

SETH W. HAMOT, et al.
Plaintiffs/Counter-Defendants

v.

TELOS CORPORATION
Defendant/Counterclaimant

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IN THE

CIRCUIT COURT

FOR BALTIMORE CITY

CASE NO.: 24-C-07-005603

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MEMORANDUM

Now pending before the court is a series of motions relating to plaintiffs’ request that the court order defendant/counterclaimant to advance to plaintiffs reimbursement for legal fees and expenses that plaintiffs have incurred or will incur in connection with their defense against Telos’ counterclaim in this case. The motions have been fully briefed, and a hearing was held. The court now rules on these motions.

BACKGROUND

Telos Corporation is a Maryland corporation. Costa Brava Partnership III, L.P. is a Delaware limited partnership that owns approximately 15.9% of the outstanding 12% Cumulative Exchangeable Redeemable Preferred Stock (“ERPS”) in Telos. On October 17, 2005, Costa Brava initiated an action in this court against Telos and certain of its directors and officers. Costa Brava and another plaintiff permitted to intervene alleged that Telos wrongfully failed to pay dividends on the preferred stock or to make required redemptions of the preferred stock, and that the management of Telos has acted so as to benefit the holders of its common stock at the expense of the holders of the preferred stock. Costa Brava Partnership III, L.P. et al. v. Telos Corporation, et al., Case No. 24-C-05-009296. The plaintiffs in that action asserted derivative and other claims. On January 7, 2008, this court dismissed the derivative claims, and

on April 15, 2008, the court dismissed the remaining claims.¹ An appeal was noted, which remains pending at this time.

Messrs. Hamot and Siegel, the plaintiffs in this action, are principals of Costa Brava. They became members of Telos' Board of Directors on June 18, 2007 after Telos failed to make dividend payments to the ERPS holders. They initiated this action on August 2, 2007, alleging that Telos had refused to provide them with access to records that they required in order to perform their duties as directors, and seeking an order directing Telos to provide them with the records. Contemporaneously they filed a motion for temporary restraining order seeking the production of certain documents. They filed an Amended Complaint and Amended Motion for Temporary Restraining Order on August 22, 2007, and a Second Amended Complaint and additional Motion for Temporary Restraining Order on September 24, 2007. Hearings were held before the court on August 7, 2007, August 27, 2007 and October 11, 2007. On August 28, 2007, the court passed an order entitled "Preliminary Injunction," containing provisions relating to the response by Telos to requests by plaintiffs for information pertinent and necessary to perform their duties as members of the Board of Directors. On October 12, 2007, the court passed an order entitled "Amended Preliminary Injunction Order," amending the previous order in several respects.

Nothing further happened in this case until April 23, 2008, when Telos filed a six count counterclaim. The basis of the counterclaim was the allegation that Hamot and Siegel had engaged in a campaign that was designed to pressure and coerce Telos' public auditors into

¹ Prior to September 2, 2008, both the Costa Brava suit and this suit were assigned to Hon. Albert Matricciani, then a member of this court. Upon Judge Matricciani's appointment to the Court of Special Appeals, the cases were reassigned to the undersigned.

accepting certain accounting treatment for the preferred stock and to undermine and sever the relationship between Telos and its auditors. Telos sought preliminary and permanent injunctive relief requiring Hamot and Siegel to refrain from any contact or communication with the auditors that sought the alteration of audit opinions or was designed to interfere with the relationship of Telos and its auditor, any communications that were designed to prevent Telos from hiring a new auditor, or any communications that sought to influence any auditor retained by Telos in the performance of its audit. Telos also sought compensatory and punitive damages. Counts One and Two alleged tortious interference with the contractual relations between Telos and its auditors. Counts Three and Four alleged tortious interference with economic or business relations between Telos and its auditors. Counts One and Three concerned relations between Telos and Goodman & Company, LLP, the company's auditor until July 2007, and Counts Two and Four concerned the relations between Telos and the Reznick Group, P.C., the company's auditor from September 2007 through March 2008. Counts Five and Six asserted claims for breach of fiduciary duty against Hamot and Siegel, respectively.

With the counterclaim Telos filed a motion for preliminary injunction. Telos asserted that without preliminary relief it would suffer irreparable injury because it would be unable to find a public accounting firm willing to act as its outside auditor, and would be unable, as a result, to produce audited financial statements and to file its 2007 Form 10-K with the Securities and Exchange Commission. After discovery and a hearing, the court granted Telos's Motion for Preliminary Injunction on June 27, 2008. It concluded that Telos had demonstrated the likelihood of success on the merits of its claims. It reasoned that the record reflected that Hamot and Siegel intentionally interfered with the relationships between Telos and its auditors, as a

result of which Telos had raised a substantial claim for tortious interference with contract under the facts presented. It further concluded that Telos was likely to demonstrate that Hamot and Siegel intentionally sought to interfere with Reznick's audit through their questionable and potentially misleading communications. Finally, the court held that Telos was likely to demonstrate that the conduct by Hamot and Siegel violated SEC Rule 13b2-2, and that the record supported Telos' claim for fiduciary duty.

As a result of these conclusions, the court ordered that Hamot and Siegel cease, desist and refrain from any and all direct or indirect communication with Goodman, Reznick or any other former, current or future auditors of Telos regarding the conduct prohibited by the injunction, during the pendency of the litigation or until such time as Telos obtained audited financial statements for 2007 and filed Form 10-K with the SEC. This injunction prohibited them from engaging in this conduct either singularly or in concert with others, including any entities through which they operate, including Costa Brava.

On July 25, 2008, Hamot and Siegel filed an appeal from the preliminary injunction. On May 6, 2009, the Court of Special Appeals issued an opinion dismissing the appeal on the basis that the appeal was moot. *Hamot v. Telos Corp.*, 185 Md. App. 352 (2009). It observed that on December 18, 2008, Telos had informed the court that the audit of the corporation's 2007 financial statements had been completed and its 2007 Form 10-K had been filed with the SEC. The court concluded that no active controversy existed in light of the time-limited nature of the preliminary injunction order. It rejected plaintiffs' arguments that the controversy was capable of repetition yet evading review, noting that a key component of Telos's irreparable harm

argument was its assertion that it could not find an outside auditor, and that Telos had secured an outside auditor who presumably continued to serve.

On September 8, 2008, Hamot and Siegel, through a letter from their counsel captioned “Demand for Indemnification and Reimbursement,” made demand for payment of the counsel fees incurred in defending against Telos’ counterclaim. The letter asserted that Hamot and Siegel were named as defendants to the counterclaim by reason of their service as directors, and demanded “payment of attorneys’ fees and expenses incurred to date and through final disposition of the counterclaim.” On October 2, 2008, at a special meeting of the board of directors, a majority of the board determined that Hamot and Siegel were not entitled to advancement or indemnification. Also on October 2, 2008, Telos filed a second amended counterclaim.² The amendment added Count Seven, which sought a declaratory judgment that Hamot and Siegel were not entitled to advancement or indemnification of their attorneys’ fees incurred in defending the counterclaim. On October 14, 2008, plaintiffs’ counsel sent a follow-up letter noting that Telos’s counterclaim alleged that plaintiffs had not provided a written affirmation of good faith and a written undertaking to repay any funds advanced if it were ultimately determined that plaintiffs were not entitled to indemnification. Appended to the letter were attachments intended to “cure these non-substantive defenses,” one of which was an undertaking to repay executed by Costa Brava. The letter asked for notification by October 17, 2008 whether Telos would comply with the demand.

Following the filing of the Second Amended Counterclaim, another period of inactivity in this case ensued, which ended on April 1, 2009, when Hamot and Siegel filed a petition for

² Telos had filed a first amended counterclaim on June 23, 2008.

constructive contempt, alleging that Telos had failed to comply with the injunctive orders of 2007 relating to production of information. After a hearing, this court entered an opinion and order on January 20, 2010, dismissing the petition for contempt.

On April 12, 2010, plaintiffs filed the instant motion for advancement of legal fees and expenses. In their motion, they asked that the court issue an order directing Telos to advance the legal fees and expenses that they had already incurred in defending the counterclaim within 30 days of the court's order, and that the court order Telos to continue to advance their legal fees and expenses incurred in defending the counterclaim within 30 days of their submission of their bills to Telos.

On May 11, 2010, Telos filed opposition to the motion for advancement, and also filed a motion for summary judgment on Count Seven of the Second Amended Counterclaim. On May 27, plaintiffs submitted a combined reply to the opposition to the motion for advancement, opposition to Telos' motion for summary judgment, cross-motion for partial summary judgment, motion to strike, and request for attorneys' fees. On June 11, Telos submitted a combined reply to the plaintiffs' opposition to motion for summary judgment, opposition to plaintiffs' motion for summary judgment and opposition to the motion to strike. On June 25, 2010, plaintiffs submitted a reply to the opposition to their cross-motion for summary judgment and to the opposition to the motion for attorneys' fees.

A hearing was held on August 17, 2010. On August 12, 2010, plaintiffs submitted new undertakings personally signed by Messrs. Hamot and Siegel.

FACTS

In order to resolve the contentions of the parties, the court has examined the exhibits submitted with their moving papers, as well as the record of the proceedings in this case. The following is a summary of the facts that are pertinent to the issues posed by the parties' motions.³

There is no real dispute about the salient facts that form the background for the counterclaim. Preceding and underlying the litigation between the parties is the dispute over Telos' actions in failing to make dividend payments on the preferred stock. There is no dispute that Costa Brava is unhappy with Telos's actions, nor that plaintiffs in this case contest the propriety of that conduct. Costa Brava and Messrs. Hamot and Seigel have engaged in a number of actions in order to attempt to cause Telos to alter its course.

Costa Brava initiated litigation in this court in 2005 in order to attempt to require Telos to alter its treatment. In addition, Costa Brava filed suit in Virginia against Goodman & Company, the independent accounting firm retained as Telos' auditor beginning in 2003, asserting claims against it based on the accounting treatment of the ERPS. While that action was pending, Hamot and Siegel were elected to the Telos board as Class D directors, resulting in Goodman's resignation as to the Telos auditor. In November 2007, a jury verdict was returned in the Virginia action which found in favor of Costa Brava on one of its claims but awarded no damages.

After Goodman's resignation, Telos selected the Reznick Group as its new auditor. In 2008, there were a number of communications sent to the Reznick Group by plaintiffs. Mr.

³ The court agrees with plaintiffs that the alleged facts reflected by Exhibits 1-3 and 6-9 submitted by Telos are not relevant to the question currently before the court. Therefore, the court will disregard those exhibits.

Siegel directed a memorandum dated March 3, 2008 to Bernard Bailey, the Chairman of the Telos Audit Committee, and another memorandum dated March 12, 2008. In these memoranda, Siegel challenged the accounting treatment of the ERPS and alleged that there were misstatements in Telos' Form 10-Ks. Copies were sent by Siegel to Reznick. On March 31, 2008, Siegel sent another memorandum to Bailey, which Siegel copied to the entire Telos Board of Directors, and to Reznick, in which he again questioned statements in the Telos 2006 Form 10-K. On April 14, 2008, Siegel sent another memorandum to Bailey, with a copy to Reznick, again raising challenges to the ERPS accounting treatment.

The event that immediately preceded the filing of the counterclaim was a letter dated March 28, 2008 to Goodman and Company that was copied to Reznick. This letter was sent on the stationery of Roark, Rearden & Hamot and was signed on behalf of Costa Brava Partnership III, L.P. Mr Hamot stated at his deposition that it was sent with his authorization and at his direction. This letter was not sent to Telos or any of its directors. The letter stated in part:

The Honorable Randy I. Bellows recently held that the evidence presented by Costa Brava Partnership III, L.P. ("Costa Brava") was sufficient to support the jury's verdict that Goodman & Company LLP ("Goodman") aided and abetted breaches of fiduciary duty owed by Telos to Costa Brava, a public preferred shareholder of Telos Corporation ("Telos") by issuing a clean audit opinion in Telos's 2004 10-K.

Goodman provided clean audit opinions for Telos's 2005 and 2006 10-Ks using the same improper accounting justifications for the classification of the mandatory redemption obligations of the public preferred stock as long-term liabilities. Accordingly, Goodman has continued to aid and abet Telos's breach of its fiduciary duty to the public preferred shareholders, and we demand that Goodman immediately withdraw its audit opinions for 2004, 2005 and 2006 to the extent that Telos continues to misclassify the

public preferred stock as a long-term liability and understates the dollar amount owed to the public preferred shareholders.

.....

Costa Brava reserves its right to bring claims against Goodman for any damages resulting from clean audit opinions relating to past or future financial statements.

On April 16, 2008, Reznick resigned as auditor for Telos, stating that “As a result of certain communications from the Class D members of the Board of Directors, the Reznick Group believes its independence has been impaired.” In its Form 8-K dated April 16, 2008, Telos asserted that Reznick perceived these communications as threatening litigation and attempts to influence its opinion on certain accounting issues. By letter dated April 22, 2008, Reznick stated that it agreed with this assertion.

In its counterclaim, Telos referred to the ongoing dispute with Costa Brava over the payment of dividends and redemption of ERPS. It further alleged that Telos has treated the obligations as non-current liabilities in accordance with generally accepted accounting principles, but that Costa Brava has refused to accept this accounting treatment, and that Costa Brava, Hamot and Siegel have filed multiple lawsuits and employed a variety of tactics in an attempt to force a change in this accounting treatment. It alleged that Hamot and Siegel have targeted the outside independent auditors who must approve the Telos accounting treatment for the ERPS. (¶ 15). It also alleged that as directors, Hamot and Siegel have a duty of loyalty to Telos, which they violated in pursuing their own financial interests and placing those interest ahead of the interest of the corporation. (¶ 16).

Telos made factual allegations concerning the alleged campaign of Costa Brava. It noted the initiation of the action by Costa Brava in October 2005, requesting dissolution of the

company, and the filing of a Second Amended Complaint in that action on February 27, 2007. (¶ 20). Telos further alleged that Costa Brava interfered with Telos' efforts to recruit directors for the board (¶¶ 27 - 29), that Costa Brava made efforts to disrupt Telos' relationship with its primary lender (¶¶ 30 - 32), that a preliminary injunction was entered in the Costa Brava litigation based upon Telos' counterclaim requiring that Costa Brava cease any communication with the lender, and that another prong of the Costa Brava campaign was various filings with the SEC. (¶¶ 34 - 41).

These assertions were followed by allegations relating to the targeting of the independent accounting firms who audited Telos' financial statements. Goodman & Company was the independent accounting firm retained as Telos' auditor from 2003 through 2007 (¶ 43). In June 2005, Costa Brava began a letter writing campaign to coerce Goodman into reversing its approval of the ERPS accounting treatment, and when these letters were unsuccessful Hamot and Siegel sought to coerce Goodman into a withdrawal of its 2004, 2005 and 2006 audit opinions. Costa Brava filed a separate action against Goodman in Virginia asserting claims against it, and while that action was pending, Hamot and Siegel were elected to the Telos board as Class D directors, resulting in Goodman's resignation as to the Telos auditor. (¶ 47). In November 2007 a jury verdict was issued in the Virginia action rejecting all Costa Brava's claims except for one. (¶ 48).

After Goodman's resignation, Telos selected the Reznick Group as its new auditor. In order to prevent any officer or director from influencing the company's external auditors, the external auditors report to the audit committee, and individual directors are not authorized to contact the auditors directly. (¶ 52). Since the ruling in this court dismissing Costa Brava's

claims, Hamot, Siegel and Costa Brava have directly communicated with Reznick in an attempt to influence Reznick. (¶ 53). The counterclaim reviewed the communications from Hamot and Siegel to the chair of the Audit Committee and to Goodman and Reznick that occurred in March and April 2008. (¶¶ 54-60). Members of the Telos board questioned Hamot and Siegel about these communications at the board meeting of April 2, 2008, but they refused to answer. (¶ 61). As a result of this conduct, Reznick has resigned as Telos' auditor. (¶ 62). Telos alleged that it needs audit opinions from an outside auditor in order to file its Form 10k and that it would be impossible for Telos to find a public accounting firm willing to act as outside auditor unless the court enjoins Hamot and Siegel and others in concert with them to cease such communications. (¶ 64).

Count One asserts a claim for tortious interference with contractual relations with Goodman. Alleging that they improperly interfered with Goodman's performance of its contractual obligations to Telos, it asserts that with an improper motive to injure Telos for their own personal gain and benefit Hamot and Siegel used coercion, intimidation, threats and misleading statements in an effort to induce Goodman to withdraw or alter its audit opinions.

Count Two alleges tortious interference with contractual relations with Reznick. It alleges that Hamot and Siegel, with an improper motive to injure Telos for their own self interest, personal gain and benefit, used coercion, intimidation, threats and misleading statements in order to improperly influence Resnick.

Count Three alleges tortious interference with economic or business relations with Goodman. It alleges that Hamot and Siegel, being aware of the contractual nature of the engagement between Goodman and Telos, are threatening Goodman with lawsuits and are doing

so in violation of SEC Rule 13b2-2 and the fiduciary duties they owe Telos as directors. It alleges that this conduct was maliciously calculated to cause damage to Telos without justification.

Count Four alleges tortious interference with economic or business relations with Reznick and asserts that Hamot and Siegel, being aware of the existence of the contract, have improperly tried to coerce, manipulate, mislead and influence Reznick.

Counts Five and Six are claims for breach of fiduciary duty against Hamot and Siegel respectively. As to each they allege that as a corporate director, the counterdefendant owed Telos a duty to act for its benefit with loyalty and good faith, without any self-interest or self-dealing, and that the counterdefendant has breached his fiduciary duties by improperly engaging in conduct to pressure Goodman and Reznick.

The order granting the motion for preliminary injunction contains the following conclusions, among others:

At the heart of the dispute between the parties is Telos' classification of its ERPS obligations as either current or long-term corporate liabilities under appropriate accounting principles. Telos makes a strong showing before this Court that the dispute has been resolved in its favor by virtue of the SEC's acceptance of the accounting classification of the ERPS . . . and on the basis of this Court's prior rulings in the shareholder litigation. . . . Indeed, the only basis Hamot and Siegel have for continuing to assert their position that the ERPS obligations constitute current liabilities of Telos is a wholly ambiguous finding by a jury in the Circuit Court in Fairfax, Virginia in Costa Brava's action against Goodman. . . .

On the basis of this rather thin reed, plaintiffs made continued demands for the withdrawal of Goodman's audit opinions, made threats of litigation against Goodman and possibly Reznick, and continued to file claims against Goodman in Fairfax, Virginia.

For the purposes of the present motion, the Court concludes that Telos has demonstrated a likelihood of success on the merits of its claims. An action for tortious interference with contract will lie when “a third party who, without legal justification, intentionally interferes with the rights of a party to a contract, or induces a breach thereof[.]” . . . In this case, Telos has contractual relationships with both Reznick and Goodman, which are reflected in their engagement letters with Telos, and Hamot and Siegel had knowledge of these relationships. The record further indicates that Hamot and Siegel intentionally interfered with these relationships, and that their interference caused the non-performance by Reznick and Goodman of the services they were engaged to perform, as well as Reznick’s termination of the engagement. Thus, Telos has raised a substantial claim for tortious interference with contract under the facts presented.

The same is true of its claim for tortious interference with business or economic relations. The Maryland Court of Appeals has stated that the types of “wrongful” conduct underlying a claim for tortious interference with business or economic relation include acts of “intimidation” or “the institution or threat of groundless civil suits... in bad faith.” *K&K Mgmt. v. Lee*, 316 Md. 137, 166 (1989); *see also Macklin*, 334 Md. at 301. The Court of Appeals has noted further that “conduct that is quite subtle, nevertheless, can be improper or wrongful.” *Macklin*, 334 Md. at 301. As discussed above, the record indicates that Telos is likely to demonstrate that Hamot and Siegel intentionally sought to interfere with Reznick’s audit through questionable and potentially misleading communications and barely-veiled threats of litigation, and that their interference caused Reznick to resign. Telos, therefore, has also raised claims going to the merits of its count for tortious interference with business or economic relations.

Additionally, Telos is likely to demonstrate that their conduct was not just wrongful, but unlawful. Under SEC Rule 13b2-2, promulgated pursuant to section 303 of the Sarbanes-Oxley Act, directors are prohibited from taking any actions to “coerce, manipulate, mislead or fraudulently influence” an auditor if he or she “knew or should have known that such action, if successful could render the issuer’s statements materially misleading.” This prohibited conduct includes the use of “pressure, threats, trickery, intimidation or some other purposeful action,” including the provision of inaccurate or misleading

information or legal analysis to an auditor. See SEC Release No. 34-37890, 2003 WL 21148349, at 5-6. In this case, Telos is likely to show that Hamot and Siegel used potentially misleading communications and threats of litigation in an effort to dictate the accounting treatment that Reznick should adopt, thereby running afoul of Sarbanes-Oxley section 303 and SEC Rule 13b2-2 and providing another basis for liability for tortious interference with business or economic relations.

Lastly, the record supports Telos' claims for breach of fiduciary duty. By statute, directors are obligated to perform their duties in good faith, in a manner they believe to be in the corporation's best interests, and with the care that an ordinarily prudent person would exercise in like circumstances. Md. Code, Corps. & Ass'ns §2-405.1. A director's actions run to the corporation as a whole and take precedence over his or her personal interest. See *Werbowisky v. Collomb*, 362 Md. 581, 599 (2001). The Maryland Court of Appeals has held that directors have "an inherent obligation ... not only that they will use their best effort to promote the interests of the shareholders, but that they will *in no manner use their positions to advance their own individual interest as distinguished from that of the corporation*[".]” *Indurated Concrete Corp. v. Abbott*, 195 Md. 496, 503-04, 74 A.2d 17, 20 (1950)(emphasis added)(quoting *Cumberland Coal and Iron Co. v. Parish*, 42 Md. 598, 605-06 (1875)).

Here, the conduct by Hamot and Siegel indicates that they put their interests ahead of the corporation they were supposed to be serving and sought to disrupt the company's essential relationships to serve their own ends. Indeed, even after being advised at Telos' April 2, 2008, board meeting that their conduct was jeopardizing the company's relationship with its auditor, they continued to send more communications to Reznick attempting to influence its opinions. Their conflicted interests are further revealed in an e-mail exchange just a few days later between Siegel and Victor Morganstern, a fellow ERPS holder, who noted that Telos was still continuing to "get contracts," and then inquired, "Are we getting anywhere?" . . . Given the record before the Court, it appears that Telos likely will be able to demonstrate that Hamot and Siegel breached their fiduciary duties to the company.

Order of June 27, 2008 entitled "Preliminary Injunction" at 4-8 (footnotes omitted).

DISCUSSION

As do all states, Maryland makes provision for the indemnification of officers and directors who are sued by reason of their service. *See generally* Rossman, *A Primer on Advancement of Defense Costs: The Rights and Duties of Officers and Corporations*, 85 Univ. Detroit Mercy L. Rev. 29 (2007). Indemnification refers to the right of the directors or officers to be reimbursed for all losses, including defense costs, incurred by them in legal or administrative proceedings related to their job responsibilities. Typically, indemnification is a right that is determined retrospectively upon conclusion of the underlying legal proceeding. *Id.* at 30-31. Maryland's statute is modeled on the provisions of the Model Business Corporation Statute. The Maryland statute is permissive in nature; it authorizes, but does not require, a corporation to indemnify such persons.

Like all other states, Maryland also permits a corporation to advance litigation expenses for a director who is made a party to a proceeding because of his or her service. Advancement refers to the right to "immediate interim relief from the personal out-of-pocket financial burden of paying the significant on-going expenses inevitably involved with investigations and legal proceedings." Rossman, *supra*, at 31 (quoting *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 211 (Del. 2005)).

The purpose and intent of providing that a corporation may advance expenses is explained in the official comment to section 8.53 of the Model Business Corporation Act. It states:

Section 8.53 recognizes an important difference between indemnification and an advance for expenses: indemnification is retrospective and, therefore, enables the persons determining whether to indemnify to do so on the basis of known facts,

including the outcome of the proceeding. Advance for expenses is necessarily prospective and the individuals making the decision whether to advance expenses generally have fewer known facts on which to base their decision. Indemnification may include reimbursement for non-advanced expenses.

Section 8.53 reflects a determination that it is sound public policy to permit the corporation to advance (by direct payment or by reimbursement) the defense expenses of a director so long as the director (i) believes in good faith that the director was acting in accordance with the relevant standard for indemnification set forth in section 8.51 or that the proceeding involves conduct for which liability has been eliminated pursuant to section 2.02(b)(4) and (ii) agrees to repay any amounts advanced if it is ultimately determined that the director is not entitled to indemnification. This policy is based upon the view that a person who serves an entity in a representative capacity should not be required to finance his or her own defense. Moreover, adequate legal representation often involves substantial expenses during the course of the proceeding and many individuals are willing to serve as directors only if they have the assurance that the corporation has the power to advance these expenses.

Official Comment to section 8.53. (8-110 to 8-111).

The Maryland statute that governs the indemnification of corporate directors is Md. Ann. Code, Corporations & Associations Article §2-418. Subsection (b)(1) provides:

(b)(1) A corporation may indemnify any director made a party to any proceeding by reason of service in that capacity unless it is established that:

(i) The act or omission of the director was material to the matter giving rise to the proceeding; and

1. Was committed in bad faith; or

2. Was the result of active and deliberate dishonesty; or

(ii) The director actually received an improper personal benefit in money, property, or services; or

(iii) In the case of any criminal proceeding, the director had reasonable cause to believe that the act or omission was unlawful.

The statute also makes provision for the advancement of fees pending the final outcome of the proceeding. Subsection (f) of section 2-418 states:

(1) Reasonable expenses incurred by a director who is a party to a proceeding may be paid or reimbursed by the corporation in advance of the final disposition of the proceeding upon receipt by the corporation of:

(i) A written affirmation by the director of the director's good faith belief that the standard of conduct necessary for indemnification by the corporation as authorized in this section has been met; and

(ii) A written undertaking by or on behalf of the director to repay the amount if it shall ultimately be determined that the standard of conduct has not been met.

(2) The undertaking required by paragraph (1)(ii) of this subsection shall be an unlimited general obligation of the director but need not be secured and may be accepted without reference to financial ability to make the repayment.

(3) Payments under this subsection shall be made as provided by the charter, bylaws, or contract or as specified in subsection (e)(2) of this section.

Telos' bylaws make provision for advancement. The provision is currently contained in bylaw Article XII, which states:

To the maximum extent permitted by Maryland law in effect from time to time, the Corporation, without requiring a preliminary determination of the ultimate entitlement to indemnification, shall indemnify and shall pay or reimburse reasonable expenses in advance of final disposition of a proceeding to (a) any individual who is a present or former director or officer of the Corporation and who is made a party to the proceeding by reason of his service in that capacity or (b) any individual who, while a director of the Corporation and at the request of the Corporation, serves or has served another corporation, partnership, joint venture, trust, employee benefit plan or any other enterprise as a director, officer, partner or trustee of such corporation, partnership, joint venture, trust, employee benefit plan or other enterprise and who is made a party to the proceeding by reason of his service in that capacity.

The Corporation may, with the approval of its Board of Directors, provide such indemnification and advance for expenses to a person who served a predecessor of the Corporation in any of the capacities described in (a) or (b) above and to any employee or agent of the Corporation or a predecessor of the Corporation.

In their motion, plaintiffs asserted that Telos is bound by its bylaws, which create a contractual right to advancement of fees and expenses in accordance with their terms. They argued that the bylaws create six prerequisites for advancement: that the expenses are reasonable; that the individual indemnified be a current or former director; that he or she be made a party; to the proceeding; by reason of his or her service in that capacity; and that the minimum indemnification requirements of Maryland law be met. They asserted that each of those six prerequisites have been satisfied. They also asserted that because there are no findings that plaintiffs have engaged in any wrongdoing, the issue of whether plaintiffs may ultimately be entitled to indemnification is irrelevant, citing *Miller v. United States Foodservice, Inc.*, 405 F. Supp. 2d 607 (D. Md. 2005)

In response to plaintiffs' position, Telos asserted three arguments. It contended that plaintiffs failed to provide an undertaking as required by section 2-418(f)(1)(ii); that plaintiffs were not made parties to the proceeding by reason of their service as members of the Telos board of directors; and finally, that plaintiffs are unable to show a good faith basis for the request for advancement. The resolution of these motions requires the court to address these three issues.

Failure to provide an undertaking

The first ground advanced by Telos for the rejection of plaintiff's request for advancement was the argument that plaintiffs had failed to provide a written undertaking to repay the corporation upon a determination that they were not entitled to receive

indemnification. Plaintiffs had submitted an undertaking to repay from Costa Brava. Defendant argued that the statute requires that the undertaking be an obligation of the director, and that an undertaking of a third party did not qualify. Prior to the hearing, plaintiffs supplied the court with an undertaking from each of the individual plaintiffs. As a result, it appears that plaintiffs have now complied with this requirement, and indeed, it appears that Telos no longer presses this argument.

Nexus between claim and plaintiffs' service as directors

The second basis for Telos's opposition to the request for advancement is the argument that plaintiffs were not made a party to a proceeding by reason of their service as members of the board of directors. Telos contends that there is no nexus between the conduct that is the subject of the counterclaim and plaintiffs' status as directors. It states that "the entire premise of the counterclaim is that Hamot and Siegel, regardless of their status, have wrongfully and tortiously interfered with vital company relationships as part of an investment strategy pursued for their own benefit . . ." Hence, Telos argues, none of these claims arise from conduct engaged in by plaintiffs due to their service on the board.

In support of this argument, Telos relies heavily upon the decision of the Court of Appeals in *Kramer v. Liberty Property Trust*, 408 Md. 1 (2009). That case involved a request for advancement of legal fees made by Kramer, who was the Chairman of the Board of Trustees, relating to an investigation, which initially involved a related entity in which Kramer held an interest, but whose eventual findings potentially implicated Kramer's fiduciary duties as a trustee. In rejecting the claim, the Court of Appeals stated:

For a "proceeding" to be by reason of one's official status, there must exist a nexus or causal connection between the underlying

proceeding and one's official status. [Homestore, Inc. v. Tafeen, 888 A.2d 204 at 214 (Del. 2005).] For example, “[t]his connection is established if the corporate powers were used or necessary for the commission of the alleged misconduct” giving rise to the “proceeding.” Bernstein v. TractManager, Inc., 953 A.2d 1003, 1011 (Del. Ch. 2007).

....

Here . . . there was no nexus between the internal investigation -- a “proceeding” within the meaning of § 2-418 -- and Kramer's status as a trustee of Republic. Republic's Audit Committee conducted an internal investigation primarily to investigate the dealings between [the related entity and another party]. . . .

Audit Committee Counsel's investigation concerned Kramer because of his ownership [of the related entity]. Although Audit Committee Counsel eventually uncovered certain deprecatory e-mails . . . that it found suggestive of Kramer's unfitness to be a trustee, those communications were not discovered in an investigation of Kramer as a trustee. Moreover, Kramer cannot contend that he was made a “party” to the internal investigation by reason of his status as a trustee because the investigation culminated in the conclusion that Kramer failed to convey, during the course of the investigation, an appropriate “tone at the top.” This conclusion by Audit Committee Counsel may implicate Kramer's fiduciary duties to Republic, but Kramer's reliance upon it blurs the distinction between the investigation and its aftermath. It ignores the reason why Kramer became of interest to Audit Committee Counsel in the first place, thereby placing undue weight upon the fact that Kramer coincidentally held positions with both RPC and Republic. If anyone made Kramer a “party” to the internal investigation by reason of his status as a trustee, it was Kramer himself, who obstructed Audit Committee Counsel's ability to meaningfully interview attorney Robert Sanders and challenged the authority of Republic's Audit Committee. Kramer cannot reasonably argue that such actions, taken for his personal benefit as co-owner of RPC, somehow make him subject to the advancement provision of Republic's Bylaws.

408 Md. at 44-47. (footnotes omitted).

Telos also relies on *Bernstein v. TractManager, Inc.*, 953 A.2d 1003 (Del. Ch. 2007) and *Stifel Financial Corp v Cochran*, 809 A.2d 555 (Del. 2002), both cited by the Court of Appeals in *Kramer*. In each of those cases, the Delaware court rejected claims for advancement. In *Bernstein*, the court reasoned that an “individual is not sued by ‘reason of the fact’ that he or she is a director simply because allegations arguably give rise to breach of fiduciary duty claims,” where the corporate powers were not critical, instrumental or used in any meaningful sense to commit these acts. Telos also cites a number of authorities for the proposition that indemnification is not available when personal motives predominate. See *Shearin v. E.F. Hutton Group*, 652 A.2d 578 (Del. Ch. 1994); *Brush Creek Mining & Dev. v. Lawson*, 1999 U.S. App. LEXIS (9th Cir. 12/9/99); *Plate v. Sun-Diamond Growers*, 225 Cal. App. 3d 1115, 275 Cal. Rptr. 667 (1990).

Plaintiffs challenge Telos’ argument that actions taken for personal benefit preclude a finding of a nexus between the claim and the director’s service. They rely on *Reddy v. Electronic Data Sys. Corp.*, 2002 Del. Ch. LEXIS 69 (Del. Ch. 2002). In that case, the court rejected EDS’s argument that the fact an employee was the subject of a criminal and civil proceeding based on his alleged wrongful actions for his personal profit meant that he was not a party to the proceedings by reason of the fact that he was an employee of EDS. The court reasoned:

The problem with EDS's argument is that it has no logical stopping point. It is not uncommon for corporate directors, officers, and employees to be sued for breach of the fiduciary duty of loyalty, and to have to defend claims that they took official action for the primary purpose of diverting corporate resources to their own pocketbooks -- in the form of contractual compensation benefits (e.g., severance payments or stock options) or an unfair return on a self-dealing transaction. Therefore, it is highly problematic to

make the advancement right of such officials dependent on the motivation ascribed to their conduct by the suing parties. To do so would be to largely vitiate the protections afforded by [the Delaware statute] and contractual advancement rights.

Id. See also Rossman, *supra*, at 41.

Plaintiffs argue that Telos' position confuses the issue of whether the claim has a nexus to the individual's status as director, "as contrasted with a claim based on actions that took place in the director's personal life," with the issue of whether the director acted with an improper personal motivation, which is not relevant to the issue of advancement. Plaintiffs also take issue with Telos' characterization of the facts. They note that Counts Five and Six of the Counterclaim explicitly assert claims for breach of fiduciary duty, which can only be asserted against individuals who are directors. Furthermore, they contend that Counts One through Four also arise by virtue of their status as directors, because their status as directors played a part in causing the actions taken by the auditors in response to their conduct.

Plaintiffs correctly assert that whether advancement is available does not depend on whether personal motives predominate in the actions that are the subject of the proceeding against the director. The predominant authority is contrary to the position asserted by Telos. *See, e.g., Homestore, Inc. v. Tafeen*, 888 A.2d 204 (Del. 2005); *Perconti v. Thornton Oil Corp.*, 2002 Del. Ch. LEXIS 51 (Del. Ch. 2002). On the other hand, the mere fact that the person who is the subject of the proceeding is a director does not establish a nexus. Cases do state, as Telos suggests, that the issue turns on whether the acts that are the subject of the proceeding were undertaken by the director in the exercise of the power of his or her position. *See Bernstein v. TractManager, Inc.*, 953 A.2d 1003, 1011 (Del. Ch. 2007)(the requisite connection is established "if the corporate powers were used or necessary for the commission of the alleged misconduct");

Paolino v. Mace Security Int'l, Inc., 985 A.2d 392 (Del. Ch. 2009)(the statute does not apply when the parties are litigating an obligation that does not involve the exercise of judgment, discretion, or decision-making authority on behalf of the corporation). However, in determining whether that standard is met, the court must consider the allegations of the claim against the director as well as other evidence concerning the director's conduct. *See, e.g., Perconti v. Thornton Oil Corp.*, 2002 Del. Ch. LEXIS 51 (Del. Ch. 2002).

There may be some basis to argue that the actions of plaintiffs that were the subject of the counterclaim were not taken in the exercise of their corporate powers. The conduct that led to the counterclaim were the alleged actions of Hamot and Siegel in attempting to influence the auditors in their treatment of the ERPS, and most immediately the threats of litigation that led to Reznick's resignation as auditor. These communications were not dependent on any power vested in them by their positions as directors. For example, the March 28, 2008 letter to Goodman that was copied to Reznick, which was the action that caused Reznick to withdraw as auditor and caused Telos to file the counterclaim, was sent by Costa Brava. There are no facts to indicate that, in causing it to be sent, plaintiffs were taking advantage of any powers conferred on them by their status as directors. Moreover, plaintiffs' actions in 2008 were a part of a course of conduct that began well before their election to the board of directors.

On the other hand, Telos' counterclaim was expressly founded in part upon plaintiffs' fiduciary duties. Counts Five and Six assert claims for breach of fiduciary duty, a duty that existed only by virtue of plaintiffs' position on the board. Therefore, plaintiffs could only be sued for these claims because of their status as directors. Furthermore, Telos' other claims were supported to some extent by plaintiffs' status as directors. Judge Matricciani based his

conclusion that there was merit to the interference claims in part on the fact that plaintiffs' conduct was unlawful because of their positions.

It is difficult to conclude that claims which explicitly seek to fasten liability based on breach of fiduciary duty do not have a nexus with the position of a director. Therefore, whether or not all of the claims depended on plaintiffs' positions, at least some of the claims were brought against them because they were directors. Where a proceeding against a director is brought at least in part because of that status, the right to advancement exists.

For these reasons, the argument that there is no nexus between the counterclaim and plaintiffs' status as directors must be rejected.

Requirement of good faith affirmation

As set forth previously, section 2-418(f) requires, *inter alia*, a written affirmation by the director of the director's good faith belief that the standard of conduct necessary for indemnification by the corporation has been met. This provision, in turn, refers to the standard of conduct set forth in section 2-418(b)(1), which provides that a corporation may indemnify a director unless it is established that the act or omission of the director was material to the matter giving rise to the proceeding, and was committed in bad faith, or was the result of active and deliberate dishonesty, or the director actually received an improper benefit in money, property, or services.

Telos argues that plaintiffs cannot submit in good faith the required affirmation that they have met the appropriate standard of conduct. As authority for the court to consider the issue of good faith, Telos cites the following statement from a leading treatise on Maryland corporate law:

A provision obligating a corporation to advance expenses to the fullest extent permitted by Maryland law is self-executing and the corporation may (and in the case of a mandatory expense advance provision must) immediately begin paying the expenses upon submission of the written affirmation and written undertaking required by Section 2-418(f)(1) . . . Nevertheless, if disinterested directors conclude, on the basis of facts then known and after appropriate inquiry, that the putative indemnitee could not have believed in good faith that he met the standard for indemnification, then that determination could be the basis for refusal to authorize advance of expenses on the ground that the good faith affirmation requirement has not been met.

J. Hanks, Maryland Corporation Law § 6.21[h].

Plaintiffs argue that the director's assertion of his or her good faith belief is all that is required to engage the statute, and that there is no basis for an inquiry into whether or not the belief professed by the director was actually held in good faith. Plaintiffs note that the statute only requires an affirmation from the director. Plaintiffs also point out, with some justification, that in a case such as this one, where the proceeding pits the director against the corporation, it would be difficult to conclude that empowering the corporation to decide whether the belief was held by the director in good faith is consistent with the policies underlying advancement.

Certainly the policies underlying advancement do not support the encouragement of disputes over whether an affirmation of good faith is genuine. On the other hand, it is difficult to conclude that the director's good faith affirmation is subject to no review under any circumstances. A rule that made the director's determination of his or her own good faith conclusive would fail to give effect to all of the provisions of the statute. If the director's profession of good faith were to be insulated from any scrutiny whatsoever, then the requirement of the written affirmation would have no function at all. In order to give that requirement some effect, it is necessary to construe the statute as supporting some form of review of the

genuineness of the director's good faith belief. Furthermore, even if the policies of advancement do not support extensive scrutiny of the good faith affirmation, those policies do not compel the conclusion that no scrutiny should be permitted even in circumstances where the record, objectively viewed, makes the maintenance of a good faith belief untenable.

This conclusion does not mean that the determination of good faith should be reposed in the corporation. Telos' bylaws provide that the corporation shall advance expenses "to the maximum extent permitted by Maryland law." This language incorporates the provisions of section 2-418(f). It is for the court to resolve the issue of whether the statutory standard for advancement has been met. As such, it is for the court to determine whether the affirmation is sufficient, i.e., the directors' belief was actually held in good faith, without regard to any determination made by the corporation.

It must be emphasized that a determination that an affirmation of good faith is insufficient is unusual, requiring a high degree of proof. Given the purposes of advancement provisions, they should be construed liberally in favor of advancement, and such a construction weighs against an overly intrusive examination into whether an affirmation was made in good faith. Furthermore, a court must take pains to avoid conducting an indemnification inquiry under the guise of an advancement determination. Therefore, it is the rare case where the court could conclude that a lack of good faith precludes advancement. This is such a rare case. Under the particular circumstances of this case, the court concludes that the record demonstrates that Hamot and Siegel could not have entertained a good faith belief that they met the statutory standards for indemnification.

The procedural setting in which the request for advancement was made is somewhat unusual. In this case, a judicial determination was made upon the facts bearing upon the directors' right to indemnification before the request for advancement occurred. While it is clear from the case law that a corporation is not authorized to deny advancement based on allegations of misconduct, that principle is typically applied in the context of allegations of misconduct that have not yet been the subject of adjudication. That distinction is significant.

As the comments to the Model Business Corporation Act reflect, the purpose of permitting a corporation to make advancement relates to enabling directors to fund their defense. As a result, a request for advancement typically will occur prior to the proceedings that are the subject of the request. In this case, because there has been no final determination of Hamot and Siegel's right to indemnity, their request for reimbursement technically qualifies as a request that the corporation advance expenses in advance of a final determination on the issue of indemnification. On the other hand, insofar as the motion for advancement seeks reimbursement, it is clear that it seeks reimbursement for expenses incurred for services that were rendered prior to the request for advancement. The request to Telos for reimbursement of expenses was made in September 2008, after the conclusion of the proceedings in this court on the motion for preliminary injunction filed with the counterclaim. The motion for advancement was filed eighteen months later, long after Telos rejected the demand for advancement and long after any other activity in this litigation. Apart from the appeal from the preliminary injunction, which was concluded on May 6, 2009, there is no indication that there were any efforts expended in defending against the counterclaim after the request for advancement was made, and certainly

no indication that any proceedings were ongoing at the time that plaintiffs filed the motion for advancement. In fact, there are no other proceedings to date to which the motion could relate.

When Hamot and Siegel filed their request for reimbursement, they were seeking reimbursement of expenses incurred in the unsuccessful defense of the preliminary injunction proceedings. At that time, this court had already preliminarily determined that they had intentionally interfered with Telos's relations with its auditors, and that they had been guilty of a breach of their duties as directors. These findings are inconsistent with the conclusion that Hamot and Siegel met the statutory standard for indemnification. In fact, as reflected by the summary set forth previously, Judge Matricciani explicitly concluded that their acts and omissions were material to the matter giving rise to the proceeding and were committed in bad faith. In light of that finding, Hamot and Siegel could not entertain a good faith belief that they met the standard, at least insofar as they requested advancement of expenses for litigation of the preliminary injunction.

This conclusion is not affected by the fact that the preliminary injunction was not a final adjudication because the appeal was dismissed as moot. The action of the Court of Special Appeals did not amount to a reversal of Judge Matricciani's order. Nor is it affected by the fact that Judge Matricciani's conclusions were reached in the context of a preliminary injunction, necessitating only that he find a probability of success on the merits of the counterclaim. What is more important is that these findings relate to the very proceedings for which plaintiffs later professed a good faith belief that their conduct met the statutory standard. Since plaintiffs are now seeking reimbursement for the expenses relating to the proceedings that culminated in those findings, those findings must furnish the standard by which their good faith belief should be

measured. Their belief is inconsistent with those findings. Therefore, Hamot and Siegel are not entitled to reimbursement for fees related to those proceedings.

This leaves the issue of whether there is a basis to grant the motion for advancement with respect to future expenses. From the conclusion of the preliminary injunction phase until the present, there has been no further litigation upon Telos' counterclaim. What further proceedings will occur is open to question. The impetus for the counterclaim was the particular exigency created by Telos's need to file its Form 10-K. Telos fulfilled that need as a result of the preliminary injunction. It is perhaps for this reason that there have been no further proceedings in connection with the counterclaim. In any event, Telos has not evinced any interest in prosecuting the damage claims set forth in the counterclaim.

Under these circumstances, the court does not deem it necessary at this time to decide the issue of whether plaintiffs are entitled to advancement for future proceedings on the counterclaim. It may be that if further proceedings occur on the counterclaim or appear likely to occur on the counterclaim, that the court will be called upon to make that determination. In such case, the calculus relating to the good faith affirmation may be different. That would depend upon the nature of the relief sought by Telos and the basis for the claims asserted by Telos. However, that is not the situation currently before the court, and under the current state of the record, the court sees no basis to grant the motion for advancement.

CONCLUSION

In light of the foregoing, the Motion for Advancement will be denied, as will plaintiffs' motion for partial summary judgment and request for fees. On the other hand, the foregoing discussion also compels the conclusion that Telos's motion for summary judgment should be

denied. The court cannot conclude as a matter of law at this juncture that there is no possibility that plaintiffs may be entitled to advancement.

Dated: _____

Judge W. Michel Pierson

SETH W. HAMOT, et al.
Plaintiffs/Counter-Defendants

v.

TELOS CORPORATION
Defendant/Counterclaimant

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IN THE

CIRCUIT COURT

FOR BALTIMORE CITY

CASE NO.: 24-C-07-005603

* * * * *

ORDER

For the reasons set forth in a Memorandum of even date, it is, this _____ day of November, 2011,

ORDERED that the Motion for Advancement of Legal Fees and Expenses (No. 82) be and it hereby is DENIED, and further

ORDERED that the Motion for Summary Judgment as to Count Seven of the Second Amended Counterclaim (No. 86) be and it hereby is DENIED, and further

ORDERED that the Cross-Motion for Partial Summary Judgment (No. 99) be and it hereby is DENIED.

Judge W. Michel Pierson