No. 17-1695

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 WRIT OF CERTIORARI TO THE SUPREME COURT OF DELAWARE

BRIEF AMICUS CURIAE OF THE COUNCIL OF INSTITUTIONAL INVESTORS IN SUPPORT OF PETITIONERS

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INTEREST OF AMICUS CURIAE[1]

The Council of Institutional Investors (CII or Council) is a nonprofit, nonpartisan association of public, corporate, and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public fund assets, and foundations and endowments, with combined assets under management exceeding $3.5 trillion. Its associate members include a range of asset managers with more than $25 trillion in assets under management. The Council's members include major long-term shareowners with duties to protect the retirement assets of millions of American workers, who work to protect those assets through proxy votes, shareholder resolutions, negotiations with regulators, discussions with

[1] Pursuant to Supreme Court Rule 37.6, counsel for *amicus* certifies that this brief was not authored in whole or in part by counsel for any party, and no person or entity other than *amicus* or its counsel has made a monetary contribution to the preparation or submission of this brief. In the interest of full disclosure for the Court's benefit, *amicus* acknowledges that several of the plaintiffs are affiliated with the Council as members. However, the views expressed in the brief are those of the Council alone. Pursuant to Rule 37.2(a), counsel further certifies that all counsel of record received timely notice of *amicus*'s intent to file this brief and granted written consent to its filing.

management, and, when necessary, litigation. The Council advocates consistently for strong corporate governance standards and regularly appears as *amicus curiae* in crucial cases affecting shareowner rights. *E.g.*, *Halliburton Co.* v. *Erica P. John Fund, Inc.*, 134 S.Ct. 2398 (2014); *Janus Capital Group, Inc.* v. *First Derivative Traders*, 564 U.S. 135 (2011); *Free Enterprise Fund* v. *Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477 (2010).

This is such a case. The issue before the Court directly implicates the interests of the Council and its members. In enacting the Private Securities Litigation Reform Act (PSLRA), Congress recognized that institutional investors are America's largest shareholders and "have the most to gain from meritorious securities litigation." H.R. Conf. Rep. No. 104-369, at 34 (1995) (quoting testimony of Maryellen Andersen, then treasurer of the Council). Institutional investors also have the most to lose from meritless litigation that depletes shareholder wealth. *See* S. Rep. No. 104-98, at 9 (1995) ("We are . . . hurt if a system allows someone to force us to spend huge sums of money in legal costs by merely paying ten dollars and filing a meritless cookie cutter complaint against a company." (quoting Ms. Andersen)).

Both of those points are just as true of shareholder derivative litigation as they are of securities-fraud litigation like that addressed by the PSLRA. Moreover, derivative suits by shareholders against board members are an important—if last-resort—mechanism to enforce good corporate governance practices of precisely the type for which the Council regularly advocates.[2] Procedural devices, like the issue-preclusive effect potentially accorded to a prior determination of demand futility or the availability of state-law books-and-records requests to ensure demand futility is adjudicated on a well-developed record, can dramatically limit or enhance access to a judicial forum. Correspondingly, such devices strongly influence the value of litigation as an enforcement mechanism. The Council thus has a robust interest in ensuring that the procedural devices employed in shareholder derivative litigation serve the ends of fostering meritorious derivative

[2] See, *e.g.*, CII, Statement on the Value of Corporate Governance, http://www.cii.org/policies_other_issues #value_corp_gov (2018) ("Shareowners may employ a variety of tools and tactics," litigation among them, "to encourage companies to adopt good corporate governance practices."); CII, Policies on Corporate Governance §1.4, http://www.cii.org/corp_gov_ policies (2017) ("Corporate governance structures and practices should protect and enhance a company's accountability to its shareowners, and ensure that they are treated equally. An action should not be taken if its purpose is to reduce accountability to shareowners.").

claims while simultaneously discouraging meritless ones.

SUMMARY OF ARGUMENT

This case presents an issue of significant importance to every member of the American shareholding public, and particularly so for the pension funds and other institutional investors who are the Council's members. Derivative suits provide a crucial last-option tool for shareholders to ensure board members' compliance with their fiduciary obligations to the corporations they serve and to discipline directors who fail in those responsibilities, as Wal-Mart's directors allegedly did here. To fulfill that valuable corporate governance function, however, shareholder derivative suits must remain a remedy that is meaningfully available to responsible and well-prepared litigants.

The holding of the Delaware Supreme Court imperils the availability of that remedy as a practical matter. It is simple reality that any particular instance of alleged corporate misfeasance is virtually certain to give rise to multiple simultaneous derivative suits. Among those, plaintiffs—and their attorneys—have significant incentives to move first and fastest, to maximize their chances of taking control of the litigation. But, all else being equal, the most inadequate complaints are both the easiest to plead and the most readily dismissed, particularly with respect to the issue on which actual representative capacity in a derivative suit turns—demand futility. Granting issue-preclusive effect to demand-futility dismissals as against all subsequent shareholder plaintiffs will create an incentive regime that exacerbates these problems and effectively freezes out the careful plaintiff who seeks to develop and prosecute a well-documented claim—precisely the type of litigant a well-functioning judicial system would want to act in a shareholder-representative capacity.

Such preclusive effect, moreover, is incompatible with due process and the Court's pointed discussion, in *Smith* v. *Bayer Corp.*, 564 U.S. 299 (2011), of that principle's application to issue preclusion in the context of putative (but failed) attempts at representative litigation. A plaintiff's failure to plead particularized facts demonstrating the futility of a pre-suit demand on a corporate board disqualifies her from acting on the corporation's behalf, and so excludes her from the selfsame representative capacity that is necessary for rulings in her suit to have binding effect on other absent shareholders. Just as in *Smith*, the ruling for which preclusionary effect is sought is the very ruling that eliminates the precondition for granting such effect.

The proper resolution of this case thus both is constitutionally proper and prudently advances important corporate governance policies. The Court should grant the petition for certiorari and reverse the decision below.

ARGUMENT

I. THE DUE PROCESS ISSUE PRESENTED IN THIS CASE IS OF CRITICAL SIGNIFICANCE TO INVESTORS NATIONWIDE.

United States capital markets are the deepest and most liquid anywhere in large part because they are widely and correctly perceived as the fairest and best policed in the entire world. The "institutional commitment of the United States to enforcement—administered by multiple and often competing enforcers, private and public"—weeds out disreputable potential issuers of stock, lowers the cost of capital, and yields significant valuation premiums. Coffee, Law and the Market: The Impact of Enforcement, 156 U. Pa. L. Rev. 229, 245-46 (2007). Private enforcement, both of securities rules and corporate governance norms, through litigation and other forms of shareholder activism is thus "fundamental to the success of our securities markets." S. Rep. No. 104-98, at 8 (quoting SEC Chairman Arthur Levitt); accord H.R. Conf. Rep. No. 104-369, at 31 ("[P]rivate lawsuits promote public and global confidence in our capital markets and help . . . to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs.").

Institutional investors such as the Council's members play a critical role in that system, bringing meritorious shareholder-litigation claims and representing broad swathes of the shareholding public in doing so. See, *e.g.*, Romano, Less Is More: Making Institutional Activism a Valuable Mechanism of Corporate Governance, 18 Yale J. on Reg. 174, 175 (2001) (noting the rise of institutional-investor activism focused on "the stated goal of improving corporate performance"). Indeed, an institutional investor serving as lead plaintiff in a derivative suit offers an essentially unique opportunity to "balance the interests of the [shareholders] with the long-term interests of the company and its public investors" in light of such an investor's fiduciary obligations. *Horn* v. *Raines*, 227 F.R.D. 1, 3 (DDC 2005). For that reason, federal and state authorities alike regularly express strong preferences for institutional plaintiffs in representative litigation on behalf of shareholders, because of their strong financial and fiduciary incentives to serve as responsible stewards of those shareholders' interests. *E.g.*, *Freeman ex rel. Tesla, Inc.* v. *Musk*, 324 F.R.D. 73, 81 (D. Del. 2018); *KBC Asset Mgmt. NV ex rel. Chemed Corp.* v. *McNamara*, 78 F.Supp.3d 599, 605 (D. Del. 2015); *King* v. *Verifone Holdings, Inc.*, 12 A.3d 1140, 1151 & n.66 (Del. 2011); *see* 15 U.S.C. §78u-4(a)(3)(B).

Institutional investors' ability to fulfill that function, however, is put at significant risk by rulings like the Delaware Supreme Court's decision below. The duty to protect the retirement savings of workers and their families is incompatible with a heedless rush to litigate. But allowing the failure of any plaintiff anywhere to adequately plead demand futility to preclude all other suits everywhere will force institutional investors and other responsible litigants into an unwinnable footrace against less conscientious plaintiffs to be the first to secure a ruling—whether right or wrong—on the question of demand futility.

That result, as the petition for certiorari demonstrates, is incompatible with the fundamental tenets of due process. 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). Thus, a "judgment or decree among parties to a lawsuit resolves issues as among them, but it does not conclude the rights of strangers to those proceedings." *Martin* v. *Wilks*, 490 U.S. 755, 762 (1989). And as the Court's recent jurisprudence makes plain, the "definition of the term 'party' can on no account be stretched so far as to cover a person . . . whom the plaintiff in a lawsuit was denied leave to represent." *Smith* v. *Bayer Corp.*, 564 U.S., at 313. Yet that is precisely the effect of the erroneous ruling below.

The rule adopted there—that, barring only grossly inadequate representation, any shareholder plaintiff who files suit purportedly on behalf of a corporation binds all other shareholders for purposes of issue preclusion, even when the plaintiff was ultimately denied authority to litigate in a representative capacity—flatly contradicts the understanding of the due-process limits on nonparty preclusion that animated the Court's holdings in *Smith*, *Taylor* v. *Sturgell*, 553 U.S. 880 (2008), and *Richards* v. *Jefferson County*, 517 U.S. 793 (1996).

Those cases define a clear, contrary rule: "A party's 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. In addition, adequate representation sometimes requires (3) notice of the original suit to the persons alleged to have been represented." *Taylor*, 553 U.S., at 900 (citations omitted).

They likewise instruct how that rule is to be implemented in the context of class-based representative litigation—a category within which shareholder-derivative suits have long been understood to reside.[3] "Neither a proposed class action nor a rejected class action may bind nonparties." *Smith*, 564 U.S., at 315. What is required to "have this effect is a class action approved under Rule 23." *Ibid.* And *Smith* makes plain that some form of judicial imprimatur, not just a party's own pleading of an allegation of representative capacity, is necessary before nonparties will be bound by a judgment: "[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." *Ibid.* "[I]n the absence of a certification under that rule, the precondition for binding" an absent member of the purported class is "not met." *Ibid.*[4]

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[3] Before the adoption of Rule 23.1 in 1966, the prior version of Rule 23 embraced a category of "true" class actions that included those "in which the right to be enforced . . . was 'secondary' in the sense that the owner of a primary right refuses to enforce that right and a member of the class thereby becomes entitled to enforce it." 7A C. Wright, A. Miller et al., Fed. Practice & Procedure §1752 (3d ed. 2018). "The most familiar example of this category is the stockholders' suit to redress a wrong done to the corporation." *Ibid.*; accord Fed. R. Civ. P. 23 advisory comm. note (1937).

[4] The necessity of judicial approval for the plaintiff proceeding in a representative capacity as a precondition to bind nonparties is well established in related derivative-litigation contexts—and

The proper application to shareholder-derivative suits of the due-process rule articulated in *Richardson* and *Taylor* is incontrovertible in light of *Smith*. The demand-futility prerequisite common to federal Rule 23.1 and state analogues like Delaware's Chancery

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particularly so when the judgment sought to be given preclusive effect is a ruling that no such capacity exists. Take, for example, a minor, injured through someone's tort, who seeks redress in a suit filed by a purported "next friend" that actually lacks the requisite connection to serve in such capacity. It is utterly uncontroversial that dismissal of a suit on such grounds does not bar other potential representatives from relitigating the next-friend issue in a subsequent suit. *See, e.g.*, *Safouane* v. *Fleck*, 226 Fed. App'x 753, 758 (CA9 2007) (dismissal of minors' relatives' next-friend suit "does not have such preclusive effect, because the children were for procedural reasons never proper parties to this suit"); *Jones* v. *Syntex Labs., Inc.*, 1 Fed. App'x 539, 542-43 (CA7 2001) (denying *res judicata* effect where mother had only purported to act ad litem on son's behalf, without required approval of state courts); *Susan R.M. ex rel. Charles L.M.* v. *Ne. Indep. Sch. Dist.*, 818 F.2d 455, 458 (CA5 1987) (dismissing next-friend suit because father had relinquished conservatorship over his disabled daughter, but noting that State authorities retained authority to act on daughter's behalf). And that is so even though, as in the shareholder-derivative context, the only right of action asserted belongs to the party on whose behalf the plaintiffs purported to litigate.

Rule 23.1 marks the threshold plaintiffs must cross before they acquire the capacity to represent the corporation and, thus, other shareholders absent from the suit: "Ordinarily, it is only when demand is excused that the shareholder enjoys the right to initiate suit on behalf of his corporation in disregard of the directors' wishes." *Kamen* v. *Kemper Fin. Servs., Inc.*, 500 U.S. 90, 96 (1991); see Fed. R. Civ. P. 23.1.[5] Without some form of judicial imprimatur approving such a demonstration, a plaintiff who purports to act in the corporation's behalf does not, in fact or law, act in a representative capacity at all. See, *e.g.*, *Hawes* v. *City of Oakland*, 104 U.S. 450, 460 (1881) (requiring that "before the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation," he must "show *to the satisfaction of the court*" that

[5] Likewise, under Delaware law, the "right to bring a derivative action" does not even arise until the shareholder "has made a demand on the board of directors to institute such an action directly, such demand has been wrongfully refused, or until the shareholder has demonstrated, with particularity, the reasons why pre-suit demand would be futile." *In re SAIC Deriv. Litig.*, 948 F.Supp.2d 366, 376 (SDNY 2013) (quoting *Khanna* v. *McMinn*, No. Civ.A. 20545-NC, 2006 WL 1388744, at *11 (Del. Ch. May 9, 2006)); see Del. Ch. R. 23.1.

demand has been made and refused, or is futile (emphasis added)).

Rather, dismissal under Rule 23.1 for failure to adequately plead demand futility, like the rejection of class certification under Rule 23, conclusively negates a plaintiff's claim to be acting as a representative of all shareholders. Thus, just as with the failed class action in *Smith*, "if we know one thing about" a derivative suit dismissed under Rule 23.1 for failure to allege demand futility, "we know that it was *not*" a suit litigated on behalf of the entire body corporate. 564 U.S., at 314. Nor is it any answer to argue that seeking to act as the corporation's representative is itself "act[ing] in a representative capacity" sufficient to confer binding effect on absent nonparties: "wishing does not make it so." *Id.*, at 315. When a plaintiff is refused authority to litigate a derivative claim, the necessary representative character of the suit "did not come to pass," and allowing rulings in such a suit "to bind nonparties would be to adopt the very theory *Taylor* rejected." *Id.*, at 316.

II. THE COURT SHOULD STEP IN TO ARREST A DESTRUCTIVE RACE TO THE BOTTOM AND PRESERVE STATES' FREEDOM TO IMPLEMENT A VARIETY OF PROTECTIONS FOR THEIR SHAREHOLDER CITIZENS.

Allowing the Delaware court's decision to serve as the final word on this matter would bless a constitutionally problematic resolution in this instance. Additionally, it would dramatically widen a loophole allowing corporate bad actors to avoid facing well-founded shareholder-derivative suits. Meanwhile, it would also sharply undermine state efforts to implement mechanisms that simultaneously screen out nonmeritorious claims and empower responsible shareholder plaintiffs to develop meritorious ones for better-informed consideration by courts.

The problem that the opinion below will exacerbate and multiply is precisely encapsulated in the history that makes this a "troubling case," as the Delaware Supreme Court itself acknowledged. *Cal. State Teachers' Retirement Sys.* v. *Alvarez*, 175 A.3d 86, 2017 WL 6421389, at *1 (Del. Jan. 18, 2017) (table). It is troubling not because multiple parallel suits were filed by different plaintiff groups, but because the careful and deliberate Delaware plaintiffs—having vigorously litigated a years-long challenge under Delaware state law to obtain corporate records that validate their demand-futility allegations—have been pipped at the post. Their responsibly well-researched and well-documented claims that the Wal-Mart board members are conflicted, making demand futile, have been foreclosed by the patent inadequacy of a complaint founded solely on a newspaper article. This is the so-called "fast filer" problem—careful plaintiffs are outstripped, and their potentially meritorious claims crowded out, by judgments against underprepared and inadequately researched complaints that, often because of that very lack of preparation, are more speedily dismissed.

To these specific plaintiffs, that resolution is an injustice; replicated across the entirety of the judicial landscape, it will be a catastrophe for untold numbers of Americans who, directly or indirectly, own shares of corporate stock. The strict regime of issue preclusion for demand-futility rulings adopted below "will amplify pressures for rapid filing," which will in turn "encourage shoddy claims that undermine the governance goals of derivative litigation." Geis, Shareholder Derivative Litigation and the Preclusion Problem, 100 Va. L. Rev. 261, 264-65 (2014). That is, the problem of the feckless fast filer will be exacerbated by the ruling below, while the overall quality of derivative claims will suffer.

It is an undeniable facet of the modern American justice system that corporate scandals engender lawsuits, often including shareholder-derivative suits. And the reality of our nationwide economy—not to mention Delaware's role as the leading situs for incorporation even for businesses headquartered elsewhere—means that derivative suits will regularly, perhaps even inevitably, be brought in multiple judicial venues at the same time. The availability of such suits is, in the Council's view, a critically important tool of corporate governance and enforcing shareholder rights. Their proliferation, on the other hand, presents risks that can, and should be, appropriately managed and avoided through careful legislative consideration.

Delaware has been a leader in developing a legislative and jurisprudential approach to derivative suits that balances those risks against the governance benefits shareholders derive from the availability of the derivative-suit device. Under that approach, Delaware courts regularly admonish plaintiffs "to use the 'tools at hand'—principally statutory inspection rights—to elicit information" to develop well-pleaded complaints, thereby lowering corporate defense costs while preserving shareholders' ability to hold management accountable through derivative litigation. Hamermesh & Wachter, The Importance of Being Dismissive: The Efficiency Role of Pleading Stage Evaluation of Shareholder Litigation, 42 Iowa J. Corp. L. 597, 611 (2017) (quoting *Brehm* v. *Eisner*, 746 A.2d 244, 262 n.57 (Del. 2000)).

Of particular note in this respect is Section 220 of the Delaware Code, a provision granting shareholders in any Delaware corporation a right to inspect the corporate books and records. See 8 Del. C. §220. "Delaware courts have strongly encouraged stockholder-plaintiffs to utilize Section 220 before filing a derivative action, in order to satisfy the heightened demand futility pleading requirements of Court of Chancery Rule

23.1." *King*, 12 A.3d, at 1145. (Indeed, then-Chancellor Strine expressly admonished the plaintiffs in this case to do so, so as to "put the strongest possible complaint on the table." *Alvarez*, 175 A.3d 86, 2017 WL 6421389, at *3 n.20.) Because requests pursuant to Section 220 must be "circumscribed with rifled precision," *Sec. First Corp.* v. *U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 570 (Del. 1997), Delaware's system avoids the enormous costs arising from the broad discovery generally available in other contexts, Hamermesh & Wachter, *supra*, at 611. And by "first prosecuting a Section 220 action to inspect books and records, the stockholder-plaintiff may be able to uncover particularized facts that would establish demand excusal in a subsequent derivative suit." *King*, 12 A.3d, at 1145-46. The plaintiffs' experience here bears out that prediction—but it also demonstrates the immediacy of the concern that litigating claims in that responsible manner is self-defeating: because it took three years, a trip to the Delaware Supreme Court, and a mandamus petition to get Wal-Mart's books and records through Section 220, the Arkansas court beat them to the punch where it ultimately counted—the ruling on demand futility.

King exhibits a salutary state jurisprudential preference for well-informed pleading of shareholder derivative suits. But that preference cannot endure in an environment that deprives plaintiffs, like those here, of a meaningful opportunity to follow *King*'s roadmap. If pursuing a Section 220 claim regularly entails a significant risk that a parallel action by less prepared plaintiffs will decide the demand-futility issue first, two things will inevitably happen. Corporations will regularly deploy scorched-earth tactics to delay resolution of Section 220 actions so that parallel, less informed derivative suits elsewhere can advance to dismissal and so garner issue-preclusive status. And, confronted with the reality that Section 220 actions offer only an illusion of assisting in the pleading of derivative claims, plaintiffs will shun them. If the benefits for pleading such claims come only at the cost of risking those claims being foreclosed entirely, Section 220 and like provisions in other states will wither on the vine.

In effect, that result will foster a race to the bottom—states with fewer shareholder protections or higher substantive hurdles to proving demand futility will become the preferred forums for defendants to arbitrage the differences across state regimes by expediting the resolution of underprepared derivative complaints. Meanwhile, valuable experimentation by Delaware and other states that recognize the significant corporate governance value of derivative suits will be stymied. Neither due process nor the risk of proliferating litigation justifies such an outcome.[6] The Court has "long recognized the role of the States as laboratories for devising

[6] The Court need not fear the phantom of an overwhelming tide of litigation, as it will inevitably be told would result from reversal. There will be no explosion of me-too refilings if demand-futility dismissals do not collaterally estop subsequent plaintiffs. Irrespective of whether they compel issue preclusion as a formal matter, prior rulings on demand futility will nevertheless command respect and will animate, or even dictate, outcomes, both as a matter of comity and as a reflection of the persuasive value of their analysis. Accord *Smith*, 564 U.S., at 317. Foolhardy indeed would be the contingent-fee plaintiffs' attorney who, confronting a Rule 23.1 dismissal in another state, decided to simply recaption his complaint and file it anew in Chancery Court—or vice versa.

The fact that the forecast explosion of securities class-action relitigation never materialized following *Smith* underscores the point. Notwithstanding vociferous arguments there that failing to grant issue-preclusive effect to class certification decisions would inevitably result in abusive refiling, securities class filings actually declined nearly 20% in the year after *Smith* was decided, with a below-average number of filings in each of the following three years. See Cornerstone Research, Securities Class Action Filings: 2017 Year in Review, at 5 (2018). And though filings have since risen, the "primary contributor" to that rise is a sharp increase in new filings concerning M&A transactions, not refilings. *Id.*, at 1. Thus, nothing suggests *Smith* has resulted in any increase solutions to difficult legal problems," *Oregon* v. *Ice*, 555 U.S. 160, 171 (2009), and it should adopt a due process rule here that protects the states' ability to effectively engage in such experimentation, rather than one that imposes a one-size-fits-all issue-preclusion straitjacket.

CONCLUSION

For these reasons, *amicus* respectfully submits that the Court should grant the petition, issue a writ of certiorari to the Supreme Court of Delaware, and reverse the decision below.

Respectfully submitted,

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in refiling of class complaints, much less in the avalanche predicted. Rather, real-world experience, and actual data, demonstrate that even this "strongest argument" in favor of preclusion, *Smith*, 564 U.S., at 316, is far weaker in reality than advertised.