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NOT TO BE PUBLISHED IN OFFICIAL REPORTS

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION FOUR

JOHN CARVER, as Trustee, etc., et al., Plaintiffs and Appellants, v. ZAHRA MANSOURI et al., Defendants and Respondents.	A127141 (San Mateo County Super. Ct. No. CIV 472229)

Minority shareholders of a corporation sued the directors for breach of fiduciary duty for using company profits to pay executive compensation instead of stock dividends. The directors moved for summary judgment and relied upon the business judgment rule in arguing that the directors had wide discretion in determining whether to declare a dividend. The trial court granted summary judgment upon concluding that the shareholders' evidence failed to raise a triable issue of fact as to whether the directors acted in abuse of discretion, fraud, or bad faith in exercising their business judgment to set compensation and to decline declaring a dividend. We reach the same conclusion and affirm the judgment.

I. FACTS

Laboratory Skin Care, Inc. (LSC) is a California corporation that develops and manufactures skin care products. LSC employs fewer than 10 people. The company was founded by defendant Zahra Mansouri in 1993, who developed and patented LSC's products. Mansouri is the president and chair of the board of directors of LSC, and has been at all times since 1993. The other directors are defendants Winfried Kuhlman and Rod Jackson.

LSC has two classes of stock: common stock and preferred stock. LSC has a total of 22,496,461 outstanding shares of common stock that are owned by 10 shareholders. Mansouri owns 22 million shares—over 97 percent—of the common stock. Director Kuhlman owns 195,297 shares of LSC common stock and director Jackson owns 150,000 shares. The balance of the common stock is owned by seven shareholders, none of whom is a party to this action.

Plaintiffs are nine owners of LSC preferred stock.[1] LSC has 1,600,271 outstanding shares of preferred stock, owned by 16 or more separate shareholders (the exact number is disputed). Collectively, plaintiffs own 614,077 shares of LSC preferred stock, or approximately 38 percent of those shares. Plaintiffs acquired their shares pursuant to a stock purchase agreement executed between 1999 and 2001. The stock purchase agreement has several exhibits, including LSC's restated articles of incorporation.

The restated articles of incorporation include the following provision relevant to dividends: "When and as declared by the corporation's board of directors, the holders of Series A Preferred Stock shall be entitled to receive, out of any funds legally available therefore, dividends at the rate of $0.068 per annum, payable in preference to any payment of any dividend on Common Stock. After payment of such dividends, any additional dividends declared shall be payable entirely to the holders of Common Stock. The right of the holders of Series A Preferred Stock to receive dividends shall not be cumulative, and no right shall accrue to holders of Series A Preferred Stock by reason of the fact that dividends on such shares are not declared or paid in any prior year."

LSC's board of directors has never declared a dividend. There are legal restrictions on a corporation's ability to declare a dividend. A corporation must have

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[1] The plaintiffs are: John Carver (as Trustee of the Carver Family Trust), Douglas Davis, Jean La Douceur, Laura Dowling, Larry Goldfarb, Georganne Papac, Frances Petrocelli, Deborah Strobin (as Trustee of the Strobin Family Trust), and Charles Wilson.

retained earnings or meet other financial requirements so that creditors' rights are not impaired by the payment of dividends. (Corp. Code, § 500; see generally Friedman, Cal. Practice Guide: Corporations (The Rutter Group 2010) ¶¶7:10-7:59, pp. 7-4 to 7-14.) Retained earnings are the sum of the company's annual net profits (revenue minus expenses). LSC never had any retained earnings, and never met the other financial tests for payment of dividends. Plaintiffs do not dispute these facts but argue that the directors engaged in a bad faith "stratagem of paying so much compensation" to the corporate president that profits were depleted and no retained earnings existed from which to pay dividends to plaintiff shareholders.

As noted above, the corporate president is defendant Mansouri, who is also the founder, majority shareholder, and chair of the board of directors. Mansouri's annual salary was set at $104,167 in 1993, and $125,000 from 1994 to 2000. Her stated salary was increased to $185,000 in December 2000. However, payment of Mansouri's salary was largely deferred from 1993 through 2005 because LSC had limited working capital. Mansouri received no salary payments in 1996, 1997, or 2000 through 2004, and the most she received in any year between 1993 and 2005 was $26,400. The unpaid salary became a debt of the corporation. LSC disclosed its indebtedness to Mansouri for accrued but unpaid salary in the stock purchase agreement provided to preferred stock shareholders like plaintiffs. In 2000, the debt was almost $1 million, and this fact was disclosed to the shareholders. By the end of 2005, LSC owed Mansouri approximately $1.8 million in unpaid salary.

In 2006, LSC started to pay Mansouri her accrued salary, and awarded her other compensation. The compensation was approved by disinterested directors Kuhlman and Jackson. In declarations filed with the court, Kuhlman and Jackson state that "LSC's revenues had grown substantially over the years and by 2006 LSC was finally in a position to begin paying off the accrued back salary owed to Mansouri." In 2006, LSC paid Mansouri almost $1.5 million toward accrued but unpaid salary for the years 1993 to 2006. LSC also assessed 10 percent interest of almost $1 million on the unpaid salary, and paid most of this amount to Mansouri in 2006.

Directors Kuhlman and Jackson each declared that their decision to pay the accrued salary and interest was the result of their "best business judgment" and that they believed the payments were in LSC's interest because LSC was obligated to pay the salary and, in order to retain Mansouri, needed to reward her "for her many sacrifices and contributions, including but not limited to her foregoing her salary in the past, her consent to allow the Company to use her patented technology without payment, and her performance of many roles at the Company."

In 2007, LSC paid Mansouri her salary of $185,000, plus a $1 million bonus. LSC also paid Mansouri the remaining back pay she was owed and all outstanding interest. In 2008, LSC paid Mansouri salary and bonuses totaling $2.5 million. The roughly $3.5 million paid in executive compensation from 2007 to 2008 is the primary focus of plaintiffs' complaint.

On the motion for summary judgment, directors Kuhlman and Jackson declared that they used their "best business judgment" in determining that the amount of compensation was in the company's best interest. The directors noted that LSC increased its revenue under Mansouri's management from approximately $270,000 in 2004 to $4 million in 2007. The directors declared that "Mansouri remained critically important to the company, she was performing several roles, and without her there would be no LSC."

In their declarations filed with the court, the directors addressed plaintiffs' claim that LSC should not have approved the compensation payments to Mansouri and instead declared a dividend. All directors (including Mansouri) stated that they "considered in good faith the payment of a dividend" in each year they served as directors and decided not to declare a dividend based on what they "perceived to be in the best interests of LSC." Directors Kuhlman and Jackson, who voted for Mansouri's compensation, explained that, in their judgment, it was important to reward Mansouri for her contributions to the company. Kuhlman and Jackson also stated that, even if Mansouri had been paid less and retained earnings were available, it would not have been in LSC's best interest to declare a dividend.

Kuhlman stated that "[v]ery few growing companies, if any, pay a dividend as the money [it] would take is better spent being re-invested in the business, both for tax and other considerations. For this reason, I have always been opposed to the payment of a dividend by LSC. In my experience, small, private life science or pharmaceutical companies never pay a dividend to their shareholders. In my experience, any surplus money held by a company like LSC is best reinvested in the corporation or otherwise used to advance the corporation's interest rather than being paid out to shareholders as dividends. Using LSC's earnings in this manner in my view is the most effective way for the Company to realize a liquidity event, such as a merger or acquisition or an Initial Public Offering [IPO] of the company's stock. In my experience, sophisticated investors understand this and disfavor payment of dividends by private companies." Jackson made a similar statement. One of the plaintiffs, John Carver, acknowledged in his deposition that he did not expect to receive dividends from LSC. Carver testified that he bought LSC shares "for capital gains in the event of an IPO. Normally, no one in their right mind would invest in a company with no money with the thought of getting dividends." Plaintiffs acknowledge this testimony but note that this is the view of just one of their number, and argue that even plaintiff Carver's testimony was premised on the condition that the company had " 'no money,' " which was true at LSC's inception but not in later years when revenue increased.

Shortly after plaintiffs sued LSC in 2008, the company commissioned an independent committee to investigate whether, as alleged, the directors breached their fiduciary duties by making excessive compensation payments to LSC president Mansouri that eliminated retained earnings and unfairly deprived plaintiff shareholders of dividends. The committee was comprised of individuals without any business dealings or social contacts with plaintiffs, defendants, LSC, or any of their attorneys. The committee concluded that all disputed actions by the directors were appropriate, authorized, and done for the best interest of LSC. The committee rejected plaintiffs' claim that there was a strategy on the part of the board of directors to artificially deflate company profits by awarding Mansouri salary and bonuses, and dismissed the claim as the product of inadequate financial or business understanding on the part of plaintiffs.

II. DISCUSSION

The trial court found undisputed evidence that LSC's directors properly exercised their business judgment in setting compensation and declining to declare a dividend. We agree.

A. Fiduciary duty and the business judgment rule

Corporate directors and majority shareholders owe a fiduciary duty to the corporation and its shareholders. (*Jones v. H.F. Ahmanson & Co.* (1969) 1 Cal.3d 93, 108-109.) Corporate directors must serve "in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders." (Corp. Code, § 309, subd. (a).) Similarly, majority shareholders must "use their ability to control the corporation in a fair, just, and equitable manner." (*Jones, supra*, at p. 108.)

The liability of corporate directors for breach of fiduciary duty is strictly limited by the business judgment rule. (Corp. Code, § 309.) "California courts (like courts elsewhere) apply the common law 'business judgment rule' in determining directors' liability for breach of their duty of care. Under this rule, courts will not review directors' business decisions, or hold directors liable for errors or mistakes in judgment" provided that the directors were "[d]isinterested and independent"; "[a]cting in good faith"; and "[r]easonably diligent in informing themselves of the facts." (Friedman, Cal. Practice Guide: Corporations, *supra*, ¶ 6:245. p 6-46.15, italics omitted.) The business judgment rule " ' " 'is based on the premise that those to whom the management of a business organization has been entrusted, and not the courts, are best able to judge whether a particular act or transaction is helpful to the conduct of the organization's affairs or expedient for the attainment of its purposes.' " ' " (*Berg & Berg Enterprises, LLC v. Boyle* (2009) 178 Cal.App.4th 1020, 1045.)

Directors "are rebuttably presumed to have acted in good faith." (Friedman, Cal. Practice Guide: Corporations, *supra*, ¶ 6:245.1, p. 6-46.15, italics omitted.) The business judgment rule " ' " 'establishes a presumption that directors' decisions are based on sound business judgment, and it prohibits courts from interfering in business decisions made by the directors in good faith and in the absence of a conflict of interest.' " ' " (*Berg & Berg Enterprises, LLC v. Boyle, supra*, 178 Cal.App.4th at p. 1045.) "In most cases, 'the presumption created by the business judgment rule can be rebutted only by affirmative allegations of facts which, if proven, would establish fraud, bad faith, overreaching or an unreasonable failure to investigate material facts. [Citation.] Interference with the discretion of directors is not warranted in doubtful cases.' " (*Id.* at p. 1046.)

The decision whether to declare a dividend falls squarely within the business judgment rule. "Whether 'a private corporation should declare and pay a dividend, or make distribution of its assets is a matter committed to the sound business judgment of the corporation's board of directors.' [Citations.] It is thus the general rule that a court will not interfere with a corporate decision to withhold dividends in the absence of a showing of abuse of the wide discretion which the courts grant to corporate directors." (*Barnes v. State Farm Mut. Auto. Ins. Co.* (1993) 16 Cal.App.4th 365, 378.) A respected treatise is emphatic on the matter: "The business judgment rule protects a board's decision regarding payment of a dividend or the making of a distribution. A court will not compel a distribution unless withholding the distribution is explicable only on the theory of an oppressive or fraudulent abuse of discretion." (3A *Fletcher, Cyclopedia of the Law of Private Corporations* (2002 rev.) ¶ 1041.20, pp. 58-59, fns. omitted.)

B. Summary judgment was proper

Defendant directors presented sufficient evidence on their motion for summary judgment to invoke the business judgment rule. Specifically, the directors presented evidence that they were disinterested and independent, acting in good faith, and reasonably diligent in informing themselves of the facts when they made the challenged business decisions concerning executive compensation and dividends. The evidence is set out in detail above, and included declarations from all directors that they "considered in good faith the payment of a dividend" in each year they served as directors and decided not to declare a dividend based on what they “perceived to be in the best interests of LSC.” The directors provided facially reasonable grounds for their determinations, including Director Kuhlman’s explanation that “[v]ery few growing companies, if any, pay a dividend as the money [it] would take is better spent being re-invested in the business, both for tax and other considerations . . . . [A]ny surplus money held by a company like LSC is best reinvested in the corporation or otherwise used to advance the corporation’s interests rather than being paid out to shareholders as dividends. Using LSC’s earnings in this manner . . . is the most effective way for the Company to realize a liquidity event, such as a merger or acquisition or an Initial Public Offering of the company’s stock.”

Plaintiffs failed to present evidence of director misconduct sufficient to overcome application of the business judgment rule. One of plaintiffs’ principal claims of misconduct rests upon the articles of incorporation, which include the following provision relevant to dividends quoted earlier: “When and as declared by the corporation’s board of directors, the holders of Series A Preferred Stock shall be entitled to receive, out of any funds legally available therefore, dividends at the rate of $0.068 per annum, payable in preference to any payment of any dividend on Common Stock. After payment of such dividends, any additional dividends declared shall be payable entirely to the holders of Common Stock. The right of the holders of Series A Preferred Stock to receive dividends shall not be cumulative, and no right shall accrue to holders of Series A Preferred Stock by reason of the fact that dividends on such shares are not declared or paid in any prior year.”

Plaintiffs insist that this provision means that the directors must declare a dividend when there are “any funds legally available” and that the directors did not properly exercise their business judgment in failing to comprehend and honor this provision when the company made profits. It is plaintiffs who fail to comprehend the provision. The provision plainly gives the directors discretion to declare a dividend (or not) and simply grants plaintiffs preference over common shareholders in the payment of dividends if, “when and as declared by the corporation’s board of directors.”

"Preferred shares are those which have a preference over other shares either as to distribution of assets on liquidation or as to payment of dividends, or some other combination of rights, preferences, privileges, and restrictions." (*Kirschner Brothers Oil, Inc. v. Natomas Co.* (1986) 185 Cal.App.3d 784, 795.) But "the decision to declare and pay dividends rests in the discretion of the board of directors and is protected by the business judgment rule. The directors have the same discretion with regard to the payment of dividends to holders of preferential rights." (12 *Fletcher, Cyclopedia of the Law of Private Corporations* (2004 rev.) ¶ 5443, pp. 75-79.) Of course, shareholder rights are contractual in nature and the articles of incorporation may mandate the payment of dividends under specified conditions. (*Ibid.*) No such mandate exists here. The articles of incorporation grant nothing more than a preference over common shareholders *if* dividends are declared by the board.

Plaintiffs also challenge the veracity of the directors' declarations, in which the directors state that they "considered in good faith the payment of a dividend" in each year they served as directors and decided not to declare a dividend based on what they "perceived to be in the best interests of LSC." The directors offered economic reasons why a growth company like LSC is not well served by the payment of dividends. Plaintiffs attack these statements as "ex post facto explanations (not reflected in any minutes)," and "bogus." More is needed to defeat the business judgment rule than conclusory allegations of improper motives. (*Berg & Berg Enterprises, LLC v. Boyle, supra,* 178 Cal.App.4th at p. 1045.) Evidence is needed, and here there is none.

Plaintiffs simply *argue*, without the citation of any evidence, that "[t]he only reason why start up companies might not pay dividends is that they generally reinvest any profits to provide working capital," and that executive compensation itself is not a good reason to forego dividends. We are not convinced. The directors declared that executive compensation at the level they awarded was essential to retaining Mansouri, who plays critical roles at LSC. Plaintiffs have failed to present evidence that the directors' proffered explanation is dishonest or totally lacks merit. "[A]bsent one of the exceptions to the business judgment rule—fraud, oppression, dishonesty, total lack of merit, illegality, or a failure of the board of directors to become sufficiently informed to make an independent decision—a corporation is not liable for a lack of dividends." (*State Farm Mutual Automobile Ins. Co. v. Superior Court* (2003) 114 Cal.App.4th 434, 451.) Without evidence of directors' misconduct, plaintiffs' argument that executive compensation should never be preferred over the declaration of dividends—even if accepted—proves nothing more than that the directors made a mistake of judgment when considering the best use of corporate revenue. Such mistakes of judgment are protected by the business judgment rule.

Plaintiffs maintain that there was misconduct on the part of at least one director, Mansouri, who personally benefitted from the executive compensation she received. But Mansouri took no part in the compensation decisions. Compensation was awarded by two directors who received no personal benefit from the decisions. The disinterested directors declared that they believed Mansouri's compensation to be in the best interest of LSC and stated plausible reasons for that belief. Plaintiffs have failed to present any evidence undermining these declarations.

Plaintiffs assert that all directors, or at least Mansouri as the majority shareholder, violated a duty to "use their ability to control the corporation in a fair, just, and equitable manner" by using control to award an inequitable share of corporate profits to Mansouri as executive compensation while denying dividends to shareholders. (*Jones v. H.F. Ahmanson & Co.*, *supra*, 1 Cal.3d at p. 108.) But plaintiffs fail to present evidence of exactly how the directors violated the duty to act "in a fair, just, and equitable manner." (*Ibid.*) Plaintiffs seem to think it sufficient to note that Mansouri received $2.5 million in compensation in 2008, as if this fact alone demonstrates misconduct or unfairness. It does not. While asserting that the compensation paid to Mansouri was a "disguised dividend" that benefitted the majority shareholder over other shareholders, plaintiffs failed to present evidence that Mansouri's compensation was in excess of the fair market value of her services to the corporation, which is necessary to support such an assertion. (*Kohn v. Kohn* (1950) 95 Cal.App.2d 708, 714.) We cannot presume that $2.5 million in annual compensation is excessive under a fair market standard, especially in this era of multimillion dollar executive compensation.

III. DISPOSTION

The judgment is affirmed.

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Sepulveda, J.

We concur:

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Reardon, Acting P.J.

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Rivera, J.