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April 22, 2021

Nevada Supreme Court Holds Statutory Business Judgment Rule Applies to All Claims Against Corporate Officers and Directors

State's Highest Court Refuses to Find Exception to Application of Statute in Favor of "Inherent Fairness" Where Target Board Agrees to Merger With a Controlling Stockholder

SUMMARY

In a March 25, 2021 decision in *Guzman* v. *Johnson*,[1] the Supreme Court of Nevada affirmed the District Court's dismissal of class action claims concerning AMC Networks, Inc.'s ("AMC") acquisition of its subsidiary, RLJ Entertainment Inc. ("RLJE"). Plaintiff claimed that, since AMC was RLJE's controlling stockholder and RLJE directors were interested parties, Plaintiff had successfully rebutted the business judgment rule and shifted the burden of proof to the Defendant directors to show that the deal was a product of both fair dealing and fair price. The Supreme Court disagreed, ruling instead that Nevada's statutory business judgment rule admits no exceptions, and thus the standards for corporate director and officer liability are the same regardless of the circumstances or the parties involved in the transaction. As codified in Nevada, the business judgment rule presumes directors and officers acted in good faith and on an informed basis, and allows for director or officer liability only when the plaintiff affirmatively rebuts the business judgment presumption *and* demonstrates that the fiduciary breach involved intentional misconduct, fraud, or a knowing violation of law. Unlike the strict, judge-made "entire fairness" test applicable to interested transactions in Delaware and a number of other states, the statutory business judgment standard in Nevada provides the "*sole avenue* to hold directors and officers individually liable for damages arising from official conduct." Applying that standard, the Court found that Plaintiff pleaded no intentional dereliction of duty and affirmed dismissal of Plaintiff's claims against RLJE directors.

The Court also dismissed fiduciary duty claims against AMC, RLJE's controlling stockholder. Although not protected by Nevada's business judgment rule, the Court held that Plaintiff's controller claims against AMC were properly dismissed because the complaint failed to allege any facts showing that AMC "force[d] a merger or, more importantly, . . . improperly influenced the [Board's] decision."

The *Guzman* decision parts ways with the rigorous "entire fairness" test developed in Delaware and certain other states for reviewing interested fiduciary transactions. *Guzman* also clarifies that, unlike in Delaware and other states employing the "entire fairness" standard, Nevada law does not impose conditions, such as requiring that such transactions must be both recommended by a disinterested committee of independent directors and then subject to a "majority of the minority" vote, in order to benefit from the protection of the business judgment rule. It remains to be seen whether other states with statutory business judgment rules (unlike Delaware's judge-made business judgment rule) will likewise find the business judgment rule applicable in interested fiduciary transactions.

BACKGROUND

AMC is a television and film entertainment conglomerate that owns and operates popular brands like AMC, BBC AMERICA, IFC, SundanceTV, WE tv, IFC Films, Sundance Now, Shudder, AMC Studios, and AMC Networks International. RLJE is a digital channel company running over-the-top branded channels, Acorn TV (British TV), and UMC (Urban Movie Channel).[2]

In August 2016, RLJE entered into an investment agreement with AMC's subsidiary Digital Entertainment Holdings, LLC ("Digital"). Under the investment agreement, AMC, through Digital, loaned RLJE $65 million, and RLJE gave AMC the option of owning 50.1 percent of RLJE's outstanding common stock, which, if exercised, would give AMC control over RLJE. The investment agreement contained a "No-Shop" provision that prohibited RLJE from considering any other acquisition proposal. The agreement also gave AMC the right to designate two directors to RLJE's board and, upon the exercise of the warrants in full, AMC had the right to designate a majority of RLJE's board. A majority of RLJE stockholders voted to approve the investment agreement.

In February 2018, AMC sent RLJE a letter offering to purchase RLJE's outstanding shares of common stock for $4.25 per share. In the letter, AMC stated that it would "not sell [its] stake in RLJE or be part of any other process" and urged RJLE to form an independent special committee to review the proposal with its own legal and financial advisors.[3] In response to AMC's proposal, RLJE's board formed a special committee consisting of two independent directors. The Special Committee asked RLJE's board to provide it with authority to consider and solicit offers from third parties. The board denied the request due to the No-Shop provision in the investment agreement.

The Special Committee rejected AMC's first proposal of $4.25 per share as insufficient. AMC then increased its offer to $4.92 per share, but the Special Committee rejected that as well, telling AMC that it would be unlikely to consider a price of less than $6.00 per share. AMC revised its offer to $5.95 per share, but the Special Committee held to a minimum negotiating price of $6.00 per share. AMC agreed to increase its offer to $6.00. The Special Committee countered with a proposed price of $6.25 per share, and AMC accepted. RJLE's stockholders approved of the merger at the October 31, 2018 stockholder meeting. AMC thereby acquired RLJE.

Subsequently, RLJE stockholder Lisa Guzman filed a class action against RLJE's individual directors and AMC, alleging that they breached their fiduciary duties to the RLJE minority stockholders in connection with the transaction. Guzman argued that AMC unfairly prevented RLJE from securing the maximum sale price by stating in its offer that it would not participate in another sale process. And while Guzman acknowledged the two members of the Special Committee "had no commercial, financial or business affiliations or relationships with any of AMC, [ ] Johnson or any of their respective affiliates," she nonetheless argued that their decision should not be respected because AMC had the ability, by exercising the options it received in the investment agreement, to replace them as board members.[4]

The individual directors and AMC moved to dismiss the compliant. The directors argued that Guzman had failed to satisfy Nevada Revised Statute 78.138, which states that plaintiffs seeking to hold directors and officers individually liable for business decisions must (1) rebut the presumption that the board acted in good faith, which under Nevada law generally requires a showing of self-interest, and (2) show that there was a breach of fiduciary duty that involved either "intentional misconduct, fraud, or a knowing violation of law."[5] AMC argued that the claims against it should be dismissed if Guzman could not make out a claim against the directors because, although NRS 78.138 only applies to directors and officers, it had deferred to the independent decision of the RJLE Special Committee and exerted no influence over the merger's approval.

Guzman responded that she had sufficiently pleaded facts to rebut the business judgment rule by alleging that the transaction was driven by an interested fiduciary—AMC—and that the Special Committee could not be considered independent in light of the fact that AMC had the ability to replace them as board members. Relying on a 1958 Nevada Supreme Court decision, *Foster* v. *Arata*,[6] Guzman argued that NRS 78.138 did not apply to interested fiduciary transactions and instead, the burden was Defendants to show that the transaction was inherently fair. Guzman also argued that the statute by its terms did not apply to AMC as a controlling stockholder.

The district court dismissed all claims. It rejected Guzman's claims against the Defendant directors, concluding that the pleadings had not sufficiently overcome the statutory business judgment presumption.

The court also held that the Special Committee, not AMC, made the only relevant decision regarding the merger, and thus the claims against AMC fell as well.

THE NEVADA SUPREME COURT DECISION

On appeal, Guzman argued that the lower court erred when it applied NRS 78.138 to assess her fiduciary breach claims instead of "inherent fairness." She further argued that, even absent inherent fairness, the complaint presented sufficient allegations to survive Defendants' motion to dismiss. The Supreme Court of Nevada disagreed, and affirmed the district court's dismissal.[7]

First, the Court recognized that, while it has "never expressly overruled" decades-old precedent reviewing interested fiduciary transactions for "inherent fairness," NRS 78.138 provided "the sole method for holding individual directors liable for corporate decisions."[8] According to the Court, NRS 78.138(7), as amended in 2001, "plainly requires the plaintiff to *both* rebut the business judgment rule's presumption of good faith *and* show a breach of fiduciary duty involving intentional misconduct, fraud, or a knowing violation of the law."[9] And since automatically shifting the burden to defendants to prove inherent fairness simply because of the nature of the transaction "would contravene" that requirement, Guzman's "inherent fairness" argument was rejected.[10]

Second, the Court considered whether "Guzman pleaded facts that, if true, would rebut the business judgment rule and show the requisite breach of fiduciary duty under NRS 78.138(7)."[11] As to the directors who were not on the Special Committee, the Court held that "Guzman failed to allege facts showing that those individual directors' interests actually affected the transaction" or that "those directors engaged in any *intentional* misconduct, fraud, or knowing violation of the law in regard to the merger."[12] As for the two Special Committee members, although Guzman claimed that they were motivated to undersell RJLE in order to keep themselves on the board, the Court found that they "agreed to be removed from the board as part of the merger agreement, and Guzman acknowledged in her complaint that [the Special Committee] negotiated with AMC for a higher sales price."[13] As a result, neither "were motivated by self-interest to undersell the stock."[14]

Third, the Court held that Plaintiff's breach of duty claims against AMC in its role as a controlling stockholder were properly dismissed because Plaintiff failed to allege any facts showing that AMC participated in "wrongful conduct going toward the approval of the merger."[15] Challenges against majority stockholders that go to the "validity of a merger usually encompass a lack of fair dealing or a lack of fair price, or both," yet the Court found that Plaintiff failed to allege particularized facts demonstrating either.[16] AMC's adherence to the rights granted to it under its investment agreement, which was approved by RLJE's stockholders, could not amount to a breach of fiduciary duty, and the Court found that Guzman failed "to

show how AMC used these contractual legal rights to force a merger or, more importantly, how AMC improperly influenced the decision to the minority shareholders' detriment."[17] It also noted that that the Special Committee repeatedly denied AMC's early offers, and "the final stock price of the sale was substantially above AMC's initial offer and was higher than the 52-week high stock price."[18]

IMPLICATIONS

With *Guzman*, the Nevada Supreme Court has affirmed that its statutory business judgment rule, not the "inherent fairness" standard, is the sole standard for any analysis involving fiduciary duty claims against corporate directors and officers in Nevada. As such, plaintiffs seeking to survive a motion to dismiss must allege that directors and officers breached their fiduciary duties *and* engaged in intentional misconduct, fraud, or a knowing violation of law. The Court also has made clear that these standards are not automatically satisfied simply because a transaction was done with a controlling stockholder. Instead, a case can be dismissed against the board and the controller where the board's statutory presumption of good faith has not been overcome and the controller has not actively exercised its control. Thus, this decision departs significantly from current Delaware law, which imposes an entire fairness burden on both the board and controller accused of self-dealing and only applies the business judgment rule in transactions with controlling stockholders when the transaction at issue is (1) negotiated by a properly functioning and empowered independent committee of the board and (2) subject to a free of coercion and fully informed majority-of-the-minority vote.[19]

Nevada has positioned itself to rival Delaware in new corporate registrations,[20] and Nevada courts therefore may continue to develop into an increasingly significant forum for corporate governance disputes. To that end, the *Guzman* Court stated that its decision affirming the statutory business judgment rule sought to give effect to the "straightforward" language in NRS 78.138 and to adhere to the "purpose of NRS Chapter 78, which is 'for the laws governing domestic corporations to be clear and comprehensible.'"[21]

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ENDNOTES

1 137 Nev. Adv. Op. 13, 2021 WL 1152875 (March 25, 2021).

2 The facts in the background section are adopted from the Court's opinion in *Guzman*, 2021 WL 1152875, at *1-2.

3 *Id*. at *1.

4 *Id*. at *2.

5 NRS 78.138(7).

6 325 P.2d 759 (Nev. 1958).

7 *Guzman*, 2021 WL 1152875, at *3-7.

8 *Id.* at *3.

9 *Id*. at *4.

10 *Id.*

11 *Id*. at *5.

12 *Id*.

13 *Id*.

14 *Id*.

15 *Id*. at *6.

16 *Id*.

17 *Id*.

18 *Id*.

19 *See, e.g.*, *Kahn* v. *M&F Worldwide Corp.*, 88 A3d 635 (Del. 2014). Notably, the Nevada legislature has also passed NRS 78.139, intentionally replacing the previously employed Delaware default standard that imposed heightened scrutiny in hostile takeover and sale of control situations.

20 *See* William J. Moon, *Delaware's New Competition*, 114 NW. U. L. REV. 1403, 1424-25 (2020) (noting that Nevada "has been identified as the only other state besides Delaware actively vying to draw corporations that physically operate outside its borders"); Robert Anderson IV, *The Delaware Trap: An Empirical Analysis of Incorporation Decisions*, 91 S. CAL. L. REV. 657, 674 (2018) (acknowledging "the incursion of Nevada into the public company market, with 22.3% of all 'public' corporations incorporating in Nevada").

21 *Guzman*, 2021 WL 1152875, at *4.

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