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DELAWARE COURT RESUSCITATES A DERIVATIVE LAWSUIT DESPITE DISMISSAL WITH PREJUDICE IN ANOTHER FORUM

On June 11, 2012, the Delaware Chancery Court ruled that a shareholder derivative case could proceed against the directors of Allergan, Inc., even after a federal court in California had dismissed with prejudice a parallel action based on identical claims. *Louisiana Municipal Police Employees' Retirement System, et al. v. Pyott, et al.*, C.A. No. 5795-VCL (*"Allergan"*). In so doing, the Chancery Court cast doubt on the finality of dismissals of derivative claims by other courts and expressed broader views on the administration of shareholder litigation that will be of interest to companies, officers, and directors who find themselves defending shareholders' claims in multiple jurisdictions.

THE CLAIMS AGAINST ALLERGAN

The same facts were alleged in both the California and Delaware cases. Allergan manufactures Botox, a drug that was approved by the FDA for both therapeutic and cosmetic uses. (The cosmetic uses were not at issue in the litigation.) Until 2010, a small market existed for FDA-approved therapeutic uses. Physicians who wished to prescribe Botox for nonapproved, "off-label" uses were free to do so, but Allergan could not legally promote or market the drug for off-label use. Notwithstanding, the U. S. Department of Justice alleged that Allergan embarked on a business plan that was predicated on significant sales of Botox for off-label uses, and the company's board approved the plan.

In September 2010, following an interagency investigation, Allergan entered into a settlement with the U.S. Department of Justice in which it consented to criminal misdemeanor misbranding and paid a total of $600 million in civil and criminal fines.

Two days after the announcement, a shareholder filed a derivative suit in Chancery Court, and in the days that followed, several derivative actions were filed in

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the California federal court. Meanwhile, yet another shareholder sent Allergan a demand to produce for inspection relevant books and records under Section 220 of the Delaware Corporate Code and sought to intervene in the Delaware case. The original Delaware plaintiff opposed these tactics as "indefensible" and "serv[ing] only to delay" the proceedings; the Chancery Court permitted intervention nonetheless.

THE DECISIONS IN CALIFORNIA AND DELAWARE

The California litigation proceeded on a faster track, and the U.S. District Court dismissed the California derivative complaint twice, the second time with prejudice. The district court held that the plaintiff had failed to establish that a pre-suit demand on Allergan's board of directors would have been futile, and that therefore it did not have standing to sue in the name of the company.

Following the California dismissal, the defendants in the Delaware case supplemented their motion to dismiss to allege that the plaintiffs' claims were barred by the doctrine of collateral estoppel. This doctrine normally bars relitigation of a claim by the same plaintiff, or a closely related party said to be "in privity" with that plaintiff, in a second case after the claim has been litigated and decided in the first proceeding. At least eight other state and federal courts have held that in derivative litigation—in which an individual shareholder purports to bring claims on behalf of the company—collateral estoppel bars a second shareholder's complaint after a prior suit based on the same claims has been dismissed, because the two shareholders are both seeking to represent the corporation and are therefore in privity with each other.

The Chancery Court, however, rejected the collateral estoppel argument and permitted the Delaware derivative case to proceed. It concluded that privity did not exist because, by dismissing the earlier case on "demand futility" grounds, the California court had actually determined that the California plaintiff was *not authorized to bring suit on behalf of the corporation*. Once it had disposed of the collateral estoppel argument, the Chancery Court reached a different conclusion than the California court on the sufficiency of the pleading. It concluded that the plaintiffs had alleged sufficient facts to support a reasonable inference that the board had acted improperly. As a result, the complaint raised a reasonable doubt that a majority of the board could properly consider a demand, and pre-suit demand on the board was therefore excused. While it recognized that the plaintiff might not be able to sustain these claims at trial, the Chancery Court determined that the plaintiff had pled them sufficiently to excuse demand.

THE IMPORTANCE OF THE CHANCERY COURT DECISION

The Chancery Court's *Allergan* decision is important for several reasons. On a procedural level, the court rejected the conclusions of numerous state and federal courts throughout the country, reflecting a willingness to second-guess the judgment of another court on matters of Delaware law. On a substantive level, the decision reflected a more lenient view of the pleading requirements for demonstrating demand futility. Whereas the California court had dismissed the case because there was "no evidence of a *decision* by board members to promote the use of off-label marketing" (emphasis in the Chancery Court opinion), the Chancery Court held that, at least at the pleading stage, the allegations supported "a reasonable inference that Allergan expected to drive increased sales by promoting off-label use," and that the board was aware of this expectation.

At a deeper level, the decision reflects Delaware's continuing frustration with the "race to the courthouse" mentality of many plaintiff law firms, and its desire to reshape the financial incentives of shareholder litigation to reward plaintiffs who are the best prepared, rather than the fastest to file. The court observed that under a regime that awards representation to the first firm to file a case, the first-filing law firm will often be poorly prepared and may well provide inadequate representation. Notwithstanding, "the resulting action has the dynamics of a lottery ticket," because "fate may bless the fast-filer with something implicating the board, or a court might be offended by the magnitude of the corporate trauma and allow the derivative action to proceed." The court went on to review its efforts through the years to reduce the incentive to be a "fast filer." One of these efforts has been to insist that plaintiffs and their attorneys

investigate their claims before filing, making use of "tools at hand" such as a Section 220 inspection demand. Here, the court concluded that it could protect the interests of shareholders by determining that the California plaintiff—who did not make a Section 220 demand—did not provide adequate representation, and declining on that basis to give preclusive effect to the dismissal of the California case.

IMPLICATIONS FOR DEFENDANTS AND THEIR COUNSEL

Public companies and their directors have become accustomed to being bombarded by multiple lawsuits in several jurisdictions following a "bad news" announcement. *Allergan* presents significant new uncertainties for defendants in these multijurisdictional proceedings. Defendants now stand to lose the assurance that a favorable determination in another jurisdiction will automatically be dispositive of the outcome in Delaware. Whereas defense counsel might otherwise be willing to allow a weaker or more poorly prepared plaintiff to litigate on a "fast track" in the hope of obtaining a quick dismissal, the chance that such a dismissal might be disregarded in Delaware may weigh against this approach. Given the preferences expressed by the Chancery Court, it will be increasingly important for defendants to insist at the outset on coordinated litigation in which all parties (and, if possible, all courts) agree at the outset on how the case is to be litigated, by whom, and in which forum. If such an agreement cannot be reached, defendants should be realistic about the preclusive effect of a dismissal on procedural grounds and should plan accordingly.

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