THE DAILY RECORD

Law

Telos wins key ruling; shareholder derivative claims dismissed

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January 9, 2008 7:14 PM

A judge in Baltimore has thrown out the shareholder derivative claims in a $79 million-plus lawsuit against several directors and officers of Telos Corp., an information technology contractor for the military.

Telos convinced the court that its Special Litigation Committee, made up of two disinterested directors advised by outside counsel, acted reasonably when it concluded that the suit was not in the company's best interest.

An attorney for plaintiff Costa Brava III L.P., a Boston-based hedge fund, said it plans to pursue the last two counts in the lawsuit, which seek to dissolve the corporation or put it into receivership.

"The court did not say our claims did not have merit," said the attorney, Harry Levy, of Shumaker & Williams in Towson. "It said that the Special Litigation Committee could reasonably reach the conclusion it did."

While she acknowledged that point, the lead counsel for Ashburn, Va.-based Telos called it a "distinction without difference" in this instance.

"Those two counts are based on identical allegations to the two counts that were dismissed," said McGuire Woods partner Ava Lias-Booker. "We think those counts should be dismissed as well."

Costa Brava and a second hedge fund, Wynnefield Partners Small Cap Value L.P., say the individual defendants abdicated their responsibilities and permitted Telos' largest investor, John Porter, and its CEO, John Wood, to control the corporation. If it weren't for mismanagement, they say, the company could have paid dividends and redeemed their shares.

Telos, though, decided that the allegations were unfounded and that the suit would not benefit the company. That call was upheld by Baltimore City Circuit Judge Albert J. Matricciani Jr., who found the company's decision was entitled to deference under Maryland's business judgment rule.

"On this one point, Maryland shows more deference to business decision-makers than Delaware," Lias-Booker said.

The hedge-fund plaintiffs had urged Matricciani to adopt Delaware's standard for evaluating the Special Litigation Committee's work. Under that standard, the judge would conduct an independent analysis of the SLC's conclusions, with the burden on Telos to show that the decision was correct.

Telos, though, is incorporated in Maryland, so Maryland law applies to the dispute.

Lias-Booker argued that Maryland law required a far more deferential standard of review, with the presumption in favor of Telos and the judge's role limited to determining if the SLC acted independently, conducted a reasonable investigation and reached a conclusion that was supported by its findings.

Her argument was helped immensely on March 1, 2007, when the Court of Special Appeals adopted essentially the same standard in another case, Bender v. Schwartz.

Costa Brava's lawyers, though, argued that Bender should not apply because the Telos litigation had been proceeding for two years before the SLC made its report. (Telos had sought a stay pending the SLC's investigation, but Matricciani denied it.)

The plaintiffs also pointed out that Telos actually had two SLCs. In August 2006, when the first committee's draft report was nearing completion, several directors resigned from the board, which then had to be reconstituted, and a new SLC formed. (Lias-Booker said the directors were purposely kept unaware of the SLC's report.) One of the outside directors named to the reconstituted SLC testified at deposition that his role was, in part, "to make the litigation go away."

After considering those claims and others, and taking expert testimony from professor Lisa Fairfax of the University of Maryland School of Law, Matricciani concluded the challenges were insufficient to cast doubt on the committee's independence or investigation.

"The real issue is what deference the court will give those decisions," Lias-Booker said. "And this opinion, combined with Bender, removes any doubt."

While she expects Costa Brava ultimately will appeal any adverse decision, she says she is gratified that Monday's ruling resolves the claims against the individual defendants.

Those defendants include past and present directors Robert Marino, John Wood, Geoffrey Baker, David Borland, Norman Byers, Fred Iklé, Langhorne Motley and Malcolm Sterrett; and officers Michael Flaherty, Robert Marino, Edward Williams, John Wood, John McDuffie, Michele Nakazawa and Richard Tracy.

Iklé's attorney, Gregory T. Lawrence of Conti, Fenn & Lawrence in Baltimore, welcomed the opinion not only for its effect on his client, but for its adherence to Maryland's pro-business business judgment rule, rather than Delaware's.

"Delaware law is very influential but it doesn't change that there are differences," he said. "In this case there is a significant difference in the standard that applies — but under either standard, we believe the court reached the right result."