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Nortel's Cowboy Lawyers

Nortel lawyers played a risky game -- and lost. Steve Jobs' fateful fumble.

By MARK VEVERKA

PAY ME NOW, OR PAY ME MORE LATER.

Nortel Networks is likely to get hit with a hefty patent-suit settlement that Wall Street has largely ignored.

A federal judge in Texas recently ruled that the struggling telecom-equipment concern must go to mediation in its intellectual-property battle with Australia's **Ipernica** (formerly QPSX) in U.S. District Court in Marshall, Texas, the court of choice for intellectual-property plaintiffs. Nortel was the only defendant, among four, to go to trial, and it lost. The jury ruled that Nortel must pay $28.1 million in damages (Plugged In, May 14). The judge ordered the two companies to mediate a settlement.

How much will this cost Nortel (ticker: NT) Some sum ranging from the $28.1 million, or 6 cents a share, to $84.3 million, or 19 cents a share, plus legal fees and interest.

Pricey patent wars are a fact of life in telecom. But the outfit that can least afford a huge settlement is on the hook for the biggest payout in the case. Ipernica (IPR.Australia) has reached settlements with the three other companies it sued: Alcatel-Lucent (ALU), Cisco Systems (CSCO) and Juniper Networks (JNPR).

I've been a fan of Nortel CEO Mike Zafirovski's turnaround effort, but his corporate lawyers haven't done him any favors with their failed litigation strategy. Nortel shares rose as high as 31 in February following publication of our feature story on the company ("Nortel's Stronger Signal," Dec. 11, 2006). But last week, its shares were back down around 17.

Clawing and scratching to survive in an overcrowded industry, Nortel could ill afford a 19-cents-a-share hit. The Street expects Nortel to earn about 55 cents a share this year.

According to Ipernica, Alcatel-Lucent's and Cisco's combined payments added up to $15 million. Juniper, which was first to settle, got off the hook the easiest, with a settlement of about $250,000.

Why would Juniper's liability be so much smaller than Nortel's? Short answer: Ipernica didn't want to go to trial against Juniper. Long answer: Nortel went to trial and the jury found the company guilty of "willful infringement," giving the judge authority to double or even triple the damages. With the risk of $84.3 million in damages hanging over their heads, Nortel's lawyers aren't negotiating from a position of strength. An early negotiated settlement of $7.5 million would have looked a heck of a lot better right now than what Nortel is facing. The Toronto-based gear maker's margin for error is too thin to be employing high-risk legal defenses. It's high time that its lawyers stop acting like cowboys, especially in plaintiff-friendly Marshall, Texas.

APPLE MAY HAVE JUMPED THE SHARK.

CEO Steve Jobs always wanted to cross over from technology into Hollywood. Now, he's looking like a network television executive who has turned a hit into a train wreck -- overnight. If, in Jobs' words, the iPhone is the greatest iPod ever, than the spectacular run of the iPod is in peril. We already know that iPod sales are flattening. Now, we have a strong sense that something is wrong with the iPhone rollout. If the decisions to slash prices on 8 gigabyte phones by $200 and to kill the 4 gigabyte phone weren't evidence enough, than the day-after mea culpa move to offer $100 rebates to early adopters was.

We all knew iPhone prices would need to fall to reach critical mass and drive volume growth, but no one anticipated cuts so steep, so soon. What's more, Apple (AAPL) generally prefers to introduce updated models, rather than trim prices. The reduction was a slap in the face to its loyalists, and the knee-jerk rebate indicated that Jobs had misread his hitherto faithful flock.

"Despite Apple's statement that iPhone sales are on track, [the] price cut appears to suggest that sales have been more sluggish than expected," says Bernstein Research analyst Toni Sacconaghi. Data from the analytical firm iSuppli suggest that Apple sold roughly 200,000 units in July, but it must average about 243,000 a month to hit the company's goal of one million units by the end of September, Sacconaghi calculates.

Company spin that higher sales will more than make up the difference in margin is hogwash, especially when issuing $100 credits to hundreds of thousands of singed customers. The rebates will directly hurt cash flow -- the metric that bulls monitor most. "Features, reliability, two-handed operation, high cost and Apple's supply-chain and manufacturing strategy will continue to limit unit sales and profits for the iPhone," predicts principal Charter Equity Research analyst Ed Snyder.

I've said that earnings are mostly baked into the stock price, but some smart money managers had planned to buy on dips if the iPhone hit its mark. It hasn't, and Apple shares plunged to about 133 Thursday, down 8% from Wednesday's open.

Apple is a resilient cult stock, often driven by blind faith. The average target price among analysts is 168. It boasts a massive stock-market value -- $115 billion -- and fat margins, largely owing to low component costs. But last week's news doesn't suggest a growth trajectory that could produce a 35-point bump in its share price. IPod growth is slowing, Macintosh growth -- though promising -- is already priced into the shares, Apple TV is a bust, and now there is static with the iPhone. Plus, the newly unveiled iPod Touch -- an iPhone without the phone -- probably will cannibalize sputtering iPhone sales.

Perhaps Jobs is betting that the iPod Touch will be the surprise holiday hit Apple desperately needs. Apple's "aggressive" pricing and blurred iPod merchandising makes it seem as if Jobs is throwing spaghetti at a wall. Something better stick, or Christmas may be a season of discontent.