Litigation Update

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Court Cracks Down On Multiple Shareholder Derivative Suits

(Pyott v. Louisiana Municipal Police Employees' Retirement System)

Delaware Supreme Court

The Delaware Supreme Court today overturned a lower-court decision that eliminated virtually all limits on the number of shareholder derivative lawsuits that may be filed against a corporation and its directors based on a single event. The lower court had held that a decision dismissing a derivative action filed by one shareholder group is not binding on a separate shareholder group seeking to assert an identical claim on behalf of the corporation.

The Supreme Court's decision in Pyott v. Louisiana Municipal Police Employees' Retirement System was a victory for the Washington Legal Foundation (WLF), which filed a brief urging reversal of the lower-court decision. The Supreme Court agreed with WLF that, under California law (the applicable law in this case), all shareholders of a corporation are in "privity" with one another with respect to derivative claims – because they are all asserting the same interests of the corporation against its board of directors – and thus should be bound by any judgment entered against another group of shareholders.

"WLF was concerned that the decision of the Delaware Court of Chancery, by denying preclusive effect to a federal court dismissal of a virtually identical shareholder derivative suit, exposed corporations and their directors to an endless series of derivative actions," said WLF Chief Counsel Richard Samp following the Supreme Court's decision. "The inevitable result would have been that corporations would face strong pressure to settle even the most insubstantial derivative claims, in order to avoid the cost of defending an endless series of suits. Such settlement expenditures are not in the best interests of shareholders," Samp said.

In a shareholder derivative lawsuit, shareholders seek to assert claims on behalf of a corporation against the corporation's directors or other insiders whose actions allegedly hurt the corporation. Normally, it is up to the corporation and its board to decide whether to file a lawsuit, so shareholders may not proceed with a derivative suit unless they can demonstrate either: (1) they demanded that the board file suit but it wrongfully refused; or (2) a request to the board would have been futile because a majority of the board was implicated in the wrongdoing. Shareholders virtually always choose the latter path because it is very difficult to demonstrate that a board's decision to refuse a litigation demand was wrongful.

Numerous plaintiffs' law firms around the country have become specialists in filing shareholder derivative actions. When a corporation experiences a traumatic event (for example, it is required to restate earnings), it is virtually certain that numerous derivative actions will be filed against corporate insiders within a matter of days. Plaintiffs' law firms seek to file quickly, in the belief that the fastest filers are more likely to be named lead counsel if any of the derivative actions are consolidated.

This case involves derivative actions filed against the directors of Allergan, Inc. after the corporation pled guilty to misdemeanor charges that it had improperly promoted the drug Botox for off-label uses. In January 2012, a federal district court in California dismissed one of the derivative actions, finding that the plaintiffs had failed to demonstrate that a majority of Allergan's directors were directly implicated in the wrongdoing, and thus that the plaintiffs had failed to demonstrate that it would have been futile to present a litigation demand to Allergan's board.

Because Allergan is incorporated in Delaware, a separate group of shareholders filed suit in Delaware court. The Court of Chancery denied Allergan's motion to dismiss the suit, ruling that the Delaware shareholders were not in privity with the California shareholders and thus were not bound by the California court's demand-futility determination. It denied the motion despite acknowledging that California case law would have given preclusive effect to the California demand-futility determination. The court reasoned that the California case law could be ignored because it was wrongly decided – the case law allegedly failed to appreciate that under Delaware corporate law, shareholders have no authority to bind the corporation and other shareholders until after they have survived a demand-futility motion.

The Delaware Supreme Court reversed, holding that federal law required Delaware to give the California judgment the same preclusive effect that a California court would give to the judgment. It agreed with WLF that because the California courts would bar other shareholder groups from maintaining a derivative action, full-faith-and-credit principles require Delaware courts to do the same – even when Delaware courts believe that the California courts have misapplied Delaware law. It also faulted the Chancery Court for establishing an irrebutable presumption that a "fast-filer" law firm is an inadequate representative of the corporation.

WLF is a public interest law and policy center with supporters in all 50 states. It devotes a substantial portion of its resources to promoting tort reform and reining in excessive litigation. WLF filed its brief with the pro bono assistance of John Reed, a partner in the Wilmington, Delaware office of DLA Piper.

For further information, contact WLF Chief Counsel Richard Samp, (202) 588-0302. A copy of WLF's brief is posted on its web site, www.wlf.org.