No. __-____

IN THE
Supreme Court of the United States

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM, ET AL.,
Petitioners,

v.

AIDA M. ALVAREZ, ET AL.,
Respondents.

On Petition for a Writ of Certiorari to the Supreme Court of Delaware

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

A shareholder seeking to bring a derivative claim on behalf of a corporation ordinarily must plead with particularity, as a precondition to prosecuting the representative action, that making a demand on the corporation's board to pursue the claim would be futile. The question presented is:

If a court determines that a complaint filed by one shareholder does not plead demand futility with the requisite particularity, does the Due Process Clause and this Court's decisions in *Taylor v. Sturgell*, 553 U.S. 880 (2008), and *Smith v. Bayer Corp.*, 564 U.S. 299 (2011), permit binding other shareholders that were not parties to the initial litigation to that decision, thus barring consideration of whether a new complaint filed by those shareholders pleads sufficient allegations to demonstrate that pre-suit demand was futile?

PARTIES TO THE PROCEEDINGS

Petitioners California State Teachers' Retirement System, New York City Employees' Retirement System, New York City Police Pension Fund, Police Officers' Variable Supplements Fund, Police Supervisor Officers' Variable Supplements Fund, New York City Fire Department Pension Fund, Fire Fighters' Variable Supplements Fund, Fire Officers' Variable Supplements Fund, Board of Education Retirement System of the City of New York, Teachers' Retirement System of the City of New York, New York City Teachers' Variable Annuity Program, and Indiana Electrical Workers Pension Trust Fund IBEW were plaintiffs and appellants in the proceedings below.

Respondents Aida M. Alvarez, James I. Cash, Jr., Roger C. Corbett, Douglas N. Daft, Michael T. Duke, Gregory B. Penner, Steven S. Reinemund, Jim C. Walton, S. Robson Walton, Linda S. Wolf, H. Lee Scott, Jr., Christopher J. Williams, James W. Breyer, M. Michele Burns, David D. Glass, Roland A. Hernandez, John D. Opie, J. Paul Reason, Arne M. Sorenson, Jose H. Villarreal, Jose Luis Rodriguezmacedo Rivera, Eduardo Castro-Wright, Thomas A. Hyde, Thomas A. Mars, John B. Menzer, Eduardo F. Solorzano Morales, and Lee Stucky were defendants and appellees in the proceedings below.

Respondent Wal-Mart Stores, Inc. was a nominal defendant and an appellee in the proceedings below.

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California State Teachers' Retirement System, et al., respectfully petition for a writ of certiorari to review the judgment of the Supreme Court of Delaware in this case.

INTRODUCTION

The Delaware Supreme Court held that a judgment in an action in which petitioners were not parties precluded petitioners' separate lawsuit in this case. In reaching that conclusion, the court revived the theory of "virtual representation" that this Court rejected as contrary to due process in *Taylor v. Sturgell*, 553 U.S. 880 (2008). The court also failed to follow the reasoning of *Smith v. Bayer Corp.*, 564 U.S. 299 (2011), which held that the failure to establish a precondition to a representative action – there, class certification – does not have preclusive effect on other litigants seeking to establish that precondition. The Delaware Supreme Court reached the opposite result in this case, holding that one shareholder's failure to adequately plead demand futility – the typical precondition to maintaining a derivative action on behalf of a Delaware corporation – has preclusive effect on all other shareholders, even if they were not parties to the case. That application of issue preclusion violated petitioners' due process rights. And the court that committed that error is the most important and influential forum in the Nation for shareholder derivative actions.

Petitioners are major institutional investors that hold substantial investments in the common stock of Wal-Mart Stores, Inc. After *The New York Times* uncovered a serious bribery scandal at Wal-Mart's Mexican subsidiary, petitioners filed shareholder derivative complaints in the Delaware Chancery Court against Wal-Mart's directors (respondents here). At an early hearing in the case, then-Chancellor Strine

(now Chief Justice of the Delaware Supreme Court) strongly advised petitioners to exercise their right under Delaware law to seek access to Wal-Mart's books and records and to use those materials to prepare the strongest possible pleading. Petitioners followed the Chancellor's advice, but, before they could complete that process, a different group of shareholder plaintiffs (who did not seek Wal-Mart's books and records) lost a motion to dismiss in Arkansas. The Arkansas court held that the plaintiffs in that case had not adequately pleaded particularized facts demonstrating that it would have been futile for them to make a demand on Wal-Mart's board to pursue the claim on the company's behalf. Thereafter, rather than considering petitioners' amended complaint on the merits, the Delaware courts dismissed petitioners' case as precluded by the result in the Arkansas litigation. They reached that result even though petitioners were not parties to the Arkansas case and even though the Arkansas court reached a decision first solely because petitioners followed Chancellor Strine's admonition and sought Wal-Mart's books and records to use in pleading the strongest possible case for demand futility.

The Delaware Supreme Court's due process holding cannot be squared with *Taylor* and *Smith*. "[I]n the absence of" a determination of demand futility – a prerequisite to representative litigation in the derivative context – "the precondition for binding [petitioners] was not met." *Smith*, 564 U.S. at 315. The Delaware Supreme Court's contrary conclusion violated petitioners' "fundamental" due process right not to be "bound by a judgment to which [they were] not a party." *Taylor*, 553 U.S. at 898.

The Delaware Supreme Court's erroneous decision deepens confusion in the lower courts over the applicability of nonparty preclusion to decisions regarding demand futility in shareholder derivative actions. The decision is also uniquely important because more than 1.18 million legal entities are incorporated in Delaware, including two-thirds of the Fortune 500, and courts across the country – both state and federal – follow the Delaware Supreme Court's lead on issues pertaining to shareholder derivative actions. The question presented is frequently recurring and crucial to investors, and it warrants this Court's review.

OPINIONS BELOW

The opinion of the Supreme Court of Delaware (App. 1a-55a) is reported at 179 A.3d 824. The opinion of the Chancery Court (App. 56a-88a) is reported at 167 A.3d 513. A prior opinion of the Supreme Court of Delaware (App. 89a-108a) and a prior opinion of the Chancery Court (App. 109a-164a) are not reported but are available at 2017 WL 6421389 and 2016 WL 2908344, respectively.

JURISDICTION

The Supreme Court of Delaware entered its judgment on January 25, 2018. On April 15, 2018, Justice Alito extended the time for filing a certiorari petition to and including June 22, 2018. App. 165a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL PROVISION INVOLVED

The Due Process Clause of the Fourteenth Amendment provides that "[n]o State shall . . . deprive any person of life, liberty, or property, without due process of law."

STATEMENT

A. Due Process Framework

The Court has recently addressed nonparty preclusion in *Taylor v. Sturgell*, 553 U.S. 880 (2008), and *Smith v. Bayer Corp.*, 564 U.S. 299 (2011).

1. In *Taylor*, the Court considered a potential "'virtual representation' exception to the general rule against precluding nonparties." 553 U.S. at 884. The question arose when the petitioner Brent Taylor filed a lawsuit under the Freedom of Information Act ("FOIA") seeking documents, after his friend had lost a lawsuit "seeking the same records." *Id.* at 885. Even though the two men had no legal relationship, the D.C. Circuit held that the earlier judgment denying the FOIA request precluded Taylor's suit, because his friend was his "virtual representative." *Id.* This Court reversed.

Citing the seminal due process decision in *Richards v. Jefferson County*, 517 U.S. 793 (1996), the Court reiterated "the fundamental nature of the general rule that a litigant is not bound by a judgment to which she was not a party." *Taylor*, 553 U.S. at 898. The Court categorized six limited and previously recognized exceptions to that rule. *Id.* at 893-95. Relevant here, the third exception for representative actions applies in "certain limited circumstances" where a nonparty was "adequately represented by someone with the same interests who [wa]s a party" to the suit, such as with "properly conducted class actions" and "suits brought by trustees, guardians, and other fiduciaries." *Id.* at 894-95 (alteration in original).[1]

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[1] The Court explained that a party's representation of a nonparty is constitutionally adequate for purposes of that exception "only if, at a minimum: (1) The interests of the nonparty and her

The Court rejected a "virtual representation" theory that would expand the third category to "authorize preclusion based on identity of interests and some kind of relationship between parties and nonparties, shorn of the procedural protections prescribed in *Hansberry[v. Lee*, 311 U.S. 32 (1940)], *Richards*, and Rule 23." *Id.* at 901. Those protections, "grounded in due process, could be circumvented were we to approve a virtual representation doctrine that allowed courts to create *de facto* class actions at will." *Id.* The Court was not persuaded by the government's argument that nonparty preclusion was necessary to prevent "limitless" duplicative litigation of identical FOIA claims. *Id.* at 903-04. Repeat litigation, the Court explained, would be mitigated by the doctrine of *stare decisis* and the "human tendency not to waste money." *Id.*

2. Three years later, the Court revisited the limitations on nonparty preclusion in *Smith*. There, two sets of plaintiffs brought parallel class actions relating to the defendant's sale of an allegedly hazardous drug; both putative classes moved for class certification. 564 U.S. at 302-03. The first court to act – the federal district court in West Virginia – denied class certification. *Id.* at 303-04. The same court then granted the defendant's motion for an injunction under the Anti-Injunction Act, 28 U.S.C. § 2283, prohibiting a West Virginia state court from certifying the second class. 564 U.S. at 304-05. The lower courts reasoned that

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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." *Taylor*, 553 U.S. at 900 (citation omitted). The Court noted that, in the class-action context, "these limitations are implemented by the procedural safeguards contained in Federal Rule of Civil Procedure 23." *Id.* at 900-01.

the second group of plaintiffs sought to certify the same class under the same legal theories; their interests were thus aligned and "sufficiently identical" to warrant preclusion. *Id.* at 305.

This Court reversed because the "injunction issued here runs into a[] basic premise of preclusion law: A court's judgment binds only the parties to a suit, subject to a handful of discrete and limited exceptions." *Id.* at 312. The Court explained that, "in the absence of a certification under [Rule 23], the precondition for binding [petitioners] was not met." *Id.* at 315. To hold otherwise "would authorize preclusion 'shorn of [Rule 23's] procedural protections'" based upon virtual representation, "the very theory *Taylor* rejected." *Id.* at 315-16 (quoting *Taylor*, 553 U.S. at 901) (alteration in original). Having concluded that *Taylor*'s articulation of the limits on nonparty preclusion (which itself relied heavily on due process principles and precedents, *see Taylor*, 553 U.S. at 891, 896-98, 901) required reversal, the *Smith* Court did not reach the petitioners' further claim that preventing relitigation of class-certification decisions violates the Due Process Clause as interpreted in *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797 (1985). *See Smith*, 564 U.S. at 308 n.7, 318 n.12.

In *Smith*, as in *Taylor*, the Court rejected the argument that nonparty preclusion was necessary to prevent repeat attempts "to certify the same class" with a different named plaintiff. *Id.* at 316. As the Court explained, that argument "flies in the face of the rule against nonparty preclusion," which "perforce" allows for relitigation. *Id.* at 316-17. The response to those concerns, the Court explained, lies in "principles of *stare decisis* and comity among courts," not "binding nonparties to a judgment." *Id.* at 317; *see China*

Agritech, Inc. v. Resh, No. 17-432, slip op. 10 n.4 (U.S. June 11, 2018) (noting that, "in *Smith*," the Court was "guided by the fundamental nature of the general rule that only parties can be bound by prior judgments" in rejecting "a stron[g] argument about the inefficiencies of serial class relitigation") (alteration in original).

B. Factual And Procedural Background

1. This case arises from Wal-Mart's bribery scandal in Mexico. From the late 1990s until 2005, Wal-Mart's foreign subsidiary (WalMex) paid hundreds of illegal bribes, totaling tens of millions of dollars, to facilitate the company's rapid expansion throughout Mexico. App. 112a-113a. The bribery scandal came to light in April 2012, when *The New York Times* published an expose.[2] That article detailed how investigators unearthed evidence of widespread bribery – complete with a paper trail – but the company shut down further inquiry and covered up the wrongdoing.

After the *Times* article, Wal-Mart shareholders filed 15 derivative actions in Arkansas and Delaware. App. 119a. Petitioners are the Delaware plaintiffs and include a number of large pension funds with significant holdings in Wal-Mart. The two sets of lawsuits were consolidated into two competing actions, one in federal district court in Arkansas and the other in Delaware Chancery Court. Both the Arkansas and Delaware complaints arose from the same bribery scheme and cover-up and asserted similar legal claims (with less specific factual allegations in Arkansas) focused on the failure of the Wal-Mart board to fulfill its fiduciary

[2] *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.

duty, under Delaware law, to conduct adequate oversight of WalMex. App. 90a.

2. To pursue a derivative action on behalf of a Delaware corporation, a shareholder ordinarily must plead with particularity that making a demand on the corporation's board of directors to commence the action would be futile. Adequately pleading demand futility is a precondition because, ordinarily, a corporation's board of directors has authority to decide whether the corporation should bring a suit. *See generally Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984). Only when the shareholder has shown that demand was futile or wrongfully refused can the "single stockholder . . . sue in the corporation's right." *Koster v. (American) Lumbermens Mut. Cas. Co.*, 330 U.S. 518, 522 (1947); *see also Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95-96 (1991) (noting demand-futility "precondition"). "The right to bring a derivative action does not come into existence until the plaintiff shareholder . . . has demonstrated that demand would be futile." *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 730 (Del. 1988).

To satisfy that pleading requirement, "Delaware courts have strongly encouraged stockholder-plaintiffs" to flesh out allegations with evidence from the company's internal files through a so-called "books and records" demand under 8 Delaware Code § 220. *King v. VeriFone Holdings, Inc.*, 12 A.3d 1140, 1145 (Del. 2011); *see also Seinfeld v. Verizon Commc'ns, Inc.*, 909 A.2d 117, 120 (Del. 2006) ("Section 220 is now recognized as an important part of the corporate governance landscape."). At the outset of this litigation, then-Chancellor Strine pointedly noted that this case "requires great care and pleading" and instructed petitioners to "get [Wal-Mart's] books and records" to

"put the strongest possible complaint on the table." *See* App. 6a, 95a n.20. Following that judicial directive, petitioners engaged in a hard-fought, three-year legal battle and eventually obtained Wal-Mart's books and records in early 2015.[3]

In the meantime, however, the Arkansas plaintiffs flouted Chancellor Strine's warning and proceeded without attempting to obtain Wal-Mart's books and records. After years of procedural wrangling, the Wal-Mart defendants moved to dismiss the Arkansas complaint for failure to plead demand futility. In April 2015, the Arkansas court granted the defendants' motion and dismissed the complaint with prejudice. *In re Wal-Mart Stores, Inc. S'holder Derivative Litig.*, No. 4:12-cv-4041, 2015 WL 13375767, at *9 (W.D. Ark. Apr. 3, 2015), *aff'd*, *Cottrell ex rel. Wal-Mart Stores, Inc. v. Duke*, 829 F.3d 983 (8th Cir. 2016).

C. The Proceedings Below

1. In May 2015, shortly after obtaining Wal-Mart's books and records and a month after the Arkansas decision, petitioners filed an amended complaint in Chancery Court, incorporating information they gleaned from those books and records. App. 10a, 61a. Defendants moved to dismiss, claiming that the

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[3] As the Delaware Supreme Court observed, the books-and-records proceeding was "unusually contentious." App. 6a. In June 2012, one of the Delaware plaintiffs made a demand to inspect Wal-Mart's books and records. After a trial before the Delaware Chancery Court and an affirmance on appeal, the Delaware plaintiffs finally obtained some books and records from Wal-Mart in late 2014. App. 6a, 60a-61a. Following a motion for contempt against Wal-Mart, Wal-Mart produced additional books and records to the Delaware plaintiffs in late 2014 and early 2015. App. 60a-61a.

Arkansas decision collaterally estopped petitioners from litigating the corporate claim.

Applying Arkansas preclusion law, the Chancery Court agreed with defendants and dismissed petitioners' amended complaint. App. 109a-164a (Bouchard, C.).[4] The court held that, even though petitioners were not parties to the Arkansas action, they were in "privity" with the Arkansas plaintiffs because both sets of plaintiffs were Wal-Mart shareholders seeking to bring derivative actions. App. 135a-148a. The court further held that the Arkansas plaintiffs "adequately represented" the nonparty Delaware plaintiffs, even though the Arkansas plaintiffs failed to seek or obtain Wal-Mart's books and records, on the ground that their conduct was not grossly deficient. App. 148a-162a. The court did not separately address petitioners' argument that applying collateral estoppel against them would violate the Due Process Clause.

On appeal, the Delaware Supreme Court remanded the case to the Chancery Court to address whether applying preclusion comported with due process. App. 89a-108a. The Delaware Supreme Court recognized that "[t]his is a troubling case," App. 89a, and stated that it had "some sympathy for the Delaware Plaintiffs' position," App. 95a. Petitioners, "who arguably had the most skin in the game" as large holders of Wal-Mart's stock, "did exactly what" the Delaware Supreme Court "has suggested on numerous occasions, namely, use the 'tools at hand' to inspect the company's pertinent books and records before filing a derivative complaint." App. 89a-90a. The Arkansas

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[4] The Chancery Court described as "unsettled" the question whether Delaware preclusion law would treat a failure to plead demand futility as binding on nonparty shareholders. App. 14a n.45, 75a n.60.

plaintiffs, who did not "heed[] the Chancellor's advice" to obtain corporate books and records, "suffered dismissal of their complaint with the ultimate effect of barring the action of the Delaware Plaintiffs, who spent nearly three years fighting the books and records battle." App. 95a.

Noting that "the importance of the Due Process issue merits closer examination," App. 103a, the Delaware Supreme Court asked the Chancery Court "to focus on the following limited question":

> 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? *See Smith v. Bayer Corp.*, 564 U.S. 299 (2011).

App. 107a-108a.

2. On remand, the Chancery Court recommended that the Delaware Supreme Court adopt the due process approach articulated in *In re EZCORP Inc. Consulting Agreement Derivative Litigation*, 130 A.3d 934 (Del. Ch. 2016). Under that approach, "as a matter of due process, a judgment cannot bind 'the corporation or other stockholders in a derivative action until the action has survived a Rule 23.1 motion to dismiss'" on demand futility. App. 75a (quoting *EZCORP*, 130 A.3d at 948).

The Chancery Court recognized that other lower courts had upheld the application of preclusion in the demand-futility context, *see* App. 57a-58a, 69a-74a, but it agreed with the court in *EZCORP* that due process warranted a different approach, *see* App. 75a, 77a, 87a. In reaching that conclusion, the court relied

on *Smith*, citing the "significant similarities between class and derivative actions." App. 78a. Derivative actions are "a form of class action" that were governed by Rule 23 until 1966 (when Rule 23.1 was adopted). *Id.* Rule 23 and Rule 23.1, the court noted, "share similar texts and structures," App. 79a, and both afford "procedural protections . . . to the unnamed class members or stockholders," including by requiring notice to absent class members or shareholders, App. 80a. As the court explained: "When a court denies a stockholder the authority to sue on behalf of the corporation by granting a Rule 23.1 motion to dismiss, the purported derivative action is no more a representative action than the proposed class action in [*Smith*] that was denied certification." App. 82a.

In so holding, the Chancery Court agreed with the reasoning of *EZCORP* that, "just 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 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." *EZCORP*, 130 A.3d at 948; *see id.* at 949 (applying "logic of *Bayer*"); *see also* App. 82a ("[A] strong case can be made that a derivative action that has not survived a Rule 23.1 motion to dismiss should not fall under the representative action exception in *[Taylor v.]Sturgell.*").

The Chancery Court also cited multiple policy considerations supporting that conclusion. *First*, a shareholder derivative plaintiff generally is not required to demonstrate affirmatively that it is an adequate representative of the corporation. App. 82a-

83a. Thus, "[a]s a practical matter, the first time a court may evaluate the adequacy of a named plaintiff's representation in a derivative action is when it applies the issue preclusion test in a subsequent case." App. 84a. In that context, the applicable preclusion standard asks only whether the representation was "grossly deficient." App. 85a. "What is lost in this back-end form of adequacy review is the ability for courts to compare the qualities of competing representatives and to choose the best representative for the corporation and stockholders up-front." App. 84a.

Second, the application of nonparty preclusion has sparked a "fast-filer problem" that punishes plaintiffs – like petitioners here – with collateral estoppel for doing precisely what Delaware courts have directed shareholders to do: taking the time to file "a more refined complaint . . . after doing additional homework, such as obtaining corporate books and records through a Section 220 proceeding." App. 85a-87a.

3. Despite acknowledging the Chancery Court's "thoughtful deliberations" on the due process question, the Delaware Supreme Court declined to follow the Chancery Court's recommendation. Instead, it affirmed that court's original decision dismissing petitioners' complaint. App. 24a. Citing *Arduini v. Hart*, 774 F.3d 622 (9th Cir. 2014), and *In re Sonus Networks, Inc. Shareholder Derivative Litigation*, 499 F.3d 47 (1st Cir. 2007), the Delaware Supreme Court reasoned that petitioners were collaterally estopped from litigating the issue of demand futility – even though they were not parties to the Arkansas suit – because "their interests were aligned with" and adequately represented by the Arkansas plaintiffs. App. 24a-25a.

The Delaware Supreme Court sought to distinguish *Smith* on the ground that, before the precondition of demand futility is met, a shareholder "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." App. 39a. According to the court below, 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." *Id.* Although the court acknowledged that a stockholder derivative plaintiff is "not a formal 'representative' of other stockholders," it nevertheless concluded that "differing groups of stockholders who seek to control the corporation's cause of action share the same interest and therefore are in privity." App. 39a-40a.

REASONS FOR GRANTING THE PETITION

I. THE DELAWARE SUPREME COURT'S DECISION CONFLICTS WITH *SMITH V. BAYER CORP.* AND *TAYLOR V. STURGELL* AND DEEPENS CONFUSION IN THE LOWER COURTS

A. The Decision Below Is Contrary To *Smith* And *Taylor*

"It is a principle of general application in Anglo-American jurisprudence that 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." *Hansberry v. Lee*, 311 U.S. 32, 40 (1940). Because of the "'deep-rooted historic tradition that everyone should have his own day in court,'" a judgment "'among parties to a lawsuit resolves issues as among them, but it does not conclude the rights of strangers to those proceedings.'"

Richards v. Jefferson County, 517 U.S. 793, 798 (1996) (quoting *Martin v. Wilks*, 490 U.S. 755, 762 (1989)); *see also Chase Nat'l Bank v. City of Norwalk*, 291 U.S. 431, 441 (1934).

Petitioners were not parties to the Arkansas action. Nor do they fall within any of the limited exceptions to the rule against nonparty preclusion that this Court articulated in *Taylor v. Sturgell*, 553 U.S. 880 (2008). The Delaware Supreme Court's holding that petitioners are nevertheless bound by the Arkansas plaintiffs' failure to plead demand futility conflicts with this Court's precedents and warrants review.

1. The Delaware Supreme Court's decision conflicts with this Court's reasoning in *Smith v. Bayer Corp.*, 564 U.S. 299 (2011). Just as a named plaintiff in a putative class action cannot represent (or bind) absent class members without first meeting the prerequisites of Rule 23, a shareholder cannot bind the corporation or nonparty shareholders without first meeting the prerequisites of Rule 23.1.

In *Smith*, the defendant – just like respondents here – argued for nonparty preclusion because the interests of the named plaintiff "were aligned with the members of the class he proposed and he act[ed] in a representative capacity when he sought class certification." *Id.* at 314-15 (alteration in original). This Court rejected that argument because, "in the absence of a certification under [Rule 23], the precondition for binding [petitioners] was not met." *Id.* at 315.

As Chancellor Bouchard recognized, *Smith*'s "logic" applies here. App. 77a-78a. Before demand futility has been adequately pleaded, a shareholder derivative action is like a putative class action before certification: in neither case has the named plaintiff met the precondition to litigate in a representative capacity.

Unless and until Rule 23.1 is satisfied, the "stockholder plaintiff is only suing in the plaintiff's own name to 'compel the corporation to sue.' The only plaintiff legitimately in the case at that point is the stockholder plaintiff." *In re EZCORP Inc. Consulting Agreement Derivative Litig.*, 130 A.3d 934, 945 (Del. Ch. 2016) (quoting *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984)). Thus, "[w]hen a court denies a stockholder the authority to sue on behalf of the corporation by granting a Rule 23.1 motion to dismiss, the purported derivative action is no more a representative action than the proposed class action in [*Smith*] that was denied certification." App. 82a.

In light of *Smith*, "[i]f we know one thing about the [Arkansas plaintiffs'] suit, we know that it was *not*" a representative action on behalf of the corporation or its stockholders. *Smith*, 564 U.S. at 314. "[I]n the absence of" a decision that the Arkansas plaintiffs had adequately pleaded demand futility, "the precondition for binding [petitioners] was not met." *Id.* at 315. A "rejected" attempt to plead demand futility does not "bind nonparties." *Id.*

2. The Delaware Supreme Court's decision also cannot be squared with this Court's rejection of the "virtual representation" theory in *Taylor*. The *Taylor* Court recognized a limited exception to the rule against nonparty preclusion for "properly conducted class actions," 553 U.S. at 894, where absent class members are protected "by the procedural safeguards contained in Federal Rule of Civil Procedure 23," *id.* at 900-01. This Court declined to expand that exception through a doctrine of "virtual representation" that would "authorize preclusion based on identity of interests and some kind of relationship between parties and nonparties, shorn of the procedural

protections prescribed in *Hansberry*, *Richards*, and Rule 23." *Id.* at 901.

The Delaware Supreme Court's decision is at odds with *Taylor*. The Arkansas action was not a "properly conducted" representative action under Rule 23.1; indeed, it was never a representative action at all. The stated basis for preclusion was a supposed identity of interests between petitioners and the Arkansas plaintiffs and their "relationship" as Wal-Mart shareholders, "shorn of the procedural protections" of Rule 23.1. App. 76a; *see* App. 39a-40a (Arkansas plaintiffs were "not a formal 'representative' of other stockholders at this stage" but "differing groups of stockholders who seek to control the corporation's cause of action"). Preclusion in these circumstances "adopt[s] the very theory *Taylor* rejected." *Smith*, 564 U.S. at 315-16; *see also id.* (*Taylor* "could hardly have been more clear that a properly conducted class action, with binding effect on nonparties, can come about in federal courts in just one way – through the procedure set out in Rule 23").

3. The Delaware Supreme Court's attempts to reconcile its analysis with *Taylor* and *Smith* are unpersuasive. The court mischaracterized *Taylor*'s third exception as having only "two prongs: (a) same interests, and (b) adequate representation of those interests." App. 45a. But that ignores *Taylor*'s explanation that the third exception applies only in "limited circumstances," such as "properly conducted class actions" and "suits brought by trustees, guardians, and other fiduciaries." 553 U.S. at 894. Although the *Taylor* Court did not provide an exhaustive list of the "limited circumstances" in which the third exception applies, the holding in that case makes clear that nonparty preclusion requires more than alignment of

interests and adequate representation. There was no dispute in *Taylor* that the two FOIA plaintiffs' interests were aligned in that both wanted to obtain the same agency documents. And there was no showing that the first FOIA plaintiff's performance was "grossly deficient" – the standard for adequate representation applied by the Delaware Supreme Court here, *see* App. 48a-50a. Nevertheless, this Court rejected nonparty preclusion as contrary to due process.

The Delaware Supreme Court erroneously relied on the fact that, in a derivative action, "[t]he corporation is always the sole owner of the claims." App. 37a. That does not make this situation the kind of "limited circumstance[]," *Taylor*, 553 U.S. at 894, in which due process permits nonparty preclusion. Unless demand futility has been properly pleaded, the shareholder plaintiff has not established its right to control the corporation's claim. A shareholder plaintiff seeking to plead demand futility is not representing the corporation or other stockholders; it is trying to establish its own right to control the litigation, *to the exclusion of* the corporation's board and other stockholders.[5] The decision below is also irreconcilable with the traditional rule that "owners of comparable equity and security interests" are co-owners who cannot preclude each other unless joined. Restatement (Second) of Judgments § 54 cmt. a (1982).

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[5] For that reason, the Delaware Supreme Court erred in concluding that the interests of petitioners and the Arkansas plaintiffs were aligned (even setting aside that mere alignment of interests does not create the limited circumstances sufficient for nonparty preclusion). The different groups of shareholders were *competing* to control the litigation on behalf of the corporation. Their interests were therefore not aligned.

A shareholder plaintiff seeking to establish demand futility is therefore fundamentally unlike a representative of a certified class, or a trustee, guardian, or other fiduciary. Those litigants all have an existing legal duty to protect the interests of unnamed class members or beneficiaries. The shareholder plaintiff does not; it "only has standing to *seek* to bring an action" in the corporation's name. App. 39a (emphasis added). The conclusion "that a shareholder-plaintiff lacks authority to prosecute a claim on the company's behalf" is irreconcilable with "the contention that that same shareholder possessed sufficient authority over the litigation to bar all subsequent lawsuits." George S. Geis, *Shareholder Derivative Litigation and the Preclusion Problem*, 100 Va. L. Rev. 261, 293-94 (2014).

Nor can nonparty preclusion be justified based on the Delaware Supreme Court's observation that the Arkansas plaintiffs "understood that they were acting in a representative capacity." App. 46a. As this Court explained in *Smith*, just because a plaintiff *wishes* to act in a representative capacity does not mean that it has met the legal requirements to actually do so: "wishing does not make it so." 564 U.S. at 315. The Arkansas plaintiffs failed to satisfy the requirement for litigating on behalf of the corporation. As a result, "the precondition for binding [petitioners] was not met." *Id.*

B. The Decision Below Deepens Confusion Regarding The Application Of Due Process Principles In The Shareholder Derivative Context

The Delaware Supreme Court's decision is consistent with decisions of the First and Ninth Circuits in precluding nonparty shareholders from bringing a derivative action when other shareholders have

attempted and failed to plead demand futility. The decision thus deepens a now-widespread misapplication of this Court's cases on nonparty preclusion.

1. Like Delaware, the First and Ninth Circuits have held that nonparty shareholders are precluded from alleging demand futility where a different group of shareholders previously tried and failed to plead demand futility. *See In re Sonus Networks, Inc. S'holder Derivative Litig.*, 499 F.3d 47 (1st Cir. 2007); *Arduini v. Hart*, 774 F.3d 622 (9th Cir. 2014). In *Sonus Networks*, two competing groups of shareholders filed suit – in Massachusetts state and federal court – alleging that the company's officers breached their fiduciary duties. 499 F.3d at 53-54. Applying Massachusetts preclusion law, the First Circuit held that a ruling dismissing the state-court complaint for failure to plead demand futility was binding on the nonparty federal plaintiffs. The court reasoned that, in both suits, the corporation was the "real party in interest," *id.* at 63, and thus, "if the shareholder can sue on the corporation's behalf, it follows that the corporation is bound by the results of the suit in subsequent litigation, even if different shareholders prosecute the suits," *id.* at 64. Although the First Circuit made a passing reference to the prohibition on "virtual representation," *see id.* at 64 n.10, it did not address the due process implications of precluding nonparty shareholders before demand futility has been established.

In *Arduini*, the Ninth Circuit similarly applied nonparty preclusion (under Nevada law) to a failure to plead demand futility. 774 F.3d at 625. The court recognized that binding nonparties to that initial ruling "does potentially raise concerns," but nevertheless applied preclusion because, it concluded, "derivative

stockholders are in privity with each other because they act on behalf of the defendant corporation." *Id.* at 633-34. The Ninth Circuit attempted to distinguish *Taylor* on the ground that the plaintiffs in *Taylor* "had no legal relationship with each other," while the shareholders in *Arduini* "were acting in a representative capacity as shareholders on behalf of" the corporation. *Id.* at 637-38.[6]

2. As with the Delaware Supreme Court, the decisions of the First and Ninth Circuits are irreconcilable with due process and with *Taylor* and *Smith*. Shareholders do not act in a representative capacity on behalf of the corporation unless and until they have satisfied Rule 23.1's precondition of demand futility. When that precondition has not been met, due process does not permit binding nonparty shareholders.

The First and Ninth Circuits erroneously based the application of nonparty preclusion on a desire to prevent duplicative litigation, which cannot override due process. *See Sonus Networks*, 499 F.3d at 64 ("defendants have already been put to the trouble of litigating the very question at issue" – *i.e.*, demand futility – and "the policy of repose strongly militates in

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[6] Although the Delaware Supreme Court indicated it was joining older cases from the Second, Fifth, and Sixth Circuits, *see* App. 41a & n.134, none of those decisions involved a failure to plead demand futility. In the Sixth Circuit, the first shareholder action had been dismissed because the statute of limitations had run. *See Nathan v. Rowan*, 651 F.2d 1223, 1226 (6th Cir. 1981). In the Second and Fifth Circuits, the derivative shareholder suits were litigated to final judgment. *See Dana v. Morgan*, 232 F. 85, 88 (2d Cir. 1916); *Smith v. Waste Mgmt., Inc.*, 407 F.3d 381, 386 (5th Cir. 2005). Those cases are all fundamentally different from this one: once a stockholder establishes demand futility under Rule 23.1, it has established the precondition to sue in a representative capacity on behalf of the corporation (and other stockholders with respect to the corporate claim).

favor of preclusion"); *Arduini*, 774 F.3d at 630 (absent nonparty preclusion, the defendants would be forced "to repeatedly relitigate demand futility, leading to 'multiple litigation,' wasted judicial resources, and potentially inconsistent proceedings"). In *Taylor* and *Smith*, this Court twice rejected the argument that preventing duplicative litigation justifies binding nonparties – explaining that the rule against nonparty preclusion "perforce leads to relitigation of many issues" and that the answer to any such problem lies in *stare decisis* and comity among courts, not "binding nonparties to a judgment." *Smith*, 564 U.S. at 316-17; *see*, *e.g.*, *Microsoft Corp. v. Baker*, 137 S. Ct. 1702, 1710-11 (2017) (noting district court's rejection of subsequent plaintiffs' argument that an intervening decision could "overcome the deference ordinarily due, as a matter of comity, the previous certification denial").

3. Other courts have properly declined to apply preclusion where – as here – a subsequent derivative complaint raises new allegations. As the New York Court of Appeals explained in declining to give preclusive effect under New York law to a prior rejection of demand futility, such a decision "does not for all time and in all circumstances insulate [directors'] conduct from similar claims." *Bansbach v. Zinn*, 801 N.E.2d 395, 401-02 (N.Y. 2003); *see also Freedman v. Redstone*, 753 F.3d 416, 425 (3d Cir. 2014) ("a prior ruling on a director's independence does not necessarily apply in a future proceeding addressing the same topic" because independence "is concerned with a possibly fluid relationship and, accordingly, differs from the determination of a fixed historical fact in the first litigation") (citing *Bansbach*); *Arduini*, 774 F.3d at 630-32 (recognizing contrast between *Freedman*

and *Sonus Networks*); *cf. Johnston v. Box*, 903 N.E.2d 1115, 1121-22 (Mass. 2009) (rejecting argument that "a demand made by a stockholder litigant in an entirely separate lawsuit precludes all similar lawsuits from proceeding on a demand futility basis").

Those decisions underscore the uncertainty regarding the preclusive effect of a ruling on demand futility and the need for this Court's guidance. The correct result – and the one required by the Due Process Clause and this Court's decisions in *Taylor* and *Smith* – is that applying any jurisdiction's preclusion law to bind nonparty shareholders to a decision rejecting demand futility is contrary to due process. This Court's review is urgently needed to clarify that important principle.

II. THE DECISION BELOW PRESENTS A RECURRING QUESTION OF NATIONAL IMPORTANCE

A. The Preclusive Effect of Demand-Futility Determinations Is A Frequently Recurring Issue Of National Importance

The question whether a failure to plead demand futility binds other shareholders is a commonly recurring and important question. If allowed to stand, the decision of the Delaware Supreme Court would undermine important due process protections, create perverse litigation incentives for plaintiffs and defendants alike, and substantially weaken a vital tool for promoting sound corporate governance and policing misconduct.

1. As the volume of decisions discussed in the opinions below demonstrates, *see* App. 24a-25a & nn.86-87; App. 137a & n.69, the question presented frequently arises in derivative actions, which are themselves common. Moreover, derivative actions are

important because they serve as the "chief regulator of corporate management," *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949), and "one of the few tools that shareholders can use to hold directors accountable for their decisions," Ann M. Scarlett, *Confusion and Unpredictability in Shareholder Derivative Litigation: The Delaware Courts' Response to Recent Corporate Scandals*, 60 Fla. L. Rev. 589, 594 (2008); *see also* Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 Geo. L.J. 1733, 1733 (1994) ("Shareholder suits are the primary mechanism for enforcing the fiduciary duties of corporate managers.").

The Delaware Supreme Court's due process holding will be highly influential in derivative actions nationwide. Delaware is the incorporation capital of America and the leading forum for corporate law. As of 2015, more than 1.18 million legal entities were incorporated in Delaware, including 66% of all Fortune 500 companies. *See* Jeffrey W. Bullock, Secretary of State, *Delaware Division of Corporations 2015 Annual Report*, https://corp.delaware.gov/Corporations_2015 Annual Report.pdf. Even among corporations that are headquartered elsewhere, the vast majority (more than 85%) are incorporated in Delaware and thus subject to Delaware law on demand futility and other corporate laws applicable to derivative suits. *See* Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 Vand. L. Rev. 1747, 1760 (2004).

Moreover, many other federal courts and States look to Delaware when deciding questions of corporate law. Indeed, the Delaware Supreme Court's outsized influence in the realm of corporate law resembles that of the Federal Circuit on patent questions. *See Mullen*

v. Academy Life Ins. Co., 705 F.2d 971, 973 n.3 (8th Cir. 1983) (per curiam) (recognizing "Delaware's position as a leader in the field of corporate law" and noting that "courts of other states commonly look to Delaware law . . . for aid in fashioning rules of corporate law"); Thompson & Thomas, 57 Vand. L. Rev. at 1761 (Delaware Chancery Court has "develop[ed] an expertise in corporate law unrivaled by any other court in the country").[7] Subsequent courts faced with the question presented will therefore look to the Delaware Supreme Court's erroneous decision in this case for guidance regarding the application of due process principles in these circumstances.

2. The decision below not only affects a large number of litigants, but also concerns exceedingly important due process principles. This Court repeatedly has recognized the "fundamental nature" of the rule that "a litigant is not bound by a judgment to which she was not a party." *Taylor*, 553 U.S. at 898. The decision below undermines that rule for the millions of shareholders of companies incorporated in Delaware, who face the prospect of being deprived of their

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[7] *See*, *e.g.*, *International Ins. Co. v. Johns*, 874 F.2d 1447, 1459 n.22 (11th Cir. 1989) ("We rely with confidence upon Delaware law to construe Florida corporate law."); *Kramer v. Liberty Prop. Trust*, 968 A.2d 120, 134 (Md. 2009) (because "Delaware courts have gained a reputation for their expertise in matters of corporate law, we deem decisions of the Delaware Supreme Court and Court of Chancery to be highly persuasive") (footnote omitted); *Strasenburgh v. Straubmuller*, 683 A.2d 818, 829-30 (N.J. 1996) (relying on Delaware law on derivative actions); *In re Aguilar*, 344 S.W.3d 41, 46-49 (Tex. App. 2011) (same for Texas); *First Union Corp. v. SunTrust Banks, Inc.*, Nos. 01-CVS-10075 et al., 2001 WL 1885686, at *8 (N.C. Super. Ct. Aug. 10, 2001) (same for North Carolina).

day in court based upon demand-futility rulings in cases to which they were not a party.

3. The Delaware Supreme Court's decision also will greatly exacerbate the "first-filer" problem and promote counterproductive gamesmanship among plaintiffs' attorneys and defense counsel alike. As the Chancery Court observed, "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." App. 57a. The decision below will, perversely, encourage that behavior, because diligent shareholders (like petitioners here) could find themselves precluded from establishing demand futility based upon the rush job of a prior plaintiff.

Even worse, the decision below encourages director defendants to permit a weaker complaint to move forward quickly in hopes of getting it dismissed for failure to plead demand futility. As a leading treatise has recognized, "[d]efendants have been known to indulge in 'plaintiff shopping' in a quest for the least vigorous plaintiff in a multitude of related actions so that a favorable judgment or settlement can be used as res judicata in the other pending actions." Deborah A. DeMott, *Shareholder Derivative Actions: Law and Practice* § 4:19, at 638 (2017-2018 ed.). The Delaware Supreme Court's decision rewards that practice, and the only check it provides – assessing whether the first shareholder's performance was "grossly deficient" – is woefully inadequate to protect the due process rights of nonparty shareholders.

This case well-illustrates the policy problems exacerbated by the decision below. The Arkansas plaintiffs' counsel rushed to court in Arkansas to file

a complaint alleging demand futility based solely on information they had read in *The New York Times*. Petitioners, on the other hand, heeded the Delaware courts' repeated directives and spent three years litigating against the recalcitrant Wal-Mart defendants to obtain the company's books and records. *See supra* pp. 10-11. For their efforts, petitioners were saddled with a determination of issue preclusion, based on a ruling in a case to which they were not parties, and were deprived of the ability to litigate their painstakingly developed complaint on the merits.

B. This Case Presents An Ideal Vehicle To Resolve The Confusion In The Lower Courts Regarding The Question Presented

This case cleanly presents the federal due process question and is an excellent vehicle for resolving lower courts' confusion over the application of nonparty preclusion to demand-futility decisions in derivative suits.

This case comes to the Court after a single-issue remand in which the Delaware Supreme Court asked the Chancery Court "to focus on the following limited question":

> 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? *See Smith v. Bayer Corp.*, 564 U.S. 299 (2011).

App. 107a-108a.

A reversal by this Court on the due process issue would answer the question posed by the Delaware

Supreme Court and resolve the entire appeal. The discussion in the decision below regarding Arkansas preclusion law would be irrelevant because a court's decision on issue preclusion, whether under state or federal law, "is, of course, subject to due process limitations." *Taylor*, 553 U.S. at 891. Therefore, reversing on the due process issue would require reversing the judgment below. The Delaware Chancery Court could then reach the allegations of demand futility in petitioners' complaint.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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