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Delaware Insider:

Collateral Estoppel Doesn't Bar Second Derivative Case After First is Dismissed

By Jason C. Jowers

In the recent case of *Louisiana Municipal Police Employees' Retirement System v. Pyott*, __ A.3d __, 2012 WL 2087205 (Del. Ch. June 11, 2012), the Delaware Court of Chancery issued a decision that has potentially significant implications for derivative actions involving Delaware corporations brought both in Delaware and in other jurisdictions. Disagreeing with a prior Court of Chancery case as well as a growing body of federal case law applying the collateral estoppel doctrine in the derivative action context, the court denied a motion to dismiss a derivative action brought by shareholder plaintiffs even though a federal court had previously dismissed with prejudice a substantially similar case brought by different shareholder plaintiffs. Applying Delaware Supreme Court precedent, Vice Chancellor Laster found that a derivative shareholder plaintiff does not have authority to step into the shoes of the corporation, if a corporation is opposing the litigation, until a court finds either that (1) demand on the board of directors is excused as futile or (2) the board is wrongfully refusing the demand. Because neither of these conditions precedent was met in the first derivative case, the first group of plaintiffs never became synonymous with the corporation. Thus, the court determined that the first derivative plaintiffs were never in privity with the corporation or the subsequent Delaware derivative plaintiffs, and collateral estoppel did not bar a subsequent derivative action involving the same facts. Relying on the internal affairs doctrine, the court concluded that Delaware determines under what circumstances shareholders of Delaware corporations are in privity with the corporation and each other. If a stockholder is not in privity with the corporation or another stockholder who brings a subsequent action, the dismissal of a first action does not bar a second action.

This article addresses: (1) the court's rationale for its decision; (2) the court's disagreement with prior case law; and (3) the potential impact on derivative litigation involving Delaware corporations post-*Pyott*, assuming the decision survives appeal.

Competing Derivative Actions

On September 1, 2010, Allergan, Inc., a Delaware corporation specializing in pharmaceuticals, entered into a settlement agreement with the United States Department of Justice following a three-year government investigation into Allergan's off-label marketing practices of Botox. As part of the settlement, Allegan agreed to pay $375 million in criminal fines for misbranding and $225 million in civil fines to resolve False Claims Act actions that also dealt with off-label marketing. The settlement was publically announced on September 1.

On September 3, 2010, Louisiana Municipal Police Employees' Retirement System (LAMPERS) filed the Delaware derivative action against the Allergan directors. U.F.C.W. Local 1776 & Participating Employers Pension Fund (UFCW), another Allergan shareholder, sent a books and records demand to Allergan pursuant to 8 Del. C. § 220 on November 3, 2010, and moved to intervene in the Delaware action on November 30, 2010. With the information obtained from the books and records demand and other publically available information, LAMPERS and UFCW, which had been permitted to intervene, filed the verified second amended derivative complaint on July 8, 2011. The Delaware complaint alleged that the Allergan board breached their fiduciary duties by consciously approving an off-marketing plan that violated a federal statutory ban on off-label marketing.

From September 9 to September 24, 2010, other Allergan shareholders filed derivative actions in federal court in California, which were subsequently consolidated before the U.S. District Court for the Central District of California. On April 12, 2011, the Central District of California dismissed the plaintiffs' first complaint without prejudice. The California plaintiffs asked Allergan to produce the documents it had produced in response to UFCW's books and records action, which it did. The California plaintiffs incorporated these documents into an amended complaint, and the director defendants again moved to dismiss. On January 17, 2012, the Central District of California granted the motion to dismiss with prejudice.

Following the dismissal of the California action, the director defendants in the Delaware action moved to dismiss, in part, on collateral estoppel grounds.

Choice of Law Analysis in *Pyott*

The *Pyott* decision begins with a complicated choice of law analysis. The defendants argued, and the court agreed, that the Delaware court was required to give the same force and effect to a foreign judgment as the foreign court rendering the judgment. The Full Faith and Credit Clause in the U.S. Constitution provides that "Full Faith and Credit shall be given in each State to the . . . judicial Proceedings of every other State." Congress adopted 28 U.S.C. § 1738 to implement the Full Faith and Credit Clause. The relevant portion of section 1738 provides that "judicial proceedings . . . shall have the same full faith and credit in every court within the United States . . . as they have by law or usage in the courts of such State . . . from which they are taken." 28 U.S.C. § 1738. In other words, when a Delaware court is asked to dismiss a case pursuant to the collateral estoppel doctrine based on a prior judgment in California, the Delaware court must give the same credit to that judgment as would a California court.

Some commentators criticizing the *Pyott* opinion have suggested that the Court of Chancery refused to apply California's collateral estoppel test, and in effect rejected the long-standing precedent interpreting the Full Faith and Credit Clause as requiring each state to give the judgment of a foreign state the same effect as it would have in the state issuing the judgment. Respectfully, such commentators are incorrect, and the court's decision is far more nuanced. Contrary to these criticisms, the court specifically stated that "defendants correctly point out that when applying collateral estoppel, this Court must give a judgment the same force and effect that it would be given by the rendering court." The court also specifically cites to the Full Faith and Credit Clause, section 1738, and case law interpreting the same in support of this conclusion.

Although accepting that California's collateral estoppel standard generally governed the effect of the prior California judgment on the Delaware action, the Court of Chancery held that Delaware law had a role to play in the analysis. The California collateral estoppel or issue preclusion standard requires that (1) the issue necessarily decided at the previous proceeding is identical to the one which is sought to be re-litigated; (2) the first proceeding ended with a final judgment on the merits; and (3) the party against whom collateral estoppel is asserted was a party or in privity with a party at the first proceeding. While generally applying California's collateral estoppel test, as it must, the court concluded that Delaware law governed whether stockholders of a Delaware corporation were in privity with each other or the corporation under that test. According to the court, "[w]hether successive stockholders are sufficiently in privity with the corporation and each other is a matter of substantive Delaware law governed by the internal affairs doctrine." The U.S. Supreme Court (in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982)) has described the internal affairs doctrine as "a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders." According to the *Pyott* decision, whether one shareholder can sue derivatively after a first shareholder attempted, and failed, to plead demand futility is a matter involving the "managerial prerogatives" of a Delaware corporation, which implicates the internal affairs doctrine.

The court went on to explain that applying the internal affairs doctrine provides a uniform approach across all jurisdictions because the law of the state of incorporation would decide whether stockholders are in privity with the corporation or each other. As Vice Chancellor Laster stated, "whether a stockholder in a Delaware corporation can sue derivatively after another stockholder attempted to plead demand futility should not be governed by potentially different rules across twelve federal circuits, fifty states, and the District of Columbia, Puerto Rico, and other territories. Applying different rules in different courts would disrupt the internal affairs of corporations."

Disagreement with Prior Court Decisions

The Court of Chancery in *Pyott* noted that "[a] growing body of precedent holds that a Rule 23.1 dismissal has preclusive effect on other derivative complaints." In these mainly federal cases, courts found that a derivative plaintiff sues in the name of the corporation. By extension, once the corporation's claims brought by its representative shareholder are dismissed, it and its privies are precluded from relitigating the same issue again. For example, in *In re Career Educ. Corp. Derivative Litigation*, 2007 WL 2875203 (Del. Ch. Sept. 28, 2007), Vice Chancellor Parsons dismissed a second derivative action based on collateral estoppel. There, relying on federal cases that had addressed this issue, the court found that "the corporation is the true party in interest in a derivative suit." Under this theory, both the first and second derivative plaintiffs are in privity with the corporation, and thus the second derivative plaintiff is precluded from bringing a subsequent derivative action after the first is dismissed. Furthermore, as the director defendants in *Pyott* argued, in *LeBoyer v. Greenspan*, 2007 WL 4287646 (C.D. Cal. June 13, 2007), a California federal court applying California collateral estoppel law had found that a shareholder who brings a derivative suit on behalf of a Delaware corporation is in privity with the corporation's shareholder who brought a prior derivative action.

Rejecting this argument and expressly disagreeing with the *Career Education* and *LeBoyer* decisions, *Pyott* held "that as a matter of Delaware law, a stockholder whose litigation efforts are opposed by the corporation does not have authority to sue on behalf of the corporation until there has been a finding of demand excusal or wrongful refusal." Relying on the seminal Delaware Supreme Court case of *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), the *Pyott* court explained that a derivative action, properly understood, has two components. In the first instance, it is an action by shareholders to compel the corporation to sue. Second, assuming demand is excused or wrongfully refused, it is an action by the shareholders on behalf of the corporation. Until the court denies a Rule 23.1 motion to dismiss or the board of directors determines it will not oppose the derivative action, the shareholder plaintiff is only bringing an action to compel the corporation to sue. Therefore, until a court denies a motion to dismiss or the board does not oppose the derivative action, the shareholder plaintiff does not have authority to carry out the second component of the derivative action, which is to sue on behalf of the corporation to remedy the wrong itself.

Under such circumstances, the *Pyott* court viewed it as inequitable for the director defendants to claim the shareholders in the Delaware action were precluded from asserting a claim following the dismissal of the earlier derivative suit. According to the court, "[h]aving first argued in their Rule 23.1 motion [in the California action] that the stockholder plaintiff lacks authority to assert claims derivatively on behalf of the corporation—and having prevailed on that point—the same defendants next argue that the stockholder nevertheless had authority to assert the claims on behalf of the corporation sufficient to bind all other stockholders. Judicial estoppel should bar such a reversal of position."

California Plaintiffs Failed to Provide Adequate Representation

As an alternative and independent basis for declining to find that the California dismissal collaterally estopped the Delaware plaintiffs from proceeding in Delaware, the Court of Chancery concluded that the California plaintiffs had not provided adequate representation. The collateral estoppel cases giving preclusive effect to a Rule 23.1 dismissal also recognize that a subsequent suit is permitted if the original plaintiff did not provide adequate representation to the corporation.

Finding that the California plaintiffs had not adequately represented the corporation, the court applied what it termed the "fast-filer presumption," which presumes that the fast-filer, by virtue of its lack of investigation, is not fit to serve as the representative for the corporation and its stockholders. Immediately following the public announcement of a "corporate trauma," there is often a race to the courthouse (if not courthouses) by competing plaintiffs' firms to file first in an effort to control the litigation. As the court observes, such complaints are often limited to conclusory allegations because they are filed before there has been any meaningful investigation. However, because many jurisdictions follow the first-to-file rule, it is difficult to obtain a stay of such cases in favor of an action brought by a representative plaintiff that conducts an investigation prior to bringing an action. Plaintiffs' firms, which are often representing shareholders for contingency fees, are motivated to win the race to the courthouse so that they may control the litigation and increase their share of any fee award. Although Delaware courts have routinely encouraged shareholders to use the "tools at hand" to make a books and records demand before filing an action on the merits, under the current system, a shareholder who pursues a books and records investigation, as well as the attorneys representing the shareholder, are disadvantaged vis-à-vis the fast-filing plaintiff.

In *Pyott*, one of the Delaware plaintiffs, UFCW, did seek books and records before intervening in the Delaware action. Although the California fast-filers eventually received the same information also, the court concluded that the California plaintiffs "already had shown where their true loyalties lay." As evidenced by their fast-filing, the court concluded the California plaintiffs were more interested in controlling the litigation so as to increase their share of any attorneys' fees award than the interests of Allergan, and thus failed to adequately represent Allergan. Accordingly, the court held that collateral estoppel did not bar the Delaware action.

Turning to the Rule 23.1 analysis and viewing the California decision as persuasive rather than binding authority, the court concluded that the plaintiffs had pled particularized allegations supporting a reasonable inference that their claims had some merit.

Implications of *Pyott*

The *Pyott* decision potentially has far-reaching consequences for Delaware directors and companies, as well as for the attorneys who represent them. The decision could lead to directors facing repetitious derivative suits brought by different shareholder plaintiffs if one or more actions are dismissed. Even if the subsequent suits are dismissed under Rule 23.1, the director defendants (and the companies indemnifying them) will be exposed at least to the expense of additional motion practice. However, as Vice Chancellor Laster's opinion explains, a court hearing the second derivative action is not required to ignore the foreign court's decision in the first derivative action. To the contrary, *Pyott* teaches that the first "decision does, of course, carry persuasive weight and can operate as *stare decisis*." Furthermore, the court emphasizes that its decision is not meant to create forum shopping for the same shareholder plaintiff. Indeed, "[w]hen the same stockholder responds to a Rule 23.1 dismissal by attempting to file a second complaint alleging demand futility, the 'same party' requirement is met and a Rule 23.1 dismissal may have preclusive effect."

The court's analysis of the problem of inadequate representation by fast-filing plaintiffs may also prove to be significant. Without a presumption that a fast-filer's representation is inadequate, there is no real incentive for plaintiffs to slow down and investigate because the ruling on the motion to dismiss in the first derivative action will either (1) allow the case to proceed (benefitting the fast-filer) or (2) dismiss the case, collaterally estopping the other shareholders from proceeding (equally harming all of the plaintiffs). Under this system, all of the plaintiffs' firms are in the same boat, except for the winner of the race to the courthouse. Accordingly, the incentive is to be first. By removing the risk of automatic dismissal of a second-filed derivative action if the first action fails or if representation by a fast-filer is inadequate, the court is encouraging plaintiffs to conduct investigations and be informed rather than merely be first-to-file. The fast-filer whose case was first but dismissed will be unable to control the litigation and obtain the potentially significant fee award from controlling a successful derivative action. As Vice Chancellor Laster put it: "A plaintiffs' firm only can obtain a fee if it first obtains a result. A firm cannot obtain a result if a competitor gains control of the case." In theory, by incentivizing plaintiffs and their attorneys to thoroughly investigate before filing a derivative action, the fast-filer presumption could reduce the number of derivative actions filed immediately following the announcement of some "corporate trauma." Admittedly, it may also increase the number of books and records demands pursuant to 8 Del. C. § 220. Although corporations may face an added expense from an increase in books and records inspection activity, the investigations may actually eliminate the subsequent filing of derivative cases if the investigation indicates that there is no potential liability.

Significantly, on July 6, 2012, the Court of Chancery granted the defendants' application for certification of an interlocutory appeal to the Delaware Supreme Court in the *Pyott* case. Therefore, practitioners should continue to monitor this case for further developments.

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