

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

Plaintiffs

v.

TELOS CORPORATION, et al.,

Defendants.

* **IN THE**
* **CIRCUIT COURT**
* **FOR**
* **BALTIMORE CITY, Part 20**
* **Case No.: 24-C-05-009296**
*

MEMORANDUM OPINION

I. Background

This action comes before the Court on plaintiffs’ motion for the appointment of a receiver. Plaintiffs seek this relief due to the recent resignations of six of the seven independent directors of Telos and the failure of efforts to restructure Telos in order to satisfy the obligations owed to plaintiffs by virtue of their ownership of publicly traded ERPS.¹

On August 16, 2006, six independent directors of Telos’ Board resigned: Ambassador Langhorne Motley, Bruce Stewart, Geoffrey Baker, Malcolm Sterrett, Thomas Owsley and Norman Byers. In their letters of resignation, Baker, Byers and Sterrett each indicated, “important participants in the corporate enterprise have impeded the board of directors from taking actions that I believed were necessary and appropriate.” Some of the independent directors felt that they would not be able to

¹ The ERPS (Exchangeable Redeemable Preferred Stock) is the only category of preferred securities issued by Telos which is publicly traded. Plaintiffs’ Amended Complaint, at ¶¶ 27, 28. The plaintiffs are entitled to 12 percent semi-annual fixed dividends in the ERPS of Telos. Plaintiffs’ Proposed Findings of Fact and Conclusions of Law, at ¶ 4.

function as fiduciaries because of John C. Porter's and John B. Wood's reluctance to pursue a strategy of selling Telos as a whole.² Telos' Form 8-K filed August 12, 2006. Both Mr. Owsley and Mr. Motley indicated that a partial reason for their resignations was that Porter and Wood advocated the sale of its subsidiary, Xacta,³ which was to benefit Telos' management at the expense of ERPS holders. Mr. Stewart's resignation was prompted by the withdrawal of counsel from the special litigation committee⁴ and for personal reasons. Deposition Transcript of Bruce J. Stewart, at 18-19, Oct. 9, 2006. Another reason for the resignations was that the independent directors disagreed with the decision of David Borland to remain a director while resigning from the Audit Committee and the Management Development Compensation Committee. Telos' Form 8-K filed August 12, 2006.

The failure of several strategic alternatives for Telos also prompted plaintiffs to file their motion. In June, 2006, Telos' board of directors established the "Strategic Group" which was to make formal recommendations to the Telos board of directors regarding a strategic transaction necessary to restructure Telos. Plaintiffs claim that they never received a formal invitation to join the Strategic Group, although defendant

² John C. Porter is a former director of Telos who owns 15,563,998 shares or 68.93 percent of the outstanding class A common stock of the company. SEC, Schedule 13E-3 Transaction Statement, filed Feb. 18, 1994. John B. Wood is director and chief executive officer of Telos. Plaintiffs' Amended Complaint, at 2.

Malcolm Sterrett stated in his deposition that Mr. Porter was impeding the Board of Directors from taking actions necessary and appropriate, including the sale of Telos. Mr. Sterrett also stated that Mr. Porter's reluctance to sell Telos was Sterrett's only reason for why he didn't believe he could effectively function as a fiduciary. Deposition Transcript for Malcolm Sterrett, 18-22. In addition, Geoffrey Baker indicated that the ability to sell Telos in its entirety was necessary for the effective functioning of the corporation, specifically "to resolve issues related to the litigation and recapitalization. Deposition Transcript for Geoffrey Baker, 19-22.

³ Xacta is a Web-based application of Telos that enables organizations to measure and enforce governmental and commercial security practices, which have been adopted by the branches of the Department of Defense, the intelligence community and other governmental departments. Defendant's Memorandum in Opp. to Motion for Appointment of Receiver, at 16-18.

⁴ The Special Litigation Committee was formed for the purpose of investigating claims made by plaintiffs in their complaint. Plaintiffs' Proposed Findings of Fact and Conclusions of Law, at ¶ 59.

indicates otherwise. Telos' Proposed Findings of Fact and Conclusions of Law, at ¶ 46. Ultimately, plaintiffs did not participate in the Strategic Group, believing that Director Wood was an impediment to the process and that the group did not have the authority to make a binding decision regarding a transaction that would recapitalize Telos. Plaintiffs' Proposed Findings of Fact and Conclusion of Law, at ¶¶ 80-82.

Due to the failure of the Strategic Group's initiative, defendant's⁵ board decided to establish the Transaction Committee in June of 2006, to determine the need to sell all or parts of Telos' business.⁶ Following an investigation, the Transaction Committee concluded that the sale of Telos in its entirety would be in the best interests of Telos and all of its stakeholders. Porter, who had the power to veto the transaction because his approval was required for the sale of substantially all of Telos' assets, opposed the sale.⁷ On August 15, 2006, in an email to Ambassador Motley, Porter expressed his opinion that

the easiest transaction to realize is that which has already been circulated to potential buyers and for which there is now a qualified list of buyers..... From what the investment managers tell me there is likely to be at least enough realization to meet those obligations of the company, which are due.... Fortunately, I believe that the sale of specific assets can be achieved quite swiftly.

Telos' Proposed Findings of Fact and Conclusions of Law, ¶57. Although Porter and Wood rejected the sale of all of Telos' assets, they advocated the sale of parts of the corporation. On August 15, 2006, Wood recommended to the Transaction Committee

⁵ References to defendant throughout this Memorandum Opinion refer solely to Telos Corporation and not to the remaining individual defendants.

⁶ The Transaction Committee was composed of five independent directors to determine "what, if any, portion of the Telos business would be sold, and to generally control the entire sales transaction process." The two management directors, Robert Marino and John Wood, seconded the motion to establish the Transaction committee. Affidavit of John B. Wood, ¶ 26.

⁷ Porter had the power to veto such a transaction pursuant to his proxy agreement and contract rights. Deposition Transcript for Geoffrey Baker, 22:5-23:10.

that investment bankers market the company to interested potential buyers in an “a la carte” or “menu” format, as a means to gain an understanding of the market available for the various components of Telos. Wood Affidavit ¶ 30. Further, Wood expressly stated to the Transaction Committee that he “was willing to ‘stand aside’ with respect to whatever personal interests” he may have in a sale of Xacta and that he would encourage other members of management to do the same. *Id.* at ¶ 30-31. Porter also approved a partial sale of the corporation involving the sale of Xacta. It is evident from plaintiffs’ memorandum in support of the present motion that plaintiffs firmly opposed the sale of Xacta because such a sale would have been insufficient to satisfy the ERPS obligations and would have directly benefited controlling shareholders. Plaintiffs stated in their memorandum that Porter’s failure to sell defendant corporation as suggested by the Transaction Committee was motivated by self-interest. Defendant contends, however, that Porter was against the sale of Telos because he was “seeking a resolution that [would] not prematurely sell assets that have yet to obtain their full value.” Wood Affidavit ¶ 30-31. Telos points out that there was a willing market through which Xacta could be sold. Even independent Director Stewart admitted that in selling Xacta, it was evident that

the buyers were interested, there were greater synergies from the potential buyers with a line of business that the Xacta group performed around enterprise software, the sale of enterprise software and security solutions to the government.... There were more buyers interested in that line of business.

Stewart Dep. 71, Oct. 9, 2006. Ultimately, the unwillingness of Porter and Wood to sell Telos in its entirety was a significant factor in the resignations of six of the seven independent directors.

II. Telos' New Independent Directors and Current Status of Telos

As of November 1, 2006, Telos has added six independent directors to replace those who resigned. None of the new members have had prior association with Telos and all are highly regarded in the business, government, and armed services communities. Within a week after the resignation of the independent directors, defendant corporation added three new directors: Bruce R. Harris, Lieutenant General Charles S. Mahan, Jr., and Vice Admiral Jerry O. Tuttle.⁸ On September 5, 2006, defendant corporation brought on board a fourth independent director, Ken Allen Peterman, vice president and general manager of Rockwell Collins Display Systems, with 27 years of experience in the global defense and aerospace market. Telos' Proposed Findings of Fact and Conclusions of Law, at ¶ 14. Two additional directors joined Telos as of November 1, 2006. Bernard Bailey, was the president and CEO of Visage Technology, Inc, and has had over 20 years of management experience in the high technology and security industries. The most recently elected director, Bill Dvoranchik, served as president and CEO of Electronic Data Systems. Defendant contends that the recent elections to the Telos' board will provide for stable operations of the board and will prevent any disruption of the corporation's affairs caused by the resignations.

In addition to electing new independent directors, defendant points out that the board of directors has reconstructed the membership of the existing committees of the

⁸ Bruce R. Harris is a retired United States Army Lieutenant General with more than 33 years of active duty. He was the Director of Information Systems for Command, Control, Communications and Computers in the Office of the Secretary of the Army and in that capacity served as the principal advisor to the Secretary and Chief of Staff of the Army on policy, planning, and acquisition of communications, automation and information management. Lieutenant General Charles S. Mahan, Jr. is President and CEO of Horne Engineering Services, LLC. Vice Admiral Jerry O. Tuttle served in the Navy for 39 years and was the Director of Space and Electronic Warfare. Telos' Proposed Findings of Fact and Conclusions of Law, at ¶ 13.

board, including the Audit Committee, the Compensation Committee and the Special Litigation Committee. Telos' Proposed Findings of Fact and Conclusions of Law, at ¶ 15. These committees appear to be in place and functioning.

Although, Telos has yet to satisfy its ERPS obligations as well as other debt obligations, the Court finds that the corporation appears to be financially viable. Telos has been successful in reducing its long-term and short term debt with preferential rights senior in position to the public preferred stock, being reduced from \$40.4 million in 1994 to approximately \$17.5 million at the end of 2005. 2005 SEC form 10-K, at 10. Further, the value of Telos' publicly traded preferred stock has continued to grow in the past several years, representing increases in the closing price of the ERPS by an aggregate annual growth rate of 196 percent. In addition, in the last five years, Telos' public preferred stock, when compared to the NASDAQ composite, has performed 101 percent better than NASDAQ. Telos' Proposed Findings of Fact and Conclusions of Law, at ¶ 10.

III. Plaintiffs are not entitled to the appointment of a receiver or a special fiduciary agent.

Sections 3-413(b) and 3-414(b) of the Maryland Corporations and Associations Article permit plaintiffs to petition a court of equity for the appointment of a receiver or trustee to take charge of the assets and operate the business of defendant corporation in a dissolution proceeding. In plaintiffs' reply memorandum and at oral argument before the Court, plaintiffs indicated that they are not seeking Telos' dissolution. Rather, they are asking the Court for the "appointment of a receiver to protect the assets of Telos from Wood, Porter and the other insiders while a legitimate buyer of the corporate entity can

be located.” Plaintiffs’ Reply Mem. at 11. Thus, the plaintiffs’ request lacks an essential statutory predicate.

Alternatively, plaintiffs seek the unusual remedy of having the Court appoint a special fiduciary agent for Telos. According to plaintiffs, the agent would investigate and analyze potential sales transactions as he/she deems appropriate, and negotiate with third parties regarding potential sales. Plaintiffs’ Proposed Findings of Fact and Conclusion of Law, at ¶¶ 22-30. Plaintiffs invoke the decision of the Maryland Court of Special Appeals in *Edenbaum v. Schwarcz-Osztreicherne*, 165 Md. App. 233 (2005) as authority for the relief they seek here. The Court, however, believes that *Edenbaum* was decided in a wholly different factual context and does not truly support plaintiffs’ position in the present case.

It is settled law in Maryland that the appointment of a receiver is an “extraordinary remedy, which should be granted with great care.” *Hamzavi v. Bowen*, 126 Md. App. 492, 497 (1999). Unlike the Model Business Corporations Act, Section 14.32, which would authorize a court to appoint one or more custodians to manage the affairs of a corporation in order to resolve internal corporate problems, the Maryland statutory scheme contemplates dissolution as the sole basis for the appointment of a receiver. In *Edenbaum v. Schwarcz-Osztreicherne*, the Court of Special Appeals expanded the scope of our statute to permit the consideration of alternative remedies such as the appointment of a special fiduciary agent. But that case involved a “freeze-out” of minority shareholder interests in a closely held corporation. The *Edenbaum* decision focuses on the unique problem presented in a closely held corporation when a minority shareholder

is held “hostage” by the controlling interest. *Id.* at 257-258.⁹ Because there is no ready market for the non-controlling shares in a closely held corporation, the plaintiff there was left with virtually no remedy short of dissolution.¹⁰ That, however, is not the case of plaintiffs here. In fact, courts have commented that disgruntled minority shareholders in a public corporation have the option to withdraw from the corporate enterprise by the sale of their stock when they lack a statutory ground for dissolution. *See Warshaw v. Calhoun*, 43 Del. Ch. 148, 155 (Del. 1966); *see also Ski Roundtop, Inc. v. Hall*, 658 P.2d 1071, 1080 (Mt. 1983) (noting the difference between closely held and publicly held corporations).

For the reasons articulated *infra* pp. 12-13, the court does not consider this an appropriate case in which to exercise such alternative equitable authority.

IV. Plaintiffs have failed to prove oppressive conduct on the part of defendant corporation.

Under Maryland corporation law, anything less than illegality, oppression or fraud will not justify dissolution and receivership. *Williams v. Salisbury Ice Co.*, 176 Md. 13, 23 (1939); *Davis v. United States Electric Power & Light Co.*, 77 Md. 35, 40-41 (stating that the court may exercise its power to appoint a receiver only where there is fraud or spoliation, or imminent danger of loss of property and these facts must be clearly

⁹ The Court of Special Appeals explains that “the very nature of a closely held corporation makes it possible for a majority shareholder to ‘freeze out’ a minority shareholder, that is, deprive a minority shareholder of her interest in the business or a fair return on her investment.” The court further notes that the limited market for stock in a closely held corporation and “the natural reluctance of potential investors to purchase a non-controlling interest in a closely held corporation...can result in minority shareholders being held hostage by the controlling interest...” *Edenbaum*, 165 Md. App. at 258.

¹⁰ The facts of the case did not support dissolution nonetheless. The Court of Special Appeals found that a minority freeze out did not constitute sufficient evidence of oppression or fraud. *Edenbaum*, 165 Md. App. at 258-259.

proved). The burden of proving oppression and fraudulent conduct rests on the moving party and the allegations must be clearly established. *Id.* at 22-23. Moreover, “mere internal dissensions among stockholders, or mere differences or disputes as to corporate management, so long as the officers do no act that is fraudulent, illegal or *ultra vires*, will not warrant intervention of a court of chancery...” *Du Puy v. Terminal Company*, 82 Md. 408, 426 (1896); *James F. Power Foundry Co. v. Miller*, 166 Md. 590, 595 (1934) (holding that although plaintiffs complained that defendants who owned all the common stock were paid excessive dividends, such grievance does not constitute fraud or oppression).

Plaintiffs have failed to allege specific facts showing oppression or fraudulent conduct. Plaintiffs’ allegations that the independent directors resigned due to the reluctance of Wood and Porter to consider the sale of Telos in its entirety, at best constitutes internal dissension within the corporation. A difference in view point between minority and majority shareholders on how to restructure the company is simply not enough to dissolve a corporation or appoint a receiver. On similar facts, *James F. Powers Foundry Co.*, 166 Md. 590, 171 A. at 845, the Court of Appeals stated:

If this is a controversy between stockholders, as it now appears to be, a majority of whom are in favor of holding the property for more favorable business conditions, the others demanding that the property be sold for what it may bring and the corporation dissolved, it means the wrecking of a business that has been and may again be successful.

Porter and Wood’s reluctance to consent to the sale of Telos in its entirety, even if motivated by a desire to protect their own interests as majority shareholders, will not be

sufficient to convince the Court that their actions were fraudulent or oppressive.¹¹

Maryland courts have held that in the “absence of fraud or illegality ...the will of the majority is entitled to control the policy and the business of the body corporate.”

Callaway v. Powhatan Improvement Co., 95 Md. 177, 185 (1902); *Du Puy*, 82 Md. 408, 426. Moreover, the record shows that Porter and Wood were willing to sell parts of Telos to attempt to resolve the obligations of holders of the public preferred interest, further casting doubt that oppression or fraud exists.

Plaintiffs rely on the cases of *Hamzavi v. Bowen*, 126 Md. App. 492 (1999) and *Birnbaum v. SL&B Optical Centers, Inc.*, 905 F. Supp. 267 (D. Md. 1995) as examples of similar situations where the court has granted receivership. The Court, however, agrees with defendant that both *Hamzavi* and *Birnbaum* are easily distinguishable from the facts of this case. In *Hamzavi*, the defendant bought the majority interest in a condominium complex and used this interest to displace all existing board members with persons completely under his control, to control and direct the board to make and enforce illegitimate assessments against the other owners. On these facts, the court appointed a receiver and removed Hamzavi from control. *Id.* at 496. In *Birnbaum*, plaintiff, who was one of three shareholders of the corporation, brought suit alleging that the other two shareholders tried to sell one of the three franchises of the company without plaintiff’s knowledge and that defendants diverted corporate funds to pay off personal loans unrelated to the corporation. The court held that plaintiff had properly brought a cause of action for dissolution. The facts of these cases bear little similarity to the facts before this Court.

¹¹ On the other hand, plaintiffs’ motivations for pressing this receivership motion, whether admissible or not, are not necessary to the Court’s determination of the issues presented by the motion.

A major distinction of *Hamzavi* and *Birnbaum* is that the conduct of the defendants in both cases crippled the operations of the relevant corporations. However, in the case of Telos, even plaintiffs admit that dissolution of the corporation is not necessary and that the current operations should continue to preserve the value of plaintiffs' interests. Defendant contends that the management of Wood and Porter has contributed to a steady increase in the value of Telos' stock. Telos' Proposed Findings of Fact and Conclusions of Law, at ¶ 10.

Plaintiffs argue that the non-payment of dividends in the face of mandatory redemption qualifies as fraud and oppression. They point out that, under Maryland law, "oppression should be deemed to arise only when the majority conduct substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and were central to the petitioner's decision to join the venture." *Edenbaum*, 165 Md. App. 258. The Court cannot find as a matter of law, however, that plaintiffs' expectations here are objectively reasonable. As defendant counters "the right of shareholders to recover dividends or redeem their stock is dependent on the financial solvency of the corporation, and is therefore not a fixed liability." *Harbinger Capital Partners Master Fund v. Granite Broadcasting Corp*, 906 A.2d 218, 225 (Del. Ch. 2006). In *Harbinger*, the Delaware Court of Chancery also explained that "mandatory redemption provisions of convertible preferred stock is an interest and not a claim precisely because the rights of shareholders to redeem shares are not guaranteed." *Id.* at 227. It is evident from a review of the 1989 Registration Statement filed with the SEC, that plaintiffs have not been denied any rights as defined by the proxy statement and prospectus forming the terms of the public preferred stock. Registration Statement of

1989 of the SEC form S-4. The public preferred shareholders' minority equity interest in Telos does not provide a guarantee in payment of dividends or redemption of their stock.¹² The public preferred ranks junior to all senior stock and debt of the company and plaintiffs knew from the registration statement for the public preferred stock that the stock represented a minority interest in the corporation. Under Maryland law, the payment of dividends and redemption of such stock is subject to the availability of funds. Thus, the Court finds that plaintiffs have failed to put forth facts that demonstrate fraud or oppression on the part of defendant corporation.

V. Without proof of oppression, the court has no interest in interfering with defendant's business.

Not only is there no legal basis for the Court to appoint a receiver for defendant corporation, but appointing a receiver would likely cripple defendant's business contracts.¹³ Defendant points out that Telos receives about 90 percent of its revenue from U.S. government contracting. All contracts with the government and Telos include a clause allowing the governmental party to terminate business for convenience. Defendant contends that the confidence that the government has in Telos' business greatly determines whether the governmental party will initiate or maintain business with defendant corporation. A governmental party in contract with Telos maintains close scrutiny of Telos' viability. Telos' Proposed Findings of Fact and Conclusions of Law, at

¹² Plaintiffs are entitled to a redemption of at least 20 percent of outstanding ERPS at \$10 per share starting December 1, 2005 through the next four years; however, this entitlement is subject to defendant's availability of funds. Plaintiffs' Proposed Findings of Fact and Conclusions of Law, at ¶¶ 4-9; *Harbinger*, 906 A.2d 218, 225.

¹³ While perhaps less drastic, the appointment of a special fiduciary agent would signal a similar message to Telos' government contacts.

¶ 61. If the Court placed Telos under the control of a receiver, this would signal to the governmental party providing Telos with business that Telos' stability is in question. Accordingly, if the Court were to appoint a receiver, most of defendant's contracts would likely be terminated. Telos' Proposed Findings of Fact and Conclusions of Law, at ¶ 61. Under the circumstances presented here, the Court finds that the imposition of a receiver for Telos may directly impair the defendant's ability to continue its important business relationship with the federal government.

V. Conclusion

Plaintiffs failed to show specific evidence of fraud, oppression or illegal conduct to permit the Court to appoint a receiver. The Court is not inclined to consider the alternative equitable remedy suggested by the plaintiffs simply because there has occurred a change in outside directors or a management dispute over strategic plans. For the reasons set forth in this memorandum opinion, plaintiffs' motion will be denied.

_____/S/_____
ALBERT J. MATRICCIANI, JR.
JUDGE
Date: Nov. 29, 2006

cc: counsel of record

