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Case Number 295,2016D

IN THE SUPREME COURT OF THE STATE OF DELAWARE

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM, NEW YORK CITY EMPLOYEES' RETIREMENT SYSTEM, NEW YORK CITY POLICE PENSION FUND, POLICE OFFICERS' VARIABLE SUPPLEMENTS FUND, POLICE SUPERVISOR OFFICERS' VARIABLE SUPPLEMENTS FUND, NEW YORK CITY FIRE DEPARTMENT PENSION FUND, FIRE FIGHTERS' VARIABLE SUPPLEMENTS FUND, FIRE OFFICERS' VARIABLE SUPPLEMENTS FUND, BOARD OF EDUCATION RETIREMENT SYSTEM OF THE CITY OF NEW YORK, TEACHERS' RETIREMENT SYSTEM OF THE CITY OF NEW YORK, NEW YORK CITY TEACHERS' VARIABLE ANNUITY PROGRAM, AND INDIANA ELECTRICAL WORKERS PENSION TRUST FUND IBEW,	)	No. 295, 2016 Appeal from the Memorandum Opinion, dated May 13, 2016, of the Court of Chancery of the State of Delaware, C.A. No. 7455-CB
Plaintiffs Below Appellants,	)	
v.	)	
AIDA M. ALVAREZ, JAMES I. CASH, JR., ROGER C. CORBETT, DOUGLAS N. DAFT, MICHAEL T. DUKE, GREGORY B. PENNER, STEVEN S. REINEMUND, JIM C. WALTON, S. ROBSON WALTON, LINDA S. WOLF, H. LEE SCOTT, JR., CHRISTOPHER J. WILLIAMS, JAMES W. BREYER, M. MICHELE BURNS,	)	

DAVID D. GLASS, ROLAND A. HERNANDEZ, JOHN D. OPIE, J. PAUL REASON, ARNE M. SORENSON, JOSE H. VILLARREAL, JOSE LUIS RODRIGUEZMACEDO RIVERA, EDUARDO CASTRO-WRIGHT, THOMAS A. HYDE, THOMAS A. MARS, JOHN B. MENZER, EDUARDO F. SOLORZANO MORALES, AND LEE STUCKY,	)
Defendants Below, Appellees	)
WAL-MART STORES, INC.,	)
Nominal Defendant Below, Appellee	)

BRIEF OF THE BUSINESS ROUNDTABLE AS *AMICUS CURIAE* IN SUPPORT OF DEFENDANTS-APPELLEES AND DISMISSAL

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INTEREST OF *AMICUS CURIAE*

Amicus the Business Roundtable (BRT) is an association of chief executive officers who lead companies with more than $6 trillion in annual revenues. The combined market capitalization of BRT's member companies is the equivalent of nearly one-quarter of total U.S. stock market capitalization. BRT was founded on the belief that businesses should play an active and effective role in the formulation of public policy, and participate in litigation as *amici curiae* where important business and corporate governance interests are at stake. As explained in BRT's motion for leave to file an amicus brief, this appeal raises such issues.

ARGUMENT

THIS COURT SHOULD NOT DEPART FROM EXISTING DOCTRINE. DELAWARE COURTS SHOULD NOT DENY PRECLUSIVE EFFECT TO NON-DELAWARE DECISIONS ON DEMAND FUTILITY IN DERIVATIVE LITIGATION.

The Business Roundtable respectfully submits that Delaware courts should not deny preclusive effect to non-Delaware decisions on demand futility.

1. The rulings below. The Chancellor's decisions below convincingly demonstrated:

a. that under the prevailing legal standard, the Arkansas court's decision would be preclusive of the demand futility issue if the Arkansas Plaintiffs were adequate representatives, that is, unless the litigation conduct of the Arkansas Plaintiffs was "so grossly deficient as to be apparent to the opposing party" or otherwise deficient under the Restatement (Second) of Judgments' criteria for adequacy of representation[1] — as both sides to this appeal appear to agree;[2]

b. that no court has adopted the proposed "bright-line" rule that would deny preclusive effect to any pre-demand futility decisions in derivative litigation;[3]

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[1] Supplemental Op. (Del Ch. July 25, 2017), at 3; *In re Wal-Mart Stores, Inc. Del. Deriv. Litig.* (*Wal-Mart I*), 2016 WL 2908344, at *18 & n.103 (Del. Ch. May 13, 2016).
[2] Order remanding action (Del. Jan 18, 2017), at 6, cited as "Order."
[3] Supplemental Op. at 4.

c. that this Court in *Pyott* in 2013 previously declined to embrace such a "bright-line" divide between pre- and post-demand futility phases in derivative litigation in the very context of the issue of privity in multiple derivative suits, and that this holding was reaffirmed about eighteen months ago in *City of Providence* v. *Dimon*, 2015 WL 4594150, at *1 (Del. Ch. July 29, 2015), *aff'd*, 134 A.3d 758 (Del. 2016);[4]

d. that due process concerns were addressed in the Court of Chancery's determination below of adequacy of representation;[5]

e. that there is no basis to conclude that the representation afforded by the Arkansas Plaintiffs was inadequate[6] — as this Court appears to concur;[7] and

f. that Arkansas courts would likely follow the precedents of several federal courts and find that the requisite privity for preclusion purposes is satisfied here.[8]

2. **<u>The issue presented</u>.** Accordingly, the question now presented is whether this Court should depart from the prevailing legal test. As the Chancellor

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[4] Supplemental Op. at 4 & n.9; *see Pyott* v. *La. Mun. Police Emps.' Ret. Sys.*, 74 A.3d 612, 616-18 (Del. 2013).
[5] Supplemental Op. at 2; *Wal-Mart I*, 2016 WL 2908344, at *17-18; *see also* Order, at 12 n.33.
[6] Supplemental Op. at 9-10.
[7] Order, at 10-11.
[8] Supplemental Op. at 7-9 (citing *Wal-Mart I*, 2016 WL 2908344, at *12-17).

stated on remand, "frankly stated, the issue presented on remand is whether the predominant approach on issue preclusion in the derivative action context constitutes such an 'extreme application[] of the doctrine of res judicata' as to affront due process."[9] More particularly, the question is whether Delaware courts should deny preclusive effect to decisions of non-Delaware courts that demand is not futile — where (a) the stockholder plaintiffs in the foreign court were adequate representatives, (b) there is no constitutional impediment to preclusion currently recognized in the case law, (c) the Delaware Plaintiffs had actual knowledge of the non-Delaware foreign proceeding and an opportunity to intervene or otherwise participate in that proceeding but chose not to do so, and (d) the non-Delaware court applied Delaware law in a manner not shown (or even claimed) to have been erroneous.

3. **Fundamental policy considerations.** The proposed departure from current law would be ill-advised for the following reasons:

a. The current state of the law protects corporations and boards of directors from the need to relitigate successively whether the board is entitled to its usual prerogative of controlling the litigation of corporate causes of action, *viz*., the essence of the demand futility issue. Once the board's right has been confirmed by

[9] Supplemental Op. at 12 (quoting *Richards* v. *Jefferson Cty., Ala.*, 517 U.S. 793, 797 (1996)).

a court of competent jurisdiction, it would be wasteful to require relitigation of *the same issue* — an issue that has nothing to do with the identity or circumstance of the particular stockholder-plaintiff.

b. Indeed, if demand non-futility rulings are denied preclusive effect, there is essentially *no limit* on the number of times the corporation and its directors may be obliged to establish that demand is not futile. Under the *EZCorp* dictum,[10] a determination that demand is not excused can never have any preclusive effect no matter how effective the representation in the original action and no matter how careful the decision of the first court.

c. The problems that would be generated by the *EZCorp* dictum only multiply when considered in the converse situation where a Delaware court dismisses the action for failure to make a demand and other stockholders press the same derivative claim in another state. Under the law described in *Pyott*, the court in the subsequent action in a different state would give to the Delaware judgment of dismissal the same effect it would have under Delaware law, which would be none under the *EZCorp* standard. This result would apply even if similar judgments by the courts of the second state would have preclusive effect under the law of that state. Such a situation would deprive Delaware corporations of one of

[10] *In re EZCorp Inc. Consulting Agreement Deriv. Litig.*, 130 A.3d 934, 948 (Del. Ch. 2016).

the key benefits of incorporating in Delaware: having derivative claims against directors decided by Delaware courts. The *EZCorp* dictum — however well-motivated — would substantially diminish the value of Delaware jurisprudence.

d. The prospect of that sort of repetitive relitigation is not only wasteful, but an invitation to abuse. Stockholder plaintiffs would face no obstacle to filing duplicative successive derivative suits, and seeking to enhance the leverage and settlement pressure that would be generated by their certain knowledge that defeat on a demand motion would not preclude successive filings.

e. Permitting successive relitigation would also rob boards of directors of the power — established by their demonstration of demand non-futility — to assert the corporate claims in a manner they deem most beneficial to the corporation and all of its stockholders. Boards could not be certain of their entitlement to do so if that right was subject to *de novo* relitigation in a subsequent derivative action. It is not even clear when, if ever, boards could be assured of that right if demand non-futile decisions were not considered preclusive.

f. At the same time, it would be especially incongruous since boards of directors who *lost* a demand futility motion would likely be collaterally estopped in any successive derivative suit. This, of course, is the famous "railroad

crash anomaly."[11] The board of directors could be successful in the first, second, or whatever action, but should it then lose a demand motion, it would be precluded, given the modern acceptance of offensive non-mutual collateral estoppel.[12] That prospect compounds the asymmetry of denying preclusive effects to rulings of demand non-futility.

Accordingly, denying preclusive effect to a demand not-futile determination is problematic, if not indefensible, from a sound corporate governance perspective.

4. Class v. derivative actions. The proposed change is not justified by a comparison of class actions and derivative litigations. Stockholder class actions and derivative litigations have in common that there are stockholders who are not named parties. Beyond that, the two types of litigation are very different. In class actions, the named plaintiffs purport to represent absentee owners of claims who are not parties to the litigation. In derivative litigation, the named plaintiffs claim the right to represent the corporation, which is a party to the litigation. There is no issue in derivative litigation about whether the holder of the claim is a party to the litigation and should be bound by the judgment reached by the court. The owner of the claim — the corporation — is before the Court.

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[11] *See* Brainerd Currie, *Mutuality of Collateral Estoppel: Limits of the Bernhard Doctrine*, 9 Stan. L. Rev. 281 (1957).

[12] *See, e.g.*, *Parklane Hosiery Co.* v. *Shore*, 439 U.S. 322, 331-33 (1979).

There is another fundamental distinction. In class actions, the named plaintiff begins by asserting an individual claim and only asserts representative claims when and if the necessary class determinations are made. In derivative litigation, the named plaintiff asserts a representative claim at the threshold. There is no individual claim that the plaintiff asserts. The cause of action belongs to the corporation, not to the named plaintiff or any other stockholder of the corporation.

The implications of these conceptual distinctions bear directly on the issue here presented. In class suits, the persons whose claims are being asserted representatively are not parties to the litigation unless and until they are made parties by the class mechanism. Consequently, an obvious issue arises whether they may be bound by the determinations made by the court. The nearly obvious answer is that they cannot be bound unless and until the class is established. This issue never arises in derivative litigation. The party that owns the claim being asserted derivatively is before the court.

Also, the demand refusal issue under Rule 23.1 has nothing to do with the characteristics of the stockholder-plaintiff; it has to do only with whether there is a legitimate basis to oust the corporation and its board of directors from their normal role as owners of the corporate cause of action. That issue is the *same* in any incarnation of the derivative suit. The focus is solely on the corporation's board of directors — its composition and its conduct — not the other stockholders.

"[B]ecause the real plaintiff in a derivative suit is the corporation, 'differing groups of shareholders who can potentially stand in the corporation's stead are in privity for the purposes of issue preclusion.'"[13] The "structural fact" that "the corporation is bound by the results" of derivative litigation, "even if different shareholders prosecute the suits," distinguishes derivative litigation from other questions of binding non-parties.[14]

Smith v. *Bayer* provides no warrant to transplant doctrine from class actions to derivative litigation.[15] *Smith* held that "[n]either a proposed class action nor a rejected class action may bind nonparties."[16] The nub of that holding was: "The definition of the term 'party' can on no account be stretched so far as to cover a person . . . whom the plaintiff in [the] lawsuit was denied leave to represent."[17] In the derivative suit context, that point has no application. The Arkansas Plaintiffs did not seek, and were not denied, leave to represent the Delaware Plaintiffs or any other stockholders. The same is true in all derivative suits. What happened in the Arkansas action is that *the corporation* was found to be entitled to

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[13] *Pyott*, 74 A.3d at 617 (quoting *LeBoyer* v. *Greenspan*, 2007 WL 4287646, at *3 (C.D. Cal. June 13, 2007)).
[14] *In re Sonus Networks, Inc, S'holder Deriv. Litig.*, 499 F.3d 47, 64 & n.10 (1st Cir. 2007); *see also Arduini* v. *Hart*, 774 F.3d 622, 634, 637-38 & n.11 (9th Cir. 2014).
[15] 564 U.S. 299 (2011).
[16] *Id.* at 315.
[17] *Id*. at 313.

maintain control over its own cause of action, and the Arkansas Plaintiffs were "denied leave to represent" *the corporation*.

5. <u>The inequitable consequences of denying preclusive effect</u>. The particular factual circumstances of this case highlight the negative policy implications of denying preclusive effect to demand futility rulings. "The Delaware Plaintiffs made no attempt to intervene in the litigation in Arkansas,"[18] apparently in the hope of evading preclusive effect of the Arkansas court's ruling. It would be poor policy to encourage one set of plaintiffs knowingly to absent themselves from the other forum. Here, that choice by the Delaware Plaintiffs — whether borne of pecuniary interest, arrogance, or other tactical motive — deprived the Arkansas court of the opportunity to "take into account the litigation pending elsewhere and make a determination as to whether any dismissal should be with or without prejudice, and as to the named plaintiff only."[19]

Moreover, denying preclusive effect will have the untoward effect of encouraging internecine disputes among sets of plaintiff-counsel. Here, the Delaware Plaintiffs failed to reach an agreement with the Arkansas Plaintiffs to join with them in Delaware because of a dispute over "the fee pie."[20] That kind of

[18] Order at 4-5.
[19] *Id.* at 9.
[20] *Id.* at 5.

dispute would only be encouraged by a rule that freed the second set of plaintiffs from the normal preclusive effect of a ruling in the first action.

6. <u>The "fast filer" question</u>. Adopting the *EZCorp* rule is not warranted by the assumption that there is a "fast filer" problem. Most importantly, there is a fundamental unfairness and disconnect between the perceived harm of "fast filers" and the proposed remedy of never giving preclusive effect to a determination of demand futility. The "fast-filers" are posited to be counsel and stockholders who compromise their professionalism and fiduciary responsibilities by filing lawsuits to advantage themselves in a search for fees. If this is the problem, the focus of the solution ought to be on the adequacy of the plaintiffs and their counsel, which is the focus of the existing law. The burden of attempting to address the problem ought not fall on every Delaware corporation and its directors who would be made to suffer the potential of repetitive litigation.

In addition, it is difficult to see how a non-preclusion rule would discourage "fast filing." If the "fast filer" survives a demand motion, that set of lawyers retain the advantage they sought. If the first court finds demand not excused, the same firm can refile, and has lost nothing. At the same time, the incentive for plaintiff-counsel to work together will be reduced, since each will know that a loss by the other cannot impact its case. If "fast filing" is a problem, it should be addressed

head on via the adequacy of representation analysis, not by burdening Delaware corporations with wasteful and endless relitigation.

7. <u>Comity</u>. Corporate governance implications aside, there is no escape from the undesirable implications inherent in the suggestion that Delaware depart from existing doctrine in order to deny preclusive effect to a derivative suit ruling by a foreign court so as to (potentially) allow the same claims to be pressed anew by the Delaware Plaintiffs in a Delaware court. The Delaware courts are widely acknowledged as preeminent in all matters corporate. A not insignificant element of that deserved reputation is their care not to overstep their role by treading on the legitimate roles of sister state courts and the federal courts, even as the Delaware courts are rightly accorded primacy on matters "in their lane." "Under this Court's precedents, the undisputed interest 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."[21] That important balance would be upset were the Court to fashion new doctrine that would deny preclusive effect to a foreign court's ruling on an issue that, under existing law, would be entitled to preclusive effect.

The application of the *EZCorp* approach in the converse situation further compounds the problem. The judgments of Delaware courts dismissing a

[21] *Pyott*, 74 A.3d at 616.

derivative claim for failure to make a demand will be given the same effect in sister states as they are given in Delaware, which under *EZCorp* is no effect at all. As noted above, corporations incorporate in Delaware on the expectation that claims against them will be resolved by the courts of this state and not by an endless process of relitigation in multiple courts in multiple states. Adopting *EZCorp* would fundamentally undermine that principle of Delaware law and policy.

CONCLUSION

The demand non-futility ruling in the Arkansas action should be accorded preclusive effect.

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