American Bar Association • Section of Business Law: Practical Resources for the Business Lawyer

BUSINESS LAW TODAY

Delaware Insider

The Debate on How to Remedy the Problem of Fast-Filing Plaintiffs in Derivative Actions Continues

By Jason C. Jowers

Over the past several years, both the Delaware Supreme Court and the Court of Chancery have recognized the problem of plaintiffs that rush to file derivative actions without first investigating their claims, usually in multiple forums, following the announcement of some corporate trauma. Typically, there is a race to the courthouse by plaintiffs' firms in an effort to obtain lead plaintiff status. Although both courts acknowledge the problem, a satisfactory solution has thus far proven elusive. On April 4, 2013, in *Pyott v. Louisiana Mun. Police Employees' Retirement System*, __ A.3d __, 2013 WL 1364695 (Del. 2013) ("*Allergan*"), the Delaware Supreme Court reversed a controversial decision last year by the Delaware Court of Chancery that attempted to address the problem of the fast-filing plaintiff. The lower court had denied dismissal on collateral estoppel grounds of a shareholder derivative action alleging *Caremark* claims despite the fact that substantially similar claims brought by other shareholders in an action in California had been dismissed with prejudice. Supporting its decision, the Court of Chancery determined that Delaware's demand futility law, which the court believed should be incorporated into the privity prong of California's collateral estoppel test, could not be met because a shareholder does not become the representative of the corporation until a motion to dismiss for failure to make a demand on the board is denied. Additionally, the Court of Chancery found that the shareholder plaintiffs in the California action were not adequate representatives of the corporation because they failed to investigate their claims before bringing the action. In so finding, the trial court established a presumption that fast-filing plaintiffs who do not seek to inspect a corporation's books and records before bringing *Caremark* derivative claims do not adequately represent the interests of the corporation, but rather represent the interests of the plaintiffs' firms who routinely bring such claims immediately after the announcement of a corporate trauma.

As soon as it was announced, the decision became controversial. Some members of the defense bar feared that the decision would result an infinite number of derivative actions in multiple jurisdictions if a dismissal with prejudice against one shareholder failed to preclude litigation instituted by another on the same issues. Conversely, from the plaintiffs' bar perspective, the decision would have required plaintiffs to slow down and spend resources bringing a books and records actions to investigate their potential claims rather than racing to the courthouse to file *Caremark* claims in an attempt to win lead plaintiff status.

Shortly after issuing its ruling, the Court of Chancery certified its decision for interlocutory appeal, and the Delaware Supreme Court accepted the appeal. Reversing, the Delaware Supreme Court found that the Court of Chancery improperly conflated California's collateral estoppel law with Delaware's demand futility law. Additionally, the Court expressly rejected an "irrebuttable presumption" that shareholder plaintiffs do not adequately represent a corporation when they quickly file a *Caremark* claim without first seeking to inspect books and records. However, the Supreme Court's decision seems to have left open two key questions for practitioners handling derivative actions brought under Delaware law. First, although finding that the Court of Chancery failed to follow California precedent in administering California's collateral estoppel test, the Supreme Court failed to answer the question of whether, for Delaware law purposes, a shareholder becomes a representative of the corporation before there is a finding of demand excusal or demand futility. Second, although rejecting an "irrebuttable presumption" that fast-filing plaintiffs are not adequate representatives of the corporation, the Court seemingly left open the possibility of a *rebuttable* presumption that fast-filing plaintiffs are inadequate representatives.

The Court of Chancery's Decision

In *Louisiana Municipal Police Employees' Retirement System v. Pyott*, 46 A.3d 313 (Del. Ch. 2012), a Delaware corporation specializing in pharmaceuticals, entered into a settlement agreement with the U.S. government following a three-year investi-

Published in *Business Law Today*, May 2013. © 2013 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

gation into its off-label marketing 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. Following the public announcement of the settlement, various shareholder plaintiffs filed derivative actions in both California and Delaware. One of the shareholder plaintiffs in one of the Delaware actions sought to inspect books and records pursuant to Section 220. The rest did not.

Following the dismissal of the California action, the director defendants in the Delaware action moved to dismiss, in part, on collateral estoppel grounds. The defendants argued, and the court agreed, that the Delaware court was required pursuant to the Full Faith and Credit Clause of the U.S. Constitution to give the same force and effect to a foreign judgment as the foreign court rendering the judgment. 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.

The California collateral estoppel or issue preclusion standard has five prongs. First, the issue sought to be precluded must be identical to that decided in a former proceeding. Second, the issue must have been actually litigated in the former proceeding. Third, it must have been necessarily decided in the former proceeding. Fourth, the decision in the former proceeding must be final and on the merits. Finally, the party against whom preclusion is sought must be the same as, or in privity with, the party to the former proceeding.

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. 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 the final prong of the 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 internal affairs doctrine generally recognizes that only one state, the state of incorporation, should have the authority to regulate a corporation's internal affairs, such as relationships among or between the corporation and its current officers, directors, and shareholders. Disagreeing with both a prior Court of Chancery case and authority from outside of Delaware, the court found that a shareholder who fails to overcome demand excusal on a motion to dismiss is not in privity with the corporation or the other shareholders. The court explained that a derivative action 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. Thus, because the shareholders in the California action did not survive the motion to dismiss, the court found they never were in privity with the corporation and its other shareholders.

Additionally, rejecting the defendants' request in part because the California plaintiffs did not properly investigate the claims, the court found that "a court in a plenary derivative action such as this one has discretion to address a rush to the courthouse by determining that the plaintiff in the original derivative action did not provide adequate representation for the corporation and declining on that basis to give preclusive effect to a Rule 23.1 dismissal of the fast-filer's complaint." The court went on to explain that "to give preclusive effect to the California Judgment would favor the lawyers who filed hastily, penalize the diligent counsel who used Section 220, and confer a case-dispositive advantage on the defendants at the potential expense of the corporation." Accordingly, the court denied the motion to dismiss based on the presumption that the fast-filing California plaintiffs had not adequately represented the company because they failed to seek books and records before filing. However, the *Allergan* court did not explain what test governed the fast-filer presumption or whether it could be rebutted.

The Court of Chancery certified the defendants' request for an interlocutory appeal, and the Delaware Supreme Court accepted the appeal.

The Delaware Supreme Court Reverses

The Delaware Supreme Court sitting *en banc* unanimously reversed the Court of Chancery. The Court found that the Court of Chancery failed to correctly apply California's collateral estoppel law when it used Delaware law to decide the privity and adequacy of representation prongs of California's collateral estoppel test. In the trial court, the defendants had argued that *LeBoyer v. Greenspan*, 2007 WL 4287646 (C.D. Cal. 2007) controlled. In *Leboyer*, on facts similar to *Allergan*, the defendants moved to dismiss based on collateral estoppel following dismissal of a different shareholder's suit. The *Leboyer* court ultimately found that "differing groups of shareholders who can potentially stand in the corporation's stead are in privity for the purposes of issue preclusion."

The Delaware Supreme Court found that the Court of Chancery erred by not following California law, set forth in *LeBoyer*, when deciding the collateral estoppel issue. According to the Delaware Supreme Court, "the motion to dismiss, based on collateral estoppel, was about federalism, comity, and finality. It should have been addressed exclusively on that basis. Under this Court's precedents, the undisputed in-

Published in *Business Law Today*, May 2013. © 2013 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

terest that Delaware has in governing the internal affairs of its corporations must yield to the stronger national interests that all state and federal courts have in respecting each other's judgments." Emphasizing that *LeBoyer* required dismissal, the Court went on to state: "The Court of Chancery should have applied California law or federal common law to analyze all elements of collateral estoppel. If the Court of Chancery had done so, rather than invoking the internal affairs doctrine to apply Delaware law to the issues of privity and adequacy of representation, the decision in *LeBoyer v. Greenspan* would have compelled it to dismiss the case."

The high court also rejected the Court of Chancery's attempt to apply what the Supreme Court construed to be an irrebuttable presumption that plaintiffs who do not investigate are inadequate representatives of the corporation. Rejecting at least an irrebuttable presumption against fast-filing plaintiffs, the Supreme Court stated:

> Undoubtedly there will be cases where a fast filing stockholder also is an inadequate representative. But, there is no record support for the trial court's premise that stockholders who file quickly, without bringing a § 220 books and records action, are *a priori* acting on behalf of their law firms instead of the corporation. This Court understands the trial court's concerns about fast filers. But remedies for the problems they create should be directed at the lawyers, not the stockholder plaintiffs or their complaints.

Unanswered Questions

The Delaware Supreme Court's decision in *Allergan* leaves two key questions unanswered with respect to fast-filing plaintiffs. First, although finding that the Court of Chancery failed to follow California precedent in administering *California*'s collateral estoppel test, the Supreme Court failed to answer the question of whether, for *Delaware* law purposes, a shareholder becomes a representative of the corporation before there is a finding of demand excusal or demand futility. The Delaware Supreme Court opted not to address this question "because, as discussed, the Court of Chancery should not have applied Delaware law in deciding whether the California Federal Court Judgment must be given preclusive effect." However, the Delaware Supreme Court expressed some skepticism of the argument that shareholders were not in privity with one another until demand was excused, noting that "that numerous other jurisdictions have held that there is privity between derivative stockholders."

Second, although rejecting an "irrebuttable presumption" that fast-filing plaintiffs are not adequate representatives of the corporation, the Court seemingly left open the possibility of a *rebuttable* presumption that fast-filing plaintiffs are inadequate representatives. In the Court of Chancery's decision in *Allergan*, the court was silent as to whether the decision was rebuttable or irrebuttable. The defendants urged in their briefs before the Supreme Court that the Court of Chancery applied an irrebuttable presumption. Similarly, when addressing this issue in its opinion, the Supreme Court found that the Court of Chancery "announced and applied an *irrebuttable* presumption." (Emphasis added). In the portion of its decision reversing, the Supreme Court makes clear that "[w]e reject the 'fast filer' *irrebuttable* presumption of inadequacy." (Emphasis added).

The modification of "presumption" with the word "irrebuttable" is potentially significant. While *Allergan* was being briefed in the Delaware Supreme Court, the same vice chancellor who decided *Allergan* in the Court of Chancery again applied the presumption against fast-filers, but in this second case made clear that the presumption was a *rebuttable* one. In *South v. Baker*, 62 A.3d 1 (Del. Ch. 2012), following the public announcement of lower silver production projections by Hecla Mining Company and the announcement of numerous safety violations by the U.S. Mine Safety and Health Administration after several accidents in Hecla's mines, plaintiffs filed two actions alleging securities law violations in Idaho. The securities cases alleged that Hecla's disclosures relating to its safety procedures had been materially misleading. In Delaware, shareholders of Hecla brought a derivative action alleging *Caremark* claims against the directors of the company for the damages the company has and will suffer as a result of the securities lawsuits.

The plaintiffs in the Delaware action failed to inspect Hecla's books and records before bringing their action, and the directors moved to dismiss. As is often the case with *Caremark* claims that are not investigated before filing, the court found the plaintiffs were unable to allege particularized facts supporting demand futility by showing that a majority of the board faced a substantial risk of liability. Explaining that fast-filers of Caremark claims display disloyalty to the corporation by not first investigating a Caremark claim, the court stated: "A plaintiff who hurries to file a *Caremark* claim after the announcement of a corporate trauma behaves contrary to the interests of the corporation but consistent with the desires of the filing law firm to gain control of (or a role in) the litigation. The natural and logical inference from this recurring scenario is that the plaintiff is serving the interests of the law firm, rather than those of the corporation on whose behalf the plaintiff ostensibly seeks to litigate."

Because the plaintiffs in *South* filed shortly after the public announcements and the filing of the securities actions and failed to conduct a books and records inspection pursuant to Section 220, their actions triggered the fast-filer presumption. However, unlike *Allergan*, the court also concluded that the presumption that the fast-filing plaintiff acted disloyally and was not an adequate representative of the corporation could be rebutted. Delaware Rule of Evidence 301 provides that "a presumption imposes on the party against whom it is directed the burden of proving that the nonexistence of the presumed fact is more probable than its existence." Pursuant to DRE 301, the court found that the party opposing the presumption could rebut it in two ways. First, the party could prove that despite the fast-filer's failure to inspect books and records under Section 220, the

Published in *Business Law Today*, May 2013. © 2013 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

shareholder had "conducted a meaningful and thorough investigation." Second, the person attempting to rebut the presumption could prove that the act of filing quickly benefitted the company, and not just the law firm.

The plaintiffs in *South* were unable to rebut the fast-filer presumption. Plaintiffs' counsel admitted to spending only "several hours" investigating the claims. Furthermore, the plaintiffs were unable to offer any reason why they could not have utilized Section 220 to investigate and then bring their *Caremark* claims if the inspection of books and records generated sufficient evidence. Finally, plaintiffs' counsel admitted that he filed the action quickly due to the fear that other plaintiffs might move faster and gain control of the action against the directors.

It remains to be seen whether the rebuttable presumption announced by the Court of Chancery in *South v. Baker*, as opposed to the irrebuttable presumption rejected by the Supreme Court in *Allergan*, will survive. What appears more certain is that the Court of Chancery will continue to attempt to solve the riddle of limiting the problem of the fast-filing plaintiff in *Caremark* derivative actions.

Jason C. Jowers is a partner at Morris James LLP in Wilmington, Delaware, where he practices in the areas of corporate, alternative entity, and complex commercial litigation.

Published in *Business Law Today*, May 2013. © 2013 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.