THE HONORABLE JOHN P. ERLICK

SUPERIOR COURT OF THE STATE OF WASHINGTON FOR KING COUNTY

ROBERT M. ARNOLD, derivatively on behalf of MOD SYSTEMS, INC. and BANANA CORPORATION, Plaintiffs, v. MARK PHILLIPS, KENNETH GORDON, JANDE DOE GORDON, and the marital community composed thereof; ANTHONY BAY, JANE DOE BAY, and the marital community composed thereof; MOD SYSTEMS, INC. and BANANA CORPORATION, Defendants.	NO. 09-2-07963-3 SEA DEFENDANT PHILLIPS' MOTION TO TERMINATE VOTING TRUST AND TO REMOVE KYLEEN CANE AND ANTHONY BAY FROM DEMAND REVIEW COMMITTEE **(ORAL ARGUMENT REQUESTED)**

I. RELIEF REQUESTED

Defendant Mark Phillips moves this Court for an order terminating the voting trust he created to enable Kyleen Cane, as trustee, to vote on behalf of his majority ownership in MOD Systems, Inc.

Defendant Phillips further moves this Court for an order removing Kyleen Cane and Anthony Bay as members of MOD Systems' "Demand Review Committee" which was created for the purpose of responding to this shareholder derivative lawsuit.

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II. STATEMENT OF FACTS

A. Mark Phillips and MOD Systems

Mark Phillips is a 35-year-old software developer and entrepreneur. He has received one patent and has over a dozen more applications pending. (Declaration of Mark Phillips, hereafter "Phillips Decl.", at ¶ 4) He formed the company which would become MOD Systems, Inc., in April 2005, together with Anthony Bay. (Phillips Decl. at ¶ 5) Bay is a minority shareholder in MOD Systems and a defendant in this lawsuit. Bay continues to serve as one of two members of MOD Systems' board of directors and one of two members of MOD Systems' "Demand Review Committee", the committee that is supposedly responsible for the corporation's response to Arnold's lawsuit. Attorney Kyleen Cane is the other board member and the other member, and chair, of the Demand Review Committee. (Phillips Decl. at ¶¶ 10 and 25)

MOD Systems is an emerging high-technology company that is developing and marketing software and hardware with kiosk systems for the distribution and sale of digital and audio media content to retail consumers. The kiosks could, for example, be used to sell digital music at a Starbucks Café. Mr. Phillips is the creator of the MOD Systems technology. Bay is a business person. (Phillips Decl. at ¶ 5) At the outset, Mr. Phillips owned 75 percent of MOD Systems shares. Bay owned 25 percent of the shares. Bay's total contribution to MOD Systems was $50,000 which he paid to increase his initial ownership percentage from 15 percent to 25 percent. Robert Arnold, who commenced this lawsuit, later invested a total of $3.5 million in MOD Systems in May 2006 to purchase a 7.84 percent ownership interest in the company. (*Id.*)

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Mr. Phillips decided in March 2007 that it was necessary to focus on flash memory and security protocols for one of his business plans. (Phillips Decl. at ¶ 5) He therefore developed an investment and working relationship with Toshiba, the inventor and leading provider of flash memory. In October 2008, he obtained $35 million in "Series A" financing from Toshiba and NRC. (*Id.*) Toshiba and NRC received approximately 30 percent ownership in MOD plus certain other rights in return. Arnold's and Bay's ownership interests were somewhat diluted by this cash infusion, but that could hardly have been surprising. At the time Arnold invested in MOD Systems, the subscription agreement stated that dilution was to be expected. (Custodial Declaration of Donovan Flora, hereafter "Flora Decl.", Ex. 1)

Prior to this lawsuit by Arnold, MOD Systems was valued at $120 million. At the point Mr. Phillips was forced out of MOD Systems, in March 2009, the company had 42 employees. (Phillips Decl. at ¶ 5)

As valuable as MOD Systems is, the potential value of Mr. Phillips' other business Banana (d/b/a MetaWallet) was far greater. Banana, which is also a defendant in this lawsuit, is a start-up company in a fast moving, very competitive environment where secrecy is paramount. Mr. Phillips formed Banana in June 2006. (Phillips Decl. at ¶ 7) There are two shareholders, Mr. Phillips and Mr. Arnold. (*Id.*) Mr. Arnold has invested $5.5 million in Banana and he owns a 15.4 percent interest. (*Id.*) Mr. Phillips owns the remainder. The idea Mr. Phillips is developing for Banana is essentially a banking system whereby money can be transferred between MetaWallet accounts using pre-paid mobile telephones, and the accounts can be used to make retail purchases or to pay bills and transfer money. Banana would essentially create mobile banking and permit international wiring of funds.

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Prior to obtaining Mr. Arnold's investment in Banana, Mr. Phillips had Banana independently valued by the accounting firm Brueggeman Johnson and Yeanoplos. It was determined that a 100 percent equity interest in the company was worth almost $60 million. (Phillips Decl. at ¶ 7) There can be no question that Arnold invested in both of Mr. Phillips' companies with complete information and ample warning about risk.

B. Jan Wallace, Kyleen Cane, and the Ouster of Mr. Phillips From His Company

The germ of this lawsuit can be traced back to March 2007 when Mr. Phillips met Jan Wallace at a social and networking event. Ms. Wallace introduced herself as a business consultant, and she and Mr. Phillips commenced a professional relationship in which she provided business advice to Mr. Phillips and introduced him to potential investors. Their business relationship eventually became a romantic one as well. (Phillips Decl. at ¶¶ 8 & 9)

Some months later, in December 2007, Wallace introduced Mr. Phillips to Kyleen Cane, an attorney who is licensed in Washington but who practices primarily in Nevada. Cane practices primarily in the area of securities law. (Flora Decl., Ex. 2) Wallace encouraged Mr. Phillips to trust Ms. Cane, and so he discussed with her MOD Systems and Banana. Mr. Phillips shared with her Banana formation documents and his Banana business plan. He also provided her with all of the material for MOD Systems to close its Series A financing, including IP valuation documents. In June 2008, approximately six months after his introduction to Cane through Wallace, Mr. Phillips asked Cane to become MOD Systems' attorney and to join MOD Systems' board of directors. On June 25, 2008, Mr. Phillips, as CEO of MOD Systems, signed an engagement letter with Ms. Cane's firm. (Phillips Decl. at ¶ 10 & Ex. 2) Mr. Phillips did not at the time know that Wallace and Cane

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had an almost 20-year history of working closely together to manipulate and exploit companies.

In October 2008, the same month MOD Systems received the $35 million cash infusion from Toshiba and NCR, Ms. Wallace informed Mr. Phillips that Arnold had retained an attorney to investigate him and that Arnold might sue him. (Phillips Decl. at ¶ 11) Mr. Phillips did not at the time know that it was Wallace who had taken selective information off his computer and provided it to Arnold and his attorney. It was this information that formed the alleged factual basis for Arnold's lawsuit.

In December 2008, Arnold's counsel sent a draft of this not-yet-filed lawsuit to MOD Systems. In response, MOD Systems formed a "Demand Review Committee" (DRC) in January 2009 to evaluate the suit and respond to it. (Flora Decl., Ex. 3) In other words, the two MOD Systems board members, Cane and Bay, appointed themselves to a special committee ostensibly to respond on behalf of the corporation to the Arnold lawsuit.

Arnold filed his lawsuit on February 18, 2009. On March 27, 2009, the DRC (Cane and Bay) interviewed Mr. Phillips. Ms. Cane subsequently provided Mr. Phillips with a "transition agreement" (his agreement to resign from MOD Systems). She also requested that he sign a voting trust agreement authorizing Cane as trustee to vote Mr. Phillips' shares. Cane advised Mr. Phillips that it was in his best interest to do what she advised which included signing the voting trust agreement. He signed the agreement on March 27, 2009. (Flora Decl., Ex. 4)

On June, 15, 2009, the MOD Systems DRC issued a report accusing Mr. Phillips and Kenneth Gordon (MOD Systems' onetime COO) of significant corporate malfeasance consisting almost exclusively of using corporate money for personal expenses. (Flora Decl.,

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Ex. 5) The accusations were false and, as will be explained later in this motion, the DRC report is a sham. Remarkably, even though the DRC report was supposed to represent an objective and disinterested evaluation of Arnold's lawsuit, the report did not even mention that DRC member Bay was himself a defendant in the lawsuit and accused of much of the same malfeasance that Mr. Phillips had supposedly perpetrated.

In July 2009, after a failed mediation Cane, even though she was Mr. Phillips' voting trustee with all the attendant fiduciary duties owed to him, demanded that he give up his entire interest in MOD Systems to settle the Arnold lawsuit. (Phillips Decl. at ¶13)

C. The Investigation

Following his ouster from the company, Mr. Phillips began to suspect that there might be more to the Cane-Wallace relationship than he had been led to believe. He hired an investigator, Dennis Mandell, who has extensive experience handling financial investigations, dispute analysis and valuation services, and he also began himself to look into the backgrounds of Cane and Wallace. They found that Cane's and Wallace's backgrounds were quite intertwined, and they discovered among other things that Cane and Wallace shared a long, involved history of corporate maneuvering. This shared history goes back at least 20 years when Michael Cane (later to become Kyleen Cane) was a Nevada securities attorney who formed a company in 1989 under the name Tele-Lawyer. (Flora Decl., Ex. 6) Tele-Lawyer later merged with a company named Dynamic Associates and Tele-Lawyer and Dynamic Associates acquired and spun off multiple companies over the following 15 years. Wallace was chair and CEO of Dynamic Associates. Cane has represented at least five companies in which Jan Wallace served as an officer including Dynamic Associates. It is undeniable that Cane and Wallace control all these entities.

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Thus far, Mr. Phillips has discovered a half dozen lawsuits involving Cane and Wallace, at least some of which share strikingly similar elements with their attempted takeover of MOD Systems here. In *Medley v. Wallace*, for example, filed in U.S. district court in California, the plaintiff Parrish Medley was CEO of a start-up company and asked Kyleen Cane for advice on how to go public to obtain financing. Cane steered Medley to Jan Wallace who sold him a "shell company" named MWMedical for $250,000 plus $50,000 to Cane for past due legal fees. Wallace later extracted an additional $10,000 from Medley and alleged various "oral agreements" that Medley denies as false. MW Medical was spun out of Dynamic Associates. Cane was the attorney for Dynamic Associates and it is a wholly owned subsidiary MWMedical. Cane and Wallace were unquestionably working these companies together for their mutual financial benefit. (See Declaration of Parrish Medley)

In a second case, a bankruptcy proceeding in Nevada, Jan Wallace was the CEO and a director of Secured Diversified Investment ("SDI"). SDI was the bankruptcy debtor. Cane's law firm petitioned the bankruptcy court to approve a reorganization plan. Certain shareholders objected to the plan, in part, because "SDI's current officers and directors ran SDI into bankruptcy by selling off all of SDI's assets and leaving SDI's shareholders with a valueless company." According to a declaration filed in the bankruptcy, when Wallace was still the CEO and a director of SDI she personally purchased a piece of property in Arizona for $200,000. She then sold a one-third interest in the property to SDI for $200,000. She raised her monthly salary from $6,000 to $15,000 and then asked for a year's salary in advance. (Flora Decl., Ex. 7, *Objection to Confirmation of Joint Plan of Reorganization of Debtor* with Gernot Trolf declaration attached, pages 6-7)

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The SDI reorganization plan, according to a shareholder's objection, involved a "reverse merger" in which another privately held company, Galaxy Gaming (which also had virtually no assets), would absorb the public company SDI and could thereby avoid going through a registration process with the SEC. This reorganization plan, which was astonishingly approved by the Nevada bankruptcy court, extinguished outstanding SDI shares. New shares were issued to the owner of Galaxy Gaming. Galaxy Gaming's owner has given Cane Clark LLP (owned by Cane and her law partner) a promissory note for $125,000 and a stock purchase warrant for shares of the new SDI. Cane's law firm is the registered agent for the new SDI.

In a related lawsuit in California state court, Wallace was sued for fraud among other things. The complaint in that case contains the following allegation: "Immediately upon her hire [as president of SDI], Defendant Wallace initiated a campaign primarily designed to personally gain complete control of the corporation, financially destroy Defendant SDI and to craft financial interests designed for her own personal profit."

Wallace's ability to insinuate herself into the management of SDI sounds a lot like her performance with Mr. Phillips and his MOD Systems. The inevitable involvement of Cane with her special expertise in securities law also parallels what happened to Mr. Phillips in this case.

No discovery has yet been done in Arnold's lawsuit. What is known as the result of Mr. Phillips' investigation, however, is that Wallace has been sued a lot with Cane somewhere in the background; Cane has been the attorney for at least five companies in which Wallace was a corporate officer; and Cane has been Wallace's attorney continuously for over 20 years.

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D. Timeline

April 2005	Mr. Phillips forms MOD Systems with Mr. Bay
May – Nov. 2005	Mr. Arnold invests $3 million in MOD Systems
June 2006	Mr. Phillips forms Banana a/k/a MetaWallet valued at $58.9 million
July 2006	Mr. Arnold invests $5.5 million Banana
March - Dec. 2007	Mr. Phillips meets Ms. Wallace who introduces him to potential MetaWallet investors
Dec. 2007 - June 2008	Ms. Wallace introduces Mr. Phillips to Ms. Cane
June 2008	Ms. Cane agrees to become MOD Systems' attorney and joins its Board
Oct. 2008	Toshiba/NCR invests $35 million in MOD Systems
Oct. 2008	Ms. Wallace tells Mr. Phillips that Mr. Arnold is investigating him and may sue him
Dec. 17, 2008	Mr. Arnold's counsel sends draft complaint to MOD Systems
Jan. 22, 2009	The MOD Systems Board (Cane and Bay) forms a DRC (Cane and Bay)
Feb. 18, 2009	Mr. Arnold files his lawsuit
March 27, 2009	The MOD Systems Board (Cane and Bay) forces Mr. Phillips to resign as director and CEO; Mr. Phillips signs a voting trust agreement with Ms. Cane as trustee
June 15, 2009	The DRC issues a report accusing Mr. Phillips and Mr. Gordon, generally, of using corporate money for personal expenses
July 2009	After failed mediation, Cane (Mr. Phillips' voting trustee) demands that he give up his interest in MOD Systems to settle Mr. Arnold's lawsuit
July 2009	Mr. Phillips hires Mr. Mandell to investigate Ms. Cane and Ms. Wallace.

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Aug. 2009	Mr. Phillips receives a letter cancelling all compensation and benefits as an employee of MOD Systems
Aug. 14, 2009	Mr. Arnold's counsel sends a settlement demand asking for Mr. Phillips' MOD Systems stock plus his collector (Breguet) watches, his Aston Martin DB-9, and his Camano Island property
July – Sept. 2009	Mr. Phillips discovers Ms. Cane's and Ms. Wallace's 20-year working relationship

II. STATEMENT OF ISSUES

Whether this Court should terminate the Voting Trust Agreement where Mr. Phillips as trust settlor and sole beneficiary is entitled to revoke the trust unilaterally and the trust does not benefit his interests and is in fact inimical to his interests.

Whether this Court should remove Kyleen Cane and Anthony Bay as members of the Demand Review Committee because they are not independent and disinterested.

IV. EVIDENCE RELIED UPON

(1) The Declaration of Mark Phillips, with exhibits.

(2) The Declaration of Charles R. T. O'Kelley, with exhibits.

(3) The Declaration of Dennis M. Mandell, with exhibits.

(4) The Supplemental Declaration of Dennis M. Mandell, with exhibits.

(5) The Declaration of Parrish Medley, with exhibits.

(6) The Custodial Declaration of Donovan Flora, with exhibits.

V. LEGAL AUTHORITY

A. Voting Trust Agreements

Voting trust agreements are authorized by RCW 23B.07.300 which provides in part:

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> One or more shareholders may create a voting trust, conferring on a trustee the right to vote or otherwise act for them, by signing an agreement setting out the provisions of the trust, which may include anything consistent with its purpose, and transferring their shares to the trustee.

As defined in Bogert's Trusts and Trustees, Ch. 14, §252, a voting trust is an instrument for securing the control and management of a corporation. "Corporate shares held by two or more stockholders are transferred to one or more trustees under an agreement that they will be voted by the trustees for a fixed or ascertainable period of time." *Id.* The Washington statute permits a single shareholder to create a voting trust as occurred in this case.

Mr. Phillips transferred his MOD stock to Kyleen Cane for a period of five years, until 2014, and Mr. Phillips received "voting trust certificates" in return. The agreement contains no statement as to its purpose.

B. This Court Should Terminate Mr. Phillips' Voting Trust Agreement

As an initial matter, Mr. Phillips is entitled to revoke his Voting Trust Agreement unilaterally and without court intervention. In *H.M. Byllesby & Co. v. Doriot*, 12 A.2d 603 (Del.Ch. 1940), the court held that a voting trust could be revoked even if the trust instrument stated that the trust was irrevocable. The court stated;

> [N]o good reason appears why a court should insist upon the continuance of a trust, where the person who has created it with respect to his own property and who alone is beneficially interested in it afterwards changes his mind and desires to terminate it.

Id. at 606. Washington regularly follows Delaware corporate law. *F5 Networks v. McAdam*, 166 Wn.2d 229, 240, 207 P.3d 433, 439 (2009).

The *Byllesby* court observed that a voting trust is a trust in the accepted equitable sense of the term; that the Delaware statue authorizing voting trusts (like its Washington

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counterpart) does not prescribe that such a trust shall be irrevocable; and that there is no reason to differentiate voting trusts from other express trusts. 12 A.2d, at 606.

As to the argument that the trust instrument was irrevocable because the trust instrument stated it was, the court held that "the mere statement in a trust instrument that it shall be irrevocable is not sufficient under authorities above cited to prevent termination by the sole settlor who is the sole beneficiary." *Id.*

In *Disher v. Fulgoni*, 161 Ill.App. 3d 1, 514 N.E.2d 767 (1987), in a case involving an attempted modification of a voting trust, the court noted "(w)here all the beneficiaries of a trust, of whom none is under legal incapacity, consent to the termination of a trust, that result can be accomplished unless the material purposes of the trust require its continuance," citing Restatement (Second) of Trusts, §338 (1959).

That section of the Restatement (Second) of Trusts provides: "If the settlor is the sole beneficiary of a trust and is not under an incapacity, he can compel the termination of the trust, although the purposes of the trust have not been accomplished."

Similarly, in Bogert's Trusts and Trustees, Ch. 47, §1004, the law regarding termination of a trust by a sole beneficiary is summarized:

> If the settlor creates a trust in which the settlor is the sole beneficiary, the question may be an easy one, even though the settlor reserved no power to revoke or alter, or even expressly declared the trust to be irrevocable. Numerous courts have found a trust to be terminated or terminable at the instance of the settlor who is also the sole beneficiary....
>
> If the sole settlor who is also the sole beneficiary demands that the trustee return the trust property and the trustee acquiesces, no one will have standing to object to the ending of the trust. If the trustee refuses the settlor's request and insists on continuing the trust administration, the court should order the trustee to comply and thus to terminate the trust.

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Although Mr. Phillips clearly has the right to revoke unilaterally the Voting Trust Agreement, this Court should nonetheless affirmatively terminate the trust to foreclose any attempt by Cane to delay matters by refusing to restore to Mr. Phillips his voting interest and therefore his control of MOD.

This Court may terminate a trust, including a voting trust, where the objectives of the voting trust had been defeated by circumstances arising after formation of the agreement. In this case, it is far from clear what the purpose of the voting trust was other than to wrest control of MOD Systems from Mr. Phillips so that Wallace and Cane could take over the company and loot it. If the trust that Mr. Phillips created, at the urging of Cane, did confer some benefit to him at some point, that point is long past. In fact, the trust is inimical to any conceivable interest Mr. Phillips has in MOD Systems.

One of the reasons the voting trust cannot (and could never) serve Mr. Phillips' interests is because the trustee, Kyleen Cane, designed the trust for her own benefit, not his. A trustee such as Cane is supposed to occupy a fiduciary relationship with the trust beneficiary, and there is case law suggesting that a *voting* trustee may owe an even greater duty of loyalty to those whose interests she represents. *Wool Growers Service Corp. v. Ragan*, 18 Wn.2d 655, 140 P.2d 512 (1943), described the voting trustee's fiduciary relation to shareholders as particularly strong. *Brown v. McLanahan*, 148 F.2d 703 (4th Cir. 1945), also found that a voting trustee occupies a fiduciary relation to the shareholder. As summarized in 5 Fletcher, Cyclopedia Corp. § 2091.10: "Voting trustees should be held to adhere to the usual fiduciary principles of a trust." The Restatement (Second) of Trusts, §170, entitled "Duty of Loyalty" states:

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> (1) The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary;
>
> (2) The trustee in dealing with the beneficiary on the trustee's own account is under a duty to the beneficiary to deal fairly with him and to communicate to him all material facts in connection with the transaction which the trustee knows or should know.

In her role as trustee, it appears that Cane has reversed things: she is administering the voting trust solely for her own benefit. She has used the voting trust to oust Mr. Phillips from his own company and is now in a position to loot Mr. Phillips' company to his great detriment. She has turned the traditional concept of a trust instrument on its head.

Generally, a court may terminate a trust, including a voting trust, if there is no longer a reason for the trust to continue. This may occur if the reason for the trust has been has been "accomplished" (admittedly a difficult concept in this context where the voting trust agreement had no apparent purpose other than to steal Mr. Phillips' company), or where there is no longer any reason for a voting trust to continue, or where accomplishment of the trust purpose has become "impossible or impractical." Bogert's Trusts and Trustees, Ch. 47, §1002.

With respect to "impossibility" of accomplishment, this can be due to a change of circumstances or a change in the status of the parties or the fact that continuance of the trust would bring no intended advantage to the beneficiary. *Id.* In *Selig v. Wexler*, 355 Mass. 671, 247 N.E.2d 567 (1969), the court affirmed termination of a voting trust by applying the doctrine of impossibility. Although the court did not consider it impossible to carry out the terms of the voting trust, the court reasoned that "the objectives for which [the trust] was created have been defeated." *Id.* at 573. The court applied a "doctrine of frustration" drawn

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from contract law to terminate the voting trust where the objectives of the voting trust had been utterly defeated by circumstances arising after formation of the agreement. *Id.*

Professor Charles R.T. O'Kelley, who has submitted a declaration in support of these motions and whose opinions will be set forth in greater detail in the following section, has concluded that "Kyleen Cane and Jan Wallace are engaged in a conspiracy to obtain control of MOD Systems, in all probability to loot it." (Declaration of Charles R. T. O'Kelley, hereafter "O'Kelley Decl.", at ¶ 8) He has also concluded that "Kyleen Cane is unquestionably unfit to serve as trustee for Mr. Phillips." (*Id.* at ¶ 10)

This Court should affirmatively terminate the Voting Trust Agreement because it is neither useful nor beneficial to Mr. Phillips and is, in fact, adverse to his interests.

C. Special Litigation Committees

In *Dreiling v. Jain*, 151 Wn.2d 900, 904-05, 93 P.3d 861 (2004), the Supreme Court explained, in the context of examining the pre-filing demand requirement of CR 23.1, that a corporation faced with a shareholder's claim may appoint a special litigation committee (or "SLC") to evaluate the claim. In discussing the SLC's role in the evaluative process, the court relied extensively on *In re Oracle Corp. Derivative Litig.*, 808 A.2d 1206 (Del.Ch. 2002).

Oracle involved an SLC's motion to dismiss a shareholder derivative action, and the opinion contains an extensive discussion of how SLCs function and how SLC decisions are scrutinized by courts. As summarized in *Oracle*, in order to justify its decision to a court, the SLC must demonstrate that its members were independent, that the members acted in good faith, and that the SLC had a reasonable basis for its recommendation to the court. Principally at issue in *Oracle* was the question of whether the SLC members were

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sufficiently independent to justify their recommendation to the court. The court summarized that inquiry as follows:

> At bottom, the question of independence turns on whether a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind. That is, the Supreme Court cases ultimately focus on impartiality and objectivity.

Id. at 938, quoting *Parfi Holding AB v. Mirror Image Internet, Inc.*, 794, 1211, 1232 (Del.Ch. 2001)(footnotes omitted)(emphasis in original), *rev'd in part on other grounds*, 817 A.2d 149 (Del. 2002), *cert. denied*, 538 U.S. 1032 (2003).

Reviewing other case law, the *Oracle* court noted: (1) independence means that the committee's decision is based on the corporate merits of the subject rather than extraneous considerations or influences; and (2) independence may be compromised if a director (or SLC member) is "beholden" to an interested person because of financial or personal or other relationships. *Id.* at 938-39. The *Oracle* court explained the importance of maintaining integrity in the SLC process with the following quotation from *Biondi v. Scrushy*, 820 A.2d 1148 (Del.Ch. 2003):

> One of the obvious purposes for forming a special litigation is to promote confidence in the integrity of corporate decision making by vesting the company's power to respond to accusations of serious misconduct by high officials in an impartial group of independent directors. By forming *a committee whose fairness and objectivity cannot be reasonably questioned* ... the company can assuage concern among its stockholders and retain, through the SLC, control over any claims belonging to the company itself.
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> * * *
>
> *Zapata* [*Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981)] *presents an opportunity for a board that cannot act impartially as a whole to vest control of derivative litigation in a trustworthy committee of the board – i.e., one that is not compromised in its ability to act impartially.* The composition and conduct of a special litigation committee therefore must be such as to instill confidence in the judiciary and, as important, the

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> stockholders of the company that the committee can act with integrity and objectivity.

Id. at 940 (Emphasis added).

D. This Court Should Remove Cane and Bay from the DRC.

To summarize the authorities in the preceding section, a special litigation committee (SLC), or a "demand review committee" (DRC) to use Cane's and Bay's terminology, is supposed to serve as an independent and disinterested evaluator of a shareholder's claim against the corporation. In other words, if the corporation's board (here consisting of Cane and Bay) cannot fairly and impartially evaluate a shareholder's claim, then the board appoints a committee (here, Cane and Bay) to perform that function.

Thus, MOD Systems' DRC from the very outset was an odd construct: two board members, who are theoretically concerned about their ability to evaluate a shareholder's claim with independence and impartiality, appoint *themselves* as a two-person committee to accomplish that task.

Professor Charles R.T. O'Kelley has literally written the book on corporations, the case book *Corporations and Other Business Associations*, now in its fifth edition. Mr. Phillips has retained Professor O'Kelley to review and evaluate a number of documents relating not only to the Arnold lawsuit but also to the history of Wallace and Cane. His opinions are contained in a 13-page declaration filed in support of these motions to terminate the voting trust and to remove Cane and Bay as DRC members.

Professor O'Kelley has concluded, in general, that:

> Kyleen Cane and Anthony Bay are unfit to serve on the Demand Review Committee. Members of such committees must be disinterested and independent, and neither Cane nor Bay comes close to that standard. Indeed, the committee's file report demonstrates on its face that there was

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> no true investigation of Arnold's lawsuit. Both Cane and Bay have conflicts of interest that require their removal from the committee.

(*Id.* at ¶ 11)

Professor O'Kelley explains in his declaration the function of a properly constituted special litigation committee: "The special litigation committee is expected to conduct an independent investigation, and then to determine how the corporation should respond to the claims investigated." (*Id.* at ¶ 17) With respect to the work performed by Cane and Bay as committee members, Professor O'Kelley concludes: "In my opinion, both Cane and Bay have disabling conflicting interests that preclude their participation as a special litigation committee member. Nothing they have done thus far as members of Mod Systems' DRC should be given any credence." (*Id.* at ¶ 19)

Based on documents he has reviewed, Professor O'Kelley found that Cane has a lengthy and involved professional relationship with Jan Wallace. Thus, as a DRC member, Cane was in a position where she was supposed to independently and objectively decide how the corporation should respond to a lawsuit her own longtime colleague and associate Wallace had instigated. (*Id.* at ¶ 20)

As for Bay, Professor O'Kelley observed that he is a named defendant in the lawsuit with significant personal liability exposure for a substantial part of the misconduct alleged by Arnold. More importantly, Bay works for Cane and is totally beholden to her for his position on the board and his position as CEO. Through her control of the voting trust, Cane can determine whether Bay stays on the board of directors and whether Bay continues to serve as CEO. Bay serves at Cane's pleasure.

It is Professor O'Kelley's conclusion that neither Cane nor Bay has the requisite independence and impartiality to serve as a DRC member.

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Professor O'Kelley also evaluated the "Final Report" issued by Cane and Bay operating as the DRC. He concludes that the report "is a truly stunning example of obfuscation and misdirection, a document devoid of meaningful content, and one that masquerades as a product of a good faith and reasonable investigation of the claims asserted in the Arnold lawsuit." (O'Kelley Declaration at ¶ 29)

Cane and Bay are wholly unsuited to serve as special litigation committee members in relation to the Arnold lawsuit. Their so-called investigation of Arnold's allegations was a sham as documented in their "final report." This Court should remove Cane and Bay as DRC members.

VI. CONCLUSION

Defendant Phillips requests that this Court grant his motion to terminate the Voting Trust Agreement and his motion to remove Kyleen Cane and Anthony Bay as members of the DRC.

DATED this 24 day of September 2009.

JOHNSON | FLORA, PLLC

By ______________________
Mark Johnson, WSBA No. 8463
Donovan Flora, WSBA No. 5624

Attorneys for Defendant Mark Phillips

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HONORABLE JOHN P. ERLICK
Hearing Date: October 9, 2009

IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON
FOR KING COUNTY

ROBERT M. ARNOLD, derivatively on behalf of MOD SYSTEMS, INC. and BANANA CORPORATION, Plaintiffs, v. MARK PHILLIPS, KENNETH GORDON, JANDE DOE GORDON, and the marital community composed thereof; ANTHONY BAY, JANE DOE BAY, and the marital community composed thereof; MOD SYSTEMS, INC. and BANANA CORPORATION, Defendants.	NO. 09-2-07963-3 SEA SUPPLEMENTAL DECLARATION OF MARK PHILLIPS

MARK PHILLIPS declares under penalty of perjury under the laws of the State of Washington as follows:

1. My name is Mark Phillips and I am over the age of 18, I have personal knowledge of the facts stated in this declaration and I am competent to testify to them.

2. I am a defendant in this case.

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ORIGINAL

3. On March 27, 2009, I signed a Transition Agreement which specified that I would remain as the Chief Technology Officer for MOD Systems, Inc., while resigning as CEO and board chairman.

4. Six days later, my attorneys advised me that I had been placed on "administrative leave" and was not to return to the Office. I continued to be paid at a reduced level.

5. It was my expectation when I signed the Transition Agreement that I would remain as the Chief Technology Officer for MOD Systems and the Agreement specified that.

6. Then, on September 4, 2009, I received a letter from MOD placing me on <u>unpaid</u> administrative leave (I was fired), and terminating my salary and all benefits. (See a true and correct copy attached as Exhibit 1).

7. I would not have signed the Transition Agreement had I been told that less than a week later I would be placed on administrative leave and then terminated.

8. Also, as part of the Transition Agreement, MOD was supposed to provide me with a report itemizing the expenses and transactions MOD believed were inappropriate. Thirty days later, I was required to provide documentation for the expenses I was claiming or had claimed and also submit any request for unreimbursed expenses. MOD has never provided me with an itemized list of the expenses and transactions. The DRC report lumps together allegations of personal and business expenses as "probable", "potential" and "questionable", among other categories and there is no itemization of each transaction and the amount for each. For example, the "questionable" business expenses category does not list a <u>single</u> specific transaction. The "probable personal" category claims $268, 252 in improper expenses but lists transactions totaling around $170,000.00. At mediation, MOD claimed $1.2 million in expenses, going back to the beginning of the company. Their work was very sloppy. The allegedly improper expenses included a trip with board members and officers to NCR, attending a Grammy's event which was purchased at a charity auction attended by Kyleen Cane, and a trip by Anthony Bay to Europe. If, for example, the DRC did not

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recognize a vendor, they would frequently designate the expense as "personal." The DRC report states it had triggered the 30-day time period for my response, but the truth is the DRC has never provided me with an itemized list of each rejected expense and transaction it contends are improper. The DRC simply has not done what it was required to do under the agreement that MOD Systems itself drafted. Instead, I have been sued for reimbursement of those alleged expenses. The Transition Agreement also provides that if there was a dispute as to the amount of expenses, the matter would be put to a vote of the shareholders of the company. To the best of my knowledge, this has never been done. Certainly, my trustee Ms. Cane has never notified of such a vote. If it has been done, I have not been notified. In addition to the procedure to contest the expenses, the Transition Agreement also provided that if there was disagreement about the terms of repayment, that issue would be subject to arbitration. MOD Systems has ignored that provision.

DATED THIS 8 day of October 2009.

Mark Phillips

MARK PHILLIPS

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EXHIBIT 1

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September 4, 2009

VIA EMAIL AND REGULAR MAIL

Mark Phillips
2801 First Avenue
Apt. 1104
Seattle, WA 98121

Re: UNPAID ADMINISTRATIVE LEAVE

Mark:

This letter is formal notice that, effective as of today, the Board of Directors of MOD Systems Incorporated ("***MOD***") has placed you on an unpaid administrative leave until completion of MOD's investigation of, among other things, possible improper conduct by you and related litigation. Your unpaid administrative leave status will continue until you receive further written notice from MOD regarding your leave status.

During the leave, unless specifically requested by MOD, you may not report to work, perform any work for MOD, or engage in any communications or activities whatsoever on behalf of MOD. Please note that during the leave, your access to MOD's business premises, as well as your access to MOD's e-mail, voicemail, and computer networks, will be suspended. In addition, during this leave, you will not be paid by, or receive any benefits from, MOD, nor will you accrue any pay, wages, salary, bonuses, commissions, reimbursable expenses or other benefits from MOD. Within the next 10 business days, you will receive a company check for all wages, salary, bonuses, commissions, reimbursable expenses, and any similar payments due you from MOD as of the date hereof.

Please note that this leave does not change the at-will nature of your employment. In addition, I remind you that you continue to be bound by the that certain Employee Innovations and Proprietary Rights Assignment Agreement dated as of May 19, 2005 (as amended, the "***Innovations Agreement***"). Pursuant to the Innovations Agreement, you: (a) will continue to hold all Proprietary Information (as defined in the Innovations Agreement) in the strictest confidence, and (b) will not make use of such Proprietary Information on behalf of yourself or any other person or entity.

MOD reserves any and all rights, claims, arguments, and remedies of whatever nature, and nothing in this letter, or the fact of your leave, may be deemed to constitute a waiver of any of MOD's rights, claims, arguments, or remedies.

Please sign below to confirm that you have read and understood this letter and return the signed copy to me. Please note that your leave is effective immediately, as set forth above, regardless of whether you sign or return this letter.

If you have any questions related to your leave status, please contact Derek de Bakker, General Counsel of MOD, at (206) 432-3773 or Rich Barber at (206) 937-1092.

Very truly yours,

MOD SYSTEMS INCORPORATED

Anthony Bay
President

Signature: ____________________
Mark Phillips

Date: ____________________

cc: Tony Gewald, Lasher Holzapfel Spery & Ebberson, PLLC
Derek de Bakker, General Counsel
William H. Bromfield, Fenwick & West LLP

HONORABLE JOHN P. ERLICK

IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON
FOR KING COUNTY

ROBERT M. ARNOLD, derivatively on behalf of MOD SYSTEMS, INC. and BANANA CORPORATION, Plaintiffs, v. MARK PHILLIPS, KENNETH GORDON, JANDE DOE GORDON, and the marital community composed thereof; ANTHONY BAY, JANE DOE BAY, and the marital community composed thereof; MOD SYSTEMS, INC. and BANANA CORPORATION, Defendants.	NO. 09-2-07963-3 SEA DECLARATION OF CHARLES R. T. O'KELLEY IN SUPPORT OF DEFNDANT PHILLIPS' MOTION TO TERMINATE VOTING TRUST, AND MOTION TO REMOVE KYLEEN CANE AND ANTHONY BAY AS MEMBERS OF MOD'S DEMAND REVIEW COMMITTEE

CHARLES R. T. O'KELLEY declares under penalty of perjury under the laws of the State of Washington as follows:

I. CREDENTIALS

1. My name is Charles R. T. O'Kelley and I am over the age of 18. The facts stated herein are of my own personal knowledge and I am competent to testify thereto.

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2. I am an attorney licensed to practice law in Oregon and Georgia. I received my J.D. degree from the University of Texas at Austin in 1972 and an LL.M. from Harvard University in 1977.

3. I am currently professor and director for the Center on Corporations, Law and Society at Seattle University School of Law with teaching responsibilities in the fields of: corporations; corporate law; corporate law appellate litigation; mergers and acquisitions; corporate governance; business planning; non-publicly-traded business associations; securities regulation; and international business transactions corporations.

4. I also serve as a member of the Washington State Bar Association's Corporation Act Revision Committee. I have served as a member of the American Bar Association's: Corporation Banking and Business Law Section; Committee on Closely-Held Corporations; and Committee on Corporate-Shareholder Relations. I have published articles and performed professional research and writings in these fields as reflected in part in my curriculum vitae which is attached as Exhibit 1. I have also co-authored a case book entitled Corporations and Other Business Associations, published by Aspen Publishers. The casebook is now in its fifth edition and is currently used at over forty American law schools.

5. Attorney Mark Johnson asked me to review and evaluate various materials related to a derivative case filed by Mr. Robert Arnold, a shareholder in two Washington corporations, MOD Systems and Banana, and to form and express opinions, *inter alia*, related to (1) whether the Voting Trust Agreement, dated March 27, 2009, is valid and enforceable; (2) whether, in any event, Kyleen Cane has conflicting interests that disqualify her from continuing to serve as trustee of the Voting Trust; (3) whether the MOD System Board of Directors Special Litigation Committee/Demand Review Committee (hereafter the "DRC") has the requisite disinterestedness and independence to act for the Company or the Board of Directors with respect to the Arnold litigation, including with respect to the evaluation of Mr. Arnold's derivative suit claims; (4) and whether, in any event, the Mod Systems Board

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of Directors (the "MOD Board") has the requisite disinterestedness and independence to act for the Company with respect to the naming of a replacement for Kyleen Cane as trustee of the Voting Trust. Further, attorney Johnson asked me to supply the Court with any other information or opinions that I might determine would be useful to an understanding of this shareholder derivative lawsuit and the underlying circumstances thereof.

6. I have reviewed a number of documents in this case including: the Verified Complaint filed in the derivative suit; the voting trust agreement, the transition agreement between MOD and Mark Phillips; the Series A Subscription Agreement, the Declarations of Mark Phillips and Parrish Medley; the Amended and Restated Article of Incorporation of MOD Systems Incorporated; the DRC report dated June 15, 2009 (the "DRC Report"); Kyleen Cane's December 18, 2006, deposition in *Kagel v. Wallace / Medley v. Wallace*; the MOD Systems Incorporated Shareholders Agreement dated October 17, 2008; an e-mail from Mr. Arnold's attorney Jeff Smyth to Mr. Phillips' prior counsel, dated August 14, 2009; the Custodial Declaration of Mark Phillips; and two declarations of Dennis Mandel.

7. The materials that I have reviewed are of the type and kind upon which it is reasonable for an attorney to rely in evaluating the issues I have been asked to examine. The materials were sufficient for me to form opinions to a reasonable degree of certainty, and the opinions I express in my declaration are so held and stated. However, this case is at a very early stage, there has been no discovery, so my review is ongoing. I reserve the right to amend my declaration, and to inform the Court of such amendment and the reasons therefore, as my subsequent review may require.

II. SUMMARY OF OPINIONS

8. Mark Phillips is the majority shareholder, founder and primary entrepreneurial force responsible for the existence and value of MOD Systems Incorporated, a Washington corporation (hereinafter "MOD Systems"). The evidence I have reviewed supports a reasonable inference that Kyleen Cane and Jan Wallace are engaged in a conspiracy to

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obtain control of MOD Systems, in all probability to loot it. The evidence I have reviewed supports a reasonable inference that Robert Arnold has, at a minimum, been duped by Jan Wallace into believing the claims asserted in his lawsuit, particularly since it appears that the information on which the lawsuit is based emanated from Wallace. Further, the evidence I have reviewed supports a reasonable inference that Anthony Bay has either been duped by Jan Wallace into believing the claims asserted in the Arnold derivative suit or is opportunistically cooperating with Wallace and Cane in order to enjoy the financial and psychic benefits of taking Phillips' place and salary package as the CEO of MOD Systems.

9. Because of the actions taken by Cane, Wallace, Bay and Arnold, including the instigation of the Arnold lawsuit, and the attempts to both strip Phillips of control of MOD Systems and to force him to surrender his equity interest in the company, the relationship between Phillips, on one hand, and Cane, Wallace, Arnold and Bay, on the other, is irreparably damaged. There is no going back.

10. Kyleen Cane is unquestionably unfit to serve as trustee for Mr. Phillips' voting trust. A trustee owes duties to the trust beneficiary including utter honesty, undivided loyalty, full disclosure and utmost good faith. She has repeatedly violated these duties as trustee. The voting trust serves no conceivable beneficial purpose for Mr. Phillips. It would appear that its only purpose was to assist Cane in her efforts to wrest control of MOD Systems from Mr. Phillips to his great detriment. The trust should be terminated.

11. Kyleen Cane and Anthony Bay are unfit to serve on the demand review committee. Members of such committees must be disinterested and independent, and neither Cane nor Bay comes close to that standard. Indeed, the committee's final report demonstrates on its face that there was no true investigation of Arnold's lawsuit. Both Cane and Bay have conflicts of interest that require their removal from the committee.

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III. OVERVIEW OF CORPORATE LAW

12. Mark Phillips has stated in his declaration that he desires to resume control of MOD Systems, because he believes that only he can deliver the entrepreneurial and technological leadership that MOD Systems requires. Washington law supports his desire to resume control of MOD Systems.

13. Of critical importance is the fact that Mark Phillips is the majority shareholder of MOD Systems. Under Washington law, and the law of all American states, a majority shareholder has the right to exercise ultimate control over the corporation and to determine the business policies and ends of the firm. While RCW 23B.08.010 and the statutory law of all American states grants management authority to the board of directors, the majority shareholder has the statutorily granted power and authority to elect each and every member of the board of directors and to remove any or all of the directors at any time, with or without cause. Indeed, a majority shareholder may choose to elect himself to serve as the corporation's sole director and may appoint himself to serve as the corporation's chief executive officer.

IV. THE VOTING TRUST

14. Mr. Phillips has placed his shares in a voting trust, under the terms of which Kyleen Cane is authorized to exercise the voting rights that otherwise would belong to him. Again, Washington law, like the law of every American state, is firmly in Mr. Phillips' corner. A voting trust, except for the limited statutory rules peculiar to it, is simply a trust. As such, it is subject to the general rules of trust law. One of the most widely accepted of those rules directly applies to the voting trust entered into by Mr. Phillips. Mr. Phillips is the only settlor (or creator) of the voting trust and he is also the only equitable beneficiary of that trust. As such, he is entitled as a matter of right to terminate the voting trust at will. This is so even if the voting trust instrument implicitly or explicitly attempts to make the voting trust irrevocable for a period of years.

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15. Even though Mr. Phillips has the right to cancel, void, revoke or terminate the voting trust agreement that he created, supposedly for his own benefit, the Court may affirmatively terminate the voting trust in order to avoid any delay caused by Cane's interest in perpetuating her voting control over MOD Systems. The Court may terminate the voting trust, for example, if it has ceased to serve any beneficial purpose for Mr. Phillips. It does not appear that the voting trust ever served a beneficial purpose for Mr. Phillips. Instead, it appears to have benefitted only Cane and her interest in seizing control of MOD Systems.

16. Illustrations of how the voting trust has been used to further Cane's interests and damage Mr. Phillips' interests are numerous. After Cane became trustee in March, 2009, she demanded (at the time of and after a failed mediation of the case in July) that Mr. Phillips give up all of his ownership in MOD Systems, meaning the beneficial interest of his shares, to settle the Arnold lawsuit. Ms. Cane's participation in a demand on Mr. Phillips to walk away from everything he had worked for, occupying a position of trustee with all its attendant fiduciary duties, shocks the conscience. Given Cane's extensive experience in corporate law as evidenced by my review, it is inconceivable that she did not knowingly use her position as trustee to attempt to extort from Mr. Phillips' his ownership interest in MODS Systems.

V. THE DEMAND REVIEW COMMITTEE

17. Mr. Phillips has asked the Court to remove Anthony Bay and Kyleen Cane from the Demand Review Committee. Members of a DRC, more typically called a special litigation committee or SLC, are supposed to be objective and independent evaluators of claims made against the corporation. It is a norm of good corporate practice that a special litigation committee, composed of disinterested and independent directors or other qualified individuals, should be appointed whenever a board of directors learns by shareholder demand or otherwise of possible misconduct that involves at least some members of the board of directors. The idea is that the board may delegate its authority to determine how to

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handle any claims that the corporation might possess to a committee whose board members are not themselves the subject of threatened litigation. The special litigation committee is expected to conduct an independent investigation, and then to determine how the corporation should respond to the claims investigated. The special litigation committee may seek to support, dismiss or settle the lawsuit. Typically, the committee will file a motion with the court asking for the action that it believes appropriate.

18. However, a court may not allow a so-called special litigation committee to participate in or influence the outcome of a shareholder derivative suit, unless the special litigation committee can convince the court that it is disinterested and independent and can act in the best interests of the corporation. The issue is always whether a particular special litigation committee is independent and impartial.

19. In my opinion, both Cane and Bay have disabling conflicting interests that preclude their participation as a special litigation committee member. Nothing they have done thus far as members of MOD Systems' DRC should be given any credence.

20. In general, Cane has a lengthy and involved professional relationship with Jan Wallace. Wallace is the person who, according to the DRC Final Report, contacted Mr. Arnold and provided him with the material (documents she took from Mr. Phillips' computer) that led to the lawsuit. Cane therefore is in a position where she is supposed to independently and objectively decide how the corporation should respond to a lawsuit her own longtime colleague and associate Wallace instigated.

21. Bay, the other member of the DRC, is a named defendant in the lawsuit with significant personal liability exposure for a substantial part of the misconduct alleged by Arnold. More importantly, Bay works for Cane and is totally beholden to her for his position on the Board and his position as CEO. Through her control of the voting trust, Cane can determine whether Bay stays on the board of directors and whether Bay continues to serve as MOD Systems' *de facto* CEO. Thus, in my opinion, Bay lacks the requisite

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independence to be considered a credible member of the DRC, because Cane is in a position of power over Bay that can reasonably be expected to influence his decision-making.

22. Beyond Cane's obvious conflicts in her dealings with MOD Systems, however, she has a much deeper and more troubling history stemming from her longstanding and very involved professional relationship with Jan Wallace. Ms. Cane has testified at deposition in a case filed in California that she has represented five companies in which Jan Wallace served an officer: MW Medical; Secured Diversified Investments; Davi Skin; Dynamic Associates; and Western Investments (or Partners). *See* Kyleen Cane deposition in Kagel v. Wallace / Medley v. Wallace, 12-17 (attached as Exhibit 2). Ms. Wallace testified at a February 2008 trial in Arizona that she had known Kyleen Cane since 1998, and that she had used Cane's law firm for SEC matters. Wallace testified that she had maintained an attorney-client relationship with Cane from 1998 forward.

23. I have reviewed the 13-page declaration of Parrish Medley who was a plaintiff in the Medley v. Wallace matter referenced in the preceding paragraph. In that case, Medley was CEO of a start-up company and asked Cane advice on how to go public to obtain financing. Cane steered Medley to Wallace who sold him a "shell company" for $250,000 plus $50,000 to Cane for past due legal fees. Wallace later extracted an additional $10,000 from Medley and alleged various "oral agreements" that Medley denied as false. Putting aside any factual issues in the case, Cane and Wallace have a long and involved history of working together to their mutual financial benefit.

24. Given the fact that Ms. Wallace is the key informant behind Arnold's lawsuit, and would be the key witness were the Arnold lawsuit litigated, it borders on the ludicrous to believe that Cane would be able to carry out her responsibilities as a member of the DRC without Ms. Wallace weighing heavily in her decision. Indeed, the evidence shows this is so. The DRC has already granted Wallace a full release from any liability that she might face should it turn out that her account of Mr. Phillips alleged misconduct is untrue. And

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they have done this, as is clearly demonstrated in a DRC "Final Report," without any real investigation. It is simply inconceivable that Ms. Cane can decide whether to recommend settling the case, without weighing heavily the benefits to herself and Ms. Cane that would flow from a settlement. First, a settlement would free Ms. Wallace from the burden of testifying, and the possibility of being exposed as a liar. Second, a settlement would free Ms. Cane from possible liability to MOD Systems for approving the release of liability to Ms. Wallace should it be determined that Ms. Wallace has lied to Arnold and the board. Further Ms. Cane would benefit from a settlement of the case because such a settlement might suggest the Court's acceptance of the conclusions of the DRC Final Report, including the conclusion that Phillips has committed breaches of fiduciary duty.

VI. THE DRC "FINAL REPORT"

25. The role of a properly functioning DRC (or special litigation committee) and the importance of an appropriately prepared committee report is explained in *Sutherland v. Sutherland,* 968 A.2d 1027, 1030 (Del.Ch. 2008):

> As the court noted in its opinion, the additional fact that the SLC destroyed its original interview notes, after using them to prepare cursory and incomplete summaries of the interviews it conducted, further undermined the court's confidence in the good faith and reasonableness of the SLC's investigation. To put it simply, the touchstone of good faith in the context of a special litigation committee report is its demonstrated willingness to deal openly and honestly with all relevant and material information. Where, instead, the record shows that material information is consciously omitted from both the report and the investigative record on which it purports to rest, the court must wonder what other information was omitted or what other information might have been uncovered by a more diligent inquiry.

The DRC Final Report that Cane and Bay produced, however, is remarkable for its patent insufficiency. I have never seen anything remotely like it.

26. A special litigation committee has the burden of demonstrating that any report it prepares is the result of an investigation conducted reasonably and in good faith. To carry this burden, the special litigation committee must be prepared to

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make available to opposing counsel and the court the evidence on which it has based its findings. A special litigation committee report must, of course, actually make specific findings. In contrast, the Cane/Bay "Final Report" couches all of its "findings" in terms of generalized conclusions. The Cane/Bay report indicates that every aspect of the purported investigation was done "informally" so as to make it impossible for the court or any interested party to evaluate the the committee's supposed analysis. The interviews of key witnesses were done "informally." Cane and Bay left no trail.

27. The Cane/Bay report tries to create the impression that the task of analyzing financial records to determine whether Phillips had acted inappropriately was assigned to former company CFO David Douglas. Reading the report more closely, however, reveals that Douglas was retained to review the company's financial records in light of the allegations contained in the Arnold complaint, but that the purpose for which he was hired was "to recommend enhanced internal financial and accounting controls for the corporation." Although the report indicates that Douglas reported periodically to the DRC, there is no indication about what he reported or any indication that anything he reported was in writing. Nor is there any explanation of why Douglas was qualified as an expert either to conduct the investigation he purportedly undertook or to give recommendations to the company.

28. The Cane/Bay report indicates that they hired Deloitte Financial Services Advisory LLP ("Deloitte") to "provide a quantitative assessment of the preliminary findings of Mr. Douglas and the DRC's accounting investigation." Deloitte made an *oral* report to the DRC on June 8, 2009. According to the purported DRC Final Report, Deloitte *orally* reported "that no material financial data or information came to its attention that would lead Deloitte to conclude that the transactions

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identified in the DRC's preliminary report did not occur." It is at least interesting that Deloitte was unwilling to put anything in writing or that Cane and Bay instructed Deloitte not to. Moreover, there is no way to determine from reading the report what Deloitte actually reviewed, or what the DRC reviewed for that matter, but the alleged conclusion by Deloitte is that Deloitte did not find anything "that would lead Deloitte to conclude that the transactions identified in the DRC's Preliminary Report did not occur." This is like a criminal jury saying it did not find anything to prove that the accused did not commit a crime and therefore he must be guilty.

29. In summary, the "DRC Final Report" by Cane and Bay is a truly stunning example of obfuscation and misdirection, a document devoid of meaningful content, and one that masquerades as a product of a good faith and reasonable investigation of the claims asserted in the Arnold lawsuit. At the very least, it is the product of a special committee whose two members were laboring under serious conflicts of interest.

VII. THE SHAREHOLDERS AGREEMENT

30. A Shareholders Agreement was entered into by MOD Systems as a part of the Series A financing whereby Toshiba, and NCR invested $35 million in the company. Both Bay and Cane were on the MOD Systems board when the Shareholders Agreement was negotiated. As directors, they would have been aware that Toshiba and NCR would agree to the Series A financing only if they were given approval rights over any fundamental change in MOD Systems or its management. As directors, Bay and Cane must have been aware that Toshiba and NCR were willing to invest in MOD Systems only because of their faith in Mark Phillips. Bay and Cane must have been aware that Toshiba and NCR would invest only if they had the right to approve any proposed change in Mark Phillips's status as CEO. As two of the three directors who approved the Shareholders Agreement, Bay and Cane are

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presumed to have been fully informed of, and familiar with, the material terms of the Shareholders Agreement, including the terms by which Toshiba and NCR could exercise their approval rights.

31. Specifically, section 2.7 of the Shareholders Agreement provides in pertinent part that "the Company will not take any of the following actions (each a "preferred approval action") without the prior written approval of Toshiba [and] NCR: ...(ix) Approve, enter into, modify or exercise rights with respect to any transaction, contract or commitments between the Company ... on the one hand, and any officer of the Company ... on the other hand [or] (xi) Appoint or dismiss the chief executive officer ...."

32. The Transition Agreement, Mr. Phillips' resignation notice and MOD Systems acceptance thereof, MOD Systems *de facto* appointment of Bay to replace Phillips as CEO, and the Voting Trust Agreement were each a "preferred approval action" under the Shareholders Agreement. As outlined above, Bay and Cane must have known, and as directors and fiduciaries are presumed to have known, that each of these transactions and agreements was a "preferred approval action." Yet, it appears that Bay and Cane did not submit these matters to Toshiba or NCR for their prior written approval as required by the Shareholders Agreement. Instead, they apparently implemented these actions with the hope that when their actions were discovered, Toshiba and NCR would accept them as a *fait accompli.*

33. In my opinion, if Cane and Bay did not notify Toshiba and NCR of their actions, they intentionally violated the contract rights of NCR and Toshiba. This would constitute a gross violation of the fiduciary duties Cane and Bay owed to both the MOD Systems and its shareholders. It would violate all standards of fair dealing, and it would operate to defraud NCR and Toshiba.

34. In my opinion, this conduct by Cane and Bay constitutes the type of dishonest conduct that justifies the Court in summarily removing them from the DRC. Moreover, if

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Cane and Bay violated the Shareholders Agreement by failing to obtain the prior written approval of NCR and Toshiba prior to taking "a preferred approval action," then each such action is void *ab initio*. This includes the voting trust that gave Cane the right to vote Mr. Phillips' shares.

Declared under penalty of perjury this 23rd day of September, 2009 in Seattle, Washington.

Charles R. T. O'Kelley

Charles R.T. O'Kelley

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Exhibit 1

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EDUCATION

- LL.M., Harvard University, 1977
- J.D., University of Texas at Austin, 1972
- B.A., University of the South, 1970

FACULTY APPOINTMENTS

- Seattle University School of Law, 2008 - Present
  Professor and Director, Center on Corporations, Law and Society
- University of Georgia School of Law, 2009 - Present
  Martin E. Kilpatrick Chair of Corporate Law, Emeritus
- University of Georgia School of Law, 1997 - 2009
  Martin E. Kilpatrick Chair of Corporate Law
- University of Oregon School of Law, 1982 - 1997
  Loran L. Stewart Professor of Business Law, 1993 - 1997
- University of Virginia, Visiting Professor, Fall 1990
- University of Alabama School of Law, 1979 - 1982
- Tulane University School of Law, 1978 - 1979

ADMINISTRATIVE APPOINTMENTS

- Interim Dean, University of Oregon School of Law, 1994-1997

  Established Law and Entrepreneurship Center

  Established Appropriate Dispute Resolution Program

  Implemented Building Renovation and Expansion Program

  - Obtained legislative approval for $9.4 million project (phase I of $18 million project)
  - Obtained legislative approval for $4.7 million in state funding, conditional on private match

  Converted Renovation Project to New Building Project

- Obtained University approval of $25,000,000 new building
- Traded current building to University for $5,700,000.
- Organized and participated in successful solicitation of $10,000,000 gift to name new Law School building.
- Obtained two $500,000 lead gifts for new building project

- Associate Dean, University of Oregon School of Law, 1993-1994
- Director, Law and Entrepreneurship Center, University of Oregon School of Law, 1994-1997

PUBLICATIONS AND OTHER ACADEMIC SCHOLARSHIP

- **Books**

  - with R. Thompson, Corporations and Other Business Associations (1992), (2d ed. 1996), (3rd ed. 1999), (4th ed. 2003), (5th ed. 2006).

  - with R. Thompson, Corporations and Other Business Associations: Selected Statutes, Rules and Forms (1992. 1994-2008)(annually edited).

  - with McDaniel, Ault, and McMahon, Surrey, Warren, McDaniel and Ault's Federal Income Taxation, Vol. II (1987 Supp.), (1988 Supp.).

- **Articles**

  - *The Entrepreneur and the Theory of the Modern Corporation,* 31 J. Corp. Law 753 (2006)
  - *Delaware Law and Transaction-Cost Engineering*, 34 GA. L. REV. 929 (2000).
  - *Foreword, The Many Futures of Teaching Corporations,* 34 GA. L. REV. 423 (2000).
  - *Understanding the Place of Limited Liability Companies in the Spectrum of Business Forms*, 73 OR. L. REV. 1 (1994).
  - *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 NORTHWESTERN UNIV. L. REV. 216 (1992).
  - *Opting In and Out of Fiduciary Duties in Cooperative Ventures: Refining the So-Called Coasean Contract Theory*, 70 WASHINGTON UNIV. L.Q. 353 (1992).
  - *The Parenting Tax Penalty: A Framework for Income Tax Reform*, 64 OREGON. L. REV. 375 (1986).
  - *Tax Policy for Post-Liberal Society: A Flat Tax Inspired Redefinition of the Purpose and Ideal Structure of a Progressive Income Tax*, 58 SOUTHERN CALIFORNIA L. REV. 727 (1985).

- *Rawls, Justice, and the Income Tax*, 16 GEORGIA L. REV. 1 (1981).
- *Corporate Distributions and the Income Tax: A Consideration of the Inconsistency Between Subchapter C and Its Underlying Policy*, 34 VANDERBILT L. REV. 1 (1981). Republished as lead article in THE MONTHLY DIGEST OF TAX ARTICLES (November 1981).
- *A Different Look at the Taxation of Corporate Distribution and Shareholder Gain*, 13 NEW ENGLAND L. REV. 89 (1977).

ACADEMIC CONFERENCES ORGANIZED

- Value-Creation and Business Lawyering, Eugene, Oregon, November 1994. Published as symposium issue of the Oregon Law Review.
- Teaching Corporate Law, Athens, Georgia, October 1999. Published as symposium issue of the Georgia Law Review, Spring 2000.

SERVICE

- **Faculty Leadership**

  <u>Chair, Admissions Committee</u> (Georgia, 1998-2003)
  <u>Chair, Admissions Committee</u> (Oregon, 1989-1994)
  <u>Chair, Curriculum Committee</u> (Oregon, 1987-1988)
  <u>Chair, Appointments Committee</u> (Oregon, 1986-1987)
  <u>Chair, Academic Standing Committee</u> (Oregon, 1986-1987)
  <u>Chair, Library Committee</u> (Alabama, 1981-1982)
  <u>Chair, Honor Code Revision Committee</u> (Tulane, 1978-1979)

- **University-Wide Service**

  Vice Chair, Living Wage Assessment Committee (2006-2007)
  University Council (Georgia, 1999-2005)(Statutes and By-Laws, 2003-2004)
  University Council Executive Committee (Georgia, 1999-2005)
  Continuing Education Task Force (Oregon, 1994-1997)
  Chair, Wayne Morse Chair Committee (Oregon, 1994-1997)
  Council of Deans (Oregon, 1994-1997)

Graduate Council (Oregon, 1993-1994)

Provost's Budget Committee (Oregon, 1992-1994)

Institutional Animal Care and Use Committee (Oregon, 1988-1990)

Research Grants Committee (Oregon, 1986-1987)

Law School Representative, University Senate (Oregon, 1984-1986)

Parliamentarian (Oregon, 1985-1986)

- **Law School Service**

Placement Committee (Georgia, 2001-2002)

Strategic Planning Committee (Georgia, 1999-2000)

Admissions Committee (Georgia, 1997-2004) (Oregon, 1988-1994)

Appointments Committee (Seattle, 2009-present) (Georgia, 1997-2001) (Oregon, 1992-1994) (Alabama, 1979-1982) (Tulane, 1978-1979)

Dean's Advisory Committee (Georgia, 1998-1999, 2000-2001) (Oregon, 1986-1987, 1992-1994)

Tenure Committee (Oregon, 1984-1985)

Curriculum Committee (Oregon, 1983-1984) (Alabama, 1980-1981) (Georgia, 2003-2005)

Dean Search Committee (Alabama, 1980-1981)

Honor Code Revisions Committee, (Tulane, 1978-1979)

Founding Faculty Mentor, OutLaws (formerly Gay and Lesbian Legal Network)(student group) (Georgia, 1998-2009)

- **Washington State Bar Association**

Member, Corporation Act Revision Committee, 2009-Present

- **Oregon State Bar Association**

Member, Executive Committee, Business Law Section, 1990-93

Member, Model Business Corporation Task Force, 1990-96

Member, Oregon Senate Judiciary Committee Joint Task Force on the Professional Corporation Act, 1992-93

Member, Uniform Partnership Act Task Force, 1995-96

- **Georgia State Bar Association**

Member (currently inactive), 1973-present

- **American Law Institute**

  Member, 2000-present

- **American Bar Association**

  Corporation Banking and Business Law Section

  Legal Education Section

  Committee on Closely-Held Corporations, 1977-1982

  Committee on Corporate-Shareholder Relations, 1977-1979

  Subcommittee on Integration, 1977-1978

  Liaison between Oregon State Bar and Committee on Corporate Law, 1994-1998

- **Association of American Law Schools**

  Executive Council, Section on Business Associations, 1994-1998

Community

Member, Advisory Board, Northwest Chapter, National Association of Corporate Directors, 2009-present.

Director, Tuscaloosa Montessori, Inc., 1979-81

Director, Druid City Historic District Association, 1979-81

Director, Kidsports, Inc., 1987-1994

Director, Town Club of Eugene, Inc., 1994-96.

Co-plaintiff, O'Kelley v. Cox and O'Kelley v. Perdue (Lawsuits by ACLU/ Lambda Legal seeking to overturn Georgia's so-called "marriage amendment").

Director, Georgia Chapter, ACLU, 2007-2008

Member, Clarke County Democratic Committee, 2005-2008(Executive Committee member and Chair, fund-raising, 2007-2008).

COURSES

- Business Courses: Corporations; Corporate Law Appellate Litigation; Mergers and Acquisitions; Corporate Governance; Business Planning; Non-Publicly-Traded Business Associations; Securities Regulation; International Business Transactions (in Verona, Italy); Corporations, Law and Society
- Tax Courses: Federal Income Taxation (Individual and Corporate); Tax Policy.

SEMINARS

- Economics Institute for Law Professors, Summer 1985, Hanover, New Hampshire.
- NEH Summer Humanities Seminar, "Liberty, Equality and Justice," Summer 1980.

LAW PRACTICE

- Dodd, Driver, Connell and Hughes, Atlanta, Georgia
  Associate Attorney, 1977-1978
- Jones, Bird and Howell, Atlanta, Georgia
  Associate Attorney, 1973-1977

Exhibit 2

KYLEEN CANE - 12/18/06

UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

DAVID KAGEL, Plaintiff, vs. JAN WALLACE, Defendant.	CASE NO.: CV 06-3357 R (SSx)
AND RELATED COUNTER-CLAIM.	
PARRISH MEDLEY, Plaintiff, vs. JAN WALLACE, Defendant.	

TELEPHONIC DEPOSITION OF KYLEEN CANE

LAS VEGAS, NEVADA

MONDAY, DECEMBER 18, 2006

REPORTED BY: Elizabeth A. Shea, CCR No. 814

Inc., Mr. Medley or Ms. Wallace?

A. Just the documents, the letters going back and forth between you and Mr. Rocktell(phonetic) that were sent to me.

Q. Okay.

A. And then the list of questions that were in your letter.

Q. Very good. Now, have you or your law firm, to

♀

your knowledge, ever represented Jan Wallace individually?

A. No.

Q. So I would be correct then, you never had any written retainer agreement between any law firm that you'd been associated with and Ms. Jan Wallace. Would that be correct?

A. Yeah, not that I'm aware of.

Q. Okay. Have you individually or any law firm that you've been associated with represented Mr. Parrish Medley in his individual capacity?

A. No.

Q. So then similar to my question with Ms. Wallace, it would be correct that you would not have a written retainer agreement between you or your law firm that you're affiliated with and Mr. Medley?

A. Not that I'm aware of.

Q. Okay. Have you or any law firm that you've been affiliated with ever represented MW Medical, Inc.?

A. Yes.

Q. And was that pursuant to a written retainer agreement?

A. I don't recall.

Q. How would you determine whether or not there was a written retainer agreement for you or your law firm's representation of MW Medical, Inc.?

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A. I'd have to look in our files.

Q. And those are maintained on the premises where your office is currently located?

A. Some. Some of the older files are put in storage.

Q. Do you recall approximately when the first time you or your firm began to represent MW Medical, Inc.?

A. Oh, it would be somewhere in the late '90s, '97, '98, in that time frame.

Q. And that would have been during the time period that you were with the firm of Cane O'Niel & Taylor?

A. In some form, yeah. I'm not sure what it was called at that time, but it was the same partners.

Q. Okay. Did you or your firm ever represent Davi Skin, Inc., in some capacity?

A. That was the name of the -- of MW Medical when it changed its name.

Q. All right. Do you recall whether or not you had a written retainer agreement with Davi Skin, Inc., whether it was before or after the name changed to Davi Skin, Inc.?

A. It would be the same answer as to MW Medical. It's the same corporation, it's just a name change.
Q. Do you presently represent Ms. Jan Wallace in any capacity?

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A. No.
Q. Do you presently represent Mr. Parrish Medley in any capacity?
A. No.
Q. So to the extent that you ever provided any legal advice to either Jan Wallace or Parrish Medley, it would have strictly been in their capacity as officers of either MW Medical, Inc., or Davi Skin, Inc.?
A. Not necessarily, no.
Q. Well, did you ever provide any legal advice -- well, let me withdraw that.
Do you believe that an attorney/client relationship was ever formed between you and Jan Wallace in her individual capacity?
A. No.
Q. Do you believe an attorney/client relationship was ever formed between you and Parrish Medley in his individually capacity?
A. No.
Q. So then in response to my question about whether or not you ever represented -- or actually, I misspoke. I believe I asked you if you ever provided any legal advice or services to either Jan Wallace or Parrish Medley in

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their capacity, other than as officers of either MW Medical, Inc., or Davi Skin, Inc., I think you said

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something, not necessarily; is that correct?

A. No. The answer is no to that.

Q. Okay. So did you ever provide any legal services for Jan Wallace in any capacity, other than as an officer of MW Medical, Inc., or Davi Skin, Inc.?

MR. CLARK: I think what we're getting hung up on here, Alan, is you're asking her if she provided legal services to Jan Wallace, and her testimony, as I understand it, is she has not. So the capacity or not, the legal services were provided to MW Medical, later known as Davi Skin, Inc., and never to Ms. Wallace.

BY MR. GUTMAN:

Q. Ms. Cane, would you adopt that as a correct interpretation of your position?

A. Yes.

Q. And would the same be true for Mr. Parrish Medley, you never provided legal services directly to Parrish Medley, as only in -- only to the companies to which he had an affiliation with?

A. Yeah, only to his companies, but -- yeah, that's correct. Only to Davi Skin, Inc. That's correct.

Q. Now, with respect to Jan Wallace, have you ever represented any other companies in which she was an officer?

A. Yes.

Q. What are the other company -- or the name of the other company or companies that you provided services to in which Jan Wallace was an officer?

A. Dynamic Associates, Inc., Secured Diversified Investments. I can't remember the exact name, but Secured Diversified Investments, SDI.

Q. Any others?

A. I think one more, Western Investments, something or other, Partners.

Q. Do you currently represent any of those entities in which Jan Wallace was or is an officer?

A. Currently represent Secured Diversified Investment.

Q. And do you know whether or not Ms. Wallace is still an officer of that company?

A. I believe she still is.

Q. Have you represented any other companies in which Parrish Medley is an officer?

A. He may have been an officer at one time of a company we represented, and I'm not certain of this, it's called MV Fund or related --

Q. MV Fund?

A. MV Funding Corp.

Q. Funding Corp?

A. Yeah. I don't know if he was ever an officer there. I can't recall at this time, but there may have been a time when he was an officer.

Q. Okay. Directing your attention to what I characterize as Parrish Medley's purchase of Jan Wallace's debt and equity in MW Medical. Did you represent any of the parties to the transactions involved in that series of events?

A. Corporation. I'm not sure -- I'm not sure what you're directing me to. That's why.

Q. Sure. I understand that from certain documents that I've reviewed that Parrish Medley was a participant in a series of events that led to the purchase of Jan Wallace's debt and equity in MW Medical.

Does that sound familiar to you?

A. Yeah.

Q. Were you representing any individual or entity in connection with that transactions?

A. Yeah, MW Medical.

Q. And none of the individuals, am I correct?

A. That's correct.

Q. Was there what I would refer to as a closing, where the transaction was finalized are completed?

A. Yes, there was.

Q. And do you recall who was present at the closing?

A. Jan Wallace; Parrish Medley; myself; Sue Johnson, my paralegal -- or maybe she wasn't. I'm sorry. I'm not really certain exactly.

Q. But you do recall Jan Wallace and Parrish Medley being present, do you not?

A. Yes, I do.

Q. And where did the closing take place?

A. At my office.

Q. Do you recall when it occurred?

A. It occurred sometime in June of 2004, June of 2004.

Q. Do you recall how long it lasted, the closing -- or the meeting at which the closing took place?

A. No. Maybe 30 minutes, fairly quick.

Q. Do you recall any discussion that occurred between Parrish Medley and Jan Wallace during the closing?

A. Nothing in particular. Possibly there was a discussion about a purse that Jan was buying.

Q. Why do you recall that in particular?

A. The purse was of some ungodly figure, like, $20,000 or something, and Parrish was -- as I recall, was actually knowledgeable in that particular brand or purse, and the fact that he knew about it and she knew about it, and it was to expensive, and she was trying to get it, and he was going to assist her in obtaining it. That was what

struck me as odd.

Q. Okay. Other than the discussion regarding this