



## The Preclusive Effect of Demand Futility

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In the recent opinion *California State Teachers’ Retirement System v. Alvarez (Walmart)*, the Delaware Supreme Court addressed the preclusive effect of demand futility decisions rendered by one court on derivative litigation pending in another forum. After careful consideration of applicable Arkansas and federal law, the court determined that the Arkansas district court’s ruling—which failed to find that demand had been excused—would preclude plaintiffs in the Delaware Court of Chancery from relitigating demand futility, and dismissed the suit.

### Issue Preclusion in Derivative Actions

Issue preclusion prohibits a party that litigated an issue in one forum from later relitigating the same issue in another forum. While the law governing issue preclusion differs somewhat by jurisdiction, the factors are similar, and a key inquiry is usually whether the prior action was between the same parties or others in “privity” with those parties.

In a derivative action, the question of whether stockholder plaintiffs are the same or in privity with one another is complicated. That is because a stockholder plaintiff in a derivative action does not sue on his or her own behalf but rather on behalf of the corporation. A finding of privity between derivative plaintiffs therefore can present serious problems for stockholders who engage different counsel, file in different courts, employ different litigation strategies and reach judicial resolutions at different times.

### Court of Chancery Finds Arkansas Ruling Preclusive, Urges Adoption of New Rule

Derivative plaintiffs in the *Walmart* action faced that very problem. In 2012, following a *New York Times* article regarding an alleged bribery scheme at Walmart’s Mexican unit, multiple Walmart stockholders filed derivative lawsuits in both the U.S. District Court for the Western District of Arkansas and the Delaware Court of Chancery. Prior to filing their derivative complaint, the plaintiffs in Delaware—unlike those in Arkansas—made a demand for books and records pursuant to Section 220 of the Delaware General Corporation Law. That books-and-records litigation took more than three years to resolve, during which time the Arkansas federal court dismissed the Arkansas derivative litigation for failure to adequately allege demand futility. The

Delaware plaintiffs were aware of the pending Arkansas decision and the risk for issue preclusion as a result—indeed, they requested expedition in Delaware on that very basis.

In its initial ruling, the Court of Chancery held that the Delaware plaintiffs were precluded from relitigating demand futility because the plaintiffs in the federal action had adequately represented other Walmart stockholders who were not parties in that action. The plaintiffs appealed, arguing, among other things, that the Court of Chancery had violated their due process rights. In January 2017, the Delaware Supreme Court issued an order directing the Court of Chancery to consider its opinion in light of due process concerns, which the Court of Chancery had not explicitly addressed.

On remand, the Court of Chancery noted that it was bound by controlling law, which would likely find that the Arkansas dismissal precluded the Delaware plaintiffs, but recommended that the Supreme Court adopt a new rule, as endorsed in a prior Court of Chancery decision in *In re EZCORP Inc. Consulting Agreement Derivative Litigation*. That decision stated in *dicta* that a derivative plaintiff may not bind a later derivative plaintiff unless and until the first derivative plaintiff survives a motion to dismiss, or the board of directors has declined to oppose the suit. In particular, the Court of Chancery expressed concern about penalizing the more diligent Delaware plaintiffs, noting that “Delaware courts have long encouraged stockholders contemplating derivative actions to use the ‘tools at hand’” by seeking books and records under Section 220.

## The Delaware Supreme Court Declines to Make New Law

After the Court of Chancery’s remand opinion, the Delaware Supreme Court once again took up the issue. In determining whether the Arkansas court’s decision on demand futility was preclusive in the Delaware action, the Supreme Court was confronted with the “troubling” nature of the case. On one hand, the Supreme Court has repeatedly admonished stockholder plaintiffs to use the “tools at hand” to obtain books and records before filing a derivative complaint—which the Delaware plaintiffs did, but the Arkansas plaintiffs did not. On the other hand, the court recognized the importance of full faith and credit, which implicates principles of comity and respect for judgment.

Ultimately, the Supreme Court affirmed the Court of Chancery’s original opinion and “decline[d] to embrace [the Court of Chancery’s] suggestion that the *EZCORP* approach become the law governing the preclusive effect of prior determinations of demand futility.” Specifically, the Supreme Court applied a two-part test to determine if issue preclusion applied—that is, it considered whether all elements of issue preclusion were present and due process was satisfied. The court recognized four elements required of collateral estoppel: (1) the issue must be the same as that in the prior litigation; (2) the issue must actually have been litigated; (3) the issue must have been determined by a valid and final judgment; and (4) the determination must have been essential to the judgment. The court also assumed two additional elements: (1) privity between the parties; and (2) adequacy of prior representation.

The Delaware Supreme Court looked to prior Arkansas Supreme Court authority, concluding that privity “exists when two parties are so identified with one another that they represent the same legal right,” which is a “flexible and practical inquiry.” Analyzing the nature of a derivative suit, the court found that the corporation is always the real party in interest. When multiple derivative actions are filed, the plaintiffs share an identity of interest in seeking to prosecute claims by and in

the right of the real party in interest—the corporation. The court concluded that “[t]hough not a formal ‘representative’ of other stockholders at this stage because the real party in interest is the corporation, differing groups of stockholders who seek to control the corporation’s cause of action share the same interest and therefore are in privity.”

The Supreme Court then addressed the adequacy of representation requirement as part of the federal due process overlay. It remarked that “the record makes clear that both sets of plaintiffs understood that a judgment in their case could impact the other stockholders. ... The Delaware Plaintiffs acknowledged the likelihood [of preclusive effect of an Arkansas judgment] and expressed concern to both the Delaware Court of Chancery and the Delaware Supreme Court about the ‘severe risk’ that an Arkansas judgment on demand futility would precede a Delaware ruling, and the Arkansas judgment would have preclusive effect.” Moreover, the court pointed out that the Arkansas court “took care to protect the interests of the nonparty Delaware plaintiffs by granting a stay while they pursued their Section 220 litigation in Delaware” (though the Arkansas district court initially granted the stay, while the Section 220 action was pending the U.S. Court of Appeals for the Eighth Circuit vacated the ruling out of concern for the stalled Section 14(a) claim) and that, while federal courts have “signaled” that derivative suits are not ones in which notice is required to bind absent parties, “[w]e need not resolve that issue as it is undisputed that the Delaware Plaintiffs had notice of the Arkansas action in this instance.”

The Supreme Court concluded that the Arkansas plaintiffs’ failure to pursue and obtain books and records did not render them “grossly deficient.” Notably, this was not a case where the Arkansas plaintiffs lacked access to any internal corporate documents before filing their complaint. They had access to internal company documents, published by

*The New York Times*, suggesting that the board knew about the alleged misconduct, and thus determined that additional Section 220 documents were not required. The court found that “[t]he Arkansas Plaintiffs’ decision to forego a Section 220 demand *in this instance* does not rise to the level of constitutional inadequacy” (emphasis in original).

## Takeaways

The Delaware Supreme Court’s decision in *Walmart* has a number of important implications.

### **Ability to Participate in Prior Action**

The Delaware Supreme Court expressly recognized that the Delaware plaintiffs not only had knowledge of the Arkansas litigation but also recognized the potential for collateral estoppel. One of the bases for the court’s decision that due process was satisfied was its determination that the Delaware plaintiffs knew of the Arkansas litigation and its potential preclusive effect, and that the Arkansas court at least initially stayed its hand so that the Delaware plaintiffs could prosecute their Section 220 action, thus taking care to protect the interests of nonparty Delaware plaintiffs. While the Supreme Court found there was no obligation for Delaware plaintiffs to intervene in the Arkansas action, it suggested on multiple occasions that the Delaware plaintiffs should have intervened or taken other action in Arkansas to protect their rights. The court “note[d] that the Delaware Plaintiffs’ awareness of the potential for collateral estoppel, combined with their failure to coordinate with the Arkansas Plaintiffs and failure to express their concerns to the Arkansas court, suggests that all the equities may not favor the Delaware plaintiffs here.” It is unclear how

much persuasive effect this equitable argument had on the court, and whether the due process analysis would be the same if the plaintiffs were unaware of the parallel or prior litigation.

### **Preclusion Law in Other Jurisdictions**

Because the Arkansas complaint asserted diversity, federal question and supplemental jurisdiction, the Delaware Supreme Court considered both state and federal authority on issue preclusion. The Arkansas Supreme Court has expressly recognized that the corporation is the real party in interest in a derivative case, and Arkansas federal courts have repeatedly held or presumed that collateral estoppel prevents the issue of presuit demand futility from being relitigated. While it appears that the great weight of state and federal court authority, as well as the Restatement, holds the same view, the possibility remains that certain states' collateral estoppel law differ. A future plaintiff attempting to distinguish *Walmart* could assert that state law precludes a finding of collateral estoppel between derivative plaintiffs. Notably, in Delaware, Court of Chancery Rule 15(aaa) permits the Court of Chancery to dismiss derivative suits as to the named plaintiff only.

### **Failure to Obtain Books and Records Under Section 220**

As part of its exposé, *The New York Times* published a number of internal Walmart documents, which the Arkansas plaintiffs incorporated into their complaint. Had such documents not been publicly available, it is not clear whether the Supreme Court's analysis would have been the same. The court emphasized that in this instance the Arkansas plaintiffs' tactical decision to proceed without using Section 220 did not render them constitutionally inadequate representatives. That leaves open the suggestion that failure to pursue books and records pursuant to Section 220 could, in different situations—such as when there are not publicly available facts or documents relating to board-level knowledge—render a plaintiff inadequate for collateral estoppel purposes.