

**SPECIAL COMMITTEES MUST BE FULLY INDEPENDENT AND  
DEMONSTRATE A “VIGOROUS” COMMITMENT TO PROTECTING  
THE INTERESTS OF THE CORPORATION**

A recent ruling by the Appellate Division in New York’s First Department reversed the dismissal of a derivative action in the high-profile Comverse Technology, Inc. (“Comverse”) options backdating matter. The court ruled that the derivative action should be allowed to proceed after finding that the plaintiff’s complaint sufficiently alleged that demand was futile because the special committee appointed by the company’s Board of Directors (the “Board”) was not sufficiently independent and the committee did not demonstrate sufficient vigor in investigating the wrongdoing—even though the report of the committee suggests that it directed a multi-million dollar investigation with the support of an independent law firm and additional independent consultants.

The case, *In re: Comverse Technology, Inc., Derivative Litigation*, is based on the alleged multi-year backdating of stock options by the former CEO, CFO and General Counsel of Comverse. Although the Board promptly appointed a special committee to investigate the alleged wrongdoing, the First Department Appellate Division held that “the mere appointment of a special committee” is not sufficient to terminate a shareholder derivative action. The court ruled that, based on the allegations in the complaint, the independence of the special committee was questionable because one of its members had been a member of the company’s compensation committee during part of the time period when options were backdated. Additionally, the court held that the complaint’s allegations raised concern about the commitment of the special committee to pursuing the interests of the corporation despite the committee’s prompt interview and ultimate termination of three senior officers, including the company’s founder and CEO. As a result of these alleged shortcomings of the special committee, the court held that dismissal of the case was inappropriate and the complaint should be reinstated.<sup>1</sup>

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<sup>1</sup> The Appellate Division also held that the complaint set forth with sufficient particularity allegations that made demand futile under two of the three prongs of the *Marx v. Akers* test—failing to inform themselves to the degree reasonably necessary and failing to exercise their business judgment. The court held that the complaint adequately alleged that the Board and the compensation committee failed to stay informed, noting that the compensation committee approved option grants without question when even a minimal review of certain materials would have prompted some additional inquiry into how the corporation used option grants. And, as noted below, the court also held that the backdating of options was so egregious that it failed to qualify as a legitimate exercise of business judgment.

## Background

The underlying facts of the case include allegations of a stock options backdating scheme orchestrated by Jacob “Kobi” Alexander, Comverse founder and CEO; David Kreinberg, Comverse’s CFO; and William F. Sorin, the General Counsel and a Director. The Board became aware of the alleged scheme as a result of inquiries by *The Wall Street Journal* while it was conducting an investigation into the backdating of stock option grants to high-level employees at approximately a dozen large companies, including Comverse. Shortly after becoming aware of the allegations, and prior to the article’s publication, Comverse’s Board formed a special committee to investigate the timing of the company’s option grants and to take appropriate action with respect to any problems uncovered. The committee was comprised of two Directors, including Ron Hiram, a Director and compensation committee member since June 2001. The committee, advised by independent legal counsel, formally interviewed Alexander, who admitted that he had participated in stock options backdating.

The complaint alleged that: 1) beginning in 1991, Alexander and Kreinberg, with the assistance of Sorin, repeatedly awarded themselves backdated stock options in violation of the company’s approved option plan; 2) the compensation committee failed to fulfill its fiduciary obligation to administer the company’s stock option plans and knowingly or recklessly approved the backdated stock options; and 3) demand was futile because the backdating of options was so egregious that it could not have been the product of sound business judgment. The lower court dismissed the action, finding that the plaintiffs failed to sufficiently set forth the reasons why demand was futile because the company, by appointing a special committee, which did conduct its own internal investigation, had exhibited its willingness to take the action necessary to protect the interests of the corporation.

The Appellate Division reversed, noting that the complaint sufficiently alleged that demand was futile because:

- the appointment to the special committee of a Director who had also been a member of the compensation committee that oversaw the granting of options called into question the special committee’s ability to fully investigate the conduct of all potentially liable parties, and this lack of disinterestedness meant that the committee’s decisions were not shielded by the business judgment rule; and
- the complaint’s allegations sufficiently called into question the commitment of the committee to protecting the company and seeking appropriate recompense even though it had promptly taken steps to obtain admissions from the scheme’s perpetrators and had removed them from the Board.

### The Appointment of and Investigation by the Special Committee

The Appellate Court, in overturning the lower court's dismissal, more deeply probed the composition of the special committee and the investigative and remedial actions taken by the committee to determine whether the Board had adequately demonstrated a willingness to take the actions necessary to protect the interests of the corporation.

The court first noted that the creation of a special committee does not in itself necessarily establish a board's willingness to take all necessary and appropriate steps to obtain the relief available. In this case, Hiram, one of the two appointed members of the special committee, was a Director and member of the compensation committee for part of the period at issue, and allegedly failed to take any steps reasonably necessary to oversee the awarding of options during that time. The court said that his appointment to the special committee arguably created a conflict of interest from the outset and called into question the committee's ability to fully investigate the conduct of all potentially liable parties.

Second, the court stated that although the special committee was appointed promptly and then took steps to obtain admissions from the perpetrators of the scheme and to remove them from the Board, the complaint raised legitimate questions as to the committee's willingness to take appropriate additional actions to protect the company. Specifically, the court noted that although Converse obtained the resignations of Alexander, Kreinberg and Sorin, the company continued to retain them as advisors for an additional four months, severing their relationship with the company only in the wake of criminal and civil charges filed by the United States Attorney for the Eastern District of New York and the Securities and Exchange Commission (the "SEC"). Furthermore, the court noted that when Director Itzik Danzinger, who allegedly received backdated stock options worth millions of dollars, resigned from the Board in September 2006, he was allowed to keep his unexercised backdated options.

Finally, although the defendants argued that the special committee's actions against high-ranking officers of the company demonstrated that it would fairly consider the possibility of suing less senior individuals, former directors and officers, and the company's outside auditors, the court found that the complaint adequately alleged otherwise. In describing the special committee's investigation as "a tepid rather than a vigorous approach to the misconduct and resultant harm," the court noted that there was no indication that the special committee would go beyond its initial actions of questioning and removing the three individuals who planned and carried out the scheme—acts the court specifically noted the Board was essentially forced to take in the wake of the SEC investigation and criminal prosecution of those individuals.

Backdating of Options Is Egregious Conduct

This decision also marks the first time that a court in New York has addressed whether backdating of options is the type of transaction that is so egregious that “it could not have been the product of sound business judgment.”<sup>2</sup> Looking to decisions of the Delaware courts, the Appellate Division held that “the approval of a decade’s worth of backdated stock options simply does not qualify as a legitimate exercise of business judgment.”

Lessons from this Decision

The Appellate Court’s decision in this case suggests that even when a company conducts a thorough investigation, fires the most senior executives at the company and cooperates with government investigations, its conduct might still be subject to an extraordinary level of scrutiny when it seeks to dismiss derivative actions. According to the report of the special committee, its initial investigation involved “131 interviews of 117 present and former officers, directors and employees” and the review of more than one million documents.<sup>3</sup> The decision also underscores the importance of appointing truly independent directors to any special committee; otherwise, a company risks losing the protection of the business judgment rule.

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<sup>2</sup> *Marx v. Akers*, 88 NY2d 189, 200-01 (1996).

<sup>3</sup> Form 8-K filed by Comverse Technology, Inc. (January 29, 2008).