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

REPLY BRIEF FOR PETITIONERS

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The Delaware Supreme Court held that a judgment in a case to which petitioners were not parties precluded their separate lawsuit. That decision "is incompatible with this Court's jurisprudence under the Due Process Clause and raises a number of public policy concerns." Civ. Pro. & Con. Law Profs. Amicus Br. 1 ("Profs. Br."). It violates the "deep-rooted" principle that a party is not bound by a judgment "in which he is not designated as a party or to which he has not been made a party by service of process." *Richards v. Jefferson County*, 517 U.S. 793, 798 (1996); *Hansberry v. Lee*, 311 U.S. 32, 40 (1940). It also cannot be reconciled with *Smith v. Bayer Corp.*, 564 U.S. 299 (2011), and *Taylor v. Sturgell*, 553 U.S. 880 (2008). By concluding that one shareholder's failure to plead demand futility precludes all other nonparty shareholders from seeking to do so, the Delaware Supreme Court – the Nation's preeminent forum for corporate litigation – has misapplied this Court's due process jurisprudence in the context of shareholder-derivative suits.

The Delaware decision not only abrogates the constitutional rule against nonparty preclusion, but also undermines the "chief regulator of corporate management," *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949), and hamstrings responsible institutional investors (like petitioners) that take care to investigate and prepare thorough complaints to meet Rule 23.1's demand-futility requirement. The looming threat of nonparty preclusion will prompt "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." Council of Inst. Invs. Amicus Br. 8 ("CII Br."). The only policy rationale respondents can muster – that nonparty preclusion is necessary to prevent an

unproven specter of duplicative litigation – is the rationale twice rejected by this Court in *Smith* and *Taylor*. Nor do respondents seriously contest the issue is of exceptional importance to corporate governance.

ARGUMENT

I. THE DELAWARE SUPREME COURT'S DECISION CONFLICTS WITH THIS COURT'S PRECEDENT AND DEEPENS CONFUSION IN THE LOWER COURTS

A. The Decision Cannot Be Reconciled With *Smith* And *Taylor*

1. The conflict between the Delaware Supreme Court's decision and *Smith* and *Taylor* is straightforward. Pet. 14-19. Just as a named plaintiff in a putative class action cannot represent (or bind) absent class members without first satisfying Rule 23 – as this Court held in *Smith* – a shareholder cannot bind the corporation or nonparty shareholders without meeting Rule 23.1's requirement to plead specific facts demonstrating why pre-suit demand should be excused. App. 77a-78a (Chancery Court opinion recognizing that *Smith*'s "logic" applies here). In short, a "rejected" attempt to plead demand futility cannot "bind nonparties." *Smith*, 564 U.S. at 315.

Moreover, as the petition also explained (at 16-17), the Delaware Supreme Court's decision reprises the theory of "virtual representation," which this Court rejected in *Taylor*. The *Taylor* Court declined to "authorize preclusion based on identity of interests and some kind of relationship between parties and nonparties." 553 U.S. at 901. Yet the Delaware Supreme Court embraced just such a theory when it held that petitioners were bound by the Arkansas plaintiffs' failure to plead demand futility, on the grounds that "their interests were [supposedly] aligned

with" and adequately represented by the Arkansas plaintiffs. App. 24a-25a.

2. Respondents' efforts to sidestep *Smith* and *Taylor* are unpersuasive.

First, contrary to respondents' suggestion (at 19), *Taylor* squarely relied upon due process in deciding the nonparty preclusion question. 553 U.S. at 891 (noting that the "federal common law of preclusion is, of course, subject to due process limitations" and proceeding to apply the Court's due process jurisprudence); *see id.* at 896-97, 901. And *Smith* – although not specifically framed in due process terms – centrally relied upon *Taylor*. 564 U.S. at 313-16. It is therefore no surprise that the Delaware Supreme Court considered the application of *Smith* to this case a matter of due process. App. 107a-108a.

Second, *Taylor* and *Smith* did not – as respondents argue (at 19-20) – create discretionary "guideposts" that lower courts are free to expand. On the contrary, this Court has "endeavored to delineate *discrete exceptions* that apply in '*limited circumstances*,'" to promote a "constrained approach to nonparty preclusion" and thereby avoid an "amorphous balancing test." *Taylor*, 553 U.S. at 898 (emphases added). Yet respondents' theory would green-light nonparty preclusion upon a lower-court finding of "privity" – which is itself an indeterminate label, *see id.* at 894 n.8 – notwithstanding *Taylor*'s six carefully circumscribed categories of "discrete" and "limited" exceptions. To accept such an amorphous end-run around the rule against nonparty preclusion "would be to adopt the very theory *Taylor* rejected." *Smith*, 564 U.S. at 316.

3. Respondents also misplace reliance (at 12-14) on the Delaware Supreme Court's use of the "privity" label.

a. The Delaware Supreme Court's conclusion that petitioners and the Arkansas plaintiffs were in "privity" for purposes of Arkansas preclusion law, App. 35a-43a, does not resolve the federal due process question, as that court recognized, App. 29a ("All parties also agree that examining privity does not end our inquiry."). As this Court has repeatedly held, state preclusion law cannot be applied in a manner that violates due process. *See*, *e.g.*, *Taylor*, 553 U.S. at 891; *South Cent. Bell Tel. Co. v. Alabama*, 526 U.S. 160, 168 (1999); *Richards*, 517 U.S. at 797. Thus, respondents' assertion (at 11-13) that the Delaware court's application of Arkansas preclusion law is an independent and adequate state ground for the judgment lacks merit.

b. As a matter of federal due process, the *Taylor* Court explained that the "privity" label has been used as a shorthand for the "substantive legal relationships justifying preclusion." 553 U.S. at 894 n.8. None of those recognized legal relationships – "preceding and succeeding owners of property, bailee and bailor, and assignee and assignor," *id.* at 894 – exists here. Nor does this case fit any of the "limited circumstances" in which nonparty preclusion has been accepted based on adequate representation. *Id.* The Arkansas case was not a "properly conducted class action[]," nor were the Arkansas plaintiffs petitioners' "trustees, guardians, [or] other fiduciaries." *Id.* at 894-95.

Consistent with this Court's guidance in *Taylor*, the petition "avoid[ed] using the term 'privity'" as part of the due process analysis to "ward off confusion" created by that overbroad and ill-defined concept. *Id.* at 894 n.8. Even so, petitioners explained why the premise of respondents' "privity" argument – the derivative nature of petitioners' claims – does not support the conclusion. Pet. 18-19.

c. Respondents' reliance on the "privity" label and their assertions (at 16-18) that the corporation was the "real party in interest" in both the Arkansas and the Delaware suits do not support their position on the due process question for three reasons.

First, although both sets of plaintiffs were *seeking* to litigate on behalf of the corporation, the Arkansas plaintiffs failed to plead demand futility and therefore never satisfied Rule 23.1's requirement for controlling the corporation's claim. Accordingly, they were never in "privity" with the corporation, let alone petitioners. *See Smith*, 564 U.S. at 315 ("[I]n the absence of a certification under [Rule 23], the precondition for binding [petitioners] was not met."); *Nationwide Mut. Fire Ins. Co. v. George V. Hamilton, Inc.*, 571 F.3d 299, 313 (3d Cir. 2009) (declining to authorize nonparty preclusion under *Taylor* where the earlier litigant was not the nonparty's "legal representative").

Second, at the demand-futility stage of a derivative suit, the named plaintiff shareholder is seeking to establish its right to control the corporation's claim *to the exclusion of* the board and other shareholders. *See* Profs. Br. 17 (at the demand-futility stage, the corporation "typically seeks to defeat the shareholder action"). Before demand futility has been pleaded, co-shareholders owe no legal duty to one another, Pet. 18 (citing Restatement (Second) of Judgments § 54 cmt. a (1982)), and are therefore not in "privity," *see Black's Law Dictionary* 1394 (10th ed. 2014) ("privity" entails "mutuality of interest"). The successive shareholder-plaintiffs are "strangers" in the operative sense – just like the plaintiffs in *Richards*, 517 U.S. at 798, and *South Central Bell*, 526 U.S. at 168.

Third, the corporation's ownership of the underlying claim does not justify nonparty preclusion because

Delaware law entitles a shareholder to *control* that claim upon a showing of demand futility. App. 38a-39a (shareholder "may assume control of the corporation's claim" upon pleading that "demand on the board would be futile"); *Schoon v. Smith*, 953 A.2d 196, 202, 208-09 (Del. 2008) (discussing the "right" of a shareholder to bring a derivative action). A shareholder cannot be deprived of that right to control the litigation without due process. *See Town of Castle Rock v. Gonzales*, 545 U.S. 748, 756 (2005) (due process attaches where a party has a "legitimate claim of entitlement" under "state law").

4. Respondents' remaining arguments are no more persuasive.

First, their contention (at 14-15) that notice of the Arkansas suit is a sufficient basis for nonparty preclusion is incorrect. This Court held in *South Central Bell* that a nonparty's awareness of an earlier litigation cannot justify nonparty preclusion. *See* 526 U.S. at 168; *Taylor*, 553 U.S. at 897 (discussing *South Central Bell*); *cf. Martin v. Wilks*, 490 U.S. 755, 765 (1989) (holding that "[j]oinder as a party, *rather than knowledge of a lawsuit and an opportunity to intervene*, is the method by which potential parties are . . . bound by a judgment") (emphasis added). The cases respondents cite (at 14) show that notice may be *necessary* to bind nonparties. But notice is never *sufficient* for nonparty preclusion.

Moreover, petitioners did not, as respondents assert (at 15), make a "knowing and deliberate decision to stand on the sidelines" while the Arkansas case was pending. Respondents prevented petitioners from effectively intervening in the Arkansas case by stonewalling petitioners' access to the company books and records. Pet. 8-9. Without those records, petitioners

could not plead demand futility with particularity – as the Chancery Court predicted at the outset of the case, *see* Pet. 1-2 – meaning intervention would have bound petitioners to a doomed effort to plead demand futility "founded solely on a newspaper article," CII Br. 14; *see* Fed. R. Civ. P. 24(c) (complaint must accompany motion to intervene).

Second, respondents' argument (at 15-16) that the Arkansas plaintiffs adequately represented petitioners is misplaced, because the Arkansas plaintiffs *never represented petitioners* (or anyone other than themselves) in the first place. The Arkansas plaintiffs failed to plead demand futility, and, unless and until that happens, the representative action "does not come into existence." *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 730 (Del. 1988). Because the Arkansas plaintiffs never represented petitioners, the question whether they were an *adequate* representative is beside the point.

Third, respondents' serial invocations of the Full Faith and Credit Clause (at 2, 11, 17, 31) are baseless. By its terms, that Clause "govern[s] the effects to be given only to state-court judgments," *Semtek Int'l Inc. v. Lockheed Martin Corp.*, 531 U.S. 497, 506-07 (2001), whereas this case involves the preclusive effect of a judgment rendered in Arkansas *federal* court. In any event, the Full Faith and Credit Clause does not authorize, let alone require, a court to bind *nonparties* to the judgment of another court – it requires only that a court enforce a state-court judgment as against parties that are properly bound by that judgment.[1]

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[1] *See Kremer v. Chemical Constr. Corp.*, 456 U.S. 461, 482 (1982) ("A State may not grant preclusive effect in its own courts to a constitutionally infirm judgment, and other state and federal courts are not required to accord full faith and credit to such a

B. The Decision Deepens Confusion About The Due Process Rights Of Shareholders In Derivative Actions

Like the Delaware Supreme Court, the First and Ninth Circuits have precluded nonparty shareholders from bringing a derivative action when a previous shareholder failed to plead demand futility. *See In re Sonus Networks, Inc. S'holder Deriv. Litig.*, 499 F.3d 47 (1st Cir. 2007); *Arduini v. Hart*, 774 F.3d 622 (9th Cir. 2014). By joining *Sonus Networks* and *Arduini*, the Delaware Supreme Court has deepened a fundamental misunderstanding of this Court's holdings on nonparty preclusion. Pet. 19-23.

1. Respondents fail to acknowledge that *Sonus Networks* (which preceded *Taylor* and *Smith*) and *Arduini* are expressly based upon a desire to prevent duplicative litigation. Pet. 21-22. That reasoning cannot be squared with *Taylor* and *Smith*, which explicitly rejected the argument that nonparty preclusion can be used to prevent duplicative litigation. Pet. 5-6, 22.

2. Respondents also overstate the consensus in the lower courts, incorrectly relying on decisions from the Second and Sixth Circuits. Opp. 26-27 (citing *Dana v. Morgan*, 232 F. 85, 88 (2d Cir. 1916); *Nathan v. Rowan*, 651 F.2d 1223, 1226-27 (6th Cir. 1981)).[2] As

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judgment.") (footnote omitted); *cf. Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 805 (1985) ("a judgment issued without proper personal jurisdiction over an absent party is not entitled to full faith and credit elsewhere").

[2] The district court cases respondents cite (at 28-29), most of which pre-date this Court's decision in *Smith*, make the same mistakes as the Delaware Supreme Court: concluding that a shareholder-plaintiff who has not met the preconditions to litigate in a representative capacity can nevertheless bind nonparty plaintiffs, based on a supposed alignment of interests.

explained in the petition (at 21 n.6), those decisions are inapposite because, in both cases, the first action was resolved on the merits, not for failure to plead demand futility.

3. As the petition demonstrated (at 22-23), other appellate courts have properly declined to apply preclusion where, as here, a subsequent derivative complaint raises new allegations. *See Bansbach v. Zinn*, 801 N.E.2d 395, 401-02 (N.Y. 2003); *Freedman v. Redstone*, 753 F.3d 416, 425 (3d Cir. 2014). The *Arduini* court recognized the tension between the First Circuit's decision in *Sonus Networks* and the Third Circuit's decision in *Freedman*. *See* 774 F.3d at 630-32.

Respondents' efforts to distinguish (at 29-30) *Bansbach* and *Freedman* on the basis that they applied state-law preclusion principles does not eliminate the divergent results the cases represent. Unlike the First and Ninth Circuits (and the Delaware Supreme Court here), the courts in *Bansbach* and *Freedman* did not adopt a rule of automatic preclusion in the demand-futility context. As a result, the Third Circuit and the New York Court of Appeals reached results consistent with due process in the same factual and procedural context as this case.

II. THIS CASE PRESENTS A RECURRING QUESTION OF NATIONAL IMPORTANCE

Respondents do not deny that the question presented frequently arises in derivative actions, which are "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). Delaware's status as the leading forum

for shareholder derivative litigation underscores the importance of the decision in this case.

A. The Delaware Supreme Court's Approach Encourages A Race To The Courthouse

Precluding nonparty shareholders from alleging demand futility will encourage plaintiffs to race to the courthouse with inadequate complaints, because shareholders who perform their due diligence risk being shut out of court by an earlier decision dismissing a weaker complaint. As the Council of Institutional Investors explained, the result "will be a catastrophe for untold numbers of Americans who, directly or indirectly, own shares of corporate stock." CII Br. 15.

Respondents incorrectly suggest (at 34) that the fast-filer problem should be left to state legislatures. The problem was created, and ought therefore to be solved, by court decisions interpreting the Due Process Clause. Interpreting and applying that constitutional provision is a quintessentially judicial role. The theoretical possibility that a state legislature may change its preclusion law cannot justify letting stand a state high court's ruling that violates due process.

This case is a stark example of a less-prepared plaintiff winning a race to the courthouse, failing to sufficiently plead demand futility, and thereby precluding other shareholders from seeking to do so, to the detriment of the corporation and all of its stakeholders (except for the directors who are shielded from answering for their breaches of fiduciary duty). Respondents grossly mischaracterize the books-and-records litigation in accusing petitioners (at 33) of "spen[ding] years litigating an overly expansive Section 220 action." To the contrary, Wal-Mart's failures to comply with its obligations created the delays

respondents seek to exploit. Wal-Mart's initial production was incomplete and "highly redacted without any explanation for the redactions." *Wal-Mart Stores, Inc. v. Indiana Elec. Workers Pension Tr. Fund IBEW*, 95 A.3d 1264, 1269 (Del. 2014). After Wal-Mart provided a supplemental production that was again deficient, the Chancery Court ordered Wal-Mart to produce a full set of documents (an order the Delaware Supreme Court affirmed). *Id.* at 1269-70. Even then, petitioners had to force compliance with the order through a contempt motion, which resulted in the production of yet more documents. *Indiana Elec. Workers Pension Tr. Fund IBEW v. Wal-Mart Stores, Inc.*, 2015 WL 2150668 (Del. Ch. May 7, 2015). Although petitioners followed the Chancery Court's guidance by fighting to obtain corporate records to prepare a thorough complaint, the Delaware Supreme Court's failure to follow this Court's due process precedents prevented that complaint from being considered on its merits.

B. This Court Has Rejected Respondents' Professed Concerns About Duplicative Litigation

Respondents erroneously assert (at 30) that vindicating investors' due process rights "would invite endless litigation to the detriment of corporations, directors and officers, and stockholders alike." As this Court recognized in *Smith* and *Taylor*, such dire predictions are unlikely to prove true, in light of "principles of *stare decisis* and comity among courts," *Smith*, 564 U.S. at 317, as well as the "human tendency not to waste money," *Taylor*, 553 U.S. at 903-04; *see* CII Br. 18-19 & n.6 (showing that Bayer's speculative forecasts of duplicative case filings in *Smith* have not materialized).

Here, because the Delaware court incorrectly concluded that petitioners were precluded from asserting demand futility, the court never considered what, if any, weight to give the Arkansas court's demand-futility ruling on a different pleading.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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