SUPERIOR COURT OF WASHINGTON, KING COUNTY

MOD SYSTEMS INCORPORATED, and ROBERT M. ARNOLD, individually and derivatively on behalf of BANANA CORPORATION, Plaintiff(s),	No. 09-2-07963-3SEA
vs.	
MARK PHILLIPS, KENNETH GORDON, JANE DOE GORDON, and the marital community composed thereof; ANTHONY BAY, JANE DOE BAY, and the marital community composed thereof, and BANANA CORPORATION, Defendant(s).	

HEARING

BEFORE THE HONORABLE JOHN P. ERLICK

NOVEMBER 6, 2009

TRANSCRIBED FROM CDs BY: ANDREA D. FAUBION, CCR 2843

(Beginning of CD Number 1.)

FEMALE VOICE: Court is back in session.

THE COURT: Morning. Please be seated. We are on the record in the matter of Robert Arnold on behalf of the MOD Systems and Banana Corporation versus Phillips, et al. It's King County Cause Number 09-2-07963-3 Seattle.

And I'd like counsel to identify themselves for our audio record at this time, please. I'll begin on my right, your left with Mr. Smyth.

MR. SMYTH: Thank you, your Honor. I'm Jeff Smyth. I'm here on behalf of Mr. Robert Arnold.

THE COURT: Thank you.

MR. BUCKLEY: Good morning, your Honor. Brian Buckley with Fenwick & West, representing MOD Systems.

THE COURT: Thank you.

MR. JOHNSON: Mark Johnson, your Honor, for Mark Phillips and -- with the Donovan Flora firm.

THE COURT: Thank you. All right. Counsel --

MR. KNUDSEN: Your Honor, Geoffrey Knudsen.

THE COURT: Oh, I'm sorry.

MR. KNUDSEN: Geoffrey Knudsen on behalf

of Banana Corporation.

THE COURT: All right. Thank you, Counsel --

MR. LEEN: I'm David Leen appearing with Mr. Gordon. I'm not going to be participating in the argument though.

THE COURT: All right. Thank you, Mr. Leen. Okay.

All right. Counsel, we have several motions here. One motion I believe we do not have is a motion for writ of attachment, so I believe that's been stricken.

We have Defendant Phillips' motion to dismiss the derivative action against MOD Systems and also to dismiss the Banana derivative action. We have motion to terminate the voting trust also brought by Mr. Phillips, and then, lastly, we have motion to remove Cane and Bay from the DRC, which I've already forgotten what it stands for so... All right.

We've set aside an hour and a half for all the hearings. I think we can probably split it -- the -- the dismissal actions, let's take 45 minutes and then 45 minutes for the other actions. That gives the plaintiff about 15 minutes on his motion.

So let's start -- I'm going to suggest we start with the motion to dismiss.

MR. JOHNSON: Okay.

THE COURT: Because I think if we -- if I were to grant that, I think that -- I don't know what that does. It might vest me of jurisdiction, unless there are counterclaims.

MR. JOHNSON: It could be --

THE COURT: Let's see what I do with it --

MR. JOHNSON: Okay.

THE COURT: -- first.

MR. JOHNSON: All right. Let me -- if I might, your Honor, just scroll forward to that.

THE COURT: All right.

MALE VOICE: Your Honor, with your permission, I can't see the screen, so I'm going to move to the jury box.

THE COURT: Please feel free to move around the courtroom as you please. If you want to come forward, you may also do that as well.

All right. So let me ask the first question, Mr. Johnson. There's a -- there's a dismissal of the MOD derivative, and there's a dismissal of the Banana derivative.

MR. JOHNSON: Yes.

THE COURT: My understanding is that there is no more MOD derivative. Is that correct or incorrect?

MR. JOHNSON: Well, that's, I think, a matter that's been undecided.

THE COURT: Okay.

MR. JOHNSON: That is not decided. Let me explain. I'll answer the Court's question. There was -- the original verified complaint was captioned as a derivative case brought by Mr. Arnold on behalf of both corporations. And then there was an amended verified complaint filed. And the amended verified complaint filed on its face says that MOD has taken over the derivative claims.

The problem we have with that is -- is that if you read the pleadings, there is -- we don't know the terms, but there was some sort of a settlement between MOD, Mr. Arnold and -- and Anthony Bay.

THE COURT: On the derivative. On the derivative? Or...

MR. JOHNSON: Well, that's what we think occurred. And I'm not the person to address that, but it appears as though that's what -- what occurred.

And so part of our argument this morning is that CR 23.1, you know, doesn't -- it isn't a may or a maybe. It's a shall. Notice of all shareholders and approval by the court of any settlement or compromise of the derivative claim. So -- so we actually didn't know when we were responding to, you know, when the dates came up for answers, exactly what complaint we should respond to, because the original complaint was a derivative (Inaudible.) by Arnold.

Then the case was stayed. And then during the stay, there was, according to what we -- what we believed in the pleadings, there was a settlement between MOD, Arnold, and Mr. Bay was also dismissed. And Mr. Bay was dismissed ex parte.

So then the new complaint came out. We're prepared to address either complaint, but we also believe that as part of our argument that this was never really a derivative case; that it was -- it really is Mr. Arnold, you know, suing Mr. Phillips.

And it certainly hasn't been treated by -- as a derivative case should be treated if it is. There was no notice to the shareholders, no approval by the court of what appears to be a compromise of the case. Mr. Bay was dismissed ex parte during the stay or shortly after the stay.

If you read both complaints, your Honor, if you read the fraud causes of action in the first complaint and the amended complaint, the fraud causes of action are clearly brought solely on behalf of Mr. Arnold. And we think the Hames case is a per se disqualification of --

THE COURT: That's the Washington case that says that you can't bring --

MR. JOHNSON: Right.

THE COURT: -- individual claims along with derivative claims; that you can only bring one or the other. Although other courts have not followed that.

MR. JOHNSON: Other courts have not followed that. I think though that, you know -- we -- we I think -- I think Hames is still good law. It's a per se disqualification. And I think the Court can easily see the mischief that can result when a shareholder is -- is bringing direct claims against the corporation and also representing the other shareholders derivatively.

THE COURT: Well --

MR. JOHNSON: If they're --

THE COURT: Let me just ask this. And again we're talking strictly about MOD Systems. Doesn't -- you're 12(b)(6) -- you're on a 12(b)(6), which means I have to accept everything as presented to the court as true.

MR. JOHNSON: Um-hum.

THE COURT: Don't I consider that the amended complaint says this is an action brought on behalf of MOD Systems, Inc. as the corporation against your client, Phillips, and the settlement -- this may or may not be settlement out there that was a derivative. That's a separate issue. I mean whether or not that's enforceable or complies with 23.1 or -- or proper notice was given, why -- why do I even have to consider that in 12(b)(6)?

Don't I simply say is this amended complaint brought by a corporation, MOD, against Phillips, et al. as actionable?

MR. JOHNSON: I don't think so, your Honor, because the amended complaint is based upon a settlement that was not approved by the Court or there were no notices to shareholders. So the settlement --

THE COURT: How -- how do I know that?

MR. JOHNSON: Well, we don't know --

THE COURT: Exactly.

MR. JOHNSON: -- other than the -- other than from the references in the pleadings, the materials that the MOD lawyers and Mr. Arnold's lawyers filed reference a settlement. That's all we have to go by.

THE COURT: But that's irrelevant. You can unwind all this -- you could put aside that settlement, but the point is is that on 12(b)(6) all I'm doing is I'm looking at the pleadings, and I'm saying under Washington law is this actionable. That's all -- that's all I look at. That's all I'm considering.

MR. JOHNSON: Okay. I --

THE COURT: Right?

MR. JOHNSON: I believe you're right, but we believe any settlement would be void and we would go back to the original complaint. But I'd like to address the Court's --

THE COURT: You don't go back to the original complaint.

MR. JOHNSON: So the amended verified complaint is what we're dealing with.

THE COURT: Sure.

MR. JOHNSON: Okay. So the amended verified complaint has -- has both individual claims by Mr. Arnold against MOD -- or against Mr. Phillips and individual claims against Mr. Phillips and Banana.

THE COURT: Well, let's -- we're not doing Banana right now.

MR. JOHNSON: Okay. We're just doing --

THE COURT: We're staying away from Banana. I just want to deal with MOD right now.

MR. JOHNSON: Okay. We think that the Hames case -- if you read the amended verified complaint, for example, the fraud cause of action --

THE COURT: Right.

MR. JOHNSON: -- Mr. Arnold is bringing individual claims in what is captioned as a derivative case.

THE COURT: But it's not a derivative case, is it? It is not a derivative case anymore.

MR. JOHNSON: If we accept the fact that MOD and Arnold have settled and that settlement is valid, I agree with the Court, yes.

THE COURT: Well, I'm not accepting that it's -- it's valid. All I'm -- all I'm accepting is that MOD purports to bring these claims.

MR. JOHNSON: MOD purports to do that.

THE COURT: That's right.

MR. JOHNSON: Okay. So that would make it a direct action, not a derivative action.

THE COURT: That's right.

MR. JOHNSON: Okay. And so then we deal with the 12(b)(6) allegations. And we have -- you know, I -- I'm having -- the reason I'm having difficulty is because there's -- for example, there's -- there's -- there certainly still are claims of Mr. Arnold directly against Mr. Phillips and others that are enmeshed in this action that MOD is bringing on its own behalf.

THE COURT: But unlike derivative actions, I don't believe Hames would proscribe a corporation and a shareholder from bringing claims against another shareholder, would it? I mean I --

MR. JOHNSON: Well, you know, focussing on the fraud claim, for example --

THE COURT: Right.

MR. JOHNSON: And this is in the amended verified complaint -- it says Phillips falsely represented material facts to Arnold and -- to get him to induce -- to induce and to invest in Banana and MOD. And so he's -- he -- clearly, Mr. Arnold is clearly bringing a fraud claim --

THE COURT: Um-hum.

MR. JOHNSON: -- against Mr. Phillips arising out of his work in the corporation, MOD. And I think there is -- there is the potential for -- for this shareholder to --

THE COURT: Um-hum.

MR. JOHNSON: -- in asserting his personal claims to affect the claims of the corporation which the corporation is bringing against Mr. Phillips. I think there's -- that's the Hames irreconcilable conflict of bringing individual claims in conjunction with other claims -- I mean, you know --

THE COURT: But the other claims you're referring to under Hames, those are derivative claims, aren't they?

MR. JOHNSON: They are derivative claims.

THE COURT: We don't have a derivative suit.

MR. JOHNSON: Okay.

THE COURT: That's what I keep going back to. Under 12(b)(6). Again this is not summary judgment. It's -- I'm not going to get into the merits. I can't get into the merits. I'm not supposed to get into the merits. I'm simply supposed to look at it and say, as a matter of law, are these claims actionable upon the facts asserted.

MR. JOHNSON: Okay. And we believe that after one year of this case being bandied about two complaints, there is no specificity whatsoever to the allegations of fraud made either by Mr. Phillips --

THE COURT: That's a -- that's a summary judgment motion.

MR. JOHNSON: Okay.

THE COURT: That's not a 12(b)(6) motion. That's a summary judgment motion.

MR. JOHNSON: So if I could ask the Court's direction.

THE COURT: Um-hum.

MR. JOHNSON: If we believe that there has been a settlement according -- and this is what we've taken out of the pleadings that MOD's lawyers and Mr. Arnold's lawyers have filed -- and that settlement is in violation of the court rule --

THE COURT: Um-hum.

MR. JOHNSON: -- I just want to make sure that the Court is not sanctioning today the validity of that settlement --

THE COURT: Absolutely not.

MR. JOHNSON: -- violate (Inaudible.)

THE COURT: We're on the record. I'm not sanctioning it. I don't know anything about it. It's not before the Court.

MR. JOHNSON: Okay. And we can raise that with the Court in a different motion.

THE COURT: Absolutely. Absolutely.

And then the question becomes, which we're not going to address today, if I find it's in violation of 23.1 and I invalidate it or void it, what are the consequences of that. But that's another bridge we can cross.

MR. JOHNSON: Well, in our -- when we were trying to make our way through this and we learned of these settlements -- and we don't know all the terms -- but -- and we know what CR 23.1 says. That's why we believe that without approval of the Court, there is no settlement.

THE COURT: Well, and -- and that very well may be. And -- but I'm not prepared to address that, because I don't think that's properly before the Court. I know that that's -- through the sine qua non, if you will, of your argument that this really is a derivative, because you can't have -- that if -- if the agreement was is that somehow the -- somehow the derivative morphed into a corporate claim based upon that settlement and the settlement is invalid or void, where's the derivative claim, I don't know, because it's not before -- that issue's not before me.

MR. JOHNSON: Okay. Well, we can get that before you relatively quickly.

THE COURT: I'll -- I'll be here, Mr. Johnson.

MR. JOHNSON: Okay. With respect to the -- may I address the Banana claims, then?

THE COURT: Yes. Let's do that --

MR. JOHNSON: Okay.

THE COURT: -- because I think those are different.

MR. JOHNSON: Well, and, you know, the Banana in the amended verified complaint it's clearly -- it's Mr. Arnold primarily is asserting personal claims.

THE COURT: Now, Banana is a derivative action; correct?

MR. JOHNSON: It's a derivative action by Mr. Arnold in which he also is asserts personal claims.

THE COURT: Correct.

MR. JOHNSON: And we believe the personal claims -- from a plain reading of the four corners of the amended verified complaint, shows that those personal claims predominate. And we think that Hames case law is -- you know, and I think again the Court can --

THE COURT: I want to take another look at --

MR. JOHNSON: -- see fairly easily the

inconsistencies between bringing -- between a shareholder bringing personal claims and bringing claims on behalf of other shareholders.

Another complicating factor in the Banana derivative case is that it is -- there's only two shareholders. And his claims are really --

THE COURT: That's what I wanted to ask you.

MR. JOHNSON: Yeah.

THE COURT: My understanding is there was no Series A with regard to Banana.

MR. JOHNSON: No. There's two shareholders. It's Mr. Arnold and Mr. Phillips. And clearly Mr. Phillips -- Mr. Arnold's claims are directed against Mr. Phillips in the way he ran the corporation, so -- so we do not believe that it is appropriate to be maintained as a derivative suit.

We also have some concerns about whether it should be maintained in the same action as the MOD issues, but that again is another day for motion (Inaudible.)

That's really all I have to say on Banana.

THE COURT: Okay. I think we're -- I think we're done on that one.

MR. JOHNSON: Okay. Thank you.

THE COURT: So I will hear from --

MR. BUCKLEY: Your Honor, Brian Buckley for MOD.

THE COURT: Mr. Buckley; correct?

MR. BUCKLEY: Yes.

THE COURT: Okay. Mr. Buckley.

Counsel, I'm going to hear from you very briefly --

MR. BUCKLEY: Yes.

THE COURT: -- because my inclination right now is to deny the 12(b)(6) as to MOD Systems.

MR. BUCKLEY: Yes.

THE COURT: And -- and I would make that ruling -- it would be without prejudice and it would -- based upon the fact that as -- as currently alleged in the amended complaint, it is a corporate claim, not a derivative claim.

MR. BUCKLEY: That's absolutely right, your Honor, and I'm not going to try to talk you out of that.

THE COURT: Okay.

MR. BUCKLEY: The only issue would be whether you want me to address the issue of the settlement. There has been no settlement (Inaudible.)

THE COURT: I do not want you to address

the issue of the settlement, because I'm not considering the settlement. If there is a settlement or not a settlement, it's not before the Court. And I -- as I stated on the record, nothing precludes plaintiff here from -- I'm sorry -- Mr. Phillips here from conducting appropriate discovery on that issue and then bringing whatever motions are appropriate before the Court.

MR. BUCKLEY: Thank you, your Honor.

THE COURT: Is there anyone else that would like to speak on the MOD Systems issue?

Okay. Let's address the derivative action on Banana. Mr. Smyth.

MR. SMYTH: Good morning, your Honor.

THE COURT: Good morning.

MR. SMYTH: Jeff Smyth on behalf of Robert Arnold.

The facts that have been alleged in the complaint are fairly complex in one sense and fairly simple in another. We have a combination of claims by Mr. Arnold both relating to his status as an investor and relating to his status as a victim of fraud and possibly theft. These were all alleged in the complaint.

The derivative complaint aspect of the case is before the Court today on 12(b)(6), and I agree with the Court that the issue of whether or not the complaint is specific enough relative to the facts alleged to satisfy the obligations of a derivative plaintiff. And we believe the answer is yes.

I haven't heard any argument with regard to the futility issue that is governed by the F5 decision, therefore I think I'll -- unless the Court has questions, I will leave that to the pleadings. I think they're pretty clear.

THE COURT: Well, reading the F5 decisions and given -- I read the materials, and it strikes me that -- looking at the evidence in the light most favorable to the nonmoving party, I would find that there's probably sufficient evidence for a plaintiff to make a futility argument here under F5, particularly in light of the fact that there are two shareholders in Banana and the antagonistic relationship between Mr. Phillips and Mr. Arnold. Although there is case law that says that in and of itself is insufficient. So I looked at the entire relationship and Mr. Arnold's position in the corporation. So nobody's addressed futility.

I would suggest we move on to preliminarily the Hames case.

MR. SMYTH: Certainly. The Hames case is a case that was decided in 1922 and has not been followed in the state of Washington in subsequent decisions and is fairly universally rejected across the country.

THE COURT: Except it's still the law here, Mr. Smyth.

MR. SMYTH: Well, it still sits on our books, but --

THE COURT: Good law is -- old law is good law.

MR. SMYTH: It is. So let me address the reasoning in that case, because I think it's important.

THE COURT: Let me bring it up while you're talking. What -- do you have a cite of the -- I didn't --

MR. JOHNSON: I think I've got it up here in my --

THE COURT: I intended on --

MR. JOHNSON: I've got a copy of the case if you want it.

THE COURT: Actually, you know, I prefer actually --

MR. JOHNSON: It's 118 Wash. 156.

THE COURT: 118 Wash. 156. Okay. Thank you. Okay.

MR. SMYTH: The decision I think leaves open to discussion and to further judicial review the question of what other decisions have called economic antagonism, namely, the reason why the court addressed the problem in the Hames case was a clear type of conflict of interest that existed between the derivative plaintiff and between the corporation itself.

Now, I have to start off by saying that there is one fatal flaw in the argument that's been made today that relies upon Hames and all the rest, and that is that Mr. Phillips clearly does not have standing to make this motion today. The standing to move to dismiss a derivative action belongs exclusively, exclusively to the corporation. And that's the WPPSS decision 109 Wash. 2d. 107. And you'll find that authority at Page 148 of that decision.

So we start off with the proposition that Hames is inapplicable, because the challenge must be brought to the -- the derivative action must be brought by the corporation. The corporation is here. It is represented today and is not challenging. Banana Corporation is not challenging the bringing of this derivative suit.

THE COURT: Well, let me ask this:

Mr. Phillips, does he still have -- the voting trust was with regard to --

MR. SMYTH: MOD only.

THE COURT: -- MOD; correct?

MR. SMYTH: That's correct.

THE COURT: So doesn't Phillips have majority stock in Banana?

MR. SMYTH: He does. He has the vast majority of the stock in Banana Corporation. His stock as I understand it, has been made subject to an irrevocable proxy coupled with an interest, which is the functional equivalent of the voting trust that was created in the MOD situation.

THE COURT: Okay. One more time. A irrevocable proxy...

MR. SMYTH: Irrevocable proxy coupled with an interest.

THE COURT: Coupled with interest.

MR. SMYTH: Now, if that doesn't take you back to corporations in law school.

THE COURT: Who -- who holds the proxy?

MR. SMYTH: I don't know the answer to that question. I think that the newly appointed independent board members do, but that's just a guess.

THE COURT: Okay. So first of all, under the WPPSS case, which I was told when I was involved in the Supply System cases that we're not supposed to call it WPPSS, but I guess that's long gone now, isn't it? Is that -- is that the Haberman one or is that -- you said 109 Wash. 2d.

MR. SMYTH: Wash. 2d. 107.

THE COURT: 107.

MR. SMYTH: And that may be Haberman. It may be one of the other cases. All I wrote down was WPPSS.

THE COURT: Okay. All right. So first argument is no standing.

MR. SMYTH: First argument is wrong guy making the motion.

THE COURT: Okay.

MR. SMYTH: Second argument is in the Hames case, the analysis that the court followed was whether or not there was an economic antagonism between the derivative plaintiff and the corporation. For example -- and just to give an example that doesn't fall in that case but I think is illustrative, the other decisions that have talked about this have addressed a situation where the derivative plaintiff stands to gain personally through, for example, a competitive position in another company if he wins or tangles up the other corporation in litigation. In this case, the focus -- and in the Hames case, I believe the focus was on that kind of economic antagonism.

In this particular instance, Mr. Arnold, who is an 81-year-old man and is essentially a philanthropist full time at this point in time, is interested only in two things:

Number one, preserving whatever value Banana Corporation may have ahead, because he is a shareholder in that company. That's for certain. And that's all mentioned in the complaint;

And number two, pursuing any rights that he might have individually as a result of having been defrauded. Those two rights are not economically antagonistic. In other words, Mr. Arnold's prosecuting these claims on behalf of Banana Corporation will not result in the situation that is inherently damaging to Banana Corporation or its prospects for success.

THE COURT: Let me ask you this from a purely practical standpoint. Mr. Arnold -- I'm sorry. Mr. Phillips has what, 75 percent -- I don't recall the figure off the top of my head.

MR. SMYTH: Most.

THE COURT: Most. All right. So whatever Mr. -- I mean isn't there a conflict between prosecuting the individual claims which will remunerate to the benefit of Mr. Arnold versus prosecuting the corporate claims which will benefit to the interest of primarily Mr. Phillips, who is the majority shareholder?

MR. SMYTH: Well, that's a good question.

THE COURT: I mean isn't that -- doesn't he want to put his eggs in the Arnold basket, not in the corporate basket or the Banana basket in this case?

MR. SMYTH: Here's the reason why we've proceeded along these lines. I think it's an incisive question, and I'm going to tell you why we did it the way we did it. We did it the way we did it, because in this type of a situation where five-and-a-half million dollars was put into a startup corporation, the -- the expected response from the defendants is you didn't get nothing when you paid your five-and-a-half million dollars. You got five-and-a-half million dollars worth of shares in the company. And those shares in the company are worth what they're worth. Maybe they're worth nothing. Maybe they're worth a billion dollars.

Who knows.

But your claim is based solely upon whatever value you say you lost or you were defrauded about or you were told the false statements about the value of the shares that you have.

THE COURT: Which is essentially a fraud of inducement argument.

MR. SMYTH: It's a fraud of inducement argument.

So we face that project in this particular situation. Now, how do we deal with that? We deal with that by looking at where the real loss and undeniable loss occurred.

The real and undeniable loss that was indirectly a loss suffered by Mr. Arnold, as is the case in all shareholder derivative actions, was suffered by Banana Corporation. Banana Corporation, according to the pleadings that are before you, according to the complaint, the only real asset that that company ever had was Mr. Arnold's five-and-a-half million dollars. There's some debate about some intellectual property, but that carries us into CR 56 territory.

So we pursued this as a derivative action for a couple of different reasons. First of all, because

Mr. Phillips looted the company out of essentially all of the five-and-a-half million dollars, the company has no resources and is incapable of pursuing its own claim. It has no money. It can't even pay its lawyers. That's in our brief.

And so if we face the prospect of having to argue against the position that Mr. Arnold bought five-and-a-half million dollars worth of stock and his recourse is with respect only to the value of that stock, we have to pursue the interests of the corporation. We have to take the claims of the corporation that its only asset, this cash, was drained off in other directions and recover it as best we can for the company.

And by doing that, what we do is we recreate the value or the expected value of the stock that Mr. Arnold purchased. So there is a community of interest.

However, the vast majority of cases across the country have said that even if there is a palpable conflict of interest, two people, the corporation and the plaintiff competing against the same limited pool of assets for recovery, it is still appropriate, particularly in a closely-held situation where there tend to be very few shareholders involved.

So our position with regard to Hames is two-fold -- three-fold: Number one, no standing; number two, no economic antagonism between Mr. Arnold and -- and MOD Systems, because there is in fact a community of interest; and number three, even if the Court were to determine that there is a palpable conflict of interest, the case law which has supplanted Hames after years and years and years of corporate litigation, and particularly cases out of corporate strongholds like New York and Delaware, make it very clear that in a situation such as this where you have only two shareholders, one predominating and one minority shareholder, pursuit of actions on behalf of the corporation right along side the claims of the individual are accepted and in fact are commonplace. And we cited many cases to that -- to that proposition.

THE COURT: What's the class here?

MR. SMYTH: Well --

THE COURT: Or I guess it's not class in the loose sense of similarly-situated individuals for purposes of 23.1.

MR. SMYTH: We cited several cases on that issue, because it -- it -- long ago the comparison between Civil Rule 23 and 23.1, numerosity of similarly-situated positions went out the window.

We've cited cases to the specific point that you mentioned that a derivative plaintiff need not show -- at least at the 12(b)(6) level need not show that there is a similarly-situated position.

That having been said, in the event that -- as difficult a conundrum as this poses, if these claims against Mr. Gordon and Mr. Phillips are successful and Banana does recover, then a percentage of -- of that recovery will belong to Mr. Phillips. It will circle back (Inaudible.)

THE COURT: But that goes back to the point I was making, which is Mr. Arnold's claims are antagonistic to those of the class or at least potentially. If there's a limited pool of money and Mr. Arnold is successful in his fraud claims --

In other words, on the one hand you want to, quote, unquote, replenish the Banana pool with five-and-a-half million dollars or whatever you claim was looted by Mr. Phillips.

MR. SMYTH: Yes.

THE COURT: On the other hand, to the extent that Mr. Arnold is successful on his individual claims, that may take some of the money away from the five-and-a-half million dollars, which would go to the corporation. So the corporate interest and the individual interest are antagonistic to one another.

MR. SMYTH: I would not use the term antagonistic. Instead I would use the term not perfectly aligned, because I think that that's where we have to be. And that's where the case law talks about. Not even aligned perhaps.

But let me add a couple of other things from the complaint that I think are important and can't be ignored here. Number 1, 2 million dollars of Mr. Arnold's money went out the backdoor of Banana Corporation to another corporation, A Dot Corporation, which borrowed the money and has not repaid it. We don't know what assets A Dot Corporation owns. It may have assets; it may not. It's wholly owned by Mr. Phillips.

One of the things that we intend to do as derivative plaintiffs on behalf of Banana is pursue collection of that debt. Another pool of assets is -- is a loan that the company made to Mr. Doug Lower. That's a six figure loan. That loan is not being collected by Banana Corporation. The reason it isn't bad faith -- the reason is because Banana Corporation doesn't have any assets. It can't collect anything from anybody. But it lent that money, not Mr. Arnold. It has the right to collect that money from A Dot and from Mr. Lower, not Mr. Arnold. And Mr. Arnold is ready, willing and able to pursue collection of those claims --

THE COURT: All right.

MR. SMYTH: -- both on behalf of the corporation and himself.

THE COURT: Let's play out that scenario a little bit.

MR. SMYTH: All right.

THE COURT: You get the money back. That's let's say $2.1 million dollars that's now in the corporation. Now Mr. Arnold is prosecuting his fraudulent inducement claim against Mr. Phillips. And if -- if you were to prevail, I assume that the investment gets undone under some type of a rescission theory, and the $2.1 million or whatever you've collected on behalf of the corporation is now going to go to Mr. Arnold.

MR. SMYTH: Well --

THE COURT: Where's the corporate interest?

MR. SMYTH: The corporate is -- the way that we've proposed it -- and again you're entitled to consider theoretical facts, as well as real facts in a 12(b)(6) motion.

The way that we have viewed this is that Banana Corporation, to the extent that it ever had any intellectual property, is given its only chance of exploiting whatever assets that it has based upon how it comes out in this litigation in terms of how it collects money.

And let's assume that the corporation is successful through Mr. Arnold's efforts in collecting $500,000 from A Dot Corporation. All right. At that point in time the stock has a value. The Banana Corporation stock has a value. Mr. Arnold has his claims. His claims may result in the attachment of Mr. Phillips' shares in either MOD Systems or Banana. His claims on behalf of Banana Corporation or against Banana Corporation will become moot for all intents and purposes, because he's pursued and collected whatever he can. And he'll turn his attention to Mr. Phillips at that point in time.

But Mr. Phillips is a separate entity from Banana Corporation. Banana Corporation has rights against Mr. Phillips, and Mr. Arnold has rights against Mr. Phillips. In the event that Banana Corporation had filed suit against Mr. Phillips and Mr. Arnold had filed a separate suit against Mr. Phillips, it is likely, in my view, that those cases would be consolidated, and we would be dealing with exactly the same situation we talk about today.

THE COURT: Well, I suppose that that's what could happen.

MR. SMYTH: Yes.

THE COURT: All right. Thank you, Mr. Smyth.

MR. SMYTH: You're welcome.

THE COURT: Mr. Johnson, would you give me just one moment, please?

MR. JOHNSON: Sure.

THE COURT: Is there anyone else who wants to say anything with respect to the motion to dismiss the derivative against Banana besides Mr. Johnson in reply? Okay.

It is Haberman, Mr. Smyth.

MR. SMYTH: Thank you, your Honor.

THE COURT: (Inaudible.)

All right. Mr. Johnson, let's start with Haberman versus Supply System.

MR. JOHNSON: Well, I think that the -- we actually cited the Haberman case also in our trust materials so I'm familiar with it.

I think that, you know, Mr. Phillips has a direct financial interest in the outcome of this action, which we believe is a direct action. And to argue that he does not as a party of this case (Inaudible.) in which 85 percent shareholder of this corporation. And you just heard them describe how they're going to use this derivative case, why it's completely a derivative case.

First of all, and the 600-pound gorilla or the 800-pound gorilla or however big the monkey is, it's attorneys' fees that you can get if you're successful in a derivative case. That's why they put the square peg in the round hole. This direct claim -- Mr. Arnold is saying -- he's saying Mr. Phillips you induced me fraudulently to invest in this company. That's the claim.

THE COURT: That's a claim.

MR. JOHNSON: Yeah, but -- but that is -- that is a claim, but that is his basic claim. Okay.

THE COURT: His individual basic claim may be that but --

MR. JOHNSON: And 85 percent of what is recovered --

THE COURT: Right.

MR. JOHNSON: Mr. Phillips is an 85 percent owner.

THE COURT: Right.

MR. JOHNSON: -- is going to go back to the corporation. That value is going to (Inaudible.) to Mr. Phillips. He is 85 percent owner, and Mr. Arnold is about a 15 percent owner. The reason this was brought as -- this was shoehorned into a derivative case even though the economic interests are antagonistic to the corporation.

You absolutely outlined the conflict, your Honor. You absolutely outlined the conflict, the economic antagonism. So the reason they brought it this way is to try to get attorneys' fees at the end of the day if they are successful. This is a direct cause of action. It's -- the Hames case is good law. It's solid law.

And the Banana case certainly may proceed as a direct claim by Mr. Arnold against Mr. Phillips, but it is not appropriately because of Hames and -- and a derivative action should not be appropriate (Inaudible.)

THE COURT: But there's -- there's -- the Supply System is pretty clear that a procedural requirement to challenge the derivative action has to come from the entity whom the plaintiff purports to represent. That is the corporation. Not the majority shareholder, but the corporation. So where's your standing to challenge this?

MR. JOHNSON: Well, because he has a direct financial interest in the outcome of the action.

THE COURT: That's -- I don't see. Is that the test under -- under Haberman?

MR. JOHNSON: I think that is a test certainly. I mean he's a defendant in a lawsuit who's been accused of fraud, a corporation in which he's an 85 percent shareholder has been accused of fraud.

THE COURT: But that's -- that's his -- I don't -- I don't see that in Haberman. Why don't you show me that in Haberman.

MR. JOHNSON: Okay. I don't have the case pulled up.

THE COURT: 109 Wash. 2d. 107. We actually have the -- the hard copies here.

MR. FLORA: Could I take a look while you --

THE COURT: Of course, Mr. Flora.

MR. JOHNSON: You have hard copies where?

THE COURT: Right over here. It should be somewhere over there. 109 Wash. 2d. I know. I rarely use books myself.

(Inaudible conversation.)

MALE VOICE: We've only got Washington App. books over here.

FEMALE VOICE: It's the tan books?

THE COURT: It's the tan books.

FEMALE VOICE: They're over (Inaudible.)

THE COURT: Thanks.

FEMALE VOICE: You're welcome.

THE COURT: Is 109 there?

MR. JOHNSON: 109?

THE COURT: 109 Wash. 2d. 107.

MR. JOHNSON: This might take (Inaudible.)

THE COURT: That's all right.

Actually, I'm looking at it myself and it does cite a Third Circuit case and a California case where it wasn't the corporation itself. I want to look at --

MR. JOHNSON: What page, your Honor?

THE COURT: I'm on Page 1060 at the very end of the page as it moves over to 1061. I'm sorry. That's the --

MR. JOHNSON: We have the Washington 2d.

THE COURT: Yeah. You got the Washington, so this would be Page 148 -- 140 -- start at the top of 149.

MR. JOHNSON: Okay. Got it.

THE COURT: Let me read it. It says, Therefore the Supply System has standing to challenge these claims. Moreover, other courts have granted standing to defendants other than the corporation to assert derivative plaintiff's lack of authority to sue for failure to comply with procedural requirements. See, for example, Shlensky versus Dorsey, 574 F.2d. 131, Third Circuit, 1978. Accountant for corporation had standing to raise plaintiff's noncompliance with procedural requirements for derivative suit. Dietzel versus Anger, 8 Cal. 2d. 373, 1937 case, defendant shareholders challenged derivative bondholder suit based on failure to meet indenture demand requirements. So it looks like it's not necessarily exclusive to the corporation.

All right. Let's get into the substance of the argument.

MR. JOHNSON: Well, you know, this is an 85/15 corporation. If you look at -- if you look at the pleading, and, you know, many of their pleadings include MOD, Banana, Arnold, but if we try to sift through it, what you see is Mr. Arnold suing over -- primarily over his investment in this corporation.

THE COURT: Well, he has -- he has two interests here. He has an interest which is a corporate interest to preserve the corporation, which is now essentially I understand impecunious. So if he can replenish the funds of the corporation by whatever source on behalf of the corporation, that's a corporate interest, and it's clearly a corporate interest.

On the other hand, as I've pointed out to Mr. Smyth, he has an antagonistic interest, which is if he gets a judgment against the corporation or equitable relief, such as rescission, that is antagonistic to the corporation, and he could simply, if he chose to, take that money, turn around and say I want it back, which is not in the interest of the corporation.

MR. JOHNSON: And how is he going to choose how to litigate these claims? If he gets down to the point where he thinks he has stronger personal claims than derivative claims and he thinks he can put money directly in his pocket in a direct claim as opposed to the corporation's, that's the conflict. That's as plain as can be. You know, he's going to have control over both these claims.

And so he can choose which ones he wants to pursue, you know, and he can -- so he can control this litigation as a derivative plaintiff and a direct plaintiff even though we -- the direct plaintiffs clearly predominate. And he can choose which claim to pursue more vigorously, thereby lining his own pockets over those of the corporation. That is the conflict. It could not be any more plain. And that's why, you know, the Hames logic is good logic.

He may have direct claims, and we'll litigate those, but he should not be the derivative -- he should not be able to put both hats on in this case. They are clearly antagonistic claims.

THE COURT: All right. Thank you.

MR. SMYTH: May I have a word or two, your Honor?

THE COURT: You may, Mr. Smyth.

MR. SMYTH: All right. Is it all right if I address you from here? I've only got a couple of words.

THE COURT: That's fine.

MR. SMYTH: All right. I think we're missing the -- the elephant in the room here. There are two shareholders involved. The Hames case, any other case that addresses this antagonistic interest talks about the absent shareholders and how they're going to be damaged intentionally in the event that there's a conflict between the interests of the derivative plaintiff and the corporation itself.

In this circumstance, there are only two people who have an economic -- there are only two entities that have an economic interest in this, Mr. Arnold and Mr. Phillips. Together they own 100 percent of this corporation.

If it is in Mr. Arnold's best interest to see this corporation flourish and his investment in this corporation to increase, then he will certainly do so, because it is in his best pecuniary interest to do so.

In the event that he believes it's -- his best course is to pursue action against Mr. Phillips, well, to the extent that Mr. Phillips' stock in the Banana Corporation gains value, he -- he may have another asset that he can pursue.

But the bottom line is this whole Hames argument is purely theoretical in the absence of shareholders who are outside looking in that don't have a voice in the process.

THE COURT: But in theory don't I have to at least respect that the corporate entity has its own existence?

MR. SMYTH: Existence, yes. But I think the focus needs to be on outside entanglements where we're talking about a shareholder who stands to gain from the destruction of the company. In this situation we don't. Again theoretically, because -- I guess we're -- that's where we are here. Theoretically, Mr. Arnold as shareholder is the only human being who will ever prosecute these claims on behalf of Banana Corporation. Definitely Mr. Phillips isn't going to do it. Who is going to sue to collect the $2 million debt from A Dot? Mr. Phillips isn't going to do it. How about the money paid over to Doug Lower, the guy who swiped the money through his secretary; do you think Mr. Phillips is going to do that? Clearly not.

In the event that this derivative claim is dismissed, no one will ever bring these claims, ever.

MR. JOHNSON: One minute?

You've got -- you've got 10 or 12 causes of action set out here. You're the lawyer. You're Mr. Arnold. You've got the derivative claim, and you've got your own personal claims. You're going to pick and choose which ones you want to pursue. You have that control to put more money in your pocket or to put more money in the corporation's pocket. That is as clear a conflict of interest as could possibly ever exist.

And I think counsel's comments about the secretary stealing the money, absolutely ridiculous. She was authorized as signer on the account. There were capital calls, but that's, you know --

THE COURT: I'm not -- I'm not going to get into that.

MR. JOHNSON: Understood. You know, which one will I choose? I'll choose this one, because I could make more money on this one. And why would I choose the corporation cause of action over this one that I could make more money on, because this -- 85 percent will be going to Mr. Phillips.

This is a direct claim in which they're trying to get attorneys' fees and cast it as a derivative case, and it should be dismissed.

THE COURT: What about the argument that if Mr. Arnold can't prosecute on behalf of the corporate claims, i.e., that there was a plundering or looting of the corporation, inappropriate conduct on behalf of Mr. Phillips, that those claims can and will never be brought?

MR. JOHNSON: Well, there's a independent board of directors that could bring those claims right now. And remember, Mr. --

THE COURT: And there's also the proxy.

MR. JOHNSON: Yeah. So they can do that. No. That -- that's why -- I mean and Mr. Smyth's argument points out the conflict, and it points out why this is inappropriate as a derivative case by Mr. Arnold.

THE COURT: All right. Thank you.

MR. KNUDSEN: Your Honor?

THE COURT: Yes, please.

MR. KNUDSEN: Since Mr. Johnson --

THE COURT: Actually, you know, I can't have you talk from there. I let Mr. Smyth do it, because there's a mike.

MR. KNUDSEN: Yes. No. No. I was going to come down.

THE COURT: Please do. And just --

MR. KNUDSEN: Geoffrey Knudsen on behalf of Banana Corporation. So I guess since it's the corporation's claim we're talking about, I have just a couple of concerns. And actually we didn't -- we didn't file a motion. We're in the midst of some -- Banana Corporation was in the midst of some settlement negotiations which are still ongoing. We didn't feel it was appropriate.

It is in fact Banana's claim, and so Banana does have some concern here. It's got sort of a concern from each side as they've approached it. One is I wouldn't want your Honor's ruling if -- if your Honor concludes that this should proceed as a derivative claim, that's not an endorsement that

Mr. Arnold in all circumstances is the person that prosecutes that claim, because in the ordinary circumstances of a derivative case, the independent board would proceed with its investigation, make its own conclusion, and it might conclude to assume its claims. And it would be entitled to do that.

And I wouldn't want the Court's determination here to say it's an appropriate derivative case to necessarily say or be an endorsement that Arnold is the only one that pursue the claim. It's really Banana's claim, and they might in fact as a result of their investigation -- Banana might decide to pursue its claim.

On the other side, we have a little bit of a concern as well, which is if the Court were to conclude that this matter that's been pending since January was inappropriate as a derivative claim, we have some concern about the opportunity for Banana to assert the claims directly -- its claims directly with the relation back on -- relation back on the filing date because of potential limitation issues.

So there are a couple of issues there that -- that the Court's ruling may -- may affect Banana's rights, the corporation's rights that I thought I should at least bring to your attention.

And I'm happy to try and address any questions that the Court might have about what in the world is happening at the Banana level, but it really wasn't our motion and so we didn't really want to interject ourselves completely (Inaudible.)

THE COURT: Counsel, who's on the board at Banana?

MR. KNUDSEN: When this case was -- when this case was initiated, Mr. Phillips, who was then the director, sought legal counsel for Banana. Counsel made various recommendations. That resulted in the appointment of two independent directors, William Hagler[phonetic] and Robert Powell[phonetic]. And they have (Inaudible.) and they undertook Banana Corporation at the beginning of an investigation as a specified litigation review (Inaudible.)

As part of that, when they became members of the independent directors, they wanted to assure that they had a complete and independent hand, and thus the creation of the irrevocable proxy with an interest, so that they effectively are the other 85 percent shareholder.

THE COURT: So they have the proxy.

MR. KNUDSEN: Yes.

THE COURT: Okay. All right. Thank

you.

And are there just two directors?

MR. KNUDSEN: Well, no. Mr. Phillips remains a director.

THE COURT: But he doesn't have -- the voting is --

MR. KNUDSEN: But -- but the decisions with respect to the derivative litigation are entrusted to the two independent directors that constitute the review committee.

THE COURT: All right. Thank you.

MR. KNUDSEN: And he doesn't have a shareholder -- I mean he doesn't have a voting shareholder interest as long as the -- as long as the committee continues to exist.

THE COURT: Thank you.

MR. KNUDSEN: Thank you, your Honor.

THE COURT: All right. Thank you all, Counsel.

This matter is before the Court on Defendant Phillips' motion to dismiss pursuant to Civil Rule 12(b)(6) the derivative action against MOD Systems, Inc. and the derivative action against Banana, Inc.

With regard to MOD Systems, Inc., the motion to dismiss is denied. The Court concludes that is not currently constituted as a derivative action, and therefore as a direct corporate action the issues raised by defense counsel on behalf of Mr. Phillips do not apply to a direct corporate action, and accordingly the motion is denied, with regard to Mr. Arnold's claim.

The Court understands the unique consequences of this situation where we have essentially only two shareholders and the majority with Mr. Phillips, who is alleged to be the misfeasing or malfeasing party being the majority shareholder.

The Court is guided by both the Hames case in Washington and the Larson versus Dumke case cited by both sides, not argued in oral argument, but which this Court has reviewed.

And in that case, the Court was addressing the exception to the general rule that a single shareholder generally cannot be representative to the class. The class being defined as other similarly-situated shareholders.

In that case the Court found that the plaintiff, Mr. Larson, had no class, and that there was no one similarly situated, because he was challenging the ESOP, and all the other employees had the ESOP. But the analysis nonetheless would be applicable here, and that is that the adequate representative in a derivative action must have the capacity to vigorously and conscientiously prosecute a derivative suit and be free from economic interests that are antagonistic to the interest of the class, citing numerous other cases in support of those propositions from Supreme Court Sixth Circuit and District of Massachusetts, and the First Circuit Court of Appeals.

Other courts have stated certain factors to determine adequacy of representation:

Indications that the plaintiff is not the true party in interest; the plaintiff's unfamiliarity with the litigation and unwillingness to learn about the suit; the degree of control exercised by the attorneys in the litigation; the degree of support received by the plaintiff from other shareholders; the lack of any personal commitment to the action on the part of the representative plaintiff; the remedy sought by plaintiff in the derivative action; the relative magnitude of plaintiff's personal interests as compared to his interest in the derivative action itself; and plaintiff's vindictiveness towards the defendants.

Many of these factors the Court has no concern over or simply are not applicable. The Court believes that the plaintiff here is the true party in interest;

that he's clearly familiar with the litigation and willing to learn about the suit. The attorneys well represent Mr. Arnold. The degree of support received by the plaintiff from other shareholders is moot or not really applicable here and is clearly not a lack of personal commitment to the action.

The concern is that raised by -- in both Hames and in Larson, and that is the relative magnitude of the plaintiff's personal interest as compared to his interest and the derivative action itself, as well as the plaintiff's vindictiveness towards the defendants.

Given the holding in -- in Hames, as well as the guidance under Larson versus Dumke, this Court can only find that Mr. Arnold's economic interest are antagonistic to the corporation itself. He has complete control as pointed out by defense counsel as to whether to vigorously prosecute his interests versus those of the corporation where he has a 15 percent interest.

There are multiple interests at issue here: Those of Mr. Arnold individually; those of Mr. Arnold on behalf of the corporation; those of Mr. Phillips. And I don't believe that they can be properly reconciled in a derivative action prosecuted by Mr. Arnold.

Now, the reality of it is that if it weren't Mr. Arnold prosecuting this -- let's say there was another derivative action and then Mr. Arnold's personal prosecution. I would probably be inclined to consolidate, but that's a separate issue.

I have significant concerns about the issues raised by Mr. Knudsen. I think that Mr. Knudsen helped me make this decision, stating that there are independent board members, and that they are conducting an investigation. And that's who properly ought to decide whether or not there are -- there is a viable basis to prosecute this claim on behalf of the corporation against Mr. Phillips and other defendants.

So the dilemma or conundrum, as put by counsel, is as follows:

First of all, as Mr. Smyth pointed out, this may not get prosecuted. I don't think this Court should consider that. That's up to the corporation and its board. The representation was -- is that the corporation is impecunious, can't prosecute it. But as we all know, there is this thing called a contingency fee out there. And if these claims are viable, then perhaps counsel would choose to prosecute them on a contingency fee basis.

The Court does not find the argument that there aren't funds to prosecute a corporate claim, a derivative claim on behalf of the corporation set by the board is -- is not persuasive. However, I have concern about the running of the statute of limitations. And I don't know and I don't think I can give an advisory opinion on the relationship back.

MR. SMYTH: Your Honor, if I might suggest that is an issue -- let me speak in a way that there's a microphone. Is there one here?

THE COURT: There's one right there. Yes.

MR. SMYTH: Okay. That may be an issue that is -- requires further analysis, perhaps input to the Court, and the Court might stay its decision based upon a finite number of amount of time to determine whether or not Banana's claims will in fact be lost under the statute when Banana Corporation commenced its internal investigation of the claims that resulted in the KPMG report. The lawsuit -- this lawsuit was in fact stayed.

The stay might be -- might resolve the issue of the statute of limitations. I don't know. But in the event that it doesn't and the action is dismissed, and Banana is left with the only means by which to enforce its own rights, and they have been lost either in total or to some significant extent as a result of the statute of limitations, I think that's something that the Court might consider.

THE COURT: All right. Mr. Johnson, I will tell you my -- I'll hear from you. My inclination is to grant a 60-day stay. And that will be put up or shut up.

MR. JOHNSON: And I would like to put it on the record, then, and that is this. It's -- as the Court has been advised, there is a independent board. They've been evaluating this case for a year. And so I -- I think that it is their decision and their decision alone. This never was a very big case (Inaudible.) the Court's making the correct decision, but it's Banana's board's decision whether to pursue these claims or not. And I would -- I understand the Court's inclination. I just want it to be on the record that (Inaudible.) inappropriate to let the board decide what they're going to decide.

THE COURT: Well, I am going to let the board decide what they're going to decide, but they have 60 days to do it. And I will -- I'm going to -- I don't -- I guess I would grant the motion to dismiss under 12(b)(6) and stay the effect of that dismissal pending for 60 days. That's it. So that is my ruling.

MR. JOHNSON: (Inaudible.) trust?

THE COURT: Yes. Counsel.

MALE VOICE: Your Honor, so I have a form of order as to the dismissal on MOD. (Inaudible.) it?

THE COURT: No. We're going to deal with -- you can start working on it. And -- but what I'm going to do is I'm going to make my ruling so we can use this time. And then we're going to recess. I'll let counsel -- I'll let counsel work on the orders while I'm back in chambers.

Actually, why don't we -- I think I should -- let's take a -- well, let's take a brief recess. Why don't we take a ten-minute recess. Then we're going to move on to motion to terminate the trust and to replace the -- the DRC members.

MALE VOICE: Thank you.

THE COURT: We'll be at recess for ten minutes. Court is recessed.

FEMALE VOICE: All rise.

(Break in recording.)

THE COURT: Please be seated. We are back on the record in the matter of Arnold versus Phillips, et al.

And, Mr. Johnson, you were going to start on the motion to terminate the trust.

MR. JOHNSON: Yes, I will. Okay. The fundamental principle of trust law which we set out from the restatement in the Byllesby case and also from Bogert's on trust or something (Inaudible.) we didn't cite that. The settler of a trust is a sole beneficiary and not under an incapacity, who may compel termination of the trust which (Inaudible.) even if the purposes haven't been accomplished and even if the terms of the trust state that it is irrevocable. And the irrevocable part is in the comment section 339 A, Restatement of Trust.

Okay. So what did this voting trust -- you heard this morning, your Honor, about this proxy (Inaudible.) But what -- so -- but we don't have that here. We have a trust, and a trust is a very specific instrument. It creates fiduciary duties from MOD to Phillips, utter honesty, complete good faith, undivided loyalty.

MOD is now suing Phillips. I say in there that MOD's apparently settled with Mr. Arnold. I don't know whether that's true or not. There was a reference in the pleading there was. I don't think it's material. MOD's lawyer have called Mr. Phillips a crook.

So the trustee for his 70 percent ownership in this company is -- is absolutely utterly and completely hostile to him. They could have chosen a proxy or something else. So MOD must act in the best interests of Mr. Phillips as the trustee, and it's in his best interest to terminate the trust.

The defense cited the transition agreement. And it was when -- when Mr. Phillips was, our contention, forced out of this company. And we think that the trust is a -- is an absolute lynchpin of that corporate overthrow. The transition agreement references that he will execute a voting trust. Okay. We cited the Haberman case. Mr. Arnold submitted opposition, the Haberman case, that he does not have standing to test the termination of the trust. Irrespective Mr. Arnold's opposition, he cites no case law, but he cites the waiver and release provision from the transition agreement.

And the waiver and the release provision simply says that Phillips waives and releases any and all claims against the company arising from or related to the provisions of this transition agreement, including its exhibits. And the exhibits include an amended employment agreement, which is not in the record unfortunately.

But I'm going to talk about it in a minute. We (Inaudible.) supplemental declaration by Mr. Phillips with respect to the terms there. -- or its implementation by the parties in accordance with its terms. I don't see how or we don't believe the waiver and release provision has anything to do with the execution of this trust. In other words, that terminating the trust has nothing to do with whether he -- he's not making a claim against the company. And so that provision cited by Mr. Arnold we don't think is applicable in any way, shape or form as to whether Mr. Phillips can terminate the trust.

Also, Paragraph 14 -- and this isn't a defense argument. I popped this in here. The severability provision says that if a court finds one provision in this agreement is illegal or invalid, it doesn't terminate the rest of the transition agreement.

Okay. MOD's opposition to terminate -- and I cite four cases, Grynberg goes first, Guardianship of Lombardo. Three of those cases are equitable estoppel cases. I want to talk about that. The Guardianship of Lombardo is kind of a funny case. It's a -- Ohio has this statutory trust law. Basically the holding was the probate court. The incompetent wasn't the sole beneficiary of the trust, and I think that was the --

the main reason the Lombardo case was decided.

They also have a different statute in Ohio, the state of Ohio which allows for irrevocable voting trusts. Washington statute does not specifically reference that at all.

Okay. So equitable estoppel, these are the elements. They didn't really -- they didn't say in their brief they were claiming equitable estoppel, but three of the four cases sort of cited it, so I thought I'd bring it up with the Court. These are the elements: Admission, statement or act inconsistent with the claim afterwards asserted, action by the other party and reasonable reliance on the admission, statement or act, and injury to the other party.

We don't think this meets any of the elements of equitable estoppel. Mr. Phillips is simply exercising his right to terminate the trust consistent with the principles of trust law. It's not an act inconsistent with any claim he is making. He has received no benefit from the voting trust.

And we have a -- Professor O'Kelley, who has been a -- I'll have some material from him on the Cane and Bay removal. He is a corporate law professor at Seattle U. He looked at the document. He cannot see --

(End of CD Number 1.)

(Beginning of CD Number 2.)

THE COURT: -- stop you there. That to me is sort of the rub of this whole issue. And neither side really addressed this issue so maybe it's not an issue.

MR. JOHNSON: Okay.

THE COURT: But isn't the voting trust agreement a term and condition of the transition agreement?

MR. JOHNSON: Well, that may be what the defense is saying. I think we made it clear in our -- and I think that was the argument that were in the four cases that they talked about.

THE COURT: Right.

MR. JOHNSON: We made it clear that there is nothing in that agreement that says that. And the trust is a separate instrument. They could have chosen many different ways to structure this, but they chose a trust. And trust -- and a trust has to be interpreted under the principles of trust law. There is nothing in the document that says that it is integrated that this is part and parcel of the transition agreement.

In fact, the severability clause I think says just the opposite. So -- but moreover because this still is -- this is a trust, the trust has been an important tool to evict Phillips from the company and damage his majority ownership -- the actions of MOD, they've now sued him, called him a crook -- are completely inconsistent with the fiduciary duties of a trustee. Besides and finally MOD breached the agreement.

This is a supplemental declaration -- a portion of (Inaudible.) supplemental declaration that we put in the record. He signed the transition agreement March 27th, 2009. He resigned as CEO and board chairman, but he remained on as chief technology officer.

Now, this is not -- the -- the employment agreement is not in the record. The defense -- or I mean -- sorry -- the plaintiff, MOD, put the transition agreement --

THE COURT: Right.

MR. JOHNSON: -- and the voting trust, but not the employment agreement into the record. Six days after he signs this transition agreement where he has -- he has put his stock in trust now. He signs this transition agreement. Six days later they place him on administrative leave.

And then on September 4th, he receives a letter from MOD placing him on unpaid administrative leave, terminating his salary and all benefits. And this is the letter, September 4th.

THE COURT: But he's got -- if there's a breach of contract his remedy is -- under the breach of contract, his remedy is to say here's our contract. You breached it. This is what I want as a remedy, not now you can't enforce these other provisions.

MR. JOHNSON: I disagree. All trusts are equitable trusts. And the only cases they cited were equitable estoppel cases. And they've got to have clean hands.

And this is -- from our perspective, this is a setup. They took control of his shares. And then -- and in conjunction with the transition agreement. And as soon as the ink is dry, they place him on -- six days later on unpaid administrative leave. And then on September 4th, they effectively terminate him.

They have -- if they're going to rely on equitable principles to enforce that trust as some integrated part of that document -- and it doesn't exist in the document. The document does not say that -- then they have to at least live up to the terms of the document.

THE COURT: Well, let me -- let me turn you back, if I can, to the restatement which has been adopted in Washington state. And it says under restatement comments -- this is Restatement Second Trust, Section 337, Comment E. If the purposes for which the trust is created are expressed in the instrument by which the trust is created, a different purpose cannot be shown by extrinsic evidence.

If, however, the purposes are not expressed in the instrument, extrinsic evidence of the surrounding circumstances to aid in the construction of the instrument is admissible in order to determine the purposes of the trust. And that's under the section about whether or not the trust can be terminated or not.

MR. JOHNSON: All right. The -- I think I know what the Court's question is, but if you look at the transition agreement -- and I'd like to -- you know, again -- and it is a trust. You can't change the essential character of the instrument. That's what it is. It is a trust. And all -- our contention is all the fiduciary duties go along with it.

But the transition agreement was entered into at a time when MOD was investigating Mr. Phillips. And -- and now they have sued him. They are overtly hostile to him. There could not be a more antagonistic relationship than a trustee with fiduciary duties who has called the beneficiary of the trust a crook with respect to really what is the corpus of that trust, the shares of stock.

THE COURT: But isn't the solution to that to remove that person as the trustee rather than to terminate the trust?

MR. JOHNSON: No. I don't agree with that, because the corporation still has control -- I mean the terms of the trust say that if Ms. Cane is removed, then the corporation has the authority to name a new trustee.

THE COURT: Right.

MR. JOHNSON: So, in other words, the corporation controls the trust. This is a MOD -- MOD is the trustee. I mean Kyleen Cane was named, but she wasn't named in her individual capacity. This was in her role as a member of the board of directors of MOD.

MOD controls this trust, and they have now sued him. So it is absolutely irreconcilable for a trustee to hold property of a beneficiary when they are overtly hostile, antagonistic to them. It simply is -- you know, even if you forget Section 339 in the Restatement of Trusts, it is -- it is absolutely an irreconcilable conflict for a trustee to hold property contrary to the wishes and intentions of the -- of the beneficiary.

THE COURT: All right. So here's how it plays out. Right now I have a direct claim of the corporation against Mr. Phillips -- sorry -- yeah, against Mr. Phillips. If I terminate the trust, Mr. Phillips will vote his shares --

MR. JOHNSON: Um-hum.

THE COURT: -- or he'll replace the board of directors --

MR. JOHNSON: Um-hum.

THE COURT: -- because he's a minority share. He'll put friendly directors on. The directors will dismiss the direct claim, and then Mr. Arnold would come around and then file a derivative suit.

MR. JOHNSON: Well, that --

THE COURT: Right?

MR. JOHNSON: That may occur, but here's -- here's the issue. First of all, he is -- he is the majority owner of that corporation. His shares are in a trust. They are locked up and he has been locked out. He has a right to go back into that corporation. I don't -- I don't believe in any way, shape or form he would create a friendly board that would dismiss these claims. I think that his intention is absolutely -- and this is in some sense --

THE COURT: He's not going to allow himself to be sued. Why would he do that?

MR. JOHNSON: Well, I'll tell you why is because -- I'll tell you why. When he was 24 years old, he applied for this patent. It's one of the patents that he's applied for. It was issued in August of 2009. He is a young man, 35 years old.

He has been accused of the most -- his ability because of the allegations in this case to raise money -- to -- you know, I mean he's -- he wants these companies to go. He wants to defend these allegations. He very much wants to.

THE COURT: Well, then why don't I let them play out in this litigation if he wants them to -- to be resolved?

MR. JOHNSON: Well, if I -- respectfully -- oh, they will be. They will be played out in this litigation, but, respectfully, he has a right to have his shares back.

You know, your Honor, I don't think this Court can say -- there is no legal basis of which I am aware where the Court can say you -- you know, you entered into this transition agreement. Even though they breached it or -- and -- or and now your property, 70 percent of this corporation is locked up by a trustee who is overtly hostile to you, and you can't have your property back.

THE COURT: Well, but that's where -- that's where perhaps contract law and trust law are getting into conflict here, but it strikes me that when you make a deal and part of the deal is I will put my shares into a voting trust until 2014, that you're bound by that.

MR. JOHNSON: Well, not according to Restatement 339. And, your Honor, don't forget --

THE COURT: But I just read you 339.

MR. JOHNSON: No. You read me 337.

THE COURT: Oh.

MR. JOHNSON: 339 is what we had started this. But, your Honor, there's a couple things here. This is the fundamental principle of trusts.

THE COURT: You're right.

MR. JOHNSON: Okay. Now, when the transition agreement was signed, the corporation was investigating the claims against him. And they -- the corporation promised that he would remain as chief technology officer of this corporation. So he --

THE COURT: That was the consideration.

MR. JOHNSON: Yeah. He puts these things in charge.

THE COURT: Okay.

MR. JOHNSON: So they fire him. He's not being paid by the corporation. And so if the Court was going to analyze this in terms of an equitable estoppel situation, the Court has to take into account that act.

THE COURT: I'm not -- I'm not -- it's not equitable estoppel. I'm not applying equitable estoppel.

MR. JOHNSON: Okay. So if you're not applying equitable estoppel, the essential character of the document is a trust, and trust law principles apply. He is the sole settler, the sole beneficiary, and he has a right to terminate. But what the Court is considering is ancillary consequences outside of this instrument.

THE COURT: That's exactly what 337 says you can do.

MR. JOHNSON: And 339 says if you have a sole beneficiary -- and we know we have that -- and we have a -- and the beneficiary and the settler are the same person, they can terminate at any time even if it says it's irrevocable.

THE COURT: And if you look at the case law interpreting that provision, it says that there are exceptions to the rule. The exceptions being typically equitable estoppel. But if you can have -- equitable estoppel is actually a higher burden than a contract.

MR. JOHNSON: But there's no cases cited by anybody that I have found.

THE COURT: The divorce case. That wasn't equitable estoppel. That was a contract.

MR. JOHNSON: Well, I think they applied equitable estoppel, but what they did is she took the benefits. Okay. What benefits has he received? There is absolutely none.

THE COURT: But his remedy is to enforce the benefits he was to receive.

MR. JOHNSON: His remedy, your Honor, I think is to terminate the trust. You have an overtly hostile trustee. And -- and this --

THE COURT: But, Counsel, I've addressed that issue.

MR. JOHNSON: Okay.

THE COURT: What you do with that is you put in somebody there who is in fact independent, who is not hostile to Mr. Phillips, who can make an independent determination.

MR. JOHNSON: The trust instrument doesn't permit for that, though. The trust instrument says MOD replaces the trustee. That is the base of the trust instrument. There's nothing that --

THE COURT: However, I can remove the current trustee. MOD will replace it -- replace that person with whoever MOD wants. And then if that's an unacceptable individual, you come back to court. You say, Judge, this is not an independent trustee.

MR. JOHNSON: You can also do something else. You can terminate the trust and -- and Mr. Phillips will agree to appoint an independent board, an independent board.

THE COURT: Well, I don't have a --

MR. JOHNSON: And an independent demand review committee.

THE COURT: Well, Mr. Johnson, here's the problem. I've got two sides to this litigation, both sides accusing the other of being crooks. All right. So Arnold and his contingent, Cane, et al., are saying that Mr. Phillips is a crook. Mr. Phillips, on the other hand, is saying that Ms. Cane is a crook, and that she has duped all these other directors and shareholders.

I can't resolve that right now. But what I can do is I can put persons who will protect the interest of the corporation in those positions of, for example, the voting trust. I could remove Ms. Cane.

MR. JOHNSON: But then the voting trust says that MOD replaces the trustee.

THE COURT: MOD replaces the trustee, and if it's somebody that's unacceptable to Mr. Phillips, he comes back to my Court and says, Judge, this isn't an independent trustee. They're not voting with my interests.

MR. JOHNSON: Well, but the terms of the trust require that the trustee devote a certain fashion. Here's -- here's the thing.

THE COURT: They vote with the --

MR. JOHNSON: Majority, right. Yeah.

THE COURT: With the --

MR. JOHNSON: To achieve NCR effectively.

THE COURT: Thank you.

MR. JOHNSON: But here's the issue. This is -- this is a trust. And all trusts are -- you know, if we can construe according to trust law, there is no reason why this settler beneficiary cannot terminate his trust in accordance with trust law. And what they have done is they -- you know, you can take their side or our side. Our side they're using this to facilitate a takeover of the corporation. They're saying you're a crook.

Well, if you side -- if you side with them, all you're doing is picking their allegations over our allegations and that is not the way --

THE COURT: Yeah.

MR. JOHNSON: -- to make a determination over -- this was at one point a hundred million dollar corporation. His interest was $70 million. And they've tied up -- they're being locked up by a corporation that has fired him, called him a crook and is suing him.

THE COURT: What I'm suggesting here is that someone make these decisions who isn't involved with either Phillips or Arnold or Cane; that the voting trust -- and the problem is if I give this -- if I -- if I revoke -- if I terminate the trust, first of all, my reading of the transition agreement is -- I mean we assume in contract law that there was consideration. And if we have a contract that says you will place this trust, it's an illusory contract. It has no meaning when it says until 2014, and then it's revocable at any time by him.

MR. JOHNSON: But it's -- if you follow

trust law, he can do that. That's all there.

THE COURT: And I'm saying I've looked at trust law, and trust law says that there are exceptions to this rule. And the exceptions are equitable estoppel and, in my opinion, when you contract to do something. If I contract for you, I'm going to put my assets into trust. If you give me a million dollars, I'll put my money into a trust.

And then -- and then the -- you give me the million dollars, and the next day I say ha-ha, and I simply revoke the trust. That's not enforceable?

MR. JOHNSON: Well, those aren't our facts. Our facts are this. And if -- if you're going to talk about a contract, what -- for you -- for the Court to say I'm going to leave this trust in place, and if MOD has the authority to place the next person in there, it will effectively continue -- Mr. Phillips will be effectively locked out of the company that he created simply because of allegations of a lawsuit. That's it.

THE COURT: But he had counsel. He made this decision -- he entered into this contract. He didn't have to enter into this contract. He could have said no, but he entered into this contract.

MR. JOHNSON: He entered into this

contract based upon the premise that he would continue as chief technology officer. And -- and, you know, who is to say he didn't enter into this contract on the -- based upon the premise that trust law applies with respect to the trust? And that's all we're saying. It doesn't change --

THE COURT: Well, I don't have any evidence to that before me.

MR. JOHNSON: And you don't have any evidence to the contrary either. So what we have is we have a trust instrument. We have a trust instrument that is -- that $70 million potentially of property is being held by somebody who is overtly hostile.

THE COURT: And I've -- we're going around in circles.

MR. JOHNSON: I know we are. I apologize.

THE COURT: All right. Let me hear from -- from Mr. Buckley.

MR. BUCKLEY: Thank you, your Honor. Brian Buckley on behalf of MOD systems.

So I think I have no choice but to talk a little bit about the facts, because as your Honor has noted, there are some general principles of trust law which we don't take issue with. What we're saying is this has no applicability here. And if there was ever a case for an exception to that, it's this case.

And the idea that there was no consideration for the transition agreement, that in some way he was duped into it even though, as your Honor noted, that counsel at the time is belied by the fact. What happened was that in June of 2008, Mr. Phillips was the CEO, director and majority shareholder of this company.

Based upon facts that aren't in the record -- and I'm not going to get into them -- the board started to be concerned about the fact that Mr. Phillips and his friend Mr. Gordon had complete control of MOD's finances.

So in response to that they did what any normal board would do and said we're going to put in some restrictions around how you can use the company's cash. And what the board did not know at the time and what has since come out was that Mr. Phillips was engaged in massive fraud. He was siphoning all the money out of the company the same way he siphoned all of Banana's (Inaudible.)

So when the board proposed to neuter his ability to do that, Mr. Phillips took the nuclear option, as some people have referred to it. He kicked the board out. He appointed his buddy Mr. Gordon as director. He actually brought in Kyleen Cane as an independent director. That was Mr. Phillips' choice. And again the purpose behind that obviously was to make sure that he could continue to do what he'd been doing, which was perpetrate a fraud.

Fast forward a couple of months. The Series A happens. $35 million comes into the company. Fast forward again to December, and Mr. Smyth and his client Mr. Arnold come to the company and say we have evidence that there is fraud going on here. We'd like you to investigate that. The DRC, the demand review committee is appointed.

And at the time there were four directors, Phillips, Gordon, Bay, Cane. It was clear that Phillips and Gordon were front and center in the lawsuit. They couldn't be on the DRC. So the only two folks left were Kyleen Cane and Anthony Bay. They were appointed to the DRC unanimously. Mr. Phillips voted to appoint them to the DRC. And in the resolution of doing that, he acknowledged that both of them were disinterested.

Everybody understood at the time -- Mr. Bay at the time was also named as a defendant. Everybody understood that Mr. Bay was going to have to recuse himself from any issues that dealt with him, but the

DRC was going to investigate all of the issues, including the claims against Mr. Bay, which it did.

That investigation played out. And, your Honor, you've seen the DRC report, because Mr. Phillips' counsel put it in. They -- the DRC report concluded that he had looted over $1.2 million from the company, most of which he hasn't contested and has done a lot of other -- engaged in a lot of other questionable behavior that I'm not going to go into here today.

But it's not like we're talking about him, you know, violating his expense reports or something. This was a very significant fraud that was being perpetrated.

THE COURT: Let me --

MR. BUCKLEY: And remember -- I apologize. I didn't mean to cut you off.

THE COURT: But go ahead.

MR. BUCKLEY: We have to remember too at the same time Banana conducted a separate investigation using KPMG and Smith & Hennessey firm, and they concluded that in a 157-page report that Mr. Phillips had engaged in all of the same conduct.

So what MOD is faced with at that point in time, the time of the transition -- and I'm getting to the point -- the transition agreement and the voting agreement, at the time those agreements are executed what MOD is faced with is two independent investigations by two big four accounting firms, Lane Powell of the law firm on one side, Smith and Hennessey, the law firm on another, concluding -- and this is not Anthony Bay and Kyleen Cane reaching these conclusions. It's all of these other entities, who presumably their reputation is beyond reproach here, concluding that Mr. Phillips was engaged in multiple million dollar secret fraud and a drug user and engaging in improper relationships with people at the company and (Inaudible.)

So what was the company supposed to do? Under other circumstances, the board at that point would have had zero -- zero discretion but to terminate Mr. Phillips; right? I mean at that point what do you do? This is your CEO. So they went to Mr. Phillips and they said we're going to terminate you. We have to based on what we found out.

And what came out of that was a settlement, an agreement, the transition agreement. And the whole point of it was that if we terminate you under the Series A documents, which Mr. Phillips negotiated, if you're terminated, the Series A shareholders get all their money back, the company fails. And, by the way, if the company can't pay the Series A investment back, the Series A shareholders have a claim directly against Mr. Phillips.

So the question of what value was there to Mr. Phillips at the time to sign the transition agreement with the advice of Lasher Holzapfel Sperry and Tony Gewald, who is a very competent lawyer who helped draft the agreement -- Tony helped draft the transition agreement, Mark's lawyer, and the voting (Inaudible.) What was the value to him of entering into the transition agreement?

It was so he wouldn't be terminated and so that the entire company wouldn't collapse. Series A take their money back. There's no money to pay it. They come after him personally. It made sense for everybody at the time.

Now, all this talk about -- let's just look at the voting trust agreement, this myopic view of the voting trust agreement. It's a standalone document in a trust. That's all true. It's a trust. But it's totally nondiscretionary. It's just an administerial document. There's zero discretion under that trust.

First of all, MOD's not the trustee. Mr. Johnson said multiple times MOD's the trustee. It is not. Kyleen Cane is the trustee. But the only reason she's the --

THE COURT: Well, his point was -- is that MOD has the ability under the agreement to appoint any replacement trustee. I think that was --

MR. BUCKLEY: We -- we offered -- and it's in Mr. Johnson's papers. We offered to replace Ms. Cane with an entity they choose. And the reason that that doesn't matter -- a monkey could do this, your Honor. The reason is the document says how the shares have to be voted.

THE COURT: Let me ask you this: If this -- if the monkey can do it --

MR. BUCKLEY: And no -- no disrespect to Ms. Cane. What I'm saying is that it's purely --

THE COURT: Or to monkeys for that matter.

MR. BUCKLEY: Or to monkeys.

It's purely mechanical. The document says here's how the shares are voted. Some -- a (Inaudible.) entity has to push the button.

THE COURT: All right. Now, and that's because of the agreement with Toshiba, NCR; correct? Or --

MR. BUCKLEY: Well, no. That's just --

there has to be some mechanism to vote the shares. My point was that there's -- that the trustee role under the voting trust, anybody can do it. Your Honor --

THE COURT: But don't they decide how -- who tells them how to vote?

MR. BUCKLEY: The document. The document says you vote in proportion to how all the other -- okay. I'm sorry. To your point, what the document says is however all the other shareholders vote, you just vote the trust shares in direct proportion.

So say we just have three -- say we have three shareholders, Arnold, Phillips and Bay. The voting trust says, okay, set the -- set Phillips' shares aside. If Arnold votes in favor and Bay votes against, then you just vote the trust shares in the exact same way, in proportion to however the other shares were voted. The idea being that you basically neuter the effect of those shares. Whatever the result would have been, the shares were voted in exactly the same way.

THE COURT: But it's 70 percent, right, or whatever the figure is?

MR. BUCKLEY: Well, it's a majority, but because they're being voted in the same proportion as the other share are voted, it's (Inaudible.) and that was the whole idea, but the transition agreement says this.

THE COURT: So what difference does it make then if Mr. Phillips has his shares back? If he's -- if he's forced to vote in a certain way under an agreement, what difference does it make?

MR. BUCKLEY: The only agreement that binds him to do that -- well, there's two. The voting trust is the mechanism for that. But the transition agreement is what -- is what binds him to do that. If you --

THE COURT: So you're saying the voting trust does not allow discretion on the part of Ms. Cane as trustee.

MR. BUCKLEY: Zero. And she gets no benefit from the trust. There's all this talk about how she's using this to somehow loot the company. She's not being paid to be the trustee. She's trustee, because Mr. Phillips asked her to be. She would like nothing more than not to be the trustee.

THE COURT: And you would have no objection at this point if the Court -- if the Court denies motion to terminate to have an appointee of Mr. Phillips' choosing.

MR. BUCKLEY: None. We've offered that.

It's in the papers. We offered it. We put it -- Mr. Johnson put it in e-mail making exactly that offer.

THE COURT: All right.

MR. JOHNSON: Your Honor, may I (Inaudible.)

THE COURT: I'm sorry?

MR. JOHNSON: May I have rebuttal?

THE COURT: You are going to have rebuttal.

MR. JOHNSON: Thank you.

THE COURT: Thank you, Mr. Buckley.

MR. BUCKLEY: Your Honor, could I make two additional points?

THE COURT: Yes.

MR. BUCKLEY: We haven't talked about the DRC.

THE COURT: We have not talked about the DRC.

MR. BUCKLEY: The DRC is totally immaterial. Do you want me to address that now or next?

THE COURT: No. I don't want to talk about the DRC.

MR. BUCKLEY: And, your Honor, the other point I want to make is that this motion is procedurally fatally flawed. It was filed on a six-day calendar. We had four days to respond to it. There's a purported expert that's (Inaudible.) in it. I mean there's a stack of materials this big.

This is a summary judgment motion. If you were inclined to grant it, at a minimum it should be re-noted. We should get a little chance for discovery, and we should actually get a chance to formally respond. The idea that we haven't addressed every (Inaudible.) in his motions is because we only had four days to respond.

MR. SMYTH: Your Honor, if I might on behalf of Mr. Arnold.

THE COURT: Mr. Smyth. And then I'll hear from you, Mr. Johnson, after I hear from Mr. Smyth.

MR. JOHNSON: Thank you, Your Honor.

THE COURT: You're welcome.

MR. SMYTH: I think it's important given the fact that we're looking at all six sides of this particular cube today to understand that there has been a settlement between Mr. Arnold and MOD Systems.

One of the foundational blocks of that settlement is the removal of Mr. Phillips from control of this company by means of the voting trust and the transition agreement. That settlement will fail as a result of the lack of consideration if this trust is set aside.

It's our view and our belief that this transition agreement and the trust that comes along with it were not only the idea of MOD's counsel, Lane Powell, but also the idea of Mr. Phillips counsel, Mr. Tony Gewald, and that's why the transition agreement specifically cites that it was jointly drafted by Lane Powell and the Lasher Holzapfel firm.

If we're going to talk about reliance, I can tell you for a fact that one very big piece of litigation -- piece of this litigation went away directly as a result of the negotiation of that deal.

THE COURT: Well, according to Mr. Johnson, it hasn't gone away, and it can't go away, because it's settling the derivative claim; correct?

MR. SMYTH: Well, it actually did not settle the derivative claim. The derivative claim was not settled. It was dismissed.

THE COURT: So this settles Mr. Arnold's claims.

MR. SMYTH: This settles Mr. Arnold's claims against MOD Systems and resulted in the dismissal of the derivative claims against MOD or on behalf of MOD. It was all -- it was all carefully coordinated by all of the parties with full knowledge of Mr. -- by Mr. Phillips that the transition agreement would be a step forward toward a final resolution that would take MOD Systems out of the litigation mode.

This is a company that has great promise as opposed to Banana that is a flat puppy. This one has promise. Mr. Arnold believes that it has promise. And dragging the litigation after it was deemed by all parties, including Mr. Phillips, to be a bad thing.

THE COURT: And yet MOD is prosecuting its claims against Mr. Phillips.

MR. SMYTH: As of this moment, that's correct.

MR. BUCKLEY: Because, your Honor, those claims were actually not dismissed. Mr. Smyth misspoke.

MR. SMYTH: I'm sorry.

MR. BUCKLEY: The company assumed control of (Inaudible.)

MR. SMYTH: That's correct. Procedurally that's correct.

MR. BUCKLEY: (Inaudible.)

MR. JOHNSON: Well, you know, we've started. We're here at 9:30 this morning. And there was a representation that the claims weren't settled. Then we have one of the lawyers stand up and say the claims were settled. And there is -- and if you look at Anthony Bay's declaration which he gave, he references just what was said is that the settlement will fall apart if Mr. Phillips gets his shares back. This collusive settlement of a derivative claim in violation of the court order will fall apart. I mean that's what they -- that's what they have just said.

Now, the facts of this case --

THE COURT: Well, if it is a derivative claim, there is no settlement, because the settlement -- because derivative claims have to be approved by the court and notice to all other parties. So I don't know that it's the derivative claim.

MR. JOHNSON: But we don't -- that's the problem. We don't know anything, because nobody's been told anything. And I'd like to -- if I may very quickly address some of the facts. Okay.

In September of 2008, a transaction took place whereby Mark Phillips licensed intellectual property to MOD. And he received stock shares and royalties. Okay? Now, one of those royalty payments they have not paid $500,000.

There is an enormous dispute about the DRC's expenses. I mean -- and you saw, and if I have time I'll go into it, you know, Professor O'Kelley's declaration, Dennis Mandell's declaration. The DRC report is an absolute and utter joke.

They have one heading where they talk about $200,000 of inappropriate expenses. You add them up and it's 170. I mean this -- this is the guts of what we're talking about here is this thing was a complete and utter whitewash.

You know, so in September of 2008, Kyleen Cane and Anthony Bay as the board members -- Mr. Phillips is out of the room. They have all the intellectual property before them, and they vote to -- to -- to -- that MOD will license this from Mr. Phillips and pay him a royalty.

One month later, $35 million comes into the corporation. Here's what we had, an admission this afternoon by Mr. Buckley that MOD is committing securities fraud. He's -- did you hear what he said very carefully? Listen to this, your Honor. He said if Mr. -- what did Mr. Phillips get in exchange from the trust. He said if he had been terminated, it would have violated the Series A.

So they create this fiction where he is on leave so they can keep getting and spending Toshiba's money. I mean this is one of the most shocking things I've ever heard. They create this legal fiction so they can keep spending Toshiba's money, but they don't -- they don't terminate Mr. Phillips, because they know they need Mr. Phillips. The Series A financing requires that he be in there. So they have -- I mean if that isn't a reason to terminate this trust, nothing is.

THE COURT: But why isn't that in the interest of the corporation?

MR. JOHNSON: Well, first of all, it's not honest.

THE COURT: It's not what?

MR. JOHNSON: It's not honest. They have terminated Mr. Phillips, but they went to keep Toshiba's money. They want to keep spending the money down. They want to keep -- you know, there's nobody that can -- there's no creative technology person at (Inaudible.)

You know, your Honor, $35 million comes into this company because of what Mr. Phillips did, and number one, his reputation, his work and -- this is critically important -- the IP that he licensed in September. Okay. The MOD board looks at everything. They -- they -- they license this from Mr. Phillips.

They agree to pay him $5 million.

A month later, in October, the $35 million comes in from Toshiba and NCR, and they have lawyers all over this transaction. They go through everything this company has ever done, Morrison Foerster, all of these people. So all this was looked at. The money comes in. Here comes the lawsuit. Oh, you know, Mr. Phillips, you've been inappropriately spending money.

So then they go to this voting trust thing and -- and -- and they force him -- he is forced out of the company. You saw the letter. No benefits, no cell phone, nothing. He is out of the company. But they allow it to appear in fiction that he's still there so they can keep Toshiba's money. Now, that is securities fraud. That's a great, great, great derivative suit.

You know, the lawyers, you know, constructing this lawsuit and constructing this eviction of this guy from the company, but they want to keep the 35 million that he brought in. He specifically said -- Mr. Buckley specifically said and absolutely said that if Mr. Phillips was terminated, it would violate the Series A agreement.

THE COURT: I -- I heard that.

MR. JOHNSON: Unbelievable.

THE COURT: And I also heard from Mr. Smyth, I thought, that they were going to vote to terminate him, but that's another issue.

MR. JOHNSON: Well, the point is this. So they have him, the guy that founded the company with 70 percent (Inaudible.) they have him locked out. And this trust is what's doing it. And they're sitting there bilking Toshiba out of this money, but they're (Inaudible.) no, no, you're not fired, Mr. Phillips. You're not fired, because if they do that, they violate that Series A, and then they've got to pay their money back, and Mr. Bay is going to lose his $500,000-a-year or whatever, his job.

So another really good reason to terminate this trust, put the founder, the majority owner to -- I mean this is -- I mean --

THE COURT: Mr. Johnson, I just have to say that I think there was an agreement here.

MR. JOHNSON: There's no contract law that supports the decision. There's none. There's equitable estoppel cases. That's it. And they can't show it. I -- I just -- you know, your Honor, if you would -- I mean we will look very hard to try to find a contract case, but --

THE COURT: Well, I spent some time

looking at this and looking at --

MR. JOHNSON: And there aren't. There are no contract cases.

THE COURT: Well, there aren't very many --

MR. JOHNSON: They're all equitable estoppel.

THE COURT: There aren't very many cases at all that fall within the exception.

MR. JOHNSON: And there's all -- they're all equitable estoppel. So I think that it would be, you know, I mean to take -- apply a contract analysis when it has not existed in the -- in the authority before, would be -- would not be the way to approach how you resolve this.

How you resolve it is to let him terminate the trust, let him go back in. What he wants to do is he wants to have -- he wants to have an independent unconflicted demand review committee analyze all the transactions.

If he owes the company money, he owes the company money. But when you've got a demand review committee report with Kyleen Cane -- and one of the chief witnesses is Jan Wallace, who's been Kyleen's attorney -- Kyleen's been her attorney for 20 years.

Anthony Bay is a defendant at the time he is analyzing the claims against Mr. Phillips, and then he's dismissed.

If you want a truly independent job, it's in his interest -- it's in his interest. He's got to resurrect his reputation here. He's been accused of everything. It's all on the internet. There's a specific allegation in the first complaint that he took money and put it offshore in Netherlands accounts, and that was embezzlement. That got picked up on the internet. Guess what? It's not in the amended complaint, because it was verifiably false when it was made even though they verified it to be true.

It's a trust. It's his property, his corporation. Just because there's these histrionic allegations and you've got a scrambled mishmash of a screed which they denominated a complaint is no reason to deprive him of the right to control the corporation as he should, to resolve this litigation in an appropriate fashion, put an independent board in, independent demand review committee. And then you don't have any problems with Toshiba.

What do you think if Toshiba -- if Toshiba's got somebody sitting back in the room there, MOD's got a problem, because they're saying they have locked

Mr. Phillips out of the corporation, but they haven't terminated him, because they would violate the Series A financing.

THE COURT: That's not any part of my decision, Counsel.

MR. JOHNSON: I know, but it's --

THE COURT: I can't consider that.

MR. JOHNSON: Well, they brought it up.

MR. BUCKLEY: Your Honor.

MR. JOHNSON: I didn't put it into the record.

THE COURT: Counsel, wait just a moment for your turn.

MR. JOHNSON: You know, the Court knows what our requested remedy is. There's no contract case law supporting this. Mr. Phillips importantly, your Honor, did not get any benefit from this trust, zero. He did not get any benefit. Where's the --

THE COURT: It's not a question of whether he gets a benefit out of the trust or whether he gets a benefit out of the transition agreement.

MR. JOHNSON: And he didn't.

THE COURT: Well --

MR. JOHNSON: The only thing he got is he was supposed to be -- remain as chief technology officer. And they terminate him and call it something else. So there is no -- even if you're going to say I'm going to apply a contract analysis -- and we don't think that's a correct analysis. We think the best they've got is equitable estoppel. We think he's got an absolute right to terminate this to begin with. But equitable estoppel would be the only defense they have.

If you're going to apply a contract analysis, he didn't get anything. There's no consideration.

THE COURT: Consideration is presumed, Counsel.

MR. JOHNSON: I am done.

THE COURT: Thank you, Mr. Johnson.

MR. BUCKLEY: If I may (Inaudible.)

THE COURT: You may.

MR. BUCKLEY: And it's in response to that accusation that I (Inaudible.) because I am also committing securities fraud.

The Series A shareholders, Toshiba and NCR, were not only aware of but involved in every step of this process. They're in every board meeting. They knew all about the transition agreement. They've known all along, and we've conferred with them at each stage that Mr. Phillips remains an employee at MOD systems. And the reason is that if he's terminated, it has all sorts of downstream implications. So the idea --

And the -- your Honor, the problem here is that we're essentially trying the case in front of you today. Mr. Johnson doesn't know the facts. That's clear. The idea that anybody is fooling Toshiba -- I was on the phone with Toshiba's counsel at (Inaudible.) this morning.

So the idea that somehow there's this fraud also being perpetrated on the Series A votes is preposterous.

Your Honor, there are contract cases. We cited them to you. We looked at the right part of the restatement. Again this might be true in a vacuum. I don't take issue with that, but that's not our case. It's clearly not the case.

The voting trust -- excuse me. The voting trust is just one piece of a bigger picture. And, your Honor, I have to say it's not hyperbole to say that if Mr. Phillips regains voting control of his shares, that's it. I mean that's -- that's the ball game for MOD. The Series A pull out. They demand their money back from the company. The company doesn't have that money, so the company is insolvent. They come after Mr. Phillips for the overage. And that's it. That's final call for MOD.

Whereas, there's a fallback position. Their argument, right, is that the trust -- it's not appropriate to have Kyleen Cane as the trustee, because somehow she's (Inaudible.) to replace her, your Honor, with anybody they choose.

THE COURT: Thank you, Counsel.

Mr. Johnson, last word briefly.

MR. JOHNSON: There's absolutely no evidence in the record that this company will collapse, absolutely none.

THE COURT: And I'm not giving that consideration.

MR. JOHNSON: Thank you. Thank you.

THE COURT: This matter is before the Court on Defendant Phillips' motion to terminate the voting trust agreement.

The black letter law as that where the settler or creator of the trust is the same as the beneficiary and others are not benefited by the creation of the trust, that regardless of the language of irrevocability or otherwise, the trust can be terminated by the settler, creator.

There are limited exceptions, and they are under the principle of equitable estoppel. And this Court also believes it is under contract law as well.

The Court refers counsel to Goss versus Edwards, 68 Cal.App.3d, 264, a 1977 California appeals case. That case is not directly on point. For one reason California has its Civil Code 22.31, which addresses the issue of proscribing irrevocable trusts. And the question in that case is not withstanding 22.31, whether or not the creation of a voting trust agreement under a property settlement agreement was enforceable under principles of contract law.

As the appellate court noted in that case, The trial court applied well-established principles of contract law and family law in reaching a conclusion not challenged by anyone. Mainly that the property settlement agreement was integrated, and that the voting trust agreement was an inseparable part thereof. And then goes on from there to state that whether or not -- the analysis was whether or not Section 22.31 essentially trumped the attempt at irrevocability of the voting trust agreement that was part of the property settlement agreement.

But the Court clearly recognizes that there can be -- in the absence of a statute, which we do not have in the state, proscribing such conduct, that there could be a voting trust agreement which is created as part of a contract which would not be revocable.

Here the express terms of the voting trust agreement provide that it would remain in place until the year 2014. The contract, the transition agreement that was entered into between Mr. Phillips and MOD Systems, Inc. was entered into with the advice of counsel.

The Court presumes the consideration as stated in that agreement, which this Court does not find solely limited to a position as the chief technical or technological officer; and that the creation and submission to the voting trust agreement was a -- a term and condition of the transition agreement and should be enforced.

Now, one, Mr. Phillips is not precluded from arguing that there was such a material breach of the agreement that the Court should find that a remedy would be a voiding of the -- or invalidation of the voting trust agreement. But that's not really before the Court.

The plaintiff -- I'm sorry. Mr. Phillips would have the burden of proof that would require some type of a different evidentiary type of hearing to determine whether or not, first of all, there was a breach; secondly, whether there -- if the breach was material; and lastly, whether the remedy for that breach would be to make him the CTO or to compensate him for his not being a CTO or to void, as I stated, the voting trust agreement, but that is not currently before the Court.

So based upon the transition agreement, the Court concludes that there is a binding provision that the voting trust agreement remain in place until 2014.

The case law provides that the trustee must be independent. And in this instance, the Court concludes that there is sufficient evidence provided by Mr. Phillips that the trustee is not independent, should be removed and should be replaced by a person designated by Mr. Phillips. That is the ruling of the Court. I would ask counsel to prepare an appropriate order reflecting that.

All right. Let's address the DRC, if we can.

MR. JOHNSON: Okay.

THE COURT: First of all, is there -- is there still a DRC? My understanding is that it's morphed into this litigation committee.

MR. BUCKLEY: Would you like me to address that, your Honor?

THE COURT: Why don't you just tell me what the status is so that we don't --

MR. BUCKLEY: They're two separate

entities. The DRC is still technically constituted, but its work is done. And there's been a new entity, the SLC created to oversee (Inaudible.)

THE COURT: All right. So can we -- is there any reason that we can't terminate the DRC, agree that the DRC should be terminated?

MR. BUCKLEY: Your Honor, I'd have to think through whether there's any reason it would still need to be constituted.

THE COURT: Okay.

MR. BUCKLEY: But I think under any circumstances, it's immaterial (Inaudible.)

THE COURT: All right. So let's go to the -- I assume that -- can I think that you're -- I mean if the DRC is terminated, no longer in effect --

MR. JOHNSON: There is to Mr. Phillips.

THE COURT: Okay.

MR. JOHNSON: And that is -- the demand review committee, generally called special litigation committees --

THE COURT: Well, but they're two different beasts here, because --

MR. JOHNSON: Well, they are saying they're two different beasts, and there are, but I mean what I'm saying is they're generally -- I'll use the term they use, demand review committee.

You know, the testimony that we put in the record of Mr. Mandell, the testimony of Professor O'Kelley -- and I think that it makes probably pretty good sense that they have to be independent impartial and (Inaudible.)

THE COURT: Well, let me just back up here for a moment --

MR. JOHNSON: Okay.

THE COURT: -- because --

All right. If the DRC is no longer active, in other words, if there's essentially no committee that's going to do anything, are you really addressing the constitution of the SLC?

MR. JOHNSON: No. I'm addressing that -- I'm addressing the fact that -- see, Mr. Phillips is stuck with the demand review committee findings.

THE COURT: Right.

MR. JOHNSON: That's our concern. And so, you know, they may have renamed it or created another committee, but the fact is when -- and there's lots of problems that flow from this. When this committee was configured, Mr. Bay was a defendant.

THE COURT: I recall that.

MR. JOHNSON: And he was accused of fraud, breach of fiduciary duty and other things. So they put him on this committee, and he has to determine the strengths of the claims -- and he's now of course been dismissed -- the strengths of the claims against Mr. Phillips and others, including himself. It makes no sense whatsoever.

Okay. Kyleen Cane, we've set out that clearly what we feel about her relationship. So none of the indicia of a committee, a demand review committee that is impartial and independent existed. And we put expert testimony in the record. Then you go to the quality of their report.

THE COURT: But I'm still not clear on the relief that you're seeking, because --

MR. JOHNSON: Well, the relief we're seeking I think -- excuse me for interrupting, your Honor.

THE COURT: That's all right.

MR. JOHNSON: -- is that this committee in essence did not exist; that its findings do not exist; that a truly independent, unconflicted demand review committee has to analyze these claims. And we don't think there was ever a fair independent analysis because of the conflicts. And we think the work product is very shoddy.

I mean when you have a report that says -- they get an -- here they're saying he stole $1.2 million. And if you look at these things, they don't even bother to list the individual transactions. They just list four or five of them, and they state $268,000 here, and it adds up to 170.

And then Deloitte, who they brought in, gives an oral report, doesn't even identify the person from Deloitte.

THE COURT: Okay. I want to get back to the relief is that you're seeking.

MR. JOHNSON: Got it. The relief we seek is that -- is that the findings of the demand review committee not be recognized for purposes of supporting the claims against Mr. Phillips because of the conflicts of interest and that an independent demand review committee analyze the claims. Because if they find that the claims were -- that these allegations by the demand review committee -- if many of them go away, that affects the lawsuit.

THE COURT: Well, why don't I just do that with regard to the -- the SLC, which is now controlling the litigation? In other words, the reason I keep coming back to this question is if Mr. Buckley is telling me the DRC isn't doing anything, it's all controlled by the SLC, what you're asking me to is to -- what I infer is you want some independent to look at the merits of this litigation.

MR. JOHNSON: We want a professional independent evaluation --

THE COURT: Okay.

MR. JOHNSON: -- of the allegations against Mr. Phillips.

THE COURT: Now, I don't think it's appropriate -- and I didn't even read this in your -- maybe I missed it -- in your briefing -- that somehow I'm supposed to say those findings weren't valid. I mean I don't know that that's really appropriate for this Court to be doing at this time. Nor did I read your briefing to say that you wanted me to make this declaratory statement that -- that they were not independent or impartial.

You were asking for the affirmative relief that they be removed from the DRC based upon lack of impartiality, independence, et cetera.

MR. JOHNSON: Exactly.

THE COURT: Now, if the DRC is in essence not active anymore, if they're not doing anything, and the SLC is running the litigation, then it strikes me that your concern should be the independence of the SLC.

MR. JOHNSON: And the independence of the SLC and the extent to which the SLC is incorporating the findings of a conflicted DRC.

THE COURT: Well, but that's up to the independent SLC. I mean that's the role of the committee to decide are we going to prosecute claims that -- that are relied -- that are based upon shoddy investigation.

MR. JOHNSON: We don't know who those members are, though.

THE COURT: Okay. Well, then that's what we ought to address.

All right. Mr. Buckley.

MR. BUCKLEY: Yes, sir. Your Honor, first of all, presumably procedure and rules all still matter here.

THE COURT: They do.

MR. BUCKLEY: I'm glad to hear it, because there is not a claim anywhere in this lawsuit that implicates the DRC, that gives you the procedural basis to issue the kind of declaratory judgment that Mr. Johnson is looking for.

What he's really asking you to do is to

conclude that the report that Lane Powell wrote in conjunction with Deloitte and Tatum was a sham. That's what he's asking.

THE COURT: No. I'm not -- no. I'm simply stating that on this record Ms. Cane and Mr. Bay serving on the DRC doesn't appear very proper. Certainly Mr. Bay.

I understand that the position of the corporation is, well, Mr. Bay was -- even though he was a defendant, he wasn't investigating -- he was recused from that portion. That doesn't make any sense whatsoever to me, because it would be in his self-interest to say oh, no, oh, it wasn't me; it was -- it was, you know, what we call the "TODDI" defense. We hear it here. "The other dude did it." So I mean that in and of itself --

MR. BUCKLEY: Your Honor, there are millions of facts around that, and we may get to them at some point, but I think that that -- there's an answer to that, but are we going to try the case here today as to whether --

THE COURT: Not in the next ten minutes.

MR. BUCKLEY: Right. So the question is the relief that's requested is do we remove Cane and Bay from the DRC. I'm representing to you this morning, your Honor, that there is an SLC. It is not comprised of Cane and Bay. It is in charge of the litigation. The DRC is not going to have anything to do going forward with the litigation.

What I can't represent is that there may not be some other reason to dissolve it. And respectfully, your Honor, I don't even think you've got the authority to dissolve a board committee here. But I also --

THE COURT: I don't think I do either.

MR. BUCKLEY: I don't think you do. But I also don't think it's necessary. I'm representing to you that the DRC is utterly irrelevant to this lawsuit going forward because the SLC will manage it.

THE COURT: Well, it's not irrelevant to Mr. Phillips, because there are allegations in the DRC which form the basis of this litigation and --

MR. BUCKLEY: Which he will challenge presumably at some point, but this is certainly not the place to do it.

THE COURT: Well, but if there are tainted investigators who are part of that committee, who had their own agenda, then it strikes me that that's, as I stated earlier, not -- not proper.

Now, without some assurance that the -- I mean I -- I am actually prepared to make a ruling that the

DRC should not proceed with any actions with Cane and Bay on the committee.

MR. BUCKLEY: Again, your Honor, that's --

THE COURT: Now, I won't -- I won't remove them. I won't remove them, but they're not to take any actions.

MR. BUCKLEY: Your Honor, I think that is -- you're painting -- you're painting with too broad a brush, because the DRC -- there may be other things for the DRC to do as a consequence of its investigation. There's still a process in place and a transition agreement --

THE COURT: That's right. And if they are, it shouldn't be Cane and Bay.

MR. BUCKLEY: Well, but they should bring appropriate claims that go to that. They've filed an answer. There are no counterclaims. Your Honor, there isn't even a procedural basis for you to issue a declaratory judgment at this point.

THE COURT: All right. Thank you.

MR. BUCKLEY: There's to basis. So we may get to that at some point. And if they want to binge a proper motion, and we have an opportunity to conduct some discovery, and we can actually present the facts to you, then maybe we'll get there.

THE COURT: Well, I had a motion. The motion was to terminate or to remove Cane and Bay. That was my motion.

MR. BUCKLEY: Yeah, but I don't think there's any procedural basis for it. They haven't asked for the relief that they're seeking. (Inaudible.)

THE COURT: Okay. Very good. Thank you.

Mr. Johnson.

MR. JOHNSON: The procedural basis is it was brought as a derivative suit. The demand review committee is part and parcel of evaluating the claims of a derivative suit. There are very few actions in our civil rules which give the Court more authority over the conduct of the action than derivative claims. It's almost like minor settlements.

There has to be an independent analysis. The Court has to approve any settlement or compromise. And that's why if this were just a regular case and not a derivative suit brought pursuant to CR 23.1 originally, we would have looked at it differently.

But, you know, because of the control that the -- the civil rules and the case law give courts over these lawsuits, that's why we felt it was appropriate to have them removed.

And there aren't counterclaims in the case yet. There are going to be. We wanted to get our answer filed, because we weren't sure about the dates. So we are going to at some point ask the Court to amend.

But the point is -- the point is this. We haven't yet identified any -- I mean Mr. Buckley hedged and he said -- first he said the DRC wasn't done. Now he said there may be some things for them do. And he still hasn't identified who's on the special litigation committee.

So if it's Cane and/or Bay, our same concerns arise. And we'll just be back here I guess in motion court on that. But these -- these lawsuits, derivative claims are highly controlled by the Court for very, very good reasons.

THE COURT: Well, this case was initially brought as a -- both a derivative action and an individual action on behalf of Mr. Arnold and on behalf of the corporation as a derivative suit.

As a derivative suit, this Court agrees with defense counsel for Mr. Phillips that the Court does have inherent authority under CR 23.1, because the basis of the derivative action was in part the conclusions reached by the DRC and the actions of the DRC on which Ms. Cane and Mr. Bay sat.

The committee on which Ms. Cane and Mr. Bay sat, this Court would find is tainted. The fact that Mr. Bay served as both a defendant in the derivative action and at the same time on what in essence was the investigatory committee created an inherent conflict of interest. And that in and of itself provokes a question of the impartiality of the committee.

With regard to Ms. Cane, it's more difficult, because of all of these allegations flying around, but there is enough there to at least question her independence given the undisclosed relationship that Ms. Cane had with Ms. Wallace and Ms. Cane's involvement -- longstanding involvement with Ms. Wallace, which was not disclosed to Mr. Phillips, in addition to other litigation that she's been involved in that is of concern to the Court.

MR. SMYTH: Your Honor, I do have to speak up here.

THE COURT: All right. Feel free.

MR. SMYTH: Because Ms. Wallace, as Mr. Phillips' lover, appointed Kyleen Cane, who was her longtime friend through Mr. Phillips to the board.

She's the one who handed them to her.

THE COURT: I am well aware of that.

MR. SMYTH: All right.

THE COURT: I am well aware of that, but I'm also stating that my understanding is there's a longstanding relationship between Ms. Wallace and Ms. Cane, which Mr. Phillips was not aware of. And that's a concern I have as to the two of them going back in terms of business dealings that Mr. Phillips was not aware of.

MR. BUCKLEY: Your Honor, I'm --

THE COURT: Feel free.

MR. BUCKLEY: -- I'm reluctant to interrupt.

THE COURT: Go ahead.

MR. BUCKLEY: But what you're putting on the record are findings. I have to --

THE COURT: I'm not making findings. I'm giving my --

MR. BUCKLEY: I have to strenuously object, because every one of those facts is incomplete.

THE COURT: All right.

MR. BUCKLEY: We have a response to every one of them. We were sandbagged on a six-day calendar. We had four days to respond.

THE COURT: Well --

MR. BUCKLEY: It's not -- what's happening here is essentially a summary judgment. And, your Honor, the rulings you're making --

THE COURT: Hardly.

MR. BUCKLEY: Your Honor, the rulings you're making are going to have far reaching impacts on all of these parties. There's a transition agreement in place with a -- with a process under it. You're basically -- if you say the DRC is tainted this morning, then we're going to have to deal with that under the transition agreement, which isn't even in front of you.

THE COURT: I'm saying that I think it is procedurally tainted.

MR. BUCKLEY: Your Honor, there -- we haven't had an opportunity to respond to that. Respectfully, I think you're wrong, and I would love a chance to actually brief it, be heard on it, actually address that. The relief that was asked for was remove Cane and Bay from the DRC.

THE COURT: Well, Counsel, you haven't heard my ruling yet.

MR. BUCKLEY: Okay. Your Honor, what I was concerned about is the (Inaudible.) Findings are being made that are just not true.

THE COURT: Well, I have to support my decision, Counsel, and I'm giving the reasoning for my decision. Now, these are not, quote, unquote, findings as you are concerned. I'm simply stating that I believe there is sufficient evidence there to raise concerns of the impartiality of this committee.

And given those concerns, the proper action to be taken is for this committee to take no further action with Mr. Bay or Ms. Cane serving on that committee based upon the evidence that's been presented to this Court.

If you feel that that decision is erroneous or that the basis of my decision is unfounded or you think that the relief is untenable, we have motions for reconsideration.

But based upon what's been presented to this Court, I believe there is sufficient evidence to state the basis for my reasoning for not allowing further action by Mr. Bay, who was a defendant or Ms. Cane, who I believe has been painted as being impartial -- excuse me -- painted as being not impartial and not being independent.

Those are not findings, if you will, with respect to any other issues in this case whatsoever, but they are my reasoning and the basis upon which I am granting the limited relief requested by the counsel for Mr. Phillips. That is that Mr. Bay, Ms. Cane are not to take any further action on the DRC.

MR. BUCKLEY: Your Honor, just a point of clarification.

THE COURT: Yes.

MR. BUCKLEY: Any action on the DRC related to the litigation or any action on the DRC period?

THE COURT: Any real --

MR. BUCKLEY: And again that goes back to my concern that I honestly don't know what the implications of that might be.

THE COURT: Well, if there's something they need to do -- I mean I don't know what the DRC is other than with respect to this litigation.

MR. BUCKLEY: Well, it actually doesn't relate to the litigation. It relates to the investigation (Inaudible.)

THE COURT: Well, they're not supposed to do -- they're not going to do anything. And if there's something that you feel that they need to do, you can bring it to this Court and ask me if they can do it. Or if you want me to reconsider my ruling, I'll do the same.

But right now I think that there's enough there that raises concerns in my mind that I don't think that these people should be serving as -- in a role that is supposed to be independently impartial. Thank you.

All right, Counsel, we have numerous orders that need to be prepared. I'd suggest we get them in today so that we don't have to all return.

I am going to ask -- let's see, we have the motion to dismiss the MOD derivative, which is --

MR. BUCKLEY: We have the orders on the dismissal (Inaudible.)

THE COURT: Okay. All right. If you have those prepared right now, I'll look at them right now.

And, Mr. Johnson, you've seen these?

MR. JOHNSON: Yes, we've agreed on the derivative claim orders.

THE COURT: Okay.

Counsel, we have a sentencing calendar starting at one. I want to give the lower bench an opportunity to take a recess. I believe Marci's back in chambers.

What I would suggest -- we've got two more orders; is that correct? We've got the voting trust, and then we have removal of Bay and Cane. Can we get orders in this morning on that or do you want to send them up to the Court?

MR. JOHNSON: My -- my preference, your Honor, would be to send them up to the Court (Inaudible.) they're going to need a little bit of it -- I know I -- I share the Court's concern (Inaudible.)

THE COURT: Because then we end up re-arguing the whole case on the language of the order. All right. Why don't you go ahead and prepare proposed orders on both of those. Do you want to do them on both of them?

MR. JOHNSON: Yes.

THE COURT: All right. And then circulate them to all counsel --

MR. JOHNSON: Okay.

THE COURT: -- via e-mail. And let's get approval from everybody. Or if there's disagreement, I'll take comments on order. I'm reticent or reluctant to suggest that but -- and let's get it to Court by next Friday, Mr. Smyth?

MR. SMYTH: Yeah. That's sounds fine. Just one point of order.

THE COURT: Yeah.

MR. SMYTH: We're clearly out of time today.

THE COURT: We are.

MR. SMYTH: We -- we had planned on doing a status conference to try to coordinate a lot of different moving parts here.

THE COURT: Yeah.

MR. SMYTH: Is it possible that we could ask the Court to look and see what's available on your schedule for that? And we can try to coordinate with the rest of counsel.

THE COURT: Marci, is this going to be our case? We don't know. Probably not.

THE BAILIFF: (Inaudible.) April.

THE COURT: Okay.

MR. JOHNSON: Are you going on the criminal calendar or something?

THE COURT: I'm going to the RJC.

MR. SMYTH: Oh, my goodness.

THE COURT: We're going to the RJC -- Marci and I are going to the RJC.

MR. JOHNSON: And when would that take place, sir?

THE COURT: We don't know. Probably

March, April. We think, unless there's a flood.

THE BAILIFF: (Inaudible.)

THE COURT: But it's a one out of 25 chance now.

Okay. Marci? So what do you want? You want a status conference?

MR. SMYTH: Yeah, I think that that would be a good idea, because there are a lot of complicated issues.

THE COURT: Okay. So are we talking half an hour, 45 minutes?

MR. SMYTH: Probably right around that, yeah.

THE COURT: Okay. How soon do you want it?

MR. SMYTH: We wanted it today.

THE COURT: You wanted it today? Okay. Marci.

THE BAILIFF: We're relatively busy (Inaudible.)

THE COURT: We don't really know that though. We could get something.

THE BAILIFF: (Inaudible.)

THE COURT: Do we have --

THE BAILIFF: We could do it 3:30 next

Tuesday.

THE COURT: 3:30 next Tuesday, the --

THE BAILIFF: 10th.

THE COURT: -- 10th. Let's see. Yes, we could.

MR. SMYTH: I am in trial.

THE COURT: You're in trial next Tuesday at 3:30?

MR. SMYTH: Yeah. Tuesday and Wednesday. It's a short one.

THE COURT: Okay. Not Wednesday. You're not in trial next Wednesday.

MR. SMYTH: Next -- I'm not?

THE COURT: No.

MR. SMYTH: Oh, it's arbitration so...

THE COURT: Oh, okay.

MR. SMYTH: So it's a court holiday, but I'm still stuck.

THE COURT: All right. So what else do we have? Oh, we could do it on Thursday. I know that's not going to take all day.

THE BAILIFF: You don't think so?

THE COURT: I hope not.

MR. JOHNSON: On Thursday and Friday I have a law of lawyering seminar at the bar.

THE COURT: Okay. Tell you what. You're all going to coordinate dates, send them up to Marci. Marci will give you some dates that we have. Tell us when you're available.

MR. JOHNSON: Okay.

MR. BUCKLEY: Sounds good.

THE COURT: Okay. Counsel, thank you very much for your presentations this morning.

MALE VOICE: Thank you, your Honor.

THE COURT: And I'll look forward to getting your order within the week and seeing you in the future.

Court is at recess. Have a good weekend.

THE BAILIFF: All rise.

(End of CD Number 2.)

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Certified Court Reporter, #2843
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