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Delaware Supreme Court Issues Decision Upholding Collateral Estoppel in Shareholder Derivative Actions

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The Delaware Supreme Court issued a decision on April 4, 2013, in *Pyott v. Louisiana Municipal Police Employees' Retirement System* concerning duplicative shareholder derivative actions and the "race to the courthouse" that often ensues. The Supreme Court held that a court must accord collateral-estoppel effect to a judgment dismissing a prior derivative action based on the plaintiff's failure to make a pre-suit demand on the corporation's board of directors. The Court also rejected the Delaware Court of Chancery's presumption that a "fast filer" who filed the first case without conducting a pre-suit investigation had not adequately represented the corporation's interests.

Factual Background

The *Pyott* case was one of several shareholder derivative actions against the directors of a pharmaceutical company that had entered into a settlement with the U.S. Department of Justice and had paid civil and criminal fines. Shortly after the settlement was announced, shareholder derivative actions were filed in Delaware Chancery Court and a California federal court. The California court dismissed the California derivative action without prejudice and then dismissed the amended complaint with prejudice, holding in both instances that the plaintiffs had failed to establish that a pre-suit demand on the company'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 and held that the Delaware plaintiffs were not collaterally estopped from asserting demand futility. 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. Second, the court ruled 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. 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 the company – another precondition for collateral estoppel. 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 Supreme Court's Decision

The Supreme Court reversed, holding that the Chancery Court had erred in all respects. The Court held that, once a court of competent jurisdiction (here, the California court) has issued a final judgment, "a successive case is governed by principles of collateral estoppel, under the full faith and credit doctrine, and not by demand futility law, under the internal affairs doctrine." Applying collateral estoppel under California law (because California was the forum of the previously decided case), the Supreme Court concluded that (*i*) the demand-failure issue was the same in both cases, (*ii*) the issue had actually been litigated and necessarily decided in California, (*iii*) the California court had entered a judgment on the merits and with prejudice, and (*iv*) privity existed between the California and the Delaware plaintiffs because the real plaintiff in both derivative actions was the corporation itself.

The Supreme Court acknowledged that, if the California plaintiffs had not adequately represented the corporation's interests, "collateral estoppel [would] not bar a second, identical claim." However, the Court found no evidence in the record to show inadequate representation. The Chancery Court had relied on what the Supreme Court called a "'fast filer' irrebuttable presumption of inadequacy," and the Court recognized that "undoubtedly there will be cases where a fast filing stockholder also is an inadequate representative." But the Supreme Court found "no record support for the trial court's premise that stockholders who file quickly, without bringing a § 220 books and records action [under Delaware law], are *a priori* acting on behalf of their law firms instead of the corporation" and are not adequately representing the corporation's interests.

Accordingly, in the absence of *evidence* of inadequacy of representation in the first case, the Supreme Court concluded that the California court's dismissal of the derivative action for lack of demand futility collaterally estopped the plaintiffs in the subsequent derivative action.

Pyott's Implications

As with the Chancery Court's now-reversed decision, neither the defense bar nor the plaintiffs' bar is likely to be completely delighted with the Supreme Court's ruling. The Supreme Court's decision increases defendants' ability to obtain dismissal of subsequent derivative actions for lack of pre-suit demand if defendants prevail on that issue in the first case to go to judgment. The ruling thus strengthens collateral-estoppel defenses on lack of demand futility.

However, the plaintiffs' bar might read the Supreme Court's decision as removing a brake that the Chancery Court had sought to impose on the filing of derivative actions in the first place. The Chancery Court had tried to encourage prospective plaintiffs to investigate their claims by using § 220 of the Delaware General Corporation Law *before* filing suit, and it had questioned the *bona fides* of plaintiffs and lawyers who "file first, and investigate and think second." The Supreme Court's reversal arguably reduces some of the risks to plaintiffs and lawyers who sue without first investigating their claims, and it thus could end up encouraging litigants to take their chances by filing first.

Nevertheless, a well-established body of § 220 law from the Supreme Court and the Chancery Court still stands as good law in Delaware, and the Supreme Court cautioned in the *Pyott* case that "remedies for the problems [that fast filers] create should be directed at the lawyers" (rather than at "the stockholder plaintiffs or their complaints"). Thus, sufficient incentive remains for plaintiffs and their counsel to investigate claims before filing potentially baseless derivative actions. Moreover, a shareholder who genuinely seeks to protect the corporation's interests by filing a derivative action should be concerned about the prospect of collateral-estoppel effects on subsequent derivative actions if a first-filed, hastily crafted complaint is dismissed with prejudice.

Some question might also exist as to whether *Pyott* addresses a first-filed derivative action that has been dismissed *without* prejudice and with leave to amend. The California court here had dismissed the case *with prejudice*, after having granted leave to replead after the first dismissal. The Delaware Supreme Court thus considered the collateral-estoppel effect of only a truly final judgment on the merits.