Tariq Mundiya

212 728 8565

tmundiya@willkie.com

Martin L. Seidel

212 728 8385

mseidel@willkie.com

Mary Eaton

212 728 8626

meaton@willkie.com

Sameer Advani

212 728 8587

sadvani@willkie.com

Jessica T. Sutton

212 728 8661

jsutton@willkie.com

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