

**UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK**

IN RE NORTEL NETWORKS CORP.
SECURITIES LITIGATION

This Document Relates to:

04-CV-2115; 04-CV-2164; 04-CV-2189;
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ECF CASE

SECOND AMENDED CONSOLIDATED CLASS ACTION COMPLAINT

**BERNSTEIN LITOWITZ BERGER
& GROSSMANN LLP**

Daniel L. Berger (DB-7748)

John P. Coffey (JC-3832)

Jennifer L. Edlind (JE-9138)

Wendy Erdly (WE-9747)

1285 Avenue of the Americas

New York, New York 10019

Telephone: (212) 554-1400

Facsimile: (212) 554-1444

Counsel for Co-Lead Plaintiffs Ontario
Teachers' Pension Plan Board and the New
Jersey Division of Investment and Lead
Counsel for the Prospective Class

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Lead Plaintiffs Ontario Teachers' Pension Plan Board and the Department of the Treasury of the State of New Jersey and its Division of Investment (collectively, "Lead Plaintiffs") bring this action individually and on behalf of all other persons and entities who purchased the common stock of Nortel Networks Corporation ("Nortel," "Nortel Networks" or the "Company") from April 24, 2003, through and including April 27, 2004 (the "Class Period") and who suffered damages thereby.

I. NATURE OF THE ACTION

1. This case arises out of an admitted fraud perpetrated by the senior management of Nortel. Specifically, in 2002 and 2003, the Company's senior officers created hundreds of millions of dollars of improper reserves and improperly maintained reserves even when it became apparent that the amounts of the reserves were excessive or would not be utilized for their original purpose. In 2003, Nortel released hundreds of millions of dollars from those reserves into income to make investors believe that Nortel had "returned to profitability" when, in fact, it had not. The creation and subsequent reversal of these so-called "cookie jar" reserves violated the most basic generally accepted accounting principles ("GAAP") and rendered the Company's financial statements throughout the Class Period materially false and misleading. The Company has admitted these facts, fired the perpetrators for cause and restated its financial results for all of fiscal year 2003, as well as earlier periods, as a result of this fraud.

2. Before Nortel admitted the true nature and extent of its financial shenanigans, however, the Company first issued a materially false and misleading restatement that made it appear as if Nortel's financial results had improved. To that end, Nortel announced on October 23, 2003 that the Company would restate its liabilities, resulting in a reduction of previously reported net losses and an increase in net assets and shareholder equity. On December 23, 2003, the Company restated its 2002 financial statements, as well as its financial statements for the first

and second quarters of 2003 (the “First Restatement”), thereby assuring the market of the integrity of its financial reporting. In the First Restatement, Nortel told investors, among other things, that it improperly recorded or failed to release approximately \$1.9 billion in reserves and provisions for the first two quarters of 2003.

3. Even as Nortel issued the First Restatement, the Officer Defendants – Frank Dunn, Douglas Beatty and Michael Gollogly – and the Audit Committee Defendants – John Edward Cleghorn, Robert Ellis Brown, Robert Alexander Ingram, Guylaine Saucier and Sherwood Hubbard Smith, Jr. – knew, or were reckless in not knowing, that these financial statements were incorrect. On December 18, 2003 – just five days before Nortel filed the First Restatement – Deloitte & Touche LLP (“D&T”), Nortel’s external auditors, warned the Company not to release the First Restatement at least until the preliminary phase of Nortel’s independent investigation was completed in January or February 2004. Nortel, the Officer Defendants, and the Audit Committee Defendants all turned a deaf ear to D&T’s warning and issued the First Restatement anyway. Within weeks, Nortel was forced to confess to the market that the First Restatement was itself false and misleading and would have to be restated.

4. Following months of further investigation and a year-long suspension of quarterly and annual financial reporting, Nortel filed a second restatement on January 11, 2005, which restated the Company’s 2001 and 2002 financial statements and its first, second, and third quarter 2003 financial statements (the “Second Restatement”). In the Second Restatement, Nortel admitted, among other things, that it improperly recorded or failed to release additional reserves and provisions, resulting in a decrease to net earnings of \$290 million.

5. Nortel has admitted that each of the Officer Defendants was responsible for this fraud. Specifically, in a press release issued on August 19, 2004, Nortel announced that these

Defendants (and seven other executives) “had primary, or substantial, responsibility for the Company’s financial reporting; that if not aware, each ought to have been aware that the establishment and/or release to income of such accruals and provisions were not in accordance with applicable [GAAP]; and that the improper application of [GAAP] with respect to these accruals and provisions misstated the Company’s financial statements.” This is the accepted definition of 10b-5 scienter: actual knowledge or recklessness as to the truth or falsity of material statements for which an officer was responsible. Thus, Nortel has admitted publicly all of the elements of Lead Plaintiffs’ securities fraud claim, as alleged herein.

6. The motive for the Officer Defendants to perpetrate this fraud is readily apparent. Dunn had been elevated to CEO of Nortel on November 1, 2001 in a management shake-up designed to reverse more than three years of unprofitability. He and CFO Beatty put their personal reputations on the line, promising investors that Nortel would return to profitability, initially promising this would take place in the fourth quarter of 2002, and then ultimately promising it would occur by the second quarter of 2003.

7. Then, in the middle of Nortel’s massive restructuring efforts in 2002, Dunn persuaded Nortel’s Board of Directors to implement a highly unusual bonus plan, dubbed the “Return to Profitability Plan.” This plan incentivized management to ensure that Dunn’s near-term promises would be kept, without any regard for the Company’s long-term financial health. Under the plan, Nortel’s senior officers were eligible to receive millions of dollars in bonuses if, and only if, the Company achieved profitability before the end of fiscal 2003.

8. This is exactly what happened. The Company announced a profit in the very first quarter of 2003 – the first quarterly profit at Nortel in three years. Unfortunately for investors, however, the Officer Directors did not achieve this profitability through legitimate means.

Rather, they manipulated the Company's reserves in order to manufacture a false profit and, thus, trigger the provisions of the Return to Profitability Plan. As a result, Dunn was able to claim that he had kept his promises to investors, and each of the Officer Defendants received millions of dollars in bonuses to which they were not legitimately entitled.

9. In addition to the Officer Defendants, the Audit Committee also bears responsibility for the fraud that was perpetrated at Nortel. The Audit Committee Defendants knowingly or recklessly disregarded specific facts that rendered the disclosures for which they were responsible false and misleading. On at least five occasions during the Class Period, D&T informed the Audit Committee that Nortel was releasing hundreds of millions of dollars of reserves into income, and that by doing so the Company was engineering positive earnings out of projected losses. D&T warned the Audit Committee that these reversals had a serious impact on the quality of Nortel's supposed earnings and that glaring internal control deficiencies relating to the reserve reversals constituted a "reportable condition." Later in the Class Period, the Audit Committee learned that D&T had revised its assessment of Nortel's internal control deficiencies downward still, determining that the deficiencies now qualified for the more serious "material weakness" designation. Although the Audit Committee Defendants plainly understood the impact of these deficiencies on the accuracy of Nortel's reported earnings, they ignored D&T's recommendation that the Company institute a rigorous review of the remaining balance sheet provisions, choosing instead to approve numerous financial disclosures reporting positive earnings results and a premature First Restatement that gave false assurance to the investing public.

10. Further, in light of the circumstances in which Nortel's purported "profitability" suddenly materialized, the Audit Committee's failure to detect the fraud could only be explained,

at a minimum, by a reckless disregard for their duties. As members of the Board of Directors, the Audit Committee Defendants approved the Return to Profitability Plan, which violated the most basic tenets of good corporate governance that its members so often touted. They then stood mute as Nortel's projected loss of \$112 million for the first quarter of 2003 mysteriously flipped to a profit of \$40 million within a matter of weeks, thereby triggering the first tier of millions of dollars in bonuses under the Return to Profitability Plan that they had just recently approved.

11. As a result of the fraud alleged herein, Nortel's stock price was artificially inflated throughout the Class Period, trading as high as \$8.50 per share on February 18, 2004. When the fraud was finally revealed, Nortel's shares fell below \$4 per share, inflicting billions of dollars of damages upon Nortel stockholders.

II. JURISDICTION AND VENUE

12. The claims of Lead Plaintiffs and the Class arise under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. §§ 78j(b) and 78t(a), and Rule 10-5, 17 C.F.R. § 240.10b-5 promulgated thereunder.

13. This Court has jurisdiction over the subject matter of the action under Section 27 of the Exchange Act, 15 U.S.C. ¶ 78aa, and 28 U.S.C. §§ 1331 and 1337. More specifically:

a. Pursuant to the "effects test" of extraterritorial jurisdiction, this Court has subject matter jurisdiction over the claims of: (i) all investors who purchased or acquired Nortel common stock traded on U.S. markets; and (ii) all United States residents who purchased or acquired Nortel common stock, regardless of where those securities traded.

b. In addition, pursuant to the "conduct test," this Court has subject matter jurisdiction over the claims of non-United States resident class members who purchased or acquired Nortel common stock traded on the Toronto Stock Exchange. Under the "conduct test,"

the Court has subject matter jurisdiction if (i) the defendants' activities in the United States were more than merely preparatory to the fraudulent conduct at issue, and (ii) defendants' actions or culpable failures to act within the United States caused the claimed losses. *See Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452 (S.D.N.Y. 2001). Here, Defendants engaged in extensive fraudulent conduct in the United States that caused the damages of Lead Plaintiffs and the Class.

c. Throughout the Class Period, Nortel's United States operations were a critical and dominant component of the Company's global business. Indeed, on its own website, Nortel expressly acknowledges that its "U.S. operations play a vital role in [its] overall corporate strategy." As the Company stated in the Second Restatement, Nortel collected its greatest amount of revenue on global basis from its United States operations: 53% of the Company's \$11.01 billion in revenues in 2002 and 53% of the Company's \$10.19 billion in revenues in 2003 came from the United States.

d. Furthermore, throughout the Class Period, all four of Nortel's core operating divisions – Wireless Networks, Enterprise Networks, Wireline Network and Optical Networks – conducted extensive business and had a widespread presence in the United States. In fact, three of the four divisions had their principal offices in the United States. The Wireless Networks Division was located in Richardson, Texas; the Enterprise Networks Division was located in the Research Triangle Park in Raleigh, North Carolina; and the Wireline Networks Division was located in Richardson, Texas. In addition to these locations, Nortel operated numerous other facilities and offices throughout the United States, including in Billerica, Massachusetts; Schaumburg, Illinois; Alpharetta, Georgia; and in Santa Clara, Simi Valley and San Ramon, California. In total, during the Class Period, Nortel had more than one hundred facilities and more than 40% of its global workforce located in the United States.

e. As discussed more fully below, Nortel's U.S. operations were the locus of much of the fraudulent activity that forms the basis of these claims. For example:

- (i) According to former employees of Nortel, including CS1, CS3, CS5 and CS9 (defined in ¶¶ 30, 32, 34, 38 below), each operating division of Nortel prepared and maintained its own financial results. Those results were then revised and consolidated at Nortel's corporate headquarters in Brampton, Ontario. Moreover, Nortel's Controller for North American operations was based in Raleigh, North Carolina, and Nortel maintained an internal accounting "control group" that was located in Nashville, Tennessee throughout the Class Period.
- (ii) Each of the U.S. divisions accounted for its own reserves in the first instance. As detailed below, this reserve accounting was at the center of the instant fraud. According to CS1 and CS7 (*see* ¶¶ 81, 233 below), it was common practice at each of the U.S. divisions to take excessive accruals in violation of GAAP. CS3 specifically stated that she was routinely asked to book improper accruals by Ken Taylor, the Vice-President for Finance in Raleigh, North Carolina who reported directly to defendant Beatty. She also stated that on at least one occasion she specifically addressed this fact with defendant Dunn, who informed her that "this was the way the Board wanted things done." (*See* discussion *infra* at ¶¶ 83-85).
- (iii) After the accounting fraud was disclosed, Nortel fired its finance chiefs for its four core divisions for cause, including three finance chiefs who were located in the United States. In so doing, Nortel admitted that each of these finance chiefs was substantially responsible for the Company's financial reporting, and that each either knew or "ought to have been aware" of the fraud alleged herein. (*See* discussion *infra* at ¶¶ 29, 205).

f. Defendants utilized the U.S. mails, interstate wires and the facilities of a U.S. securities exchange in furtherance of this fraud. Among other things, Nortel filed its materially false and misleading financial statements and press releases with the Securities Exchange Commission ("SEC"); it conducted numerous conference calls with analysts located in the United States; and it distributed its materially false and misleading financial results in

quarterly reports to shareholders residing throughout the United States. As a result of the Defendants' fraudulent activities in and affecting the United States, both the SEC and the United States Attorney's Office for the Northern District of Texas, Dallas Division, have initiated investigations. These investigations are on-going.

14. Venue is proper in this District pursuant to Section 27 of the Exchange Act and 28 U.S.C. § 1391(b). The Company's stock traded on the New York Stock Exchange at all relevant times.

III. PARTIES

A. Lead Plaintiffs

15. **Ontario Teachers' Pension Plan Board** ("Ontario Teachers") is a public pension fund organized for the benefit of the current and retired teachers of the Province of Ontario, Canada. The fund is located in Toronto, Ontario and has total assets of approximately US\$76.5 billion. Ontario Teachers purchased shares of Nortel common stock on both the Toronto Stock Exchange ("TSX") and the New York Stock Exchange ("NYSE") during the Class Period, and suffered a substantial loss as a result of the violations of the federal securities laws alleged herein. By Order entered July 1, 2004, the Court appointed Ontario Teachers as Co-Lead Plaintiff in this Action pursuant to 15 U.S.C. §78u-4. *See In re Nortel Networks Corp. Sec. Litig.*, 04 Civ. 02115 (LAP), Docket No. 61.

16. **Department of the Treasury of the State of New Jersey and its Division of Investment** ("New Jersey") is a public pension fund organized for the benefit of current and retired employees of the State of New Jersey. The fund is located in Trenton, New Jersey and has total assets of approximately \$83.2 billion. New Jersey purchased shares of Nortel common stock on the TSX during the Class Period, and suffered damages as a result of the violations of the federal securities laws alleged herein. By Order entered July 1, 2004, the Court appointed

New Jersey as Co-Lead Plaintiff in this Action pursuant to 15 U.S.C. §78u-4. *See* Docket No. 61.

17. The following additional plaintiffs purchased Nortel common stock on the open market and suffered damages as a result of Defendants' violations of the federal securities laws: Cary Savitz; Ben H. Bradley; Michael Sarbacker; Leonard Semerad; Ralph Favilla; Henry Kolokowsy; Patricia Kolokowsky; Paul Krsek; Felipe Yap; Paulino Yap; Thomas Rotchford; Bobby D. Torres; Kamran Mirza; Susan Daniels; Pierre A. Nader; Gunther Jurgen Neuhauser; Julie Kapsh; Sara A. Wilkins; James D. Wilkins III; Franklin L. Hanks; Tom Cosgrove; S. Myron Goldstein; Bernard Lubinsky; Bernard Barry; Milton Pfeiffer; Rolland Schach; Donald J. Kelly; Adma Management Inc.; and the Indiana Electrical Workers Pension Trust Fund IBE.

B. Defendants

18. **Defendant Nortel Networks** is a Canadian corporation with its principal executive offices located at 8200 Dixie Road, Brampton, Ontario, Canada. Nortel has offices located throughout the United States, including in Georgia, California, North Carolina and Texas. Nortel files annual, quarterly and other reports with the Ontario Securities Commission and the SEC. Its common stock is listed and traded on both the TSX and the NYSE under the symbol NT. Nortel provides networking and communication services to customers located in over 150 countries. Nortel's products and services focus on expanding global communications by eliminating the linear boundaries between voice and data, wireline and wireless, and public and private networks. The Company designs, develops, manufactures, assembles, markets, sells, licenses, installs, services and supports various types of communication networks.

19. **Defendant Frank Dunn** ("Dunn") served as Nortel's Chief Executive Officer ("CEO") and President from November 1, 2001 until April 27, 2004 when he was terminated for cause. Prior to being fired, Dunn spent twenty-eight years at the Company, working his way up

through the ranks. He is an accountant by training and held numerous financial positions at Nortel, including serving as its Chief Financial Officer (“CFO”) from February 2000 to November 1, 2001, when he was named President and CEO. Between February 11, 2002 and July 17, 2002, Dunn served as both Nortel’s CEO and CFO. Defendant Dunn signed and, as required by the Sarbanes-Oxley Act of 2002, certified the accuracy of the Company’s financial statements as presented in Nortel’s (1) Form 10-K/A for the year ended December 31, 2002; (2) certified Forms 10-Q for the quarters ended March 31, 2003; June 30, 2003 and September 30, 2003; and (3) certified Forms 10-Q/A for the quarters ended March 31, 2003 and June 30, 2003. In addition, and as more particularly set forth below, until his termination for cause on April 28, 2004, Defendant Dunn made statements in Company conference calls, press releases, meetings and shareholder publications, including Nortel’s Quarterly Reports to Shareholders.

20. **Defendant Douglas C. Beatty** (“Beatty”) served as Nortel’s CFO from July 2002 until he was terminated for cause on April 27, 2004. Beatty joined the Company as its Controller in 1999, a position he held through July 2002. He is a chartered accountant and holds a Bachelor of Commerce degree from the University of Toronto. As CFO, Beatty was responsible for reviewing the Company’s financial reports that were filed with the SEC and, according to the description of this position on the Company’s website, he “le[d] Nortel Networks’ global finance function.” During the Class Period, he signed and, as required by the Sarbanes-Oxley Act of 2002, certified the accuracy of the Company’s financial statements as presented in Nortel’s (1) Form 10-K/A for the year ended December 31, 2002; (2) Forms 10-Q for the quarters ended March 31, 2003; June 30, 2003; and September 30, 2003; and (3) Forms 10-Q/A for the quarters ended March 31, 2003 and June 30, 2003. In addition, as more particularly set forth below, until

his termination in April 2004, Defendant Beatty made statements in Company conference calls, meetings and press releases.

21. **Defendant Michael J. Gollogly** (“Gollogly”) served as Nortel’s Controller from the second half of 2002 until he was terminated for cause on April 27, 2004. As Controller, Defendant Gollogly was the Company’s top accounting manager and controlled all balance sheet reviews. Prior to serving as Nortel’s Controller, Defendant Gollogly was the Vice President of Finance for Nortel’s Wireless Networks Division. During the Class Period, Defendant Gollogly signed Nortel’s (1) Form 10-K/A for the year ended December 31, 2002; (2) Forms 10-Q for the quarters ended March 31, 2003; June 30, 2003; and September 30, 2003; and (3) Forms 10-Q/A for the quarters ended March 31, 2003 and June 30, 2003.

22. Defendants Dunn, Beatty and Gollogly are referred to collectively in this Complaint as the “Officer Defendants.” On March 15, 2004, Nortel placed Defendants Beatty and Gollogly on paid leaves of absence based on their involvement in this fraud. Thereafter, on April 27, 2004, Nortel terminated all three Officer Defendants “for cause.” As noted earlier, the Company explained in its August 19, 2004 press release that it had done so because these individuals “had primary, or substantial, responsibility for the Company’s financial reporting” and each was “aware [or] each ought to have been aware that the establishment and/or release to income of such accruals and provisions were not in accordance with applicable generally accepted accounting principles; and that the improper application of generally accepted accounting principles with respect to these accruals and provisions misstated the Company’s financial statements.”

23. **Defendant John Edward Cleghorn** (“Cleghorn”), upon information and belief, served as Chairman of Nortel’s Audit Committee throughout the Class Period. Defendant

Cleghorn has been a director of Nortel since May 24, 2001. He has also served on the Board of Directors of Canadian Pacific Railway Company, Canadian Pacific Railway Limited, Finning International Inc. and SNC-Lavalin Group Inc., where Cleghorn also served as Chairman of the Board of Directors. From January 1995 through July 2001, Cleghorn was Chairman and Chief Executive Officer of the Royal Bank of Canada. Cleghorn signed Nortel's Form 10-K/A for the year ended December 31, 2002.

24. **Defendant Robert Ellis Brown** ("Brown"), upon information and belief, was a member of Nortel's Audit Committee during the Class Period. Throughout the Class Period, Defendant Brown also served as the Chairman of the Joint Leadership Resources Committee of Nortel's Board of Directors, the committee responsible for compensation matters. Defendant Brown has been a director of Nortel since March 7, 2000, and he previously served as President and Chief Executive Officer of Bombardier Inc. and President and Chief Operating Officer of Bombardier Aerospace. Brown signed Nortel's Form 10-K/A for the year ended December 31, 2002.

25. **Defendant Robert Alexander Ingram** ("Ingram"), upon information and belief, was a member of Nortel's Audit Committee during the Class Period. Throughout the Class Period, Defendant Ingram also served on the Joint Leadership Resources Committee of Nortel's Board of Directors, the committee responsible for compensation matters. Defendant Ingram has been a director of Nortel since March 7, 2000, and he also served on the board of directors of Edwards Lifesciences Corporation, Lowe's Companies, Inc., Misys plc, Molson Inc., and Wachovia Corporation. Ingram is also Vice Chairman of GlaxoSmithKline plc, a position he has held since January, 2003. Previously, Ingram served as the Chief Operating Officer and President of GlaxoSmithKline, Pharmaceutical Operations; Chief Executive of Glaxo Wellcome

plc; Chairman, President, and Chief Executive Officer of Glaxo Wellcome; and non-executive Chairman of OSI Pharmaceuticals, Inc. Ingram signed Nortel's Form 10-K/A for the year ended December 31, 2002.

26. **Defendant Guylaine Saucier** ("Saucier"), upon information and belief, was a member of Nortel's Audit Committee during the Class Period. Saucier was a director of Nortel from March 7, 2000 to June 29, 2005, and also served on the board of directors of AXA Assurances Inc., Bank of Montreal, Petro-Canada, Tembec Inc. and the International Federation of Accountants. Saucier served as Chair of the Joint Committee on Corporate Governance, which was jointly established in 2000 by the Canadian Institute of Chartered Accounts, the Canadian Venture Exchange and the Toronto Stock Exchange for the purposes of reviewing the state of corporate governance in Canada and making recommendations in connection therewith. Defendant Saucier previously served as Chair of the Canadian Institute of Chartered Accounts and Chair of the Board and a director of the Canadian Broadcasting Corporation. Saucier signed Nortel's Form 10-K/A for the year ended December 31, 2002.

27. **Defendant Sherwood Hubbard Smith, Jr.** ("Smith"), upon information and belief, was a member of Nortel's Audit Committee during the Class Period. Throughout the Class Period, Defendant Smith also served on the Joint Leadership Resources Committee of Nortel's Board of Directors, the committee responsible for compensation matters. Smith was a director of Nortel from March 7, 2000 to June 29, 2005, and also served as chairman emeritus of the board of directors of CP&L, trustee of the Northwestern Mutual Life Insurance Company, director and chairman of the Triangle Universities Center for Advance Studies, Inc. and vice chairman of the Research Triangle Foundation. Previously, Smith was chairman emeritus of the

board of directors, and non-executive chairman of the board of directors, of Carolina Power & Light Company. Smith signed Nortel's Form 10-K/A for the year ended December 31, 2002.

28. Defendants Cleghorn, Brown, Ingram, Saucier and Smith are collectively referred to as the "Audit Committee Defendants," the "Audit Committee," or the "Committee." As set forth in the Audit Committee Mandate, during the Class Period the Audit Committee was responsible for "the oversight of the reliability and integrity of accounting principles and practices, financial statements and other financial reporting, and disclosure practices followed by management." The Audit Committee was also responsible for (i) overseeing the performance of D&T; (ii) the Company's establishment of adequate internal controls; and (iii) the Company's compliance with applicable laws.

C. Additional Unnamed Parties and Confidential Sources

29. On April 27, 2004, Nortel placed the following individuals on paid leaves of absence because of their involvement in the improper manipulation of Nortel's accounts: James Kinney ("Kinney"), the Finance Chief for Nortel's Wireless Networks Division (Richardson, Texas); Ken Taylor ("Taylor"), Vice-President for Nortel's Enterprise Networks Division (Raleigh, North Carolina); Craig Johnson ("Johnson"), Finance Director for Nortel's Wireline Networks Division (Richardson, Texas); and Doug Hamilton ("Hamilton"), Finance Director for Nortel's Optical Networks Group (Montreal, Quebec). Thereafter, on August 19, 2004, Nortel fired Kinney, Taylor, Johnson, and Hamilton, as well as the following individuals, for cause: Michael Gasnier ("Gasnier"), Vice-President of Finance for Europe; Robert Ferguson ("Ferguson"), Vice-President of Finance for China; and William Bowrey ("Bowrey"), Controller for Asia. In announcing these terminations, Nortel admitted in its press release that each one of these individuals was "aware [or] each ought to have been aware that the establishment and/or release to income of such accruals and provisions were not in accordance with applicable

generally accepted accounting principles; and that the improper application of generally accepted accounting principles with respect to these accruals and provisions misstated the Company's financial statements."

30. Confidential Source ("CS") 1 is a former Finance Director at Nortel, who worked at the Company for approximately ten years until January 2003. During his last three years at Nortel, he served as the Finance Director of Global Operations for Europe, the Middle East and Asia. In this capacity, CS1 was responsible for many aspects of budgetary and financial control in Europe, especially with regard to the Company's Optical Networking business. He reported to Ken Crosson ("Crosson"), the Vice-President of Finance and Global Operations in Raleigh, North Carolina who in turn, reported directly to Defendant Beatty. Crosson left Nortel in July 2003 after being accused of trading his Nortel stock during a prohibited time period.

31. CS2 is a former Regional Controller for Nortel, who was located in Raleigh, North Carolina and worked at the Company for approximately seventeen years, until November 2002. As Regional Controller, CS2 had a wide range of accounting and finance responsibilities, including reviewing the establishment and reversal of accrued liabilities before the accruals were sent to corporate headquarters in Brampton for review. CS2 reported to Greg Harris, Nortel's Senior Manager of Finance. During his last six years at the Company, CS2 held the title of Director.

32. CS3 worked in Nortel's Raleigh, North Carolina office as a Finance Manager for approximately three years, until November 2003. For her entire three year period at Nortel, CS3 was part of a training and documentation group that both taught end users how to use Nortel products and wrote the technical materials that explained the products. From October 2002 through December 2003, CS3 reported to Ken Taylor, the Vice-President for Nortel's Enterprise

Division, who was terminated for cause on August 19, 2004. Taylor reported to Defendant Beatty. CS3 stated that she left Nortel because she was “very uncomfortable with the way the Company was doing its accounting and with the instructions that Taylor was giving her,” primarily with respect to the booking of improper reserves.

33. CS4 is a former Senior Financial Analyst and Assistant Controller for Nortel. CS4 joined Nortel in August 1998, serving as a Financial Analyst in Brampton, Ontario until August 1999. In this capacity, CS4 worked on corporate financial planning and budgeting, including tracking whether the Company’s revenue and earnings were on target to meet its previously issued forecasts. Thereafter, from September 1999 until February 2000, CS4 worked as a Senior Financial Analyst in Nortel’s Enterprise Networks Division and was located in Richardson, Texas. In this role, he focused on professional services and reported to the Vice President of Enterprise Sales. Finally, in his last two years with the Company, CS4 served as an Assistant Controller for Regional Sales Finance in Richardson, Texas. In this role, he was responsible for proper revenue recognition; representing the finance department during negotiations of customer contracts; and devising ways to improve Nortel’s collection of receivables.

34. CS5 worked for Nortel for approximately six and a half years, until August 2004. After spending his first year in Richardson, Texas and his second year and a half in Beijing, China, CS5 spent his remaining four years at Nortel serving as a Finance Manager in Hong Kong, China for Nortel’s Enterprise Networks Division. As a Finance Manager, CS5 was responsible for the financial planning and organizing of Nortel’s Asia-based projects. In this role, he reported directly to Bowrey, who was the Controller of Asia before being terminated for cause on August 19, 2004. Bowrey reported to Ferguson, who was the Vice-President of

Finance in China before being terminated for cause on August 19, 2004. Ferguson reported directly to Beatty until March 15, 2004, when Defendant Beatty was placed on leave before being terminated for cause on April 28, 2004.

35. CS6 worked at Nortel for approximately thirty-three years, until July 2002. During his tenure, CS6 served in various positions, including serving as President of Nortel's Enterprise Networks Division in 2000 and the first half of 2001. In this position, CS6 reviewed the Enterprise Networks Division's financial statements every quarter with Taylor, the Vice-President for Nortel's Enterprise Networks Division, who was terminated for cause on August 19, 2004. Taylor reported to Defendant Beatty.

36. CS7 worked at Nortel for approximately twenty-one years, until mid-2002. During his time at Nortel, CS7 held several different financial management positions. Specifically, between 1997 and 1998, he served as Vice-President of Finance for Public Carrier Networks Operations and Technology in Raleigh, North Carolina. Thereafter, from 1998 until mid-2002, CS7 served as Vice-President of Finance for Global Operations. Nortel's Global Operations Finance Group handled finance issues relating to engineering, manufacturing, configuration, and testing. In this position, he reported to Crosson, who reported directly to Beatty.

37. CS8 is a former Financial Analyst for Nortel's Wireless Networks Division. CS8 worked in this position at Nortel for approximately three years, until July 2003, and was based in Richardson, Texas. His job responsibilities included consolidating the financial statements for the Wireless Networks Division. In this position, CS8 reported to the Director of Finance of the Wireless Networks Division, who reported directly to Kinney, the Division's Finance Chief until

he was terminated for cause on August 19, 2004. Kinney reported to Beatty, but he also interacted with Gollogly during balance sheet reviews.

38. CS9 worked at Nortel for nine years, until May 2003. From March 2002 until May 2003, CS9 was a Program Manager for Global SAP ERP system implementation in Raleigh, North Carolina. In this position, CS9 managed the deployment of SAP software, primarily focusing on European and Asian operations. Prior to this time, CS9 was Nortel's Finance Program Manager for Global SAP ERP system implementation in Raleigh, North Carolina. In this role, he managed the initial design and deployment of SAP, with an emphasis on finance requirements.

IV. CLASS ACTION ALLEGATIONS

39. Lead Plaintiffs bring this action as a class action pursuant to Federal Rules of Civil Procedure 23(a) and (b)(3) on behalf of a class consisting of all persons or entities who purchased Nortel Networks common stock during the period beginning April 24, 2003 through and including April 27, 2004 (the "Class Period"), and who suffered damages thereby (the "Class"). Excluded from the Class are (i) the Defendants; (ii) the additional unnamed parties specified in ¶ 29 above; (iii) members of the immediate family of each of Defendants and/or the individuals referenced above; (iv) any entity in which any Defendant and/or any of the individuals referenced above has a controlling interest; (v) any parent, subsidiary or affiliate of Nortel; (vi) any person who was an officer or director of Nortel or any of its subsidiaries or affiliates during the Class Period; and (vii) the legal representatives, heirs, predecessors, successors, or assigns of any of the specified excluded persons or entities.

40. The members of the Class are so numerous that joinder of all members is impracticable. As of September 10, 2004, there were approximately 4,268,236,000 shares of Nortel Networks common stock outstanding. While Lead Plaintiffs do not know the exact

number of Class members, Lead Plaintiffs believe that there are, at a minimum, thousands of members of the Class who purchased Nortel Networks common stock during the Class Period.

41. Common questions of law and fact exist as to all members of the Class and predominate over any individual questions affecting members of the Class. Among the questions of law and fact common to the Class are:

- a. whether the federal securities laws were violated by Defendants' acts as alleged herein;
- b. whether the Audit Committee Defendants acted with scienter in issuing false and misleading statements during the Class Period;
- c. whether the Officer Defendants are liable as control persons under the federal securities laws;
- d. whether the Audit Committee Defendants are liable as control persons under the federal securities laws;
- e. whether the market price of Nortel Networks common stock during the Class Period was artificially inflated because of the Defendants' conduct alleged herein; and
- f. whether the members of the Class have sustained damages and, if so, what is the proper measure of damages.

42. In addition to the common questions of law or fact, there are certain undisputed material facts that pertain to the claims of all class members. Among those undisputed facts are the following:

- a. Nortel has admitted issuing false and misleading statements during the Class Period;
- b. Nortel has admitted that its false and misleading statements during the Class Period were material; and
- c. Nortel has admitted that its officers with primary responsibility for the Company's financial reporting – the Officer Defendants – acted with scienter in issuing false and misleading statements during the Class Periods.

43. Lead Plaintiffs' claims are typical of the claims of the other members of the Class for Lead Plaintiffs and all members of the Class sustained damages arising out of Defendants' wrongful conduct in violation of Sections 10(b) and 20(a) of the Exchange Act.

44. Lead Plaintiffs will fairly and adequately protect the interests of the members of the Class and have retained counsel competent and experienced in class actions and securities litigation. Lead Plaintiffs have no interests antagonistic to or in conflict with the Class.

45. A class action is superior to other available methods for the fair and efficient adjudication of the controversy since joinder of all members of the Class is impracticable. Furthermore, because the damages suffered by the individual Class members may be relatively small, the expense and burden of individual litigation make it impossible for the Class members individually to redress the Defendants' wrongful conduct. There will be no difficulty in the management of this action as a class action.

V. SUBSTANTIVE ALLEGATIONS

A. Background

46. Throughout the Class Period, Nortel was one of the largest telecommunications companies in the world. Its business consisted primarily of supplying products and services that supported the Internet and other public and private data, as well as voice and multimedia communications networks, using wireline and wireless technologies. Utilizing these technologies, Nortel provided its customers – which include local and long-distance communications companies, wireless service providers, cable system operators, governmental agencies, and educational institutions – with data, voice, and multimedia communications capabilities on a local, regional and global scale.

47. At all times relevant to this Complaint, Nortel's business was organized into four core divisions: Wireless Networks, Enterprise Networks, Wireline Network, and Optical Networks.

a. Nortel's Wireless Networks Division, located in Richardson, Texas, supported wireless devices such as cellular telephones and personal digital assistants and specialized in third generation "packet-based networking," cutting-edge technology designed to enhance data rates and support greater numbers of customers on the same network.

b. Nortel's Optical Networks Division, located in Montreal, Quebec, supplied devices to enhance light wave signals in fiber optic cable lines. Its customers included telephone companies, cable operators, and internet service providers.

c. Nortel's Enterprise Networks Division, located in Research Triangle Park, Raleigh, North Carolina, supported wireline voice (telephone) and multimedia communications, and offered services such as network design and planning, operations planning and consulting, and technical support for existing networks.

d. Nortel's Wireline Networks Division, located in Richardson, Texas, provided "converged wireline solutions," a system designed to consolidate voice, video, data, and broadband applications into one packet network to simplify a customer's existing networks. Its customers include telephone companies, wireless service providers, internet service providers, and cable multiple system operators.

48. The story of Nortel during the late 1990's and early 2000's, like that of the telecommunications and dot.com sectors as a whole, was one of rapid and phenomenal growth. To compete in the quickly evolving telecom industry, between 1998 and 2000, Nortel embarked upon a massive acquisition campaign. During this period, the Company acquired numerous

technology companies – including Bay Networks, Inc., a provider of networking products and services; Alteon WebSystems, Inc., a provider of Internet infrastructure solutions; and Xros, Inc., a developer of photonic switching – at a cost of approximately \$31 billion. Nortel acquired most of these companies in stock-for-stock transactions. Thus, the Company used its own stock as currency. Moreover, in acquiring these assets, the Company paid billions of dollars more than their book value, attributing the difference between purchase price and book value to goodwill.

49. By the end of 1999, Nortel was widely regarded as an industry leader and was a core holding for telecommunications portfolios. Indeed, a December 15, 2000 *Financial Times* and PricewaterhouseCoopers survey of more than 700 CEOs from over 70 countries named Nortel Networks as one of the world's 10 most respected high-tech companies. Similarly, on October 2, 2000, Fortune magazine ranked Nortel Networks as the third most admired company in the Network Communications/Internet Tech sector in the world.

50. However, when the technology bubble burst in mid to late 2000, Nortel's fortunes quickly took a turn for the worse. In contrast to the boom years, Nortel's customers sharply curtailed their spending and were no longer investing in new networks or equipment based on potential future demand. As a result, Nortel's revenues were dramatically impacted.

51. In its 2001 Annual Report to Shareholders, Nortel attempted to explain its plight. Specifically, Nortel said that economic downturns in the U.S. and Europe had resulted in a decline in capital markets generally, and that the telecommunications industry, in particular, had undergone a period of significant adjustment. Consequently, "significant excess network capacity [existed] as a result of the pace of new network construction during 1999 and 2000." Nortel further explained that the downturn had created financial difficulties for a number of communications service providers around the world, reducing the amounts that these providers

were willing to spend on communications technologies. In sharp contrast to 1999 and 2000, in 2001, “service provider customers [were] no longer investing in new networks or equipment based primarily on potential future demand.”

52. On February 15, 2001, Nortel revealed that it would not be able to meet its previously announced revenue and earnings targets, and that it would be forced to restate its financial results for fiscal 2000 as a result of widespread accounting improprieties and mismanagement that had gone on without detection by the Company’s Audit Committee and others for years. Following this revelation, Nortel’s stock price fell even further, closing at \$20.00 per share on February 16, 2001. Based on these announcements, numerous class action lawsuits were filed against the Company and certain of its senior officers, alleging violations of the federal securities laws. Those actions were consolidated on October 16, 2001 and are currently pending before the Honorable Richard M. Berman, U. S. District Judge for the Southern District of New York.

53. In November 2001, the Company’s Board of Directors (the “Board”) took dramatic steps in an effort to stem the tide at Nortel and turn it back into a profitable company. The Board purged a number of the Company’s most senior officers and elevated several corporate insiders to the most senior positions in management. At that time, Defendant Dunn became the CEO of Nortel, replacing John A. Roth. Before serving as CEO, Dunn had served as Nortel’s CFO from March 2000 to November 2001.

54. Beginning in February 2002, Dunn held the positions of both CEO and CFO. In July 2002, Defendant Beatty, the Company’s Controller during 1999-2002, was promoted to replace Dunn as CFO. In the second half of 2002, Defendant Gollogly was promoted from Vice-President of Finance of the Wireless Networks Division to be Nortel’s new Controller.

B. The Officer Defendants Promise a Return to Profitability

55. In an effort to combat the disappointments of Nortel's recent past, the Company's decimated stock price and the general downturn in the telecom industry, the Officer Defendants quickly initiated a radical restructuring plan to reduce the Company's fixed costs and position Nortel for a financial recovery. Specifically, beginning in late 2001, Nortel slashed approximately 60,000 jobs, renegotiated its credit facilities, discontinued certain operations, sold non-core businesses, and took massive write downs of the goodwill on its balance sheet.

56. According to the Officer Defendants, these steps were necessary to get the Company's costs in line and to position the Company for future success. Indeed, in the Company's January 17, 2002 press release, which announced the Company's net loss of \$1.83 billion, or \$.57 per share, for the fourth quarter of 2001, Dunn explained that the Company's bottom line results, which included losses arising from its workforce reduction, facility closings and sale of businesses, evidenced the Company's commitment to move forward by "reflecting [the Company's] focus on [its] high value portfolio." Dunn promised "an ongoing steady improvement from our fourth quarter 2001 performance *and to return to profitability in the fourth quarter of 2002.*" (Emphasis added.)

57. Over the next several months, even though his target date was pushed back to 2003, Dunn continued to reiterate publicly his promise to return the Company to profitability. In announcing the Company's net loss of \$697 million, or \$.20 per share, for the second quarter of 2002, Dunn stated: "I am pleased with the progress we have made amidst the challenging industry contraction. Our actions this quarter have solidified our balance sheet while we continued to make significant progress in repositioning our business model and addressing our priorit[y] to return to profitability in the near term."

58. Thereafter, despite lowering its outlook for its third quarter 2002 results on both August 27, 2002 and September 25, 2002, Dunn continued to promise that Nortel would return to profitability by the end of June 30, 2003. Specifically, in the Company's August 27, 2002 press release, he announced that his "top priority remains to return to profitability by the end of June 2003."

59. In Nortel's September 25, 2002 press release, Dunn reiterated his promise by stating: "Despite the continued challenging market environment, our top priority remains to return to profitability by the end of June 2003. We are progressing well in our restructuring plan, and we will continue to monitor the market and the spending market and take additional actions, as appropriate, to achieve our profitability goals."

60. Dunn's promises to return the Company to profitability continued throughout the remainder of 2002. On October 17, 2002, in reporting that Nortel had a net loss of \$1.8 billion, or \$.42 per share, for the third quarter of 2002, Dunn stated, "[w]e made significant progress again this quarter in our drive to profitability." Similarly, in announcing the Company's fourth quarter 2002 net loss of \$248 million, or \$.06 per share, Dunn again focused on returning the Company to profitability. He stated, "I am extremely pleased with the progress we made as reflected in our fourth quarter performance.... As we enter 2003, the focus on profitability will continue."

C. Nortel's Board Approves a Bonus Program That Was Ripe for Abuse

61. At the same time that the Officer Defendants were promising a return to profitability and overseeing the Company's widespread restructuring efforts, they were encouraging Nortel's Board of Directors to create a bonus program that would so incentivize the Officer Defendants to fulfill their promised targets by dates certain that, when cost-cutting and

jawboning would not get the numbers where they needed to be, Nortel's senior executives would turn to large-scale fraudulent book-keeping.

62. Prior to the Class Period, Nortel had implemented a bonus plan, known as the "SUCCESS Incentive Plan," which provided for potential cash bonus payments to all Nortel employees based on multiple performance objectives – such as revenue and earnings per share, earnings per employee and customer loyalty – achieved over various six-month periods. In 2001, the corporate performance objectives were focused on the Nortel's revenues, while in 2002, the most heavily weighted performance target was earnings. Not surprisingly, based on the market downturn and the Company's massive restructuring effort, Nortel did not make any bonus payments under the SUCCESS Plan in either the 2001 or 2002 fiscal years.

63. However, in July 2002 the Board amended the SUCCESS Plan to allow for a discretionary cash bonus system, which was established in the third quarter of 2002 and named the "Return to Profitability" bonus plan. For regular employees, the special cash bonus was to be paid in full if Nortel became profitable in a single fiscal quarter, *so long as this was accomplished by the end of 2003*. Senior executives were eligible for cash bonuses "based on a multiple of base salary" that would be paid in three parts: (a) 20% of the aggregate potential bonus amount would be paid for one profitable quarter, *so long as the Company achieved this goal by the end of 2003*; (b) 40% of the aggregate potential bonus amount would be paid for a cumulative profit over two quarters, *so long as the Company achieved this goal by the end of 2004*; and (c) the final 40% of the aggregate potential bonus amount would be paid for a cumulative four-quarter profit, *so long as the Company achieved this goal by the end of 2004*. If the first portion of the bonus was not paid to the senior executives, then the second and third

components could not be paid. Moreover, if Nortel did not achieve two or four quarters of profitability by the end of 2004, then the Return to Profitability Plan would lapse.

64. The Return to Profitability Plan provided Nortel executives with a motive to commit fraud and was contrary to the interests of Nortel's shareholders for a number of reasons. First, the plan employed a single performance trigger – short-term profitability – that made it fertile ground for abuse. Corporate governance experts uniformly recognize that bonus plans should incorporate several performance triggers before executives are eligible to receive cash awards. Contrary to the single objective model employed by the Return to Profitability Plan, multiple performance triggers serve as a “checks and balances” system to ensure that management is striving to improve the overall health of the Company rather than manipulating the financial records to engineer an illusory short-term “profit.”

65. Second, the plan did not incorporate any standardized or uniformly recognized method for measuring the quality of Nortel's reported earnings. Rather than employing a GAAP measure of earnings, the Return to Profitability Plan utilized a pro forma definition of earnings, which the Company defined in its January 23, 2003 press release as “reported net [gain or] loss from continuing operations, minus certain items.” Unlike GAAP, the Company's pro forma method of measuring earnings allowed Nortel and the Officer Defendants to exclude numerous costs and charges from the earnings calculation, such as restructurings and write downs of goodwill from Nortel's prior acquisitions – further increasing the potential for abuse. In August 2003, the Return to Profitability Plan was amended to require the Board to confirm that the pro forma profitability targets were met before bonuses were paid.

66. Finally, the short-term nature of the pro forma profitability target encouraged immediate results at the expense of long-term shareholder value. This aspect of the plan directly

contradicts recognized corporate governance principles, as Defendant Brown recognized in a statement issued by the Canadian Council of Chief Executives entitled *Governance, Values and Competitiveness: A Commitment to Leadership*: “We continue to believe that executive compensation should be tied significantly to both short and longer-term performance [and] suggest that boards could consider a heavier emphasis on compensation tied to sustained appreciation in shareholder value.”

67. In addition to the immediate cash benefits that would inure to the Officer Defendants under the Return to Profitability Plan, these Defendants stood to reap tremendous long-term gains from their Return to Profitability bonuses as well. Under Nortel’s Supplementary Executive Retirement Plan (“SERP”), 100% of any bonus payment received under the Return to Profitability Plan would be included in the calculation of the Officer Defendants’ long-term retirement benefits. Because SERP retirement benefits would be calculated based on the average of the Officer Defendants’ three highest consecutive years of earnings, and because no bonuses had been paid under SUCCESS in 2001 and 2002, the Officer Defendants were incentivized to boost their three-year average earnings by ensuring that they received the maximum Return to Profitability bonuses. In effect, the Officer Defendants stood to benefit from their Return to Profitability bonuses twice – first, when the Company achieved the various profitability targets and then again during retirement.

68. Furthermore, on top of the Return to Profitability Plan, the Board also modified its restricted stock unit plan (the “RSU Plan”) for the benefit of Nortel executives. Prior to the Class Period, stock units were to be awarded to executives, and to vest, using performance periods of no less than two years. In January 2003, however, the Board amended the RSU Plan to introduce shorter “performance segments” within the two-year performance period, thus

permitting Nortel executives to receive stock units which would vest in less than two years. Indeed, on January 29, 2004, Gollogly was issued 97,500 stock units, which he converted to cash only five days later, receiving approximately \$620,461 on February 3, 2004.

69. Nortel provided virtually no disclosure to the investing public regarding the RSU Plan, such as the performance criteria for receiving stock units, the length of time of the “performance segments,” the number of units awarded, the vesting periods, and the prices at which the units were converted to cash. Based on public filings filed with the SEC on Form 4, however, Dunn received at least \$2,153,050 under the RSU Plan in 2003, while Beatty received at least \$830,875 and Gollogly received at least \$432,413, in addition to the \$620,461 he received in 2004. Upon information and belief, the RSU Plan provided added incentive for the Officer Defendants to commit fraud because it awarded them an additional form of short-term compensation, which these Defendants could receive entirely in cash.

70. In sum, by approving a variety of short-term and highly unusual incentives, the Board provided a financial motive for Nortel’s senior managers to manipulate and falsify the Company’s financial results. As discussed in more detail below, the Officer Defendants, in fact, responded in just that way, manipulating the Company’s financial results to create a profit where none actually existed.

71. Further, each of Nortel’s Audit Committee members had a heightened obligation to verify the accuracy of Nortel’s reported earnings in light of the powerful incentive created by the RTP and other bonus plans discussed in ¶¶ 61-66. As members of the Board of Directors, each of the Audit Committee members participated in enacting these bonus plans. Several of them – composing a majority of the Audit Committee – were also members of the Joint Leadership Resources Committee, the compensation committee of the Board, and should

unquestionably have grasped the temptation created by the plans they had themselves recommended for approval by the Board. Having created such a powerful incentive for the Officer Defendants to stage-manage Nortel's financial reporting, the Committee members could not simply sit back and watch the show. Rather, each member of the Audit Committee had a duty to vigilantly guard against the very manipulation that ultimately occurred. As set forth more fully in ¶¶ 153-187 below, the Audit Committee's failure to prevent the issuance of the false and misleading disclosures challenged herein, especially in light of the numerous red flags identified by D&T, was, at a minimum, a reckless departure from the standards of care to which the Committee members were obligated to adhere.

D. Nortel Takes Advantage of its Restructuring Activities to Create Fraudulent "Cookie Jar" Reserves, Which Are Then Reversed into Income in Fiscal 2003

1. "Cookie Jar" Reserves

72. Nortel's massive restructuring effort afforded the Officer Defendants the opportunity to engage in a classic form of accounting fraud: creating "cookie jar" reserves, which they could then reverse into income in later periods when the Company was falling short of investor expectations. Indeed, in the August 19, 2004 press release, the Company admitted that "a significant number of accruals and provisions were established and/or released in 2002 and 2003 that were not in accordance with applicable [GAAP]." Specifically, in 2002, Nortel established improper "cookie jar" reserves, including, primarily, restructuring and contractual reserves, and then improperly reversed those reserves into income in 2003. It was only as a result of these financial manipulations that Nortel and the Officer Defendants were able to claim that the Company had returned to profitability in the first quarter of 2003.

73. Generally, companies are permitted to establish reserves in connection with restructuring activities, divestitures, acquisitions or other unusual, one-time events in order to

account for future costs associated with these events. Such costs may include anticipated future obligations for severance, vacation pay, plant closures, etc., and the reserve is designed to offset such costs. Because these events are “unusual,” the market typically will discount or ignore the size of the reserve established, because the costs are not part of, or incurred by a company’s continuing operations. Creating such a reserve provides an opportunity for accounting fraud, through the creation of additional “cookie jar” reserves.

74. The term “cookie jar” reserves is a term of art that refers to inappropriate or excessive reserves that are created by management, allegedly in connection with legitimate business events. For example, a company can deliberately over-estimate the amount set aside in the reserve for future contingencies associated with a restructuring activity, thus creating a “cookie jar” that management can dip into in future periods when it needs to prop up earnings. Then, in future periods when the company’s operating results don’t provide sufficient earnings to meet investor expectations, management can raid the cookie jar and either reverse some of the inappropriate reserves into earnings, or use the reserve to offset current operating expenses.

75. The utilization of cookie jar reserves distorts a company’s financial picture in two ways: first, it reduces the company’s earnings in earlier periods, when the excess reserve is established, and second, it artificially inflates the company’s earnings in later periods, when the reserve is released into income, making investors believe that the company has been more successful than it actually has. As Walter P. Schuetze, former Chief Accountant of the SEC’s Division of Enforcement stated in an April 22, 1999 speech at the Nineteenth Annual Ray Garrett, Jr., Corporate and Securities Law Institute, “I have seen the amounts of those initially established reserves arbitrarily increased for good measure. These excessive amounts of reserves then are leached, undisclosed, into subsequent operating income, at a rate that is under

someone's radar screen of materiality." Arthur Leavitt, the former Chairman of the SEC, also described the illusory financial impact of a company reversing its excess reserves into income in his famous speech "The Numbers Game" presented at the NYU Center for Law and Business: "if [reserve] charges are conservatively estimated with a little extra cushioning, that so-called conservative estimate is miraculously reborn as income when estimates change or future earnings fall short."

76. The creation and reversal into income of cookie jar reserves violates the most basic principles of GAAP. Under GAAP, reserves may be created only when (1) it is probable that an asset has been impaired or a liability has been incurred, and (2) the effects on a company's financial statements are "reasonably estimable." General liabilities or reserves for unspecified business risks do not meet the conditions for accrual. Statement of Financial Accounting Standards No. 5. Further, these liabilities, defined by GAAP as the probable future sacrifice of assets (as set by date, occurrence of a particular event, or by demand) as a result of an obligation arising out of a past transaction or event, can only be reversed (1) at a determinable date; (2) upon the occurrence of a specified event; or (3) upon demand – *i.e.*, when they no longer constitute legitimate liabilities. Statements of Financial Accounting Concepts No. 6, *Elements of Financial Statements* ("CON 6").

77. In addition, GAAP has very specific rules with respect to restructuring reserves, such as those at issue here. Specifically, under GAAP, companies are permitted to take reserves for legitimate restructuring activities so long as the charges are part of a "comprehensive plan that has been rigorously developed and thoroughly supported" by management. Emerging Issue Task Force, Issue No. 94-3 ("EITF 94-3"). These charges may include, for example, costs related to employee benefits such as costs of severance and termination benefits, costs associated

with the elimination and reduction of product lines, costs to consolidate or relocate plant facilities, costs for new systems development or acquisition, costs to retrain employees to use newly deployed systems, and losses on asset impairments and disposals of assets. However, these charges may only be taken if (i) management has established an “exit plan” that provides that “all significant actions are documented in the plan in sufficient detail;” (ii) management has reliably estimated each step of the plan; and (iii) the plan reflects the “most likely outcome.” *See* SAB 100; EITF 94-3. Furthermore, GAAP strictly prohibits management from retaining any unused or excess part of a restructuring reserve as a general accrual, or using these reserves for any purposes other than that for which the reserve was initially established. *See* EITF 94-3, *see also* SAB 100.

2. The Impact of the Improper Use of Reserves on Nortel’s Financial Statements

78. Nortel violated GAAP by creating improper and excessive reserves in connection with its business restructurings, and then subsequently utilizing those reserves to artificially inflate earnings. In 2002 alone, Nortel booked approximately \$1.6 billion in new reserves (on top of the \$3.5 billion in reserves that the Company was already carrying on its balance sheet from fiscal 2001). Upon information and belief, as a result of Nortel’s inappropriate reversal of reserves, the Company’s income was overstated by at least \$460 million during 2003.

79. Lead Plaintiffs estimate the amounts of Nortel’s improper reserves and the effect that they had on the Company’s reported results based on the following facts:

a. On March 10, 2004, Nortel announced that it would be forced to restate its financial results for the year ended December 31, 2003; for certain of its 2003 quarterly financial results; and for one or more earlier periods. The need for the Second Restatement was based on the Audit Committee’s conclusion that “significant numbers of accruals and provisions were

established and/or released in 2002 and 2003 that were not in accordance with applicable [GAAP].”

b. On November 11, 2004, Nortel announced that the Second Restatement would result in a reduction of approximately 35 percent of its previously announced net earnings for 2003 (adjusted from the 50 percent previously announced). The Company stated that approximately 30 percent of the 2003 net income reductions would impact the Company’s continuing operations, with the remaining 70 percent affecting discontinued operations (adjusted from the previous estimate of an approximately equal impact between continued and discontinued operations). The Company also announced that approximately two-thirds of the reduction in net earnings would impact the first half of 2003.

c. Based on the Company’s announcements to date and the Second Restatement, the estimated impact of Nortel’s accounting improprieties on its reported results for fiscal 2003 can be approximated as follows:

(\$ in millions)	Net earnings (as originally reported)	Net earnings (as reported in the First Restatement)*	Net earnings or loss (as reported in the Second Restatement)	Impact of Restatements
Q1 2003	54	11	(124)	(178)
Q2 2003	(14)	37	(101)	(87)
Q3 2003	185	185	131	(54)
Q4 2003	499	499	528	29
2003 Total	724	732	434	(290)

Source: 1Q2003 10-Q/A; 2Q2003 10-Q/A; 3Q2003 10-Q; 4Q press release of 1/29/04; 2002 10-K/A; 2003 10-K.

* Note: Figures reported for Q3 2003 and Q4 2003 are as originally reported, as these periods were not restated in the First Restatement.

(\$ in millions)	Net earnings or loss from continuing operations (as originally reported)	Net earnings or loss from continuing operations (as reported in the First Restatement)*	Net earnings or loss from continuing operations (as reported in the Second Restatement)	Impact of Restatements
Q1 2003	(136)	(171)	(234)	(98)
Q2 2003	(14)	38	(93)	(79)
Q3 2003	130	130	88	(42)
Q4 2003	390	390	501	111
2003 Total	370	387	262	(108)

Source: 1Q2003 10-Q/A; 2Q2003 10-Q/A; 3Q2003 10-Q; 4Q press release of 1/29/04; 2002 10-K/A; 2003 10-K.

* Note: Figures reported for Q3 2003 and Q4 2003 are as originally reported, as these periods were not restated in the First Restatement.

3. Witness Testimony Evidencing Improper Reserve Accounting

80. Numerous former employees have confirmed that Nortel's senior management intentionally created millions of dollars worth of cookie jar reserves, and then reversed those reserves into income in order to artificially inflate the Company's financial results. For example, CS1 stated that during 2001 and 2002, Nortel's senior management purposefully established improper and excessive reserves so that they would then have those reserves available for later periods when the Company needed a boost in order to meet analyst expectations or, as it turned out, to report a return to profitability. According to CS1, the Officer Defendants understood that they could create cookie jar reserves during this period of massive restructuring because the Company already looked "so bad in the marketplace" that no one would be expected to question or further devalue the Company's stock based on additional losses.

81. In fact, according to former Nortel finance employees, the improper inflation of reserves for later use was such an accepted practice at Nortel that executives gave the existence of cookie jar reserves its own name: "hardness." To Nortel's finance executives, having "hardness" meant having reserves on hand that could be released to help the Company meet profit targets. CS6 described "hardness" at Nortel as meaning "having lots of money (in

reserves) to protect against worst case scenarios.” According to CS1, the improper creation and maintenance of “hardness” was “the widespread culture of the Company.” It was routine and universally practiced throughout all of Nortel’s geographic regions, including in Canada (in Brampton) and in the United States (in Raleigh and Richardson). Specifically, CS1 stated, “that kind of behavior was common throughout the Company. When managers have to make their budgets, they keep things in reserve for bad times, and that is how things began to get out of hand.” CS1 emphasized that “if [Division Vice-Presidents] had any opportunity to take a provision, they would do it.” CS1 also stated that Dunn, due to his time with the Company, including his time as CFO, really knew how to “turn the numbers . . . Dunn knew which reserves had been established, why they had been established and whether they could be reversed in later periods.”

82. According to CS4, “it was common knowledge that there were reserves that [would be] used to release back into earnings and accruals taken to reduce earnings.” CS4 further stated that it was common knowledge that Defendant “Dunn would release reserves or accrue expenses as required to meet Wall Street earnings estimates.”

83. CS3, who reported directly to Taylor – one of the executives fired for cause as a result of this fraud – also confirmed that improper reserves were routinely established and utilized at Nortel. In fact, she stated that on numerous occasions she was pressured by senior management, including Taylor, to engage in this misconduct. CS3 explained that “there were an awful lot of [liability] entries being made where there was no reason for making them.” She estimated that, between March and May 2003 alone, she and two of her colleagues were asked to do about \$800,000 of “padding” with respect to her division’s reserve accounts.

84. According to CS3, “[w]e were accruing bonuses that you knew would never get paid. We were accruing 9 ½% to 10% on all salaries for bonuses while no bonuses were paid the whole time I was there.” She further indicated that she specifically confronted Dunn about this improper accounting for bonus accruals. In response to her objections, Dunn acknowledged the inappropriate accruals, but then dismissed her concerns, stating, “this is the way the Board of Directors wanted things to be done.”

85. CS3 also described an instance involving the improper accounting for legal contingencies. According to CS3, in or around December 2002, Taylor instructed her to accrue a \$15 million liability for Nortel’s exposure to a pending lawsuit, despite the fact that the Company’s legal department believed that the case had no merit and had assessed that, even in a worst-case scenario, the Company’s exposure was no more than \$1 million. She refused to make the accounting entry and informed Taylor that there was no GAAP justification for it. In response to this objection, Taylor simply found another employee who was willing to make the entry for him. CS3 then received a telephone call from one of Taylor’s staff telling her “to forget that the request had ever been made.”

86. Another former employee of Nortel, CS8, explained that the decisions concerning which reserves to release were made by the Company’s senior officers, *i.e.*, Defendants Dunn, Beatty and Gollogly. He stated that, within the Wireless Networks Division in Richardson Texas, it was Kinney who “had the power to massage the numbers,” but Kinney always had to run the numbers by Gollogly: “Even at Kinney’s level, Gollogly would have to agree before the final decision to establish or release reserves was made.”

87. In addition, CS8 made numerous statements regarding the excessive reversal of Nortel’s reserves in 2003. Specifically, he stated that during March 2003, Nortel had taken “too

much in released provisions that [it] shouldn't have." CS8 also emphasized that "hundreds of millions of dollars" in released reserves came out of Nortel's Wireless Division alone between the last quarter of 2002 and the first two quarters of 2003. CS8 further stated that "[w]e released provisions for contractual liabilities too aggressively in the first and second quarters of 2003, especially in the first quarter." In discussing the improperly released provisions for contractual liabilities, CS8 explained that Nortel had very large contractual liabilities because the Company would guarantee that products would work to certain specifications, that they would be installed by a certain date, and/or that the cost of installation would be within a certain range. However, CS8 said it was odd for Nortel to aggressively release provisions for contractual liabilities during that time period because "dates were being pushed back on installations" and a contractual liability is not extinguished until the product is installed; thus, if installation dates were being pushed further into the future, the liability should have remained on the books.

88. CS8 stated that, in the last quarter of 2002, he was directed by his supervisor, Barbara Heitzner, to compile lists of all the liabilities in the Wireless Division. According to CS8, this order was at Kinney's direction. Kinney told Heitzner to "scrub the books" because "[w]e really need to release provisions we don't need anymore." When asked about this incident and his division's reversal of reserves, CS8, who worked under Kinney, explained that Kinney "came under pressure from Beatty."

89. Finally, according to CS5, every quarter his group submitted the Enterprise Division's financial statements for Asia-related operations to Brampton for review and consolidation and, every quarter, "[his group] would get instructions from Brampton to release additional contractual liabilities." CS5 explained that this occurred despite the fact that he "always believed that the numbers were sound and correct when submitted." When asked to

provide specific information regarding these additional releases, CS5 stated that this was “a routine, regular occurrence that happened every quarter.” CS5 also explained that only top level executives located in Brampton, including the Officer Defendants, had access to all of the Company’s numbers and, thus, full visibility into the Company’s finances.

E. Nortel Deceives the Market, Claiming a Return to Profitability, by Reversing Reserves into Income

90. By the beginning of 2003, the Officer Defendants were well-positioned to claim that they had made good on their promises to return the Company to profitability and to reap the huge rewards that had been established in connection with the Company’s new bonus programs. All they had to do was begin to reverse into income the billions of dollars of improper reserves they had created. And reverse these reserves they did.

91. Indeed, Defendants’ reversal of these reserves was deliberate and well-timed. In January 2003, Nortel’s executives internally advised Nortel’s Board of Directors that the Company would lose \$112 million in the first quarter. As the quarter progressed, however, Nortel’s expected losses began to shrink mysteriously. By mid-February, Nortel’s expected quarterly losses had dropped to \$32 million. One week later, this loss figure was again revised downward, this time to \$20 million. By the time the quarter ended on March 31, Nortel had a “profit” of \$40 million -- its first positive quarterly result in over three years.

92. According to documents reviewed by *The Wall Street Journal*, these revised estimates were tracked in a document circulated among Nortel’s finance executives regarding the Company’s quarterly earnings targets. Each time Nortel’s earnings target improved, another number in a column called “balance sheet” decreased, demonstrating that Nortel’s increase in profits was a direct result of reversals from reserve accounts.

93. As a result of this misconduct, the Defendants were able to report a “profit” – as that term is defined in the Return to Profitability Plan – in every quarter of 2003. The Company has now admitted, however, that all of these profits were falsely created; that Nortel had never truly returned to profitability; and that the Company’s reported financial results for each quarter of fiscal 2003 were materially false and misleading.

1. The Materially False and Misleading First Quarter 2003 Disclosures

94. On April 24, 2003, the first day of the Class Period, Nortel surprised the investing public by announcing that it had become profitable ahead of its prior guidance and analysts’ expectations. On that date, the Company issued a press release before the opening of the market announcing its financial results for the quarter ended March 31, 2003 (the “1Q 2003 Press Release”), which the Company stated were prepared in accordance with U.S. GAAP.

Specifically, Nortel reported that revenues were \$2.4 billion in the first quarter of 2003 (compared to \$2.91 billion for the same period in 2002) and net earnings were \$54 million, or \$0.01 per common share, up from a net loss of \$841 million, or \$0.26 per common share, for the same period in 2002.

95. Commenting on Nortel’s first quarterly profit in three years, Dunn stated,

I am extremely pleased to have achieved profitability in the first quarter of 2003 and reached our goal one quarter early ... We continue to successfully engage our customers and leverage our technology leadership and portfolio to deliver solutions that meet their needs. Moving forward, we will continue to drive to improve our market position and our financial performance.

96. Based on the Company’s reported return to profitability, most of the Company’s employees received payments equivalent to 10% to 25% of their annual salaries pursuant to the Return to Profitability Plan. Although Nortel has refused to publicly disclose complete information regarding payments under this Plan, the payments were at least \$75 million, and some commentators have estimated that the payments could total as much as \$123 million.

97. That same day, April 24, 2003, the Company held a conference call for the investing community and financial analysts (the “1Q 2003 Conference Call”). Beatty opened the call by confirming the results announced in the 1Q 2003 Press Release and stating, “[l]et me remind everyone that Nortel Networks’ financials are in U.S. dollars and are presented in accordance with U.S. GAAP.”

98. During the 1Q 2003 Conference Call, Dunn and Beatty emphasized the Company’s alleged return to profitability. Beatty announced, “we are pleased with our results this quarter, achieving our profitability target ahead of schedule.” Dunn echoed Beatty’s sentiment, declaring:

I’m delighted with the results. We’re profitable for the first time in three years, over three years, and we met our profitability objective one quarter early. We had very strong margin performance and we continue to focus on driving a business model that continues to accelerate our margin as an overall objective in this business.

99. Dunn specifically attributed the Company’s positive results to its improved margins and market share. In response to an analyst’s question, Dunn denied that Nortel’s earnings were the result of a one-time event and confirmed that Nortel’s improving market share was the driver behind the positive earnings announcement. Dunn summarized the quarter as follows:

We made a tremendous turn around. When [we] go through what we’ve gone through in the last two years, it’s tough on morale, it’s tough on the employees in this company to stay focused... And we’re moving ahead. We’ve turned the page on the world of 2001, 2002, and we’re moving ahead.

100. With respect to the bonuses that were to be awarded upon the Company’s purported return to profitability, Beatty announced that:

[S]ome accrual revision reversals ... were more than offset by a combination of the return to profitability bonus, which is the bonus relative to returning to profitability, and we did eat – hit the profitability target in the first quarter...[s]o

that bonus is accrued within the numbers and it's spread throughout the P&L primarily on, obviously, cost of goods sold, SG&A and R&D.

101. However, Dunn and Beatty refused to answer specific questions from analysts relating to the bonus payments. When asked about the amount of the charge relating to bonus payments, Beatty stated, "I'm not going to comment on that," and Dunn added that "[i]t's a practice not to provide those." Dunn urged analysts to view the profitability bonuses as a "one time payment for getting back to profitability."

102. Deutsche Bank analyst George Notter reported, "[w]e're feeling more constructive about Nortel given the faster-than-expected rise in profitability." Similarly, Legg Mason analyst Timm Bechter concluded that Nortel's revenues for the first quarter of 2003 were "surprisingly strong given the weak capex spending environment in the U.S. markets."

103. On May 9, 2003, Nortel Networks filed with the SEC its Form 10-Q for the quarter ending March 31, 2003 (the "1Q 2003 Form 10-Q"), which was signed by Beatty and Gollogly. The 1Q 2003 Form 10-Q confirmed and reiterated the consolidated financial results reported in the 1Q 2003 Press Release. In the 1Q 2003 10-Q, Beatty and Gollogly attested that the Company's financial statements were prepared in accordance with GAAP, stating:

The accounting policies used in the preparation of the accompanying unaudited consolidated financial statements are the same as those described in Nortel Networks' audited consolidated financial statements prepared in accordance with GAAP for the three years ended December 31, 2002.

104. As required by the Sarbanes-Oxley Act of 2002, Dunn and Beatty also signed certifications attached to the 1Q 2003 Form 10-Q, which asserted, *inter alia*, that the 1Q 2003 10-Q accurately portrayed the Company's financial condition and that each had inspected the Company's internal controls and found them to be effective:

1. I [Dunn and Beatty] have reviewed this quarterly report on Form 10-Q of Nortel Networks Corporation;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

105. The statements set forth above at ¶¶ 94-95, 97-101, 103-104 were materially false and misleading. The Company has since admitted that its financial statements were *not* prepared

in conformity with GAAP, and the only reason that the Company was able to report a first quarter profit was because the Officer Defendants had reversed into income millions of dollars worth of improper reserves that they had created in earlier periods. (See ¶¶ 203, 225).

Specifically, upon information and belief, Nortel improperly reversed at least **\$236 million** of reserves into income during the first quarter of 2003, thereby artificially inflating its earnings and turning losses for the first and second quarters into profits. This information and belief is based upon the Company's revised results announced in its First Restatement, discussed at ¶¶ 135-38 below, subsequent Company representations about the on-going review of its financial results, and the Company's revised results announced in its Second Restatement (discussed at ¶¶ 211-219 below).

2. The Materially False and Misleading Second Quarter 2003 Disclosures

106. After the market closed on July 24, 2003, Nortel issued a press release announcing its financial results, which the Company pledged were prepared in accordance with GAAP, for the second quarter of 2003, ended June 30, 2003 (the "2Q 2003 Press Release"). In the 2Q 2003 Press Release, the Company reported that it essentially broke even with a net loss of \$14 million, or \$0.00 per common share. This was an enormous improvement as compared to the second quarter of 2002, when Nortel had reported a net loss of \$697 million, or \$0.20 per common share.

107. Commenting in the press release on the second quarter results, Dunn stated:

Our second quarter results reflected the continued cautious spending exhibited by our customers. Although the industry conditions remained difficult, our momentum and leadership position continued across our key focus areas. We continued to engage and create value for our customers, focusing on the growth opportunities and leveraging our technology and solutions leadership.

108. Beatty also commented on the second quarter results, adding, "I am pleased that our business model performed well in this challenging market. Going forward, we will continue

to manage each of our businesses based on individual performance and market opportunities.” Summarizing the second quarter results, Dunn stated that he was “encouraged ... in [Nortel’s] ability to improve our market position going forward” based on the support from the Company’s customers. Dunn also vowed to “continue to manage [Nortel’s] business cautiously in the near term” in response to industry conditions.

109. Although Nortel reported GAAP earnings per share of \$0.00 for the second quarter of 2003, the Company was “profitable” on a pro forma basis for the quarter, as defined in the Return to Profitability Plan. A pro forma basis, as explained in the Company’s January 23, 2003 press release, is a non-GAAP earnings measure which does not account for one-time gains and losses, such as special charges relating to restructurings and acquisitions, in the reported period’s earnings. Accordingly, by using this pro forma measure, upon information and belief, based on press reports and public commentators, forty-three senior executives shared \$21 million under the Return to Profitability Plan, including \$2.15 million received by Dunn, \$831,000 received by Beatty and \$287,000 received by Gollogly.

110. The Company hosted a conference call on July 24, 2003 for financial analysts and investors to report on the second quarter 2003 results (the “2Q 2003 Conference Call”). During the conference call, Beatty falsely stated that “Nortel Networks’ financials ... are presented in accordance with U.S. GAAP” and confirmed the financial results announced in the 2Q 2003 Press Release.

111. In its second quarter disclosures, the Company discussed that it had commenced an analysis of whether all its assets and liabilities were appropriately stated. In particular, Nortel acknowledged that “relatively minor” misstatements of amounts of the Company’s assets and

liabilities could have a material effect on its reported financial results. Thus, the 2Q Press Release stated:

Given [that] in 2003 relatively minor amounts may have greater effect on reported results, the Company has initiated a comprehensive review and analysis of its assets and liabilities. The outcome of the activity may result in the elimination of certain assets and liabilities but is not expected to have a negative impact to net assets. No amounts relating to the elimination of any such assets and liabilities have been included in the results for the second quarter of 2003.

112. Similarly, on the 2Q 2003 Conference Call, Beatty announced that the Company had instituted a detailed review of its balance sheet but reassured investors that this review would not have a negative effect on Nortel's results. Specifically, Beatty stated:

We are pleased with the significantly improved operating results, but they have introduced the company to a new environment where relatively minor amounts, both expense and income, have a much greater opportunity to mature the impact reported results each quarter [sic]. Plainly speaking, minor amounts included in results prior to 2003 would not have been considered material, but those same amounts today could have the effect of changing reported results in a quarter from a profit to a loss or vice versa. In this environment, we have begun a review in the second quarter to determine whether all assets and liabilities are appropriate, given the effect minor adjustments may have on reported results. This work is currently in process, and we believe the outcome of this review will not reduce the net assets of the company, meaning no negative effect on Nortel's profits and loss performance, and to confirm again the Q2 results we reviewed today do not include any effects on this initiative.

113. Beatty and Dunn's assurances that the asset/liability review would have no negative effect on assets or meaningful effect on Nortel's profits and losses were false. Both knew that these accounts had been used to manipulate Nortel's results to create phony earnings to falsely improve Nortel's reported results, as detailed above.

114. In response to the Company's 2Q 2003 earnings, Merrill Lynch High Yield advised, "Margins improve yet again, maintain." Likewise, Desjardins analyst Paul Howbold reported, "Nortel outperforms its peers in a tough market."

115. On August 11, 2003, Nortel filed its Form 10-Q for the second quarter ended June 30, 2003 (the “2Q 2003 Form 10-Q”), which was signed by Beatty and Gollogly. The 2Q 2003 Form 10-Q confirmed and reiterated the results for the Company’s earnings and earnings per share for the quarter ended June 30, 2003, as announced in the 2Q 2003 Press Release and 2Q 2003 Conference Call. In the 10-Q, Beatty and Gollogly pledged that the second quarter financials conformed to GAAP:

The accounting policies used in the preparation of the accompanying unaudited consolidated financial statements are the same as those described in Nortel Networks’ audited consolidated financial statements prepared in accordance with GAAP for the three years ended December 31, 2002.

116. As required by the Sarbanes-Oxley Act of 2002, Dunn and Beatty also signed certifications attached to the 2Q 2003 Form 10-Q, which asserted, *inter alia*, that the 2Q 2003 10-Q accurately portrayed the Company’s financial condition and that each had inspected the Company’s internal controls and found them to be effective.

117. The statements set forth above at ¶¶ 106-108, 110-112, 115-116 were materially false and misleading. The Company has since admitted that its 2Q 2003 financial statements were *not* prepared in conformity with GAAP, and the only reason that the Company was able report a break-even quarter was because the Officer Defendants had reversed into income millions of dollars worth of improper reserves they had created in earlier periods. (See ¶¶ 203, 225). Specifically, upon information and belief, Nortel improperly reversed at least **\$147 million** of reserves into income during the first and second quarters of 2003, thereby artificially inflating its earnings and turning what actually were losses into profits. This information and belief is based upon the Company’s revised results announced in its First Restatement, discussed at ¶¶135-138 below, subsequent Company representations about the on-going review of its

financial results, and the Company's revised results announced in its Second Restatement discussed at ¶¶ 211-219 below.

3. The Materially False and Misleading Third Quarter 2003 Earnings Disclosures

118. On October 23, 2003, Nortel issued a press release after the market closed announcing "preliminary selected [financial] results" for the third quarter ended September 30, 2003 (the "3Q 2003 Press Release"). The 3Q 2003 Press Release reported net earnings of "approximately" \$179 million, or \$0.04 per common share on a diluted basis, and affirmed that the financial results were prepared in accordance with GAAP. At the same time, Nortel announced that it planned to restate its financial results for 2000, 2001, and 2002 and the first and second quarters of 2003. (The resulting First Restatement is discussed at ¶¶ 135-143 below.)

119. Commenting on these reported results, Dunn stated:

The preliminary results announced today reflect our continued progress in an environment of cautious capital spending by our customers. I am particularly pleased with the continued momentum in our wireless networking solutions, the market leadership of our converged networking and voice over packet solutions, and the building momentum in our enterprise segment. We continue to work very closely with our customers providing solutions that drive new revenue opportunities, reduced operating costs, enhanced customer service capability and improved productivity.

120. In the 3Q 2003 Press Release, Dunn provided positive guidance for Nortel's financial performance for the remainder of 2003, stating, "[w]e expect revenue for the fourth quarter of 2003 to grow sequentially compared to the third quarter of 2003, and we expect a profit for the full year 2003."

121. Thereafter, on November 19, 2003, Nortel issued a press release (the "November 19, 2003 Press Release") announcing the filing of its Form 10-Q for the third quarter ended September 30, 2003 (the "3Q 2003 Form 10-Q").

122. The November 19, 2003 Press Release explained that:

The Third Quarter 2003 Form 10-Q also includes the impact on revenues and earnings (loss) of the restatement adjustments for the quarterly periods ended March 31, 2003 and June 30, 2003 and for the years ended December 31, 2000, 2001 and 2002, as well as on the Company's accumulated deficit as at each of these dates, prepared in accordance with U.S. GAAP. The net effect of the restatement adjustments was a reduction in accumulated deficit as at June 30, 2003 of \$505 million.

123. At the same time, Nortel Networks filed the 3Q 2003 Form 10-Q with the SEC, which was signed by Beatty and Gollogly. The 3Q 2003 Form 10-Q announced net earnings of \$185 million, or \$0.04 per share, for the quarter. In the 3Q 2003 Form 10-Q, Beatty and Gollogly pledged that the Company's financial statements conformed with GAAP:

The accounting policies used in the preparation of the accompanying unaudited consolidated financial statements are the same as those described in Nortel Networks audited consolidated financial statements prepared in accordance with GAAP for the three years ended December 31, 2002.

124. As required by the Sarbanes-Oxley Act of 2002, Dunn and Beatty also signed certifications attached to the 3Q 2003 Form 10-Q, which asserted, *inter alia*, that the 3Q 2003 10-Q accurately portrayed the Company's financial condition and that each had inspected the Company's internal controls and found them to be effective.

125. The statements set forth above at ¶¶ 118-124 were materially false and misleading. The Company has since admitted that its financial statements were *not* prepared in conformity with GAAP, and that the Company artificially inflated its profits by reversing into income millions of dollars worth of improper reserves. (See ¶¶ 203, 225). The Company restated its results for 3Q 2003 on January 11, 2005. Upon information and belief, Nortel improperly released at least \$77 million dollars into income during the third quarter.

4. Nortel's Misrepresentations Regarding the Phony Restatement of its Results from the First Two Quarters of 2003

126. As noted above, in connection with the announcement of its third quarter 2003 results, Nortel also announced that it had initiated a review of its financial results for fiscal 2002

and the first two quarters of 2003. This review ultimately culminated in the First Restatement on December 23, 2003 (the “First Restatement”). All of Nortel’s statements about this First Restatement were materially false and misleading.

127. On October 23, 2003, the Company stated that the review of Nortel’s balance sheet, which was first publicly disclosed in the Company’s 2Q 2003 Press Release, would result in a \$900 million restatement of the Company’s liabilities, which would be released into prior periods. The Company explained that shareholders would benefit from the First Restatement, the net effect of which would be to reduce previously reported net losses for 2000, 2001 and 2002, and to increase shareholder equity and net assets as previously reported on Nortel’s balance sheet. Furthermore, Nortel emphasized that the First Restatement would have no negative effects on the Company’s future financial performance, stating “*[n]one of the adjustments are expected to have any impact on cash balance as at June 30, 2003 nor does the Company expect the adjustments to impact its forward business operations.*”

128. Defendants Dunn and Beatty reiterated that message on a conference call later that day (the “3Q 2003 Conference Call”). Dunn emphasized that, despite the Company’s need to restate its liabilities, Nortel had still returned to profitability and would post a profit for the full year for the first time in six years:

I think the message I wanted to give you is, we’re going through a very important matter that we take very seriously, and *I wanted to make sure also, people don’t lose the focus that Nortel returned to profitability*, and you’re correct, based on what we made this quarter and the first half of the quarter, the first six months and so on. It doesn’t take anybody to figure out that we should make a profit. But I also think it’s very important to realize that when I was entering this year, a lot of people didn’t think Nortel would make a profit in a quarter, and *I wanted to just maybe point out to you the progress that we’ve made, that we will make not only profit in the quarter, but a profit on the full year, and that’s the first time in six years.*

* * *

We expect revenue for the 4th quarter 2003 to grow sequentially, compared to this quarter 2003 3rd quarter. And we expect, based on where we are on a year-to-date basis and the performance we had in the 3rd quarter and based on where we see for the 4th quarter, to return to profitability of the full year for 2003. That will be the first time in six years that Nortel's returned to a full-year profitability.

129. Beatty also emphasized that the First Restatement would result in a net benefit to shareholders, claiming that the \$900 million in liabilities at issue represented only a small fraction of the Company's total liabilities as of June 30, 2003.

130. The market generally believed these representations and viewed Nortel's restatement announcement as a positive event. For example, on October 24, 2003, financial analyst Inder M. Singh of Prudential Financial reported that the net effect of the First Restatement would be beneficial to shareholders: "[w]hile the study is not yet complete, [the First Restatement] is expected to have a favorable impact to the balance sheet by lowering liabilities by roughly \$900 million. This is also expected to reduce net losses for 2000, 2001 and 2002; increase shareholders' equity and net assets, and to have no impact to the cash balance or forward operations."

131. Paul Silverstein of Needham similarly reported that "[a]t this juncture, we are not overly concerned regarding a restatement based on Nortel's characterization of the reasons for the restatement and their projected impact on operating results and cash balances. Our revenue forecasts for both calendar 2003 and 2004 remain largely unchanged."

132. Credit Suisse analyst James Parmelee added, "[a]lthough unfortunate, [we] view [the] restatement as a benign event that has no impact on cash and our going forward outlook... [w]e do not view this restatement as significant or intended to mislead investors."

133. Likewise, Chris Umiastowski of Orion stated, "[t]he company's cash position, ongoing operations and future outlook are naturally unaffected by this process, hence we do not consider it to be material to our valuation." Theodore J. Moreau of Baird U.S. Equity Research

went even further to state, “We believe Nortel is the best positioned vendor in the telecommunications sector.”

134. By no later than November 19, 2003, the Audit Committee had assumed responsibility for the First Restatement. Indeed, in the 3Q 2003 10-Q, the Company announced that the Audit Committee was conducting “[a]n independent review ... to examine the facts and circumstances leading to the need to restate our financial statements for the relevant periods and to consider appropriate improvements to our processes and procedures. The law firm of Wilmer, Cutler & Pickering has been retained by and will report to our Audit Committee for such purposes.”

135. On December 23, 2003, Nortel filed certain restated financial statements with the SEC, including (1) its 2002 Form 10-K/A (the 2002 Form 10K/A”); (2) its first quarter 2003 Form 10-Q/A (the “1Q 2003 Form 10-Q/A”) and (3) its second quarter 2003 Form 10-Q/A (the “2Q 2003 Form 10-Q/A”). The 2002 Form 10K/A restated Nortel’s financial results for the years ended December 31, 2002, 2001 and 2000 and was signed by Defendants Dunn, Beatty, Gollogly, Brown, Cleghorn, Ingram, Saucier and Smith. The 1Q 2003 Form 10-Q/A and the 2Q 2003 Form 10-Q/A (collectively, the “Forms 10-Q/A”) restated Nortel’s financial results for the quarters ended March 31, 2003 and June 30, 2003 and were signed by Beatty and Gollogly, who certified that they were prepared in accordance with GAAP.

136. In the 2002 Form 10-K/A, the Company restated approximately \$935 million and \$514 million of accruals and provisions carried on its previously reported consolidated balance sheet as of December 31, 2001 and 2002, respectively, that should have been released to income. In addition, Nortel made certain adjustments that reduced the Company’s accumulated deficit by \$497, \$178, and \$31 million as of December 31, 2002, 2001, and 2000 respectively.

137. In the 1Q 2003 Form 10-Q/A, the Company restated approximately \$912 million of accruals and provisions carried on its previously reported consolidated balance sheet as of March 31, 2003 that should have been released to income and made certain adjustments that reduced the Company's accumulated deficit by \$454 million as of March 31, 2003.

138. In the 2Q 2003 Form 10-Q/A, the Company restated approximately \$952 million of accruals and provisions carried on its previously reported consolidated balance sheet as of June 30, 2003 that should have been released to income and made certain adjustments that reduced the Company's accumulated deficit by \$505 million as of June 30, 2003.

139. As required by the Sarbanes-Oxley Act of 2002, Dunn and Beatty also signed certifications attached to the Forms 10-Q/A, which asserted, *inter alia*, that the reports accurately portrayed the Company's financial condition and that each had inspected the Company's disclosure and internal financial reporting controls and found them to be effective.

140. In connection with these filings, Nortel revealed for the first time that D&T had uncovered "reportable conditions" constituting a "material weakness" in Nortel's internal control procedures and reported them to the Board and the Audit Committee. Specifically, D&T found a "lack of compliance with established Nortel Networks procedures for monitoring and adjusting balances relating to certain accruals and provisions, including restructuring charges," as well as a "lack of compliance with established Nortel Networks procedures for appropriately applying generally accepted accounting principles to the initial recording of certain liabilities."

141. According to the American Institute of Certified Public Accountants,

a "reportable condition" is a matter that comes to an auditor's attention that represents a significant deficiency in the design or operation of internal control that could adversely affect an entity's ability to initiate, record, process and report financial data consistent with the assertions of management in the financial statements. A "material weakness" is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to

a relatively low level the risk that misstatements cause by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

142. Nevertheless, given the Defendants' assurances, the market responded favorably to the First Restatement, believing that it represented only minor adjustments that gave the Company a clean slate going forward. On December 29, 2003, Thomas J. Moreau of Baird stated that "[a]s expected, the adjustments do not impact the company meaningfully." That same day, Inder M. Singh of Prudential Financial noted that "these adjustments are of limited magnitude and have no impact on our revenue and EPS forecasts."

143. The statements set forth above at ¶¶ 127-129, 135-138 were materially false and misleading. Specifically, the Company has since admitted that its financial results issued in connection with the First Restatement were materially misstated, because, in truth, there were several hundreds of millions of dollars of additional improper reserves that had been created in 2002 and reversed in 2003 so as to mask Nortel's true financial condition. Moreover, despite the Defendants' repeated assertions, the truth was that the Company had *not* returned to profitability in the first or second quarter of 2003. The Company restated these periods again on January 11, 2005.

5. The Materially False and Misleading Fourth Quarter and Year End 2003 Disclosure

144. On January 29, 2004, Nortel issued a press release announcing its unaudited financial results, which the Company pledged were prepared in accordance with U.S. GAAP, for the quarter and year ended December 30, 2003 (the "4Q 2003 Press Release"). In the 4Q 2003 Press Release, the Company reported that net earnings increased in the fourth quarter of 2003 to \$499 million, or \$0.11 per common share, from a net loss of \$168 million, or \$0.04 per common share, for the same period in 2002. For the year ended 2003, the Company reported that net

earnings increased to \$732 million, or \$0.17 per common share, from a net loss of \$3.27 billion, or \$0.85 per common share, for the year ended 2002.

145. Dunn commented on Nortel's fourth quarter results and provided financial guidance for 2004 as follows:

With the challenges that we faced in 2003, the Company had a tremendous year, truly marking a turning point for Nortel Networks. I am extremely proud of the dedication, passion and commitment of the entire employee team that delivered the performance not only in the fourth quarter, but throughout the year.

* * * * *

While we expect that the percentage growth in the overall capital spending by our customers will be in the low single digits in 2004 compared to 2003, we expect to grow faster than the market by leveraging our particular strengths in Voice and over IP wireless data solutions.

146. Following the January 29, 2004 earnings announcement, Nortel's senior executives were eligible to receive the final bonus payment authorized by the Return to Profitability Plan. Upon information and belief based on press reports, thirty-seven senior executives shared an additional \$41 million in bonus payments. Specifically, Dunn received approximately \$4.9 million, Beatty received approximately \$1.75 million, and Gollogly received approximately \$470,000 based on their false reports that Nortel had achieved pro forma profitability throughout 2003.

147. Also on January 29, 2004, the Company hosted a conference call (the "4Q 2003 Conference Call") for the investing public and analysts at which Dunn and Beatty confirmed the Company's unaudited results announced in the 4Q 2003 Press Release for the fourth quarter of 2003 and for the entire year 2003. Dunn began the call by proclaiming the great progress Nortel had made in 2003. He stated:

First of all, welcome and this is a great year. Nortel has had a tremendous fourth quarter and an extremely strong full year. In the fourth quarter we showed strength across the board in our revenues. The total, we came in \$2.8 billion of

revenues, up 25% sequentially and up 12% from the fourth quarter of last year. All our business segments show sequential growth, and from an earnings perspective we made just under \$500 million for the year, and from our continuing business we made just under \$400 million.... We really did have a tremendously strong fourth quarter, and I am so very proud of our Nortel team. Congratulations to all of our employees, with commitment, passion and their endurance to deliver these kinds of results. As I mentioned for the year, our revenues came in at \$9.8 billion and our earnings for the full year came in at \$732 million, which is really the first profit we have had on a full-year basis. The last time we made profits was six years ago.

148. Dunn then announced that he “expect(s) the overall market in 2004 to grow in the low single-digits” and that with respect to Nortel specifically, he “expect(s) [Nortel] to grow faster than the market in 2004.”

149. Beatty also assured investors that “Nortel’s financials are in U.S. dollars and ... present[ed] ... in accordance with U.S. GAAP.” Beatty echoed Dunn’s positive sentiment in regard to 2003 and upcoming 2004 stating:

I am very pleased with our results, as we close out 2003. We have made significant progress on strengthening our financial position. I look forward to building on this position in 2004.

150. Responding to news of Nortel’s positive earnings, Deutsche Bank analyst George Notter declared, “Nortel Networks Corporation As Hot as Paris Hilton! Reiterate Buy, Raising Target.” Summarizing the Company’s results, Notter reported, “Q4 results reinforce our view that Nortel, over time, will take market share, drive margins higher, and create further upside in earnings power....It remains our favorite big cap name in the group.” Likewise, JP Morgan analyst Dr. Ehud Gelblum, proclaimed, “[a]ny way you slice it, Nortel’s topline was flat out impressive....Nortel remains our favorite telco carrier-centric equipment vendor.” Similarly, Desjardins analyst Paul Howbold told investors, “Blowout 4Q results are just the beginning... increasing target to C\$12.50 and reiterating our Top Pick-Above-[A]verage Risk rating.”

151. Following the Company's earnings announcement at 4:09 p.m. on January 29, 2004, Nortel's stock price rose from \$6.58 in New York to \$7.82 on January 30. The stock price continued to climb on February 2, 2004, the second day of trading, to close at \$8.17. Over those two trading days, the stock gained 24% in value. In Toronto, Nortel's shares rose 25% over the same two trading day period -- from \$8.76 (CD) on the day of the announcement, to \$10.38 (CD) on January 30, 2004, reaching \$10.94 (CD) on February 2, 2004.

152. The statements set forth above at ¶¶ 144-145, 147-149 were materially false and misleading. The Company has since admitted that its financial statements were *not* prepared in conformity with U.S. GAAP, and that the Company had artificially inflated its profits by reversing into income millions of dollars worth of improper reserves they had created in earlier periods. As discussed more fully at ¶¶ 211-219, on January 11, 2005, the Company restated its results for the year end and fourth quarter 2003.

F. The Audit Committee Participates in Misleading the Market

153. The Audit Committee is also responsible for the fraud at Nortel. According to the Committee's own minutes, its members repeatedly reviewed and approved SEC filings and press releases that were contrary to specific facts within their knowledge. In so doing, the Committee knowingly or recklessly authorized the release of the materially false and misleading statements discussed in Section E above.

154. Throughout the Class Period, the Audit Committee approved numerous disclosures that characterized as "earnings" what the Committee knew or recklessly disregarded were actually reversals of improper reserves. Although the Committee was repeatedly informed during 2003 that Nortel was releasing into earnings substantial reserves that had been inappropriately placed on its books, the Committee actively reviewed and approved disclosures regarding Nortel's purportedly improved earnings and failed to disclose that these earnings were

actually the product of accounting improprieties. The Committee members knew, or recklessly disregarded, that these disclosures were false and misleading. By no later than July 18, 2003, each of the Committee members was also aware of and failed to disclose the existence of material deficiencies in Nortel's internal controls and that these deficiencies were directly related to the improper establishment and release of the very reserves which were released in significant numbers to create the appearance of income during 2003.

155. The Audit Committee also misled the public with respect to the internal investigation that had been initiated as early as July 24, 2003 – the day of the deceptive 2Q 2003 Press Release. Although this investigation arose from and was at all times predominantly focused on improper reserve accounting, the Committee mischaracterized the investigation as a general balance sheet review and failed to disclose any specific concern with Nortel's accounting treatment of reserves. Until the Committee was forced to admit the widespread manipulation of reserves and earnings at Nortel, the Committee knowingly or recklessly disregarded the facts before it and repeatedly approved disclosures that it could not have reasonably believed were truthful or accurate.

The 1Q 2003 Press Release and the 1Q 2003 10-Q

156. The Audit Committee knew or was reckless in disregarding that the 1Q 2003 Press Release and the 1Q 2003 10-Q, issued on April 24, 2003 and May 9, 2003 respectively, were false and misleading. As set forth in ¶¶ 94 and 103, the 1Q 2003 Press Release and the 1Q 2003 10-Q announced net earnings of \$54 million for the first quarter. As set forth in ¶105, the 1Q 2003 Press Release and the 1Q 2003 10-Q were false and misleading because, among other things, neither revealed that these "earnings" were actually the result of accounting machinations related to reserves.

157. The mysterious appearance of “profitability” at the precise moment necessary to trigger a generous bonus plan should, even in the absence of specific contrary information, have alerted the Committee to the presence of the fraud. As each of the Committee members undoubtedly knew, Nortel had just suffered through a long string of consecutive quarterly losses and the Company had itself predicted, in its 1Q 2003 Press Release, that “the overall telecommunications market [would] be down modestly in 2003 compared to 2002.” Internal estimates likewise predicted a decline in earnings for the first quarter. As late as its January 23, 2003 meeting, the Board of Directors received a presentation entitled “Financial Update: Q4 2002 Results and Q1 2003 Outlook,” which predicted a \$112 million dollar loss for the quarter.

158. At the same time, the Audit Committee members were well aware of management’s incentive to report a return to profitability because they had each recently participated in enacting the “Return to Profitability” bonus plan described in ¶¶ 62-71. Indeed a majority of the Committee’s members—composed of defendants Brown, Ingram, and Smith—were also members of the Joint Leadership Resources Committee, the compensation committee of the Board, and should therefore have been particularly sensitive to the risk of manipulation that the bonus plans created.

159. With this knowledge alone, the sudden and unexpected emergence of “profitability” should have led the Audit Committee to question the accuracy of Nortel’s reported earnings, delve deeply into the circumstances surrounding the ostensibly remarkable turnaround in Company performance, and thereby prevent the false and misleading disclosures that took place during the Class Period. The Committee’s failure to do so, even without more information at its disposal, was reckless.

160. But the Audit Committee actually knew far more. In meetings leading up to the release of earnings data for the first quarter of 2003, the Committee was made aware that Nortel had substantial provisions on its books that were being released into earnings. The Committee received several presentations during this period that discussed the state of reserve accounts. D&T highlighted Nortel's "significant provisions" during the Committee's February 27, 2003 meeting. Moreover, at the Committee meeting held the day before the April 24, 2003 issuance of the 1Q 2003 Press Release, D&T also informed the Committee that over \$300 million in provisions had been released into earnings during the first quarter.

161. Then, on May 9, 2003, the day the Audit Committee approved the 1Q 2003 Form 10-Q for release, the Audit Committee Members received a detailed presentation from D&T regarding Nortel's "quality of earnings." The presentation dealt specifically with the "[i]mpact on earnings of the release of provisions" and made clear that "[v]arious balance sheet provisions were released into income in the quarter totaling approximately \$332 million." D&T also emphasized that "[q]uality of earnings is a key focus of regulators" and recommended that the Company "perform a rigorous review of all remaining balance sheet provisions and ensure that only appropriate provisions are recorded."

162. Thus, with knowledge of the Company's own negative financial projections, and aware of the Return to Profitability bonus plan and the incentive to create the appearance of profitability, the Audit Committee learned that Nortel had released over \$300 million of reserves into earnings and that D&T was increasingly concerned with the quality of Nortel's earnings in connection with its accounting treatment of reserves. Upon information and belief, without the improper release of reserves, Nortel's earnings would have been at least \$236 million lower than actually reported.

163. Nevertheless, the Audit Committee members reviewed and approved the release of the 1Q 2003 Press Release and the 1Q 2003 10-Q even though these disclosures described Nortel as profitable and failed to disclose that Nortel's "earnings" were the result of reversing problematic reserves. In this context, the Committee's failure to investigate the circumstances surrounding the sudden reversal of Nortel's fortunes in the first quarter of 2003 was, at best, a reckless departure from ordinary standards of care. Accordingly, the Committee knowingly or recklessly disregarded that the 1Q 2003 Press Release and the 1Q 2003 10-Q were false and misleading.

The 2Q 2003 Press Release and the 2Q 2003 10-Q

164. The Audit Committee knew or was reckless in disregarding that the 2Q 2003 Press Release and the 2Q 2003 10-Q, issued on July 24, 2003 and August 11, 2003 respectively, were false and misleading. As set forth in ¶¶ 106 and 115, the 2Q 2003 Press Release and the 2Q 2003 10-Q announced break-even earnings results representing a \$0.00 loss per common share. These reported earnings results were extremely favorable in light of Nortel's recent financial difficulties and represented an enormous improvement over the Company's reported \$697 million net loss during the same period in the previous year. As set forth in ¶ 117, the 2Q 2003 Press Release and the 2Q 2003 10-Q were false and misleading because, among other things, they did not disclose that the "break-even" results they reported were based on income that did not really exist and was actually the product of improper manipulation of reserves. The 2Q 2003 Press Release and the 2Q 2003 10-Q were also false and misleading because they did not disclose any concern with the accuracy or integrity of Nortel's reported earnings. Upon information and belief, without the improper release of reserves during this quarter, Nortel earnings would have been at least \$147 million lower than actually reported.

165. By the time of the 2Q 2003 Press Release, each of the Audit Committee members was in possession of sufficient information to have concluded that Nortel was misleading the market with respect to its purported return to profitability and the integrity of its financial reporting. From the issuance of the 2Q 2003 Press Release until Nortel's disclosure of major accounting improprieties in March 2004, each of the Audit Committee members knew, or was reckless in not knowing, that all of Nortel's SEC filings and earnings releases contained materially false and misleading statements.

166. At its July 18, 2003 meeting, one week before the issuance of the 2Q 2003 Press Release, the Audit Committee discussed an internal review begun by management to resolve problems with Nortel's accounting for reserves. As set forth in the minutes of the Committee's July 18th meeting, D&T explained to the Committee that management had commenced a project "to gather support and determine the proper resolution of certain reserve balances." D&T went on to describe Nortel's reserves as the "key issue" with respect to the Company's second quarter financials, noting that "[s]ignificant reserves and provisions are recorded on the balance sheet" and that "[s]ignificant additions, usages, and releases have occurred in the current quarter."

167. On the morning of July 24, 2003, the day of the 2Q 2003 Press Release, D&T reported to the Audit Committee the existence of a "reportable condition" in connection with the Company's establishment of reserves. Specifically, as set forth in the Committee's minutes from the July 24th meeting:

[D&T] commented on the external auditors' interim review of provisions. [D&T] stated that, based on information available to the external auditors at the time of the Committee meeting, there was a lack of documentation relating to certain accruals and provisions on the balance sheet at June 30, 2003, and that such a lack of documentation constituted a "reportable condition" under [generally accepted accounting standards].

168. D&T defined “reportable condition” for the Audit Committee in a section of its presentation entitled “Second Quarter – Interim Review: Provisions and *Effect on Earnings*” (emphasis added):

[M]atters coming to the auditor’s attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization’s ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

169. There is no doubt that the Audit Committee members understood the earnings impact of the reversal of improper reserves that had been maintained on Nortel’s books. As D&T’s presentation to the Committee explained: “Second quarter earnings were positively impacted by provision releases of approximately \$372 [million].” A document entitled “Chairman’s Notes” from the July 24, 2003 Audit Committee meeting makes clear that “Mr. Cawthorne [a representative of D&T] focused his comments on the matter of provision balances and their effect on earnings [and stated that] a reportable condition exists with respect to internal controls around provision balances.” Handwritten notes from the meeting also reflect that the “possibility of restatement” was discussed with D&T at the July 24, 2003 Audit Committee meeting.

170. The Audit Committee reviewed and approved the disclosure of favorable earnings data in the 2Q 2003 Press Release despite specific warnings from the Committee’s auditor that a reportable condition existed with respect to Nortel’s reserve accounts, that the “profitability” for which Nortel was claiming credit was in fact the result of releases of hundreds of millions of dollars in reserve accounts into earnings, and that an internal review had been initiated to resolve the problem. The 2Q 2003 Press Release disclosed none of these facts or concerns that D&T had

previously brought to the Committee's attention and failed to publicly disclose any apprehension regarding the accuracy of Nortel's reported income.

171. Moreover, the Audit Committee must have known that the 2Q 2003 Press Release's disclosure of the existence of an internal review was misleading to investors. Despite having discussed, that very same day and previously, that an internal investigation had been commenced in direct response to concerns regarding Nortel's accounting treatment of reserves, the following was the extent of the 2Q 2003 Press Release's disclosure regarding this investigation:

Given [that] in 2003 relatively minor amounts may have greater effect on reported results, the Company has initiated a comprehensive review and analysis of its assets and liabilities. The outcome of the activity may result in the elimination of certain assets and liabilities but is not expected to have a negative impact to net assets. No amounts relating to the elimination of any such assets and liabilities have been included in the results for the second quarter of 2003.

This description plainly failed to disclose material facts regarding the investigation—*i.e.*, that the investigation was commenced because of concerns with Nortel's accounting treatment of reserves, the manipulation of which was the engine for the Company's "return to profitability." This information was undeniably known by the members of the Committee at the time of the 2Q 2003 Press Release.

172. Significantly, the Audit Committee was directly involved in drafting the 2Q 2003 Press Release. According to the minutes of the July 24, 2003 Committee meeting, the meeting broke at noon with the intention to reconvene at 1:30 p.m. in order to review suggested revisions to the press release. Fax transmittal sheets indicate that the Committee members, who participated in the meeting remotely, each received a fax during this break containing proposed language for the press release describing the internal review. The language is almost identical to

the misleading disclosure ultimately approved for release that evening and, like the 2Q 2003 Press Release, makes no mention of any concern with provisions.

173. The Audit Committee was likewise aware that the 2Q 2003 Form 10-Q, which reiterated the same earnings data as the 2Q 2003 Press Release and did not disclose the existence of a reportable condition that went to the heart of the accuracy of Nortel's reported earnings, was false and misleading. D&T reported to the Committee on August 11, 2003, the date of the 2Q 2003 10-Q filing, that "there were no new matters or changes to the matters previously reported to the Committee" and advised the Committee, again, that there existed a reportable condition in connection with the "deficiency in the operation of internal controls pertaining to the lack of documentation for the existence on the balance sheet of various accruals and provisions." Despite these communications, the Committee reviewed and approved the false and misleading 2Q 2003 Form 10-Q for release.

The 3Q 2003 Press Release and the 3Q 2003 10-Q

174. The Audit Committee knew or was reckless in disregarding that the 3Q 2003 Press Release and the 3Q 2003 10-Q, issued on October 23, 2003 and November 19, 2003 respectively, were false and misleading. As set forth in ¶ 118, the 3Q 2003 Press Release announced net earnings of "approximately" \$179 million. The 3Q 2003 10-Q revised this figure upward to \$185 million. As set forth in ¶ 121, the 3Q 2003 Press Release and the 3Q 2003 10-Q were false and misleading because, among other things, they failed to disclose that Nortel's reported earnings were really the product of the improper release of reserves and did not reveal any concern regarding the accuracy of Nortel's internal controls or reported earnings. Upon information and belief, had Nortel not improperly released reserves into income during the third

quarter, Nortel's earnings would have been \$77 million lower than reported in the 3Q 2003 10-Q.

175. With the 3Q 2003 Press Release, the Audit Committee continued to hide the existence of the reportable condition and persisted with the charade, begun with the 2Q 2003 Press Release, that the internal review was a generalized review of the balance sheet, rather than the product of specific concerns with reserves. The 3Q 2003 Press Release provided preliminary unaudited financial results—including \$179 million in net earnings—and disclosed that these results were subject to the ongoing internal review. Nevertheless, by failing to disclose that this internal review was directly related to improper reserves—the very source of at least a significant portion of these supposed “earnings”—the Committee knew or recklessly disregarded that the 3Q 2003 Press Release was exceedingly misleading.

176. As set forth in ¶ 167, by no later than July 24, 2003, the Audit Committee knew of the existence of the reportable condition and that the internal review was focused on the improper reserves maintained on Nortel's balance sheet. The Committee was, moreover, repeatedly updated regarding the status of the investigation in the period leading up to the 3Q 2003 Press Release. For example, the Committee was updated on the internal review and its ongoing focus on reserves and provisions during Committee meetings held on September 25, 2003, October 10, 2003 and October 20, 2003. Accordingly, the Committee knowingly or recklessly approved the misleading 3Q 2003 Press Release.

177. On November 18, 2003 – the day before the 3Q 2003 Form 10-Q was filed—the Committee learned that D&T now considered the reportable condition relating to Nortel's accounting for reserves to be a “material weakness.” Specifically, as described in a draft “Material Weakness Letter” provided by D&T to the Committee at the November 18th meeting,

the “[l]ack of compliance with established Company procedures for monitoring and adjusting balances relating to certain accruals and provisions” constituted a “material weakness.” As D&T’s presentation explained:

A material weakness in internal control is a reportable condition in which the design or operation of one or more of the internal control elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

178. In addition to learning of the material weakness with respect to internal controls over the establishment and release of reserves, at its November 18, 2003 meeting the Audit Committee formally retained the law firm then called Wilmer Cutler & Pickering (now Wilmer Cutler Pickering Hale & Dorr LLP) (“Wilmer Cutler”) to “conduct an independent review of the facts and circumstances that led to the announcement by [Nortel] of [its] intention to restate previously issued financial statements and to report the results of such review to the Committee.” The minutes of the November 18th Committee meeting also indicate that Defendant Cleghorn, the Chairman of the Committee, had previously met with a representative of Wilmer Cutler in connection with the independent review and that Nortel “had commenced the delivery of documents in furtherance of the independent review following [that] earlier meeting.”

179. The Audit Committee also approved the misleading 3Q 2003 Form 10-Q at the November 18, 2003 meeting. Among other reasons, the 3Q 2003 Form 10-Q was misleading because it disclosed positive earnings results but did not disclose the existence of the material weakness in internal controls – a weakness that bore directly on the quality of those earnings. The Committee failed to disclose the material weakness despite learning about it at the very same meeting that the Committee approved the false and misleading 3Q 2003 Form 10-Q.

The First Restatement

180. The Audit Committee knew, or was reckless in disregarding, that Nortel's December 23, 2003 First Restatement—consisting of Nortel's 2002 Form 10-K/A, 1Q 2003 Form 10-Q/A and the 2Q 2003 form 10-Q/A – was materially false and misleading. As set forth in ¶¶ 135-38, the 2002 Form 10-K/A restated roughly \$935 million and \$514 million of accruals and provisions carried on the Company's previously reported consolidated balance sheets for 2001 and 2002 respectively. In its 1Q 2003 Form 10-Q/A, the Company restated approximately \$912 million of accruals and provisions carried on its previously reported consolidated balance sheet as of March 31, 2003. And, in its 2Q 2003 form 10-Q/A, the Company restated approximately \$952 million of accruals and provisions carried on its previously reported consolidated balance sheet as of June 30, 2003. The Company has now admitted that the First Restatement materially misstated Nortel's financial results by nearly \$300 million.

181. As described in ¶ 177, the Audit Committee was aware of the existence of an unresolved material weakness in internal controls related to the establishment of reserves well before the time of the First Restatement. The Committee was also aware that Nortel did not have sufficient information to accurately and confidently restate its reported financials because the independent investigation it had recently initiated into the matter was incomplete and ongoing. Indeed, as set forth below, D&T had specifically advised the Committee to postpone filing the First Restatement until the independent investigation had proceeded further. That advice went unheeded.

182. As previously discussed in ¶ 178, the Audit Committee had retained Wilmer Cutler as of November 18, 2003 to conduct an independent investigation into the facts and circumstances that led to the First Restatement. That independent investigation was still in

progress at the time of the December 23, 2003 filing of the First Restatement and the circumstances that caused the improper establishment and release of hundreds of millions of dollars in reserves by Nortel had not been clarified or resolved. Moreover, the Committee was aware that D&T, which, as set forth in the minutes of the Committee's December 18th meeting, had only just provided "recommendations to management regarding improvements to internal control to remediate the material weakness," believed that the material weakness in internal controls related to reserves was still unresolved.

183. In an apparent rush to calm the market after Nortel's November 19, 2003 announcement of a planned \$900 million restatement, the Audit Committee was intent on filing the First Restatement as soon as possible regardless of the state of the Wilmer Cutler investigation. On December 18, 2003, five days before the filing of the First Restatement, D&T advised the Committee that Nortel should delay filing the First Restatement until Wilmer Cutler's work was complete. As described in the Committee's minutes, D&T representatives "suggested that the Corporation consider deferring the filing of the restated financial statements until the preliminary results of the independent review were known in late January or early February 2004."

184. The Audit Committee disregarded D&T's advice and filed the First Restatement nonetheless. Thus, the Committee approved the filing of the false and misleading First Restatement against its own external auditor's advice, and its awareness of the existence of a material internal control deficiency that bore directly on the quality of its restated earnings.

The 4Q 2003 Press Release

185. The Audit Committee knew or was reckless in disregarding that the 4Q 2003 Press Release, issued on January 29, 2004, was false and misleading. As noted in ¶ 144, the 4Q

2003 Press Release represented that Nortel had net earnings of \$499 million during the fourth quarter and \$732 million for the year. As set forth in ¶ 152, the 4Q 2003 Press Release was false and misleading because, among other reasons, it did not disclose that these “earnings” were at least in part the product of the release of improper reserves and provisions. Nor did the 4Q 2003 Press Release disclose any concern with the accuracy of Nortel’s reported earnings. Upon information and belief, had Nortel not improperly released reserves throughout 2003, its earnings for the full year would have been at least \$460 million lower than reported.

186. The Audit Committee had numerous reasons to doubt the integrity of Nortel’s reported earnings. At the time of the 4Q 2003 Press Release, the Committee was aware of the continued existence of a material weakness in connection with the establishment and release of reserves and that remedial measures with respect to that material weakness had yet to be implemented. For example, minutes of the January 29, 2004 Committee meeting reflect that D&T reiterated the existence of the material weakness, stating that “based on the procedures performed to date and *except for the previously notified material weaknesses in internal controls*, the external auditors were not aware of any other reportable conditions or material weaknesses to bring to the attention of the Committee” (emphasis added). The minutes further reflect that D&T discussed “the remedial actions taken *and being taken* by management to address the material weaknesses in internal controls” (emphasis added). D&T also “confirmed that the internal audit function would increase its focus in areas related to financial reporting in 2004.” The Committee was thus plainly on notice that work to resolve the material weakness was still ongoing.

187. Similarly, the Audit Committee knew that the Wilmer Cutler investigation was still in progress and that, as a consequence, the facts and circumstances behind the First

Restatement and the release of hundreds of millions of dollars of reserves into earnings during 2003 were not fully understood. And, just as D&T had advised the Committee at the December 18, 2003 meeting to postpone filing the First Restatement until the Wilmer Cutler investigation had proceeded further, the minutes of that meeting make clear that D&T had likewise advised the Committee to “consider changes to the timetable for the year-end disclosure documents, pending receipt of the preliminary results of the independent review.” Despite this admonition, the Committee behaved as though the December issuance of the First Restatement had resolved all outstanding issues with Nortel’s accounting and financial reporting and approved the misleading 4Q 2003 Press Release for publication. Accordingly, the Committee knowingly or recklessly misled the investing public by reviewing and approving the 4Q 2003 Press Release.

G. The Truth Begins to Emerge

188. On March 10, 2004, Nortel shocked the investing public when it announced that it would again be forced to restate its financial results for 2003, and that it would delay the filing of its 2003 Form 10-K with the SEC. Specifically, the Press Release stated:

[T]he Nortel Networks Audit Committee is undertaking an independent review of the circumstances leading to the restatement of Nortel Networks’ financial statements which was announced in 2003. As a result of the work done to date, Nortel Networks is re-examining the establishment, timing of, support for and release to income of certain accruals and provisions in prior periods. Nortel Networks believes it is likely that it will need to revise its previously announced unaudited results for the year ended December 31, 2003 and the results reported in certain of its quarterly reports for 2003, and to restate its previously filed financial results for one or more earlier periods. Nortel Networks cannot predict at this time when such review will be completed. . . .

189. Immediately following this revelation issued after market close on March 10, 2004, Nortel’s stock price dropped 7% to close at \$6.37 in New York and 7% to close at \$8.40 (CD) in Toronto on March 11, 2004.

190. On March 15, 2004, Nortel placed Defendants Beatty and Gollogly on paid leaves of absence, pending the Audit Committee's completion of an independent review of the Company's financial statements. The Company also announced prior to the market opening that it would be delaying the filing of its Form 10-K for 2003 until after March 30, 2004. In response to this announcement, the Company's stock price plummeted 19% on both exchanges, closing at \$5.24 in New York and \$6.98 (CD) in Toronto.

191. On April 5, 2004, after the market had already opened, Nortel announced that the SEC had instituted a formal investigation into the Company's First Restatement and the March 2004 announcement of the impending Second Restatement. On that date, Nortel's shares fell 4% to close at \$6.06 in New York and fell 4% to close at \$7.94 (CD) in Toronto.

192. After the market closed on April 13, 2004, Nortel announced that the Ontario Securities Commission had begun its own investigation into the Company's accounting. In response, on April 14, 2004 shares of Nortel fell 3% to close at \$5.71 in New York and fell 2% to close at \$7.70 (CD) in Toronto. The stock price continued to fall on April 15, 2004, reaching \$5.62 in New York and \$7.57 (CD) in Toronto.

193. Then, before the market opened on April 28, 2004, Lynton Wilson ("Wilson"), the Chairman of Nortel's Board revealed that there had been massive fraud perpetrated at the Company. He reported that Nortel had been forced to take action related to the "accountability of our financial reporting." Specifically, he announced the "for cause" termination of Defendants Dunn, Beatty and Gollogly. In addition, he announced that the Company had placed four unnamed senior finance executives – later identified in the media as Kinney, Taylor, Johnson and Hamilton – on paid leaves of absence. Wilson admitted that these changes in

management were the result of an on-going investigation concerning “management’s practices regarding accruals and provisions,” *i.e.* Nortel’s reserve accounting.

194. In addition, the Company also announced that the Audit Committee had expanded its accounting review to include all of 2003 and that further, this review would delay indefinitely the filing of Nortel’s first quarter 2004 financials. Nortel also predicted that the investigation would result in a 50% reduction of the Company’s 2003 profit, and it advised that its “financial results for the year ended December 31, 2003 and the quarterly periods included therein should not be relied upon.”

195. Wilson characterized the “for cause” terminations of Nortel’s senior management as “an important step in the process of restoring confidence in the Company’s leadership and financial reporting.” He also proclaimed that, going forward, the Company would aim to “meet the highest standards of integrity and transparency in its financial reporting.”

196. The Company hosted a conference call later that day, in which Wilson, newly-appointed CEO Bill Owens (“Owens”), and newly-appointed CFO Bill Kerr (“Kerr”) participated. Heralding the future as a time when “trust and transparency will be watchwords,” Wilson admitted that the Board’s decision to terminate Dunn and the other senior managers was “about accountability for financial reporting.” He then confirmed that the focus of the Second Restatement would be accrued liabilities and, specifically, “the establishment of accruals, the release of those accruals, and the usage of those accruals, and the timing with respect to all of those.” Nortel refused to provide any additional information about the Company’s bonus plan in response to an analyst’s question except to say that “the independent review is still underway and we’ll complete it as soon as is possible.”

197. In reaction to the announcements of April 28, 2004, the price of Nortel's shares fell 28% to close at \$4.05 in New York, and fell 31% to close at \$5.26 (CD) in Toronto.

198. Following these dramatic announcements, circumstances at Nortel continued to worsen. On May 14, 2004, Nortel announced that, in addition to the on-going investigations by the SEC and the Ontario Securities Commission, it had received a federal grand jury subpoena commanding the Company to produce financial statements and corporate, personnel and accounting records from January 1, 2000 to the present in connection with a criminal investigation by the U.S. Attorney's Office for the Northern District of Texas, Dallas Division.

199. Thereafter, on May 17, 2004, the Ontario Securities Commission barred Nortel's officers and directors from trading in the Company's stock and other securities.

200. As a result of Nortel's failure to timely file its financial statements, the Company was required to provide bi-weekly updates to the Ontario Securities Commission. In an update issued on June 2, 2004, the Company announced that the previously announced 50% reduction of the Company's net earnings for 2003 – from \$732 million to \$366 million – could be revised to reflect an even greater decrease in profits.

201. On a conference call later that day, Owens revealed that the Audit Committee had extended the time period of its independent review beyond the first two quarters of 2003, as previously announced, to include the third and fourth quarters of 2003. He declined, however, to give any guidance on how much longer the restatement process would continue.

202. On June 23, 2004, Nortel announced that the Ontario Superior Court of Justice granted the Company an extension of time to hold its annual shareholder meeting until December 31, 2004, citing the Company's inability to meet the Canadian legal requirement that it present its financial statements to shareholders at its annual meeting.

203. On July 13, 2004, Nortel announced that the Second Restatement would result in an approximately 50% reduction in previously announced net earnings for 2003. The Company then went on to explain that the reduction in 2003 net earnings would impact the Company's continuing operations, rather than discontinued operations, resulting in the elimination of substantially all of its net earnings from continuing operations for fiscal 2003.

204. In mid-August 2004, Nortel revealed that the Integrated Market Enforcement Team of the Royal Canadian Mounted Police (the "RCMP") was elevating their informal review of the Company's accounting problems to a full-blown criminal investigation. Media reports called the investigation "one of Canada's largest white-collar crime investigations" and indicated that the RCMP had joined forces with the SEC and the U.S. Attorney's Office for the Northern District of Texas to investigate the Company's accounting improprieties.

205. The Company revealed additional information concerning the full impact of Nortel's accounting scandal in a press release and conference call on August 19, 2004. Specifically, the Company disclosed that it had terminated "for cause" seven additional "business unit/regional finance executives." Although the Company declined to name these executives, the media reported shortly thereafter that this new group of fired executives included Kinney, Taylor, Johnson and Hamilton – all of whom had been placed on paid leave in April 2004 – as well as Gasnier, Ferguson and Bowrey. Nortel also announced that it would seek to recoup \$10 million in bonuses that had been improperly awarded to these ten individuals.

Specifically, Nortel stated:

[T]he Board of Directors found that each of these ten individuals had primary, or substantial responsibility for the Company's financial reporting; that if not aware, each ought to have been aware that the establishment and/or release to income of such accruals and provisions were not in accordance with applicable generally accepted accounting principles; and that the improper application of generally accepted accounting principles with respect to these accruals and

provisions misstated the Company's financial statements. The Company will demand repayment by these individuals of payments made under the Company bonus plan in respect of 2003, and will take further action with respect to these individuals, if appropriate. (Emphasis added).

206. Nortel then announced that it expected to issue its Second Restatement by the end of September 2004, and that the Company still expected the Second Restatement to eliminate 50% of Nortel's 2003 profits. Finally, Nortel announced further efforts to revamp the Company by reducing 10% of its workforce (approximately 3,600 employees), mostly from its management personnel.

207. On August 25, 2004, Nortel issued a "Material Change Report," announcing various changes to its earlier disclosures. In that Report, the Company stated that approximately three-quarters of the expected 50% reduction in earnings would affect the first half of fiscal 2003, up from two-thirds as previously announced.

208. On September 2, 2004, the Company revised the expected completion date for the Audit Committee's review and the filing of restated financial results for fiscal 2003 and earlier periods.

209. On September 10, 2004, Nortel announced that it had hired Accenture to assist the Company "in develop[ing] a plan to transform its financial organization's structure, processes and systems in line with Nortel Networks goal of developing a 'best practices' finance organization."

210. On several occasions beginning in September 2004, the Company predicted that the filing date of its restated financial results for 2003 and earlier periods was near at hand. Despite these announcements, Nortel repeatedly delayed its filing in order to allow Wilmer Cutler's investigation to proceed further. On November 11, 2004, the Company stated that approximately 30 percent of the 2003 net income reductions would impact the Company's

continuing operations, with the remaining 70 percent affecting discontinued operations (adjusted from the previous estimate of an approximately equal impact between continued and discontinued operations). On December 8, 2004, Nortel announced that it would restate its financials for 2003 and previous periods on January 10, 2005.

H. Nortel Issues Its Second Restatement

211. On January 11, 2005, Nortel filed the Second Restatement, its long-awaited restated financial results for the years ended December 31, 2002 and 2001; and for the quarters ended March 31, 2003 and 2002; June 30, 2003 and 2002; and September 30, 2003 and 2002. The restated results offer further proof of the pervasive and egregious manipulation of reserves at Nortel during the Class Period.

212. Although the Second Restatement explicitly admitted that Nortel had overstated its reported earnings for 2003 as a result of the improper booking and/or release of reserves, Nortel reported the impacts of its extensive reserve reversals as part of other adjustments and declined to isolate information regarding the total amount of these reserve-related manipulations and consequent restatement items.

213. The adjustments to Nortel's financial results contained in the Second Restatement related primarily to seven categories: revenues and cost of revenues; foreign exchange; intercompany balances; special charges; reclassifications; discontinued operations; and other. Upon information and belief, the adjustments related to the improper accounting treatment of reserves impacted the intercompany balances, discontinued operations, and other categories. Upon further information and belief, it is likely that the restatement adjustments also impacted the special charges category.

214. The overall impact of Nortel's Second Restatement on the Company's financial statements is staggering. The 2003 net earnings of \$732 million trumpeted in the Company's

First Restatement were slashed by almost \$300 million to \$434 million in the Second Restatement. And, the Company's 2003 net earnings from continuing operations plummeted by well over \$100 million from \$387 million to \$262 million. Assuming Nortel's Second Restatement fully discloses the extent to which Nortel's financial performance was misstated during the Class Period, Nortel has now admitted that it misstated its net earnings from the First Restatement to the Second Restatement by \$298 million in 2003.

215. In the Second Restatement, Nortel incorporated a report from Wilmer Cutler summarizing the conclusions of the independent investigation conducted at the Audit Committee's behest (the "Independent Review").

216. As set forth in Wilmer Cutler's report:

former corporate management (now terminated for cause) and former finance management (now terminated for cause) in the Company's finance organization endorsed, and employees carried out, accounting practices relating to the recording and release of provisions that were not in compliance with U.S. generally accepted accounting principles ("U.S. GAAP") in at least four quarters, including the third and fourth quarters of 2002 and the first and second quarters of 2003. In three of those four quarters – when Nortel was at, or close to break even – these practices were undertaken to meet internally imposed . . . targets. While the dollar value of most of the individual provisions was relatively small, the aggregate value of the provisions made the difference between a profit and a reported loss, on a pro forma basis, in the fourth quarter of 2002 and the difference between a loss and a reported profit, on a pro forma basis, in the first and second quarters of 2003.

217. Wilmer Cutler specifically determined that Nortel had improperly released approximately \$361 million of reserves in the first quarter of 2003 alone – reserves that were either improperly reserved in the first place or subsequently reversed in the wrong period. Wilmer Cutler also found over \$370 million of released reserves in the second quarter of 2003 to be "questionable."

218. Nortel management deliberately reversed these "cookie jar" reserves in 2003 to help it meet the profitability deadline set by Defendant Dunn. According to Wilmer Cutler:

[R]oadmaps were developed [by Nortel's finance management] to show how the [Q1 and Q2 2003] targets could be achieved. These roadmaps made clear that the internal [earnings before taxes] targets for the quarter could only be met through release from the balance sheet of excess provisions that lacked an accounting trigger in the quarter. At the request of finance management in each business unit, finance employees identified excess, or "hard," provisions from the balance sheet, and, together, they determined which provisions to release to close the gap and meet the internal [earnings before taxes] targets.

219. The Independent Review thus confirms Lead Plaintiffs' allegations regarding the method, means and scope of the fraud perpetrated by Nortel on the investing public.

VI. CLAIMS FOR RELIEF

COUNT ONE

Against Nortel and the Officer Defendants for Violations of Section 10(b) of the Exchange Act and Rule 10b-5 Promulgated Thereunder

220. Lead Plaintiffs repeat and reallege each of the allegations set forth above. This Count is brought pursuant to Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder against Defendants Nortel, Dunn, Beatty and Gollogly.

221. Throughout the Class Period, Defendants Nortel, Dunn, Beatty and Gollogly, individually and in concert, directly and indirectly, by the use of the means and instrumentalities of interstate commerce, the mails and the facilities of a national securities exchange, did employ devices, schemes and artifices to defraud, made untrue statements of material facts and omitted to state material facts necessary in order to make statements made, in light of the circumstances under which they were made, not misleading, and engaged in acts, practices and courses of business which operated as a fraud and deceit upon Lead Plaintiffs and the members of the Class.

222. Nortel and the Officer Defendants, who were the most senior officers of Nortel during the Class Period, are liable as direct participants in this fraud for the materially misleading statements and omissions set forth herein. Through their positions of control and authority, the Officer Defendants each were in a position to control, and did control, all of the Company's false

and misleading statements and omissions, including the contents of all of its public statements. Similarly, all of the false and misleading statements alleged herein constituted “group published information,” which the Officer Defendants were responsible for creating, reviewing and disseminating. The Company is also liable for all of the statements of the Officer Defendants through the principles of respondeat superior.

223. More particularly, Defendants Nortel, Dunn and Beatty are liable for the following specific statements:

- a. The false and misleading statements in Nortel’s April 24, 2003 press release;
- b. The false and misleading statements in Nortel’s April 24, 2003 conference call;
- c. The false and misleading statements in Nortel’s Form 10-Q for the quarter ended March 31, 2003;
- d. The false and misleading statements in Nortel’s July 24, 2003 press release;
- e. The false and misleading statements in Nortel’s July 24, 2003 conference call;
- f. The false and misleading statements in Nortel’s Form 10-Q for the quarter ended June 30, 2003;
- g. The false and misleading statements in Nortel’s October 23, 2003 press release;
- h. The false and misleading statements in Nortel’s October 23, 2003 conference call;
- i. The false and misleading statements in Nortel’s November 19, 2003 press release;
- j. The false and misleading statements in Nortel’s Form 10-Q for the quarter ended September 30, 2003;
- k. The false and misleading statements in Nortel’s Form 10-K/A for the year ended December 31, 2002;

- l. The false and misleading statements in Nortel's Form 10-Q/A for the quarter ended March 31, 2003;
 - m. The false and misleading statements in Nortel's Form 10-Q/A for the quarter ended June 30, 2003;
 - n. The false and misleading statements in Nortel's January 29, 2004 press release; and
 - o. The false and misleading statements in Nortel's January 29, 2004 conference call.
224. Defendant Gollogly is liable for the following specific statements:
- a. The false and misleading statements in Nortel's Form 10-Q for the quarter ended March 31, 2003;
 - b. The false and misleading statements in Nortel's Form 10-Q for the quarter ended June 30, 2003;
 - c. The false and misleading statements in Nortel's Form 10-Q for the quarter ended September 30, 2003;
 - d. The false and misleading statements in Nortel's Form 10-K/A for the year ended December 31, 2002;
 - e. The false and misleading statements in Nortel's Form 10-Q/A for the quarter ended March 31, 2003; and
 - f. The false and misleading statements in Nortel's Form 10-Q/A for the quarter ended June 30, 2003.

The Company and the Officer Defendants Acted with Scienter

1. Facts Raising a Strong Inference of Scienter

225. The Company has admitted that Defendants Dunn, Beatty, and Gollogly perpetrated the fraud alleged herein with scienter. On August 19, 2004, the Company issued a press release, stating that "a significant number of accruals and provisions [that] were established and/or released in 2002 and 2003...were not in accordance with applicable [GAAP]," and that *each* of the Officer Defendants, who had been fired "for cause," "had primary, or substantial, responsibility for the Company's financial reporting." Furthermore, the Company admitted

“that, if not aware, each [of these defendants] ought to have been aware that the establishment and/or release to income of such accruals and provisions were not in accordance with applicable [GAAP]; and that the improper application of generally acceptable accounting principles with respect to these accruals and provisions misstated the Company’s financial statements” (emphasis added).

226. Indeed, the fact that these Defendants were fired “for cause” based on their “accountability for financial reporting,” as the Company stated in its April 28, 2004 and August 19, 2004 press releases, raises a strong inference that they acted intentionally or with reckless disregard for the systematic manipulation of Nortel’s reserve accounts. Under the applicable Canadian law, a corporation can only fire an employee for cause if a blameworthy act can be shown. Furthermore, in Nortel’s own Executive Retention and Termination Plan, Nortel defines “cause” as follows:

“CAUSE” means:

- (i) conviction (including any pleas guilty or nolo contendere) of a criminal offence or felony that involves fraud in connection with the performance by the Specified Executive of the duties of the Specified Executive’s employment with Nortel Networks or moral turpitude;
- (ii) the willful and continual failure of the Specified Executive substantially to perform the duties of the Specified Executive’s employment with Nortel Networks (other than any such failure due to the Specified Executive’s physical or mental illness), after a written for substantial performance has been delivered to the Specified Executive by the Nortel Networks Board, and a reasonable opportunity to cure has been given to the Specified Executive by the Nortel Networks Board;
- (iii) material violation of any written agreement between the Specified Executive and Nortel Networks not to disclose any confidential or proprietary information of Nortel Networks or confidential or proprietary information of a third person in respect of which Nortel Networks is under a written confidentiality obligation to such third party of which the Specified Executive has received prior written notice; or

(iv) *fraud or willful and serious misconduct in connection with the performance of the Specified Executive's duties for Nortel Networks, which, in the case of any such misconduct, has caused direct material injury to Nortel Networks* (emphasis added).

227. More recently, Nortel has publicly adopted the conclusions of the Independent Review conducted by Wilmer Cutler, which were incorporated into and filed along with the Second Restatement. As set forth in ¶¶ 215-219, the Independent Review further confirms Lead Plaintiffs' allegations regarding the method, means and scope of the fraud perpetrated by Nortel on the investing public.

228. In addition, former employees interviewed by Lead Counsel, as discussed herein, have confirmed that the improper creation and reversal of reserves was commonplace, and that each of the Officer Defendants knowingly used such accounting manipulations to deceive investors. In fact, as noted above, Nortel's practice of inflating reserves was such an accepted practice that the executives at Nortel gave these cookie jar reserves their own name: "hardness."

229. CS1 stated that during 2001 and 2002, Nortel's "senior management" purposefully established improper and excessive reserves so that they would then have those reserves available for later periods when the Company may need a boost in order to meet analyst expectations or, as it turned out, to report a return to profitability. According to CS1, the Officer Defendants understood that they could create cookie jar reserves during this period of massive restructuring, because the Company already looked "so bad in the marketplace" that no one would question or further devalue the Company's stock based on additional losses.

230. Further, as reported in *The Wall Street Journal*, Nortel finance executives regularly distributed documents outlining the Company's earning targets to Dunn, Beatty and Gollogly. These documents detailed the Company's financial results for the quarter and the balance sheet's bottom line number. Tellingly, as the Company's results improved from losses

to profits, there was a corresponding change to the entry on the document to the “balance sheet” number, indicating the increase in earnings was funded by a reversal in Nortel’s liabilities.

231. Additionally, the Officer Defendants attended the Audit Committee meetings discussed in ¶¶ 153-187 above, and therefore, possessed specific information that contradicted the Company’s false and misleading disclosures referenced above.

232. Defendant Dunn. The following additional facts further support a strong inference that Defendant Dunn acted with scienter:

a. As Nortel’s CEO and President, Defendant Dunn was involved in every important decision affecting the Company. With the assistance of and regular reporting from Defendants Beatty and Gollogly, Dunn ran Nortel. Defendant Dunn spent twenty-eight years at Nortel, working his way up through the financial and managerial ranks at the Company, and, through his experience, was intimately familiar with all aspects of the Company’s business and finances, including its accounting for accruals and liabilities. In addition, Defendant Dunn served as the Company’s CFO and Vice-President from February 1999 through November 2001. His tenure as CFO further exposed him to and familiarized him with the Company’s accounting practices as well as its accruals and liabilities.

b. CS5 stated that only top level executives located in Brampton, including Defendant Dunn, had access to all of the numbers and full visibility into the Company’s finances. Further, CS5, as well as CS9, explained that all numbers were sent to Brampton, where these same top level executives controlled the consolidation and final reporting process. In fact, CS5 advised that every quarter his group submitted the Enterprise Division’s financial statements for Asia-related operations to senior management in Brampton, including Dunn, for review and

consolidation. And every quarter, “[his group] would get instructions from Brampton to release additional contractual liabilities.”

c. CS1 stated that Defendant Dunn, as a result of his long tenure with the Company, including as CFO, really knew how to “turn the numbers ... Dunn knew which reserves had been established, why they had been established and whether they could be reversed in later periods.”

d. CS4 also stated that “it was common knowledge that there were reserves that [would be] used to release back into earnings and accruals taken to reduce earnings.” He also emphasized that Defendant “Dunn would release reserves or accrue expenses as required to meet Wall Street earnings estimates.”

e. Further, CS3 stated that she specifically confronted Dunn about the creation of improper reserves and that Dunn acknowledged the situation and then responded that “this is the way the Board of Directors wanted things to be done.”

f. CS8 confirmed that the decision of which reserves to release was made by the Company’s senior management in Brampton, including Dunn.

233. Defendant Beatty. The following additional facts further support a strong inference that Defendant Beatty acted with scienter:

a. As Chief Financial Officer, as set forth in the Company’s description of the position on its website, Defendant Beatty “le[d] Nortel Networks global finance function.” In this role, he knew virtually every fact regarding the Company’s financial position. Additionally, Defendant Beatty was the direct supervisor and received direct reports from Ferguson, the Vice-President of Finance in China, who was terminated for cause on August 19, 2004, as well as from Crosson, the Vice-President of Finance and Global Operations. Defendant

Beatty also received second level reports from CS1, CS7 and Bowrey, the Controller of Asia, who also was fired for cause on August 19, 2004.

b. CS5 – who reported to Bowrey and Ferguson – stated that only top level executives located in Brampton, including Defendant Beatty, had access to all of the numbers and full visibility into the Company’s finances. Further, CS5, as well as CS9, explained that all numbers were sent to Brampton, where these same top level executives controlled the consolidation and final reporting process. In fact, CS5 advised that every quarter his group submitted the Enterprise Division’s financial statements for Asia-related operations to senior management in Brampton, including Beatty, for review and consolidation. And every quarter, “[his group] would get instructions from Brampton to release additional contractual liabilities.”

c. According to CS1 – who reported to Defendant Beatty and Crosson – the improper creation and maintenance of “hardness” was “the widespread culture of the Company.” CS1 stated it was routine, “common throughout the company” and universally practiced behavior throughout all of Nortel’s geographic regions, including in Canada (in Brampton) and in the United States (in Raleigh and Richardson).

d. CS1 and CS7 – both of whom reported to Defendant Beatty and Crosson – stated that it was common practice at each of the Nortel’s U.S. divisions to take excessive accruals in violation of GAAP. Thereafter, according to CS1, CS7 and CS5, the financial statements of the U.S. Divisions were submitted to Brampton for consolidation and review, where Nortel’s senior management purposefully established improper and excessive reserves so that they would then have those reserves available for later periods when the Company needs a boost in order to meet analyst expectations or, as it turned out, to report a return to profitability.

e. CS8 confirmed that the decision of which reserves to release was made by the Company's senior management in Brampton, including Defendant Beatty.

f. CS8 also stated that, in the last quarter of 2002, he was directed by his supervisor Barbara Heitzner, to compile lists of all the liabilities in the Wireless Division. According to CS8, this order was given at Kinney's direction. Kinney told Heitzner to "scrub the books" because "[w]e really need to release provisions we don't need anymore." When asked about this incident and his division's reversal of reserves, CS8, who worked under Kinney, explained that Kinney "came under pressure from Beatty."

g. According to CS3 – who reported to Defendant Beatty and Taylor – improper reserves were routinely established and utilized at Nortel. In fact, CS3 indicated that on numerous occasions she was pressured by senior management, including Taylor to engage in this misconduct. CS3 estimated that, between March and May 2003 alone, she and two of her colleagues were asked to do about \$800,000 of "padding" with respect to her Division's reserve accounts.

h. CS3 – who reported to Defendant Beatty and Taylor – also stated that, in or around December of 2002, Taylor instructed her to accrue a \$15 million liability for Nortel's exposure to a pending lawsuit, despite the fact that the Company's legal department believed that the case had no merit and had assessed that, even in a worse-case scenario, the Company's exposure was no more than \$1 million. She refused to make the accounting entry and informed Taylor that there was no GAAP justification for it. In response to this objection, Taylor simply found another employee who was willing to make the entry for him. CS3 then received a telephone call from one of Taylor's staff telling her "to forget that the request had ever been made."

234. Defendant Gollogly. The following additional facts further support a strong inference that Defendant Gollogly acted with scienter:

a. As Controller, Defendant Gollogly was Nortel's top accounting manager. In this position, he knew virtually every fact regarding the Company's accounting practices, including its accounting for accruals and liabilities. Indeed, Gollogly controlled the Company's balance sheet review.

b. CS5 stated that only top level executives located in Brampton, including Defendant Gollogly, had access to all of the numbers and full visibility into the Company's finances. Further, CS5, as well as CS9, explained that all numbers were sent to Brampton, where these same top level executives controlled the consolidation and final reporting process. In fact, CS5 advised that every quarter his group submitted the Enterprise Division's financial statements for Asia-related operations to senior management in Brampton, including Gollogly, for review and consolidation. And every quarter, "[his group] would get instructions from Brampton to release additional contractual liabilities."

c. CS8 confirmed that the decision of which reserves to release was made by the Company's senior management in Brampton, including Gollogly. He indicated that within the Wireless Networks Division in Richardson Texas, it was Kinney who "had the power to massage the numbers," but Kinney always had to run the numbers by Defendant Gollogly. He emphasized that "even at Kinney's level, Gollogly would have to agree before the final decision to establish or release reserves was made."

2. Motive and Opportunity to Commit Fraud

235. The Officer Defendants also had the motive and opportunity to commit this fraud. First, each of the Officer Defendants, as a result of his position as an officer and/or a financial executive and manager of the Company, possessed the ability to control and did control Nortel's

financial reporting, and particularly its accounting for reserves. Thus, each of the Officer Defendants had the opportunity to manipulate the Company's accounting for reserves and, as a result, make the Company appear profitable. In addition, each of the Officer Defendants had the motive to overstate the Company's financial condition because of the Company's Return to Profitability Bonus Plan.

236. As detailed above, Nortel's Return to Profitability Bonus Plan established a \$100 million bonus pool that would be paid out fully so long as the Company achieved profitability (no matter how small the margin of profitability) by the end of 2004. As Albert Lin, an analyst with American Technology Research, stated, "The Board had a \$100 million carrot in front of executives to get profitable. If you set the stage with a \$100 million bonus for showing profit, the executives will be completely driven and motivated by the bonus."

237. Under the plan, the Officer Defendants were guaranteed huge bonus payments so long as Nortel reported a profit for a single quarter before the end of fiscal 2003. Moreover, in the event that the Company maintained its profitability over subsequent quarters, the Officer Defendants were guaranteed even larger bonuses in fiscal 2004. Specifically, as detailed above, the Officer Defendants were eligible for cash bonuses, calculated as a multiple of their base salaries and split into three separate payments.

238. Moreover, the Officer Defendants were eligible to benefit from these bonus payments twice. As detailed above at ¶ 64, under Nortel's SERP, 100% of any bonus payments received under the Return to Profitability Plan would be included in the calculation of the Officer Defendants' long-term benefits. This created yet another dramatic incentive for the Officer Defendants to artificially inflate Nortel's financial results.

239. Thus, when the Company announced a profit in the first quarter of 2003, the Officer Defendants were awarded 20% of the total aggregate bonus amount. Then, when the Company reported a “pro forma” profit for the second straight quarter in the second quarter of 2003, the Officer Defendants were awarded an additional 40% of the total aggregate bonus amount. Finally, the Officer Defendants were awarded their final payoff when the Company reported that it had achieved and maintained pro forma profitability for all four quarters of 2003. On August 19, 2004, Nortel announced that it will seek repayment of \$10 million in bonuses that were awarded to the Officer Defendants and seven other finance executives – *i.e.*, the “ten people who have been relieved for cause.” On January 31, 2005, Nortel filed a lawsuit in Canada against Dunn, Beatty, and Gollogly seeking the return of certain Return to Profitability payments, restricted stock unit allocations, and other payments. Specifically, according to the Company’s complaint filed in that action, Defendant Dunn received approximately \$4.9 million (nearly five times his \$900,000 salary); Defendant Beatty received approximately \$1.75 million; and Defendant Gollogly received approximately \$470,000.

240. In total, based on the provisions of the Return to Profitability Bonus Plan, the Company paid out more than \$62 million in bonuses to its senior executives and as much as \$123 million in bonuses to all of its employees.

241. Moreover, the Officer Defendants had a motive to falsify the Company’s financial results in order to obtain stock unit awards under Nortel’s RSU Plan. According to the complaint filed by Nortel in Canada to recover bonuses paid to Dunn, Beatty, and Gollogly, Dunn received \$2,953,050,203.50 under the RSU Plan, while Beatty received \$1,151,236.25, and Gollogly received \$1,338,207.01.

Fraud on the Market: Presumption of Reliance

242. At all relevant times, the markets for Nortel stock were efficient markets for the following reasons, among others:

- a. Nortel stock was traded on two highly efficient markets, the NYSE and the TSX;
- b. As a regulated issuer, Nortel filed periodic public reports with the SEC and the Ontario Securities Commission;
- c. Nortel common stock was followed by approximately 20 analysts, whose reports were publicly available and entered the marketplace;
- d. Nortel regularly issued press releases which were carried by national and international newswires. Each of these releases was publicly available and entered into the marketplace;
- e. The market price for Nortel reacted rapidly to new information entering the market; and
- f. The market for Nortel securities promptly digested current information with respect to Nortel from all publicly-available sources and reflected such information in Nortel's stock price.

243. As a result of the misconduct alleged herein, Nortel's stock price was artificially inflated throughout the Class Period. Under such circumstances, the fraud on the market theory applies. Lead Plaintiffs and the members of the Class relied upon either the integrity of the market or the statements of the Defendants in purchasing Nortel stock at artificially inflated prices.

244. As a direct and proximate result of the wrongful conduct alleged herein, Lead Plaintiffs and other members of the Class suffered damages in connection with their purchase of Nortel stock. Had Lead Plaintiffs and the other members of the Class known of the material misstatements and omissions alleged herein, they would not have purchased Nortel stock at artificially inflated prices.

245. By virtue of the foregoing, Nortel and the Officer Defendants violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder and are liable to Lead Plaintiffs and the other members of the Class, each of whom has been damaged as a result of such violations.

COUNT TWO

Against the Officer Defendants for Violations of Section 20(a) of the Exchange Act

246. Plaintiffs repeat and reallege each of the allegations set forth in the foregoing paragraphs. This Count is brought pursuant to Section 20(a) of the Exchange Act against Defendants Dunn, Beatty, and Gollogly.

247. As detailed in Count One above, Defendant Nortel committed a primary violation of the federal securities laws, through its knowing and/or reckless dissemination of materially false and misleading statements and omissions throughout the Class Period.

248. Each of the Officer Defendants was a controlling person of Nortel within the meaning of Section 20(a) of the Exchange Act throughout the Class Period. Defendant Dunn, as Nortel's CEO, had the power and authority to cause, and did cause, Nortel to engage in the wrongful conduct complained of herein by virtue of his position in the Company. Dunn was the CEO of the Company and managed the affairs of Nortel throughout the Class Period. The Company has admitted that Defendant Dunn "had primary, or substantial, responsibility for the Company's financial reporting...."

249. Defendant Beatty also had the power and authority to cause, and did cause, Nortel to engage in the wrongful conduct complained of herein by virtue of his position as the Company's CFO throughout the Class Period. As the CFO, Beatty (along with Gollogly, the Controller) was responsible for the Company's financial reporting and compliance with GAAP.

The Company has admitted that Defendant Beatty “had primary, or substantial, responsibility for the Company’s financial reporting....”

250. Finally, Defendant Gollogly had the power and authority to cause, and did cause, Nortel to engage in the wrongful conduct complained of herein by virtue of his position as the Corporation’s Controller the Class Period. As the Controller, Gollogly was responsible for the Company’s financial reporting and compliance with GAAP. The Company has admitted that Defendant Gollogly “had primary, or substantial responsibility for the Company’s financial reporting....”

251. In addition, as detailed above, each of the Officer Defendants was fired “for cause” based on the fact that each was a culpable participant in the fraud alleged herein. None of the Officer Defendants possessed reasonable grounds for the belief that the statements contained in the SEC filings, press releases and statements complained of herein were true and devoid of any misstatements or omissions of material fact.

252. For all of the reasons set forth above at ¶¶ 242-244, the fraud on the market theory is applicable to this Count. As a result of the false and misleading statements and omissions alleged herein, the market price of Nortel common stock was artificially inflated throughout the Class Period. Lead Plaintiff and the other members of the Class relied upon either the integrity of the market or the public statements that were made by Nortel and the Officer Defendants, as detailed above, in purchasing Nortel stock at artificially inflated prices.

253. As a direct and proximate result of the wrongful conduct alleged herein, Lead Plaintiffs and other members of the Class suffered damages in connection with their purchase of Nortel stock. Had Lead Plaintiffs and the other members of the Class known of the material

misstatements and omissions alleged herein, they would not have purchased Nortel stock at artificially inflated prices.

254. By virtue of the foregoing, Defendants Dunn, Beatty and Gollogly are liable under Section 20(a) of the Exchange Act to Lead Plaintiffs and the other members of the Class, each of whom has been damaged as a result of this fraud.

COUNT THREE

Against the Audit Committee Defendants for Violations of Section 10(b) of the Exchange Act and Rule 10b-5 Promulgated Thereunder

255. Lead Plaintiffs repeat and reallege each of the allegations set forth above. This Count is brought pursuant to Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder against the Audit Committee Defendants.

256. Throughout the Class Period, the Audit Committee Defendants, individually and in concert, directly and indirectly, by the use of the means and instrumentalities of interstate commerce, the mails and the facilities of a national securities exchange, did employ devices, schemes and artifices to defraud, made untrue statements of material facts and omitted to state material facts necessary in order to make statements made, in light of the circumstances under which they were made, not misleading, and engaged in acts, practices and courses of business which operated as a fraud and deceit upon Lead Plaintiffs and the members of the Class.

257. The Audit Committee Defendants are liable for the false and misleading statements contained in Nortel's SEC filings and related earnings releases for fiscal year 2003, including:

- a. The false and misleading statements in Nortel's April 24, 2003 press release;
- b. The false and misleading statements in Nortel's Form 10-Q for the quarter ended March 31, 2003;

- c. The false and misleading statements in Nortel's July 24, 2003 press release;
- d. The false and misleading statements in Nortel's Form 10-Q for the quarter ended June 30, 2003;
- e. The false and misleading statements in Nortel's October 23, 2003 press release;
- f. The false and misleading statements in Nortel's Form 10-Q for the quarter ended September 30, 2003;
- g. The false and misleading statements in Nortel's Form 10-K/A for the year ended December 31, 2002;
- h. The false and misleading statements in Nortel's Form 10-Q/A for the quarter ended March 31, 2003;
- i. The false and misleading statements in Nortel's Form 10-Q/A for the quarter ended June 30, 2003; and
- j. The false and misleading statements in Nortel's January 29, 2004 press release.

The Audit Committee Defendants Acted With Scienter

258. The allegations set forth herein with respect to the Audit Committee Defendants are more than sufficient to raise the required strong inference of scienter. It is well settled that the scienter requirement of Section 10(b) and Rule 10b-5 can be satisfied by allegations of actual knowledge, as well as allegations of recklessness. Here, the Audit Committee Defendants were in possession of specific facts that contradicted the contents of the above-referenced financial disclosures for which they were responsible. Further, even in the absence of such actual knowledge, the Committee's failure to initiate an appropriate investigation and prevent these misleading disclosures was a reckless departure from ordinary standards of care.

259. The Committee knew or recklessly disregarded specific facts that rendered the disclosures referenced above false and misleading. As set forth in Section V.F, the Committee was fully aware of deficiencies in internal controls over reserves by no later than July 24, 2003—

the day of the 2Q 2003 Press Release. On that day, D&T described to the Committee the existence of a reportable condition with respect to internal controls over the establishment and release of reserves. Nevertheless, the Committee did not disclose the existence of any deficiency in internal controls related to reserves—even when the reportable condition was upgraded to a material weakness—until the materially false and misleading First Restatement was filed on December 23, 2003. Rather, the Committee reviewed and approved numerous disclosures of favorable earnings data that made no mention of the internal control deficiency that, in D&T’s words to the Committee, directly affected the “quality of earnings” reported by Nortel.

260. The Committee also knowingly misled the market with respect to the nature of the internal review commenced for the specific purpose of resolving deficiencies in internal controls related to the establishment and release of reserves. The Committee was made aware of the internal review, and its explicit focus on these internal control deficiencies, by as early as July 18, 2003 and monitored it closely thereafter. As set forth in Section V.F, the Committee reviewed and approved numerous disclosures that characterized this internal review as a generalized balance sheet review, even though the Committee knew full well the review was the product of specific concerns with inappropriate provisioning activity.

261. Further, the Audit Committee Defendants knew or recklessly disregarded that the First Restatement—consisting of the Company’s 2002 10-K/A and the 1Q 2003 10-Q/A and 2Q 2003 10-Q/A—was itself false and misleading. Aware of the continuing existence of a material weakness in Nortel’s internal controls, and with an independent investigation conducted by Wilmer Cutler still in its preliminary phase, on December 18, 2003 the Committee was advised by D&T to delay filing the First Restatement until the investigation had proceeded further. The Committee disregarded this advice and approved the filing of the First Restatement, which would

itself need to be restated as a result of its gross inaccuracies. At a minimum, the Committee was reckless in ignoring its own auditor's recommendation and rushing to publish a misleading "restatement."

262. For similar reasons, the Committee knew or recklessly disregarded that the 4Q 2003 Press Release, regarding the fourth quarter and year-end results for 2003, was false and misleading. As set forth in Section V.F, the Committee had substantial reason to doubt the integrity of Nortel's reported earnings for 2003. The Committee was aware that work to resolve the Company's material deficiencies in internal controls was ongoing, as was the investigation conducted by Wilmer Cutler. As with the filing of the First Restatement, the Committee had also been advised by D&T to consider altering the timetable for disclosing year-end results.

263. Moreover, even if the Audit Committee Defendants did not have in their possession specific facts to contradict their disclosures, the Committee's failure to prevent the false and misleading disclosures referenced above was reckless. In light of the Audit Committee's key role in the Company's financial reporting process, the context in which Nortel's "profitability" materialized, and the widespread nature of the fraud within the Company, the Committee's failure to discover the existence of the fraud could only be explained by a reckless departure from any reasonable standard of care.

264. In the rules promulgated pursuant to the Sarbanes Oxley Act of 2002, the SEC emphasized the vital importance of audit committees to the integrity of a company's financial reporting, stating:

The audit committee, composed of members of the board of directors, plays a critical role in providing oversight over and serving as a check and balance on a company's financial reporting system. The audit committee provides independent review and oversight of a company's financial reporting processes, internal controls and independent auditors. It provides a forum separate from management in which auditors and other interested parties can candidly discuss concerns. By

effectively carrying out its functions and responsibilities, the audit committee helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess management's practices and internal controls, and that the outside auditors, through their own review, objectively assess the company's financial reporting practices.

265. Indeed, in its SEC filings, Nortel represented that the Audit Committee had responsibility for “the oversight of the reliability and integrity of accounting principles and practices, financial statements and other financial reporting, and disclosure practices followed by management.” The duties and responsibilities of the Audit Committee were set forth in the Audit Committee Mandate attached to Nortel’s proxy filings during the Class Period. In particular, the Audit Committee Mandate indicated that the Audit Committee’s primary areas of responsibility were: (1) the performance of the Company’s independent auditors, Deloitte & Touche LLP; (2) the Company’s establishment of adequate internal controls; and (3) the Company’s compliance with applicable laws. Additionally, the Audit Committee Mandate provides that the Audit Committee was responsible for the following duties, among others:

(i) to review and monitor practices and procedures adopted by management to assure compliance with applicable laws, including reporting and disclosure requirements under applicable securities laws related to financial performance and material undertakings and activities of the corporation and its subsidiaries, and, where appropriate, make recommendations or reports thereon to the Board of Directors; [. . .]

(m) to review, with the independent auditor where appropriate, public disclosure documents containing material audited or unaudited financial information, including any earnings press releases, prospectuses, annual and quarterly reports on Form 10-K and Form 10-Q, financial statements, management’s discussion and analyses of financial condition and results of operations, and, where appropriate, make recommendations or reports thereon to the Board of Directors; [and]

(o) to review the activities and business practices followed by senior management as to assess compliance with appropriate Corporate Policies and the Code of Business Conduct and to address any deficiencies in such compliance.

266. Of all the Board's committees, the Audit Committee had the greatest responsibility for the oversight of the financial statements of the Company. Indeed, it was fundamental that the Audit Committee have a detailed understanding of the Company, and particularly its financial systems and internal controls, as well as the corporate culture at Nortel and the impact that this culture had on the Company's financial reporting.

267. In this regard, the Audit Committee knew, or was reckless in not knowing, that the only way that the Company was able to report a profit in the first quarter of 2003, and in every quarter of 2003 thereafter, was through fraudulent accounting. The Audit Committee knew that the Company had reported a string of quarterly losses during 2002, losing \$463 million in the first quarter, \$697 million in the second quarter, \$1.8 billion in the third quarter and \$248 million in the fourth quarter. Further, Company management informed the Audit Committee and the rest of the Board of Directors in January 2003 that Nortel would post a loss of \$112 million in the first quarter of 2003. Within a matter of weeks, however, that figure was revised downward several times until the Company ultimately reported \$40 million in profits. This sudden reversal of Nortel's earnings should have immediately alerted the Audit Committee that these results were fabricated and likely the result of intentional manipulation.

268. Based on general market conditions and the outlook for the telecommunications industry in the beginning of 2003, the Audit Committee knew, or should have known, that Nortel's first quarter results were an aberration and inconsistent with the Company's own statements in its 1Q 2003 Press Release: "the Company continues to expect the overall telecommunications equipment market to be down modestly in 2003 compared to 2002. Given the ongoing economic, geopolitical uncertainty customers continue to spend cautiously." Saucier, chair of the Joint Committee on Corporate Governance, has acknowledged that the

Audit Committee had a responsibility to keep abreast of general market conditions and trends and utilize that information for the benefit of the shareholders: “We have the same analysts’ reports that you read, we read the same papers you read, and it is our rule to ensure that the right information and timely information is going to shareholders at the appropriate time.”

269. Consistent with the Audit Committee’s financial reporting responsibilities, and in light of both the Company’s loss projections and the negative industry outlook, the Audit Committee was obligated to delve deeply into the Company’s dramatic first quarter 2003 turnaround. Had they undertaken any reasonable investigation, the Audit Committee would have uncovered the real reason for the Company’s profit announcement – namely, that the Officer Defendants had improperly reversed reserves into income.

270. Further, the Audit Committee Defendants, all of whom are members of the Board of Directors, were approved a bonus plan that handsomely rewarded executives – in increasing amounts up to two to four times their salaries in cash – so long as Nortel reported a profit, even a small profit, in the near term, without any regard for the Company’s long-term health. By approving this “Return to Profitability” Plan, the Audit Committee Defendants essentially invited the Officer Defendants to fraudulently manipulate the Company’s accruals and provisions in order to create profits and, consequently, trigger their huge bonus payments. Thereafter, the Audit Committee Defendants’ knowing or reckless disregard for their duties allowed the Officer Defendants to reap handsome rewards for their fraud. In total, Dunn received approximately \$4.9 million, Beatty received approximately \$1.75 million and Gollogly received \$470,000 in bonus payments under the Return to Profitability Plan.

271. The Audit Committee knew that the highly unusual terms of the Return to Profitability Plan violated principles of good corporate governance. One principle that was

flagrantly violated by the Return to Profitability Plan was that management's interests should not be misaligned with the interests of shareholders, *i.e.*, management should not be incentivized to achieve short term profits at the expense of long term results. Indeed, in September 2002, Brown, who serves as the Vice-President of the Canadian Council of Chief Executives, signed the council's publication on corporate governance entitled "Governance, Values and Competitiveness, A Commitment to Leadership." In this publication, the Council discussed appropriate compensation for executives, stating that outside directors should "ensure that the design of compensation to management and employees reflects an appropriate balance between the short and longer-term performance of the Company. It is especially important to avoid unintended incentives such as an undue emphasis on short term changes in stock price." Nevertheless, in stark contrast to these principles, the Return to Profitability Plan created perverse incentives by rewarding senior executives for short term, illusory profit announcements.

272. More significantly, after approving the Plan, the Audit Committee Defendants made no effort to verify that these incentives did not motivate the Officer Defendants to commit fraud. Indeed, they made no reasonable effort to monitor the Company's financial reporting or to detect the rampant fraud that pervaded the Company's internal accounting. Had they conducted even the most basic investigation, they would have recognized that there was no basis to report that Nortel's financial statements fairly represented the results of the Company's operations in accordance with GAAP.

273. Similarly, had the Audit Committee spoken to its own finance executives, it would have recognized that the improper creation of reserves was a pervasive and systematic practice at Nortel, and that those reserves were routinely reversed inappropriately to boost Nortel's income. As detailed above at ¶¶ 80-89, at least nine former executives of Nortel have

indicated to Lead Plaintiffs that these practices permeated every single Division of the Company. Indeed, the establishment of cookie jar reserves was so commonplace that it had its own name within Nortel: “hardness.” Everyone understood that if a Division had “hardness,” then it had inappropriate reserves available that could be used to boost earnings. These facts are further supported by the extraordinary amounts of reserves that the Company has since announced it will be forced to reverse. One former employee even provided evidence that the Board was aware of, and had condoned the practice of, creating inappropriate cookie jar reserves. Specifically, as detailed above, CS3 indicated that she confronted Defendant Dunn about the Company’s improper accounting for bonus accruals, and Dunn responded by stating, “this is the way the Board of Directors wants things to be done.” All of these facts support a strong inference of scienter.

274. For all of the reasons set forth above at ¶¶ 242-244, the fraud on the market theory is applicable to this Count. As a result of the false and misleading statements and omissions alleged herein, the market price of Nortel common stock was artificially inflated throughout the Class Period. Lead Plaintiff and the other members of the Class relied upon either the integrity of the market or upon the financial statements that were signed and approved by the Audit Committee Defendants in purchasing Nortel stock at artificially inflated prices.

275. The Committee is liable for the material misrepresentations alleged herein because each was specifically reviewed and approved by the Committee. In light of the Committee’s pervasive involvement with the preparation and approval of the above-referenced disclosures, the Audit Committee Defendants are also liable for these material misrepresentations under the group pleading doctrine.

276. As a direct and proximate result of the wrongful conduct alleged herein, Lead Plaintiffs and other members of the Class suffered damages in connection with their purchase of Nortel stock. Had Lead Plaintiffs and the other members of the Class known of the material misstatements and omissions alleged herein, they would not have purchased Nortel stock at artificially inflated prices.

277. By virtue of the foregoing, the Audit Committee Defendants violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder and are liable to Lead Plaintiffs and the other members of the Class, each of whom has been damaged as a result of such violations.

COUNT FOUR

Against the Audit Committee Defendants for Violations of Section 20(a) of the Exchange Act

278. Plaintiffs repeat and reallege each of the allegations set forth in the foregoing paragraphs. This Count is brought pursuant to Section 20(a) of the Exchange Act against the Audit Committee Defendants.

279. As detailed in Count One above, defendant Nortel committed a primary violation of the federal securities laws, through its knowing and/or reckless dissemination of materially false and misleading statements and omissions throughout the Class Period.

280. Each of the Audit Committee Defendants was a controlling person of Nortel within the meaning of Section 20(a) of the Exchange Act throughout the Class period. As set forth in the Audit Committee Mandate in place during the Class Period, the Audit Committee is responsible for:

Review[ing], with the independent auditor where appropriate, public disclosure documents containing material audited or unaudited financial information, including any earnings press releases, prospectuses, annual and quarterly reports on Form 10-K and Form 10-Q, financial statements, management's discussion

and analyses of financial condition and results of operations, and, where appropriate, mak[ing] recommendations or reports thereon to the Board of Directors.

Each of the Audit Committee Defendants had the power and authority to cause, and did cause, Nortel to engage in the wrongful conduct complained of herein by virtue of their position as members of the Audit Committee and Board of Directors of the Company.

281. For all of the reasons set forth above at ¶¶ 242-244, the fraud on the market theory is applicable to this Count. As a result of the false and misleading statements and omissions alleged herein, the market price of Nortel common stock was artificially inflated throughout the Class Period. Lead Plaintiff and the other members of the Class relied upon either the integrity of the market or the public statements that were made by Nortel, as detailed above, in purchasing Nortel stock at artificially inflated prices.

282. As a direct and proximate result of the wrongful conduct alleged herein, Lead Plaintiffs and other members of the Class suffered damages in connection with their purchase of Nortel stock. Had Lead Plaintiffs and the other members of the Class known of the material misstatements and omissions alleged herein, they would not have purchased Nortel stock at artificially inflated prices.

283. By virtue of the foregoing, the Audit Committee Defendants are liable under Section 20(a) of the Exchange Act to Lead Plaintiffs and the other members of the Class, each of whom has been damaged as a result of this fraud.

VII. PRAYER FOR RELIEF

WHEREFORE, Lead Plaintiffs, on their own behalf and on behalf of the Class, pray for judgment as follows:

A. Declaring this action to be a proper class action and certifying Lead Plaintiffs as class representatives under Rule 23 of the Federal Rules of Civil Procedure;

B. Awarding compensatory damages in favor of Lead Plaintiffs and other members of the Class against all Defendants, jointly and severally, for the damages sustained as a result of the wrongdoings of Defendants, together with interest thereon;

C. Awarding Lead Plaintiffs the fees and expenses incurred in this action, including a reasonable allowance of fees for Lead Plaintiffs' attorneys and experts; and

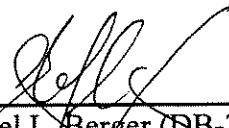
D. Granting such other and further relief as the Court may deem just and proper.

VIII. JURY TRIAL DEMAND

Lead Plaintiffs demand a jury trial of all issues so triable.

Dated: September 16, 2005

Respectfully submitted,



Daniel L. Berger (DB-7748)
John P. Coffey (JC-3882)
Jennifer L. Edlund (JE-9138)
Wendy Erdly (WE-9747)
**BERNSTEIN LITOWITZ BERGER
& GROSSMANN LLP**
1285 Avenue of the Americas
New York, New York 10019
Telephone: (212) 554-1400
Facsimile: (212) 554-1444

*Counsel for Co-Lead Plaintiffs Ontario
Teachers' Pension Plan Board and the New
Jersey Division of Investment and Lead
Counsel for the Prospective Class*