



Derivative Litigation and Stockholder Preclusion

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The Delaware Supreme Court recently unanimously affirmed the Delaware Court of Chancery's dismissal of a stockholder derivative claim against directors of Wal-Mart, holding that these claims were precluded because a federal court in Arkansas had already dismissed a derivative claim filed by different Wal-Mart stockholders.¹ The Supreme Court held that an exception to the general rule against nonparty preclusion was appropriate in derivative cases because the interests of the plaintiffs in Arkansas and Delaware were sufficiently aligned, and the Arkansas plaintiffs were adequate representatives. The Supreme Court determined the preclusive effect of the Arkansas federal court's dismissal was governed by Arkansas state law, subject to Constitutional standards of Due Process, and that all of the requisite elements for preclusion under Arkansas law, including privity and adequacy of representation, had been satisfied. At the same time, the court also declined the Court of Chancery's invitation to adopt a different rule that would only give preclusive effect to a judgment by a sister court in some circumstances.

The action arose from an alleged bribery scheme at Wal-Mart's Mexican subsidiary that was the subject of a 2012 exposé by *The New York Times*. Following the publication of the *Times* piece, derivative lawsuits bringing claims against Wal-Mart's board of directors were filed by various stockholders across the country, including in the U.S. District Court for the Western District of Arkansas and the Delaware Court of Chancery. While the Delaware plaintiffs heeded the repeated advice of Delaware courts and made a demand for books and records to support their derivative complaint—and ended up litigating for more than two years to get access to significant corporate records—the Arkansas plaintiffs moved forward with their derivative lawsuit without having sought corporate books and records. The Arkansas plaintiffs' complaint was ultimately dismissed with prejudice for failure to plead that demand on the board of directors would have been futile (for example, on the basis that the board faced a substantial likelihood of liability). After the Delaware plaintiffs finally obtained books and records and moved forward with their derivative claims, the Court of Chancery dismissed their complaint, holding that the Delaware plaintiffs were estopped by the Arkansas court's dismissal.

On appeal, the Delaware Supreme Court asked the Court of Chancery to address in a supplemental opinion whether the dismissal violated the Delaware plaintiffs' Due Process rights. The Court of Chancery, while acknowledging the wealth of case law supporting the position that

¹ *California State Teachers' Ret. Sys. et al. v. Alvarez et al.*, C.A. No. 295, 2016 (Del. Jan. 25, 2018).

such a dismissal does not violate Due Process, encouraged the Supreme Court to rely on the reasoning in another recent Court of Chancery decision, *In re EZCORP Inc. Consulting Agreement Deriv. Litig.*,² and adopt a rule that a judgment in a derivative action cannot bind a corporation or other stockholders until the suit has survived a motion to dismiss for failure to plead demand futility. In *EZCORP*, Vice Chancellor Laster had indicated, in dicta, that a judgment in a derivative case involving one plaintiff may not bind a later derivative plaintiff unless and until the first plaintiff survives a Rule 23.1 motion to dismiss, or the board of directors gives the plaintiff authority to proceed by declining to oppose the suit. Vice Chancellor Laster analogized to case law in the class action context recognizing that a judgment cannot bind absent class members before the class has been certified.

The Delaware Supreme Court declined to adopt the Court of Chancery's proposed rule, holding that under federal law the dismissal of the Delaware complaint did not offend Due Process. The Court acknowledged the competing policy considerations at play: On one hand, Delaware courts have repeatedly counseled plaintiffs to seek company books and records to substantiate their allegations before filing derivative complaints; on the other hand, Delaware courts have recognized the importance of respecting the judgments of other courts. However, applying Arkansas and federal law, the Supreme Court affirmed the original decision of the Court of Chancery that granted the motion to dismiss on collateral estoppel grounds. In doing so, the court distinguished the precedent arising in the class action context and cited in *EZCORP*. The court explained that, unlike in a class action, the real party in interest in a derivative suit is the corporation, which is always the sole owner of the claims. Although at the start of a derivative suit, the stockholder derivative plaintiff only has standing to "set in motion the judicial machinery on the corporation's behalf," the suit is always on the corporation's behalf and the derivative plaintiff never has an individual cause of action. Thus, at all stages, the suit is always about the corporation's right to seek redress for alleged harm to the corporation and, therefore, it does not offend Due Process to give effect to a judgment by another court at an early stage of the derivative suit.

As part of its Due Process analysis, the Delaware Supreme Court also addressed the Arkansas plaintiffs' failure to seek corporate books and records, and held that such failure did not, in this case, render their representation "grossly deficient." The court speculated that the outcome may have been different if the Arkansas plaintiffs had not obtained *any* documents, but they had relied on internal Wal-Mart documents that were in the public domain as a result of the article by *The New York Times*.

As a result of this case, Delaware companies can take some degree of comfort that they should not, under most circumstances, be forced to litigate the issue of demand futility in multiple jurisdictions. More broadly, this case gives assurance to Delaware companies that Delaware courts will respect the judgments of sister courts. With that said, the limits of the Delaware Supreme Court's holding remain to be seen because, among other things, the court did not indicate precisely what type of conduct might be deemed "grossly deficient" such that a holding in one derivative action might not constitute collateral estoppel.

² 130 A.3d 934 (Del. Ch. 2016).