

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

In Re: Converse Technology, Inc.
Derivative Litigation

Index No. 601272/2006

**LEAD PLAINTIFFS' MEMORANDUM OF LAW IN OPPOSITION
TO COMVERSE TECHNOLOGY, INC.'S MOTION TO DISMISS**

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I. INTRODUCTION

This case involves a decade-long secret scheme, led by Defendants¹ Alexander, the co-founder of Comverse, Kreinberg and Sorin, to steal from Comverse Technology, Inc. (“CTI” or the “Company”) by, among other things, backdating stock options grants in order to award themselves and other officers “in-the-money” options in flagrant violation of the Company’s shareholder-approved stock option plans (the “Plans”). CTI has already admitted that backdating occurred at the Company and, as a result, expects to restate its historical financial statements to account for additional material compensation expenses.² ¶ 158.³ When the options backdating scandal broke with CTI in the spotlight, government officials affirmed that the practice of backdating was undeniably improper and illegal. As Senator Chuck Grassley stated, backdating is “behavior that, to put it bluntly, is disgusting and repulsive. It is behavior that ignores the concept of an ‘honest day’s work for an honest day’s pay’ and replaces it with a phrase that we hear all too often today, ‘I’m going to get mine.’” ¶ 171.

The circumstances surrounding the stock option granting practices in place at CTI from fiscal years 1991 through 2002 (the “Relevant Period”) were particularly egregious. In addition to masterminding the pervasive backdating scheme, Defendants Alexander, Kreinberg and Sorin actually invented fictitious employees to allow them to make additional stock option grants over and above those authorized under the Plans. ¶ 109-124. Such granting practices also violated a myriad

¹ Defendants in the Action are: Jacob “Kobi” Alexander (“Alexander”), John H. Friedman (“Friedman”), William F. Sorin (“Sorin”), Ron Hiram (“Hiram”), Itsik Danziger (“Danziger”), Sam Oolie (“Oolie”), Carmel Vernia (“Vernia”), Francis Girard (“Girard”), Igal Nissim (“Nissim”), David Kreinberg (“Kreinberg”), Zeev Bregman (“Bregman”), Dan Bodner (“Bodner”), Shaula A. Yemini (“S. Yemini”), Zvi Alexander (“Z. Alexander”), Yechiam Yemini (“Yemini”) and Shawn K. Osborne (“Osborne”), who shall be referred to herein collectively as “Defendants.” ¶¶ 12-27.

² The recipient of the backdated grant pays less to the company when the options are exercised to obtain greater compensation than he or she is entitled to, and the entire purpose of the shareholder-approved stock option plans — namely, to provide senior executives with an incentive to boost the company’s future profitability and value above that which exists on the grant date — is stripped away. ¶ 5.

³ All paragraphs references (“¶”) are to Consolidated and Amended Shareholder Derivative Complaint (the “Complaint”) Attached to the Affirmation of Eric A. Bensky as Exhibit 1.

of accounting rules and regulations regarding the deductibility of compensation expenses and led to the issuance of materially false and misleading financial statements in violation of Generally Accepted Accounting Principles (“GAAP”) throughout the Relevant Period. ¶¶ 125-127.

During the Relevant Period, members of the Stock Option and Remuneration Committee, later renamed the Compensation Committee (the “Compensation Committee”), Friedman, Oolie, S. Yemini and Hiram—the supposed gatekeepers of the Plans—wholly abdicated their fiduciary duties of care and loyalty by knowingly or recklessly: (1) delegating to Alexander their responsibility under the Plans to determine grantees and their respective number of options; (2) allowing Alexander, Sorin and Kreinberg to use hindsight to select grant dates with stock prices lower than that on the actual grant date; (3) allowing backdated options to be granted to fictitious employees; and (4) signing consent forms bearing false grant dates.

Once the Defendants’ scheme was brought to light by *The Wall Street Journal’s* (“*WSJ*”) inquiry⁴ into the suspicious patterns of CTI’s past stock option grants, the Board, on March 10, 2006, created a “Special Committee” purportedly to conduct an internal investigation of the Company’s historical stock option granting practices. ¶ 144. The Special Committee, however, was tainted from inception because one of its two members was also a member of the Company’s Compensation Committee that approved the wrongful backdating. ¶¶ 15, 208(f). In fact although Friedman originally suggested that the Special Committee be comprised of all the outside directors, he “stated that after further consideration, he agreed that he and Mr. Oolie should not sit on the proposed special committee.” Fraser Aff. Exh. 2, C 012001-012002. Shortly thereafter, on April 11, 2006, this shareholder’s derivative action (the “Action”) was brought against Defendants, which

⁴ The *WSJ* inquiry, which began in March 3, 2006, was made in preparation for an article published on March 18, 2006 called “The Perfect Payday” that laid out the *WSJ* analysis of several companies’ “lucky” stock option granting patterns. ¶ 134, 155. See Affirmation of Neil Fraser in Opposition to Comverse Technology, Inc.’s Motion to Dismiss (the “Fraser Aff.”), Exh. 1.

forced the Special Committee to take action against certain CTI officers. On May 1, 2006, over seven weeks after being contacted by the *WSJ* regarding options backdating, the Special Committee finally sought the resignation of certain Defendants while retaining them as advisors. ¶¶ 144, 149, 155, 160. Only after the Securities and Exchange Commission (“SEC”) filed civil charges and the Department of Justice (“DOJ”) filed criminal charges against Defendants Alexander, Kreinberg, and Sorin for their participation in the stock option backdating scheme did the Board finally terminate their employment agreements.⁵ ¶ 164-165, 167. But Defendant Alexander fled from the country to evade prosecution for his illegal conduct. ¶ 166.

Against this factual backdrop, CTI has the temerity to assert, *inter alia*, that Plaintiffs should have made a pre-suit demand on the Board. While CTT’s motion requires the Court to be the first to consider the demand futility issue in the context of the options backdating scandal under New York law, the Delaware Court of Chancery has already had occasion to uphold two derivative complaints under virtually identical facts and circumstances. *See Ryan v. Gifford*, 2007 Del. Ch. LEXIS 22, *32 (Feb. 6, 2007) (Fraser Aff. Exh. 3); *In re Tyson Foods, Inc.*, No. CIV.A. 1106-N, 2007 WL 416132, at *18 n.74 (Del. Ch. Feb. 6, 2007) (Fraser Aff. Exh. 4) (“[T]he backdating of options always involves a factual misrepresentation to shareholders. Issuance of options in conjunction with such deception, and against the background of a shareholder-approved stock-incentive program, amounts to a disloyal act taken in bad faith.”). Contrary to CTT’s assertion that Plaintiffs should have made a pre-suit demand on the Board, as the Delaware Court of Chancery recently held in *Ryan*, 2007 Del. Ch. LEXIS 22, *32, demand is futile where “the director defendants violated an

⁵ Kreinberg and Sorin have since pled guilty to the criminal charges relating to their fraudulent scheme to manipulate stock options. Also, Sorin has agreed to pay \$3 million to settle the SEC civil lawsuit alleging his participation in the backdating scheme and will be permanently barred from serving as a corporate lawyer, officer or director of a publicly traded company.

express provision of two option plans and exceeded the shareholders' grant of express authority.”

The *Ryan* court further held that:

A director who approves the backdating of options faces at the very *least* a substantial likelihood of liability Backdating options qualifies as one of those “rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.”

Id. at *33 (citation omitted) (emphasis in original).

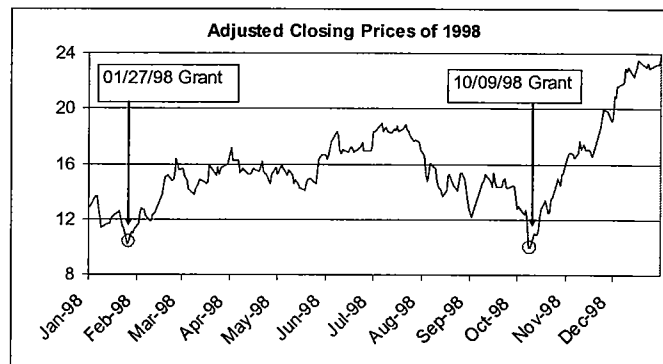
Moreover, a majority of the Board, at the time this action was commenced, was self-interested because they either received backdated options (Alexander, Sorin and Danziger), breached their fiduciary duties to the Company and violated the law by approving and issuing backdated options as part of the Compensation Committee (Friedman, Hiram and Oolie), issued materially false and misleading financial information on behalf of the Company (Defendants Alexander, Friedman, Sorin, Hiram, Danziger and Oolie and director Raz Alon) and/or engaged in insider trading (Alexander, Danziger, Friedman, Hiram, Oolie and Sorin). Third, the two person Special Committee, which CTI extols as capable of cleaning house and pursuing remedies against the wrongdoers on behalf of the Company, was populated by Defendant Hiram who served on the very Compensation Committee that awarded the illegally backdated options. Thus, demand on the Board is plainly futile, and CTI's motion should be denied.

II. STATEMENT OF FACTS

Defendants Friedman, Hiram, and Oolie were members of the Compensation Committee, which was responsible for administering the Plans, from at least 2001, and at the time demand would have been made. ¶¶ 13, 15, 17, 48-49. The Plans authorized CTI to grant options with the express requirement that the exercise price of options “**shall not be less than the fair market value of a share of the Common Stock on the date of the grant,**” where fair market value is defined as “**the closing sale price of a share of the Common Stock . . . on such date.**” *Id.*

(Emphasis added). Notwithstanding these explicit rules, over a ten year period, beginning in 1991, the Compensation Committee members knowingly or recklessly approved backdated CTI stock options. ¶ 56. Incredibly, the Compensation Committee secretly delegated their responsibility to administer the Plans to Alexander, who, along with Kreinberg, consistently selected grant dates with the benefit of hindsight in order to provide themselves and other CTI executives with options underlying millions of shares of CTI stock with exercise prices lower than the market price on the actual grant date. ¶¶ 52, 54-55.

These facts are borne out by a review of the stock option grants during the Relevant Period, which exhibit a striking pattern in that each and every one of the grants were dated just after a sharp drop and just before a substantial rise in CTI's stock price. ¶¶ 61, 96. Defendants often backdated CTI stock options to coincide with CTI's lowest closing prices of the entire year. *See Fraser Aff.*, Exh. 5. For instance, Defendants selected two grant dates in 1998 that coincided with CTI's two lowest closing prices of that year (¶¶ 71, 74):



The *WSJ*'s inquiry regarding the unusual patterns of CTI's stock option grants prompted the Company's investigation of its historical option granting practices and led to the public revelation of the backdating scheme. ¶¶ 134-138, 143-154. The Company has since admitted that CTI stock options were backdated and expects to restate their historical financial statements. ¶ 158.

Consequently, the SEC filed civil charges and the DOJ filed criminal charges against Defendants Alexander, Kreinberg, and Sorin for their participation in the scheme. ¶ 164-165.

As described in the SEC Complaint and FBI affidavit (Fraser Aff. Exhibits 6 and 7), Sorin performed the paperwork to obtain Compensation Committee approval and eventually sent unanimous written consents (“UWCs”) to the Compensation Committee for their signatures. ¶ 55-56. Rather than having a space for members of the Compensation Committee to date their UWCs, the UWCs had an earlier “as of” date that was chosen by Alexander and/or Kreinberg. *Id.* As such, the members of the Compensation Committee knew or recklessly disregarded that the “as of” date did not reflect the actual grant date when they approved the backdated option grants. ¶¶ 56. Defendants Alexander and Kreinberg also expanded the backdating scheme by creating a secret slush fund that held hundreds of thousands of options granted to fictitious employees. ¶¶ 109-124. These slush fund options were later given to actual employees in order to circumvent certain limitations on grants under the Plans. *Id.*

To conceal their improper option backdating scheme, certain Defendants caused CTI to disseminate annual proxy statements that falsely reported the dates of stock option grants to the Defendants and falsely represented that options were granted at fair market value during the Relevant Period. ¶ 128. In addition, Defendants Alexander, Kreinberg and Sorin made false representations and/or material omissions to regulators, the investing public and the Company’s auditors and counsel. ¶¶ 130-157. For instance, according to the SEC Complaint, in a meeting with CTT’s lawyer about the *WSJ* inquiry, Defendants Alexander, Kreinberg and Sorin “falsely stated that CTI acted quickly on the days CTI stock price dropped, and the selection of the grant date and approval of the option grant occurred on the same day. Sorin added that the grants were done

appropriately.” ¶ 136. Sorin also provided Deloitte & Touche LLP (“D&T”) ⁶ with the UWCs containing the false “as of” dates and stated that “the ‘as of’ dates on the written consent forms that were sent to the Compensation Committee reflected the date that he received their approval by telephone.” ¶¶ 140-142.

Due to Defendants’ misconduct, CTI has been damaged especially with regard to the costly investigations by SEC and DOJ. ¶¶ 164-165. CTI is set to restate its financial statements for fiscal years 2001 through 2006 to account for additional stock-based compensation expenses. ¶ 158. Finally, Defendants’ misconduct has caused the Company’s stock and two of its subsidiaries’ stock to be de-listed. ¶¶ 159, 162-163; *see also* Fraser Aff., Exhibits 8, 9, and 10.

III. ARGUMENT

A. Standard of Review

The plaintiff is accorded “the benefit of every possible inference” on a motion to dismiss brought pursuant to CPLR 3211. *511 W. 232nd Owners Corp. v. Jennifer Rlty. Co.*, 98 N.Y.2d 144, 152 (2002). The motion must be denied “if from the pleadings’ four corners factual allegations are discerned which taken together manifest any cause of action cognizable at law.” *Id.* (internal quotations and citations omitted). Therefore, the complaint must be liberally construed and all facts alleged in the complaint and any submissions in opposition to the dismissal motion must be accepted as true. *Id.* Assuming the requirements of pleading futility of demand (as described below) are met, plaintiffs in shareholder derivative suits are afforded such deference as well. *See In re Viacom Inc. Shareholder Derivative Litigation*, No. 602527/05, 2006 N.Y. Misc. LEXIS 2891, at *8 (N.Y. County June 23, 2006) (Ramos, J.). (Fraser Aff. Exh. 11) Furthermore, “pre-discovery dismissal of pleadings in the name of the business judgment rule is inappropriate where those pleadings suggest

⁶ The Action is also brought on behalf of the Company against D&T seeking to remedy its professional negligence, breach of contract and negligent misrepresentation in connection with D&T’s role as the Company’s auditors. ¶ 1.

that the directors did not act in good faith.” *Ackerman v. 305 E. 40th Owners Corp.*, 189 A.D.2d 665, 667 (1st Dept. 1993)

In a shareholder derivative suit, a complaint must plead “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.” N.Y. B.C.L. § 626(c). “Demand is futile, and excused, when the directors are incapable of making an impartial decision as to whether to bring suit.” *Bansbach v. Zinn*, 1 N.Y.3d 1, 9 (2003) (finding that demand was futile). As the Court of Appeals has explained, this occurs in three circumstances: (1) “when a complaint alleges with particularity that a majority of the board of directors is interested in the challenged transaction;” (2) “when a complaint alleges with particularity that the board of directors did not fully inform themselves about the challenged transaction to the extent reasonably appropriate under the circumstances;” *or* (3) “when the complaint alleges with particularity that the challenged transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors.” *Id.* (quoting *Marx v. Akers*, 88 N.Y.2d 189, 200-01 (1996)).⁷ The test is disjunctive; only one prong of the demand futility test need be met for plaintiffs to overcome a motion to dismiss. *See id.* Furthermore, when evaluating whether any demand would have been futile, the Court of Appeals recognizes that “[i]t is clear that the demand is generally designed to weed out unnecessary or illegitimate shareholder derivative suits. This prophylactic device assuredly should not be allowed to frustrate the true derivative suit, the very thing it was designed to protect.” *Barr v. Wackman*, 36 N.Y.2d 371, 378 (1975).

⁷ *Marx* also makes clear that Delaware’s approach “resembles New York law in some respects.” *Marx*, 88 N.Y.2d at 198. For example, Delaware uses a two-prong disjunctive test for demand futility. *Id.* 88 N.Y.2d at 195. Those factors are whether “(1) the directors are disinterested and independent and (2) the challenged transaction was otherwise a product of a valid exercise of business judgment.” *Id.* Delaware’s first factor is analogous to New York’s first factor, while Delaware’s second factor is analogous to New York’s third factor. Furthermore, Delaware’s second factor, which includes a requirement of “informed decision” (*Id.* 88 N.Y.2d at 196) overlaps with New York’s second prong. *See* Block, Dennis J., Nancy E. Barton, and Stephen A. Radin, *The Business Judgment Rule, Fiduciary Duties of Corporate Directors*, Volume II at p. 1549 (5th Ed. 2002).

B. Demand Futility Is Determined at Commencement of Action

Contrary to CTT's assertion (MTD at 3-5, 7-8, 14)⁸, demand futility is analyzed “*at the time the complaint was filed.*” *Miller v. Schreyer*, 257 A.D.2d 358, 360 (1st Dept. 1999) (emphasis added); accord *Aronson v. Lewis*, 473 A. 2d 805, 809-10 (Del. Ch. 1984) (“[f]utility is gauged by the circumstances existing at the *commencement* of a derivative suit”) (emphasis added).⁹ In the instant case, whether demand was futile must be assessed by analyzing the composition of the Board on April 11, 2006, the date of the first-filed complaint in this Action, and whether that Board would have been capable of considering a demand. Subsequent actions of the Special Committee or the Board are not relevant to the demand futility analysis. On April 11, 2006, the Board consisted of defendants Alexander, Sorin, Danziger, Friedman, Hiram, Oolie and non-defendant Alon. As alleged in the Complaint (¶¶ 205-211), demand would have been futile under each of the three prongs of demand futility because the majority of the Board was hopelessly conflicted, interested in the transactions at issue, and/or allowed the egregious backdating of options to proceed unhindered for a decade.

C. *Ryan v. Gifford*: Demand is Futile in Well-Pleaded Options Backdating Cases

On February 6, 2007, the Delaware Chancery Court provided significant guidance for how courts should look at demand futility allegations in options backdating cases in *Ryan*, 2007 Del. Ch. LEXIS 22,¹⁰ a shareholder derivative stock-option backdating case involving Maxim Integrated Products, Inc. It is a critical decision in litigation pending throughout the country because it was the

⁸ All references to (“MTD at ___”) are to CTT's Memorandum of Law in Support of Converse Technology, Inc.'s Motion to Dismiss for Failure to Make a Demand.

⁹ A subsequent change to the composition of the board “does not require a derivative plaintiff to present a demand to the new board, or to allege facts that would excuse demand as of the time a plaintiff elects to amend his pleadings.” *Harris v. Carter*, 582 A. 2d 222, 231 (Del. Ch. 1990). *Strougo v. BEA Associates*, No. 98-C3725, 2000 U.S. Dist. Lexis 346, (S.D.N.Y. January 19, 2000) (Same.) (Fraser Aff. Exh. 12)

¹⁰ Although decided under Delaware law, *Ryan* should be viewed as persuasive authority by this Court in deciding demand futility in actions involving options backdating.

first opportunity for the Delaware Chancery Court to apply Delaware law — which many states turn to for guidance in matters of corporate law — in the context of options backdating. The holding of *Ryan* is broad and far-reaching. As Chancellor Chandler stated:

The allegations in this case involve backdating option grants and whether such practice violates one or more of Delaware’s common law fiduciary duties. This question is one of great import to the law of corporations. It encompasses numerous issues, including the propriety of this type of executive compensation, requisite disclosures that must accompany such compensation, and the legal implications of intentional non-compliance with shareholder-approved plans (if such practices are deemed non-compliant), to name only a few. Investors are challenging this very practice in many courts throughout the United States, including this Court.

See id. at *15-16 (footnote omitted).

The factual predicate for *Ryan* is almost identical to the present case except the facts in this Action are more persuasive because CTI has already conceded that option grants made during the Relevant Period were actually backdated. In fact, CTI is among the most high-profile of all companies involved in the nationwide backdating scandal. *See Fraser Aff. Exhibits 13, 14 and 15.*

Most importantly, the *Ryan* Court determined that a Board decision to backdate stock options is *as a matter of law* undeserving of the protection of the business judgment rule, thereby excusing demand, because “[a]ltering the actual date of the grant so as to affect the exercise price contravenes the [shareholder-approved stock option] plan” and is not a result of a valid exercise of business judgment.¹¹ *See id.* at **28-29. As stated by Chancellor Chandler, manipulation of Company stock options cannot possibly amount to anything except bad faith on the part of the directors:¹²

¹¹ The court also found that plaintiffs’ allegations pointing to “specific grants, specific language in option plans, specific public disclosures, and supporting empirical analysis to allege knowing and purposeful violations of shareholder plans and intentionally fraudulent public disclosures . . . provide sufficient particularity in the pleading to survive a motion to dismiss for failure to make demand...” *See id.* at *32.

¹² In *In re Tyson Foods, Inc.*, the Delaware Court in Chancery also explained that “[n]ot all acts of disloyalty or bad faith will directly benefit the malefactor, and a director may be held personally liable for a breach of the duty of loyalty in the absence of a personal financial gain. Where the beneficiary of disloyalty is not directly liable for losses, that beneficiary might still be found to retain ‘money or property of another against the fundamental principles of justice or equity and

I am unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith. It certainly cannot be said to amount to faithful and devoted conduct of a loyal fiduciary. Well-pleaded allegations of such conduct are sufficient, in my opinion, to rebut the business judgment rule and to survive a motion to dismiss.

See id. at *40. Similar to *Ryan*, Plaintiffs have alleged that CTI directors represented to its shareholders that the exercise price of any option grant would be no less than 100% of the fair market value on the grant date. As *Ryan* holds, “shareholders, possessing an absolute right to rely on those assurances when determining whether to approve the plans, in fact relied upon those representations and approved the plans,” and, therefore, directors’ violation of the Plans is not and could not be protected by the business judgment rule.

In addition, the court in *Ryan* found a reasonable doubt as to directors’ disinterestedness because “[a] director who approves the backdating of options faces at the very least a substantial likelihood of liability, if only because it is difficult to conceive of a context in which a director may simultaneously lie to his shareholders (regarding his violations of a shareholder-approved plan, no less) and yet satisfy his duty of loyalty.” *See id.* at *34. With respect to particularity as to a director’s knowledge of the backdating, the court in *Ryan* stated that:

[I]t is difficult to understand how a plaintiff can allege that directors backdated options *without* simultaneously alleging that such directors *knew* that the options were being backdated. After all, any grant of options had to have been approved by the committee, and that committee can be reasonably expected to know the date of the options as well as the date on which they actually approve a grant. Nor is it any defense to say that directors might not have had knowledge that backdating violated their duty of loyalty. Directors of Delaware corporations should not be surprised to find that lying to shareholders is inconsistent with loyalty, which necessarily requires good faith.

See id. at *32 n.35 (emphasis in original). The court further held that “[b]ackdating options qualifies

good conscience,’ and thus to be unjustly enriched.” *In re Tyson Foods, Inc.*, 2007 WL 416132, at *18 n.72. (quoting *Schock v. Nash*, 732 A.2d 217, 232-233 (Del. 1999)).

as one of those ‘rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.’” *See id.* at *34 (citing *Aronson*, 473 A.2d at 815).

IV. DEMAND IS EXCUSED UNDER ALL THREE PRONGS OF *MARX*

At the time of suit, the Board consisted of seven directors, including Defendants Alexander, Sorin, Danziger, Friedman, Oolie and Hiram and non-defendant Alon. Defendants do not bother arguing that Defendants Alexander, Sorin or Danziger are not interested in the subject transactions because these Director Defendants were recipients of backdated stock options. As a result, in order for demand to be excused, Plaintiffs must only plead that one additional director is interested to meet the first prong of the *Marx* test.

CTI primarily relies on the actions of the Special Committee (undertaken almost entirely after commencement of this action) and its very narrow interpretation that only *recipients* of backdated options are interested under *Marx*, as the backbone of its Motion. This argument overlooks two critical points. First, it is well-settled that demand futility is examined at the time when an action is filed — not subsequent to the Board taking action in response to the allegations asserted in a derivative action.¹³ Second, even if the members of the Compensation Committee did not personally benefit from the misconduct in a concrete way — which they did— these Defendants’ actions (or inactions) demonstrate that they were controlled by Defendant Alexander, an interested person.

CTI’s argument that the second and third prongs of *Marx* do not apply is erroneous because the Compensation Committee members (Defendants Friedman, Oolie and Hiram) improperly delegated the authority to select grant dates to Alexander and signed UWCs without question,

¹³ In addition, as explained below, the Special Committee supposedly formed to investigate the stock option granting practices was not even independent at the time this Action was filed, as it consisted solely of two members and one of the members was on both the Compensation Committee and the Audit Committee during the Relevant Period.

effectively “rubber-stamping” the backdating of CTI stock options. Pursuant to *Marx*’s second prong, the Compensation Committee members did not sufficiently inform themselves about the grants they were approving or about the false financial statements and proxies they were issuing in the name of the Company to the extent required by their fiduciary duty of due care. *See Barr*, 36 N.Y.2d at 380-81 (“That unaffiliated directors may not have personally profited from the challenged actions does not necessarily end the question of their potential liability to the corporation and the consequent unlikelihood that they would prosecute the action.”). Lastly, options backdating is exactly the type of egregious misconduct that the third prong of the *Marx* test was designed to cover, such that even if the first two prongs are not met, demand such still be excused under these facts and circumstances.

A. Defendants Hiram, Oolie and Friedman Did Not Exercise Due Care

The second independent prong of *Marx* makes clear that all directors have an affirmative duty to make informed decisions. Hiram, Oolie and Friedman’s conduct does not pass the second prong of *Marx* because they did not inform themselves to a degree reasonably necessary about the transaction, *i.e.*, the backdating of Company stock options. The “long-standing rule” is that a director “does not exempt himself from liability by failing to do more than passively rubber-stamp the decisions of the active-managers.” *Marx*, 88 N.Y.2d at 201; *See also Barr*, 36 N.Y.2d at 381; *Miller*, 257 A.D.2d at 362 (finding that demand would have been futile because “[i]n view of the illegal purpose of the transactions, their magnitude and duration, their timing, and the identity of their beneficiary, the matter should have come to the attention of senior management even on a rudimentary audit.”).¹⁴ Furthermore, “[w]hether a board has validly exercised its business judgment must be evaluated by determining whether the directors exercised procedural (informed decision)

¹⁴ *Accord Aronson*, 473 A.2d at 812 (“[I]t should be noted that the business judgment rule operates only in the context of director action. Technically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act”).

and substantive (terms of transaction) due care.” *Marx*, 88 N.Y.2d at 195-96. This prong of the *Marx* test has clearly been failed by these Defendants.

The conduct identified in the Complaint rises to the level of what is known in Delaware as a *Caremark* claim, i.e., that Directors are “interested” if they allow a situation to develop which exposes the corporation to “enormous legal liability.” *Striffler v. Purcell*, Index No. Index No. 601935/03 (N.Y. Sup. Ct. July 1, 2004) (Fried, J.) (Fraser Aff. Exh. 16) at 11 (citing *In re Caremark Int’l Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996)); *See also In re Abbott Labs. Derivative S’Holders Litig.*, 325 F.3d 795, 807-10 (7th Cir. 2003) (analyzing *Caremark* and finding demand futile because board’s inaction rebutted presumption of business judgment rule). In *Spear v. Conway*, No. 401919/03 (N.Y. Sup. Ct. 2003) (Lowe, J.) (Fraser Aff. Exh. 17), this Court carefully reasoned that a *Caremark* claim requires wrongful conduct by the Board of Directors, as is present here, coupled with “red flags” that are “either waived in one’s face or displayed so that they are visible to the careful observer.” *See id.* at 7. Such “red flags,” which are abundantly present in the case at bar, demonstrate that the director had knowledge of the misconduct, and his actions or inactions would not be protected under the business judgment rule. *See id.* The members of the Compensation Committee, through their inaction, were grossly negligent because numerous “red flags” did exist upon which they should have acted, but did not. This unlawful conduct perpetrated by certain officers and Board members was far-reaching, continued for more than a decade, and has exposed the corporation to enormous legal liability.¹⁵

In *Brown v. LaBranche*, Index No. 0603512/03 (N.Y. Sup. Ct. November 8, 2004) (Freedman, J.) (Fraser Aff. Exh. 18), the Court agreed that to establish “the lack of good faith that is necessary

¹⁵The failures of the Defendants who were members of the Compensation Committee did not stop with respect to the options backdating. These defendants were also members of the Audit Committee and consistently allowed the Company to issue materially false and misleading financial statements and/or proxies, which affirmatively represented that options were granted at fair market value on the date of grant.,

to condition liability” the Court must find a “sustained or systemic failure of the board to exercise oversight ...” *LaBranche* at 7 (citing *Caremark*, 698 A.2d 959). In the case at bar, the Compensation Committee (Friedman, Oolie and Hiram) failed to act in good faith and breached their fiduciary duty when they systemically failed to exercise oversight of the stock option granting process and prevent the backdating of stock options despite the clear “red flags.”

The Plans expressly vested exclusive authority in the Compensation Committee to approve all option grants and expressly required the grants to be issued “at fair market value.” ¶¶ 48-49. Notwithstanding this clear and concise requirement, Defendants Hiram, Oolie and Friedman secretly abdicated this responsibility and allowed Defendants Alexander, Sorin and Kreinberg to entirely control and implement the process of granting stock option. ¶¶ 50, 52. Thus, instead of taking the active role required by the Plans and their fiduciary duties, these directors merely “rubber-stamped” the actions of Alexander, Sorin and Kreinberg. As the Court of Appeals in *Marx* held:

Demand is excused because of futility when a complaint alleges with particularity that the board of directors did not fully inform themselves about the challenged transaction to the extent reasonably appropriate under the circumstances. The “long standing rule” is that a director “does not exempt himself from liability failing to do more than passively rubber-stamp the decisions of the active managers.”

Marx, 88 N.Y.2d at 200 (citation omitted).

Even the slightest amount of diligence by any of these Defendants could have put an end to the options backdating scheme. The Compensation Committee’s “rubber-stamping” of the UWCs is but one example of where they failed to act or investigate events or occurrences amounting to “red flags.” According to the SEC Complaint, the UWCs were presented to the Compensation Committee, as shown on the accompanying cover letters, on later dates than the purported grant dates. ¶¶ 63, 77, 87, 93. This happened repeatedly, sometimes more than a month after the grant date. *Id.* Despite the obvious irregularities in the UWCs and subsequent dramatic rise in the stock

price between the “as of” date and the true grant date , the Compensation Committee members allowed the backdating scheme to continue unabated in violation of CTI’s by-laws and the Plans.

In addition, the existence of the “slush fund,” controlled by Alexander with the acquiescence of the indifferent Compensation Committee, could have been discovered with a minimal amount of investigation or diligence. ¶¶ 109-122. For example, in 2000, if Defendants Oolie or Friedman had ever bothered to examine the Equity Edge print-out, they would have discovered that 200,000 options (the Phantom/Fargo account) were omitted from the line item print-out but included in the total of options granted. ¶ 209(f)(iii).

Similarly, in 2001, a simple review of the names on the option grantee list and its comparison to a recent CTI employee list by Hiram, Oolie or Friedman would have revealed the existence of the twenty-five fictitious employees who received grants totaling 250,000 options that year. ¶ 115. A “rudimentary audit” would have brought this illegal activity to their attention if they were truly performing their duties rather than just “rubber-stamping” the actions of the very individuals they had a fiduciary duty to monitor.¹⁶

Such Dickensian “benign neglect” cannot be reconciled with the directors’ duty to adequately inform themselves and demand must be excused. *See Miller*, 257 A.D.2d 358.¹⁷ Thus, the members of the Compensation Committee, Defendants Hiram, Oolie and Friedman, clearly violated the fiduciary duty of due care, which obligates directors to act in an informed and reasonably diligent basis when considering material information. *See Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781

¹⁶ “No custom or practice can make a directorship a mere position of honor void of responsibility, or cause a name to become a substitute for care and attention. The personnel of a directorate may give confidence and attract custom; it must also afford protection.” *Barr*, 36 N.Y.2d at 380-81 (citation and quotation omitted).

¹⁷ *Miller*, which found that a demand would have been futile, arose out of a \$900 million “parking scheme” in which high quality United States Treasury securities were exchanged for junk bonds held by an insurance company “for the purpose of falsifying the insurer’s year-end balance sheet.” *Miller*, 257 A.D.2d at 358. The complaint in *Miller* alleged that “the failure of Merrill Lynch’s board of directors to monitor operations and implement procedures to prevent such misconduct constitutes a breach of the directors’ fiduciary duty” and that “the corporation sustained damages by virtue of its exposure to criminal and civil liability.” *Id.* The allegations in this action are at least as egregious as those in *Miller*.

F.2d 264, 274-75 (2d Cir. 1986). As a result, at a minimum, both the recipients of backdated grants (Alexander, Sorin and Danziger) and the members of the Compensation Committee (Hiram, Oolie and Friedman) ‘failed to fully inform themselves to the extent reasonably appropriate under the circumstances’ rendering demand futile under the second prong of *Marx*.

B. A Majority of the Board Was “Interested”

Under New York law, “[d]irector interest may either be self-interest in the transaction at issue . . . , or a loss of independence because a director with no direct interest in a transaction is ‘controlled’ by a self-interested director.” *Marx*, 88 N.Y.2d at 200-201; *see also Bansbach*, 1 N.Y.3d at 9. Furthermore, “[d]irectors are interested in a challenged transaction where they will receive direct financial benefit from the transaction which is different from the benefit to the shareholders generally.” *Id.* at 202. Plaintiffs have sufficiently alleged that the majority of the Board, particularly the members of the Compensation Committee, fall into both categories of interestedness, thus excusing demand.

The Compensation Committee members abdicated their role in the granting process to Alexander and knowingly or recklessly approved the backdated stock options. They played an essential role in the backdating scheme by delegating their authority to Alexander and signing UWCs weeks and sometimes months after the “as of” date. CTT’s argument that “there is no allegation that the [Compensation Committee members] knowingly approved backdated options,” MTD at 15, was made to and rejected by the Delaware Chancery Court under the same circumstances. “[I]t is difficult to understand how a plaintiff can allege that directors backdated options *without* simultaneously alleging that such directors *knew* that the options were being backdated. After all, any grant of options had to have been approved by the committee, and that committee can be reasonably expected to know the date of the options as well as the date on which they actually approve a grant.” *Ryan*, 2007 Del. Ch. LEXIS 22, *32 n.35.

1. The Compensation Committee Was Self-Interested

CTI argues that Defendants Hiram, Oolie and Friedman cannot be classified as “interested” under *Marx* because they did not receive backdated options as part of the company-wide grants or otherwise. MTD at 10-11. This argument is a red herring because receipt of ill-gotten gains is not the only circumstance allowing for demand to be excused under the first prong of *Marx*. Furthermore, this argument ignores the fact that each of these Defendants actually sold portions of their personal holdings in CTI stock during the Relevant Period. ¶¶ 127, 208(d). The Company’s financial statements were based on the faulty premise that stock options had been granted at fair market value on the date of the grant, thereby presenting materially understated compensation expenses and overstated net income. ¶¶ 125-127. Furthermore, Defendants Hiram, Oolie and Friedman as members of the Audit Committee approved the false financial statements such that they personally benefited from their participation and concealment of the backdating scheme. As a result, just like Defendants Alexander, Sorin and Danziger benefited from receiving backdated grants, these Director Defendants benefited financially from the scheme by selling personal holdings of their Comverse stock at artificially inflated prices.

2. The Compensation Committee was Dominated by Alexander

At the time the first of these consolidated actions were filed, the Compensation Committee was controlled by Alexander (a.k.a. Kobi). In this regard, the Compensation Committee completely delegated the decision-making authority with respect to stock option grants to Alexander without approval from the shareholders in violation of the Plans and signed UWCs with incorrect grant dates without question. Their submission to “Kobi’s Law” allowed Alexander to perpetrate a scheme of backdating. The Compensation Committee’s abdication of its responsibilities under the Plans exemplifies its submission to Alexander’s will.

In addition, the fact that such an expression as the “Law of Kobi” or “Kobi’s Law” (¶ 209(h)-(i)) even existed cannot be cavalierly dismissed, as the defendants would like. MTD at 17-19. This is compelling evidence of Alexander’s total control over the entire Company, including the Board and Compensation Committee. Two former employees from different parts of the United States confirm Alexander’s dominance over the Company. A former customer care center manager from Georgia employed by CTI during the Relevant Period said that Alexander had complete control of the Board and that all members marched in lockstep with him: “If Kobi said it, that was it... Absolutely, at 100%, everyone followed the Law of Kobi.” ¶ 209(h). Additionally, a former technical operations manager for the U.S., Canada, and Brazil at CTI Info Systems who worked out of the Woodbury, New York office stated that Alexander had quite a bit of control and that he was familiar with the expression “Kobi’s law.” ¶ 209.

Alexander’s influence over the boards of CTI subsidiaries Ulticom and Verint -- which have also admitted to backdating options (*see* Fraser Aff., Exhibits 19 and 20)-- serves as concrete examples, not conclusory arguments, of the way boards of CTI typically acceded to Alexander’s authority. The lack of independence of a director can be established if the transaction in question is controlled by a self-interested director, or if the self-interested director exerts “undue influence” over that director. See *Marx*, 88 N.Y.2d at 195, 200-201. Here, Alexander populated the boards of Ulticom and Verint with his cronies such as CTI directors, Hiram (director at Ulticom (¶ 15)) and Sorin (director at Ulticom and Verint (¶ 14)) and CTI officers, Nissam (CFO and director at Verint (¶ 20)), Bodner (CEO and/or director at Verint (¶ 23)) and Kreinberg (director of Ulticom and Verint (¶ 21)). Alexander also sat on the boards of Ulticom and Verint. Alexander controlled the granting process and in turn the backdating scheme. He unduly influenced Hiram, Oolie and Friedman to approve backdated stock options. This influence manifested itself in the actions of these Defendants, separate and distinct from any financial interest they may have had in these

