SHAREHOLDER DERIVATIVE LITIGATION AND THE PRECLUSION PROBLEM

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Shareholder derivative litigation differs from other types of representative lawsuits because a lead plaintiff does not purport to stand in for an entire class of similarly situated parties. Rather, the plaintiff seeks to wrest governance control from the corporate entity itself in order to prosecute a lawsuit on the firm's behalf. This is an extreme act: why should one shareholder get to take the reins of an entire firm? Accordingly, corporate law only permits these lawsuits to go forward in rare circumstances, typically when there are strong signs 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. This, in turn, raises a very tricky question for derivative litigation: when can we be confident that a given shareholder adequately prosecutes a claim—such that the matter should be closed? When a case is dismissed in one court, the failure to collaterally estop a sister case (relating to the same misdeed) in another jurisdiction raises the possibility of never-ending litigation. But inevitable dismissal of follow-on filings could create a situation where an opportunistic corporation sponsors an ill-informed plaintiff to rush to the courthouse with a weak complaint in order to insulate the firm from legitimate derivative claims. Relatedly, early filing pressures, amplified under a strict collateral estoppel regime, may encourage jurisdiction shopping and shoddy claims that undermine the governance goals of derivative litigation.

This Article offers a three-part strategy for managing the preclusion problem in derivative litigation. First, more claims should be channeled into a single jurisdiction through the robust adoption (and judicial validation) of forum selection provisions for derivative litigation in corporate charters or bylaws. This will minimize the race to the courthouse(s) and alleviate conflicting judicial treatment of derivative claims. Second, following recent Delaware precedent, collateral estoppel should not be triggered until a shareholder-plaintiff is permitted to represent the firm in the litigation—through a judicial determination that

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demand is excused. This will prevent a corporation from sponsoring "patsy" litigation that obstructs legitimate claims. Finally, courts should be encouraged to implement legal fee shifting whenever a plaintiff undertakes derivative litigation 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 strong presumption 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 plaintiff introduces substantial incremental evidence related to the misdeed. Taken together, these reforms should minimize duplicative litigation and mitigate specious claims—while still preserving the promise of shareholder lawsuits as a meaningful safeguard against dysfunctional corporate governance.

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]

[1] *See, e.g.,* Del. Code Ann. tit. 8 § 141(a) (2011) (placing responsibility for managing a

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 corrupt 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 primary actors in these cases, the plaintiff's lawyers, are entitled to receive payment for their services through contingency fee arrangements or payments from the corporation itself. And finally, the litigation is *risk-limited* because the American rule for attorney's fees states that a losing party does not need to pay for the costs of the winning party. 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. 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 world-views 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

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corporation with the board of directors).

[2] *See, e.g.,* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 389 (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. 462 (1991).

[4] *See* John C. Coffee, *Litigation Governance: Taking Accountability Seriously*, 110 COLUM. L. REV. 288, 290-92 (2010).

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 examines the preclusion problem in the context of shareholder derivative litigation. Shareholder derivative claims differ 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. 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. 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 plaintiff's 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 derivative litigation.[5] 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,

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[5] *See, e.g.,* Leo E. Strine, Jr. et al., *Putting Stockholders First, not the First-Filed Complaint,* (working draft dated Jan. 10, 2013), *available at* http://ssrn.com/abstract=2200499.

meaning that both the party seeking to employ collateral estoppel and the party against whom collateral estoppel is sought were parties to the prior action. Can we comfortably conclude that there is privity when a new shareholder seeks to file the claim? More generally, 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 U.S. Department of Justice relating to improper marketing practices for Botox.[6] Allergan paid a massive $600 million in fines and penalties—approximately its entire annual net income.[7] Not surprisingly, this blockbuster announcement quickly attracted lawsuits from angry shareholders: how could Allergan's management have sanctioned such conduct? A case was filed on September 3, 2010, in Delaware Chancery Court (Allergan's state of incorporation), and several other claims followed in both Delaware and California (where the firm maintained headquarters).[8]

The Delaware vice chancellor postponed hearing on the company's motion to dismiss because some Delaware plaintiffs were investigating the matter more fully though a books and records inspection.[9] The California case moved more quickly, however, and that judge eventually dismissed the case with prejudice on January 17, 2012.[10]

Armed with this development, Allergan supplemented its motion to dismiss the case in Delaware with a collateral estoppel argument. According to the defendants, 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.[11] In short, the matter

[6] Louisiana Municipal Police Employees' Retirement System v. Pyott, 46 A.3d 313, 321 (2012).

[7] *Id.*

[8] *Id*. at 321-22.

[9] *Id*. at 322. Delaware Corporate law provides shareholders with these inspection rights, for a proper purpose, under section 220 of the Delaware General Corporate Code.

[10] Louisiana Municipal Police Employees' Retirement System v. Pyott, 46 A.3d at 322.

[11] *Id.*

had already been decided, and Delaware was obligated under the principles of collateral estoppel to follow California's lead. Allergan cited numerous cases to support this position.[12]

But the Delaware vice chancellor disagreed, refusing to apply collateral estoppel on two separate grounds. 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.[13] 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.[14] Second, the vice chancellor found that the California plaintiffs were inadequate representatives of Allergan because these shareholders had cobbled together a bare-bones lawsuit without conducting any meaningful investigation of the Botox situation.[15]

This was a controversial ruling, and the case attracted attention. One commentator called it a "cross-county bench-slap" by the vice chancellor.[16] Another headline blared, "Delaware Court of Chancery 'Overrules' Federal Court."[17] Eventually the case was certified for interlocutory appeal to the Delaware Supreme Court.[18] Beyond the media zingers, however, the Allergan case surfaces two fundamental questions in shareholder litigation. When should a derivative case be put to rest? And, relatedly, when should

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[12] *See, e.g.*, In re Sonus Networks, Inc. S'holder Deriv. Litig., 499 F.3d 47 (1st Cir. 2007); Arduini ex rel. Int'l Game Tech. v. Hart, 2012 WL 893874 (D. Nev. 2012); In re Bed Bath & Beyond Inc. Deriv. Litig., 2007 WL 4165389 (D.N.J. 2007); Hanson v. Odyssey Healthcare, Inc., 2007 WL 5186795 (N.D. Tex. 2007); LeBoyer v. Greenspan, 2007 WL 4287646 (C.D. Cal. 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., 2007 WL 2875203 (Del. Ch. 2007); Carroll ex rel.Pfizer, Inc. v. McKinnell, 19 Misc. 3d 1106(A), 2008 WL 731834 (N.Y. Sup. Ct. 2008).

[13] Louisiana Municipal Police Employees' Retirement System v. Pyott, 46 A.3d at 326-34.

[14] *Id.*

[15] Id. at 335.

[16] David Marcus, "Laster Issues Cross-Country Bench Slap," *The Deal Pipeline* (June 20, 2012), *available at* http://www.thedeal.com/content/restructuring/laster-issues-cross-country-bench-slap.php. The vice chancellor took issue with these sensationalist reports during the oral arguments on the motion to certify the case for interlocutory appeal. *See* Oral Arguments Transcript at 42-55.

[17] Keith Paul Bishop, "Delaware Court of Chancery 'Overrules Federal Court," *California Corporate & Securities Law* (June 18, 2002), *available at* http://calcorporatelaw.com/2012/06/delaware-court-of-chancery-overrules-federal-court/ .

[18] Oral Arguments Transcript at 84.

legal decisions in one state bind the hands of courts in another? These apparently technical problems have some profound complications for corporate law.

This Article advances a three-step blueprint for navigating the collateral estoppel quagmire in shareholders derivative litigation. 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 reduce the multiple forum problem, but importantly it would not prevent either pasty litigation or harassing follow-on lawsuits. Accordingly, the second step is to embrace the Allergan court's conception of privity in order to stymie any efforts by a defending corporation to block legitimate shareholder investigations. Finally, corporate law must put incentives in place to discourage never-ending lawsuits. One plausible solution is to encourage courts to embrace fee shifting statues (currently on the books in many states) 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 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, 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 proceeds as follows. Part I outlines the rules of shareholder derivative litigation and the theory of internal litigation as a corporate governance device. Part II introduces the collateral estoppel complication and illustrates the perverse incentives that can arise under either strict compliance or absolute rejection of this doctrine. Part III charts a path down the middle, offering a three-part strategy for reforming 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. Unlike securities litigation or shareholder class action lawsuits, the corporation is not technically the defendant. Rather, 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. 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.

The critical question in every SDL action is who gets to make this decision. 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're 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 obtaining a judgment. 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.[19] 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.[20]

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. Accordingly, 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 discretion. 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

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[19] 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 (2008).

[20] *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.").

should be understood as the person who has really suffered a legal slight—then there is no need to bother with the SDL framework. 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 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.

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. 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. Shareholders cannot claim direct harm, however, just because the price of their stock drops as the result of firm mismanagement.[21]

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 the claim will likely be direct. 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). If, on the other hand, any recovery would belong to the corporation, then the claim is probably derivative. 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. 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

[21] *See, e.g.*, Armstrong v. Frostie Co, 453 F.2d 914 (4th Cir. 1971).

understood as a breach of the board's fiduciary obligations). 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 action.

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. 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. 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 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, who is now entitled to decide whether to pursue the litigation. 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'll 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. 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.[22] 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 most derivative actions. Indeed, for all practical purposes it assumes central importance in the litigation dynamics.[23]

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.[24] 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.[25] 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. Plus it is often much more difficult to mine for information about the decision to drop the case; even a decision 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 SLD case usually centers around whether demand should be excused as futile.

When, then, is demand excused, such that the outside plaintiff-shareholder 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.[26] 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

[22] *See, e.g.,* Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747 (2004).

[23] *See, e.g.,* Deborah A. Demott, *Demand in Derivative Actions: Problems of Interpretation and Function*, 19 U.C. DAVIS L. REV. 461 (1986).

[24] *See* Grimes v. Donald, 673 A.2d 1207 (Del. S. Ct. 1996).

[25] *Id.*

[26] 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.,* MBCA § 7.42.

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 judgment of the directors.[27] 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.[28]

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. 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. Accordingly, a shareholder-plaintiff must cobble the story together using what Delaware calls "the tools at hand." It is not entirely clear what this means, though these tools seem to include media stories about the alleged wrongdoings, inside whistleblowers who are willing to step forward and describe the misdeeds, and a shareholder's individual right to inspect corporate books and records for a proper purpose. The latter technique had 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.[29] These inspection requests take time, however, and often result in separate direct litigation over the breadth and proper purpose of a books and records request.[30] Nevertheless, a motivated plaintiff may be able to muster sufficient information to excuse demand in egregious cases of governance abuse.

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

[27] Corporate law guards famously against the risk of Monday-morning quarterbacking by offering directors the protection of the business judgment rule. Risk pervades all business activity, and corporate law does not wish to discourage managers from taking a flier on a new product or market. Because the business judgment rule offers so much leeway to directors, we almost never 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.

[28] In this case, the court may dismiss the case without prejudice, thereby permitting a shareholder-plaintiff to push forward by filing demand with the board. But because it is so difficult to challenge a board's refusal to prosecute the claim, the practical result of a finding that demand is required is typically termination of the case.

[29] *See infra* note 103 and accompanying text.

[30] According to some legal scholars, the delay that results from this need to muster information on demand futility significantly reduces the charm of derivation litigation for many potential plaintiffs. **cite.

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.[31] 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."[32] 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.[33]

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 blanche.[34] Rather, it must surmount at least two hurdles. First, the special

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[31] *See, e.g.,* DEL. CODE ANN. tit. 8, § 141(c)(1) (2001) ("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.").

[32] *Id.*

[33] *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, section 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. The older provision, section 141(c)(1), has a longer list of proscribed matters, though nothing the prevents the use of a special committee to evaluate shareholder derivative litigation.

[34] 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

committee must truly be comprised of disinterested directors. Second, the committee must conduct a full and reasonable investigation of the matter. If these steps are followed, then any ultimate decision to drop the lawsuit can be clothed in the protection of the business judgment rule.[35] This ability to take the power back by special committee has been criticized by commentators for undercutting the legs of SDL governance,[36] though a recent empirical study suggests that many special committees do take their duties quite seriously and frequently pursue claims against insiders.[37] 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 in a single jurisdiction. Yet this is often not the case; several distinct plaintiffs commonly litigate SDL claims in two or more states.[38] This multi-dimensional wrinkle is creating some very difficult problems for corporate law.

II. THE COLLATERAL ESTOPPEL PROBLEM

The federal statute implementing the Constitution's Full Faith and Credit Clause[39] demands that "judicial proceedings ... shall have the same full faith and credit in every court within the United States … as they have

derivative action, created to benefit the corporation, will produce the opposite, unintended approach." Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

[35] Interestingly, Delaware is even more worried 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. *Id.* 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. Derivative Litigation, 824 A.2d 917 (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).

[36] *See, e.g.,* Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305 (2005).

[37] *See* Minor Myers, *The Decisions of the Corporate Special Litigation Committees: An Empirical Investigation*, 84 IND. L.J. 1309 (2009) (finding that approximately 40 percent of special committees pursue or settle claims during a study period from 1993 to 2006).

[38] One recent study estimates that nearly two-thirds of public company derivative suits involve multiple jurisdictions. *See* Jessica Erickson, *Overlitigating Corporate Fraud: An Empirical Examination*, 97 IOWA L. REV 49, 54 (2011).

[39] 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."

by law or usage in the courts of such State." [40] Full faith and credit has long been understood to incorporate the doctrine of collateral estoppel (also known as issue preclusion) which sets out a general rule of justice and fairness: parties should not be required to re-litigate an issue that has already been resolved by a court of competent jurisdiction.[41]

A defendant seeking to assert collateral estoppel must typically establish five different requirements. First, the issue must be *identical* to that decided in the prior case. 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."[42] Third, the issue must have been *necessarily decided* in the prior case. 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. Finally, the plaintiff against whom collateral estoppel is being asserted must be in *privity* with the prior plaintiff.

In the SDL context, the first three requirements are relatively straightforward.[43] 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.[44] The fourth requirement—a final

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[40] 28 U.S.C. § 1738.

[41] *See* Allen v. McCurry, 449 U.S. 90, 96 (1980); Miga v. Warren City Sch. Dist. Bd. Of Educ., 465 U.S. 75, 81 (1984).

[42] *See, e.g.,* LeBoyer v. Greenspan, 2007 WL 4287646 (C.D. Cal 2007). 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.* at *2.

[43] A few cases do seem to bungle the identical issue requirement. In *Holt v. Golden*, for example, an SDL claim was filed against the gun maker Smith and Wesson in connection with bribery charges for military sales in Afghanistan. Holt v. Golden, 880 F.Supp.2d 199 (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.* 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. 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 than the first. The courts assertion that "while the charged misconduct may be different, the material issue—the disinterestedness of essentially the same S&W board—was precisely identical in both 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 factually pleadings in the second case fell short of the threshold for demand excusal. *Id.* This latter holding does not invoke collateral estoppel, but it is totally justifiable on the record.

[44] *See,* Leboyer at *2 (rejecting plaintiff's argument that a claim was not actually litigated due to the availability of new evidence); In re Bed Bath & Beyond Inc. Derivative

decision on the merits—is more difficult to evaluate because a lawmaker 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."[45] Many other cases disagree with this characterization, 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.[46] This latter approach is much better reasoned, as the demand requirement is crucially linked to the substantive outcome of any SDL case.[47] Resolution of demand futility is the main show, and it should be seen as a decision on the merits.

But the fifth requirement of privity presents a much greater challenge to the use of collateral estoppel in SDL. In many other contexts, privity is a non-issue because 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 lawmaker needs to determine exactly when two different shareholders step into the same shoes. The easiest way to illustrate this challenge is with an extended study of the recent Allergan case.

A. *Botox Injections for Derivative Litigation?*

Allergan is a Delaware corporation that markets a wide variety of pharmaceutical and medical devices. In 1989, it received FDA approval for the use of Botox to treat eye muscle disorders like strabismus (crossed

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Litigation, 2007 WL 4165389, *6 (D.N.J. 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.").

[45] *See, e.g.,* Ex Parte Capstone Dev. Corp., 779 So.2d 1216 (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); Kaplan v. Bennett, 456 F. Supp. 555 (S.D.N.Y. 1979) (describing the lack of demand futility as a "procedural requirement [that] is not to be given preclusive effect"). See also Haseotes v. Bentas, 2002 WL 31058540, *4 (Del. Ch. 2002) (offering dicta comparing the demand requirement to a standing requirement).

[46] *See, e.g.,* In re Bed Bath & Beyond Inc. Derivative Litigation, 2007 WL 4165389, *6 (D.N.J. 2007) ("A dismissal for failure to make demand on a board is considered substantive and not procedural."); LeBoyer v. Greenspan, 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); In re Sonus Networks Inc., 449 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.").

[47] The U.S. Supreme Court has stated as much in a unanimous opinion. *See* Kamen v. Kemper Fin. Services Inc., 500 U.S. 90, 96 (1991) (describing the demand futility analysis as substantive).

eyes). 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. 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.[48] This practice of prescribing an approved pharmaceutical product for non-approved applications (often called "off-label" use) is not illegal. Indeed, such practices are common in the medical community, and manufacturers may sell products that will be used in this manner.[49] It is illegal, however, for firms to actively advertise and market a product for off-label use.[50]

During the 1990s, Allergan noticed that the market for therapeutic Botox was skyrocketing. Delighted with this turn of events, it sponsored a series of seminars to educate doctors about the many uses of Botox. The firm also sought to help doctors receive financial reimbursement from insurance companies and government healthcare programs for off-label Botox prescriptions. Indeed, Allergan's CEO became such a loud advocate for the product that he acquired the nickname "Mr. Botox." By 2005, Botox accounted for roughly a third of Allergan's total net sales.

Unfortunately for Allergan, its activities attracted the interest of the Food and Drug Administration (FDA). The FDA, fearing that the company had passed far beyond the mere sale of off-label products, sent several warning letters to Allergan. But the firm did not seem to pay much attention to these notices.[51] Rather, Allergan continued to sponsor doctors and other speakers to tout the benefits of Botox for headaches and other off-label uses. The Botox sales force tripled.

By 2007, U.S. officials had had enough. The FDA partnered with the Federal Bureau of Investigation (FBI) and the Department of Human Health and Services (DHHS) to launch a joint investigation of Allergan's off-label marketing of Botox. Three years later, Allergan settled the case by pleading guilty to a criminal misdemeanor (misbranding) and paying a whopping $600 million in civil and criminal fines. It also entered into a five-year Corporate Integrity Agreement with the DHHS to monitor future compliance with the law.

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

[49] *See, e.g.,* James M. Beck & Elizabeth D. Azari, *Off-Label Use and Informed Consent: Debunking Myths and Misconceptions*, 53 FOOD & DRUG L.J. 71 (1998).

[50] Doing so will violate the Food, Drug, and Cosmetics Act, 21 U.S.C. § 331(a), (d) and/or the Public Health Service Act, 42 U.S.C. § 262(a)(1), (b). *See also* 21 C.F.R. § 601.12 (codifying implementing regulations).

[51] Neither did it pay much attention to Allergan's general counsel, who warned the firm's leaders that this was "a potentially very serious matter" and that the probability of the FDA taking some action was significant.

$600 million was a lot of money for Allergan, roughly its entire annual net earnings, 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 Delaware Chancery Court. Several other claims were filed in California Federal Court during the following weeks (Allergan's corporate headquarters are in Irvine). All of these initial complaints were based on public information, and they lacked the particular details necessary to support an excusal of demand.[52]

About two months later, another plaintiff shareholder filed a request under Delaware law to inspect the books and records of Allergan. 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. The vice chancellor, eager to let the inspection request proceed, postponed any hearings until after the "diligent" plaintiff had an opportunity to investigate this matter more fully. This took about six months, and eventually both Delaware plaintiff groups joined forces to prosecute the claim with an amended complaint that incorporated details from the new internal information received from Allergan.

Meanwhile, the California track of the SDL litigation moved forward in a parallel manner. The judge dismissed a bare-bones complaint without prejudice, and the plaintiffs also pursued a books and records investigation to rehabilitate the case. 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. 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. In short, the Allergan boardroom did not seem rotten enough for the California court.

Allergan immediately supplemented its Delaware defense by invoking collateral estoppel. 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 plaintiffs 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 the privity requirement. According to the court, there was a difference between

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[52] One plaintiff even made demand on Allergan—a litigation strategy with some very interesting potential consequences. *See infra* notes **-** and accompanying text.

a shareholder plaintiff who was legitimately acting on the behalf of the corporation and one who was still attempting to do so. Noting that the shareholder "does not have authority to sue on behalf of the corporation until there has been a finding of demand excusal,"[53] the vice chancellor held that a prior shareholder who lost on the demand futility question had not yet stepped into the shoes of the corporation.[54] For this reason, a subsequent shareholder plaintiff could not be viewed as in privity with the prior shareholder plaintiff for purposes of collateral estoppel.[55] In short, the privity trigger does not fire until demand is excused.

Having rejected the collateral estoppel argument, the court went on to re-evaluate whether the Delaware plaintiffs needed to make demand on the Allergan board. And here, the vice chancellor flat out disagreed with the California federal judge, holding that demand was excused. 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." Said differently, the court held that one could reasonably infer that the board approved and monitored a business plan embracing illegal activity.[56] This 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 have some merit" such that demand was futile and the plaintiffs could keep control of the litigation.

Despite the logic of Allergan's reasoning, the holding of this case clearly diverged from previous decisions on collateral estoppel in the SDL context. Most courts did not view the privity question as hinging on whether demand was required or excused. Rather, the prevailing understanding was that all shareholders were in privity with each other the moment that an SDL case was initiated. *Kaplan v. Bennett*, an influential case involving foreign bribery charges by GTE, put it this way: "A derivative action represents prosecution of a claim not belonging to the individual shareholder, but to the corporation on whose behalf suit is brought. To

[53] *Id.* at 23.

[54] The court also offered a second, independent basis for refusing to give way to the California holding: that the California plaintiffs were not adequate representatives of Allergan. *Id.* at 37.

[55] *Id.* By 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 32.

[56] This was buttressed by quotes from slide decks and memos describing major expansion opportunities in off-label uses of Botox. *Id.*

determine whether the parties are identical, the court looks to the identity of the real party in interest, the corporation, rather than to the identity of the nominal party seeking to champion the corporate claim."[57] Other cases reached similar conclusions.[58]

Given this break from the past, the Allergan case moved quickly into the corporate law spotlight, and commentators began to dissect the implications of this holding.[59] The focus only increased when the decision was certified for interlocutory appeal to the Delaware Supreme Court. 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 undermined normal business activity.[60] Corporate litigators seemed to agree, advising their clients that "while this decision represents a strong and public rebuke of the current approach of the plaintiff's bar, it could very well have the perverse effect of increasing the number of derivative suits brought against corporations and their boards."[61]

The counterargument, made forcefully by the vice chancellor, was that this outcome was the only way to deter frivolous and rapidly-filed SDL claims and re-establish shareholder litigation as an effective tool for sound corporate governance. Ultimately, these differing views raise questions about the optimal paradigm for SDL litigation and when shareholder representation should be deemed adequate. But before diving further into competing paradigms of privity and adequacy, it is necessary to spend some time on the incentives of SDL plaintiffs.

B. 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

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[57] Kaplan v. Bennett, 456 F. Supp. 555, 560 (S.D.N.Y. 1979).

[58] *See, e.g.,* LeBoyer v. Greenspan, 2007 WL 4287646 (C.D. Cal. 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.").

[59] *See* sources cited supra notes 16-17.

[60] Brief of Chamber of Commerce of the United States of America as Amicus Curiae in Support of Reversal, Louisiana Municipal Police Employees' Retirement System, et al. v. David Pyott (August 21, 2012).

[61] Daniel Perry & John M. Yarwood, "Delaware Court of Chancery Rules that Shareholder Derivative Lawsuits are not Collaterally Estopped by Previously Dismissed Suits Involving Similar Claims," Milbank Litigation Memo (June 14, 2012), *available at* **

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[62]) 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.[63] The legal framework—which allows any lawyer with 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. Bill Lerach, the infamous plaintiff's lawyer who made a fortune from settling shareholder lawsuits (before going to prison for abuse of the system) used to crow "I have the greatest practice of law in the world…I have no clients."[64] This is obviously not how the system is supposed to work. But plaintiff's lawyers may undoubtedly be inclined to settle large cases on disadvantageous 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.[65] Even a settlement agreement can include provisions for legal fees as long as some "substantial benefit" is conferred on the corporation.[66] Said differently, SDL can be self-funding because plaintiffs do not need to foot their legal bill for successful outcomes.

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[62] *See* TOM BAKER & SEAN J. GRIFFITH, *ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION* (2011).

[63] *See* Coffee, *supra* note 4.

[64] PATRICK DILLON & CARL CANNON, *CIRCLE OF GREED: THE SPECTACULAR RISE AND FALL OF THE LAWYER WHO BROUGHT CORPORATE AMERICA TO ITS KNEES* (2010).

[65] See MBCA 7.46.

[66] 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.*, RMBCA 7.46(1).

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 plaintiffs 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 firm and its individual directors fight a claim to the bitter end, and prevail on the merits, they will be stuck writing checks for their own legal fees (or higher insurance premiums).[67] To be sure, the plaintiff's 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 who has done nothing legally wrong—but who 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 NPV victory. The lawyers prosecuting these claims are aware of this pressure, of course, and they may choose to respond accordingly.

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[67] 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. 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.

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 plaintiff's 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 plaintiff's lawyers can 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 that all of the undesirable characteristics of self-appointed corporate watchdogs will be amplified.

C. Competing Paradigms of Privity and Adequacy

Putting these incentives to the side, for a minute, how should we understand the collateral estoppel privity requirement in the SDL context? Is *Allergan* right, as a formal matter, that privity cannot attach until demand is excused as futile? Any resolution of the SDL preclusion problem needs to be grounded in a sound legal analysis.

Unfortunately, the indicators of privity are difficult to articulate with precision, and the contours of this requirement are typical 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."[68] Or preclusion "applies to those … who could have entered the proceeding but did not avail themselves of the opportunity."[69] Or "privity exists, for purposes of collateral estoppel, 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."[70] 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* court's holding. For example, one recent 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

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[68] Deaton v. Burney, 107 669 N.E.2d 1 (D.C. Ohio 1995).
[69] Howell v. Richardson, 544 N.E.2d 878 (D.C. Ohio 1989).
[70] Kinsky v. 154 Land Co., LLC., 371 S.W.3d. 108 (Mo. App. 2012).

of [preclusion] is not inequitable."[71] 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" (emphasis added). This notion of adequate representation provides much more support for the argument that hasty and sparse SDL claims do not preclude other shareholders from filing more detailed and substantial follow-up claims.[72] It is difficult to reconcile the argument that a shareholder plaintiff lacks authority to assert claims on the firm's behalf (made when a defending firm insists that demand is not excused) with the follow-up argument that that same shareholder possesses sufficient authority over the litigation to bar all subsequent claims.[73]

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.[74] Most cases in the SDL context do conclude that privity is satisfied when the initial claim is filed.[75] But this holding is reached though the almost conclusory statement that the corporation is the real plaintiff-in interest in both lawsuits. It is not obvious that this must be the case, and the Allergan holding—that privity is only triggered when a court denies a motion to dismiss for demand futility—is perhaps just as defensible.

Given the difficulties of identifying a precise technical trigger for privity, it becomes necessary to examine the policy question 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. Can the law distinguish between meritorious lawsuits and abusive strike suits? Any

[71] Stonecrafters, Inc. v. Wholesale Life Ins. Brokerage, Inc. 915 N.E.2d 51 (Ill. App. 2d. (2009).

[72] The concept of inadequate representation also served as an independent basis for the vice chancellor's decision to reject the collateral estoppel defense in the Allergan case. This is also consistent with recent judicial sentiment that fast-filing shareholder plaintiffs who do not conduct a meaningful investigation should be presumed to provide inadequate representation. *See, e.g.,* King v. VeriFone Holdings, 994 A.2d 354 (Del. Ch. 2010); Baca v. Insight Enters., Inc., 2010 WL 2219715 (Del. Ch. 2010).

[73] Allergan, at **.

[74] *See, e.g.,* Smigelski v. Kosiorek, 54 A.3d 584 (Conn. App. 2012) (privity is "difficult to define"); Williams v. Peabody, 719 S.E.2d 88 (N.C. 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."); Jim Parker Bldg. Co., Inc. v. G&S Glass & Supply Co., 69 So.3d 124 (Ala. 2011) ("Privity, for purposes of issue preclusion, is a flexible legal term, comprising several different types of relationships"); Apollo Real Estate Investment Fund IV, L.P. v. Gelber, 2010 WL 546369 (Ill. App. 1 Dist. 2010) ("There is no generally prevailing definition of 'privity' that the court can apply to all cases involving collateral estoppel or res judicata; rather, determining privity requires careful consideration of the circumstances of each case.").

[75] *See, e.g.,* LeBoyer v. Greenspan 2007 WL 4287646, * 3 (C.D. Cal 2007).

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 collateral estoppel problem in SDL 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 proposes 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, following the Allergan precedent, the privity requirement for collateral estoppel should not be triggered until demand is excused. This should solve the patsy lawsuit problem because the dismissal of a bare-bones complaint, filed to preempt meaningful litigation, will not block a substantive follow-on lawsuit. Finally, courts should be willing to implement 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, 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 develops 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.[76] 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.[77] 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.[78] These provisions, which have attracted some recent attention in Delaware, 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.[79] But historically, only a handful of corporations 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.[80] Picking up on the suggestion, lawyers[81] and academics[82] have started to pitch forum

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[76] *See* Erickson, *supra* note 38.

[77] The Allergan case 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 be reached on a substantially similar factual record (though it is not clear whether the California plaintiffs fully incorporated information from the books and records investigation into their complaint).

[78] *See, e.g.,* Sarah Lewis, Note, *Transforming the "Anywhere but Chancery" Problem into the "Nowhere but Chancery" Solution*, 14 STAN. J. L. BUS. & FIN. 199 (2008); Edward B. Micheletti & Jenness E. Parker, *Multi-Jurisdiction Litigation: Who Caused this Problem and Can it be Fixed?*, 37 DEL. J. CORP. L. 1 (2012); Brian JM Quinn, *Shareholder Lawsuits, Status Quo Bias, and Adoption of the Exclusive Forum Provision*, 45 U.C. DAVIS L. REV. 137 (2011); Faith Stevelman, *Regulating Competition, Choice of Forum, and Delaware's Stake in Corporate Law*, 34 DEL. J. CORP. L. 57 (2009).

[79] *See, e.g.,* Matthew D. Cain & Steven M. Davidoff, *Delaware's Competitive Reach*, 9 J. EMPIRICAL STUD. 92 (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 (2009) (finding that roughly 40 percent of the contracts included in Form 8-K filings contain a choice of forum provision).

[80] In re Revlon Inc. Shareholders Litigation, 990 A.2d 940, 960 (Del. Ch. 2010) ("[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.")

[81] *See, e.g.,* Claudia H. Allen, *Study of Delaware Forum Selection in Charters and Bylaws*, Neal, Gerber & Eisenberg presentation dated Jan. 25, 2012, *available at* **;

[82] *See, e.g.,* Joseph A. Grundfest, *Choice of Forum Provisions In Intra-Corporate Litigation: Mandatory and Elective Approaches*, The 2010 Pileggi Lecture (Oct. 6, 2010),

exclusivity provisions as a solution to the multi-jurisdiction mess. According to one recent study, approximately eighty corporations adopted exclusivity provisions during 2012.[83]

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 claim in another state would be a nonstarter—as long as the other state respects these provisions.[84] Claims would be channeled into a single state, and the collateral estoppel problem would recede. Importantly, however, 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 plaintiff's 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 will be able to 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 prior action to preempt the claim.

One difficult question that has arisen is whether a forum exclusivity provision needs to reside in a corporate charter or whether a bylaw amendment will be sufficient.[85] This is not just an academic distinction; charter amendments require a shareholder approval vote, while bylaw modification can often be accomplished with director authorization. Even though an enlightened shareholder might conceivably embrace forum exclusivity—to prevent other shareholders and their attorneys from wasting

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available at **

[83] Claudia H. Allen, *Exclusive Forum Provisions: Putting on the Brakes*, 10 CORPORATE ACCOUNTABILITY REPORT 1266 (2012), *available at* **

[84] This should not be taken for granted and may depend on the way that the forum exclusivity provision is adopted. *See infra* note 85.

[85] One California court, for instance, has recently held that an exclusive forum bylaw provision adopted by Oracle Corp. was not enforceable under federal law. *See* Galaviz v. Berg, 763 F. Supp. 2d 1170 (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. 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 & Park Client Memo (Sept. 2012), *available at* **.

corporate assets through duplicative lawsuits—many established firms do not seem to be interested in pursuing shareholder approval votes.[86] Larger firms have been willing to adopt unilateral bylaw amendments, though many of these boards have chosen to abandon the effort in the wake of shareholder challenges.[87] A few firms are litigating in Delaware to defend their use of bylaw forum exclusivity provisions, and this litigation is worth watching very closely.

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. Even a strong legal nudge toward the adoption of exclusive forum provisions, however, is unlikely to cause every corporation to climb on the bandwagon. For this reason, the problem of multiple lawsuits in different states will persist.[88] But broader use of these 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 a sympathetic shareholder to file an unsubstantiated SDL

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[86] 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 81. One possible reason for the established firm reluctance is that proxy advisory firms are beginning to state that they do not consider exclusive forum provisions to be "best practice" for corporate governance and that they will recommend a vote against the election of the chairman of the governance committee if a forum exclusivity provision is adopted by bylaw or bundled with another matter for shareholder approval. *Id.* About half of the forum exclusivity provisions 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 Client Memo (June 21, 2012), *available at* http://www.davispolk.com/briefing/corporategovernance/blog.aspx?entry=186.

[87] 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. *Id.*

[88] 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 5.

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.[89] 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 would promote sound governance.

Even moving away from conspiracy theories, rules 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 are allowed to carry the day.

For this reason, delaying the SDL privity clock is a second important strategy for getting the balance right. Automatically treating any initial case as triggering sufficient shareholder privity to support a collateral estoppel defense becomes a powerful catalyst for undermining SDL governance. All follow-on efforts are blocked. By contrast, adopting the *Allergan* conception of SDL privity—that privity only attaches when demand is excused—would 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 one conception of privity. But as we have seen above, privity is an amorphous concept that is often used to balance equitable considerations. In other words, 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—such as preventing the SDL governance door from being slammed shut too quickly—to influence judicial treatment of privity. On balance, the Chancery Court's understanding of privity comes closer to promoting sound

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[89] 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?

governance incentives, and this conception of SDL preclusion seems preferable to alternatives.[90]

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.[91] Assiduous judicial assessment of any settlement agreement is perhaps the best way to manage this problem, though this is a topic for another day. It is clear, however, that to the extent that one believes SDL can serve as a meaningful governance device,[92] the rapid imposition of collateral estoppel amounts to a showstopper. It simply makes it too easy for sloppy claims to block legitimate shareholder interests.

There is a potential dark side, of course, to delaying privity in this manner. This strategy presents a clear risk of never-ending lawsuits and

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[90] Any decision to the contrary could also exacerbate a race to the bottom, with certain states taking on a role as pro-defendant by quickly accelerating SDL case law in order to attract litigation fees. *See, e.g.,* Matthew D. Cain & Steven M. Davidoff, *A Great Game: The Dynamics of State Competition and Litigation* (working draft 2013) (analyzing this phenomenon in the merger litigation context).

[91] The most infamous example of this is the Occidental Petroleum drama of 1989-90. *See* Kahn v. Occidental Petroleum, 1989 WL 79967 (Del. Ch. 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. Occidental moved to settle one of the claims by paying the plaintiff's attorneys $800,000, (allegedly) allowing shareholders to attend the grand opening of the museum with the purchase of a $40 ticket, naming the museum the Occidental Petroleum Center Building, and insisting on a few other governance and financial requirements for the museum. *See* Kahn v. Occidental, 1992 WL 9045 (Del. Ch. 1992); Los Angeles Business Journal (Aug. 29, 1990). 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. *Id.* It is important to note, that the settlement decision had been approved by a special committee of disinterested directors, which let the court to believe that the business judgment rule would protect any legal challenge. *Id.* Nevertheless, corporate law commentators railed against this outcome as an egregious abuse of governance authority. *See, e.g.,* Nell Minnow, "Hollow Shareholder Suits Show Rottenness in Delaware Courts," LEGAL TIMES 25 (Sept. 17, 1990).

[92] 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, 84-85 (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 the settled suits.").

harassing litigation to eke out lucrative settlements for illegitimate purposes. For this reason, the adoption of *Allergan's* privity requirement must be counterbalanced with additional incentives that 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 a delayed privity standard is the fear that zombie lawsuits might rise repeatedly from the graves of failed demand futility claims. If a collateral estoppel defense does not "ripen" until demand is excused, then what is to stop a motivated plaintiff's attorney from repeatedly re-litigating a claim until the corporation rolls over and settles? This sentiment is clearly expressed by courts who apply collateral estoppel in an effort to provide closure to SDL claims.[93]

For this reason, legal adoption of a delayed privity requirement should also 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, lawmakers have searched for strategies to alleviate the dark side of derivative litigation—ranging from plaintiff verification under the threat of perjury[94] to continuous holding periods to minimum ownership stakes.

But, as is so often the case, one of the best motivators may be money. New York and many other 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.

When is the plaintiff responsible for the defendant's fees? Under the Model Business Corporation Act ("MBCA"), 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."[95] New York has a higher standard, requiring evidence of "malicious intent or fraud" to

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[93] *E.g.,* LeBoyer, *supra* note 42, at ** ("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.)

[94] FRCP 23.1. The fear was softened, however, in 1966 when the Supreme Court held that it was OK for the plaintiff shareholder to reasonably rely on her attorney's investigation and advice. *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363 (1966).

[95] MBCA 7.46 (2).

support fee shifting.[96] Given the open ended nature of these standards, there is also a meaningful body of common law that fleshes out "reasonable cause" in more detail.[97]

There does not seem to be extensive use of fee shifting under this rule, but judges do require plaintiffs to reimburse defending corporations and directors from time to time. The Tennessee case of Brady v. Calcote[98] is illustrative. A plaintiff shareholder brought an SDL claim against a bank for a variety of charges—including presenting inaccurate financial statements, paying directors a monthly fee (which had purportedly been cancelled until the firm resumed profitability), and offering 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 litigation expenses form the plaintiff. The court, after analyzing the sufficiency of the charges and canvassing the fee-shifting standards 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 these claims.[99]

In this manner, courts should not hesitate to use fee shifting statutes to 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 only occur when a plaintiff initiates a lawsuit in a manner consistent with the state's corporate code—typically, without reasonable cause or for an improper purpose.

An interesting variant of this idea, for firms incorporated in states such as Delaware that have not provided for reimbursement in corporate statutes, might be to adopt a charter or bylaw provision related to fee shifting. A corporate charter could conceivably track the exact language of the MBCA, stating that the corporation's legal fees must be repaid if an SDL claim is brought "without reasonable cause." This would again extend the analogy between corporate law and contract law; numerous private agreements include provisions where losing parties must reimburse winning parties for

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[96] **confirm this standard.

[97] *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) plaintiffs claim's … 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.").

[98] 2005 WL 65535 (Tenn. App. 2005).

[99] 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.

subsequent litigation.[100] To be sure, this strategy would present important questions about consent and the extent to which corporate governance should be shaped ex ante by charter or bylaw provisions that are not explicitly agreed to by downstream shareholders. Moreover, the practical ability (or willingness) of some corporations to adopt these provisions may be questionable.[101] A more detailed assessment of this idea is necessary, but the use of private fee shifting charter provisions does raise some intriguing possibilities.

Turning more specifically to the legal standards for evaluating fee shifting, 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 fully when an SDL claim is filed a couple hours after bad corporate news is revealed?[102] Such an approach would also be consistent with other recent decisions that increasingly emphasize the need to conduct a thorough investigation before initiating shareholder litigation.[103] This presumption can be rebutted, of course, if the plaintiff possesses information at the time of filing that strongly suggests 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 has 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 there is a

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[100] Relatedly, 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 can't find a trustworthy private party to exercise discretion: judges are tasked with the job of approving fee requests.

[101] *See supra* notes 85-87 and accompanying text.

[102] 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., Inc., 643 F.2d 441, 444-45 (6th Cir. 1981) (assessing Tennessee's law); Blumenthal v. Teets, 745 P.2d 181, 189 (Ariz. Ct. App. 1987); White v. Banes Co., 866 P.2d 339, 343-44 (N.M. 1993).

[103] *See, e.g.,* South v. Baker, 2012 WL 6114952 (Del. Ch. 2012) (holding that an SDL plaintiff is presumptively an inadequate representative when a claim is filed without first initiating a books and records inspection).

reasonable inference that the litigation has been brought for the improper purpose of using a delayed privity trigger to harass the defendant into settlement. Implementing these standards will obviously rely heavily on judicial discretion and the fact specific nature of SDL.

Adopting this third strategy of limited fee-shifting, in an effort to balance SDL incentives, does raise a concern that imposing some plaintiff risk will eradicate all derivative claims.[104] 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 carefully 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 attorney—may begin to internalize some of the costs of bringing a hasty or harassing claim.

CONCLUSION

[to be written]

[104] 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 lawmakers 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, may often be greater than the expected recovery to a small shareholder-claimant.