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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ORIGINAL

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.

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