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California Court Adopts the *Caremark* Standard for Oversight Claims

The decision articulates the standard for plaintiffs asserting derivative claims based on an alleged failure of oversight by directors and officers of California companies.

Nearly three decades ago in the seminal case *In re Caremark International Inc. Derivative Litigation*,[1] the Delaware Court of Chancery set forth a test to determine whether a director failed to "exercise reasonable oversight."[2] The court concluded that a director could be held liable for such claims only where a plaintiff could establish a director's "lack of good faith as evidenced by sustained or systematic failure" of oversight.[3] These director oversight claims became broadly known as "*Caremark* claims." As *Caremark* case law continued to develop, most plaintiffs attempting to meet this high standard did not survive a motion to dismiss, though in recent years Delaware courts have denied dismissal in a handful of cases.

Despite Delaware's development of extensive case law on *Caremark* over the years, no California court has published binding authority on the personal liability standard for director oversight claims under California law. Further, California courts have abstained from adopting the *Caremark* standard for similar claims against directors and officers of California corporations and refrained from stating whether bad faith was necessary for such claims. This lack of guidance created uncertainty in California corporate law for shareholder derivative actions against directors and officers based on an alleged failure of oversight.

On June 2, 2023, however, the Second District Court of Appeal in *Kanter v. Reed*[4] expressly adopted the *Caremark* standard to evaluate an alleged failure of oversight. According to *Kanter*, to establish a breach of the duty of oversight, a plaintiff must establish that the defendant directors knew they were acting in bad faith either by (1) failing to implement any system or controls of monitoring or reporting of the company's operations or (2) having implemented such a system or controls, consciously failing to monitor or oversee its operations.[5]

Whether other California appellate courts, including, ultimately, the California Supreme Court, will follow *Kanter* in applying *Caremark* remains to be seen. Regardless, California boards should follow best practices to protect themselves from *Caremark* claims, including (as discussed further below) establishing and maintaining functional oversight systems, forming risk management committees if appropriate, and documenting board oversight efforts.

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Caremark Background

In re Caremark International Inc.

Caremark was decided in the context of a Chancery Rule 23.1 motion to approve a proposed settlement of a consolidated derivative action, which requires the court to assess the strengths and weaknesses of the claims to evaluate the fairness of the proposed settlement.[6] The underlying claims were brought on behalf of Caremark International, Inc., a healthcare provider of patient care and managed care services, against its board of directors.[7] The complaint alleged the director defendants breached their "duty of attention or care" regarding the business's ongoing operations.[8] According to the complaint, the directors allegedly failed in their oversight functions — i.e., they "allowed a situation to develop and continue which exposed the corporation to enormous legal liability" and thereby "violated a duty to be active monitors of corporate performance."[9] Namely, the directors allegedly failed to oversee employees who violated federal and state laws and regulations applicable to healthcare providers.[10]

The Delaware Court of Chancery ultimately found that the director defendants did not fail to exercise their oversight duties because Caremark's information systems constituted "a good faith attempt to be informed of relevant facts."[11] This was true despite the directors' failure to know "the specifics of the activities that le[]d to the [employees'] indictments."[12] The court held that "only 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 — will establish the lack of good faith that is a necessary condition to liability."[13] The court cautioned that a *Caremark* claim is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[14]

Evolution of the *Caremark* Doctrine in Delaware

A decade later, the Delaware Supreme Court in *Stone ex rel. AmSouth Bancorporation v. Ritter* affirmed the *Caremark* test for assessing director oversight liability.[15] The court clarified that a board breaches its duty of oversight under *Caremark* if the board: (1) "utterly fail[ed]" to implement any system or controls of reporting or information or (2) failed to respond to "red flags indicating wrongdoing."[16] This test is rooted in concepts of bad faith, requiring "proof that a director acted inconsistent[ly] with his fiduciary duties" and that "the director knew he was so acting."[17] Over time, and as initially cautioned by the *Caremark* court, *Caremark* claims became exceptionally difficult to adequately plead. More often than not, such claims failed to survive a motion to dismiss.

More recently, beginning in 2019, Delaware courts denied motions to dismiss *Caremark* claims more often. While such claims are still held to a high standard, a handful of cases survived the pleading stage as Delaware courts found that director defendants could not defeat *Caremark* claims at the pleading stage where specific alleged facts established that directors "consciously ignored red flags,"[18] that "chronic deficiencies" plagued internal controls of reporting,[19] or that the company's reporting systems were "woefully inadequate."[20] Further, Delaware courts cautioned that director defendants' oversight functions would be held to a more "rigorous" standard "when a company operates in an environment where externally imposed regulations govern its 'mission critical' operations[.]"[21]

Caremark in California

For over a quarter of a century, California courts have declined to address or specifically adopt the *Caremark* standard for California corporations. In fact, prior to June 2023, there were no published California court decisions that relied on *Caremark* to determine whether a plaintiff adequately pleaded a director oversight claim under California law.

While *Caremark* has been cited by California courts — e.g., in 2013 in *Leyte-Vidal v. Semel*[22] and in 2022 in *Tola v. Bryant*[23] — those courts applied *Caremark* because the corporations at issue were Delaware corporations, requiring the application of Delaware law.[24] And another California court, in an unpublished decision, analyzed demand futility for failure of oversight but did not apply or analyze the claim under the *Caremark* doctrine or the California Corporations Code standards for exculpation.[25] Federal courts applying California law have held that *Caremark*'s standard applies to oversight claims.[26]

Kanter v. Reed[27]

The *Kanter* court, however, potentially changed the course of California corporate law when it explicitly applied the *Caremark* doctrine to a consolidated shareholder derivative action against officers and directors of two California corporations — Sempra Energy and its wholly owned subsidiary, Southern California Gas Company (SoCalGas) — alleging failure of board oversight. The lawsuit was filed following a natural gas leak at the largest natural gas storage reservoir in California, the Aliso Canyon Natural Gas Storage facility, which is maintained by SoCalGas. SoCalGas employees ultimately discovered the leak and reported it to government agencies. The leak allegedly resulted in more than $1.1 billion in damages.

According to the complaint, the directors had actual knowledge of the "substantial" risks posed by the facility prior to the leak.[28] Plaintiffs alleged that the director defendants breached their fiduciary duties "by failing to take steps to maintain an adequate inspection program, documentation, monitoring, and risk management plan to ensure safety at [the] Aliso Canyon [facility], including [the Well.]"[29] Plaintiffs did not serve a demand on the directors prior to filing suit, instead alleging that it would be futile to do so.[30]

Defendants demurred and the court sustained the demurrer, holding that plaintiffs failed to sufficiently allege demand futility after interpreting *Aronson*.[31] Plaintiffs amended their complaint to include allegations that defendants failed in their oversight duties related to safety issues at Aliso Canyon.[32] Defendants demurred on the same grounds regarding demand futility, and the trial court, considering *Caremark*[33] and *Marchand*[34] instructive,[35] sustained the demurrer and held that plaintiffs failed to sufficiently allege "an utter failure by [d]efendants to attempt to assure a reasonable information and reporting system exists" under *Marchand*.[36]

The Second District Court of Appeal affirmed.[37] Finding that the seminal Delaware test was consistent with California Corporations Code standards for exculpation,[38] the court explicitly adopted and applied the *Caremark* doctrine.[39] The court concluded that the "[b]oard minutes demonstrate[d] the existence of some oversight by the [directors] over SoCalGas's gas storage infrastructure," including:

- in response to certain risks, the directors formed an Environmental, Health, Safety, and Technology Committee, which met 10 times in two-and-a-half years and regularly reported to the board;
- the directors received annual risk-management reports that included gas infrastructure and reliability risks, as well as general rate case updates; and
- the directors asked questions and ultimately approved SoCalGas's plan to seek a rate increase for a proposed storage management program.[40]

Though the plaintiffs challenged the effectiveness of the monitoring system, the Second District Court of Appeal held that the allegations were insufficient to demonstrate that the directors "intentionally abandon[ed] or abdicate[ed] their duties to monitor" or "made no [good faith] effort to put in place a board-level compliance system."[41] Because the plaintiffs failed to allege "particularized facts supporting their

Caremark theory of liability," the plaintiffs failed to plead a "substantial likelihood of liability," and thus ultimately "failed to plead demand futility[.]"[42]

How *Kanter* Impacts California Law

By adopting the *Caremark* doctrine, the Second District Court of Appeal has articulated a standard for California plaintiffs pursuing shareholder derivative claims based on failure of oversight. Pre-*Kanter*, there was no precedential authority on the standard for plaintiffs asserting derivative claims against directors and officers of California companies for personal liability based on an alleged failure of oversight under California law.[43] However, according to *Kanter*, a plaintiff must allege bad faith (i.e., intentional conduct on the part of the director defendant) for oversight claims.[44] Specifically, a plaintiff must plead that the director defendants *intentionally* acted or failed to act in a manner that is not in accordance with their duties, or *consciously* failed to act in the face of a known duty to act, thereby creating a substantial risk of serious harm to the corporation or its shareholders.[45]

Put simply, based on *Kanter*, a plaintiff claiming failure of director oversight can survive a demurrer only if the plaintiff alleges particularized facts showing that the defendant directors knew they were acting in bad faith by intentionally abandoning or abdicating their duties to monitor the business. This may be demonstrated by pleading facts supporting a reasonable inference that the directors did not undertake good-faith efforts to implement a board-level system of monitoring and reporting or that the directors deliberately ignored red flags based on the monitoring and reporting of the company's operations.

Per *Kanter*, general allegations that the defendant directors engaged in acts or omissions that demonstrated a "reckless disregard for the director's duty to the corporation or its shareholders" or constituted an "unexcused pattern of inattention that amounts to an abdication of the director's duty" are insufficient.[46] Furthermore, allegations attacking the *effectiveness* of a monitoring and reporting system are similarly inadequate.[47]

By applying a standard of bad faith — i.e., the *Caremark* standard — *Kanter* creates a shield for directors of California companies and makes it more difficult for plaintiffs to prevail on a shareholder derivative action based on director oversight liability. The *Kanter* court made clear that the *Caremark* standard focuses on whether the plaintiff pleads particularized facts showing that the board made no effort to implement a board-level compliance system, instead of facts regarding the effectiveness of the system.[48]

Under this standard, plaintiffs may have difficulties alleging and proving that a director acted in bad faith without a conflict of interest or facts suggesting ill motive, making these claims "possibly the most difficult theory in corporate law upon which a plaintiff might hope to win a judgment," as forewarned by the Delaware Court of Chancery.[49] Ultimately, *Kanter*'s implications will be determined by the California Supreme Court or by whether other California appellate courts fall in line with *Kanter*, and how California courts apply the *Caremark* test.

Best Practices for California Boards

Below are some best practices that California boards should consider implementing in light of *Kanter*.

1. **Create and maintain a functional system of oversight for key risks to the company's operations.** California boards should implement an oversight system with regular management reports to the board about key risks and developments that are central to the company's operations. Further, boards should implement and monitor processes and protocols for management to report in

these areas to the board. By keeping apprised of these main issues, California boards can demonstrate supervision over the company's operations.

2. **Risk management committees.** In addition to establishing a general oversight system, California boards should consider forming committees tasked with staying abreast of and addressing key risks in the company's operations, particularly with respect to matters subject to regulatory oversight based on recent Delaware case law. In *Kanter*, the fact that the board formed a committee that regularly reported to the board about concerns — even one not specifically focused on the concern at issue — helped defeat the complaint.

3. **Document the board's oversight efforts in the minutes.** California companies should maintain records of the board's efforts to establish, implement, and monitor oversight systems, as well as the regular interactions between the board and management relating to compliance issues and key risks and developments in the relevant industry. Specifically, boards should maintain board minutes and, as appropriate, board-level materials detailing these efforts. In *Kanter*, both the majority and dissent analyzed the board minutes to determine the existence and sufficiency of the compliance monitoring.

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Endnotes

[1] 698 A.2d 959 (Del. Ch. 1996).

[2] *Id.* at 971.

[3] *Id.*

[4] 92 Cal. App. 5th 191 (2023), *review filed* (July 12, 2023).

[5] *Id.* at 210.

[6] *See* 698 A.2d at 960-61.

[7] *Id.* at 961.

[8] *Id.* at 967.

[9] *Id.* at 960.

[10] *Id.* at 960, 971.

[11] *Id.* at 971.

[12] *Id.* at 971-72.

[13] *Id.* at 971.

[14] *Id.* at 967.

[15] 911 A.2d 362, 365 (Del. 2006).

[16] *Id.* at 370, 373.

[17] *In re Boeing Co. Derivative Litig.*, No. CV 2019-0907-MTZ, 2021 WL 4059934, at *25 (Del. Ch. Sept. 7, 2021) (citations omitted); *see also Marchand v. Barnhill*, 212 A.3d 805, 809 (Del. 2019).

[18] *In re Clovis Oncology, Inc. Derivative Litig.*, No. CV 2017-0222-JRS, 2019 WL 4850188, at *15 (Del. Ch. Oct. 1, 2019).

[19] *Hughes v. Xiaoming Hu*, No. CV 2019-0112-JTL, 2020 WL 1987029, at *15, 17 (Del. Ch. Apr. 27, 2020).

[20] *Teamsters Local 443 Health Servs. & Ins. Plan v. Chou*, No. CV 2019-0816-SG, 2020 WL 5028065, at *2 (Del. Ch. Aug. 24, 2020).

[21] *Clovis*, 2019 WL 4850188, at *13 (citing *Marchand*, 212 A.3d at 824).

[22] 220 Cal. App. 4th 1001, 1015 (2013).

[23] 76 Cal. App. 5th 746, 752 (2022).

[24] *Caremark* was also cited in *Robbins v. Alibrandi*, 127 Cal. App. 4th 438, 449 (2005), but only for the standard of review applicable to approving settlements as fair and reasonable.

[25] *See Shapiro v. Kennedy*, No. G042017, 2011 WL 3567415, at *9 (Cal. Ct. App. Aug. 15, 2011), *as modified* (Sept. 9, 2011) (unpublished); Cal. Corp. Code § 204 (a)(10).

[26] *See, e.g.*, *In re Edison Intl Derivative Litig.*, No. 15CV1581-BEN-KSC, 2016 WL 4793186, at *7 (S.D. Cal. Sept. 14, 2016).

[27] 92 Cal. App. 5th 191 (2023).

[28] *Id.* at 200.

[29] *Id.* at 202 (alteration in original).

[30] *Id.*

[31] To determine the adequacy of pleading demand futility "[w]here a decision of the board of directors is challenged in the derivative suit, the *Aronson* test asks 'whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.'" *Apple Inc. v. Superior Court*, 18 Cal. App. 5th 222, 233 (2017) (quoting *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984) (alternations in original)). If the board did not make a business decision that is being challenged in the derivative suit, the Delaware's *Rales* test asks the court to determine whether "'the particularized factual allegations … create a reasonable doubt that … the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. If the derivative plaintiff satisfies this burden, then demand will be excused as futile.'" *Id.* at 205-06 (citing *Rales*, 634 A.2d at 934). Directors are not independent or disinterested if they face a "substantial likelihood of personal liability." 92 Cal. App. 5th at 206 (internal citations and quotations omitted).

[32] 92 Cal. App. 5th at 202.

[33] 698 A.2d 959.

[34] 212 A.3d 805 (requiring plaintiffs to plead facts demonstrating "an utter failure by [d]efendants to attempt to assure a reasonable information and reporting system exists").

[35] 92 Cal. App. 5th at 202. The Court noted that while it previously "applied the *Aronson* test when ruling on the demurrers to the original complaint," "[i]n the opposition to the demurrers to the First Amended Complaint (FAC), Plaintiffs d[id] not advocate for one test over another [], but clearly, they have moved on to the *Rales* test with a new theory, asserted in the opposition, based on a *Caremark* claim." *Kanter v. Reed,* Case No. BC664302, Dec. 30, 2020 Minute Order at 3.

[36] 92 Cal. App. 5th at 202.

[37] *Id.* at 213.

[38] Sections 204(a)(10)(iv) (reckless disregard) and (v) (unexcused pattern of inattention that amounts to an abdication of duty).

[39] 92 Cal. App. 5th at 207-10. Recently, the Delaware Supreme Court in *United Food and Commercial Workers v. Zuckerberg*, 262 A.3d 1034 (Del. 2021), affirmed a modernized three-part demand futility test and noted that the test effectively "[b]lend[s] the *Aronson* test with the *Rales* test." *Id.* at 1058. The Court of Appeal did not consider the recent ruling in *Zuckerberg*, 262 A.3d at 1058-59, applied the *Rales* test, and determined that "*Caremark* articulates the necessary conditions for assessing director oversight liability." 92 Cal. App. 5th at 206.

[40] 92 Cal. App. 5th at 211.

[41] *Id.*

[42] *Id.*

[43] *Bader*, 179 Cal. App. 4th at 792.

[44] 92 Cal. App. 5th at 210.

[45] *Id.* at 208-10.

[46] Cal. Corp. Code § 204 (a)(10)(iv), (v).

[47] 92 Cal. App. 5th at 211.

[48] *Id.*

[49] *Caremark*, 698 A.2d at 967.