NEW YORK LAW SCHOOL

NYLS Law Review

Volume 48 | Issue 4 Article 10

January 2004

In re Nortel Networks Corp. Securities Litigation

Janis Golubock
New York Law School

IN RE *NORTEL NETWORKS CORP. SECURITIES LITIGATION*

(decided September 5, 2003)

JANIS GOLUBOCK*

When should the United States judiciary be responsible for claims by foreign investors, on foreign exchanges, against foreign companies? The Securities Exchange Act of 1934 lays out a plethora of requirements for companies based in the United States, but is "silent as to its extraterritorial application."[1] Through its decisions, the Second Circuit Court of Appeals has developed the "conduct" and "effects" tests[2] to help a court determine if it has subject matter jurisdiction over foreign securities transactions and fraud claims. In *In re Nortel Networks Corp. Securities Litigation,*[3] the United States District Court for the Southern District of New York utilized these tests in deciding whether to certify a class of plaintiffs led by Ontario Public Employees' Union Pension Trust Fund ("OPTrust") for a class action suit against Nortel Networks Corp. ("Nortel"), a Canadian company. While the court properly held that it had subject matter jurisdiction over U.S. investors on U.S. exchanges, it went beyond the scope of its own standard to find that it had subject matter jurisdiction over foreign investors on foreign exchanges.

Under the "conduct" test, a federal court has subject matter jurisdiction "if the defendant's conduct in the United States was more than merely preparatory to the fraud, and particular acts or culpable failures to act within the United States directly caused losses to foreign investors abroad."[4] The "conduct" test focuses on the relationship between the defendant's conduct in the United States and the alleged fraudulent scheme; not whether domestic investors or markets were affected.[5]

---

* J.D. candidate New York Law School, 2005. The author would like to thank Professor Sydney M. Cone, III for his feedback.

1. Itoba Ltd. v. LEP Group PLC, 54 F.3d 118, 121 (2d Cir. 1995).
2. *Id.* at 121-22.
3. No. 01 Civ. 1855, 2003 U.S. Dist. LEXIS 15702 (S.D.N.Y. Sept. 5, 2003).
4. Alfadda v. Fenn, 935 F.2d 475, 478 (2d Cir. 1991).
5. *Itoba,* 54 F.3d at 123.

Under the "effects" test, a federal court has subject matter jurisdiction "where illegal activity abroad causes a 'substantial effect' within the United States."[6] The "effects" test pertains to situations where "the transactions involve stock registered and listed on a national securities exchange, and are detrimental to the interests of American investors."[7]

Nortel has been a leader in the Internet and telecommunications industries for over 100 years.[8] In the late 1990's Nortel began to "re-engineer" itself to become an Internet powerhouse and pursued a strategy of aggressive research and development and targeted acquisitions.[9] In April 2000, Nortel was spun off from its then parent company, Bell Canada, to become a completely independent company.[10]

In January 2000, Nortel reported record revenues and operating results for 1999 and anticipated continued success in 2000.[11] In April 2000, Nortel announced that it achieved record results for the first quarter of 2000 and raised its financial performance outlook for the year.[12] In its second quarter earnings announcement in July, Nortel once again reported record results and again raised its outlook for 2000.[13]

By October 2000, however, several of Nortel's largest customers reduced orders for Nortel products and indicated to Nortel salespeople that orders for 2001 would be even lower.[14] However, on October 24, 2000, Nortel issued its third quarter earnings release and indicated that it experienced strong growth for the third

---

6. *Alfadda*, 935 F.2d at 478.

7. Schoenbaum v. Firstbrook, 405 F.2d 200, 208 (2d Cir. 1968).

8. http://www.nortelnetworks.com/corporate/corptime/index.html (*last visited* Jan. 31, 2004).

9. http://www.nortelnetworks.com/corporate/corptime/1998.html (*last visited* Jan. 31, 2004).

10. http://www.nortelnetworks.com/corporate/news/newsreleases/2000b/04_28_0000268_titan2_court_release.html (*last visited* Jan. 31, 2004).

11. http://www.nortelnetworks.com/corporate/news/newsreleases/2000a/01_25_0000011_yearend_results.html (*last visited* Jan. 31, 2004).

12. http://www.nortelnetworks.com/corporate/news/newsreleases/2000b/04_25_0000238_q1_earnings.html (*last visited* Jan. 31, 2004).

13. http://www.nortelnetworks.com/corporate/news/newsreleases/2000b/07_25_0000461_q2_earnings.html (*last visited* Jan. 31, 2004).

14. *In re* Nortel Networks Corp. Sec. Litig., 238 F. Supp. 2d 613, 617 (S.D.N.Y. 2003).

quarter ending September 30, 2000. In the release, Nortel commented that based on its performance during the first nine months of the year and a strong order backlog, it expected positive sales and earnings growth to continue in 2000 and 2001.[15]

By December 2000, Nortel was in talks with JDS Uniphase ("JDSU") to purchase JDSU's Zurich business for approximately $3 billion in Nortel stock.[16] On January 18, 2001, Nortel issued another allegedly false and misleading press release reporting strong revenue and earnings growth for the fourth quarter and full-year 2000.[17] On February 15, nine days after acquiring JDSU's Zurich business, Nortel issued a press release in which it dramatically lowered its expectations for the first quarter and fiscal year 2001.[18] Nortel indicated that the change in outlook was "due to a 'faster and more severe economic downturn in the United States' and longer than expected delays in spending by Nortel customers."[19] On February 16, Nortel's stock price fell almost 34% from the day before.[20] After the drop in stock price, more than two dozen lawsuits were filed against Nortel in a number of district courts and on October 16, 2002, those actions were consolidated in the United States District Court for the Southern District of New York.[21]

On March 2, 2001, trustees of OPTrust, on behalf of a putative class, alleged that Nortel, its CEO and President, COO and CFO, had violated Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b),[22] Rule 10b-5 promulgated thereunder, 17 C.F.R

15. http://www.nortelnetworks.com/corporate/news/newsreleases/2000c/10_24_0000665_q3_earnings.html (*last visited* February 13, 2004).

16. *Nortel Networks Corp.*, 238 F. Supp. 2d at 620.

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.* at 621.

21. *Id.* at 617 n.1.

22. 15 U.S.C.A. § 78j(b) (West 1997).

> Manipulative and deceptive devices. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

§ 240.10b-5[23] and Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a)[24], by "knowingly or recklessly issuing a stream of materially false and misleading representations to the investing public."[25]

Plaintiffs alleged that Nortel: 1) materially misstated its third quarter results in its October earnings release[26] and third quarter 2000 Form 10-Q filed with the Securities and Exchange Commission ("SEC");[27] 2) reiterated its false and misleading positive outlook for 2000 and 2001 at its Annual Investor Conference on November 21, 2000 and in press releases issued on November 1 and December 14, 2000;[28] and 3) concealed and toned down the negative impact of the soft market on its financials through practices that materially enhanced and misstated its financial results in violation of Generally Accepted Accounting Principles ("GAAP") and SEC reporting rules.[29]

---

23. 17 C.F.R. § 240.10b-5 (2003).

> Employment of manipulative and deceptive devices. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

24. 15 U.S.C.A. § 78t(a) (West 1997).

> Liability of controlling persons and persons who aid and abet violations. (a) Joint and several liability; good faith defense. Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

25. *Nortel Networks Corp.*, No. 01 Civ. 1855, 2003 U.S. Dist. LEXIS 15702, at *2 (S.D.N.Y. Sept. 5, 2003) (citing Second Consolidated and Amended Class Action Complaint at 2, *In re* Nortel Networks Corp. Sec. Litig., 238 F. Supp. 2d 613 (S.D.N.Y. 2003) (01 Civ. 1855)).

26. *Nortel Networks Corp.*, 238 F. Supp. 2d at 618.

27. *Id.*

28. *Id.* at 619-20.

29. *Id.* at 618. Plaintiffs alleged several ways in which Nortel improperly boosted revenue in the third and fourth quarters of 2000, including:

> i) improperly us[ing] 'vendor financing' to generate hundreds of millions of dollars of illusory revenues; ii) engag[ing] in a series of improper prac-

On February 1, 2002, the United States District Court for the Southern District of New York approved OPTrust as sole lead plaintiff in a class action suit against Nortel.[30] OPTrust moved to certify a class consisting of persons and entities who suffered damages as a result of purchasing Nortel common stock or call options, or selling Nortel put options from October 24, 2000 through February 15, 2001.[31] Such persons and entities, included, but were not limited to, those who traded in Nortel securities on the New York Stock Exchange and/or the Toronto Stock Exchange.[32] OPTrust argued that the action met all the requirements of Rule 23(a) of the Federal Rules of Civil Procedure ("FRCP").[33] OPTrust then moved to certify the class under FRCP Rule 23(b)(3)[34] asserting that "all members of the class relied upon Defendants' allegedly 'deceptive and materially false and misleading statements to the investing public,'"[35] On September 5, 2003, the court certified the class and determined that it had subject matter jurisdiction over all class members.[36]

---

tices that caused Nortel to recognize hundreds of millions of dollars of revenue; iii) fail[ing] to properly account for hundreds of millions of dollars of uncollectible receivables; and iv) fail[ing] to timely and properly recognize approximately $12.5 billion in impairment losses in connection with four of Nortel's recent Internet and telecommunications acquisitions until the second quarter of 2001, after the end of the class period. *Id.* at 619 n.5.

30. *Nortel Networks Corp.*, No. 01 Civ. 1855, 2002 U.S. Dist. LEXIS 1633 (S.D.N.Y. Feb. 1, 2002).

31. *Nortel Networks Corp.*, No. 01 Civ. 1855, 2003 U.S. Dist. LEXIS 15702, *2 (S.D.N.Y. Sept. 5, 2003).

32. *Id.* at *2-3.

33. To determine whether a party is qualified to act as lead plaintiff in a class action lawsuit, courts look to the prerequisites outlined in Rule 23(a) of the Federal Rules of Civil Procedure: (1) the class is so numerous that joinder of all members is impracticable; (2) there are questions of law or fact common to the class; (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class; and (4) the representative parties will fairly and adequately protect the interests of the class. Plaintiffs must then show that the class falls within one of three categories set forth in Rule 23(b). FED. R. CIV. P. 23(a).

34. *Nortel Networks Corp.*, 2003 U.S. Dist. LEXIS 15702, at *4 n2. The rule requires the court to find "that questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy." FED. R. CIV. P. 23(b)(3).

35. *Nortel Networks Corp.*, 2003 U.S. Dist. LEXIS 15702, at *3.

36. *Id.*

Nortel argued that the court did not have subject matter jurisdiction over foreign purchasers of Nortel stock[37] and that the court should exclude such purchasers for several reasons, including: (1) "[W]hen foreign purchasers on a foreign exchange seek to rely upon the *Exchange Act*, the Second Circuit has held that [its] securities laws should not be exported to foreign countries that are perfectly capable of policing the companies that reside within them;"[38] (2) Nortel's senior management is based in Canada, the allegedly fraudulent statements were disseminated from Nortel's headquarters in Ontario, and the challenged accounting decisions were made in Canada;[39] and (3) Accepting jurisdiction over Canadian purchasers of Nortel stock would overlap and supplant at least three pending class actions brought on behalf of such purchasers in the Canadian courts.[40]

OPTrust countered that Nortel's activities in the United States were "much more than merely preparatory to the fraud and thus favor[ed] a finding of subject-matter jurisdiction,"[41] because:

> (1) The vast number of customers and potential customers with whom Nortel did business during the Class Period were overwhelmingly located in the U.S.[42]; and
> (2) Nortel funded an aggressive growth-by-acquisition strategy by using its artificially inflated stock, then misled investors by not writing down the goodwill associated with its U.S. acquisitions despite declines in their value.[43]

OPTrust also contended that the mere existence of Canadian lawsuits should not prevent the court from granting certification.[44]

---

37. *Id.*

38. *Id.* at *20 (citing Defendant's Brief at 21, *In re* Nortel Networks Corp. Sec. Litig., 238 F. Supp. 2d 613 (S.D.N.Y. 2003) (01 Civ. 1855)).

39. *Id.* (citing Defendant's Brief at 22, *In re* Nortel Networks Corp. Sec. Litig., 238 F. Supp. 2d 613 (S.D.N.Y. 2003) (01 Civ. 1855)).

40. *Id.* (citing Defendant's Brief at 24-25, *In re* Nortel Networks Corp. Sec. Litig., 238 F. Supp. 2d 613 (S.D.N.Y. 2003) (01 Civ. 1855)).

41. *Nortel Networks Corp. Sec. Litig.*, 2003 U.S. Dist. LEXIS 15702, at *22 (citing Plaintiff's Reply Brief at 8-9, *In re* Nortel Networks Corp. Sec. Litig., 238 F. Supp. 2d 613 (S.D.N.Y. 2003) (01 Civ. 1855)).

42. *Id.*

43. *Id.* (citing Plaintiff's Reply Brief at 9, *In re* Nortel Networks Corp. Sec. Litig., 238 F. Supp. 2d 613 (S.D.N.Y. 2003) (01 Civ. 1855)).

44. *Id.*

The court concluded that Nortel's activities in the U.S. satisfied the test for subject matter jurisdiction.[45] In reaching this conclusion, the court noted that the "conduct" and "effects" tests should be applied when determining if a court has subject matter jurisdiction over a foreign transaction, and pointed to an allegation by OPTrust that during the class period Nortel "consummat[ed] risky vendor financing deals" with U.S. customers in order to increase revenues.[46]

In its holding, the *Nortel* court did not identify how it applied the "conduct" and "effects" tests, and thus provided inadequate guidance as to how it reached its decision regarding subject matter jurisdiction. It simply said that "[d]efendants [sic] activities in the United States satisfy the test for subject matter jurisdiction"[47] and mentioned a few of the allegations put forth by OPTrust.

While the court did not mention that it used the "effects" test, there does not seem to be a question that by applying this test the court could have found it had jurisdiction over American plaintiffs that invested in the U.S. markets, (assuming Nortel knew the information it provided the markets prior to February 15, 2001 was materially false and misleading and therefore, illegal). The decisions that Nortel made with regard to how it would represent its financial position, including the press releases that it issued, originated in and were disseminated from Canada.[48] Furthermore, Nortel's decision to revise downward its first quarter and full year 2001 financial performance negatively impacted the stock price in the United States, as indicated by its 34% one-day decline. This situation is similar to that of *Nathan Gordon Trust v. Northgate Exploration, Ltd.*[49] In that case, the court limited the class to claims stemming from transactions on the New York Stock Exchange, finding that it did not have subject matter jurisdiction over the claims arising from transactions on foreign exchanges. The court found that the relevant conduct "occurred in Canada where the alleged misleading information was authored. The mere filing of reports with the SEC and the dissemination of some materials to shareholders in the

45. *Id.* at *23.
46. *Id.* at 23-24.
47. *Nortel Networks Corp.*, 2003 U.S. Dist. LEXIS 15702, at *23.
48. *Id.* at *20.
49. 148 F.R.D. 105 (S.D.N.Y. 1993).

United States were merely incidental to the authorship, preparation and dissemination of the allegedly false information. . . ."[50]

The question is whether the *Nortel* court appropriately found that Nortel's activities satisfied the "conduct" test, to justify its finding that it had subject matter jurisdiction over foreign investors who invested only on foreign exchanges. While the court did not explain how it applied the test, in its holding it mentioned allegations put forth by OPTrust relating to Nortel's U.S. vendor financing deals. The court's use of these allegations indicates that it found such activities sufficient to meet jurisdictional requirements under the "conduct" test, (presumably because the financing deals involved companies in the U.S., which Plaintiffs argued led to an adverse effect on foreign investors). However, a careful analysis of the facts and the arguments put forth by Plaintiff as to why Nortel's activities in the United States were more than "merely preparatory" to the fraud suggests that the court did not, in fact, reach the right conclusion.

As noted above, in evaluating whether a plaintiff meets the requirements of the "conduct" test, a court must consider if: 1) the defendants' conduct in the United States was more than merely preparatory to the fraud and 2) particular acts or omissions within the United States directly caused losses to foreign investors abroad.[51]

In the current situation, Nortel's conduct in the United States was arguably not more than merely preparatory to the fraud. An example of where a company's particular acts within the United States were "more than merely preparatory" is *In re Gaming Lottery Sec. Litig.*[52] In that securities fraud class action case, the plaintiffs alleged that Gaming Lottery Corporation ("GLC") illegally operated a U.S. subsidiary. The Corporation proceeded to incorporate the earnings of the subsidiary into its financial statements when, in fact, GLC operated the subsidiary without regulatory approval and knowing that such approval would not be forthcoming.[53] Here,

50. *Id.* at 108.

51. Alfadda v. Fenn, 935 F.2d 475, 478 (2d Cir. 1991).

52. 58 F. Supp. 2d. 62 (1999) (finding that defendant's acts in the U.S. were more than merely preparatory to the fraud and directly caused the Canadian plaintiffs' losses).

53. *Id.* at 74.

however, the companies with whom Nortel did business were legitimate organizations[54] and it is not contended that the financing arrangements themselves were illegal. Rather, conduct that was "preparatory to the fraud" stemmed from the decisions Nortel made regarding how it would account for revenue from the financing arrangements. Furthermore, any alleged violations of GAAP and Nortel's own internal revenue recognition guidelines originated in Canada.[55]

Nortel's situation can also be distinguished from the recent case of *SEC v. Berger,*[56] where the activities that took place in the United States and were materially related to the fraud included: (1) creation of false financial information; (2) transmission of that false financial information overseas; [and] (3) approval of the resulting false financial statements prior [to] the statements being sent to investors."[57] In contrast, and even as acknowledged by Nortel, any of these activities by Nortel took place in Canada.[58]

Furthermore, particular acts or culpable failures to act within the United States did not *directly* cause losses to foreign investors abroad. OPTrust alleged that by recognizing revenue from its financing arrangements with fiber-optic cable networks and internet service providers located in the U.S., Nortel violated GAAP and its own internal revenue recognition guideline policies.[59] However, arguably any acts claimed to have harmed investors were the alleged fraudulent and misleading accounting and communications decisions that emanated from Canada; not these financing arrangements or Nortel's U.S. acquisitions themselves. *Tri-Star Farms Ltd. v. Marconi, PLC*[60] provides support for such a conclusion.

In *Tri-Star Farms,* the plaintiffs alleged that Marconi, a United Kingdom corporation with its principal place of business in

54. Plaintiffs have not alleged and there is no evidence indicating otherwise.

55. *Nortel Networks Corp.*, No. 01 Civ. 1855, 2003 U.S. Dist. LEXIS 15702, *20 (S.D.N.Y. Sept. 5, 2003).

56. 322 F.3d 187 (2d Cir. 2003) (finding federal jurisdiction over all parties when foreign investors in a mutual fund sued a mutual fund incorporated in the Virgin Islands, a fund manager who resided in New York, and the fund's accounting firm).

57. *Id.* at 194 (citing Defendant's Brief at 11, SEC v. Berger, 244 F. Supp. 2d 180 (S.D.N.Y. 2001) (00 Civ. 333)).

58. *Nortel Networks Corp.*, 2003 U.S. Dist. LEXIS 15702, at *20.

59. *Nortel Networks Corp..*, 238 F. Supp. 2d 613, 619 (S.D.N.Y. 2003).

60. 225 F. Supp. 2d 567 (W.D.Pa. 2002).

London, violated the federal securities laws by artificially inflating the market price for its securities by issuing fraudulently false and misleading statements.[61] The key question in that case was "whether Marconi's alleged wrongful conduct within the United States [was] sufficient to establish subject-matter jurisdiction . . . over the claims of foreign purchasers of Marconi ordinary shares on a foreign exchange."[62] The court held that it was not, finding that the alleged fraudulent misrepresentations originated in England.[63] Plaintiffs argued that "the allegedly fraudulent statements defendants made in the United Kingdom constitute[d] activity in the United States because the misrepresentations and omissions concerned the status of Marconi's United States operations."[64] The court found, however, that Marconi's U.S. business operations were not fraudulent and that the fraud arose from the representations Marconi did or did not make about those operations. It noted that "[s]imply making fraudulent statements about what is happening in the United States does not make those statements 'United States conduct' for purposes of the conduct test."[65] Such is the case here. Nortel's business dealings in the United States were not in and of themselves fraudulent. Rather, it was Nortel's representations about their impact on the Company's financial position that was allegedly fraudulent.

Considering the above analysis, it is possible to conclude that this was not a time for the United States judiciary to be responsible for claims by foreign investors, on foreign exchanges, against foreign companies. Nortel's activities in the United States were not more than merely preparatory to the alleged fraud against foreign investors on foreign exchanges and the Company's particular acts or culpable failures to act within the United States did not directly cause losses to foreign investors abroad.

For years, "the federal securities laws have protected the integrity of the capital markets in America."[66] While the courts have leeway to interpret and apply the laws, the *Nortel* court went beyond

61. *Id.* at 569-70.
62. *Id.* at 572.
63. *Id.* at 577.
64. *Id.* at 578 (internal quotations omitted).
65. *Id.*
66. *In re* Network Assocs. Sec. Litig., 76 F. Supp. 2d 1017, 1018 (N.D.Cal. 1999).

the scope of its own standard in applying the "conduct" test and further opened the door to the use by foreign individuals and entities of the scarce resources of the United States judicial system.