

CORPORATE LITIGATION:

PRECLUSION IN DERIVATIVE LITIGATION

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February 7, 2018

The dismissal of a putative stockholder derivative complaint for failure to make pre-suit demand has long been understood to have preclusive effect against attempts by different stockholders to relitigate the demand issue in another court. Because a stockholder derivative plaintiff sues in the company's name, privity for preclusion purposes exists between the plaintiffs in the first and subsequent actions making similar allegations; in both, the company is the real party in interest. A recent Delaware Supreme Court en banc decision has ended uncertainty in Delaware and potentially elsewhere introduced when two Court of Chancery decisions urged that this longstanding derivative preclusion rule violates due process. In *California State Teachers' Ret. Sys. v. Alvarez*, 2018 WL 547768 (Del. Jan. 25, 2018), the Supreme Court (1) reaffirmed that because the corporation in a derivative suit is the real party in interest, stockholders of the same corporation seeking the same relief on behalf of the same entity are in privity with one another, and (2) held that according preclusive effect to the dismissal of the prior complaint on demand futility grounds did not violate the due process rights of non-party stockholders.

Pre-Suit Demand and Preclusion

Derivative claims belong to the corporation, which is why a stockholder must make a pre-suit demand on the company's board or adequately allege demand futility to pursue derivative claims on the company's behalf. To prevent abuse of the derivative form of suit, as a precondition to seeking to enforce a right of a corporation a stockholder must demonstrate that the corporation refused to proceed as requested after suitable demand (unless demand is excused because particularized allegations create reasonable doubt that a majority of the board could impartially consider a demand).

Parallel lawsuits regarding the same allegations are a familiar dynamic in stockholder litigation. In derivative litigation, recent Delaware decisions have sought to curb fast-filed, inadequately-investigated complaints by emphasizing that when stockholders sue in Delaware in a representative capacity, "first-to-file" does not control which plaintiff and its counsel will be granted the leadership role. When suits are filed in more than one forum, a key strategic objective for defendants is avoiding the burden and expense of litigating the same issues in multiple jurisdictions. Once the first final decision on demand-related allegations is rendered, preclusion doctrine protects these interests by prohibiting different stockholders from relitigating the derivative claim.

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A request that one court give preclusive effect to a judgment entered in another court invokes constitutional full faith and credit principles. The preclusive effect of a judgment is determined by the law of the forum in which the judgment was rendered. In Delaware and elsewhere, subject to due process, courts give the same preclusive effect to the judgment of another state or federal court as the original court would give. *Pyott v. La. Mun. Police Empls.' Ret. Sys.*, 74 A.3d 612, 615-16 (Del. 2013).

‘Alvarez’

Allegations of a bribery scheme involving Wal-Mart’s Mexican arm engendered derivative suits by different stockholders in Arkansas federal court and Delaware. While the Delaware plaintiffs (*Alvarez*) were litigating a books and records demand in an effort to bolster their complaint, the Arkansas suit was dismissed for failure to plead demand futility. The Chancellor then dismissed the Delaware action based on the issue-preclusive effect of the Arkansas decision. On appeal, the Delaware Supreme Court stated that it was “presently satisfied” that the Chancellor properly applied Arkansas privity law and correctly determined that the stockholders in both suits were in privity because in both, the corporation was the real party in interest. The Supreme Court noted that the Delaware plaintiffs could have intervened in the Arkansas suit, but did not. It remanded the case, however, concluding that the Chancellor had not sufficiently addressed whether precluding the subsequent suit was consistent with due process, specifically pointing to *In re EZCORP Consulting Agreement Deriv. Litig.*, 130 A.3d 934 (Del. Ch. 2016). In *EZCORP*, the court in dictum extended to derivative suits the reasoning of the U.S. Supreme Court’s *Smith v. Bayer*, 564 U.S. 299 (2011)—which held that absent class members are non-parties who are not bound by any rulings in the case unless and until a class is certified—so that stockholders pursuing derivative actions are not in privity with each other until the prior action has survived a motion to dismiss for failure to adequately plead demand futility. On remand, Chancellor Andre G. Bouchard reconsidered and changed his prior ruling in *Alvarez* and recommended that the Supreme Court adopt the rule proposed in *EZCORP*.

The Supreme Court declined the recommendation, holding that the Arkansas dismissal bound other stockholders of the company. The court stated that for issue preclusion to bar relitigation, the party asserting preclusion must demonstrate that (1) all elements of issue preclusion under the rendering State are present and (2) due process is satisfied. Issue preclusion in Arkansas (and elsewhere) requires privity between the parties and adequacy of the prior representation. As to privity, the court ruled that privity focuses “on whether the person arguably precluded is so identified in interest with the former litigant that she represents the same legal right.” In a stockholder derivative suit, the stockholder seeks to pursue a claim that belongs exclusively to the corporation. While “the stockholder-derivative plaintiff may assume control of the corporation’s claim only if he demonstrates that demand on the board would be futile, ... through the entire process, the corporation alone is the real party in interest because the suit is always on its behalf.” When multiple derivative actions are filed, the separate plaintiffs “share an identity of interest in seeking to prosecute claims by and in the right of the same real party in interest—i.e., as representatives of—the corporation.” Differing groups of stockholders are in privity because each seeks to control the corporation’s claim and shares the same interest at all stages. Noting that federal law is in accord, the Supreme Court therefore declined to withhold preclusive effect from a prior derivative suit unless and until the plaintiff in the prior suit has acquired authority to proceed on the corporation’s behalf.

Due process, however, generally limits the preclusive effect of a proceeding to its actual parties. This general rule against non-party preclusion is subject to exceptions, including that a “non-party may be bound by a judgment because she was adequately represented by someone with the same interests who [wa]s a party to the suit.” *Alvarez*, 2018 WL 547768, at *19. Relying on U.S. Supreme Court guidance, *Alvarez* identified three

minimum requirements to establish adequate representation for preclusion purposes: (1) the interest of the nonparty and her representative must be aligned; (2) “either the party understood herself to be acting in a representative capacity or the original court took care to protect the interests of the nonparty;” and (3) “‘sometimes’ notice is required.” *Id.* (quoting *Taylor v. Sturgell*, 553 U.S. 880, 900 (2008)).

The alignment requirement was easily satisfied through the court’s privity determination. As to whether the initial derivative plaintiffs understood that they were acting in a representative capacity, court concluded that the record showed “that both sets of plaintiffs understood that a judgment in their case could impact the other stockholders,” citing, among other things, the federal court’s warning to the Arkansas plaintiffs that its decision would have preclusive effect on other stockholders. “Moreover, the Arkansas court took care to protect the interests of the nonparty Delaware Plaintiffs by granting a stay while they pursued their Section 220 [books and records] litigation in Delaware.” *Id.* As to notice, the court observed that “federal courts have signaled that derivative suits are situations where notice is not required to comply with Due Process,” but did not resolve that issue because the Delaware Plaintiffs admitted they had timely notice of the Arkansas action. The court reinforced its conclusion that the prior representation was adequate by noting that while grossly inadequate or conflicted representation will result in a finding of inadequacy, the record supported neither conclusion.

The court paused to address the Delaware plaintiffs’ criticism of the Arkansas plaintiffs for failing to seek additional corporate books and records prior to litigating demand futility. The Delaware Chancellor had issued a warning—of which the Arkansas plaintiffs were aware—that any derivative pleading about the underlying controversy needed sufficient documentary support in order to survive a demand futility challenge. The Supreme Court noted that the Arkansas plaintiffs did obtain some internal documents that had become publicly available, and made a tactical decision to proceed without seeking additional records. While this turned out to be “a tactical error, the Arkansas Plaintiffs’ decision to forgo a Section 220 demand” did “not rise to the level of constitutional inadequacy. Reasonable litigants can differ on such tactical decisions.” *Id.* at *22.

Conclusion

According preclusive effect to the first final decision on demand-related allegations is fair and efficient, and promotes the vital interests of respect for judicial rulings, finality and prevention of relitigation of issues decided. The rule that stockholders asserting derivative claims in Delaware cannot relitigate demand futility allegations asserted unsuccessfully elsewhere will likely spur an increase in efforts by plaintiffs to intervene in parallel derivative suits filed in other fora (particularly later-filed ones), either to seek a stay of the parallel suit or otherwise be heard on demand futility matters. *Id.* at *4 (“Once the litigation train began going down the Arkansas tracks, it would seem to have been incumbent upon the Delaware Plaintiffs to take steps there to attempt to prevent foreclosure of their action in Delaware.”). In addition, for corporations that do not have a Delaware forum-selection bylaw, *Alvarez* may prompt an increase in derivative litigation filings outside of Delaware. Delaware courts have repeatedly admonished plaintiffs to use the “tools at hand”—a demand for company books and records under §220 to attempt to substantiate their allegations before filing derivative complaints. In *Alvarez*, however, the Delaware Supreme Court held that the failure of purported derivative plaintiffs to seek corporate records before filing suit outside of Delaware will not necessarily render their representation inadequate. Plaintiff’s counsel seeking to initiate the first-filed derivative suit regarding an alleged corporate claim may perceive advantage in proceeding outside of Delaware without any delay occasioned by a books and records demand. Nevertheless, a sue-first, explain-demand-futility-later approach carries risk in all jurisdictions. In evaluating whether pre-suit demand on the board was excused, a non-

Delaware court also may take into account whether demand futility allegations were made with the benefit of adequate pre-suit investigation.

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