Delaware Supreme Court Holds That Collateral Estoppel Requires Dismissal of Shareholder Suit

Last week, the Delaware Supreme Court held in *Pyott v. Louisiana Municipal Police Retirement System* that an order dismissing a shareholder derivative suit in federal court in California had a preclusive effect on an essentially identical suit pending before the Delaware Chancery Court. The Supreme Court reversed a controversial decision of the Chancery Court that had allowed the second suit in Delaware to proceed even after the first in California had been dismissed. While *Pyott* may have limited application on the issues of derivative plaintiff privity and adequacy of representation under Delaware law, it will make it more difficult for plaintiffs to have multiple bites of the apple by filing duplicative derivative suits in multiple jurisdictions, since a negative ruling in one jurisdiction will likely be given preclusive effect in Delaware.

Background: Derivative Suits in California and Delaware

In September 2010, Allergan, Inc. settled allegations of improper off-label marketing of BOTOX with the United States Department of Justice, agreeing to plead guilty to the criminal misdemeanor of misbranding and to pay a total of $600 million in civil and criminal fines. In response, several Allergan stockholders filed derivative suits in Chancery Court in Delaware and in federal court in California, alleging that Allergan's directors had failed to properly monitor its marketing practices.

Allergan and its directors moved to dismiss both cases for failure to plead demand futility as required by Rule 23.1. The California federal court ruled on its motion first and dismissed the action with prejudice, holding that as a matter of Delaware law demand was not futile. The Delaware Chancery Court then rejected the argument that the preclusive effect of the California federal court's order required the dismissal of the action, holding that the elements required for collateral estoppel were not present. In doing so, the Chancery Court invoked the internal affairs doctrine to apply Delaware law to the issues of privity and adequacy of representation in its collateral estoppel analysis.

The Delaware Supreme Court Reversal

The Delaware Supreme Court reversed, holding that the Chancery Court should have applied California law or federal common law, and not Delaware law, to analyze the collateral estoppel effect of the California federal court's decision. The court concluded that each of the five factors of collateral estoppel under California law were met. In particular, the court held that the plaintiffs in the two actions were in privity because under California law, the real plaintiff in a shareholder derivative suit is the corporation. The court specified that "differing groups of shareholders who can potentially stand in the corporation's stead are in privity for the purposes of issue preclusion."

The Question of Privity

Interestingly, the court left open the question of whether privity between derivative stockholders exists under Delaware law. The court acknowledged that Delaware law is unclear on this issue and that some Delaware courts have held that until a stockholder survives a motion to dismiss based on failure to make demand, the stockholder is not acting for the corporation and thus does not have privity with other shareholders. However, the court also noted that numerous other jurisdictions have held that there is privity between derivative stockholders, perhaps hinting at the direction it would rule.

Section 220 Issues

The court also considered the issue of whether the plaintiffs in the California Federal Court action were adequate representatives for purposes of collateral estoppel. The Chancery Court held they were not, because they filed their complaint without bringing a Section 220 books and records action, adopting a "fast filer" irrebuttable presumption of inadequacy of representation. The court recognized the concern that fast filers may be acting on behalf of their law firms instead of the corporation, but rejected an irrebuttable presumption of inadequacy of representation in these circumstances without additional supporting evidence. The court provided little guidance on the issue, however, merely finding that the concern over fast filing should be directed at the lawyers, and not at the stockholder plaintiffs.

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