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Delaware Chancery Court Issues Decision on Collateral Estoppel in Shareholder Derivative Actions

June 14, 2012

The Delaware Chancery Court issued a potentially important decision on June 11, 2012 in *Louisiana Municipal Police Employees' Retirement System v. Pyott* concerning duplicative shareholder derivative actions and the "race to the courthouse" that often accompanies the filing of such cases. The court (through Vice Chancellor Laster) held that Delaware law governs whether a court should accord collateral-estoppel effect to the dismissal of a prior derivative action for failure to make a pre-suit demand on the board of directors – and that, under Delaware law, a prior dismissal for lack of demand futility does *not* collaterally estop a different shareholder's subsequent derivative suit. The court held in the alternative that collateral estoppel would not apply because the first, dismissed case had been filed by a "fast filer" who had rushed to the courthouse without conducting a pre-suit investigation and thus had not adequately represented the corporation's interests.

Factual Background

The *Pyott* case was one of several shareholder derivative actions against the directors of Allergan, Inc., which had entered into a settlement with the U.S. Department of Justice arising from an investigation into Allergan's alleged promotion of Botox for off-label uses. Allergan had pled guilty to criminal misdemeanor branding and had paid a total of $600 million in civil and criminal fines.

Two days after the settlement was announced, a shareholder derivative action was filed in Delaware Chancery Court. Within the next three weeks, additional derivative actions were filed in a California federal court. Yet another shareholder later served a demand on Allergan to inspect the company's books and records, and that shareholder eventually became a plaintiff in the consolidated complaint in the Delaware case.

For "reasons not entirely clear" to Vice Chancellor Laster, the California cases proceeded faster than the Delaware action, and the California court – "without the benefit of oral argument" – dismissed the California derivative actions with prejudice, holding that the plaintiffs had failed to establish that a pre-suit demand on Allergan's board would have been futile. The defendants then sought to dismiss the Delaware action, arguing that the California court's ruling on lack of demand futility collaterally estopped the Delaware plaintiffs from trying to show that a pre-suit demand would have been futile.

The Chancery Court's Decision

The Chancery Court disagreed with the California court's ruling on virtually every major point and held that the Delaware plaintiffs were not collaterally estopped from asserting demand futility in the Delaware derivative action.

First, the Chancery Court held that, under the internal-affairs doctrine, Delaware law – not California law (the law of the forum that had rendered the earlier judgment) – should govern whether collateral estoppel applies. Courts routinely recognize that a corporation's internal affairs – including the relationship between a corporation's directors and its stockholders – should be governed by the law of the corporation's state of incorporation (in this case, Delaware). Vice Chancellor Laster ruled that "whether a stockholder can sue derivatively after another stockholder attempted to plead demand futility is . . . a matter involving the managerial prerogatives within a corporation. It is therefore a matter controlled by the internal affairs doctrine and governed by the law of the state of incorporation."

Second, the court held that a shareholder whose derivative suit has been dismissed for lack of demand futility is not in *privity* with other shareholders or with the corporation itself; accordingly, other shareholders cannot be collaterally estopped in subsequent derivative actions. Vice Chancellor Laster reasoned that, under 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 [*i.e.*, futility] or wrongful refusal" (emphasis added). Without authority to assert the corporation's claim, the shareholder in the first case was asserting only his or her own claim, not the corporation's or any other shareholder's claim.

Third, and "[a]s an independent basis for declining to give collateral estoppel effect" to the California judgment, the court held that the California plaintiffs had not *adequately represented* Allergan – another precondition for collateral estoppel. "The decisions that give preclusive effect to a Rule 23.1 dismissal [for lack of demand futility] universally recognize that another stockholder still can sue if the first plaintiff provided inadequate representation." The court based its finding of inadequate representation on a presumption that "a fast-filing stockholder with a nominal stake, who sues derivatively after the public announcement of a corporate trauma in an effort to shift the still-developing losses to the corporation's fiduciaries, but without first conducting a meaningful investigation, has not provided adequate representation."

The court acknowledged the economic motives that incite some plaintiffs and their lawyers to "sue first, and investigate and think second." Winning the race to the courthouse can determine lead-plaintiff and lead-counsel status in some jurisdictions (although not in Delaware), so lawyers have a financial interest in speedy filing. But "b[y] leaping to litigate without conducting a meaningful investigation, the California plaintiffs' firms failed to fulfill the fiduciary duties they voluntarily assumed as derivative action plaintiffs. Rather than seeking to benefit Allergan, they sought to benefit themselves by rushing to gain control of a case that could be harvested for legal fees. In doing so, the fast-filing plaintiffs failed to provide adequate representation."

Pyott's Implications

Neither the defense bar nor the plaintiffs' bar is likely to be completely delighted with the *Pyott* decision. The ruling disagrees with the decisions of other courts that have held that a dismissal for lack of demand futility can collaterally estop different plaintiffs in subsequent derivative actions. If other judges now follow Vice Chancellor Laster's opinion, defendants might have more trouble disposing of duplicative derivative actions after winning a demand-futility motion in the first one.

In addition, the *Pyott* decision is yet another addition to a line of Delaware cases highlighting the importance of demands to inspect corporate books and records under § 220 of the Delaware General Corporation Law. Corporations might therefore see an increase in such demands.

But the decision is also a powerful warning to the plaintiffs' bar about the need to investigate and determine the likelihood that a claim exists before running to court and filing a derivative complaint. Plaintiffs and lawyers who "file first, and investigate and think second" might end up losing a lead-plaintiff skirmish; they might also see a later-filed case take precedence over their own lawsuit if a court views the later-filed case as having been more responsibly filed. Moreover, defendants might be reluctant to settle with a hasty filer if the circumstances create questions about whether that filer adequately represented the corporation on the derivative claims. For all of these reasons, plaintiffs would be well advised to exercise appropriate diligence before filing derivative actions.