To Be Argued By:
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New York Supreme Court

APPELLATE DIVISION—FIRST DEPARTMENT

IN RE: COMVERSE TECHNOLOGY, INC.

DERIVATIVE LITIGATION

BRIEF FOR NOMINAL DEFENDANT-RESPONDENT COMVERSE TECHNOLOGY, INC.

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Questions Presented

(1) Whether the pre-suit demand requirement in a shareholder derivative case would be excused as futile where, by the time the case was filed, the nominal defendant corporation's board of directors had already created a special committee to investigate the underlying wrongdoing, and the special committee had promptly hired independent counsel and accountants, obtained key admissions from the company's three most senior officers, and shared its findings with government regulators, and the company had publicly announced the investigation and the potential need for a restatement of the company's financial statements. The court below correctly ruled that demand would not have been futile.

(2) Whether, for purposes of determining whether the pre-suit demand requirement in a shareholder derivative case would be excused as futile, outside directors are considered interested simply by virtue of having made sales of properly acquired stock at allegedly artificially inflated prices where the derivative plaintiffs failed to allege with particularity that the sales resulted from the possession of inside information, that the directors knew of any improper conduct, or even that the shares had been acquired at prices that were not likewise allegedly artificially inflated. The court below correctly held that the outside directors are not considered interested.

(3) Whether a corporation's statutorily authorized charter provision exculpating its directors from liability for actions short of bad faith or intentional misconduct prevents the corporation's outside directors from having any substantial fear of liability with respect to the transactions that are the subjects of a shareholder derivative complaint where the complaint lacks particularized allegations of reckless, knowing, or intentional misconduct by those directors. The court below did not reach this question, but instead opined only that the business judgment rule did not protect certain outside directors from liability.

Introduction

The Commercial Division of the Supreme Court for New York County dismissed Appellants' shareholder derivative complaint because they failed to make the pre-suit demand required under the state's Business Corporations Law and were not excused from that requirement despite their claims it would have been futile where, before Appellants ever filed suit, the board of directors formed a special committee of two disinterested directors to investigate potential stock options backdating, and, again before the instant case was filed, the committee hired independent counsel and accountants, obtained key admissions from the three most senior officers of the company, shared its findings with government regulators, and publicly announced its investigation and the potential need for a financial restatement. Shortly thereafter, the committee secured resignations from

the officers – the Chairman and Chief Executive Officer, the Chief Financial Officer, and the Senior General Counsel – and stripped them of their vested and unvested compensation. Moreover, the board's and committee's swift actions and cooperation with governmental authorities led to the prompt filing of civil and criminal charges against the former executives and plaudits from the government and the press.

Those actions led the Commercial Division to conclude – correctly – that the derivative plaintiffs had failed to allege with particularity why the very directors who formed the special committee that conducted the investigation, shared its findings with government authorities, and removed the most powerful executives in the company could not have considered fairly a demand to take action against those same executives and/or less prominent individuals. As a result, the decisions as to what further actions to take in light of the committee's findings can remain in the hands of the special committee instead of being usurped by a handful of shareholders (and their counsel) who have no apparent experience in assessing the best interests of the corporation or determining and executing strategies to advance those interests. That result is in full accord with New York law, which gives a corporation's board, not its shareholders, the power to decide whether and how to pursue the corporation's legal remedies, and with the Court of Appeals' self-described reluctance to permit shareholder derivative suits.

Nevertheless, Lead Plaintiffs-Appellants Leonard Sollins and Timothy Hill ("Appellants" or "Derivative Plaintiffs") seek to overturn the Commercial Division's Decision and Order ("Decision") granting the motion to dismiss of Nominal Defendant-Respondent Comverse Technology, Inc. ("Comverse" or "CTI"), but the grounds for reversal advanced in their appeal brief ("Brief" or "Br.") have no merit. First, their argument that the court should not have considered the pre-suit actions of Comverse's board of directors ("Board") and the two-person special committee it created ("Special Committee") conflicts with unanimous case law and the very purpose of the demand requirement by pretending the Court of Appeals' traditional test for predicting how a board would respond to a demand requires one to ignore what a board has actually done in a situation where, as here, the directors' actions make any such prediction unnecessary.

Second, Appellants' characterization of the Special Committee's investigation as a "sham" is demonstrably unfounded when it is undisputed that the pre-filing efforts of that investigation secured confessions that were reported to the government and produced indictments and civil regulatory charges against the company's top executive, top accountant, and top lawyer. In fact, the very allegations for (and the language of) Derivative Plaintiffs' Consolidated and

Amended Shareholder Derivative Complaint ("Complaint") are largely copied from the government's charging papers.

Third, Appellants' claim that outside directors who received none of the intentionally backdated options are interested by virtue of having sold validly acquired shares of stock at prices that, unbeknownst to them, may have been inflated as a result of the backdating finds no judicial support and is entirely too conclusory to meet the particularity requirements of Section 626(c) of the Business Corporations Law.

Finally, Appellants' assertion that the outside directors could not have considered a demand objectively because of a substantial fear of liability due to an absence of business judgment rule protection for having allegedly "rubberstamped" management's "egregious" conduct ignores the fact, which the Supreme Court had no occasion to reach, that Comverse's statutorily authorized director exculpation provision eliminated any potential liability concerns where, as here, the outside directors' actions or inactions did not amount to bad faith, but instead have been described in terms no worse than negligence by two different judges.

Thus, 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, as here none of the outside directors who comprised a majority of Comverse's Board had any financial interest with respect to the options backdating, and their prompt appointment (some four weeks before this case was filed) of a special committee to investigate and take all action relating to option grant issues ended the need to scrutinize their ability objectively to consider a demand, which, had it been made, would have gone to the special committee that quickly took decisive action even without having received a demand. That action conclusively demonstrates that a demand to take action would not have been futile.

Statement of Facts

On March 10, 2006, more than a month before this action was commenced, the Board created the Special Committee to investigate all issues relating to Comverse's historical stock option grants (R. 122-23, ¶¶ 144, 149) and delegated to that committee the power to take all actions necessary to deal with any issues it discovered and to respond to any inquiries or litigation (see R. 501). The Special Committee's members – Raz Alon and Ron Hiram – were from outside the company and never received backdated options. See infra p. 11. Independent counsel was promptly retained and, on March 14, the company promptly announced to the public the Special Committee's formation and the potential for a restatement. R. 123-24, ¶ 149. Contrary to certain representations in Appellants' Brief (see Br. at 5, 15), the Complaint does not and could not allege that any press

report (particularly including the first Wall Street Journal article on March 18, 2006 (R. 125, ¶ 155)) or government inquiry preceded this announcement.

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 (collectively, the "Former Executives"), two of whom (Alexander and Kreinberg) had unsuccessfully urged that independent counsel not be hired (R. 122, ¶ 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. R. 124, ¶ 150; see also id., ¶ 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." Id., ¶ 153; see also R. 124-25, ¶ 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." R. 126, ¶ 157. The results of each of these interrogations were promptly reported to the government. R. 124-26, ¶¶ 150-54, 156-57; R. 302, n.49.

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 (R. 198-203),[1] and, by May 1, the Special Committee had secured the resignations of the Former Executives from their officer and director positions (R. 58-60, 128-29, ¶¶ 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 (R. 214-22). 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 decades ago and built it into a major supplier of voice-messaging software and other products. Two other executives also resigned." R. 129, ¶ 161.[2]

On August 9, 2006, the United States Securities and Exchange Commission ("SEC") announced the filing of civil charges, and the Department of

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1 The Supreme Court was entitled to consider publicly available SEC filings when ruling on the motion to dismiss. See Levin v. Kozlowski, No. 602113/02, 13 Misc. 3d 1236(A), 2006 WL 3317048, at *2 n.1 (Sup. Ct. N.Y. Cnty. Nov. 14, 2006) (R. 205) (citing Gibraltar Steel Corp. v. Gibraltar Metal Processing, 19 A.D.3d 1141, 1142 (4th Dept. 2005)).

2 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 & Kara Scannell, Legal Aid: In Options Probes, Private Law Firms Play Crucial Role, Wall St. J., Oct. 28, 2006, at A1 (R. 224).

Justice ("DOJ") announced the filing of criminal charges, against the Former Executives. R. 131, ¶¶ 164-65; see also R. 58-60, ¶¶ 12, 14, 21. Deputy Attorney General Paul McNulty, whose congressional testimony Derivative Plaintiffs quote in the Complaint (see R. 133-35, ¶ 172), explicitly credited Comverse's cooperation for allowing the government to bring charges quickly:

> 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.

R. 232.

A week later, Comverse announced that, in accordance with determinations of the Special Committee, the company was providing notice to the Former Executives "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." R. 131-32, ¶ 167. Comverse further announced that it would not make "any severance or other payments to" them, and that it would "pursue rights and remedies against them in respect of their acts or omissions relating to stock 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, and added to the Special Committee. R. 234; R. 240-42; R. 247.

Nevertheless, on April 11, 2006, 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" (R. 57, ¶ 4 (emphasis added)) from 1991 through 2001 (R. 55, 75, 78-106, ¶¶ 1, 50, 60-102), and it acknowledges that the Compensation Committee members did not intend to grant in-the-money options (R. 154-55, ¶ 209(c)(iv)), but were deceived by company executives (R. 111-12, 159-60, ¶¶ 112, 114, 115, 209(f)(iii), 209(f)(iv)). Meanwhile, Comverse's Certificate of Incorporation provides, in relevant part, that no director shall be personally liable to the corporation or its shareholders so long as his acts or omissions are not adjudged to have been "in bad faith" or to have "involved intentional misconduct or a knowing violation of law." R. 470.

The Complaint admits that no demand was made on Comverse's Board (R. 147, ¶ 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.[3] As the Supreme Court recognized (see R. 18), the Complaint does not and could not identify a single backdated option received by any Outside Director (see R. 79-81, 83, 85, 87, 89, 99-100, 116-17, ¶¶ 62, 65, 69, 72, 76, 80, 86, 91, 128) and it expressly acknowledges that Alon "was not a recipient of backdated options" (R. 62, ¶ 30; see also R. 148, ¶ 208(c)). Moreover, the Special Committee, which would have considered any demand, then included Hiram, who did not become a Comverse director until June 2001 (R. 59, ¶ 15) (i.e., just prior to the last allegedly backdated option grant), and Alon (R. 251), who became a director in December 2003 (R. 62, ¶ 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.).

Comverse moved to dismiss under Bus. Corp. L. § 626(c) and C.P.L.R. 3211, and, in its Decision entered August 14, 2007, the Commercial Division granted the motion. R. 11-22. In doing so, the court explained that the case was filed "approximately a month after the Board learned about the questionable practices," and, by that time, the Board had "already authorized the Special Committee's formation to investigate the allegations, and secured

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[3] Nor did Derivative Plaintiffs make a demand before filing their consolidated amended complaint in September 2006, by which time the Special Committee consisted exclusively of directors who joined the Board well after the last backdated options had been granted. See R. 234.

admissions by Board Members and Officers Alexander and Sorin. This demonstrates that demand on the Board was not futile because the Board clearly was willing to investigate when the allegations of potential wrongdoing emerged." R. 21. Thus, "the Board's state at the time of the instant action's commencement . . . was one of investigator." Id.

Argument

The futility exception to the derivative demand requirement is a narrow one that is reserved for the rare situation in which the board of directors cannot be expected to consider a demand fairly in the best interests of the corporation. Under the law of New York,[4] "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., 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"); see also Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 95 (1991) (explaining that it is a "basic principle of corporate governance"

[4] 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 (R. 467-70).

that "decisions of a corporation – including the decision to initiate litigation – should be made by the 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 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). As explained below, the actions of Comverse's Board and Special Committee demonstrated that this is not one of the rare cases for which corporate decisions may be taken away from the duly elected directors.

I. THE SUPREME COURT CORRECTLY HELD THAT THE BOARD'S ACTIONS PRIOR TO WHEN THE CASE WAS FILED DEMONSTRATED THAT DEMAND WOULD NOT HAVE BEEN FUTILE.

In the typical case, courts consider whether certain indicators of futility are present, see Marx, 88 N.Y.2d at 200-01, in an effort to predict whether demand would be futile. As the Commercial Division recognized, however, no such prediction is necessary here because the actions of the Special Committee and the Board show they are actively engaged in protecting the company. R. 21-22; contrast with Marx, 88 N.Y.2d at 194 (explaining that cases in which demand is excused as futile are those in which it is necessary "for the court to chart the course for the corporation which the directors should have selected, and which it is presumed they would have chosen if they had not been actuated by fraud or bad faith" (emphasis added; internal quotation marks omitted)). Specifically, more than a month before this case was filed, the company announced the formation of the Special Committee, that it would review the accuracy of the stated dates of option grants, and the likely need for the company to restate its financial statements; and the Special Committee immediately and continuously cooperated

with the investigations thereafter commenced by the government. Indeed, the Complaint itself is a direct product of that cooperation and of the Special Committee's investigation, as Derivative Plaintiffs chiefly relied on the SEC's August 9 complaint ("SEC Complaint") (see R. 74, ¶ 46 n.2; R. 75-77, 79-80, 82-83, 85, 87, 89-100, 104, 110-14, 120-21, 153, 159, 169, ¶¶ 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, 210) and on the affidavit the United States Attorney's Office filed in support of arrest warrants for the Former Executives ("FBI Affidavit") (see R. 77, ¶ 57 & n.4; R. 77, 83, 85-90, 105-06, 110-13, 117-26, 152-68, ¶¶ 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), and those documents, in turn, are principally based on information the Special Committee provided to the government (see, e.g., R. 261 & n.3; R. 302 n.49.). Based on those actions alone, the only possible conclusion is the one the Supreme Court reached – that demand would not have been futile.[5] Having shown such a willingness to reach all the way to the heights of the

[5] Though not relied on by the Supreme Court in its Decision, the Special Committee's subsequent actions only further confirm the legitimacy and sincerity of the Board's appointment and the Special Committee's work. Just six weeks into its investigation, the Special Committee secured the resignations of Alexander, Kreinberg, and Sorin from their officer and director positions and eliminated all or virtually all of their compensation. See supra p. 8. Less than four months later, the Special Committee revoked their vested and unvested unexercised options, restricted stock, and other equity compensation and announced that the company would pursue its rights against them. See supra pp. 9-10. Derivative Plaintiffs argue that such actions should not be considered because they took place after this case was initially filed (see Br. at 21), but they identify no authority in support of their strange suggestion that, on a motion to dismiss, the Court should not consider matters alleged in the very complaint that is the subject of the motion.

company, there can be no question that the Special Committee or Board could have fairly considered any demand to sue those same individuals, less senior individuals, mere former directors and other officials, or the company's outside auditors.[6]

The Supreme Court's recognition of that fact places it in good company, as at least four other courts have rejected demand futility arguments on the same or lesser facts. Most recently, for example, the United States District Court for the Southern District of California rejected a demand futility claim in part because the "officers and directors voluntarily initiated an investigation . . . , retaining outside firms," even though that board had nothing to show for the investigation by the time the case was filed. In re Infosonics Corp. Deriv. Litig., No. 06cv1336 BTM(Wmc), 2007 WL 2572276, at *8 (S.D. Cal. Sept. 4, 2007). The court explained that "[t]hese actions by the Board undermine Plaintiffs' argument that Defendants are incapable of acting in the best interest of the Company." Id. Similarly, the court presiding over In re Ferro Corp. Derivative Litigation, Case No. 1:04CV1626, 2006 U.S. Dist. LEXIS 11608 (N.D. Ohio Mar. 21, 2006) (R. 328), rejected demand futility where "the facts illustrate[d] the individual

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[6] The Supreme Court focused its analysis on whether a majority of the full Board was capable of fairly considering a demand, and that is certainly appropriate under traditional demand futility analysis. Here, however, it would be at least equally appropriate to focus on just the Special Committee, insofar as any demand at the time the case was filed would have been handled by it. (See R. 501 (resolution granting Special Committee authority to respond to any litigation or third-party inquiries).)

Defendants ha[d] not been inactive. Indeed, they commenced an independent investigation utilizing outside firms and restated quarterly reports." Id. at *18-*19. Where the board took some additional action, the court in Kanter v. Barella, 388 F. Supp. 2d 474 (D.N.J. 2005), rejected a demand futility argument where "the Directors responded appropriately to allegations . . . by ordering an independent review" and by taking disciplinary action against five employees found to have engaged in unlawful billing practices, as the board's actions "painted a picture of a board of directors that acted responsively given the circumstances." Id. at 481. In the same vein, in Andropolis v. Snyder, Civil Action No. 05-cv-01563-EWN-BNB, et al., 2006 WL 2226189 (D. Colo. Aug. 3, 2006) (R. 307-20), the board of directors initiated an internal investigation to look into claims against its Chairman/President/CEO, and when the investigation revealed improprieties the CEO was forced to reimburse the company and resign from his executive positions (while remaining as a consultant). Id. at *2. 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.

In the face of such unrebutted precedent and uncontested facts, Appellants resort to mischaracterizing the Supreme Court's decision, the Special Committee's investigation, and the case law. First, they suggest the Decision holds

that the "mere formation" of any special committee "mandates" dismissal in all circumstances (see Br. at 43, 48, 53), but the Supreme Court actually held simply that demand was not futile here in light of the Board's creation of the Special Committee to investigate matters that had not yet received public or regulatory attention and, importantly, the securing early in that investigation of critical admissions from senior executives and fellow board members. (See R. 21.)

Appellants also claim the Decision requires shareholders to "defer to the business judgment of" the Special Committee (Br. at 45) and "is tantamount to blessing the findings of the Special Committee before" they are made (id. at 52), but that is not so. As Appellants themselves point out elsewhere, the Court of Appeals has explained that shareholders and courts can still inquire into "'the disinterested independence and good faith of the special litigation committee and the adequacy and appropriateness of that committee's investigative procedures and methodologies'" (Br. at 46 (quoting Parkoff v. General Telephone & Electronics Corp., 53 N.Y.2d 412, 417 (1981)).) Any such inquiries, however, would come after the committee has responded to a demand (or moved to terminate a suit for which demand had been excused or in which the corporation had not challenged the lack of a demand), or as part of a separate suit challenging the judgments of the special committee. This action, however, was not brought following a rejected demand or as a challenge to the judgments of the Special Committee; it was

brought as a challenge to the underlying conduct (i.e., the backdating scheme), and it cannot go forward because, before this case was filed, the Board and Special Committee had demonstrated themselves to be capable of considering fairly any demand regarding such conduct.

Second, though the investigation has been lauded by federal prosecutors and the Wall Street Journal, Appellants mischaracterize it as a "sham" (see Br. at 42-43, 52) by claiming it began "after the company was faced with the metaphorical gun to its head" (Br. at 44-45) and that it resulted in no action (see id. at 47, 48, 53). As to timeliness, the investigation began before Derivative Plaintiffs filed suit, before any government inquiry was launched, and before any press article was published. As to the actions taken, before the derivative action was filed, the Special Committee had hired independent counsel, reviewed documents, interviewed witnesses, obtained admissions from all three of the Former Executives, notified the SEC, and announced that the company likely would have to restate financial results. See, e.g., R. 57, ¶ 6 (admitting that "[t]his scheme came to light on March 14, 2006 when the Company announced that it had created a Special Committee of its Board of Directors to investigate its stock option grants"); R. 123-26, ¶¶ 149-54, 156-57.[7] Perhaps most tellingly, the

[7] Likewise, Derivative Plaintiffs' claim that Comverse was "forced" to admit options backdating had taken place only after it was exposed by the press "and subsequent governmental inquiries in March 2006" (Br. at 5, 15) does not appear in the Complaint and is simply wrong, as it was the Special Committee that voluntarily provided the government with the very information

Complaint itself quotes a Wall Street Journal article reporting that Comverse, "for one, acted swiftly." R. 129, ¶ 161 (emphasis added).

It also bears repeating that it was the Special Committee that exposed the matters that form the basis for the bulk of the Complaint. See supra p. 15 (listing Complaint's allegations that rely on SEC Complaint and FBI Affidavit).[8] Appellants' concern that the Former Executives' admissions, "and the resulting SEC and criminal actions, do not bring the Company any relief from its injuries" (Br. at 50) ignores the fact that the law under which the SEC and United States Attorney's Office have charged the Former Executives 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). In this regard, the United States Attorney's Office obtained an arrest warrant to seize Alexander's brokerage accounts reportedly containing approximately $49 million of assets. See R. 420-24. 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 R. 425), and the SEC consent includes Kreinberg's promise to pay disgorgement of $2,394,917.68 (see

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that caused the SEC and later the DOJ to open their investigations. R. 302 n.49; R. 123-24, ¶ 149, R. 219-20.

[8] It would be ironic indeed (and terrible policy) if the Special Committee were to lose the power to act on the results of its investigation by virtue of its having provided Derivative Plaintiffs with the very detail that they claim satisfies the particularity requirement of Bus. Corp. L. § 626(c).

R. 426-39). Sorin likewise pled guilty, and the government (correctly) estimated his restitution obligation as $51 million as well. See R. 440. Sorin also 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 R. 441-55.[9] Further, Appellants' suggestion that the Special Committee should have sued Danziger or cancelled his compensation is irrelevant insofar as Derivative Plaintiffs (who mistakenly appear to equate interestedness with guilt) fail to allege any misconduct on his part.[10]

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[9] In any case, failure to initiate litigation does not resolve the question of director interest. See, e.g., Ji v. Van Heyningen, 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.") (R. 412); Kaltman v. Sidhu, 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 Richardson v. Graves, No. Civ. 6617, 1983 WL 21109, at *3 (Del. Ch. June 17, 1983)) (R. 418). (On January 16 and 17, 2008, however, Comverse did sue the Former Executives and obtained an order temporarily restraining Alexander from transferring seven Manhattan apartments that are the subject of a motion by Comverse for pre-judgment attachment under Article 62 of the C.P.L.R. Comverse Technology, Inc. v. Alexander, Index No. 08-600142 ("CTI v. Alexander"), Complaint (Sup. Ct. N.Y. Cnty. Jan. 16, 2008); CTI v. Alexander, Order to Show Cause with Temporary Restraining Order (Jan. 17, 2008); Comverse Technology, Inc. v. Kreinberg, Docket No. L-466-08, Complaint (N.J. Sup. Ct., Bergen Cnty. Jan. 17, 2008).)

[10] Additionally, the notion that the Special Committee should not have sought to secure the cooperation of the Former Executives after their resignations by retaining them for a brief period as advisors at a nominal salary (see Br. a 49-50 n.21) has no merit, see Andropolis, 2006 WL 2226189, at *9 (rejecting argument that board's retaining disgraced CEO as a consultant supported demand futility), and the statement that "the Board's response was so delayed that Defendant Alexander was able to flee the country to evade prosecution for his illegal conduct" (Br. at 49-50 n.21) is simply ridiculous. Putting aside the obvious question of what the Board possibly could have done to prevent him from fleeing, Appellants seem to forget the fact that it was the Board's and Special Committee's actions in investigating Alexander and sharing the fruits of that investigation with the government that caused the very prosecution that intimidated Alexander into fleeing in the first place.

Finally, we emphasize that Derivative Plaintiffs have yet to cite any authority in support of their view that actions such as those taken by the Board and Special Committee are insufficient. Instead, they place great reliance on Marx and Bansbach v. Zinn, 1 N.Y.3d 1 (2003), but Marx did not involve pro-active, pre-filing board action such as that present here, and its predictive test has never been held to apply in this context, and in Bansbach, the board had elected to indemnify and reimburse the corporation's chief executive officer for legal expenses he had incurred in a criminal proceeding (and related litigation) in which he had pled guilty to election fraud to the detriment of the company. 1 N.Y.3d at 5-7. The other decisions on which Appellants rely (see Br. at 44-46, 48) involve special committees that were formed only after litigation regarding the underlying transactions had been commenced, and none of them address questions of demand futility. See Parkoff, 53 N.Y.2d at 418-19, 422; Katz v. Renyi, 282 A.D.2d 262, 263 (1st Dept. 2001); Weiser v. Grace, N.Y.L.J., Sept. 22, 1998 (Sup. Ct. N.Y. Cnty. 1998) (R. 776-81); Strougo ex. rel. Brazilian Equity Fund, Inc. v. Bassini, No. 97-3579, 1999 U.S. Dist. LEXIS 5951, at *3, *8 (S.D.N.Y. Apr. 26, 1999).[11]

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[11] Appellants' cases from outside New York (see Br. at 49 n.20) are equally unhelpful to them. The investigation in Conrad v. Blank was conducted by counsel who represented the individual defendants along with the corporation, and the investigators "carefully" avoided a conclusion of backdating. C.A. No. 2611-VCL, 2007 WL 2593540, at *7 (Del. Ch. Sept. 7, 2007). In re Zoran Corp. Derivative Litigation, 511 F. Supp. 2d 986 (N.D. Cal. 2007), likewise involved an investigation that exonerated the company's senior management, and, in any case, the futility holding rested on the fact that a majority of the board had received backdated options. Id. at 1002-03, 1008-09. Finally, Appellants simply misread In re FirstEnergy Shareholder Derivative Litigation, 320 F. Supp. 2d 621 (N.D. Ohio 2004), where the special committee was

II. EVEN ASIDE FROM THE BOARD'S AND SPECIAL COMMITTEE'S ACTIONS, DERIVATIVE PLAINTIFFS FAILED TO ALLEGE ADEQUATELY THAT DEMAND WAS FUTILE.

Though, as explained above, the Board's and Special Committee's actions obviate any need for this Court to consider the predictive Marx factors applicable to cases that do not involve proactive board action prior to suit, applying those factors would likewise demonstrate that demand was not excused in this case.[12] Indeed, the director defendants in Marx had voted for unreasonably high compensation received by certain corporate executives, but 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, as the below application of the Marx test shows, the Outside Directors here were not "interested" in option grants that they themselves did not receive, and there are no

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not formed until after suit had been brought. See id. at 627 n.5 ("If a board responds to a derivative suit by appointing a special litigation committee . . . ." (emphasis added)); see also In re F5 Networks, Inc. Deriv. Litig., Master File No. C06-794RSL, 2007 WL 2476278, at *15 (W.D. Wash. Aug. 6, 2007) (distinguishing FirstEnergy on that basis).

[12] This Court may affirm the Decision on any ground advanced in the court below. See, e.g., Town of Massena v. Niagara Mohawk Power Corp., 45 N.Y.2d 482, 488 (1978) (holding that appellee was "entitled to raise . . . alternative grounds for sustaining the County Court judgment"); Am. Dental Coop., Inc. v. Attorney Gen. of the State of N.Y., 127 A.D.2d 274, 279 n.3 (1st Dept. 1987) ("An appellate court need not rely on the rationale articulated in the court of original jurisdiction to affirm a decision.").

particularized allegations that the Outside Directors participated in the accounting errors described in the Complaint.

A. The Supreme Court Correctly Held That A Majority Of The Board Was Not Interested.

As the Supreme Court explained, "[u]nder New York law, a director may be deemed interested under two scenarios: A self-interest in the transaction at issue, or a loss of independence because the disinterested director is controlled by the interested one(s)." R. 17. A director is self-interested in a transaction if s/he stands to receive a direct financial benefit not shared by the stockholders generally. See Marx, 88 N.Y.2d at 202. After analyzing Derivative Plaintiffs' various arguments, the court correctly concluded that a majority of the Board members "were disinterested and this prong of the Marx test was not satisfied." R. 19. On appeal, Derivative Plaintiffs abandon their argument that the Board was controlled by Alexander, and instead focus principally on whether the receipt of backdated options or the sale of company stock makes a director interested. (See Br. at 22-27.) Consistent with its position below, Comverse does not address the question of whether the receipt of intentionally backdated options is itself enough to make a director interested, or whether Danziger was otherwise interested, because resolution of those issues does not affect the outcome of this appeal insofar as both a majority of the full, seven-person Board (Alon, Hiram, Friedman, and Oolie) and

100 percent of the Special Committee the Board had authorized to respond to any demand (Alon and Hiram) received no such options and was capable of considering any demand fairly. As explained below, however, this Court should affirm the holding that selling artificially inflated stock that was properly acquired does not make one interested. See R. 18.

The law is clear that a mere allegation that a director 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,[13] or even that the Outside Directors

[13] See, e.g., In re Merck & Co., Inc. Deriv. & "Erisa" Litig., Nos. 05 Civ. 1151, 05 Civ. 2368, 2006 WL 1228595, at *11 (D.N.J. May 5, 2006) (R. 398) (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), rev'd on other grounds, 493 F.3d 393 (3d Cir. 2007).

knew of any improper conduct. (On the contrary, it alleges information was concealed from the Compensation Committee members. See infra p. 29.)[14]

Further, the Complaint makes no allegation regarding when any of the Outside Directors acquired their stock, so their purchases may have been at allegedly inflated prices as well. This is especially true with respect to Hiram, who did not join the board until the alleged backdating scheme had been in place for almost ten years. See supra pp. 10-11. Thus, Derivative Plaintiffs failed to include particularized allegations that he, Friedman, or Oolie "personally profited" from the scheme. Moreover, even if they had "profited" by acquiring the stock at pre-inflation prices and selling when the market value was artificially inflated, that still would not render them interested absent particularized allegations as to why they would be required to return or disgorge such profits. Absent particularized allegations of misconduct and/or culpable knowledge by themselves – as the Supreme Court required – it is unclear why they would be under any greater obligation to return profits than any other shareholder who happened to buy before the scheme and sell before the corrective disclosures.

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[14] Likewise, in the absence of similar particularized allegations of knowledge that the financial statements were false, audit committee membership does not establish director interestedness, and Appellants identify no law to the contrary (see Br. at 26). See, e.g., Kenney v. Koenig, 426 F. Supp. 2d 1175, 1183 (D. Colo. 2006) ("All that plaintiffs[] demonstrate[] is that . . . the four independent outside director defendants were members of [the audit] committee during the period where the accounting improprieties occurred. That is not enough."); Andropolis, 2006 WL 2226189, at *13 (holding that conclusory allegations regarding audit committee's failure to monitor are insufficient to excuse demand); Ji, 2006 WL 2521440, at *12 (rejecting argument that directors interested by virtue of positions on audit committee).

B. Futility Is Not Established Based On Rubberstamping Or Egregiousness Either.

While the first prong of Marx is designed to predict situations where directors would less likely be able to consider a demand objectively because of either their own pecuniary interest in the transaction or because they are beholden to someone with an interest, the second and third prongs are designed to predict situations where directors have a substantial fear for their own personal liability with respect to the underlying transaction. Because the business judgment rule ordinarily obviates any such fear with respect to board decisions made after reasonable consideration in the best interests of the corporation, the rubberstamping and egregiousness prongs of Marx are meant to identify those circumstances in which the business judgment rule likely would not apply due to a "sustained or systematic failure . . . to exercise oversight" (Lead Pls.' Mem. Law. in Opp. to Comverse Technology, Inc.'s Mot. to Dismiss ("Opp.") at 14-15 (quoting Brown v. LaBranche, Index No. 603512/03, slip op. at 7 (Sup. Ct. N.Y. Cnty. Nov. 8, 2004) (R. 743) (emphasis added)) – a standard that, if nothing else, irrefutably cannot be met as to Hiram, who did not join the Board until just before the last option grant in question and had no connection with the company or the

grants made during the prior years in which the backdating took place. See supra pp. 10-11.[15]

While Appellants devote the bulk of their attention to arguing that the business judgment rule would not protect the Outside Directors from liability (see, e.g., Br. at 40), they fail entirely to address the fact that, even if that were the case, the Outside Directors still would not have a substantial fear of personal liability because the director exculpation provisions in Comverse's charter go further than the business judgment rule and would protect them from liability for just the sort of assertedly negligent behavior alleged here. Similarly, while the Supreme Court opined that the Compensation Committee members (i.e., Friedman, Oolie, and, for the last allegedly backdated grant only, Hiram) would not be protected by the business judgment rule (R. 21), the court did not reach the separate issue of whether they were protected by the company's director exculpation provisions,

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[15] While Appellants note that the courts of this state have not addressed egregiousness in the context of options backdating (Br. at 38), it should be pointed out that Justice Ramos of the New York Supreme Court recently followed Marx in dismissing a derivative complaint alleging stock options backdating for failure of demand, explaining that "[t]he mere presence of directors on committees is not particular as to their individual participation or alleged collusion with interested directors in the backdating of stock options." Wandel v. Eisenberg, Index No. 603665/06, slip op. at 7 (Sup. Ct. N.Y. Cnty. filed May 18, 2007) (a copy of this decision is being submitted to the Court under separate cover); see also Jannett v. Gilmartin, No. HNT-L-341-05, 2006 WL 2195819, at *5-6 (N.J. Super. Ct. July 21, 2006) (holding that allegations that directors sitting on compensation committee approved allegedly unlawful compensation grants are insufficient to establish demand futility in absence of particularized allegations as to directors' interests). Further, Appellants fail to mention that the Supreme Court decision in In re Omnicom Group Inc. Shareholder Derivative Litigation, No. 602383/2002 (Sup. Ct. N.Y. Cnty. June 23, 2006), upon which they do rely for their egregiousness argument (see Br. at 41) was reversed by this Court last fall. See 43 A.D.3d 766 (1st Dept. 2007).

which, in accord with New York's Business Corporations Law, exculpate them from liability for any conduct that did not rise to the level of bad faith or intentional misconduct. See N.Y. Bus. Corp. L. § 402(b); R. 470.

Yet no such behavior is alleged here. In fact, the Complaint alleges that management took affirmative steps to conceal the truth from the Compensation Committee. See R. 159, ¶ 209(f)(iii) & n. 14 (alleging that Alexander and Kreinberg limited certain grants to "small amounts that would not attract the Committee's attention" so as "to deceive the Compensation Committee"); R. 160, ¶ 209(f)(iv) (referring to an additional "act of concealment . . . designed to deceive the Committee"); see also R. 111-12, ¶¶ 112, 114, 115.[16] Similarly, the Complaint admits that the Compensation Committee members acted "in reliance on SORIN" (R. 154-55, ¶ 209(c)(iv)), the Harvard Law School educated general counsel (R. 59, ¶ 14) who himself owed a professional, as well as fiduciary, duty to Comverse. See In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 969 (Del. Ch. 1996) ("[A]bsent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf.").

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[16] The same allegations belie the Brief's claim that the Compensation Committee rubberstamped management's proposed options grants by "delegating" or "abdicating" responsibility over the stock option plans to Alexander (see Br. at 6, 10, 17, 29).

Thus, as the Decision indicates and as even Derivative Plaintiffs themselves seem to recognize, the Compensation Committee members' actions were no worse than negligent (see R. 21 ("they later neglected the[ir] duties"); Br. at 34 (arguing the members of the Compensation Committee "violated the fiduciary duty of due care")) or "grossly negligent" (Br. at 7; Opp. at 14), which is also consistent with the recommendation of Magistrate Judge Reyes in the options backdating class action currently pending before the United States District Court for the Eastern District of New York, see In re Comverse Technology, Inc. Sec. Litig., No. 06-CV-1825 (NGG) (RER), Report & Recommendation at 40 (E.D.N.Y. Oct. 31, 2007) (recommending dismissal of federal securities fraud claims against Friedman, Oolie, and Hiram because complaint's allegations merely showed they "were negligent," not reckless or intentional) (a copy of this decision is being submitted to the Court under separate cover). Even gross negligence, however, is insufficient to overcome the exculpation provisions. See In re Walt Disney Co., 906 A.2d 27, 64-65 (Del. 2006) ("[G]rossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith.").

The cases cited by Appellants are easily distinguishable, as each involved intentional decisions to participate in or ignore wrongdoing. In Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007) (see Br. at 38-40 & n.17), the court applied

Delaware law (which, unlike New York's, requires only a "reasonable doubt" as to director interest to establish futility, see, e.g., Marx, 88 N.Y.2d at 195-96, 198) to a situation where the body on whom demand was to be made "deliberate[ly]" violated the company's stock option plans and "intended" to "lie to" investors, see Ryan, 918 A.2d at 355, 358, with respect to each of nine challenged transactions over a four-year period, see id. at 346;[17] and the other cases upon which Appellants rely involve intentional decisions by a majority of the directors to ignore misconduct even well after they had been notified of it. See Miller v. Schreyer, 257 A.D.2d 358, 362 (1st Dept. 1999) ("patently improper scheme extended over a five-year period," and directors failed even to "launch a vigorous investigation well after the facts ha[d] come to light") (Br. at 33); Katz v. Renyi, 282 A.D.2d 262, 263 (1st Dept. 2001) (explaining that directors in Katz v. Renyi, Index No. 604465/99 (Sup. Ct. N.Y. Cnty. filed Dec. 15, 2000) (Br. at 37), failed to conduct investigation until more than a year after derivative proceeding had been

[17] Moreover, the Ryan court applied hindsight from 2006-07 – when everyone was attuned to the possibility and danger of options backdating – to a time when the issue was not on the minds of corporate directors. Rather, when considering proposed options grants, directors understandably focused on business matters such as the total number of options to be granted and whether the amounts for senior executives were appropriate. To assume that compensation committee members focused on the theretofore unappreciated issue of whether the stated grant dates were correct – and to conclude that they knew those dates were inaccurate – but nonetheless knowingly approved backdated options (without any economic incentive to do so) is to ignore the reality of the situation at the time. See, e.g., John Hechinger, Broadcom Faces at Least $750 Million Charge to Correct Options Errors, Wall St. J., July 15, 2006, at A4 (describing academic study estimating "that 29% of the nearly 8,000 firms studied had backdated or otherwise manipulated grants to top executives at some point between 1996 and 2005") (R. 818-19).

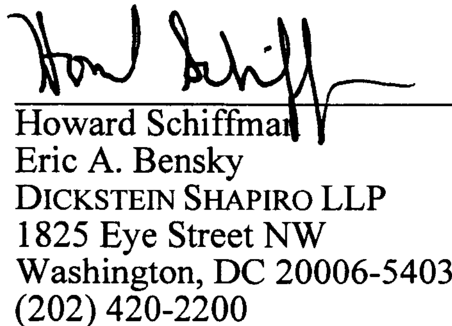
commenced and well after government investigations and media reports had highlighted alleged misconduct); Spear v. Conway, 6 Misc. 3d 1023(A), 2003 WL 24012118, at *6 (Sup. Ct. N.Y. Cnty. Oct. 17, 2003) (explaining that, in In re Abbott Laboratories Deriv. Litig., 325 F.3d 795 (7th Cir. 2003) (Br. at 37), "the members of the board were explicitly aware of the alleged practices complained of over a lengthy period of time and had consciously chosen not to act in response thereto – . . . the board's 'inaction' was intentional and conscious, and . . . the directors knew of the violations of law [but] took no steps in an effort to prevent or remedy the situation." (emphasis added)); In re Oxford Health Plans, Inc., 192 F.R.D. 111, 115 (S.D.N.Y. 2000) (Br. at 31-32) ("[T]he misconduct was largely, if not entirely, a situation of intentional nonfeasance and acquiescence with knowledge of management's repeated misrepresentations to the financial markets . . . .").

Conclusion

A majority of the Board and 100 percent of the Special Committee that would have considered any demand had no financial interest with respect to the options backdating that is the subject of the Complaint, 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 they quickly took decisive action even without having received a demand. 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 was properly dismissed.

Respectfully Submitted,

Dated: January 25, 2008

By: 

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