UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

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<tr><td>UNITED STATES SECURITIES
AND EXCHANGE COMMISSION,

Plaintiff,

v.

FRANK A. DUNN, DOUGLAS C. BEATTY, MICHAEL J. GOLLOGLY, MARYANNE E. PAHAPILL (a.k.a. MARY ANNE POLAND), DOUGLAS A. HAMILTON, CRAIG A. JOHNSON, JAMES B. KINNEY and KENNETH R.W. TAYLOR

Defendants.</td><td>)
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(ECF CASE)

AMENDED COMPLAINT
SECURITIES FRAUD</td></tr>
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The United States Securities and Exchange Commission (the "Commission") alleges that:

SUMMARY

1. This case involves two fraudulent accounting schemes, a revenue fraud scheme and an earnings management scheme, which enabled Nortel Networks Corporation ("Nortel" or "the Company") to meet the unrealistic revenue and earnings guidance that its top executives had provided to Wall Street in 2000 and again in 2002 and 2003. The first scheme – led by three corporate executives – accelerated material amounts of revenues into 2000 and created the false appearance that Nortel was weathering an industry-wide economic downturn better than its competitors. The second scheme – led by two of the same corporate executives, a third (but different) corporate executive and four business unit executives – reduced or increased Nortel's earnings as necessary to create the false appearance that Nortel had stabilized its operations and returned to profitability for the first time in over three years, and was designed to pay bonuses.

2. In the late 1990s, the United States economy experienced substantial and rapid growth in the telecommunications and internet sectors. In 2000, however, those sectors contracted significantly. Demand for such products waned. Access to capital was severely constricted.

3. By September 2000, Nortel's revenues began to slip from internal projections by hundreds of millions of dollars. Orders softened. Anticipated revenues from many customers failed to materialize. By mid-October 2000, Nortel was internally estimating that revenues for 2000 would fall short of projections by almost $2 billion. A similar shortfall appeared likely for the first half of 2001. Nortel's competitors and customers were similarly affected by this dramatic slowdown. Nortel, however, did not share its bad news with Wall Street. Nortel instead continued to claim that it would experience substantial growth for the remainder of 2000 and into 2001, despite its internally-reduced expectations.

4. Starting no later than October 2000, defendant Frank A. Dunn ("Dunn"), Nortel's Chief Financial Officer ("CFO") and later its President and Chief Executive Officer ("CEO"), responded to market pressures by engaging in a fraudulent accounting scheme in which he and others (i) primed Wall Street's expectations by issuing unrealistic financial guidance for Nortel and (ii) then used accounting adjustments that did not comport with US Generally Accepted Accounting Principles ("US GAAP"), to move Nortel's revenues and earnings upward or downward as necessary to meet Wall Street's unrealistic expectations. Dunn was joined at various points in the two schemes by (a) defendant Douglas C. Beatty ("Beatty"), Nortel's Controller and later its CFO, (b) defendant Michael J. Gollogly ("Gollogly"), Beatty's successor to the position of Controller, (c) defendant MaryAnne E. Pahapill (a.k.a. Mary Anne Poland) ("Pahapill"), Nortel's Assistant Controller and Vice President of Corporate Reporting and later its Controller, and (d) the vice presidents of finance for Nortel's four business units, defendants

Douglas A. Hamilton ("Hamilton"), Craig A. Johnson ("Johnson"), James B. Kinney ("Kinney") and Kenneth R.W. Taylor ("Taylor").

5. The fraudulent conduct took two forms:

6. In November of 2000, Dunn (then CFO), Beatty (then Controller) and Pahapill (then Assistant Controller) (collectively, "Revenue Fraud Defendants") altered Nortel's revenue recognition policies to accelerate revenues into 2000, as needed to meet Nortel's quarterly and annual revenue guidance, and to hide the worsening condition of Nortel's business. Bill and hold transactions were at the center of the scheme. US GAAP permits a company to recognize revenues prior to the delivery of a product if the transaction meets certain specific criteria. In the second quarter of 2000, Nortel banned the use of such transactions company-wide, but, after Nortel's revenues fell short of expectations in the third quarter of 2000, Dunn, Beatty and Pahapill reintroduced bill and hold transactions into the Company's sales and accounting practices. This change principally affected the reporting of revenues on Nortel's optical business – a metric closely watched by Wall Street – by enabling Nortel to recognize revenues on idle, undelivered inventory sitting in its warehouses and offsite storage locations. The transactions did not satisfy US GAAP requirements, but, Nortel nonetheless recognized revenues as if they did. In all, Nortel accelerated more than $1 billion in revenues into 2000 through improper bill and hold transactions. In doing so, Dunn, Beatty and Pahapill not only enabled the Company to report increased optical (and other) revenues, but also, they were able to steer Nortel's reported fourth quarter and fiscal year 2000 results in line with Wall Street's expectations. Nowhere was the existence or effect of this accounting scheme disclosed.

7. In February 2001, Nortel finally lowered its guidance to account for the fact that its business was suffering from the same widespread economic downturn that was impacting the entire telecommunications industry. Its business plummeted throughout the remainder of 2001

and it suffered serious losses. The Company reacted by implementing a restructuring that, among other things, reduced its workforce by two-thirds and resulted in significant write-downs of assets. Dunn became Nortel's President and CEO in the midst of the restructuring.

8. In the summer of 2002, as Nortel began to emerge from the downturn, Dunn publicly announced that he expected Nortel to return to profitability by the second quarter of 2003. Beginning in the fourth quarter of 2002, Dunn, Beatty (then CFO) and Gollogly (then Controller) embarked on a second scheme – the manipulation of Nortel's reserves – to manage Nortel's publicly-reported earnings, create the false appearance that their leadership and business acumen were responsible for Nortel's return to profitability, and to pay out millions of dollars in bonuses to themselves and other executives and employees of Nortel. Hamilton, Johnson, Kinney and Taylor – who, at the time, were the vice presidents of finance of Nortel's Optical, Wireline, Wireless and Enterprise business units, respectively – actively participated in and materially contributed to this earnings management scheme.

9. From at least July 2002 through at least June 2003, Dunn, Beatty, Gollogly, Hamilton, Johnson, Kinney and Taylor (collectively, "Earnings Management Defendants") improperly established, maintained and released excess reserves. When Nortel internally (and unexpectedly) determined that it would return to profitability in the fourth quarter of 2002 – sooner than Dunn had indicated in his guidance to the investment community – Dunn, Beatty and Gollogly ordered the establishment of additional unnecessary reserves to reduce earnings for the quarter, avoid reporting a profit earlier than Dunn had publicly predicted, and to add to Nortel's existing stockpile of excess reserves that could be (and were) released in future quarters to improve Nortel's consolidated financial results. Hamilton, Johnson, Kinney and Taylor responded to this order by improperly establishing tens of millions of dollars of additional unnecessary reserves at the business unit level.

10. When fiscal year 2003 turned out to be rockier than expected, Dunn, Beatty and Gollogly orchestrated the improper release of sufficient excess reserves to cause Nortel to report a profit in the first quarter of 2003, a quarter earlier than the public expected, and to pay defendants and others substantial bonuses. Hamilton, Johnson, Kinney and Taylor actively contributed to the result by improperly releasing tens of millions of dollars of reserves from the books and records of their respective business units for the first quarter of 2003. In public statements, Dunn falsely attributed Nortel's first quarter 2003 return to profitability to the strength of his business model. Dunn, Beatty and Gollogly again planned to release sufficient excess reserves to achieve profitability in the second quarter of 2003 and Hamilton, Johnson, Kinney and Taylor again improperly released tens of millions of dollars in excess reserves in furtherance of that objective. Ultimately, however, the Earnings Management Defendants were unable to make all of reserve releases they had planned. Nevertheless, because a significant portion of the planned releases were made, Nortel still reported nearly break-even results (though not actual profit) and it reached profitability on a *pro forma* basis, which triggered the payment of another round of bonuses.

11. In the second and third quarters of 2003, Nortel's outside auditors cautioned Nortel's senior executives and the Audit Committee of Nortel's Board of Directors ("Audit Committee") about Nortel's handling of reserves and, the earnings management scheme began to unravel. Nortel's management – led by Dunn and Beatty – responded by conducting a purportedly "comprehensive review" of Nortel's assets and liabilities. This resulted in an announcement, on October 23, 2003, that Nortel would restate its financials for fiscal years 2000, 2001 and 2002.

12. On November 19, 2003, Nortel filed its quarterly report on Form 10-Q for the period ending September 30, 2003, in which it restated approximately $948 million in liabilities (the

"First Restatement"). In December 2003, the Company amended its 2002 Form 10-K and its Forms 10-Q for the first and second quarters of 2003.

13. Nortel's First Restatement, in reality, was a cover-up. The supposedly "comprehensive review" consisted of a superficial and sharply limited review of reserve releases. The review – and thus the First Restatement – did not in any way address the revenue recognition fraud that Dunn, Beatty and Pahapill had engaged in for the fourth quarter of 2000. Moreover, because of the restricted focus of the review, the First Restatement also did not capture a significant number of the improper reserve set-ups and releases that Dunn, Beatty, Gollogly, Hamilton, Johnson, Kinney and Taylor had made in the fourth quarter of 2002 and in the first and second quarters of 2003. This, in turn, concealed any pattern of fraud in the liabilities Nortel restated. Dunn and Beatty continued to mislead the public by claiming that the First Restatement was simply a result of accounting errors that had been made during a volatile period when demand for Nortel's products dropped and the Company underwent a restructuring.

14. Shortly after Nortel announced on October 23, 2003 that it needed to restate its financial statements, Nortel's Audit Committee commenced an independent investigation and hired outside counsel to help it "gain a full understanding of the events that caused significant excess liabilities to be maintained on the balance sheet that needed to be restated," as well as to recommend any necessary remedial measures. The investigation uncovered evidence that Dunn, Beatty and Gollogly, and certain other financial managers, were responsible for Nortel's improper use of reserves in the second half of 2002 and first half of 2003.

15. In March 2004, Nortel suspended Beatty and Gollogly and announced that it would "likely" need to further revise and restate previously filed consolidated financial results. Dunn, Beatty and Gollogly were terminated for cause in April 2004. Hamilton, Johnson, Kinney and Taylor were terminated for cause in August 2004. Pahapill resigned in or about February 2005.

16. On January 11, 2005, Nortel filed its Form 10-K for the period ending December 31, 2003 (the "Second Restatement"), which restated approximately $3.4 billion in misstated revenues and at least another $746 million in liabilities for fiscal years 2001 and 2002 and the first and second quarters of 2003. The financial statement effects of Nortel's two accounting fraud schemes were corrected as of this date, albeit, there remained lingering effects from defendants' internal control and other non-fraud violations. Nortel also disclosed the findings to date of the Audit Committee's independent review, which concluded, among other things, that Dunn, Beatty, Gollogly and other senior finance employees were responsible for Nortel's improper use of reserves in the second half of 2002 and first half of 2003. The Second Restatement, however, did not reveal that Nortel's top executives had also engaged in revenue recognition fraud in 2000.

17. In May 2006, in its Form 10-K for the period ending December 31, 2005 ("2005 Form 10-K), Nortel admitted for the first time that its restated revenues had resulted in part from management fraud, stating that "in an effort to meet internal and external targets, the senior corporate finance management team … changed the accounting policies of the Company several times during 2000," and that those changes were "driven by the need to close revenue and earnings gaps."

18. Throughout their schemes, Dunn, Beatty, Gollogly and Pahapill made materially false and misleading statements and omissions to Nortel's independent auditor in connection with the auditor's quarterly reviews and annual audits of the financial statements that were materially misstated. Among other things, each of these defendants submitted management representation letters to the auditor that concealed their frauds and made false statements, including that the affected quarterly and annual financial statements were presented in conformity with US GAAP, and that they had no knowledge of any fraud that could have a material affect on the financial

statements. Dunn, Beatty and Gollogly also submitted a false management representation letter in connection Nortel's First Restatement, and Pahapill likewise made false management representations in connection with Nortel's Second Restatement.

19. Defendants' schemes resulted in Nortel issuing materially false and misleading quarterly and annual financial statements and related disclosures for at least the financial reporting periods ending December 31, 2000 through December 31, 2003, and in filings made with the Commission that incorporated those financial statements and related disclosures by reference, including registration statements.

20. By engaging in such conduct, each defendant violated Section 17(a) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. § 77q(a)], Sections 10(b) and 13(b)(5) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§ 78j(b) and 78m(b)(5)], and Exchange Act Rules 10b-5 and 13b2-1 [17 C.F.R. §§ 240.10b-5 and 240.13b2-1]. In addition, Dunn, Beatty, Gollogly and Pahapill violated Exchange Act Rule 13b2-2 [17 C.F.R. § 240.13b2-2], and Dunn and Beatty violated Exchange Act Rule 13a-14 [17 C.F.R. § 240.13a-14]. Through their conduct, each defendant also aided and abetted Nortel's violations of Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) [15 U.S.C. §§ 78m(a), 78m(b)(2)(A) and (B)] and Exchange Act Rules 12b-20, 13a-1 and 13a-13 [17 C.F.R. §§ 12b-20, 240.13a-1 and 240.13a-13]. Hamilton, Johnson, Kinney and Taylor also aided and abetted Dunn, Beatty and Gollogly's violations of Exchange Act Section 10(b) and Exchange Act Rule 10b-5.

21. Unless enjoined, each defendant is likely to commit such violations in the future. Each defendant should be permanently enjoined from doing so, ordered to disgorge any ill-gotten gains or benefits derived as a result of his or her violations (whether realized, unrealized or received), and prejudgment interest thereon, and be ordered to pay appropriate civil money penalties. In addition, each defendant should be prohibited from acting as an officer or director

of any issuer that has a class of securities registered pursuant to Exchange Act Section 12 [15 U.S.C. § 78l] or that is required to file reports pursuant to Exchange Act Section 15(d) [15 U.S.C. § 78o(d)].

JURISDICTION AND VENUE

22. The Commission brings this action pursuant to Securities Act Section 20(b) [15 U.S.C. § 77t(b)], and Exchange Act Section 21(d) [15 U.S.C. § 78u(d)].

23. This Court has jurisdiction over this action under Securities Act Sections 20(b) and 22(a) [15 U.S.C. §§ 77t(b) and 77v(a)] and Exchange Act Sections 21(d) and 27 [15 U.S.C. §§ 78u(d) and 78aa].

24. Venue is proper pursuant to Securities Act Section 22(a) [15 U.S.C. § 77v(a)] and Exchange Act Section 27 [15 U.S.C. § 78aa]. Certain of the acts, practices and courses of conduct alleged herein which constitute violations of the Securities Act and Exchange Act occurred within the Southern District of New York, including, but not limited to, transactions in Nortel's common stock which were executed through the facilities of the New York Stock Exchange.

25. The defendants, directly or indirectly, made use of the means and instrumentalities of interstate commerce, of the mails, or of the facilities of a national securities exchange in connection with the acts, practices and courses of conduct alleged herein.

THE DEFENDANTS

26. **Frank A. Dunn**, 53, is a Canadian citizen last known to be residing in Ontario, Canada. Dunn, a Certified Management Accountant, spent his entire career with Nortel and its predecessor companies after graduating from college in 1976. He was CFO of Nortel from March 2000 to October 31, 2001 and was Acting CFO from February 2002 to July 2002. He became Nortel's President and CEO effective November 1, 2001. He was a director of Nortel

beginning in May 2000. Dunn was terminated for cause as President and CEO on April 28, 2004 and he resigned as a director effective May 21, 2004.

27. **Douglas C. Beatty**, 52, is a Canadian citizen and Chartered Accountant last known to be residing in Ontario, Canada. Beatty joined Northern Telecom (Nortel's predecessor) in October 1986 and worked there until December 1995, when he left to work for another company. He returned to Nortel in March 1999 to become its Controller. He was promoted to CFO of Nortel on July 17, 2002. Beatty was placed on leave of absence on March 15, 2004 and, on April 28, 2004, he was terminated for cause.

28. **Michael J. Gollogly**, 48, is a Canadian citizen and Chartered Accountant last known to be residing in Ontario, Canada. Gollogly joined Northern Telecom (Nortel's predecessor) in October 1996 as an Assistant Vice President for Corporate Reporting and subsequently held various positions within the Company. He became Nortel's Controller in July 2002. Gollogly was placed on leave of absence on March 15, 2004 and, on April 28, 2004, he was terminated for cause.

29. **MaryAnne E. Pahapill (a.k.a Mary Anne Poland)**, 46, is a Canadian citizen and Chartered Accountant last known to be residing in Ontario, Canada. Pahapill joined Northern Telecom (Nortel's predecessor) in April 1998 as its Vice President of Corporate Reporting. She was given the additional title of Assistant Controller in February 1999, and held those positions until May 2001. She also served as Nortel's Controller from March 15, 2004 until her resignation, which became effective February 7, 2005. On September 15, 2006, Pahapill notified a Commission staff attorney that she has "reverted" to her legal maiden name of "Mary Anne Poland."

30. **Douglas A. Hamilton**, 44, is a British citizen last known to be residing in Quebec, Canada. Hamilton joined Nortel in 1990 and, from July 2002 until his suspension in April 2004,

he served as the vice president of finance for Nortel's Optical business unit. He was terminated for cause on August 9, 2004.

31. **Craig A. Johnson**, 48, is a US citizen last known to be residing in Frisco, Texas. Johnson joined Nortel in 1995 and, from December 2002 until his suspension in April 2004, he served as the vice president of finance for Nortel's Wireline business unit and was based in Nortel's facilities in Richardson, Texas. Johnson was terminated for cause on August 9, 2004.

32. **James B. Kinney**, 53, is a Canadian citizen last known to be residing in Canada's Northwest Territories. Kinney joined Nortel in 1980 and, from August 2002 until his suspension in April 2004, he served as the vice president of finance for Nortel's Wireless business unit and was based in Nortel's facilities in Richardson, Texas. He was terminated for cause on August 9, 2004. Kinney is a Certified Management Accountant.

33. **Kenneth R.W. Taylor**, 42, is a Canadian citizen last known to be residing in Raleigh, North Carolina. Taylor joined Nortel in 1987 and, from December 2002 until his suspension in April 2004, he served as the vice president of finance for Nortel's Enterprise business unit and was based in Nortel's facilities in Raleigh, North Carolina. Taylor was terminated for cause on August 9, 2004.

OTHERS

34. **Nortel Networks Corp. ("Nortel")** is a Canadian corporation, with principle executive offices in Toronto, Ontario, Canada, and operations world-wide. Nortel's business consists of the design, development, assembly, marketing, sale, licensing, installation, servicing and support for networking solutions. More than one-third of Nortel's full-time workforce was employed in the United States during fiscal years 2000, 2001, 2002, and 2003; and, for each of those years, the majority of Nortel's revenues came from the United States. Nortel's common stock is and at all relevant times was registered with the Commission pursuant to Exchange Act

Section 12(b) and trades publicly on the New York and Toronto Stock Exchanges under the symbol "NT." Nortel also has periodically issued in the United States debt securities that trade on the New York Stock Exchange.

35. **Nortel Networks Ltd. ("NNL")**, a Canadian corporation located in Toronto, Ontario, Canada, is the principle operating subsidiary of Nortel. NNL's common stock is wholly owned by Nortel and its financial statements are reported on a consolidated basis with Nortel's. NNL also files periodic reports with the Commission under its own name. It is a guarantor of certain Nortel debt securities that are registered with the Commission and that trade on the New York Stock Exchange.

THE DEFENDANTS' FRAUDULENT SCHEMES

36. Nortel's top executives had long instilled the Company with an extremely target-driven culture. It was understood across the Company that either missing or exceeding a financial target reflected a failure to manage the Company's business properly. Dunn, as CFO and later as President and CEO, reinforced this culture by, among other things, reviewing and inquiring about particular accounting entries during the quarterly and year-end closing processes, and, more generally, through his constant emphasis on the importance of hitting targets and his well-known disregard for internal accounting and financial controls. In that environment, accounting did not serve to measure Nortel's performance; instead, Nortel's executives and finance managers treated their books as tools to meet the Company's financial objectives.

37. In January 2000, Nortel began reporting its results under US GAAP. It did not, however, update the Company's internal accounting guidelines to conform to US GAAP and, at best, offered sporadic and superficial training to employees. Nortel's executives thereby maintained the ability to – and did – selectively apply or disregard US GAAP concepts as desired to meet Nortel's financial targets.

A. The First Scheme: Revenue Recognition Fraud

38. On July 25, 2000, in an earnings release which Dunn reviewed and approved, Nortel made public its consolidated financial results for the second quarter of 2000 ("Second Quarter 2000 Earnings Release") and announced that it was raising its outlook for the remainder of 2000. The Company's revised outlook primed the market to expect revenue growth from Nortel that exceeded 40 percent for the year, up from Nortel's previous guidance of 30 to 35 percent, and to expect operating earnings growth in the "high 30s." Dunn participated in an earnings conference with analysts on the same day ("Second Quarter 2000 Earnings Call"), in which analysts were told that Nortel's second quarter results and its newly-announced expectations for the year were attributable to the performance of its optical business:

> This is being driven obviously by a very, very strong performance of our optical business. Revenue growth in optical in [the second] quarter was, once again, 150%. I think the last time that we had this call we talked about our ambitions to break $10 billion of shipments in optical business this year. Now we feel quite comfortable we'll exceed that number and we'll have a number for the year that will be somewhere north of $10 billion of shipment for the year.

Nortel's then-CEO, John Roth, even suggested in September 2000, that optical revenues might possibly reach $12 billion. The Second Quarter 2000 Earnings Release also attributed Nortel's revised growth expectations to "the momentum we have been experiencing during the first half of this year, supported by an 85 percent increase in order input and a 1.35 book to bill in the quarter." With respect to the third quarter of 2000, Dunn told analysts: "We are gaining momentum so we do have a very solid quarter coming."

1. *Third Quarter 2000: Dunn And Others Withhold Nortel's Changing Internal Expectations From The Public*

39. Not long after releasing its second quarter 2000 financials, Nortel experienced a softening of orders, which, in turn, caused it internally to lower its expectations for the remainder

of the year. Dunn was informed of this no later than September 15, 2000. On that date, Dunn received from one of Nortel's finance vice presidents a set of charts – containing internal forecasts for the business units – which showed that Nortel was expected to miss third quarter 2000 revenue targets by at least $405 million, and third quarter 2000 earnings targets by at least $506 million. The finance vice president succinctly described the situation to Dunn as follows: "Frank, as discussed. Its [sic] not pretty."

40. By October 17, 2000, Nortel determined that its yearly revenues were off by more than $1 billion from expectations. Nortel's business unit finance personnel noted:

- "Lost $1.9 [billion in] 2nd half [2000] revenue over last 4 weeks";
- "Margin shows no sign of recovery"; and
- "1st half 2001 already $1.5 [billion] off expectation."

Anticipated orders from multiple large customers were, in some cases, below expectations by hundreds of millions of dollars. The optical sales forecast was at least $500 million below the $10 billion level for which Nortel had primed the market. At the time, it was also noted that third quarter 2000 revenues were $900 million less than Nortel originally had budgeted. Further, as of October 17, 2000, Nortel's expected fourth quarter 2000 earnings were at least $320 million short of the amount needed to meet consensus earnings per share. This information was shared with Dunn.

41. Dunn and Beatty knew of Nortel's worsening condition, yet, did not share this information with the public. Instead, Nortel continued to make optimistic forecasts which, by this point, Dunn and Beatty knew or were reckless in not knowing, could not be met through Nortel's operations alone.

42. In an earnings release dated October 24, 2000, Nortel made public its consolidated financial results for the third quarter of 2000 ("Third Quarter 2000 Earnings Release"). The

release reported third quarter revenues of $7.31 billion and net earnings of $574 million (or $0.18 per share). Dunn reviewed, approved and is quoted in the release. Although Nortel's earnings for the quarter exceeded analyst expectations by 1 cent per share, analysts expressed concern that revenues came in at the low end of the expected range of $7.3 billion to $7.8 billion.

43. During Nortel's October 24, 2000 earnings call ("Third Quarter 2000 Earnings Call"), which Dunn participated in, analysts expressed concern about Nortel's sales of optical internet gear and questioned whether Nortel expected lower optical sales for the remainder of 2000. Dunn responded by reassuring analysts that Nortel expected to sell out of its optical gear in the fourth quarter. He rejected the suggestion that there was a slow-down in performance or growth and instead partially blamed third quarter results on, among other things: (i) slow installations of optical equipment and (ii) customers who were working through existing supplies but were expected to place orders in the fourth quarter of 2000. Nortel told the public there was no change in its guidance for 2000 and reaffirmed its prior-announced growth expectations for 2000, stating: "We continue to expect that our percentage growth in revenue and earnings per share from operations in 2000 … will be in the low 40's." Nortel also continued to predict that "annual optical equipment sales will surpass $10 billion" in 2000, albeit, there was no mention of the $12 billion optical sales figure that Nortel's CEO had mentioned as a possibility in September 2000. The market reacted negatively, and Nortel's stock price fell more than 34 percent over the course of the next two days.

44. External pressure to increase revenues (particularly from sales of optical equipment, which, at the time, made up a significant portion of Nortel's revenues and were closely followed by analysts) mounted. Nortel – through the actions of Dunn, Beatty and Pahapill – embarked on a scheme to manipulate its results for the remainder of 2000 through accounting changes.

2. Fourth Quarter 2000: Dunn, Beatty and Pahapill ***<u>Manipulate Nortel's Revenue Recognition Policies To Meet Targets</u>***

45. In late October 2000, Beatty held meetings with Pahapill and other senior finance managers to discuss ways to increase Nortel's revenues (particularly optical revenues) for the remainder of 2000. Among the issues discussed were Nortel's then-current revenue recognition policies and the effect of such policies on Nortel's ability to reach its revenue targets for 2000.

46. Beatty and Pahapill – and certain other finance managers – were particularly eager to find a solution for the hundreds of millions of dollars in inventory (consisting primarily of optical products) sitting in Nortel's warehouses and offsite storage locations. Revenues could not be recognized for this inventory because US GAAP revenue recognition rules generally require goods to be delivered to the buyer before revenue can be recognized.

47. Nortel's inventory levels had grown, in part, because orders for its optical inventory had slowed and Nortel had experienced installation delays. Additionally, in June 2000, Nortel banned bill and hold transactions from its sales and accounting practices. A bill and hold transaction is one where the customer agrees to purchase a product but the seller (here Nortel) retains physical possession until the customer can accept delivery. US GAAP permits revenue from a bill and hold transaction to be recognized prior to delivery, if certain stringent criteria, described in Paragraph 50 below, are met. Once revenues are recognized, the product no longer appears on the seller's books as inventory. When Nortel banned bill and hold transactions in June 2000, it no longer could recognize as revenue, or remove from inventory, equipment that had been sold but not yet delivered. Beatty and Pahapill – with Dunn's knowledge and acquiescence – had banned bill and hold transactions in June 2000 because they had concluded that US GAAP requirements for such transactions were too difficult to meet, that such transactions were being "scrutinized" by the Commission, and also because second quarter 2000

revenues were sufficiently robust without the use of such transactions. However, throughout the third and fourth quarters of 2000, as revenue pressures increased, and as Wall Street increasingly focused on Nortel's optical numbers, pressure mounted within Nortel to repeal the ban. The ban on bill and hold transactions was short-lived.

a. Reintroduction Of Bill And Hold Transactions

48. In late October 2000, as a first step toward re-introducing bill and hold transactions into Nortel's sales and accounting practices, Beatty and Pahapill asked Nortel's outside auditor Deloitte & Touche LLP ("Deloitte") to explain, among other things, (i) "[u]nder what circumstances can revenue be recognized on product (merchandise) that has not been shipped to the end customer?" and (ii) whether merchandise accounting can be used to recognize revenues "when installation is imminent" or "when installation is considered to be a minor portion of the contract"?

49. On November 2, 2000, Deloitte presented Beatty and Pahapill with a set of charts which, among other things, explained the US GAAP criteria that must be met in order for revenues to be recognized prior to delivery (including additional factors to consider for bill and hold transactions) and also provided an example of a customer request for a bill and hold sale "that would support the assertion that Nortel should recognize revenue" prior to delivery.

50. US GAAP permits revenue from a bill and hold transaction to be recognized prior to delivery of the goods only if certain stringent criteria are met, including: (i) risk of ownership must have passed to the buyer; (ii) the buyer must have made a fixed commitment to purchase the goods; (iii) the buyer (not the seller) must request the transaction be on a bill and hold basis, and must have a substantial business purpose for ordering the goods on a bill and hold basis; (iv) there must be a fixed schedule for delivery of the goods; (v) the seller must not have retained any specific performance obligations such that the earnings process is not complete; (vi) the

ordered goods must be segregated from the seller's inventory and not used to fill other orders; and (vii) the goods must be complete and ready for shipment. Also relevant to the analysis is whether the seller has modified its normal billing terms, whether the buyer has the expected risk of loss in the event of a decline in the market value of the goods, and whether the seller's custodial risks are insurable and insured. If all of the above criteria are not met, revenue recognition must be deferred until either the bill and hold criteria have been satisfied or physical delivery has occurred.

51. Beatty and Pahapill largely ignored Deloitte's guidance and, on November 7, 2000, Pahapill distributed to certain Nortel accounting and finance personnel different revenue recognition guidance that she and Beatty had drafted. The Nortel guidance – consisting of a handful of PowerPoint charts – omitted key portions of the Deloitte presentation relating to US GAAP. For example, in discussing bill and hold transactions, the Nortel guidance contained no mention that (i) the customer must request that the transaction be on a bill and hold basis or (ii) the customer must have a substantial business purpose for ordering the goods on a bill and hold basis. Other US GAAP criteria were omitted from the Nortel guidance as well.

52. Deloitte had reviewed the Nortel guidance before November 7, 2000, and warned Pahapill that it was too brief and did not give the intended users – Nortel's accounting and finance personnel – sufficient information to always make the correct assessment of the appropriate accounting treatment. Deloitte asked Pahapill to distribute its guidance as well. Pahapill declined. She deflected Deloitte's concerns by asserting that her charts were merely tools meant to encourage Nortel's accounting and finance personnel to bring questions to her about revenue recognition. The truth was very different. Pahapill concealed the fact that Nortel intended to urge multiple customers to enter into bill and hold transactions in order to boost

fourth quarter 2000 revenues, and that the charts would be distributed to Nortel personnel as part of that effort.

53. The Nortel guidance reintroduced bill and hold transactions into Nortel's sales and accounting practice in November 2000. This reversal in Nortel's approach to bill and hold transactions was designed to improve inventory levels, including particularly the level of optical inventory, which had been a strong focus of the third quarter earnings conference, and to assist Nortel in meeting its public revenue forecasts for 2000. By choosing not to explain US GAAP requirements for bill and hold transactions to Nortel's employees, Beatty and Pahapill retained the ability to control the accounting for bill and hold transactions and to manipulate Nortel's revenues. Dunn knew or was reckless in not knowing of the existence and purpose of this accounting change.

54. On November 8, 2000, Beatty informed recipients of Nortel's revenue recognition guidance – certain Nortel accounting and finance employees – that Nortel was having difficulty meeting its fourth quarter 2000 revenue targets and that bill and hold transactions were being reintroduced to assist Nortel in meeting those targets. Beatty directed them to formulate a plan to implement the new guidance.

55. A few days after the November 8, 2000 conference call, accounting and finance employees sent a plan to Beatty and Pahapill. The plan was for Nortel's sales force to approach and urge certain customers to execute so-called "risk of loss letters" (Nortel's parlance for bill and hold transactions) for undelivered inventory. Customers that were unlikely to take delivery of ordered inventory by year-end were to be identified and targeted. Beatty and Pahapill understood that the proposed plan would lead to transactions that were not consistent with US GAAP, or Deloitte's guidance, but, they approved the plan anyway, with Dunn's knowledge and acquiescence or recklessness, and Nortel's fraud was thereby set in motion.

56. Starting in November 2000, Nortel systematically approached targeted customers and urged them to execute risk of loss letters. Customers that previously had placed orders were approached and asked to restructure their agreements. Customers that told Nortel they expected to place orders and take delivery in 2001 were provided incentives to execute risk of loss letters in 2000. New customers were asked to execute risk of loss letters too. Nortel induced such customers with offers of price discounts, interest deferments and extended billing terms. The vast majority of transactions entered into had no substantial business purpose for the buyer. Pahapill reviewed and approved many of these transactions.

57. Dunn, Beatty and Pahapill knew, or were reckless in not knowing, that Nortel's risk of loss letters did not comply with US GAAP requirements and, thus, that revenue could not be recognized on these transactions prior to delivery. They also knew, or were reckless in not knowing, that the primary reason for reintroducing bill and hold transactions at Nortel was to accelerate revenues on optical transactions to enable Nortel to meet its revenue forecasts for 2000.

58. Beatty and Pahapill also knew, or were reckless in not knowing, that Nortel's risk of loss letters had been structured in a manner that concealed the true nature of the transactions and that was intended to deceive Nortel's outside auditors, who would be the only persons outside of the transacting parties to see these letters. Specifically, while US GAAP requires bill and hold transactions to be customer-initiated, Beatty and Pahapill's guidance did not mention this requirement, but rather, provided a sample risk of loss letter for Nortel's employees to follow and instructed employees merely that the transactions must be evidenced on customer letterhead. Nortel employees took this guidance and typically drafted the letters themselves and forwarded the drafts to customers for printing on customer letterhead. Beatty and Pahapill were aware that the customer letterhead requirement in their guidance was merely a fiction designed to provide

audit evidence to mislead Nortel's outside auditors into believing that the risk of loss letters had been customer-initiated.

59. In late November 2000, Nortel compliance personnel – certain employees responsible for analyzing and providing guidance on accounting questions – learned of the manner in which Nortel was obtaining risk of loss letters. They raised concerns with Beatty and Pahapill that such transactions may not comply with US GAAP. Beatty convened a conference call on December 8, 2000, to respond. On this call, Beatty told the compliance personnel that it did not matter who initiated a bill and hold transaction as long as it was written on customer letterhead. He then directed Nortel's compliance personnel to stop mentioning the customer-initiation requirement to Nortel's salespeople and customer account managers.

60. In sum, Beatty and Pahapill – with Dunn's knowledge and acquiescence or recklessness – directed a campaign to accelerate revenues into 2000 through improper bill and hold transactions, despite knowing that such transactions did not satisfy US GAAP requirements and, accordingly, that revenues were not permitted to be recognized on such transactions prior to delivery.

61. As part of its Second Restatement, Nortel reversed approximately $1 billion in revenues that had been recognized in the fourth quarter of 2000 through these improper bill and hold transactions.

b. Recognition Of Revenues On Sales To A Pass-Through Entity

62. In the fourth quarter of 2000, Nortel also improperly recognized millions of dollars in revenues upon delivery of its goods to Telamon Corporation ("Telamon"), a pass-through entity for certain business deals.

63. Nortel used Telamon, a minority-owned business, to satisfy the business requirements of certain Nortel customers. Those customers were required to make a percentage of purchases from minority- or women-owned businesses; accordingly, rather than purchase Nortel's products directly from Nortel, they purchased Nortel's products from Telamon.

64. Nortel recognized revenue when it delivered goods to Telamon. Telamon, however, did not accept the risks of ownership of the Nortel products. It could not (and did not) pay for the products until such products had been resold and Telamon had received payment from the end customer. Telamon also routinely returned unsold products to Nortel. Indeed, in 2000, Telamon returned hundreds of millions of dollars of goods to Nortel that it was unable to resell due to softening orders.

65. Beatty knew, or was reckless in not knowing, that Telamon served merely as a pass-through entity, yet, he allowed Nortel to recognize revenues throughout 2000 upon delivery of Nortel's products to Telamon. This did not comport with US GAAP which provides, generally, that revenue from sales to intermediate parties for resale should be recognized only when the risks and rewards of ownership have passed. When, as here, the reseller is acting, in substance, as an agent, the sale is treated as a consignment sale and revenue should not be recorded until the reseller delivers the product to the end user.

66. In the fourth quarter of 2000, Beatty considered but rejected the idea of changing Nortel's policy so that revenues would not be recognized on Telamon sales until the end customer had paid for the goods. Dunn, Beatty and Pahapill likewise discussed but decided against correcting the policy during the 2000 year-end closing process. The decision, both times, was influenced by the fact that changing the practice would negatively impact Nortel's optical revenues.

67. Nortel improperly recognized approximately $150 million in revenues for sales to Telamon in the fourth quarter of 2000. These revenues were ultimately reversed by Nortel's Second Restatement and, starting in 2001, Nortel began to recognize revenues on Telamon sales when the risk of ownership had passed to the end customer.

c. The Partial Reversal Of Revenues In Response To The Success Of Bill And Hold Transactions

68. The revenue recognition manipulations that Dunn, Beatty and Pahapill engaged in during 2000 pulled in more revenues than were necessary for Nortel to meet its publicly-announced revenue guidance for 2000. It was apparent no later than the first week of January 2001 that Nortel would exceed its targets for fiscal year 2000 by at least $500 million. Indeed, on January 5, 2001, Nortel's corporate financial planning group concluded that "[e]arnings are there, but [r]evenue is too high." Dunn, Beatty and Pahapill reacted by selectively reversing certain low margin, non-optical revenue items during the fiscal 2000 year-end closing process. The point of the effort was to bring Nortel's revenues in line with its guidance for 2000, while at the same time preserving Nortel's optical revenues and consolidated earnings results.

69. On January 5, 2001, Beatty directed Pahapill and several of Nortel's vice presidents of finance to find low margin, non-optical revenue entries for reversal. Nortel's finance managers responded by carefully searching for low margin, non-optical items for reversal. They submitted proposed reversal entries to Pahapill for consideration.

70. On January 7, 2001, Dunn, Beatty, Pahapill and others held a conference call to discuss the proposed reversal entries in detail and to cull from the list those entries that would accomplish the result they sought. They reviewed each proposed entry, determined its impact on overall revenues, optical revenues and consolidated earnings, and then selected specific entries to reverse, based upon their impact. Certain bill and hold transactions had been proposed for

reversal, but, because those transactions primarily impacted optical revenues, they were not selected for reversal. This process enabled Dunn, Beatty and Pahapill to precisely engineer Nortel's fourth quarter 2000 results such that Nortel met but did not exceed public forecasts.

71. Beatty and Pahapill acted to conceal Nortel's activities from Deloitte. On January 8, 2001, a Nortel employee who worked closely with Pahapill and was involved in the reversal effort sent a "confidential" email to other participants in which he wrote, "we need to ensure that we have a crisp story on why we reversed these entries for the auditors that will be in today." On or about the same day, and in anticipation that Deloitte would notice and question the reversals, Beatty misleadingly told a Deloitte partner that Nortel had reversed certain revenue entries as part of a normal-course review conducted during its year-end closing process. Beatty said the reversals resulted from a complete scrub of revenue entries. In their discussions with Deloitte, neither Beatty nor Pahapill explained the criteria under which revenue entries had been reversed, or the true reason for their reversal.

72. Further, on or about February 1, 2001, in connection with Deloitte's annual audit of Nortel for 2000, Dunn and Beatty provided Deloitte with a management representation letter – printed on Beatty's letterhead – which falsely represented, among other things:

(a) The consolidated financial statements for the period ending December 31, 2000, are presented in conformity with US GAAP;

(b) The unaudited interim financial information accompanying Nortel's financial statements has been prepared and presented in conformity with US GAAP and Commission guidance applicable to interim financial information;

(c) There have been no irregularities involving management or employees who have significant roles in the system of internal control or other employees or that could have a material effect on the financial statements;

(d) There are no violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency; and

(e) There are no significant transactions that have not been properly recorded in the accounting records underlying the financial statements.

d. Nortel's Materially False And Misleading *<u>Fourth Quarter 2000 Earnings Release and 2000 Form 10-K</u>*

73. Beatty and Pahapill were responsible for preparing Nortel's consolidated financial statements for the fourth quarter and year-end 2000. Pahapill, in her role as Vice President of Corporate Reporting, was also responsible for compiling and preparing disclosures for Nortel's annual report on Form 10-K for the period ending December 31, 2000 ("2000 Form 10-K"). Dunn participated in the preparation of the fourth quarter and year-end 2000 financial statements and reviewed and approved the financial statements prior to their public release. Dunn also signed the 2000 Form 10-K.

74. On January 18, 2001, in an earnings release which Dunn reviewed and approved, Nortel made public its consolidated financial results for the fourth quarter of 2000 ("Fourth Quarter 2000 Earnings Release"). The release reported revenues of $8.82 billion for the fourth quarter (a 34% increase from the corresponding quarter in 1999) and revenues of $30.28 billion for the year (a 42% increase from 1999). The release stated that "the fourth quarter capped a year of exceptional growth, which was in line with … expectations." It touted, among other things, Nortel's optical revenues, which "topped $10 billion for the year, more than doubling 1999 revenues" and attributed its optical revenues to "strong growth" in the United States and other geographic regions. Dunn confirmed Nortel's financial guidance for 2001, saying that Nortel expected revenue and earnings to grow by 30 percent in 2001, a lower growth rate than in prior years.

75. Dunn, and others, carefully crafted the timing of Nortel's Fourth Quarter 2000 Earnings Release to mislead investors about Nortel's performance just long enough for Nortel to complete a $2.5 billion acquisition in February 2001. Specifically, on February 13, 2001, with

the benefit of an artificially-inflated share price, Nortel paid $2.5 billion to acquire 980 NPLC, JDS Uniphase's Zurich, Switzerland-based subsidiary and related assets in New York. Nortel issued 65.7 million shares of common stock as consideration for the purchase. The price of those shares was artificially inflated because it was based on Nortel's fraudulent fourth quarter 2000 results (announced on January 18, 2001), and because Nortel predicted strong growth in 2001, despite knowing that its business was softening and that it had drawn revenues out of 2001 in order to meet its fourth quarter 2000 forecasts.

76. On March 13, 2001, Nortel filed its 2000 Form 10-K with the Commission. The 2000 Form 10-K reported revenues of $8.818 billion for the fourth quarter of 2000 and $30.275 billion for the year and represented that the financial statements therein were prepared in conformity with US GAAP.

77. Dunn, Beatty and Pahapill caused Nortel to report materially overstated fourth quarter and year-end 2000 revenues in its Fourth Quarter 2000 Earnings Release and its 2000 Form 10-K. Specifically, at the time, absent the reintroduction of improper bill and hold transactions into Nortel's accounting and sales practices and absent Nortel's improper accounting for Telamon sales, Nortel would have reported fourth quarter revenues of approximately $7.64 billion (13% less) and year-end revenues of approximately $29.10 billion (4% less).

78. Dunn, Beatty and Pahapill knew, or were reckless in not knowing, that the Fourth Quarter 2000 Earnings Release misrepresented and/or omitted at least the following facts, disclosure of which was necessary to make the statements made not misleading:

(a) The accounting changes implemented by Dunn, Beatty and Pahapill in the fourth quarter of 2000 caused Nortel to materially overstate revenues and understate net losses for the fourth quarter and fiscal year 2000. Specifically, Dunn, Beatty and Pahapill had implemented accounting changes which reintroduced bill and hold transactions into Nortel's sales and accounting practices. Such transactions did not comply with US GAAP and resulted in the premature recognition of approximately $1 billion of revenues in the fourth quarter of 2000. These accounting adjustments had a particularly positive impact on Nortel's optical revenues for 2000, and were implemented specifically to assist the Company in meeting its public guidance. Absent these manipulations, Nortel could not have met its revenue (much less its optical revenue) guidance for the fourth quarter and fiscal year 2000.

(b) Dunn's statement about "strong growth" in the United States was materially false and misleading because, as Dunn knew or was reckless in not knowing, Nortel had entered into bill and hold transactions principally with U.S. customers, which, in turn, materially increased U.S. revenue growth.

(c) Dunn's statement about the expected growth rate of 2001 revenue and earnings was materially false and misleading because, as Dunn knew or was reckless in not knowing, one of the reasons why revenues were expected to grow more slowly in 2001 was that Nortel's improper acceleration of revenues in 2000, through bill and hold transactions and consignment sales, had cannibalized part of Nortel's 2001 revenues.

79. Dunn, Beatty and Pahapill knew, or were reckless in not knowing, that the 2000 Form 10-K misrepresented and/or omitted at least the following material facts, disclosure of which was necessary to make the statements made not misleading:

(a) The 2000 Form 10-K falsely represented in Note 2 to the financial statements and Item 7 (Management's Discussion and Analysis of Financial Condition and Results of Operations) that Nortel's consolidated financial statements for

2000 had been prepared in accordance with US GAAP. This statement was materially false and misleading because, through the actions of Dunn, Beatty and Pahapill, Nortel had prematurely recognized revenue on bill and hold transactions that did not satisfy US GAAP. Nortel's revenues for 2000 would have been approximately $1 billion lower and its net loss materially higher if revenues on the improper bill and hold transactions had been recognized at the time of delivery, in accordance with US GAAP. This statement was materially false and misleading for the additional reason that, through the actions of Dunn, Beatty and Pahapill, Nortel had prematurely recognized revenue on consignment sales when its products were delivered to the consignee, Telamon. If revenues on sales to Telamon had been recognized in accordance with US GAAP, Nortel's revenues for 2000 would have been lower by approximately an additional $150 million.

(b) The 2000 Form 10-K also falsely represented in Note 2 to the financial statements that Nortel had adopted the recommendations of the Commission's "Staff Accounting Bulletin: No. 101 – Revenue Recognition in Financial Statements" ("SAB 101") effective January 1, 2000 and that "[t]he application of SAB 101 did not have a material adverse effect on the business, results of operations or financial condition of [Nortel]." SAB 101 sets forth certain criteria that must be met in order for a company to recognize revenue on bill and hold transactions prior to delivery. This statement was materially false and misleading because Nortel, through the actions of Dunn, Beatty and Pahapill, had rejected SAB 101 and had recognized revenues on bill and hold transactions that did not satisfy either SAB 101 or other US GAAP cited within SAB 101. Moreover, the revenue that it recognized pursuant to such improper bill and hold arrangements was material to an understanding of Nortel's business, results of operation and financial condition. Specifically, Nortel recognized approximately $1 billion from improper bill and hold transactions entered into during the fourth quarter of 2000. If Dunn, Beatty and Pahapill had adopted the recommendations of SAB 101, as Nortel said, Nortel's revenues for fiscal year 2000 would have been approximately $1 billion lower than reported and its revenues from optical equipment sales would have been particularly negatively affected.

(c) The 2000 Form 10-K also purported to describe Nortel's revenue recognition policies in Note 2 to its financial statements. Nortel thereby created the impression that all revenues had been recognized in accordance with the enumerated policies. This was materially false and misleading because the manner in which Nortel had accounted for bill and hold transactions in the fourth quarter of 2000 and fiscal year 2000 did not comport with any of the disclosed policies.

(d) The 2000 Form 10-K, in comparing Nortel's 2000 results against its 1999 results, attributed Nortel's revenue growth to "[t]he considerable increase in sales of optical networking systems" in 2000, which it said was "driven by substantial growth across all regions…." This statement omitted to disclose that a material part of the growth in Nortel's 2000 optical revenues (approximately $1 billion) was attributable not to natural growth, but rather, to Nortel's improper use of bill and hold transactions.

(e) Dunn and Beatty also knew that they had provided Nortel's outside auditors with a materially false and misleading management representation letter in connection with their audit of Nortel's financial statements.

80. The revenue figures that were misstated in the 2000 Form 10-K affected future public filings which incorporated those figures by reference, including, but not limited to: (i) Nortel's Forms 10-Q for the periods ended March 31, 2001, June 30, 2001 and September 30, 2001 (respectively, "First Quarter 2001 Form 10-Q," "Second Quarter 2001 Form 10-Q" and "Third Quarter 2001 Form 10-Q"), (ii) Nortel's Form 10-K for the period ended December 31, 2001 ("2001 Form 10-K"), (iii) Nortel's Forms 10-Q for the periods ended March 31, 2002 and June 30, 2002 (respectively, "First Quarter 2002 Form 10-Q" and "Second Quarter 2002 Form 10-Q"), (iv) Nortel's Form 10-K for the period ended December 31, 2002 ("2002 Form 10-K"), (v) Nortel's Form 10-K/A for the period ended December 31, 2002 ("Amended 2002 Form 10-K"), (vi) Nortel's Forms 10-Q/A for the periods ended March 31, 2003 and June 30, 2003 (respectively, "Amended First Quarter 2003 Form 10-Q" and "Amended Second Quarter 2003 Form 10-Q"), (vii) Nortel's Form 10-Q for the period ended September 30, 2003 ("Third Quarter 2003 Form 10-Q") and (vii) all of Nortel's Forms S-3, S-4 and S-8 filed with the Commission from March 23, 2001 through August 5, 2003.

B. <u>The Second Scheme: Earnings Management Fraud</u>

81. Nortel suffered serious losses in 2001 due to a widespread economic downturn that impacted the entire telecommunications industry. It implemented a company-wide restructuring plan, which resulted in the dismissal of two-thirds of its workforce (approximately 60,000 employees), real estate closures and dispositions, write-downs of capital assets, goodwill and other intangible assets, and contract settlements with customers and suppliers.

82. Dunn became CEO in October 2001, and, in January 2002, for the first time since it began its restructuring, Nortel again began to issue forward-looking earnings guidance to Wall Street.

83. During the summer of 2002, as Nortel began to emerge from its downturn, Dunn told the investment community that he expected to return Nortel to profitability by the second quarter of 2003. The Company established a "return to profitability" ("RTP") bonus program to spur Nortel's employees toward that goal.

84. Starting no later than the fourth quarter of 2002, Dunn, Beatty (then CFO) and Gollogy (then Controller) – with the active participation of Hamilton, Johnson, Kinney and Taylor (the vice presidents of finance of Nortel's four business units) – embarked on a scheme to improperly establish and maintain reserves and later improperly release reserves in a calculated effort to manage the Company's earnings and deceive investors. The efforts of these defendants turned Nortel's unexpected fourth quarter 2002 *pro forma* profit into a reported loss and its first quarter 2003 loss into a reported profit; and, but for their inability to make all of the reserve releases they intended to make in the second quarter of 2003, their efforts also would have turned Nortel's second quarter 2003 loss into a reported profit. The second quarter 2003 loss nonetheless was largely erased as a result of these defendants' efforts.

1. The Establishment And Maintenance Of Excess Reserve Balances At Nortel

85. It was long-standing practice across Nortel to establish reserves on a "worst-case" basis, which, in practice, meant at an amount equal to the maximum possible exposure. This approach did not comply with US GAAP and resulted in the creation of reserves in amounts that far exceeded the Company's reasonable expectations for future liabilities.

86. US GAAP states that an anticipated liability can be accrued (i.e., a reserve can be established) if it is "probable" – meaning that "[t]he future events are likely to occur" and "the amount of the loss can be reasonably estimated." If the anticipated liability falls within a range, the accrual must be based on the best estimate. Where no estimate within the range is better than any other, US GAAP requires the accrual to be set at the bottom of the range. US GAAP does not permit for reserves to be established outside of these criteria.

87. US GAAP requires reserves to be released in the quarter in which they no longer are needed. If the excess amount is not released on a timely basis – i.e., if it is not released when the liability for which it was created has been resolved and an excess determination has been made – the company must disclose the effect of the release on the current period (if it is material) and the company must also disclose what the effect would have been if the reserve had been timely released, and it may be required to restate previous financial statements.

88. Dunn in particular ensured that reserves would be established in excess of the Company's liabilities by making it known that he would not tolerate unanticipated losses where reserves had not been set high enough. Dunn communicated to employees that he wanted to deal with liabilities once and not readdress them in the future. His management style was gruff and he was known to lash out in anger at employees who did not establish sufficient reserves. Those actions helped to maintain a culture that led to the establishment and maintenance of unnecessary reserves.

89. Dunn and others also encouraged Nortel's finance managers across the Company to establish excess reserves when their quarterly results exceeded forecasts. When Gollogly became Nortel's Controller, in 2002, he told Kinney – his successor in the Wireless business unit – that he had left the unit's balance sheets padded with excess reserves. As Gollogly later explained in an email to his subordinates in the Controller's office, "[Nortel's] general approach

is to sand bag good news and close 'hard' to the forecast." These practices, and others, led to the establishment and maintenance of unnecessary reserves across the Company, including at the business unit and regional operations levels.

90. In addition to establishing excess reserves as part of the normal course of business, Nortel also "topped up" existing reserve accounts in 2001, when it underwent its company-wide restructuring. Specifically, in connection with the restructuring, Nortel established massive reserves for severance and fringe benefits costs, lease termination costs, and costs related to the disposal of assets, but, on top of that, it added arbitrary excess amounts for reasons having nothing to do with actual anticipated liabilities.

a. __Quantification Of Existing Excess Reserves__

91. By the summer of 2002, investment analysts began to question why Nortel's accrued liabilities remained so high given that, by this point, Nortel had undergone a restructuring and was about one-third of its former size. Analysts questioned whether Nortel could satisfy its still enormous lingering liabilities.

92. Beatty assured analysts that Nortel could meet its obligations. He then directed Nortel's Assistant Controller to ascertain the quantity and status of Nortel's reserve balances company-wide. Nortel's corporate consolidation staff, over the next few months, compiled data showing hundreds of millions of dollars in excess reserves across the Company.

93. Hamilton, Kinney and Taylor oversaw the balance sheet review process for their respective business units and, as a result, each was aware of the amount of excess reserves held on his business unit's balance sheet. Wireline was not a separate business unit until December 2002, and, thus, did not participate in the initial survey.

94. Hamilton learned during the review process that the Optical unit was holding approximately $21 million in excess reserves. He reported this amount to Nortel's corporate

consolidations staff in October 2002. Kinney reported $36 million in excess reserves to the corporate consolidations staff in October 2002; although, at the time, he knew Wireless held a significantly higher amount of excess reserves on its balance sheet. Taylor instructed his staff to report that the Enterprise unit held no excess reserves, but, at the time, he knew that Enterprise held excess reserves and subsequently he learned there were at least $55 million in excess reserves on the Enterprise balance sheet.

95. Johnson coordinated the balance sheet reviews for the Wireline unit when he became the vice president of finance for Wireline in December 2002. His staff estimated, in December 2002, that the Wireline unit held over $10 million in excess reserves. Hamilton, Kinney and Taylor and their staffs track excess reserves for their units from October 2002 forward and Johnson and his staff tracked excess reserves for the Wireline unit from December 2002 forward.

96. In October 2002, Beatty and Gollogly were informed that Nortel was carrying on its balance sheets at least $303 million in excess reserves company-wide. Among the reserve accounts identified to Beatty and Gollogly were the following corporate-level accounts:

F. Dunn Discretionary Provision (a/k/a Degree of Difficulty Provision)
Intercompany Out of Balance
R&D Out of Balance
Short Close Exposure
EDSN Minority Interest
Montreal Consolidation
QST Provision
Siemens Settlement
Global Crossing
QWEST
General Provision

Some of these reserve accounts had loosely-identified purposes. One account was simply labeled “General Provision,” which the corporate control staff described as “left in place per Doug Beatty.” Another account labeled “F. Dunn Discretionary Provision” was described by

Nortel's corporate control staff as "left in place per Frank Dunn." Other reserve accounts were maintained on justifications that shifted from period to period.

97. Beatty and Gollogly informed Dunn, in early November 2002, of the size of Nortel's excess reserves. Under US GAAP, because these known excess reserves would have been material to Nortel's fourth quarter 2002 results, they should have been released during the quarter and disclosed publicly; and, Nortel should have evaluated the need to restate its financial results to reflect the proper periods into which the reserves should have been released. Dunn, Beatty and Gollogly instead concealed the amount and nature of these reserves and maintained them for future earnings management purposes as needed. Hamilton, Johnson, Kinney and Taylor likewise chose not to immediately release the known excess reserves from their business unit books and records during the fourth quarter of 2000; instead, they improperly maintained such reserves for future use in managing their business unit results and, in turn, managing the Company's results.

b. <u>Creation of Additional Excess Reserves</u>

98. Dunn and Beatty had groomed market expectations throughout 2002 by telling investment analysts that their goal was to return Nortel to profitability by the second quarter of 2003. On July 18, 2002, during Nortel's second quarter 2002 earnings call, Dunn told analysts that "by June of next year I expect to … turn profitable." Beatty reiterated this guidance on October 17, 2002, during Nortel's third quarter 2002 earnings call, when he told analysts:

> We are continuing to target profitability by the second quarter of 2003…. This drive to profitability is based on the targeted breakeven model of the quarterly revenues of below $2.4 million. Having further worked with specific plans in recent weeks, we expect to support this business model with approximately 35,000 people and expect to have most of the actions completed by the end of 2002.

Dunn and Beatty thereby conveyed the impression that Nortel's performance was stabilizing and marching consistently toward profitability under their management.

99. By late December 2002, however, Nortel internally had determined that it would show a *pro forma* profit for the fourth quarter of 2002, two quarters earlier than expected. (At the time, Nortel reported *pro forma* figures alongside its US GAAP results and therefore its *pro forma* profit for the fourth quarter of 2002 would have been reported publicly.) This information was conveyed to Dunn, Beatty and Gollogly, but, was unexpected by them and contrary to: (i) Dunn and Beatty's statements to the public in October 2002 that they expected Nortel to return to profitability in the second quarter of 2003 and (ii) Dunn and Beatty's statements to Nortel's Board of Directors in December 2002, that they anticipated a loss of approximately $65 million for the fourth quarter of 2002. Moreover, a *pro forma* profit would trigger payouts under Nortel's "return to profitability" ("RTP") bonus program. Dunn believed investors would not react favorably to the payment of millions of dollars of bonuses at the end of a year in which the Company lost over $3 billion from its continuing operations.

100. Dunn and Beatty reacted to this unexpected news of a fourth quarter 2002 *pro forma* profit by ordering the establishment of additional excess reserves company-wide to ensure that Nortel instead would post a loss for the fourth quarter of 2002, in line with the public's expectations and the expectations of Nortel's Board of Directors. Among their concerns, at the time, was that Nortel might show a loss in the first quarter of 2003, and, thus, any fourth quarter 2002 profit would be seen as an aberration that did not reflect a stable return to profitability.

101. Gollogly spearheaded the effort. He instructed Nortel's director of corporate financial planning to contact Hamilton, Johnson, Kinney, Taylor and certain regional finance and control managers, and to direct them to accrue additional reserves. Gollogly and Beatty also

contacted certain finance personnel directly to encourage them to find more reserves to establish for the quarter.

102. On or around January 6, 2003, during the 2002 year end closing process, Beatty held a conference call with Hamilton, Johnson, Kinney and Taylor during which he told them that they needed to establish additional reserves at the business unit level because the Company's results were coming in better than expected.

103. Hamilton responded by causing the Optical business unit to improperly establish approximately $7 million in unnecessary reserves. Johnson responded by causing the Wireline business unit to improperly establish approximately $12 million in unnecessary reserves. Kinney responded by causing the Wireless business unit to improperly establish over $20 million in unnecessary reserves. Taylor responded by causing the Enterprise business unit to improperly establish over $5 million in unnecessary reserves. Because the business units had already closed their books for the quarter, these reserve entries were submitted directly to Corporate to be made as top side adjustments to Nortel's consolidated earnings. Hamilton, Johnson, Kinney and Taylor knew or were reckless in not knowing that the unnecessary reserves they established during the fourth quarter 2002 closing process did not comply with US GAAP and that they were active participants in a coordinated effort to reduce Nortel's consolidated earnings. Additionally, prior to their participation in this effort, Hamilton, Johnson, Kinney and Taylor made other improper adjustments to their business unit books and records (including set-ups of additional unnecessary reserves) to ensure that their business units reported results in line with Corporate's targets.

104. Proposed reserve entries were submitted to Gollogly and his staff between January 6 and 8, 2003, and Gollogly oversaw the booking of these additional reserves until he determined that Nortel's fourth quarter 2002 earnings would be reduced to within a few million dollars of the

$65 million loss that Dunn and Beatty had internally predicted and shared with Nortel's Board of Directors. Gollogly also succeeded in pressuring Nortel's U.S. Regional Controller to reduce the planned release of a fringe benefit reserve by $11 million. On January 8, 2003, Beatty reported to Dunn the results of his and Gollogly's efforts. Through their eleventh-hour efforts, Dunn, Beatty and Gollogly improperly made $176 million in downward earnings adjustments for the fourth quarter of 2002.

105. Further, in order to obtain the precise earnings result that they had so carefully engineered for the fourth quarter of 2002, Beatty and Gollogly, with Dunn's knowledge and acquiescence or recklessness, carried out yet another last-minute manipulation of Nortel's fourth quarter 2002 earnings. On or about January 22, 2003 – the day before Nortel's fourth quarter 2002 results were announced – Nortel decided it needed to change its accounting for its acquisition of the JDS Uniphase subsidiary, 980 NPLC. This accounting change had the effect of reducing Nortel's earnings and thus increasing its fourth quarter 2002 loss by approximately $25 million. To counter the impact of the $25 million charge, Beatty and Gollogly caused $25 million of excess reserves that Gollogly helped establish in early January 2003, to be reversed. Nortel had planned to made $176 million in downward earnings adjustments, but instead, it made $151 million in downward adjustments. The reason for this reversal was to keep the previously-engineered numbers for the quarter the same and thereby ensure that losses were in-line with (but not greater than) expectations.

106. These actions generated a loss for the fourth quarter of 2002, thereby enabling the Company to (i) report results that were consistent with the public's (and Nortel's Board's) expectations, and (ii) avoid showing a *pro forma* profit sooner than the Company had forecast in its public guidance. These actions also added to Nortel's existing stockpile of excess reserves.

107. Hamilton, Johnson, Kinney and Taylor were each responsible for preparing, analyzing and submitting the financial data of their respective business units to Corporate for consolidation into the Nortel's fourth quarter 2002 financial statements. Hamilton, Johnson, Kinney and Taylor also caused their units to submit reserve entries directly to Corporate to be made as top-side adjustments to the Company's consolidated fourth quarter results. Gollogly was responsible for preparing Nortel's consolidated financial statements for the fourth quarter of 2002. Beatty participated in the preparation of such financial statements. Beatty and Dunn reviewed and approved Nortel's consolidated financial statements and related disclosures prior to their public release. Hamilton, Johnson, Kinney and Taylor also reviewed the Company's consolidated financial statements before their public release and approved any business-unit specific disclosures in the 2002 Form 10-K.

108. On January 23, 2003, in an earnings release which Dunn and Beatty reviewed and approved, Nortel made public its consolidated financial results for the fourth quarter of 2002 ("Fourth Quarter 2002 Earnings Release"). The release reported a *pro forma* loss for the quarter of $62 million (or $0.01 per share) and US GAAP loss for the quarter of $248 million (or $0.06 per share). Dunn announced that the Company was "just short of *pro forma* profitability in the quarter" and had stabilized its business model. He promised that "[a]s [Nortel] enter[s] 2003, the focus on profitability will continue."

109. On March 10, 2003, Nortel filed with the Commission its annual report on Form 10-K for the period ending December 31, 2002 ("2002 Form 10-K"). The 2002 Form 10-K represented in the "Quarterly Financial Data (Unaudited)" section that the Company's fourth quarter 2002 net loss was $248 million and its "basic and diluted loss per common share" was $0.06 per share.

110. The Earnings Management Defendants' establishment of additional excess reserves during the 2002 year-end closing process caused Nortel to report materially overstated losses in its Fourth Quarter 2002 Earnings Release and 2002 Form 10-K. Specifically, at the time, absent Nortel's downward adjustments of $151 million, Nortel would have reported a *pro forma* profit of $89 million instead of a *pro forma* loss of $62 million and it would have reported a fourth quarter US GAAP loss of approximately $97 million (or a $0.02 US GAAP loss per share) instead of a $248 million loss (or $0.06 US GAAP loss per share).

111. Dunn, Beatty and Gollogly knew, or were reckless in not knowing, that Nortel's Fourth Quarter 2002 Earnings Release misrepresented and/or omitted at least the following material facts, disclosure of which was necessary to make the statements made not misleading:

(a) Before Nortel's year-end 2002 financial statements were finalized, $151 million in improper downward earnings adjustments were made for the express purpose of reducing the Company's fourth quarter earnings and reporting a fourth quarter loss. These adjustments were attributable primarily to the establishment of excess reserves. Such adjustments caused Nortel to materially overstate its *pro forma* net losses for the fourth quarter of 2002 and materially overstate its US GAAP losses for the quarter and year. Absent the $151 million in downward earnings adjustments, Nortel would have reported a *pro forma* profit (instead of a *pro forma* loss) for the quarter and its US GAAP loss would have been reduced by more than half.

(b) The Company was holding more than $400 million of excess reserves on its books. These excess reserves were not disclosed and were not released into their proper periods, but rather, they were being improperly maintained on Nortel's books and records for future earnings management purposes.

(c) Further, Dunn knew or was reckless in not knowing that the Company's true results – as opposed to the results achieved through the earnings management fraud – were not "just short of *pro forma* profitability." But for the establishment of unnecessary reserves, Nortel would have achieved *pro forma* profitability.

(d) Also, though it may be true that Dunn expected his "focus on profitability" to continue, such a statement was, at best, grossly misleading because Dunn knew at the time that Nortel was internally forecasting a *pro forma* loss for 2003 and did not expect to achieve profitability through ordinary operations. He expected, at the time, that Nortel would need to release at least some amount of excess reserves in future quarters in order to achieve profitability by his publicly-disclosed timeline.

112. Hamilton, Johnson, Kinney and Taylor likewise knew, or were reckless in not knowing, that the financial results reported in Nortel's Fourth Quarter 2002 Earnings Release were false and misleading. Each knew or was reckless in not knowing that his business unit was improperly maintaining excess reserves on its books and records, which, under US GAAP, were required to be released, but which, the business unit instead was maintaining for future earnings management purposes. Each had caused his business unit to provide unnecessary reserve entries to Corporate which he knew were consolidated with the Company's financial results and which he knew or was reckless in not knowing were provided to Corporate for purposes of reducing the Company's consolidated earnings for the fourth quarter of 2002. Each knew or was reckless in not knowing that his efforts resulted in a material understatement of his business unit's financial results for the fourth quarter of 2002 and, in turn, Nortel's consolidated earnings for the fourth quarter of 2002.

113. Dunn, Beatty and Gollogly knew, or were reckless in not knowing, that Nortel's 2002 Form 10-K misrepresented and/or omitted at least the following material facts, disclosure of which was necessary to make the statements made not misleading:

(a) The 2002 Form 10-K falsely represented in Note 2 to the financial statements and Item 7 (Management's Discussion and Analysis of Financial Condition and Results of Operations) that Nortel's consolidated financial statements for 2002 had been prepared in accordance with US GAAP. This statement was materially false and misleading because, through the actions of the Earnings Management Defendants, Nortel inappropriately made approximately $151 million in downward earnings adjustments that did not satisfy US GAAP.

(b) The 2002 Form 10-K falsely represented the Company's fourth quarter results in the "Quarterly Financial Data (Unaudited)" section of the financial statements. The section states that the Company had a achieved a net loss of $248 million (or $0.06 per share) in the fourth quarter of 2002. These results were caused by the $151 million in improper downward earnings adjustments. Absent such improper adjustments, the Company's fourth quarter net loss and loss per share would have been less than half that reported.

(c) The 2002 Form 10-K purported to describe Nortel's policy for establishing reserves in Item 7 (Management's Discussion and Analysis of Financial Condition and Results of Operations), under the heading "Application of Critical Accounting Policies." Nortel claimed that it recognized reserves "when it is probable that an asset has been impaired or a liability has been incurred and the amount of loss can be reasonably estimated." That statement was false and misleading because Nortel's common practice was to set reserves at the greatest possible liability, without regard to any reasonable estimation of the liability. The description was also misleading because the manner in which Nortel established reserves during the fourth quarter closing process did not comport with any of the disclosed policies; specifically, the 2002 Form 10-K made no mention of the fact that defendants established unnecessary reserves during the fourth quarter closing process simply to lower the Company's consolidated earnings. The description of Nortel's policy also claimed that Nortel "regularly evaluate[d] current information available to us to determine whether such accruals should be adjusted." That statement was misleading because it gave no indication that the practice across Nortel was to adjust reserve amounts as necessary to meet quarterly earnings targets.

(d) The Company was holding more than $400 million of excess reserves on its books, which the 2002 Form 10-K did not disclose and which were not released into their proper periods, but rather, were being improperly maintained for future earnings management purposes.

114. Hamilton, Johnson, Kinney and Taylor also knew or were reckless in not knowing that the 2002 Form 10-K contained false and misleading disclosures concerning their business unit metrics, including "contribution margin," which were materially affected by each business unit's establishment of additional unnecessary reserves during the 2002 year-end closing process.

2. Releases Of Excess Reserves To Fabricate Profits

115. The change that Nortel made in late January 2003 to its accounting for the acquisition of the JDS Uniphase subsidiary, 980 NPLC, not only impacted Nortel's results for the fourth quarter of 2002, as alleged in Paragraph 105 above, but also caused Nortel internally to revise downward its earnings forecasts for 2003. Nortel's previously forecasted *pro forma* profit (of

$220 million) for 2003, became a forecasted *pro forma* loss (of $44 million) for 2003. The accounting change threatened Nortel's ability to return to profitability by the second quarter of 2003. It also threatened Nortel's ability to pay RTP bonuses in 2003. Dunn, Beatty and Gollogly understood that the accounting change removed $172 million in anticipated earnings from Nortel's fiscal year 2003 budget, and caused Nortel's projected fiscal year 2003 profit to become a projected loss.

116. Despite their expectation that Nortel would produce a loss for the year, Dunn and Beatty continued to tell the public that they expected Nortel to achieve *pro forma* profitability by the second quarter of 2003. In Nortel's Fourth Quarter 2002 Earnings Release, for example, Beatty reaffirmed Nortel's earlier guidance that Nortel expects to achieve *pro forma* profitability by the second quarter of 2003.

117. Dunn, Beatty and Gollogly refused to accept this negative turn of events and decided instead to best their own projections and to fabricate profits by releasing excess reserves company-wide during the first and second quarters of 2003.

a. <u>First Quarter 2003</u>

118. Dunn and Beatty reacted to the downward-revised internal forecast for 2003 by setting new (and higher) earnings targets for Nortel for the first and second quarters of 2003, and by instructing Nortel's corporate financial planners on multiple occasions to devise plans, called "roadmaps," to assist Nortel in reaching profitability. The goal articulated by Dunn at the time was to achieve actual US GAAP profitability in the first quarter of 2003 and to pay RTP bonuses that quarter.

119. Dunn regarded RTP bonuses – payment of which was triggered by *pro forma* profitability – as necessary to hold together his management team. He believed, however, that paying RTP bonuses based on *pro forma* profits would anger investors if Nortel did not also turn

a profit under US GAAP and thus he placed great importance on reaching an "all-in GAAP profit" in the first quarter of 2003.

120. The corporate financial planners, as instructed, created and distributed roadmaps to Dunn, Beatty and Gollogly, which reflected (i) revised consolidated earnings targets for Nortel and (ii) how much each business unit was expected to contribute to Nortel's newly-established earnings targets.

121. On or around February 19, 2003, Beatty conveyed the first and second quarter earnings targets to Hamilton, Johnson, Kinney and Taylor and, later that day, Beatty and Gollogly held a conference call with Hamilton, Johnson, Kinney and Taylor to discuss whether and how each business unit could meet their earnings targets. Beatty told them that Dunn wanted the Company to generate a profit for the first quarter of 2003. During that call, and in subsequent discussions with Nortel's corporate financial planners, Hamilton, Johnson, Kinney and Taylor disclosed to Corporate that they intended to release excess reserves from their balance sheets in order to meet their target numbers. The amounts they planned to release were incorporated into Corporate's roadmaps. Hamilton, Johnson, Kinney and Taylor knew or were reckless in not knowing that they were active participants in a coordinated effort to boost Nortel's consolidated first and second quarter 2003 earnings through reserve releases.

122. While Dunn, Beatty and Gollogly were scheming to return Nortel to profitability, its actual results were worsening. On or about March 22, 2003, internal forecasts that were provided to Beatty and Gollogly, and later conveyed to Dunn, stated that revenues were "softening versus [business unit] budgets" and that "Q1 and Q2 results [were] dependent on non-operating clean ups." Nortel's corporate financial planners, as instructed, revised the roadmaps to increase (i) the amount of corporate-level excess reserves to be released and (ii) the amount of excess reserves that Corporate expected Kinney's business unit to release into first quarter 2003

earnings. Separately, as results worsened, Hamilton, Johnson, Kinney and Taylor adjusted the amount of excess reserves they planned to release from their respective balance sheets to meet Corporate's targets.

123. The profit targets set by Dunn, Beatty and Gollogly for the first quarter of 2003 were ultimately met, in part, through Nortel's release of $361 million in reserves. Approximately $272 million of those reserves were excess reserves specifically released at the direction of Dunn, Beatty and Gollogly to meet earnings and bonus targets for the first quarter of 2003. Dunn, Beatty and Gollogly improperly released approximately $118 million of excess corporate reserves into first quarter 2003 income but continued to maintain other known corporate excess reserves for future earnings management purposes, as needed.

124. The Optical, Wireline, Wireless and Enterprise business units contributed approximately $154 million toward the $272 million in improper reserve releases for the first quarter of 2003. Hamilton, Johnson, Kinney and Taylor took an active role in reviewing excess reserve levels at their respective business units and tracking their units' ability to meet Corporate's targets as the first quarter progressed. Hamilton caused the Optical business unit to improperly release into first quarter income approximately $78 million in excess reserves from Optical's books and records. Johnson caused the Wireline business unit to improperly release into first quarter income approximately $13 million in excess reserves from Wireline's books and records. Kinney caused the Wireless business unit to improperly release into first quarter income approximately $45 million in excess reserves from Wireless' books and records. Taylor caused the Enterprise business unit to improperly release into first quarter income approximately $18 million in excess reserves from Enterprise's books and records. These improper releases of business unit reserves were a critical part of Nortel's effort to fabricate a profit for first quarter 2003. Nortel could not have reported a profit in the first quarter of 2003 without such releases.

Moreover, Hamilton, Johnson, Kinney and Taylor were aware of additional excess reserves on their balance sheets which they chose not to release in order to use them for later earnings management purposes. Indeed, in the first quarter of 2003, each released only that amount of excess reserves necessary to reach his business unit's first quarter 2003 earnings targets.

125. Hamilton, Johnson, Kinney and Taylor were responsible for preparing, analyzing and submitting the financial data of their respective business units to Corporate for consolidation into the Nortel's first quarter 2003 financial statements. Gollogly was responsible for preparing Nortel's consolidated financial statements for the first quarter of 2003. Beatty participated in the preparation of those consolidated financial statements and he and Dunn reviewed and approved the consolidated financial statements and related disclosures prior to their public release. Hamilton, Johnson, Kinney and Taylor also reviewed the Company's consolidated financial statements before their public release and approved any business-unit specific disclosures in the Company's Form 10-Q. Additionally, Dunn and Beatty certified Nortel's consolidated financial statements as required by Section 302 of the Sarbanes-Oxley Act of 2002.

126. On April 24, 2003, in an earnings release which Dunn and Beatty reviewed and approved, Nortel made public its consolidated financial results for the first quarter of 2003 ("First Quarter 2003 Earnings Release"). The release reported that Nortel had achieved US GAAP net earnings of $54 million (or $0.01 earnings per share) for the first quarter of 2003. Dunn touted his success, stating that he was "extremely pleased to have achieved profitability in the first quarter of 2003 and reached [his publicly stated] goal one quarter early." Rather than disclose the real reason for Nortel having achieved profitability in the first quarter of 2003, during the earnings conference that day, Dunn attributed Nortel's profitability to a strong business model:

> Before I talk about the market, our product position, some of the events that have taken place, let me make a few comments on the results of the first quarter. 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. We had positive results in our cash. Our cash from operations before restructuring costs generated cash. And again, that's a very important milestone for us and we're very focused on that aspect.

127. On May 9, 2003, Nortel filed with the Commission its quarterly report on Form 10-Q for the period ending March 31, 2003 ("First Quarter 2003 Form 10-Q"). Nortel reported US GAAP net earnings of $54 million ($0.01 per share) for the first quarter of 2003. Additionally, in Note 3 to the financial statements ("Consolidated Financial Statement Details – Other") and Item 2 ("Management's Discussion and Analysis of Financial Condition and Results of Operations"), Nortel stated that:

> [d]uring the three months ended March 31, 2003, Nortel Networks net earnings (loss) included approximately $80 [million] of favorable impacts … associated with reductions in accruals principally related to the wind-down of integration activities of previously acquired companies, operations originally structured as joint ventures and miscellaneous tax matters.

The Form 10-Q falsely suggested that Nortel had determined, that quarter, that $80 million of reserves were no longer necessary and could appropriately be released into income in the first quarter of 2003:

> During the three months ended March 31, 2003, we reviewed the matters related to the wind-down and settlement of balances associated with the integration activities of previously acquired companies and operations originally structured as joint ventures and determined that based on decreases in transactional activity and magnitude of their net position that it was appropriate to reduce certain accruals…. These balances were considered to be in dispute, erroneous and/or for amounts which could not be resolved.

The Form 10-Q was signed by Beatty and Gollogly, certified by Dunn and Beatty and filed with the Commission on May 9, 2003.

128. The Earnings Management Defendants' improperly-timed releases of excess reserves (totaling approximately $272 million) caused Nortel to report in its First Quarter 2003 Earnings Release and its First Quarter 2003 Form 10-Q materially overstated net earnings for the quarter. Specifically, at the time, absent the improper and out-of-period releases of approximately $272 million in excess reserves, Nortel would have reported an approximate $218 million loss (or $0.05 US GAAP loss per share) instead of a $54 million profit (or $0.01 US GAAP earnings per share) for the quarter. (A reserve is released "out-of-period" (and the release is improperly timed) if no triggering event occurs within an accounting period to justify its release.)

129. Dunn, Beatty and Gollogly knew, or were reckless in not knowing, that Nortel's First Quarter 2003 Earnings Release and First Quarter 2003 Form 10-Q misrepresented and/or omitted at least the following material facts, disclosure of which was necessary to make the statements made not misleading:

(a) The First Quarter 2003 Form 10-Q falsely represented in Note 1 to the financial statements and Item 2 (Management's Discussion and Analysis of Financial Condition and Results of Operations) that Nortel's consolidated financial statements for the first quarter of 2003 had been prepared in accordance with US GAAP. This statement was materially false and misleading because, through the actions of the Earnings Management Defendants, Nortel had inappropriately released approximately $272 million in excess reserves that did not satisfy US GAAP.

(b) Nortel's profit for the quarter had actually been reverse-engineered by Dunn, Beatty and Gollogly through the improperly-timed release of approximately

$272 million of excess reserves. The releases had been timed specifically to meet earnings and bonus targets for the first quarter of 2003.

(c) Nortel's margins improved because of the release of excess reserves.

(d) Although Nortel acknowledged the release of $80 million in reserves – and a resulting favorable impact on Nortel's earnings for the quarter – those reserves had been released out-of-period and were part of a much larger pool of previously-identified excess reserves that had also been improperly released in the first quarter of 2003.

(e) Nortel continued to hold other excess reserves on its books and records which were not disclosed in the First Quarter 2003 Earnings Release or First Quarter 2003 Form 10-Q and were not released into their proper periods, but rather, were being maintained for future earnings management purposes.

130. Hamilton, Johnson, Kinney and Taylor likewise knew, or were reckless in not knowing, that the financial results reported in Nortel's First Quarter 2003 Earnings Release and First Quarter 2003 Form 10-Q were materially false and misleading. Each knew, or was reckless in not knowing, that excess reserves had been improperly released into first quarter income from his business unit's balance sheet for purposes of meeting Corporate's targets. Each knew, or was reckless in not knowing, that his business unit's improper and out-of-period reserve releases were incorporated into Nortel's consolidated first quarter financial statements. Each knew or was reckless in not knowing that his efforts resulted in a material overstatement of his business unit's financial results for the first quarter of 2003 and, in turn, Nortel's consolidated earnings for the first quarter of 2003. Hamilton, Johnson, Kinney and Taylor also knew or were reckless in not knowing that Nortel's First Quarter 2003 Form 10-Q contained false and misleading

disclosures concerning their business unit's metrics, including "contribution margin" and "gross margin," which were materially affected by each business unit's improper release of excess reserves during the first quarter of 2003.

131. In addition to the foregoing, on or about May 9, 2003, in connection with Deloitte's review of Nortel's first quarter 2003 results, Dunn, Beatty and Gollogly provided Deloitte with a management representation letter – printed on Gollogly's letterhead – which falsely represented, among other things:

> (a) The interim consolidated financial statements for the period ending March 31, 2003, are presented in conformity with US GAAP;
>
> (b) They have no knowledge of any fraud or suspected fraud affecting the Company involving: management, employees who have significant roles in internal control, or others, where fraud could have a material effect on the interim financial information;
>
> (c) During the three months ended March 31, 2003, the Company recorded $80 million of reductions in certain accruals as described in the notes to the consolidated interim financial statements. The Company has reviewed the amount of the reductions, the remaining related accrual balances, and the related disclosures and determined that they are appropriate; and
>
> (d) There are no significant deficiencies, including material weaknesses, in the design or operations of internal controls that could adversely affect the Company's ability to record, process, summarize and report interim financial data.

132. Nortel's Second Restatement, which includes adjustments for defendants' improperly-timed first quarter reserve releases but also makes other adjustments for the first quarter, revealed that Nortel should have recorded at least a $124 million loss for the first quarter of 2003.

b. <u>Second Quarter 2003</u>

133. Dunn's goal in the second quarter of 2003, just as in the first quarter, was for Nortel to report a US GAAP profit. The corporate financial planners continued, as instructed by Dunn and Beatty, to create and revise roadmaps for achieving that result and to communicate targets to

the business units. Overall Nortel intended to release approximately $514 million in reserves in the second quarter of 2003, approximately $370 million of which were specifically timed to meet earnings and bonus targets. The plan, if fully executed, was expected to result in a *pro forma* profit of $186 million and a US GAAP profit of $131 million for the second quarter of 2003. These results were not achieved, however, because, during the second quarter closing process, Nortel had to reverse $142 million of its second quarter releases after it informed Deloitte that it did not have the support to justify releasing those reserves into second quarter income. As a result, Nortel reported a US GAAP loss for the second quarter of 2003. Nevertheless, because defendants made more than half of the improper and out-of-period releases they had planned to make that quarter, Nortel reached a *pro forma* profit in the second quarter of 2003, which triggered the payment of another round of RTP bonuses.

134. Specifically, in March 2003, based on communications with Gollogly's staff, Deloitte learned that Nortel had released at least $80 million in excess reserves in the first quarter of 2003. Deloitte asked Nortel to provide support for the timing of those releases. By the end of April 2003, it was apparent that Nortel could not produce support.

135. When Nortel could not produce support demonstrating into which periods the $80 million in excess reserves should appropriately have been released, Deloitte expressed concern to Gollogly about the releases and cautioned him not to release any further reserves for which Nortel did not have appropriate support. Deloitte also informed Nortel's Audit Committee, on April 23, 2003, that Nortel's reserve levels and the impact of reserve releases on earnings would require Deloitte's focus during the second quarter 2003 review and the year-end 2003 audit. Additionally, on May 9, 2003, Deloitte made a presentation to the Audit Committee in which it identified reserves and reserve releases as a "quality of earnings" issue, and recommended that (i) "[m]anagement should perform a rigorous review of all remaining balance sheet provisions

and ensure that only appropriate required provisions are recorded" and (ii) "[r]eleases of provisions should only be recorded after appropriate review and requirements and documented rationale for releases." Dunn and Beatty were present during Deloitte's April 23 and May 9 presentations to the Audit Committee.

136. Gollogly responded to Deloitte's suggestion, with the knowledge and acquiescence of Dunn and Beatty, by tasking certain subordinates to undertake a limited review of reserves released from Nortel's balance sheet during the second quarter of 2003.

137. In early July 2003, while Nortel was in the midst of its second quarter closing process, Gollogly disclosed to Deloitte that $142 million of the releases made that quarter were out-of-period. Gollogly knew of other improper releases made in the second quarter of 2003, but did not disclose those to Deloitte.

138. The $142 million of out-of-period releases identified to Deloitte were reversed. Nortel could not provide support justifying their release into second quarter income and, moreover, their release would have materially affected Nortel's results by turning its second quarter 2003 loss into a profit. On or about July 7, 2003, when Nortel was in the midst of its second quarter closing process, Deloitte asked Gollogly to keep the $142 million on Nortel's books until appropriate support could be gathered to justify they releases and they could be released into the proper periods. Gollogly told Dunn and Beatty about the $142 million reversal. Deloitte determined that this was a reportable condition and, on July 24, 2003, it made a presentation to Nortel's Audit Committee in which it indicated that "[i]t is unclear, due to the lack of documentation at this time …, what the original rationale for recording certain provisions was and whether it would have been appropriate to reduce these in prior years." Deloitte also informed the Audit Committee that "[m]anagement has a project underway to gather support and

determine proper resolution of certain provision balances." Dunn and Beatty were present during Deloitte's presentation to the Audit Committee on July 24, 2003.

139. Defendants' scheme for achieving second quarter US GAAP profitability was thus thwarted. Nortel had released approximately $372 million of reserves (approximately $228 million of which were excess reserves released specifically to meet earnings and bonus targets) in the second quarter of 2003, but, it was unable to release sufficient excess reserves in that quarter to achieve US GAAP profitability.

140. Hamilton, Johnson, Kinney and Taylor took an active role in reviewing excess reserve levels at their respective business units and tracking their unit's ability to meet Corporate's targets as the second quarter progressed. Each knew, or was reckless in not knowing, that he continued to be an active participant in the coordinated effort to increase Nortel's consolidated earnings.

141. The Optical, Wireline, Wireless and Enterprise business units ultimately contributed approximately $191 million toward the approximately $228 million in improper reserve releases for the second quarter of 2003. Hamilton caused the Optical business unit to improperly release into second quarter income approximately $54 million in excess reserves. Johnson caused the Wireline business unit to improperly release into second quarter income approximately $28 million in excess reserves. Kinney caused the Wireless business unit to improperly release into second quarter income approximately $92 million in excess reserves. Taylor caused the Enterprise business unit to improperly release into second quarter income approximately $17 million in excess reserves. These improper releases of business unit reserves were a critical part of the coordinated effort to fabricate a profit for second quarter 2003.

142. Hamilton, Johnson, Kinney and Taylor had also released from their books and records an additional $77 million in excess reserves during the second quarter of 2003 ($14 million from

Optical, $17 million from Wireline, $35 million from Wireless and $11 million from Enterprise), but, those releases were part of the $142 million that Gollogly had identified to Deloitte and later reversed. Hamilton, Johnson, Kinney and Taylor knew of the reversal and that $77 million of their designated releases were not made. Their business units each fell short of their second quarter 2003 targets.

143. Hamilton, Johnson, Kinney and Taylor were responsible for preparing, analyzing and submitting the financial data of their respective business units to Corporate for consolidation into the Nortel's second quarter 2003 financial statements. Gollogly was responsible for preparing Nortel's consolidated financial statements for the second quarter of 2003. Beatty participated in the preparation of those consolidated financial statements and he and Dunn reviewed and approved the financial statements and related disclosures prior to their public release. Hamilton, Johnson, Kinney and Taylor also reviewed the Company's consolidated financial statements before their public release and approved any business-unit specific disclosures in the Company's Form 10-Q. Additionally, Dunn and Beatty certified Nortel's second quarter 2003 consolidated financial statements as required by Section 302 of the Sarbanes-Oxley Act of 2002.

144. On July 24, 2003, in an earnings release which Dunn and Beatty reviewed and approved, Nortel made public its consolidated financial results for the second quarter of 2003 ("Second Quarter 2003 Earnings Release"). The release reported a US GAAP net loss for the second quarter of $14 million (or $0.00 earnings per share).

145. On August 12, 2003, Nortel filed with the Commission its quarterly report on Form 10-Q for the period ending June 30, 2003 ("Second Quarter 2003 Form 10-Q"). Nortel's Form 10-Q reported a US GAAP net loss of $14 million (or $0.00 earnings per share) for the second quarter of 2003. In Note 3 to the financial statements ("Consolidated Financial Statement Details – Other") and Item 2 ("Management's Discussion and Analysis of Financial Condition

and Results of Operations"), Nortel made no mention of the release of approximately $228 million in excess and out-of-period reserves that quarter, but rather, merely reiterated its prior incomplete disclosure about its first quarter release of the $80 million in reserves. It stated:

> [d]uring the three months ended March 31, 2003 and six months ended June 30, 2003, Nortel Networks net earnings (loss) included approximately $80 [million] of favorable impacts … associated with reductions in accruals principally related to the wind-down of integration activities of previously acquired companies, operations originally structured as joint ventures and miscellaneous tax matters.

The Form 10-Q was signed by Beatty and Gollogly, certified by Dunn and Beatty and filed with the Commission on August 11, 2003.

146. The Earnings Management Defendants' improperly-timed release of approximately $228 million in excess reserves caused Nortel to report in its Second Quarter 2003 Earnings Release and its Second Quarter 2003 Form 10-Q materially understated net losses for the quarter. Specifically, at the time, absent the release of approximately $228 million in excess out-of-period reserves, Nortel would have reported an approximate $242 million loss (or $0.06 US GAAP loss per share) for the quarter instead of a $14 million loss (or $0.00 US GAAP earnings per share).

147. Dunn, Beatty and Gollogly knew, or were reckless in not knowing, that Nortel's Second Quarter 2003 Earnings Release and Second Quarter 2003 Form 10-Q misrepresented and/or omitted at least the following material facts, disclosure of which was necessary to make the statements made not misleading:

(a) The Second Quarter 2003 Form 10-Q falsely represented in Note 1 to the financial statements and Item 2 (Management's Discussion and Analysis of Financial Condition and Results of Operations) that Nortel's consolidated financial statements for the second quarter of

2003 had been prepared in accordance with US GAAP. This statement was materially false and misleading because, through the actions of the Earnings Management Defendants, Nortel had inappropriately released approximately $228 million in excess reserves that did not satisfy US GAAP.

(b) Nortel's second quarter results had been reverse-engineered by Dunn, Beatty and Gollogly through the improperly-timed release of approximately $228 million of excess reserves. The release of those reserves had been specifically timed to meet earnings and bonus targets for the quarter.

(c) Nortel continued to hold excess reserves on its books and records which were not disclosed in the Second Quarter 2003 Earnings Release or Second Quarter 2003 Form 10-Q and were not released into their proper periods, but rather, were maintained on Nortel's books and records.

(d) The $80 million in reserves were released in – and had a favorable impact on Nortel's earnings for – the first quarter of 2003. Such releases were out-of-period and represented a fraction of total out-of-period releases made by Nortel in the first and second quarter of 2003.

148. Hamilton, Johnson, Kinney and Taylor likewise knew, or were reckless in not knowing, that the financial results reported in Nortel's Second Quarter 2003 Earnings Release and Second Quarter 2003 Form 10-Q were materially false and misleading. Each knew, or was reckless in not knowing, that excess reserves had been improperly released into second quarter income from his business unit's balance sheet for purposes of meeting Corporate's targets. Each

knew, or was reckless in not knowing, that his business unit's improper and out-of-period reserve releases were incorporated into Nortel's consolidated second quarter financial statements. Each knew or was reckless in not knowing that his efforts resulted in a material overstatement of his business unit's financial results for the second quarter of 2003 and, in turn, Nortel's consolidated earnings for the second quarter of 2003. Hamilton, Johnson, Kinney and Taylor also knew or were reckless in not knowing that the Second Quarter 2003 Form 10-Q contained materially false and misleading disclosures concerning their business unit's metrics, including "contribution margin" and "gross margin," which were materially affected by the unit's improper reserve releases during the second quarter of 2003.

149. In addition to the foregoing, on or about August 11, 2003, in connection with Deloitte's review of Nortel's second quarter 2003 results, Dunn, Beatty and Gollogly provided Deloitte with a management representation letter – printed on Gollogly's letterhead – which falsely represented, among other things:

(a) The interim consolidated financial statements for the period ending June 30, 2003, are presented in conformity with US GAAP;

(b) They have no knowledge of any fraud or suspected fraud affecting the Company involving: management, employees who have significant roles in internal control, or others, where fraud could have a material effect on the interim financial information;

(c) There are no significant deficiencies, including material weaknesses, in the design or operations of internal controls that could adversely affect the Company's ability to record, process, summarize and report interim financial data.

150. Nortel's Second Restatement, which includes adjustments for defendants' improperly-timed second quarter reserve releases but also makes other adjustments for the second quarter, revealed that Nortel should have reported at least a $101 million loss for the second quarter of 2003.

151. The earnings and loss figures that were misstated in the First and Second Quarter 2003 Forms 10-Q affected future public filings which incorporated those figures by reference, including, but not limited to: (i) Nortel's Form 10-Q for the period ending June 30, 2003 ("Third Quarter 2003 Form 10-Q") and (ii) all of Nortel's Forms S-3, S-4 and S-8 filed with the Commission from June 30, 2003 through August 5, 2003. The earnings and loss figures that were misstated in the First and Second Quarter 2003 Forms 10-Q were restated on November 19, 2003 and December 23, 2003 as part of the First Restatement, and on January 11, 2005 as part of the Second Restatement.

3. Nortel Rewards Its Executives And Others With Undeserved Bonuses On The Basis Of Results Achieved Through Its Fraudulent Scheme

152. Defendants and other Nortel employees received millions of dollars in bonuses as a result of the defendants' earnings management scheme in 2002 and 2003. The scheme artificially created the *pro forma* profit levels necessary to trigger bonuses.

153. Dunn and Beatty specifically took RTP bonus payments into account when deciding the amount of excess reserves to release in the first and second quarters of 2003. Specifically, they ordered the Company's corporate financial planners to plan for the release of sufficient reserves not only to generate a profit in those quarters, but also, to pay RTP bonuses.

154. In 2003, approximately $92 million was paid in RTP bonuses. Of that amount, approximately $19 million went to forty-three top executives, including Dunn, Beatty and Gollogly, and the remainder was spread out over a 30,000-person workforce. Approximately $10 million was paid in the second quarter of 2003 alone because, although Nortel had not posted a US GAAP profit that quarter, it nonetheless had achieved a $34 million *pro forma* profit, thereby triggering payment of RTP bonuses. In 2003, Dunn received $3,643,161 in RTP bonuses, while Beatty and Gollogly received $1,311,161 and $353,100, respectively. Hamilton,

Johnson, Kinney and Taylor received RTP bonuses in 2003 of $37,506, $66,845, $52,000 and $52,000, respectively.

155. The reserve releases in the first and second quarters of 2003 also enabled Nortel to artificially meet the criteria for issuing “Restricted Stock Units” (“RSUs”) to Nortel’s top management. Forty-three top executives received 6.26 million RSUs in July 2003, and thirty-seven of those collected an additional 5.6 million RSUs in January 2004. Similar to their pursuit of RTP bonuses, Dunn and Beatty ordered Nortel’s corporate financial planners to track and tailor reserve releases to ensure the Company met RSU performance milestones. Indeed, Nortel’s corporate financial planners continually analyzed the effect that planned reserve releases would have on management’s ability to receive RSUs. Dunn received $2,906,954 in income from RSU grants in 2003, while Beatty and Gollogly received $1,061,499 and $1,000,671, respectively.

156. These same releases also allowed Nortel’s management to claim that they had met the criteria for receiving so-called “SUCCESS” bonuses. In January 2004, approximately $8.2 million was awarded to twenty four of Nortel’s top executives in the form of a SUCCESS bonus. Dunn and Beatty received no SUCCESS bonus because Nortel’s Board halted their payments until the conclusion of the Audit Committee’s investigation. Dunn and Beatty were ultimately terminated and did not receive a SUCCESS bonus. Gollogly, however, received $148,650. Hamilton, Johnson, Kinney and Taylor received SUCCESS bonuses of $79,134, $150,321, $135,400 and $103,000, respectively.

4. Fraudulent Statements Made About The Circumstances Behind The First Restatement

157. Nortel’s earnings management scheme began to unravel at the end of the second quarter of 2003. On the morning of July 24, 2003, the same day on which Nortel issued its

Second Quarter 2003 Earnings Release, Deloitte informed Nortel's Audit Committee that it had found a "reportable condition" with respect to weaknesses in Nortel's accounting for the establishment and disposition of reserves.

158. Deloitte informed the Audit Committee that, in response to its concerns, Nortel's management had undertaken a project "to gather support and determine proper resolution of certain provision balances." Management, in fact, had undertaken this project at Deloitte's insistence because Deloitte required adequate audit evidence for their upcoming year-end 2003 audit. Dunn and Beatty, who spearheaded the review of Nortel's balance sheet in the second half of 2003, attended the Audit Committee meeting but did not reveal any of their past misconduct.

159. Nortel concealed Deloitte's concerns from the public. Nortel's Second Quarter 2003 Earnings Release contained no mention of Deloitte's concerns and merely stated that:

> Given 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.

During the earnings call that same day ("Second Quarter 2003 Earnings Call"), Beatty explained that Nortel was undertaking a "comprehensive review of assets and liabilities" because Nortel's improved operating results had "introduced the company to a new environment, where relatively minor amounts, both expense and income, have a much greater opportunity to [materially] impact reported results each quarter." He went on to say that "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."

160. Dunn, Beatty and Gollogly knew, or were reckless in not knowing, that Nortel's disclosures about its review of assets and liabilities in 2003 were materially false and misleading because such disclosures failed to state that the review had been prompted by Deloitte's report to the Audit Committee and that Deloitte had expressed concern about Nortel's creation and use of reserves and the quality of its earnings. Additionally, the disclosures omitted any mention of Dunn, Beatty and Gollogly's fraudulent manipulation of reserve accounts to manage earnings.

161. On August 12, 2003, in its Second Quarter 2003 Form 10-Q, Nortel disclosed for the first time that Deloitte had raised a "reportable condition," but it omitted any mention of the nature of the concern or that the Company had engaged in improper accounting practices with respect to its reserves. Instead, Nortel merely reiterated what it had told the public in the past:

> In light of a period of unprecedented industry adjustment and subsequent restructuring actions, including workforce reductions and asset write-downs, in the second quarter of 2003 Nortel Networks initiated a comprehensive review and analysis of identifiable categories of its assets and liabilities (the "comprehensive review"). The amounts under review were recorded when Nortel Networks balance sheet and income statement were much larger. Specifically, what would have been relatively minor amounts in prior periods may be considered to be material to current periods. The comprehensive review is in addition to reviews normally performed by Nortel Networks in connection with the recording of current period financial results.

Such disclosures created the materially false and misleading impression that the review concerned activities pre-dating the restructuring, when "Nortel['s] … balance sheet and income statement were much larger." Dunn, Beatty and Gollogly knew such disclosures were materially false and misleading because, the review, in fact, concerned activities that impacted the Company's 2002 and 2003 financials, as well as financials from earlier periods. No mention was made of Deloitte's concern about the creation and use of reserves, except for a cryptic statement that:

> In connection with the assessment of the liabilities (including accruals and provisions) identified above, Nortel Networks has noted certain deficiencies in documentary support. Nortel Networks continues to address this matter as part of the comprehensive review.

Such a disclosure failed to reveal the elaborate earnings management scheme that the defendants and others had engaged in.

162. Just prior to the filing of Nortel's Second Quarter 2003 Form 10-Q, Gollogly sent a candid email to employees assisting him in the First Restatement which warned that Nortel's comprehensive review would put an end to the Company's historical practice of using reserves to manage earnings. On July 31, 2003, he wrote, "I think we need to reinforce the importance of forecasting. It's [sic] seems like a throwaway comment, but if we "clean up" the balance sheet, the [business units'] ability to deliver earnings based partly on discretionary elements pretty much goes away."

163. Dunn and Beatty nonetheless continued to trumpet Nortel's supposed return to profitability. On October 23, 2003, during Nortel's third quarter 2003 earnings call, Dunn said "we will make not only [a] profit in the [third] quarter, but a profit on the full year, and that's the first time in six years." Likewise, during Nortel's fourth quarter 2003 earnings call, Dunn said "our revenues came in at $9.8 billion and our earnings for the full year came in at $372 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." Dunn, Beatty and Gollogly knew, or were reckless in not knowing, such statements were materially false and misleading because Nortel's first and second quarter 2003 results – and thus its results for 2003 – had been artificially boosted by improper reserve releases.

164. At the same time, Dunn and Beatty also misrepresented the reasons behind Nortel's need to restate its prior financial results. On October 23, 2003, Nortel announced in a press

release that it would need to make a financial restatement. During Nortel's third quarter 2003 earnings call, also held on October 23, 2003, Dunn and Beatty misleadingly characterized the restatement as an effort to clean up honest control lapses in prior years. Dunn innocuously explained that "following a period of dramatic restructuring" the Company found some "mistakes" in its accounting. Beatty repeated that theme and also pointed out that Nortel decided to review its assets and liabilities because the "impact of materiality" had recently changed as Nortel's results were "picking around along break-even." Dunn likewise stated in a press release issued the same day that "[t]he challenges that faced Nortel Networks and our industry over the past few years were unprecedented … It is clear now that in such a volatile environment, errors were made." At no time did they give any indication that intentionally improper accounting was to blame.

165. Shortly after Nortel announced on October 23, 2003 that it needed to restate its financial statements, Nortel's Audit Committee commenced an independent investigation and hired outside counsel to help the Audit Committee "gain a full understanding of the events that caused significant excess liabilities to be maintained on the balance sheet that needed to be restated," as well as to recommend any necessary remedial measures.

166. On November 19, 2003, in its quarterly report on Form 10-Q for the period ending September 30, 2003 ("Third Quarter 2003 Form 10-Q"), Nortel filed its First Restatement, which restated approximately $948 million in total liabilities. The First Restatement offered the same explanations that had been provided earlier by management and likewise gave no indication that any misconduct led to the restatement. Moreover, due to the restricted nature of the management-led review and its focus only on certain reserve issues, the First Restatement did not restate any revenues that had been affected by Dunn, Beatty and Pahapill's revenue recognition scheme and it did not restate for a significant number of the improper set-ups and

releases made by Dunn, Beatty, Gollogly and the business unit vice presidents of finance as part of the earnings management scheme.

167. Gollogly was responsible for preparing Nortel's consolidated financial statements for the third quarter of 2003 and the restated results reported in the First Restatement. Beatty participated in the preparation of such financial statements and he and Dunn reviewed and approved the financial statements prior to their public release. Additionally, Dunn and Beatty certified the statements as required by Section 302 of the Sarbanes-Oxley Act of 2002.

168. Additionally, in connection with Deloitte's review of Nortel's third quarter 2003 results, and 2002 restated results, Dunn, Beatty and Gollogly had provided Deloitte with a management representation letter – printed on Gollogly's letterhead – which remained completely silent about the nature and extent of their accounting schemes and the effect of such schemes on Nortel's prior reported financial results. The management representation letter, dated November 18, 2003, falsely represented, among other things:

(a) The interim consolidated financial statements for the period ending September 30, 2003, and December 31, 2002 (as restated) are presented in conformity with US GAAP;

(b) They have no knowledge of any fraud or suspected fraud affecting the Company involving: management or other employees who have a significant role the Company's internal control over financial reporting, or others, where the fraud could have a material effect on the interim financial information;

(c) They have no knowledge of any allegations of fraud or suspected fraud affecting the Company in communications from employees, former employees, analysts, regulators, short sellers or others;

(d) Note 2 to the financial statements accurately summarize and describe he nature and amount of the restatement adjustments. The Company has determined that sufficient procedures have been performed to conclude that the restatement adjustments are complete and are prepared and presented in conformity with US GAAP;

(e) There are no significant deficiencies, including material weaknesses, in the design or operations of internal controls that could adversely affect the

> Company's ability to record, process, summarize and report interim financial data.

169. Defendants' fraud finally crumbled in early 2004 when Nortel's Audit Committee began to see evidence of the improper establishment and use of reserves, beyond what had led to the First Restatement. Over the next two months, Nortel concluded that it needed to restate its results for a second time. The Company also terminated Dunn, Beatty, Gollogly, Hamilton, Johnson, Kinney and Taylor and three other finance managers.

170. On January 11, 2005, Nortel issued a "Second Restatement," which restated Nortel's liabilities by at least another $746 million and restated its revenues by approximately $3.4 billion. The financial statement effects of Nortel's two accounting fraud schemes were restated as of this date, albeit, there remained lingering effects from Nortel's internal control and other non-fraud violations. Nortel also disclosed the findings to date of the Audit Committee's independent review, which concluded, among other things, that Dunn, Beatty and Gollogly were responsible for Nortel's improper use of reserves in the second half of 2002 and first half of 2003.

171. On January 10, 2005, in connection with Deloitte's audit of the Company's financial statements for the period ending December 31, 2003, restated for 2002, Pahapill had signed a management representation letter which falsely stated that, among other things, she knew of no fraud affecting the Company that was not already disclosed to Nortel's outside auditor.

172. In May 2006, in its Form 10-K for the period ending December 31, 2005 ("2005 Form 10-K), Nortel disclosed that its restated revenues in part had resulted from management fraud, stating that "in an effort to meet internal and external targets, the senior corporate finance management team … changed the accounting policies of the Company several times during 2000," and that those changes were "driven by the need to close revenue and earnings gaps."

FIRST CLAIM
Violations of Securities Act Section 17(a)

173. The Commission realleges and incorporates by reference each and every allegation contained in Paragraphs 1 through 172 above.

174. Defendants Dunn, Beatty, Gollogly, Pahapill, Hamilton, Johnson, Kinney and Taylor, directly or indirectly, knowingly, recklessly or negligently, in the offer or sale of Nortel securities, by use of the means or instruments of transportation or communication in interstate commerce, or by use of the mails, have each: (a) employed devices, schemes or artifice to defraud; (b) obtained money or property by means of untrue statement of material fact or omitted to state a material facts necessary to make the statements made, in light of the circumstances under which they were made, not misleading; or (c) engaged in transactions, practices or courses of business which operated or would have operated as a fraud or deceit upon purchasers of Nortel securities.

175. By engaging in the conduct alleged above, defendants Dunn, Beatty, Gollogly, Pahapill, Hamilton, Johnson, Kinney and Taylor each violated Securities Act Section 17(a) [15 U.S.C. § 77q(a)].

SECOND CLAIM
Violations of Exchange Act Section 10(b)
and Exchange Act Rule 10b-5 Thereunder

176. The Commission realleges and incorporates by reference each and every allegation contained in Paragraphs 1 through 175 above.

177. Defendants Dunn, Beatty, Gollogly, Pahapill, Hamilton, Johnson, Kinney and Taylor, directly or indirectly, by use of the means or instruments of interstate commerce, or of the mails, or of a facility of a national securities exchange, knowingly or recklessly: (a) employed devices, schemes or artifices to defraud; (b) made untrue statements of a material fact or omitted to state a

material fact necessary to make statements made, in light of the circumstances under which they were made, not misleading; or (c) engaged in acts, practices or courses of business which operated or would operate as a fraud or deceit on any person, in connection with the purchase or sale of securities.

178. By engaging in the conduct alleged above, defendants Dunn, Beatty, Gollogly, Pahapill, Hamilton, Johnson, Kinney and Taylor each violated Exchange Act Section 10(b) [15 U.S.C. § 78j(b)] and Exchange Act Rule 10b-5 [17 C.F.R. § 240.10b-5].

THIRD CLAIM
Violations of Exchange Act Section 13(b)(5) and Exchange Act Rule 13b2-1

179. The Commission realleges and incorporates by reference each and every allegation contained in Paragraphs 1 through 178 above.

180. Defendants Dunn, Beatty, Gollogly, Pahapill, Hamilton, Johnson, Kinney and Taylor, knowingly circumvented or knowingly failed to implement a system of internal accounting controls or knowingly falsified books, records or accounts subject to Exchange Act Section 13(b)(2).

181. Defendants Dunn, Beatty, Gollogly, Pahapill, Hamilton, Johnson, Kinney and Taylor directly or indirectly, falsified or caused to be falsified books, records or accounts subject to Exchange Act Section 13(b)(2).

182. By engaging in the conduct alleged above, defendants Dunn, Beatty, Gollogly, Pahapill, Hamilton, Johnson, Kinney and Taylor each violated Exchange Action Section 13(b)(5) [15 U.S.C. § 78m(b)(5)] and Exchange Act Rule 13b2-1 [17 C.F.R. § 240.13b2-1].

FOURTH CLAIM
Violations of Exchange Act Rule 13b2-2
(Defendants Dunn, Beatty, Gollogly and Pahapill Only)

183. The Commission realleges and incorporates by reference each and every allegation contained in Paragraphs 1 through 182 above.

184. Defendants Dunn, Beatty, Gollogly and Pahapill directly or indirectly, (i) made or caused to be made materially false or misleading statements or (ii) omitted to state, or caused others to omit to state, material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, to an accountant in connection with an audit, review or examination of financial statements or the preparation or filing of a document or report required to be filed with the Commission.

185. By engaging in the conduct alleged above, defendants Dunn, Beatty, Pahapill and Gollogly each violated Exchange Act Rule 13b2-2 [17 C.F.R. § 240.13b2-2].

FIFTH CLAIM
Violations of Exchange Act Rule 13a-14
(Defendants Dunn and Beatty Only)

186. The Commission realleges and incorporates by reference each and every allegation contained in Paragraphs 1 through 185 above.

187. Defendants Dunn and Beatty certified in Nortel's 2002 Form 10-K, its First, Second and Third Quarter 2003 Forms 10-Q and its Amended 2002 Form 10-K that, among other things, they reviewed each of these reports and, based on their knowledge, these reports: (i) did not contain any untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading and (ii) included financial statements and other information which fairly present, in all material respects, Nortel's financial condition, results of operations and cash flows.

188. By engaging in the conduct alleged above, defendants Dunn and Beatty each violated Exchange Act Rule 13a-14 [17 C.F.R. § 240.13a-14].

SIXTH CLAIM
Aiding and Abetting Nortel's Violations of Exchange Act Section 13(a) and Exchange Act Rules 12b-20, 13a-1 and 13a-13 Thereunder

189. The Commission realleges and incorporates by reference each and every allegation contained in Paragraphs 1 through 188 above.

190. Exchange Act Section 13(a), and Rules 13a-1 and 13a-13 thereunder, require issuers of registered securities to file with the Commission factually accurate annual and quarterly reports. Exchange Act Rule 12b-20 further provides that, in addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they were made, not misleading.

191. Nortel violated Exchange Act Section 13(a) [15 U.S.C. § 78m(a)] and Exchange Act Rules 12b-20, 13a-1 and 13a-13 [17 C.F.R. §§ 240.12b-20, 240.13a-1 and 240.13a-13].

192. By engaging in the conduct alleged above, defendants Dunn, Beatty, Gollogly, Pahapill, Hamilton, Johnson, Kinney and Taylor knowingly provided substantial assistance to and thereby aided and abetted Nortel in its violations of Exchange Act Section 13(a) [15 U.S.C. § 78m(a)] and Exchange Act Rules 12b-20, 13a-1 and 13a-13 [17 C.F.R. §§ 240.12b-20, 240.13a-1 and 240.13a-13]; therefore, each is liable pursuant to Section 20(e) of the Exchange Act [15 U.S.C. §78t(e)].

SEVENTH CLAIM
Aiding and Abetting Nortel's Violations of Exchange Act Sections 13(b)(2)(A) and 13(b)(2)(B)

193. The Commission realleges and incorporates by reference each and every allegation contained in Paragraphs 1 through 192 above.

194. Exchange Act Section 13(b)(2)(A) requires issuers to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the issuer's assets. Exchange Act Section 13(b)(2)(B) requires issuers to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with US GAAP and to maintain accountability for the issuer's assets.

195. Nortel violated Section 13(b)(2)(A) during fiscal years 2000 through 2005 as alleged above and as further demonstrated by Nortel's three restatements, running into billions of dollars. Likewise, by having insufficient internal controls to prevent the recording of erroneous, misleading and outright fraudulent entries, Nortel did not prepare its financial statements in accordance with US GAAP, and thus violated Section 13(b)(2)(B). Nortel has admitted in its public filings to "material weaknesses in [its] internal controls over financial reporting." Those control failures include:

- insufficient controls around the application of its internal accounting guidelines;
- insufficient controls around manual journal entries which allowed finance personnel to record entries in Nortel's general ledger without supporting documentation;
- insufficient controls over the preparation and review of post-closing adjustments;
- a lack of emphasis on the account reconciliation process;
- insufficient authority on the part of Nortel's accounting compliance organization to resolve accounting issues and insist upon accounting practices that conformed to US GAAP;
- the failure of Nortel's technical accounting function to proactively review contracts to establish an appropriate revenue recognition method;

- inconsistent application of revenue recognition methods across the Company;
- the failure of Nortel's internal audit function to provide an independent check on the integrity of Nortel's financial reporting to determine whether Nortel's accounting policies were in compliance with US GAAP, and to evaluate whether these policies were properly applied; and
- the lingering existence of multiple accounting systems which require thousands of manual journal entries to the general ledger system each quarter.

196. Dunn, in particular, made known his lack of respect for Nortel's control organization, which he saw as an impediment to the Company's ability to do business quickly. While serving as CFO, Dunn crafted and implemented a set of practices known as the "Fast Finance Initiative." While purportedly designed to streamline Nortel's processes by focusing attention on sales and customer service, the initiative instead de-emphasized Nortel's control function company-wide. A presentation on the Initiative given by Dunn at Nortel's May 2000 Senior Finance Conference directed employees to "[g]ive up on logic," "free [themselves] from the tyranny of managing useless detail," and ignore such non-revenue generating activities as reconciling accounts.

197. By engaging in the conduct alleged above, defendants Dunn, Beatty, Gollogly, Pahapill, Hamilton, Johnson, Kinney and Taylor knowingly provided substantial assistance to and thereby aided and abetted Nortel in its violations of Exchange Act Sections 13(b)(2)(A) and 13(b)(2)(B); therefore, each is liable pursuant to Section 20(e) of the Exchange Act [15 U.S.C. §78t(e)].

EIGHTH CLAIM

Aiding and Abetting Dunn, Beatty and Gollogly's Violations of Exchange Act Section 10(b) and Rule 10b-5 Thereunder (Defendants Hamilton, Johnson, Kinney and Taylor Only)

198. The Commission realleges and incorporates by reference each and every allegation contained in Paragraphs 1 through 197 above.

199. Dunn, Beatty and Gollogly violated Exchange Act 10(b) [15 U.S.C. § 78j(b)] and Exchange Act Rules 10b-5 [17 C.F.R. §§ 240.10b-5].

200. By engaging in the conduct alleged above, defendants Hamilton, Johnson, Kinney and Taylor knowingly provided substantial assistance to and thereby aided and abetted Dunn, Beatty and Gollogly's violations of Exchange Act Section 10(b) and Exchange Act Rule 10b-5; therefore, each is liable pursuant to Section 20(e) of the Exchange Act [15 U.S.C. §78t(e)].

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that this Court:

(a) permanently restrain and enjoin each defendant from violating Securities Act Section 17(a), Exchange Act Sections 10(b) and 13(b)(5) and Exchange Act Rules 10b-5 and 13b2-1, and from aiding and abetting violations of Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) and Exchange Act Rules 12b-20, 13a-1, 13a-13;

(b) permanently restrain and enjoin defendants Dunn, Beatty, Gollogly and Pahapill from violating Exchange Act Rule 13b2-2;

(c) permanently restrain and enjoin defendants Dunn and Beatty from violating Exchange Act Rule 13a-14;

(d) permanently restrain and enjoin defendants Hamilton, Johnson, Kinney and Taylor from aiding and abetting violations of Exchange Act Section 10(b) and Exchange Act Rule 10b-5;

(e) order each defendant to disgorge, with prejudgment interest, all ill-gotten gains, compensation, and benefits (whether realized, unrealized or received) by virtue of the conduct alleged herein;

(f) pursuant to Securities Act Section 20(d) and Exchange Act Section 21(d)(3), order each defendant to pay civil penalties;

(g) pursuant to Securities Act Section 20(e) and Exchange Act Section 21(d)(2), prohibit each defendant from acting as an officer or director of any issuer that has a class of securities registered pursuant to Exchange Act Section 12 or that is required to file reports pursuant to Exchange Act Section 15(d);

(h) grant any equitable relief that may be appropriate or necessary for the benefit of investors pursuant to Exchange Act Section 21(d)(5); and

(i) grant such other relief as the Court may deem just and appropriate.

Dated: September 12, 2007
Washington, DC

Respectfully submitted,

/s/ Suzanne J. Romajas
Suzanne J. Romajas (SR-4531)
Lead Attorney To Be Noticed

- and -

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