

NEAL HURWITZ, on behalf of
VIRNETX HOLDING
CORPORATION,

V.

C.A. No. 2020-0425-JRS

Original version: October 16, 2020
Public version: October 23, 2020

VIRNETX HOLDING
CORPORATION, a Delaware
Corporation,

Nominal Defendant.

Plaintiff Neal Hugh Hurwitz (“Plaintiff”), investor in VirnetX Holding Corporation (“VirnetX” or the “Company”), by and through his undersigned counsel, brings this action derivatively on behalf of VirnetX, and makes the following allegations in this Verified Amended Stockholder Derivative Complaint (the “Complaint”) against the members of the board of directors of VirnetX (the

“Board”). Plaintiff makes these allegations upon personal knowledge as to those allegations concerning Plaintiff and, as to all other matters, upon information and belief derived from the investigation of counsel, which included, without limitation, (i) review and analysis of public filings with the United States Securities and Exchange Commission (“SEC”); (ii) review of internal VirnetX documents obtained pursuant to a books and records request served pursuant to 8 *Del. C.* § 220 (“220 Demand”) and subsequent, follow-up books and records requests; and (iii) review and analysis of press releases, news reports, industry reports, and other information available in the public domain.

INTRODUCTION

1. This is a stockholder derivative action brought on behalf of nominal defendant VirnetX following years of self-dealing by numerous VirnetX insiders. In particular, this action arises from a collective decision by Kendall Larsen, Robert D. Short, III, Gary Feiner, Michael F. Angelo, and Thomas M. O’Brien (“Director Defendants”) to delay the filing of material information with the Securities and Exchange Commission (the “SEC”) for six days, allowing the Director Defendants to issue themselves underpriced option awards. Indeed, once the material information reached the market, the Company’s stock price increased by over 50%. To achieve recovery on behalf of the Company, Plaintiff brings claims for breach of fiduciary duty, waste, and unjust enrichment.

2. On May 31, 2017, the Director Defendants caused VirnetX to enter into a purported business partnership with Public Intelligence Technology Associates KK (“PITA”), which the Director Defendants represented to be a “Japanese Private Equity and Strategic Consulting alliance between a consortium of Japanese corporations and financial institutions.” The agreements with PITA included (i) a \$20 million share purchase agreement for VirnetX common stock; and (ii) a license agreement and revenue sharing agreement for VirnetX’s GABRIEL Collaboration Suite (“GABRIEL”), the Company’s lone product (collectively, the “PITA Agreements”). Excluding patent litigation settlements, the partnership with PITA and the PITA Agreements would have constituted VirnetX’s most significant business development since its inception as a public company and its first attempt to commercialize its one and only product, GABRIEL.¹

¹ See, e.g., VirnetX’s Form 10-Q filed with the SEC on August 9, 2017, at 27-28 (“our GABRIEL Collaboration Suite is not currently generating revenue”); *id.* (“[We] are at an early stage in the development and commercialization of our GABRIEL Collaboration Suite”); *id.* (“We recently launched our first commercial product, the GABRIEL Collaboration Suite. As such, we have a small technical team, which limits our ability to rapidly adapt our product to customer requirements or add new product features to maintain our competitive edge and drive adoption. Based on the scale of our technical resources, our limited historical financial data upon which to base our projected revenue or planned operating expenses related to our GABRIEL Collaboration Suite, we may not be able to effectively generate revenues or profit from product sales”).

3. The timing of the May 31, 2017 signing of the PITA Agreements was inopportune for the Director Defendants, who were due to receive option awards in the coming days. All told, between June 1 and June 2, 2020, VirnetX insiders received options to purchase 331,000 shares of VirnetX common stock. The exercise prices for these options were either \$3.70 per share or \$3.85 per share, reflecting the closing price of VirnetX stock on the day that the options were issued. In an effort to keep the Company's stock price temporarily depressed, the Director Defendants delayed disclosing the existence of the PITA Agreements with the SEC. The benefit to the Director Defendants—and the resulting harm to VirnetX—was predictable.

4. The PITA Agreements eventually caused significant increases in VirnetX's stock price, resulting in the Company's stock price closing as high as \$5.30 in the days following the PITA Agreements. However, to keep the market from immediately digesting the PITA Agreements, the Company delayed for six days, until June 6, 2017, to file a Form 8-K with the SEC (the "June 6, 2017 8-K"). Instead, the Company issued a single press release regarding the PITA Agreements on June 1, 2017. As demonstrated by the chart below, the six-day delay in filing the June 6, 2017 8-K resulted in the Director Defendants receiving option awards with exercise prices virtually unaffected by the PITA Agreements:

Date	Open	Close	Volume	Event
May 30, 2017	\$3.60	\$3.55	303,100.00	
May 31, 2017	\$3.50	\$3.40	210,300.00	VirnetX Enters into PITA Agreements
June 1, 2017	\$3.55	\$3.70	727,900.00	Options to Purchase 37,500 Shares Awarded to Insiders
June 2, 2017	\$3.85	\$3.85	685,900.00	Options to Purchase 293,500 Shares Awarded to Insiders
June 5, 2017	\$3.95	\$4.50	2,989,900.00	
June 6, 2017	\$4.55	\$4.80	1,347,600.00	VirnetX Files the Form 8-K with the SEC
June 7, 2017	\$4.90	\$5.15	1,928,100.00	
June 8, 2017	\$5.30	\$5.30	1,252,500.00	

5. The strategic delay in disclosing the PITA Agreements fits squarely within a larger pattern of self-dealing that has been evident at the Company for years. By way of example, roughly one-third of the Company's 20 full-time employees are family members of VirnetX's top two executives. In addition, the Director Defendants have caused or approved VirnetX to lease an aircraft owned by an LLC held jointly by Defendant Kendall Larsen ("Larsen"), the Company's founder, Chief Executive Officer ("CEO"), President, Chairman, Chief Compliance Officer and largest stockholder, and his wife, VirnetX co-founder, Kathleen Larsen, for which the Company has paid the Larsens millions of dollars per year for purported "business use."

6. VirnetX has been, and will continue to be, harmed by the Director Defendants' manipulation of the Company's stock price, including the receipt of the underpriced stock options. Plaintiff brings this suit to recover on the Company's behalf.

JURISDICTION

7. This Court has jurisdiction over this action pursuant to 10 *Del. C.* § 341 and over VirnetX pursuant to 10 *Del. C.* § 3111. As directors and officers of a Delaware corporation, the Director Defendants have consented to the jurisdiction of this Court pursuant to 10 *Del. C.* § 3114.

8. Venue is proper in this forum because this action involves significant issues of Delaware corporate law, including the fiduciary duties of loyalty, good faith, and oversight, and is therefore suitable for adjudication before the Delaware Court of Chancery.

PARTIES

9. Plaintiff Neal Hugh Hurwitz is a holder of VirnetX common stock. Plaintiff has continuously held shares of VirnetX common stock since at least January 2017.

10. Defendant Kendall Larsen (“Larsen”) has at all relevant times served as the Company’s CEO, President, Chairman, and Chief Compliance Officer. Larsen founded the Company with his wife, Kathleen Larsen. Four of Larsen’s family members, including Mrs. Larsen, who serves as the Company’s Chief Administration Officer, are employed by VirnetX. Larsen is the Company’s largest stockholder, with beneficial ownership of 11% of the Company’s outstanding shares and control of over 21% of the voting shares.

11. Defendant Robert D. Short, III (“Short”) has been a director at the Company since July 9, 2010. Defendant Short has been the Chief Scientist for the Company since May 2006 and, in June 2010, became the Company’s Chief Technical Officer as well. From February 2000 to April 2007, Defendant Short was Assistant Vice President and Division Manager at Science Applications International Corporation (“SAIC”), from which VirnetX acquired key patents in 2006. From 1994 to February 2000, Defendant Short also held various other positions at SAIC. Short owns approximately 1.5% of the Company’s outstanding shares. Short’s son, Nathaniel Jackson Short, is listed as an inventor on two VirnetX patents, filed in 2013 and 2016

12. Defendant Gary Feiner (“Feiner”) has been a director at the Company since May 2014. Defendant Feiner serves as a member of the Audit Committee, the Compensation Committee, and the Nominating and Corporate Governance Committee. Defendant Feiner chairs the Compensation Committee. Defendant Feiner does not have a college degree but certifies [REDACTED]

[REDACTED].² Since 2014, Defendant Feiner has earned over \$793,000 in total compensation for serving as a VirnetX director, an amount that is material to Feiner. Much of the misconduct complained

² See, e.g., VHC 01012-41 [REDACTED]).

of herein occurred while Feiner served as a director. Defendant Feiner has served as the President of Feiner Financial since 1990.³ As described in more detail below, Defendant Larsen and his wife were clients of Feiner Financial years before Feiner was appointed to the VirnetX Board.

13. Defendant Michael F. Angelo (“Angelo”) has served as a director at VirnetX since July 2007. Defendant Angelo serves as a member of the Audit Committee, the Compensation Committee, and the Nominating and Corporate Governance Committee. Defendant Angelo chairs the Nominating and Corporate Governance Committee. Defendant Angelo, who has no college education, certified

[REDACTED]

[REDACTED].⁴ Since 2007, Defendant Angelo has earned over \$2.93 million in total compensation for serving as a VirnetX director, an amount which is material to

³ Feiner’s company, Feiner Financial, Inc., holds itself out to be a tax and financial planning services company. (<https://www.feinerfinancial.com/>) Feiner holds neither a CPA license or Certified Financial Planner certification. Feiner was sued in a 2009 lawsuit that alleged constructive trust and financial elder abuse by Feiner. *See Rosemeyer v. Feiner*, C.A. No. RG09433515 (Cal. Super. Ct., County of Alameda). The complaint in that action alleged that Feiner convinced an elderly couple to invest their life saving, \$350,000, into his real estate investment fund, Live Oak Fund, LLC to finance Rockridge Heights, LLC, a company which is owned by Feiner and that he uses to “flip” properties, primarily in Berkeley, California. The plaintiffs alleged that Feiner knew he did not have the assets to pay on the debentures issued at the time of investment. The case was settled for an unknown amount. The complaint indicates that the plaintiffs, for whom Feiner prepared their taxes, believed Feiner to be a CPA.

⁴ *See, e.g.*, VHC 01042-71 [REDACTED].

Angelo. Substantially all the misconduct complained of herein occurred while Defendant Angelo served as a director.

14. Defendant Thomas M. O'Brien ("O'Brien") has served as a director at VirnetX since July 2007. Defendant O'Brien serves as a member of the Audit Committee, the Compensation Committee, and the Nominating and Corporate Governance Committee. Defendant O'Brien chairs the Audit Committee. Since 2007, Defendant O'Brien has earned over \$3 million in total compensation for serving as a VirnetX director, an amount which is material to O'Brien. Substantially all the misconduct complained of herein occurred while Defendant O'Brien served as a director.

15. Larsen, together with Short, Angelo, Feiner, and O'Brien constitute the entire Board and are collectively referred to as the "Director Defendants."

16. Nominal Defendant VirnetX is a Delaware corporation with principal executive offices located at 308 Dorla Ct., Zephyr Cove, Nevada 89448. Its registered agent for service of process within the State of Delaware is the Corporation Service Company, Corporation Trust Center, 251 Little Falls Drive, Wilmington Delaware 19808. VirnetX purports to be a technology company. The Company's stock is traded on the New York Stock Exchange under the ticker symbol "VHC."

BREACHES OF FIDUCIARY DUTIES

17. Each Director Defendant, by virtue of his position as a director and/or officer of the Company, owed to VirnetX and to its stockholders the fiduciary duties of loyalty and care. The Director Defendants were, and are, required to act in furtherance of the best interests of VirnetX and its stockholders to benefit all stockholders equally and not in furtherance of their personal interests or benefit.

18. The Director Defendants, because of their positions of control and authority as directors and/or officers of VirnetX, were able to and did, directly and/or indirectly, exercise control over the wrongful acts complained of herein. Because of their advisory, executive, managerial, and directorial positions with VirnetX, each Director Defendant had knowledge of material information regarding the Company.

19. By virtue of such duties, the Director Defendants were required to, among other things:

- a. Exercise good faith to ensure that the Company was operated in a diligent, honest and prudent manner and complied with all applicable federal and state laws, rules, regulations, and requirements, and all contractual obligations, including acting only within the scope of its legal authority; and
- b. When put on notice of problems with the Company's business practices and operations, exercise good faith in taking

appropriate action to correct the misconduct and prevent its recurrence.

20. The Director Defendants each breached their duty of loyalty and care by engaging in self-dealing and corporate waste; participating in, benefitting from, permitting, enabling and/or recklessly disregarding the self-dealing and waste of their co-directors; failing to monitor, prevent and/or terminate the misconduct of their co-directors, including and especially Larsen; and participating in, benefitting from, permitting, enabling and/or recklessly disregarding the delay of the public disclosures to the Company's stockholders and the public regarding PITA and the PITA Agreements. The Director Defendants' actions constitute gross mismanagement and corporate waste.

DERIVATIVE ALLEGATIONS

21. VirnetX is named as Nominal Defendant solely in a derivative capacity. Plaintiff brings this action derivatively in the right and for the benefit of the Company to redress the Director Defendants' breaches of fiduciary duties.

22. Plaintiff was a stockholder of VirnetX at the time of the wrongdoing complained of, has continuously been stockholders since that time, and is a current VirnetX stockholder.

23. Plaintiff will adequately and fairly represent the interests of the Company and its stockholders in enforcing and prosecuting its rights.

FACTUAL ALLEGATIONS

A. Background

24. VirnetX began as a unit within government contractor SAIC that was spun out with certain SAIC patents intact. As of its most recent 10-K, VirnetX, had a market capitalization of over \$350 million and just twenty employees.⁵ VirnetX holds itself out as an “Internet security software and technology company.” However, as described *infra*, VirnetX derives its income almost exclusively from patent litigation and “licensing” agreements derived from patent litigation. In the media, VirnetX is commonly referred to as a “patent troll.”^{6 7 8}

25. The Company claims that its “strategy is to become *the market leader* in securing real-time communications over the Internet and to establish our GABRIEL Communications Technology™ as the industry standard security platform” (emphasis added) and represents that the three key elements of its business strategy are to:

⁵ See VirnetX Form 10-K for year ended Dec. 31, 2019 (“2019 10-K”), filed with the SEC March 16, 2020.

⁶ See, e.g., <https://www.independent.co.uk/life-style/gadgets-and-tech/how-virnetx-beat-apple-the-strange-case-of-the-patent-trolls-a6880036.html>.

⁷ <https://gizmodo.com/apple-ordered-to-pay-patent-troll-virnetx-502-6-million-1825164376>.

⁸ <https://www.theverge.com/2020/2/10/21131945/apple-virnetx-patent-case-us-appeals-court-lawsuit-legal>.

Introduce our Gabriel Secure Communication Platform™ and Gabriel Collaboration Suite™ products in the general market in the first half of 2015 for sale directly to end-user enterprises.

Continue to grow our technology licensing program to commercialize our intellectual property, including our GABRIEL Connection Technology™ by adding more licensees.

Establish VirnetX as the exclusive universal registry of secure domain names and to enable our customers to act as registrars for their users and broker secure communication between users on different registries.⁹

26. However, despite the Company's representations *in 2015* that it was *successfully implementing* its strategic licensing strategy of its three-pronged business plan,¹⁰ the referenced license agreements all related to, and were derived from, patent litigation settlements.¹¹ And, the Company continues to highlight these

⁹ 2014 10-K. at 9.

¹⁰ *See id.* at 5 (“We have signed Patent License Agreements with Avaya Inc., Aastra USA, Inc., Microsoft, Mitel Networks Corporation, NEC Corporation and NEC Corporation of America, Siemens Enterprise Communications GmbH & Co. KG, and Siemens Enterprise Communications Inc. to license certain of our patents, for a one-time payment and an ongoing royalty for all future sales through the expiration of the licensed patents with respect to certain current and future IP-encrypted products.”).

¹¹ *Id.* at 33 (“we recognized royalty revenue as part of license agreements entered into with customers during the patent infringement actions. These revenues relate to both payment for use of our patented technology prior to the signing of a license agreement, and royalty payments after the execution of the license agreements. No amounts were allocable to settlement fees, expense reimbursement, damages or any other amounts other than historical and future sales as no such amounts were requested or received.”) (citations omitted).

settlement agreements in its SEC filings as the only examples of purportedly signed “Patent License Agreements.”¹² In fact, other than GABRIEL, the Company has still not developed **any** commercial products.¹³

27. Indeed, in an internal document dated May 2017, [REDACTED]
[REDACTED]¹⁴ And, over the five years since GABRIEL’s purported launch in May 2015,¹⁵ GABRIEL has generated **no meaningful revenue** and its user base is, at best, still limited (despite VirnetX consistently representing that it intends to “continue to expand [its] customer base with targeted promotions and direct sales initiatives”).¹⁶

¹² 2019 10-K at 5.

¹³ *See id.* at 20 (“We currently have only one commercial product, the GABRIEL Collaboration Suite”).

¹⁴ *See* VHC 00132.

¹⁵ As revealed in the Company’s subsequent disclosures, contrary to VirnetX’s representations, GABRIEL does not appear to have been launched commercially in May 2015, rather, it was still being beta tested. *See* 42B1 Prospectus Supplement, filed with the SEC March 9, 2018, at S-3.

¹⁶ *See, e.g.*, 2019 10-K at 4.

28. Nevertheless, despite generating no material revenue from activities other than litigation since at least 2014,¹⁷ the Director Defendants continue to represent to the public that the Company is an internet security software and technology Company, and, since 2017, has issued apparently deceptive press releases about the commercialization of GABRIEL.¹⁸

29. For instance, on April 5, 2016, Larsen authored an article for Corporate Counsel with the title “Are We Patent Trolls? Ask Jason Bourne.” In the article, Larsen once again touted the GABRIEL software in a misleading manner to paint VirnetX as anything but a patent troll:

It always astonishes me when the reporters routinely write that VirnetX ‘has no products.’ Have they never heard of the Apple’s App Store or the Google Play Store? All you have to do is look in the app store on your iPhone and you’ll find the Gabriel Collaboration Suite, a set of integrated applications that enable secure messaging, secure voice and video calling, secure mail and secure encrypted file sharing with any other device. We created and sell these products.

B. The PITA Agreements and Underpriced Options

¹⁷ Notably, despite the (no longer) recent US Supreme Court ruling in, *TC Heartland LLC v. Kraft Food Group*, 2017 WL 2216934 (2017), Defendants do not appear to acknowledge the significance of that decision on VirnetX’s actual business model, other than tangentially, via non-specific risk disclosures added in the Company’s 2017 Form 10-K (which could not reasonably serve as notice of the risk to anyone not already aware of same).

¹⁸ See 2019 10-K at 4; VirnetX’s Press Release, dated March 20, 2017, announcing “expansion” of GABRIEL usage.

30. On Wednesday, May 31, 2017, VirnetX and PITA, which VirnetX states is a “Japanese Private Equity and Strategic Consulting alliance between a consortium of Japanese corporations and financial institutions,” entered into a “five-year, multifaceted definitive agreement to build a strategic alliance of 4G Service Providers, Application Developers, Japanese Content Developers, Government Agencies and Enterprises around GABRIEL Technologies” (*i.e.*, the PITA Agreements).¹⁹

31. Although the execution of the PITA Agreements occurred on Wednesday, May 31, 2017 (and the Director Defendants aver that this highly material development was disclosed in a press release issued on the next day), Larsen and the other Director Defendants did not cause VirnetX to file the press release or related June 6, 2017 8-K with the SEC until after the close of trading almost a week later.²⁰ Because VirnetX did not have analyst coverage at the time, Director Defendants were aware that the market would be slow to digest the press release.

¹⁹ See June 6, 2017 8-K.

²⁰ As detailed below, VirnetX’s stock price activity and trading volume between June 1, 2017 and June 6, 2017 demonstrate that the broad market was not aware of the PITA Agreements until at least June 7, 2017, when VirnetX’s stock price reached above \$5 per share for the first time since June 2016, and closed at \$5.15 per share, a 33% increase compared to VirnetX’s closing price on Friday, June 2, 2017. Similarly, VirnetX’s daily trading volume surged to nearly 3 million shares on June

32. On June 1, 2017, during the week that the Director Defendants and/or Larsen delayed the disclosure and were in possession of material information about the PITA Agreements, Defendants Angelo, Feiner, and O'Brien awarded themselves underpriced stock and option awards with fair values and strike prices that were unaffected by the imminent price inflation to VirnetX's stock price that was about to occur once the Director Defendants announced the PITA Agreements.²¹ The Compensation Committee granted the Board 37,500 underpriced options and 24,999 spring-loaded RSUs.²²

33. The Company's minutes reflect that the full Board, in a meeting that was held on June 1, 2017 at 12:15 p.m. Pacific Time, [REDACTED]

[REDACTED]

[REDACTED]

5 compared to the 685,900 shares that traded on Friday, June 2 and 727,900 shares that traded on June 1.

²¹ See 2018 Proxy, filed April 12, 2018, at 17 ("2018 Proxy"); *see also*, Angelo, Feiner, and O'Brien Form 4s, dated June 5, 2017 (for options and stock awards dated June 1, 2017, with fair values of \$3.70 per share). All of the underpriced option and stock awards were based on improper "fair values" and thus the various proxies and SEC filings detailing the executive and director compensation during this period are materially misleading.

²² 2018 Proxy, at 71.

²³ The minutes further reflect that

²⁴

34. The following day, on June 2, 2017, after personally receiving underpriced option and stock awards, and while still in possession of material information about the PITA Agreements, Defendants Angelo, Feiner, and O'Brien (*i.e.*, the Compensation Committee) reciprocated to Larsen, Short, Kathleen Larsen (and Richard Nance, VirnetX's Chief Financial Officer), by increasing each of their base salaries and approving new grants of similarly underpriced equity awards to Larsen, Short, Kathleen Larsen, Nance, and numerous other Company insiders.²⁵

35. The minutes of the June 2, 2017 meeting of the Compensation Committee, which was held at 3:00 p.m. Pacific Time, reflect that

²⁶

Collectively, on June 2, 2017 the Compensation Committee awarded options to

²³ See VHC 00137-40.

²⁴ See VHC 00138.

²⁵ See 2018 Proxy, at 26; *see also*, Larsen, Short and Nance Form 4s, dated June 5, 2017 (for options and stock awards dated June 2, 2017, with fair values of \$3.85 per share).

²⁶ See VHC 00146-49.

purchase [REDACTED]²⁷ This award included (i) options to purchase 40,000 shares granted to Larsen, (ii) options to purchase 20,000 shares issued to Short, (iii) options to purchase 20,000 shares issued to Kathleen Larsen; (iv) [REDACTED] (v) options to purchase 6,000 shares issued to Nance; (vi) [REDACTED] and (vii) [REDACTED]

[REDACTED].²⁸ The minutes of the June 2, 2017 Compensation Committee meeting reflect that [REDACTED]

[REDACTED]²⁹ The options were granted to, among others, [REDACTED]

36. In just the three months ended June 30, 2017, the Board awarded themselves, their family members (as well as other employees) options to purchase 331,000 VirnetX shares and 220,664 RSUs.³⁰

²⁷ See VHC 00115.

²⁸ *Id.*

²⁹ See VHC 00147.

³⁰ See VirnetX Form 10-Q for period ended June 30, 2017 (“2017 10-Q”) at 8.

37. Within days of the entry into the PITA Agreements, the price of VirnetX common stock increased over 50%, from \$3.40 per share to \$5.30 per share, with concomitant increases in the value of the underpriced options that the Director Defendants had just awarded themselves (and members of their immediate families, as discussed in more detail below). Following the filing of the Company's June 6, 2017 8-K, which described the execution of the PITA Agreements in an attached press release, VirnetX's trading volume surged between approximately 500% and 1,000% on June 5 through 9, 2017, and its share price increased sharply. The increase in VirnetX's stock price and attendant increase in the value of the underpriced options is represented in the chart below:

Date	Open	Close	Volume	Event
May 30, 2017	\$3.60	\$3.55	303,100.00	
May 31, 2017	\$3.50	\$3.40	210,300.00	VirnetX Enters into PITA Agreements
June 1, 2017	\$3.55	\$3.70	727,900.00	Options to Purchase 37,500 Shares Awarded to Insiders
June 2, 2017	\$3.85	\$3.85	685,900.00	Options to Purchase 293,500 Shares Awarded to Insiders
June 5, 2017	\$3.95	\$4.50	2,989,900.00	
June 6, 2017	\$4.55	\$4.80	1,347,600.00	VirnetX Files the Form 8-K with the SEC
June 7, 2017	\$4.90	\$5.15	1,928,100.00	
June 8, 2017	\$5.30	\$5.30	1,252,500.00	

38. Thus, each of the Director Defendants directly benefited from the scheme relating to the timing and content of disclosures regarding the PITA Agreements by, at a minimum, receiving stock and option grants with predicate fair values and strike prices that were unaffected by the price inflation injected into VirnetX's stock price in connection with the PITA Agreements.

C. **Additional Information Regarding the PITA Agreements**

39. Ultimately, the inflation caused by the PITA Agreements was short-lived. As described in more detail below, within a few months PITA began requesting extensions of time to perform its obligations under the agreements, and the PITA Agreements were ultimately canceled. As further described below, the PITA Agreements were entered into at a time when [REDACTED]

[REDACTED]

However, regardless of whether the Board believed that the PITA Agreements were viable, the Director Defendants were aware that the disclosure of the PITA Agreements would have a material impact on the Company's stock price, and delayed disclosing the PITA Agreements in its SEC filings for six days to allow for the issuance of the underpriced options.

40. Most disturbingly, the Director Defendants failed to disclose to stockholders that Larsen was both a *stockholder and a director* of PITA, and thus had an undisclosed, personal interest in the PITA Agreements. Indeed, a version of the PITA website that was archived on August 4, 2017³¹ confirms that Larsen was one of four PITA directors, along with Johan Willem van de Gronden, Michael Al

³¹ See <https://web.archive.org/web/20170804102152/http://pitakk.com/index.php?company-outline#p1>.

Silva, and Gregory Duane Ellis. Larsen is also listed as one of nine PITA stockholders. Larsen's dual fiduciary role as a stockholder and director of PITA was not disclosed in any VirnetX filings and was not discussed in any VirnetX Board or Committee meetings. Accordingly, either Larsen kept his personal stake in PITA a secret in breach of his duty of candor to the Company, or the Board was aware of Larsen's personal interests in PITA and was complicit in hiding this information from the Company's stockholders. At this pleading stage, it is inferable that the Board must have known about Larsen's personal interest in PITA but that they conspired to keep this fact from the stockholders because they personally benefited from the disclosure of the PITA Agreements. It is also inferable that the reason that Larsen's personal interest in PITA was not disclosed was that it could have dampened the market's reaction to the news of the PITA Agreements.

41. As part of the PITA Agreements, PITA agreed to purchase 5,494,505 shares of common stock from VirnetX at an all-cash purchase price of \$3.64 per share in a private placement transaction, for a total of \$20 million (the "Share Purchase" and "Share Purchase Agreement"). According to the Company, the Share Purchase would close "as promptly as practicable following the satisfaction or waiver of certain closing conditions, but in any case, no later than June 19, 2017."³²

³² See June 6, 2017 8-K.

42. The PITA Agreements also included a Gabriel License Agreement for the marketing and promotion of the Company's GABRIEL products and services by PITA in Japan and a revenue share agreement, which was subsequently amended, for revenues generated by the products sold in Japan by PITA (the "Revenue Share Agreement"). This would have been a boon for the Company, finally connecting GABRIEL with a user base.

43. On June 27, 2017, after a June 19, 2017 deadline had lapsed without the Share Purchase closing, the Company announced that VirnetX and PITA mutually agreed to extend the deadline for the closing of the Share Purchase to July 17, 2017. The announcement blamed the delay on "unforeseen circumstances on the part of [PITA]" and represented that no amendments were made to the Share Purchase Agreement.³³

44. On July 14, 2017, the Company announced that PITA had:

recently informed the Company that the closing of the Share Purchase will not occur on July 17, 2017 because [PITA's] financing sources have not yet completed their diligence of [PITA]. The Company believes that the closing of the Share Purchase will occur in the future, as the Company is continuing discussions with [PITA] and assisting in the due diligence process being conducted by [PITA's] financing sources with the goal of facilitating the closing of the Share Purchase. However, although the closing of the Share Purchase is not subject to any conditions, the Company cannot provide assurance that [PITA] will

³³ See VirnetX's Form 8-K, filed with the SEC on June 28, 2017 ("June 28, 2017 8-K").

be able to obtain financing and consummate the closing of the Share Purchase or when the closing of the Share Purchase may occur. The Company will continue to reevaluate its position based on its ongoing discussions with [PITA]. In the event that [PITA] is unable to complete the Share Purchase, the Company will evaluate alternatives available to it; however, the Company cannot be certain it will be able to recover the consideration due to it under the Purchase Agreement.³⁴

45. Shares of VirnetX stock had closed at \$4.60 per share on July 14, 2017.

On July 17, 2017, the trading day following the July 14, 2017 announcement, shares of VirnetX opened at \$3.50 per share and closed at \$4.05 per share.

46. On October 18, 2017, the Company and PITA signed a termination letter mutually agreeing that the Share Purchase Agreement would be terminated effective as of October 18, 2017.

47. On October 19, 2017, the Company announced that:

[a]fter ongoing discussions with [PITA], and in light of the increase in the Company's trading price, the Company and [PITA] determined not to proceed with the Share Purchase. The Company and [PITA] agreed to terminate the Purchase Agreement and retain the revenue share and marketing and promotion arrangements under the Revenue Sharing Agreement and Gabriel License Agreement, respectively

48. On March 16, 2018, the Company delivered a letter to PITA acknowledging the termination of the PITA Agreements but also notifying PITA that, though the Company considers the PITA Agreements effectively terminated,

³⁴ See VirnetX's Form 8-K, filed with the SEC on July 14, 2017.

the letter also constituted a notice of termination pursuant to the relevant termination provisions of the PITA Agreements.

49. As referenced above, the announcement of the PITA Agreements had the effect of inflating the Company's stock price [REDACTED]

[REDACTED] In April 2017, one month before the PITA Agreements were publicly announced, the Board received a presentation explaining that [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Following the announcement of the PITA Agreements on June 6, 2017, the Company's stock price rose [REDACTED]

³⁵ VHC 00052.

50. Although Short abstained from executing his call options to purchase over a million shares during the approximately six week period that his options were in the money and yet to expire, Short was cognizant of the fact that VirnetX's share price was artificially inflated and was likely concerned with risk of executing and monetizing his options at the time.

51. Soon thereafter, on September 14, 2017, the Board, Compensation Committee and Larsen made Short whole and awarded him a new option grant.³⁶ Indeed, the minutes of the September 14, 2017 Compensation Committee reflect that the committee, in awarding the substantial option award to Short and others,

[REDACTED]

[REDACTED]

37

52. However, in their haste, and as one of many examples of the Company's defective oversight and compliance controls, Larsen and the Committee approved the grant to purchase 1,100,000 shares at \$4.15 per share (representing over 60,000 shares more than the expired options AND also a strike price \$0.05

³⁶ See 2018 Proxy, at 26; see also, *id.* at 28 (“[A]fter a review of Dr. Short’s overall performance, the Company’s performance and Dr. Short’s equity holdings, **including recently expired options that he held**, the compensation committee granted Dr. Short an option to purchase 980,000 shares of the Company’s common stock in September 2017. The compensation committee believed this grant was important to provide retention incentives to Dr. Short.”).

³⁷ See VHC 00161.

below the expired options). In addition to serving to perpetuate the Director Defendants' abuse of the Company, this grant violated the limits imposed by the Company's 2013 Equity Incentive Plan (the "2013 Plan").

53. Finally, during the year ended December 31, 2017, at least partly during the period VirnetX's stock price was artificially inflated in connection with the PITA Agreements, the Company sold 730,444 shares of common stock at an average sales price per share of \$5.19, a price that is over 40% higher than VirnetX's average daily closing price in 2017 and which only prevailed in the months that the market had any cause to believe in the legitimacy of the PITA Agreements.

D. Larsen is the Controlling Stockholder of VirnetX

54. It is well-settled under Delaware law that a stockholder owes fiduciary duties when "the stockholder (1) owns more than 50% of the voting power of a corporation or (2) owns less than 50% of the voting power of the corporation but '*exercises control* over the business affairs of the corporation.'"³⁸

55. The test for a minority stockholder to be deemed a controller, while not easy to satisfy, can be met where that minority stockholder holds "such formidable

³⁸ *In re KKR Fin. Holdings LLC S'holder Litig.*, 101 A.3d 980, 991 (Del. Ch. 2014), *aff'd sub nom. Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015) (quoting *Kahn v. Lynch Commc'ns Sys., Inc.*, 638 A.2d 1110, 1113–14 (Del.1994).

voting and managerial power that [he], as a practical matter, [is] no differently situated than if [he] had majority voting control.”³⁹

56. Larsen owns 11% of the Company’s outstanding shares and is therefore considered a “minority stockholder.” However, Larsen is the Company’s *largest* stockholder, exercises control over the business affairs of the Company, and exerts such formidable managerial power, that he, as a practical matter, is no differently situated than if he had total voting control. Indeed, VirnetX is controlled by one stockholder—Larsen.

57. Moreover, as a group, VirnetX’s executive officers and directors (who are beholden and/or related to Larsen) beneficially own 13.2% of the outstanding common stock and control the votes of a group of stockholders that, as of December 31, 2007, held 4,766,666 shares, or approximately 8% of the outstanding common stock, likely raising his voting control to over 21%.⁴⁰ Additionally, Larsen’s 11% ownership expressly excludes 613,530 shares held by his wife’s trust and the unknown number of shares held by Larsen’s children. 2020 Proxy at 18. Presumably the holdings of Short’s family are also excluded from the reported control figures.

³⁹ *In re KKR*, 101 A.3d at 992 (internal quotation marks and citations omitted).

⁴⁰ 2019 10-K, at 25.

58. In addition to serving as the Company’s CEO, President, Chairman, *and* Chief Compliance Officer, Larsen also co-founded the Company with his wife, Kathleen Larsen.

59. Through these roles, but especially in his capacity as controlling stockholder, Larsen employed four of his family members—his wife, son, and two stepsons. Larsen’s family members each receive annual compensation worth six or seven figures and were collectively paid, in just 2019, nearly over \$12 million in total compensation.

60. While the Board’s Committees made the “official” decision to hire and compensate Larsen’s family members, [REDACTED]

[REDACTED] 41 [REDACTED]

[REDACTED] 42

61. Based on its public disclosures, without Larsen, VirnetX believes it would crumble. The Company’s Internal Risk Assessment highlights:

[REDACTED]

⁴¹ VHC 00001-3; VHC 00146-149.

⁴² VHC 00001.

62. In the Company’s latest Form 10-Q, VirnetX disclosed: “**Due to the specialized nature of our business and limited staff, we are *particularly dependent on Kendall Larsen, our Chief Executive Officer and President.***”⁴⁴

63. Larsen has even exerted his control over the Company by causing VirnetX to lease a private jet not from an independent third-party, but from an entity jointly owned by Larsen and his wife. In just 2019, the Company paid Larsen and Mrs. Larsen approximately \$1,790,000 in rental fees for the aircraft.⁴⁵ VirnetX fails to explain the purpose of the millions of dollars expended on Larsen and his wife’s private air travel.

64. Finally, even though Larsen [REDACTED]

[REDACTED]

[REDACTED]

⁴⁶ Indeed, the Board minutes demonstrate that Larsen was responsible for “negotiating” the PITA Agreements, and he provided updates to the Board regarding the status of his

⁴³ VHC 00431 (emphasis added).

⁴⁴ See VirnetX’s Form 10-Q, filed with the SEC on August 10, 2020, at 28.

⁴⁵ See VirnetX’s Proxy Statement, filed with the SEC on April 10, 2020, at 31.

⁴⁶ VHC 00158; 210.

negotiations. For example, the minutes of the May 5, 2017 meeting of the full Board reflect that [REDACTED]

[REDACTED]

[REDACTED]⁴⁷ The minutes of the August 8, 2017 meeting of the full Board reflect that [REDACTED]

[REDACTED]

[REDACTED]⁴⁸ The minutes do not reflect [REDACTED] At a Board meeting dated March 15, 2018, the minutes reflect that [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]⁵⁰

65. The facts demonstrate that Larsen is VirnetX's controlling stockholder.

⁴⁷ VHC 00058.

⁴⁸ VHC 00158.

⁴⁹ VHC 00210.

⁵⁰ VHC 00131.

E. Nepotism is Rampant at VirnetX

66. In another example of the lack of controls at the Company, in his capacity as the *de facto* controller of VirnetX Larsen has caused the Company to spend millions of dollars hiring family members of VirnetX executives for jobs purportedly working on GABRIEL. Larsen has leveraged his multiple roles and control of the Company to secure tens of millions of dollars in cash, stock, options, and other compensation for himself, Mrs. Larsen, and their three children employed by VirnetX.

67. As of December 31, 2019, VirnetX had just 20 full and part-time employees.⁵¹ 25% (five) of VirnetX's employees are Larsen's family members, including (i) Larsen; (ii) Mrs. Larsen; (iii) Larsen's son, Parker; and Larsen's stepsons (iv) Dustan Sheehan; and (v) Joshua Sheehan.⁵² In addition, Cory Hoback ("Hoback"), the son-in-law of Defendant Short, VirnetX's other executive officer and a VirnetX director, is also employed by the Company. Including Short and Hoback, approximately 33% of VirnetX's employees are related to the Board and the Company's executive officers.

***Kathleen Larsen,
Chief Administrative Officer***

⁵¹ See 2019 10-K at 14.

⁵² See VirnetX's Proxy Statement, filed with the SEC on April 10, 2020 ("2020 Proxy") at 30-31.

68. Larsen's wife, Kathleen Larsen, serves as VirnetX's Chief Administrative Officer and appears to have been hired in that capacity in 2011.⁵³ Prior to this position, Mrs. Larsen served as VirnetX's Vice President, Administration and Human Resources, since February 2005. Mrs. Larsen also served as the Treasurer and Chief Financial Officer of VirnetX from March 2006 until July 2007.

69. In 2011, Mrs. Larsen received an aggregate of \$471,780.81 in the form of salary and bonus, and \$857,200 in the form of option grants, for a total compensation of approximately \$1.3 million.⁵⁴

70. Similarly, Mrs. Larsen received total compensation of approximately: \$1.15 million in 2013; \$1.04 million in 2014; \$633,000 in 2015; \$732,000 in 2016; \$746,000 in 2017; \$1.5 million in 2018; and \$636,411 in 2019.⁵⁵

⁵³ See VirnetX's Proxy Statement, filed with the SEC on April 24, 2012 (2012 Proxy") at 41. The first Larsen family members were hired in 2011 following VirnetX's only profitable year after its reverse triangular merger with PASW, Inc. in June 2007.

⁵⁴ *Id.*

⁵⁵ See VirnetX's Proxy Statement, filed with the SEC on April 11, 2014 ("2014 Proxy") at 42; VirnetX's Proxy Statement, filed with the SEC on April 3, 2015 ("2015 Proxy") at 34; VirnetX's Proxy Statement, filed with the SEC on April 19, 2016 ("2016 Proxy") at 36; VirnetX's Proxy Statement, filed with the SEC on April 14, 2017 ("2017 Proxy") at 49; VirnetX's Proxy Statement, filed with the SEC on April 12, 2018 ("2018 Proxy") at 35; VirnetX's Proxy Statement, filed with the SEC on April 11, 2019 ("2019 Proxy") at 36; 2020 Proxy at 31.

71. During fiscal 2018, Larsen, the Board, and the Compensation Committee approved an aggregate of \$671,383 in the form of salary and bonus, \$826,600 in the form of option grants, and \$42,666 in the form of stock awards, for total compensation of over \$1.5 million, to Mrs. Larsen. All for serving as Chief Administration Officer for VirnetX's 20 other employees. During fiscal 2019, Mrs. Larsen received an aggregate of \$461,466 in the form of salary (including payment of \$31,781 for accrued, but unused vacation in fiscal 2019), \$93,480 in the form of option grants and \$81,465 in the form of stock awards.

***Joshua Sheehan,
Global Operations Manager, Product and Sales Test and Support Engineer***

72. During fiscal 2019, Mrs. Larsen's son (Defendant Larsen's stepson) Joshua Sheehan served as Global Operations Manager, Product and Sales Test and Support Engineer, (sharing responsibilities with his brother Dustan) and was awarded an aggregate of \$115,940 in the form of salary and bonus, \$46,740 in the form of option grants and \$40,729 in the form of stock awards, for total compensation in excess of \$160,000.⁵⁶

⁵⁶ See 2020 Proxy at 30.

73. Joshua Sheehan was employed as a VirnetX Research Analyst in 2013, and, incredibly, he received total compensation in excess of \$1.23 million that year.⁵⁷ The national average total compensation for Research Analysts, as of August 5, 2019, was approximately \$68,000.⁵⁸ Thus, Joshua's total compensation in 2013 was approximately 1,800% of the national average.

74. Joshua's position changed to operations manager in 2014, and he received over \$180,000 in 2014; approximately \$115,000 in 2015; and \$120,000 in 2016.⁵⁹ The national average total compensation for Operations Managers, as of August 18, 2019, was approximately \$85,000.⁶⁰ For 2017, Joshua's title was changed, once again, to Operations Manager, Product and Sales Test and Support Engineer and he received approximately \$160,000 in total compensation for fiscal 2017.⁶¹

⁵⁷ See 2014 Proxy at 42.

⁵⁸ See Glassdoor, Research Analyst Salaries, available at <https://www.glassdoor.com/Salaries/research-analyst-salary-SRCHKOO.16.htm>.

⁵⁹ See 2014 Proxy at 42; 2015 Proxy at 35; 2016 Proxy at 36; 2017 Proxy at 49.

⁶⁰ See Glassdoor, Operations Manager Salaries, available at https://www.glassdoor.com/Salaries/operations-manager-salary-SRCH_KO0,18.htm.

⁶¹ See 2018 Proxy at 35.

75. Internal documents reveal that [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

62

63

⁶² See VHC 00146-149.

⁶³ See VHC 00154.

***Dustan Sheehan,
Graphics, Web, Product Test and Support Engineer, former Webmaster***

76. Defendant Larsen's other stepson, Dustan Sheehan, appears to have joined VirnetX as its Webmaster in 2011.⁶⁴ In his first year with the Company, Dustan received an aggregate of \$53,171.72 in the form of salary and bonus and \$857,200 in the form of option grants, for total compensation of approximately \$910,000.⁶⁵

77. Dustan continued to be employed as the Company's Webmaster and received approximately \$244,000 in total compensation in 2013; \$188,000 in 2014; \$120,000 in 2015; and \$118,000 in 2016.⁶⁶

78. Dustan Sheehan appears to have been promoted in 2017 to Graphics, Web, Product Test and Support Engineer (sharing responsibilities with his brother Joshua) and received total compensation of approximately \$150,000.⁶⁷ During fiscal 2018, Dustan received an aggregate of \$129,190 in the form of salary and bonus, \$11,650 in the form of option grants, and \$10,666 in the form of stock awards, for

⁶⁴ See 2012 Proxy at 41.

⁶⁵ *Id.*

⁶⁶ See 2014 Proxy at 42; 2015 Proxy at 35; 2016 Proxy at 36; 2017 Proxy at 49.

⁶⁷ 2018 Proxy.

total compensation in excess of \$150,000.⁶⁸ During fiscal year 2019, Dustan Sheehan received an aggregate of \$98,568 in the form of salary, \$23,370 in the form of option grants, and \$20,365 in the form of stock awards.⁶⁹ And, although Dustan's exact position and titles appear unique, the national average total compensation for a Product Test Engineer, as of August 5, 2019, is approximately \$83,000.⁷⁰ Similarly, the national average total compensation for a Product Support Engineer, as of August 5, 2019, is approximately \$76,000.⁷¹ Thus, Dustan's total compensation in 2017 and 2018 appears to have been approximately 200% of the national average.

79. Internal documents reveal that [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

⁶⁸ 2019 Proxy.

⁶⁹ 2020 Proxy.

⁷⁰ See Glassdoor.com, Product Test Engineer Salaries, available at https://www.glassdoor.com/Salaries/product-test-engineer-salary-SRCH_KO0,21.htm.

⁷¹ See Glassdoor.com, Product Support Engineer Salaries, available at https://www.glassdoor.com/Salaries/product-support-engineer-salary-SRCH_KO0,24.htm.

[REDACTED] ⁷² [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] ⁷³

*Parker Larsen,
Product Test Engineer, former Assistant*

80. Defendant Larsen's son, Parker, [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] ⁷⁴ [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

⁷² See VHC 00146-149.

⁷³ See VHC 00154.

⁷⁴ See 2019 Proxy at 49.

81.

[REDACTED]

82.

[REDACTED].⁷⁷

83.

[REDACTED]

⁷⁵ See VHC 00001-3.

⁷⁶ VHC 00001.

⁷⁷ See VHC 00001, 22, 165, 204, 215, 342.

⁷⁸ See VHC 00005-7.

[REDACTED]

[REDACTED].

84. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

⁷⁹ See VHC 00008-9.

⁸⁰ VHC 00008.

[REDACTED]

[REDACTED]

85. In 2017, Parker was awarded total compensation of approximately \$110,000.⁸¹ Currently, the national average total compensation for a Product Test Technician (presumably a position more senior than an “assistant”) is approximately \$45,500; and, when adjusted for Parker’s experience (*i.e.* 0-1 years) and VirnetX’s size (*i.e.* 0 to 50 employees) the average total compensation is approximately \$36,000.⁸²

86. For fiscal 2018, Parker was promoted from assistant to Product Test Engineer, and received an aggregate of \$70,200 in the form of salary and bonus, \$11,650 in the form of option grants, and \$10,666 in the form of stock awards, for total compensation in excess of \$90,000.⁸³ During fiscal 2019, Parker Larsen received an aggregate of \$67,600 in the form of salary, \$23,370 in the form of option grants, and \$20,365 in the form of stock awards, for total compensation in excess of

⁸¹ See 2018 Proxy, at 35.

⁸² See Glassdoor.com, Product Test Technician Salaries, *available at* https://www.glassdoor.com/Salaries/product-test-technician-salary-SRCH_KO0,23.htm.

⁸³ See 2018 Proxy at 36.

\$110,00.⁸⁴ The national average total compensation for a Product Test Engineer that has 1-3 years of experience and works at a company with up to 50 employees is approximately \$66,500.⁸⁵

87. Despite purportedly being employed full-time at VirnetX, in March 2020, Parker Larsen formed Prime Performance Properties, located in South Lake Tahoe, CA. The company “is a real estate solutions and investment firm that specializes in sourcing value added real estate opportunities with the purpose of revitalizing our communities, producing thriving income properties, and to partner with qualified investors.”⁸⁶

⁸⁴ 2020 Proxy at 31.

⁸⁵ See Glassdoor, Product Test Engineer Salaries, *available at* https://www.glassdoor.com/Salaries/product-test-engineer-salary-SRCH_KO0,21.htm.

⁸⁶ https://www.linkedin.com/in/parker-larsen-570abb134?challengeId=AQFGm2VFYUThnAAAAXT66GoQu5JA5IRTdrOnLQsCt08lm_rqhabzfb67MXY8ScS745IJkLPVJ29uV1jnxpaIaauZ7jtADGx9wQ&submissionId=7521c6d0-8c39-3b16-8bac-250bbb57c958.

***Corby Hoback,
Senior Software Engineer***

88. Corby Hoback, the son-in-law of Defendant Short, joined the Company as a Senior Software Engineer in 2014 (the fiscal year after Defendant Short was hired) and received total compensation of approximately \$470,000 in 2014; \$282,000 in 2015; \$286,000 in 2016; \$282,000 in 2017; and, for some undisclosed purpose, received an additional \$84,300 in options and \$81,000 in stock awards in February 2018.⁸⁷

89. For 2018, Corby received an aggregate of \$239,324 in the form of salary and bonus, \$113,425 in the form of option grants and \$107,666 in the form of stock awards, for total compensation in excess of \$460,000.⁸⁸ For 2019, Corby received an aggregate of \$174,811 in the form of salary, \$58,425 in the form of option grants and \$50,915 in the form of stock awards, for total compensation in excess of \$280,000.⁸⁹ Currently, the national average total compensation for a Senior Software Engineer is approximately \$140,000; for companies with 50 or less

⁸⁷ See 2015 Proxy at 35; 2016 Proxy at 36; 2017 Proxy at 49; 2018 Proxy at 35.

⁸⁸ See 2018 Proxy at 36.

⁸⁹ 2020 Proxy at 31.

employees, the average total compensation is approximately \$120,000, with a reported high of approximately \$180,000.⁹⁰

90. Even though all of the insider children are purportedly employed to work on the GABRIEL product line (which, as described here, is virtually nonexistent in terms of revenue generation), and were collectively paid nearly \$1 million in 2019, the Company includes risk disclosures indicating that it has “limited technical resources” and “a small technical team, which may limit [its] ability to rapidly adapt [its] product to customer requirements or add new product features to maintain [its] competitive edge and drive adoption.”⁹¹

F. The VirnetX Board and Board Committees

91. The Board is comprised of just five members, including three purportedly independent directors (Michael Angelo, Gary Feiner and Thomas O’Brien) and Larsen and Short (two out of VirnetX’s three executive officers).⁹² All three Board Committees are comprised of Defendants Angelo, Feiner and O’Brien, with each of them chairing one of the Committees and serving as members of the

⁹⁰ See Glassdoor.com, Senior Software Engineer Salaries, available at https://www.glassdoor.com/Salaries/senior-software-engineer-salary-SRCH_KO0,24.htm.

⁹¹ See 2018 Proxy, at 19.

⁹² See 2020 Proxy at 12.

other two.⁹³ Notably, since Feiner joined the Board in 2014 and was elected Chairman of the Compensation Committee in 2015, the Chairmanships of the three Board Committees has stayed exactly the same. Despite the identical composition and homogeneity of each Committee, and the lack of any other independent directors on the Board, the Committees each purportedly have discreet responsibilities, processes and procedures. Larsen regularly sits in on committee meetings.

92. Given the identical composition, it is impossible for each of the committees to act independently from the other. Indeed, internal documents reveal that [REDACTED]

[REDACTED]⁹⁴

Nominating and Corporate Governance Committee

93. Defendants Angelo, Feiner and O'Brien comprise the Nominating and Corporate Governance Committee, with Mr. Angelo serving as the chairman. The Committee met two times during fiscal 2018 and its responsibilities include:

- assisting the Board in identifying prospective director nominees and recommending to the Board director nominees for each annual meeting of stockholders, vacancy, or newly created director position;

⁹³ *Id.* at 12.

⁹⁴ *See, e.g.*, VHC 00001 [REDACTED]; VHC 00008 [REDACTED]; VHC 00014, 18; VHC 00022, 30, 39; VHC 00204, 207, 211; VHC 00220, 226; VHC 00342, 348, 356.

- providing oversight with respect to corporate governance and ethical conduct;
- developing and recommending to the Board the Code of Ethics and assessing such Code of Ethics and recommending changes; and
- delegating such of its authority and responsibilities as it deems proper to members of the nominating and governance committee or a subcommittee thereof.⁹⁵

Audit Committee

94. Defendants Angelo, Feiner and O'Brien also comprise the Audit Committee, with Mr. O'Brien serving as the chairman. The Committee met five times during fiscal 2018 and its responsibilities include:

- appointment of and approval of compensation for our independent public accounting firm and overseeing its performance and independence;
- overseeing our accounting and financial reporting processes;
- overseeing the audits of our financial statements;
- overseeing the effectiveness of our internal controls over financial reporting; and
- preparing the audit committee report that the SEC requires in our annual proxy statement.⁹⁶

⁹⁵ See 2020 Proxy at 12.

⁹⁶ *Id.* at 14.

95. In addition to the foregoing, the Audit Committee is responsible for reviewing and approving in advance any proposed related person transactions.⁹⁷ The Audit Committee supposedly reviews any such proposed related person transactions on a quarterly basis, or more frequently as appropriate.⁹⁸ In cases in which a transaction has been identified as a potential related person transaction, management must present information regarding the proposed transaction to the Audit Committee for consideration and approval or ratification.⁹⁹ The Audit Committee is also responsible for reviewing the Company's policies with respect to related person transactions and overseeing compliance with such practices.¹⁰⁰

96. Defendant Feiner does [REDACTED]

[REDACTED]¹⁰¹

97. Defendant Angelo also [REDACTED]

[REDACTED]¹⁰²

⁹⁷ *Id.* at 30.

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *See, e.g.*, VHC 01012-41 [REDACTED]

¹⁰² *See, e.g.*, VHC 01042-71 [REDACTED]

98. And, as noted above, Larsen was permitted to [REDACTED]

[REDACTED]¹⁰³

99. Defendants Angelo, Feiner, and O'Brien comprise the Compensation Committee with Mr. Feiner serving as the chairman. The Committee met six times during fiscal 2018.¹⁰⁴ VirnetX's Compensation Committee's responsibilities and primary processes for establishing and overseeing executive compensation include, among other things:

- exclusive authority to determine the amount and form of compensation paid to the Company's Chief Executive Officer;
- determining the amount and form of compensation paid to the Company's executive officers, officers, employees, consultants and advisors;
- administering VirnetX's equity incentive plans;
- engaging, compensating and terminating compensation consultants, legal counsel and such other advisors to assist the compensation committee;
- reviewing and discussing with management Company's proposed disclosure under "Compensation Discussion and Analysis" as set forth in Regulation S-K and recommending to the Board whether such disclosure should be included in the Company's public filings;
- preparing the compensation committee report that the SEC requires in VirnetX's annual proxy statement; and

¹⁰³ See VHC 00001, 22, 165, 204, 215, 342.

¹⁰⁴ 2020 Proxy at 15.

- making regular reports to the Board with respect to significant actions and determinations made by the compensation committee.¹⁰⁵

100. Nevertheless, Defendant Larsen “generally attends compensation committee meetings *and makes recommendations to [the VirnetX] compensation committee regarding the amount and form of the compensation* of the other executive officers [*i.e.* Defendant Short, and Mrs. Larsen] *and key employees.*”¹⁰⁶

101. Incredibly, VirnetX’s Compensation Committee (which is composed of the Company’s three non-employee directors) is even responsible for recommending the compensation of its own members, which is then established by the five-person Board.¹⁰⁷

102. Belying any claim of independence, and unequivocally demonstrating their unfailing loyalty to Larsen, the Compensation Committee rationalized raising Larsen’s salary in early June 2017 because he “helped drive significant growth in our revenues and market capitalization, as well as achievement of our operational

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* at 16 (emphasis added).

¹⁰⁷ *See* 2019 Proxy at 16 (VirnetX’s “[n]on-employee directors’ compensation is established by the Board upon the recommendation of our compensation committee.”).

and strategic milestones.”¹⁰⁸ However, as noted herein, as of June 2017, including at least the preceding six years (and through at least the end of fiscal 2019) VirnetX had not generated any material revenue and, but for additional share issuances, had continuously burned through its market capitalization. Larsen most certainly did not drive ‘significant growth’ in VirnetX’s revenues.

103. Additionally, the compensation committee not only approved the June 2, 2017 disloyal grants of stock options and restricted stock units to Larsen, Short and Nance, they also purportedly approved the nearly 1,000,000 additional stock option to Short on September 14, 2017, which appears to have been done at Larsen’s direction in order to placate Short for any misgivings he may have had concerning the artificial price inflation injected into the market following the announcement of the PITA Transactions and his inability to exercise his then-recently expired options without calling attention to himself.¹⁰⁹

G. The Aircraft Lease with K2 Investment Fund LLC

104. Beginning in 2014, the Company leased the use of an aircraft from K2 Investment Fund LLC (“K2”) purportedly for employee business travel.¹¹⁰

¹⁰⁸ *Id.*

¹⁰⁹ *See* 2018 Proxy, at 27.

¹¹⁰ *Id.* at 31.

Defendant Larsen and Mrs. Larsen are the sole member-managers and control the equity interests of K2.¹¹¹ The respective agreements with K2 were approved by the Audit Committee.¹¹²

105. During fiscal 2019, the Company purportedly spent approximately \$1.79 million in rental fees for the use of the Larsens' aircraft. During fiscal 2018, with just 21 employees – and while the Company was losing money – the Company paid approximately \$1.59 million in rental fees to Larsen and his wife, via K2, indicating approximately 200 hours of use in 2018.¹¹³ Similarly, in fiscal 2017, the Company paid approximately \$1.24 million in rental fees to the Larsens for approximately 155 hours of use.¹¹⁴ The rate and fees paid to the Larsens for the use of the aircraft have steadily increased since the first Aircraft Lease Agreement was executed in 2014 through fiscal 2019.

106. Moreover, the Company has failed to detail exactly who uses the aircraft, how often, and for what purposes. VirnetX has few customers from which it generates little income. The Larsens have a residence in Aptos, California, which is over a four-hour drive from the Company's office. It would seem to be a

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *See id.*

¹¹⁴ *See* 2018 Proxy, at 35.

reasonable inference that most if not all of the aircraft travel paid for by the Company involves the Larsens' personal travel and occasional, excessively costly, commutes between their home in California and the Company office in Nevada.

DEMAND FUTILITY ALLEGATIONS

107. The Board is comprised of exactly five directors. Two of the directors, Defendants Larsen and Short, are executives of the Company and therefore are not independent for the purposes of demand futility. Moreover, both Defendants Short and Larsen have abused their roles as fiduciaries of the Company to secure the employment of their family members at VirnetX in unnecessary roles and at grossly unfair terms.

108. The Board has for years allowed rampant self-dealing and nepotism at the Company. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

109. Demand upon the Board members is excused because they face a substantial likelihood of liability for breaching their fiduciary duties to the Company.

¹¹⁵ VHC 01077.

110. The Board members owe VirnetX and its stockholders the utmost fiduciary duty of loyalty. In violation of this duty (i) on June 1, 2017, during the six day period that the Director Defendants delayed the disclosure of PITA Agreements with the SEC, all the Director Defendants, acting on the recommendation of the Compensation Committee, awarded the non-executive directors underpriced stock and option awards with fair values and strike prices that were unaffected by the imminent price inflation to VirnetX's stock price that was about to occur once the PITA Agreements were digested by the market; and (ii) on June 2, 2017, after personally receiving spring loaded option and stock awards, Defendants Angelo, Feiner, and O'Brien (acting as members of the Compensation Committee), approved new grants of similarly underpriced equity awards to Larsen, Short, and members of their immediate families. These awards were made while the Board was aware that the market had not yet digested the PITA Agreements due to the six-day delay in disclosure to the SEC. For this additional reason, demand is futile as to the entire Board. Accordingly, demand is futile, and thus, excused.

111. Moreover, Defendants Larsen and Feiner have a longstanding relationship which predates Feiner's 2014 appointment to the Board by at least several years. Defendant Feiner has served as the President of Feiner Financial since 1990. Feiner Financial, which was founded in 1977, holds itself out as "an accounting and financial planning services company." Upon information and belief,

Feiner and Larsen had a preexisting business relationship prior to Weiner's appointment to the Board. For example, in early 2011 Larsen and his wife purchased a lakefront house in Zephyr Cove, Nevada for \$6 million. A deed for this purchase states that tax documents related to the transaction are to be mailed to Gary Weiner of Weiner Financial. Thus, prior to his appointment to the VirnetX Board, Weiner appears to have been Larsen's financial planner and was entrusted by the Larsens to manage a \$6 million asset on their behalf. Thereafter, Larsen facilitated Weiner's appointment to the Board in 2014. The appointment has been particularly lucrative for Weiner who has so far been paid more than \$793,000 for serving on the Board, an amount that is material to Weiner. Given the foregoing mutually beneficial business relationships that have been ongoing for years, and their affinity for one another, Defendants Larsen and Weiner are incapable of impartially considering a demand to sue each other. Further, there is reasonable doubt that they could impartially consider a demand to sue the remaining Director Defendants because the misconduct undertaken by those individuals is substantially similar to their own (and each other's) misconduct. Accordingly, any suit against those individuals would necessarily implicate and expose themselves and each other to liability.

CAUSES OF ACTION

COUNT I AGAINST THE DIRECTOR DEFENDANTS FOR BREACH OF FIDUCIARY DUTIES

112. Plaintiff incorporates by reference and realleges each and every allegation contained above, as though fully set forth herein.

113. The Director Defendants owed and owe VirnetX fiduciary obligations. By reason of their fiduciary relationships, the Director Defendants must exercise candor, good faith, care, and loyalty in the management and administration of VirnetX's business and affairs.

114. The Director Defendants violated and breached their fiduciary duties of loyalty and care by putting the interest of company insiders ahead of the long-term interests of the Company by issuing the underpriced equity awards and approving the other self-interested equity arrangements complained of herein. In breach of their fiduciary duties to VirnetX, these Director Defendants caused the Company to expend unnecessarily its corporate funds rendering them personally liable to the Company.

115. As a direct and proximate result of the Director Defendants' failure to perform their fiduciary obligations, VirnetX has sustained significant damages. As a result of the misconduct alleged herein, the Director Defendants are liable to the Company.

116. Plaintiff on behalf of VirnetX, has no adequate remedy at law.

**COUNT II
AGAINST THE DIRECTOR DEFENDANTS**

FOR WASTE OF CORPORATE ASSETS

117. Plaintiff incorporates by reference and reallege each and every allegation contained above, as though fully set forth herein.

118. As detailed above, in approving the underpriced options, the Director Defendants diverted corporate assets for improper and unnecessary purposes while receiving no benefit for VirentX in exchange. Any purported benefits received by the Company cannot reasonably be viewed as a fair exchange for the corporate assets and monies expended by VirentX.

119. The Director Defendants wasted VirentX's corporate assets by agreeing to the underpriced options while wrongfully delaying SEC disclosures regarding the PITA Agreements. The Director Defendants agreed to the underpriced options not for any legitimate business purpose, but to further their own self interests.

120. No person of ordinary, sound business judgment would view this exchange of consideration as fair or reasonable.

121. As a result of this waste of corporate assets, the Director Defendants are liable to the Company.

122. Plaintiff, on behalf of VirnetX, has no adequate remedy at law.

COUNT III AGAINST THE DIRECTOR DEFENDANTS FOR UNJUST ENRICHMENT

123. Plaintiff incorporates by references and reallege each and every allegation contained above, as though fully set forth herein.

124. By their breaches of fiduciary duty, as set forth above, the Director Defendants were unjustly enriched at the expense of and to the detriment of VirnetX, in the form of the equity compensation they received, at the expense of and to the detriment of VirnetX.

125. Plaintiff, as a stockholder and representative of VirnetX, seeks restitution from the Director Defendants, and each of them, and seeks an order of this Court disgorging all profits, benefits, and other compensation obtained by these Director Defendants, and each of them, from their wrongful conduct and fiduciary breaches.

126. Plaintiff has no adequate remedy at law.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff demands judgment as follows:

A. Against all the Director Defendants for the amount of damages sustained by the Company as a result of the Director Defendants' breaches of fiduciary duty and corporate waste;

B. Directing the Board to take all necessary actions to reform and improve its corporate governance and internal procedures to comply with applicable laws and

to protect VirnetX and its stockholders from a repeat of the damaging events described herein;

C. Extraordinary equitable and injunctive relief as permitted by law, equity, and state statutory provisions sued hereunder, including attaching, impounding, imposing a constructive trust on, or otherwise restricting the proceeds of the Director Defendants' trading activities or their other assets so as to assure that Plaintiff, on behalf of VirnetX, has an effective remedy;

D. Awarding to VirnetX restitution from the Director Defendants, and each of them, and ordering disgorgement of all profits, benefits, or other compensation obtained by the Director Defendants;

E. Awarding to Plaintiff the costs and disbursements of the action, including reasonable attorneys' fees, costs, and expenses; and

F. Granting such other and further relief as the Court deems just and proper.

HEYMAN ENERIO
GATTUSO & HIRZEL LLP

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Dated: October 16, 2020

CERTIFICATE OF SERVICE

I, Kurt M. Heyman, hereby certify that on October 16, 2020, copies of Plaintiff's Verified Amended Stockholder Derivative Complaint for Breach of Fiduciary Duty, Unjust Enrichment, and Waste of Corporate Assets were served upon the following Counsel:

Brad Sorrels, Esq.
Andrew Cordo, Esq.
Andrew Berni, Esq.
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Wilmington, DE 19801

/s/ Kurt M. Heyman
Kurt M. Heyman (# 3054)