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SHAREHOLDER DERIVATIVE LITIGATION AND THE PRECLUSION PROBLEM

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INTRODUCTION

WHY would a shareholder ever sue her own company? One might easily understand a claim by a mistreated employee or customer. But shareholders own the firm, so isn't this just a case of slashing your own tires? The answer is rooted in that most fundamental aspect of the corporation: representation. Shareholders are the residual owners of a company, but they do not collectively vote on every firm decision. Rather, they cede power to a small group of representatives who are entrusted to call most of the shots.[1] This is the genius of the corporation: It can be efficient to centralize power in this manner.[2] But it is also the peril. These representative managers are flawed, like all of us, and human nature sometimes causes corporate leaders to behave badly.[3] For this reason, suing your company is not the same as slashing your tires; it is a plausible strategy for righting a wrong, for promoting sound governance, and for halting the mischiefs of a rogue leader.

But as soon as corporate law opens a window for shareholder lawsuits, it becomes apparent that writing the rules to govern these claims is fraught with difficulty. Our current approach to shareholder litigation has four fundamental features that, for better or worse, act as tent poles to a sort of carnival.[4] First, the litigation is *representative* because a single shareholder can assert claims on behalf of the entire body of shareholders. Second, the litigation is (usually) *preclusive* because any given resolution to a claim cannot easily be revisited and will typically bind other shareholders. Third, the litigation is *self-funding* because the pri-

[1] See, e.g., Del. Code Ann. tit. 8, § 141(a) (2011) (placing responsibility for managing a corporation with the board of directors).

[2] See, e.g., R.H. Coase, The Nature of the Firm, 4 Economica 386, 390–98 (1937).

[3] This duality is sometimes known as the authority-responsibility tension. We want corporate leaders to have authority to make centralized decisions about other people's money. But we also want to hold those same leaders accountable when bad things happen. See Michael P. Dooley, Two Models of Corporate Governance, 47 Bus. Law. 461, 463–64 (1992). The robust literature on corporate agency costs documents these managerial concerns, along with efforts to contain the distortions, in careful detail. See, e.g., Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, J. Fin. Econ., Oct. 1976, at 1, 5–7, 10.

[4] See John C. Coffee, Jr., Litigation Governance: Taking Accountability Seriously, 110 Colum. L. Rev. 288, 291–92 (2010).

mary actors in these cases, the plaintiffs' lawyers, are entitled to receive payment for their services through contingency fee arrangements or payments from the corporation itself.[5] And finally, the litigation is *risk-limited* because the American rule for attorneys' fees states that a losing party does not need to pay for the costs of the winning party.[6] A defending corporation who fights to the bitter end and wins will still be on the hook for its own legal bills.

These four features of shareholder litigation produce some very complicated incentives. Consider the representation problem. Clearly it is impracticable to require a unanimous shareholder vote as a trigger to the lawsuit. But a firm's full roster of shareholders can run into the tens of thousands (more, if intermediate ownership vehicles like mutual funds are looked through), and this is a diverse group.[7] Someone will disagree with any corporate action, and certainly we cannot use the legal system to second-guess all business decisions. Some shareholders have private grievances or worldviews that may not be shared by most other owners. Why should they control the agenda? And even if every shareholder is upset by something, there can be a coordination problem because many owners will lack sufficient stakes to invest in an uncertain lawsuit. Why should you spend thousands of dollars to litigate for better governance if you only own a few shares? Just dump the stock and buy Apple.

One way to solve this coordination problem is to empanel a single shareholder to represent the entire group of equity owners. But to give this representation any real effect, the law must make the litigation binding on other similarly situated shareholders. It makes little sense to litigate the same concern over and over again. The corporation would have to deal with each individual shareholder, and a lack of systemic resolution would haunt the firm. So resolving one dispute should typically settle the matter for everyone.

Or should it?

This Article will examine the preclusion problem in the context of shareholder derivative litigation. Shareholder derivative claims differ

[5] Id. at 292.

[6] Id. For a more general discussion of fee-shifting rules, see Thomas D. Rowe, Jr., The Legal Theory of Attorney Fee Shifting: A Critical Overview, 1982 Duke L.J. 651, 651–52.

[7] It is difficult to establish a more precise number of shareholders for any given company because firms are not required to disclose the total number of individual holders or average investor holdings. But given that many large firms have outstanding shares in the eight, nine, or even ten figures, an estimate of tens of thousands of individual investors seems conservative.

from other forms of representative litigation because a lead plaintiff seeks to wrest governance control from the corporate entity itself in order to prosecute a lawsuit on the firm's behalf.[8] This is an extreme act: Why should one shareholder be able to take the reins of an entire firm? Accordingly, corporate law only permits these lawsuits to go forward in rare circumstances, typically when we suspect that something is rotten in the boardroom.

Many claims are filed each year, however, and a single alleged bad act will often attract lawsuits in multiple jurisdictions.[9] This, in turn, raises a very tricky question for derivative litigation: When can we be confident that a given shareholder representative has adequately prosecuted a claim, such that the matter should be closed? On the one hand, when a case is dismissed in one court, the failure to collaterally estop a sister case (relating to the same facts) in another jurisdiction raises the possibility of a "zombie" lawsuit that will never rest. A motivated plaintiffs' lawyer might simply reincarnate the claim, through a different shareholder, and begin the process anew.

On the other hand, inevitable dismissal of later cases under collateral estoppel could empower an opportunistic company to "sponsor" an ill-informed plaintiff to rush to the courthouse with a weak complaint in order to insulate the firm from legitimate derivative claims. (We might call this a "patsy" lawsuit.) Less Machiavellian, a strict collateral estoppel regime will amplify pressures for rapid filing, and this, in turn, may encourage shoddy claims that undermine the governance goals of deriva-

[8] For a useful overview of the shareholder's derivative litigation technique, see Stephen M. Bainbridge, Corporate Law 187–219 (2d ed. 2009); Deborah A. DeMott, Shareholder Derivative Actions: Law and Practice (2013-2014 ed. 2013). For helpful commentary on the derivative litigation framework, see Reinier Kraakman et al., When Are Shareholder Suits in Shareholder Interests?, 82 Geo. L.J. 1733 (1994); Mark J. Loewenstein, Shareholder Derivative Litigation and Corporate Governance, 24 Del. J. Corp. L. 1 (1999); Jonathan R. Macey & Geoffrey P. Miller, The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform, 58 U. Chi. L. Rev. 1 (1991); Ann M. Scarlett, Confusion and Unpredictability in Shareholder Derivative Litigation: The Delaware Courts' Response to Recent Corporate Scandals, 60 Fla. L. Rev. 589 (2008); Robert B. Thompson & Randall S. Thomas, The Public and Private Faces of Derivative Lawsuits, 57 Vand. L. Rev. 1747 (2004).

[9] See, e.g., John Armour et al., Delaware's Balancing Act, 87 Ind. L.J. 1345, 1363 (2012); Jessica M. Erickson, Overlitigating Corporate Fraud: An Empirical Examination, 97 Iowa L. Rev. 49, 54 (2011); Joseph A. Grundfest & Kristen A. Savelle, The Brouhaha Over Intra-Corporate Forum Selection Provisions: A Legal, Economic, and Political Analysis, 68 Bus. Law. 325, 335 (2013).

tive litigation.[10] Moreover, the basic principles of collateral estoppel do not easily map onto the architecture of shareholder derivative claims because a *different* shareholder brings each case. Collateral estoppel typically requires privity, meaning that there is a clear link of identity between the parties in both actions.[11] Can we comfortably conclude that there is privity when a new shareholder seeks to file the claim? Relatedly, how should we determine whether any given plaintiff is an adequate representative of the shareholder class?

An illustration may be helpful. Botulinum toxin, more commonly known as Botox, is famously used by dermatologists to smooth frown lines and arrest facial wrinkles. The effects are only temporary, lasting about six to eight months, but repeat Botox injections can keep patients looking young (and keep their doctors in Land Rovers). Interestingly, a recent legal episode involving the maker of Botox, Allergan, Inc., may turn into a fountain of youth for shareholder derivative claims. This treatment might alleviate some of the concerns about derivative litigation, but it also raises a risk that some firms will be unable to put claims behind them without resorting to a binding settlement agreement.

On September 1, 2010, Allergan settled charges with the United States Department of Justice relating to improper marketing practices for Botox.[12] Allergan paid a massive six hundred million dollars in fines and penalties—approximately its entire annual net income.[13] Not surprisingly, this blockbuster announcement quickly attracted lawsuits from angry shareholders: How could Allergan's management have permitted such conduct? A case was filed on September 3, 2010, in the Delaware Court of Chancery (Allergan is incorporated in Delaware), and several other claims followed in both Delaware and California (where the firm maintained headquarters).[14]

The Delaware vice chancellor postponed hearings on the company's motion to dismiss because some Delaware plaintiffs were investigating

[10] See, e.g., Leo E. Strine, Jr. et al., Putting Stockholders First, Not the First-Filed Complaint (Jan. 10, 2013) (unpublished manuscript, available at http://ssrn.com/abstract=2200499).

[11] See infra note 95 and accompanying text.

[12] La. Mun. Police Emps.' Ret. Sys. v. Pyott (Allergan I), 46 A.3d 313, 321 (Del. Ch. 2012), rev'd, 74 A.3d 612 (Del. 2013).

[13] Id.

[14] Id. at 321–22.

the matter more fully through a books and records inspection.[15] The California case moved more quickly, however, and that judge eventually dismissed the case with prejudice on January 17, 2012.[16]

Armed with this development, Allergan supplemented its motion to dismiss the case in Delaware with a collateral estoppel argument. According to the firm, the fact that one group of shareholders had litigated and lost in one state meant that other shareholders were precluded from continuing the derivative litigation in another state.[17] In short, the matter had already been decided, and Delaware was obligated under the principles of collateral estoppel to follow California's lead. Many previous cases supported this position.[18]

But the Delaware vice chancellor disagreed, refusing to apply collateral estoppel on two separate grounds.[19] First, he ruled that the Delaware shareholders were not in privity with the California shareholders because both groups were still acting in their individual capacities—such that neither shareholder had stepped into the shoes of the corporation.[20] According to the court, privity only occurs after the demand requirement is excused because this is when a plaintiff-shareholder is empowered to pursue the derivative litigation as a representative of the entire firm. Since the California case had *approved* the defendant's motion to dismiss (maintaining the demand requirement), there was no preclusive effect on the Delaware proceeding.[21] Second, the vice chancellor found that the California plaintiffs were inadequate representatives of the Delaware litigation because these shareholders had cobbled together a bare-

[15] Id. at 322. Delaware corporate law provides shareholders with these inspection rights, for a proper purpose, under § 220 of the Delaware General Corporation Law. Del. Code Ann. tit. 8, § 220 (2011).

[16] *Allergan I*, 46 A.3d at 322.

[17] Id.

[18] See, e.g., In re Sonus Networks S'holder Deriv. Litig., 499 F.3d 47 (1st Cir. 2007); Arduini ex rel. Int'l Game Tech. v. Hart, No. 3:11-cv-00255-ECR-VPC, 2012 WL 893874 (D. Nev. Mar. 14, 2012); In re Bed Bath & Beyond Deriv. Litig., No. 06-5107(JAP), 2007 WL 4165389 (D.N.J. Nov. 19, 2007); Hanson v. Odyssey Healthcare, No. 3:04-CV-2751-N, 2007 WL 5186795 (N.D. Tex. Sept. 21, 2007); LeBoyer v. Greenspan, No. CV 03-5603-GHK (JTLx), 2007 WL 4287646 (C.D. Cal. June 13, 2007); Henik ex rel. LaBranche & Co. v. LaBranche, 433 F. Supp. 2d. 372 (S.D.N.Y. 2006); In re Career Educ. Corp. Deriv. Litig., No. 1398-VCP, 2007 WL 2875203 (Del. Ch. Sept. 28, 2007); Carroll ex rel. Pfizer, Inc. v. McKinnell, No. 50567(U) (N.Y. Sup. Ct. Mar. 17, 2008).

[19] *Allergan I*, 46 A.3d at 324–51.

[20] Id. at 327–28.

[21] Id. at 334–35.

bones lawsuit before conducting any meaningful investigation of the Botox situation.[22]

This was a controversial ruling, and the case attracted attention. One commentator called it a "cross-country bench slap" by the vice chancellor.[23] Another headline blared, "Delaware Court of Chancery 'Overrules' Federal Court."[24] Eventually the case was certified for interlocutory appeal to the Delaware Supreme Court.[25] The state's high court reversed the lower court decision, but it did so on broad grounds relating to the United States Constitution's Full Faith and Credit Clause.[26] Importantly, the decision refused to clarify Delaware's privity requirement for collateral estoppel claims, leaving a split among the lower court decisions.[27] This means that fundamental questions persist about the finality of any given derivative case and the precise standards for adequate representation in this context. These apparently technical problems have some profound implications for corporate law.

This Article will advance a three-step blueprint for navigating the derivative litigation preclusion problem. First, corporations should have significant latitude to channel derivative actions into a single state by adopting forum selection provisions in corporate charters or bylaws. This would mitigate the multiple-forum problem, but, importantly, it would not prevent either patsy litigation or harassing follow-on lawsuits. Accordingly, the second step is to encourage more stringent monitoring of adequate representation in order to counter the ability of fast-filing shareholders to stymie legitimate shareholder investigations. Finally, corporate law should put incentives in place to discourage never-ending

[22] Id. at 335.

[23] David Marcus, Laster Issues Cross-Country Bench Slap, Deal Pipeline (June 20, 2012, 6:00 AM), http://www.thedeal.com/content/restructuring/laster-issues-cross-country-bench-slap.php.

[24] Keith Paul Bishop, Delaware Court of Chancery "Overrules" Federal Court, Cal. Corp. & Sec. L. (June 18, 2012), http://calcorporatelaw.com/2012/06/delaware-court-of-chancery-overrules-federal-court/. The vice chancellor took issue with these headlines during the oral arguments on the motion to certify the case for interlocutory appeal. See Transcript of Oral Argument–Motion to Stay, Application for Certification of Interlocutory Appeal at 42–55, La. Mun. Police Emps.' Ret. Sys. v. Pyott (Allergan I), 46 A.3d 313 (Del. Ch. 2012) (No. 5795-VCL).

[25] Pyott v. La. Mun. Police Emps.' Ret. Sys. (Allergan II), 74 A.3d 612, 615 (Del. 2013).

[26] Id.

[27] Id. at 617. More specifically, the unwillingness of the Delaware Supreme Court to address the privity question leaves a split between the chancery court's *Allergan I* opinion and *In re Career Educ. Corp. Deriv. Litig.*, No. 1398-VCP, 2007 WL 2875203 (Del. Ch. Sept. 28, 2007). I discuss this concern further infra note 163 and accompanying text.

lawsuits. One plausible approach is to embrace fee-shifting statues (currently on the books in some states) or to uphold bylaw provisions that require a plaintiff to cover the defendant's legal bills when a lawsuit is filed without reasonable cause or for an improper purpose. In particular, the failure to incorporate information from a books and records investigation into a complaint might raise concerns that the lawsuit was brought without reasonable cause. Similarly, filing a follow-on lawsuit after an initial claim has been dismissed should only meet the reasonable cause test if the subsequent shareholder-plaintiff introduces substantial incremental evidence related to the misdeed. Taken together, these reforms should minimize duplicative litigation and mitigate baseless derivative claims—while still preserving the promise of shareholder lawsuits as a meaningful safeguard against dysfunctional corporate governance.

The discussion will proceed as follows. Part I will outline the rules of shareholder derivative litigation and the theory of internal litigation as a corporate governance device. Part II will introduce the collateral estoppel complication and illustrate the perverse incentives that can arise under either strict compliance or absolute rejection of this doctrine. Part III will chart a path down the middle, offering a three-part strategy for managing shareholder derivative litigation. A brief Conclusion summarizes the Article.

I. SHAREHOLDER DERIVATIVE LITIGATION

A. Litigation as Corporate Governance

Corporations (or really the people who run them) can do some very bad things, and the promise of a bold shareholder rising up as a final bulwark against selfish insider behavior is attractive. If—and this is a big "if"—shareholders can recognize the treachery of a rogue agent, then bringing a lawsuit may force a company to clean up its act. Even better, the threat of private legal action could prevent bad behavior in the first place.

Shareholder derivative litigation ("SDL") is concerned with a corporation's right to sue.[28] Unlike securities litigation or shareholder class action lawsuits, the corporation is not technically the defendant.[29] Rather,

[28] See DeMott, supra note 8, § 1:1, at 1–2.
[29] Id. at 2.

the fundamental issue in any SDL claim is who should have the power to make decisions about a potential legal claim that belongs to the corporate entity itself[30]—in other words, who runs the show when the firm is plaintiff.

Imagine, for instance, that you hire a builder to remodel your kitchen, and he botches the job. You now have several options. You might sue the builder for breach of contract, ask for a price adjustment to settle your claim, lump it by just living with the imperfect kitchen, or pursue some other action. Your decision here will likely depend on a number of factors, including how bad the kitchen looks, whether you think you can win a lawsuit, how much it will cost you to obtain a judgment, whether you have the mental energy to deal with this hassle, and whether the builder has any money. After mulling things over, you may conclude that the net present value of a lawsuit is negative and not bother to file a complaint.

In this same fashion, just because a corporation has suffered a legal slight, it does not automatically follow that it is in the firm's best interest to pursue the claim. It may very well be—if the legal entitlement is clear, the magnitude of recovery large, and the cost of prosecution small. But some claims may not be worth it because they are too uncertain, too harmful to morale, or just too expensive.[31]

The critical question in every SDL action is who gets to make this decision.[32] In the kitchen-remodeling example, it is easy to answer the control-of-litigation question: you signed the contract, you own the kitchen, you are on the hook for any legal fees, and you are going to call the shots. But corporate decision-making involves many more players, and the range of claims is diverse.

One way to make a litigation decision would be to gather all shareholders together, physically or virtually, and ask them to vote on whether a given legal claim is worth pursuing. This is obviously unrealistic. But, sticking with the thought experiment for a moment, how would an enlightened shareholder act in this situation? In theory, she would do the same thing that you do when dealing with your delinquent kitchen remodeler: decide whether the expected net present value of a claim is positive, adjusting for the risk of future uncertainties and the total cost of

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[30] Id. at 4.

[31] For a more detailed discussion of the economic tradeoffs, see Kraakman et al., supra note 8, at 1738–45.

[32] See Bainbridge, supra note 8, at 204.

obtaining a judgment.[33] The problem, however, is that shareholders rarely hold the information needed to make a careful decision. Moreover, the relatively small ownership stake of most shareholders will keep them from getting involved. Corporations can face dozens of legal claims each year, and most shareholders are rationally apathetic. Even large shareholders—the ones who could theoretically have the information and incentives to weigh in on this sort of decision—may prefer to just influence firm governance through more conventional methods, such as director elections.

More generally, installing a shareholder ballot box whenever a firm is contemplating a lawsuit runs counter to the entire point of organizing economic activity within a corporation. The genius of the corporate structure is centralized decision-making, and shareholders do not want to vote on routine decisions like whether the company cafeteria should serve burgers or pizza for lunch. Corporate leadership is representative, and we only ask shareholders to vote on the most important of issues: board elections, merger transactions, charter amendments, and perhaps a few other vital decisions.[34] So just as most decisions are delegated to the board of directors or top corporate managers, we might expect that these same appointed officers should determine whether any given legal claim is worth pursuing on the firm's behalf. By and large this is the approach taken by corporate law.[35]

But there is one problem. What happens if the legal claim that could conceivably be brought by the firm would require a corporation to sue its own officers or directors? If, for instance, the entire board pilfers the corporate treasury, we can hardly expect those same directors to make a reasonable decision about whether to launch a fiduciary duty lawsuit against themselves to recover the money. Corporate law permits top officers to decide whether it makes sense to ring up the lawyers for most legal claims. But in a very limited set of circumstances—where the legal problem relates directly to top managerial action or inaction—corporate law does not trust the inside representatives with unqualified discre-

[33] Vice Chancellor Laster makes a very similar point in the context of *Allergan I*. See 46 A.3d at 344–46.

[34] Even here, voting may not work that well. See, e.g., Marcel Kahan & Edward Rock, The Hanging Chads of Corporate Voting, 96 Geo. L.J. 1227, 1230–31 (2008).

[35] See, e.g., Daily Income Fund v. Fox, 464 U.S. 523, 530 (1984) ("[A] basic principle of corporate governance [is] that the decisions of a corporation—including the decision to initiate litigation—should be made by the board of directors or the majority of shareholders.").

tion.[36] The inelegant governance compromise is the shareholder derivative lawsuit: the right of an individual shareholder to prosecute a claim on behalf of the company when something seems rotten in the boardroom.

B. The SDL Domain

In order to determine who gets to control a legal claim, the law must first decide whether a potential lawsuit belongs to the corporate entity or to an angry shareholder. If the claim is direct—that is, if the shareholder should be understood as the person who has really suffered a legal slight—then there is no need to bother with the SDL framework.[37] Rather, the shareholder can simply decide whether she wishes to exercise her legal rights—just like she might do when initiating a private tort or contract claim. All else being equal, many plaintiffs would prefer to bring a direct claim because the rules that govern derivative actions can be onerous (more on this shortly). But some claims clearly belong to the corporation itself, and, if so, an aggrieved shareholder can only take action derivatively by seeking to compel the corporation to initiate and pursue a lawsuit. For example, officers and directors are generally understood to owe fiduciary duties to the corporate entity, not to individual shareholders. This means that breach of loyalty or care claims against corporate officers must typically be brought as derivative actions.[38]

How can you tell whether any given claim is direct or derivative? The precise borders are fuzzy, but generally a court will ask two related questions: (1) who is injured; and (2) who would receive any relief.[39] If a shareholder is harmed personally—often in connection with a right to vote, receive declared dividends, or exercise some other perquisite of ownership—then the claim is direct.[40] Shareholders cannot claim direct harm, however, just because the price of their stock drops as the result of firm mismanagement.[41]

The second question is whether any recovery would go directly to the shareholder or be paid into the corporation. If the shareholder receives relief—either in the form of money damages or some other remedy, then

[36] See Bainbridge, supra note 8, at 187.
[37] Id.
[38] See Kraakman et al., supra note 8, at 1733–34.
[39] See Bainbridge, supra note 8, at 187–88.
[40] Id. at 187.
[41] See, e.g., Armstrong v. Frostie Co., 453 F.2d 914, 917 (4th Cir. 1971).

the claim will likely be direct.[42] Good examples here include a lawsuit to obtain shareholder inspection rights or a challenge to some other action where voting rights are denied (such as the sale of substantially all of the corporation's assets without a shareholder vote).[43] If, on the other hand, any recovery would belong to the corporation, then the claim is probably derivative.[44] Consider director embezzlement from the corporate treasury. The corporation itself suffers the harm, and any money recovered from the rogue directors should be returned to the firm. Shareholder wealth will increase, but only to the extent that the recovery inflates the assets of the corporation and thereby bolsters the price of the stock.

Sometimes it can be difficult to determine whether a given claim is direct or derivative because there are mixed elements of harm and recovery.[45] For example, if the board of directors refuses to honor a valid request by a shareholder to inspect the books, then this may implicate both a direct claim (the shareholder is entitled to this information) as well as a derivative one (if failure to honor the request is made in bad faith or can otherwise be understood as a breach of the board's fiduciary obligations).[46] With these borderline cases, the way that a shareholder characterizes the claim will sometimes be controlling and careful pleading can pay off. We are concerned not with these close calls, however, but rather with cases that clearly must be structured as derivative actions.

C. Something's Rotten in the Boardroom

As mentioned above, corporate law seeks to limit SDL to situations where something seems rotten in the boardroom. Practically, this is accomplished in the most important jurisdictions through the "demand" requirement.[47] Unless demand is excused as futile, for reasons we will discuss in a moment, a plaintiff must approach the board of directors and demand that it initiate the lawsuit on behalf of the firm.[48] There are detailed rules for asserting demand, but we can think of this like a formal notice from the shareholder to the directors saying, "Guess what? I just

[42] DeMott, supra note 8, § 1:1, at 2.
[43] DeMott, supra note 8, § 2:4, at 118–19.
[44] Bainbridge, supra note 8, at 188.
[45] Id. at 189.
[46] DeMott, supra note 8, § 2:3, at 102–03.
[47] Id. § 5:7, at 644–45.
[48] Id.

found out about this lawsuit that the corporation is entitled to file against some outsider. Why don't you take a closer look at the details and launch a lawsuit on the corporation's behalf in order to boost the firm's coffers and thereby increase shareholder value?"

If demand is made, control of the lawsuit passes to the board of directors, which is now entitled to decide whether to pursue the litigation.[49] As discussed above, just because a lawsuit is possible does not mean that it is always in the firm's best interest to maintain the claim. Any decision here needs to take into account the probability of success, the likely recovery, the impact on the firm's image, and other various factors. Despite all this, one might expect that the typical board response would run as follows: "Thanks for letting us know about this great opportunity to boost the stock price. We will look into it and follow up if it seems like the lawsuit has a positive net present value."

Hardly. It turns out that nearly every shareholder derivative claim involves allegations of wrongdoing by the inside directors themselves.[50] Shareholder-plaintiffs are not interested in calling out breach of contract claims or other routine business litigation; they want to police corruption or recklessness in the boardroom. This, in turn, raises a tricky problem for corporate law: If a shareholder-plaintiff must exercise her voice by filing a demand notice that immediately transfers control of the claim to the insiders, can we really trust the board of directors to make a sound decision about whether to sue themselves? If the claim is uncertain, one might expect that the temptation to ignore the problem would be too great for most directors. And if the claim is meritorious, then any board who would commit the bad acts should have no qualms about using the control afforded to them by the demand requirement to bury the problem.

For this reason, informed shareholders *never* file demand with the board.[51] Rather, a shareholder-plaintiff will seek to maintain control of the lawsuit by insisting that demand is excused under the facts and circumstances of the case. In response, the corporation (acting through the insiders) will typically file a motion to dismiss the case for failure to make demand. Accordingly, the seemingly obscure and technical issue of demand futility has become a significant barrier to the prosecution of

[49] Bainbridge, supra note 8, at 204.
[50] See Thompson & Thomas, supra note 8, at 1766.
[51] Id. at 1782.

most derivative actions. Indeed, for all practical purposes it assumes central importance in the litigation dynamics.[52]

Before considering the contexts for demand futility, however, it is important to understand one last wrinkle related to timing: A shareholder who does make demand cannot later argue that demand should have been excused as futile. She is understood to have conceded that demand was required.[53] If this happens, and the board refuses to prosecute the case, the game is not technically over. As the Delaware Supreme Court has put it, an aggrieved shareholder still has another "'arrow' in the 'quiver'" because she can now argue that the board breached its fiduciary obligations when it decided to drop the claim.[54] But this is a very different and difficult case to prove because the cause of action now centers on the decision not to litigate—not on the underlying transaction or concern that called the shareholder-plaintiff to arms in the first place.[55] Plus, it is often much more difficult to mine for information about the decision to drop the case; even decisions to drop cases that reek of bad governance can often be justified under the business judgment rule. For all of these reasons, the entire viability of an SDL case usually centers around whether demand should be excused as futile.

When, then, is demand excused, such that the outside shareholder-plaintiff and her attorneys are allowed to maintain control over the litigation? The exact rules differ slightly from state to state, and some jurisdictions do not even conduct an inquiry into demand futility.[56] Generally, however, corporate law pulls its trust of insider governance when a shareholder-plaintiff can demonstrate one of the following three concerns: (1) a majority of directors are self-interested in a transaction at issue; (2) a majority of directors are unable to evaluate the disputed transaction with independence because they are controlled or dominated by a self-interested insider; or (3) the challenged transaction is so egregious on its face that it could not have been the product of a sound business

[52] Id. at 1783–84. See also Deborah A. DeMott, Demand in Derivative Actions: Problems of Interpretation and Function, 19 U.C. Davis L. Rev. 461 (1986) (discussing the importance of demand for resolution of derivative litigation in many jurisdictions).

[53] Grimes v. Donald, 673 A.2d 1207, 1219–20 (Del. 1996), overruled by Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

[54] Id. at 1218–19.

[55] See, e.g., Bainbridge, supra note 8, at 211.

[56] These alternative jurisdictions subscribe to a system of universal demand. All SDL plaintiffs must make demand, but a back-end decision by the firm to drop the litigation is now subjected to greater substantive inquiry. See, e.g., Model Bus. Corp. Act § 7.42 (2011).

judgment of the directors.[57] If the shareholder-plaintiff can meet one of these three exceptions, then she will keep control. Otherwise, the lawsuit will be dismissed for a procedural failure to make demand.[58]

It is important to note that a shareholder must allege his basis for demand futility with particularity; it is not enough to make general statements that the board is compromised.[59] This need for detailed information about the alleged transgression is no trivial matter because discovery is not yet available at this stage of the game.[60] Accordingly, a shareholder-plaintiff must cobble the story together using what Delaware calls "the tools at hand."[61] It is not entirely clear what this means, though these tools seem to include media stories about the alleged wrongdoings, a shareholder's individual right to inspect corporate books and records for a proper purpose, and potentially the statements of corporate insiders who are willing to step forward and describe the misdeeds.[62] The inspection technique has become especially important in Delaware, as the chancery court looks with suspicion upon thin allegations of demand futility when a shareholder inspection request has not been made.[63] These requests take time, however, and often result in separate direct litigation over the breadth and proper purpose of a books and records request.[64] Nevertheless, a motivated plaintiff may be able to muster sufficient information to excuse demand in egregious cases of governance abuse.

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[57] See *Grimes*, 673 A.2d at 1216; Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993); Marx v. Akers, 666 N.E.2d 1034, 1039 (N.Y. 1996). Because the business judgment rule offers so much leeway to directors, we rarely see situations where this third context is successfully used to assert demand futility. It is possible to imagine facts that would satisfy this exception, of course, but without extended discovery one would be hard-pressed to present a compelling case that the business judgment rule could not shield the disputed decision.

[58] In this case, the court may dismiss the case without prejudice, thereby permitting a shareholder-plaintiff to push forward by gathering more information about the alleged misdeed to develop a detailed account of why demand should be excused (or conceivably by filing demand with the board).

[59] See, e.g., *Grimes*, 673 A.2d at 1216–17.

[60] Id. at 1218 n.22 (citing Levine v. Smith, 591 A.2d 194, 198 (Del. 1991), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000)).

[61] Id. at 1218 (internal quotation marks omitted).

[62] Id. at 1216 n.11; Bainbridge, supra note 8, at 207.

[63] See infra note 243 and accompanying text.

[64] See, e.g., S. Mark Hurd & Lisa Whittaker, Books and Records Demands and Litigation: Recent Trends and Their Implications for Corporate Governance, 9 Del. L. Rev. 1, 1 (2006). The delay that results from the need to muster this information may conceivably reduce the charms of derivative litigation for many potential plaintiffs.

What happens if a corporation loses its motion to dismiss for demand futility? Does this mean that the plaintiff-shareholder will have untrammeled discretion to pursue the lawsuit on the firm's behalf? It turns out that there is a last card to play in this game—one that may allow the corporation to reassert decision-making authority over the lawsuit and tug back control from a shareholder-plaintiff.

D. Taking the Power Back

A board of directors can typically delegate governance over an explicit decision to a smaller committee of directors.[65] In Delaware, for example, a subset of the full board "shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation."[66] The law may impose a few exceptions to this general power of delegation—such as the right to adopt or repeal a corporate bylaw—but these exceptions are rare.[67]

This possibility of board governance through subcommittee raises an interesting question for the dynamics of SDL. In a situation where demand is excused—perhaps because a majority of directors are implicated by an alleged wrongdoing—might the board nevertheless compose a special committee of the remaining, disinterested directors to wrest control of the litigation back from a plaintiff-shareholder? This should reflect proper procedure and would seem to shield any subsequent decisions from the taint of conflicted directors. But even directors with the highest integrity may nevertheless feel a temptation to exonerate their friends and co-directors from a lawsuit.

Corporate law has concluded, perhaps a bit uncomfortably, that a special committee can indeed yank back control of the litigation from a plaintiff-shareholder. But judges will not give the committee carte

[65] See, e.g., Del. Code Ann. tit. 8, § 141(c)(1) (2010) ("The board of directors may, by resolution passed by a majority of the whole board, designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation.").

[66] Id.

[67] Id. This analysis is complicated by the presence of two different provisions in this statute—one applying to firms incorporated before July 1, 1996 and one applying to firms incorporated on or after that date. Id. The modern provision, § 141(c)(2), only prohibits the delegation of board approval rights for matters that also require shareholder approval and for the delegation of bylaw amendment powers. Id. § 141(c)(2). The older provision, § 141(c)(1), has a longer list of proscribed matters, though nothing that prevents the use of a special committee to evaluate shareholder derivative litigation. Id. § 141(c)(1).

blanche.[68] Rather, it must surmount at least two hurdles. First, the special committee must truly be comprised of disinterested directors.[69] Second, the committee must conduct a full and reasonable investigation of the matter.[70] If these steps are followed, then any ultimate decision to drop the lawsuit can be clothed in the protection of the business judgment rule.[71] This ability to take the power back by special committee has been criticized by commentators for undercutting the legs of SDL governance,[72] though a recent empirical study suggests that many special committees do take their duties quite seriously and frequently pursue claims against insiders.[73] In any event, these are the rules of the game.

All of this seems to assume, however, that any given SDL claim will be pursued by a single party. Yet this is rarely the case; several different plaintiffs commonly litigate SDL claims in two or more jurisdictions. And even when a dispute is confined to a single court, multiple plaintiffs will often bring claims over an extended period of time. One recent

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[68] As one Delaware Supreme Court case nicely put it:

> [T]he problem is relatively simple. If, on the one hand, corporations can consistently wrest bona fide derivative actions away from well-meaning derivative plaintiffs through the use of the committee mechanism, the derivative suit will lose much, if not all, of its generally recognized effectiveness as an intra-corporate means of policing boards of directors. If, on the other hand, corporations are unable to rid themselves of meritless or harmful litigation and strike suits, the derivative action, created to benefit the corporation, will produce the opposite, unintended result.

Zapata Corp. v. Maldonado, 430 A.2d 779, 786–87 (Del. 1981) (citations omitted).

[69] Id. at 788–89.

[70] Id. at 789.

[71] See, e.g., Auerbach v. Bennett, 393 N.E.2d 994, 1004 (N.Y. 1979). Interestingly, Delaware appears more worried than New York about the risk that special committees will unravel the fiber of SDL. It has imposed a very unusual third requirement, requiring any ultimate decision of the special committee to survive an additional *substantive* review of reasonableness by the court. *Zapata*, 430 A.2d. at 787–89. This is in some tension with the business judgment rule (under which courts will not second-guess substantive board decisions) and should highlight the magnitude of the concern. That said, Delaware courts do not invoke this substantive review on a regular basis and appear more comfortable striking down the use of a special committee under one of the other requirements. See, e.g., In re Oracle Corp. Deriv. Litig., 824 A.2d 917, 942–48 (Del. Ch. 2003) (holding that a special committee's decision to drop a derivate claim was not effective because the members of the committee were not sufficiently independent).

[72] See, e.g., Kenneth B. Davis, Jr., Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence, 90 Iowa L. Rev. 1305, 1306 (2005).

[73] See Minor Myers, The Decisions of the Corporate Special Litigation Committees: An Empirical Investigation, 84 Ind. L.J. 1309, 1320–21 (2009) (finding that approximately forty percent of special committees pursued or settled claims during a study period from 1993 to 2006).

study, for instance, estimates that nearly two-thirds of public company derivative suits involve multiple plaintiffs and that more than fifty percent of public company derivative suits have claims that are brought in multiple jurisdictions.[74] These multi-dimensional wrinkles are creating some very difficult problems for corporate law.

II. THE PRECLUSION PROBLEM

The federal statute implementing the United States Constitution's Full Faith and Credit Clause[75] demands that "judicial proceedings . . . shall have the same full faith and credit in every court within the United States . . . as they have by law or usage in the courts of such State."[76] Full faith and credit has long been understood to incorporate the doctrines of res judicata (also known as claim preclusion) and collateral estoppel (also known as issue preclusion) which set out a general rule of justice and fairness: Parties should not be required to re-litigate problems that have already been resolved by a court of competent jurisdiction.[77]

A defendant seeking to assert collateral estoppel must typically establish five different requirements.[78] First, the issue must be *identical* to that decided in the prior case.[79] Second, the issue must have been *actually litigated* in the prior proceeding, meaning that the party against whom estoppel is being asserted had "notice, opportunity, and incentive to litigate."[80] Third, the issue must have been *necessarily decided* in the prior

[74] See Erickson, supra note 9, at 65.
[75] Article IV, § 1, of the United States Constitution states that "Full faith and credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State." U.S. Const. art. IV, § 1.
[76] 28 U.S.C. § 1738 (2006).
[77] See Migra v. Warren City Sch. Dist. Bd. of Educ., 465 U.S. 75, 84 (1984); Allen v. McCurry, 449 U.S. 90, 96 (1980).
[78] See, e.g., LeBoyer v. Greenspan, No. CV 03-5603-GHK (JTLx), 2007 WL 4287646, at *1 (C.D. Cal. June 13, 2007). Some jurisdictions collapse the inquiry into a shorter list of requirements. See, e.g., Stonecrafters, Inc. v. Wholesale Life Ins. Brokerage, 915 N.E.2d 51, 63 (Ill. App. Ct. 2009) ("Three minimum threshold elements must be satisfied before the circuit court may conclude that a prior adjudication precludes litigation of an issue in the case before it: (1) the issue decided in the prior suit is identical to the one presented in the pending suit; (2) there was a final judgment on the merits in the prior adjudication; and (3) the party against whom the estoppel is asserted was either a party or in privity with a party in the prior suit.").
[79] *LeBoyer*, 2007 WL 4287646, at *1.
[80] Id. at *2. This does not mean that the plaintiff must have offered the same evidence during the prior case—only that she might have done so if she wished. Id.

case.[81] Fourth, the earlier decision must be *final and on the merits*; dismissal of the earlier case on tangential procedural grounds will not satisfy this requirement.[82] Finally, the plaintiff against whom collateral estoppel is being asserted must be in *privity* with the prior plaintiff.[83]

Collateral estoppel also sits upon a foundation of adequate representation. Even if all five requirements are clearly present, a collateral estoppel defense can be overrun if the subsequent claimant demonstrates that the prior plaintiff provided inadequate representation.[84] Unfortunately, it is difficult to pin down exactly what adequate representation requires as this term is raised in at least three different contexts.[85] Inadequate representation is sometimes used to denote substandard performance efforts, such as when the first attorney failed to prosecute the claim with "due diligence and reasonable prudence."[86] The term is also used to challenge structural conflicts of interest between members of the class or between the initial attorney and the class as a whole.[87] Finally, inadequate representation is sometimes used to signify federal constitutional due process concerns related to a lack of personal jurisdiction by the ruling court over class members.[88] Clearly, the two words, "inadequate representation," are wobbling under a heavy analytical load,[89] and the law would benefit from a more granular exposition of the concerns and standards.

[81] Id.

[82] Id.

[83] Id.

[84] See, e.g., Samuel Issacharoff & Richard A. Nagareda, Class Settlements Under Attack, 156 U. Pa. L. Rev. 1649, 1652 (2008).

[85] Id. at 1656–57.

[86] See, e.g., Restatement (Second) of Judgments § 42(1) (1982) ("A person is not bound by a judgment for or against a party who purports to represent him if: . . . (e) [t]he representative failed to prosecute or defend the action with due diligence and reasonable prudence, and the opposing party was on notice of facts making that failure apparent.").

[87] See Issacharoff & Nagareda, supra note 84, at 1656–57.

[88] See, e.g., Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 811–12 (1985).

[89] Diverse academic commentary on adequate representation reinforces the view that these two words alone are unable to provide sufficient guidance for managing all collateral attacks in the representative litigation context. See, e.g., Marcel Kahan & Linda Silberman, The Inadequate Search for "Adequacy" in Class Actions: A Critique of *Epstein v. MCA, Inc.*, 73 N.Y.U. L. Rev. 765, 770 (1998); Susan P. Koniak, How Like a Winter? The Plight of Absent Class Members Denied Adequate Representation, 79 Notre Dame L. Rev. 1787, 1790–91 (2004); Richard A. Nagareda, Administering Adequacy in Class Representation, 82 Tex. L. Rev. 287, 288–89 (2003); William B. Rubenstein, Finality in Class Action Litigation: Lessons from Habeas, 82 N.Y.U. L. Rev. 790, 795 (2007); Patrick Woolley, The Availability of Collateral Attack for Inadequate Representation in Class Suits, 79 Tex. L. Rev. 383, 388 (2000).

A. Collateral Estoppel and SDL

Turning to the SDL context, how does the typical collateral estoppel battle play out? The fact pattern follows a standard plot: One shareholder brings a lawsuit against his company, and the firm obtains a dismissal for failure to make demand. A second shareholder files suit, possibly in a different jurisdiction, and the firm now defends with collateral estoppel. Will the defense hold? Turning to the requirements for collateral estoppel listed above, the first three elements—an identical issue that was actually litigated and necessarily decided—are usually easy to establish.[90] Sometimes a plaintiff will argue that he has uncovered additional evidence demonstrating that an earlier case was not actually litigated, but this is a tough row to hoe.[91] The fourth requirement—a final decision on the merits—is more difficult to evaluate because a judge must determine whether refusing to excuse demand is substantive and "on the merits" or procedural and akin to a lack of standing. Some courts do characterize the demand requirement as a warm-up issue and not "on the merits."[92] Many more recent cases disagree with this characterization,

[90] A few cases do seem to bungle the identical issue requirement. In *Holt v. Golden*, for example, an SDL claim was filed against the gunmaker Smith & Wesson in connection with bribery charges linked to military sales in Afghanistan. Holt v. Golden, 880 F. Supp. 2d 199, 201–02 (D. Mass. 2012). More specifically, the plaintiffs alleged that the resulting charges, brought under the Foreign Corrupt Practices Act ("FCPA"), revealed a failure on the board's part to meet its *Caremark* duties to monitor and prevent wrongdoing by the corporation. Id. at 201. The court held that the plaintiff-shareholder was collaterally estopped from proceeding with the case because an earlier SDL case (involving misleading statements about the company's financial situation) had been dismissed for failure to make demand. Id. at 202. This seems plainly wrong: The alleged wrongdoing only came to light after the first case was dismissed, and the factual context of the second case is entirely different from that of the first. Id. The court's assertion that "[w]hile the charged misconduct may be different, the material issue—the disinterestedness of essentially the same S & W board—was precisely identical in both the state court and this one" is totally unconvincing. Id. at 203. A board is not deemed "pure" or "corrupt" in toto; rather the board's conduct must be assessed in relation to the specific facts and circumstances of each alleged wrongdoing. It is worth noting that the court asserted an alternative basis for requiring demand: that the factual pleadings in the second case fell short of the threshold for demand excusal, so the faulty preclusion analysis may have been harmless error. Id.

[91] See, e.g., In re Bed Bath & Beyond Deriv. Litig., No. 06-5107, 2007 WL 4165389, at *6 (D.N.J. Nov. 19, 2007) ("[Just] because the prior plaintiff did not plead every possible cause of action or include every possible time period or defendant does not alter the central issue—whether demand . . . would have been futile . . . ."); LeBoyer v. Greenspan, No. CV 03-5603-GHK (JTLx), 2007 WL 4287646, at *2 (C.D. Cal. June 13, 2007) (rejecting plaintiff's argument that a claim was not actually litigated due to the availability of new evidence).

[92] See, e.g., Kaplan v. Bennett, 465 F. Supp. 555, 561 (S.D.N.Y. 1979) (describing the lack of demand futility as a "procedural requirement [that] is not to be given preclusive effect");

however, and state quite explicitly that judicial resolution of the demand question is substantive and on the merits—and therefore that collateral estoppel can bar subsequent litigation over demand futility.[93] This latter approach is much better reasoned, as the demand requirement is crucially linked to the substantive outcome of any SDL case.[94] Resolution of demand futility is the main show, and it should be seen as a decision on the merits.

The fifth requirement of privity presents a much greater challenge, however, to the use of collateral estoppel in SDL. Privity is obviously a non-issue if the same person brings both claims; everyone is in privity with himself. But the architecture of SDL makes it much more complicated to unpack the privity requirement because a judge needs to decide exactly when two different shareholders step into the same shoes.[95] Likewise, determining whether the initial lawsuit provided adequate representation is tricky because of inherent conflicts between the attorneys who drive SDL cases forward and the shareholder body at large.[96] The easiest way to illustrate these challenges is with an extended study of the recent litigation involving Allergan, Inc.

Ex parte Capstone Dev. Corp., 779 So. 2d 1216, 1217–1219 (Ala. 2000) (holding that resolution of the demand requirement is a "precondition" and not "on the merits" in a derivative action involving a limited partnership); Haseotes v. Bentas, No. Civ.A. 19155 NC, 2002 WL 31058540, at *4 (Del. Ch. Sept. 3, 2002) (offering dicta comparing the demand requirement to a standing requirement).

[93] See, e.g., In re Sonus Networks S'holder Deriv. Litig., 499 F.3d 47, 60 (1st Cir. 2007) ("[S]tate dismissal was 'on the merits' on the issue of whether it would have been futile to demand the . . . board to sue themselves on behalf of the corporation."); *In re Bed Bath & Beyond*, 2007 WL 4165389, at *6 ("A dismissal for failure to make demand on a board is considered substantive and, therefore, on the merits."); *LeBoyer*, 2007 WL 4287646, at *2–3 (holding that a dismissal for failure to make a required demand is substantive such that collateral estoppel bars re-litigation).

[94] The United States Supreme Court has stated as much in a unanimous opinion. See Kamen v. Kemper Fin. Servs., 500 U.S. 90, 96–97 (1991) (describing the demand futility analysis as substantive).

[95] A similar problem is presented by class action litigation where a follow-on plaintiff argues that she is not precluded by the outcome of an earlier representative proceeding. See sources cited supra note 89. This situation presents parallel concerns of privity, but differs in some important dimensions from the SDL context. For example, the possibility of group identification and conflicting interests may be minimized in the SDL context because all conceivable plaintiffs have a common affiliation of shareholder. On the other hand, SDL plaintiffs purport to represent the firm, not themselves, raising additional questions related to the precise timing of privity.

[96] See infra Section II.C.

B. Botox Injections for Derivative Litigation?

1. The Facts

Allergan is a Delaware corporation that markets a wide variety of pharmaceutical and medical devices.[97] In 1989, it received Food and Drug Administration ("FDA") approval for the use of Botox to treat eye muscle disorders like strabismus (crossed eyes).[98] Over the next several years, Botox was also approved for the treatment of a certain type of neck muscle pain and for excessive underarm sweating.[99] Moreover, doctors began to prescribe and administer Botox for a wide variety of off-label therapeutic uses, such as chronic migraine headaches and upper limb spasms.[100] This practice of prescribing an approved pharmaceutical product for non-approved applications (often called "off-label" use) is perfectly legal.[101] Indeed, such practices are common in the medical community, and manufacturers may sell products that will be used in this manner.[102] It is illegal, however, for firms to actively advertise and market a product for off-label use.[103]

During the 1990s, Allergan noticed that the market for therapeutic Botox was skyrocketing.[104] Delighted with this turn of events, it sponsored a series of seminars to educate doctors about the many uses of Botox.[105] The firm also sought to help doctors receive financial reimbursement from insurance companies and government healthcare programs for off-label Botox prescriptions.[106] Indeed, Allergan's CEO became such a loud advocate for the product that he acquired the nickname "Mr.

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[97] Allergan Inc., Annual Report (Form 10-K), at 1 (Feb. 26, 2013), available at http://files.shareholder.com/downloads/AGN/2755645332x0xS850693-13-2/850693/filing.pdf.

[98] La. Mun. Police Emps.' Ret. Sys. v. Pyott (Allergan I), 46 A.3d 313, 317 (Del. Ch. 2012), rev'd, 74 A.3d 612 (Del. 2013).

[99] Id.

[100] Id. The more commonly known use of Botox for cosmetic purposes was not at issue in the case.

[101] Id. at 317–18.

[102] See, e.g., James M. Beck & Elizabeth D. Azari, FDA, Off-Label Use, and Informed Consent: Debunking Myths and Misconceptions, 53 Food & Drug L.J. 71, 72 (1998).

[103] Doing so will violate the Food, Drug, and Cosmetic Act, 21 U.S.C. § 331(a), (d) (Supp. V 2012), and/or the Public Health Service Act, 42 U.S.C. § 262(a)(1), (b) (2006 & Supp. V 2012). See also 21 C.F.R. § 601.12 (2013) (codifying implementing regulations).

[104] *Allergan I*, 46 A.3d at 319.

[105] Id. at 318.

[106] Id. at 318–19.

Botox."[107] By 2005, Botox accounted for roughly a third of Allergan's total net sales.[108]

Unfortunately for Allergan, its activities attracted the interest of the FDA.[109] The FDA, fearing that the company had passed far beyond the mere sale of off-label products, sent several warning letters to Allergan.[110] But the firm did not seem to pay much attention to these notices.[111] Rather, Allergan continued to sponsor doctors and other speakers to tout the benefits of Botox for headaches and other off-label uses.[112] The payroll for the Botox sales force tripled.[113]

By 2007, U.S. officials had had enough. The FDA partnered with the Federal Bureau of Investigation ("FBI") and the Department of Health and Human Services ("HHS") to launch a joint investigation of Allergan's off-label marketing of Botox.[114] Three years later, Allergan settled the case by pleading guilty to a criminal misdemeanor (misbranding) and paying a whopping six hundred million dollars in civil and criminal fines.[115] It also entered into a five-year Corporate Integrity Agreement with the HHS to monitor future compliance with the law.[116]

2. The Trial(s)

Six hundred million dollars was a lot of money for Allergan, roughly its entire annual net income,[117] and the stench of this settlement immediately attracted attention from angry shareholders (and their lawyers). Two days after the settlement was announced, an SDL complaint was filed in the Delaware Court of Chancery.[118] Several other claims were filed in California federal court during the following weeks.[119] All of these initial complaints were based on public information, and they

[107] Id. at 318.
[108] Id. at 320.
[109] Id. at 319–20.
[110] Id.
[111] Id. at 320. Neither did it pay much attention to Allergan's general counsel, who warned the firm's leaders that this was "a potentially serious matter" and that the probability of the FDA taking some action was significant. Id.
[112] Id. at 320–21.
[113] Id. at 321.
[114] Id.
[115] Id.
[116] Id.
[117] Id.
[118] Id.
[119] Id. Allergan's corporate headquarters is in Irvine. See Allergan Inc., supra note 97.

lacked the particular details necessary to support an excusal of demand.[120]

Two months later, another plaintiff-shareholder filed a request under Delaware law to inspect the books and records of Allergan.[121] Shortly thereafter, this diligent plaintiff moved to intervene in the Delaware side of the SDL; this soon led to some squabbling with the other Delaware plaintiff over control of the litigation.[122] The vice chancellor, eager to let the inspection request proceed, postponed the hearings to allow the "diligent" plaintiff to investigate this matter more fully.[123] This process took about six months, and eventually both Delaware plaintiff groups joined forces to prosecute the claim with an amended complaint.[124]

Meanwhile, the California track of the SDL litigation moved forward in a parallel manner.[125] The judge dismissed a bare-bones complaint without prejudice, and the plaintiffs also pursued a books and records investigation to rehabilitate the case.[126] They received the internal information from Allergan (apparently the same documents that had been provided to the Delaware plaintiffs), and the California plaintiffs re-filed a more substantive complaint.[127] Motions ensued in both jurisdictions. But the California track of the litigation proceeded more rapidly than the Delaware case, and on January 17, 2012, the California judge dismissed the case with prejudice—holding that the plaintiffs had not adequately demonstrated demand futility.[128] In short, the Allergan boardroom did not seem rotten enough for the California court.

Allergan immediately supplemented its Delaware defense by invoking collateral estoppel.[129] As the argument went, California had fully evaluated and dismissed the SDL, and all of the requirements for collateral estoppel were established. The issue was identical, it was actually litigated, and it was necessarily decided on the merits. Further, the plain-

[120] *Allergan I*, 46 A.3d at 320–22. One plaintiff even made demand on Allergan—a litigation strategy with some very interesting potential consequences. See infra note 220.

[121] *Allergan I*, 46 A.3d at 322.

[122] Id.

[123] Id.

[124] Id.

[125] Id.

[126] Id.

[127] Id.

[128] Id.

[129] Id.

tiffs in both tracks were in privity because they were each representing the real plaintiff-in-interest: Allergan, Inc.

The Delaware vice chancellor disagreed, hinging his analysis on two alternative justifications. The first problem with a collateral estoppel defense, according to the court, was the lack of privity between the shareholder-plaintiffs.[130] Departing from earlier cases on this topic, the vice chancellor saw an important difference between a shareholder-plaintiff who was legitimately acting on behalf of the corporation and one who was still attempting to do so.[131] Noting that a shareholder "does not have authority to sue on behalf of the corporation until there has been a finding of demand excusal,"[132] the court held that a prior shareholder who had lost on the demand futility question had not yet stepped into the shoes of the corporation.[133] For this reason, the follow-up Delaware plaintiff lacked privity with the prior California plaintiff.[134] In short, the privity trigger did not fire until demand was excused.

The court also presented a second, independent justification for refusing to apply collateral estoppel: The California plaintiffs were inadequate representatives of the litigation.[135] In a long and detailed discussion, the vice chancellor determined that the incentives for the initial plaintiffs (and their lawyers) to file rapid complaints placed them at odds with most shareholders who would rationally wish to investigate a potential concern more fully before tying up the company in litigation.[136] In response, the court of chancery established a presumption that any plaintiff filing a derivative complaint without first seeking internal information under a books and records request would be deemed an inadequate representative.[137] Accordingly, the California decision would not estop the Delaware litigation, and the case could proceed.

Having thus rejected the collateral estoppel defense, the court went on to decide whether the Delaware plaintiffs needed to make demand on the

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[130] Id. at 334–35.
[131] Id. at 327–28.
[132] Id.
[133] Id. at 334.
[134] Id at 334–35. By way of contrast, if the *same* initial shareholder filed a second SDL lawsuit after an initial dismissal for failure to make demand, then collateral estoppel would, in the vice chancellor's view, block the second claim. Id. at 333.
[135] Id. at 335.
[136] Id. at 336–51.
[137] Id. at 335–36.

Allergan board.[138] And here, the vice chancellor flat out disagreed with the California federal judge by holding that demand was excused under the circumstances.[139] This assessment was based on the fact that a series of annual strategic plans, discussed and approved by the board, anticipated such a rapid expansion of Botox sales that "it necessarily contemplated marketing and promoting off-label uses within the United States."[140] Said differently, the court held that one could reasonably infer that the board approved and monitored a business plan embracing illegal activity.[141] This holding required an inferential leap—just because a board expected rapid growth in off-label sales, it does not inevitably follow that these sales were to be driven by illegal marketing activities. But the vice chancellor was convinced by facts uncovered from the books and records investigation that the plaintiffs had made a "threshold showing . . . that their claims [had] some merit,"[142] such that demand was futile and the plaintiffs could retain control of the litigation.[143]

3. The Appeal

The *Allergan I* decision clearly diverged from prior treatment of collateral estoppel in the SDL context. Earlier case law, including a recent Delaware Court of Chancery opinion,[144] did not view the privity question as turning on whether demand was required or excused. Rather, the prevailing understanding was that all shareholders were in privity with one another from the moment that an SDL case was initiated. *Kaplan v. Bennett*, an influential SDL case from New York, put it this way:

> A derivative action represents prosecution of a claim belonging not to the individual shareholder but to the corporation on whose behalf suit is brought. To determine whether the parties are identical, the court looks to the identity of the real party in interest, the corporation, rather

[138] Id. at 351.
[139] Id. at 356–58.
[140] Id. at 352.
[141] Id. at 353. This holding was buttressed by quotes from slide decks and memoranda describing major expansion opportunities in off-label uses of Botox. Id. at 353–54.
[142] Id. at 356–57 (quoting Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993)).
[143] Id. at 356–58.
[144] In re Career Educ. Corp. Deriv. Litig., No. 1398-VCP, 2007 WL 2875203, at *11 (Del. Ch. Sept. 28, 2007).

> than to the identity of the nominal party seeking to champion the corporate claim.[145]

Other cases had reached similar conclusions.[146] Likewise, these earlier cases seemed to set a very low bar for adequacy of representation.[147]

Given this break from the past, the *Allergan I* case moved quickly into the corporate law spotlight, and commentators began to dissect the implications of the decision.[148] The focus only increased when the decision was certified for interlocutory appeal to the Delaware Supreme Court.[149] In an amicus brief, the U.S. Chamber of Commerce warned that "the Court of Chancery's approach . . . would leave corporations guessing whether a final resolution of a derivative suit really is final" and that this uncertainty would harm both corporate owners and managers—as the threat of repeatedly putting down identical lawsuits undermines normal business activity.[150] Corporate litigators seemed to agree, advising clients that "[w]hile this decision represents a strong and public rebuke of the current approach of the plaintiffs [sic] bar, it could very well have the perverse effect of increasing the number of derivative suits brought against corporations and their boards."[151] The counterargument, of course, was that this outcome was the best way to deter frivolous and

[145] Kaplan v. Bennett, 465 F. Supp. 555, 560 (S.D.N.Y. 1979) (citations omitted).

[146] See, e.g., LeBoyer v. Greenspan, No. CV 03-5603-GHK (JTLx), 2007 WL 4287646, at *3 (C.D. Cal. June 13, 2007) ("Finally, the fifth element is satisfied in that in both suits the plaintiff is the corporation itself. The differing groups of shareholders who can potentially stand in the corporation's stead are in privity for the purposes of issue preclusion.").

[147] These cases did acknowledge, however, the possibility that an inadequate representative could negate the assertion of a collateral estoppel defense. See, e.g., In re Sonus Networks S'holder Deriv. Litig., 499 F.3d 47, 64 (1st Cir. 2007) ("[T]o bind the corporation, the shareholder plaintiff must have adequately represented the interests of the corporation."); *In re Career Educ.*, 2007 WL 2875203, at *10 ("Where a plaintiff alleges that the interests of the corporation were not suitably represented in the prior proceeding collateral estoppel may not apply.").

[148] See, e.g., Marcus, supra note 23; Bishop, supra note 24.

[149] Pyott v. La. Mun. Police Emps.' Ret. Sys. (Allergan II), 74 A.3d 612, 615 (Del. 2013).

[150] Motion of Chamber of Commerce of the United States of America to File Brief as Amicus Curiae in Support of Reversal at 2, *Allergan II*, 74 A.3d 612 (Del. 2013) (No. 380, 2012).

[151] Client Alert, Milbank, Tweed, Hadley & McCloy LLP, Delaware Court of Chancery Rules that Shareholder Derivative Lawsuits Are Not Collaterally Estopped by Previously Dismissed Suits Involving Similar Claims 3 (June 14, 2012), http://www.milbank.com/images/content/8/7/8772/Del-Court-Shareholder-Derivative-Lawsuits-Are-Not-Collaterally-E.pdf.

rapidly filed SDL claims in order to re-establish shareholder litigation as an effective tool for corporate governance.

On appeal, the Delaware Supreme Court sided with the defendants, overruling the lower court and dismissing the case.[152] But it did so on general principles relating to full faith and credit and without providing explicit guidance on the SDL preclusion problem.[153] The supreme court took issue with both prongs of the vice chancellor's decision. Starting with the privity issue, the supreme court determined that it was incorrect for the lower court to assess privity under Delaware law when deciding whether the California judgment should be given preclusive effect.[154] Rather, the full faith and credit doctrine required the lower court to give the California decision "the same force and effect as it would be entitled to in the California federal or state courts under *California's* preclusion rules."[155] An earlier California case had clearly stated that a subsequent shareholder-plaintiff was in privity with an earlier claimant—even when demand was not dismissed as futile in the prior case.[156] Accordingly, the Delaware Supreme Court held that the vice chancellor should have concluded that the two plaintiff groups were in privity under California law—and thereby given the initial judgment preclusive effect.[157]

The Delaware Supreme Court also disagreed with the chancery court's determination that the California plaintiff was an inadequate representative of the shareholder class.[158] It did so by rejecting the vice chancellor's holding that a "fast filer" plaintiff who rapidly initiates a complaint without taking time to conduct a books and records investigation is presumptively inadequate.[159] Noting a lack of factual support in the record for the assertion that these fast filers were acting on behalf of the law firms prosecuting the case, rather than the company's shareholders, the Delaware Supreme Court reversed.[160] While clearly sympathetic to the structural abuses that can arise from knee-jerk SDL filings, the court also noted that the substance of both complaints was almost identi-

[152] *Allergan II*, 74 A.3d at 614.
[153] Id. at 615–18.
[154] Id. at 616–17.
[155] Id. at 616 (emphasis added).
[156] LeBoyer v. Greenspan, No. CV 03-5603-GHK (JTLx), 2007 WL 4287646, at *1, *3–4 (C.D. Cal. June 13, 2007).
[157] *Allergan II*, 74 A.3d at 616–17.
[158] Id. at 618.
[159] Id.
[160] Id.

cal—raising tough questions about how the Delaware plaintiff could be deemed adequate if the California plaintiff was not.[161]

So where does this decision leave us? Because the Delaware Supreme Court handled the privity issue through full faith and credit principles, the case provides no guidance about Delaware's current approach to shareholder privity. Specifically, the court mindfully declined to determine whether privity attaches with the filing of an SDL complaint or only upon a determination that demand is excused.[162] This leaves Delaware with an explicit lower court split on the issue.[163]

If future courts elect to follow the chancery court's approach in the *Allergan I* case, then the supreme court's reversal will leave open several strains of the preclusion problem. Imagine, for example, that a shareholder brings a case in Delaware that is quickly dismissed for failure to plead demand futility in sufficient detail. A follow-up SDL claim is brought in California. Can the defending corporation assert collateral estoppel to avoid retrying the case? The California court would need to assess privity under Delaware law (full faith and credit works both ways), and the lower-court *Allergan I* decision offers a good argument that the answer may be no. So while the earlier-in-time dismissal may be persuasive to the adjudication of the follow-up California case, the issue of demand futility is reopened for the California plaintiff to litigate anew. Indeed, there is no need to move to a different jurisdiction. Under the *Allergan I* case's privity standards, serial plaintiffs might file numerous lawsuits against the same company in Delaware—all relating to the same alleged misdeed. As soon as one lawsuit is dismissed for failure to make demand, the next one rises from the ash heap.[164]

And while the Delaware Supreme Court did explicitly reject an irrefutable presumption of fast-filer inadequacy, it chose not to write at length on this issue.[165] Accordingly, the supreme court opinion leaves unanswered questions about the precise standards for adequate representation. What facts must be placed on the record to uphold a finding of in-

[161] Id.

[162] Id. at 617–18.

[163] *In re Career Education* states that privity is established with the filing of the initial case, while the lower court *Allergan I* opinion states that excusal of demand is needed to create privity. *Allergan I*, 46 A.3d at 323; In re Career Educ. Corp. Deriv. Litig., No. 1398-VCP, 2007 WL 2875203, at *10–11 (Del. Ch. Sept. 28, 2007).

[164] This assumes, of course, that the statute of limitations has not yet tolled for the alleged misdeed.

[165] *Allergan II*, 74 A.3d at 618.

adequacy? Does the case come out the same way if an initial fast-filer fails to amend her complaint to incorporate books and records data?[166] And, more generally, how should a court even begin to determine whether representation is adequate in the SDL context? But before we explore these questions in more detail it is necessary to flesh out the complicated incentives of SDL plaintiffs.

C. The Trouble with Self-Appointment

Just because we permit a shareholder to step into the shoes of a corporation and prosecute a lawsuit on the firm's behalf does not mean that shareholders will have incentives to do so. The problem relates to rational apathy: Why would a small player bother to initiate an SDL action if a successful outcome means that she foots the bill for a recovery that is shared pro rata with all other shareholders?

To break this free-rider problem, corporate law needs to find another primary actor to take the reins. For better or worse, lawyers often play this role, working through nominal plaintiff-shareholders. Most attorneys will not work for free, however, so a legal system that embraces this approach must also decide who will pay for these private regulators. If the corporation (or its insurer[167]) foots the bill, either directly or via contingency fee arrangements, this introduces a significant risk that entrepreneurial lawyers will drum up hollow cases to generate buy-off settlements.[168] The legal framework—which allows any lawyer who can recruit a single shareholder to self-select as a firm protector and precludes quick dismissals—is simply too tempting.

Even when a watchdog attorney steps in to prosecute a grievous governance abuse, the effective control enjoyed by that lawyer may cause him to take action that is not in the best interest of shareholders. This is obviously not how the system is supposed to work. But plaintiffs' lawyers may undoubtedly be inclined to settle large cases on disadvanta-

[166] In Delaware, for instance, judges have taken steps to prevent rapid filers from amending their complaints—in an effort to encourage mindful consideration of the claims prior to filing. See, e.g., Braddock v. Zimmerman, 906 A.2d 776, 783 (Del. 2006) (describing Delaware Court of Chancery Rule 15(aaa), which is designed to limit a plaintiff's ability to amend his complaint).

[167] See generally Tom Baker & Sean J. Griffith, Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation (2010) (describing the use of directors and officers liability insurance and analyzing corporate governance concerns that can arise when firms purchase these policies).

[168] See Coffee, supra note 4, at 339, 342.

geous terms for dispersed shareholders as long as the legal fees have enough zeros. Who will watch these watchdogs?

Money is thus inexorably linked to this self-appointment problem. There are actually two concerns, each related to the payment of legal fees. First, unlike the approach taken with most other forms of litigation, a shareholder-plaintiff who wins her case is able to recover her attorney's fees from the corporation.[169] Even a settlement agreement can include provisions for legal fees as long as some "substantial benefit" is conferred on the corporation.[170] Said differently, SDL can be self-funding because plaintiffs do not need to foot their legal bill for successful outcomes.

Why is this the case? It should be easy to see that any system that forces an individual shareholder to shoulder all of the legal fees related to filing and prosecuting a derivative claim is doomed. That shareholder would be subsidizing all other shareholders—who could piggyback on the gains to the corporation without sharing any of the costs. In theory, the shareholders might negotiate a cost-sharing agreement at the outset of the litigation. But this is unrealistic for large firms with thousands of shareholders; the temptation to free-ride on the efforts of others is simply too great. With an each-side-pays-its-own-lawyer approach to derivative litigation, only a shareholder with a very large stake or a very hot temper would bother to take action.

For this reason, it is necessary to provide fee reimbursement in at least some circumstances. This approach makes sense if we believe that (1) the derivative action has legitimate uses as a governance device; and (2) the prosecuting party will act as a sensible steward for the legal action. Indeed, if the lawsuit generates a substantial benefit for the corporation as a whole, then it seems only fair to reimburse the plaintiff for the costs of generating this positive outcome. In theory, then, corporate law solves the free-rider problem by imposing a mandatory rule that all shareholders must bear their fair share of the litigation expense.

This is complicated, however, by a second rule: Legal fee shifting is rarely sanctioned for successful corporate defendants. Even if a corporation fights a claim to the bitter end and prevails on the merits, it will still be stuck writing checks for its legal fees (or higher insurance premi-

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[169] E.g., Model Bus. Corp. Act § 7.46(1) (2011).

[170] See id. This is true even if the benefit from the settlement involves no monetary recovery and is of questionable value to the firm and its shareholders. See, e.g., id.

ums).[171] To be sure, the plaintiffs' lawyers will not be delighted at this state of affairs—especially if they have structured a contingency fee arrangement and receive nothing with the loss. Moreover, as we will see, any rule to the contrary raises the question of who must pay for a winning defendant's legal fees. Requiring individual shareholders to do so may put an enormous damper on SDL.

For all of these reasons, the SDL framework presents a risk that a defending firm which has done nothing legally wrong—but which has made a business error sufficient to spark litigation—will hold its nose and settle a claim just to make it go away. The costs of doing so may be far cheaper than fighting to the bitter end and celebrating a negative net present value victory. The lawyers prosecuting these claims are aware of this pressure, of course, and they may choose to respond accordingly.

All of these incentives are compounded by the collateral estoppel problem. Assume, for instance, that a defending firm is torn between fighting a case to the end and settling with the plaintiffs' lawyers to make the problem disappear. Assume further that the management is absolutely confident that no legal wrongdoing has occurred. If the expected cost of litigating one claim to conclusion is less than the expected cost of settling, then the firm will choose to fight. But if the firm is now advised that the plaintiffs' lawyers can likely recruit a second (or third) shareholder claimant and start the process anew, this calculus may change. Lenient preclusion, without any other adjustments to the SDL framework, thus presents a serious risk of amplifying the undesirable characteristics of self-appointed corporate watchdogs.

D. Competing Paradigms of Privity and Adequacy

1. Privity

Putting these incentives to the side, for a minute, how should we understand the collateral estoppel privity requirement in the SDL context? Is *Allergan I* right, as a formal matter, that privity cannot attach until demand is excused as futile?

[171] The pressure to settle SDL claims is further intensified by rules allowing the corporation to indemnify individual defendant directors for their legal fees when a case is settled. See, e.g., William A. Klein et al., Business Associations: Cases and Materials on Agency, Partnerships, and Corporations 209 (8th ed. 2012). By contrast, this permissive indemnification is typically taken away if the directors litigate and lose. In short, it is in everyone's interest (except perhaps the corporation's itself) to settle most claims.

Unfortunately, the indicators of privity are difficult to articulate with precision, and the contours of this requirement are typically stated at a high level of generality. A court might say that privity exists when two parties have "mutual interests, including the same desired result";[172] or preclusion applies "to those who could have entered the proceeding but did not avail themselves of the opportunity";[173] or "[p]rivity exists where the party in the second case has interests that are so closely aligned to the party in the earlier litigation that the non-party can be fairly said to have had his or her day in court."[174] These conceptions of privity all seem to suggest that there is no need for demand to be excused before a potential shareholder-plaintiff is linked to a prior litigant. Any shareholder could have presumably filed a complaint in the deciding court and joined in the first round of litigation.

On the other hand, some decisions offer general descriptions of privity that seem more in line with the *Allergan I* court's holding. For example, one case suggested that the main consideration in determining the existence of privity is that "the interest of the party to be precluded must have been sufficiently represented in the prior action so that the application of [preclusion] is not inequitable."[175] Another concluded that for purposes of application of the doctrine of collateral estoppel, "privity is said to exist between parties who *adequately represent* the same legal interests."[176] This notion of adequate representation provides much more support for the argument that hasty and sparse SDL claims should not preclude other shareholders from filing more detailed and substantial follow-up lawsuits.[177] Moreover, it is difficult to reconcile the firm's contention that a shareholder-plaintiff lacks authority to prosecute a claim on the company's behalf (made through the argument that demand

[172] Robinson v. Springfield Local Sch. Dist. Bd. of Educ., No. 20606, 2002 WL 462860, at *8 (Ohio Ct. App. Mar. 27, 2002) (citing Deaton v. Burney, 669 N.E.2d 1, 5 (Ohio Ct. App. 1995)).

[173] Howell v. Richardson, 544 N.E.2d 878, 881 (Ohio 1989).

[174] Kinsky v. 154 Land Co., 371 S.W.3d. 108, 113 (Mo. Ct. App. 2012) (citing James v. Paul, 49 S.W.3d 678, 683 (Mo. 2001) (en banc)).

[175] Mazziotti v. Allstate Ins. Co., 695 A.2d 1010, 1019 (Conn. 1997) (citing Aetna Cas. and Sur. Co. v. Jones, 596 A.2d 414 (Conn. 2008)).

[176] Stonecrafters, Inc. v. Wholesale Life Ins. Brokerage, 915 N.E.2d 51, 63 (Ill. App. Ct. 2009) (emphasis added) (citing Yorulmazoglu v. Lake Forest Hosp., 834 N.E.2d 468 (Ill. App. Ct. 2005)).

[177] Of course, using this test to determine whether privity exists raises the question of whether this concept is analytically distinct from the more general principle that collateral estoppel requires a foundation of prior adequate representation. See infra Subsection II.D.2.

should not be excused) with the contention that that same shareholder possessed sufficient authority over the litigation to bar all subsequent lawsuits.[178]

But the only conclusion that can be reached with certainty is that privity is an amorphous concept, often tailored to meet the equities of any given dispute.[179] Most cases in the SDL context do conclude that privity is satisfied when the initial claim is filed.[180] But this holding is reached through the almost conclusory statement that the corporation is the real party in interest in both lawsuits. It is not obvious that this must be the case, and the *Allergan I* holding—that privity is only triggered when a court denies a motion to dismiss for demand futility—is perhaps just as defensible.

2. Adequacy of Representation

Turning to the adequacy of representation issue, the gateway question is whether this is any different from the privity inquiry. Indeed, as we have just seen, courts will sometimes ask whether an earlier plaintiff has "adequately represent[ed] the same legal interests" in order to decide whether privity is present between shareholders.[181] This would seem to give a judge leeway to use either doctrine (or both) as a means of avoiding collateral estoppel. But the law does make an independent distinction here, and it is possible that a party who is found to be in privity with

[178] The vice chancellor made this exact point to support his finding in *Allergan I*: that there was a lack of privity between the California and Delaware plaintiffs. See 46 A.3d at 330 n.10. One might try to reconcile the two positions, however, by noting the different contexts for the inquiry. The corporate defendant is challenging the demand excusal petition in an effort to retain insider control over the litigation. In the estoppel context, by contrast, the defending firm is arguing that some shareholder representative has already attempted to litigate the demand issue in a prior proceeding.

[179] See, e.g., Jim Parker Bldg. Co. v. G & S Glass & Supply Co., 69 So. 3d 124, 132 (Ala. 2011) ("'Privity' is a flexible legal term, comprising several different types of relationships . . . ." (quoting EEOC v. Pemco Aeroplex, Inc., 383 F.3d 1280, 1286 (11th Cir. 2004))); Apollo Real Estate Inv. Fund, IV, L.P. v. Gelber, 935 N.E.2d 963, 973 (Ill. App. Ct. 2010) ("There is no generally prevailing definition of 'privity' that the court can apply to all cases; rather, determining privity requires careful consideration of the circumstances of each case." (citing Hayes v. State Teacher Certification Bd., 835 N.E.2d 146, 156–57 (Ill. App. Ct. 2005))); Williams v. Peabody, 719 S.E.2d 88, 94 (N.C. Ct. App. 2011) ("[T]he meaning of 'privity' has proven to be elusive, and there is no definition of the word . . . which can be applied in all cases . . . ." (quoting Whitacre P'ship v. Biosignia, Inc., 591 S.E.2d 870, 893 (N.C. 2004))).

[180] See sources cited supra note 18.

[181] E.g., *Stonecrafters*, 915 N.E.2d at 63 (citing *Yorulmazoglu*, 834 N.E.2d at 468).

an earlier claimant may nevertheless be able to win a collateral attack that the prior party was an inadequate plaintiff.

What does adequate representation require in the SDL context? There have been recent developments, apart from *Allergan I* and *Allergan II*, suggesting that a shareholder-plaintiff who files a very rapid complaint in the wake of a corporate trauma may fail to meet this standard. For example, in the Delaware case of *King v. Verifone Holdings, Inc.* a shareholder-plaintiff filed a knee-jerk derivative claim (in California federal court) in response to a corporate financial restatement.[182] When the case was dismissed without prejudice for failure to make demand, that same shareholder sought to muster the details necessary to support a demand futility pleading by launching a books and records inspection lawsuit in the Delaware Court of Chancery.[183] The chancellor questioned, in passing, whether this type of plaintiff could adequately represent the interests of the corporation and its investors:

> When a derivative plaintiff files a damages action hastily in the wake of a public announcement, there is no basis for expediting the case to further the interests of the corporation and its stockholders, and, when the derivative plaintiff forewent a books and records investigation and a period of deep reflection on the publicly available documents and the law, should not the presumption be that the plaintiff is not fit to serve as the lead fiduciary for the corporation and its stockholders?[184]

Other Delaware opinions have reflected a similar sentiment that fast-filing shareholder-plaintiffs who do not conduct a meaningful investigation may be providing inadequate representation.[185]

[182] 994 A.2d 354, 357–58 (Del. Ch. 2010), rev'd en banc, 12 A.3d 1140 (Del. 2011).

[183] Id at 359. The Delaware chancellor rejected the request, though this decision was ultimately reversed by the Delaware Supreme Court. King v. Verifone Holdings, Inc., 12 A.3d 1140, 1150–52 (Del. 2011). More specifically, the lower court ruled that a books and records request brought after a derivative lawsuit had been dismissed would be denied as an improper purpose for initiating such a request. *King*, 994 A.2d at 356. The Delaware Supreme Court, while recognizing the concerns over nurturing meritless claims, was unwilling to erect such a barrier against the shareholder's inspection request. *King*, 12 A.3d at 1150.

[184] *King*, 994 A.2d at 364 n.34.

[185] See, e.g., Baca v. Insight Enters., No. 5105-VCL, 2010 WL 2219715, at *5 (Del. Ch. June 3, 2010) ("Absent pressure from a statute of limitations or some other reason meriting prompt filing, one can well question whether a stockholder with a nominal stake who files an indemnification-based derivative action prior to a ruling on a motion to dismiss in the underlying federal securities action and without using [a books and records request] (or otherwise conducting an independent investigation) is adequately representing the interests of the corporation, as opposed to facilitating the pursuit of economic self-interest by an entrepreneurial

But the precise requirements for adequate representation are still evolving, and the Delaware Supreme Court made it clear in *Allergan II* that it will not support strong presumptions of inadequacy.[186] This only raises follow-up questions, however, about the precise factors that must be examined in order to determine adequacy of representation in the SDL context.[187] Given the difficulties of identifying bright line rules—both here and in the privity context—it thus becomes necessary to examine the policy implications more closely. What incentives will be put in place by differing approaches to the preclusion problem? As is so often the case in corporate law, there are legitimate theoretical concerns on both sides of the debate. Any resolution of this problem needs to be grounded in a practical assessment of the promises, incentives, and limits of shareholder litigation.

III. A BLUEPRINT FOR ACTION

A strategy for managing the SDL preclusion problem needs to accomplish three distinct goals. First, to the extent possible, multiple claims should be channeled into a single jurisdiction in order to conserve judicial resources, minimize the race to the courthouse, and prevent conflicting legal treatment of identical derivative claims. Second, corporate law should deter underdeveloped litigation that hinders legitimate claims. Finally, the law should discourage the repeated filing of substantially similar SDL complaints that undermine finality and tend toward harassment.

These policy goals are complex, however, and no single response is likely to get the balance of incentives exactly right. Accordingly, this section will propose a three-part blueprint for action. First, corporate law should encourage and support the use of corporate forum exclusivity provisions to channel and consolidate SDL claims into a single state. Second, judges should adopt more stringent monitoring of adequate rep-

law firm."). The recent case of *South v. Baker*, 62 A.3d 1, 22–25 (Del. Ch. 2012), went even further by establishing a presumption of disloyalty when a shareholder files a hasty and shoddy derivative claim under circumstances where there was no need to rush and without any deliberate or meaningful pre-suit investigation.

[186] See supra notes 158–61 and accompanying text.

[187] See, e.g., In re Revlon, Inc. S'holders Litig., 990 A.2d 940, 955 (Del. Ch. 2010) ("Just what measure of representation is adequate is a question of fact that depends on each peculiar set of circumstances." (quoting Guerine v. J & W Inv., Inc., 544 F.2d 863, 864 (5th Cir. 1977)) (internal quotation marks omitted)).

resentation in the event of rapid or weak claims. This should solve the patsy lawsuit problem because the dismissal of a bare-bones complaint, which might otherwise preempt meaningful litigation, will not block a substantive follow-on lawsuit. Finally, courts should sanction legal fee shifting, under which defendants are reimbursed whenever a plaintiff initiates a lawsuit without reasonable cause or for an improper purpose. In particular, the failure to incorporate information from a books and records investigation into a complaint should raise a presumption that the lawsuit was brought without reasonable cause. Similarly, filing a follow-on lawsuit after an initial claim has been dismissed (and representation has been deemed inadequate) should only meet the reasonable cause test if the subsequent shareholder-plaintiff introduces substantial incremental evidence related to the purported misdeed.

The balance of this Article will develop each of these three ideas in more detail.

A. Channeling SDL Claims

The first goal of a sensible SDL system should be to channel related lawsuits into a single jurisdiction. Currently, many firms must defend SDL claims on two fronts: in the state of incorporation and in the state where the firm maintains its headquarters.[188] This makes very little sense—irrespective of the merits of these claims. The duplicative litigation is a waste of judicial resources and legal fees. Even though both jurisdictions will typically apply the same legal rules (under the internal affairs doctrine) there will inevitably be circumstances where two well-intentioned judges reach different conclusions.[189] This does nothing to inspire confidence in corporate law.

One promising framework for channeling shareholder litigation into a single state involves the use of exclusive forum provisions in corporate charters or bylaws.[190] These provisions, which have attracted some re-

[188] See sources cited supra note 9.

[189] *Allergan I* is an obvious example of this: Recall that the California court insisted on demand, while the Delaware court excused demand as futile. Both outcomes appear to have been reached on a substantially similar factual record.

[190] See Edward B. Micheletti & Jenness E. Parker, Multi-Jurisdictional Litigation: Who Caused This Problem, and Can It Be Fixed?, 37 Del. J. Corp. L. 1, 24–25, 35–36 (2012); Brian JM Quinn, Shareholder Lawsuits, Status Quo Bias, and Adoption of the Exclusive Forum Provision, 45 U.C. Davis L. Rev. 137, 163–65 (2011); Faith Stevelman, Regulating Competition, Choice of Forum, and Delaware's Stake in Corporate Law, 34 Del. J. Corp. L.

cent attention, insist that SDL claims (and potentially other types of shareholder lawsuits) can only be filed in a single state—typically the place of incorporation. Forum selection clauses are common in many private contracts, of course, where they are widely respected and enforced.[191] But historically, only a handful of corporations have elected to adopt analogous provisions to govern shareholder litigation over corporate matters.

This began to change around 2010, however, when a Delaware judicial opinion hinted via dicta that these provisions would be respected.[192] Picking up on the suggestion, lawyers[193] and academics[194] have started to pitch forum exclusivity provisions as a solution to the multi-jurisdiction mess. According to one recent study, approximately eighty corporations adopted exclusivity provisions during 2012.[195]

The benefits of forum exclusivity for the SDL preclusion problem should be obvious. If a shareholder is required to file her claim in the state of incorporation, then any effort to launch a parallel proceeding in another location would be a nonstarter—as long as the other state respects these provisions.[196] Claims would be channeled into a single state, and the collateral estoppel problem would recede. Importantly, however,

57, 132–35 (2009); Sara Lewis, Note, Transforming the "Anywhere but Chancery" Problem into the "Nowhere but Chancery" Solution, 14 Stan. J.L. Bus. & Fin. 199, 202–03 (2008).

[191] See, e.g., Matthew D. Cain & Steven M. Davidoff, Delaware's Competitive Reach, 9 J. Empirical Legal Stud. 92, 93–94, 105–06 (2012) (documenting the widespread use of Delaware forum selection provisions in corporate merger agreements); Theodore Eisenberg & Geoffrey P. Miller, The Flight to New York: An Empirical Study of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies' Contracts, 30 Cardozo L. Rev. 1475, 1478 (2009) (finding that roughly forty percent of the contracts included in Form 8-K filings contain a choice of forum provision).

[192] *In re Revlon*, 990 A.2d at 960 ("[I]f boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes.").

[193] See, e.g., Claudia H. Allen, Study of Delaware Forum Selection in Charters and Bylaws, Katten Muchin Rosenman LLP 11 (Jan. 25, 2012), http://65.17.213.81/Files/45103_Jan_%202012_Forum_Study.pdf.

[194] See, e.g., Joseph A. Grundfest, The History and Evolution of Intra-Corporate Forum Selection Clauses: An Empirical Analysis, 37 Del. J. Corp. L. 333, 373–78 (2012); Joseph A. Grundfest, Choice of Forum Provisions in Intra-Corporate Litigation: Mandatory and Elective Approaches 24 (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper No. 91, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1690561.

[195] Claudia H. Allen, Exclusive Forum Provisions: Putting on the Brakes, 10 Corp. Accountability Rep. (BNA) 1286, 1291 (Dec. 14, 2012).

[196] This should not be taken for granted and may depend on the way that the forum exclusivity provision is adopted. See infra note 197.

it would not disappear entirely because a follow-on lawsuit could still conceivably be filed in the designated state.

Another benefit from channeling SDL claims into a single forum would arise through the selection of a lead plaintiff. When multiple shareholders (or lawyers) vie for control of the litigation, a single judge can evaluate the quality of each filing in order to appoint the best leader. Often the plaintiffs' attorneys will just negotiate a combined leadership role, and divide responsibility for prosecuting the claim, when they are forced into a single jurisdiction. Likewise, a unitary court will be able to manage the timing of the case. For example, a judge might stay proceedings in order to allow a motivated plaintiff to pursue a books and records inspection request without worrying that an alternative jurisdiction will take hastier action that preempts the claim.

One difficult question that arises with forum exclusivity provisions is whether these terms need to reside in a corporate charter or whether a bylaw amendment will be sufficient.[197] This is not just an academic distinction: Charter amendments require a shareholder approval vote, while bylaw modification is usually accomplished via authorization by the board of directors. Even though an enlightened shareholder might conceivably embrace forum exclusivity—to prevent other shareholders and their attorneys from wasting corporate assets through duplicative lawsuits—many established firms do not seem to be interested in pursuing shareholder approval votes.[198] Larger firms have been willing to adopt

[197] One California court, for instance, has recently held that an exclusive forum bylaw provision adopted by Oracle Corp. was not enforceable under federal law. Galaviz v. Berg, 763 F. Supp. 2d 1170, 1175 (N.D. Cal. 2011). The court did state that the argument for enforcing the provision would be stronger if it had been approved by shareholders—suggesting that a charter amendment to the same effect could have been upheld. Id. Moreover, the bylaw provision had been adopted after the alleged wrongdoing took place; it is possible that this case could be distinguished if a corporation adopted the bylaw provision before any alleged wrongdoing. See Marc A. Alpert & Patrick J. Narvaez, Continuing Challenges to Exclusive Forum Bylaw Provisions, Chadbourne & Parke LLP 2 (Sept. 2012), http://www.chadbourne.com/ (follow "Publications" hyperlink; then follow "Articles" hyperlink; then follow "Continuing Challenges to Exclusive Forum Bylaw Provision" hyperlink).

[198] This should be contrasted with emerging public firms, which seem quite willing to include forum exclusivity provisions in their corporate charters during the initial public offering process. See Allen, supra note 193, at 1. One possible reason for the established firm reluctance is that proxy advisory firms are beginning to state that they may not consider exclusive forum provisions to be "best-practice" for corporate governance; one leading proxy advisor, Glass Lewis, has stated that it will recommend a vote against the election of the chairman of the governance committee if a forum exclusivity provision is adopted without a shareholder approval vote. Id. at 5–6. About half of the forum exclusivity provisions

unilateral bylaw amendments, though some of these boards are abandoning the effort in the wake of shareholder challenges.[199] Forum exclusivity provisions undoubtedly raise difficult legal tradeoffs. A corporation is not the same as a contract, and there are legitimate issues of notification and consent. But there may be a stronger argument for supporting forum selection provisions related to SDL claims—because the ultimate plaintiff is the firm itself.

An important recent decision in Delaware, *Boilermakers Local 154 Retirement Fund v. Chevron Corp.* addressed this exact question of the appropriate home for SDL forum selection provisions.[200] The facts are simple. In late 2010, Chevron's board of directors adopted a bylaw provision that restricted SDL lawsuits (as well as some other types of lawsuits) to Delaware.[201] The plaintiffs, who were shareholders in the firm, sued the corporation (in Delaware), contending that the provision was invalid as a matter of both statutory corporate law and state contract law. The chancery court disagreed with both assertions and upheld the ability

that are put up for shareholder vote appear to have passed, but this represents a very small number of votes. See Bill Kelly & Elizabeth Weinstein, Exclusive Forum Provisions Update, Davis Polk & Wardwell LLP (June 21, 2012), http://www.davispolk.com/briefing/corporategovernance/61637/.

[199] It is likely that shareholders suspect a plot by insiders to channel litigation to a management-friendly jurisdiction in another version of corporate law's race to the bottom. The withdrawal of bylaw provisions seems to be driven by a reaction to activist shareholders who threaten to oppose forum exclusivity via litigation. In February 2012, for example, a dozen complaints were filed against Delaware corporations that had adopted bylaw amendments. All but two of these firms elected to drop the provision. See Kelly & Weinstein, supra note 198.

[200] 73 A.3d 934, 938–39 (Del. Ch. 2013).

[201] Id. at 941–42. The full text of the forum selection provision read as follows:

> Unless the Corporation consents in writing to the selection of an alternative forum, the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the Corporation, (ii) any action asserting a claim of breach of a fiduciary duty owed by any director, officer or other employee of the Corporation to the Corporation or the Corporation's stockholders, (iii) any action asserting a claim arising pursuant to any provision of the Delaware General Corporation Law, or (iv) any action asserting a claim governed by the internal affairs doctrine shall be a state or federal court located within the state of Delaware, in all cases subject to the court's having personal jurisdiction over the indispensible [sic] parties named as defendants. Any person or entity purchasing or otherwise acquiring any interest in shares of capital stock of the Corporation shall be deemed to have notice of and consented to the provisions of this [bylaw].

Id. at 942 (alteration in original) (emphasis removed).

of directors to unilaterally adopt forum selection provisions through bylaw modifications.[202]

Noting first that Delaware law provides significant latitude for bylaw provisions,[203] the court went on to deem the forum selection provisions permissible, as a matter of corporate statutory law, because they regulate a proper subject matter (the exercise of shareholder claims against the corporation).[204] The court analogized to advance notice bylaws, which require shareholders who wish to make a proposal at an upcoming shareholders meeting to notify the firm of their intentions in advance.[205] Likewise, the court held that the untraditional nature of this bylaw did not render it impermissible and that the provision was reasonable because the board could always waive the forum exclusivity requirement in unusual circumstances.[206] Finally, the court noted that the board itself could be subject to a breach of fiduciary duty claim if the clause was used for some improper purpose.[207]

Turning to the contractual validity of the provisions, the court reasoned that the bylaw was perfectly consistent with the structural relationship between shareholders and the firm.[208] It is true, of course, that the shareholders were not able to manifest explicit consent for the forum exclusivity provision through a vote of agreement; the board unilaterally adopted the provision. But the shareholders could be fairly understood to have consented to the fundamental governance structure of the corporation—set out in the firm's charter—which permitted the board to establish future bylaw provisions that are consistent with corporate law.[209] In other words, the rights of shareholders are not vested at the moment of purchase, but rather are subject to a flexible governance structure that expressly contemplates unilateral adjustments by the board (within certain limits).[210]

[202] Id. at 938–39.
[203] Del. Code Ann. tit. 8, § 109(b) (2011) states that "[t]he bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees."
[204] *Boilermakers*, 73 A.3d at 950–54.
[205] Id. at 952.
[206] Id. at 954.
[207] Id.
[208] Id. at 955–56.
[209] Id.
[210] Id. at 956.

One very interesting question is the extent to which a board can act in this manner to tinker with the rights of shareholders. The plaintiffs in *Chevron* attacked the forum selection provision by marching out a "[p]arade of [h]orribles" to argue how supporting unilateral board action might lead to unreasonable hardships for some types of shareholders in some types of circumstances.[211] The court seemed receptive to the possibility that unilateral modifications might go too far, in this or other contexts,[212] but it rejected the argument that such infirmities rendered the forum exclusivity provision invalid per se.[213] Rather, it took solace in three other factors. First, the board could always waive the forum exclusivity provision in extreme circumstances.[214] Second, shareholders could band together to repeal the bylaws under the division of governance powers set out in the corporate charter.[215] Finally, shareholders might sue the board for a breach of fiduciary duty in egregious circumstances.[216] The precise limits of unilateral board bylaw power present fascinating questions of corporate and contract law. But going forward, these borders will be established in Delaware with specific factual circumstances, not by a blanket prohibition on unilateral bylaw amendments.

What will happen next? A reasonable (though not inevitable)[217] prediction is that *Chevron* will lead to the rapid adoption of bylaw forum selection provisions for many Delaware firms. Similarly, corporations in other jurisdictions may feel empowered to adopt bylaw amendments with an expectation that their courts will follow suit.[218] Of course, even a strong legal nudge towards the adoption of exclusive forum provisions is unlikely to cause every corporation to climb on the bandwagon; it is too early to determine whether this case has sparked a tipping point. For this

[211] Id. at 958, 960–61.

[212] More specifically, the chancellor preserved the court's ability to strike down a forum exclusivity provision, as applied, if the context for enforcement would place the plaintiffs in a catch-22 situation where an otherwise plausible claim could not be brought (typically for a failure of jurisdiction). Id. at 958–59.

[213] Id.

[214] Id. at 963.

[215] Id. at 956.

[216] Id. at 963.

[217] See supra note 198.

[218] Indeed, the concern over redundant litigation seems so great that some large firms may be willing to reincorporate to Delaware (or other states permitting bylaw forum selection provisions) if their home state does not follow suit.

reason, the problem of multiple lawsuits in different states will persist.[219] But broader use of forum selection provisions would undoubtedly mitigate the preclusion problem in SDL by channeling lawsuits into a single adjudicative body.

B. Keeping the Door Open (Long Enough)

The promise of shareholder litigation as a governance device quickly fades if corporate insiders can game the system. One continuing worry is that disingenuous directors, who have indeed engaged in a wrongful act, might convince an accomplice shareholder to file an unsubstantiated SDL claim. The firm can then file a motion to dismiss—seizing upon the complaint's failure to state with particularity why demand is excused—and offer a convincing argument that the SDL claim is too weak to proceed.[220] If a court agrees, then the liberal use of collateral estoppel would prevent subsequent claims from advancing. This is true even if a follow-up shareholder takes the time to actively investigate the situation and presents a very convincing explanation that something *is* rotten in the boardroom. It is simply too late. Said differently, the rapidly-filed claim inoculates directors against downstream lawsuits that might promote sound governance. Even moving away from conspiracy theories, rules or incentives that encourage the knee-jerk filing of bare-bones complaints may have very similar effects. A poorly drafted SDL claim, rushed to the courthouse, could become a moment of joy for guilty corporate insiders—if broad notions of preclusion carry the day.

For this reason, keeping the SDL door open (long enough) is a second important strategy for getting the balance right. Automatically treating any initial case as supporting a collateral estoppel defense becomes a powerful catalyst for undermining SDL governance. All follow-on efforts are blocked. But how, exactly, should the door be propped open?

The chancery court's decision in *Allergan I* sets out two clear possibilities.[221] First, Delaware might continue to embrace *Allergan I*'s con-

[219] It is worth noting that other legal reforms, such as broader judicial emphasis on the doctrine of forum non conveniens, could also be used to manage some of these concerns. See Strine et al., supra note 10, at 8.

[220] Another possible "strategy" might be to have a patsy plaintiff make demand immediately on the firm—thereby conceding that demand is indeed required and shifting the focus to the board's refusal to prosecute the lawsuit. Could that conceded demand act to bind all similarly situated plaintiffs and undermine the entire SDL framework?

[221] See supra Subsection II.B.2.

ception of SDL privity: that privity only attaches when demand is excused.[222] This would clearly prevent clumsy initial lawsuits from hindering subsequent meritorious claims. The diligent shareholder-plaintiff could simply file her delayed complaint, sidestep any efforts by the defending firm to quash the lawsuit with collateral estoppel, and take whatever time is necessary to develop a compelling account of the governance abuse.

This strategy would be a non-starter, of course, if a technical analysis of collateral estoppel clearly supported a different conception of privity. But, as we have seen above, privity is an amorphous concept that is often used to balance equitable considerations.[223] It is not at all clear that privity must attach at the moment that an SDL complaint is filed. It is true that any ultimate claim belongs to the corporation itself. But it is also the case that the plaintiff-shareholder has not yet been authorized to represent the corporation in this matter and that privity embraces concepts of adequate representation. There is room for policy considerations to influence judicial treatment of privity.

There are, however, a few possible concerns with this approach. First, future courts may be uncomfortable adopting the *Allergan I* privity analysis as the case was, of course, overturned (though not on this basis). Second, linking the privity determination to the demand futility inquiry sweeps with a very broad brush and does not explicitly get at the fundamental issues related to preclusion. For example, this approach may lead to situations where the initial plaintiff did an outstanding and thorough job prosecuting the lawsuit but nevertheless was unable to convince a court that demand was futile. By all accounts, the case should be closed, but the *Allergan I* privity standard would allow another plaintiff to take up the same case anew. Finally, this approach may lead to confusing jurisdictional differences between Delaware and other states that do not parse the privity question as finely (finding immediate privity among all shareholder-plaintiffs) or embrace a universal demand requirement.[224] More generally, if the best argument for a lack of privity is that the prior plaintiff did not sufficiently represent broad shareholder interests, then

[222] *Allergan I*, 46 A.3d 323, 325–30.

[223] See supra Subsection II.D.1.

[224] A related concern is that these differences may exacerbate a race to the bottom, with certain states taking on a role as pro-defendant by closing the SDL door rapidly in order to attract corporate franchise fees.

why not just conduct that analysis under an *explicit* inquiry into adequacy of representation?

Perhaps, then, it would be better to adopt an SDL "doorstop" that directly considers whether the prior representation was adequate. From a substantive point of view, this approach seems almost identical with the privity inquiry—as the primary policy consideration for both approaches seems to be the extent to which the earlier shareholder-plaintiff reasonably stood in for the interests of the entire body of shareholders. But an explicit collateral attack on adequacy of representation might still be developed in a manner that is consistent among different jurisdictions. Moreover, this concept can guard directly against a corporation that "sponsors" a bare-bones complaint in order to inoculate the firm against meaningful investigation of a plausible governance concern. Clearly any insider link, should it be detected, must be seen as promoting inadequate representation.[225] Similarly, the approach should prevent rapid filers who are not conspiring with insiders—but simply perceive that they can win control of the litigation through a rapid response—from hijacking more considered claims.

How exactly should adequacy of representation be used in the SDL context to sidestep the preclusive effect of bare-bones filings? The Delaware Supreme Court clearly rejected an irrefutable presumption that fast-filing plaintiffs who fail to pursue a books and records inquiry are inadequate representatives.[226] But it did leave room for lower courts to embrace these collateral attacks on prior litigation. For example, the fact that a plaintiff refuses to pursue a books and records inquiry might still give rise to a rebuttable presumption of inadequacy (or at least persuasive evidence of a structural defect in representation). Likewise, the court could explore whether a plaintiff holds a meaningful ownership position in the firm, how much time the plaintiff took to investigate the factual circumstances of the concern, the general nature of the SDL case, and (conceivably) whether the shareholder-plaintiff is a gadfly investor who routinely brings SDL claims against many different companies.[227] All of these concerns might raise issues related to both diligence in

[225] The challenge, of course, is for a court to link casual or latent encouragement by the defending firm to a patsy plaintiff on the basis of a thin factual record.

[226] See supra notes 158–61 and accompanying text.

[227] E.g., South v. Baker, 62 A.3d 1, 24–26 (Del. Ch. 2012) (holding explicit hearings on the adequacy of SDL representation and finding that the representation was inadequate).

claim prosecution and conflicting interests that could lead a court to decide that the effort suffers from a structural deficiency.[228]

In any event, it is reasonable to conclude that the overall SDL framework would work better if the door is left open to diligent claimants by adopting a greater willingness to call out weak plaintiffs as inadequate representatives. To the extent that one believes SDL can serve as a meaningful governance device,[229] the rapid imposition of collateral estoppel amounts to a showstopper. It simply makes it too easy for sloppy claims to block legitimate shareholder interests.

As a quick aside, it is worth noting that cunning corporate insiders may still retain other devices to neuter SDL claims. For example, a guilty board could try to settle an SDL claim with a "friendly" plaintiff—on terms favorable to that plaintiff's lawyers but meaningless to most shareholders—in order to obstruct a more intrusive investigation by a competing "diligent" shareholder-plaintiff.[230] Assiduous judicial as-

[228] There are also parallels with class action litigation that might be helpful in this context, though the legal approach here is hardly a model of clarity. Nevertheless, courts might borrow conceptually from the case law and academic commentary on collateral attacks in the class action context. See sources cited supra note 89.

[229] There are some who counsel against SDL as a governance device, arguing that litigation costs (broadly defined) likely outweigh any conceivable policy gains from improved corporate governance. See, e.g., Roberta Romano, The Shareholder Suit: Litigation Without Foundation?, 7 J.L. Econ. & Org. 55, 84 (1991) (conducting an empirical study of shareholder litigation, including both SDL and class action lawsuits, and concluding that "[t]here are financial recoveries in only half of settled suits, and per share recoveries are small. . . . The principal beneficiaries of the litigation . . . appear to be attorneys, who win fee awards in 90 percent of settled suits.").

[230] The most infamous example of this is the Occidental Petroleum drama of 1989–90. See Kahn v. Occidental Petroleum Corp., No. 10808, 1989 WL 79967, at *660–61 (Del. Ch. July 19, 1989). In this case, the Occidental board approved a massive expenditure (over one third of the corporation's annual earnings) for an art museum that would hold the private art collection of Occidental's flamboyant CEO, Armand Hammer. Two competing SDL claims soon followed. Id. at *658. Occidental moved to settle one of the claims by paying the plaintiffs' attorneys $800,000, naming the museum the Occidental Petroleum Center Building, and agreeing to a few other governance and financial requirements for the museum. See Kahn v. Sullivan, 594 A.2d 48, 56–57 (Del. 1991); Kahn v. Occidental, Nos. 10808, 10823, 10860, 1992 WL 9045, at *1–2 (Del. Ch. Jan. 10, 1992). The other shareholder-plaintiff protested the settlement, suggesting that it was merely a way to paper over troubling lapses in corporate governance, but these objections were dismissed by the Delaware court—which approved the settlement, albeit begrudgingly. Sullivan v. Hammer, No. 10823, 1990 WL 114223, at *1634–35 (Del. Ch. Aug. 14, 1990). It is important to note that the settlement decision had been approved by a special committee of disinterested directors, which led the court to believe that the business judgment rule would protect any legal challenge. Id. at *1632. Nevertheless, corporate law commentators railed against this outcome as an egre-

sessment of any settlement agreement is perhaps the best way to manage this problem, though this is a topic for another day.

There is a potential dark side, of course, to leaving the SDL door open through more stringent judicial monitoring of adequacy of representation. This strategy presents a clear risk of never-ending lawsuits and harassing litigation to eke out lucrative settlements for illegitimate purposes.[231] For this reason, a greater willingness to certify bare-bones plaintiffs as inadequate representatives should be counterbalanced with additional incentives that might prevent the pendulum from swinging too far towards abusive claims.

C. Limiting the Risk-Limited Nature of SDL

As we have seen, the primary concern with repeat SDL claims is a fear that zombie lawsuits might rise repeatedly from the graves of failed demand futility rulings. If a collateral estoppel defense can be easily surmounted with a claim of inadequate representation, then what will stop a motivated plaintiffs' attorney (or a consortium of attorneys) from repeatedly re-litigating a claim until the corporation rolls over and settles? This sentiment is clearly expressed by courts that embrace collateral estoppel to provide closure to SDL.[232]

For this reason, legal willingness to support inadequate representation rulings should be accompanied by legal and economic incentives that push back the other way—to mitigate harassing serial litigation. The problem of avoiding specious derivative claims is not new, of course, though it is amplified by legitimate threats to repeatedly pound the SDL battering ram against the boardroom door. Over the years, judges have searched for strategies to alleviate the dark side of derivative litigation—

gious abuse of governance authority. See, e.g., Nell Minow, Op-Ed., Hollow Shareholder Suits Show Rottenness in Delaware Courts, Legal Times, Sept. 17, 1990, at 25.

[231] One other possibility here might be to dismiss a case with prejudice only with respect to the initial plaintiff. Such an approach should leave the case open to a different shareholder-plaintiff, while closing off the bare-bones filer from the action. See, e.g., *South*, 62 A.3d at 26 ("[T]he dismissal of the [plaintiffs'] complaint should not have preclusive effect on the litigation efforts of more diligent stockholders . . . ."). One wonders, however, whether the law firm that brought the first case might be able to recruit a different shareholder to file the follow-on case in order to press the corporation to settle the dispute.

[232] E.g., LeBoyer v. Greenspan, No. CV 03-5603-GHK (JTLx), 2007 WL 4287646, at *3 (C.D. Cal. June 13, 2007) ("Were the demand futility issue not final and on the merits it could be infinitely litigated in subsequent suits by successive individual plaintiffs suing in a derivative capacity.").

ranging from plaintiff verification under the threat of perjury[233] to continuous holding periods to minimum ownership stakes.[234]

But, as is so often the case, one of the best motivators may be money. A number of states (but not Delaware) have historically coupled the carrot that a plaintiff's legal fees can be repaid for successful outcomes with the stick that the shareholder-plaintiff may need to reimburse the defending corporation for SDL expenses under certain contexts. In other words, some jurisdictions contemplate a variant of the English rule, which requires the party who loses a case to pay the legal fees of the other side. For example, under the Model Business Corporation Act ("MBCA"), which is followed by approximately half of the states, a court may order fee shifting when a plaintiff pursues a lawsuit "without reasonable cause or for an improper purpose."[235]

Historically, there does not seem to be extensive use of fee-shifting provisions in this context, but judges do require plaintiffs to reimburse defending corporations and directors from time to time.[236] The Tennessee case of *Brady v. Calcote* is illustrative.[237] A plaintiff-shareholder brought an SDL claim against a bank for a variety of concerns—including inaccurate financial reporting, excessive fee payments to directors, and the offering of preferential loans to customers at an automobile dealership owned by one of the directors. When the lawsuit was dismissed, following a special committee inquiry, the bank sought to recover its litigation expenses from the plaintiff. The court, after analyzing the sufficiency of the charges and canvassing the fee-shifting standards

[233] See 28 U.S.C. § 1746 (2006); Fed. R. Civ. P. 23.1. The fear was softened, however, in 1966 when the Supreme Court held that it was sufficient for the plaintiff-shareholder to reasonably rely on her attorney's investigation and advice. Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 370–374 (1966).

[234] See, e.g., Malaika M. Eaton et al., The Continuous Ownership Requirement in Shareholder Derivative Litigation: Endorsing a Common Sense Application of Standing and Choice-of-Law Principles, 47 Willamette L. Rev. 1, 5–14 (2010) (describing jurisdictional differences in ownership requirements for bringing an SDL claim). Most jurisdictions do not set an explicit ownership threshold as a precondition to SDL, but the rules may be adjusted to discourage lawsuits by very small owners. New York, for example, has required shareholder-plaintiffs to post a security bond for expenses whenever they hold less than five percent of the shares. N.Y. Bus. Corp. Law § 627 (Consol. 1983).

[235] Model Bus. Corp. Act. § 7.46(2) (2011).

[236] See, e.g., Bass v. Walker, 99 S.W.3d. 877, 885 (Tex. App. 2003) (holding that a plaintiff acts without reasonable cause if "(1) plaintiff's claims . . . are not warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law; or (2) plaintiff's allegations . . . are not well grounded in fact after reasonable inquiry").

[237] No. M2003-01690-COA-R3-CV, 2005 WL 65535 (Tenn. Ct. App. Jan. 11, 2005).

used in other jurisdictions, concluded that the plaintiff "brought her shareholder derivative action 'without reasonable cause'" and that she should reimburse the defendants for legal expenses related to this proceeding.[238]

In this manner, one plausible way to mitigate the risk of illegitimate SDL claims is for courts to be less reticent about embracing fee-shifting provisions that limit the risk-limited nature of SDL. Even the most cantankerous shareholder might think twice about initiating a questionable claim if he has to pay the firm's legal fees upon losing the case. Of course this obligation is not unqualified: Fee shifting should occur only when a plaintiff initiates a lawsuit without reasonable cause or for an improper purpose.

Imposing these incentives obviously requires a legal basis for shifting fees; judges cannot abandon the American rule sua sponte. If the state of incorporation follows the MBCA, or has adopted some other statute that permits fee shifting in the SDL context, then a judge need only espouse a willingness to impose these incentives more regularly. The ensuing case law can provide guidance about the precise meaning of the statutory language. But what about states (such as Delaware) that have not established attorney fee reimbursement provisions in corporate statutes? Obviously one solution would be for the state legislatures to enact such a provision in the corporate code in an effort to balance incentives in SDL proceedings.

There is another promising idea, however, for corporations that wish to be governed by an SDL fee-shifting provision in the absence of legislative action. Borrowing from the recent approach used for forum selection provisions, a corporation might consider adopting a charter or bylaw provision that expressly establishes fee shifting in the SDL context. For instance, the board of directors might enact a bylaw that tracks the precise language of the MBCA, stating that the corporation's legal fees must be repaid if an SDL claim is brought "without reasonable cause or for an improper purpose." If legally permissible, this might allow the firm to opt into a framework that seeks to incentivize shareholder-plaintiffs to perform some due diligence before initiating a lawsuit.

[238] Id. at *8. The court was unwilling, however, to require the plaintiff to reimburse the corporation's expenses related to the special committee, holding that the plain text of the Tennessee Code would not support such a reading of the fee-shifting provision. Id. at *8–9.

Would this type of provision be upheld in, say, Delaware? This could be a close call and will likely depend on the precise language that is used in a given bylaw. Certainly it would extend the analogy between corporate bylaws and contract law; numerous private agreements do include provisions where losing parties must reimburse winning parties for subsequent litigation under certain circumstances.[239] Following the recent *Chevron* decision,[240] it is plausible that Delaware would conclude that a fee-shifting provision (with a reasonable standard and, possibly, a waiver clause) is consistent with a proper corporate purpose. To be sure, this strategy would present important questions about consent and the extent to which corporate law can be shaped ex ante by charter or bylaw provisions that are not explicitly agreed to by downstream shareholders. Moreover, the political costs of adopting a fee-shifting provision may scare some corporations away from taking this step.[241] Nevertheless, the use of private fee-shifting provisions does raise some intriguing possibilities for balancing SDL incentives.

Assuming, for argument's sake, that a fee-shifting provision would be upheld, how might a court determine whether an SDL action has been brought without reasonable cause or for an improper purpose? First, the failure to incorporate information from a books and records investigation into a complaint might raise a presumption that the lawsuit was brought without reasonable cause. Can a plaintiff really be expected to have investigated the matter carefully when an SDL claim is filed just a couple hours after the headlines report some corporate trauma?[242] Such an approach would also be consistent with other recent decisions that are increasingly emphasizing the need to conduct a thorough investigation before initiating shareholder litigation.[243] This presumption might be rebutted, of course, if the plaintiff possesses information at the time of fil-

[239] Of course any system that reimburses legal fees for successful outcomes needs to determine how the bill should be tallied. It is patently problematic to allow an attorney to just put in for any amount; there must be some check on atmospheric billing rates. The law strikes a compromise here by doing what it often does when it cannot find a trustworthy private party to exercise discretion: judges are tasked with the job of approving fee requests.

[240] See supra notes 200–16 and accompanying text.

[241] See supra notes 197–99 and accompanying text.

[242] Importantly, many of the fee-shifting statutes require judicial assessment of reasonableness *at the commencement* of the case—not once subsequent information has been uncovered and incorporated. See, e.g., Owen v. Modern Diversified Indus., 643 F.2d 441, 444–45 (6th Cir. 1981) (assessing Tennessee's law); Blumenthal v. Teets, 745 P.2d 181, 188–89 (Ariz. Ct. App. 1987); White v. Banes Co., 866 P.2d 339, 343–44 (N.M. 1993).

[243] E.g., South v. Baker, 62 A.3d 1, 12 & n.2 (Del. Ch. 2012).

ing that strongly suggests that demand should be excused—such as evidence that all directors in a firm are clearly implicated as conflicted participants in a self-dealing transaction.

In the collateral estoppel context, the reasonable cause or improper purpose test might also be applied when a follow-on lawsuit is filed after the first SDL claim has been dismissed. In this situation, the fact that a books and records inspection has already taken place should be less persuasive—especially if the prior lawsuit already incorporated this information. Rather, the follow-up lawsuit should only meet the reasonable cause test if the subsequent shareholder-plaintiff introduces substantial incremental evidence related to the purported misdeed. Otherwise, courts may wish to infer that the litigation has been brought for the improper purpose of using serial lawsuits—in the face of heightened privity requirements or an inadequate representation determination—to harass the defendant into settlement. Implementing these standards would obviously rely heavily on judicial discretion and the fact specific nature of SDL, but it is difficult to imagine how any other approach would suffice.

Adopting limited fee shifting in an effort to balance SDL incentives does raise a concern that imposing some plaintiff risk will eradicate all derivative claims.[244] Forcing a single shareholder to shoulder the possibility of paying a defendant's legal fees may indeed chill interest in bringing the lawsuit. But even a risk-averse plaintiff should be willing to bring a claim that is supported by a books and records investigation. She will not be on the hook for the firm's legal fees if the case is simply dismissed—only if the court makes a follow-up determination that the lawsuit was a hasty and unsubstantiated effort. Moreover, the imposition of this risk might lead to another interesting structural shift if plaintiff-shareholders begin to seek indemnification from their lawyers as a condition of signing onto the lawsuit. If such an arrangement is upheld, then the party who often retains effective control of the litigation—the attor-

[244] Inevitably, it will also raise questions about whether an individual shareholder could actually be able to pay the firm's legal fees. Historically, some states addressed this concern by insisting that a plaintiff-shareholder post a security bond as a condition of filing the suit (though exemptions were sometimes offered for large shareholders). This bonding requirement is much less common today—as judges came to believe that it would smother derivative claims. The cost of posting the bond, even before it is combined with the risk that the money might be lost, can be greater than the expected recovery to a small shareholder-claimant.

ney—may begin to internalize some of the costs of bringing a hasty or harassing claim.

CONCLUSION

Representative shareholder litigation is an extreme act that should be used sparingly to chill outrageous managerial conduct. As we have seen, the challenge with using SDL as a governance mechanism is how to balance meritorious claims against specious efforts that seek to line the pockets of rapid-filing attorneys at the expense of the broader body of shareholders. This problem is compounded by recent developments that may allow claimants to have two or more bites at the apple through the relaxation of collateral estoppel. But automatic preclusion, which would slam the SDL door shut in the wake of a hasty or ill-considered claim, undermines the promise of shareholder litigation as a governance backstop.

This Article has offered a three-part strategy for managing the SDL preclusion problem. Channeling multiple claims into a single jurisdiction, through the greater use of forum exclusivity provisions, would narrow the problem considerably. Adopting heightened standards of adequate representation would keep the promise of SDL alive by preventing knee-jerk claims from stopping the show. And a greater willingness to require plaintiffs to pay the firm's legal fees when claims are brought without a reasonable investigation or for an improper purpose should arrest the temptation to file serial SDL claims that seek to harass the firm into settlement. The problem is admittedly complex. But, taken together, these reforms should minimize duplicative litigation and mitigate hollow derivative claims—while still preserving the promise of shareholder lawsuits as a meaningful safeguard against tainted corporate governance.