



IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

MARTHA S. SUTHERLAND, as Trustee of)
the Martha S. Sutherland Revocable Trust)
dated August 18, 1976,)

Plaintiff,)

v.)

Civil Action No. 2399-VCL

PERRY H. SUTHERLAND, TODD L.)
SUTHERLAND, and MARK B.)
SUTHERLAND,)

Defendants,)

and)

DARDANELLE TIMBER CO., INC., and)
SUTHERLAND LUMBER SOUTHWEST,)
INC.,)

Nominal Defendants.)

**OPENING BRIEF OF NOMINAL DEFENDANTS DARDANELLE
TIMBER CO., INC. AND SUTHERLAND LUMBER-SOUTHWEST, INC.
IN SUPPORT OF THEIR MOTION TO DISMISS**

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April 27, 2007

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NATURE AND STAGE OF THE PROCEEDINGS

On or about September 6, 2006, plaintiff Martha S. Sutherland (“plaintiff” or “Martha”), as Trustee of the Martha S. Sutherland Revocable Trust dated August 18, 1976 and purportedly on behalf of Dardanelle Timber Co., Inc. (“Dardanelle”) and its wholly-owned subsidiary, Sutherland Lumber-Southwest, Inc. (“Southwest”), commenced this shareholder derivative action against individual defendants Perry H. Sutherland (“Perry”), Todd L. Sutherland (“Todd”), and Mark B. Sutherland (“Mark”) (collectively, the “Individual Defendants”) and nominal defendants Dardanelle and Southwest (collectively, the “Companies”). On October 20, 2006, the Companies’ boards of directors adopted resolutions creating special litigation committees (together, the “Special Committee” or “SLC”) of one independent director and vested the Special Committee with final and binding authority with respect to the allegations contained in plaintiff’s Complaint. By March 26, 2007, the Special Committee had completed its investigation and its report (the “Report”). The Special Committee concluded that further prosecution of the claims asserted in the Complaint on behalf of the Companies is not in the Companies’ best interests and that the Complaint should be dismissed. On March 26, 2007, the Companies moved to dismiss the Complaint. This is the Companies’ opening brief in support of their motion to dismiss the Complaint.

STATEMENT OF FACTS¹

A. The Claims Asserted In The Complaint.

As set forth more fully in the Report, plaintiff's Complaint contains three counts: the first is for breach of fiduciary duty and asserts claims derivatively on behalf of Dardanelle; the second count is for waste; and the third count is for breach of fiduciary duty and asserts double derivative claims on behalf of Southwest. The Complaint generally asserts that the Individual Defendants breached their fiduciary duties by "engag[ing] in self-dealing or misuse of corporate office for personal gain" (Compl. ¶ 111) and caused the waste of the Companies' assets by, among other things, causing Dardanelle to incur "enormous legal fees and related costs" to defend an action brought by Martha pursuant to 8 *Del. C.* § 220 (the "Section 220 Action").

More specifically, the Complaint alleges that the Individual Defendants have received excessive compensation and perquisites. Plaintiff asserts that Perry receives excessive compensation from the Companies for "part-time" work and challenges perquisites relating to the use of a CJ1 Cessna aircraft (the "Aircraft") co-owned by Southwest and a company owned by a separate line of the Sutherland family, Sutherland Lumber & Home Center, Inc. ("Home Center"). Plaintiff alleges that the Aircraft serves no legitimate business purpose because it has been used minimally for the retail lumber business and predominately for personal trips by Perry and Todd. The Complaint also challenges the receipt of perquisites relating to the use of a facility commonly known as the Maysville Training Center ("Maysville") and the right of Perry and Todd to receive personal tax and accounting services from Cimarron Lumber & Home

¹ Citations to the SLC's Report appear as "Report ____" and citations to the Complaint appear as "Compl. ¶ ____."

Supply Company, Ltd. (“Cimarron”). In particular, Perry allegedly has caused the Companies to pay Cimarron to perform significant tax and accounting services for his horseracing venture, Choctaw Racing Stables (“Choctaw”).²

In addition to her challenge to the compensation and perquisites received by Perry and Todd, plaintiff’s Complaint alleges that Dardanelle’s defense of the Section 220 Action, at the direction of the Individual Defendants, constituted waste because “no business person of ordinary sound judgment could conclude that Dardanelle has received adequate consideration.” *Id.* ¶ 106. The Complaint also alleges that the compensation and perquisites “are, in effect, gifts to the Individual Defendants.” *Id.* ¶ 107.

In claims related to her charges of excessive compensation and perquisites, plaintiff challenges certain terms of written employment agreements between the Companies and Perry and Todd. She challenges, among other things, the base compensation paid for what she characterizes as part-time work, the unlimited nature of the particular fringe benefits provided under the employment agreements, the contractual right to compete with the business of the Companies, and provisions in the agreements providing for the payment of base salary for two years after a termination. Finally, the Complaint asserts that Perry and Todd have “indulged in a myriad of [] personal extravagances at company expense, including such things as rental cars, expensive hotels, limousines, club memberships, chartered private railroad cars for extended personal trips, private parties and personal living expenses, among many others.” *Id.* ¶ 64.

² Martha, Dwight D. Sutherland, Jr. (“Dwight Jr.”), Perry and Todd are siblings, and the children of Norma and Dwight D. Sutherland, Sr. Mark Sutherland, the third individual defendant, is a cousin of plaintiff, Perry and Todd. Although the Complaint does not allege that Mark has received any improper benefits, plaintiff generally alleges that he is not independent of Perry or Todd.

B. The Formation Of The Special Committee And The Retention Of Independent Advisors.

As set forth in the Report, after the Complaint was filed on or about September 6, 2006, the Companies' board of directors, by resolutions adopted on October 20, 2006, appointed an outside and independent director, Bryan Jeffrey, as the SLC. Those resolutions provided, among other things, that the SLC's determinations with respect to the claims asserted in the Complaint "shall not be subject to review by the [Companies' boards of directors]." Report 5. The resolutions also authorized the SLC to engage counsel and other advisors, at the Companies' expense, and directed the Companies' officers and employees to cooperate with the SLC and assist it as needed. *Id.*

1. Bryan Jeffrey.

Mr. Jeffrey, the sole member of the Special Committee, became a director of both Dardanelle and Southwest on October 20, 2006. Report 4. Mr. Jeffrey received his bachelor's degree in business administration with an emphasis in accounting from the University of Arkansas, Fayetteville in 1980, and earned his CPA designation in 1983. *Id.* at 7. He received a law degree from the University of Arkansas Law School at Little Rock in 1984, where he served as associate editor of the Arkansas Law Review. *Id.*

Mr. Jeffrey worked as a certified public accountant with Deloitte Haskins & Sells before forming JPMS, which became JPMS Cox, PLLC ("JPMS") in 2004, with Jim Phillips, David L. Mosley, and B. Gene Scott in 1987. *Id.* JPMS offers a wide array of accounting and consulting services to individuals, businesses, and non-profit organizations, and is the fourth largest accounting and consulting firm in Arkansas, with more than fifty employees. *Id.* Mr. Jeffrey has more than twenty-three years' experience in public accounting focusing on partnerships, corporations, trusts and estates, healthcare, the food industry, and construction and

real estate accounting. *Id.* at 7-8. He also works with high net worth individuals on income tax and business planning issues and has assisted several limited partnerships in the tax credit certification process. *Id.* at 8. Mr. Jeffrey serves on the board of directors of the Arkansas Development Finance Authority, which holds more than a billion dollars of assets, where he has chaired the audit committee and currently chairs the professional selection committee and holds the position of vice-chair. *Id.* He is also a member of the American Institute of Certified Public Accountants and the Arkansas Society of Certified Public Accountants. *Id.*

2. The Special Committee's Independent Advisors.

Among the first actions of the Special Committee was its decision to retain outside counsel to assist in its investigation of the claims asserted in the Complaint. The Special Committee evaluated and considered various law firms and ultimately determined to retain Morris, Nichols, Arsht & Tunnell LLP ("Morris Nichols"). Report 6. Morris Nichols has substantial experience in all aspects of the Delaware General Corporation Law, including representation of special litigation committees charged with investigating derivative claims, and had no prior relationship with the Companies, Mr. Jeffrey or the Individual Defendants. *Id.* at 7.

In addition, the Special Committee retained JPMS to assist it with the organization of documents produced to it relating to the flight records of the Aircraft. The work done by employees at JPMS was billed at JPMS's standard hourly rates and was done to assist the Special Committee in its analysis of the usage of the Aircraft.

The Special Committee also decided that it would benefit from consultation with a compensation expert to assist it in assessing the objective fairness of the total compensation received by Perry. Report 101. Following a search by the Special Committee and its counsel,

the Special Committee retained RSM McGladrey, Inc. (“McGladrey”)³ to provide consulting and advisory services to the Special Committee and its counsel, including a market compensation competitiveness survey. *Id.* McGladrey had no prior relationship with the Companies or the Individual Defendants.

C. The Special Committee’s Investigation.

The Special Committee’s investigation into the claims asserted in the Complaint was objective, disciplined and thorough. A detailed description of the Special Committee’s investigation, including Special Committee meetings, documents reviewed, witnesses interviewed, analyses conducted and other matters, is set forth at Section I(C) of the Report.

The Special Committee and its advisors reviewed more than 14,000 pages of documents relating to the allegations in the Complaint. Report 13. The Special Committee served informal and formal document requests on the Individual Defendants and the Companies. *Id.* at 11-12. In addition, the Special Committee served informal document requests and subpoenas seeking relevant documents from Cimarron and Home Center. *Id.* Furthermore, in identifying documents to review, the Special Committee specifically requested that plaintiff provide to it any documents that she wished the Special Committee to consider and to advise it of any categories of documents she believed the Special Committee should review as part of its investigation. *Id.* at 11-13.

The Special Committee and its advisors also interviewed eighteen witnesses (generally in separate interview sessions), and conducted follow-up interviews with certain of

³ McGladrey provides tax, accounting, and business consulting services to mid-market sized companies in a number of industries. *See* <http://www.rsmmcgladrey.com/About-Us/Our-Vision/>. McGladrey has approximately 100 offices in 22 states. *See* <http://www.rsmmcgladrey.com/About-Us/Our-U-S-Locations/>.

those witnesses. *Id.* at 13. The Special Committee's interviews included each of the Individual Defendants, plaintiff, plaintiff's counsel, Dwight Jr., non-defendant members of the Companies' management, various officers and employees of Cimarron, the pilot of the Aircraft and others. *Id.* at 13-14. The SLC interviewed each person it had identified as potentially having knowledge of facts material to its investigation.

During its investigation of the claims asserted in the Complaint, the Special Committee met formally with its counsel on nine separate occasions, with meetings ranging from one hour to a full day. At these meetings, the SLC discussed with its counsel the fiduciary duties of its member, relevant documents, interviews of witnesses and numerous other matters pertaining to the investigation. Mr. Jeffrey devoted many hours to the investigation and preparation of the Report before concluding that the Complaint should be dismissed.

D. The Special Committee's Report And Conclusions.

The Report is the result of more than five months of investigation and consists of 133 pages, divided into six sections, plus exhibits and a separate Appendix. Section I of the Report describes the claims asserted in the Complaint, the formation of the Special Committee and provides a summary of the scope of the Special Committee's investigation. Section II sets forth a recitation of the facts pertaining to the claims asserted in the Complaint. Section III recites the allegations of the Complaint and compares and contrasts those allegations with the facts as found by the Special Committee. Section IV of the Report, titled "Legal Analysis And Conclusions," sets forth the general legal principles applicable to plaintiff's claims asserted in the Complaint, and applies those legal principles to the facts the Special Committee ascertained in the course of its investigation. Sections V and VI of the Report set forth the range of possible

responses and other considerations evaluated by the Special Committee, as well as the reasons for its determination that the Complaint should be dismissed.

The Special Committee's conclusions that litigation would not serve the best interests of the Companies and their shareholders are well supported by the record and are reasonable, as required by *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788 (Del. 1981). The Special Committee found no evidence that the Individual Defendants had breached their fiduciary duties, nor that they had committed waste of corporate assets.

1. The Special Committee Concluded The Facts Did Not Support The Material Allegations Of The Complaint.

Although space constraints prevent a full recitation of each of the conclusions the Special Committee reached during its investigation, the findings contained in Section III of the Report evidence the absence of any factual support for many of the material allegations plaintiff made in her Complaint. For example, with respect to plaintiff's claims that Perry and Todd received excessive compensation and perquisites:

- Contrary to the allegations in the Complaint, prior to the amendment to Perry's employment agreement in September 2005, additional compensation was added to Perry's W-2 according to IRS guidelines for every personal flight he took on the Aircraft. Report 41-43. Furthermore, after the September 2005 amendment, Perry was charged and personally paid for all of his personal flights on the Aircraft. *Id.* at 42, 45.
- Contrary to the allegations in the Complaint, Todd personally paid for all of his personal flights on the Aircraft, with the exception of flights on which he was Perry's guest to attend events hosted by Perry. Report 43-44. In addition, Perry never allowed Todd to bill his personal flights to Perry so that those flights would be charged to Perry as income. *Id.* at 45.
- Contrary to plaintiff's claim that the Companies paid for the flights taken by Perry on the Aircraft in connection with

Choctaw Racing Stables (“Choctaw”), Choctaw was billed and paid for the flights that were related to it. Report 44.

- Paragraph 59 of the Complaint alleges that “there are many more [] personal flights beyond the number of flights listed in required flight records.” The SLC’s investigation revealed that there was no factual basis for this allegation, as the contemporaneous documents and the witnesses interviewed indicated that the activity of the Aircraft was properly recorded in the flight records maintained by Home Center and the Aircraft’s pilot. Report 41.
- Contrary to the allegations in the Complaint, Perry and Todd’s use of Maysville was insignificant and the expenses associated with their use were added to the compensation they received from the Companies. Report 48-49.
- Plaintiff alleges that the tax and accounting services provided by Cimarron to Perry and Todd present a substantial potential cost to the Companies. Compl. ¶¶ 46, 50. The Special Committee’s investigation revealed that the costs absorbed by the Companies associated with tax and accounting services provided by Cimarron to Perry and Todd was not significant and that estimated amounts, prepared by others, were added to Perry and Todd’s Forms W-2 as compensation. Report 53-54.
- Plaintiff alleges that the Companies have absorbed “substantial fees and costs” associated with the IRS audit of Choctaw and that Connie Campfield, a Cimarron employee, has been working full time on Choctaw accounting matters at the expense of the Companies. Compl. ¶¶ 62, 75. The SLC determined that Choctaw has been billed for the accounting work performed by Cimarron. Report 54-56. In addition, Ms. Campfield, as explained in her interview and evinced in documentary evidence reviewed by the SLC, has been responsible for far more than just Choctaw; she has responsibilities related to approximately seven Dwight D. Sutherland, Sr. Family investments, along with other entities owned by other branches of the Sutherland family. *Id.* at 56. Furthermore, the SLC’s investigation uncovered that Choctaw engaged and paid outside professionals for services in connection with the IRS audit. *Id.*
- Similar findings based upon objective and irrefutable evidence demonstrated that plaintiff’s miscellaneous claims were premised upon speculation, not fact. For example, Perry and

Todd's charter rail trips were paid for by personal checks, no club memberships were paid for by the Companies, there was no pattern of expensive hotel or limousine use, and the \$360,000 charitable contribution reported in the Companies' tax returns had nothing whatsoever to do with either Perry or Todd's charitable predilections. Report 112-128.

2. The Special Committee Determined That The Statute of Limitations Would Most Likely Bar Certain Of Plaintiff's Claims.

A three-year statute of limitations applies to plaintiff's claims for breach of fiduciary duty and waste of corporate assets. Report 95; *see also In re Dean Witter P'ship Litig.*, 1998 WL 442456, at *3 (Del. Ch.), *aff'd*, 725 A.2d 441 (Del. 1999) (citing 10 *Del. C.* § 8106); 10 *Del. C.* § 8112. With respect to plaintiff's claims of self-dealing and improper personal benefits, the Special Committee observed that the Individual Defendants would have a significant argument that claims based upon events pre-dating September 6, 2003 would be barred by the three-year statute of limitations because of plaintiff's strong suspicions of systematic self-dealing at the Companies dating back to the 1990s, including specific knowledge concerning the ownership and use of the Companies' aircraft, and the likelihood that the delay in asserting such claims was in deference to Dwight Sr. and not a lack of notice. Report 96-97. Despite the substantial argument the Individual Defendants possess, the Special Committee analyzed significant claims and events occurring before September 6, 2003 and did not rely solely upon the probable availability of the statute of limitations defense in reaching any of its conclusions. *Id.* at 98.

3. The Special Committee's Conclusions Regarding The Compensation And Perquisites Of Perry And Todd.

The Special Committee determined that plaintiff's claims that Perry and Todd were receiving excessive compensation and perquisites were without merit. Report 98-104.

- a. Perry's compensation was entirely fair to the Companies.

The Special Committee found that Perry devotes the equivalent of full time to his work at Dardanelle and Southwest and that he is a "fully-engaged executive." Report 98-99. Perry works a full workday Monday through Friday, with routine Saturday morning and some additional weekend work, and has a significant level of responsibility at the Companies, where he is the only senior executive with day-to-day responsibilities. *Id.* Perry's responsibilities include (i) having ten store managers that report directly to him; (ii) handling strategic planning and the decisions to acquire or dispose of stores; (iii) employment decisions regarding the top three individuals at each store; (iv) handling all equipment purchases; and (v) reviewing every inventory order over \$1,000. *Id.*

During the course of its investigation, the Special Committee also found that Perry's compensation of \$100,000 per year from each of Dardanelle and Southwest was largely derived from what Dwight Sr. had approved and the good faith attempt to follow what had been years' long practice at the Companies. *Id.* at 100. In addition, the Special Committee found that the historical value of the Maysville perquisite and the value of the tax and accounting services provided by Cimarron to Perry had not been material. *Id.* at 101. The Special Committee also found that the benefit of the use of the Aircraft that was added as compensation to Perry's W-2 was objectively fair and that Perry, after the amendments to his employment agreements in September 2005, paid for his personal use of the Aircraft. *Id.* at 101-02. In sum, the Special Committee determined that Perry's total compensation was well below the average total cash compensation that an executive at a comparable company would earn and was, accordingly, objectively reasonable and entirely fair to the Companies. *Id.* at 102-03.

b. Todd's compensation was entirely fair to the Companies.

With respect the compensation and perquisites received by Todd, the Special Committee found that Todd spends approximately 150-200 hours each year on the Companies' business and that he regularly consults with Perry on matters such as lending relationships, the structure of debt, and decisions whether to purchase versus lease at new store locations. *Id.* at 99. Todd, as the only family member other than Perry active in the business, tries to keep sufficient contact with the details of the Companies' business so that he would be capable of stepping in on an interim basis were Perry to die or become disabled. *Id.* at 100. The Special Committee also determined that the value of the Maysville and Cimarron perquisites that Todd received was *de minimis*. *Id.* at 101. Based on Todd's financial background and the fact that he is only other family-member executive familiar with the Companies' business and able to step in on an interim basis should Perry become unable to fulfill his duties, the Special Committee concluded that Todd's compensation is entirely fair to the Companies. *Id.* at 103-04.

4. The Special Committee's Conclusions Regarding Southwest's Acquisition And Continued Ownership Of The Aircraft.

The Special Committee found that the Companies' decision to purchase the Aircraft in 2001 and retain a 50% interest in the Aircraft for the past 6 years constitutes a reasonable business expense which would be protected by the business judgment rule. Report 104. Among the factors relating to the Companies' purchase and ownership of the Aircraft that the SLC considered are: (i) Southwest has minimized its expense by owning only 50% of the Aircraft, and further reducing costs through its time-share relationships; (ii) the need for efficient air transportation for business purposes is apparent given the relatively remote and geographically diverse locations of most of the Companies' stores; (iii) the Companies' business

usage of the Aircraft, on a mileage basis, exceeds that of Dwight Sr., Norma, Perry, Todd and Choctaw in the aggregate; (iv) the cost of invoiced travel is dictated by federal regulation; (v) the average negative cash flow to Southwest over the past five years to own the Aircraft, in excess of invoiced amounts for travel, is approximately \$38,000; (vi) the reported depreciation on the Aircraft represents an opportunity for tax deferrals; and (vii) if the recent \$1.55 million appraised value (of a 50% interest) in the Aircraft is accurate and were the Aircraft to be sold, Southwest would likely recover a substantial portion of its initial \$1.9 million investment, less the carrying cost of the investment. *Id.* at 104-05.

5. The Special Committee's Conclusions Regarding Plaintiff's Challenge To The Defense Of The Section 220 Action.

Plaintiff alleges that the legal fees and related costs incurred by the Companies defending the Section 220 Action constitute a waste of corporate assets and that Perry, Todd, and Mark breached their fiduciary duties by causing the Companies to incur such costs. Compl. ¶¶ 85-89, 99, 101, 106, 112; Report 58-79. After a thorough investigation of the record in the Section 220 Action and review of the deposition transcripts and hearing transcripts, the Special Committee concluded that such allegations are without merit. Report 105-11.

a. The expenditures by the Companies defending the Section 220 Action did not constitute waste.

The Special Committee found that at the time the Individual Defendants decided to defend the Section 220 Action and over the course of the litigation, the Individual Defendants could not know what the outcome of the Section 220 Action would be and spent what they believed, based on the facts and circumstances that were present, was necessary to defend it. Report 107-08. Although the Court ultimately decided that plaintiff did have a proper purpose in

seeking the documents and allowed an inspection of certain of the documents sought by plaintiff, the Individual Defendants were not in a position to know that result until the Court rendered its final decision. *Id.* Accordingly, because the concept of waste is not measured with the benefit of hindsight available when an expense is authorized (*Ash v. McCall*, 2000 WL 1370341, at *8 (Del. Ch.)), the Special Committee concluded that the Individual Defendants did not commit waste when they authorized the Companies to defend the Section 220 Action. Report 107-08.

The Special Committee also observed that much of the expense incurred in defending the Section 220 Action appears to have been the result of the need to respond to discovery initiated by plaintiff and the duplication resulting from the initial assignment of the case to a master. *Id.* at 108. In addition, the Special Committee determined that the discovery taken in the Section 220 Action was somewhat broader than other Section 220 cases and that the total number of hours spent on each phase of the litigation does not appear to have been excessive, and noted that the Companies succeeded in limiting the scope of the production the Companies were ordered to produce to plaintiff. *Id.* at 108-09.

- b. The Individual Defendants did not breach their fiduciary duties defending the Section 220 Action.

Based upon interviews with the persons involved, the Special Committee determined that the Individual Defendants believed in good faith that production of all the documents sought by plaintiff was not in the Companies' best interests and that plaintiff had ulterior motives – namely, to harass the Individual Defendants. Report 109. The Individual Defendants based their belief that plaintiff had ulterior motives on the timing of her request, shortly after Dwight Sr.'s death and after her mother informed her she would not alter her estate plan, and because she simultaneously made books and records demands on other Sutherland

entities. *Id.* at 109-10. In addition, the Individual Defendants and the Companies' counsel engaged in costs-benefits discussions before the litigation began and numerous times throughout the litigation concerning whether it was reasonable to defend the Section 220 Action. *Id.* at 110. The Special Committee also considered the Individual Defendants' decision not to appeal Vice Chancellor Lamb's decision granting plaintiff access to certain books and records. *Id.* Ultimately, the Special Committee found no evidence that the Individual Defendants had a dishonest purpose in causing the Companies to defend the Section 220 Action or that they were attempting to conceal wrongdoing on their part.

6. The Special Committee's Conclusions Regarding
The Terms Of The Employment Agreements.

The Special Committee determined that plaintiff's challenge to the terms of Perry and Todd's employment agreements that allow them to compete with the Companies and provide them with severance benefits upon termination are not ripe for adjudication because they are prospective claims which depend on the occurrence of events that have not occurred and may never occur. Report 111-12. In making this determination, the SLC considered the fact that neither Perry nor Todd is currently competing or intends to compete with the Companies and the absence of any intention by the Companies to terminate their employment. *Id.* Notwithstanding the conclusion that such claims are not ripe, Mr. Jeffrey indicated his intention to propose to the full Board of Directors of each of the Companies that modifications to Perry and Todd's employment agreements, including clarification that the Companies' payments for tax and accounting work performed by Cimarron for Perry and Todd be limited to the preparation of individual tax returns for them and their immediate families, the elimination of the right to compete with the Companies, and the adoption of an appropriate "for cause" carve-out to the severance benefits, be negotiated between the Companies and Perry and Todd. *Id.* at 112.

7. The Special Committee's Conclusions Regarding Plaintiff's Miscellaneous Claims.

The Complaint includes allegations that several other specific transactions and practices evidence the Individual Defendants' self-dealing and breach of fiduciary duties. The Special Committee investigated each of these allegations and found no evidence of wrongdoing.

In reaching this conclusion, the Special Committee determined, *inter alia*, that:

- Perry and Todd have not charged a “myriad of personal extravagances at company expense.” Compl. ¶ 64. In particular, the Special Committee found no evidence that Perry and Todd improperly used rental cars, expensive hotels or limousines at company expense or that they chartered private railroad cars at company expense. Report 113-16. In addition, the Special Committee found that Perry did not submit mileage for rental vehicles to be reimbursed by the Companies. *Id.* at 114-15.
- Perry did not have the Companies pay for his personal membership at The River Club. Report 117-18.
- The Companies did not subsidize the construction of Perry's personal residence. Report 118. The Special Committee did find that Perry purchased certain construction materials at cost from Cimarron in 1999-2000, a benefit generally available to the members of the Sutherland family. *Id.*
- The legal dispute between Boylan, LLC and Dardanelle regarding the sale of fourteen acres in Overland Park, Kansas was handled properly. Report 118-20. The Special Committee also found no evidence that the Companies were improperly being charged for personal legal matters. *Id.* at 120-21.
- There is no evidence that the miscellaneous expense category on the Companies' financial statements is being used to conceal improper personal benefits to any of the Individual Defendants. Report 121-22.
- The short-term loans from Sutherland family members to the Companies are at rates fair to the Companies and provide the Companies with the benefit of avoiding reaching the cap on their line of credit with Security Bank of Kansas City. Report 122-23. The long-term loans between the Companies and

various entities owned by Sutherland family members are properly documented and tracked by Cimarron and the interest rates on each of these loans were premised upon arm's-length rates at the time of issuance. *Id.* at 123-24.

- The loan Dardanelle made to Sutherland Lumber of Arizona, which was later assumed by Perry and Todd, was fair to Dardanelle and the Companies were not damaged as a result of it. Report 124-25. In particular, the Special Committee found that the loan principal and interest were paid in full, the interest received by Dardanelle was at its borrowing rate, and there was availability of bank credit exceeding the amount of the loan throughout the loan period. *Id.*
- The alleged \$360,000 charitable contribution that Perry and Todd caused Dardanelle to make to their favorite charity actually arose as an integral part of a business transaction to acquire Dardanelle's Brenham, Texas store and was not the result of any decision made by either Perry or Todd. Report 125-27.
- The amendments to the Companies' certificates of incorporation eliminating cumulative voting and adding the protections from director liability authorized by 8 *Del. C.* § 102(b)(7) were properly approved, eliminating any claims of self-dealing or breach of fiduciary duties with respect to these actions. Report 127-28.

ARGUMENT

Delaware law empowers an independent committee to investigate the allegations in a derivative lawsuit and to take whatever action the committee deems appropriate in its considered business judgment, including pursuing the action, negotiating a settlement of the action or moving to terminate the action. *See* 8 *Del. C.* § 141(c); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 786 (Del. 1981) (“The committee can properly act for the corporation to move to dismiss derivative litigation that is believed to be detrimental to the corporation’s best interest.”); *Carlton Invs. v. TLC Beatrice Int’l Holdings, Inc.*, 1997 WL 305829, at *20 (Del. Ch.) (approving settlement of derivative action based on report of special litigation committee); *Katell v. Morgan Stanley Leveraged Capital Fund, Inc.*, 1995 WL 376952 (Del. Ch.) (dismissing derivative action based on report of special litigation committee); *Kaplan v. Wyatt*, 484 A.2d 501, 519 (Del. Ch. 1984) (same), *aff’d*, 499 A.2d 1184 (Del. 1985). The authority to appoint a special litigation committee to investigate derivative claims arises from the fundamental principle of Delaware law that directors, not stockholders, “manage the business and affairs of the corporation . . . and are responsible for deciding whether to engage in derivative litigation.” *White v. Panic*, 783 A.2d 543, 550 n.18 (Del. 2001) (quoting *Levine v. Smith*, 591 A.2d 194, 200 (Del. 1991)).

Even a board of directors “tainted by the self-interest of a majority of its members . . . can legally delegate its authority” concerning litigation decisions on behalf of the corporation to a special committee consisting of disinterested and independent directors. *Zapata*, 430 A.2d at 786. “By forming a committee whose fairness and objectivity cannot be reasonably questioned . . . the company can assuage concern among its stockholders and retain, through the SLC, control over any claims belonging to the company itself.” *In re Oracle Corp. Derivative*

Litig., 824 A.2d 917, 940 (Del. Ch. 2003) (quoting *Biondi v. Scrushy*, 820 A.2d 1148, 1156 (Del. Ch. 2003)).

Delaware courts review a motion to terminate a derivative suit based on the determination of a special litigation committee under the two-step analysis established by the Delaware Supreme Court in *Zapata*. 430 A.2d at 788-89. First, the Court examines the independence of the committee and the process by which the special litigation committee reached its conclusion. *See id.* Specifically, the Court must determine whether the special litigation committee: (i) functioned independently of the parties to the action, (ii) acted in good faith and conducted a thorough investigation, and (iii) had reasonable bases for its conclusions. *Id.* at 788; *see also Kindt v. Lund*, 2001 WL 1671438, at *1 (Del. Ch.). In making these determinations, the Court employs a standard “akin” to a motion for summary judgment. *Katell*, 1995 WL 376952, at *6; *see also Kaplan*, 484 A.2d at 508. At this point, if the corporation has met its burden, the Court may grant the motion and dismiss the action. *Zapata*, 430 A.2d at 789.

The second, discretionary step in the *Zapata* analysis permits the Court to apply its own independent business judgment to decide whether the motion to dismiss should be granted. 430 A.2d at 789; *see also Kaplan*, 484 A.2d at 508 (the court’s “function is to exercise its own independent business judgment in striking a balance between ‘legitimate corporate claims’ as expressed in the derivative suit and the corporation’s best interest as ascertained by the [special litigation committee]”). In applying its business judgment, the Court may consider whether the results of the special litigation committee’s investigation satisfy the “spirit” of step one of the *Zapata* analysis, as well as matters of law, public policy or good corporate governance. *Id.* The second, discretionary step of the *Zapata* framework is “designed to offer protection for cases in which, while the court could not consciously determine on the first leg of

the analysis that there was no want of independence or good faith, it nevertheless ‘felt’ that the result reached was ‘irrational’ or ‘egregious’ or some other such extreme word.” *Carlton Invs.*, 1997 WL 305829, at *2. However, when the result of the court’s application of the first step of the *Zapata* analysis “does not run counter to the spirit of *Zapata*,” the Court need proceed no further in its analysis. *Kaplan*, 484 A.2d at 520.

I. THE MEMBER OF THE SPECIAL COMMITTEE IS INDEPENDENT.

Under *Zapata*, a party moving to terminate a derivative action based on the report of a special litigation committee must meet its burden of demonstrating that there is no genuine issue of material fact that the special committee is independent. *See Zapata*, 430 A.2d at 788; *Kaplan*, 484 A.2d at 519. A special litigation committee is independent if it is in a position to base its decision on “the merits of the issue rather than being governed by extraneous considerations or influences.” *Kaplan*, 499 A.2d at 1189 (citing *Aronson v. Lewis*, 473 A.2d 805 (Del. 1985)); *Katell*, 1995 WL 376952, at *7. “[I]t is the care, attention and sense of individual responsibility to the performance of one’s duties that touch on [the] independence” of a special litigation committee. *Kaplan*, 499 A.2d at 1189. Here, there can be no genuine dispute that Mr. Jeffrey is independent.

A. Mr. Jeffrey Has No Personal Interest In the Outcome Of This Action.

Bryan Jeffrey became a director of the Companies after the Complaint was filed and is not named as a defendant in the Complaint. It is undisputed that he has no personal interest in the outcome of the Action. Prior to joining the Companies’ boards of directors, Mr. Jeffrey had no business or personal relationships with the Companies or the Individual Defendants. Mr. Jeffrey had never met Perry or Todd. Report 9, n.2. He had been acquainted

with Mark through a mutual friend when Mark lived in Little Rock, at which time JPMS did *de minimis* accounting work for an antique business run by Mark's wife. *Id.* Until the interview of Mark in this matter, Mr. Jeffrey and Mark had no contact since Mark moved to Kansas City more than six years ago. *Id.*

Furthermore, Mr. Jeffrey has never been an employee of the Companies or any of the Individual Defendants, and, apart from his status as a director, does not have a business relationship or other affiliations with the Companies or the Individual Defendants. Simply put, Mr. Jeffrey does not have any relationships with the Companies or the Individual Defendants that would have impaired, or even influenced, his ability to base his decision on the merits of the case.

B. The Special Committee Retained Independent Advisors.

The Special Committee ensured that its legal advisor and compensation expert were independent of the Companies and the Individual Defendants. Neither Morris Nichols nor McGladrey has ever done any work for the Companies or for any of the Individual Defendants.

C. The Special Committee Conducted The Investigation Without Interference.

The Special Committee conducted its investigation without interference from the Companies or the Individual Defendants. None of the Individual Defendants attended any interview other than his own. Similarly, none of the Individual Defendants or their counsel was present at any of the Special Committee's interviews or meetings. No objection was raised to

any question posed by the Special Committee and/or its counsel, and no interviewee refused to answer any question asked.⁴

When the Special Committee requested documentation, documents were promptly delivered that allowed the Special Committee to investigate thoroughly the specific matter and make a determination. Report 131. As the investigation proceeded, the Special Committee developed a high degree of confidence in the administrative and internal controls of the Companies. *Id.* at 131-32. All of the parties to this dispute cooperated with the Special Committee's investigation and certain third parties, including Cimarron and Home Center, devoted substantial time and resources in responding to requests. *Id.* at 132.

In sum, Mr. Jeffrey is not named as a defendant and was not a member of the board of directors of the Companies at the time the Complaint was filed. He has no prior business dealings with the Companies or the Individual Defendants. Accordingly, the Special Committee's independence and its ability to render an unbiased decision on the merits of the Complaint have been conclusively demonstrated.

II. THE SPECIAL COMMITTEE ACTED IN GOOD FAITH AND CONDUCTED A REASONABLE INVESTIGATION.

As noted above, the Companies' boards of directors appointed an independent, outside director to the Special Committee and vested the Special Committee with full authority, not subject to review by the Companies' other directors, with respect to claims in the Complaint. After careful consideration, the Special Committee retained Morris Nichols, which had not

⁴ The Individual Defendants were interviewed by the Special Committee with their outside counsel present. However, their counsel only observed the interviews and did not participate in the questioning by the Special Committee or suggest answers to questions that had been posed.

previously represented the Companies or any of the Individual Defendants, to act as its legal advisor. It is undisputed that Morris Nichols is independent and qualified.

As recommended by the *Katell* Court, the member of the Special Committee “reviewed documents related to the transactions and [he and his] counsel interviewed many of the persons involved in the transactions.” *Katell*, 1995 WL 376952, at *9. In particular, the Special Committee and its advisors reviewed more than 14,000 pages of documents that allowed the Special Committee to investigate and analyze plaintiff’s allegations. For example, the Special Committee reviewed numerous documents relating to (i) the expenses incurred in maintaining and operating the Aircraft partially owned by Southwest; (ii) the flight logs and invoices for all personal and business flights taken by the Individual Defendants and Dwight Sr., as well as other Sutherland family members, on the Aircraft for the past five years; (iii) the invoices for the use of the Maysville Training Center by the Individual Defendants over the past five years; (iv) the charges to the Individual Defendants and other Sutherland family members for the use of Cimarron’s tax and accounting services; (v) the compensation and perquisites provided to the Individual Defendants; and (vi) the employment agreements entered into by Perry and Todd.

Furthermore, the Special Committee interviewed eighteen individuals with knowledge relating to the allegations in the Complaint, including each of the Individual Defendants, plaintiff, plaintiff’s counsel, Dwight Jr., non-defendant members of the Companies’ management, various officers and employees of Cimarron, the pilot of the Aircraft and others. Report 13-14. Mr. Jeffrey actively participated in the interviews conducted during the investigation. In addition, although the Special Committee delegated certain discrete tasks to counsel, the record reflects that Mr. Jeffrey remained active in the investigation by interviewing

witnesses, reviewing documents, asking questions and preparing the Report. *See, e.g.*, Report 8. The SLC conducted its investigation without any interference and with the cooperation of those persons with knowledge about the allegations asserted in the Complaint. That the Special Committee acted in good faith and conducted a reasonable investigation is confirmed by the comprehensive, logical and detailed nature of its 133-page Report.

III. THE SPECIAL COMMITTEE HAD REASONABLE BASES FOR ITS CONCLUSIONS.

Under *Zapata*, when the Court reviews a special litigation committee's conclusions, it "does not take an independent look at the merits of the lawsuit, but must find that the Special Committee's consideration of the merits of the claims was reasonable." *Katell*, 1995 WL 376952, at *12. "In order to meet the *Zapata* standard, the Special Committee must show reasonable bases for its conclusions of law and fact." *Id.* at *34. Here, the record demonstrates that the SLC had reasonable bases for each of the conclusions set forth in the Report. The legal issues addressed by the Report generally are not novel ones, and the Special Committee appropriately applied existing precedent in its analysis. The Special Committee similarly had reasonable bases for the detailed factual conclusions set forth in the Report. *See supra* 7-17; Report 14-83.

The Special Committee concluded that the Individual Defendants did not breach their fiduciary duties in their roles as officers and directors of the Companies. In particular, the Special Committee examined Perry and Todd's compensation and perquisites under the entire fairness standard of review and found Perry and Todd's total compensation to be objectively reasonable and entirely fair to the Companies. Furthermore, the Special Committee found no evidence of wrongdoing by the Individual Defendants in causing Southwest to purchase and continue to own an interest in the Aircraft.

The Special Committee also found that the Individual Defendants did not waste the Companies' assets by causing the Companies to defend the Section 220 Action. The Special Committee concluded that plaintiff would be unable to prove that the decision to defend the Section 220 Action was unreasonable when made and that no benefit inured to the Companies from the defense of the Section 220 Action.

IV. IF THE COURT DETERMINES TO EXERCISE ITS DISCRETION TO APPLY THE SECOND STEP OF ZAPATA, THIS ACTION NONETHELESS SHOULD BE DISMISSED.

Under *Zapata*, the Court has discretion to apply its own independent business judgment to decide whether a motion to dismiss derivative litigation should be granted. In applying this discretionary, second step, the Court may consider the merits of plaintiff's claims, as well as various ethical, commercial, promotional, public relations, employee relations and other considerations. *See Zapata*, 430 A.2d at 788. The purpose of this discretionary, second step is to prevent abuse where the "technical requirements" have been satisfied, but a dismissal nonetheless appears "irrational" or "egregious." *Katell*, 1995 WL 376952, at *13; *Carlton Invs.*, 1997 WL 305829, at *2. Given the clear and undisputed record of independence and the good faith and reasonableness of the Special Committee's investigation and conclusions, there is no reason for this Court to apply the second step of *Zapata*. *See, e.g., Katell*, 1995 WL 376952, at *13.

Nonetheless, if the Court opts to apply the second step of *Zapata*, the Special Committee respectfully submits that the Court should concur with the conclusions set forth in the Report. The Special Committee based its determination on the absence of any factual support for many of plaintiff's allegations, and its conclusion that the claims asserted in the Complaint lack merit. While the absence of merit to the claims asserted by plaintiff alone provides a sufficient

basis for the Special Committee to determine in the exercise of its business judgment that continued prosecution of meritless claims is not in the best interests of the Companies or their stockholders, the Special Committee considered other factors that also counsel in favor of dismissal. Among the factors the Special Committee considered were (i) the likelihood of success of the claims in the Complaint; (ii) the likely time until recovery on the claims; (iii) the risk that the Individual Defendants would be successful in their defense and would therefore be entitled to indemnification of their legal expenses from the Companies; (iv) the direct and indirect uninsured costs to the Companies of prosecution by either plaintiff or one or both of the Companies of the claims in the Complaint, including the impact of pending litigation on the Companies' reputation with employees, vendors, customers and in the community generally; and (v) diversion of management time and resources that would be incurred during the prosecution of some or all of the claims. This action, accordingly, should be dismissed.

CONCLUSION

For all of the foregoing reasons, this action should be dismissed.

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