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Tenth Circuit Upholds Nevada Law By Denying Stockholders Standing to Bring Claims on Behalf of Nevada Corporation

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In *In re Zagg Inc. Shareholder Derivative Action*, No. 15-4001, 2016 U.S. App. LEXIS 11095 (10th Cir. June 20, 2016), the United States Court of Appeals for the Tenth Circuit held that stockholders of a Utah-based, Nevada corporation, who failed to make pre-suit demand that the corporation's board of directors cause the corporation to file claims against past and present directors (including one-half of the corporation's board of directors), could not litigate those claims derivatively. The Court rested its decision on Nevada's exculpation statute, Nev. Rev. Stat. § 78.138(7), which protects directors and officers of Nevada corporations from personal liability to the corporation when the statute's requirements are met. According to the Court, the complaint did not plead a non-exculpated claim, and so did not show that the current directors faced a risk of liability sufficient to render them self-interested such that a pre-suit demand on the board would have been futile. Hence, the lack of pre-suit demand required dismissal. The decision confirms the extensive personal liability protection Nevada affords officers and directors of Nevada corporations. It also illustrates how, by broadly limiting director and officer liability, Nevada further allocates to boards of directors (as opposed to stockholders) the power to control the corporation's decision to litigate.

In *Zagg*, the corporation's CEO and chairman was forced by his broker to sell millions of Zagg shares he had pledged as collateral to cover losses in his margin account. These sales caused Zagg's share price to drop sharply, allegedly harming the company and its stockholders, and resulting in the CEO's resignation. Without making a pre-suit demand, plaintiffs sued, alleging, among other claims, that the director defendants violated Section 14(a) of the Exchange Act of 1934, 15 U.S.C. § 78n(a), and breached fiduciary duties by failing to publicly disclose the pledged status of the securities as required by a specific SEC regulation. The current director defendants had, among other things, reviewed, approved and signed the SEC filings in question. The defendants moved to dismiss the complaint on grounds that included plaintiffs' failure to make a pre-suit demand on Zagg's board or adequately allege demand futility. The United States District Court for the District of Utah granted the motion and plaintiffs appealed.

The Tenth Circuit affirmed. It acknowledged that, under Nevada law, pre-suit demand is excused when at least half of the board's directors are interested in the matter demanded because the director faces a substantial likelihood of personal liability. But it also observed that such a situation "is greatly reduced in Nevada" because of Nevada's director-and-officer exculpation statute, which applies "unless it is proven that" the alleged violation "involve[s] intentional misconduct, fraud or a knowing violation of law."

The plaintiffs argued that they were under no affirmative duty to plead facts negating exculpation. The Tenth Circuit disagreed on the ground that pleading burdens generally correspond to burdens of proof and the statute explicitly allocated the burden of proving non-exculpation to the party asserting the claim against the director or officer. The Court also pointed to the pleading obligation imposed by Fed. R. Civ. P. 23.1. That rule mandates that shareholder derivative complaints "state with particularity . . . the reasons for not obtaining the [desired] action [from the directors] or not making the effort." The Court explained that, if the reason for not making the demand is that the directors face liability, "[t]hat would include why the directors are not protected by Nev. Rev. Stat. § 78.138(7)."

Plaintiffs alternatively insisted the complaint did in fact plead non-exculpated claims under Section 78.138(7). Although not alleging fraud, plaintiffs argued the complaint showed that defendants' failure to disclose the pledged shares was "intentional misconduct." The Tenth Circuit, however, disagreed. To give the statute a "realistic function," it construed the phrase "intentional misconduct" as requiring facts showing knowledge that the conduct violates the law, not just that the director "knew what his or her actions were." According to the Court, absent such construction, "the exculpatory statute would be an empty gesture."

Turning to the complaint, the Court held that the requisite knowledge could not be inferred merely from allegations that the director defendants reviewed and signed the SEC filings that failed to disclose the pledged stock, stating "[w]e doubt that board members are expected to know the minutiae of SEC regulations." Also falling short was the complaint's allegation that two of the directors served on Zagg's audit committee and so were in charge of complying with SEC rules and regulations and overseeing the integrity of the filing. "[I]t would be too much of a stretch to read [audit committee membership] as requiring the committee members to have detailed knowledge of all SEC regulations. Corporations have lawyers and accountants for that purpose. Who would take on that responsibility as a board member?" The Court concluded that the alleged facts failed to show "knowledge of wrongfulness" and so failed to overcome the exculpation statute and excuse the lack of pre-suit demand on Zagg's board of directors.

The Tenth Circuit's application of Nevada's exculpatory statute in *Zagg* illustrates the statute's broad effects. Not only does the statute limit the personal liability of directors and officers, in so doing, it aids in preserving the board of directors' authority to decide whether or not to litigate.

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