



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

DHRUV KHANNA, PATRICK SAMS, and)
SYBIL MEISEL,)

Plaintiffs,)

v.)

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,)

and)

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

Nominal Defendant.)

**MEMORANDUM IN SUPPORT OF COVAD COMMUNICATIONS
GROUP, INC.'S MOTION TO DISMISS AMENDED DERIVATIVE
AND CLASS ACTION COMPLAINT**

OF COUNSEL:
Paul H. Dawes
Darius Ogloza
David M. Friedman
LATHAM & WATKINS LLP
135 Commonwealth Drive
Menlo Park, CA 94025
(650) 328-4600

Jesse A. Finkelstein (Bar No. 1060)
Candice M. Toll (Bar No. 4465)
RICHARDS, LAYTON & FINGER, P.A.
One Rodney Square
P. O. Box 551
Wilmington, Delaware 19899
(302) 651-7700
Attorneys for Defendant
Covad Communications Group, Inc.

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INTRODUCTION & SUMMARY OF ARGUMENT

By this motion, nominal defendant Covad Communications Group, Inc. (“Covad” or “Company”) asks this Court to dismiss with prejudice the amended derivative and class action complaint (“Amended Complaint”) filed by the Company’s former General Counsel, Dhruv Khanna (“Khanna”), and two other putative shareholder plaintiffs on August 3, 2004.

As this Court observed at the November 18, 2003 trial in *Khanna v. Covad Communications, Inc.*, Case No. 20481 (“Section 220 Case”), this is no ordinary shareholder litigation. Rather than pursue his personal, employment-related grievances through customary channels, Khanna elected, instead, to harass his perceived enemies on Covad’s Board in this Court, under the guise of acting as a champion for Covad’s shareholders. In his haste to file the derivative litigation he first threatened to bring after being relieved of his duties as Covad’s General Counsel in June 2002, Khanna filed an original complaint in this Court that plainly warranted dismissal under Delaware Court of Chancery Rule 23.1 (“Rule 23.1”). Rather than test his original complaint’s sufficiency against the motions to dismiss filed by Covad and by the individual defendants, Khanna elected to file an Amended Complaint. Yet, despite having access to the more than 4,000 pages of internal Company documents produced to him in Section 220 Case, the Amended Complaint fails to cure the defects evident in his original complaint.

Plaintiffs failed to adequately plead wrongful rejection of demand. The Amended Complaint manifestly lacks the particularity necessary to plead that Covad’s Board *wrongfully rejected* Khanna’s initial June 2002 demand. To do this, Khanna (and

the co-plaintiffs he has apparently solicited in an attempt to cure another fatal defect in his original complaint)¹ must plead particularized facts showing that the Board failed to conduct a reasonable and good faith inquiry into his allegations of wrongdoing in connection with the transactions he challenges in the Amended Complaint (Counts I-VII). Even when viewed in the light most favorable to the plaintiffs, the Amended Complaint fails to raise any doubt (much less a reasonable doubt) concerning the thoroughness or good faith of the Board's investigation into Khanna's meritless allegations. In fact, fairly read, the Amended Complaint establishes that plaintiffs cannot meet this burden. Accordingly, their derivative claims should be dismissed with prejudice.

Plaintiffs failed to adequately plead demand futility. Unable to plead to this stringent standard, plaintiffs attempt to rewrite history. Ignoring the historical facts, the Amended Complaint alleges that Khanna did *not* make a demand on Covad's Board and that he is excused from doing so. This allegation is demonstrably false and should be disregarded. However, even if this revisionist history is accepted for purposes of this motion, the Amended Complaint still fails to satisfy Rule 23.1's requirement for pleading demand futility. Specifically, the Amended Complaint fails to plead—as it must to survive a motion to dismiss—particularized facts showing that Covad's Board as constituted at the time the original complaint was filed (Covad's "Current Board") is

¹ As addressed in Covad's concurrently-filed motion to disqualify, Khanna's filing of this derivative and class litigation is in disregard of principles of legal ethics that continue to govern his relationship with Covad, his former client. Delaware law is clear that the same ethical considerations that bar an attorney from acting as counsel against a former client disqualify him or her from acting as a derivative plaintiff. As also addressed in Covad's concurrently-filed motion to disqualify, Khanna's belated solicitation of two additional putative shareholder plaintiffs in his Amended Complaint is insufficient as a matter of law to cure this fatal defect.

incapable of making an impartial decision regarding a demand or that one or more of the challenged transactions was not the product of valid business judgment.

The Amended Complaint's attempt to show that the Current Board could not act impartially on a demand fails. In fact, the Amended Complaint fails to raise any reasonable doubt about the independence or disinterestedness of at least six of Covad's eight current directors. Plaintiffs' attempt to show that the challenged transactions are undeserving of business judgment rule protection is also inadequate. At bottom, the Amended Complaint's allegations boil down to the following theory: Some directors benefited from disclosed and evaluated related-party transactions that other, financially disinterested directors approved and so (the logic goes) the financially disinterested directors who approved the transactions must have failed to exercise their independent judgment, because now (with 20/20 hindsight) it appears that the transactions were not beneficial for Covad. Lacking the required particularized facts, plaintiffs necessarily rely on conclusory and speculative allegations and on gross mischaracterizations of internal Company communications produced in the Section 220 Case to plead their case—precisely the kind of allegations Delaware courts have repeatedly rejected as inadequate under Rule 23.1. In short, plaintiffs fail to adequately plead their case under both prongs of the *Aronson* test and, accordingly, the Amended Complaint's derivative claims require dismissal even if Khanna had not made a demand.

Plaintiffs' class claims should also be dismissed. Covad also moves to dismiss the Amended Complaint's three putative class action claims, by which plaintiffs seek to void the results of three board elections (Counts VII-X). Plaintiffs demand this

extraordinary relief based on Covad's directors' alleged duty to disclose Khanna's June 2002 allegations of unadjudicated wrongdoing in proxy materials issued in connection with July 2002, August 2003 and June 2004 directorial elections.

In addition to the fact that none of the plaintiffs qualify to serve a class representatives,² Delaware law requires dismissal of the class claims for two independent reasons. *First*, Plaintiffs' class claims fail to state a claim for which relief can be granted. In short, Covad's June 10, 2002, June 25, 2003 and April 30, 2004 proxy statements disclosed all of the facts regarding Khanna's allegations that required disclosure; plaintiffs' contention that more disclosure was required runs afoul of the Delaware "self-flagellation" rule. *Second*, plaintiffs' demand that this Court exercise its equitable powers to unwind these board elections is barred by laches. Plaintiff Khanna knew of the alleged proxy disclosure violations more than a year before he initially filed his class action lawsuit. Rather than seeking immediate injunctive relief, Khanna chose to sit on his hands until after the Company incurred the cost of completing two elections, seating six board members and attending to a year's worth of board business. Putative plaintiffs Sams and Meisel were on notice of the alleged disclosure violations as early as March 31, 2003, when Khanna's allegations were disclosed in Covad's annual report for the 2002 year. Nevertheless, Sams and Meisel chose to wait until after the 2003 and 2004 directorial elections were concluded before filing their class action lawsuits.

² These considerations are addressed in Covad's concurrently-filed motion to disqualify.

STATEMENT OF FACTS³

A. The Parties

Covad is a Delaware corporation headquartered in San Jose, California. It was founded in 1996 and is a leading national service provider of broadband high-speed Internet and network access utilizing Digital Subscriber Line (“DSL”) technology. Covad’s Current Board is comprised of eight directors: L. Dale Crandall, Robert Hawk, Charles Hoffman, Larry Irving, Richard A. Jalkut, Daniel Lynch, Charles McMinn and Hellene Runtagh. Am. Compl. ¶¶ 8-9, 12, 15-16, 17, 19, 20.

Plaintiff Dhruv Khanna is a Covad founder and former officer. See Section 220 Case Trial Transcript (“Tr.”) 29:19 – 30:1, 31:6-13, attached as Ex. A to Affidavit of Candice M. Toll (“Toll Aff.”).⁴ From Covad’s founding until June 2002, when he was relieved of his duties, Khanna was employed as Covad’s General Counsel and was involved with assessing matters regarding conflicts of interest. See Tr. 127:11-21 (“[o]n matters of conflict of interest, I felt I had a role to play. I felt I played that role very well”). As the Company’s General Counsel, Khanna also came into possession of

³ Covad disputes many of the factual allegations in the Amended Complaint and takes as true the pleaded allegations solely for purposes of this motion.

⁴ Covad requests this Court to take judicial notice of the trial transcript and trial exhibits admitted into evidence in the case *Khanna v. Covad Communications, Inc.*, No. 20481-NC. Courts routinely take judicial notice of trial transcripts of related proceedings and other records in cases before the same court and the same judge. See, e.g., *Holland v. Great Eastern, Inc.*, 1978 Del. Ch. LEXIS 514, at *9 (Del. Ch. Jan. 25, 1978); see also 1 JACK B. WEINSTEIN & MARGARET A. BERGER, WEINSTEIN’S FEDERAL EVIDENCE § 201.12[3] (2d ed. 2003). These materials are not subject to reasonable dispute as this Court (and this Vice-Chancellor), plaintiff and his attorneys were present and the proceedings were recorded by a professional court reporter. See *D.R.E.* 201(b)(2). Trial exhibits referenced herein are attached to the Toll Affidavit as Exhibits A to L.

privileged and confidential information relating to the related-party transactions he now challenges. *See Khanna v. Covad*, No. 20481-NC Trial Exhibit (“Trial Ex.”) J124.⁵ Plaintiffs Patrick Sams and Sybil Meisel claim to be Covad shareholders, who joined in this lawsuit sometime after Khanna filed his original complaint and, presumably, after they reviewed documents produced to Khanna in the Section 220 Case.⁶

B. Procedural History

On or about June 19, 2002—only a couple of weeks after being relieved of his duties as chief legal officer—Khanna sent Covad’s Current Board a letter setting forth the derivative allegations contained in the Amended Complaint. In the letter, Khanna asserted that he intended to bring suit if necessary to seek redress for the alleged breaches of fiduciary duty. Am. Compl. ¶¶ 27(b), 196; Trial Ex. J123.

Khanna thereafter offered in writing not to pursue litigation against Covad if the Board agreed to grant him certain lavish perquisites. Trial Ex. J123. Khanna offered to

⁵ Trial Exhibits J123 and J124 (respectively, the June 19, 2002 and July 9, 2002 letters from plaintiff Khanna and his attorneys to the Covad Board and CEO Hoffman) should also be judicially noticed as they were referenced in the Amended Complaint. This Court has held that it is appropriate to consider documents referred to and incorporated in a complaint on a motion to dismiss. *See, e.g., Leung v. Schuler*, 2000 Del. Ch. LEXIS 41, at *3 (Del. Ch. Feb. 29, 2000) (deciding motion to dismiss based on complaints and documents incorporated by reference therewith); *In re ML/EQ Real Estate P’ship Litig.*, 1999 Del. Ch. LEXIS 238, at *5 (Del. Ch. Dec. 20, 1999) (“by expressly referring to and so heavily relying on these documents in the Amended Complaint, plaintiffs have incorporated them by reference”) (citation omitted).

⁶ Plaintiff Meisel is not new to shareholder litigation. She apparently was a lead plaintiff in several class action securities and derivative cases. *See Friedman v. Salomon/Smith Barney*, 313 F.3d 796 (2d. Cir. 2002); *Ganesh LLC v. Computer Learning Ctrs., Inc.* 183 F.R.D. 487 (E.D. Va. Dec. 18, 1998); *Meisel v. Cali* (C.A. 9734401, Baltimore Circuit Court, MD); *Meisel v. Nussbaum* (C.A. No. 16905-NC, Del. Ch.).

drop all of his allegations if the Board agreed to re-hire him, either as Vice President of Corporate Strategy, General Counsel, or the Company's CEO. He also demanded a seat on the Company's Board, a significant increase in salary, a no-termination employment relationship for no less than fifteen years and a public statement clearing him of all wrongdoing. *See* Tr. 145:14-24; 150:4-21; 151:13 – 153:9; 154:19-21; 157:22 – 159:7; 164:5 – 165:17; Trial Ex. J123 at 11-12. On July 9, 2002, Khanna sent a “draft” derivative complaint to the Board, “specifically articulating causes of action to address the multiple self-dealing transactions” alleged in the Amended Complaint. Trial Ex. J124; Am. Compl. ¶ 123. Khanna and the Board entered into settlement discussions during the period from July 10-23, 2002. Am. Compl. ¶ 116.

Meanwhile, the Board established a Special Investigation Committee (“Committee”), consisting of directors Runtagh and Crandall,⁷ to investigate Khanna's allegations of fiduciary breaches by Covad's directors. Am. Compl. ¶ 124. Khanna corresponded frequently with the Committee's counsel regarding his allegations through the latter half of 2002. *Id.* ¶¶ 2, 128. Khanna also met with the Committee on three separate occasions. *Id.* On December 26, 2002, the Committee informed Khanna that his allegations were “without merit.” *Id.* ¶ 133. Khanna's employment was terminated shortly thereafter. *Id.*

Approximately six months after he was terminated, Khanna made a demand to inspect Covad's books and records. On August 11, 2003, Khanna filed suit under Section 220 of the Delaware General Corporation Law. *See Khanna v. Covad Communications*,

⁷ Director Jalkut was added to the Committee shortly after he was appointed to the Board in July 2002. Am. Compl. ¶ 126.

Inc., 2004 Del. Ch. LEXIS 11 (Del. Ch. Jan. 23, 2004) . On September 15, 2003, before trial in the Section 220 Case, Khanna filed the original complaint in this action, purportedly because of limitations concerns. *Id.* at *11. On December 12, 2003, the individual defendants filed motions to dismiss and the Company moved to dismiss and disqualify Khanna. Before responsive briefing was filed, this Court ordered the production of several categories of documents identified in Khanna’s inspection demand but determined that the Company did not have to produce any privileged or work product documents as Khanna had “not sought to circumvent either the attorney-client privilege or work product doctrine and, certainly, has not made any necessary showing.” *Id.* at *26. After the order issued, the Company produced more than 4,000 pages of documents to Khanna subject to a protective order. Rather than responding to the motions to dismiss or the motion to disqualify, Khanna, along with plaintiffs Sams and Meisel, filed an Amended Complaint on August 3, 2004.

C. The Alleged Breaches of Fiduciary Duty

In the derivative portion of the Amended Complaint, plaintiffs purport to state five causes of action for breach of fiduciary duty against certain current and former Covad directors, arising out of four related-party transactions that were approved by Covad’s Board between November 1999 and February 2002.

Specifically, plaintiffs allege that the defendant directors breached their fiduciary duty by approving:

- (1) in “late 1999,” a \$5 million investment in Certive, a new enterprise founded by defendant McMinn;

(2) in June 2000, a merger between Covad and a “Covad look-alike company,” BlueStar, in which defendant McMinn had a direct financial interest and defendants Shapero and Hawk had indirect financial interests through their venture firm, defendant Crosspoint;

(3) in April 2001, the payment of 3,250,000 shares of Covad stock to former BlueStar shareholders, including defendants McMinn, Shapero and Hawk, as part of a negotiated settlement of the BlueStar shareholders’ contractual earn-out rights; and

(4) in February 2002, a settlement with Dishnet, an Indian telecommunications company, on whose board defendant McMinn sat at the time of the settlement.

Plaintiffs allege that these transactions were made at “inflated valuations” over Khanna’s objections and/or the objections of other members of management. Plaintiffs further allege that these transactions were approved to benefit director McMinn, and with regard to the Certive and the two BlueStar transactions, also to benefit directors Shapero and Hawk, and the latter two directors’ venture capital firm, defendant Crosspoint. Plaintiffs also allege that defendants Lynch and Marshall had financial interests in the Certive transaction due to the fact that at some **unspecified point in time** they joined a Certive advisory board. Am. Compl. ¶ 56. The Amended Complaint further alleges, in conclusory fashion, that the Board was so dominated and controlled by McMinn that the directors who approved these transactions “refused” to exercise independent judgment. *See* Am. Compl. ¶¶ 138-141.

In addition to challenging the Covad Board’s approval of the four related-party transactions, plaintiffs purport to state two additional causes of action relating to the 1999 Certive transaction. Specifically, the Amended Complaint includes a cause of action against defendants McMinn, Shapero, and the venture firm, defendant Crosspoint, for

usurpation of an alleged corporate opportunity, and a cause of action alleging that various directors breached their fiduciary duty by allowing director McMinn to vest his founder's shares in Covad despite the fact that he allegedly was founding Certive while remaining an employee of Covad. Am. Compl. at ¶¶ 149-157; ¶¶ 146-147.

Plaintiffs also purport to state two causes of action solely against Crosspoint for aiding and abetting the alleged breaches of fiduciary duty stemming from the Certive and BlueStar transactions, and a respondeat superior claim based on the actions of director Shapero, as Crosspoint's general partner and managing partner, and director Hawk, due to his special limited partner investor status in Crosspoint.

Plaintiffs' three putative class action claims (Counts VIII-X) purport to arise out of the director defendants' alleged failure to "accurately and properly" disclose the contents of Khanna's June 19, 2002 letter in proxy materials issued in connection with directorial elections held in July 2002, August 2003 and June 2004. The Amended Complaint alleges that the directors breached their duty of candor by failing to disclose both the asserted "real" reasons for Khanna's removal and Khanna's allegations of alleged corporate wrongdoing. *See* Am. Compl. ¶¶ 1, 191-219.

D. Demand Futility Allegations

Plaintiffs contend that Khanna's June 19, 2002 letter challenging and demanding redress for the alleged wrongdoing that is the subject of the Amended Complaint did not constitute a demand and that demand on the Current Board would have been futile. Am. Compl. ¶ 136. To support its demand futility allegations, the Amended Complaint

alleges that the Board is incapable of making an impartial decision and that the challenged transactions were not the product of valid business judgment.

The Amended Complaint contains no allegations concerning any purported lack of disinterestedness on the part of director Crandall—indeed, director Crandall joined the Board after the challenged transactions occurred. Likewise, director Jalkut joined the Board after the challenged transactions occurred. Nevertheless, plaintiffs purport to challenge director Jalkut’s disinterestedness on the basis that he was appointed to the Board in the midst of the continuing discussions between Khanna and Covad concerning the allegations raised in Khanna’s June 19, 2002 letter. Am. Compl. ¶¶ 116-117, 136.

Plaintiffs’ only allegations regarding the purported lack of disinterestedness on the part of directors Hoffman, Runtagh, and Irving appear to be that because they voted for one or more of the challenged transactions, they purportedly face a “substantial likelihood” of liability for their decisions as Board members. See Am. Compl. ¶ 141. Plaintiffs also contend that director Runtagh is not disinterested because the Board resolutions creating the Special Investigation Committee gave Mr. Crandall the authority to act alone *in the event that an alleged material conflict arose* as to Ms. Runtagh’s ability to serve on the Committee. Am. Compl. ¶¶ 125, 137. Finally, plaintiffs allege that director Lynch is not disinterested as to the challenged Certive transaction because, *at some unspecified time*, he was asked to join an advisory board of that start-up company. Plaintiffs also allege that director Lynch lacks disinterestedness in the challenged BlueStar earn-out transaction because he helped negotiate the settlement that was subsequently approved by Covad’s Board. *Id.* ¶¶ 137-138.

Plaintiffs' allegations that the Current Board lacks independence to impartially consider a demand are either conclusory or legally irrelevant or both. Plaintiffs allege, in conclusory fashion, that all of the Board members are dominated and controlled by McMinn. Am. Compl. ¶ 138. Plaintiffs contend that this domination and lack of independence is somehow evidenced by the fact that certain members of the Current Board approved the challenged transactions which allegedly benefited McMinn and/or that those members recruited McMinn to rejoin Covad. *Id.* Plaintiffs also contend that director Hoffman is not independent because he is an employee of the company, has admitted that he regards McMinn (the Board's Chairman) as "his boss," and "owes his livelihood to maintaining his positions at Covad." *Id.* As to director Jalkut, Khanna contends, bizarrely, that he lacks the independence to consider a demand because he is CEO of a Covad customer. *Id.* ¶¶ 17, 138. Lastly, the Amended Complaint alleges that director Lynch lacks independence because he is a personal friend and neighbor of McMinn's and continues to serve on Certive's advisory board "at the pleasure of McMinn." *Id.* ¶¶ 9, 138.

The Amended Complaint attempts to show that the four challenged related-party transactions were not the product of valid business judgment essentially by alleging (conclusorily and with the benefit of 20/20 hindsight) that the transactions were bad business decisions that cost Covad's shareholders "millions." Specifically, as to the BlueStar merger transaction, plaintiffs allege that the transaction improperly benefited McMinn (who was not affiliated with Covad at the time the transaction was approved), Hawk and then-director Shapero, who was also a member of the Board of Directors of

BlueStar (allegedly in violation of the Board’s anti-conflict policy). Am. Compl. ¶ 11. Plaintiffs also allege that the Board members who approved the transaction acted “in haste” and made a bad business decision, on the advice of defendant and then-CEO Knowling (and at the urging of Shapero) but against the advice of certain other members of management, including Khanna. *Id.* ¶¶ 61-62. Plaintiffs further contend that the merger was made at an inflated price to benefit McMinn, Shapero and Hawk. *Id.* ¶ 73. Regarding the BlueStar earn-out transaction, plaintiffs contend that the payment of 3,250,000 shares of Covad stock to former BlueStar shareholders in settlement of those shareholders’ contractual claims was unfair to Covad, improperly benefited McMinn, Shapero, and Hawk, and was approved by less than a quorum of directors. *Id.* ¶¶ 74-75. As to the Dishnet settlement, plaintiffs allege that the transaction was improper because McMinn served on the boards of both companies at the time the settlement was approved. *Id.* ¶¶ 139, 173. Notably, the Amended Complaint does not even attempt to allege that the directors who approved these related-party transactions lacked disinterestedness. Indeed, plaintiffs concede this fact in their Amended Complaint, and Khanna conceded it at the November 18, 2003 trial. *Id.* ¶¶ 72, 75-80, 92; Tr. 187:16 – 190:8; 199:16 – 201:1; 216: 10-17; 217:2 – 218:24.

As to the Certive-related transactions, the Amended Complaint alleges that Covad’s \$5 million investment in that start-up company improperly benefited directors McMinn, Shapero, and Hawk. Uniquely with respect to this transaction, the Amended Complaint alleges that it was approved by an interested Board in that two of the voting directors, director Lynch and then-director Marshall, joined an advisory board of Certive,

without pleading that membership arose before the Covad Board approved its \$5 million investment in this start-up company. The Amended Complaint is silent as to when Lynch and Marshall joined the advisory board and pleads no specifics as to what remuneration was or is paid to the advisory board members. Am. Compl. ¶ 56.

ARGUMENT

I. PLAINTIFFS HAVE NOT PLED PARTICULARIZED FACTS SHOWING WRONGFUL REJECTION OF DEMAND

Plaintiffs allege (albeit in a waffling way) that they did not make a demand on the Board and that demand is excused. Am. Compl. ¶¶ 136. This is revisionist history designed to avoid Delaware's stringent requirement for pleading that a pre-lawsuit demand was wrongfully rejected. However, plaintiffs cannot now avoid the judicially noticeable fact that *Khanna's June 19, 2002 letter constituted a demand on Covad's Board*. See Trial Ex. J123. Plaintiffs' counterfactual allegations relating to pre-lawsuit demand should be disregarded. See, e.g., *In re Wheelabrator Techs., Inc. S'holders Litig.*, 1992 Del. Ch. LEXIS 196, at *13 (Del. Ch. Sept. 1, 1992) (court can disregard allegations in the complaint that are contradicted by judicially noticed facts contained in a proxy). Because plaintiff Khanna made a demand on Covad's Board (a decision plaintiffs now apparently regret) the sufficiency of plaintiffs' derivative claims must be analyzed under the standard applicable to complaints alleging wrongful rejection—a standard the Amended Complaint fails to meet.

A. Plaintiff Khanna Made a Demand on Covad's Board

Khanna's June 19, 2002 letter satisfies Delaware law's requirements for a demand. A demand letter does not need to "assume a particular form" or "be made in

any specific language.” *Stoner v. Walsh*, 772 F. Supp. 790, 796 (S.D.N.Y. 1991) (New York law); *Allison v. Gen. Motors Corp.*, 604 F. Supp. 1106 (D. Del. 1985, *aff’d mem.*, 782 F.2d 1026 (3d Cir. 1985); *see also Yaw v. Talley*, 1994 Del. Ch. LEXIS 35, at *20-21 (Del. Ch. Mar. 2, 1994) (“[t]here is no all-inclusive legal formula defining what types of communications will constitute a demand”). To be deemed a demand, the letter need only do three things: “[i] identify the wrongdoers, [ii] describe the factual basis of the wrongful acts and the harm caused to the corporation, and [iii] request remedial relief.” *Yaw*, 1994 Del. Ch. LEXIS 35, at *21 (quoting *Allison*). Khanna’s June 19, 2002 letter satisfies all three of these elements and consequently qualifies as a demand under Delaware law.

First, the June 19, 2002 letter purports to identify all of the Covad directors who, plaintiffs now allege, wrongfully benefited from the challenged transactions. Trial Ex. J123 at 3, 7. The letter also identifies defendants McMinn and Shapero as having breached their fiduciary duties of loyalty in connection with the challenged transactions and as having orchestrated alleged breaches of fiduciary duty by other Covad directors. *Id.* at 2-3. The June 19, 2002 letter also contends that Covad’s directors acted under McMinn’s and/or Shapero’s domination and control in approving the challenged transactions. *Id.* at 2-3.

Second, the June 19, 2002 letter describes in detail the factual basis for the allegedly wrongful acts described in the Amended Complaint and the harm those acts allegedly caused the Company. The letter plainly alleges that McMinn usurped a corporate opportunity by founding Certive while he was an employee of Covad. Trial

Ex. J123 at 2. Moreover, each of the four related-party transactions challenged in the Amended Complaint is referred to in the letter. For example, the letter asserts that the Board committed waste and breached its duty of loyalty by investing in Certive and that those actions cost the Company millions of dollars. *Id.* As to Dishnet, the letter contends that McMinn served as a director of both the Covad and Dishnet Boards while the companies were engaged in settlement negotiations and that McMinn caused the Board to approve a settlement that resulted in losses of millions of dollars to the Company. *Id.* at 2-3. Similarly, the June 19, 2002 letter charges that the BlueStar merger and subsequent earn-out transaction were orchestrated by McMinn and his “cronies” on the Board, including Shapero and Hawk (partners in the venture capital fund, defendant Crosspoint) for their own personal benefit. *Id.* at 3. This allegedly harmed the Company to the tune of more than \$100 million and caused “substantial equity dilution.” *Id.* In short, the June 19, 2002 letter clearly and unambiguously provided notice to the Board of the facts and circumstances surrounding each of the challenged transactions and resulting fiduciary breaches now alleged in the Amended Complaint. Furthermore, the letter provided sufficient information for the Board to investigate plaintiffs’ allegations. Indeed, as the Amended Complaint acknowledges, the Board promptly formed the Committee for the purpose of investigating the charges in the June 19, 2002 letter. Am. Compl. ¶ 3.

Third, the June 19, 2002 letter demands remedial action. *See* Trial Ex. J123 at 11-12. Specifically, 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. This fact is confirmed by Khanna’s subsequent, repeated

correspondence with the Committee and again at the November 18, 2003 trial. Am. Compl. ¶ 128; *see, e.g.*, Tr. 106:8-9. Plaintiffs (including plaintiffs Sams and Meisel) concede in the Amended Complaint that the letter “included Khanna’s intention to bring suit *if necessary* to seek redress.” Am. Compl. ¶ 27(b) (emphasis added).

Plaintiffs cannot fairly argue now that Khanna did not seek remedial action in light of his repeated written demands for all manner of “redress” during the Committee’s investigation. In fairness and equity, plaintiff Khanna should not be permitted to participate actively in the Committee’s investigation, to pepper the Committee with additional facts and contentions over a six-month period, and then, unhappy with the result, allege that Khanna never made a demand—when in fact plaintiff Khanna knew and expected the Board to investigate the allegations made in the June 19, 2002 letter.⁸

B. Khanna Has Not Pled Facts Sufficient to Show Wrongful Rejection of His Demand

The Committee’s decision to reject plaintiff Khanna’s demand, like all board decisions, is protected by the business judgment rule. *See Levine v. Smith*, 591 A.2d 194, 200 (Del. 1991) (“[t]he decision to bring a lawsuit or to refrain from litigating a claim on behalf of a corporation is a decision concerning the management of the corporation”). The rule presumes that, in making business decisions, the directors acted on an informed basis and in good faith. *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984). In

⁸ The fact that plaintiffs Sams and Meisel joined this lawsuit after Khanna sent the demand letter is of no moment. By joining the lawsuit (as opposed to filing their own), Khanna’s pre-lawsuit conduct is properly imputed to them. *See, e.g., Stotland v. GAF Corp.*, 469 A.2d 421 (Del. 1983) (holding that because one plaintiff made a demand, all of the plaintiffs in that action made a demand, and therefore the appeal challenging demand futility was moot).

challenging the rejection of a demand, plaintiffs must plead *particularized facts* that create a reasonable doubt that the Committee made a reasonable inquiry in response to the demand or failed to act in good faith. *Baron v. Siff*, 1997 Del. Ch. LEXIS 152, at *5 (Del. Ch. Oct. 17, 1997). Conclusory allegations are insufficient to rebut the presumption of the business judgment rule so as to adequately plead wrongful rejection of demand. *Id.*; *Levine*, 591 A.2d at 214.

Whether a majority of the Current Board is independent and disinterested is immaterial for the purposes of determining if a demand was wrongfully rejected. By making a demand, plaintiffs have “tacitly concede[d] the disinterest and independence of the board.” *Scattered Corp. v. Chicago Stock Exch.*, 701 A.2d 70, 73 (Del. 1997); *Grimes v. Donald*, 673 A.2d 1207, 1219 (Del. 1996) (“plaintiff, by making a demand, waived his right to contest the independence of the board”).

1. Plaintiffs Have Not Pled Particularized Facts Creating a Reasonable Doubt that the Committee Conducted a Reasonable Inquiry

Rather than raising reasonable doubts, the Complaint tends to *confirm* that the Committee conducted a reasonable inquiry into Khanna’s allegations. The Amended Complaint’s only allegations bearing upon the Committee’s inquiry are that the Committee came to “a hasty conclusion” and that “there is no record that the Committee even investigated Khanna’s claims.” Am. Compl. ¶¶129, 132.

These allegations are conclusory and should be disregarded. Similar conclusory allegations have been repeatedly rejected as insufficient. *See, e.g., Levine*, 591 A.2d at 214 (holding that plaintiff’s allegations that directors “did not undertake an

investigation’ and ‘did nothing’ represent conclusory allegations” which are insufficient to show wrongful rejection of demand); *Mt. Moriah Cemetery v. Moritz*, 1991 Del. Ch. LEXIS 68 (Del. Ch. Apr. 4, 1991) (allegations that Committee acted “without serious deliberation, question, or request for any further inquiry” were conclusory and insufficient to plead wrongful rejection of demand).

Moreover, plaintiffs’ conclusory allegations concerning the Committee’s purportedly inadequate inquiry are contradicted elsewhere in the Amended Complaint. For instance, the Amended Complaint admits that the Board created the Committee to investigate Khanna’s allegations. Am. Compl. ¶¶ 3, 128, 131. The Committee hired counsel to assist it. *Id.* Committee counsel met with Khanna on three separate occasions and exchanged reams of correspondence with him. *Id.* ¶ 128. Finally, the Amended Complaint recites that Committee counsel informed Khanna of the Board’s decision on December 26, 2002, *six months after the investigation began*, thereby negating any inference that the Board had acted “hastily.” *Id.* ¶ 133.

Perhaps most glaring is the Amended Complaint’s failure to allege any specific facts raising a reasonable doubt that the Committee made an informed decision on Khanna’s demand. For example, the Amended Complaint does not allege that the Committee failed to interview key witnesses, review relevant documents or hire counsel to assist with the investigation. Indeed, the Amended Complaint does not plead *any* specific facts about the Committee’s investigative process. Rather, the Amended Complaint asks this Court to draw an adverse inference from the purported fact that Covad failed to produce documents disclosing the Committee’s deliberative process in

the Section 220 Case. Am. Compl. ¶¶ 129, 132 (alleging that Covad’s failure to produce deliberative materials constitutes a “de facto waiver of [the Company’s] right to claim that the Committee’s investigation and decision, if any, were in compliance with Delaware law”). This argument is legally unsupportable and factually incorrect. First, the law imposes the obligation upon Khanna to plead *particularized facts* that create a reasonable doubt that the Committee conducted a reasonable investigation. *See Baron*, 1997 Del. Ch. LEXIS 152, at *5. Drawing an adverse inference on the record in this case would require the Company to prove the adequacy of its investigation—contrary to the business judgment rule and years of case law. Moreover, documents evidencing the Committee’s deliberative process were withheld from production in the Section 220 Case due to attorney-client privilege (as indicated on a privilege log). This withholding was specifically permitted by this Court when it found that Khanna had “not sought to circumvent either the attorney-client privilege or work product doctrine and, certainly, has not made any necessary showing.” *Khanna*, 2004 Del. Ch. LEXIS 11, at *26.

Lastly, the Amended Complaint’s allegations that the Committee reached the purportedly wrong result does not meet the stringent pleading standard under Rule 23.1. *See Grimes*, 673 A.2d at 1220 (“[t]he complaint generally asserts that the refusal could not have been the result of an adequate, good faith investigation since the Board decided not to act on the demand. Such conclusory, *ipse dixit*, assertions are inconsistent with the [pleading] requirements”).

2. Plaintiffs Have Not Pled Particularized Facts Creating a Reasonable Doubt that the Committee Acted in Good Faith

Plaintiffs' sole attempt to demonstrate that the Committee acted in bad faith revolve around the allegation that the Committee was improperly constituted. Plaintiffs allege that: (a) the Committee was charged *initially* only with investigating a portion of Khanna's allegations relating to management's certifications to the Company's independent auditors; (b) Committee member director Runtagh was interested in the outcome because the enabling resolutions stated that *if an alleged material conflict arose*, director Crandall would have authority to act alone; (c) that director Jalkut was added to the Committee; and (d) that the Committee was under the auspices of the Audit Committee. Am. Compl. ¶¶ 124-126. All of these allegations are insufficient.

To plead that the Committee acted in bad faith, plaintiffs must allege particularized facts showing that the directors acted for some purpose other than a genuine attempt to act in the best interests of the corporation or that the "decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith." *In re J.P. Stevens & Co. S'holders Litig.*, 542 A.2d 770, 780-81 n.5 (Del. Ch. 1988). Assertions of bad faith must be supported by facts rather than invective and conclusory allegations. *See In re Gen. Tire & Rubber Co. Sec. Litig.*, 726 F.2d 1075, 1083 (6th Cir. 1984) (Ohio law).

First, plaintiffs' allegation that the scope of the Committee's investigation was improperly limited is contradicted in other portions of the Amended Complaint, where they admit that the scope was expanded to investigate "all of the allegations made by Khanna." Am. Compl. ¶ 126.

Second, the fact that the resolution appointing Crandall and Runtagh to the Committee included a provision where authority would be vested to Crandall alone *if an alleged material conflict of interest arose with respect to Ms. Runtagh*, does not suggest Ms. Runtagh *had* a conflict or that the Committee acted in bad faith. In fact, it suggests the exact opposite—namely, that the Company wanted to ensure there were no conflicts. In any event, plaintiffs have not alleged with any of the requisite specificity that Ms. Runtagh had a conflict. Moreover, because plaintiffs made a demand, they conceded the disinterestedness and independence of the Board, including Ms. Runtagh. *See Scattered Corp.*, 701 A.2d at 73.

Third, the fact that director Jalkut was added to the Committee does not suggest bad faith. Director Jalkut was appointed to the Board after the time of the alleged wrongdoing. Moreover, the subsequent appointment of a manifestly disinterested and independent director is indicative of good faith. The Amended Complaint’s related allegation that Jalkut’s appointment was contrary to a “Standstill Agreement” is immaterial. Plaintiffs’ allegation does not suggest that Jalkut or the Committee acted for some purpose other than a genuine attempt to act in the best interests of the corporation.⁹

Finally, the allegations that the Committee was under the auspices of the Audit Committee and that it was not given any authority to act independently of the Board or

⁹ Plaintiffs’ claim of breach also misses the mark.

136; The appointment to the Committee of a newly appointed director (to a Board position that was vacant even before Khanna was placed on leave) has no bearing on Compl. ¶

Audit Committee are insufficient to support a finding of bad faith. Plaintiffs have not alleged (and cannot allege) *any* particularized facts showing that the Audit Committee had any actual (or for that matter theoretical) control over the Committee or its investigation. The Amended Complaint does not allege that the Audit Committee made the decision to reject Khanna's demand or that the Audit Committee dictated, circumscribed or in any way influenced the scope of the Committee's investigation (let alone was even involved in it). These are the types of allegations necessary to allege bad faith, and they are completely absent from the Amended Complaint. Consequently, the Amended Complaint fails to plead facts that raise a reasonable doubt that the decision to reject Khanna's demand was made in good faith.

II. PLAINTIFFS HAVE NOT PLED WITH PARTICULARITY THAT DEMAND IS FUTILE

Even if plaintiffs had not made a demand on the Board, the Amended Complaint nonetheless fails to meet the pleading requirements necessary to excuse demand. Pre-lawsuit demand is excused only when a complaint pleads *particularized facts* establishing that demand on the board would have been futile. *See* Rule 23.1. Specifically, to establish demand futility as to the claim that McMinn usurped a corporate opportunity by founding Certive and that McMinn and other directors breached their duties by allowing McMinn's founder's shares to vest (Counts I-II), plaintiffs must plead particularized facts creating a reasonable doubt that, at the time the initial complaint was filed in this lawsuit, "the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993). To establish demand futility as to the other derivative causes of action

(Counts III-V), plaintiffs must either satisfy the test above or plead particularized facts creating a reasonable doubt that each “challenged transaction was otherwise the product of a valid exercise of business judgment.” *Aronson*, 473 A.2d at 814.

Pleading demand futility *with particularity* means that “[c]onclusory allegations of fact or law which are not supported by allegations of specific fact may not be taken as true.” *Levine*, 591 A.2d at 211 (citation omitted). Moreover, “[g]eneralities, artistically ambiguous, all-encompassing conclusory allegations are not enough. What is required are pleadings that are specific and, if conclusory, supported by sufficient factual allegations that corroborate the conclusion and support the proposition that demand is futile.” *Richardson v. Graves*, 1983 Del. Ch. LEXIS 466, at *5 (Del. Ch. June 17, 1983). The burden is on plaintiffs to show that demand is futile. *Aronson*, 473 A.2d at 812. A complaint must set forth allegations that demand is futile as to each allegedly actionable transaction. *See, e.g., Grimes*, 673 A.2d at 1216.

A. The Amended Complaint Does Not Allege Specific Facts Creating Reasonable Doubt that a Majority of the Current Board Is Capable of Making an Impartial Decision

To survive this motion, the Amended Complaint must plead particularized facts showing that the Current Board could not have properly exercised its *independent* and *disinterested* business judgment in responding to Khanna’s demand at the time the initial complaint was filed. *Seminaris v. Landa*, 662 A.2d 1350 (Del. 1995) (emphasis added). Under Delaware law, Board members lack disinterestedness when it is shown they: (i) obtained a personal financial benefit that was not provided to shareholders generally or (ii) that they stood on both sides of a transaction. *See Aronson*, 473 A.2d at 812. Board

members lack independence when it is shown that they could not make a decision as to a demand “based on the corporate merits of the subject before the board rather than extraneous considerations or influences.” *Id.* at 816.

Covad’s Current Board is composed of eight directors, including Crandall, Hawk, Hoffman (also the CEO), Irving, Jalkut, Lynch, McMinn, and Runtagh. *See* Am. Compl. ¶136. As shown below, the Amended Complaint fails to raise any reasonable doubt about the disinterestedness or independence of at least six of these eight directors. Accordingly, plaintiffs have failed to plead demand futility as to the claims that McMinn usurped a corporate opportunity and that certain directors breached their duties by allowing McMinn’s founder’s shares to vest (Counts I-II). Plaintiffs have also failed to satisfy the first prong of the demand futility test concerning the five other derivative causes of action (III-V).

1. Directors Crandall and Jalkut Are Disinterested and Independent

The Amended Complaint concedes that director Crandall is disinterested. He joined Covad’s Board on June 20, 2002, *after all the alleged breaches of fiduciary duty occurred*. *See* Am. Compl. ¶ 19. The Amended Complaint does not assert derivative claims against him.

Likewise, no derivative claims are asserted against director Jalkut—he joined the board a month after Crandall, on July 18, 2002. *See* Am. Compl. ¶ 20. Plaintiffs, however, contend that Jalkut is not disinterested because his appointment to the Board allegedly violated the Standstill Agreement. As explained above, this allegation is factually incorrect and of no moment as it does not even remotely suggest

interestedness—i.e., that Jalkut received some financial benefit from the alleged wrongdoing or that he stood on both sides of a transaction. Indeed, Jalkut was in no position to receive any benefit from any of the challenged transactions.

The Amended Complaint also lacks any specific allegations sufficient to challenge these directors' independence. Neither director is even alleged to have any personal or financial relationships with any of the other defendant directors. Indeed, the Amended Complaint's only allegation regarding these directors' independence is that Jalkut is the CEO of a *customer* of Covad's. Am. Compl. ¶ 20. The 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 as to a demand. In fact, plaintiffs do not even plead whether the amount of revenues derived from Jalkut's company is material. *See Katz v. Chevron Corp.*, 22 Cal. App. 4th 1352, 1368 (1994) (“[a] director's association with a company that does business with the corporation does not in and of itself establish a lack of independence”). In short, Crandall's and Jalkut's disinterestedness and independence as of the time the initial complaint was filed cannot reasonably be questioned.

2. Directors Irving and Runtagh Are Disinterested and Independent

The Amended Complaint's allegations regarding the purported lack of disinterestedness of directors Irving and Runtagh also fail to meet the requirements for pleading demand futility under Rule 23.1. First, plaintiffs allege that Runtagh is interested and cannot consider a demand because the resolutions appointing her to the Committee contemplated that in the event an alleged material conflict were to develop,

the Committee's other director could act alone. As explained above, this allegation cannot support an inference of interestedness on the part of director Runtagh.

Plaintiffs also allege that Runtagh and Irving cannot consider the demand because they each approved two of the challenged transactions. *See, e.g.*, Am. Compl. ¶¶ 75, 92. Delaware courts have repeatedly held that directors will not be deemed interested merely because a plaintiff accuses them of approving allegedly wrongful conduct. *See Brehm v. Eisner*, 746 A.2d 244, 257 n.34 (Del. 2000) (“[i]t is no answer to say that demand is necessarily futile because [directors] . . . approved the underlying transaction”); *Pogostin v. Rice*, 480 A.2d 619, 624-625 (Del. 1984) (plaintiff cannot establish director interest by alleging that directors participated in and would be liable for the wrongs alleged). Rather, plaintiffs must allege “specific facts establishing that ‘the potential for liability is not ‘a mere threat’ but instead may rise to a substantial likelihood.” *Kohls v. Duthie*, 791 A.2d 772, 779 (Del. Ch. 2000); *see also Aronson*, 473 A.2d at 815. The Amended Complaint fails to make any such showing as to either of these directors.

Director Runtagh faces no “substantial likelihood of liability” stemming from her approval of the BlueStar merger or the BlueStar earn-out transaction. As to these transactions, Khanna conceded at the November 18, 2003 trial that Runtagh had no financial interest in BlueStar. Tr. 188:15-18. Furthermore, as shown below at III-B-2, the Complaint fails to allege particularized facts that remove the BlueStar transactions from the protections of the business judgment rule. For instance, the Amended Complaint sets forth no particularized facts from which it could be inferred that Runtagh acted with gross negligence in approving the merger or the earn-out. Even if the

Amended Complaint did support an inference of gross negligence (which is not the case), Runtagh would still not face a “substantial likelihood of liability” due to the director protection provision set forth in Covad’s Articles of Incorporation (“Articles”).¹⁰

Director Irving also faces no “substantial threat of liability” for his approval of the BlueStar earn-out and Dishnet transactions. Khanna conceded director Irving’s lack of any financial interest in either transaction at the November 18, 2003 trial, and all the plaintiffs concede the point (by their silence) in the Amended Complaint. Tr. 200:1-17; Am. Compl. ¶¶ 80, 89. Moreover, Irving faces no threat of liability for approving either of these transactions for the same reason that Runtagh faces no genuine threat of liability. Plaintiffs have not pled any particularized facts to support the inference of gross negligence in connection with the Board’s approval of the Dishnet transaction or, for that matter, any other facts that could conceivably disturb the business judgment rule presumption.¹¹ If plaintiffs had pleaded such facts (which is not the case), Irving would still not face a “substantial likelihood of liability” on account of the Articles’ director protection provision. Accordingly, Irving, like Runtagh, faces no genuine threat of liability and decidedly does not lack the disinterestedness necessary to consider a demand. *See, e.g., Aronson*, 473 A.2d at 818.

¹⁰ Where, as here, Covad’s Certificate of Incorporation eliminates the personal liability of its directors for breach of fiduciary duty except in the most egregious circumstances, it is a “rare case where the circumstances are so egregious that there is a substantial likelihood of liability.” *In re Baxter Int’l*, 654 A.2d 1268, 1271 (Del. Ch. 1995).

¹¹ Indeed, this Court was previously concerned with the scarcity of allegations concerning DishNet in the Section 220 case. *Khanna*, 2004 Del. Ch. LEXIS 11, at * 23 n.25 (“In general and **particularly with respect to DishNet**, Khanna may ultimately fall well short of demonstrating that anything wrong occurred.”) (emphasis added).

Plaintiffs' attempt to portray these directors as lacking independence also fails. The Amended Complaint alleges that Irving and Runtagh, two highly-esteemed professionals (a former Assistant Secretary of Commerce and the former President and CEO of GE Information Services, respectively), were under the domination and control of McMinn. Am. Compl. ¶¶ 138-140. In support of this allegation, plaintiffs rely principally on insufficient conclusory allegations of domination and control in the Amended Complaint. *See, e.g.*, Am. Compl. ¶ 92.

Delaware courts place a high burden on plaintiffs claiming to excuse demand based on "domination and control." In the demand-futility context, "a plaintiff charging domination and control of one or more directors must allege particularized facts manifesting 'a direction of corporate conduct in such a way as to comport with the wishes or interests of the [persons] doing the controlling.'... The shorthand shibboleth of 'dominated and controlled directors' is insufficient." *Aronson*, 473 A.2d at 816 (citation omitted).

The only arguably specific allegations as to how Irving and Runtagh are beholden to McMinn are that they were allegedly recruited to the Covad Board by him and that they received ordinary fees from serving on the Board. Am. Compl. ¶¶ 15-16. This does not demonstrate that the directors were "dominated or controlled" or otherwise lacked the independence to consider a demand. It is well-settled that "it is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election" to successfully plead domination and control. *Aronson*, 473 A.2d at 816; *see also In re Western Nat'l Corp. S'holders Litig.*, 2000 Del. Ch.

LEXIS 82, at *52-53 (Del. Ch. May 22, 2000) (CEO's role in the nomination process by itself does not "automatically foreclose a director's potential independence"). Likewise, the allegation that the directors received benefits and compensation from Covad is not enough to prove a lack of independence from or domination and control by McMinn. Conclusory allegations of this nature are manifestly inadequate. *See, e.g., White v. Panic*, 793 A.2d 356, 366 (Del. Ch. 2000) (in dismissing derivative complaint and holding that demand was not excused, the Court of Chancery stated that "the fact that each [director] is paid an annual retainer of \$30,000 plus a fee of \$1,000 for each meeting attended and annual grants of stock options does not make them beholden to [another director]"), *aff'd* 783 A.2d 543 (Del. 2001); *Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988) ("[an] allegation that all GM's directors are paid for their services as directors ... without more, do[es] not establish any financial interest").

Plaintiffs also argue that because directors Irving and Runtagh approved transactions that allegedly benefited McMinn and his friends, they are somehow beholden to McMinn. *See* Am. Compl. ¶ 139. This attempt to show domination and control is improper bootstrapping. It does not meet the test to establish domination—i.e., it does not suggest that directors Runtagh and Irving owe their livelihood to McMinn. *See, e.g., Benerofe v. Cha*, 1996 Del. Ch. LEXIS 115, at *20 (Del. Ch. Sept. 12, 1996). Moreover, the allegations are nonsensical. For instance, the fact that the Board allegedly approved a "lavish compensation package" to Hoffman is irrelevant to the question of whether the Board was dominated by McMinn. *See* Am. Compl. ¶ 139. The Amended Complaint

does not allege that McMinn received personal benefits from Hoffman's compensation package (nor could it).

In the final analysis, plaintiffs' attempt to portray these directors as incapable of impartially considering a demand falls short of the mark.

3. Director Lynch Is Disinterested and Independent

Plaintiffs attempt to raise a reasonable doubt as to director Lynch's disinterestedness on the theory that Lynch not only approved the challenged transactions, but also that he assisted in negotiating one of the challenged transactions (i.e., the BlueStar earn-out) and (at some unspecified time) joined an advisory board of Certive at the request of McMinn. These attempts to establish a lack of disinterestedness lack merit.

As to the BlueStar earn-out transaction, the Amended Complaint is more notable for what it fails to allege than for what it purports to allege: the absence of any financial interest of Lynch in BlueStar. The Amended Complaint also fails to allege with particularity any facts from which it could be inferred that Lynch was grossly negligent in negotiating the earn-out settlement. In short, for the same reasons that it fails to make the requisite showing as to Irving and Runtagh, the Amended Complaint fails to plead particularized facts showing that Lynch lacks disinterestedness on account of any purported "substantial likelihood of liability" in connection with the BlueStar earn-out transaction. *Aronson*, 473 A.2d at 815.

The fact that Lynch became a member of a Certive advisory board also does not establish a lack of disinterestedness to consider a demand relating to that transaction. Am. Compl. ¶ 56. This conclusory allegation is irrelevant even if Lynch became

affiliated with Certive before Covad invested in the company. Plaintiffs do not give any specifics as to the alleged benefits to Lynch from his service on the Certive board of advisors. The only allegation is that advisory boards are generally sought-after positions in Silicon Valley and that Lynch receives some unspecified stock interest or other compensation for his service. *Id.* There are no other factual allegations in the Amended Complaint that describe these alleged benefits or facts from which it can be inferred that such alleged benefits are material relative to his other sources of income. *See, e.g., Langner v. Brown*, 913 F. Supp. 260, 266 (S.D.N.Y. 1996) (Delaware law) (receipt of director fees and “[t]he fact that several director defendants sat on the same boards of directors of other companies does not in itself establish lack of independence”); *accord Miller v. Loucks*, 1992 U.S. Dist. LEXIS 16966, at *24-26 (N.D. Ill. Nov. 3, 1992) (Delaware law). It is also true that Lynch does not face a substantial threat of liability from his vote to approve the \$5 million Certive investment. Indeed, the statute of limitations has run as to the Certive transaction, eliminating any risk of liability for approving the investment.¹²

Similarly, plaintiffs’ allegations that Lynch breached his fiduciary duty by permitting McMinn’s founder’s shares to vest while McMinn was purportedly working for Crosspoint and founding Certive does not establish a lack of disinterestedness.

¹² The statute of limitations in Delaware for breach of fiduciary duty claims is three years. *In re Dean Witter P’ship Litig.*, 1998 WL 44256, at *4 (Del. Ch. July 17, 1998). The Certive investment was approved in November 1999. Am. Compl. ¶ 55. The first complaint was filed on September 15, 2003, more than three years later after the investment occurred.

Second, as with the Certive investment, plaintiffs' allegations are time-barred (as the events occurred more than three years before the filing of the complaint), further minimizing the risk of liability to director Lynch. *See supra* note 12. Third, director Lynch would not face a substantial threat of liability as he is protected by the director protection provision set forth in Covad's Articles. Lastly, plaintiffs' theory of liability appears to be predicated on the directors' failure to prevent the vesting of McMinn's shares. As this court has commented, a theory predicated on a failure to act is "the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." *In re Caremark Int'l*, 698 A.2d 959, 967 (Del. Ch. 1996). Accordingly, plaintiffs have not pled particularized facts that cast a reasonable doubt as to director Lynch's disinterestedness in considering the demand as to the allegedly improper vesting of McMinn's founder's shares.

In a last ditch-effort to attack Lynch's ability to consider a demand, plaintiffs purport to allege with particularity that Lynch is dominated and controlled by McMinn

because they are “long-time friends and business associates” and that he is McMinn’s neighbor, owns a winery near McMinn’s, continues to serve on the Certive advisory board, and was recruited to Covad by McMinn. Am. Compl. ¶¶ 4, 8-9, 33, 38, 138. These allegations are inadequate to establish that Lynch lacked the independence to impartially consider a demand. The fact that Lynch is allegedly friends and neighbors (both in Los Altos Hills and in St. Helena) with McMinn does not taint his independence. “Delaware courts have consistently rejected assertions that a personal friendship, without more, establishes a lack of independence.” *Merchants’ Nat’l Props., Inc. v. Meyerson*, 2000 Del. Ch. LEXIS 109, at *18 (Del. Ch. July 24, 2000); *see also Odyssey Partners, L.P. v. Fleming Cos., Inc.*, 735 A.2d 386, 409 (Del. Ch. 1999) (“[t]hat Field and Devening were neighbors or former neighbors is of no moment”). Likewise, the fact that Lynch had past or even current business relationships with McMinn is not enough. *Orman v. Cullman*, 794 A.2d 5, 27 (Del. Ch. 2002) (“[t]he naked assertion of a previous business relationship is not enough to overcome the presumption of a director’s independence”); *Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 980 (Del. Ch. 2000) (holding that a “long-standing 15-year professional and personal relationship” between a director and the CEO and Chairman of the company was insufficient to support a finding of control). Courts have also rejected arguments that a director lacks independence because he sits on another board with a fellow director. *See, e.g., Strougo v. Bassini*, 112 F. Supp. 2d 355, 363 (S.D.N.Y. 2000) (committee member independent and not interested where he served on another company’s board with one of the other defendants) (applying Delaware law).

Notably absent from the Amended Complaint is any allegation that Lynch is, “*for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind.” *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938 (Del. Ch. 2003) (citation omitted). The complaint does not allege that Lynch received substantial compensation (beyond ordinary directoral perquisites), that his economic livelihood would be in jeopardy, that he was related to director McMinn, or that director McMinn did (or was in some other position to) exert considerable influence over him. These are the types of circumstances or relationships that courts have found to constitute a lack of independence (or “domination and control”) and these facts have not been pled by plaintiffs. *See, e.g., id.* at 943 (finding a committee member lacked independence where the director-defendant Larry Ellison could be a significant benefactor to the member’s employer); *Rales*, 634 A.2d at 936-937 (finding that two directors were not independent where they received \$300,000 and \$1 million respectively in salaries of companies controlled by the director-defendant).

4. Director Hoffman Is Disinterested and Independent

Plaintiffs do not appear to allege that Covad director and CEO Hoffman lacks the disinterestedness to consider a demand. The only arguable basis for any such allegation would have been Hoffman’s approval of the Dishnet settlement in February 2002, a transaction for which Hoffman does not face a “substantial likelihood of liability” for the same reasons Irving does not.

The focus of plaintiffs’ allegations regarding this director are on independence. Specifically, the Amended Complaint alleges that Hoffman lacks independence to

consider a demand because he was hired by the Board, allegedly regards McMinn as his boss, and receives a substantial salary from Covad as its chief executive. Am. Compl. ¶ 139. None of these allegations, however, are sufficient to create a reasonable doubt that Hoffman could have exercised his independent business judgment in responding to a demand.

The Delaware Supreme Court has held that the appointment of a director by other Board members alleged to have engaged in wrongdoing is not sufficient to show a lack of independence. *See Aronson*, 473 A.2d at 816 (“[i]t is the care, attention and sense of individual responsibility to the performance of one’s duties, not the method of election, that generally touches on independence”). Plaintiffs’ allegation that Hoffman lacks independence because he allegedly regards McMinn as his boss also misses the mark. McMinn is no more Hoffman’s “boss” than are the other six directors on Covad’s Board, including the other five independent and disinterested directors discussed above. Plaintiffs have not pled any facts to suggest that McMinn somehow exercises more control over Hoffman’s employment than any of the other directors do. In fact, Hoffman’s compensation as CEO is set by the Compensation Committee consisting of directors Irving, Lynch, and Runtagh. *See Toll Aff.*, Ex. D.

Indeed, in this era of increased scrutiny on public companies, Hoffman realistically faced no threat of retribution if he determined, in his independent business judgment, that plaintiffs’ allegations had merit or that derivative litigation against other directors was in Covad’s best interests. If Hoffman’s employment were affected as a result of his determination to accept plaintiffs’ demand, he had available to him a panoply

of remedies under state and federal law, including the whistleblower protections available under the Sarbanes-Oxley Act. *See* 18 U.S.C. § 1514A. Moreover, any retaliatory dismissal would undoubtedly have been noticed by the Company's shareholders, the public, and the SEC.¹³

5. Because a Majority of the Current Board Are Disinterested and Independent, Plaintiffs' Claim for Usurpation of a Corporate Opportunity Must be Dismissed

Where the subject of a derivative claim is not a decision of the Board, demand futility is determined solely by examining whether the current board is independent and disinterested to act on the demand. *Rales*, 634 A.2d at 933-34. The Amended Complaint's claim against McMinn and others for usurping a corporate opportunity and for allowing McMinn's founder's shares to vest do not challenge decisions of the Covad Board. *See* Am. Compl. ¶¶ 145-148, 153-156. Consequently, the substantive allegations concerning these claims are of little moment. *See, e.g., In re Fuqua Indus., Inc. S'holder Litig.*, 1997 Del. Ch. LEXIS 72, at *50-51 (Del. Ch. May 13, 1997) ("The appropriate test ... is not an examination of whether the board has already demonstrated an inability to exercise business judgment with respect to the challenged transaction..."). Rather, the *only* issue is whether plaintiffs have created a reasonable doubt that the Current Board is sufficiently independent and disinterested to consider a demand. *Id.*; *see also Rales*, 634

¹³ Covad's decision not to contest the adequacy of the Amended Complaint's demand futility allegations as to the two remaining current directors, Messrs. McMinn and Hawk, is not meant to comment on their ability to act impartially in fact.

A.2d at 934. Because plaintiffs have not made the necessary showing, these claims must be dismissed.¹⁴

B. The Amended Complaint Fails to Plead Particularized Facts Creating a Reasonable Doubt that any Challenged Transaction Was the Product of Valid Business Judgment

Plaintiffs have also failed to plead particularized facts creating a reasonable doubt that any of the challenged related-party transactions approved by the Board were the product of a valid exercise of business judgment. *Aronson*, 473 A.2d at 814. Failing to plead sufficient facts to satisfy this second prong of the *Aronson* test, the Amended Complaint's derivative claims require dismissal even if a demand on Covad's Board had not been made.

1. The Certive Investment

The Amended Complaint's allegations fail to create reasonable doubt that the Board's decision to invest in Certive was the product of valid business judgment. Specifically, the Complaint fails to plead particularized facts showing that a *majority* of the directors who approved the Certive transaction were interested, lacked independence, or failed to inform themselves of all material information before approving the decision. Because they have not pled particularized facts taking this transaction outside the business judgment rule protections, plaintiffs have failed to adequately plead demand futility as to this transaction, as required by Rule 23.1.

¹⁴ Plaintiffs' claims solely against defendant Crosspoint (Counts VI and VII) must also be dismissed for the same reason. Plaintiffs' have failed to create a reasonable doubt that a majority of the Current Board are independent and disinterested from considering a demand as to defendant Crosspoint.

At the time of Covad's investment in Certive, the Board was comprised of eight directors, including Landy, Lynch, Hawk, Knowling, Kressel, Marshall, and McMinn,¹⁵ and Shapero. Trial Ex. D-1. Hawk, Knowling, Lynch, and Marshall voted to approve the \$5 million investment in Certive. *Id.*

The Amended Complaint alleges that this transaction does not deserve business judgment rule protection because it was not approved by a majority of the disinterested directors. Specifically, the Amended Complaint appears to allege that three of the four directors who voted to approve the investment—Hawk, Marshall and Lynch—were not disinterested, due to Hawk's own economic interest in Certive (through Crosspoint) and Lynch's and Marshall's service on a Certive advisory board. Am. Compl. ¶¶ 48, 56.

The Amended Complaint's allegations are insufficient. Specifically, the Amended Complaint fails to plead any particularized facts to show what specific benefits Lynch or Marshall allegedly received from their service, or any facts from which it could be inferred that the benefits they received were material relative to their other sources of income.¹⁶ By failing to allege specific facts that these directors benefited meaningfully from their service on this advisory board, the Amended Complaint fails to plead that they

¹⁵ As the Amended Complaint appears to acknowledge, director McMinn, while still formally on the Board as of the date this transaction was approved on October 11, 1999, had already tendered his resignation and was in process of transitioning off the Board. *See also* Trial Ex. D-1 (detailing Covad Board members at the time of each challenged transaction).

¹⁶ Indeed, the Amended Complaint does not plead that Lynch or Marshall were affiliated with Certive at the time the Board approved the investment. Indeed, at the November 18, 2003 trial, Khanna admitted that he had no idea as to when Lynch and Marshall joined the advisory board. Tr. 217:2 – 218:24.

lacked disinterestedness and, concomitantly, that the Certive investment was not approved by a majority of the disinterested directors.

The Amended Complaint also lacks particularized allegations taking this transaction outside the business judgment rule presumption. For instance, plaintiffs do not plead any particularized facts from which it can be inferred that the directors acted with gross negligence in approving this modest investment in a start-up company. There is no allegation that the directors failed to inform themselves of all material information about Certive. Likewise, the allegation that Covad paid more than the initial investors in Certive is both not surprising and not sufficient to take the decision outside the protections of the business judgment rule. *See, e.g., Gagliardi v. Trifoods Int'l*, 683 A.2d 1049, 1053-1054 (Del. Ch. 1996) (allegation that directors overpaid is not enough to rebut the business judgment rule). Nor does the Amended Complaint adequately plead that the decision to invest in Certive was procedurally flawed. In this respect, plaintiffs merely allege that the Board failed to form a special committee of disinterested directors to determine whether to invest in Certive. Am. Compl. ¶ 141. This allegation is premised on the erroneous proposition that there is something inherently wrongful or impermissible about a related-party transaction. That is not the case. In fact, the Delaware legislature created a safe-harbor provision to ensure that Delaware corporations could engage in related-party transactions as long as the corporation followed certain procedures. 8 *Del. C.* § 144 (2004); *see Cede & Co. v. Technicolor*, 634 A.2d 345, 365 (Del. 1993) (“Section 144(a)(1) appears to be a legislative mandate that, under such circumstances, an approving vote of a majority of informed and disinterested directors

shall remove any taint of director or directors' self-interest in a transaction"); *see also In re Frederick's of Hollywood, Inc.*, 2000 WL 130630, at *7 (Del. Ch. Jan. 31, 2000) (dismissing fiduciary duty claim; where "interested" director transaction approved by a majority of "disinterested" directors, "the duty of loyalty claim fails for lack of a valid premise"). Plaintiffs concede that the Certive investment was approved by a majority of informed and disinterested directors, and therefore, the investment decision falls within the safe harbor.

2. The BlueStar Merger Transaction

The Amended Complaint's allegations concerning Covad's merger with BlueStar also fail to raise a reasonable doubt that this business decision was the product of a valid exercise of business judgment.

At the time the BlueStar merger was approved, Covad's Board was comprised of eight directors: Dunn, Hawk, Irving, Knowling, Lynch, Marshall, Runtagh, and Shapero. Trial Ex. D-1. All of the directors who voted approved the transaction. Covad's purportedly interested directors—Hawk and Shapero—neither voted nor attended the Board meeting at which the merger was approved. *Id.*; Trial Ex. J117.

Again, the Amended Complaint's allegations fail to remove this transaction from the protections of the business judgment rule. Indeed, the Amended Complaint (by its silence) concedes that a majority of Covad's Board at the time the BlueStar merger was approved (i.e., directors Lynch, Marshall, Knowling, Dunn, Irving and Runtagh) had *no* financial interest of any kind in BlueStar. Am. Compl. ¶ 72. Khanna confirmed this fact in his testimony at the trial in the Section 220 Case. Tr. 187:16 – 190:8.

Plaintiffs also attempt to attack the process in which the BlueStar merger was approved. Specifically, plaintiffs claim that the directors acted in “haste,” relied on a conflicted investment banker, and were lobbied by Shapero to approve the transaction. These allegations, without more, fall far short of taking the transaction outside the business judgment rule presumption because they fail to plead *particularized* facts that any of the voting directors were *grossly negligent* in approving the BlueStar merger. *See Brehm*, 746 A.2d at 259; *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

As an initial matter, plaintiffs’ claims that the Board acted in “haste” or that Knowling did not conduct any diligence are contradicted elsewhere in the Amended Complaint and by Khanna’s own testimony in the Section 220 Case. Tr. 184:17 – 185:18; 186:10-19 (admitting the directors retained several “top-notch” law firms to assist with the transaction); Am. Compl. ¶¶ 58, 73 (alleging that the merger agreement was signed six weeks after first being presented to Board);

As a legal matter,

boilerplate allegations that a board acted in “haste” or failed to inform themselves of all material information do not take the transaction outside the protections of the business judgment rule. *See, e.g., Levine*, 591 A.2d at 214 (allegations that committee “did nothing” represent conclusory allegations and fails to rebut presumption of the business

judgment rule). Likewise, the allegation that the Board chose not to follow the advice of certain Covad employees, including Khanna, also does not rebut the presumption. This allegation raises no inference other than that the Board reached its own conclusions as to the merits of the merger. Delaware corporate law entrusts the management of a corporation to directors, who are free to manage or delegate as they see fit. 8 *Del. C.* § 141(a) (2004). Directors are not required to heed the advice of management, much less the business advice of the corporation's General Counsel. That the directors made an informed business decision based on legitimate business reasons is confirmed by the S-4 filed in connection with this merger. Trial Ex. J111.

The allegations that the transaction was somehow improper because Shapero sat on BlueStar's board in alleged violation of Covad's internal corporate opportunity policy and then lobbied for the acquisition does not remove the transaction from the protections of the business judgment rule.¹⁸ As discussed above, there is nothing improper *per se* about related-party transactions. Even the fact that an interested party lobbied for a transaction does not take it outside Delaware's safe harbor statute. 8 *Del. C.* § 144.

Finally, the Amended Complaint ignores the well-established tenet that hindsight is irrelevant in determining whether a decision is protected by the business judgment rule. *See, e.g., Ash v. McCall*, 2000 Del. Ch. LEXIS 144, at *34 (Del. Ch. Sept. 15, 2000).

¹⁸ Plaintiffs also allege that there was no finding by the Covad Board that Crosspoint's, Hawk's, and Shapero's investment in BlueStar were proper. Plaintiffs do not allege any causes of action for usurping a corporate opportunity as to BlueStar, and consequently, the allegation is irrelevant.

3. The BlueStar Earn-Out Transaction

The Amended Complaint also fails to adequately plead demand futility as to the BlueStar earn-out transaction. The transaction, which settled claims brought by former BlueStar shareholders based on their earn-out rights under the merger agreement, was approved by directors Irving, Lynch, Marshall, and Runtagh. Trial Ex. D-1. The other directors at the time—Hawk, McMinn, and Shapero—did not vote on the transaction and were not present at the telephonic meeting during which the settlement was approved. Trial Ex. J115.

As is true of the BlueStar merger, plaintiffs have failed to plead particularized facts removing this transaction from the business judgment rule presumption. As is also true of the merger, the Amended Complaint does not (and cannot) allege that any of the Covad directors who approved the settlement had any financial interest in BlueStar. Nor does the Amended Complaint allege that any of the interested directors (i.e. directors McMinn, Hawk or Shapero) participated in the negotiations or voted for the transaction. Instead, plaintiffs concede that the transaction was approved by a disinterested majority, but allege (for no legally relevant reason) that the earn-out transaction was approved by less than quorum of directors.¹⁹ Am. Compl. ¶ 80.

¹⁹ This allegation is puzzling in light of the fact that the Board's approval of the earn-out settlement was transmitted to Khanna by e-mail only minutes after the decision was made, meaning that Khanna was aware that only four directors (one short of a quorum) had approved this transaction. Trial Ex. J115. As Covad's chief legal officer, Khanna presumably is himself at personal risk of liability should his contention be true

Likewise, it is irrelevant that BlueStar's business model allegedly failed before Covad settled with the former BlueStar shareholders through the earn-out transaction. *See* Am. Compl. ¶ 74. 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. What is relevant is whether the directors who approved the earn-out settlement were grossly negligent in informing themselves of all material facts reasonably knowable to them before making that approval decision. Particularized allegations to support the inference that they did not reasonably inform themselves are wholly absent from the Amended Complaint.

4. The Dishnet Settlement

The final challenged transaction, the settlement with Dishnet, was also a proper exercise of business judgment. There is nothing in the Amended Complaint to raise a reasonable doubt to the contrary. At the time of the transaction, the Board was comprised of eight directors, including Hoffman, Hawk, Irving, Lynch, Marshall, McMinn, Runtagh, and Shapero. Trial Ex. D-1. McMinn, Runtagh and Shapero did not vote on the transaction and were not present at the portion of the meeting where the settlement was approved. *Id.*; Trial Ex. J118.

The only arguably material allegation in the Amended Complaint hinting at any impropriety in connection with this transaction is that McMinn served on the boards of

that the directors breached their fiduciary duty by approving the transaction with less than a quorum of directors present at the meeting. In any event, Delaware's safe-harbor statute is available to interested director transactions "*even though the disinterested directors be less than a quorum.*" 8 *Del. C.* § 144(a)(1) (emphasis added).

both Covad and Dishnet at the time the Board approved the settlement of Dishnet's bankruptcy claim against Covad. This allegation is facially inadequate. The Amended Complaint does not allege that McMinn participated in or voted to approve the settlement (he did not). Nor does it allege that any of Covad's seven other directors at the time (i.e., Lynch, Hawk, Shapero, Marshall, Runtagh, Irving or Hoffman) had any financial interest in Dishnet (they did not). Moreover, the Amended Complaint does not allege facts which fairly raise an inference that the directors who approved the settlement did so without conducting any diligence or without relying on the advice of its counsel—at that time, Mr. Khanna. In short, the Amended Complaint does not allege facts sufficient to create reasonable doubt that the Dishnet settlement was the product of valid business judgment.

III. PLAINTIFFS' CLASS CLAIMS SHOULD BE DISMISSED

A. Plaintiff's Class Claims Fail to State a Claim for which Relief May Be Granted

A claim based on violation of a director's common-law disclosure duty must allege that facts are missing from the proxy statement, identify those specific facts, and then describe why they meet the materiality standard and how the omission caused injury. *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 141 (Del. 1997). The Amended Complaint's class action claims fail to meet this standard as a matter of law.

Plaintiffs' class action claims allege that the director defendants failed to "accurately and properly disclose . . . the nature, extent, or existence of Khanna's allegations about the Board's self-dealing transactions or against which directors the [derivative] allegations were directed." Am. Compl. ¶ 2. In a nutshell, the class action claims boil down to one question: Did the director defendants have a duty to disclose the

allegations set forth in Khanna's June 19, 2002 letter in connection with the 2002, 2003 or 2004 directorial elections? Because Delaware law is clear that the answer is "no," plaintiffs' class action claims should be dismissed at the pleading stage.

Whether plaintiffs have stated claims for violations of the duty of disclosure is controlled by the Delaware Supreme Court's decision in *Loudon*. In *Loudon*, the Supreme Court reaffirmed that the common-law disclosure duty does not impose a duty on directors to confess to wrongdoing prior to any adjudication of guilt. 700 A.2d at 144. In affirming the Chancery Court's dismissal, as a matter of law, of a class complaint based on the allegations that are essentially indistinguishable from the allegations involved here, the court in *Loudon* reasoned:

the [relevant] portions of the complaint do not state the omission of a material fact. Rather, they pose a question, the answer to which would seem to require the . . . Board to engage in self-flagellation. Nowhere does the complaint allege that, at the time the complaint was filed, an adjudication of these activities had occurred. Nevertheless, plaintiff's argument would have the . . . Board confess to wrongdoing prior to any adjudication of guilt. This is precisely the situation the self-flagellation rule was designed to prevent.

700 A.2d at 145. As in *Loudon*, plaintiffs are not alleging in the Amended Complaint that the facts of the challenged transactions were not disclosed. Rather, they manifestly were disclosed in Covad's June 10, 2002, June 25, 2003, and April 30, 2004 proxy statements. Instead, plaintiffs allege that the defendant directors failed to disclose that the transactions were wrongful—in essence, they fault the directors for failing to disclose Khanna's own pejorative characterizations of the related-party transactions. As *Loudon* makes clear, what plaintiffs are demanding is nothing but "self-flagellation," and the Amended Complaint thus lacks a legal basis to support a disclosure violation.

B. Plaintiffs' Class Action Claims Are Barred by Laches

Under Delaware law, for the equitable doctrine of laches to apply, three elements must be shown: (1) plaintiffs' *knowledge* of the alleged wrong, (2) an *unreasonable delay* in challenging the wrongful action, and (3) *injury or prejudice* to the defending party due to the delay by plaintiff. *Stengel v. Rotman*, 2001 Del. Ch. LEXIS 22, at *18 (Del. Ch. Feb. 26, 2001). All three of these elements are met here. Accordingly, dismissal of plaintiffs' class action claims is warranted on this independent basis as well.

That plaintiff Khanna had knowledge of the alleged omissions from the Company's 2002 proxy statements shortly after the issuance of the June 2002 proxy is established by judicially noticeable facts. Khanna specifically called the alleged omissions from the June 10, 2002 proxy statement to the attention of Covad's in-house counsel as early as November 13, 2002. Trial Ex. J33. Moreover, Khanna cannot deny that he had knowledge of the underlying facts well before the Board elections. Khanna himself admitted that the alleged conflicts of interest which form the basis for Khanna's claims of fiduciary breaches were publicly disclosed in Covad's own SEC filings. Tr. 169:20 – 170:3.

Yet, despite this knowledge, Khanna failed to seek any form of judicial relief on account of the alleged disclosure violations for more than a year, waiting until after the August 2003 directorial election to assert a claim for injunctive relief. This inaction plainly constitutes unreasonable delay. In cases involving board elections, Delaware courts require shareholders to take action *before* the elections occur (and in any event no later than the period immediately following the election). *See Bay Newfoundland Co. v.*

Wilson & Co., 37 A.2d 59 (Del. 1944). As the Court in *Bay Newfoundland* observed, in connection with a shareholder challenge to a charter amendment approved at a noticed annual meeting, a shareholder is:

under a duty to the corporation and the stockholders to make known its dissent at a time when its objection might have had effect. ... Having elected the course of silence and inaction when it was its duty to speak or act, equity will now withhold its aid.

Id. at 63 (citation omitted).²⁰

The harm to Covad from Khanna's unreasonable delay in asserting plaintiffs' class claims is substantial. As acknowledged by the court in *Stengel*, a corporation is prejudiced by any form of delay in challenging a noticed shareholder vote—the corporation has spent considerable amounts of money on proxy solicitations, published disclosures, and on the shareholder meeting itself. Covad has incurred these costs and—what is more—now stands threatened to have the elections of a majority of its Board (six of its eight current Board members) voided months or years after the alleged disclosure violations took place. Requiring the Company to now void the challenged elections would serve no legitimate corporate purpose, but rather would threaten substantial harm

²⁰ Plaintiffs Sams and Meisel's claims should also be barred by laches. First, they elected to join this lawsuit, and therefore Khanna's conduct should be imputed to them. Second, Sams and Meisel apparently were solicited by Khanna, and therefore arguably knew about his allegations from the get-go. *See* Tr. 54:8-13. At the very least, plaintiffs Sams and Meisel knew about Khanna's allegations when they were first disclosed in the 2002 10-K, filed on March 20, 2003. Rather than joining this lawsuit upon its initial filing or filing one of their own immediately, they chose to wait until after two Board elections were held. Consequently, they too should be barred from asserting class claims due to laches.

to the corporation and its shareholders. It is precisely these circumstances that cry out for application of the equitable doctrine of laches.

CONCLUSION

For the foregoing reasons, Covad requests that the motion to dismiss be granted with prejudice.



Jesse A. Finkelstein (Bar No. 1060)
Candice M. Toll (Bar No. 4465)
RICHARDS, LAYTON & FINGER, P.A.
One Rodney Square
P. O. Box 551
Wilmington, Delaware 19899
(302) 651-7700
Attorneys for Defendant
Covad Communications Group, Inc.

OF COUNSEL:

Paul H. Dawes
Darius C. Ogloza
David M. Friedman
LATHAM & WATKINS LLP
135 Commonwealth Drive
Menlo Park, CA 94025
(650) 328-4600

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