IN THE SUPREME COURT OF THE STATE OF DELAWARE

DAVID PYOTT, HERBERT W. BOYER, LOUIS J. LAVIGNE, GAVIN S. HERBERT, STEPHEN J. RYAN, LEONARD SCHAEFFER, MICHAEL R.` GALLAGHER, ROBERT ALEXANDER INGRAM, TREVOR M. JONES, DAWN E. HUDSON, RUSSELL T. RAY, DEBORAH DUNSIRE, and ALLERGAN, INC.,	:	
Defendants-Below/ Appellants,	:	No. 380, 2012
v.	:	On Appeal From The Court Of Chancery
LOUISIANA MUNICIPAL POLICE EMPLOYEES' RETIREMENT SYSTEM and U.C.F.W. LOCAL 1776 & PARTICIPATING EMPLOYERS PENSION FUND,	:	C.A. No. 5795-VCL
Plaintiffs-Below/ Appellees.	:	

BRIEF OF THE WASHINGTON LEGAL FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF APPELLANTS' INTERLOCUTORY APPEAL SEEKING REVERSAL

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INTERESTS OF *AMICUS CURIAE*

The Washington Legal Foundation ("WLF") is a nonprofit public interest law and policy center based in Washington, D.C., with members and supporters in all 50 States, including many in Delaware. WLF devotes a substantial portion of its resources to defending and promoting free enterprise, individual rights, and a limited and accountable government.

This brief focuses solely on whether the Delaware courts are required to give preclusive effect to the judgments of other courts -- here, the United States District Court for the Central District of California. WLF takes no position on whether the allegations of the complaint at issue were sufficient to give rise to a reasonable inference that Allergan Inc.'s directors intended the company to break the law.

SUMMARY OF ARGUMENT

In January 2012, the California district court dismissed, with prejudice, a derivative action filed by shareholders of Allergan, Inc., finding that the complaint had failed to allege adequately that pre-suit demand on Allergan's Board of Directors would have been futile. (A529-31.) In denying a motion to dismiss a largely identical derivative action against Allergan, the Court of Chancery cited two grounds for declining to grant preclusive effect to the California judgment. First, the court held that the plaintiff-shareholders in the Delaware action were not in privity with the plaintiff-shareholders in the California action, reasoning that privity is not established until one derivative action "passes the Rule 23.1 stage." Op. at 26. Second, the court held that the California plaintiffs did not adequately represent the interests of Allergan and its other shareholders. WLF submits that the Court of Chancery erred with respect to both of those holdings.

The Court of Chancery's privity holding is contrary to binding California law. The court correctly recognized that it was required to "give a judgment the same force and effect that it would be given by the rendering court." Op. at 16. That recognition should have caused the Court of Chancery to give preclusive effect to the California judgment. It is beyond cavil that California would apply issue preclusion to bar relitigation of the demand-futility issue because there is a California decision to that effect directly on point. *See LeBoyer v. Greenspan*, 2007 WL 4287646 (C.D. Cal., June 13, 2007). The court's refusal to give preclusive effect to the California demand-futility ruling violates federal common law and should be reversed. *Semtek Int'l Inc. v. Lockheed Martin Corp.*, 531 U.S. 497, 508 (2001).

The Court of Chancery justified its issue preclusion ruling -- *i.e.*, its determination that the Delaware shareholders were not in privity with the California shareholders and thus not bound by the California judgment -- on the grounds that *LeBoyer* was wrongly decided. Op. at 22. The court concluded that, in light of its explanation regarding why privity is lacking, the California federal court "should," and thus likely would, refuse to follow *LeBoyer* "[i]f the collateral estoppel issue were properly presented." Op. at 15. Because (in its view) the California federal court would not apply issue preclusion, the Court of Chancery concluded that it need not do so either. Op. at 16.

The Court of Chancery's analytic approach finds no support in the case law and is an invitation to judicial chaos. The court in essence concluded that it was not bound to follow California issue preclusion case law because it disagreed with that case law and hoped that California courts could be persuaded to overrule it. However, whether the Court of Chancery's analysis of the privity issue is correct is largely beside the point. Full faith and credit requires Delaware courts to give the same issue preclusion effect to the California demand-futility determination that the determination would be entitled to in a California federal district court. Even if a California district court misinterpreted California issue preclusion law (as the Court of Chancery believes it has done), a Delaware court is not free to reject that interpretation based on a hope that the California federal district court may change its mind in the future. The practical operation of our national court system demands nothing less.

The Court of Chancery also erred in denying issue preclusion based on a determination that the California shareholders did not adequately represent Allergan and other shareholders. That determination was based

solely on the court's newly minted "fast-filer presumption" -- an irrebutable presumption that a shareholder-plaintiff is an inadequate derivative representative if it files suit before seeking books and records pursuant to 8 *Del. C.* § 220. This Court's case law does not support creation of such a presumption. Nor did the Court of Chancery make *any* findings suggesting that the California shareholders did a less-than-adequate job of presenting their demand-futility argument to the California federal district court. The Court of Chancery adopted its fast-filer presumption based on its conclusion that the presumption would provide a solution to "the fast-filer problem" -- *i.e.*, the seemingly irresistible incentives that encourage lawyers to file derivative actions without first obtaining corporate books and records. This Court, however, has identified several methods of addressing the problem that are far less drastic than the Court of Chancery's approach and that do not create such severe litigation difficulties for corporations faced with multiple derivative lawsuits.

Moreover, the Court of Chancery's approach, with its seeming preference for litigation in the Delaware courts, is constitutionally problematic. Delaware's courts are deservedly renowned for their expertise on issues of corporate law. That expertise does not, however, permit the State to disregard judgments of other courts raising Delaware corporate law issues. Any other conclusion raises serious constitutional concerns, not only based on full-faith-and-credit requirements, but also under the Commerce Clause if the design or effect of the approach is to encourage such litigation only in Delaware. In the absence of any evidence that the California shareholders litigated their claims in a grossly deficient manner, the Court of Chancery's inadequate representation finding should be reversed.

ARGUMENT

I. BECAUSE THE CALIFORNIA FEDERAL COURT WOULD GIVE PRECLUSIVE EFFECT TO ITS DEMAND-FUTILITY DETERMINATION, DELAWARE IS REQUIRED TO DO SO AS WELL

As the Court of Chancery correctly recognized, it was required to "give a judgment the same force and effect that it would be given by the rendering court." Op. at 16. That requirement ultimately derives from the U.S. Constitution's Full Faith and Credit Clause,[1] and the Full Faith and Credit Act (FFCA), 28 U.S.C. § 1738. The FFCA "has long been understood to encompass the doctrines of *res judicata*, or 'claim preclusion,' and collateral estoppel, or 'issue preclusion.'" *San Remo Hotel, L.P. v. City of San Francisco*, 545 U.S. 323, 336 (2005).

The Full Faith and Credit Clause does not expressly apply when the "rendering court" is a federal court rather than a state court. The United States Supreme Court nonetheless has held that federal common law requires a state court to adhere to preclusion rules when faced with a contention that a claim or issue raised in the state court has previously been decided by a federal court. Indeed, when (as here) a federal court issues its judgment in a diversity jurisdiction case, the United States Supreme Court has held that a state court is required to give the federal judgment "the same force and effect" as it would be given under the preclusion rules of the State in which the federal court is sitting (in this case, California). *Semtek,* 531 U.S. at 507-08. In other words, federal common law imposes on Delaware a full-faith-and-credit requirement to give the California federal district court judgment the same force and effect as it would be entitled to in the California federal or state courts under

[1] "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State." U.S. Const., Art. IV, § 1.

California's preclusion rules.[2]

A. The Full-Faith-and-Credit Requirement Serves Important National Interests and Trumps the Court of Chancery's Public Policy Concerns Regarding Incentives That Encourage Fast-Filing

The full-faith-and-credit requirement serves important national interests. The Full Faith and Credit Clause was incorporated into the Constitution to make "an aggregation of independent, sovereign States into a nation." *Sherrer v. Sherrer*, 334 U.S. 343, 355 (1948). By requiring each independent sovereign State to respect the sovereignty of each other as well as the independent judicial function of the federal courts, full faith and credit helps to forge a national government without abrogating the sovereignty of any State.[3]

Our federal system mandates that each court judgment "have the same credit, validity, and effect, in every other court of the United States, which it had in the state where it was pronounced." *Hampton v. McConnel*, 3 Wheat. (16 U.S.) 234, 235 (1818) (Marshall, C.J.). That approach promotes harmony among the States without imposing upon them any particular substantive policy of the federal government. Of course, this approach can sometimes encroach on each State's sovereignty, as it can require States to enforce policies contrary to their own. *See, e.g., Baker v. General*

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[2] Delaware has independently determined, as a matter of state law, that it will afford the same respect to federal court judgments that the Full Faith and Credit Clause requires it to afford to judgments from other States. *Iowa-Wisconsin Bridge Co. v. Phoenix Finance Corp.*, 25 A.2d 383, 391 (Del. 1942) (holding that "[t]he same sanctity and effect is granted to a judgment of a federal court rendered in a like case and in similar circumstances, as is conceded to a judgment of a state court").

[3] Absent the federal command, each State would be "free to ignore . . . the judicial proceedings of the others." *Milwaukee County v. M.E. White Co.*, 296 U.S. 268, 277 (1935). And history proves they would. As Alexander Hamilton observed, "To look for a continuation of harmony between a number of independent, unconnected sovereignties in the same neighborhood, would be to disregard the uniform course of human events, and to set at defiance the accumulated experience of ages." *The Federalist* No. 6 (Alexander

Motors Corp., 522 U.S. 222, 232-33 (1998) (noting that "[r]egarding judgments . . . the full faith and credit obligation is exacting" and that there is "no roving 'public policy exception' to the full faith and credit due judgments"); *Estin v. Estin*, 334 U.S. 541, 546 (1948)(full faith and credit "order[s] submission . . . even to hostile policies reflected in the judgment of another State, because the practical operation of the federal system, which the Constitution designed, demanded it").

In sum, because the full-faith-and-credit requirement serves important national interests, Delaware should be reluctant to permit public policy considerations -- such as a desire to address the "fast-filer problem" -- to interfere with its obligations to respect the judgments of other state and federal courts.

B. *LeBoyer* Has Already Answered the Key Issue In This Case, and the Court of Chancery Was Required to Abide by That Answer

The Court of Chancery recognized that federal law required it to give the California federal court judgment "the same force and effect that it would be given by the rendering court." Op. at 16. *LeBoyer* supplies a ready answer to the question of the "force and effect" that the California District Court would give to its judgment dismissing the derivative action filed by Allergan's shareholders.

LeBoyer involved a derivative suit filed in federal court by shareholders of eUniverse, Inc., which was one of several such suits filed following the corporation's 2003 restatement of earnings. A state court judge in 2004 dismissed a separate shareholder derivative action for failure to establish demand-futility. The *LeBoyer* defendants then moved to dismiss on collateral estoppel grounds. In granting the motion, the federal court determined that the California courts would give issue

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Hamilton).

preclusion effect to the demand-futility finding of the first derivative action, and therefore, the *LeBoyer* defendants were entitled to invoke issue preclusion as well. *LeBoyer*, 2007 WL 4287646 at *4. In particular, the federal court rejected the claims of the second group of shareholders that they were not in privity with the shareholders who had filed the initial action:

> [Privity] is satisfied in that in both suits the plaintiff is the corporation. The differing groups of shareholders who can potentially stand in the corporation's stead are in privity for the purposes of issue preclusion.

Id. at *3.[4]

LeBoyer cannot be distinguished on its facts. Accordingly, faithfully adherence to *LeBoyer* as an accurate statement of California law would have required dismissal of this action on issue preclusion grounds. *LeBoyer* indicates unequivocally that the Plaintiffs in this case are in privity with the Allergan shareholders who filed the California derivative action.

The Court of Chancery nonetheless concluded that it was not bound by *LeBoyer* because (in its view) the decision did not accurately reflect California preclusion law. The court stated that whether shareholders of a Delaware corporation "are sufficiently in privity with the corporation and each other is a matter of substantive Delaware law governed by the internal affairs doctrine." Op. at 19. It concluded that California preclusion rules require California courts to look to Delaware law to determine the privity issue and that *LeBoyer* erred in failing to do so.

[4] California law applies a five-element test for issue preclusion. The fifth element is privity: "the party against whom preclusion is sought must be the same as, or in privity with, the party to the former proceeding." *LeBoyer* at *1.

The court stated that *LeBoyer* -- and virtually every other case that has addressed the issue, *see, e.g., In re Sonus Networks, Inc. S'holders Deriv. Litig.*, 499 F.3d 47 (1st Cir. 2007) -- erred in concluding that all shareholders are in privity with one another with respect to the demand-futility issue. Op. at 22. The Court of Chancery stated that "[t]hese cases miss that as a matter of Delaware law, a stockholder whose litigation efforts are opposed by the corporation does not have authority to sue on behalf of the corporation until there has been a finding of demand excusal or wrongful refusal." *Id.* It concluded that, in light of its explanation regarding why privity is lacking, the California federal court "should," and thus likely would, refuse to follow *LeBoyer* "[i]f the collateral estoppel issue were properly presented." Op. at 15. Because (in its view) the California federal court would not apply issue preclusion, it concluded that it need not do so either. Op. at 16.

The Court of Chancery cited no case law in support of its position that it need not accept *LeBoyer* as an accurate statement of California preclusion law, and there is none. If state courts were free to ignore another State's preclusion case law with which they disagree (or which they believe would be overruled if the issue were to arise again), full faith and credit would amount to nothing. State courts would be free to ignore a judgment issued by a court in another jurisdiction by simply adopting a novel interpretation of the other jurisdiction's preclusion law.

The United States Supreme Court has repeatedly held that state courts are not free to ignore their full faith and credit obligations simply because they have public policy objections to the judgment of a court in another jurisdiction. *See, e.g., Baker*, 522 U.S. at 664 (there is "no roving

'public policy exception' to the full faith and credit due judgments"). Nor does it make a difference that a State believes that the other jurisdiction's judgment was based on a misinterpretation of the State's own laws, because full faith and credit still requires recognition of the judgment. *See, e.g.*, *Fauntleroy v. Lum*, 210 U.S. 230, 237 (1908) (judgment of a Missouri court is entitled to full faith and credit in Mississippi even if it rested on a misapprehension of Mississippi law); *Underwriters Nat'l Assurance Co. v. North Carolina Life and Accident and Health Ins. Guar. Assoc.*, 455 U.S. 691 (1982) (issue determined by an Indiana court was entitled to full faith and credit in North Carolina, despite the Supreme Court's recognition that the determination "may well have been erroneous as a matter of North Carolina law").

The Court of Chancery's disagreement with *LeBoyer* was driven largely by its public policy conviction that something needed to be done to address the "fast-filer problem." Devising a solution to that problem occupied much of the court's opinion. However, whether its analysis of the privity issue is correct is beside the point. Full faith and credit requires Delaware courts to give the same issue preclusion effect to the California judgment that *LeBoyer* determined such judgments are entitled to in a California federal district court. Even if *LeBoyer* violated Delaware public policy or misinterpreted California preclusion law (as the Court of Chancery believed it had done), Delaware is not free to reject that interpretation based on a mere hope that the California court may change its mind in the future. The operation of our national court system demands nothing less.

II. THE COURT OF CHANCERY ERRED IN DENYING ISSUE PRECLUSION BASED ON A DETERMINATION THAT CALIFORNIA SHAREHOLDERS DID NOT ADEQUATELY REPRESENT ALLERGAN AND OTHER SHAREHOLDERS

The Court of Chancery held alternatively that the California shareholders did not adequately represent the interests of Allergan and other shareholders, and thus that the California federal court judgment should not be given preclusive effect. It did not base that holding on an examination of the manner in which the California shareholders conducted their lawsuit; indeed, the Court of Chancery acknowledged that the California complaint raised virtually the same claims as those raised in this case, and that the California shareholders had full access to (and made full use of) the public documents and Section 220 materials that were available to the Delaware shareholders. Rather, the court's inadequate representation determination was based *solely* on the court's newly minted "fast-filer presumption" -- an irrebutable presumption that a shareholder plaintiff is an inadequate derivative representative if it files suit before seeking corporate books and records pursuant to 8 *Del. C.* § 220. The Court of Chancery's inadequate representation finding lacks an evidentiary basis and does not support the trial court's refusal to give preclusive effect to the California judgment.

A. The Irrebutable Presumption of Inadequate Representation Is Inconsistent with Existing Case Law and Serves No Rational Purpose

The Due Process Clause limits the circumstances under which an individual can be bound by a judgment in a lawsuit in which he is not designated as a party. Among the due process limitations, an individual may not be bound under those circumstances if his interests are not adequately represented by one of the parties. *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 812 (1985). Accordingly, a judgment dismissing a

derivative action for failure to establish demand-futility is not deemed to have preclusive effect on an identical derivative action filed by a different set of shareholders if the plaintiffs in the first suit did not fairly and adequately represent the interests of all shareholders. *Sonus Networks*, 499 F.3d at 64-65. A finding that the initial plaintiffs did not adequately represent all shareholders requires, however, a showing by the second group of shareholders that the initial plaintiffs' performance was "so grossly deficient as to be apparent to the opposing party." *Id.* at 66 (quoting *Restatement (Second) of Judgments* § 42(1)(E), Comment f). In the absence of *any* findings by the Court of Chancery that the California shareholders prosecuted their lawsuit in a "grossly deficient" manner, the inadequate representation holding cannot stand.

Presuming fast-filers to be inadequate representatives of other shareholders is inconsistent with the decisions of this Court. For example, this Court has referred to fast-filing (*i.e.*, filing a derivative suit before gaining access to the books and records of the corporation) as "ill-advised" but *not* "fatal." *King v. Verifone Holdings, Inc.* ["*King II*"], 12 A.3d 1140, 1146 (Del. 2011). Indeed, by expressly authorizing shareholders to file a lawsuit to obtain books and records under Section 220 even after having filed a derivative action (provided only that the derivative action has not yet been dismissed with prejudice), *King II* made clear that fast-filers should not automatically be deemed to be inadequate representatives of other shareholders. *Id.* at 1150.

The Court of Chancery adopted its fast-filer presumption based on its conclusion that the presumption would provide a solution to "the fast-filer problem." This Court, however, has identified several methods of addressing the problem that are far less drastic than the Court of

Chancery's proposed solution, and that do not create new litigation difficulties for corporations faced with multiple derivative lawsuits. *See King II*, 12 A.3d at 1151-52. The "solution" to the fast-filing problem adopted by the Court of Chancery creates serious problems for corporations that have experienced traumatic events. If, as contemplated by the Court of Chancery, a corporation can *never* make preclusive use of a judgment dismissing a derivative action on the basis of failure to demonstrate demand-futility, it faces the prospect of an endless series of derivative actions. Plaintiffs can keep filing them until one demand-futility motion to dismiss is denied. The inevitable result is that corporations will face strong pressure to settle even the most insubstantial derivative claims, in order to avoid the cost of defending an endless series of derivative actions. WLF does not believe that such settlement expenditures are in the best interests of shareholders, nor is it even clear that the same rationale used to deny preclusive effect could not be employed to reject a settlement approved by a non-Delaware court.

Moreover, the Court of Chancery's "solution" will do little to deter fast-filing. Lawyers file derivative suits quickly in hopes of being named lead counsel and obtaining a hefty fee award in the event they prevail. The Court of Chancery's irrebutable presumption will have no effect on those incentives. Indeed, if a derivative suit has been dismissed with prejudice for failure to establish demand-futility, lawyers for the plaintiff will be largely unconcerned by the preclusive effect that the judgment will have on *other* derivative suits against the same corporation; their opportunity to earn a fee has already been lost.

In sum, the presumption of inadequate representation created by the Court of Chancery has little to recommend it. It bears no relationship to the adequacy of the plaintiff-shareholders' representation of other shareholders, would create significant litigation difficulties for defendants in derivative actions, and would do little if anything to deter fast-filing.

B. Denying Enforcement of Judgments Based on Insubstantial Adequacy-of-Representation Findings Violates The Full Faith and Credit Clause and Raises Serious Commerce Clause Concerns

The Court of Chancery made its inadequate representation determination without any reference to California preclusion law. Nothing in California preclusion law supports the court's conclusion that fast-filing creates an irrebutable presumption that the California shareholders did not fairly and adequately represent Allergan and other shareholders. Accordingly, the court's reliance on inadequacy of representation as its rationale for failing to give preclusive effect to the California judgment is inconsistent with Delaware's full-faith-and-credit obligations.

The Court of Chancery's fast-filer presumption raises particular constitutional concerns because the court appeared to have adopted it, at least in part, for the purpose of favoring litigation in Delaware. WLF notes, for example, that the Court of Chancery appeared to apply its "fast-filer presumption" in an asymmetrical manner: it held that the California shareholders could not adequately represent Allergan's interests once they revealed "where their true loyalties lay" by engaging in fast-filing, yet it permitted one of the Plaintiffs here (the Louisiana Municipal Police Employees' Retirement System, which was also a fast-filer but apparently had the good sense to file in Delaware) to remain as a

plaintiff in this lawsuit. At the July 6 hearing on Defendants' motion for stay, the Vice Chancellor repeatedly made statements indicating that the intent of his fast-filer presumption was: (1) to discourage the filing of derivative suits by non-Delaware law firms (who he identified as the worst offenders among fast-filing firms and as less likely than Delaware firms to possess technical expertise in Delaware corporate law); and (2) to encourage the filing of derivative suits in Delaware instead of in other forums because of their greater expertise in corporate law. Hearing Tr. 38-40.

Rules designed to prevent/discourage other forums from hearing shareholder derivative actions arising under Delaware corporate law raises serious full-faith-and-credit issues. As the United States Supreme Court recently explained in rejecting efforts to prevent cases raising Texas probate issues from being heard outside the State:

> Texas law governs the substantive elements of [the plaintiff's] claims. It is also clear, however, that Texas may not reserve to its probate courts the exclusive right to adjudicate a transitory tort. . . . Jurisdiction . . . cannot be defeated by the extraterritorial application of a state statute even though it created the right of action.

Marshall v. Marshall, 547 U.S. 293, 313-14 (2006).

The Court of Chancery's adoption of policies designed to favor Delaware courts and law firms also raises serious Commerce Clause concerns. The dormant Commerce Clause bars States from engaging in economic protectionism by discriminating against interstate commerce. *See*, *e.g.*, *Gibbons v. Ogden*, 22 U.S. 1 (1824). This Court can avoid addressing either of these difficult constitutional issues by ruling that Delaware does not recognize the fast-filer presumption espoused by the court below.

WLF is concerned with the bigger picture -- *i.e.*, that the Court of Chancery's refusal to abide by the decision of the California district court establishes an unsettling precedent that does not bode well for the goal of nationwide uniformity of judicial decisions. Federal law requires courts to provide full faith and credit to the judgments of other American courts under all but extraordinary circumstances. Creation of any sort of amorphous "public policy exception" to full faith and credit would undermine our unified and symbiotic system of laws. There must be finality to derivative litigation, and the dismissal by the California district court, which gave the Court of Chancery concern, is a proper basis for an appeal and review of the California judgment (where the Ninth Circuit Court of Appeals can certify any questions of Delaware law to this Court pursuant to Supreme Court Rule 41(a)(ii)), as opposed to the Court of Chancery sitting as an appellate court over the California District Court. Affirming the rule of law enunciated below could be used by non-Delaware courts to further subject directors/officers of Delaware corporations to derivative litigation that has been previously dismissed with prejudice by the Court of Chancery. That would be chaotic.

CONCLUSION

For the foregoing reasons, the decision below should be reversed and the case remanded with instructions that the complaint be dismissed with prejudice.

DATED: August 21, 2012

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