



IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

DHRUV KHANNA, PATRICK SAMS, and)
SYBIL MEISEL, derivatively, and on behalf)
of all those similarly situated,)

Plaintiffs,)

v.)

C.A No. 20545 NC

CHARLES MCMINN, DANIEL LYNCH,)
FRANK MARSHALL, RICH SHAPERO,)
ROBERT HAWK, ROBERT E.)
KNOWLING, JR., DEBRA DUNN,)
HELLENE RUNTAGH, LARRY IRVING,)
CHARLES HOFFMAN, L. DALE CRANDALL,)
RICHARD A. JALKUT, and)
CROSSPOINT VENTURE PARTNERS, L P,)

Defendants,)

PUBLIC VERSION

and)

COVAD COMMUNICATIONS GROUP,)
INC, a Delaware corporation,)

Nominal Defendant)

**PLAINTIFFS' ANSWERING BRIEF IN OPPOSITION TO COVAD
COMMUNICATIONS GROUP, INC.'S MOTION TO DISMISS AMENDED
DERIVATIVE AND CLASS ACTION COMPLAINT**

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TABLE OF CONTENTS

TABLE OF AUTHORITIES	iii
PRELIMINARY STATEMENT	1
NATURE AND STAGE OF THE PROCEEDINGS	4
FACTUAL STATEMENT	4
I. THE SELF-DEALING TRANSACTIONS	5
A. THE CERTIVE TRANSACTION	5
B. THE BLUESTAR TRANSACTIONS	10
C. THE DISHNET TRANSACTION	14
II. THE SPECIAL COMMITTEE INVESTIGATION	15
ARGUMENT	20
I. KHANNA DID NOT MAKE A DEMAND ON THE COVAD BOARD	20
II. EVEN IF KHANNA HAD MADE A DEMAND, IT WAS WRONGFULLY REFUSED	22
A. COVAD SHOULD BE ESTOPPED FROM CLAIMING THAT THE COMMITTEE CONDUCTED A REASONABLE INVESTIGATION	22
B. THE ALLEGATIONS OF THE AMENDED COMPLAINT ESTABLISH THAT THE COMMITTEE DID NOT ACT IN GOOD FAITH	26
III. DEMAND ON THE COVAD BOARD WOULD HAVE BEEN FUTILE	29
A. THE CLAIMS SURROUNDING CERTIVE	30
1. McMinn and Hawk Are Interested In the Certive Transaction	30
2. Lynch Is Interested In the Certive Transaction And Is Otherwise Beholden to McMinn	31
3. Hoffman, Covad's CEO, Lacks Independence	32
4. Jalkut Lacks Independence Because His Company Is A Customer of Covad	33

5.	Crandall Lacks Independence Because He Is Affiliated With A Company That Sell Millions Of Dollars Of Services To Covad Each Year.....	34
B.	THE BLUESTAR TRANSACTIONS	34
1.	Hawk Is Interested In The BlueStar Transaction.....	35
2.	McMinn Is Interested In The BlueStar Transaction	35
3.	Hoffman, Jalkut, Lynch and Crandall Lack Independence	36
4.	Runtagh, Irving, and Lynch Were Grossly Negligent In Approving The First BlueStar Transaction	36
5.	Runtagh and Irving Were Grossly Negligent In Approving The Second BlueStar Transaction	37
C.	THE DISHNET TRANSACTION	40
1.	McMinn Fails Prong One Of <i>Aronson</i>	40
2.	Hoffman, Lynch, Jalkut and Crandall Lack Independence	41
3.	Hoffman, Hawk, Lynch and Irving Were Grossly Negligent In Approving the Dishnet Settlement	41
4.	Hoffman, Hawk, Lynch and Irving Lack Independence Because They Have Exhibited A Pattern and Practice of Deferring to McMinn's Wishes	42
IV.	PLAINTIFFS HAVE STATED CLAIMS FOR BREACH OF THE DUTY OF DISCLOSURE	43
V.	PLAINTIFFS' CLASS CLAIMS ARE NOT BARRED BY LACHES	45
	CONCLUSION	48

TABLE OF AUTHORITIES

Alidina v Internet com Corp,
2002 WL 31584292 (Del. Ch.)44

Aronson v Lewis,
473 A.2d 805 (Del. Ch. 1984)*passim*

Beam ex rel. Martha Stewart Living Omnimedia, Inc v Stewart,
833 A.2d 961 (Del. Ch. 2003)29, 31, 32, 41

Beam ex rel Martha Stewart Living Omnimedia, Inc v Stewart,
845 A.2d 1040 (Del. 2004)31, 36, 41

Biondi v Scrushy,
820 A.2d 1148 (Del. Ch. 2003)26, 27, 28

Boeing Co. v Shrontz,
1994 WL 30542 (Del. Ch.)24

California Public Employees' Ret Sys v Coulter,
2004 WL 1238443 (Del. Ch.)42

Clark v. Packem Assoc,
1991 WL 36470 (Del. Ch.)46

Erickson v Centennial Beauregard Cellular LLC,
2003 WL 1878583 (Del. Ch.)46

Garner v Wolfenbarger,
430 F.2d 1093 (5th Cir. 1970)24

Goldman v. Pogo.com Inc,
2002 WL 1358760 (Del. Ch.)3, 46, 47

Grimes v DSC Comm Corp,
724 A.2d 561 (Del. Ch. 1998)24, 25

Kaplan v Wyatt,
499 A.2d 1184 (Del 1985)24

Khanna v Covad Comm Group, Inc.,
2004 WL 187274 (Del. Ch.)23

<i>Kohler Co v Kohler Int'l, Ltd</i> , 196 F. Supp. 2d 690 (N.D. Ill. 2002)	3, 43
<i>Leslie v. Telephonics Office Tech, Inc.</i> , 1993 WL 547188 (Del. Ch.)	21
<i>Levine v Smith</i> , 591 A.2d 194 (Del. 1991)	24
<i>In re Oracle Corp Deriv Litig</i> , 824 A.2d 917 (Del. Ch. 2003)	26, 27
<i>Parfi Holding AB v Mirror Image Internet, Inc</i> , 794 A.2d 1211 (Del. Ch. 2001)	20
<i>Rales v Blasband</i> , 634 A.2d 927 (Del. 1993)	30
<i>Scattered Corp v Chicago Stock Exchange, Inc</i> , 701 A.2d 70 (Del. 1997)	24
<i>Seibert v Harper & Row, Publishers, Inc</i> , 1984 WL 21874 (Del. Ch.)	21
<i>Stroud v Grace</i> , 606 A.2d 75 (Del. 1992)	43
<i>Tafeen v Homestore, Inc</i> , 2004 WL 556733 (Del. Ch.)	46
<i>Weingarden v Meenan Oil Co</i> , 1985 WL 44705 (Del. Ch.)	44
<i>Yaw v. Talley</i> , 1994 WL 89019 (Del. Ch.)	20, 22, 30
<i>Zapata Corp v Maldonado</i> , 430 A.2d 779 (Del. 1981)	24, 25, 26, 27

PRELIMINARY STATEMENT

This is a case about a group of directors on the board of directors ("Board") of Covad Communications Group, Inc. ("Covad" or the "Company") who have repeatedly caused Covad to bail out their own personal investments. Charles McMinn ("McMinn"), a founder of Covad and its Chairman, has treated Covad as his own bank account that he could delve into whenever the need arose with his outside business interests. He stacked the Board with his cronies and business partners so that there would be no challenge to his dipping into Covad's coffers.

Covad entered into highly unfavorable transactions with no fewer than three companies in which McMinn and/or certain of his fellow directors had a financial interest. The results were, predictably, disastrous for Covad. When plaintiff Dhruv Khanna ("Khanna"), also a founder of Covad, protested, his employment at Covad was summarily terminated. His allegations of the directors' wrongdoing were hastily investigated by a special committee ("Committee") that cannot demonstrate it conducted any investigation, let alone a thorough one.

Khanna heeded this Court's and the Delaware Supreme Court's admonition that shareholders utilize 8 *Del C* § 220 to inspect corporate records before bringing a derivative suit. Before a trial could be held in the matter of Khanna's § 220 rights, Khanna brought this suit to seek redress on Covad's behalf for the significant harm the interested directors have inflicted on Covad with their self-dealing transactions. The three year anniversary of one of the most damaging transactions was looming, and Khanna did not want to take the chance that the statute of limitations would expire on Covad's claim. Khanna prevailed at his § 220 trial before this Court, and Covad produced documents that revealed that McMinn had

usurped a Covad business opportunity and violated the agreement by which he acquired a significant portion of his Covad shares. Khanna amended his complaint in this action ("Amended Complaint") as a result of his findings in the § 220 matter. He has now been joined in this action by two other Covad shareholders, Patrick Sams and Sybil Meisel.

Covad seeks to dismiss this action on a number of grounds, all equally without merit. First, Covad contends that Khanna made a demand on the Board, and that plaintiffs have been unable to allege sufficient facts to show that the demand was wrongfully rejected. Memorandum in Support of Covad Communications Group, Inc.'s Motion to Dismiss Amended Derivative and Class Action Complaint ("Covad Motion to Dismiss"), at 14-23. Covad's argument fails at its premise, however, because it cannot establish (and it is its burden to do so clearly and convincingly) that Khanna's communication with the Board about the wrongdoing constituted a demand.

Even if Covad had met its burden to prove a demand had been made, the Amended Complaint is replete with facts demonstrating its wrongful refusal. The most glaring fact is that pursuant to the Court's § 220 order, Covad did not produce a single document to show that the Committee did anything to investigate Khanna's allegations. The Committee also cannot claim that it acted in good faith, as it was improperly constituted. The Committee was: (1) placed under the authority of certain of the directors Khanna claimed were the architects of the wrongdoing; (2) tainted from the start because the very resolution creating the Committee admitted that one of its two members had a disabling conflict of interest; and (3) not given decision-making authority, which remained with the self-interested board.

Covad next argues that even if a demand were not made, plaintiffs have not alleged facts to demonstrate the futility of making a demand. Covad Motion to Dismiss, at 23-46.

Plaintiffs have set forth numerous undisputed facts to establish that a majority of the directors were either interested in each transaction challenged or lacked independence from those who were interested. Moreover, the directors who approved the transactions were grossly negligent in doing so.

Finally, Covad moved to dismiss plaintiffs' class claims alleging breaches of the fiduciary duty of disclosure on the grounds that those counts fail to state claims and that they are barred by laches. Covad Motion to Dismiss, at 46-50. Covad, however, lacks standing to even move on these counts as it is not a named defendant in them. *Kohler Co v Kohler Int'l, Ltd*, 196 F. Supp. 2d 690, (N.D. Ill. 2002). Regardless, the disclosure claims state valid causes of action because the director defendants did not disclose the nature of Khanna's allegations of wrongdoing or the reason his employment was terminated in Covad's last three proxy statements. Covad contends that the directors are not obligated to engage in "self-flagellation," but that is not what plaintiffs contended they were obligated to do. All they revealed was that Khanna had accused them of "engaging in or approving transactions which constituted waste or self-dealing" – they did not even identify which transactions were at issue. This omission of material information is clearly actionable.

Covad's motion on laches grounds fails no better. Laches is a fact-intensive defense that cannot be decided on a motion to dismiss. *Goldman v. Pogo com Inc.*, 2002 WL 1358760, at *2 n.16 (Del. Ch.). The decision of whether Khanna unreasonably delayed bringing suit can only be decided on a fully developed factual record. Khanna has not even had the opportunity to present the factual reasons why Khanna brought suit when he did. Plaintiffs' claims cannot therefore be dismissed on laches grounds.

NATURE AND STAGE OF THE PROCEEDINGS

Khanna brought this action on September 15, 2003. He had previously brought a § 220 proceeding against Covad, but that action was not fully adjudicated until January 2004. After receiving Covad's § 220 production in May 2004, Khanna amended the complaint. Two new plaintiffs, Patrick Sams and Sybil Meisel, joined the action with the filing of the Amended Complaint.

Plaintiffs were forced to file the Amended Complaint under seal because Covad had designated its entire § 220 production confidential pursuant to a confidentiality stipulation entered in this action. Plaintiffs challenged the confidentiality designation of the information in the Amended Complaint under Chancery Court Rule 5, and Covad responded on August 12, 2004 with a motion for the continued sealing of the Amended Complaint. On August 23, 2004, Covad moved to strike certain allegations in the Amended Complaint as revealing Covad's attorney-client privileged information. Covad also moved on August 23, 2004 to disqualify the plaintiffs.

Covad, the director defendants and defendant Crosspoint Venture Partners, L.P. ("Crosspoint") each filed motions to dismiss this action under Chancery Court Rules 23.1 and 12(b)(6) on August 23, 2004. Covad filed its opening brief in support of its motion to dismiss on October 8, 2004. This is plaintiffs' answering brief on that motion.

FACTUAL STATEMENT

Defendant McMinn, along with plaintiff Dhruv Khanna and another investor, founded Covad in the late 1990s. Amended Derivative and Class Action Complaint ("Am. Compl.") ¶¶ 5, 8. McMinn, the Company's first Chairman and CEO, recruited a number of his friends and business partners to join him on the Covad Board. Defendant Rich

Shapero ("Shapero"), the General Partner and the Managing Partner of Crosspoint Venture Partners, L.P. ("Crosspoint"), a venture capital firm and Covad investor, joined the Board at McMinn's request. Am. Compl. ¶¶ 11, 34. Defendant Robert Hawk ("Hawk"), a special limited partner in Crosspoint, joined Covad's Board shortly after Shapero. *Id.* ¶¶ 12, 36. Defendant Daniel Lynch ("Lynch"), a longtime friend and neighbor of McMinn's, was the next McMinn recruit. *Id.* ¶¶ 9, 33. Defendant Frank Marshall ("Marshall"), another of McMinn's lifelong friends and a co-investor with Crosspoint, rounded out the McMinn cronies on the Covad Board. *Id.* ¶¶ 10, 35. Having stacked the Board with his loyal friends, McMinn was free to use Covad's capital to shore up his and Crosspoint's outside investments.

McMinn, Shapero and Hawk caused Covad to enter into a series of transactions designed to bolster their own personal investments. The terms and conditions of Covad's investments in these companies were always shockingly unfair to Covad -- in one of them Covad paid three times as much for its shares as McMinn and Crosspoint did for their shares less than three weeks prior. An examination of each of the transactions, set forth below, reveals the rampant self-dealing by certain of Covad's directors and the acquiescence therein by the directors they dominated.

I. THE SELF-DEALING TRANSACTIONS

A. THE CERTIVE TRANSACTION

By May 1999, McMinn had successfully launched Covad and was anxious to pursue other investment opportunities with and on behalf of Crosspoint. *Id.* ¶ 42. However, under his Restricted Stock Purchase Agreement, McMinn was required to remain a full-time employee of Covad until November 2000 to fully vest in his founders' shares of the

Company. *Id.* If he did not maintain full-time employment with the Company until all of his shares were vested, Covad had the right under the Restricted Stock Purchase Agreement to repurchase his unvested shares for mere pennies. *Id.*

Thus, McMinn was trapped between his desire to move on to new investment vehicles for Crosspoint and his need to remain employed full-time at Covad for the next 19 months to fully vest his Covad founders' shares. He decided to go forward with the search with Crosspoint for new investments anyway, knowing that he had the Board and the Company's CEO, defendant Robert Knowling ("Knowling") in his pocket. *Id.* ¶ 43.

At the time McMinn was pursuing these interests for Crosspoint and himself, he was Covad's Chairman of the Board.

Knowling knew that McMinn was pursuing his and Crosspoint's investment instead of working full-time for Covad. *Id.*

Knowling stated that "I trust you and Rich [Shapero - General Partner and Managing Partner of Crosspoint]" and that "[t]he manner in which you are approaching the Crosspoint

relationship is good...You are the founder and exceptions can be made to make anything work.” *Id.* ¶ 46. Those exceptions were made for McMinn, who, unbeknownst to Covad’s public shareholders, continued vesting his Covad founders’ shares, drew a full-time salary from Covad, and served as its Chairman of the Board – all while pursuing his and Crosspoint’s own investments.¹ *Id.*

One of those investments was with a company called Certive Inc. (“Certive”), a privately-held internet company. Founded by McMinn, Certive was formally incorporated on July 26, 1999 – while McMinn was still Chairman of Covad’s board and a full-time employee of Covad.² *Id.* ¶ 47. At no time prior to September 1999 did McMinn offer the Certive business opportunity to Covad despite the fact that Certive, a provider of computerized data integration services, was clearly within Covad’s line of business. *Id.* ¶ 48. Knowling, Shapero and Hawk knew that McMinn was developing Certive for himself and Crosspoint rather than for Covad – and doing it on Covad’s time to boot. *Id.*

McMinn and Crosspoint rewarded themselves handsomely in the founding of Certive. McMinn received 1,333,333 founders’ shares, and invested \$1 million for an additional 666,667 Series A Preferred shares. *Id.* ¶ 49. Crosspoint received 3 million Series A

¹ It was not until Covad was ordered to produce documents in Khanna’s § 220 action that plaintiffs learned of McMinn’s working for Crosspoint in early 1999, the exact timing of certain of McMinn’s investment activities on behalf of himself and Crosspoint (and, therefore, also on behalf of Hawk and Shapero) and of Knowling’s assistance to and cooperation with McMinn, Shapero, Hawk and Crosspoint in that regard. Am Compl ¶ 46.

² Even Certive’s own website confirms that McMinn founded Certive while he was supposed to be working full-time for Covad. It stated that “Certive, which is developing a full-service e-business network to provide live support and systems to entrepreneurs over a broadband connection, was founded in August 1999 by three top software industry executives: Chuck McMinn, chairman and chief executive officer of Certive, was the founding CEO of DSL leader Covad Communications.” Am Compl ¶ 47.

Preferred shares for an investment of \$4.5 million. *Id.* Thus, McMinn and Crosspoint received their Series A Preferred shares for \$1.50 per share. *Id.*

McMinn and Crosspoint did not offer Covad the opportunity (that they themselves had enjoyed) to invest in the Certive Series A Preferred shares at the bargain-basement price of \$1.50 per share. *Id.* §§ 51, 52. Rather, they offered Covad the right to purchase Series B-1 Preferred shares (ranking lower in the equity hierarchy than McMinn's and Crosspoint's shares) at three times the price they had paid. *Id.* § 55. They offered Covad 1,111,111 Series B-1 Preferred shares at \$4.50 per share. *Id.*

To make this action seem less offensive and suspicious, the Board adopted a corporate opportunity policy which expressly required the prior approval of the Board before a fiduciary of Covad could take a corporate opportunity for himself ("Corporate Opportunity Policy"). *Id.* The Corporate Opportunity Policy also expressly forbade any Covad director to sit on the board of or invest in a company in competition with Covad. *Id.* It would not be long before the defendants compounded the violations of their own ex post facto policy.

Only nineteen days after purporting to ratify McMinn's and Shapero/Crosspoint's investments in Certive, the Covad Board suddenly decided that Covad should invest in

³ Khanna was present for only a portion of this meeting. He was asked to leave the meeting when the Board discussed and voted to approve McMinn's usurpation of the Certive opportunity and to adopt a corporate opportunity policy going forward.

Certive. *Id.* ¶ 55. Despite the Board's having stated less than three weeks previously that Covad was not interested in "pursuing an investment in [Certive] on the terms and conditions offered to Mr. McMinn and Crosspoint" due to the "seed stage nature of [Certive] and other circumstances regarding the status and risk of [Certive]," the Board approved Covad's investment in Certive on Certive's Series B-1 Preferred shares. *Id.* In other words, the Board had found Certive to be too risky to invest in at \$1.50 per share, but three weeks later the Board was willing to invest in a subordinated class of shares for \$4.50 per shares. The Board added insult to injury by causing Covad to enter into a Shareholders' Rights Agreement with Crosspoint, McMinn and other shareholders which contractually bound Covad to vote its shares in favor of Crosspoint's and McMinn's designees on the Certive board. *Id.*

Despite the obvious scheme of wrongdoing perpetrated by McMinn, Shapero, Hawk
and Crosspoint in founding and funding Certive,

Lynch (who was a Covad director at that time and continues to serve on the Board today) and Marshall (who was a Covad director at that time) also joined and continue to serve on Certive's Advisory Board. *Id.* ¶ 56. McMinn and Shapero/Crosspoint caused Certive to grant stock interests in Certive and/or provide some form of compensation to both Lynch and Marshall. *Id.* According to Certive's website, while "many companies use Advisory Boards as window dressing[,] Certive believes they should be much more. . . [The Certive Advisory]

Board meets quarterly and provides insight that we actively use to run the business. [Advisory] Board meetings are lively and protracted – one and a half days. And, everyone attends.” *Id.*

B. THE TWO BLUESTAR TRANSACTIONS

The next self-dealing transaction was the merger of Covad with BlueStar Communications Group, Inc. (“BlueStar”). *Id.* ¶ 58. BlueStar, a Nashville, Tennessee-based DSL service provider, served small and mid-sized businesses in the southeastern United States. *Id.* BlueStar’s services competed directly with Covad’s services in large areas of the southeastern part of the United States. *Id.* ¶¶ 58-59. The BlueStar business model was based upon a model tried and rejected by Covad – direct sales through salespeople or “feet-on-the-street.” *Id.* BlueStar sold its DSL services directly to retail customers, but Covad was fundamentally a wholesaler, selling its DSL services to ISP partners, such as Earthlink, who in turn sold to retail customers. *Id.*

Defendant Crosspoint owned approximately 46% of BlueStar’s outstanding shares, and Hawk and McMinn (who by the time of the merger, had resigned from Covad’s Board) individually owned a substantial number of BlueStar’s shares.⁵ *Id.* ¶¶ 59, 72. Shapero sat on BlueStar’s board as Crosspoint’s designee. *Id.* ¶ 60. Despite the adoption of Covad’s Corporate Opportunity Policy in September 1999, there was no finding by the Board that Hawk’s and Shapero/Crosspoint’s direct investments in BlueStar were proper, i.e., not usurping a corporate opportunity. *Id.* ¶ 60. There was no finding that BlueStar was not a

⁵ McMinn was the beneficial owner of approximately 656,942 shares of BlueStar common stock. Shapero’s venture capital firm, Crosspoint, owned approximately 30 million shares of BlueStar stock. Am Compl ¶ 72.

competitor of Covad, a finding which was required for Shapero to sit on the Bluestar board and for Hawk to invest in Bluestar. *Id.*

By 2000, BlueStar was hemorrhaging millions of dollars every month, and had failed at its attempt to launch an IPO. *Id.* ¶¶ 61, 63. At the end of its fiscal year just preceding the merger, BlueStar had revenues of less than \$500,000 and a negative EBITDA. *Id.* ¶ 63. BlueStar's investment banker, Donaldson, Lufkin & Jenrette stated that "[t]he management of the Company . . . informed us that the Company, as of June 14, 2000, expected to exhaust its liquidity in the near term and did not have a financing source for funding its anticipated operating and capital needs over the following 12 months." *Id.*

Crosspoint (with Shapero as its Managing General Partner) and Hawk needed a savior for BlueStar. *Id.* ¶¶ 61, 62. They turned to Covad and proposed a merger between the two companies. *Id.* Shapero lobbied then-CEO Knowling through lengthy emails on the weekend of May 20-21, 2000 to have Covad acquire BlueStar. *Id.* ¶ 62. After Shapero's full-court press, Knowling decided on May 21, 2000 – without any due diligence – that Covad should acquire BlueStar. *Id.*

The merger with BlueStar made no financial sense from Covad's standpoint. Even setting aside BlueStar's dismal performance, Covad would not be gaining much in service territory, as BlueStar and Covad had territorial overlap in roughly 70% of BlueStar's service areas. *Id.* ¶ 68. This fact was made known to Knowling as early as May 1999 by McMinn himself. *Id.* ¶ 60. To the extent that the Board as a whole did not already know this stunning fact, it was informed of it on or prior to June 15, 2000 when a Covad executive, Ron Marquardt, presented a due diligence report which stated that the acquisition would be virtually useless because of the overlap in the companies' networks. *Id.*

On June 16, 2000, Covad announced it had entered into a definitive merger agreement with BlueStar (the "BlueStar Merger"). *Id.* ¶ 58. The Board's "process" leading up to that decision was a corporate governance nightmare. The Board did not form a special committee of disinterested directors to consider the BlueStar transaction. *Id.* ¶ 65. It did not heed the detailed due diligence report prepared by Ron Marquardt and others that pointed out many of the key acute problems of BlueStar, or even obtain a rebuttal to these reports. *Id.* It accepted the fairness opinion of Covad's investment banker, Bear Stearns, despite the fact that Bear Stearns had a glaring conflict of interest with respect to the merger. *Id.* ¶ 66. Bear Stearns Corporate Lending, Inc., an affiliate of Bear Stearns, had given BlueStar a \$40 million financing commitment to fund BlueStar's continuing operations, and would have had no hope of recouping a dime of that money without the merger. *Id.*

On September 22, 2000, Covad completed its acquisition of BlueStar by issuing approximately 61 million shares of Covad common stock to BlueStar stockholders according to an exchange ratio by which BlueStar stockholders received an average market price of \$14.23 in exchange for all outstanding preferred and common stock. *Id.* ¶ 73. In addition, the outstanding BlueStar stock options and warrants were converted into options to purchase approximately 225,000 shares of the Company's common stock at a fair value of \$6.55 per share. *Id.* The value of the options, as well as direct transaction costs, were included as elements of the total purchase cost. *Id.* As a result, the Covad Board, in order to further the bail-out needs of Shapero and Hawk, effectively put a grossly inflated price of at least \$200 million on BlueStar in connection with the merger. *Id.*

The merger agreement also provided BlueStar stockholders with a follow-up bonus of up to 5 million additional Covad shares to be paid at the end of 2001 if BlueStar achieved

certain specified levels of revenues and EBITDA throughout 2001. *Id.* ¶ 74. The earning benchmarks of this provision, known as the “earnout,” were never met. *Id.* BlueStar continued to lose millions, even with Covad’s coffers now shoring it up. *Id.*

The dismal performance of BlueStar is almost an aside, however, because only seventeen days into BlueStar’s benchmark year the Covad Board determined that it should pay out another 3.25 million Covad shares in settlement of the earnout provision. *Id.*; see also Ex. D to the Affidavit of Candice M. Toll filed by Covad on October 8, 2004. Without even waiting to see if any liability for payment of the earnout shares would arise, the Board, now with McMinn back at the helm as Chairman,⁶ tasked Lynch to negotiate with the former BlueStar shareholders (which group included Shapero’s Crosspoint, Hawk and McMinn) and approved the settlement payout of 3.25 million Covad shares he reached almost instantaneously. *Id.* ¶¶ 74-75.

In April 2001 Covad finalized the remaining terms of the January agreement with BlueStar representatives. *Id.* ¶ 74. After obtaining the concurrence of defendants Marshall, Irving and Runtagh, defendant Lynch agreed to the price of 3.25 million Covad shares, or 65% of the maximum payout under the earnout provision. *Id.* ¶ 75.

⁶ McMinn returned to Covad as its Chairman on November 1, 2000. Am. Compl. ¶ 8

To compound the questionable nature of the transaction, proper corporate procedures were not followed and appropriate records were not even kept. *Id.* ¶ 77. There is no corporate record that the Covad Board even formally approved the agreement. *Id.*

On June 25, 2001, just nine months after the merger was completed and an incredible two months after the payment of the earnout shares, Covad announced it would dissolve BlueStar and lay off 400 employees. *Id.* ¶ 82. BlueStar made an irrevocable assignment for the benefit of its creditors ("ABC") of all its assets to an independent trustee (the "Assignee") in the State of Tennessee. *Id.* ¶ 83. Immediately thereafter, the Assignee began an orderly liquidation of BlueStar that was expected to take approximately one year. *Id.* Under Tennessee law, an ABC is a non-judicial alternative to a plan of liquidation under Chapter 7 of the Bankruptcy Code. *Id.* Consequently, the liquidation of BlueStar's assets and the discharge of its liabilities have been under the sole control of the Assignee. *Id.*

C. THE DISHNET TRANSACTION

McMinn is also, and has for well over two years been, a member of the board of directors of DishnetDSL ("Dishnet") and holds options to purchase shares of that company. *Id.* ¶ 86. Dishnet, a privately-held Indian telecommunications company, is a provider of high speed DSL Internet access service and is one of the five largest dial-up access providers in India. *Id.* Covad, through a wholly-owned subsidiary, purchased 2,000,000 equity shares of Dishnet (represented by an equal number of American Depositary Receipts) for a total purchase price of \$22,980,000 pursuant to a Subscription Agreement dated February 15, 2001. *Id.* Also as part of the deal, Dishnet entered into an agreement with Covad to license Covad's proprietary operational support system for use in India. *Id.* Within four months, Covad had lost more than \$8 million on the Dishnet investment. *Id.* ¶ 87

The strain of the losses Covad incurred from the self-dealing Certive, BlueStar and Dishnet transactions took its toll on Covad. On August 15, 2001, Covad filed for bankruptcy. *Id.* ¶ 94. In October 2001, Dishnet filed a proof of claim in the Bankruptcy Court for the District of Delaware against Covad asserting damages in excess of \$24 million, claiming a breach by Covad of its obligations under the software agreement between Dishnet and Covad. *Id.* ¶ 89. This resulted in the absurd situation of McMinn sitting simultaneously on the boards of both Covad and Dishnet while the companies were engaged in a contentious legal battle. *Id.* At or about the same time, Covad recognized the error of its investment and attempted to exercise its \$23 million put option against Dishnet. *Id.* ¶ 91. Again, McMinn stood on both sides of the transaction. *Id.*

In February 2002, Covad entered into a settlement agreement with Dishnet and its other investors to extract itself from its failed investment in Dishnet. *Id.* ¶ 92. The agreement included (without the benefit of the necessary financial and legal analysis): (i) the sale or put of Covad's 6% interest in Dishnet for \$3,000,000 in cash (representing a loss of about \$20 million), (ii) a settlement of Dishnet's claim alleging breach of a software license agreement, and (iii) the relinquishment of Covad's \$23 million put option with respect to its holdings in Dishnet. *Id.* Covad also granted Dishnet a license to use certain software developed by Covad until March 2003. *Id.* Thus, the Covad Board, which was dominated and controlled by McMinn, surrendered valuable claims and lost millions of dollars to McMinn's other company, Dishnet. *Id.*

II. THE SPECIAL INVESTIGATIVE COMMITTEE

On June 19, 2002, plaintiff Khanna sent a letter to the Board outlining, among other things, the breaches of fiduciary duty alleged against the Board in this Complaint, including

the Board's conduct in the Certive, BlueStar and Dishnet Transactions. *Id.* ¶ 122. After describing in detail the self-dealing conduct of defendants McMinn, Shapero and Hawk, Khanna stated that he would refrain from litigation if he was given, *inter alia*, an executive officer position with 15 year tenure and membership on the Board. On July 9, 2002, Khanna circulated a draft derivative complaint to the Board. *Id.* ¶ 123.

Covad and Khanna agreed to enter into confidential settlement discussions during the period July 10, 2002 through July 23, 2002. *Id.* ¶ 116. During this negotiating period, the parties also agreed that neither would take any acts to advance, or have the effect of advancing, their respective litigation positions (the "Standstill Agreement"). *Id.* On July 23, 2002, the Standstill Agreement was extended by counsel for the Board and Khanna's counsel to and including July 26, 2002. *Id.* The Standstill Agreement provided: "During the Negotiating Period, neither party shall take any actions to advance, or that will have the effect of advancing, its litigation position, and they shall diligently and vigorously focus their attention on resolving the disputes among them." *Id.*

The Board appointed what it termed a "special investigative committee," (the "Committee") consisting of defendants Runtagh and Crandall, to "investigate" Khanna's allegations about the Certive, BlueStar and DishNet transactions. *Id.* ¶ 124. The Committee was originally formed as a subcommittee of the Audit Committee (with members Hawk, Lynch, Crandall and Runtagh), and the Committee members were Runtagh and Crandall. *Id.* Amazingly, the Committee was not given any authority to act independently of the Board or even of the Audit Committee. *Id.* The Committee was charged only with the task of "investigat[ing] Mr. Khanna's allegations regarding the certifications provided to the Company's independent auditors, to assemble information concerning those certifications

from the Company's employees and agents and from third parties and to make a recommendation to the Audit Committee and/or the Board of Directors based on the outcome of this investigation" *Id.* Thus, the Committee charged to investigate the wrongdoing was under the control of two of the primary wrongdoers – Lynch (the Chairman of the Audit Committee, longtime friend of McMinn, and self-dealing participant in the Certive transaction) and Hawk (Crosspoint limited partner and self-dealing participant in the Bluestar and Certive transactions). *Id.*

The same Board resolution which created the Committee also stated that the Committee "shall consist of Mr. Crandall, who shall serve as the chairperson, and Ms. Runtagh; provided that Mr. Crandall shall have the authority to act alone in the event that, in his sole judgment, an alleged material conflict of interest arises with respect to Ms. Runtagh." *Id.* ¶ 125. Thus, not only did the Board fail to give the Committee proper authority to remove the taint of the control of the wrongdoers on the Board over the claims, it also constituted the Committee with at least one member it deemed as having a conflict of interest. *Id.*

On July 18, 2002, in direct violation of the Standstill Agreement, defendant Jalkut was appointed to the Board and the Board resolved that defendants Crandall and Runtagh had the authority to add Jalkut as a member of the Committee. *Id.* 126. There was still no grant of authority to the Committee to determine on its own whether Khanna's claims should be pursued.⁷ *Id.* The Committee was therefore still constrained strictly to making a

⁷ It was not until September 20, 2002 – after the meetings between Khanna and the Committee's counsel – that the Board gave the Committee the authority to act on its behalf in the determination of whether to bring suit based upon Khanna's allegations of wrongdoing. By that time, defendant Jalkut had been added as a member, although that fact was never disclosed to Khanna. Am. Compl. ¶ 131.

recommendation to either the Audit Committee or the full Board – both of which were controlled by the wrongdoers. *Id.*

Despite his misgivings about the oversight of the Committee by Lynch and Hawk, Khanna cooperated fully with the Committee. *Id.* ¶ 128. He met with counsel for the Committee on three separate occasions and participated in a teleconference with Runtagh and Crandall. *Id.* He also exchanged correspondence with counsel for the Committee throughout the latter half of 2002. *Id.*

Shortly after its representatives met with Khanna, the Committee came to a hasty conclusion in early October 2002 that the Company would not pursue legal action with regard to the Certive transaction. *Id.* ¶ 129. On December 26, 2002, counsel for the Committee informed Khanna that the Committee believed his allegations were without merit. *Id.* ¶ 133. The only public disclosure of Khanna's allegations and the Committee's investigation came in March 2003 when Covad disclosed the following in its Form 10-K:

In June 2002, Dhruv Khanna was relieved of his duties as our General Counsel and Secretary. Shortly thereafter, Mr. Khanna alleged that, over a period of years, certain current and former directors and officers had breached their fiduciary duties to the Company by engaging in or approving actions that constituted waste and self-dealing, that certain current and former directors and officers had provided false representations to our auditors and that he had been relieved of his duties in retaliation for his being a purported whistleblower and because of racial or national origin discrimination. He has threatened to file a shareholder derivative action against those current and former directors and officers, as well as a wrongful termination lawsuit. Mr. Khanna was placed on paid leave while his allegations were being investigated.

Our Board of Directors appointed a special investigative committee, which initially consisted of Mr. Crandall and Ms. Runtagh, to investigate the allegations made by Mr. Khanna. Mr. Jalkut was appointed to this committee shortly after he joined our Board of Directors. This committee retained an independent law firm to assist in its investigation. Based on this investigation, the committee concluded that Mr. Khanna's allegations were without merit and that it would not be in the best interests of the Company to commence

litigation based on these allegations. The committee considered, among other things, that many of Mr. Khanna's allegations were not accurate, that certain allegations challenged business decisions lawfully made by management or the Board, that the transactions challenged by Mr. Khanna in which any director had an interest were approved by a majority of disinterested directors in accordance with Delaware law, that the challenged director and officer representations to the auditors were true and accurate, and that Mr. Khanna was not relieved of his duties as a result of retaliation for alleged whistleblowing or racial or national origin discrimination. Mr. Khanna has disputed the committee's work and the outcome of its investigation.

After the committee's findings had been presented and analyzed, the Company concluded in January 2003 that it would not be appropriate to continue Mr. Khanna on paid leave status, and determined that there was no suitable role for him at the Company. Accordingly, he was terminated as an employee of the Company. While the Company believes the contentions of Mr. Khanna referred to above are without merit, and will be vigorously defended if brought, it is unable to predict the outcome of any potential lawsuit.

Id.

Khanna then made a demand pursuant to § 220 action to inspect the records of the Committee's "investigation." *Id.* ¶ 135. That demand was made on June 10, 2003 and was flatly rejected, without the production of a single document, on June 18, 2003. *Id.* Thereafter, Khanna filed a § 220 action on August 11, 2003. *Id.* The Court found in Khanna's favor on his § 220 demand, and Covad was ordered to produce virtually every category of document sought by Khanna. *Id.*

There is absolutely no record that the Committee even investigated Khanna's claims – other than to have its counsel meet Khanna. *Id.* ¶ 132. Not a single document has been produced to plaintiffs to show that the Committee conducted interviews, reviewed documents, discussed the allegations among themselves or with their advisors, made formal conclusions, issued a report, or resolved that suit should not be brought on Khanna's allegations. *Id.* Covad did submit to plaintiffs a deficient and extremely vague privilege log

which appears to include documents which may relate to the Committee's investigation, but Covad's failure to produce any of those documents is a de facto waiver of its right to claim that the Committee's investigation and decision, if any, were in compliance with Delaware law. *Id.*

ARGUMENT

I. KHANNA DID NOT MAKE A DEMAND ON THE COVAD BOARD

Covad argues that Khanna's June 19, 2002 letter to the Board constituted a demand under Delaware law. Covad is simply wrong.

This Court has been clear that a communication will not be deemed to be a demand unless "there is clear and unambiguous evidence" that all the criteria of a demand are met. *Parfi Holding AB v Mirror Image Internet, Inc*, 794 A.2d 1211, 1237 n.75 (Del. Ch. 2001), *rev'd on other grounds*, 817 A.2d 149 (Del. 2002). The communication must contain the following information in order to be a demand:

- (i) the identity of the alleged wrongdoers; (ii) the wrongdoing they allegedly perpetrated and the resultant injury to the corporation; and
- (iii) the legal action the shareholder wants the board to take on the corporation's behalf.

Yaw v Talley, 1994 WL 89019, at *7 (Del. Ch.) Only when all of these criteria are met "will the communication acquire the dignity of a legally significant act that would entitle the board to argue that a demand was made and properly refused." *Id.*

The most crucial criteria in the "is it a demand" analysis is the request for legal action on the corporation's behalf, and it is the burden of the party claiming a demand was made to establish it with clear and unambiguous evidence. *Id.* ("the party asserting a demand was made...should bear the burden of proof"). As Covad's own cited authority demonstrates, "[l]etters to the board requesting a meeting or threatening suit in an effort to extract ...

concessions specific to the individual plaintiff have [] been held not to constitute a demand.” *Id.* at *7 n.10; see also *Leslie v Telephonics Office Tech, Inc*, 1993 WL 547188, at *10 (Del. Ch.) (draft complaint sent as threat to pressure directors to give plaintiffs information did not constitute demand); *Seibert v Harper & Row, Publishers, Inc*, 1984 WL 21874, at *2-3 (Del. Ch.) (letter was not demand where it asked for opportunity to address board rather than for corrective action).

Covad cannot demonstrate that Khanna requested legal action on behalf of the corporation in the June 19, 2002 letter. Covad argues that Khanna requested “remedial action,” and that the third criteria of a demand was therefore met. Covad Motion to Dismiss, at 16-17. Covad claims that “the letter is clear that Khanna expected the Board to investigate his allegations and, unless the Board took corrective action, Khanna would seek redress against the responsible parties.” *Id.* at 16. Of course, Covad has no quote from or even a cite to the June 19, 2002 letter on this point because Covad knows full well that Khanna never requested that the Board take legal action against the wrongdoers. Rather, as Covad was quick to point out elsewhere in its brief, Khanna requested that he be given a directorship with the Company and be elevated to an executive officer. Affidavit of Candace M. Toll, Ex. K (J123), at 11-12. Covad can dispute his motivations for such a request,⁸ but it cannot turn them into a request for legal action on behalf of the corporation. This request was for

⁸ Khanna testified in the § 220 action that he sought these positions in order to have the power to stop the individual defendants’ self-dealing transactions going forward. Transcript of Trial and Argument on Defendant’s Motion to Dismiss Plaintiff’s Section 220 Demand, dated November 18, 2003, attached to Declaration of Cynthia A. Calder in Support of Plaintiffs’ Answering Briefs (“Calder Decl.”) as Ex. A, at 153-156. Covad states that Khanna “offered in writing not to pursue litigation against Covad if the Board agreed to grant him certain lavish perquisites” and cites to the June 19, 2002 letter as support for this contention. Covad Motion to Dismiss at 6. Indeed, at the § 220 trial Covad’s counsel asked Khanna if, in the letter, “you ask for the following, as it was put by your lawyer, corrective steps. Those were all personal benefits to you, weren’t they?” Calder Decl., Ex. A, at 154. Under either viewpoint, it is clear that Khanna was not requesting that the board take action against the wrongdoers for Covad.

“concessions specific to” Khanna and therefore cannot constitute a request for action on behalf of the corporation. See *Yanv*, 1994 WL 89019, at *7 n.10. As such, no demand was made by the June 19, 2002 letter.

II. EVEN IF KHANNA HAD MADE A DEMAND, IT WAS WRONGFULLY REFUSED.

Although Covad did not meet its burden to establish that Khanna made a demand, it nonetheless goes on to argue that Khanna has not demonstrated that the demand was wrongfully rejected. Covad contends that plaintiffs have not alleged specific facts to show that the Committee did not act reasonably or in good faith. Covad Motion to Dismiss, at 17-23. Contrary to Covad’s contentions, plaintiffs have demonstrated that the Committee did not act reasonably or in good faith.

A. COVAD SHOULD BE ESTOPPED FROM CLAIMING THAT THE COMMITTEE CONDUCTED A REASONABLE INVESTIGATION.

Covad argues that plaintiffs have not set forth sufficient facts to demonstrate that the Committee did not conduct a reasonable investigation into Khanna’s allegations of wrongdoing. What it fails to tell the Court is that Khanna tried to gather information about the conduct of the Committee’s investigation through his § 220 action, but Covad withheld every single document which might possibly show what the Committee actually did or did not do.

In his § 220 demand and subsequent action to enforce his inspection rights, Khanna sought the production of, *inter alia*;

- (4) all documents provided to, considered by, or generated by any committee or subcommittee (however denominated) of the Board or of the Board’s audit committee in 2002 or thereafter, including any law firm(s) or other agents hired by such committee(s) or subcommittee(s) (hereinafter individually or collectively, “Special Investigative Committee”) to investigate allegations that certain

directors and executive officers of the Company had breached their fiduciary duties and/or otherwise engaged in allegedly unlawful or otherwise wrongful conduct while acting on behalf of the Company;

- (7) all documents presented to the Company's Board of Directors or any committee or subcommittee thereof relating to the findings and investigation of the Special Investigative Committee; and
- (8) all documents reviewed or considered by the Special Investigative Committee in concluding that the allegations of wrongdoing "were without merit and that it would not be in the best interests of the Company to commence litigation based upon these allegations," as represented in the Company's Form 10-K filed with the Securities and Exchange Commission on or about March 20, 2003.

This Court ruled that those categories of documents had to be produced, subject only to the attorney-client privilege and the work product doctrine. *Khanna v. Covad Communications Group, Inc*, 2004 WL 187274, at *8 (Del Ch.).

Covad took the Court's small proviso about privilege as license to withhold every single document which would reveal what the Committee did or did not do. Covad produced only copies of the Committee's meeting minutes with everything but the attendees' identities redacted. It withheld entirely documents purporting to contain the results of "interviews"⁹ and the Committee's report itself.

The Chancery Court has clearly held that where a company has refused a Rule 23.1 demand, the shareholder making the demand is entitled via a § 220 inspection to see "copies of the Special Committee's report, minutes of the meetings of the Special Committee and minutes of any meeting of the board of directors relating to the creation or functioning of the Special Committee, including any meeting of the board of directors at which the

⁹ Several entries in Covad's privilege log are described as "confidential interview memorandum," without revealing who was interviewed. Several of the entries bear the same date, and plaintiffs cannot even tell if they are actually referring to only one document in multiple copies. Covad Privilege Log from § 220 action, attached to the Calder Decl., as Ex. B.

recommendation of the Special Committee was considered or approved” *Grimes v DSC Comm. Corp*, 724 A.2d 561, 567 (Del. Ch. 1998).

In *Grimes*, the Court granted the shareholder access to these documents over the company’s argument that they were protected by the attorney-client privilege. The Court found that the shareholder had adequately demonstrated the need for privileged information under the *Garner v Wolfenbarger*, 430 F.2d 1093 (5th Cir. 1970) analysis because the committee’s privileged documents were the only source of the information the shareholder would need to determine whether his demand was wrongfully refused. 724 A.2d at 569-70. Likening the scope of the inspection to the scope of discovery permitted under *Zapata Corp v Maldonado*, 430 A.2d 779, 786 (Del. 1981) and *Kaplan v Wyatt*, 499 A.2d 1184 (Del. 1985) into the conduct and good faith of a special litigation committee recommending the dismissal of derivative litigation, the Court granted the shareholder access to the committee’s report and meeting minutes regardless of the privilege issue. *Garner*, 724 A.2d at 569-70.

It is clear that under *Grimes* Khanna was entitled to see the Committee’s report and the minutes of its meetings.¹⁰ To hold otherwise would be to turn on its head the Delaware Supreme Court’s admonition in *Scattered Corp v Chicago Stock Exchange, Inc.*, 701 A.2d 70, 78 (Del. 1997) that shareholders should utilize the tool of the § 220 inspection to gather the necessary information to resist a Rule 23.1 motion to dismiss. Covad knew prior to the Court’s ruling in the §220 action that it would argue Khanna had made a Rule 23.1 demand

¹⁰ Covad will undoubtedly argue that under *Boeing Co v Shrontz*, 1994 WL 30542, at *4 (Del. Ch.) the refusal to provide a derivative plaintiff with a copy of the special committee’s report is not evidence of wrongful refusal. In rejecting the plaintiff’s argument that the refusal proved a wrongful rejection, the *Boeing* Court was merely adhering to the holding of *Levine v Smith*, 591 A.2d 194 (Del. 1991) that a derivative plaintiff trying to establish wrongful refusal would not be given any discovery in the derivative action to aid in that showing. The plaintiff in *Boeing* had not pursued § 220 inspection rights to obtain the report, as had the plaintiff in *Grimes* and as Khanna has done here. Because the Committee’s report was sought in the § 220 action, *Boeing* is simply inapposite.

and that it had refused that demand, yet it withheld and continues to withhold from Khanna the documents he would need (and is owed under *Grimes*) to demonstrate that the Committee did not conduct a reasonable investigation. Covad should not now be heard to argue that Khanna has failed to demonstrate the wrongful refusal of a Rule 23.1 demand when Covad has wrongfully withheld the means for him to do so.

Even without the benefit of the Committee documents Khanna is entitled to under *Grimes*,¹¹ plaintiffs have established that the Committee did not reach all of its conclusions after six months of investigation, as Covad claimed in its brief. Covad Motion to Dismiss, at 17, 19. In October of 2002, the Committee had already determined that it would not pursue legal action on the Company's behalf with regard to the Certive transaction. From the substantively redacted minutes of Committee meetings Covad did produce, the Committee met only three times prior to making the decision on the Certive transaction. Documents Bates Labeled LWDK0003796-7; LWDK0003798-3800 and LWDK0003801-3 attached to the Calder Decl., as Ex. C.

Even more telling is the fact that the Committee met only twice more before rendering its decision on Khanna's remaining allegations of wrongdoing. Documents Bates Labeled LWDK0003804-6 and LWDK0003807-12 attached to the Calder Decl., as Ex. D. The transactions Khanna challenged were complicated, and the details of the wrongdoing were set forth in what was by Covad's description "reams" of correspondence from Khanna to the Committee. Covad Motion to Dismiss, at 19. The Committee's counsel had to meet

¹¹ Covad's unwillingness to turn over a single substantive document also runs afoul of *Zapata Corp v Maldonado*, 430 A 2d 779, 778 (Del. 1981). While plaintiffs believe that they have adequately demonstrated the Committee lacked independence and did not conduct its investigation in good faith with the facts at hand, they have filed a Motion for Limited Discovery simultaneously with this brief to preserve their *Zapata* rights.

with Khanna on three separate occasions just to understand the complexities of Khanna's allegations. Am. Compl. ¶ 128 How then could a properly functioning committee conduct a reasonable investigation into the allegations with a grand total of five meetings? The answer is that it could not do so.

**B. THE ALLEGATIONS OF THE AMENDED COMPLAINT ESTABLISH
THAT THE COMMITTEE DID NOT ACT IN GOOD FAITH**

Covad argues that plaintiffs' "sole" attack on the Committee's good faith is that the Committee was improperly constituted. Covad Motion to Dismiss, at 21. Covad is not accurate in its characterization of plaintiffs' allegations against the Committee's good faith, but even so, the constitution of the Committee is really all the plaintiffs need to impugn its good faith.

The reason for forming a special committee is that the board as a whole suffers from a disabling conflict. *Zapata Corp v Maldonado*, 430 A 2d 779, 786 (Del. 1981). As the Court stated in *Biondi*, "[o]f course, one of the key reasons for the formation of a special litigation committee is to insulate the company's decision making process from the influence of those under suspicion." *Biondi v Scrushy*, 820 A 2d 1148, 1156 (Del. Ch. 2003). In essence, a board will form a special committee in order to reclaim the protections of the business judgment rule.

In order for a special committee to be accorded any of the presumptions of the business judgment rule – more particularly, to enjoy a presumption of good faith – it must be properly constituted. *Biondi*, 820 A.2d at 1155-56 (improperly constituted special litigation committee). A special committee is not properly constituted if it remains subject to the influence of the alleged wrongdoers. *Biondi*, 820 A 2d at 1155-56 (special litigation committee was not charged to act independently of board); see *In re Oracle Corp. Deriv*

Litig, 824 A.2d 917, 942-945 (Del. Ch. 2003) (special litigation committee's motion to dismiss denied where members were not free of financial influence of alleged wrongdoers). In particular, a special committee must be charged with all of the decision making power about whether the corporation should pursue legal action. *Biondi*, 820 A.2d at 1155-56; *Zapata*, 430 A.2d at 786.

The Covad Committee was not properly constituted. From the outset, it was placed under the authority of the Audit Committee, whose members included Hawk and Lynch. Hawk is a special limited partner of Crosspoint, whose interests were furthered at Covad's expense in the Certive and BlueStar transactions. Am. Compl. ¶ 12. Hawk had a direct, personal interest in the BlueStar transaction as a BlueStar shareholder. *Id.* Lynch is an extremely close friend of McMinn, a major player in virtually all of the wrongdoing the Committee was to investigate. Am. Compl. ¶ 9. Moreover, Lynch is a member of Certive's Advisory Board, having received that position thanks to McMinn's co-founding of Certive with Crosspoint. Am. Compl. ¶ 56.

Covad does not even try to argue that the Audit Committee's authority over the Committee was proper, as it cannot. Rather, Covad simply argues that plaintiffs have not set forth any facts to demonstrate that the Audit Committee exerted any influence over the Committee. Covad Motion to Dismiss, at 22-23. Plaintiffs do not have to show such exertion of influence, however, because the mere fact that the Committee was not constituted to operate independently of Hawk and Lynch taints its investigation. *See Biondi*, 820 A.2d at 1156; *see also Oracle*, 824 A.2d at 942-945.

An even more egregious flaw existed for the Committee, however. The Committee was not even charged at its creation with the power to make the decision about whether the

corporation would pursue legal recourse for the wrongdoing alleged. Rather, the Committee was charged only with the power to investigate, and was expressly denied the power to decide Covad's treatment of Khanna's allegations. That power was reserved to the Board, which would receive merely a recommendation from the Committee. Am. Compl. ¶ 124. A less blatant reservation of power for the board doomed the special committee in *Biondi*. 820 A.2d at 1155-56 (court would not defer to committee charged with decision making power where board retained authority to control litigation)

The deficiencies of this Committee do not even end there. The resolution creating the Committee under the authority of Hawk and Lynch's Audit Committee also allowed Chairman Crandall to act alone if "an alleged material conflict arises with respect to Ms. Runtagh." Am. Compl. ¶ 125. Covad tries to explain this oddity away by claiming that it was only a proviso to cover the circumstance should a Runtagh conflict it arise. Covad Motion to Dismiss, at 22 ("the Company wanted to ensure there were no conflicts"). This explanation rings hollow. If it were just a measure of insurance that the Committee could continue to function in the event of a conflict, there would have been a reciprocal provision allowing Runtagh to continue should a conflict arise for Crandall – but there was no such reciprocity in the resolution.¹² Rather, the logical conclusion is that Runtagh already had a conflict and the Board was leaving itself a loophole in the eventuality the conflict was discovered by someone outside of the Board.

¹² It seems that the McMinn dominated directors wanted to leave themselves the loophole to pare down the Committee to just Crandall, who has disabling conflict himself. As is described in Section III.A.5 below, Crandall sits on the board of a company that sold more than \$2.3 million in software and services to Covad in 2003 alone. Covad Communications Corp. 2004 Proxy Statement as filed with the Securities and Exchange Commission on April 30, 2004 attached to Calder Decl. as Ex. E.

The final blow to the Committee was the appointment of Jalkut to it. This was not the appointment of a “manifestly disinterested and independent director” as Covad would have the Court believe. Covad Motion to Dismiss, at 22. Jalkut is the CEO of TelePacific, one of Covad’s resellers. Covad contends that Jalkut is independent, and that plaintiffs cannot refute that independence with the allegation that his company is a customer of Covad. Covad Motion to Dismiss, at 12 & 26 (“[a]s to director Jalkut, Khanna contends, bizarrely, that he lacks... independence...because he is CEO of a Covad customer” and “[t]he fact that Jalkut’s company *purchases* goods and/or services from Covad (as opposed to *receiving* substantial income from Covad) obviously does not taint his ability to act impartially”). Customers, however, can be influenced by the company from whom they purchase services because the company controls the price at which the customer can obtain the service. That price can be controlled by the wrongdoers here, and Jalkut is therefore subject to their influence if he wants his TelePacific to continue to purchase services from Covad on favorable terms. His appointment to the Committee, accomplished surreptitiously to avoid detection by Khanna, was in violation of the Standstill Agreement because it stacked the Committee with a member directly beholden to the wrongdoers on the Board

III. DEMAND ON THE COVAD BOARD WOULD HAVE BEEN FUTILE

Covad argues that plaintiffs have failed to make sufficiently particularized factual allegations to demonstrate that demand on the Covad Board would have been futile. Covad Motion to Dismiss, at 23-46. Covad muddles the claims in an attempt to obscure the true facts. An appropriate analysis examining each of the claims reveals the legal and factual errors of Covad’s contentions. *Beam ex rel Martha Stewart Living Omnimedia, Inc v*

Stewart, 833 A.2d 961, 977 n.48 (Del. Ch. 2003) (“[d]emand futility analysis is conducted on a claim-by-claim basis”); *Yaw v Talley*, 1994 WL 89019, at *9 (Del. Ch.).

A. THE CLAIMS SURROUNDING CERTIVE

The claims related to the Certive Transaction are: (1) Count I, which challenges McMinn’s vesting in his founder’s shares while failing to fulfill the requirement that he work full-time for Covad because he was devoting time to working for Crosspoint and founding Certive; (2) Count II, which alleges that McMinn, Shapero and Crosspoint usurped Covad’s corporate opportunity in Certive; and (3) Count III, which alleges the Board of Covad breached its fiduciary duties in approving the Certive Transaction. Because a majority of the Board has changed since these events took place, the standard enunciated in *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993) applies. That standard requires the plaintiff to show “whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations.” *Id.* The answer here is that it cannot. A majority of the directors (McMinn, Hawk, Lynch, Hoffman, Jaikut and Crandall) have disabling conflicts that would prevent them from appropriately considering a demand.

1. McMinn and Hawk Are Interested In The Certive Transaction.

Covad does not even try to argue that McMinn and Hawk were not financially interested in the Certive Transaction, as it is an undisputed fact that they both were interested. McMinn co-founded Certive with Crosspoint, taking the opportunity away from Covad. Both McMinn and Crosspoint received shares in Certive. Hawk, as a special limited partner of Crosspoint, shared in Crosspoint’s interest in Certive. McMinn is also clearly interested in the vesting of his founder’s shares. Hawk, through Crosspoint, also was interested in McMinn’s actions in violation of the Agreement by which he derived his founder’s shares

because the work he was doing (founding Certive) was for Crosspoint. It is therefore beyond peradventure that both McMinn and Hawk are unable to disinterestedly consider a demand.

**2. Lynch Is Interested In The Certive Transaction
And Is Otherwise Beholden To McMinn.**

Lynch is equally interested in the Certive Transaction. Covad contends that plaintiffs' allegations regarding Lynch's membership on the Certive Advisory Board lack the specificity required to demonstrate the influence this position would have on his ability to consider a demand. Covad Motion to Dismiss, at 31-32. Plaintiffs, however, were very specific in their allegations about the materiality of membership on the Certive Advisory Board. The Amended Complaint states that Lynch received highly valuable stock options and other compensation for his work on the Certive Advisory Board – all of which he receives at the pleasure of McMinn. Am. Compl. ¶ 56

McMinn's influence over Lynch is stronger than even the Certive Advisory Board – they have long been close friends. *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v Stewart*, 845 A.2d 1040, 1050 (Del. 2004) (“[a] variety of motivations, including friendship, may influence the demand futility inquiry”). This relationship is not the sort of “professional and social relationships that naturally develop among members of a board...” *Id.* at 1051. Lynch and McMinn's friendship runs so deep, they purchased homes in the same neighborhood. Am. Compl. ¶ 9. This is not mere coincidence – they even own neighboring wineries. *Id.* This deep-seated friendship sterilizes Lynch's judgment. *See Beam*, 845 A.2d at 1051 (mere allegations of attending same social functions do not establish “bias producing” friendship).

Lynch also has a proven record of voting in line with McMinn's wishes. According to the documents produced in the § 220 action, Lynch has never voted against McMinn.

Documents Bates Labeled LDWK0000123-129 attached to the Calder Decl., Ex. F; Ex. I; Ex. L; Ex. M As the Court in *Beam* made clear, a pattern and practice of voting in line with a dominant figure on the board can impugn the independence of the voting board member. 833 A.2d at 981

By any measure, Lynch is not independent of McMinn and cannot impartially consider a demand.

3. **Hoffman, Covad's CEO, Lacks Independence.**

Covad concedes, as it must, that Hoffman derives a "substantial salary" from Covad. Covad Motion to Dismiss at 36. Indeed, Hoffman's compensation exceeded \$1.2 million dollars in 2003. Covad Communications Corp 2004 Proxy Statement as filed with the Securities and Exchange Commission on April 30, 2004, attached to the Calder Decl. as Ex. E. *Beam*, 833 A.2d at 976 (finding president and COO with compensation of \$980,000 annually had "a material interest in her own continued employment"). Covad tries to struggle out from under this crushing fact by arguing that McMinn has no more authority to remove Hoffman from this lucrative position than do any of the other directors. Covad Motion to Dismiss, at 36. This statement does not negate McMinn's control over Hoffman's livelihood, particularly since McMinn is the Chairman of the Board. *Id.* (chairman had authority to "affect [officer's] employment and compensation"). Moreover, at least three of the other members of the Board (Lynch, Hawk and Jalkut, as described below) have their own disabling conflicts and their influence over Hoffman's employment, together with McMinn's, makes it quite clear that Hoffman can be removed at the pleasure of those under suspicion. Covad argues that the compensation committee of the Board sets Hoffman's annual compensation, but neglects to tell the Court that Lynch (whose disinterest and independence is impugned above) is on that

committee. Calder Decl., Ex. E. Covad also employs Hoffman's brother, Gary Hoffman, so Hoffman is sensitive not only to his own livelihood but that of his brother as well. Calder Decl., Ex. E. As such, Hoffman cannot impartially and independently consider a demand.

4. **Jalkut Lacks Independence Because His Company Is A Customer Of Covad.**¹³

Jalkut is the CEO of TelePacific, a Covad reseller. Covad insists that Jalkut is independent because "Jalkut's company *purchases* goods and/or services from Covad (as opposed to *receiving* substantial income from Covad) . . ." Covad Motion to Dismiss, at 26. The naiveté of this statement is almost shocking. A purchaser of goods and/or services is no less interested in the financial terms of the transaction than a seller is. The purchaser wants to get the goods and/or services at the lowest price and on the best terms possible. This is particularly important for a reseller, as the price it gets from its supplier necessarily dictates the price it can charge its own customers. These are the very things that are at stake for Jalkut if he were to try to break free of the taint of the other directors described above

The Covad-TelePacific business dealings are not inconsequential. In 2002 and 2001, Covad recognized in excess of \$1.3 million and \$1.8 million in revenues from TelePacific, respectively. Calder Decl., Ex. E. This obviously represented even more millions in revenue for TelePacific, who resold the services it purchased from Covad to its own customers at a marked up price. Jalkut clearly does not want TelePacific to have to pay more for those

¹³ Plaintiffs do not believe that Jalkut is appropriately considered in the demand analysis as to any of the claims because he was placed on the Board in violation of the Standstill Agreement. The Standstill Agreement required the parties to refrain from taking any actions which would advance their respective position. Contrary to Covad's assertions that the appointment of Jalkut could not be seen as causing a disadvantage to Khanna, the addition of Jalkut to the Board gave the McMinn-tainted Board one more vote in its camp. Jalkut obviously is not going to do anything to jeopardize the terms on which his TelePacific can obtain services from Covad.

services, and McMinn, Lynch, Hawk, and Hoffman have the ability to cause that to happen if he does not vote their way. As such, Jalkut lacks independence.

5. **Crandall Lacks Independence Because He Is Affiliated With A Company That Sells Millions of Dollars Of Services To Covad Each Year.**

Even though plaintiffs have demonstrated above that a majority of the Board (five of eight directors) cannot appropriately consider demand, they can further show that Crandall lacks independence. Crandall sits on the board of BEA Systems, which supplies Covad with software and related support. Calder Decl., Ex. E. In 2004 alone, Covad paid in excess of \$2.2 million to BEA Systems. *Id.* Crandall clearly has an interest in keeping that lucrative business for BEA Systems – business which can be taken away by McMinn and the other directors (Hawk, Lynch, Hoffman, and Jalkut) who are either interested in the Certive Transaction or who lack independence from those who are.

B. **THE BLUESTAR TRANSACTIONS**

Because a majority of the Board has not changed since the BlueStar merger and earnout settlement, the standard applied to measure demand futility is the *Aronson* test. Under that test, demand will be futile if plaintiffs create a reasonable doubt that: (1) the directors are disinterested and independent; or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. *Aronson v Lewis*, 473 A.2d 805, 811 (Del. 1984). Plaintiffs have more than adequately demonstrated that reasonable doubt for all of the directors (Hawk, McMinn, Lynch, Hoffman, Jalkut, Crandall, Runtagh and Irving) as to both of the BlueStar transactions.

1. **Hawk Is Interested In The BlueStar Transactions.**

Hawk clearly is disqualified under prong one of *Aronson* from considering a demand on the BlueStar Transactions. Covad concedes that Hawk was interested in the BlueStar Transactions. Covad Motion to Dismiss, at 44. Hawk was a BlueStar shareholder *before* the merger, and therefore stood on both sides of the transaction. Am. Compl. ¶ 59. Hawk was at that time (and still is) a special limited partner of Crosspoint, which also was a BlueStar shareholder *before* the merger. *Id.* Hawk received Covad shares for his BlueStar shares in the merger, consummated on September 22, 2000. He, along with Crosspoint and defendant Shapero, also received more than 50% of the shares paid in the Second BlueStar Transaction – the settlement of the merger's earnout provisions. Am. Compl. ¶ 78. This is interest by any measure.

2. **McMinn Is Interested In The BlueStar Transactions**

McMinn was a BlueStar shareholder, and as such, benefited from both of the BlueStar Transactions. Am. Compl. ¶ 72. He therefore is disqualified from impartially considering a demand as to these transactions. *Aronson*, 473 A.2d at 811.

Covad concedes that McMinn is interested in the BlueStar Transactions, but tries to minimize this fact by pointing out that McMinn was not on the Board at the time of the merger transaction. Covad Motion to Dismiss, at 12 & 44. This is of no moment. First, McMinn was on the Board at the time of the settlement of the earnout provisions. Am. Compl. ¶¶ 8, 74 (McMinn rejoins Board on November 1, 2000; negotiation of number of shares to be paid in earnout provision settlement concludes January 2001). Second, the fact that McMinn had a financial interest in the transaction and the fact that he was on the Board

at the time Khanna filed this suit is all that is necessary to demonstrate his inability to consider a demand. *Beam*, 845 A.2d at 1049; *Aronson*, 473 A.2d at 811.

**3. Hoffman, Jalkut, Lynch and Crandall
Lack Independence.**

For the reasons discussed in greater detail above in Sections III A.2-5, Hoffman, Jalkut, Lynch and Crandall lack independence. In brief, Hoffman is an officer of Covad and derives his livelihood from that employment. Jalkut and Crandall are affiliated with companies who do substantial amounts of business with Covad. Lynch serves on the Certive Advisory Board at the pleasure of McMinn, who was a BlueStar shareholder and benefited from the transactions. Am. Compl. ¶ 72 (McMinn owned approximately 656,942 shares of BlueStar). There is therefore a reasonable doubt under prong one of the *Aronson* test that these directors are independent.

**4. Runtagh, and Lynch Were Grossly Negligent
In Approving The First BlueStar Transaction.**

Under prong two of the *Aronson* test, a plaintiff can create a reasonable doubt that the transaction was the product of a valid exercise of business judgment if the plaintiff can demonstrate that the directors were grossly negligent in approving it. *Aronson*, 473 A.2d at 812. Covad does not dispute that the BlueStar merger was disastrous for Covad, but contends that plaintiffs can impugn the business judgment of the directors approving that merger only with facts gleaned in "hindsight." Covad Motion to Dismiss at 43-44. The Amended Complaint, however, is replete with facts known to the Board at the time it approved the transaction which unequivocally show the gross negligence of Runtagh and Lynch.

The Board did not employ any of the traditional corporate governance safeguards, such as a special committee or an independent fairness opinion. Am. Compl. ¶ 65. The only financial opinion before the Board was that of Bear Stearns, Covad's investment banker. That opinion was hopelessly conflicted (and the Covad Board knew it) because a subsidiary of Bear Stearns had a \$40 million bridge loan outstanding to BlueStar and would not see a dime of that money returned to it unless Covad acquired BlueStar. Am. Compl. ¶ 66. The only due diligence done on the First BlueStar Transaction was a report which showed that Covad had overlapping physical assets to provide DSL coverage in 70% of BlueStar's service territory. That report demonstrated that only 30% of BlueStar's territory would be of any use to Covad. Am. Compl. ¶ 68. BlueStar employed a business model (direct sales) that had been tried and rejected at Covad, which employed an entirely different business model (ISP providers). Thus, after the merger, Covad would be competing with itself in the acquired BlueStar territories. Am. Compl. ¶ 69. BlueStar was losing millions when Covad acquired it, and had already failed in its attempts to go public. Am. Compl. ¶ 68. To add insult to injury, the Board (which included Runtagh, Irving and Lynch) flatly violated its own Corporate Opportunity Policy. There was no finding that Hawk and Shapero's interests in BlueStar were appropriate under that policy. Am. Compl. ¶ 60.

These contemporaneous facts show that the Board's decision to approve and consummate the BlueStar merger was not the product of a valid exercise of business judgment.

5. **Runtagh and Irving Were Grossly Negligent
In Approving The Second BlueStar Transaction.**

Runtagh, Irving and McMinn (who had rejoined the Board by the time of the Second BlueStar Transaction) were grossly negligent in approving the settlement of the merger's

earnout provision. Under the earnout provision, the former shareholders of BlueStar would be entitled to an additional five million Covad shares if BlueStar met certain revenue criteria during the full calendar year immediately after the merger (*i e*, 2001). Am. Compl. ¶ 74.

Covad does not dispute that BlueStar never met those criteria. Covad Motion to Dismiss, at 44-45. Rather, Covad contends that the “Amended Complaint lacks any allegations from which the inference could be drawn that BlueStar’s failure (or any other intervening event, for that matter) relieved Covad from any and all liability for payment of the earn-out shares” *Id* at 45. The Amended Complaint, however, is very specific in its allegations that Covad was *not* obligated to pay these shares because BlueStar never achieved the operating results that were the condition precedent to any such obligation for Covad to pay any shares. Am. Compl. ¶¶ 74, 76.

The shocking reality is that the McMinn dominated Board was so anxious to give Hawk, Shapero and McMinn the shares under the earnout, they made the decision to settle only 17 days into the financial year (2001) which was to be the benchmark. Am. Compl. ¶ 74. In other words, BlueStar had only 17 days of performance out of 365 to determine whether the liability to pay any shares would even arise.

Plaintiffs further allege that Runtagh and Irving were grossly negligent in approving the settlement of the earnout provisions because Runtagh and Irving had delegated all negotiations to Lynch. Am. Compl ¶ 74. Lynch was clearly beholden to the interested directors (Hawk, Shapero and McMinn) because those directors controlled whether Lynch stayed on the Certive Advisory Board and continued receiving the perquisites of that position. The impact of these directors’ standing on the other side of the transaction was

significant, as they alone were in line to receive approximately 50% (or roughly 1.6 million) of all shares paid pursuant to the earnout. Am. Compl. ¶ 78.

Runtagh, Irving and Lynch utterly failed to inform themselves before approving the settlement. There were no documents in the § 220 production to show that Lynch did anything to inform himself (or that the other Board members did anything to inform themselves) of whether the earnout provisions were even likely to be triggered before the “settlement” was prematurely negotiated. They certainly did not wait until the books were closed on BlueStar’s performance that year. Am. Compl. ¶ 74. They did not have any financial advisors (such as Covad’s auditor) even look at the books to give them a reading on whether the criteria of the earnout provisions were even remotely close to being met. *Id.*

Of course, the reality is that everyone on the Board knew that BlueStar failed miserably and that its operating results simply could not satisfy the requirements of the earnout provisions. Covad tries to fudge this fact with a contention that there is nothing in the Amended Complaint to establish that there was no liability under the provisions. Covad Motion to Dismiss, at 45. But if that liability was as undefined as Covad would have it, then the directors were grossly negligent in not waiting until the completion of the benchmark year to get the definitive operating results before approving the payment of 3.25 million Covad shares. Just seventeen days into the benchmark year, the Board had *no* data on which to base any payment of Covad shares to the former BlueStar shareholders, let alone 3.25 million Covad shares. *See* Affidavit of Candice M. Toll, filed by Covad on October 8, 2004, at Ex. D

C. THE DISHNET TRANSACTION

Covad argues that plaintiffs have not demonstrated demand futility as to the Dishnet Transaction because the only allegation plaintiffs have levied is that McMinn sat on both the Dishnet board and the Covad Board at the time the of the settlement of Dishnet's adversary proceeding against Covad. Covad Motion to Dismiss, at 45-6. Covad has once again glossed over the many factual allegations of the Amended Complaint which demonstrate that a majority of the Board (McMinn, Hoffman, Lynch, Jalkut, Crandall, Hawk and Irving) are disqualified from considering a demand.

1. McMinn Fails Prong One Of Aronson

Covad contends that plaintiffs fail to impugn McMinn's ability to exercise his business judgment about pursuing the Dishnet claim because the "Amended Complaint does not allege that McMinn participated in or voted to approve the settlement (he did not)." Covad Motion to Dismiss, at 46. Covad does not understand the law of demand futility.

The fact that McMinn may have abstained from voting on the Dishnet settlement is not the least bit relevant to the futility analysis. The pertinent question is does he have any interest or influence over him that could interfere with his ability to validly exercise his business judgment on the claim. *Aronson*, 473 A.2d at 811. The answer to that question is that he does have an interest that, under prong one of the *Aronson* test, disqualifies him from considering a demand.

McMinn sat on the board of Dishnet before Covad invested in Dishnet (he was the reason Covad made such a risky investment) and continues to serve on that board today. Am. Compl. ¶ 86. He was in the untenable position of sitting on both boards during the time that they were litigation adversaries. *Id* ¶ 89. Nor is he simply a director of Dishnet as Covad

would have it. He also owns stock options in the company. *Id.* ¶ 86. As McMinn stands on both sides of the transaction, it is abundantly clear that he cannot consider a demand. *Beam*, 845 A.2d at 1049; *Aronson*, 473 A.2d at 811.

2. **Hoffman, Lynch, Jalkut and Crandall
Lack Independence**

For all the reasons set forth in Section III.A.2-5 above, Hoffman, Lynch, Jalkut and Crandall lack independence. Hoffman owes his livelihood to McMinn allowing him to remain employed at Covad. Lynch owes his lucrative position on the Certive Advisory Board to McMinn. Jalkut and Crandall are affiliated with companies who do a substantial business with Covad and do not want to risk the favorable terms of those dealings with Covad by displeasing McMinn. In short, these directors fail the independence test of prong one of *Aronson*.

3. **Hoffman, Hawk, Lynch and Irving Were Grossly
Negligent In Approving the Dishnet Settlement**

Given that Covad's Chairman (McMinn) was sitting on the board of a litigation adversary who was claiming \$24 million in damages from Covad, the Board's failure to employ any of the traditional corporate governance safeguards in approving the settlement of that claim is not just grossly negligent – it is shocking. The Board did not get any financial or legal analysis of the terms of the settlement. *Am. Compl.* ¶ 92. As with the BlueStar earnout settlement, the Board failed to even get an opinion as to the strengths and weaknesses of Covad's position. Covad makes the nonsensical argument that "the Amended Complaint does not allege facts which fairly raise the inference that the directors who approved the settlement did so without conducting any due diligence or without relying on the advice of its counsel – at that time, Mr. Khanna." *Covad Motion to Dismiss*, at 46. How much clearer

can plaintiffs be – no due diligence was conducted and no such advice was sought. Am. Compl. ¶ 92. There certainly were no documents evidencing any such actions on the Board's part in the § 220 production. Moreover, it is outrageous that Covad would even intimate that Khanna provided any legal advice on the settlement. Khanna was unequivocal in his testimony in the § 220 proceeding that the Board never sought his advice on any of the transactions at issue and he never provided any legal advice on the subjects.¹⁴ Transcript of Trial and Argument on Defendant's Motion to Dismiss Plaintiff's Section 220 Demand, dated November 18, 2003, C.A. No. 20481 attached to the Calder Decl. as Ex. A. Hoffman, Hawk, Lynch and Irving were therefore grossly negligent in approving the Dishnet settlement.

4. **Hoffman, Hawk, Lynch and Irving Lack Independence Because They Have Exhibited A Pattern and Practice of Deferring to McMinn's Wishes**

As this Court held in *Beam*, a pattern and practice of voting in line with and for the interests of another director can establish a director's independence. 833 A.2d at 981 (“[a]rmed with [] information [about a director's pattern of voting for dominating director's proposals], plaintiff (and this Court) would be in a much better position to evaluate whether there exists a reasonable doubt of the outside directors' resolve to act independently of [the dominating director]”); *see also California Public Employees' Retirement Sys v Coulter*, 2004 WL 1238443, at *7 (Del. Ch.) (evidence of directors voting for interests of Chairman

¹⁴ Khanna did inform the Board that he wanted McMinn to resign from the Dishnet board, but this certainly was not legal advice – it was business advice. Am. Compl. ¶ 89. Certainly no one on the Board solicited Khanna's legal opinion on the matter. In fact, after Khanna expressed his views on McMinn's continued service on the Dishnet board, the members of the Covad Board shunned him. *Id.*

“would serve to show a continuing pattern on the part of the Board” and would “serve to question the independence of the Board”).

Hoffman, Hawk, Lynch and Irving have also displayed a pattern of voting for whatever McMinn wants, regardless of the consequences to Covad. The § 220 production made by Covad establishes that each of these directors have voted in favor of every transaction in which McMinn had a personal interest. This fact alone demonstrates the futility of demand on these directors *Beam*, 833 A.2d at 981.

IV. PLAINTIFFS HAVE STATED CLAIMS FOR BREACH OF THE DUTY OF DISCLOSURE.

Covad contends that plaintiffs have failed to state claims for defendants’ failure to disclose any of the facts surrounding Khanna’s allegations of wrongdoing. Covad Motion to Dismiss, at 46-47. Covad should have read the counts of the Amended Complaint a little more closely. If it had, it would have seen that plaintiffs did not name Covad as a defendant in those counts.¹⁵ Covad therefore lacks standing to even seek the dismissal of these claims. *Kohler Co v Kohler Int’l, Ltd*, 196 F. Supp. 2d 690, (N.D. Ill. 2002) (corporation could not move to dismiss claims not asserted against it).

Even if Covad did have standing to pursue dismissal of these claims, it has failed to present the Court with any basis to grant such a dismissal. Covad does not dispute that “directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the board’s control when it seeks shareholder action.” *Stroud v. Grace*, 606 A 2d 75, 84 (Del. 1992). It simply argues that the omissions plaintiffs have alleged are not material. Covad has dredged up the defendants’ standard “self-flagellation”

¹⁵ Covad is named in this action as a nominal defendant only. Plaintiffs did not assert any direct claims against Covad.

argument as the reason plaintiffs have failed to state a claim. Specifically, Covad argues that the directors were under no obligation to “disclose Khanna’s own pejorative characterizations of the related-party transactions.” Covad Motion to Dismiss, at 47. Once again, Covad misapprehends the allegations of the Amended Complaint.

Plaintiffs do not allege that the directors breached their duty of disclosure to Covad’s shareholders by not setting forth Khanna’s characterizations of their wrongdoing. Rather, plaintiffs alleged that the director defendants utterly failed to disclose even the most basic facts of what Khanna asserted was at issue. The deficient disclosure made was as follows:

Mr. Khanna alleged that, over a period of years, certain current and former directors and officers had breached their fiduciary duties to Covad by engaging in or approving actions that constituted waste and self-dealing....

Am Compl. ¶ 133 Covad contends that the “facts of the challenged transactions” were “manifestly disclosed in Covad’s June 10, 2002, June 25, 2003, and April 30, 2004 proxy statements.” Covad Motion to Dismiss, at 47. The problem with this syllogism is that the directors never even identified which transactions Khanna was challenging or why. How were the shareholders even supposed to know which transactions were at issue? Disclosure elsewhere in the proxy statements of the fact that the transactions occurred without tying them in any way to Khanna’s allegations certainly does not meet the duty of disclosure. *Alidina v Internet com Corp*, 2002 WL 31584292, at *9 (Del. Ch.) (finding plaintiffs stated disclosure claim where there was no attempt to provide more information beyond self-serving statement); *cf Weingarden v Meenan Oil Co*, 1985 WL 44705, at *3 (Del. Ch.) (finding no disclosure violation where initial disclosure in filing expressly cross-referenced other portion of filing where greater detail could be found).

Even if Covad's contentions could somehow satisfy the law on disclosure, which they cannot, Covad ignores that certain directors' interests were never disclosed. While the Certive transaction and McMinn's interest therein has generally been disclosed, the interest of Shapero and Hawk (through Crosspoint) in Certive has never been disclosed in Covad's public filings. Even if shareholders were to comb through all disclosures of every interested transaction, they would never find the Shapero/Hawk ties to the Certive transaction.

Covad also completely ignores that plaintiffs also alleged the director defendants failed to disclose the reasons for Khanna's termination. The only disclosure surrounding Khanna's termination is as follows:

we concluded in January 2003 that it would not be appropriate to continue Mr. Khanna on paid leave status, and determined that there was no suitable role for him at Covad. Accordingly, he was terminated as an employee of Covad.

Am. Compl. ¶ 133 The reason Khanna was terminated is quite simple – he dared to challenge the directors who were engaging in self-interested transactions which were harming Covad. The directors can point to no other reason for his dismissal, as their own specially commissioned investigation into sexual harassment and discrimination claims against him exonerated him. Am. Compl. ¶ 216 Given that Khanna was trying to protect the corporation from the wrongdoers and they retaliated, the reasons for his dismissal would clearly have been material to Covad's shareholders.

V. PLAINTIFFS' CLASS CLAIMS ARE NOT BARRED BY LACHES

Covad contends that all of plaintiffs' class claims should be barred under the doctrine of laches because Khanna did not assert the first of these claims until roughly a year after the first challenged election of 2002. Covad Motion to Dismiss, at 48. Covad's motion must be denied for several reasons

First, laches is a fact-based defense that cannot be resolved on a motion to dismiss. *Goldman v Pogo com Inc*, 2002 WL 1358760, at *2 n.16 (Del. Ch.) (refusing to dismiss claims for laches on undeveloped factual record); *see also Erickson v Centennial Beauregard Cellular LLC*, 2003 WL 1878583, at *9 (Del. Ch.) (laches defense could not be decided on incomplete factual record); *Tafeen v Homestore, Inc*, 2004 WL 556733, at *8 (Del. Ch.) (“[w]hether or not [the] elements [of laches] exist is generally a fact-based inquiry, and therefore summary judgment is rarely granted on a laches defense”); *Clark v Packem Assoc*, 1991 WL 36470, at *5 (Del. Ch.) (“[t]he determination of the validity of the laches defense is one of fact, and is rarely granted on summary judgment”) Covad simply is not entitled to dismissal on laches grounds at this stage of the proceedings.

Second, although Covad’s arguments do not even address the issue of laches being a fact-driven defense not amenable to a Rule 12(b)(6) motion, plaintiffs can point to specific factual issues that prevent the grant of a laches dismissal. Covad has claimed that Khanna knew about the deficiencies of the 2002 proxy statement but failed to bring suit until a year later. What Covad fails to tell the Court is that counsel to the Committee advised Khanna that Covad had retained separate counsel for Khanna’s allegations of the deficiencies of Covad’s disclosures. E-mail communication from Dhruv Khanna to Covad’s counsel, dated November 13, 2002 E-Mail Communication from Dhruv Khanna to Doug Carlen dated November 13, 2002 (Document Bates Labeled KH 000021-22 (Joint § 220 Trial Exhibit 33)) attached to Calder Decl. as Ex G; Letter from Stephen D. Ross, P.C. to George Grellas, Esquire dated February 13, 2003 (Document Bates Labeled KH 000317-318 (Joint § 220 Trial Exhibit 62)) attached to Calder Decl. as Ex H. Khanna naturally believed that Covad had retained the counsel to examine his disclosure claims, and he refrained from bringing suit

while that counsel conducted its inquiry. It now appears that no such inquiry was ever conducted,¹⁶ but this is a factual issue which cannot be adjudicated at the motion to dismiss stage. *Goldman*, 2002 WL 1358760, at *2 n.16.

Third, Covad's arguments for why laches should apply are all directed at only the class action count challenging the 2002 election. Covad, in its typical broad-brush fashion, makes a factually-based argument (which cannot be the basis for a dismissal at this stage of the proceedings) as to the 2002 election claims and sweeps the 2003 and 2004 claims into the same mix. There is obviously less of a gap of time between filing of the original complaint and the 2003 and 2004 elections,¹⁷ and Covad does not even address why laches should apply to those claims.

¹⁶ Plaintiffs cannot tell if the Committee ultimately addressed Khanna's allegations of disclosure violations or not because Covad has refused to give Khanna the Committee's report. All Khanna (and the investing) public have been told is that the Committee found Khanna's "allegations were without merit." Am Compl ¶ 133

¹⁷ The 2004 election had not even occurred when the action was originally filed. There simply cannot be any laches defense as to the claim on that election.

CONCLUSION

For all the foregoing reasons, plaintiffs respectfully submit that Covad's Motion to Dismiss Amended Derivative and Class Action Complaint be denied.

Dated: November 19, 2004

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CERTIFICATE OF SERVICE

I hereby certify that on the 19th day of November, 2004 the foregoing Plaintiffs' Answering Brief in Opposition to Covad Communications Group, Inc.'s Motion to Dismiss Amended Derivative and Class Action Complaint was served via electronic filing upon the following:

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