

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

In Re: Converse Technology, Inc.
Derivative Litigation

Index No. 601272/2006

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

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I. INTRODUCTION

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

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

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

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

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

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

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

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

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

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

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

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

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

The *Ryan* court further held that:

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

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

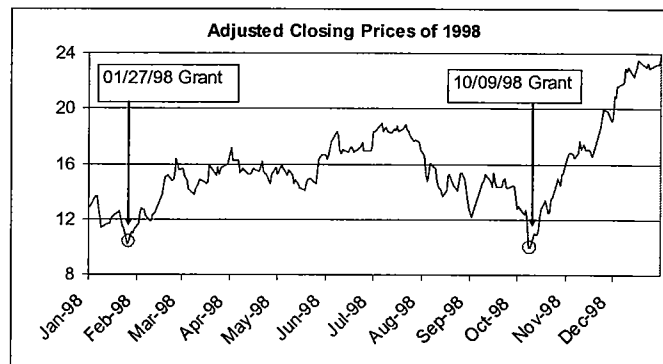
Moreover, a majority of the Board, at the time this action was commenced, was self-interested because they either received backdated options (Alexander, Sorin and Danziger), breached their fiduciary duties to the Company and violated the law by approving and issuing backdated options as part of the Compensation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

II. STATEMENT OF FACTS

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

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

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



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

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

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

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

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

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

III. ARGUMENT

A. Standard of Review

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

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

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

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

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

B. Demand Futility Is Determined at Commencement of Action

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

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

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

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

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

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

