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DELAWARE COURT OF CHANCERY RULES THAT SHAREHOLDER DERIVATIVE LAWSUITS ARE NOT COLLATERALLY ESTOPPED BY PREVIOUSLY DISMISSED SUITS INVOLVING SIMILAR CLAIMS

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In a significant opinion with wide-ranging implications for both the plaintiffs and defense bar, Vice Chancellor J. Travis Laster of the Delaware Chancery Court ruled that dismissal of a shareholder derivative suit for failure to make a demand on the board of directors, as required by Del. Ch. Ct. R. 23.1,[1] does not preclude different shareholders from subsequently asserting similar claims. *See La. Mun. Police Emps.' Ret. Sys. v. Pyott*, C.A. No. 5795-VCL, 2012 WL 2087205, at *8-18 (Del. Ch. June 11, 2012). In so ruling, Vice Chancellor Laster harshly criticized the current "first-to-file mentality" of the shareholder plaintiffs bar. *See id.* at *18-29. At the same time, the decision upends established preclusion doctrine for shareholder derivative claims and provides the plaintiffs bar the ability to investigate and file, in a new forum, derivative claims even when another court has already rejected those claims as insufficient.

Background

Allergan, Inc. ("Allergan") manufactures the muscle relaxant Botox. In a settlement with the United States Department of Justice on September 1, 2010, Allergan pleaded guilty to claims of misbranding and off-label marketing of Botox from 2000-2005. Allergan agreed to pay $600 million in criminal and civil fines, exceeding its net income in each of the previous two years and constituting 96% of its net income in 2010.

Within days of the settlement, Louisiana Municipal Police Employees' Retirement System ("LAMPERS") commenced an action in Delaware, relying solely on public information and Allergan's press release announcing the settlement, and later amended

1 Rule 23.1 requires a shareholder, pre-suit, to prove that a demand was made on the board that was unreasonably denied or that demand is futile ("demand futility").

the complaint with additional public information. Within three weeks, three similar derivative suits were filed in the United States District Court for the Central District of California and were eventually consolidated (the "California Litigation"). Allergan moved to dismiss all complaints.

In November of 2010, the U.F.C.W. Local 1776 & Participating Employment Pension Fund ("UFCW") made a books and records demand on Allergan under 8 Del. C. § 220 and moved to intervene in *LAMPERS v. Pyott*. Vice Chancellor Laster denied intervention without prejudice but stayed any decision on the motion to dismiss until completion of UFCW's review of Allergen's books and records. Subsequently, LAMPERS and UFCW reached an agreement permitting both to serve as co-plaintiffs and filed an amended complaint, on July 8, 2011, based on information discovered through the books and records demand.

On April 21, 2011, the court dismissed the California Litigation for failure to make a demand, and plaintiffs there subsequently filed an amended complaint based on information from UFCW's books and records demand. On January 17, 2012, the court dismissed the California Litigation amended complaint. Allergan then supplemented their *LAMPERS* motion to dismiss, claiming that collateral estoppel barred the suit.

Chancery Court Ruling

In denying the motion to dismiss, Vice Chancellor Laster ruled that collateral estoppel did not apply. He based his ruling on two grounds: (1) dismissal of a derivative suit for failure to make a demand does not preclude subsequent derivative suits based on similar allegations and (2) even if it did, the plaintiffs in the California Litigation did not provide adequate representation of Allergan, or its shareholders, because they failed to conduct a meaningful investigation before "hastily" filing their claims. *See id.* at *37.

The decision first analyzes the collateral estoppel doctrine in derivative suits. That doctrine requires that the party facing estoppel must be the same as, or in privity with (here, parties representing the same entity in a representative action), a party in the previously litigated case. There is a large body of state and federal law holding that dismissal of one shareholder derivative suit for failure to establish demand futility precludes other shareholders from bringing similar suits. This case law relies on the idea that all shareholders of a corporation who sue derivatively do so as a representative of the corporation, which puts those shareholder plaintiffs in privity with each other. Hence, when one shareholder's case is dismissed under Rule 23.1, the issue of demand futility is settled for all shareholders.

In reaching a contrary conclusion, Vice Chancellor Laster reasoned that shareholder plaintiffs do not have standing to bring a derivative suit until they fulfill Rule 23.1's requirements by establishing that demand was futile or unreasonably denied. *See id.* at *11-12. And prior to meeting Rule 23.1's requirements, a shareholder is suing in its own name for the right to represent the corporation. *See id.* at *12-13. Thus, at the initial stage where the court is evaluating whether demand would have been futile, a shareholder is not in privity with other shareholders and collateral estoppel is inapplicable until the motion to dismiss under Rule 23.1 is *denied*. *See id.* at *12-16. Because the California Litigation motion to dismiss was *granted*, those plaintiffs were not, according to Vice Chancellor Laster, in privity with LAMPERS and UFCW, rendering collateral estoppel inapplicable. *See id.* at *8, 17, 37.

Vice Chancellor Laster then found that, even if collateral estoppel applied, the California Litigation did not preclude the *LAMPERS* claims because the California plaintiffs were inadequate representatives. *See id.* at *17, 28-29, 37.

The decision is particularly notable for its scathing critique of the current derivative lawsuit landscape, where plaintiffs' law firms race to be the first to file, "eschew[ing] . . . investigations" of their claims prior to filing suit. *Id.* at *18-25. Vice Chancellor Laster characterized first-to-file complaints as "lottery tickets" for plaintiffs'

firms who are "[i]ncentivized by contingent fees" and whose "interests can diverge from the class or entity they represent." *Id.* at *18, 25. While such complaints are usually dismissed as insufficient, a plaintiffs' firm needs only one lawsuit that "fate may bless" in order to generate very substantial fees. *Id.* at *25. Vice Chancellor Laster noted that "fast-filing imposes real costs on corporations and their stockholders" by creating an incentive to rush to file poorly conceived of claims in the hope of hitting the jackpot. *Id.* at *19. This decision adds to a string of Delaware judicial opinions strongly urging plaintiffs to first use 8 Del. C. § 220 to request the books and records of the corporation, conduct a thorough investigation, and assess whether litigation is necessary and appropriate. S*ee e.g., Wood v. Baum*, 953 A.2d 136, 144 (Del. 2008); *Beam v. Stewart*, 845 A.2d 1040, 1056-57 (Del. 2004); *White v. Panic*, 783 A.2d 543, 556-57 (Del. 2001); *Brehm v. Eisner*, 746 A.2d 244, 266-67 (Del. 2000); *Grimes v. Donald*, 623 A.2d 1207, 1216 (Del. 1996); *In re Dow Chem. Co. Derivative Litig.*, No. 4349-CC, 2010 WL 66769, at *13 (Del. Ch. Jan. 11, 2010); *Desimone v. Barrows*, 924 A.2d 908, 951 (Del. Ch. 2007); *Rattner v. Bidzos*, No. Civ.A. 19700, 2003 WL 22284323, at *14 (Del. Ch. Sept. 30, 2003); *Guttman v. Huang*, 823 A.2d 492, 493 (Del. Ch. 2003).

Conclusion

While this decision represents a strong and public rebuke of the current approach of the plaintiffs bar, it could very well have the perverse effect of increasing the number of derivative suits brought against corporations and their boards. Without the full protection of the collateral estoppel doctrine, the plaintiffs bar will be incentivized to file quickly outside of Delaware (notwithstanding Vice Chancellor Laster's criticisms) and then, in the event that lawsuit is dismissed, pursue (through a different plaintiff represented by a different law firm) a books and records investigation and subsequent litigation in Delaware to try to rehabilitate the initial claim.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any member of our Litigation and Arbitration Group listed below.

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