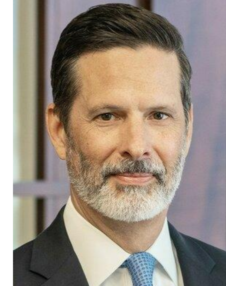
Why Calif. Applying Del. Caremark Standard Is A Big Deal

By **Warren Rissier, Karen Pieslak Pohlmann and Robert O'Leary** (September 27, 2023)



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In Kanter v. Reed, where review was denied by the California Supreme Court on Aug. 30, the Court of Appeal of the State of California for the Second Appellate District, applying California law, followed the Caremark framework used by Delaware courts to evaluate breach of fiduciary duty claims based on an alleged failure of oversight.[1]

The Caremark theory of liability was established by the Delaware Court of Chancery in its 1996 In re: Caremark International Inc. opinion. Courts throughout the country use Delaware's Caremark standard to evaluate potential director liability for breach of fiduciary duty claims against corporate directors based on a board's alleged failure to oversee the corporation's operations.

The Kanter ruling is important because it is the first time that a California court has adopted Delaware's influential Caremark standard for directors of a California corporation.

In Caremark, the plaintiffs alleged that the board of directors breached their fiduciary duty to oversee the company's operations after the various employees were found to have violated certain health care laws.

In the context of approving a settlement of claims against the directors providing only modest benefits to the corporation, the Court of Chancery concluded that the settlement was nonetheless adequate because the claims against the directors premised on an "ignorance of liability creating activities" are subject to "a demanding test of liability."

The court observed "the lack of good faith" that is "a necessary condition to liability" for such claims requires a "sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exists."

In short, under the Caremark standard, a director must make a good faith effort to oversee the company's operations and put in place a system of internal controls to inform the board of risks requiring its attention.

In Kanter, a natural gas leak occurred in California at the Aliso Canyon storage facility operated by Southern California Gas Co., a subsidiary wholly owned by Sempra Emergy. The plaintiffs alleged that Sempra and SoCalGas' directors and officers breached their duty of oversight for their alleged failure to oversee natural gas storage safety at the Aliso Canyon storage facility in the years before the leak.

The plaintiffs further argued that they, as shareholders of Sempra's stock, could assert

claims on behalf of the company for damages resulting from the leak because it was futile to demand that Sempra's directors take action given that they allegedly faced a substantial likelihood of personal liability.

Key to assessing the plaintiffs' standing to assert claims on behalf of the company was a determination of the correct legal standard to apply to the directors' conduct.

After surveying California statutes and case law, the court panelists unanimously agreed that the Caremark standard is consistent with California law and should apply to the plaintiffs' allegations.

In doing so, the Second Appellate District specifically rejected the plaintiffs' argument that directors of California corporations have a heightened duty to inquire about their companies' operations that exceed the duty imposed on directors of Delaware corporations.

More specifically, the court rejected the plaintiffs' arguments that California's corporation law statutes are inconsistent with Delaware's Caremark decision and its progeny.[2] The court noted that while in some instances the California statutes and the Caremark case law use different terminology, the underlying principles are consistent.

Accordingly, the court held that there is no compelling reason for California to diverge from Delaware.

Bottom line, the Second Appellate District — after parsing the language in California's statutory scheme and comparing it to Delaware law — held that the Caremark standard is consistent with California's statute.

The result was that the Second Appellate District upheld the trial court's dismissal of the plaintiffs' claims on the pleadings, reasoning in part that Sempra's directors had exercised appropriate oversight when they established a committee responsible for natural gas safety and received reports about safety issues from that committee and management.[3]

This ruling applying the Caremark standard is significant for California corporations and their directors and officers. If the Second Appellate District had held otherwise, it would have left California as an outlier, given the broad acceptance of the Caremark standard throughout the U.S.

Indeed, Delaware's Caremark standard has been adopted for companies incorporated in numerous other states, including, for example, Florida, Georgia, Illinois, Minnesota, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee and Washington.

By holding that California law follows the Delaware standards set forth in Caremark, the ruling in Kanter is based on sound policy reasons.

A basic principle of corporate governance vests the board, not corporate shareholders, with responsibility for corporate oversight. Directors are to exercise their business judgment in managing the corporation. They are generally insulated from liability when they do so in good faith.

Liability rules need to respect that directors are not to be guarantors of the success of the businesses they serve. Exercises of business judgment can be flawed without thereby suggesting any basis for director culpability, and courts are ill-equipped to second-guess the kinds of decisions associated with running a particular business.

The law and its director liability rules should also encourage qualified persons to serve as corporate directors. Directors typically serve on a part-time basis. They are often called upon to oversee at the same time many different facets of a corporate business and operations.

Realistically, there are necessary limits on each director's access to day-to-day information about all aspects of a wide-ranging business.

Directors also need to be able to reasonably rely on company executives and employees to make them aware of significant facts relating to the business, just as they should be able to rely for their information on systems designed to bring to their attention facts arising from a corporation's extensive operations.

The potential liabilities associated with directorships should not be so great as to discourage director service or require that corporations pay inflated sums to attract and retain qualified directors.

Nor should the potential liabilities be so great as to permit aggressive shareholders to try to turn directors into guarantors of business success, which could cause directors to avoid any risk and stifle innovation.

And California corporations should not be at a disadvantage in attracting qualified board members because they are out of step with the standards applied by Delaware and other jurisdictions.

The Kanter ruling is consistent with a long history of California appellate decisions finding that California corporate law is consistent with Delaware law. As the Kanter ruling explained, "California courts have routinely relied 'on corporate law developed in the State of Delaware given that it is identical to California corporate law for all practical purposes.'"[4]

Delaware corporate law is also widely followed throughout the nation. The Second Appellate District's refusal to allow the plaintiffs to drive a wedge between California and Delaware law reinforces that California corporations and their directors may continue to look to Delaware corporate law for guidance in matters regarding corporate governance.

Although the Kanter ruling affirmed the dismissal of the plaintiffs' claims, the ruling recognizes that directors should be held liable when they do not act in good faith. As explained in Kanter,

Bad faith is established, under Caremark, when "the directors [completely] fail to implement any reporting or information system or controls[,] or ... having implemented such a system or controls, consciously fail to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." In short, to satisfy their duty of loyalty, directors must make a good faith effort to implement an oversight system and then monitor it.[5]

The Kanter opinion thus demonstrates the importance of creating and using board-level informational and reporting mechanisms that fulfill the board's duty of oversight.

Unforeseen incidents will sometimes occur.

The board's duties are not to guarantee that such unexpected events will never occur, but

instead to implement and effectively utilize an information gathering and reporting system that is tailored to the company's operations and the nature of its business, so that directors are appropriately overseeing the company's operations and applying their talents to help the company achieve success.

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Disclaimer: The authors of this article represented Sempra in its defense of the Kanter action.

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[1] See In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 961 (Del. Ch. 1996).

[2] Kanter, 92 Cal. App. 5th at 206.

[3] Kanter, 92 Cal. App. 5th at 211.

[4] 92 Cal. App. 5th at 208 (citation omitted).

[5] Id. at 210.