

COSTA BRAVA PARTNERSHIP III,
L.P., et al.

Plaintiffs,

v.

TELOS CORPORATION, et al.

Defendants.

* * * * *

TELOS CORPORATION

Counter-Plaintiff,

v.

COSTA BRAVA PARTNERSHIP III,
L.P.

Counter-Defendant.

* * * * *

MEMORANDUM AND OPINION

I. Background

The instant litigation was initiated in this Court on October 17, 2005. The plaintiff was Costa Brava Partnership III, L.P. (“Costa Brava”), a Delaware limited partnership,¹ and the defendants were Telos Corporation (“Telos”), a Maryland corporation, and certain of its officers

¹ Costa Brava owns approximately 15.9% of the outstanding 12% Cumulative Exchangeable Redeemable Preferred stock (“ERPs”) in Telos. Second Amended Complaint ¶ 47 (Feb. 27, 2007).

and directors. Wynnefield Partners Small Cap Value, L.P. (“Wynnefield”),² was granted leave to intervene as an additional party plaintiff on May 24, 2006, and an Amended Complaint was filed on May 31, 2006, including Wynnefield. A Second Amended Complaint was filed on February 27, 2007. It contained seven counts and a jury demand. Following the Court’s consideration of a motion to dismiss, Counts I, II and V were dismissed by Order of June 6, 2007, and the litigation continued in anticipation of a February 2008 trial date.

From its inception, the issues in this case have been hotly contested, and the Court has conducted countless hearings on requests for preliminary injunction, emergency relief, including a request for the appointment of a receiver to manage Telos, discovery disputes and requests for protective orders. Related litigation has been initiated in Montgomery County Circuit Court, the Fairfax County, Virginia Circuit Court and in this Court. Plaintiffs, who claim they are owed at least \$79 million in accrued and unpaid dividends on their public preferred stock in Telos, see Second Amended Complaint ¶ 52, have been relentless in their complaints about the management and control of Telos and its alleged efforts to benefit the holders of its common stock at the expense of the holders of the public preferred stock. Telos has been equally adamant in its defense of its corporate acts.

Prior to filing this litigation, plaintiffs made demand on Telos’ board of directors by letter dated September 9, 2005. A second demand letter was directed to the Telos board on December 27, 2005, after suit was filed. Telos’ board established a Special Litigation Committee (“1st SLC”) on December 22, 2005, composed of outside directors Bruce Stewart and Thomas

² Wynnefield Partners owns approximately 4.1% of the outstanding 12% Cumulative Exchangeable Redeemable Preferred stock (“ERPs”) in Telos. Second Amended Complaint ¶ 48 (Feb. 27, 2007).

Owsley, to investigate Costa Brava's claims. A Board Resolution was adopted and the 1st SLC engaged counsel from the Fulbright & Jaworski law firm as independent legal advisors. A significant amount of work was completed by the 1st SLC and its counsel, with a nearly final draft report in the works on August 16, 2006, when Stewart, Owsley and four other board members suddenly resigned. It appears that the 1st SLC's final draft report, in conjunction with an Interim Report issued on May 12, 2006, would have recommended dismissal of plaintiffs' derivative claims, but no final decision was made.

When Telos' board was reconstituted in the fall of 2006, it established a 2nd SLC composed of independent directors Vice Admiral (ret.) Jerry O. Tuttle and Lt. General (ret.) Bruce R. Harris.³ The 2nd SLC engaged legal counsel from the LeClair Ryan law firm to assist it in its investigative efforts. Building on the substantial investigative work completed by the 1st SLC and its attorneys, the 2nd SLC performed additional work and reviewed thousands of documents. It reached a preliminary conclusion on May 2, 2007, to recommend dismissal and issued a Revised Report on July 20, 2007, finding no evidence to support plaintiffs' derivative claims.⁴

On August 24, 2007, Telos filed the present motion to dismiss plaintiffs' derivative claims on the basis of the Revised Report and recommendations of the 2nd SLC. The issues have been fully briefed and argued by counsel for the respective parties. The Court conducted two evidentiary hearings, on November 21, 2007, and December 4, 2007, at which it received

³ The board's resolution creating the 2nd SLC is dated October 19, 2006.

⁴ The Revised Report concluded that it was not in the company's best interests to support the plaintiffs' derivative claims, that the additional expense and distraction involved was not justified and that the claims would not likely result in significant net recovery for Telos. Revised Report of the 2nd Special Litigation Committee 41 (July 20, 2007) (hereinafter Revised Report).

testimony from both LeClair Ryan lawyers, Thomas J. McGonigle and Andrew J. Frisch, expert opinion testimony from Professor Lisa Fairfax of the University of Maryland School of Law's Business Law program and a documentary record of literally hundreds of pages. The parties also designated portions of deposition testimony for the Court's review and highlighted that testimony during the course of their arguments on the motion.

Thus, the Court has before it a well developed and rather complete record of the investigative work of the 1st SLC and 2nd SLC. The question presented at this time is whether the Court should defer to the business judgment of Telos' board and dismiss plaintiffs' derivative claims without a trial on their merits.

II. Plaintiffs' Derivative Claims

Plaintiffs' Second Amended Complaint contains two derivative claims. Count VI alleges breaches of fiduciary duties by the Telos director defendants, Robert Marino, John Wood, Geoffrey Baker, David Borland, Norman Byers, Fred Iklé, Langhorne Motley and Malcom Sterrett. Count VII alleges breaches of fiduciary duties by the Telos officer defendants, Michael Flaherty, Robert Marino, Edward Williams, John Wood, John McDuffie, Michele Nakazawa and Richard Tracy.

Besides generally alleging that the named director and former director defendants failed to act in good faith and in the best interests of the corporation, plaintiffs make specific claims that will be discussed infra at pages 21-33 in more detail, but which essentially charge the defendant directors with several schemes to divert Telos' assets to John Porter and Telos management while contending that the company was unable to pay dividends to the ERPs holders or to proceed with redemption of their public preferred shares.

Similar claims are made about the Telos officers and former officers in Count VII. A consistent theme of the Second Amended Complaint is repeated, namely that the directors and officers abdicated their responsibilities and permitted Telos' largest investor, John Porter, and its CEO, John Wood, to control the corporation.

The Court must determine here whether it was unreasonable for the 2nd SLC to decline to pursue plaintiffs' claims.

III. The Court's Standard of Review

The critical issue, which has permeated all of the parties' arguments to the Court and colored their analysis, is the appropriate standard of review to be applied by a Maryland court in passing on defendant's motion to dismiss. The determination of this question will likewise establish the proof burdens to be met by the parties and may well be outcome determinative of the motion.

The parties here have focused on two very different standards and urged the Court to adopt one or the other. As Stephen M. Bainbridge explains in his article, "The Business Judgment Rule as Abstention Doctrine":

Two conceptions of the business judgment rule compete in the case law. One views the business judgment rule as a standard of liability under which courts undertake some objective review of the merits of board decisions. This view is increasingly widely accepted, especially by some members of the Delaware [S]upreme [C]ourt. The other conception treats the rule not as a standard of review but as a doctrine of abstention, pursuant to which courts simply decline to review board decisions.

Stephen M. Bainbridge, Law and Economics Research Paper, "The Business Judgment Rule as Abstention Doctrine" ¶ 2 (2003). This philosophical dispute is at the heart of the debate presently before the Court.

Plaintiffs assert that the most appropriate standard of review is that articulated by the Supreme Court of Delaware in Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). The Court admits that there is much to admire in the Zapata opinion. It forthrightly characterizes the real tension between a corporation's use of an independent SLC to rid the corporation of time consuming and expensive shareholder litigation without merit and the need to protect shareholders' rights to police directors' actions through derivative litigation. As explained by the Delaware Supreme Court:

At the risk of stating the obvious, the problem is relatively simple. If, on the one hand, corporations can consistently wrest bona fide derivative actions away from well-meaning derivative plaintiffs through the use of the committee mechanism, the derivative suit will lose much, if not all, of its generally-recognized effectiveness as an intra-corporate means of policing boards of directors. If, on the other hand, corporations are unable to rid themselves of meritless or harmful litigation and strike suits, the derivative action, created to benefit the corporation, will produce the opposite, unintended result. It thus appears desirable to us to find a balancing point where bona fide stockholder power to bring corporate causes of action cannot be unfairly trampled on by the board of directors, but the corporation can rid itself of detrimental litigation.

Id. at 786-87 (citations omitted).

While not considering the "interest taint" of the board majority who selects the SLC a *per se* legal bar to the delegation of the board's power to an independent committee composed of disinterested board members, the Delaware court found sufficient risk in the realities of the situation to justify caution beyond adherence to the theory of business judgment. In other words, the inherent structural bias in the SLC mechanism calls for more than mere deference to the business judgment rule.

As a consequence, the Zapata court fashioned a two prong analysis. The first prong

requires the Chancery Court to inquire into the independence and good faith of the committee and the bases supporting its conclusions. The burden of proof at this stage is to be borne by the corporation. If not satisfied with the proof on any of these issues, the Chancery Court is to deny the motion to dismiss. If the corporation meets its burden of proof, the Chancery Court is to apply its own independent business judgment in determining whether the motion should be granted. When appropriate, the Chancery Court is to give special consideration to matters of law and public policy in addition to the corporation's best interests. Id. at 788-89.

Unlike Delaware, Maryland has a statutory business judgment rule, codified as Maryland Code Annotated, Corporations and Associations Article, § 2-405.1 (2007), which establishes a presumption that corporate directors act in accordance with the best interests of the corporation. Our appellate courts have consistently deferred to the business judgment of corporate boards of directors. See, e.g., Werbowsky v. Collomb, 362 Md. 581, 618-19 (2001); Bender v. Schwartz, 172 Md. App. 648, 666-68 (2007). Recognizing such deference, the circuit courts sitting in business cases have followed suit. See, e.g., Hudson v. Prime Retail, Inc., No. 24-C-03-5806, 2004 WL 1982383, at *11 (8th Cir. Md. April 1, 2004); Sekuk Global Enter. Profit Sharing Plan v. Keveaides, Nos. 24-C-03-007496, 24-C-03-007876, 24-C-03-008010, 2004 WL 1982508, at *3 (8th Cir. Md. May 25, 2004); Jasinover v. Rouse Co., No. 13-C-04-59594, 2004 WL 3135516, at *9 (5th Cir. Md. November 4, 2004).

Recognizing that shareholder derivative suits are governed by the state of incorporation, Telos, a Maryland corporation, insists that its corporate acts are entitled to business judgment deference. This extends logically to the judgment of an independent SLC to terminate such litigation in the corporation's best interests. Telos argues that the appropriate standard of review

is that set forth in a demand refused context by Maryland's intermediate appellate court in

Bender v. Schwartz, 172 Md. App. 648 (2007):

[A] court reviews the board's investigation under the business judgment rule, deferring to the decision of the board or committee not to pursue litigation unless the stockholders can show either that the board or committee's investigation or decision was not conducted independently and in good faith, or that it was not within the realm of sound business judgment. The court asks whether any rational business person could have reached that result, proceeding independently and in good faith with the best interests of the corporation in mind. A stockholder must show more than mere suspicions and must state a claim in particular, rather than conclusory terms. "The burden is on the party challenging the decision to establish facts rebutting the presumption" that the directors acted reasonably and in the best interests of the corporation.

Id. at 666-67 (internal citations omitted).

In the Court's judgment, the Maryland cases cited above indicate that Maryland corporate law follows the abstention doctrine line of cases when faced with evaluating corporate directors' business judgment. Although decidedly positioned on that side of the philosophical debate, however, it is not clear how much deference is owed to the decision of an SLC to terminate shareholder litigation. While it appears to be accurate that a majority of courts accept the so-called "special litigation committee defense" to shareholder derivative claims, that does not mean that they will turn a blind eye to the problems inherent in the scheme. In the judgment of this Court, it has a special obligation to base such an important decision as that presented here on an adequate record and to provide plaintiffs with a sufficient opportunity to raise legitimate challenges to the SLC's independence and investigative efforts. As the California appellate court noted in Desaigoudar v. Meyercord, 108 Cal.App. 4th 173, 187 (2003), the court's scrutiny of independence and reasonableness is not a perfunctory one. This Court, although functioning

within the business judgment deference scheme adopted by the Maryland appellate courts, will not grant such deference without a close examination of the evidence on the issues before it. The Court has no interest in interfering in the business and affairs of a corporation, managed under the direction of its board of directors. The Court must take seriously, however, any evidence that continuation of the litigation is actually in the corporation's best interests.

The Court, therefore, finds that plaintiffs bear the burden of proof on the issues of independence, good faith and reasonableness. If the record supports the 2nd SLC's Revised Report and recommendations, the plaintiffs' derivative claims will be dismissed with prejudice.⁵

IV. Procedural Posture

Telos filed its motion to dismiss plaintiffs' derivative claims pursuant to Md. Rule 2-502.

The rule reads as follows:

If at any stage of an action a question arises that is within the sole province of the court to decide, whether or not the action is triable by a jury, and if it would be convenient to have the question decided before proceeding further, the court, on motion or on its own initiative, may order that the question be presented for decision in the manner the court deems expedient. In resolving the question, the court may accept facts stipulated by the parties, may find facts after receiving evidence, and may draw inferences from these facts. The proceedings and decisions of the court shall be on the record, and the decisions shall be reviewable upon appeal after entry of an appealable order or judgment.

Defendant cites the statement of the Court of Appeals in Werbowsky v. Collomb, 362 Md. 581, 621 (2001), that a demand futility question is "a perfect candidate for resolution pursuant to Maryland Rule 2-502" to support its view that the present motion should be treated similarly. Defendant points as well to the Court of Special Appeals' approval of the use of this

⁵ Telos has argued that all remaining claims are essentially derivative and should be dismissed, but the Court declines to so hold here.

procedural device to determine an analogous question in Bender v. Schwartz, 172 Md. App. 648, 663-64 (2007). The Court concurs.

Having determined that a Maryland court faced with a motion to dismiss shareholder derivative claims upon the recommendation of an independent board special litigation committee will not adopt the standards and burdens assigned the parties under Delaware corporate law, Zapata v. Maldonado, 430 A.2d 779, 788-89 (Del. 1981), this Court will likewise reject the Zapata court's suggestion to treat the present motion as one for summary judgment. Id. at 788.

In the Court's judgment, Md. Rule 2-502 is a more appropriate vehicle for determination of the present motion. Limited discovery, the evidentiary hearings conducted and the record before the Court are entirely consistent with the rule's purpose. See Niemeyer and Schuett, Maryland Rules Commentary 361-63 (3d ed. 2003).

V. The Motion to Dismiss the Derivative Claims

The factual determinations to be made by the Court in connection with the present motion are: (1) were the 2nd SLC members independent and did they perform their duties in good faith?; (2) did the 2nd SLC undertake a reasonable investigation of plaintiffs' derivative claims?; and (3) are the findings and conclusion of the 2nd SLC reasonable?

A. The 2nd SLC's Independence and Good Faith

The Revised Report of the Special Litigation Committee of Telos Corporation dated July 20, 2007, sets forth at pages 11-14 the bases for its finding that the 2nd SLC members and their legal advisors were independent from Telos, its officers and directors, and disinterested in the present litigation.

The plaintiffs have raised issues concerning Director David Borland's military service

under General Harris' command and the selection of the LeClair Ryan law firm. They assert that the law firm was recommended by defendant Flaherty⁶ and has two former partners from the McGuire Woods firm which represents Telos, including Thomas McGonigle.⁷ But neither claim was supported by evidence that the 2nd SLC's independence was compromised thereby.

The real focus of plaintiffs' attack on the 2nd SLC's independence related to Adm. Tuttle's deposition testimony and to Thomas McGonigle's and Andrew Frisch's hearing testimony. In the deposition portion of Adm. Tuttle's testimony, reviewed by the Court and highlighted by plaintiffs in argument, he appears to view his role, in part, as requiring him to "make the litigation go away" in order for Telos to get back to business and make profits. Deposition Testimony of Adm. Tuttle at 108-09 (Oct. 24, 2007). He characterized himself as a former Navy officer who has developed a talent as a businessman to save troubled companies, like Telos. Plaintiffs assert that this "bias" informed the investigative work of the 2nd SLC, with Adm. Tuttle and Gen. Harris essentially rubber-stamping the findings and recommendations of counsel without careful scrutiny.

Plaintiffs also question the independent judgment of the LeClair Ryan lawyers on the basis of their almost total deference to the work of the 1st SLC's counsel from Fulbright & Jaworski, whose expertise they extolled. Hearing Testimony of Messrs. McGonigle and Frisch (Nov. 21, 2007). Plaintiffs contend that McGonigle and Frisch brought to their work a clear bias

⁶ Thomas McGonigle testified that LeClair Ryan had been recommended also by William McLucas, former director of division of enforcement at the SEC. Mr. McLucas currently works at Wilmer Hale. Hearing Testimony of Mr. McGonigle (Nov. 21, 2007).

⁷ Plaintiffs also suggested a problem with Mr. McGonigle receiving a copy of the complaint in this action before the 1st SLC was formed, but there was no evidence to support any untoward motive or taint.

in favor of the preliminary conclusions of the 1st SLC and that they received marching orders to look for signs of “dishonesty”⁸ on the part of Telos’ management and directors rather than to focus on the substance of the derivative claims.

Telos counters that the members of the 2nd SLC⁹ were new to its board, had no prior connections with Telos, were not defendants in the litigation, and obviously did not participate in the actions forming the subject matter of plaintiffs’ claims. Telos further argues that Adm. Tuttle and Gen. Harris do not stand to benefit personally from the dismissal of the derivative claims and that they maintained no close personal relationship with any of the named defendants.

While Gen. Harris did have some prior association with individuals in Telos’ executive management, as well as Director David Borland, no bias appeared to color the 2nd SLC’s findings with respect to Borland or Telos’ officers. In fact, the 2nd SLC stated that the failure of Borland and Wood to disclose the fact that Borland had been provided a corporate membership at the Robert Trent Jones Golf Club created an “appearance of impropriety” due to Borland’s role as chair of the Telos Compensation Committee, which authorized a \$750,000 bonus to Wood in February 2005. Revised Report 16 n.13. The 2nd SLC went on to recommend complete disclosure of all corporate perquisites in its Revised Conclusions. Revised Conclusions 4. The 2nd SLC also found this issue to be a contributing factor to the Telos board resignations in August 2006. Revised Report 14.

As described in more detail infra, pages 21-33, the 2nd SLC did not limit the scope of its

⁸ Gen. Harris testified in his deposition that the first thing he and Adm. Tuttle asked their lawyers to do was to determine if CEO John Wood was guilty of the charges against him made by the plaintiffs. Gen. Harris Deposition at 56-57. In the Court’s view, this inquiry was directly linked to plaintiffs’ derivative claims.

⁹ The independence of the 1st SLC and its legal advisors is not challenged.

inquiry merely to allegations of breach of fiduciary duties by defendants. Finally, and importantly, both Adm. Tuttle and Gen. Harris had excellent credentials to undertake an SLC investigation as independent board members.

Defendant denies any basis to challenge the LeClair Ryan legal advisors as well. It contends that potential conflicts were fully disclosed and proper precautions were put in place to avoid any actual conflicts. Mr. McGonigle left McGuire Woods in 2001, has no recollection of performing work for Telos, and the evidence indicates de minimis representation at most. The other former McGuire Woods partner at LeClair Ryan, William Donnolly, was carefully isolated from the work of the 2nd SLC.

It appears to the Court that plaintiffs' bias claims regarding the 2nd SLC and its counsel are not actually challenges to the ability of the 2nd SLC to be independent in an objective sense.¹⁰ They are rather assertions that a subjective bias affected the 2nd SLC members' ability to act independently.

The case law, whether it embraces the process of Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979) (abstention doctrine) or Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (standard of liability), focuses its analysis of an SLC's independence on the benchmark concepts of "good faith," "objectivity" and lack of "bias."¹¹ Unlike situations where interested directors

¹⁰ This analysis is consistent with the statement in Bender v. Schwartz, 172 Md. App. 648, 666 (2007): "By making a demand, the shareholder(s) 'are deemed to have waived any claim they might otherwise have had that the board *cannot independently act* on the demand.' Scattered Corp. v. Chicago Stock Exchange, Inc., 701 A.2d 70, 71, 74 (1997). The plaintiff may still allege, however, that the board *in fact* did not act independently or that demand was wrongly refused." Bender, 172 Md. App. at 666 (citing Scattered Corp., 701 A.2d at 71) (emphasis in original).

¹¹ There is a lack of clarity in the case law as to which analysis a Maryland court will apply. Under differing circumstances, federal courts faced with this determination have gone in

maintain control of the SLC's decision-making or where the SLC has an obvious conflict of interest, subjective bias claims are difficult to assess. Here, the Court is asked to determine whether Adm. Tuttle's candor about his desire to get past the litigation so impaired his judgment as to cause him to ignore evidence in support of plaintiffs' derivative claims.¹² Also, the Court is to decide whether the LeClair Ryan attorneys' views of the quality of the work performed by their predecessors from Fulbright & Jaworski caused them to overlook evidence that defendants had breached their fiduciary duties.

The record before the Court, however, provides little direct evidence that bias undermined the findings and conclusions of the 2nd SLC. Citing Strougo v. Bassini, 112 F. Supp. 2d 355, 362 (S.D.N.Y. 2000), and the American Law Institute's Principles of Corporate Governance, Telos' expert witness, Professor Lisa Fairfax, opined that the 2nd SLC met good corporate governance standards for independence. Prof. Lisa Fairfax, Expert Witness Report 3-5 (November 7, 2007) (hereinafter Fairfax Report). Notably, she quoted McLaughlin on Class Actions § 9:18: "At bottom, an SLC is independent if it is in a position to base its decision on the merits of the issue presented rather than being governed by extraneous considerations or influences." Joseph M. McLaughlin, McLaughlin on Class Actions § 9:18 (3d ed. 2006). Other than the testimony noted earlier, plaintiffs can point to nothing else in the extensive record

different directions. Compare Grossman v. Johnson, 89 F.R.D. 656, 664 (D. Mass. 1981) and Strougo on Behalf of Brazil Fund, Inc. v. Padege, 1 F.Supp.2d 276, 281 (S.D.N.Y. 1998) with Rosengarten v. Buckley, 613 F.Supp. 1493, 1504 (D. Md. 1985). The Court believes, however, that the Maryland appellate courts have now come down on the Auerbach side of the debate. See Werbowsky v. Collomb, 362 Md. 581 (2001); Bender v. Schwartz, 172 Md. App. 648 (2007).

¹² Stein v. Bailey is instructive as to the attitude of the members of the 2nd SLC, particularly Adm. Tuttle. That decision specifically finds an SLC's determination to "put this episode behind it" to have been made in good faith. Id. at 695.

before the Court which supports their theory of a biased 2nd SLC,¹³ with the exception of the process undertaken to investigate plaintiffs' claims. Thus, this issue, as framed by plaintiffs' arguments, bleeds over into the second factor that the Court must consider on the motion to dismiss. See Strougo v. Bassini, 112 F.Supp. 2d 355, 365 (S.D.N.Y. 2000) ("The Court's focus in this area is intertwined with its analysis of whether the SLC conducted a reasonable investigation."). On the evidence presented on the issue of the 2nd SLC's independence alone, the Court is not persuaded that Adm. Tuttle, Gen. Harris or their legal advisors were compromised to the point where they could not base their decision on the merits of plaintiffs' derivative claims.

B. The Reasonableness of the 2nd SLC's Investigation

The 1st SLC, created in December 2005, was comprised of directors Thomas Owsley and Bruce Stewart. It retained counsel from Fulbright & Jaworski as independent legal advisors and conducted its investigation until mid-August 2006, reviewing over 70,000 pages of documents and interviewing 16 witnesses, including most of the defendants, Telos management and investment bankers from Jefferies & Co., Inc. Seven drafts of an SLC report were prepared addressing the issues raised by plaintiffs' claims. The 1st SLC issued an interim report on May 12, 2006, and its final draft report was dated August 16, 2006, the date upon which directors Owsley, Stewart and four others resigned from Telos' board. That draft contained a recommendation that continuing the litigation was not in the best interests of the corporation.

When Telos' board was reconstituted in October 2006, the 2nd SLC was established and

¹³ The unexecuted Draft Proxy Agreement with Respect to Capital Stock of Telos Corporation, dated September 19, 2006, pursuant to which both Adm. Tuttle and Gen. Harris were to serve as proxies for John Porter, by its terms requires independent judgment and cannot form the basis for a valid bias claim. Draft Proxy Agreement at 7 (September 19, 2006).

composed of Lt. Gen. (Ret.) Bruce Harris and Vice Admir. (Ret.) Jerry Tuttle. They retained the law firm LeClair Ryan as independent legal advisors. The LeClair lawyers obtained and reviewed approximately 35 boxes of materials from Fulbright & Jaworski, including witness interview notes and drafts of the preliminary reports of the 1st SLC. Both the members of the 2nd SLC and their counsel believed that directors Owsley, Stewart and Fulbright & Jaworski had conducted an extensive investigation and elected not to re-do all of their work. Instead, they saw their task as evaluating the work of the 1st SLC and supplementing it with additional interviews and document review. Additional work was created when plaintiffs filed a second amended complaint on February 27, 2007, containing allegations about Telos' investment in its Enterworks subsidiary.

On March 29, 2007, the 2nd SLC presented a draft summary of its conclusions to the Telos board. On May 3, 2007, it presented a report to the board. The 2nd SLC's report concluded that it was not in the corporation's best interests to pursue the litigation. Thereafter, the 2nd SLC collected and reviewed additional documents and conducted additional interviews on issues relating to the Enterworks allegations. When this additional work was completed, the 2nd SLC submitted a Revised Report, dated July 20, 2007, reaching the same conclusion.

Plaintiffs here challenge the thoroughness, direction and premises upon which the 2nd SLC's investigation was conducted. Costa Brava asserts that the 2nd SLC engaged in "only a subjective inquiry" of their derivative claims. Their contention is that the independent directors essentially delegated the entire investigation to their legal advisors from LeClair Ryan and, in doing so, skewed the investigation to issues of "dishonesty" by officers and directors rather than

to the merits of their claims.¹⁴ According to plaintiffs, the 2nd SLC glossed over the serious allegations of mismanagement by CEO John Wood, which almost resulted in his termination. Moreover, plaintiffs assert that the 2nd SLC relied too heavily on the depositions taken in connection with the receivership motion, which this Court disposed of by Order dated November 29, 2006. They challenge the timing of the 1st SLC's investigative work because it predated the filing of the second amended complaint, the actions concerning the potential termination of John Wood, the August 2006 resignations and the information concerning director David Borland and his corporate golf club membership. Plaintiffs further challenge the record upon which the 2nd SLC based its conclusions, charging that the LeClair Ryan lawyers failed to obtain the documents sought from defendants by Fulbright & Jaworski in connection with the 1st SLC, merely engaged in a "verification" process with Telos' management on critical issues and had no direct contact with directors Owsley or Stewart, even though the 2nd SLC relied so heavily upon their efforts. Plaintiffs contend that Adm. Tuttle and Gen. Harris were not adequately informed, not as careful about the dual roles that they played as SLC members and directors of the corporation, and that their lack of direct involvement in the investigation significantly impaired that process.¹⁵

As a starting point for the Court's analysis of the reasonableness of the 2nd SLC's investigation, it appears that the heart of the matter is really the reasonableness of the 2nd SLC's decision to rely so heavily on the work conducted by the 1st SLC and its counsel. In Stein v.

¹⁴ As indicted supra, at page 12-13, the Revised Report addressed the significant issues raised by plaintiffs and was not unduly limited in scope.

¹⁵ The 2nd SLC's delegation of the direct contact with interviewees to its legal advisors did not render its process unreasonable, according to Professor Fairfax's testimony and Expert Witness Report. Fairfax Report 7.

Bailey, 531 F.Supp. 684, 694 (S.D.N.Y. 1982), the federal court in New York, applying a Zapata analysis under Delaware law,¹⁶ held that it was reasonable for an SLC to review the investigative work already performed by the company's Audit Committee on shareholder stock plan claims without re-doing that committee's work. In her report, Professor Fairfax noted this case law and pointed out that the 1st SLC here undertook its investigation for more than six months, that it was extensive and that its work, although incomplete, was recently performed. Fairfax Report 5. In fact, the 1st SLC left off in August of 2006 and the 2nd SLC picked up on October 19, 2006, merely two months later. The evidence is that the 2nd SLC met six to twelve times over the course of nine months and that Adm. Tuttle and Gen. Harris communicated with their attorneys from LeClair Ryan via telephone and e-mail an average of 1-2 times per month. Hearing Testimony of Mr. McGonigle (Nov. 21, 2007). The Revised Report issued July 20, 2007, is of adequate length, demonstrates sufficient identification of plaintiffs' claims and analysis thereof and, in this Court's judgment, is not fatally flawed by either the selection of the LeClair Ryan independent legal advisors or the delegation to them of most of the work.

In order for plaintiffs to establish a lack of good faith or a biased investigation, they must come forth with "[p]roof . . . that the investigation has been so restricted in scope, so shallow in execution, or otherwise so pro forma or halfhearted as to constitute a pretext or sham[.]" Stein, 531 F.Supp. at 695 (quoting Abramowitz v. Posner, 513 F.Supp. 120, 132 (S.D.N.Y. 1981) (quoting Auerbach, 393 N.E.2d at 1002)). The record in the present case does not approach that kind of proof. Plaintiffs' complaints here include the fact that neither Adm. Tuttle nor Gen.

¹⁶ It is worthy of note that the Stein court read Zapata to require a two prong analysis only in demand excused shareholder cases. As for cases like this one, even the Zapata analysis concedes more deference to the will of the board of directors because the shareholders never acquired the ability to sue. Stein, 531 F.Supp. at 692.

Harris personally attended witness interviews, although they were briefed on the substance of those interviews by LeClair counsel; that the 2nd SLC and/or its attorneys failed to interview the 1st SLC or its legal advisors about the proposed termination of John Wood, a termination which did not occur; that the depositions reviewed were taken in connection with plaintiffs' unsuccessful receivership motion and were unduly limited; that the 2nd SLC failed to obtain information sought by the 1st SLC but not received; and finally, that the 2nd SLC "verified" information provided by the 1st SLC by submitting same to Telos' management.

None of these charges, individually or collectively, is sufficient to convince the Court that the 2nd SLC conducted a fatally flawed investigation or acted in bad faith. The scope of the work performed by the combined efforts of the 1st and 2nd SLCs was extensive, even if it did not turn over every stone. The members of the 2nd SLC were adequately informed despite the fact that they did not take a "hands on" approach to the investigation. Moreover, the 2nd SLC did investigate the circumstances surrounding the so-called "bill of particulars" against CEO John Wood. Because much of those claims were directly related to other plaintiffs' claims concerning Xacta stock options and the golf club membership of Director Borland, there was limited evidence of independent wrongdoing by John Wood. Indeed, it seems inconsistent for plaintiffs to complain about a curtailed investigation of Wood's activities while also criticizing the 2nd SLC for directing its counsel to look for "dishonesty" on the part of Telos' officers and directors. The 2nd SLC did not stand to gain much from interviewing Owsley, Stewart or their lawyers¹⁷ on these points because they had what little evidence existed before them and determined that the

¹⁷ The Court does not find that the 2nd SLC had an obligation to interview Mr. Borland or representatives of the Robert Trent Jones Golf Club either. It had the facts before it concerning non-disclosure of his membership and his personal and business use of it.

claims were insubstantial. In light of the large volume of documents actually reviewed in this case, the Court is not prepared to find that the record is inadequate, even if all records sought were not received. At some point in any investigation, it is reasonable to conclude that the investigation is complete, if not exhaustive. Finally, the Court is not persuaded that the “verification” process utilized with respect to certain company information unfairly handed the responsibilities of the 2nd SLC over to company management. The 2nd SLC’s Revised Report demonstrates a sufficient understanding of the facts to prove that an independent analysis was undertaken.

Professor Fairfax was permitted to offer expert testimony on the present motion with respect to “best practices” of corporate governance. While not amounting to legal standards of conduct, “[a]spirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability.” In re Walt Disney Co. Derivative Litigation, 907 A.2d 693, 745 n.399 (Del. Ch. 2005), *aff’d en banc*, 906 A.2d 27 (Del. 2006) (citing Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000)). In her Expert Witness Report, Professor Fairfax notes: “The reasonableness of an SLC’s investigation depends on a variety of factors including (1) whether the committee sought the assistance of independent counsel, (2) the length and nature of the SLC report, (3) whether the SLC properly identified relevant claims, (4) whether the SLC interviewed or reviewed the testimony of relevant witnesses, (5) whether the SLC and its counsel reviewed relevant documents, and (6) the number of times the committee met.” Fairfax Report 5. See Bender, 172 Md. App. at 670-74; McLaughlin, supra; Am. Law Inst. Principles of Corporate Governance §

7.09 (1992). Taking those factors into consideration here, Professor Fairfax opined that the 2nd SLC satisfied the criteria for a reasonable investigation performed in good faith. Fairfax Report 5. Her testimony was to the same effect, Hearing Testimony of Prof. Fairfax (Dec. 4, 2007), and the Court concurs.

C. The Reasonableness of the 2nd SLC's Findings and Conclusions

The Director's Resignations

The Revised Report of the 2nd SLC traces the history of the failed efforts of the Telos board to involve plaintiffs in a Strategic Group to address the disparate interests of the company's common shareholders and its public preferred shareholders. It details the creation of Telos' Transaction Committee and its unsuccessful efforts to resolve the dispute through a strategic transaction, leading to the withdrawal of the DLA Piper law firm as counsel to the directors on the Transaction Committee and, in short order, to the resignations of the six directors constituting the Transaction Committee and the 1st SLC.

Three issues are identified as contributing directly or indirectly to the resignations: (1) an impasse on how to resolve the competing interests of the company's stakeholders; (2) a rift among board members caused by Director Borland's failure to disclose his use of a company golf membership; and (3) the withdrawal of DLA Piper as counsel to certain directors. The Revised Report goes on to address these issues and their impact on the decisions of the six directors to resign from Telos' board. Revised Report 15-18.

Lying at the heart of the director resignations is, of course, the dispute which triggered the present lawsuit. Plaintiffs contend that, in resisting a sale of Telos and an anticipated payment of the dividends on their public preferred shares, Telos' management in the person of

CEO John Wood violated its fiduciary duties to the company.¹⁸ Wood's involvement with the three above-cited issues emerged from the SLC investigation. The evidence showed that in the face of opposition by John Porter to a sale of the company, Wood attended a board meeting on August 15, 2006, and suggested an alternative course of action involving a valuation and potential sale of Telos' business lines and assets. Revised Report 15. If this involved a sale of Xacta, however, it would trigger stock options for Wood at the expense of ERPs holders. By the time Wood made this suggestion to the board, the 1st SLC had already addressed the Xacta stock option issue in its Interim Report of May 12, 2006. Thus, the board was aware of the problem and had the benefit of the 1st SLC's recommendations regarding any sale of Xacta. The 2nd SLC adopted those recommendations, Revised Conclusions 3-4, and found no breach of duty by Wood.

As to the Borland golf membership, its non-disclosure by Wood or Borland caused board contention, compounded by Borland's refusal to resign from Telos' board. The 2nd SLC considered this a significant factor contributing to the other board resignations. It also found that Borland's receipt of use of the Robert Trent Jones Golf Club membership created an appearance of impropriety because he was chair of the company's Compensation Committee when it authorized a \$750,000 bonus to John Wood on February 8, 2005. But the 2nd SLC reviewed the available evidence on the timing of these events and found no proof of corrupt motives attributable to Borland or Wood.

The final issue, DLA Piper's withdrawal of representation to certain directors, arose from

¹⁸ The Second Amended Complaint also contained a Count V against John Porter for shareholder oppression, but the Count was dismissed with prejudice by this Court's Order dated June 6, 2007.

a perceived conflict of interest in its dual representation of the directors and of Enterworks, Inc., one subject of the Telos corporate structure controversy. In the course of the investigation of this issue, the 2nd SLC found that Enterworks had recently acquired a Seattle-based web design company called Saltmine, of which John Wood was a director. The 2nd SLC determined, however, that Wood had made a timely disclosure of his interests in Saltmine, Revised Report 17, again finding no breach of duty to Telos.

In connection with the investigation of DLA Piper's withdrawal as counsel, the 2nd SLC looked into the claims against John Wood outlined in the David Clarke e-mail of August 5, 2006. This matter is addressed merely by footnote at page eighteen of the Revised Report and plaintiffs allege an inadequate investigation of the claims. A number of them relate, however, to the proposed Xacta sale and/or to the Borland golf membership and were investigated separately. None found substantial support in the available evidence and the reconstituted Telos board has taken no action to terminate or sanction John Wood. It is reasonable, therefore, to find no evidence of a breach of fiduciary duty on the record reviewed by the 2nd SLC.

In addition to the written record, the 2nd SLC reviewed the depositions of the resigned directors concerning their reasons for leaving the Telos board. The 2nd SLC concluded that the directors' inability to resolve the on-going dispute with plaintiffs was the primary reason for their resignations. Coupled with the evidence concerning the Borland golf membership and the DLA Piper withdrawal, the investigators concluded that the directors' resignations did not warrant continued pursuit of plaintiffs' derivative claims. The Court finds that conclusion rational and supported by the record.

Corporate Structure and Xacta Stock Options

The 2nd SLC's investigation revealed that Telos has a complex corporate structure not fully understood by its directors. The Revised Report sets forth the historical development of this corporate structure. Revised Report 18-22. As now constituted, and since July 2000, Telos wholly owns a number of subsidiary corporations through the vehicle of a holding company known as "ubIQuity.com." The Revised Report describes the business plan as follows:

Put another way, the plan was for the corporate aspects of the operation to remain with Telos, and for the business aspects to be placed in the subsidiaries, such as Enterworks and later Xacta, which would mature and develop value, and then be sold more easily because they were separate entities (meaning the purchaser would not be concerned with Telos' financial situation to the same extent as they would if they were dealing with Telos directly.). Part of the plan to "incubate" and eventually spin off businesses would necessarily entail transferring assets from Telos to its subsidiaries.

Revised Report 21-22.

The 2nd SLC's investigation concluded that the available evidence did not support plaintiffs' claims that Telos' corporate structure was intended to enrich senior management or John Porter at the expense of the ERPs holders. It found that the available evidence did not contradict Telos' position that the elements of corporate structure challenged by plaintiffs (e.g., Xacta and Enterworks) were intended to advance the company and to produce the type of capital event that would benefit all company stakeholders, including the ERPs holders. The 2nd SLC recognized that upon a sale of Xacta and a transfer of assets from Telos to Xacta, option holders would enjoy priority over ERPs holders and that a future capital event may not produce sufficient liquidity in Telos to satisfy all its stakeholders. But the Court notes that no such event is in the works and any proposed transaction will be reviewed by Telos' board, including the

Class D directors.¹⁹ Moreover, the board has committed itself to perform that review in light of the Revised Report's recommendations to serve the legitimate interests of each holder of the company's securities to the extent possible. The Court cannot say that, under these circumstances, pursuit of plaintiffs' derivative claims would result in any significant recovery to the corporation. Thus, the 2nd SLC's conclusion on this issue is reasonable.

The Revised Report also recounts the allocation of Xacta stock options to Telos management, primarily to Messrs. Wood, Flaherty, Marino, Williams and Tracy. Revised Report 24-25. The 2nd SLC's investigations revealed that if all Xacta options held by Telos executives and employers were exercised they would amount to over 30% of the then issued and outstanding Xacta common stock. Revised Report 25.

Plaintiffs have challenged this concentration of Xacta stock options in Telos insiders, alleging that the company and its officers are engaged in a scheme to divert Telos' assets and profitable businesses away from the company in order for Wood and others to exercise their options to the detriment of the ERPs holders. They charge that the 2000 Xacta Stock Incentive Plan was not disclosed to Telos' stakeholders or to the SEC. Plaintiffs question the growth in value of the Xacta stock options from approximately \$4.875 million in 2004 to between \$30-50 million in 2006, according to John Wood. Finally, plaintiffs allege accounting improprieties in Telos' public filings with the SEC.²⁰

¹⁹ The Class D directors are, of course, Seth Hamot and Andrew Siegel, both of whom are principals of Costa Brava and, consequently, plaintiffs in this action.

²⁰ Costa Brava cites the Court to a jury verdict in the Virginia litigation finding that Telos' outside auditors aided and abetted breaches of fiduciary duties by its officers and directors. This finding is recent and was not included directly in the claims which the 2nd SLC was authorized to investigate. To the extent that it may indicate misstatements of Telos' ERPs obligations in the company's public filings, plaintiffs have raised the issue here. The Revised

The Court agrees with Plaintiffs that the Revised Report glosses over many of the issues raised by them in connection with the valuation, disclosure of the Xacta stock options and Telos' accounting practices. But the "bottom line" on the Xacta question is whether the 2nd SLC made a reasonable business decision not to pursue plaintiffs' derivative claims based on the above-listed allegations.

The Revised Report finds that the available evidence does not support the scheme plaintiffs allege to divert assets and to avoid meeting Telos' obligations to its public preferred shareholders. Revised Report 27. It references Telos' board resolutions of January 1, 2003, and January 31, 2003, to the effect that Xacta options outstanding and unexercised under the 2000 Xacta Stock Incentive Plan may now only be exercised upon the occurrence of a change of control. Revised Report 26. The 2nd SLC also accepted Telos' position that the quantity of options awarded was large because a sale of Xacta would necessarily require a transfer of Telos' assets to Xacta for its stock, thereby diluting the holdings of Xacta stockholders. Revised Report 27.

As Telos argues here, the 2nd SLC had the benefit of the 1st SLC's extensive review of the Xacta stock option issues. Following the issuance of its interim report on May 12, 2006, Telos' board approved a resolution of the same date implementing its recommendations and allowing for Telos' board to review and evaluate any future sale or asset transfer involving Xacta. These actions foreclosed the possibility of the alleged "scheme" becoming successful. The Court can conceive of little purpose in pursuing the breach of fiduciary duty claims related to Xacta, given these developments, which were occasioned by the investigation performed by the 1st SLC.

Report does not address that issue, presumably because any such misstatement is not material to plaintiffs after Telos' June 2005 admission of error.

Under the circumstances, the decision of the 2nd SLC is reasonable.

Management Compensation

The 2nd SLC also investigated plaintiffs' claim that the Telos officers received exorbitant salaries and bonuses and lucrative stock options despite their assertion that the company was insolvent and unable to pay dividends to the ERPs holders. It determined not to support plaintiffs' derivative claims on this ground.

The expressed basis for the 2nd SLC's conclusion is that Telos has employed a Compensation Committee since 1995, which sets compensation for the CEO and approves his recommendations for the salaries of other officers and employees. The Committee apparently felt that this was a reasonable and standard corporate practice given the wide discretion the board has in setting compensation. Professor Fairfax agreed that it is compatible with good corporate governance practice. Fairfax Report 10.

Moreover, the Telos Compensation Committee had engaged the firm of Watson Wyatt in 2006 to review the compensation of its eight most senior executives. Its findings confirmed that their compensation was not excessive for comparable corporate executives. The 2nd SLC relied on this report to conclude that there was no evidence of a scheme to divert benefits to the Telos executives and away from plaintiffs. Revised Report 31.

Finally, the 2nd SLC declined to pursue plaintiffs' claims related to compensation based on Xacta stock options, finding that the options have little or no current value and cannot be "quantitatively considered" until the consummation of a capital event making them exercisable. It characterized such an occurrence as a "hypothetical future event." Revised Report 28. The Court concurs that this is an inadequate basis upon which to pursue derivative claims.

Plaintiffs complain that the Watson Wyatt report of September 6, 2006, ignores the history of exorbitant executive compensation from 1998 to 2005 while the company was reporting operating losses. They contend that this is sufficient evidence of a scheme to support their derivative claims. The Court, however, disagrees. The Compensation Committee structure in place during those years, combined with the independent analysis of comparable executive compensation performed in 2006, established a reasonable basis for the 2nd SLC's conclusion on this issue. Plaintiffs were unable to meet their burden of proof to convince the Court to the contrary.

The ERPs

The 2nd SLC determined that a derivative claim based upon Telos' failure to pay dividends on or to redeem the ERPs was not justified. It predicated that conclusion upon four findings: (1) the terms of the ERPs themselves; (2) the statutory restrictions on dividend payments contained in Maryland Code Annotated, Corporations and Associations Article, § 2-311 (2007); (3) the November 7, 2005, McGuire Woods opinion concerning Telos' loan agreement with Wells Fargo; and (4) a finding of no false or misleading conduct by Telos relating to its earlier stated intention to pay the ERPs holders payment-in-kind ("PIK") dividends, which were not paid, and its accounting treatment of those proposed PIK dividends.

The Court cannot disagree with the first two findings, which are based in part on its ruling of November 29, 2006, that payment of the dividends and redemption of the ERPs were subject to the availability of funds. The 2nd SLC's third basis concerning the impairment of Telos' credit line with Wells Fargo was also the subject of earlier proceedings before this Court. Telos' reliance on the McGuire Woods opinion to withhold ERPs dividends while debt on the

credit facility remains outstanding is both reasonable and supported by the record. Lastly, the company changed its position on payment of PIKs to plaintiffs when it received a 1992 legal opinion indicating that they were not permitted under its existing corporate charter. Although not correcting its stated intentions, the company never amended its charter and, instead, turned its focus to other means to solve its dispute with the ERPs holders. As the Revised Report points out, this ultimately amounts to a valuation issue, which is premature. The decision not to pursue plaintiffs' claims on this issue is reasonable as well.

John Porter's Note and Consulting Agreement

The essence of the plaintiffs' claims regarding John Porter's note and consulting agreement are that: (1) the 17% interest rate on the 1995 subordinated note issued to Porter in exchange for a \$5 million loan is excessive; (2) the pre-payment penalty of up to \$13.5 million inhibits the company's ability to consummate a strategic transaction which would allow payment of ERPs dividends; and (3) Porter's consulting fees are bogus.

The 2nd SLC's investigation of these issues revealed that Porter's note was obtained at a point in its history when Telos could not access other sources of capital. Its high interest rate is a reflection of the leverage acquired by Porter as the company's principal benefactor. The note and its pre-payment penalties have been extended several times since with the consent of Wells Fargo, which insisted that Telos' indebtedness to Porter remain subordinate to its obligations to Wells Fargo. The 2nd SLC also found that Porter's consulting fees reflect compensation for his services to the company as well as a corporate desire to reward him for his good will and historical beneficence.

Plaintiffs point out, however, that Porter has received more than \$20 million in payments

from Telos, representing principal and interest on his note and consulting fees. He has also received \$15.2 million in pre-payment penalties on the note. The consulting agreement has apparently not been subject to board review until recently and there is scant evidence of services actually rendered. The Revised Report offers no real analysis of the company's credit situation or its ability to retire the Porter note and eliminate an obstacle to its capital restructuring.

The Court agrees that the record before it is thin on evidence that the Porter note and consulting agreement continue to be viable business commitments for Telos. On the other hand, the 1st SLC had interviewed John Porter and a number of other witnesses concerning the company's on-going relationship with him. The 2nd SLC raised these issues again with John Wood and Michael Flaherty. Based upon the evidence obtained, the 2nd SLC concluded that the interest rate on the Porter note reflected the risk undertaken by Porter at the time it was executed and his status as a lender of last resort. The extensions of the pre-payment penalties²¹ were required to secure financing from Wells Fargo. Finally, there was witness interview evidence from both Porter and Wood that Porter had contributed significant consulting services to Telos in terms of business contacts, financial support, marketing and business strategies, and "ambassadorial" services with vendors, customers and third parties, as outlined in the consulting agreement itself.

While the note pre-payment penalties remain an obstacle to a sale of Telos, Porter has expressed the view that such a transaction now would be premature and that the company will bring more value over time.

²¹ The terms of the subordinated note were not negotiated by Porter directly, but rather by Perry Chapman of Graphite Capital, a European leveraged buy-out firm, according to Porter and Wood.

For these reasons and on the basis of the admittedly sparse record compiled concerning the Porter issues, the 2nd SLC determined that Telos' relationship with Porter represents reasonable business judgment and is not a ground to support plaintiffs' derivative claims. Plaintiffs' suspicions concerning Porter and Wood are insufficient to meet their burden of proof on this issue. Thus, the Court does not disagree with the 2nd SLC.

Enterworks

The Second Amended Complaint first raised issues concerning Telos' wholly-owned subsidiary, Enterworks, Inc. The 2nd SLC investigated plaintiffs' claims and learned that Enterworks was incorporated in 1994 and was considered a prospect for an initial public offering, but that opportunity was lost in 2000 when the value of "tech stocks" declined rapidly.

The issues raised concerning Enterworks go to the company's initial investment in it, its continuing investments in it and its value. Plaintiffs contend that Enterworks represents a failed investment and that it was conceived as yet another scheme to enrich John Porter, John Wood and others at the expense of ERPs holders.

Telos claims that the planned Enterworks IPO would have satisfied the claims of all Telos' stakeholders, including the ERPs holders.

Because that event did not occur, the investigation naturally focused on Telos' on-going investment in Enterworks. The company produced evidence to show that Enterworks represented a net gain of \$19,853,000 as of May 2007. It further advised the Committee that Enterworks was valued this year at between \$25 and \$35 million. Telos provided the 2nd SLC with a summary of ownership interests in Enterworks, from which the Committee was able to calculate stock option values to John Wood in the event of a sale of Enterworks. These figures

satisfied the 2nd SLC that Enterworks is a reasonable business investment for Telos and not a scheme to divert company assets from plaintiffs.

Plaintiffs take exception to the 2nd SLC's analysis and conclusions regarding Enterworks. They charge that Telos' investment and expenses related to Enterworks amount to \$39 million, but that Telos' filings with the SEC show an equity value of that investment at under \$200,000. Further, they claim that the interest on Enterworks' debt to Telos has been deemed uncollectible and written down to zero and that the amount of that interest exceeds \$7 million.

During the motion hearing, the 2nd SLC's counsel, Andrew Frisch, was questioned about this discrepancy in valuations. He indicated that the figures provided by the company to the 2nd SLC represented an historical picture of the cost and returns associated with Enterworks over a period of several years. The Telos SEC 10-K upon which plaintiffs base their allegations, however, is merely a financial snapshot of the company at the time represented and pursuant to GAAP accounting standards. He characterized the two financial analyses as "apples" and "oranges" and denied that they were inconsistent. Hearing Testimony of Mr. Frisch (Nov. 21, 2007). It does not appear that this comparison was deemed relevant by the 2nd SLC or its counsel in investigating the Enterworks issues.

On the evidence, the 2nd SLC did not find a basis to support the Enterworks claims. The Court believes that conclusion to be reasonable.

The SecureInfo Lawsuit

Plaintiffs point to litigation instituted in a federal court in Virginia by a Telos competitor, SecureInfo Corporation, as evidence of Telos' illegitimate business practices. They claim that these business practices subject the company to unnecessary risk and high legal fees. See

Plaintiffs' First Amended Complaint at 78-83; Letter from Lewis T. Stevens to Lawrence Storch 7 (April 3, 2006).

While the complaint in that action initially set forth eleven counts, only two survived Telos' motion to dismiss: copyright infringement and common law detinue. These remaining counts were settled before trial and dismissed, with prejudice, on March 22, 2006. The settlement contained on-going business agreements between Telos and SecureInfo.

The Revised Report states that the available evidence does not show any "unusually egregious" activities or actions that would constitute breaches of fiduciary duty, undertaken by the management or director defendants in connection with or giving rise to the SecureInfo lawsuit. Revised Report 39. These allegations were deleted from plaintiffs' Second Amended Complaint and plaintiffs appear to have abandoned these claims as a basis to deny the current motion. In any event, the 2nd SLC had little or no evidentiary record to consider in connection with the SecureInfo claims and reasonably concluded that they did not constitute a basis for action by the company against the officers or directors named as defendants in that case.

VI. Conclusion

Because of the deference owed to corporate board decisions under Maryland law, the Court was sensitive to the need to provide plaintiffs with adequate discovery on defendant's motion to dismiss the derivative claims and to create a sufficient record upon which to rule. At the completion of the two hearings conducted on the motion, the Court had before it the 2nd SLC's Revised Report of July 20, 2007 (41 pages in length), and Revised Conclusions (4 pages in length), as well as twenty-five document exhibits appended to the Revised Report and Conclusions. Additionally, the record was composed of all pleadings previously filed in the

litigation which were relevant to the issues posed by the present motion; all hearing exhibits pertaining to the work of the 1st and 2nd SLCs, including the Fulbright & Jaworski SLC proposal of January 11, 2006, correspondence, handwritten notes of members, witness interview lists, memoranda and notes of the 1st and 2nd SLC, meeting minutes,²² seven prior draft 1st SLC Reports and one interim 1st SLC Report to the board, the 2nd SLC Revised Report and Conclusions; deposition transcripts and dvd's of the depositions of Messrs. Tuttle, Harris, Owsley, Stewart, Motley, Baker, Sterrett, and Byers; internal Telos documents including Amended and Restated Bylaws, the Certificates of Resolution, a list of committee members and their powers and duties, draft minutes of meetings of the board of directors, Transaction Committee meeting minutes, salary schedule of defendants; Telos Corporation Forms 10-Q, 10-K and 8-K; Telos draft proxy agreements, board meeting agenda and minutes; Telos Corporation Certificate of Resolutions and ubIQuity.com unanimous written consents regarding Telos and Xacta; deposition, hearing testimony and report of Professor Fairfax; hearing testimony of Messrs. McGonigle and Frisch; and various correspondence in e-mail, letter and fax form among and between the parties.

The Court reviewed a substantial portion of the record and is familiar with the issues presented due to its management of the present litigation for more than two years. On the basis of this well-developed record and the extensive briefs and arguments of counsel for the respective parties, the Court finds that the members of the 2nd SLC, Adm. Tuttle and Gen. Harris, and their legal advisors, were independent, disinterested and performed their duties in good faith;

²² The plaintiffs criticized the 2nd SLC for failing to keep minutes or summaries of their interviews, but the Court finds that the record here is adequate to support the 2nd SLC's findings and conclusions.

that the 2nd SLC undertook a reasonable investigation of plaintiffs' derivative claims;²³ and that the 2nd SLC's findings and conclusions are reasonable.²⁴ Again, plaintiffs have failed to prove otherwise, and the Court believes that its proper role is not to second guess the 2nd SLC if its findings and conclusions represent reasonable business judgment.

Accordingly, the Court will enter an Order this 7th day of January, 2008, dismissing with prejudice Counts VI and VII of the plaintiffs' Second Amended Complaint, the derivative causes of action.

Albert J. Matricciani, Jr.
Judge

cc: all counsel via LexisNexis File and Serve

²³ As the 2nd SLC noted in its Revised Conclusions, the present lawsuit served to impair full access to witnesses, specifically Telos' former directors, but in the Court's judgment this is not a legitimate ground to criticize the investigation. Revised Conclusions at 1.

²⁴ Not only did the 2nd SLC render conclusions which comport with reasonable business judgment, but it also made important recommendations to ensure better governance practices in the future and to protect the interests of all Telos' stakeholders. Revised Conclusions at 4.