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

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

DICKSTEIN SHAPIRO LLP
1825 Eye Street NW
Washington, DC 20006-5403
T: (202) 420-2200
F: (202) 420-2201

Counsel for Nominal Defendant Comverse Technology, Inc.

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Introduction

There is no dispute that, at the first hint of potential issues regarding the historical stock option granting practices at Comverse, its Outside Directors created a Special Committee that immediately launched an investigation that reached the highest levels of the company, resulted in the ouster of its most senior officers, and prompted acclaim from the national press and the government. In opposing Comverse's motion to dismiss, those uncontested facts vitiate Derivative Plaintiffs' claim that the Special Committee was "dominated" by the same Chief Executive Officer whose unexercised options were cancelled and who was forced to resign by that very Committee. Derivative Plaintiffs' Opposition brief never addresses this obvious contradiction or the case law providing that demand is not excused as futile in such circumstances.

In the same vein, whatever the force of Derivative Plaintiffs' allegations of "rubberstamping" and their claims of "egregiousness" premised on the notion of a sustained, systematic failure to detect backdating over several years with respect to some Board members, they have no force at all with respect to the two members of the Special Committee, which the Board had created and vested with the authority to respond to any inquiries or litigation a month before this action was commenced. (See Fraser Aff. Ex. 2.) Raz Alon did not even join the Board until well after the alleged backdating scheme had concluded, and Ron Hiram did not join until just before the last option grant in question and had no connection with the company or the grants made during the ten prior years in which the backdating took place. Derivative Plaintiffs attempt to disguise this fact by saying that Hiram served on the Compensation Committee "during the Relevant Period" (Lead Pls.' Mem. of Law in Opp. to Comverse Technology, Inc.'s Mot. to Dismiss ("Opposition" or "Opp.") at 12 n.13) and that he "awarded the illegally backdated options" (id. at 4 (emphasis added)), but a more accurate statement would be that he

happened to have been appointed to the Board and committee just before the end of the relevant period. Finally, neither Special Committee member ever received any backdated option grants or is alleged to have sold stock as a result of inside knowledge of improper option practices. Under these circumstances, as opposed to those present in the cases cited by Derivative Plaintiffs,[1] the law does not excuse demand.

Argument

I. THE ACTIONS OF THE SPECIAL COMMITTEE DEMONSTRATE THAT DEMAND WOULD NOT HAVE BEEN FUTILE.

Derivative Plaintiffs assert that the "Special Committee was a reactive entity" that took action only when "forced" to do so by "this shareholder's derivative action," "intense media scrutiny and the threat of criminal proceedings." (Opp. at 2-3, 22; see also id. at 12.) It is undisputed, however, that the Special Committee acted substantially before Derivative Plaintiffs or the government alleged any misconduct. In fact, in the month between the time the Board created the Special Committee over Alexander's objections (¶ 143) and the filing of the derivative action, the Committee hired independent counsel, reviewed documents, interviewed witnesses, obtained admissions from all three of the now former executives, notified the SEC of the backdating problems, and announced that the company likely would have to restate financial results. (See, e.g., Mem. Law Supp. Comverse Technology, Inc.'s Mot. Dismiss for Failure to Make a Demand ("Memorandum" or "Mem.") at 2-3; ¶¶ 6, 149-54, 156-57.)[2] Far from

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[1] See Opp. at 3-4, 9-12, 14, 16, 17, 20, and cases discussed infra at 4 n.6, 7 n.13, 7-8, in which the Board knew of improper conduct (rather than merely being "deceived," which is what is pled here) or, unlike the Comverse Board, had not appointed a Special Committee or otherwise initiated an investigation prior to the filing of a derivative complaint.

[2] Derivative Plaintiffs' claim that the Special Committee "was not formed until investigations were initiated by . . . the FBI and the SEC" (Opp. at 22) does not appear in the Complaint and is simply wrong, as it was the Special Committee that notified the SEC of the potential backdating, thereby leading to the SEC's initiating of its investigation. (The FBI and U.S. Attorney's Office initiated their investigation some weeks later based on the information the Special Committee had already provided to the SEC.)

supporting Derivative Plaintiffs' claim that the Special Committee has been "slow to act" (Opp. at 21), the Complaint itself quotes a Wall Street Journal article reporting that Comverse, "for one, acted swiftly." (¶ 161 (emphasis added).)[3] And in any event, even if Derivative Plaintiffs were correct that the Special Committee acted only in response to shareholder efforts to spur the company to take action, that itself would contradict the claim that demand would have been futile. See, e.g., Kanter v. Barella, 388 F. Supp. 2d 474, 481 (D. N.J. 2005) (rejecting demand futility claim where directors "responded appropriately to allegations . . . by ordering an independent review" (emphasis added)).[4] Moreover, the Opposition (unwittingly) provides further evidence that demand would not have been futile by pointing out that the Special Committee expanded its inquiry beyond options backdating to explore potential accounting issues that Derivative Plaintiffs later brought to its attention. (See Opp. at 25.).[5]

As for the fact that the Special Committee has not yet authorized the filing of lawsuits, Derivative Plaintiffs never explain why the company should file suit before learning whether the government actions against Alexander, Kreinberg, and Sorin will allow for recovery without litigation expense. (See Mem. at 14-15.) Nor do Derivative Plaintiffs allege that the

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[3] Derivative Plaintiffs suggest they should be given discovery regarding the actions of the Special Committee (see Opp. at 25 n.21), but such discovery is neither necessary nor appropriate, as the Complaint's failure to allege demand futility with particularity is demonstrated by the facts alleged in the Complaint regarding the Special Committee's actions – which are not in dispute – along with publicly available SEC filings of which courts may take judicial notice.

[4] Derivative Plaintiffs stress that demand futility is analyzed at the time the case is filed, and that "[s]ubsequent actions of the Special Committee or the Board are not relevant to the demand futility analysis." (Opp. at 9.) But the Complaint fails to include particularized allegations showing why demand would have been futile on the day the action was filed or at any other time. Furthermore, Derivative Plaintiffs identify no authority in support of their strange suggestion that, on a motion to dismiss, the Court should not consider matters alleged in the very complaint that is the subject of the motion.

[5] Accordingly, this Court should not grant Derivative Plaintiffs leave to amend to add the accounting allegations because doing so would not change the only two facts that matter: that Derivative Plaintiffs failed to make a pre-suit demand and that such a demand would not have been futile.

Compensation Committee members did anything more than "allow[] themselves to be deceived by . . . relying on" the company's senior lawyer (Opp. at 24), or explain why an action by the company against those directors or Danziger would overcome the director exculpation provisions contained in the company's Certificate of Incorporation. (See Mem. at 17.) On the contrary, Derivative Plaintiffs' only claim is that the Compensation Committee members were "grossly negligent" (Opp. at 14), and that is insufficient to overcome the exculpation provisions. See In re Walt Disney Co., 906 A.2d 27, 64-65 (Del. 2006). ("[G]rossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith.").[6]

II. EVEN IF THE SPECIAL COMMITTEE HAD NOT TAKEN VIGOROUS ACTION, THERE WOULD BE NO SHOWING OF FUTILITY.

Derivative Plaintiffs wisely (see Mem. at 12-14) seem to abandon their claim that outside business interests or personal relationships rendered the Special Committee members interested, and they do not really dispute that neither director on that Committee (nor, for that matter, any of Comverse's Outside Directors) ever received backdated employee options (see id. at 5-6).[7] Instead, the Opposition baldly asserts that Hiram and others (not including Alon) engaged in "insider trading" and that all the directors approved the issuance of erroneous financial statements. (See Opp. at 4, 18.) In doing so, Derivative Plaintiffs ignore the case law holding that (1) directors' sales of inflated stock is not enough to establish futility absent

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[6] Derivative Plaintiffs' reliance on In re Abbott Laboratories Deriv. Litig., 325 F.3d 795 (7th Cir. 2003), is misplaced because, as this Court has explained, in Abbott, "the members of the board were explicitly aware of the alleged practices complained of over a lengthy period of time and had consciously chosen not to act in response thereto – . . . the board's 'inaction' was intentional and conscious, and . . . the directors knew of the violations of law [but] took no steps in an effort to prevent or remedy the situation." Spear v. Conway, 800 N.Y.S.2d 357, 2003 WL 24012118, at *6 (N.Y. Sup. Ct. 2003) (Lowe, J.) (emphasis added). The Complaint alleges no such conscious and intentional decisions by the Outside Directors here.

[7] While Derivative Plaintiffs mildly express skepticism over this point (see Opp. at 20 n.18), what matters, and what they do not and cannot dispute, is that the Complaint does not allege with particularity that the Outside Directors received such options.

particularized allegations that the sales resulted from the possession of inside information (see Mem. at 11-12), and (2) in the absence of similar particularized allegations of knowledge that the financial statements were false, even audit committee membership does not establish director interestedness.[8]

Derivative Plaintiffs' argument that the Outside Directors were dominated by Alexander (see Opp. at 18-20) simply ignores common sense and last summer's decision in Andropolis v. Snyder, where the court rejected demand futility arguments because it was "difficult to conceive that a majority of the Board was so 'beholden' to [the CEO], yet they were able to initiate an internal investigation and force [his] retirement." No. 05-cv-01563-EWN-BNB, et al., 2006 WL 2226189, at *9 (D. Colo. Aug. 3, 2006). Nor is this defect cured by quotations from unnamed former employees (see Opp. at 19; ¶ 209(h-i)) who never attended Board meetings or, it appears, had any contact with Board members, and whose statements support nothing more than the unremarkable proposition that the company's employees followed the dictates of its CEO during some unspecified period. Similarly, the curious argument that the boards of two Comverse subsidiaries included directors whom Derivative Plaintiffs baldly call Alexander's "cronies" (Opp. at 19) provides no insight into the separate question of whether Comverse's Special Committee members were dominated by Alexander in April 2006.[9]

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[8] See, e.g., Kenney v. Koenig, 426 F. Supp. 2d 1175, 1183 (D. Colo. 2006) ("All that plaintiffs[] demonstrate[] is that [nominal defendant] had an audit committee and the four independent outside director defendants were members of this committee during the period where the accounting improprieties occurred. That is not enough."); Andropolis v. Snyder, Civil Action No. 05 Civ. 1563, 2006 WL 2226189, at *13 (D. Colo. Aug. 3, 2006) (holding that conclusory allegations regarding audit committee's failure to monitor are insufficient to excuse demand); Ji v. Van Heyningen, No. 05 Civ. 273, 2006 WL 2521440, at *12 (D.R.I. Aug. 29, 2006) (rejecting argument that directors interested by virtue of positions on audit committee); Seminaris v. Landa, 662 A.2d 1350, 1354 (Del. Ch. 1995) (finding allegation that directors were interested because they signed misleading SEC Form 10-K and registration statement insufficient to excuse demand).

[9] Additionally, Derivative Plaintiffs' statement that one of these subsidiaries – Verint – has "admitted to backdating options" (Opp. at 19) is simply false, as the very SEC filing they cite

Ultimately, Derivative Plaintiffs appear to rely on the proposition that the Compensation Committee members face a substantial likelihood of personal liability for having made business decisions that would not be shielded by the business judgment rule because they "delegated" authority to select grant dates and "signed the UWCs without question." (Opp. at 12-13.) That argument conflicts with the Complaint's allegations that Compensation Committee members did raise questions before signing Unanimous Written Consents and that Alexander and Kreinberg needed to deceive the members to overcome their scrutiny. (¶ 209(f)(iii) & n.14; see also ¶¶ 112, 114, 209(f)(v).)[10] More fundamentally, it ignores the fact that the Compensation Committee and the Special Committee are not the same, and that, more than four weeks before the derivative action was filed, the Comverse Board delegated to the Special Committee all power to deal with issues involving option grants, including responding to any demand. See supra p. 1. For this reason, whether Compensation Committee members "could have" discovered or stopped the alleged misconduct (see Opp. at 15, 16, 24)[11] has nothing to do with whether the Special Committee is disinterested and independent, which is the only question where the directors who would consider a demand are different than those in place at

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makes clear. (See Fraser Aff. Ex. 19 (explaining that certain Verint employees received Comverse options from Comverse prior to when Verint went public in 2002).)

[10] It is for this reason, no doubt, that Derivative Plaintiffs try to define the approved "transaction" excessively narrowly as "the backdating of Comverse stock options" (Opp. at 13 (emphasis added)) rather than the granting of such options.

[11] The law does not require such 20-20 hindsight, as one can always say a question "could have" been asked or an action "could have" been taken but was not. Here, for example, Derivative Plaintiffs assert that the Compensation Committee members could have discovered the Phantom/Fargo account if they had compared the names of the hundreds of grant recipients to a "recent . . . employee list" for the then Fortune 500 company with numerous domestic and international offices. (See Opp. at 16.) But corporate directors are hardly expected to engage in such pedantic exercises or to presume that management is concealing documents, concocting fictitious employees, or backdating options. See, e.g., In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 969 (Del. Ch. 1996) ("absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf").

the time of the alleged wrongdoing. See Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993). That is the situation here, as Hiram was a brand new director who joined the Board just prior to the last backdated grant, and Alon did not join the Board for another two years after that.[12] Those facts likewise preclude any claim of bad faith, which Derivative Plaintiffs acknowledge requires a "sustained or systematic failure . . . to exercise oversight" (Opp. at 14-15 (quoting Brown v. LaBranche, Index No. 603512/03, Slip Op. at 7 (N.Y. Sup. Ct. Nov. 8, 2004)) (emphasis added)).[13]

The Opposition attempts to refute Comverse's claim that no court had ever excused demand based on the "egregiousness" prong of Marx (Mem. at 18) by digging up an unpublished Supreme Court decision that is not available even electronically on Lexis or Westlaw and that has never been cited by any court. (See Opp. at 20 (citing Katz v. Renyi, No. 604465/99 (N.Y. Sup. Ct. Dec. 12, 2000).) In addition to the fact that one such case hardly defeats the proposition that futility based on "egregiousness" is truly extraordinary, even that decision does not support finding futility here because there the directors had failed to appoint a special litigation

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[12] The ability of the other Outside Directors to respond appropriately to a demand is not relevant here because a month before this action was filed, the Board had delegated authority to the Special Committee. But even if this were not so, disinterestedness and independence would still be the only applicable test because Derivative Plaintiffs admit they assert a "Caremark" claim (see Opp. at 14), to which courts do not apply the demand futility tests designed to determine whether challenged transactions were the product of business judgment. See, e.g., Spear, 2003 WL 24012118, at *3-*4; David B. Shaev Profit Sharing Account v. Armstrong, No. Civ. A. 1449-N, 2006 WL 391931, at *4 (Del. Ch. Feb. 13, 2006) ("[I]n a Caremark claim, there is no challenged transaction to test against the business judgment rule.") (May 3, 2007 Affirmation of Eric A. Bensky ("May Aff.") Ex. 1). Further, the traditional Marx inquiries would be of no avail to Derivative Plaintiffs in any event, as "rubberstamping" and "egregiousness" are not present. See supra p. 6; infra pp. 7-8; Mem. at 17-19.

[13] Contrast with Abbott, 325 F.3d at 799-801 (majority of board that would have considered demand served during six-year period when FDA sent four explicit warning letters to directors and the press reported company's FDA problems, but directors failed to take any action) (Opp. at 14, 20); Miller v. Schreyer, 257 A.D.2d 358, 362 (1st Dept. 1999) ("patently improper scheme extended over a five-year period," and directors failed even to "launch a vigorous investigation well after the facts ha[d] come to light") (Opp. at 13, 16 n.17).

committee and conduct an investigation until more than a year after the derivative proceeding had been commenced and well after government investigations and media reports had highlighted the alleged misconduct. See Katz, Slip Op. at 6; Katz v. Renyi, 282 A.D.2d 262, 263 (1st Dept. 2001).

Finally, Derivative Plaintiffs rely heavily (see Opp. at 3-4, 9-12, 17, 20) on a decision applying Delaware law that deals with a situation where the body on whom demand was to be made "deliberate[ly]" violated the company's stock option plans and "intended" to "lie to" investors (see, e.g., Opp. at 11 (quoting Ryan v. Gifford, Civil Action No. 2213-N, 2007 Del. Ch. LEXIS 22, 40 (Feb. 6, 2007)); see also Ryan at *34) with respect to each of nine challenged transactions over a four-year period (see Ryan at *4, *29). But here, a demand would have been handled by the Special Committee, not by a committee that oversaw the company's stock option plans, and, in any event, the Complaint alleges the directors were affirmatively misled, that Alexander and Kreinberg concealed information from them (see ¶¶ 112, 114, 115, 206(f)(iii), 209(f)(iv)), and that Sorin told them the as-of dates on the Unanimous Written Consents were the dates on which Compensation Committee members orally approved the grants (¶ 209(c)(iv)). Further, Derivative Plaintiffs claim that the facts here are worse than those presented to the Ryan court because Comverse "has already conceded that option grants made during the Relevant Period were actually backdated" (Opp. at 10), but that very "concession" shows why demand would not have been futile in this case: it was made by, and based on the investigation of, the very Special Committee to whom Derivative Plaintiffs should have made the demand, thus demonstrating that the Special Committee was not comprised of or controlled by persons interested in suppressing the matters that are the subject of the Complaint.[14]

[14] Moreover, the Ryan court applied hindsight from 2006-07 – when everyone is attuned to the possibility and danger of options backdating – to a time when the issue was not on the minds of corporate directors. Rather, when considering proposed options grants, directors understandably focused on business matters such as the total number of options to be granted and

Conclusion

The Comverse Board that Derivative Plaintiffs criticize acted exactly as the law and any reasonable shareholder would hope it would by promptly appointing a Special Committee to act on all matters relating to options backdating. From that point forward, all demands relating to options would have been within the province of that Committee. To find that demand would have been futile when directed to a Special Committee that commenced an investigation, notified the government, and removed wrongdoers from office would contravene unanimous precedent to which Derivative Plaintiffs do not even respond, and would render the demand requirement a virtual nullity. Therefore, Comverse respectfully requests that this Court grant the motion to dismiss and permit its newly constituted Board to continue to address the matters at issue in the best interests of the company and its shareholders.

Respectfully Submitted,

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By: /s/ Eric A. Bensky

Howard Schiffman
Eric A. Bensky
DICKSTEIN SHAPIRO LLP
1825 Eye Street NW
Washington, DC 20006-5403
T: (202) 420-2200
F: (202) 420-2201

Counsel for Nominal Defendant Comverse Technology, Inc.

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whether the amounts for senior executives were appropriate. To assume that compensation committee members focused on the theretofore unappreciated and, it would seem, picayune issue of whether the stated grant dates were correct – and to conclude that they knew those dates were inaccurate – is to ignore the reality of the situation at the time. Indeed, under the Ryan court's analysis, every compensation committee member at hundreds, and perhaps thousands, of companies acted in bad faith by knowingly approving backdated options (without any economic incentive to do so). See, e.g., John Hechinger, Broadcom Faces at Least $750 Million Charge to Correct Options Errors, Wall St. J., July 15, 2006, at A4 (describing academic study estimating "that 29% of the nearly 8,000 firms studied had backdated or otherwise manipulated grants to top executives at some point between 1996 and 2005") (May Aff. Ex. 2).