SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

IN RE COMVERSE TECHNOLOGY, INC. DERIVATIVE LITIGATION	**MEMORANDUM OF LAW IN SUPPORT OF COMVERSE TECHNOLOGY, INC.'S MOTION TO DISMISS FOR FAILURE TO MAKE A DEMAND** Index No. 601272/2006 Justice Richard B. Lowe, III IAS Part 56

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Introduction

The Derivative Plaintiffs claim they may bring this action without a prior demand on the Board of Directors because such a demand would be futile. The Board's actions, however, show that this claim is without merit. After questions first surfaced as to whether employee stock options had been backdated improperly, the Board promptly created a Special Committee of two non-management directors to investigate and to take all appropriate action in response to any wrongdoing discovered. Within days, the Special Committee obtained key admissions from the Chief Executive Officer (a founder of the company), Chief Financial Officer, and Senior General Counsel. In less than two months, it secured their resignations and, shortly thereafter, revoked all their vested and unvested unexercised options, restricted stock, and other equity compensation. Throughout, the Special Committee shared the information it uncovered with the United States Securities and Exchange Commission and the United States Attorney for the Eastern District of New York, which, respectively, used that information to file civil and criminal charges against the three former executives. More recently, the Board has elected six new directors with no prior ties to the company, and four of those new Board members have joined the Special Committee.

It is black letter law that a corporation's board, not its shareholders, has the power to decide whether and how to pursue the corporation's legal remedies. Therefore, before commencing derivative litigation, shareholders ordinarily must demand that the board take action, and that requirement is excused only in rare cases where a demand would be "futile." Nonetheless, only a month after the Special Committee began its investigation, various shareholders sought to usurp its authority by filing derivative lawsuits purportedly for the benefit of the corporation. Ironically, the current amended Complaint quotes extensively from an FBI affidavit and an SEC complaint that are based on evidence gathered by the Special Committee, while at the same time claiming it would have been "futile" to demand that the Special Committee and the Board protect the company's interests.

The actions described above amply demonstrate that the Board and Special Committee took extremely vigorous action to address stock option issues. Indeed, if this Special Committee and this Board are not impartial and disinterested for demand futility purposes, then it is scarcely possible to imagine how such bodies ever could be. Accordingly, the Complaint should be dismissed pursuant to CPLR § 3211(a)(3), CPLR § 3211(a)(7), and/or BCL § 626(c), and the Special Committee should be permitted to continue to exercise its business judgment concerning appropriate steps to be taken to obtain redress for the corporation.

Factual Background

On March 10, 2006, the Board of Nominal Defendant Comverse Technology, Inc. ("Comverse" or "CTI") created the Special Committee to investigate all issues relating to Comverse's historical stock option grants (¶¶ 144, 149),[1] and delegated to that committee the power to take all actions necessary to deal with any issues it discovered. The Special Committee's members – Raz Alon and Ron Hiram – were from outside the company and never received backdated options. <u>See</u> <u>infra</u> pp. 5-6. Independent counsel was promptly retained, and within days the Special Committee secured admissions from the most senior officers of the company – CEO Kobi Alexander, CFO David Kreinberg, and Senior General Counsel William Sorin (two of whom had unsuccessfully urged that independent counsel not be hired) (¶ 143). For example, "[i]n a March 16, 2006 interview with the Special Committee, Alexander admitted that option grants were backdated to dates before" approval for such grants was obtained from the Compensation Committee, as required by the company's employee stock option plans.

[1] All citations to the Consolidated and Amended Shareholder Derivative Complaint ("Complaint"), a copy of which appears as Exhibit ("Ex.") 1 of the Affirmation of Eric A. Bensky ("Aff.") filed herewith, will appear as "¶ __."

(¶ 150; see also ¶ 152.) Likewise, Kreinberg admitted during his interview with the Special Committee that he began participating in the backdating of options in 1998, and that "Alexander and he would discuss which dates would be good option grant dates and advised Sorin of their chosen dates." (¶ 153; see also ¶ 154.) During Sorin's March 23, 2006 interview with the Special Committee, he ultimately "admitted that, in hindsight, 'maybe' disclosure to the Compensation Committee was not proper." (¶ 157.)

On April 17, 2006, Comverse announced that the Special Committee had reached a preliminary conclusion that the company would need to restate certain of its financial statements,[2] and, by May 1, the Special Committee had secured the resignations of Alexander, Kreinberg, and Sorin from their officer and director positions (¶¶ 12, 14, 21, 160), essentially eliminated their salaries, and suspended their rights to receive equity or incentive compensation, to exercise vested options, and to have options vest.[3] In fact, the Complaint acknowledges the Special Committee's prompt results by quoting from a May 6, 2006 Wall Street Journal article observing that Comverse, "for one, acted swiftly. Within days of beginning a probe led by outside directors, it said it would probably have to restate results. Within weeks, the investigation led to the resignation of Kobi Alexander, who founded Comverse more than two

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[2] See Comverse SEC Form 8-K filed Apr. 17, 2006, available at <http://www.sec.gov/Archives/edgar/data/803014/000090951806000421/mv4-17_8k.txt>. The Court may consider publicly available SEC filings when ruling on a motion to dismiss. See Levin v. Kozlowski, No. 602113/02, 2006 WL 3317048, at *2 n.1 (N.Y. Sup. Ct. Nov. 14, 2006) (citing Gibraltar Steel Corp. v. Gibraltar Metal Processing, 19 A.D.3d 1141, 1142 (4th Dept. 2005)). For the convenience of the Court, a copy of the cited filing appears at Aff. Ex. 2, and a copy of the Levin case appears at Aff. Ex. 3.

[3] See Comverse SEC Form 8-K filed May 4, 2006, available at <http://www.sec.gov/Archives/edgar/data/803014/000090951806000467/mv5-4_8k.txt> (Aff. Ex. 4).

decades ago and built it into a major supplier of voice-messaging software and other products. Two other executives also resigned." (¶ 161.)[4]

On August 9, 2006, the United States Securities and Exchange Commission ("SEC") announced the filing of civil charges, and the Department of Justice announced the filing of criminal charges, against the company's three principal officers. (¶¶ 164-65; see also ¶¶ 12, 14, 21.) Deputy Attorney General Paul McNulty, whose congressional testimony Derivative Plaintiffs quote in the Complaint (see ¶ 172), explicitly credited Comverse's cooperation for allowing the government to bring charges quickly.[5]

A week later, Comverse announced that, in accordance with determinations of the Special Committee, the company was providing notice to Alexander, Kreinberg, and Sorin "terminating all prior employment or similar agreements or arrangements with the company . . . and revoking any and all vested and unvested unexercised options, restricted stock and any other equity compensation previously granted." (¶ 167.) Comverse further announced that it would not make "any severance or other payments to" Alexander, Kreinberg, or Sorin, and that it would "pursue rights and remedies against them in respect of their acts or omissions relating to stock

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4 A subsequent Wall Street Journal article echoed that point, reporting that the criminal charges "rested on information from [the Special Committee's] lawyers," who "kept government officials informed every step of the way." James Bandler and Kara Scannell, Legal Aid: In Options Probes, Private Law Firms Play Crucial Role, Wall St. J., Oct. 28, 2006, at A1 (Aff. Ex. 5).

5 See Transcript of Press Conference Regarding the Indictment of Three Former Comverse Technology Executives (Aug. 9, 2006, posted Aug. 10, 2006), available at <http://www.usdoj.gov/dag/speech/2006/dag_speech_060810.htm> ("In this particular case, we also had the added benefit of cooperation. If you look at some of the dates in here, you'll note that this conduct became known only in March of this year, and here we are today in early August. So you see that a great deal has been accomplished in a relatively short period of time, and that's attributable to the fact that we got good cooperation from Comverse and the assistance that companies often provide in bringing information to light that they have found through their efforts, and we see this operating here. [¶] And so that helped get sufficient information faster, and that's the kind of cooperative approach that we really seek from corporations. . . . And I hope we see more of that in the cases to come.") (Aff. Ex. 6).

option grants." (Id.) Additionally, in July and November 2006, the Board recruited and elected no fewer than six new members who had no prior affiliation with the company.[6]

Nevertheless, on April 11, 2006, a month after the Board created the Special Committee, co-lead plaintiff Sollins filed the first of several derivative complaints against Alexander, Kreinberg, Sorin, and a number of other current and former officers and directors, as well as Comverse's auditor. The Complaint alleges that it was Comverse "executives [who] caused the Company to engage in an undisclosed and illicit scheme to backdate the grant dates of the stock options" (¶ 4; ¶¶ 1, 61 (emphasis added)) from 1991 through 2001 (¶¶ 50, 60-102), and it acknowledges that the Compensation Committee members did not intend to grant in-the-money options (¶ 209(c)(iv)), but were deceived by company executives (¶¶ 112, 114, 115, 209(f)(iii), 209(f)(iv)).

The Complaint admits that no demand was made on Comverse's Board (¶ 207), which, at the time of the first complaint, consisted of three inside or employee directors – Alexander, Sorin, and Itsik Danziger – and four outside directors who held no other positions with the company ("Outside Directors") – John Friedman, Sam Oolie, Hiram, and Alon. The Complaint does not and could not identify a single backdated option received by any Outside Director (see ¶¶ 62, 65, 69, 72, 76, 80, 86, 91, 128) and it expressly acknowledges that Alon "was not a recipient of backdated options" (¶ 30; see also ¶ 208(c)). Moreover, the Special Committee, which would have considered any demand, then included Hiram, who did not

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6 See Comverse SEC Form 8-K filed Aug. 2, 2006, available at <http://www.sec.gov/Archives/edgar/data/803014/000090951806000733/mm8-0206_8k.txt> (Aff. Ex. 7); Comverse SEC Form 8-K filed Nov. 22, 2006, available at <http://www.sec.gov/Archives/edgar/data/803014/000090951806001073/mm11-2206_8k.txt> (Aff. Ex. 8); Comverse SEC Form 8-K/A filed Dec. 15, 2006, available at <http://www.sec.gov/Archives/edgar/data/803014/000090951806001179/mm12-1506_8ka.txt> (Aff. Ex. 9).

become a Comverse director until June 2001 (¶ 15), and Alon,[7] who became a director in December 2003 (¶ 30) and "was neither a director nor employee of CTI or any of its subsidiaries and/or affiliates during the time when backdated options were granted" (id.). Nor did Derivative Plaintiffs make a demand before filing their consolidated amended complaint in September 2006, even though, by that time, the Special Committee, whose investigation continues, consisted exclusively of directors who joined the Board well after the last backdated options had been granted.[8]

Argument

Under the law of New York,[9] "the business of a corporation shall be managed under the direction of its board of directors." N.Y. Bus. Corp. L. § 701. This includes decisions as to how best to pursue legal remedies for the corporation. See, e.g., Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 95 (1991) (explaining that it is a "basic principle of corporate governance" that "decisions of a corporation – including the decision to initiate litigation – should be made by the board of directors"); Auerbach v. Bennett, 47 N.Y. 2d 619, 631 (1979) (explaining that "claims against corporate directors belong to the corporation itself. As with other questions of corporate policy and management, the decision whether and to what extent to explore and prosecute such claims lies within the judgment and control of the corporation's board of directors"). Accordingly, the Court of Appeals has "historically been reluctant to permit shareholder derivative suits," as, "[b]y their very nature, shareholder derivative actions infringe upon the

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7 See Comverse SEC Form 8-K filed Apr. 13, 2006, available at <http://www.sec.gov/Archives/edgar/data/803014/000090951806000416/mv4-13_8k.txt> (Aff. Ex. 10).

8 See Comverse SEC Form 8-K filed Aug. 2, 2006.

9 Questions of standing in shareholder derivative litigation are determined according to the law of the state of incorporation, see Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 98-107 (1991), and Comverse is a New York corporation.

managerial discretion of corporate boards." Marx v. Akers, 88 N.Y.2d 189, 194 (1996). The policy behind this reluctance is that:

> Necessarily such decisions must be predicated on the weighing and balancing of a variety of disparate considerations to reach a considered conclusion as to what course of action or inaction is best calculated to protect and advance the interests of the corporation. This is the essence of the responsibility and role of the board of directors, and courts may not intrude to interfere.

Auerbach, 47 N.Y.2d at 631.

To effectuate those policies, N.Y. Bus. Corp. L. § 626(c) requires that, in any derivative action, "the complaint shall set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the board or the reasons for not making such effort." Courts excuse a failure to make demand only in rare circumstances, and only "when a complaint alleges with particularity" facts establishing futility. Marx, 88 N.Y.2d at 200-01. As courts throughout the country have recognized, this "is not merely a technical pleading hurdle." In re BankAmerica Sec. Litig., 636 F. Supp. 419, 420 (C.D. Cal. 1986). Rather, it "is a rule of substantive right designed to give a corporation the opportunity to rectify an alleged wrong without litigation, and to control any litigation which does arise." Aronson v. Lewis, 473 A.2d 805, 809 (Del. 1984). Here, the Board's actions demonstrate that a demand would not have been futile.

I. THE BOARD'S AND SPECIAL COMMITTEE'S ACTIONS OVERWHELMINGLY DEMONSTRATE THEIR ABILITY TO CONSIDER IMPARTIALLY A PRE-SUIT DEMAND.

As described above, nearly a month before this case was filed, the Board created the Special Committee, which immediately began investigating Comverse's stock option grants and continuously cooperated with the investigations commenced shortly thereafter by the SEC and U.S. Attorney's Office. Indeed, the Complaint chiefly relies on the SEC's August 9 complaint ("SEC Complaint") (see ¶ 46 n.2; ¶¶ 50, 51, 52, 53, 54, 55, 56, 57, 58, 59, 63, 66, 70, 73, 77, 78, 82, 85, 87, 90, 91, 93, 96, 109, 110-24, 139-42, 209) and on the affidavit the U.S. Attorney's Office filed in support of arrest warrants for Alexander, Kreinberg, and Sorin ("FBI Affidavit") (see ¶ 57 & n.4; ¶¶ 58, 73, 77, 78, 82, 87, 97, 98, 100, 101, 109, 110-15, 117-19, 122, 129-39, 141-43, 145-48, 150-54, 156, 157, 209, 210), which, in turn, are principally based on information the Special Committee provided to the government. (See, e.g., FBI Affidavit at 5 & n.3, 46 n.49 (Aff. Ex. 11).) The Special Committee quickly secured the resignations of Alexander, Kreinberg, and Sorin from their positions as CEO, CFO, and Senior General Counsel, respectively, as well as from the Board, and soon thereafter revoked their vested and unvested unexercised options, restricted stock, and other equity compensation and announced that the company would pursue its rights against them.[10]

The law is that such actions demonstrate independence and defeat demand futility arguments. Most recently, for example, the board of directors of the Red Robin restaurant chain initiated an internal investigation to look into claims that its Chairman/President/CEO had used the company's airplane and other assets for personal use. Andropolis v. Snyder, Civil Action No. 05-cv-01563-EWN-BNB, et al., 2006 WL 2226189, at *2 (D. Colo. Aug. 3, 2006) (Aff. Ex. 12). When the investigation revealed improprieties, the company forced the CEO to reimburse the company and resign from his executive positions while remaining as a consultant. Id. The court rejected the plaintiff's demand futility arguments, explaining that it was "difficult to conceive that a majority of the Board was so 'beholden' to [the CEO], yet they were able to initiate an internal investigation and force [his] retirement." Id. at *9; see also In re Ferro Corp. Derivative Litig., Case No. 1:04CV1626, 2006 U.S. Dist. LEXIS 11608, at *18-*19 (N.D. Ohio

[10] Thus, the Board's and Special Committee's actions stand in stark contrast to those in Bansbach v. Zinn, 1 N.Y. 3d 1 (2003), where, notwithstanding the Chairman/CEO's admission in open court that he had implicated the corporation in his criminal conduct, the board elected to indemnify and reimburse his legal expenses from a criminal investigation and prosecution that resulted in his guilty plea for misusing the corporation's funds.

Mar. 21, 2006) (rejecting demand futility argument where "the facts illustrate the individual Defendants have not been inactive. Indeed, they commenced an independent investigation utilizing outside firms and restated quarterly reports.") (Aff. Ex. 13); Kanter v. Barella, 388 F. Supp. 2d 474, 481 (D.N.J. 2005) (rejecting demand futility argument where "the Directors responded appropriately to allegations . . . by ordering an independent review of the Company's billing practices" and by taking disciplinary action against five employees found to have engaged in unlawful billing practices, and observing that the board's actions "painted a picture of a board of directors that acted responsively given the circumstances").

Courts normally consider whether indicators of futility are present, in an effort to predict whether demand would be futile, but where, as here, the actions of the Special Committee and the Board show they are actively engaged in protecting the company, the Court need go no further. Based on those actions alone, the only possible conclusion is that demand would not be futile.

II. DERIVATIVE PLAINTIFFS' ASSERTED GROUNDS FOR DEMAND FUTILITY ARE MERITLESS.

Derivative Plaintiffs organize their futility argument according to the test outlined in Marx v. Akers, 88 N.Y.2d 189 (1996), which, importantly, did not involve proactive board or special committee action such as that present in this case.[11] In Marx, the plaintiffs alleged demand should be excused because the director defendants had voted for unreasonably high

[11] In Marx, the Court of Appeals explained that demand is excused because of futility when a complaint alleges with particularity that: (a) "a majority of the board of directors is interested in the challenged transaction," either due to the director's self-interest or due to the director's being "'controlled' by a self-interested director"; (b) "the board of directors did not fully inform themselves about the challenged transaction to the extent reasonably appropriate under the circumstances," based on the "long-standing rule . . . that a director does not exempt himself from liability by failing to do more than passively rubber-stamp the decisions of the active managers"; or (c) "the challenged transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors." Marx, 88 N.Y.2d at 200-01 (citations and internal quotation marks omitted).

compensation received by certain corporate executives. The Court affirmed a dismissal for failure to make a demand because "[a] board is not interested in voting compensation for one of its members as an executive or in some other nondirectorial capacity," and the allegations that the board used "faulty accounting procedures" did not "move beyond conclusory allegations of wrongdoing which are insufficient to excuse demand." Id. at 201-02. Similarly, the Outside Directors here are not "interested" in option grants that they themselves did not receive, and there are no particularized allegations that the Outside Directors participated in the accounting errors described in the Complaint. Thus, as explained below, even if the Board and Special Committee had not already demonstrated their independence through their actions, the Complaint's asserted bases for demand futility still would fail because the alleged grounds for futility that Plaintiffs assert are not present here.

A. The Outside Directors Were Not Interested.

None of Derivative Plaintiffs' various arguments as to why a majority of the Board was interested has merit. First, several of Plaintiffs' futility allegations relate only to directors Alexander, Sorin, and Danziger (¶ 208(a-b, h, j)), whom Comverse does not contend are part of the disinterested majority of the Board.[12]

Second, noting that the FBI Affidavit states that every company-wide grant of stock options between 1998 and 2001 was backdated, Plaintiffs conclude that, "[t]herefore, it is likely that every member of the CTI board of directors, except for Director Alon . . . holds backdated options." (¶ 208(c) (emphasis added).) But Plaintiffs never allege – and could not allege – that

[12] Though Danziger is alleged to have been an employee of Comverse (¶ 16), the Complaint's only allegation as to his supposed interest is that he received and profited from backdated options (¶ 208(a)). It does not allege that he actively participated in or knew about the backdating. For purposes of this motion to dismiss, however, the Court need not resolve any question as to Danziger's interest or disinterest, both because the disinterested Outside Directors themselves comprised a majority of the Board and because both Special Committee members were disinterested.

any Outside Directors received options as part of the company-wide grants. (See ¶¶ 60-89.) The absence of any such particularized allegations is explained by the fact that, as Derivative Plaintiffs know, only employees and employee-directors received backdated stock options,[13] and, by definition, the Outside Directors are not employees or employee-directors.[14] Additionally, the exercise price for director options always was the fair market value of the stock "as of the date two business days after the publication of the audited year-end financial statements."[15] Therefore, director options could not have been backdated.

Third, while the Complaint generally alleges (see ¶ 208(d)) that three of the Outside Directors "personally profited" from backdating "by selling their CTI shares during the relevant period for substantial profits while in possession of materially adverse information," it does not allege the Outside Directors knew of any improper conduct. On the contrary, it alleges that information was concealed from the Compensation Committee members. (See ¶¶ 112, 114, 115, 209(f)(iii), 209(f)(iv).) In any event, a mere allegation that a director is interested simply by

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13 (See ¶ 1 (alleging that the Board breached its fiduciary duties by "allowing and participating in a scheme to backdate the grant dates of employee stock options"); ¶ 46 ("CTI has granted stock options to its employees and employee-directors…." (emphasis added)); see also FBI Affidavit ¶ 32 ("The defendants [Kobi Alexander, David Kreinberg, and William Sorin] repeatedly backdated CTI's annual company-wide option grants to themselves, other executives and employees….").)

14 See, e.g., 2001 Stock Incentive Compensation Plan, Sec. 2 (defining "Employee" as "an officer or other key employee of the Company . . . including a director who is such an employee," and defining "Director" as "each member of the Board who is not an Employee, who does not receive compensation from the Company . . . in any capacity other than as a Director"); 2000 Stock Incentive Compensation Plan, Sec. 2 (same); 1999 Stock Incentive Compensation Plan, Sec. 2 (same); 1997 Stock Incentive Compensation Plan, Sec. 2 (same); 1996 Stock Option Plan, Sec. 6 (making similar distinction between director and employee); 1995 Stock Option Plan, Sec. 6 (making similar distinction between director and employee). (Copies of the plans, which are referenced in the Complaint (¶¶ 46-49) and publicly filed with the SEC, appear at Aff. Exs. 14-19.)

15 See, e.g., 2001 Stock Incentive Compensation Plan, Sec. 3.2; 2000 Stock Incentive Compensation Plan, Sec. 3.2; 1999 Stock Incentive Compensation Plan, Sec. 3.2; 1997 Stock Incentive Compensation Plan, Sec. 3.2; 1996 Stock Option Plan, Sec. 6; 1995 Stock Option Plan, Sec. 6.

virtue of having sold stock at artificially inflated prices is insufficient to establish director interest. See, e.g., Guttman v. Huang, 823 A.2d 492, 502 (Del. Ch. 2003) ("[I]t is unwise to formulate a common law rule that makes a director 'interested' whenever a derivative plaintiff cursorily alleges that he made sales of company stock in the market at a time when he possessed material, non-public information."). Corporate insiders sell company stock as a matter of course, and such sales are not suspect. See id. Thus, a plaintiff instead must also plead particularized facts showing that the sales resulted from the possession of inside information. See McCabe v. Foley, 424 F. Supp. 2d 1315, 1322 (M.D. Fla. 2006). Here, the Complaint includes no allegations as to the motive for the stock sales. See, e.g., In re Merck & Co., Inc. Derivative & "Erisa" Litigation, Nos. 05 Civ. 1151, 05 Civ. 2368, 2006 WL 1228595, at *11 (D.N.J. May 5, 2006) (holding that, despite outside directors' "substantial" proceeds, plaintiff failed to provide sufficient evidence to excuse demand where he failed (1) to provide particularized facts regarding what percentage of each outside director's overall stock the sales represented, (2) to specify the directors' previous trading practices or whether the company imposed restrictions on the timing of director trading, (3) to allege any particularized facts linking stock sales to specific material, non-public information, and (4) to identify specific dates when two of the outside directors sold) (Aff. Ex. 20).

Fourth, outside business ties, standing alone, are insufficient to impugn a director's independence. See, e.g., Beam v. Stewart, 845 A.2d 1040, 1050 (Del. 2004) ("Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence."). Rather, to render a director unable to consider a demand, "a relationship must be of a bias-producing nature," such that "the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director." Id. at 1050, 1052; see also id. at 1045-46, 1050-54 (holding that three outside directors of Martha Stewart Living who, respectively, had a prior business and current personal relationship with Stewart, had a close personal friendship with Stewart, and had used her position on the board of a publishing house to dissuade it from publishing an unflattering biography of Stewart were not interested so as to excuse demand).

The Complaint here alleges nothing of the sort as to the Outside Directors. All it says is that, long before joining Comverse's Board, Alon and Hiram each worked at Lehman Brothers, which provides some investment banking services to Comverse (¶ 208(f)),[16] and that Hiram, from 1993 until some time before 2005, served as a director for a company for which Alexander served as chairman and that had been founded by two other defendants (S. and Y. Yemini).[17] These allegations are woefully insufficient to establish interestedness. For example, in In re Merck, 2006 WL 1228595, one outside director sat on the board of, and another served as chief executive officer for, an investment bank that served as co-lead underwriter for the nominal defendant's debt offering. Id. at *15. The court held that those relationships did not excuse demand because the plaintiff did not explain how the relationships affected the directors' ability to act independently. Id. at *16. The same is true with even greater force here, where Hiram's and Alon's alleged associations with one of Comverse's investment banks each ended seven years before they joined Comverse's Board,[18] and the Complaint never explains how

[16] (See ¶ 15 (alleging Hiram ceased working at Lehman Brothers in 1994 and did not become a Comverse director until 2001); ¶ 30 (alleging Alon worked at Lehman Brothers until 1996 and did not become a Comverse director until December 2003).)

[17] (See ¶ 208(g) ("Defendant Hiram was appointed a director of System Management ARTS, Inc., also known as 'SMARTS,' which was founded by Defendants S. Yemini and Y. Yemini in 1993. At the same time Defendant Hiram was a director of SMARTS, Defendant Alexander served as chairman of the board of SMARTS. In December 2004, SMARTS was sold to EMC for $260 million in cash and $25 million in options.").)

[18] Moreover, the Complaint does not even specify whether Hiram and Alon worked together at Lehman Brothers or how such former employment would have affected their independence for purposes of pre-suit demand.

Hiram's prior service as a director for another company could have affected his ability to act independently here.

Finally, any suggestion that the Board and Special Committee "failed to immediately take any action" (¶ 208(i)) is laughable, as their prompt actions spurred key resignations and indictments, and are the only reason Derivative Plaintiffs even are aware of the matters that form the basis for the bulk of their allegations. <u>See</u> <u>supra</u> pp. 7-8 (listing Complaint's allegations that rely on SEC Complaint and FBI Affidavit); <u>see also</u> ¶ 6 (admitting that "[t]his scheme came to light on March 14, 2006 when <u>the Company</u> announced that it <u>had created a Special Committee</u> of its Board of Directors to investigate its stock option grants" (emphasis added)). Furthermore, the notion that the Special Committee should not have sought to secure the cooperation of Alexander, Kreinberg, and Sorin after their resignations by retaining them for a brief period as advisors at a nominal salary and acknowledging their past service has no merit. <u>See</u> <u>Andropolis</u>, 2006 WL 2226189, at *9 (rejecting argument that board's retaining disgraced CEO as a consultant supported demand futility). And the fact that no suit has yet been filed by the company is irrelevant to the question of director interest. <u>See, e.g.</u>, <u>Ji v. Van Heyningen</u>, No. 05 Civ. 273, 2006 WL 2521440, at *11 (D.R.I. Aug. 29, 2006) ("[A] failure of the board to sue will always be present in the demand futility context, and it cannot, by itself, indicate interestedness.") (Aff. Ex. 21); ; <u>Kaltman v. Sidhu</u>, No. 03 Civ. 1057, 2004 WL 357861, at *5 (N.D. Tex. Feb. 26, 2004) ("The mere fact that the Board has elected not to sue before the derivative action was filed should not itself indicate 'interestedness.'" (quoting <u>Richardson v. Graves</u>, No. Civ. 6617, 1983 WL 21109, at *3 (Del. Ch. June 17, 1983)) (Aff. Ex. 22). This is particularly true where, as here, the company may well receive significant recoveries without the need for, and the expense of, private litigation, as the law under which the SEC and U.S. Attorney's Office have charged Alexander, Kreinberg, and Sorin allows the government to direct the proceeds it obtains to victims such as Comverse. See, e.g., 18 U.S.C. § 981(e)(6); 18 U.S.C. § 3663(a)(1)(A); 15 U.S.C. § 7246(a).[19]

B. Marx's Second and Third Prongs Do Not Apply Here and Would Not Establish Futility in any Event.

The second and third prongs of Marx, which excuse a demand where the directors acted as a mere "rubber-stamp" or where their actions were so egregious that they could not have been the product of a valid exercise of business judgment, have no applicability here because the Special Committee members who would have considered any demand did not even join the Board until just months before (Hiram) or well after (Alon) the last backdated options were granted. Moreover, these exceptions to the demand requirement cannot apply where directors have been affirmatively misled or have simply failed to act. As to the first, there is no allegation that the Outside Directors knowingly approved backdated options. Rather, as detailed infra, the

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[19] In this regard, it is noteworthy that, this past summer, the United States Attorney's Office obtained an arrest warrant to seize Alexander's brokerage accounts reportedly containing approximately $49 million of assets. See United States v. All Funds on Deposit at: Citigroup Smith Barney Account No. 600-00338 Held in the Name of Kobi Alexander and Citigroup Smith Barney Account No. 600-27694 Held in the Name of Kobi J. Alexander, Amended Warrant for Arrest of Articles In Rem, Civil Action No. 06-CV-3730 (NGG) (RER) (E.D.N.Y. Aug. 17, 2006) (Aff. Ex. 23). In October, Kreinberg pled guilty and consented to the entry of judgment in an action brought against him by the SEC. The criminal violations require restitution, which the government estimates amounts to $51 million, see "David Kreinberg, Former CFO of Comverse Technology Inc., Pleads Guilty to Securities Fraud Charges," Press Release issued by Office of the United States Attorney for the Eastern District of New York (Oct. 24, 2006), available at <http://www.usdoj.gov/usao/nye/pr/2006/2006Oct24a.htm> (Aff. Ex. 24), and the SEC consent includes Kreinberg's promise to pay disgorgement of $2,394,917.68, see Securities and Exchange Commission v. Alexander, et al., No. 06-CV-03844-NGG-RER, Consent of Defendant David Kreinberg (E.D.N.Y. Oct. 18, 2006 (dated); Oct. 24, 2006 (filed)) (Aff. Ex. 25). In November, Sorin likewise pled guilty, and the government estimates his restitution obligation as $51 million as well. See "William F. Sorin, Former General Counsel of Comverse Technology Inc., Pleads Guilty to Securities Fraud Charge," Press Release issued by Office of the United States Attorney for the Eastern District of New York (Nov. 2, 2006), available at <http://www.usdoj.gov/usao/nye/pr/2006/2006Nov02b.htm> (Aff. Ex. 26). More recently, Sorin consented to the entry of judgment against him in the SEC action and promised to pay disgorgement and a civil penalty totaling more than $3 million. See Alexander, No. 06-CV-03844-NGG-RER, Consent of Defendant William F. Sorin (E.D.N.Y. Dec. 22, 2006 (dated); Jan. 10, 2007 (filed)) (Aff. Ex. 27).

allegation is that they allowed themselves to be duped. But, unlike one who affirmatively acts to rubber-stamp self-interested actions by management, or one who knowingly approves obviously inappropriate corporate action, one who learns he has been duped is not likely to ratify or condone wrongful conduct accomplished through such deceit. Certainly, as detailed above, that was not the reaction of the Outside Directors of Comverse. Cf. Rales v. Blasband, 634 A.2d 927, 933-34 (Del. 1993) (ruling that, "[w]here there is no conscious decision by directors to act or refrain from acting," a court should ask what the board would have done if presented with the demand at the time of the complaint). Accordingly, Derivative Plaintiffs' attempts to avoid demand on these grounds are legally irrelevant.

As to a failure to act, courts have not directly addressed the issue under New York law, but courts have explicitly recognized that Delaware law's similar grounds for excusing demand (which are reflected in the second prong of the demand futility test laid out in Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984)), do not apply where the alleged wrong is a failure to act. See, e.g., Spear v. Conway, 800 N.Y.S. 2d 357, 2003 WL 24012118, at *4 (N.Y. Sup. Oct. 17, 2003) (Lowe, J.) ("Where . . . inaction rather than action by a board is charged, the inquiry is limited to the first prong of the Aronson test." (citations omitted)) (Aff. Ex. 28); Seminaris v. Landa, 662 A.2d 1350, 1354 (Del. Ch. 1995) ("the second step of Aronson does not apply where directors are sued for failing to take some action, such as failing to properly supervise the corporation's employees"); id. at 1353-54 (holding that allegations that certain board members signed misleading statements did not trigger second prong of Aronson); see also Fink v. Weill, No. 02 Civ. 10250, 2005 WL 2298224, at *3 n.6 (S.D.N.Y. Sept. 19, 2005) (holding that generalized allegations that directors knew or should have known of illegitimate corporate transactions, participated in them, and did nothing to stop them did not warrant application of the second prong of Aronson) (Aff. Ex. 29).

In any case, the allegations of the Complaint fail to establish passive rubberstamping or egregiousness. First, the allegations with respect to the Compensation Committee (¶ 209(a-g)) affirmatively contradict the notion of passive rubber-stamping, as they acknowledge that company executives recognized the affirmative need to conceal the scheme from the Compensation Committee. (See ¶ 209(f)(iii) & n. 14 (alleging that Alexander and Kreinberg were careful to limit certain of the proposed 1999 grants to "small amounts that would not attract the Committee's attention" so as "to deceive the Compensation Committee" because the executives knew that "members of the Compensation Committee sometimes asked questions of management if an employee whose name the members did not recognize was to receive more than 10,000 options"); ¶ 209(f)(iv) (referring to an additional "act of concealment . . . designed to deceive the Committee"); see also ¶¶ 112, 114, 115.) Similarly, the Complaint admits that the Compensation Committee members acted "in reliance on SORIN" (¶ 209(c)(iv)), the Harvard Law School educated general counsel (¶ 14) who himself owed a professional, as well as fiduciary, duty to Comverse. In any event, the Compensation Committee members have no fear of personal liability because New York's Business Corporations Law and Comverse's Certificate of Incorporation exculpate them from liability for any conduct that does not rise to the level of bad faith or intentional misconduct, which is not alleged here. See N.Y. Bus. Corp. L. § 402(b); Comverse Form 10-K filed Mar. 31, 1995 Ex. 3(A)(2) Art. Sixth, available at <http://www.sec.gov/Archives/edgar/data/803014/0000950130-95-000619.txt> (Aff. Ex. 30).

Second, Derivative Plaintiffs' bare allegations that one former employee claimed Comverse was run by the "Law of Kobi," that another former employee was "familiar" with the expression "Kobi's law," and that Alexander "had complete control of the board and that all members all marched in lockstep with him" (¶ 209(h-i)) do not raise an inference of passive rubber-stamping or otherwise establish demand futility. Mere allegations of domination or control, standing alone, are insufficient to excuse demand, as a derivative plaintiff must plead particularized facts demonstrating that the directors were beholden to the controlling director. See, e.g., Alpert v. Nat'l Assoc. of Securities Dealers, 801 N.Y.S.2d 229, 2004 WL 3270188, at *9 (N.Y. Sup. July 28, 2004) (Lowe, J.) (plaintiffs failed to explain with particularity how two directors were dominated by the alleged controlling director) (Aff. Ex. 31); Spear, 2003 WL 24012118, at *5 (indicating that mere allegations of control are insufficient to demonstrate director control); Aronson, 473 A.2d at 816 ("it is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election"). The Complaint does not come close to meeting that standard, as it is devoid of any well-pleaded facts showing that any of the Outside Directors were "materially dependent on [Alexander's] good graces to make a living or beholden to [him] for any other personal reason." Guttman, 823 A.2d at 503. More fundamentally, Derivative Plaintiffs cannot seriously argue that the Board was controlled by Alexander or beholden to him, Kreinberg, or Sorin, when the Board created and empowered the Special Committee, which secured their resignations, cancelled their unexercised options, obtained admissions from them, and shared their statements with the government, thereby leading to their prosecution. Indeed, the Board got involved and independent counsel was hired despite the protestations of Alexander and Kreinberg. (¶ 143.)

Finally, demand is not excused by virtue of the Complaint's assertion that the backdating was egregious. (¶ 210.) No court has ever excused demand based on the egregiousness prong of Marx. See, e.g., Alpert, at *15 (stating that the Court could not find, and plaintiffs did not cite, "any case where demand was excused because a transaction, of the type [in Alpert], was so egregious on its face that it could not have been the product of sound business judgment"). That is not surprising because such a finding would run the risk of allowing a rare exception to eviscerate the demand rule. The facts here certainly do not support making this the first case to satisfy the egregiousness prong of Marx. Moreover, a ruling that demand was required would merely recognize that the decision of when, how, and whether to seek redress from the responsible parties lies with the Board (through the Special Committee) rather than with individual shareholders.

Conclusion

Though the ordinary rule that corporate decisions are entrusted to a company's board of directors is subject to a very narrow exception for the rare case where a majority of directors have disabling financial conflicts or are otherwise incapable of acting in the best interests of the corporation, this case represents the antithesis of such a situation. None of the Outside Directors who comprised a majority of Comverse's Board and 100 percent of its Special Committee had any financial interest with respect to the options backdating, and those bodies' prompt and dramatic actions when the issue emerged conclusively demonstrate that a demand to take action would not have been futile, as the Board and Special Committee quickly took decisive action even without having received a demand. Indeed, the spuriousness of the Complaint's demand futility argument is exemplified by the fact that it claims the Outside Directors were not independent because they followed the "Law of Kobi" notwithstanding that those same Outside

Directors took the very actions that quickly resulted in Kobi's resignation and indictment. In short, the unusual step of excusing the pre-suit demand requirement imposed by New York law is not justified here, and the Complaint therefore must be dismissed.

Respectfully Submitted,

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By: /s/ Eric A. Bensky________________________

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