

THE CASE FOR DO-OVER DERIVATIVE SHAREHOLDER SUITS IN DELAWARE CHANCERY COURT

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Most of the literature addressing shareholder derivative litigation has emphasized the perils of excessive multi-forum shareholder litigation, proposing various solutions to sidestep the problems encountered in cases like California State Teachers' Retirement System v. Alvarez (Wal-Mart II). This Note addresses a separate and distinct problem—a long overlooked inquiry into the due process implications of using nonparty issue preclusion to curb what is seen as an overgrowth of shareholder derivative litigation.

The Delaware Chancery Court's recent decision in Wal-Mart II illustrates a conceptual puzzle in the application of issue preclusion rules in the context of derivative shareholder suits. In Wal-Mart II, a separate federal suit was dismissed on the grounds that the plaintiffs had failed to satisfy the demand requirement, a crucial step for establishing the plaintiffs' authority to bring a derivative suit on behalf of the corporation. The Delaware courts gave preclusive effect to the federal court's ruling in barring a derivative action by different shareholders. But how can such a judgment—finding that a shareholder plaintiff seeking to bring a derivative action lacks authority to bring suit on behalf of the corporation—be given preclusive effect to bar a future suit by other shareholders? A rule that would resolve this inconsistency was proposed by Chancellor Bouchard's decision for the Chancery Court late in 2017, In re Wal-Mart Stores Delaware Derivative Litigation (Wal-Mart I). While the Delaware Supreme Court declined to adopt the proposal, an analysis of the Delaware Supreme Court's decision suggests that Chancellor Bouchard's proposal may have been the right rule at the wrong time. This Note proposes adoption of the rule proposed in Wal-Mart I as Delaware's preclusion law, arguing that the current treatment of nonparty preclusion in derivative shareholder suits is incompatible with the strong presumption against nonparty preclusion and inconsistent with the treatment of a related mechanism: the class action. In doing so, this Note advocates for an approach to nonparty issue preclusion that would deny preclusive effect to putative derivative suits dismissed prior to satisfaction of the demand requirement.

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INTRODUCTION

In April 2012, *The New York Times* broke a story that exposed an alleged bribery scheme and cover-up perpetrated by executives at Wal-Mart’s Mexican unit, Wal-Mart de Mexico (WalMex). It became publicly known that WalMex had made \$24 million in suspect payments and Wal-Mart officials in the United States and Mexico had turned a blind eye, and even actively limited investigation into the bribery.¹ Wal-Mart subsequently entered into a settlement with the United States Department of Justice, committing the corporation to a settlement payment of \$283 million.² Wal-Mart shareholders brought suit in Delaware and Arkansas against Wal-Mart’s Board of Directors for breaching their fiduciary duties in response to allegations of bribery by Wal-Mart officials in Mexico.³ Eight derivative actions filed in federal court were consolidated into an action in the Western

¹ See David Barstow, *Wal-Mart Hushed Up a Vast Mexican Bribery Case*, N.Y. TIMES (Apr. 21, 2012), <https://www.nytimes.com/2012/04/22/business/at-wal-mart-in-mexico-a-bribe-inquiry-silenced.html>.

² See Jef Feeley, *Wal-Mart Beats Back Suits Against Directors over Bribes*, BLOOMBERG (Jan. 28, 2018), <https://www.bloomberg.com/news/articles/2018-01-25/wal-mart-investors-lose-bid-to-revive-mexican-bribery-claims> (reporting that Wal-Mart set aside \$283 million to cover a settlement with the U.S. Government).

³ See *Cal. State Teachers’ Ret. Sys. v. Alvarez (Wal-Mart II)*, 179 A.3d 824, 830 (Del. 2018) (summarizing claims).

District of Arkansas, alleging breach of fiduciary duties and violations of the Securities and Exchange Act. In Delaware, seven state court derivative actions were consolidated into an action before the Delaware Chancery Court.⁴ The two parallel actions proceeded in different forums, though the claims were largely the same.

Facing the first procedural hurdle, the plaintiffs in each action were tasked with satisfying the demand requirement, an important first step in establishing a shareholder's authority to bring suit on behalf of the corporation.⁵ To satisfy this requirement, the plaintiffs would have to show that Wal-Mart's Board of Directors was either incapable or unwilling to take protective action on behalf of the corporation, often proven by documentary evidence obtained through discovery.⁶ While the Chancery Court advised the Delaware plaintiffs to make a books and records demand⁷ on Wal-Mart per Section 220 of Title 8 of the Delaware Code,⁸ the Arkansas plaintiffs proceeded in federal court with no such attempt.⁹

The Arkansas plaintiffs' decision not to engage in comprehensive discovery proved fatal to their claim. After final resolution of the Delaware plaintiffs' Section 220 action but before an amended complaint could be filed in the Delaware action, the federal court dismissed the action in Arkansas for failure to satisfy the demand requirement.¹⁰ In so holding, the federal judge found that the

⁴ See *id.* at 830 n.9.

⁵ See *infra* Section I.A (explaining the demand requirement).

⁶ The demand requirement typically entails a plaintiff requesting intervention by the corporation's Board of Directors. The plaintiff may only proceed to bring a derivative suit where the corporation's Board of Directors refuses to intervene and the plaintiff can establish that demand was wrongfully denied. In practice, shareholder-plaintiffs rarely make demand upon the Board of Directors. The demand requirement is instead typically satisfied by a showing that demand was excused as futile. See *infra* Section I.A (discussing demand requirement and futility exception).

⁷ Section 220 of Title 8 of the Delaware Code provides that a stockholder has the right to inspect a corporation's books and records, exercised by making a written demand on the corporation. DEL. CODE ANN. tit. 8, § 220(b) (2017).

⁸ See *id.* ("Any stockholder . . . shall, upon written demand under oath stating the purpose thereof, have the right . . . to inspect for any proper purpose, and to make copies and extracts from . . . [t]he corporation's stock ledger, a list of its stockholders, and its other books and records . . ."). If the corporation refuses to permit inspection upon receipt of a stockholder's demand or fails to respond within five days after demand has been made, a stockholder may "apply to the Court of Chancery for an order to compel such inspection." *Id.* § 220(c).

⁹ *Wal-Mart II*, 179 A.3d at 830–31; *In re Wal-Mart Stores, Inc. S'holder Derivative Litig.*, No. 4:12-cv-4041, 2015 WL 1470184, at *4 (W.D. Ark. Mar. 31, 2015) (discussing Arkansas plaintiffs' claims).

¹⁰ *In re Wal-Mart Stores, Inc. S'holder Derivative Litig.*, No. 4:12-cv-4041, 2015 WL 1470184, at *10 (W.D. Ark. Mar. 31, 2015) (order), *amended by* 2015 WL 13375767 (W.D. Ark. Apr. 3, 2015) (correcting typographical errors but making no substantive changes to

Arkansas shareholders lacked the authority to act for the corporation.¹¹ With the federal district court judgment in hand, Wal-Mart moved to dismiss the action in the Delaware Chancery Court, arguing that the decision by the Western District of Arkansas precluded re-litigation of the issue of demand futility.¹² The Delaware shareholders raised due process objections, arguing that they were not bound by the Arkansas decision because they were not a party to the Arkansas litigation—not as plaintiffs in their own right and not on behalf of Wal-Mart.¹³ Following an initial dismissal and appeals proceedings, the Delaware Supreme Court ultimately affirmed dismissal of the action, finding that such an approach to issue preclusion in derivative cases was consistent with federal law and due process protections for plaintiffs beaten to the courthouse by “fast-filers.”¹⁴

Most of the literature addressing this topic has emphasized the perils of excessive multi-forum shareholder litigation, proposing various solutions to sidestep the problems encountered in cases like *Wal-Mart II*.¹⁵ This Note addresses a separate and long-overlooked problem: the due process implications of using nonparty issue preclusion to curb what is seen as an overgrowth of shareholder derivative litigation. The *Wal-Mart II* example illustrates a conceptual puzzle in the application of issue preclusion rules in the context of derivative shareholder suits. In *Wal-Mart II*, the first suit was dismissed on the

initial order), *aff'd sub nom.* Cottrell *ex rel.* Wal-Mart Stores, Inc. v. Duke, 829 F.3d 983 (8th Cir. 2016).

¹¹ *See id.* at *4 (noting that demand or futility are prerequisites to a shareholder being allowed to represent the interests of a corporation via derivative litigation).

¹² *See Wal-Mart II*, 179 A.3d at 833 (discussing demand futility).

¹³ *See id.* at 834 (introducing Delaware plaintiffs’ claim that Chancery Court’s findings as to privity and adequacy of representation violated due process).

¹⁴ *See id.* at 855. *Wal-Mart II* is only the most recent in a pattern of cases involving parallel shareholder derivative litigation as a follow-up to lapses in corporate governance. This issue was also raised in *Pyott v. Louisiana Municipal Police Employees Retirement System* after Allergan, Inc., the maker of Botox, settled charges with the United States Department of Justice in connection with improper marketing practices. *See* 74 A.3d 612, 615 (Del. 2013). Shareholders filed several actions in a California federal district court, where Allergan was headquartered, and in the Delaware Chancery Court, Allergan’s state of incorporation. *Id.* As in *Wal-Mart II*, the Delaware Chancery Court required a more thorough books and records inspection process, and the federal court ruled first, dismissing the case on failure to make demand. *Id.* Allergan moved to dismiss in Delaware, arguing issue preclusion. *Id.* The Delaware Chancery Court declined to apply issue preclusion, citing lack of privity and inadequate representation, but was reversed by the Delaware Supreme Court on broad grounds referencing the U.S. Constitution’s Full Faith and Credit Clause. *See id.* at 616–18.

¹⁵ *See, e.g.,* Anna Fiscella, Note, *An Exclusive Solution to the Multitude of Problems in Multi-Forum Shareholder Litigation*, 42 DEL. J. CORP. L. 687, 702–06 (2018) (suggesting exclusive forum provisions in corporate bylaws as a means to reduce multi-forum shareholder litigation).

grounds that the plaintiffs had failed to make demand on the corporation or adequately plead demand futility, a crucial step in derivative actions for establishing the plaintiffs' authority to bring suit on behalf of the corporation.¹⁶ But how can such a judgment—finding that a shareholder plaintiff seeking to bring a derivative action lacks authority to bring suit on behalf of the corporation—be given preclusive effect to bar future suit by other shareholders?¹⁷ Preclusion on this basis is even more puzzling given the strong presumption against nonparty preclusion articulated by the Supreme Court in *Taylor v. Sturgell*, which described the rule against nonparty preclusion as one of constitutional dimensions, implicating due process.¹⁸ How do we square the outcomes in cases like *Wal-Mart II* with the general rule that binding nonparties to a judgment violates due process? Next, consider the clearly inconsistent treatment of the class action, a close cousin of the derivative action. Despite the shared attributes between class actions and derivative actions, particularly the mechanism for establishing representative authority, preclusion is applied very differently. Whereas it is settled law that a denial of certification is binding only as to the named plaintiff in a putative class action,¹⁹ most jurisdictions treat dismissal of a derivative suit on demand grounds as binding on all other shareholders.²⁰

A rule that would resolve these inconsistencies was proposed by the Chancery Court in *Wal-Mart I*, based on reasoning articulated in dicta in the unrelated case, *In re EZCORP Inc. Consulting Agreement*

¹⁶ See *Wal-Mart II*, 179 A.3d at 830, 832–33; see also *Pyott*, 74 A.3d at 615 (dismissing under similar circumstances to *Wal-Mart II*).

¹⁷ See Lawrence A. Hamermesh & Jacob J. Fedechko, *Forum Shopping in the Bargain Aisle: Wal-Mart and the Role of Adequacy of Representation in Shareholder Litigation*, in RESEARCH HANDBOOK ON REPRESENTATIVE SHAREHOLDER LITIGATION 156, 173 (Sean Griffith et al. eds., 2018) (highlighting a paradox where “the preclusive order denied a stockholder the opportunity to represent the class or corporation, but absentees are bound because that stockholder represented the class or corporation”).

¹⁸ See *Taylor v. Sturgell*, 553 U.S. 880, 901 (2008) (“[O]ur decisions emphasize the fundamental nature of the general rule that a litigant is not bound by a judgment to which she was not a party.”). In *Taylor*, the plaintiff, a “close associate” of the party to a prior unsuccessful action under the Freedom of Information Act (FOIA), brought a subsequent FOIA suit requesting the same documents, represented by the same lawyer. *Id.* at 887, 889. The district and circuit courts held that Taylor was a “virtual representative” of the prior plaintiff and thus collaterally estopped by the prior judgment. *See id.* at 889. The Supreme Court rejected the doctrine of preclusion by “virtual representation,” which would have allowed nonparty preclusion based on an “identity of interests.” *See id.* at 898–904.

¹⁹ See *Smith v. Bayer Corp.*, 564 U.S. 299, 315 (2011) (“Neither a proposed class action nor a rejected class action may bind nonparties.”).

²⁰ See *Wal-Mart II*, 179 A.3d at 840 (“Most other cases on this issue have granted preclusive effect to a prior court’s decision on demand futility, though many of these opinions do not expressly address Due Process.”).

*Derivative Litigation.*²¹ Focusing on the dual nature of derivative actions—first establishing the plaintiff’s right to bring suit and next litigating the merits of the underlying claims—Vice Chancellor Laster suggested in *EZCORP* that precluding subsequent shareholders from bringing suit, where the prior suit was voluntarily dismissed prior to establishing demand, would violate due process.²² Based on this reasoning, Chancellor Bouchard of the Delaware Chancery Court proposed a rule in *Wal-Mart I* that would deny preclusive effect to judgments dismissing derivative actions on demand grounds.

While the Delaware Supreme Court declined to adopt the proposal in *Wal-Mart*,²³ an analysis of the Delaware Supreme Court’s decision suggests that Chancellor Bouchard’s proposal may have been the right rule at the wrong time.²⁴ This Note proposes adopting the rule presented in *Wal-Mart I* as Delaware’s preclusion law in derivative suits, arguing that the current treatment of nonparty preclusion in derivative shareholder suits is incompatible with the strong presumption against nonparty preclusion and inconsistent with the treatment of a related mechanism: the class action. In doing so, this Note advocates for an approach to nonparty issue preclusion that would deny preclusive effect to putative derivative suits dismissed prior to satisfaction of the demand requirement.

Part I will lay out the relevant background, particularly the mechanism of derivative shareholder suits and the doctrine of issue preclusion. Part II will provide a critical analysis of the current practice in most jurisdictions of giving preclusive effect to putative derivative shareholder actions dismissed at the demand phase. Part III will draw upon an analogy to class actions to advocate for an approach introduced in dicta in *EZCORP* and proposed—but rejected—in *Wal-Mart II*, that would deny preclusive effect to judgments in derivative shareholder suits dismissed at the demand stage. Part IV addresses the practical implications of the rule proposed in Part III.

²¹ See *In re Wal-Mart Stores, Inc. Del. Derivative Litig.*, 167 A.3d 513, 516 (*Wal-Mart I*) (Del. Ch. 2017) (“I recommend that the Supreme Court adopt the rule proposed in *EZCORP*.”); *In re EZCORP Inc. Consulting Agreement Derivative Litig.*, 130 A.3d 934, 949 (Del. Ch. 2016) (explaining that the Due Process Clause “forecloses a judgment in a derivative action that is entered before the stockholder plaintiff acquires authority to litigate on behalf of the corporation from binding anyone other than the named stockholder plaintiff”).

²² *In re EZCORP, Inc.*, 130 A.3d at 949.

²³ See *Wal-Mart II*, 179 A.3d at 840 (“We decline to embrace [Chancellor Bouchard’s] suggestion that the *EZCORP* approach become the law governing the preclusive effect of prior determinations of demand futility . . .”).

²⁴ See *infra* Part III (discussing *Wal-Mart II* decision and advocating adoption of *EZCORP* approach).

I

DERIVATIVE SHAREHOLDER ACTIONS AND ISSUE PRECLUSION

A basic review of corporate law and due process principles is necessary to contextualize the problems posed by derivative shareholder actions for courts applying issue preclusion. This Part will provide a general overview of the relevant background, particularly the mechanism of derivative shareholder suits and the general rule against non-party preclusion and its exceptions to introduce the unique problems that derivative shareholder actions pose for courts applying issue preclusion.

A. *Derivative Shareholder Suits: The Demand Requirement and Futility*

The derivative shareholder suit is a mechanism that exists to reconcile the idea of the corporation as an independent legal entity with the reality that a corporate entity is composed of and controlled by individual actors.²⁵ The basic premise of the derivative action is that where a corporation has been wronged in some way but cannot, or will not, take action against its own directors, shareholders can sue on the corporation's behalf to seek the appropriate legal remedy.²⁶ Because the cause of action results from an injury to the corporation, the corporation itself owns these claims and receives any recovery awarded in the action.²⁷ As such, the decision of whether or not to pursue a claim belongs to the corporation itself, which is managed by its directors and officers.²⁸

The plaintiff in a derivative suit establishes authority to bring the action on behalf of the corporation by displacing the Board of

²⁵ See George S. Geis, *Shareholder Derivative Litigation and the Preclusion Problem*, 100 VA. L. REV. 261, 271 (2014) ("The inelegant governance compromise is the shareholder derivative lawsuit: the right of an individual shareholder to prosecute a claim on behalf of the company when something seems rotten in the boardroom.").

²⁶ See *id.* at 270–71.

²⁷ *E.g.*, *Wal-Mart II*, 179 A.3d at 846 ("The corporation is always the sole owner of the claims."). The derivative shareholder suit is not to be confused with the direct shareholder suit, by which shareholders directly seek remedy for violation of their individual rights as shareholders. A direct shareholder suit is analogous to a shareholder class action and does not present the problems discussed in this Note.

²⁸ In shareholder derivative suits, the derivative plaintiff is asserting injury on behalf of the corporation and is therefore required to demand that the board address this injury. See DEL. CH. CT. R. 23.1(a) ("The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiffs' failure to obtain the action or for not making the effort."); see also FED. R. CIV. P. 23.1(b)(3) (requiring particularized pleading like that required in Delaware in derivative actions).

Directors as the proper plaintiff in the action. Past opinions by the Delaware Chancery Court have referred to the twofold nature of derivative litigation.²⁹ In the first phase of a derivative action, “the stockholder sues individually to obtain authority to assert the corporation’s claim” and is permitted to litigate only the Board’s capacity to control the corporation’s claim.³⁰ A shareholder bringing a derivative claim is not deemed to be acting on behalf of the corporation until a court has found the Board could not or would not have acted on its own.³¹ In order for a shareholder action to be upheld as a properly brought derivative action, the plaintiff must establish authority to sue on behalf of the corporation.³² This can be done by establishing that the Board of Directors for the corporation is incapable or unwilling to take protective action on behalf of the corporation.³³

Under the demand requirement, a plaintiff must plead particularized facts regarding steps taken to obtain relief directly from the directors or explain the failure to do so, including the futility of making demand upon the Board of Directors.³⁴ Where a shareholder has made a demand upon the corporation’s Board of Directors and the Board has assumed responsibility for the action on behalf of the corporation, the shareholder is not authorized to bring a derivative action.³⁵

Where the shareholder has made a demand upon the Board and the Board has declined to act, the shareholder may proceed in bringing the action if she can establish that demand was wrongfully

²⁹ See, e.g., *In re EZCORP Inc. Consulting Agreement Derivative Litig.*, 130 A.3d 934, 944 (Del. Ch. 2016).

³⁰ *Id.* at 945.

³¹ See *id.* (“[U]ntil the derivative action passes the Rule 23.1 stage, the named plaintiff does not have authority to sue on behalf of the corporation or anyone else.”).

³² See Geis, *supra* note 25, at 272–75 (introducing demand requirement and futility exception).

³³ See *id.* at 274–75 (discussing futility).

³⁴ See DEL. CH. CT. R. 23.1(a) (“The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff’s failure to obtain the action or for not making the effort.”); see also FED. R. CIV. P. 23.1(b)(3) (requiring a shareholder complaint to “state with particularity: (A) any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and (B) the reasons for not obtaining the action or not making the effort”).

³⁵ See Geis, *supra* note 25, at 273 (“If demand is made, control of the lawsuit passes to the board of directors, which is now entitled to decide whether to pursue the litigation.”). But see Thomas P. Kinney, Comment, *Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ. L. REV. 172, 176 (1994) (“Despite the possibility that a corporation may choose to accept demand and bring suit against the wrongdoers, the reality is that boards rarely do so.”).

denied.³⁶ By making a demand, the plaintiff is deemed to have conceded that the Board is independent.³⁷ Therefore, when a Board refuses a demand, a court will allow the plaintiff to challenge only the good faith and reasonableness of the Board's investigation.³⁸ Thus, in order to establish that demand was wrongfully denied, the plaintiff must establish that: (1) the Board failed to reasonably investigate whether bringing suit is in the corporation's best interest; or (2) that the Board did not act in good faith.³⁹ Where a plaintiff has made a demand on the Board of Directors, she has waived the argument that demand was excused as futile.⁴⁰

In practice, shareholders rarely make a demand, viewing demand futility as the only viable option for seeking to bring a derivative suit.⁴¹ A shareholder-plaintiff will typically "seek to maintain control of the lawsuit by insisting that demand is excused as futile under the facts and circumstances of the case."⁴² To assert demand futility, a plaintiff will attempt to demonstrate that demand is excused because it would have been futile, meaning that the Board lacks independence, is entrenched, or is otherwise incapable of making sound litigation decisions on behalf of the corporation.⁴³ While the contours of this inquiry may differ slightly from state to state, there are three generally accepted sets of circumstances that, if established, will excuse demand as futile:

- (1) a majority of directors are self-interested in a transaction at issue;
- (2) a majority of directors are unable to evaluate the disputed transaction with independence because they are controlled or dominated by a self-interested insider; or

³⁶ Ala. By-Prod. Corp. v. Cede & Co. *ex rel.* Shearson Lehman Bros., 657 A.2d 254, 265 (Del. 1995) (citing Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993)) ("Chancery Rule 23.1 limits the right of a shareholder to prosecute a derivative suit to those situations where the stockholder has demanded that the board pursue a corporate claim and is met with a wrongful refusal, or where demand is excused because the directors are incapable of reaching an impartial decision to pursue such litigation.").

³⁷ Levine v. Smith, 591 A.2d 194, 212 (Del. 1991) ("A shareholder plaintiff, by making demand upon a board before filing suit, 'tacitly concedes the independence of a majority of the board to respond.'" (quoting Spiegel v. Buntrock, 571 A.2d 767, 777 (Del. 1990))).

³⁸ Spiegel, 571 A.2d at 777.

³⁹ *Id.*

⁴⁰ See Geis, *supra* note 25, at 274 ("A shareholder who does make demand cannot later argue that demand should have been excused as futile. She is understood to have conceded that demand was required.").

⁴¹ *Id.* at 273; Kinney, *supra* note 35, at 177 ("[M]any plaintiffs now avoid demand by filing suit and pleading to the court that demand would have been futile.").

⁴² Geis, *supra* note 25, at 273.

⁴³ See *id.* at 274–75 (discussing futility).

(3) the challenged transaction is so egregious on its face that it could not have been the product of a sound business judgment of the directors.⁴⁴

Defendants will almost invariably make a motion to dismiss a derivative suit for failure to make pre-suit demand.⁴⁵ If the court finds that the plaintiff has failed to satisfy the demand requirement, either by failing to make a demand on the Board or failing to establish demand futility, the derivative suit must be dismissed.⁴⁶ The basis of this dismissal is that the plaintiffs in the action have not shown that they have authority to bring these claims on behalf of the corporation.⁴⁷ As the plaintiff bears the burden of pleading demand or establishing demand futility, dismissal for failure to make demand means that the suit fails because the plaintiff has not met her burden of showing that the directors were not independent. As such, dismissal on this basis does not mean that the court has concluded that the directors were independent, just that the court has not found a basis to rebut the presumption of independence.⁴⁸ Thus, that the first plaintiff has failed to show demand futility does not necessarily mean that a future plaintiff could not have established demand futility in a future action if allowed to proceed.⁴⁹

B. Issue Preclusion: The Rule Against Nonparty Preclusion and Its Exceptions

Dismissal of a shareholder's derivative claim for failure to satisfy the demand requirement raises questions as to the preclusive effect of such dismissal on the issue of demand futility in derivative suits subse-

⁴⁴ *Id.* (citing *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993)).

⁴⁵ *See id.* at 273 (“[T]he corporation (acting through the insiders) will typically file a motion to dismiss the case for failure to make demand.”); *Kinney*, *supra* note 35, at 176 (noting that the “corporation usually moves to dismiss”).

⁴⁶ *See Kinney*, *supra* note 35, at 176 (noting that the court must grant the corporation's motion to dismiss if the shareholder cannot overcome the presumption of the business judgment rule: “in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company” (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (internal quotations omitted))).

⁴⁷ *See Geis*, *supra* note 25, at 275 (explaining that surviving dismissal at the demand stage allows a shareholder to keep control of the lawsuit).

⁴⁸ *See Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048–49 (Del. 2004) (“[T]he directors are entitled to a presumption that they were faithful to their fiduciary duties. In the context of presuit demand, the burden is upon the plaintiff in a derivative action to overcome that presumption.”).

⁴⁹ *See Gabriela Jara*, Note, *Following on the Foreign Corrupt Practices Act: The Dynamic Shareholder Derivative Suit*, 63 DUKE L.J. 199, 234–35 (2013) (“[L]ater plaintiffs [may] allege different facts that could excuse demand if those facts were previously available.”).

quently filed by other shareholders. Issue preclusion, also known as collateral estoppel, bars relitigation of issues of law or fact actually litigated in a prior suit between the same parties.⁵⁰ Issue preclusion operates as an affirmative defense, and, as such, the party claiming preclusion in an action bears the burden of pleading and proving the defense.⁵¹ Application of issue preclusion requires four elements:

(1) the issue sought to be precluded must be the same as that involved in the prior litigation; (2) that issue must have been actually 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.⁵²

Even where the four elements are met, application of issue preclusion is subject to due process limitations.⁵³

Issue preclusion naturally implicates the Due Process Clause of the Fourteenth Amendment, which provides that no state shall “deprive any person of life, liberty, or property without due process of law.”⁵⁴ Issue preclusion is justified by the presumption that a party to an earlier lawsuit has had a “full and fair opportunity to litigate” and the policy rationale of avoiding “the expense and vexation attending multiple lawsuits, conserving judicial resources, and fostering reliance on judicial action by minimizing the possibility of inconsistent decisions.”⁵⁵ As nonparties typically are not afforded a “full and fair opportunity to litigate” claims and issues settled in a suit to which they are not a party, application of issue preclusion against nonparties naturally runs up against the protections of the Due Process Clause—namely, the “opportunity to be heard” and the “deep-rooted historic

⁵⁰ See *Kremer v. Chem. Constr. Corp.*, 456 U.S. 461, 466 n.6 (1982) (“Under collateral estoppel, once a court decides an issue of fact or law necessary to its judgment, that decision precludes relitigation of the same issue on a different cause of action between the same parties.”); RESTATEMENT (SECOND) OF JUDGMENTS § 27 (AM. LAW INST. 1982) (“When an issue of fact or law is actually litigated and determined by a valid and final judgment, and the determination is essential to the judgment, the determination is conclusive in a subsequent action between the parties, whether on the same or a different claim.”).

⁵¹ See *Taylor v. Sturgell*, 553 U.S. 880, 907 (2008) (“[A] party asserting preclusion must carry the burden of establishing all necessary elements.” (quoting 18 CHARLES A. WRIGHT & ARTHUR R. MILLER, *FEDERAL PRACTICE AND PROCEDURE* § 4405, at 83 (2d ed. 2002) (alteration in original))).

⁵² *Wal-Mart II*, 179 A.3d 824, 830, 843 (Del. 2018) (quoting *Riverdale Dev. Co. v. Ruffin Bldg. Sys., Inc.*, 146 S.W.3d 852, 855 (Ark. 2004)).

⁵³ See *Kremer*, 456 U.S. at 482 (“A State may not grant preclusive effect in its own courts to a constitutionally infirm judgment, and other state and federal courts are not required to accord full faith and credit to such a judgment.”).

⁵⁴ U.S. CONST. amend. XIV, § 1.

⁵⁵ *Montana v. United States*, 440 U.S. 147, 153–54 (1979).

tradition that everyone should have his own day in court.”⁵⁶ Accordingly, the Supreme Court has held that, as a general matter, nonparty preclusion violates the Due Process Clause of the United States Constitution.⁵⁷ As such, under the general rule of nonparty preclusion, “one is not bound by a judgment *in personam* in a litigation in which he is not designated as a party or to which he has not been made a party by service of process.”⁵⁸

The general rule against nonparty preclusion is subject to exceptions, where nonparty preclusion does not violate the Due Process Clause. The Supreme Court in *Taylor v. Sturgell*, 553 U.S. 880 (2008), provided some guidance on which actions may justify an exception to the rule against preclusion of nonparties. In *Taylor*, the Government argued that Taylor’s Freedom of Information Act (FOIA) suit was collaterally estopped by an adverse judgment in a prior action brought by a “close associate,” who had requested the same documents and been represented by the same counsel. The district and circuit courts held that Taylor, though not a party to the prior action, was a “virtual representative” of the prior plaintiff and thus collaterally estopped by the prior judgment.⁵⁹ In rejecting the doctrine of preclusion by “virtual representation,” the Supreme Court set forth a non-exhaustive list of categories of exceptions to the general rule against nonparty preclusion where the party to be precluded:

- (1) Agreed to be precluded by contract;
- (2) Had a pre-existing substantive legal relationship with the prior litigant;
- (3) Was adequately represented by the prior litigant who shared its interests;
- (4) Assumed control over the prior litigation;

⁵⁶ *Richards v. Jefferson County*, 517 U.S. 793, 798 (1996) (quoting 18 CHARLES A. WRIGHT, ARTHUR R. MILLER & EDWARD H. COOPER, FEDERAL PRACTICE AND PROCEDURE, § 4449, at 417 (1981)) (internal quotation marks omitted); see also *id.* at 797 n.4 (noting that the state “cannot, without disregarding the requirement of due process, give a conclusive effect to a prior judgment against one who is neither a party nor in privity with a party therein.” (quoting *Postal Tel. Cable Co. v. City of Newport*, 247 U.S. 464, 476 (1918))).

⁵⁷ See *Taylor v. Sturgell*, 553 U.S. 880, 893 (2008) (noting that the rule against nonparty preclusion is “hardly in doubt”).

⁵⁸ *Id.* at 893 (quoting *Hansberry v. Lee*, 311 U.S. 32, 40 (1940) (internal quotation marks omitted)); see also 18A CHARLES A. WRIGHT, ARTHUR R. MILLER & EDWARD H. COOPER, FEDERAL PRACTICE AND PROCEDURE § 4449, Westlaw (database updated Apr. 2019) (“The basic premise of preclusion is that parties to a prior action are bound and nonparties are not bound.”); RESTATEMENT (SECOND) JUDGMENTS § 34 cmt. a (AM. LAW INST. 1982) (noting that this principle “is of constitutional dimension” and citing authorities).

⁵⁹ See *Taylor*, 553 U.S. at 889.

- (5) Is attempting to act as a proxy for the prior litigant seeking to relitigate a given issue; or
 (6) Is expressly prohibited by a statutory scheme that complies with Due Process.⁶⁰

Nonparty preclusion is permitted in the context of representative actions under the third of the exceptions identified in *Taylor*—“in certain limited circumstances” where a nonparty was “adequately represented by someone with the same interests who [was] a party” to the suit.⁶¹ Thus, the third *Taylor* exception “has two prongs: (a) same interests, and (b) adequate representation of those interests.”⁶² The Supreme Court has held that representation of a nonparty is “‘adequate’ for preclusion purposes only if, at a minimum: (1) the interests of the nonparty and her representative are aligned . . . ; and (2) either the party understood herself to be acting in a representative capacity or the original court took care to protect the interests of the nonparty.”⁶³ Additionally, the Supreme Court has held that “adequate representation sometimes requires . . . notice of the original suit to the persons alleged to have been represented.”⁶⁴ Courts applying nonparty preclusion in the derivative context have relied on *Taylor*’s third exception to justify precluding successive sets of derivative plaintiffs.⁶⁵

C. *Preclusive Effect of Dismissal on Demand Grounds*

Dismissal of a derivative claim by shareholders for failure to make a demand raises questions as to the preclusive effect of such dismissal. In dismissing a derivative shareholder action for failure to make demand, the court is essentially finding that the plaintiffs lack the authority to bring this case on behalf of the corporation.⁶⁶ Because the plaintiffs have not successfully brought a case on behalf of the corporation, it follows that the corporation is not formally a party to the action before the court. Under this formulation, the applicable parties and relationship to review in applying issue preclusion rules in

⁶⁰ *Id.* at 893–95.

⁶¹ *Id.* at 894 (alteration in original) (quoting *Richards*, 517 U.S. at 798) (internal quotation marks omitted).

⁶² *Wal-Mart II*, 179 A.3d 824, 850 (Del. 2018).

⁶³ *Taylor*, 553 U.S. at 900 (citations omitted).

⁶⁴ *Id.* (citing *Richards*, 517 U.S. at 801–02).

⁶⁵ *See, e.g.,* *Arduini v. Hart*, 774 F.3d 622, 633–34 (9th Cir. 2014); *cf. In re Sonus Networks, Inc. S’holder Derivative Litig.*, 499 F.3d 47, 64 (1st Cir. 2007) (“However established the principle that the same party, the corporation, has sued in each derivative action, it is subject to an important caveat: to bind the corporation, the shareholder plaintiff must have adequately represented the interests of the corporation.”); *Nathan v. Rowan*, 651 F.2d 1223, 1226–28 (6th Cir. 1981) (finding adequate representation in a former shareholder’s derivative suit and precluding future claims).

⁶⁶ *See supra* text accompanying notes 46–49.

a subsequent putative derivative action would be the shareholder-plaintiff in the prior action and the shareholder-plaintiff seeking to bring the subsequent action. Here, the court looks to whether the subsequent plaintiff shares the same interests and was adequately represented by the prior plaintiff such that the subsequent plaintiff, a nonparty to the prior action, can properly be precluded from bringing a subsequent action under the third exception of *Taylor*.⁶⁷ Thus, the inquiry in nonparty preclusion in this context boils down to whether the prior and subsequent plaintiffs are in privity with one another and whether the prior plaintiff was an adequate representative of the subsequent plaintiff.⁶⁸

II

NONPARTY PRECLUSION IN DERIVATIVE ACTIONS DISMISSED PRE-DEMAND

This Part will provide a critical analysis of the current practice of applying issue preclusion to derivative actions dismissed for failure to make demand. Courts in most jurisdictions have granted preclusive effect to putative derivative shareholder actions dismissed at the demand phase, allowing preclusion of subsequent derivative suits brought by other shareholders. In such cases, courts never reach the merits of the underlying claims. Thus, the current scheme allows issue preclusion, initially meant as a narrow exception to prevent waste of judicial resources, to be employed to dismiss and preclude otherwise meritorious claims brought by shareholder-plaintiffs.

A. Current Treatment

The Supreme Court has characterized the rule that “[a] court’s judgment binds only the parties to a suit, subject to a handful of *discrete and limited exceptions*” as a “basic premise of preclusion law.”⁶⁹ While the rule against nonparty preclusion is subject to exceptions, the Supreme Court has emphasized that those exceptions are narrow, stating that “[t]he importance of this rule and the narrowness of its exceptions go hand in hand.”⁷⁰ The rejection of the virtual representation theory in *Taylor v. Sturgell*⁷¹ underscores this point. In *Taylor*, the defendant proposed to bind nonparties under a theory of “virtual representation” based on “identity of interests and some kind of rela-

⁶⁷ See *infra* text accompanying notes 79–92.

⁶⁸ See *infra* text accompanying notes 79–92.

⁶⁹ *Smith v. Bayer Corp.*, 564 U.S. 299, 312 (2011) (emphasis added).

⁷⁰ *Id.* at 312–13.

⁷¹ 553 U.S. 880 (2008).

tionship between parties and nonparties.”⁷² Noting that such a theory would allow circumvention of procedural protections for nonparties grounded in due process, the Supreme Court unanimously rejected the virtual representation theory.⁷³ The Supreme Court reiterated this point in *Smith v. Bayer*⁷⁴ a few years later. In *Smith*, the Court considered whether a prior denial of class certification in a case brought by an unrelated party could preclude a subsequent plaintiff from seeking class certification on the same claims.⁷⁵ The Court stated: “We have repeatedly ‘emphasize[d] the fundamental nature of the general rule’ that only parties can be bound by prior judgments; accordingly, we have taken a ‘constrained approach to nonparty preclusion.’”⁷⁶

For derivative suits, current practice in most jurisdictions stands in stark contrast to the Supreme Court’s cautious approach to nonparty preclusion in *Taylor* and to the established approach for class actions as observed in *Smith*.⁷⁷ Whereas courts applying this exception within the class action context have required certification of the class action before granting preclusive effect to a judgment in the case, courts overseeing putative derivative actions have granted preclusive effect to judgments in prior putative derivative suits dismissed at the demand futility stage.⁷⁸

Much of the current treatment of derivative suits dismissed for failure to make demand turns on the notion of “privity.”⁷⁹ Often characterized as amorphous and unwieldy,⁸⁰ the runaway conception of

⁷² *Id.* at 901.

⁷³ *Id.* at 904.

⁷⁴ 564 U.S. 299 (2011).

⁷⁵ See *Smith*, 564 U.S. at 307 (“The question here is whether the federal court’s rejection of McCollins’ proposed class precluded a later adjudication motion.”).

⁷⁶ *Id.* at 313 (quoting *Taylor*, 553 U.S. at 898).

⁷⁷ See *infra* Part III.

⁷⁸ Compare *Smith*, 564 U.S. at 315 (“[I]n the absence of a certification under [Rule 23], the precondition for binding *Smith* was not met. Neither a proposed class action nor a rejected class action may bind nonparties.”), with *Arduini v. Hart*, 774 F.3d 622, 634 (9th Cir. 2014) (affirming dismissal of a putative derivative action on preclusion grounds based on dismissal of a prior action for failure to allege demand futility), and *In re Sonus Networks, Inc. S’holder Derivative Litig.*, 499 F.3d 47, 56 (1st Cir. 2007) (same).

⁷⁹ See generally *Developments in the Law—Res Judicata*, 65 HARV. L. REV. 818, 855 (1952) (describing persons affected by a judgment); John K. Morris, Comment, *Nonparties and Preclusion by Judgment: The Privity Rule Reconsidered*, CALIF. L. REV. 1098, 1101 (1968) (“Traditionally, the determination of who will be bound by a judgment has been made with reference to the privity standard: A party cannot assert a prior judgment against one who was not a party or in ‘privity’ with a party to the prior action.”).

⁸⁰ See, e.g., *Wal-Mart II*, 179 A.3d 824, 837 (Del. 2018) (“[Privity] has been used to cover a range of different relationships and . . . has referred to substantive legal relationships justifying preclusion and, alternatively, the term has also been used more broadly ‘as a way to express the conclusion that nonparty preclusion is appropriate on any

privity remains in use under many states' laws.⁸¹ While the Restatement of Judgments and the Supreme Court have abandoned the term "privity,"⁸² many jurisdictions continue to rely on this amorphous concept to justify nonparty preclusion in derivative shareholder suits.

But what exactly is "privity," and how does it factor into the analysis handed down by the Supreme Court? One judge, in an oft-quoted discussion, suggested that "privity" is a term referring to the conclusion that interests between two entities is such that preclusion of the nonparty based on its relationship with the related party would not offend due process.⁸³ Under the current state of the law in most jurisdictions, a stockholder who files a derivative action is deemed to be in privity with all other stockholders of the corporation he purports to represent.⁸⁴ This "automatic" finding of privity between shareholders of a corporation is based on the idea that the corporation is the true claimant in the underlying action. Under this line of reasoning, shareholder-plaintiffs are in privity with one another because they seek to bring claims by and in the right of the same real party in interest.⁸⁵

Once a court presiding over a subsequent action has found privity, it undertakes a bare-bones check for adequacy of representation. The Supreme Court has held that representation of a nonparty is

ground.'" (quoting *Taylor*, 553 U.S. at 894 n.8)); see also *Richards v. Jefferson County*, 517 U.S. 793, 798 (1996) ("[T]he term 'privity' is now used to describe various relationships between litigants that would not have come within the traditional definition of that term.").

⁸¹ See, e.g., *Pyott v. La. Mun. Police Emps.' Ret. Sys.*, 74 A.3d 612, 614 (Del. 2013) ("Under California law, which controls on this issue, derivative stockholders are in privity with each other because they act on behalf of the defendant corporation."); *Wal-Mart II*, 179 A.3d at 843 (identifying privity as an element of issue preclusion under Arkansas law).

⁸² *Wal-Mart II*, 179 A.3d at 845–46 ("[T]he United States Supreme Court has abandoned the term 'privity.'").

⁸³ *Bruszewski v. United States*, 181 F.2d 419, 423 (3d Cir. 1950) (Goodrich, J., concurring). The commentators have agreed. See RESTATEMENT OF JUDGMENTS § 83 cmt. a (AM. LAW INST. 1942); Allan D. Vestal, *Preclusion/Res Judicata Variables: Parties*, 50 IOWA L. REV. 27, 45 (1964); *Developments in the Law—Res Judicata*, *supra* note 79, at 855–56.

⁸⁴ See, e.g., *Wal-Mart I*, 167 A.3d 513, 528–29 (Del. Ch. 2017).

⁸⁵ See *Pyott*, 74 A.3d at 617 ("[B]ecause the real plaintiff in a derivative suit is the corporation, 'differing groups of shareholders who can potentially stand in a corporation's stead are in privity for the purposes of issue preclusion.'" (quoting *LeBoyer v. Greenspan*, No. CV 03-5603-GHK (JTLx), 2007 WL 4287646, at *3 (C.D. Cal. June 12, 2007))); see also *Parkoff v. Gen. Tel. & Elecs. Corp.*, 425 N.E.2d 820, 824 (N.Y. 1981) ("Because the claim asserted in a stockholder's derivative action is a claim belonging to and on behalf of the corporation, a judgment rendered in such an action brought on behalf of the corporation by one shareholder will generally be effective to preclude other actions predicated on the same wrong brought by other shareholders.").

“‘adequate’ for preclusion purposes only if, at a minimum: (1) the interests of the nonparty and her representative are aligned; and (2) either the party understood herself to be acting in a representative capacity or the original court took care to protect the interests of the nonparty.”⁸⁶ Somehow, state courts and federal district courts appear to have converted these minimum requirements into an inverse presumption. Rather than requiring a showing of adequate representation, the courts presume there is adequate representation unless the party to be precluded can prove inadequate representation.⁸⁷ This stands in stark contrast to the careful review that adequacy of representation receives in the class action context.⁸⁸ Whereas a purported class representative in a class action must affirmatively establish her adequacy in order to obtain class certification, a putative derivative plaintiff is presumed to be adequate with the burden on the defendant to show that the plaintiff is not an adequate representative.⁸⁹ The adequacy of the named plaintiff’s representation is only evaluated on the back-end by a court applying issue preclusion in a subsequent case.⁹⁰ And even when a court does undertake an evaluation of adequacy of representation on the back-end, the standard applied—the “grossly deficient” standard—sets a relatively high bar for challenging the adequacy of representation.⁹¹ The practical result is an “automatic privity rule,” with a low standard for finding adequacy of representation and a high bar for challenging that finding.⁹²

Courts have not scrutinized application of the third *Taylor* exception to the rule against nonparty preclusion in derivative actions to

⁸⁶ *Taylor v. Sturgell*, 553 U.S. 880, 900 (2008) (first citing *Hansberry v. Lee*, 311 U.S. 32, 43 (1940); then citing *Richards v. Jefferson County*, 517 U.S. 793, 801 (1996)).

⁸⁷ See *Wal-Mart II*, 179 A.3d at 853 (“[T]he Arkansas Plaintiffs were adequate representatives because . . . (i) the quality of their representative was not grossly deficient, and (ii) their economic interests were not antagonistic to other stockholders.”); *Wal-Mart I*, 167 A.3d at 527 (“[D]isparity between class and derivative actions in terms of how adequacy of representation is assessed in practice.”); RESTATEMENT (SECOND) OF JUDGMENTS § 42 cmt. f (AM. LAW INST. 1982) (noting that representation is inadequate “[w]here the representative’s management of the litigation is so grossly deficient as to be apparent to the opposing party”).

⁸⁸ See *Wal-Mart I*, 167 A.3d at 527–28 (“[I]n the class action context, the purported class representative has to affirmatively demonstrate his adequacy in order to obtain certification. In a derivative action, by comparison, the burden is on the defendant to show that the plaintiff is an inadequate representative.”).

⁸⁹ See *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 592–93 n.15 (5th Cir. 1974) (holding that under Federal Rule of Civil Procedure 23.1, the “burden is on the defendants to obtain a finding of inadequate representation”); see also 7C CHARLES A. WRIGHT, ARTHUR R. MILLER & MARY K. KANE, FEDERAL PRACTICE AND PROCEDURE § 1834, Westlaw (database updated Apr. 2019) (discussing equitable defenses).

⁹⁰ *Wal-Mart I*, 167 A.3d at 527–29.

⁹¹ *Id.* at 528–29 (noting that the “grossly deficient” standard is a high standard).

⁹² See *id.* (internal quotation marks omitted).

establish that the third exception applies. Based on the Supreme Court's holding in *Taylor*, there is a plausible argument that a derivative shareholder suit dismissed at the demand stage does not fall within the third *Taylor* exception. Notably, the language used to justify binding a subsequent derivative shareholder plaintiff—"identity of interests"—was also used to describe the relationship between Herrick and Taylor, the prior and subsequent plaintiffs in *Taylor*.⁹³ While the Supreme Court has emphasized that the rule against nonparty preclusion is a strong rule, implicating constitutional concerns and with only narrow exceptions,⁹⁴ state courts and lower federal courts have essentially assumed that the representative action exception applies to derivative suits, in contrast to the strong presumption against nonparty preclusion and without addressing the inconsistency in the treatment of class actions and derivative actions. What is happening in the derivative context—an auto-privy rule with a low bar for finding adequacy of representation—may be exactly the "common-law kind of class action" that the Supreme Court unanimously rejected in *Taylor*.⁹⁵ Based on the Supreme Court's cautious approach to preclusion—a strong rule against nonparty preclusion with narrowly defined exceptions—any doubt as to propriety of nonparty preclusion should counsel courts to err on the side of disallowing preclusion.

B. Practical Implications

*Wal-Mart II*⁹⁶ presents an illustration of the quintessential policy problems posed by the existing jurisprudence—perverse incentives for ambitious plaintiffs' lawyers to engage in fast-filing practices.⁹⁷ In *Wal-Mart*, it was supposed that the Delaware plaintiffs had engaged in higher-quality lawyering and a more comprehensive discovery process and thereby had a greater likelihood of success on the merits than did the Arkansas plaintiffs, who had rushed to file their papers without

⁹³ See *Smith v. Bayer Corp.*, 564 U.S. 299, 315 (2011) (describing the question in *Taylor* as concerning the "propriety of binding nonparties under a theory of 'virtual representation' based on 'identity of interests and some kind of relationship between parties and nonparties.'" (quoting *Taylor v. Sturgell*, 553 U.S. 880, 901 (2008))).

⁹⁴ See *id.* at 312–13.

⁹⁵ See *Taylor*, 553 U.S. at 901.

⁹⁶ 179 A.3d 824 (Del. 2018).

⁹⁷ See *Geis*, *supra* note 25, at 264–65 ("[A] strict collateral estoppel regime will amplify pressures for rapid filing, and this, in turn, may encourage shoddy claims that undermine the governance goals of derivative litigation."); see also Leo E. Strine, Jr., Lawrence A. Hammermesh & Matthew C. Jennejohn, *Putting Stockholders First, Not the First-Filed Complaint*, 69 *Bus. Law.* 1, 18 (2013) ("Plaintiff's counsel who opts for investigation and deliberation may find herself the 'loser' under rules of jurisdictional priority that favor the first-filed lawsuit.").

making the standard books and records demands.⁹⁸ After the Delaware plaintiffs completed discovery and filed a timely amended complaint in the action, the Chancery Court found the Delaware suit was precluded by the judgment in the parallel Arkansas action.⁹⁹ Despite claims about the caliber of the Arkansas plaintiffs' lawyering, the court found that the Arkansas action was litigated adequately enough to fairly bind the Delaware shareholder plaintiffs.¹⁰⁰ The Delaware Chancery Court scolded the plaintiffs' lawyers for both the Arkansas and Delaware shareholder-plaintiffs for their failure to coordinate.¹⁰¹ But the reality of derivative shareholder litigation is that plaintiffs' lawyers have incentives to race to file rather than coordinate and share legal fees with other plaintiff-side firms.¹⁰²

The current scheme incentivizes shareholders and plaintiffs' attorneys to file fast and reach a resolution quickly, even at the expense of forfeiting more comprehensive discovery that would lead to stronger claims, lest another plaintiff group file first and take control of the litigation. Filing fast does not necessarily mean filing well; it is likely, perhaps even inevitable, that plaintiffs' attorneys may sacrifice quality for speed in bringing derivative actions.¹⁰³ The current approach to preclusion may even encourage "patsy" lawsuits, where "an opportunistic company [may] 'sponsor' an ill-informed plaintiff to rush to the courthouse with a weak complaint in order to insulate the firm from legitimate derivative claims."¹⁰⁴ In this way, corporate insiders could conspire with accomplice shareholders to file unsubstantiated complaints that will preclude future suits once dismissed on demand futility grounds.¹⁰⁵

Learning from the lessons of cases like *Wal-Mart II*,¹⁰⁶ ambitious plaintiffs' attorneys may elect to bring suit in jurisdictions outside of

⁹⁸ *Wal-Mart II*, 179 A.3d at 853. The Delaware plaintiffs argued that the documents relied upon by the Arkansas plaintiffs did not address board-level conduct and that the Arkansas plaintiffs should have known they would be unable to meet the pleading requirements to establish demand futility. *Id.*

⁹⁹ *Id.* at 854.

¹⁰⁰ *Id.*

¹⁰¹ *See id.* at 832–33 n.29.

¹⁰² *Wal-Mart I*, 167 A.3d 513, 515 (Del. Ch. 2017) (describing the "fast-filer" phenomenon, where counsel handling cases on a contingent basis have a significant financial incentive to race to the courthouse in an effort to beat out their competition and seize control of a case, often at the expense of undertaking adequate due diligence").

¹⁰³ *See supra* note 97.

¹⁰⁴ Geis, *supra* note 25, at 264.

¹⁰⁵ *See id.* at 303.

¹⁰⁶ *See Wal-Mart II*, 179 A.3d at 831–33 (explaining that the Delaware Chancery Court instructed plaintiffs to make a required books and records demand, whereas the federal court in Arkansas allowed the suit to proceed without such discovery and ruled first); *Pyott v. La. Mun. Police Emps.' Ret. Sys.*, 74 A.3d 612, 615 (Del. 2013) (explaining that the

the Delaware Chancery Court, where courts may require less thorough discovery procedures.¹⁰⁷ Whereas Delaware courts have urged plaintiffs to use the “tools at hand”—namely, a demand for company books and records under Section 220 of the Delaware General Corporation Law¹⁰⁸—to substantiate their allegations before filing derivative complaints,¹⁰⁹ courts outside Delaware have not required such thorough discovery.¹¹⁰ The Delaware Supreme Court held in *Wal-Mart* that failure to seek corporate records before filing suit will not necessarily render representation in a prior action inadequate for preclusion purposes.¹¹¹ Thus, plaintiffs’ counsel may elect to bring derivative actions in jurisdictions outside of Delaware without undertaking the comprehensive discovery often required by the Delaware Chancery Court in order to reach resolution faster and take control of the corporation’s claim.¹¹² This poses a potential to destabilize Delaware’s position as the center of corporate law, a concern that is compounded by Delaware’s reputation for being notoriously conservative in awards and highly defendant friendly.¹¹³

After *Wal-Mart II*, an initial dismissal on demand futility would bind all other shareholders, collaterally estopping any future derivative lawsuits seeking to litigate demand futility.¹¹⁴ If the action is dis-

Delaware Chancery Court instructed plaintiffs to make a required books and records demand, whereas the federal district court in California required no such discovery and ruled first on demand futility).

¹⁰⁷ See Joseph M. McLaughlin & Shannon K. McGovern, *Preclusion in Derivative Litigation*, N.Y.L.J. (Feb. 7, 2018), <https://www.law.com/newyorklawjournal/sites/newyorklawjournal/2018/02/07/preclusion-in-derivative-litigation> (“[*Wal-Mart*] may prompt an increase in derivative litigation filings outside of Delaware. . . . Plaintiff’s counsel seeking to initiate the first-filed derivative suit regarding an alleged corporate claim may perceive advantage in proceeding outside of Delaware without any delay occasioned by a books and records demand.”).

¹⁰⁸ DEL. CODE ANN. tit. 8, § 220 (2017).

¹⁰⁹ See, e.g., *Wal-Mart II*, 179 A.3d at 839, 853 (“Delaware courts have repeatedly urged parties to use Section 220 to seek relevant books and records before filing derivative complaints.”).

¹¹⁰ See *id.* at 839 (“In contrast [to the Delaware Plaintiffs], the Arkansas Plaintiffs did not seek books and records, and their complaint was dismissed with prejudice.”); see also *Pyott*, 74 A.3d at 615 (explaining that the federal district court in California required no books and records demand and ruled first on demand futility).

¹¹¹ See *Wal-Mart II*, 179 A.3d at 854 (“Although it might have been a tactical error, the Arkansas Plaintiffs’ decision to forgo a Section 220 demand in this instance does not rise to the level of constitutional inadequacy.” (emphasis omitted)).

¹¹² See *supra* note 107 and accompanying text.

¹¹³ See *Fiscella*, *supra* note 15, at 688 (noting that shareholders are fleeing from Delaware courts because “the Delaware Court of Chancery, although highly revered for its expertise in corporate law, is also well-known for its conservative fee awards and harsh verdicts”).

¹¹⁴ See *id.* at 692 (“[W]eaker claims get through the courtroom doors, precluding more meritorious claims from being heard.”).

missed on grounds of failure to make demand, the underlying claims may never be adjudicated.¹¹⁵ Thus, issue preclusion, initially meant as a narrow exception to prevent waste of judicial resources, may be employed to dismiss and preclude otherwise meritorious claims.

III

LOGICAL EXTENSION OF *SMITH V. BAYER* TO DERIVATIVE ACTIONS

In exploring questions of preclusion in derivative shareholder actions, we can look to a related representative action—the class action—for guidance. A close cousin of the derivative action, the class action has enjoyed a comparative wealth of attention in legal literature.¹¹⁶ The guidelines governing class certification and the preclusive effect of judgments in class actions are well developed.¹¹⁷ While derivative suits are not identical to shareholder class actions, there are key similarities between derivative shareholder actions and class actions.¹¹⁸ The class action, like the derivative shareholder suit, is an equitable mechanism used to bring suit where alternative methods of doing so are impracticable.¹¹⁹ Both mechanisms are representative in nature, allowing a named plaintiff to bring suit on behalf of absent

¹¹⁵ See *id.*

¹¹⁶ See, e.g., Robert G. Bone, *The Puzzling Idea of Adjudicative Representation: Lessons for Aggregate Litigation and Class Actions*, 79 GEO. WASH. L. REV. 577 (2011) (describing what adequate representation means in class actions); Richard D. Freer, *Preclusion and the Denial of Class Certification: Avoiding the “Death by a Thousand Cuts,”* 99 IOWA L. REV. BULL. 85 (2014) (discussing problems with issue preclusion in class actions); Antonio Gidi, *Issue Preclusion Effect of Class Certification Orders*, 63 HASTINGS L.J. 1023 (2012) (analyzing issue preclusion in class actions).

¹¹⁷ See generally FED. R. CIV. P. 23 (federal procedural rule on class actions); DEL. CH. CT. R. 23 (Delaware procedural rule on class actions).

¹¹⁸ See *Wal-Mart I*, 167 A.3d 513, 525–27 (Del. Ch. 2017) (noting the similarities between class actions and derivative suits); *Parfi Holding AB v. Mirror Image Internet, Inc.*, 954 A.2d 911, 940 (Del. Ch. 2008) (“Although it is too often overlooked, derivative suits are a form of representative action. Indeed, they should be seen for what they are, a form of class action.”). But see Ángel Oquendo, *Six Degrees of Separation: From Derivative Suits to Shareholder Class Actions*, 48 WAKE FOREST L. REV. 643 (2013) (arguing that the derivative suit and class action mechanisms resemble each other only superficially but diverge on a deeper level). Acknowledging that there are indeed differences between derivative and class action suits, this Note focuses on the similarities and differences between the two mechanisms that are relevant for the purposes of ascertaining preclusive effect.

¹¹⁹ See Martin H. Redish & Megan B. Kiernan, *Avoiding Death by a Thousand Cuts: The Relitigation of Class Certification and the Realities of the Modern Class Action*, 99 IOWA L. REV. 1659, 1671 (2014) (“As a technical matter, at least, the class action is nothing more than an elaborate aggregation device established by the Federal Rules of Civil Procedure.”).

claimants.¹²⁰ Although it has long been overlooked, the class action device and the derivative action mechanism share a common history.¹²¹ In fact, the rules governing class actions and derivative actions in federal courts share a common ancestry. In the federal courts, derivative actions were conducted under Federal Rule 23, the same rule governing class actions, until 1966, when Federal Rule 23.1 was added to address derivative actions more specifically.¹²² Given the shared history and structural similarities between the two mechanisms, class actions provide a useful tool for comparison.

This Part will advocate for an approach proposed in *Wal-Mart* that draws upon an analogy to the related class action mechanism to deny preclusive effect to judgments in derivative shareholder suits dismissed at the demand stage.¹²³ While the conceptual inconsistencies and practical concerns highlighted in Part II apply generally across all jurisdictions, this Part focuses on Delaware as a case study, based on its preeminent position as a leader in corporate law, and proposes a change to Delaware's preclusion practice that would resolve these inconsistencies.

¹²⁰ Compare FED. R. CIV. P. 23 and DEL. CH. CT. R. 23 (permitting “[o]ne or more members of a class [to] sue or be sued as representative parties on behalf of all members” under certain circumstances), with FED. R. CIV. P. 23.1 (“[A] derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association.”) and DEL. CH. CT. R. 23.1 (permitting a shareholder to serve as a “representative plaintiff” on behalf of a corporation or unincorporated association).

¹²¹ See Ann M. Scarlett, *Shareholder Derivative Litigation's Historical and Normative Foundations*, 61 BUFF. L. REV. 837, 843 (2013) (“The shared history of these two forms of representative actions has long been overlooked, but . . . the shareholder derivative action is more closely related to the class action than is commonly recognized.”).

¹²² See FED. R. CIV. P. 23.1 advisory committee's note to 1966 amendment (“A derivative action by a shareholder of a corporation or by a member of an unincorporated association has distinctive aspects which require the special provisions set forth in the new rule.”).

¹²³ This Note relies on an analogy between class actions and derivative suits that has not been universally accepted in the legal literature. See, e.g., Oquendo, *supra* note 118, at 644 (describing competing views on how the derivative suit and class action mechanisms “coincide in their essence and differ only in their technical details” or “converge only formally, yet diverge critically”); see also Susanna M. Kim, *Conflicting Ideologies of Group Litigation: Who May Challenge Settlements in Class Actions and Derivative Suits?*, 66 TENN. L. REV. 81, 111–18 (1998) (distinguishing between class actions and derivative suits in the context of settlement challenges); Note, *Shareholder Derivative Suits: Are They Class Actions?*, 42 IOWA L. REV. 568, 570–72 (1957) (describing the “error in viewing a shareholder's derivative suit as a class action”). Thus, acceptance of the broader proposal set forth in Section III.B hinges on adoption of this controversial analogy.

A. Chancellor Bouchard's Proposal in Wal-Mart I

The Delaware plaintiffs in *Wal-Mart II* relied upon an analogy to class actions in bringing their appeal.¹²⁴ Under the Delaware plaintiffs' argument regarding privity, a subsequent derivative plaintiff lacks privity with an earlier derivative plaintiff who did not survive a motion to dismiss because that earlier derivative plaintiff was not designated as a representative by the court.¹²⁵ Just as in class actions, where such judicial designation or authority is conferred through the class certification procedures of Federal Rule of Civil Procedure 23 or the state law equivalent, the right of stockholders to try to sue derivatively cannot be extinguished by a foreign judgment if no representative authority was conferred.¹²⁶ Such representative authority is conferred only after the derivative complaint survives a motion to dismiss for failure to plead demand futility: "a stockholder's right to seek leave to compel assertion of the corporate claim is an individual one . . . and the plaintiff does not represent any person until obtaining that leave," i.e., by a court's finding that the plaintiff's complaint has survived a motion to dismiss.¹²⁷

Acknowledging the parallel between a pre-demand futility derivative action and a pre-certification class action, the Delaware Supreme Court originally remanded the case on appeal to the Chancery Court with instructions to entertain briefing on the shareholders' due process rights.¹²⁸ In particular, the court inquired whether the same reasoning in *Smith v. Bayer* should be applied to derivative plaintiffs who fail to plead demand futility, given the similarities between a pre-demand futility derivative action and a pre-certified class action.¹²⁹

In a supplemental opinion, Chancellor Bouchard noted that the Delaware Supreme Court generally agreed with his earlier issue preclusion analysis and characterized the issue on remand as whether the predominant approach on issue preclusion in the derivative action context constitutes such an "extreme application[]" of the doctrine of

¹²⁴ See *Wal-Mart II*, 179 A.3d 824, 844–45 (Del. 2018) (summarizing arguments).

¹²⁵ See *id.*

¹²⁶ See *id.*

¹²⁷ *Id.* at 845.

¹²⁸ See *Cal. State Teachers' Ret. Sys. v. Alvarez*, No. 7455-CB, 2017 WL 6421389 (Del. Jan. 18, 2017).

¹²⁹ See *id.* ("In a situation where dismissal by the federal court in Arkansas of a stockholder plaintiff's derivative action for failure to plead demand futility is held by the Delaware Court of Chancery to preclude subsequent stockholders from pursuing derivative litigation, have the subsequent stockholders' Due Process rights been violated?" (citing *Smith v. Bayer Corp.*, 564 U.S. 299 (2011))).

res judicata” as to affront due process.¹³⁰ Upon reconsideration of the issue in light of due process questions, Chancellor Bouchard found that it was not a violation of the due process rights of later derivative plaintiffs for a court to conclude that a federal court’s dismissal of a prior plaintiff’s derivative action for failure to plead demand futility precludes subsequent stockholders from pursuing derivative litigation relating to the same issues—unless the prior representation was inadequate.¹³¹ Nevertheless, Chancellor Bouchard recommended adoption of a rule that would allow subsequently filed derivative suits to proceed until prior foreign actions survive a motion to dismiss for demand futility, based largely on an analogy between class actions and derivative actions.¹³² To reach this conclusion, Chancellor Bouchard cited then-Vice Chancellor Strine in *Parfi Holding AB v. Mirror Image Internet*,¹³³ who had described derivative suits as “a form of class action,”¹³⁴ and dicta from *EZCORP* finding that “until a derivative action passes the Rule 23.1 stage, the named plaintiff does not have authority to sue on behalf of the corporation or anyone else.”¹³⁵ Based on this reasoning, Chancellor Bouchard proposed a rule stating that, just as class members’ interests are not actually represented by lead plaintiffs until the class is certified, shareholders are not representatives of all investors until they have been granted the right to sue on behalf of the corporation.¹³⁶

Reviewing the case en banc, the Delaware Supreme Court, satisfied that the Chancery Court found no clear violation of the plaintiffs’ due process rights, affirmed the Chancery Court’s original opinion granting the defendants’ motion to dismiss.¹³⁷ In doing so, the Delaware Supreme Court declined to adopt the approach advocated by Chancellor Bouchard, finding that its approach to issue preclusion in derivative cases was consistent with federal law and due process protections for plaintiffs beaten to the courthouse by “fast-filers.”¹³⁸ Chancellor Bouchard’s proposed rule seemed to suggest that other jurisdictions would not be bound by valid judgments dismissing share-

¹³⁰ *Wal-Mart I*, 167 A.3d 513, 520 (Del. Ch. 2017).

¹³¹ *See id.* at 525.

¹³² *See id.*

¹³³ 954 A.2d 911 (Del. Ch. 2008).

¹³⁴ *Wal-Mart I*, 167 A.3d at 525 (citing *Parfi Holding AB*, 954 A.2d at 940–41 (“Although it is too often overlooked, derivative suits are a form of representative action. Indeed, they should be seen for what they are, a form of class action.”)).

¹³⁵ *In re EZCORP Inc. Consulting Agreement Derivative Litig.*, 130 A.3d 934, 945 (Del. Ch. 2016).

¹³⁶ *Wal-Mart I*, 167 A.3d at 525.

¹³⁷ *See Wal-Mart II*, 179 A.3d 824, 855 (Del. 2018).

¹³⁸ *Id.* at 829–30, 840 (summarizing proceedings).

holder derivative suits, and the Delaware Supreme Court was unwilling to adopt a rule that threatened to impair the “delicate balance” between Delaware’s state interest in governing the internal affairs of Delaware corporations and the “stronger national interests that all state and federal courts have in respecting each other’s judgments.”¹³⁹ Referencing principles of comity and full faith and credit, the Delaware Supreme Court affirmed the Chancery Court’s original order dismissing the action.¹⁴⁰

B. Defending the EZCORP Rule: Extension of Smith v. Bayer to Derivative Suits

While the court in *Wal-Mart II* was bound by the applicable preclusion rules of another jurisdiction,¹⁴¹ the proposal put forth in *Wal-Mart* raises questions about the propriety of the current scheme of applying issue preclusion to subsequent derivative suits. Based on the considerations expressed in *EZCORP* and a logical extension of *Smith* to the derivative context, Chancellor Bouchard’s proposal in *Wal-Mart I* may provide a more prudent preclusion rule for Delaware.¹⁴² This would mean treating pre-demand derivative suits dismissed in Delaware courts like pre-certification class actions. Supporting this proposition requires an analysis of the arguments raised in *Wal-Mart II*, in particular the Delaware Supreme Court’s conclusions in its final opinion rejecting Chancellor Bouchard’s proposal.

1. The Role of Representative Authority

In his supplemental opinion in *Wal-Mart I*, Chancellor Bouchard highlighted the role of representative authority in applying issue preclusion to representative actions, drawing from Vice Chancellor Laster’s opinion in *EZCORP*. Commenting on the dual nature of derivative litigation, Vice Chancellor Laster stated in *EZCORP*:

¹³⁹ *Id.* at 839, 855 (quoting *Pyott v. La. Mun. Police Emps.’ Ret. Sys.*, 74 A.3d 612, 616 (Del. 2013)).

¹⁴⁰ *See id.*

¹⁴¹ *See Taylor v. Sturgell*, 553 U.S. 880, 891 (2008) (“The preclusive effect of a federal-court judgment is determined by federal common law.”) (citing *Semtek Int’l Inc. v. Lockheed Martin Corp.*, 531 U.S. 497, 507–08 (2001)); *Wal-Mart II*, 179 A.3d at 841 (“Though, by its terms, the Full Faith and Credit Clause of the United States Constitution does not explicitly apply to judgments of federal courts, the United States Supreme Court has held that a state court is required to give a 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.” (internal quotations and citations omitted)).

¹⁴² States are generally free to come up with their own preclusion rules, subject to due process limitations. *See Richards v. Jefferson County*, 517 U.S. 793, 798 (1996).

“[T]he first phase of the derivative action [is one] in which the stockholder sues individually to obtain authority to assert the corporation’s claim. . . . [U]ntil the derivative action passes the Rule 23.1 stage, the named plaintiff does not have authority to sue on behalf of the corporation or anyone else.”¹⁴³ The class certification process in the class action context addresses similar considerations to the demand requirement—inquiring whether a litigant can adequately represent the interests of the corporation or proposed class such that a judgment in the action would legitimately bind the corporation or class.¹⁴⁴ Vice Chancellor Laster’s dicta in *EZCORP* relied on an analogy to class action practice, analogizing shareholders in derivative actions to potential class members in class actions.¹⁴⁵

The U.S. Supreme Court said in *Smith*, a class action case involving analogous facts, that the absent members of an uncertified class are not parties to the class action and are not bound by rulings within it.¹⁴⁶ In *Smith*, Respondent Bayer argued that Petitioner Smith was precluded by a prior action brought by George McCollins, which had been brought as a class action but was denied certification, because “McCollins’ interests were aligned with the members of the class he proposed and he ‘act[ed] in a representative capacity when he

¹⁴³ *In re EZCORP Inc. Consulting Agreement Derivative Litig.*, 130 A.3d 934, 945 (Del. Ch. 2016); *see also id.* at 943 (“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” (citing *Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993))); *id.* at 944 (“The right to bring a derivative action does not come into existence until the plaintiff shareholder has made a demand on the corporation to institute such an action or until the shareholder has demonstrated that demand would be futile.” (quoting *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 730 (Del. 1988))); *Ala. By-Products Corp. v. Cede & Co. ex rel. Shearson Lehman Bros.*, 657 A.2d 254, 265 (Del. 1995) (“Conceptually, there are two aspects to a derivative action: (1) an effort by the shareholders against the corporation to compel it to sue; and (2) the underlying claim by the corporation, asserted by shareholders on its behalf, against those who caused the corporation legal injury.” (citing *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984))).

¹⁴⁴ *Compare* FED. R. CIV. P. 23 (permitting “[o]ne or more members of a class [to] sue or be sued as representative parties on behalf of all members” under certain conditions, including where “the representative parties will fairly and adequately protect the interests of the class”), *and* DEL. CH. CT. R. 23 (same), *with* FED. R. CIV. P. 23.1 (“[A] derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members who are similarly situated in enforcing the right of the corporation or association.”), *and* DEL. CH. CT. R. 23.1 (permitting a shareholder to serve as a “representative plaintiff” on behalf of a corporation or unincorporated association).

¹⁴⁵ *See In re EZCORP Inc. Consulting Agreement Derivative Litig.*, 130 A.3d at 948–49.

¹⁴⁶ *See Smith v. Bayer Corp.*, 564 U.S. 299, 315 (2011); *supra* text accompanying notes 75–76.

sought class certification.’”¹⁴⁷ In rejecting this argument, the Supreme Court noted a “conundrum” faced by the defendant arguing preclusion: that “the very ruling that Bayer argues ought to be given preclusive effect is the District Court’s decision that a class could not properly be certified.”¹⁴⁸ In declining to find preclusion, the Supreme Court emphasized the absence of certification under Rule 23, the precondition for binding Smith to a judgment in the prior action, declaring, “Neither a proposed class action nor a rejected class action may bind nonparties.”¹⁴⁹

Drawing from the Supreme Court’s decision in *Smith*, Vice Chancellor Laster emphasized the role of representative authority in declining to give preclusive effect to the plaintiff’s voluntary dismissal in *EZCORP*. In *EZCORP*, the plaintiff sought a voluntary dismissal without prejudice of his derivative complaint against three outside directors of EZCORP, Inc. Defendants sought dismissal with prejudice. Applying Court of Chancery Rule 15(aaa), the Court ruled that the complaint should be dismissed with prejudice but only as to the named plaintiff, explaining that the Due Process Clause “forecloses a judgment in a derivative action that is entered before the stockholder plaintiff acquires authority to litigate on behalf of the corporation from binding anyone other than the named stockholder plaintiff.”¹⁵⁰ Extending the Supreme Court’s reasoning in *Smith*, Vice-Chancellor Laster reasoned:

[J]ust as the Due Process Clause prevents a judgment from binding absent class members before a class has been certified, the Due Process Clause likewise prevents a judgment from binding the corporation or other stockholders in a [subsequent] derivative action until the action has survived a Rule 23.1 motion to dismiss, or the board of directors has given the plaintiff authority to proceed by declining to oppose the suit.¹⁵¹

Thus, Vice Chancellor Laster concluded that a judgment in a derivative action entered prior to conferral of representative authority was binding only on the named shareholder plaintiff.¹⁵²

¹⁴⁷ *Smith*, 564 U.S. at 314–15 (quoting Brief for Respondent at 36, *Smith v. Bayer Corp.*, 564 U.S. 299 (2011) (No. 09-1205)).

¹⁴⁸ *Id.* at 314 (“So Bayer wants to bind Smith as a member of a class action (because it is only as such that a nonparty in Smith’s situation can be bound) to a determination that there could not be a class action.”).

¹⁴⁹ *Id.* at 315.

¹⁵⁰ *In re EZCORP Inc.*, 130 A.3d at 948–49.

¹⁵¹ *Id.* at 948.

¹⁵² *Id.* at 949.

2. The Corporation as “Real Party in Interest”

The identity of the “real party in interest” is a major distinction between class actions and derivative suits that courts have cited to justify treating preclusion differently in the derivative context.¹⁵³ In *Wal-Mart II*, the Delaware Supreme Court rejected the reasoning in *EZCORP*, distinguishing between derivative actions and class actions on this basis:

The “dual” nature of the derivative action does not transform a stockholder’s standing to sue on behalf of the corporation into an individual claim belonging to the stockholder. The named plaintiff, at this stage, only has standing to seek to bring an action by and in the right of the corporation and never has an individual cause of action. This highlights a fundamental distinction from class actions, where the named plaintiff initially asserts an individual claim and only acts in a representative capacity after the court certifies that the requirements for class certification are met.¹⁵⁴

Thus, the Delaware Supreme Court’s response to Vice Chancellor Laster’s conceptualization of the dual nature of derivative suits emphasized ownership of an individual claim or cause of action, as captured in the “real party in interest” rationale for finding shareholder privity.¹⁵⁵

But courts applying preclusion on this basis have not made explicit how the identity of the real party in interest figures into the decision on preclusion, particularly regarding the question of representative authority.¹⁵⁶ As Chancellor Bouchard noted in his supplemental opinion in *Wal-Mart I*, “[t]hat the corporation is the real party

¹⁵³ See *In re Sonus Networks, Inc. S’holder Derivative Litig.*, 499 F.3d 47, 63 (1st Cir. 2007) (citing *Ross v. Bernhard*, 396 U.S. 531, 538–39 (1970)) (“It is a matter of black-letter law that the plaintiff in a derivative suit represents the corporation, which is the real party in interest.”); *Pyott v. La. Mun. Police Emps.’ Ret. Sys.*, 74 A.3d 612, 617 (Del. 2013) (applying California law) (“[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.’” (quoting *LeBoyer v. Greenspan*, No. CV 03-5603-GHK(JTLx), 2007 WL 4287646, at *3 (C.D. Cal. June 13, 2007))); see also *Parkoff v. Gen. Tel. & Elecs. Corp.*, 425 N.E.2d 820, 824 (N.Y. 1981) (“Because the claim asserted in a stockholder’s derivative action is a claim belonging to and on behalf of the corporation, a judgment rendered in such an action brought on behalf of the corporation by one shareholder will generally be effective to preclude other actions predicated on the same wrong brought by other shareholders.”).

¹⁵⁴ *Wal-Mart II*, 179 A.3d 824, 847 (Del. 2018).

¹⁵⁵ See *id.*

¹⁵⁶ See *Wal-Mart I*, 167 A.3d 513, 527 (Del. Ch. 2017) (“‘[T]he common theme in the opinions’ that have concluded that privity exists between different stockholder plaintiffs who file separate derivative actions ‘is that the corporation is the real party in interest in both the first derivative action and the subsequent suit.’” (quoting *In re Wal-Mart Stores, Inc. Del. Derivative Litig.*, No. 7455-CB, 2016 WL 2908344, at *3 (May 13, 2016))).

in interest, however, does not answer who has the authority to represent the corporation.”¹⁵⁷ The answer, it appears, lies in the view that shareholders seeking to bring action on behalf of the same corporation share an “identity of interest.”

3. *Identity of Interest*

In finding absent shareholders bound by a dismissal on demand grounds in a prior derivative suit, courts have emphasized “the identity of interest derivative plaintiffs share in having a stockholder control the corporation’s claim instead of the directors.”¹⁵⁸ While the first shareholder plaintiff does not represent the second shareholder plaintiff, “both plaintiffs sue on behalf of the corporation and are essentially interchangeable.”¹⁵⁹ This concept of an identity of interest based on a shared relationship with the real party in interest was described in *Wal-Mart II*:

[P]laintiffs share an identity of interest in seeking to prosecute claims by and in the right of the same real party in interest—i.e., as representatives of—the corporation. Here, the Delaware and Arkansas Plaintiffs sought to enforce the same legal rights by stepping into Wal-Mart’s shoes to assert the corporation’s claims related to the same alleged misconduct and investigation. Though 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.¹⁶⁰

Thus, the real party in interest formulation views preclusion of shareholders appropriate based on an identity of interest between shareholders seeking to bring claims on behalf of the same real party in interest.

Notably, the rationale for applying preclusion in the context of derivative shareholder actions—that subsequent plaintiffs bring suit on behalf of the same “real party in interest,” the corporation, and therefore share an “identity of interest”—has also been advanced in the class action context.¹⁶¹ As in derivative actions, the named plaintiff seeking class certification is bringing suit on behalf of another entity—the class, which is the “real party in interest.”¹⁶² Under the

¹⁵⁷ *Id.*

¹⁵⁸ *Wal-Mart II*, 179 A.3d at 848.

¹⁵⁹ *Wal-Mart I*, 167 A.3d at 518 (quoting *In re Wal-Mart Stores, Inc.*, WL 2908344, at *13)).

¹⁶⁰ *Wal-Mart II*, 179 A.3d at 847.

¹⁶¹ See *Smith v. Bayer Corp.*, 564 U.S. 299, 314–15 (2011).

¹⁶² While academics are divided on the effect of certification on the class, it has been argued that certification has a transformative effect on the group of claimants who seek to

reasoning applied to allow preclusion of subsequent derivative shareholder actions, a subsequent named plaintiff seeking to certify a class on the same claims would be collaterally estopped, since both plaintiffs seek to represent the same “real party in interest” and therefore share an “identity of interest.” This rationale has clearly been rejected in the class action context.¹⁶³ In *Smith*, Bayer argued that Smith was precluded by a prior action by McCollins, which had been brought as a class action but denied certification, because “McCollins’ interests were aligned with the members of the class he proposed and he ‘act[ed] in a representative capacity when he sought class certification.’”¹⁶⁴ The Supreme Court rejected this argument, reinforcing its view in *Taylor*, where the Court had unanimously rejected a similar nonparty preclusion theory based on “identity of interests and some kind of relationship between parties and nonparties.”¹⁶⁵ “To allow McCollins’ suit to bind nonparties would be to adopt the very theory *Taylor* rejected.”¹⁶⁶ It is well-settled that absent claimants are not bound by a denial of class certification, following the Supreme Court holding in *Bayer*.¹⁶⁷

IV IMPLICATIONS OF EXTENDING THE *EZCORP* RULE TO DERIVATIVE ACTIONS

It is important to note that the rule endorsed in Section III.B would not affect outcomes in cases like *Wal-Mart* and *Pyott*, where a federal court issued the prior judgment. Under federal common law, the courts in those cases were bound by the preclusion rules of the states in which the prior actions were adjudicated.¹⁶⁸ Nevertheless, the proposed rule offers a more sensible approach to preclusion in pre-

be certified as a class—such that certification leads to the creation of a new entity, the class. See David L. Shapiro, *Class Actions: The Class as Party and Client*, 73 NOTRE DAME L. REV. 913, 919 (1998) (describing the “entity” model of class actions, in which “the entity is the litigant and the client”).

¹⁶³ *Smith*, 564 U.S. at 308 n.7 (drawing a bright-line rule between class actions pre- and post-certification).

¹⁶⁴ *Id.* at 314–15 (citing Brief for Respondent at 36, *Smith v. Bayer Corp.*, 564 U.S. 299 (2011) (No. 09-1205)).

¹⁶⁵ *Id.* at 315–16 (citing *Taylor v. Sturgell*, 553 U.S. 880, 901 (2008)).

¹⁶⁶ *Id.* at 316.

¹⁶⁷ See *id.* at 315 (“Neither a proposed class action nor a rejected class action may bind nonparties.”).

¹⁶⁸ See *Taylor*, 553 U.S. at 891 (citing *Semtek Int’l Inc. v. Lockheed Martin Corp.*, 531 U.S. 497, 507–08 (2001)) (“The preclusive effect of a federal-court judgment is determined by federal common law.”); *Wal-Mart II*, 179 A.3d 824, 841 (Del. 2018) (“Though, by its terms, the Full Faith and Credit Clause of the United States Constitution does not explicitly apply to judgments of federal courts, the United States Supreme Court ‘has held that a state court is required to give a federal judgment the same force and effect as it

demand derivative suits dismissed in Delaware, which more easily fits into the framework for nonparty preclusion endorsed by the U.S. Supreme Court and is more consistent with the treatment of the related class action mechanism. This Part addresses the practical implications of the proposal outlined in Section III.B—namely, concerns over the need to rein in duplicative derivative litigation.

The loudest criticism of the proposed rule is bound to come from those who fear the perils of duplicative litigation. But while litigants and academics refer to the perils of duplicative litigation,¹⁶⁹ it is unlikely that the proposed rule, if adopted, would lead to the grave consequences contemplated. For one, plaintiffs carry the burden of proof in pleading and proving demand is satisfied or excused.¹⁷⁰ The issue litigated at the demand futility stage—whether the plaintiff can affirmatively demonstrate that the corporation’s Board of Directors lacks independence—is notoriously difficult for plaintiffs to establish.¹⁷¹ Further, despite fears about subjecting corporations and directors to duplicative lawsuits, in reality, corporate defendants face minimal burden in defending against shareholder derivative litigation. While the Chancery Court tends to require a more thorough discovery process than many other courts,¹⁷² the corporate books and records relevant to the issue of demand futility in prior and subsequent cases addressing substantially similar claims would be the same. Defendant

would be given under the preclusion rules of the state in which the federal court is sitting.” (quoting *Pyott v. La. Mun. Police Emps.’ Ret. Sys.*, 74 A.3d 612, 616 (Del. 2013))).

¹⁶⁹ See, e.g., Geis, *supra* note 25, at 264 (explaining how a motivated plaintiffs’ lawyer could use the “zombie” lawsuit” to “reincarnate the claim, through a different shareholder, and begin the process anew.”); Strine, Hammermesh & Jennejohn, *supra* note 97, at 3–4 (describing a multi-forum litigation problem, where plaintiffs’ lawyers often bring parallel actions against the same defendant in multiple jurisdictions).

¹⁷⁰ Geis, *supra* note 25, at 274.

¹⁷¹ *Id.* at 275 (describing the difficulty for a plaintiff seeking to establish demand futility); John H. Matheson, *Restoring the Promise of the Shareholder Derivative Suit*, 50 GA. L. REV. 327, 365–66 (2016) (describing the substantial difficulty a derivative plaintiff faces in satisfying the demand requirement).

¹⁷² See *Wal-Mart II*, 179 A.3d at 839 (“[T]his Court has repeatedly admonished plaintiffs to use the ‘tools at hand’ and to request company books and records under Section 220 to attempt to substantiate their allegations before filing derivative complaints.” (citing *Cal. State Teachers Ret. Sys. v. Alvarez*, 175 A.3d 86, 86 (Del. 2017))). In both *Wal-Mart* and *Pyott*, the Delaware Chancery Court required plaintiffs to make a books and records demand under Delaware General Corporate Law Section 220, whereas the federal courts required no such discovery in the competing actions. See *Pyott*, 74 A.3d at 615 (noting that the Delaware Court of Chancery postponed briefing on Allergan’s motion to dismiss for failure to show demand futility until after completion of a books and records demand and the federal court in California ruled on the issue first); *Wal-Mart II*, 179 A.3d at 824 (noting that Delaware plaintiffs, at the Court’s insistence, demanded company books and records, whereas the Arkansas plaintiffs proceeded without making any substantial discovery requests).

corporations could even submit the same motion papers in support of dismissal, with the same boilerplate language arguing that plaintiffs have not met their burden of proof in establishing demand futility.

Even if the threat of duplicative litigation proved to be true, preclusion should be used sparingly due to its grave constitutional implications. Despite the practical advantages of using preclusion doctrine to limit excessive shareholder litigation, the Supreme Court has cautioned that convenience is not a good reason to use preclusion doctrine to curb litigation in a way that is questionable under due process.¹⁷³ The same policy arguments were made in the class action context and soundly rejected. In *Smith*, Bayer argued that “class counsel can repeatedly try to certify the same class ‘by the simple expedient of changing the named plaintiff in the caption of the complaint.’”¹⁷⁴ Bayer argued that the Court’s approach would lead to “serial relitigation of class certification” where “defendants would be forced in effect to buy litigation peace by settling.”¹⁷⁵ The Supreme Court noted that a similar argument was made in *Taylor* by the Government, which argued that “unless [the Supreme Court] bound nonparties[,] a ‘potentially limitless’ number of plaintiffs, perhaps coordinating with each other, could ‘mount a series of repetitive lawsuits’ demanding the selfsame documents.”¹⁷⁶ Rejecting the Government’s policy argument in favor of a loose preclusion rule, the Supreme Court stated:

[T]his form of argument flies in the face of the rule against nonparty preclusion. That rule perforce leads to relitigation of many issues, as plaintiff after plaintiff after plaintiff (none precluded by the last judgment because none a party to the last suit) tries his hand at establishing some legal principle or obtaining some grant of relief. . . .

[O]ur legal system generally relies on principles of *stare decisis* and comity among courts to mitigate the sometimes substantial costs of similar litigation brought by different plaintiffs. We have not thought that the right approach (except in the discrete categories of cases we have recognized) lies in binding nonparties to a judgment.¹⁷⁷

¹⁷³ See *Taylor*, 553 U.S. at 903 (stating that nonparty preclusion is not the right approach to mitigate the substantial costs of similar litigation brought by different plaintiffs).

¹⁷⁴ *Smith v. Bayer Corp.*, 564 U.S. 299, 316 (2011) (citing Brief for Respondent 47–48, *Smith v. Bayer Corp.*, 564 U.S. 299 (2011) (No. 09-1205)).

¹⁷⁵ *Id.*

¹⁷⁶ *Id.* at 317 (citing *Taylor*, 553 U.S. at 903).

¹⁷⁷ *Id.* at 316–17.

As made explicit by the Supreme Court in its decisions in *Taylor* and *Smith*, concerns about duplicative derivative lawsuits are not an appropriate justification for invoking the preclusion doctrine against nonparties.

CONCLUSION

Under the current state of the law in most jurisdictions, courts have granted preclusive effect to putative derivative shareholder actions dismissed at the demand phase, allowing preclusion of subsequent derivative suits brought by other shareholders.¹⁷⁸ The sole check for due process rights of shareholder plaintiffs is a review for adequacy of representation, evaluated at the back end when a court applies issue preclusion in a subsequent action. And even then, the applicable “grossly deficient” standard sets a relatively high threshold for challenging the adequacy of representation.¹⁷⁹ This nearly automatic privity rule, combined with a lenient standard of review and the high bar for challenging adequacy of representation, results in a system where the first-filed shareholder complaint precludes any future derivative litigation on the same claims.¹⁸⁰ This formulation presents both conceptual and practical problems. Conceptually, current treatment of pre-demand dismissed derivative shareholder suits seems inconsistent with the rule against nonparty preclusion and the requirements of due process. So far, courts have purported to resolve this ambiguity with conclusory references to the fact that the corporation is the real party in interest and a bare-bones test for adequate representation, without addressing whether pre-demand derivative plaintiffs are authorized to represent the corporation or the clear inconsistency in treatment between pre-certification class actions and pre-demand derivative actions. Where there is an ambiguity, this Note argues that courts should err on the side of the strong presumption against nonparty preclusion, paying heed to the Supreme Court in *Taylor*, which emphasized the narrowness of exceptions to the rule against nonparty preclusion.

Further, in finding that subsequent shareholders are precluded from bringing an action on the same claims, the practical implication of the court’s decision is that a corporation with an entrenched Board of Directors is effectively bound by the decision even though it was not a party to the action because future shareholders cannot bring

¹⁷⁸ See, e.g., *Wal-Mart II*, 179 A.3d 824, 829–30, 855 (Del. 2018); *Pyott v. La. Mun. Police Emps.’ Ret. Sys.*, 74 A.3d 612, 614 (Del. 2013).

¹⁷⁹ See *supra* Section II.A.

¹⁸⁰ See *supra* Section II.A.

actions on behalf of a corporation.¹⁸¹ As a practical matter, this means that the shareholders of a corporation are at the mercy of the first-filer. While academics refer to the perils of duplicative litigation and the advantages of using preclusion doctrine to limit excessive shareholder litigation, there are alternative ways to address these problems rather than through preclusion. And while many commentators refer to the fairness of giving a litigant only one “bite[] at the apple,”¹⁸² it seems inequitable to require millions of shareholders to share a single “bite,” to be taken by whoever files first.

As a practical matter, the current scheme creates perverse incentives for ambitious plaintiffs’ lawyers to engage in “fast-filing” practice, even at the expense of forfeiting more comprehensive discovery that would lead to stronger claims, lest another plaintiff group file first and take control of the litigation.¹⁸³ In this way, the current system of applying issue preclusion can result in the unintended preclusion of otherwise meritorious claims, which may have a significant financial impact on many shareholders. The rule proposed in *Wal-Mart I*, based on dicta by Chancellor Laster in *EZCORP*, presents a workable alternative to the prevailing treatment of pre-demand dismissals that would better safeguard shareholders’ due process rights and centralize shareholder derivative litigation in Delaware.

¹⁸¹ See *supra* Section II.B.

¹⁸² See, e.g., Geis, *supra* note 25, at 312 (referring to “recent developments that may allow claimants to have two or more bites at the apple through the relaxation of collateral estoppel”).

¹⁸³ See *supra* Section II.B.