

Corporate and Securities Litigation

Expert Analysis

Due Process Rights in Multi-Jurisdiction Shareholder Derivative Actions

In several recent cases, the Delaware Court of Chancery has addressed due process issues arising out of shareholder derivative actions.¹ The Delaware Supreme Court has now taken up the baton in a case called *California State Teachers' Retirement System v. Alvarez*, — N.E.3d —, 2017 WL 239364 (Del. Jan. 18, 2017), which raised the question of when a court in a subsequent action is obligated to honor an earlier dismissal of a shareholder derivative action for failure to plead demand futility. After making several pointed observations about the case, the court remanded the action to the Court of Chancery for further consideration of the due process challenge. However that court eventually decides the dispute, it is certain to influence strategic considerations for both plaintiffs and defendants.

Two Different Paths

Following publication of a New York Times article describing the cover up of an alleged bribery scandal at a Mexican subsidiary of Wal-Mart Stores, two groups of shareholders filed separate actions asserting derivative claims on behalf of the company.² One case was filed in Arkansas federal court, alleging Delaware state claims and federal



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securities laws claims, while the other was filed in Delaware state court, alleging Delaware state claims only. At an initial pre-trial conference in the Delaware case, then-Chancellor Leo Strine Jr. “explicitly

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warned plaintiffs’ counsel that the extant complaints before him likely would not survive a motion to dismiss,” as he did not see how plaintiffs could adequately allege demand futility as to each defendant. Chancellor Strine also “urged counsel” to undertake a careful review and examination of Wal-Mart’s books and records before filing a derivative claim. The Delaware plaintiffs heeded that warning and pursued a books-and-records demand and lawsuit, which took over three years to complete. Meanwhile,

the Arkansas plaintiffs chose to proceed without the books-and-records inspection, relying instead on the New York Times article that described the alleged bribery in some detail and that referred to a series of internal documents published on the newspaper’s website.

The Delaware plaintiffs moved for a stay in the Arkansas court pending the outcome of their own action in Delaware, which was granted by the district court but reversed on appeal by the Eighth Circuit due to the federal claims alleged solely in the Arkansas action. The Delaware plaintiffs then sought a partial stay of just the Delaware claims in the Arkansas case, citing the delays they were experiencing in the books-and-records inspection fight. The Arkansas district court denied that motion, adding a warning that “it is likely that the first decision on demand futility will be entitled to collateral estoppel effect.” While the Delaware plaintiffs tried other tactics to slow down the litigation in Arkansas—such as attempting to persuade the Arkansas plaintiffs to join them in the Delaware action—they made no effort to intervene in the Arkansas case.

Soon thereafter, the Arkansas court dismissed the Arkansas complaint for failure to adequately allege demand futility. As expected, the defendants then argued that the Delaware plaintiffs were collaterally estopped from raising demand futility in the Delaware action.

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The Court of Chancery agreed and held the Delaware action barred, which the Delaware plaintiffs appealed to the Delaware Supreme Court.

Due Process Rights

On appeal, the Delaware plaintiffs challenged their dismissal on several grounds, including that their due process rights were violated, and that the various requirements for collateral estoppel were not satisfied. The Delaware Supreme Court had no disagreement with the Court of Chancery on the latter. The high court expressed “some sympathy” for the Delaware plaintiffs because they heeded the Chancellor’s advice and fought for access to Wal-Mart’s books and records, while the Arkansas plaintiffs ignored it and suffered a dismissal. But it criticized both sets of plaintiffs for their failure to coordinate, which helped neither’s case. More pointedly, the court faulted the Delaware plaintiffs for failing to seek intervention in Arkansas, stating:

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. Instead, they took no action in the Arkansas court—leaving them to address the litigation fallout in Delaware.

According to the court, even if the Arkansas court had ultimately denied intervention, such a motion would have ensured that it “[took] into account the litigation pending elsewhere and ma[de] a determination as to whether any dismissal should be with or without prejudice, and as to the named plaintiff only, and what provision, if any, should be made to protect the interests of other shareholders litigating in other fora.”

Further to this point, the Delaware Supreme Court appended a footnote observing that under New York law, there

is an exception to the ordinary rules of claim preclusion in shareholder derivative actions where the plaintiff seeks to intervene in the prior action to protect its interest but is denied leave to do so.³ This was an intriguing observation, since (as the court itself recognized) New York law did not apply to the case at hand, and moreover the main New York precedent involved *res judicata*, not collateral estoppel. Although the court did not say so explicitly, it seemed to be hinting that it might consider adopting such a rule in Delaware for similar situations, if plaintiffs had no other recourse.

The Delaware Supreme Court did not need to go that far, however, because it concluded that the Chancellor had not adequately grappled with the plaintiffs’ due process argument. Citing a different Court of Chancery decision, it held that as a matter of due process, the judgment in an earlier shareholder derivative action does not attach to the corporation or to its shareholders in a later action unless and until the first plaintiff survives a motion to dismiss or the board of directors has given the plaintiff authority to proceed by declining to oppose the suit.⁴ The Delaware Supreme Court directed the lower court to consider and address whether due process precludes the Delaware plaintiffs from being bound by the Arkansas court’s dismissal for failure to plead demand futility. It therefore remanded the case.

Potential Consequences

Both plaintiffs and defendants involved in multi-jurisdiction derivative actions will undoubtedly draw strategic lessons from *Alvarez*, however it ultimately comes out. The Delaware Supreme Court’s critique of the Delaware plaintiffs’ failure to seek intervention in the Arkansas action, notwithstanding that all their other steps had been rebuffed, suggests that the court is setting a high bar before a party will be allowed to escape the preclusive effect of a shareholder derivative judgment in

another jurisdiction. Plaintiffs in such situations would be prudent to move to intervene whenever there are multiple derivative actions filed and one appears to be moving faster than the rest. And yet the court’s reference to inapplicable New York state law that a nonparty shareholder in a derivative action is not bound by the outcome of a prior derivative action if she unsuccessfully sought to intervene seemingly points the other way, as do the court’s due process concerns. If federal due process rights prohibit preclusion of a subsequent derivative action where a prior one has been dismissed for lack of demand futility, defendants in such situations may be less incentivized to proceed with a motion to dismiss on demand futility. To know which incentives will prove superior, stay tuned for the next chapter in the case.

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1. See, e.g., *In re EZCORP Consulting Agreement Deriv. Litig.*, 130 A.3d 934 (Del. Ch. 2016); *South v. Baker*, 62 A.3d 1 (Del. Ch. 2012).

2. Following the New York Times article, a total of 15 shareholder derivative actions were filed in Arkansas and Delaware. Those actions were then consolidated into two: the Arkansas action and the Delaware action.

3. See *Parkoff v. Gen. Tel. & Elecs.*, 425 N.E.2d 820 (1981). In *Parkoff*, the New York Court of Appeals explained that a judgment rendered in one derivative action brought on behalf of a corporation by one shareholder “will generally be effective to preclude other actions predicated on the same wrong brought by other shareholders,” so long as “the judgment raised as a bar is not the product of collusion or other fraud on the nonparty shareholders and ... the shareholder sought to be bound by the outcome in the prior action not have been frustrated in an attempt to join or intervene in the action that went to judgment.” *Id.* at 824.

4. See *In re EZCORP*, 130 A.3d 934. That case in turn relied on the U.S. Supreme Court’s decision in *Smith v. Bayer*, 564 U.S. 299 (2011), which held that “[n]either a proposed class action nor a rejected class action may bind nonparties,” though a certified class could bind an unnamed member of the certified class. *Id.* at 315.