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 a Writ of Certiorari to the Supreme Court of Delaware

BRIEF OF CIVIL PROCEDURE AND CONSTITUTIONAL LAW PROFESSORS AS *AMICI CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	iii
INTEREST OF THE *AMICI CURIAE*	1
SUMMARY OF ARGUMENT	2
ARGUMENT	5
I. Due Process Prohibits The Use Of Issue Preclusion Based Upon A Finding Of Commonality Of Interest Unless The Initial Court Took Steps To Ensure That The Rights Of Nonparty Litigants Would Adequately Be Protected	5
II. The Decision Of The Delaware Supreme Court In *Walmart*, And The Federal Appellate Decisions Upon Which It Relies, Are Inconsistent With This Court's Decisions Setting Forth The Due Process Limitations On Nonparty Issue Preclusion	11
A. *Walmart* And The Federal Court Decisions Premise Nonparty Issue Preclusion On A Form Of "Privity" That Is Based Exclusively Upon A Presumed Identity Of Interests	11
1. Legal Framework Governing Derivative Litigation	11
2. The *Walmart* Decision	12
3. The Appellate Decisions In *Arduini* And *Sonus*	15

TABLE OF CONTENTS—Continued

Page

B. Relying On Interest-Based "Privity" For Nonparty Preclusion Abrogates Due Process Rights And Raises Significant Public Policy Concerns 16

III. The Use Of A "Grossly Deficient" Standard To Determine Adequacy Of Representation Misapprehends This Court's Rulings And Is Inconsistent With Due Process 19

CONCLUSION 22

APPENDIX

APPENDIX: List of *Amicus Curiae* 1a

TABLE OF AUTHORITIES

CASES Page(s)

Arduini v. Hart,
774 F.3d 622 (9th Cir. 2014).................... *passim*

California State Teachers' Ret. Sys., et al. v. Alvarez, et al.,
179 A.3d 824 (Del. 2018).......................... *passim*

City of Birmingham Ret. & Relief Sys. v. Good,
177 A.3d 47 (Del. 2017)............................. 12

Hansberry v. Lee,
311 U.S. 32 (1940).................................... *passim*

In re Sonus Networks, Inc. S'holder Derivative Litig.,
499 F.3d 47 (1st Cir. 2007) .... *passim*

In re Wal-Mart Stores, Inc. S'holder Derivative Litig.,
No. 4:12-cv-4041, 2015 WL 13375767 (W.D. Ark. Apr. 3, 2015), *aff'd sub nom.*, *Cottrell ex rel. Wal-Mart Stores, Inc. v. Duke*, 829 F.3d 983 (8th Cir. 2016).......... 13

Kamen v. Kemper Fin. Servs., Inc.,
500 U.S. 90 (1991)..................................... 12

Koster v. (American) Lumbermens Mut. Cas. Co.,
330 U.S. 518 (1947)................................... 12

Martin v. Wilks,
490 U.S. 755 (1989)................................... 6

Richards v. Jefferson Cnty., Alabama, 517 U.S. 793 (1996).. *passim*

TABLE OF AUTHORITIES—Continued

Page(s)

Ross v. Bernhard,
396 U.S. 531 (1970).................................. 20

Semtek Int'l Inc. v. Lockheed Martin Corp.,
531 U.S. 497 (2001).................................. 14

Smallwood v. Pearl Brewing Co.,
489 F.2d 579 (5th Cir. 1974)..................... 21

Smith v. Bayer Corp.,
564 U.S. 299 (2011).................................*passim*

Snyder v. Harris,
394 U.S. 332 (1969).................................. 20

South Cent. Bell Tel. Co. v. Alabama,
526 U.S. 160 (1999)............................... 7, 10, 11

Taylor v. Sturgell,
553 U.S. 880 (2008).................................*passim*

CONSTITUTION

U.S. Const. amend. XIV ....*passim*

STATUTES

8 *Del. C.* § 141(a) 12

RULES

Fed. R. Civ. P. 23..*passim*

Fed. R. Civ. P. 23(a)(4) 20

Fed. R. Civ. P. 23(c)..................................... 21

Fed. R. Civ. P. 23(d)(1)(A) & (B) 21

Fed. R. Civ. P. 23e(1)................................... 21

Fed. R. Civ. P. 23e(2)................................... 21

TABLE OF AUTHORITIES—Continued

Page(s)

Fed. R. Civ. P. 23.1 .... *passim*

Fed. R. Civ. P. 23.1(a) 4, 20

Fed. R. Civ. P. 23.1(b)(3) 12

Fed. R. Civ. P. 23.1(c) 21

Fed. R. Civ. P. 23.1, Adv. Comm. Note (1966) 21

OTHER AUTHORITIES

Benjamin Kaplan, *Continuing Work of the Civil Committee: 1966 Amendments of the Federal Rules of Civil Procedure (I)*, 81 HARV. L. REV. 356 (1967) 20

Restatement (Second) of Judgments § 42 (1982) 20

Restatement (Second) of Judgments § 54 (1982) 17

INTEREST OF THE *AMICI CURIAE*[1]

Amici curiae listed in the Appendix are professors and scholars of civil procedure, corporate governance, and constitutional law who are concerned that the decision of the Delaware Supreme Court is inconsistent with the Court's recent due process jurisprudence as it is applied to the doctrine of issue preclusion in federal and state courts. Regardless of any differences in our views on issue preclusion, *amici* agree and strongly believe that the protections of due process must be applied to ensure that litigants are not unfairly prevented from access to the courts by being precluded from raising issues that were decided in litigation to which they were not a party and in which the court did not take care to protect the rights of nonparties, as required by *Hansberry v. Lee*, 311 U.S. 32 (1940), and its progeny, *Taylor v. Sturgell*, 553 U.S. 880 (2008), and *Smith v. Bayer Corporation*, 564 U.S. 299 (2011). The Delaware Supreme Court's decision here is incompatible with this Court's jurisprudence under the Due Process Clause and raises a number of public policy concerns. *Amici* therefore contend that certiorari is plainly warranted and should be granted in this case.

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[1] The parties have consented to the filing of this brief. Counsel of record for both parties received notice at least 10 days prior to the due date of *amici curiae's* intention to file this brief. No counsel for a party authored this brief in whole or in part, and no counsel for a party (nor a party itself) made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amici* or their counsel made a monetary contribution to its preparation or submission.

SUMMARY OF ARGUMENT

The doctrine of issue preclusion is a well-established mechanism for ensuring efficient operation of the judicial system by avoiding the relitigation of issues previously decided. Application of issue preclusion against nonparties to a prior litigation, however, raises substantial due process concerns because it denies such litigants access to the judicial system. For at least 80 years, since this Court's decision in *Hansberry v. Lee*, due process has been understood to impose significant limitations on the ability of courts to bind to a judgment those who are not parties to the proceeding in which the judgment is issued. While recognizing that in some instances "a nonparty may be bound by a judgment because she was 'adequately represented by someone with the same interests who [wa]s a party' to the suit," this Court has specifically concluded that due process does not "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." *Taylor*, 553 U.S. at 894, 901 (quoting *Richards v. Jefferson Cnty., Alabama*, 517 U.S. 793, 798 (1996)).

Contrary to this Court's clear precedents, the Delaware Supreme Court in its decision in *California State Teachers' Retirement System v. Alvarez*, 179 A.3d 824 (Del. 2018) ("*Walmart*") held that a decision in a shareholder derivative action denying a plaintiff authority to represent a corporation was binding upon all other shareholders of the corporation, even though they were not parties to the original lawsuit. The Delaware Supreme Court based its decision upon a finding of "privity" between otherwise unrelated shareholder derivative plaintiffs, whom the court held

"***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." *Walmart*, 179 A.3d at 847 (emphasis added). The *Walmart* decision effectively adopts the theory of "virtual representation"—*i.e.*, representation of a nonparty by a party with ostensibly shared interests, but with no procedural protections for the nonparty—which this Court specifically rejected in *Taylor. Walmart* is also contrary to the reasoning of *Smith v. Bayer Corp.* that a court's denial of class certification does not preclude other putative class members from bringing their own subsequent representative action(s). Preclusion based solely upon similar interests is not permissible. Nonparties whose interests were adequately represented may be bound but only under "certain limited circumstances"—where formal steps were taken to protect their interests, such as in "properly conducted class actions, and suits brought by trustees, guardians, and other fiduciaries[.]" *Taylor*, 553 U.S. at 894-95 (citations omitted).

Under this Court's longstanding precedent, the touchstone for binding a litigant to a prior decision where the litigant was not a party is that the procedure adopted in the first case "fairly insures the protection of the interests of absent parties who are to be bound by it." *Hansberry*, 311 U.S. at 42. *See also Taylor*, 553 U.S. at 900 ("[a] party's representation of a nonparty is 'adequate' for preclusion purposes" where, among other things, "the original court took care to protect the interests of the nonparty" (citing *Hansberry*, 311 U.S. at 43)). In a shareholder derivative action pursuant to Fed. R. Civ. P. 23.1 (and state law equivalents), because there is no preexisting fiduciary-type relationship between shareholders (just as in a proposed class action there is no such

relationship between putative class members), the only situation in which the rights of nonparties are adequately protected is where the court determines that the proposed derivative plaintiffs meet the requirements of the Rule, *e.g*., they "fairly and adequately represent the interests of shareholders." *See* Fed. R. Civ. P. 23.1(a). Any decision that dismisses a derivative action at the pleading stage for failure to meet the requirements of Rule 23.1 does not adequately protect the interests of nonparties, and therefore should not be permitted to bind them.

With regard to the due process aspects of issue preclusion, there is no reasoned distinction between a court decision declining to allow a plaintiff to proceed derivatively on behalf of the nominal defendant corporation and a court decision denying class certification and declining to allow a plaintiff to proceed on behalf of a putative class. In the latter situation, this Court unequivocally has concluded that denial of class certification does not bind absent class members. *Smith*, 564 U.S. at 315-16.

The standard for applying issue preclusion in the context of derivative actions was incorrectly resolved in *Walmart* and in at least two federal appellate decisions upon which the Delaware Supreme Court relied—*Arduini v. Hart*, 774 F.3d 622 (9th Cir. 2014), and *In re Sonus Networks, Inc. S'holder Derivative Litig.*, 499 F.3d 47 (1st Cir. 2007); hence there is good reason to believe this issue is not just important, but is likely to arise again. Thus, *amici* believe that this significant question of corporate and procedural law warrants this Court's immediate review and urge the Court to grant the petition in this case.

ARGUMENT

I. Due Process Prohibits The Use Of Issue Preclusion Based Upon A Finding Of Commonality Of Interest Unless The Initial Court Took Steps To Ensure That The Rights Of Nonparty Litigants Would Adequately Be Protected

This Court began its examination of the due process limitations on nonparty issue preclusion in its seminal decision in *Hansberry v. Lee*. There, the Court proceeded from the bedrock

> 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.

Id. at 40. This long-standing rule requires that "the litigant whose rights have thus been adjudicated has been afforded such notice and opportunity to be heard as are requisite to the due process which the Constitution prescribes." *Id*. Thus, in *Hansberry,* the Court rejected the preclusive effect of prior litigation designed to perpetuate racial segregation in housing and concluded that there is "a failure of due process" in cases "where it cannot be said that the procedure adopted, fairly insures the protection of the interests of absent parties who are to be bound by it." *Id*. at 42. *Hansberry* mandates that if nonparties are to be bound by prior litigation, there must be indicia that the court in the first case took steps to protect their interests.

Fifty years after *Hansberry*, in *Richards*, the Court again addressed the due process limitations on the use

of issue preclusion against nonparties. *Richards* involved an attempt to invalidate on due process grounds a tax that had been upheld in prior litigation. The Alabama court held that the decision in the earlier case barred subsequent claims by the *Richards* plaintiffs.

This Court began its analysis by noting the "'deep-rooted historic tradition that everyone should have his own day in court . . . .'" *Richards*, 517 U.S. at 798 (1996) (quoting *Martin v. Wilks*, 490 U.S. 755, 762 (1989)). The Court then reiterated its core conclusion in *Hansberry* that to have binding effect upon future litigants, a prior proceeding must "be 'so devised and applied as to insure that those present are of the same class as those absent and that the litigation is so conducted as to insure the full and fair consideration of the common issue[.]'" *Richards*, 517 U.S. at 801 (quoting *Hansberry*, 311 U.S. at 43). The Court then specifically noted that the plaintiffs in the initial tax challenge litigation "did not sue on behalf of a class; their pleadings did not purport to assert any claim against or on behalf of any nonparties; and the judgment they received did not purport to bind any county taxpayers who were nonparties." *Id.*

Given the posture of the plaintiffs in the first action, the Court found that "there is no reason to suppose that the [prior] court took care to protect the interests of petitioners in the manner suggested in *Hansberry*." *Id.* at 802. It then held that

> Because petitioners and the [prior case] litigants are best described as mere 'strangers' to one another, we are unable to conclude that the [prior] plaintiffs provided representation sufficient to make up for the fact that petitioners neither participated in, nor had the

> opportunity to participate in, the [prior] action. Accordingly, due process prevents the former from being bound by the latter's judgment.

Id. (citations omitted). Thus, even though the plaintiffs in the two suits had similar interests in invalidating the Alabama tax at issue, *Richards* makes clear that similar litigation goals are insufficient to bind subsequent litigants who did not participate in the prior litigation.

The Court's next step in its evolving nonparty preclusion jurisprudence was in *South Cent. Bell Tel. Co. v. Alabama*, 526 U.S. 160 (1999). That decision addressed multiple, consecutive challenges to a (different) Alabama tax and an Alabama court decision again precluding a later suit based upon the results of a prior suit. Unlike *Richards*, however, in *South Central Bell* it was clear that the later plaintiffs were fully aware of—and arguably could have participated in—the initial litigation. While the Alabama courts had seen this as a decisive distinction, this Court concluded that knowledge of the earlier litigation was irrelevant, holding that "[t]hese circumstances, however, created no special representational relationship between the earlier and later plaintiffs. Nor could these facts have led the later plaintiffs to expect to be precluded, as a matter of res judicata, by the earlier judgment itself[.]" *Id.* at 168. *South Central Bell* thus establishes that shared interests, and knowledge by a subsequent litigant of the shared interests, do not provide sufficient protection to the later litigant to satisfy the requirements of due process.

Many of the themes animating this Court's earlier applications of due process to issue preclusion were thoroughly explored and clarified in *Taylor v. Sturgell*. In *Taylor*, this Court considered, as a matter of federal

common law, a potential "virtual representation" exception to the general rule against precluding nonparties, which had been adopted, albeit inconsistently, by certain lower courts. 553 U.S. at 884. The litigation at issue concerned a lawsuit filed by Petitioner Taylor under the Freedom of Information Act ("FOIA") seeking documents related to an antique airplane design. A prior lawsuit brought by a fellow aviation enthusiast and friend of Taylor's seeking the same records had been dismissed. *Id.* at 885. The two litigants had even used the same counsel. The D.C. Circuit held that Taylor's knowledge of the prior suit and the complete identity of interests between the two litigants had made Taylor's friend his "virtual representative" and thus allowed Taylor's suit to be dismissed on issue preclusion grounds. *Id.* This Court rejected the D.C. Circuit's "virtual representation" theory and reversed.

Reiterating the strong policy of allowing every litigant his or her "day in court," this Court identified six categories of recognized exceptions to the "general rule that a litigant is not bound by a judgment to which she was not a party." *Id.* at 893-95, 898. Of relevance here is the Court's third category,[2] which permits preclusion where, under "certain limited circumstances," a nonparty was "adequately represented by someone with the same interests who [wa]s a party" to the suit, such as properly conducted class

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[2] Other scenarios where nonparty preclusion can occur are: (i) where a person to be bound has some form of actual control over or involvement in the initial case (categories 1, 4 & 5 identified by the Court); (ii) there is a pre-existing "substantive legal relationship" between parties (category 2); or (iii) a special statutory scheme "expressly foreclos[es] successive litigation by nonlitigants" (category 6). *Id.* at 893-95 (citations omitted).

actions and suits brought by "trustees, guardians, and other fiduciaries." *Id.* at 894-95 (citations omitted).

Setting forth the principles to be distilled from its prior due process decisions and the recognized exceptions to the rule against nonparty preclusion, the Court held that,

> 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.

Id. at 900 (citations omitted). This Court then explained that "virtual representation" ran afoul of these requirements because it "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 Court also rejected a policy argument from the government that preclusion of subsequent similar suits was required to prevent "limitless" litigation of largely identical FOIA claims. *Id.* at 903-04. The Court found that such duplicative litigation would be deterred by "the human tendency not to waste money." *Id.* (citation omitted).

The Court most recently revisited the limitations on nonparty preclusion in *Smith v. Bayer Corporation*. *Smith* involved a federal diversity action in which class certification was denied. Thereafter, the district court enjoined relitigation of the class certification issue in another class action against Bayer, this one

brought by Smith, who would have been a member of the federal class if it had been certified, in state court.

This Court, having held that the injunction was not authorized by the Anti-Injunction Act, also concluded that "[t]he definition of the term 'party' can on no account be stretched so far as to cover a person like Smith, whom the plaintiff in a lawsuit was denied leave to represent." 564 U.S. at 313. This Court found that "in the absence of a certification under [Fed. R. Civ. P. 23], the precondition for binding Smith was not met. Neither a proposed class action nor a rejected class action may bind nonparties." *Id.* at 315.

Addressing Respondent Bayer's claim that this Court's prior decision in *Taylor* had not involved a class action, the Court held that "we do not see why that difference matters. Yes, [the prior plaintiff] wished to represent a class, and made a motion to that effect. But it did not come to pass. To allow [the prior] suit to bind nonparties would be to adopt the very theory *Taylor* rejected." *Id*. at 315-16. The Court also rejected Bayer's argument that preclusion was required to prevent repeated attempts to certify the same class. *Id.* at 316. As it had in *Taylor,* the Court explained that the argument "flies in the face of the rule against nonparty preclusion," which explicitly allows for relitigation of issues. *Id.* at 316-17.

This Court's decisions on nonparty issue preclusion establish a strict rule that even a nonparty whose interests were aligned with a party's interests may be bound only if "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. Neither notice of a suit (*South Central Bell*), nor identity of interest between plaintiffs in earlier and later suits (*Richards*, *South*

Central Bell, *Taylor* and *Smith*), is sufficient to permit nonparties to be bound by a previously-rendered judgment. Thus, the key to allowing a decision in a prior case to have preclusive effect on a nonparty in subsequent litigation is formal legal protection (such as court approval or the existence of a legal/fiduciary relationship) sufficient to ensure that the party's interests were adequately represented.

In the case of class and derivative actions, those protections are codified in Rules 23 and 23.1, respectively, which require affirmative court approval that the plaintiff in the initial case is to act in a representative capacity for all parties who might subsequently be bound. Only such an explicit determination by a court—coupled with adequate notice to potentially impacted litigants—demonstrates that the prior court "took care to protect the interests" of nonparties. *Taylor*, 553 U.S. at 896; *Richards*, 517 U.S. at 801-02; *see also Hansberry*, 311 U.S. at 42.

II. The Decision Of The Delaware Supreme Court In *Walmart*, And The Federal Appellate Decisions Upon Which It Relies, Are Inconsistent With This Court's Decisions Setting Forth The Due Process Limitations On Nonparty Issue Preclusion

A. *Walmart* And The Federal Court Decisions Premise Nonparty Issue Preclusion On A Form Of "Privity" That Is Based Exclusively Upon A Presumed Identity Of Interests

1. Legal Framework Governing Derivative Litigation

Walmart, and the appellate decisions in *Arduini* and *Sonus* upon which it relies, arise in the context of

shareholder derivative actions and concern the question of whether a decision denying a shareholder the right to represent a corporation derivatively may preclude subsequent litigation by other shareholders seeking to bring the same or similar derivative claims. It is basic corporate law that the board of directors of a corporation is entitled to direct the corporation's business, including pursing a lawsuit on behalf of the corporation. 8 *Del. C.* § 141(a) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . ."); *City of Birmingham Ret. & Relief Sys. v. Good*, 177 A.3d 47, 45 (Del. 2017) (a derivative claim is "a claim belonging to the corporation"). Therefore, a shareholder who wishes to pursue a claim on behalf of a corporation must demand that the board take action or plead with particularity why no such demand should be required; and, as this Court held in its most recent explication of the derivative litigation procedure, "it is only when demand [upon the corporate board] 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) (citation omitted); *see also Koster v. (American) Lumbermens Mut. Cas. Co.*, 330 U.S. 518, 522 (1947). This requirement has been codified in Fed. R. Civ. P. 23.1(b)(3).

In light of the above requirements, when a shareholder plaintiff fails to establish that demand is excused, that litigant does not have any "right to initiate suit on behalf of his corporation." *Kamen*, 500 U.S. at 96 (citation omitted).

2. The *Walmart* Decision

Walmart revolved around allegations that the company had paid bribes in Mexico to obtain favorable

treatment for its expansion plans in that country. App. 112a-113a. Derivative suits regarding this conduct were filed in both Arkansas (Walmart's headquarters location) and Delaware (its state of incorporation). App. 119a. Although the Arkansas federal court action initially was stayed pending the action in Delaware, the latter action was delayed by Walmart's refusal to provide corporate books and records to which the Delaware plaintiffs (Petitioners herein) were entitled. *See* App. 6a, 95a n.20. Ultimately, the Arkansas case went forward, and the federal court held that the Arkansas plaintiffs had not adequately alleged that demand on the Walmart board was excused. *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 sub nom.*, *Cottrell ex rel. Wal-Mart Stores, Inc. v. Duke*, 829 F.3d 983 (8th Cir. 2016).

The Delaware Court of Chancery initially held that the Arkansas federal court decision precluded the derivative litigation in Delaware. App. 95a. Petitioners appealed that decision to the Delaware Supreme Court, which remanded the case back to the Court of Chancery. App. 107a-108a. On remand, the Court of Chancery changed course and held that precluding Petitioners, who were not parties to the Arkansas case, would be improper. App. 82a (quoting *Smith*). The issue then returned to the Delaware Supreme Court on interlocutory appeal.

The Delaware Supreme Court recognized that merely seeking to represent the corporation does not equate to actually representing the corporation: "[a]t the start of the derivative suit, the stockholder-derivative plaintiff only has standing, as a matter of equity, to set in motion the judicial machinery on the corporation's behalf." *Walmart*, 179 A.3d at 847. The

Delaware Supreme Court further acknowledged that "[t]he 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." *Id.*

Despite these holdings, and its recognition that the Arkansas shareholder was ***denied*** the right to represent the corporation, the Delaware Supreme Court held there was sufficient "privity" between the sharehold-ers to permit issue preclusion under Arkansas law.[3] The court held that "when multiple derivative actions are filed (in one or more jurisdictions), ***the plaintiffs 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," *Walmart*, 179 A.3d at 845 (emphasis added), and concluded that "[p]rivity under Arkansas law 'exists when two parties are so identified with one another that they represent the same legal right.'" *Id.* at 845 (citation omitted).

The Delaware Supreme Court also addressed what it perceived to be the requirements of due process, holding that "'a nonparty may be bound by a judgment because she was 'adequately represented by someone with the same interests who [wa]s a party' to the suit.' Thus, this exception has two prongs: (a) same interests, and (b) adequate representation of those interests.'" *Id.* at 850 (citing *Taylor*, 553 U.S. at 894). The court concluded that so long as there is common-

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[3] Federal common law governs the preclusive effects of a federal judgment, but in a diversity state law action, state preclusion law is borrowed as federal law except where contrary to federal interests. *See Semtek Int'l Inc. v. Lockheed Martin Corp.*, 531 U.S. 497 (2001). For these purposes, the requirements of due process are pre-emptive federal law.

ality of interest, a retrospective "evaluation of the adequacy of the prior representation becomes the primary protection for the Due Process rights of subsequent derivative plaintiffs." *Id.*

3. The Appellate Decisions In *Arduini* And *Sonus*

The Delaware Supreme Court in *Walmart* cited to and relied upon federal appellate decisions in *Sonus* and *Arduini* for the proposition that all shareholders of a corporation are in "privity" for the purpose of permitting preclusion of suits by later derivative plaintiffs.[4] *Walmart,* 179 A.3d at 848. *Sonus* involved derivative suits brought separately in state and federal courts regarding alleged financial manipulation by the officers of a corporation. When the state cases were dismissed for failure to adequately plead demand futility, the defendant moved to dismiss the federal proceeding on the ground that dismissal of the state proceeding had preclusive effect. The motion was granted and an appeal was taken. The First Circuit rejected plaintiffs' argument that there was no privity, holding: "[t]he question was whether demand on the board of directors would have been futile, which is an issue that would have been the same no matter which shareholder served as nominal plaintiff." *Sonus*, 499 F.3d at 64. The court further noted that "[t]he defendants have already been put to the trouble of litigating the very question at issue, and the policy of repose strongly militates in favor of preclusion." *Id.*

Subsequently, the identical issue of preclusion in the derivative litigation context came before the Ninth

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[4] In *Taylor*, this Court specifically noted that it "avoid[ed]" the use of the term privity. 553 U.S. at 894 n.8.

Circuit in *Arduini*. That court, relying upon *Sonus*, concluded that "the shareholders are acting on behalf of the corporation and its shareholders and the underlying issue of demand futility is the same regardless of which shareholder brings suit. We therefore hold that shareholders bringing derivative suits are in privity." *Arduini*, 774 F.3d at 634.

B. Relying On Interest-Based "Privity" For Nonparty Preclusion Abrogates Due Process Rights And Raises Significant Public Policy Concerns

The central conclusion of the Delaware Supreme Court in *Walmart*, and the appellate courts in *Arduini* and *Sonus*, is that a form of privity based upon an "identity of interest," without any procedural protections whatsoever, is sufficient to permit a decision dismissing one derivative action for failure to meet the pleading requirements of Rule 23.1 to preclude all shareholders from pursuing similar derivative claims on behalf of the corporation. *See Walmart*, 179 A.3d at 847; *Arduini*, 774 F.3d at 634; *Sonus*, 499 F.3d at 64. This conclusion is contrary to *Taylor*, which rejected the concept 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." *Taylor*, 553 U.S. at 901. *Walmart* is also irreconcilable with *Smith*, in which this Court observed that "[w]e could hardly have been more clear [in *Taylor*] 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." *Smith*, 564 U.S. at 315.

In addition to being constitutionally infirm, *Walmart*'s holdings that different shareholders seeking to represent the corporation derivatively have the "same interests" and that the corporation is the "real party-in-interest" are misplaced. At the demand futility stage, the corporation is only a nominal plaintiff and typically seeks to defeat the shareholder action. The shareholder plaintiff that seeks to stand in the shoes of the corporation is trying to establish its ***own*** right to control the litigation, to the exclusion of the corporation's board ***and*** other shareholders. Hence, the other shareholders' interests are not yet directly joined or in issue. And to the extent shareholder interests are implicated in the nascent proceeding, the corporation is trying to *prevent* its owners from recovering for directors' alleged malfeasance. A term like "real party-in-interest" should not obscure the reality of the situation: the nascent action is being prosecuted by a non-representative individual plaintiff, and defended by the board. How, then, can a judgment regarding a shareholder's standing in favor of the defendant preclude another plaintiff who poses a different set of facts regarding its standing?

The difference in interests between shareholders at the demand futility stage is one of the bases for 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), and contradicts the facile finding of "identity of interests" upon which *Walmart* and the predecessor decisions rely.

In *Taylor*, this Court enumerated certain "limited circumstances" in which a nonparty could be precluded "by someone with the same interests who [wa]s a party," including "properly conducted class actions,

and suits brought by trustees, guardians, and other fiduciaries[.]" 553 U.S. 894-95 (citation omitted). In each of the enumerated circumstances, the prior litigant is under an existing fiduciary or similar legal duty to protect the interests of those not present. In derivative litigation at the pleading stage, stockholders owe no such legal duty to each other. Just as a would-be class representative who fails to establish the requirements for certification of a class under Rule 23 has no duty to, and cannot bind, absent members of the proposed class, a would-be derivative plaintiff who fails to establish demand futility under Rule 23.1 has no duty to, and cannot bind, absent shareholders.

The rule adopted by *Walmart* and its predecessors also has untoward public policy implications. Allowing an adverse demand futility decision in a prior case to preclude a later action promotes a "race to the courthouse" and creates disincentives for shareholders to take the time to use mechanisms such as Delaware's books and records statute to gather additional facts before filing a derivative complaint.

Further, the demand futility analysis evaluates only the plaintiff's pleading, and not actual evidence. It is particularly violative of due process to give preclusive effect to a decision based on a single shareholder's inadequate pleading when no other shareholders had any ability to control that pleading. If the Delaware Supreme Court decision stands, the interests of nonparty shareholders will get no protection from the courts, so shareholders will be forced to protect themselves by monitoring every court in which a derivative claim might be brought and then rushing in with a motion to intervene every time a potentially inadequate derivative complaint is filed.

Finally, the concerns over recurring litigation that this Court found to be unavailing in *Taylor* and *Smith* present even less of a concern in derivative litigation. In seeking class certification under Rule 23 or in bringing FOIA requests, the variations in pleading that potentially could be brought are limited only by the imagination of counsel. In pleading demand futility, on the other hand, the factual variations that can be pled can be enlarged by diligent research, but are limited to those supported by the available factual record. This enormously reduces the likelihood that courts will have to adjudicate endless numbers of cases on essentially the same issues.

III. The Use Of A "Grossly Deficient" Standard To Determine Adequacy Of Representation Misapprehends This Court's Rulings And Is Inconsistent With Due Process

In employing their identity-of-interests-based privity analysis as the primary consideration in permitting nonparty preclusion, the Delaware Supreme Court in *Walmart* and the appellate courts in *Arduini* and *Sonus* ostensibly sought to satisfy due process by inquiring into the "adequacy of representation" in the initial suits. All three courts held that representation of nonparty shareholders in an initial suit would be "adequate" so long as a subsequent court—which had no direct knowledge of the quality of the representation in the earlier case—was able to find that the earlier representation was not "grossly deficient." *Walmart*, 179 A.3d at 852; *Arduini*, 774 F.3d at 635 (a finding of inadequate representation requires representation "so grossly deficient as to be apparent to the opposing party.'" (quoting *Sonus*, 499 F.3d at 66)). These decisions misapprehend this Court's jurisprudence on "adequacy," which centers on whether a

court "took care to protect the interests" of nonparties by, in the class and derivative litigation context, making the affirmative determinations required by Rules 23 and 23.1. *Taylor*, 553 U.S. at 894-96; *see also Richards,* 517 U.S. at 801-02. While a judgment lacks preclusive effect if the court in a subsequent action determines that a party received grossly deficient representation, *see* Restatement (Second) of Judgments § 42 cmt. f (1982), that standard is wholly inapplicable where nonparties in the prior litigation were never represented and there was no mechanism to protect their interests.

This conclusion is bolstered by the history of Rules 23 and 23.1. Derivative actions in federal court were governed by Rule 23 until 1966, when Rule 23.1 was added. *See Ross v. Bernhard*, 396 U.S. 531, 541-42 (1970); *Snyder v. Harris*, 394 U.S. 332, 351 n.13 (1969). Rule 23.1, according to one of its draftsmen, did not "disturb the procedural balance previously established in this kind of litigation." Benjamin Kaplan, *Continuing Work of the Civil Committee: 1966 Amendments of the Federal Rules of Civil Procedure (I)*, 81 HARV. L. REV. 356, 387 n.118 (1967); *see also id.* (stating that derivative suits "with large numbers of shareholders resemble class actions in that they generate similar problems of . . . procedural management generally").

Rule 23.1 employs effectively the same standard as Rule 23 to safeguard absent parties' due process rights. Fed. R. Civ. P. 23(a)(4) requires that a class representative "fairly and adequately protect the interests of the class," while Fed. R. Civ. P. 23.1(a) mandates that a "derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of sharehold-

ers." Similar procedural protections also are mandated, in that both rules require court oversight of the entire litigation and settlement process. *Compare* Fed. R. Civ. P. 23(c), (d)(1)(A) & (B), e(1), (e)(2) (requiring court to issue orders that "determine the course of proceedings" to, among other things, "protect class members and fairly conduct the action," including permitting settlement of class actions "only with the court's approval" and requiring the court to "direct notice in a reasonable manner to all class members who would be bound by the [settlement] proposal" and directing that "[i]f the [settlement] proposal would bind class members, the court may approve it only after a hearing and on finding that it is fair, reasonable, and adequate"), *with* Fed. R. Civ. P. 23.1(c) (providing that "[a] derivative action may be settled, voluntarily dismissed, or compromised only with the court's approval" and requiring that "[n]otice of a proposed settlement, voluntary dismissal, or compromise must be given to shareholders or members in the manner that the court orders"); Advisory Committee's Note (1966) ("[t]he court has inherent power to provide for the conduct of the proceedings in a derivative action, including the power to determine the course of the proceedings and require that any appropriate notice be given to shareholders or members"). Thus, the key protection for adequate representation under due process as embodied in Rule 23.1 is a court in the *initial* case taking "care to protect the interests" of nonparties. *Taylor,* 553 U.S. at 896.

Reviewing adequacy of nonparty protection on a judicial process basis, rather than through a backward-looking assessment of the performance of counsel, is particularly necessary in the derivative context because the burden is upon the defendants to establish lack of adequacy. *See Smallwood v. Pearl Brewing Co.*, 489

F.2d 579, 592 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"). Where the defendants perceive weak opposing counsel or a weak argument on demand futility, there would be little incentive to challenge the plaintiff's counsel's adequacy. Rather, rational defendants would seek to obtain a demand futility decision they could later argue had preclusive effect on other shareholder plaintiffs. The adequacy rule adopted in *Walmart* effectively allows opponent selection by defendants and violates established due process principles.

CONCLUSION

For the foregoing reasons, *Amici* urge the Court to grant the investors' petition.

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APPENDIX

APPENDIX

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