

additional substantial evidentiary support will exist for the allegations set forth herein after a reasonable opportunity for discovery.

Nature of the Action

2. Plaintiffs bring this action as a class action on behalf of a class (the "Class") consisting of themselves and all other persons or entities who purchased Xerox common stock during the period October 22, 1998 (when Xerox first claimed that it was benefitting from the restructuring) through October 7, 1999 (when Xerox finally disclosed the massive problems that affected its operations and the impact of these problems on its revenues), inclusive (the "Class Period"), seeking to pursue remedies under the Securities Exchange Act of 1934 (the "Exchange Act").

3. In April of 1998, Xerox announced a Company-wide restructuring by which it intended to consolidate its regional customer service centers into three central locations, eliminate approximately 9,000 jobs, and take a \$1.6 billion charge before taxes to account for the restructuring.

4. This aggressive consolidation saved costs by, among other things, under-staffing the Company's remaining customer service locations with unskilled employees to handle the jobs of sales support, order processing, and customer follow-up. These overwhelmed and unprepared workers failed to do the job. The failure of these functions quickly impacted sales, shipment of products, and customer relationships. These essential operations continued to deteriorate throughout the second half of 1998 and all of 1999.

5. Throughout the Class Period, the customer service operations also deteriorated because the Company's sales personnel were required to assume paperwork and follow-up tasks

that had been handled by the service centers prior to the restructuring. Sales representatives spent almost half their time on paperwork and dealing with complaints, instead of selling. Customers grew frustrated with delays in product shipment and poor customer service. Invoices were incorrect and Xerox overcharged customers. Xerox made fewer sales, lost pending sales, and ultimately lost customer relationships. This breakdown in Xerox's operations was widespread throughout the Company.

6. During the Class Period, defendants, while informing investors about the cost savings from the restructuring and claiming its financial and operational benefits, failed to disclose the material negative impact that the restructuring had on the Company's operations and revenue. In January of 1999, with knowledge or reckless disregard of the above-stated problems, defendants made additional statements concerning the restructuring to investors which they knew or recklessly disregarded were false. Shortly after making these particular statements, senior executives sold \$51.7 million of their Xerox stock.

7. It was not until October 8, 1999 that the Company fully disclosed that "sales productivity was affected by the continued realignment of the customer administration restructuring." This belated disclosure had a catastrophic effect on Xerox's stock. On that day the price of Xerox stock fell more than 25%, the largest single day drop in more than 20 years.

8. Analysts expressed dismay and skepticism with respect to Xerox's disclosure. One analyst, in summarizing the Company's admissions, stated: "[i]t calls into question the credibility of management."

Jurisdiction and Venue

9. This Court has jurisdiction over the subject matter of this action pursuant to 28 U.S.C. §§ 1331 and 1337, and § 27 of the Exchange Act (15 U.S.C. § 78aa).

10. This action arises under §§ 10(b) and 20(a) of the Exchange Act (15 U.S.C. §§ 78j(b) and 78t(a)) and Rule 10b-5 promulgated under § 10(b) by the SEC. (17 C.F.R. § 240.10b-5).

11. Venue is proper in this District pursuant to § 27 of the Exchange Act, and 28 U.S.C. § 1391(b). Many of the acts charged herein, including the preparation and dissemination of materially false and misleading information, occurred in substantial part in this District. Additionally, defendants maintained their chief executive offices and principal place of business within this District during the Class Period.

12. In connection with the acts alleged in this complaint, defendants, directly or indirectly, used the means and instrumentalities of interstate commerce, including, but not limited to, the mails, interstate telephone communications and the facilities of the New York Stock Exchange ("NYSE"), a national securities exchange.

Parties

13. By order of the Court, Woodstock Corp., Shellsign & Co., Thomas Zanbito and Carol Zanbito, and Thomas Dalberth were appointed Lead Plaintiffs. Each of the Lead Plaintiffs purchased Xerox common stock at artificially inflated prices during the Class Period, as set forth in the Certifications previously filed with the Court and incorporated herein by reference, and were damaged thereby.

14. a. Defendant Xerox Corporation is a New York corporation with its principal executive offices located at Stamford, Connecticut, P.O. Box 1600, 06904-1600. Xerox purports to be the world's leading document processing company. The Company purports to develop, manufacture, market, service and finance a full range of products, services and solutions that allow businesses to increase productivity by creating faster and easier access to information and documents.

b. At all times relevant to this action, Xerox common stock was actively traded on the NYSE, a national securities exchange, under the ticker symbol "XRX" and was registered pursuant to §12 of the Exchange Act (15 U.S.C. § 78l). The market for the Company's common stock was therefore open, well-developed, and efficient at all relevant times. During the Class Period, Xerox filed annual, quarterly, and other reports with the SEC in accordance with the Exchange Act.

15. The following defendants are collectively referred to as the "Individual Defendants," and served at all times material to the claims set forth herein, in the following positions:

a. Defendant Paul Allaire ("Allaire") has served as Chairman of the Board of Directors since May 1999, Chief Executive Officer from May 1991 to April 1999, Chairman of the Executive Committee, and a Member of the Board of Directors since 1986. Defendant Allaire was paid an annual salary of \$975,000 in 1998 and 1999, and additional compensation in the amount of \$4,701,443 in 1998 and \$118,644 in 1999. During the Class Period, Defendant Allaire exercised 200,000 options for proceeds of \$11,818,740.

b. Defendant Richard Thoman ("Thoman") has served as President and Chief Operating Officer since June 1997, Chief Executive Officer since April 1999, a Member of the Executive Committee, and a Member of the Board of Directors since June 1997. Defendant Thoman was paid an annual salary of \$700,000 in 1998 and \$900,000 in 1999 and additional compensation of \$3,403,977 in 1998 and \$189,642 in 1999. During the Class Period, Defendant Thoman exercised 300,000 options for proceeds of \$18,353,005.

c. Defendant Barry Romeril ("Romeril") has served as Executive Vice President and Chief Financial Officer since 1993, Vice Chairman of the Board of Directors since April 1999 and a Member of the Board of Directors since April 1999. Defendant Romeril was paid an annual salary of \$513,333 in 1998 and \$575,000 in 1999 and was paid additional compensation of \$1,535,789 in 1998 and \$170,047 in 1999. During the Class Period, Defendant Romeril sold 20,524 shares of Xerox for proceeds of \$1,200,654.

16. It is appropriate to treat the Individual Defendants as a group for pleading purposes and to presume that the false, misleading and incomplete information conveyed in the Company's public filings, press releases, and other publications, as alleged herein, are the collective actions of the narrowly defined group of defendants identified above. Each of the above officers or directors of Xerox, by virtue of their high-level positions with the Company, directly participated in the day-to-day management of the Company, was directly involved in the daily operations of the Company at the highest levels, and was privy to confidential proprietary information concerning the Company and its business, operations, products, growth, financial statements, and financial condition, as alleged herein. The defendants were involved in drafting, producing, reviewing and/or disseminating, the false and misleading statements and information

alleged herein, and were aware or recklessly disregarded, that the false and misleading statements were being issued regarding the Company, and approved or ratified these statements, in violation of the federal securities laws.

17. As officers, directors, and controlling persons of a publicly-held company whose common stock was, and is, registered with the SEC pursuant to the Exchange Act, traded on the NYSE, and governed by the provisions of the federal securities laws, the Individual Defendants each had a duty to disseminate promptly, accurate and truthful information about to the Company's financial condition and performance, growth, operations, financial statements, business, products, markets, management, earnings and present and future business prospects, and to correct any previously-issued statements that had become materially misleading or untrue, so that the market price of the Company's publicly-traded securities would be based upon truthful and accurate information. The Individual Defendants' misrepresentations and omissions during the Class Period violated these specific requirements and obligations.

18. The Individual Defendants participated in the drafting, preparation, and/or approval of the various public and shareholder and investor reports and other communications complained of herein and were aware of, or recklessly disregarded, the misstatements contained therein and omissions therefrom. Because of their Board membership and/or executive and managerial positions with Xerox, each of the Individual Defendants had access to the adverse undisclosed information about Xerox's business prospects and financial condition and performance, as particularized herein, and knew (or recklessly disregarded) that these adverse facts rendered the positive representations made by or about Xerox and its business, by the Company, materially false and misleading.

19. The Individual Defendants, because of their positions of control and authority as officers and directors of the Company, were able to, and did, control the contents of the various quarterly and annual financial reports, press releases and other public statements pertaining to the Company. Each Individual Defendant was provided with copies of the financial statements and documents alleged herein to be false and misleading prior to, or shortly after, their issuance, and had the ability and opportunity to prevent their issuance or to cause them to be corrected. Accordingly, each of the Individual Defendants is responsible for the accuracy of the financial statements and public reports and releases detailed herein and is therefore primarily liable for the representations contained therein.

20. Each of the defendants is liable as a direct participant in a fraudulent scheme and course of business that operated as a fraud or deceit on Xerox common stock purchasers by disseminating materially false and misleading statements and/or concealing material adverse facts. The scheme: (i) deceived the investing public regarding Xerox's business, the true state of its impaired operations following the consolidation of its customer service centers and the further implementation of its restructuring, its actual growth, and the intrinsic value of Xerox common stock; and (ii) caused plaintiffs and other members of the Class to purchase Xerox common stock at artificially inflated prices.

Plaintiffs' Class Action Allegations

21. Plaintiffs bring this action as a class action pursuant to Federal Rule of Civil Procedure 23(a) and (b)(3) on behalf of the Class, consisting of all persons who purchased Xerox common stock during the Class Period and who were damaged thereby. Excluded from the Class are defendants, the officers and directors of the Company, at all relevant times, members of their

immediate families and their legal representatives, heirs, successors or assigns and any entity in which defendants have or had a controlling interest.

22. The members of the Class are so numerous that joinder of all members is impracticable. Throughout the Class Period, Xerox common shares were actively traded on the NYSE. As of July 31, 1999, there were approximately 663.07 million shares of Xerox common stock issued and outstanding. While the exact number of Class members is unknown to plaintiffs at this time and can only be ascertained through appropriate discovery, plaintiffs believe that there are hundreds if not thousands of members in the proposed Class. Record owners and other members of the Class may be identified from records maintained by Xerox or its transfer agent and may be notified of the pendency of this action by mail, using the form of notice similar to that customarily used in securities class actions.

23. Plaintiffs' claims are typical of the claims of the members of the Class as all members of the Class are similarly affected by defendants' wrongful conduct in violation of federal law that is complained of herein.

24. Plaintiffs will fairly and adequately protect the interests of the members of the Class and have retained counsel competent and experienced in class and securities litigation.

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

- (a) whether the federal securities laws were violated by defendants' acts as alleged herein;

- (b) whether statements made by defendants to the investing public during the Class Period misrepresented material facts about the business, operations and financial statements of Xerox; and
- (c) to what extent the members of the Class have sustained damages and the proper measure of damages.

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

Substantive Allegations

Background

Xerox's April 7, 1998 Restructuring Announcement

27. From 1995 through 1998, the price of Xerox common stock consistently increased, reaching a price as high as \$ 54 5/32 per share¹ in March of 1998. However, in early 1998, it became clear that, to remain competitive, the Company needed to reduce its operating costs.

28. On March 25, 1998, *The Washington Times* published an article concerning an earlier report in the *Rochester Democrat and Chronicle* that Xerox planned to announce the elimination of 10,000 jobs by April 6, 1998. The article further reported:

"They [Xerox] need to be even tougher on efficiency because competition is pretty tough," said Bob Spremulli, an analyst at Teachers Insurance & Annuity Association-College Retirement Equities Fund Investment Management, which owned about 6.9 million Xerox shares as of December. "It's a revitalized organization

¹All stock prices have been adjusted to reflect the stock-split announced in January 1999.

which, *if it gets tougher on costs*, can do even better." [Emphasis added.]

* * *

The company has struggled, however, *to pare costs as it makes the transition* from old-style copiers that operate with lenses and light bulbs to the new digital models that can be upgraded to include scanners, fax machines and printers when connected to personal computers. [Emphasis added].

The April 1998 Consolidation

29. On April 7, 1998, Xerox officially announced, over the *Business Wire*, that it would engage in such a restructuring. Although the Company styled its restructuring as a pro-active move, it was, in fact, a response to the material deterioration of the market for Xerox's traditional products -- a problem observed by analysts and investors.

30. In connection with the restructuring, the Company announced, among other things, that it would consolidate customer service centers and lay-off 9,000 people, or approximately 11% of its entire workforce. In the press release, Xerox and defendant Allaire described the restructuring, stating, among other things:

The company will rationalize and consolidate functions and locations to reduce duplication and to *increase speed of response to the marketplace*. -- Overhaul administrative processes and associated resources to achieve significantly greater productivity and speed of implementation. For example, Xerox will close one of four geographically-organized U.S. customer administrative centers with the remaining three re-focused by customer segment, enabling improved customer support *at lower cost*. When fully implemented the ongoing pre-tax savings from the initiatives will be approximately \$ 1 billion annually.

* * *

These initiatives will underpin the consistent delivery of double-digit revenue growth and mid- to high teens earnings-per-share growth. This restructuring is another step in our sustained strategy to lead the digital document world and provide superior customer and shareholder value. [Emphasis added.]

Undisclosed Adverse Material Facts

The Breakdown of Operations

31. Throughout the balance of 1998, Xerox's operations deteriorated as a result of the restructuring. The consolidation of the Company's customer service centers created three regional centers -- set up in Illinois, Texas, and Florida -- that were responsible for executing the core elements of Xerox's sales and customer support function. These centers recorded orders, booked revenue, and supported customers in the critical period immediately following the sale. In fact, Xerox consolidated not four centers into three, as it stated, but as many as 36 regional centers into three. This deception concealed from investors the actual magnitude of the undertaking.

32. As part of the restructuring, Xerox switched from a system in which sales orders were processed on a local level -- by experienced and skilled Xerox employees -- to a system in which the Company's national sales force was required to rely upon the three regional centers, each of which was staffed primarily by inexperienced employees. The consolidation brought specific negative effects on Xerox's sales, operations, and revenue process, which defendants were aware of, or recklessly disregarded at the time they were making the statements described further herein, yet failed to disclose.

33. Xerox primarily employed inexperienced and unskilled employees to staff its newly consolidated customer service centers. Many of its skilled workers, who had staffed such centers in the past, had refused to relocate to work at the three remaining centers. With the loss of skilled

and experienced employees, the inexperienced staff had neither the skill nor the guidance necessary for them to perform their function.

34. The jobs of paperwork and order tracking, which skilled administrative workers used to do, now fell onto the sales personnel. But the sales representatives lacked both the time and the skill to do paperwork and track orders. About 80% of the paperwork the sales representatives prepared contained mistakes that prevented customer service from processing the order. These contracts lacked a customer signature, lacked a product serial number, or referred to a product that did not exist on the Company's product list. The back office could not enter them into the computer system. Therefore, the customer service personnel had to send these flawed contracts to the Company's PC specialists for processing. These specialists became overwhelmed with a backlog of orders. This led to significant delays in the delivery of the Company's products.

35. The delays and inability to track orders frustrated customers, who canceled orders and severed relationships with Xerox, especially since Xerox's competitors could deliver comparable products in a few days.

36. Furthermore, the customer service representatives were working as many as 30 to 40 hours of overtime at the end of each quarter to try to input the contracts. As a result, Xerox lost much of the cost savings expected from the restructuring. Management did not disclose this material operating deficiency until the end of the Class Period, nearly a year and a half after it happened.

37. The experience of one newly-hired service employee at the Illinois service center is representative of the problems affecting all of Xerox's operations. With no experience, this person was placed in charge of processing all contracts coming out of two states: North Carolina and South Carolina. To process the order, she had to read the contract, enter the product information, and input

all of the information necessary to ship the product. She had to process each contract within a day of its receipt. But because many of the contracts she received were flawed (*i.e.*, missing various pieces of information such as a customer signature, a product serial number, or an existing Xerox product), she could not meet the deadline. As a result, she sent the contracts to the Company's PC specialists for processing; soon there was a massive backlog of orders.

38. Top management, including defendants, knew of or recklessly disregarded these problems, which were reported through the regular chain of command, and through project teams that made reports to senior management about the progress of the restructuring. As defendants admit in the Company's Form 10-K for 1998, the Company is constantly "surveying, measuring, and analyzing customer satisfaction," and therefore knew of widespread customer dissatisfaction during this period. Nonetheless, during the Class Period, management failed to disclose these adverse and material effects on Xerox's operations. Also, throughout the Class Period, during and after sales meetings, sales representatives informed top management that the customer service problems were harming sales and customer relations.

39. By relying on unskilled service representatives, orders submitted by the Company's customers were subject to long delays. Xerox had to placate customers by reducing prices on products already sold. As a result, and unknown to the investing public, Xerox was unable to book and record revenues, to collect promptly, and to provide customer service in the critical post purchase period.

Customer Dissatisfaction and Loss of Sales

40. The Company's reliance on unskilled customer service representatives caused dissatisfaction, delays, and the loss of customers.

41. Because of the processing problems discussed above, Xerox customers were subjected to lengthy delays before receiving their products, waiting as long as 90 days from the date of the executed contracts. In contrast, competitors, such as Cannon, Ricoh, and Hewlett Packard, were delivering comparable products in only a few days.

42. For example, customers at the Illinois service center, who had been accustomed to waiting one to two minutes to receive telephone help, now had to wait 15 minutes before reaching an actual person. Customer representatives were handling 70 to 80 calls per day, as opposed to the 40 to 50 calls per day prior to the restructuring. The heavier call volume prevented customer representatives from doing administrative paperwork, filing, or faxing documents to clients in a timely manner. This quickly led to massive disorganization, an undisclosed condition that persisted at this center, and the other service centers throughout the second part of 1998 and all of 1999.

43. The Lewisville, Texas service center, for example, had a time limit in which service representatives had to answer calls. Because they could not meet the time limit, workers transferred the calls to the Company's Chicago service center. Often, customers, whose calls were transferred, would speak to a representative who was unable to help them or answer their questions. Customers became frustrated and angry.

44. The undisclosed breakdown of Xerox's customer service processing system caused the Company to lose pending sales from both its long-standing and newly-established customers and to lose its valuable relationships with these customers, as well. Xerox overcharged many customers, causing sales representatives to spend time correcting invoices and dealing with customer complaints. Thus, any cost-cuts or savings that the Company was claiming it derived from the

restructuring, as well as the favorable impact that the restructuring was having on Xerox's operations, were illusory.

45. As alleged above, the consolidation had the negative effect of placing administrative burdens on the Company's sales representatives. The time and effort once put into selling the Company's products was now spent doing paperwork. This undisclosed impact on the sales force led to these consequences, among others:

a. *A material decrease in the number of sales.* Sales representatives spent more time doing paperwork and dealing with problems, and made fewer sales.

b. *Delayed deliveries and improper follow-up service.* Not only were sales representatives not selling the same volume of product, but on sales they did make, customers did not get timely delivery of the ordered product and did not receive proper follow-up service.

c. *The cancellation of numerous orders due to unacceptable delays and the absence of service.* Many new customers canceled their purchases because of slow delivery, poor follow-up and overcharges. Major long-time customers, such as Fidelity Investments of Boston, began to cancel their long-term contracts with Xerox, opting to pay a cancellation penalty rather than deal with the Company. Other dissatisfied customers forced Xerox to settle accounts at prices below market value.

d. *The impairment of Xerox's sales and revenue.* As a result of the restructuring, Xerox's sales representatives, the Company's front line revenue producers, were forced to do more administrative work and deal with disgruntled customers. Thus, they had less time available to sell the Company's products and services. Their commission structure was changed several times during the restructuring, causing great uncertainty about how sales reps were getting paid. The customer

service centers, largely staffed by the unskilled, inexperienced, low-wage workers, inaccurately calculated the sales force's commission income every month. Nonetheless, Xerox doubled its sales quotas for 1998 and 1999. The new quotas did not take into account whether the market could support such quotas and was a desperate effort by management to meet the expectations that they had inculcated in investors. Nonetheless, senior management, including the Individual Defendants, continued to make and disseminate sales projections based on these quotas.

46. Xerox was informed by its sales force, early in 1999 that the Company's sales projections were not reasonable. The sales force informed management that in 1999 it faced unique obstacles, including price cuts that required higher volume to meet revenue quotas, billing center problems, customer dissatisfaction, and other problems associated with the restructuring. One of the top salesmen, for example, in the Northwest Xerox Business Systems ("XBS") division, ended his year with a nearly 150% increase over the previous year, yet still did not meet his quota. Lesser performing sales representatives fell farther short.

Operational Condition, January 1999

47. By the end of 1998, Xerox had been severely hobbled by the restructuring. Any short-term savings the Company claimed to have realized by consolidating the customer service centers were, by the end of 1998, outweighed by the lost efficiency of its sales force, delayed order processing and recognition of revenue, delayed shipment of products, and the loss of sales to competitors due to its customers' frustration.

48. Although Xerox was experiencing the foregoing operational difficulties, defendants gave investors a far different picture of Xerox in January of 1999. In this regard, defendants:

- told the market that the restructuring would help Xerox meet double-digit earnings targets;
- described the restructuring as successful and on track to be completed;
- told the market that the restructuring allowed Xerox to grow its sales and cut costs at the same time;
- led the market to believe that the costs savings from the restructuring would enable the Company to weather the Asian and Brazilian economic crises; and
- told the market that a sales force realignment would build on the base of the Company's successful restructuring.

49. On January 6, 1999, Xerox announced that it had "reorganized" into four operating groups, changing from geographical orientation to a vertical industry based organization. The largest of the four was the "Industry Solutions [Group], which [was to] include most of the Company's direct sales force." William Buehler was promoted to "head the group." The "General Markets" group covered retail, Internet and third party sales. Ann Mulcahey was promoted to lead that group. Defendants led the investing public to believe that Xerox was being reorganized into a high-end, high margin, digital company. The market's response was positive: Xerox's stock rose \$2 5/16 per share on the announcement. A little more than a month after this announcement, Buehler sold more than \$3.2 million of his Xerox stock into the market, and Mulcahey sold \$ 1.375 million of her Xerox shares.

50. In reality, throughout most of the country, Xerox did not begin its sales force reorganization until after the Class Period, and in some cases not until as late as February 2000. Yet, defendants used the reorganization to convince investors that they were facing challenges and responding to market forces and competition.

51. Company employees were amazed that senior management made public statements about the sales force realignment that had not occurred. "We were all waiting to see when all the analysts were going to figure this all out -- when they were going to peel the covers off this thing and figure out that its not what it appeared to be" said one former sales representative from the Company's XBS Seattle office.

52. Taking advantage of the artificial inflation in the price of Xerox stock, Company insiders, including the Individual Defendants herein, sold over \$51.77 million worth of their personally held Xerox stock while in possession of materially adverse non-public information.

False and Misleading Statements Made During the Class Period

Xerox's Third Quarter 1998

53. On October 22, 1998, defendants caused Xerox to announce over the *Business Wire* increased earnings for the third quarter of 1998. With respect to the restructuring, defendants stated that:

In connection with the restructuring program, 1,700 employees left the company during the third quarter, bringing the total to 3,200. Approximately 9,000 jobs will be eliminated under the program, which is designed to enhance the company's competitive position and *further align its cost structure* with the demands of the digital world. [Emphasis added.]

54. Following the release of the Company's third quarter results, Xerox conducted a teleconference with analysts, money and portfolio managers, large Xerox shareholders, brokers, and stock traders to discuss the Company's restructuring and update them on the Company's operations. During that conference call, defendant Romeril claimed that the Company was realizing the cost-cutting benefits of the restructuring program, stating:

Our third quarter document processing earnings increased by 18 percent to \$1.05 a share and income increased 19 percent to \$381 million, primarily as a result of outstanding growth in digital product revenues and improved operating margins, *including the initial benefits from our worldwide restructuring program.*

* * *

Our focus on productivity paid off on the bottom line. Operating profit margin improved by 170 basis points in the third quarter reflecting our focus on productivity and *the initial benefits of our worldwide restructuring.* [Emphasis added.]

Defendants also claimed that the Company's service productivity had improved for the year and further misled investors to believe that the restructuring was successful, when, in fact, it was not:

As you are all aware, as we implement the worldwide restructuring, *SG&A* [sales, general and administrative expenses] as a percent of revenue will move from the high 20's to the low 20's, *driven primarily by large reductions in G&A overhead costs.* [Emphasis added.]

55. During the conference call, defendant Romeril made additional misleading representations concerning the *present* condition of the Company's operations:

We are also very well positioned to cope with any continued difficulties in the global economic environment. We have a large, strong, consistent recurring revenue stream; we have an exceptional product line with significant competitive advantage; and we are really focused on improving productivity and capturing the benefits of our restructuring program. We have some discretion in the timing of reinvestment of some of the restructuring savings. [Emphasis added.]

56. On November 10, 1998, defendants caused Xerox to file its Form 10-Q for the third quarter 1998 with the SEC. The Form 10-Q stated, among other things:

Restructuring - the Registrant's ability to ultimately reduce pre-tax annual expenditures by approximately \$1 billion is dependent upon its ability to successfully implement the 1998 restructuring program including the elimination of 9,000 jobs worldwide, the closing and

consolidation of facilities, and the successful implementation of process and systems changes.

* * *

Income from continuing operations increased 19 percent to \$381 million in the 1998 third quarter from \$320 million in the 1997 third quarter, primarily as a result of outstanding growth in digital product revenues and improved operating profit margins, including the *initial benefits from the worldwide restructuring program*.

* * *

When fully implemented, the ongoing pre-tax savings from the restructuring initiatives will be approximately \$1 billion annually. Initially, more than half of the savings will be reinvested to implement process and systems changes in order to enable the restructuring, and in ongoing efforts to broaden and strengthen marketing programs and distribution channels to enhance revenue growth.

Selling, administrative and general expenses as a percentage of revenue will move from the high 20's to the low 20's over time, driven primarily by large reductions in overhead costs. [Emphasis added.]

57. The market quickly absorbed defendants' misrepresentations. As further evidence that the materially false and misleading statements issued by the Company misled analysts, on October 22, 1998, based substantially upon the Company's representations concerning its restructuring, Prudential Securities issued an analyst report that stated, in part, the following:

We believe Xerox has significant cost flexibility and discretionary buying power within its system even in the face of global economic uncertainty. This is why we heralded Xerox's . . . restructuring announcement taken in a time of gathering momentum as a watershed type event. We believe the restructuring allows Xerox to pursue its aggressive roll out plans of new products at a time when the macro-economic picture is cloudy at best and still meet the Street's earnings expectations.

58. The statements referenced above in ¶¶ 53-57 were each materially false or misleading when issued because they misrepresented and omitted the adverse facts set forth above in ¶¶ 31-52 and further failed to disclose, among others, the following adverse facts which then existed, and disclosure of which was necessary to make the statements not false and misleading:

- a. Xerox "align[ed] its cost structure" by cutting vital support personnel;
- b. The Company's customer service centers were severely understaffed as a result of the Company's job cuts;
- c. The Company was experiencing deep and widespread operating problems at its customer service centers;
- d. Centralizing customer administration centers negatively impacted on the company's revenues, profits and cash flow;
- e. The sales force was spending its time on paperwork and dealing with customer complaints instead of building new customers;
- f. Xerox was losing sales because it could not book orders and deliver products on time;
- g. Xerox was losing customer relationships because of its undisclosed customer service problems;
- h. The sales force had communicated to management that it was being hindered by the problems of excessive paperwork, the lack of customer support, customer dissatisfaction, commission structure changes, and unrealistic quotas;
- i. At the time of these statements, the restructuring was a failure. The Company had no ability to achieve savings until the problem was fixed. Therefore, the statement that the "ability

to achieve savings is dependent on its ability to successfully implement the 1998 restructuring" was false; and

j. The Company was not getting benefits from its "worldwide restructuring" because European operations were also crippled by the restructuring as management time was consumed in dealing with regulatory problems.

Xerox's Fourth Quarter 1998

59. On January 25, 1999, defendants caused Xerox to announce over the *Business Wire* the Company's increased earnings for the fourth quarter and full year 1998. In the press release, defendants also falsely attributed the Company's fourth quarter increases to "outstanding growth" in digital product revenues, improved operating margins and the *ongoing benefits from the worldwide restructuring program.* [Emphasis added.] Within the press release, defendants Allaire and Thoman further stated:

The overall strength of Xerox and our excellent prospects for continuing consistent growth prompted our board to increase the dividend and split the stock, underscoring our commitment to shareholder value.

On February 4, 1999, just nine days after making this statement, defendant Allaire sold 200,000 (post-split) Xerox shares for approximately \$11.8 million.

60. Following the release of the Company's fourth quarter results, Xerox conducted a teleconference with analysts, money and portfolio managers, large Xerox shareholders, brokers, and stock traders to discuss the Company's restructuring and update them on the Company's operations. During the conference call, defendant Romeril claimed that earnings had increased, and that the

Company had realized cost-cutting benefits and improved service productivity due to the unimpeded progress that it was making with its restructuring program:

primarily as a result of outstanding growth in digital product revenues, improved operating margins and *the ongoing benefits from our worldwide restructuring program.*

* * *

Operating profit margin improved by 160 basis points in the fourth quarter reflecting our focus on productivity and *the ongoing benefits of our worldwide restructuring.*

* * *

As you are all aware, as we implement the worldwide restructuring, SG&A as a percent of revenue will move from the high 20's to the low 20's, driven primarily by large reductions in G&A overhead costs, with some of the earlier savings being reinvested in marketing and promotion initiatives to drive revenue growth. In the fourth quarter *we reinvested a significant portion of the restructuring savings* - in areas like the new advertising campaign.

* * *

Our restructuring provision provides for large savings in 1999 and with the amount of savings that we reinvest being somewhat discretionary, it really does widen to a degree the envelope of economic environments in which we can reach our earnings commitment. In fact, in the last few weeks [we] have had a further tightening of our cost controls to accommodate uncertainties.

* * *

We have an exceptional product line with significant competitive advantage; and we are really focused on improving productivity and *capturing the benefits of our restructuring program.* We have some discretion in the timing of reinvestments of some of the restructuring savings. [Emphasis added.]

61. On March 23, 1998, defendants caused Xerox to file its Form 10-K for 1998 with the SEC. The Form 10-K was signed by defendant Allaire and stated, among other things:

Our highest priority is customer satisfaction. Our research shows that satisfied customers are far more likely to repurchase products and that the cost of selling a replacement product to a satisfied customer is far less than selling to a "new" customer. *We regularly survey customers on their satisfaction, measure the results, analyze the root causes of dissatisfaction, and take steps to correct any problems.* [Emphasis added.]

The Form 10-K additionally contained statements concerning the Company's operating condition, the purported benefits of its restructuring and the cost savings derived therefrom, which were substantially similar to the statements in the January 25, 1999 press release and teleconference call, including the following statements:

Initially, more than half of the savings is being reinvested to implement business process and systems changes in order to enable the restructuring, and in ongoing efforts to broaden and strengthen marketing programs and distribution channels to enhance revenue growth. Selling, administrative and general expenses as a percentage of revenue will move from the high 20's to the low 20's over time, driven primarily by large reductions in overhead costs

* * *

When fully implemented, the ongoing pre-tax savings from the restructuring initiatives will be approximately \$1 billion annually. Initially, more than half of the savings is being reinvested to implement business process and systems changes in order to enable the restructuring, and in ongoing efforts to broaden and strengthen marketing programs and distribution channels to enhance revenue growth. Selling, administrative and general expenses as a percentage of revenue will move from the high 20's to the low 20's over time, driven primarily by large reductions in overhead costs.

62. Defendants' materially false and misleading statements had their intended market effect. On January 25, 1999, *Bloomberg* reported:

"What really stands out is the language," said Prudential Securities analyst B. Alex Henderson, who has a "strong buy" rating on the stock. "Clearly they are intending to convey to (Wall Street) that they can make earnings estimates going forward." [Emphasis added.]

63. One day later, on January 26, 1999, *Bloomberg* further reported, in part, the following:

Xerox [Corp.] shares rose 10 percent after the world's largest copier maker said forth-quarter profit rose 17 percent and declared its second stock split in three years.

The stock rose 10 15/16 to 116 5/16. Earlier, the shares rose as high as 118 13/16 giving *Xerox the highest percentage gain in [the last] 18 years, according to Bloomberg data.*

* * *

Xerox's earnings, which were reported after the close of New York trading and a day earlier than expected, reaffirmed profit projections for 1999 and beyond in the "mid- to high-teens."...

"This company has done a great job of learning to be able to manage through adversity, and over time, that should be translated to a higher valuation." said Eric Lucera, an analyst at Independence Investment Associates, which owned more than 3.3 million Xerox shares at the end of September. [Emphasis added.]

In addition to the foregoing, defendants also utilized the January 26 news release to reduce investors' concerns regarding the negative impact Brazil, whose economy was suffering serious difficulties at this time, was having, and would continue to have, on the Company. As evidence of this conditioning, the news release continued, in part, as follows.

Brazil accounted for about 8 percent of sales in 1998, down from about 10 percent in 1997. Even so, the company remains "confident" in its projections for per-share growth in 1999, [defendant Romeril] said. The troubled economy in Brazil may even be giving Xerox an advantage over competitors.

"What's happening down there is clearly going to frighten some of the competition away," he [defendant Romeril] said. "The only word there of caution is if we had a meltdown whose effects were felt elsewhere, you'd have to revisit the thing."

* * *

"It would take a general market meltdown, not just Brazil, to derail them from earnings growth," said Morgan Stanley Dean Witter analyst Rebecca Runkle. [Emphasis added.]

Several days following these statements, on February 4, 1999, defendant Romeril sold 20,524 Xerox shares for approximately \$1.2 million.

64. On January 26, 1999, *The New York Times* also reported on Xerox's fourth quarter financial results, quoting analyst Rebecca Runkle, who stated that Xerox's "*results look pretty rock solid*" and that "they surprised by a couple of pennies and gross margins improved." [Emphasis added.]

65. On February 2, 1999, in an article entitled "Xerox Recasts Itself As Formidable Force In Digital Revolution," *The Wall Street Journal* reported on Xerox's purported success with its restructuring. This article outlined the changes that Xerox had previously announced and summarized the then current market conditions. Significantly, the article quoted Xerox representatives, who boasted of the immediate, positive impact the restructuring was having on the Company. As evidence of this, the *Journal* reported, in part, the following:

"I'm hunting whales," says Phil Pilibosian, a Xerox senior vice president, as he explains how his staff is focusing on 300 major companies in financial services and health care, moving to an industry-specific focus. "We're moving through the Blues [Blue Cross and Blue Shield companies] like Grant through Richmond," says Mr. Pilibosian, who hails from New England.

At the Leesburg sales meeting, Xerox management sounds a confident note. There are gibes about keeping Hewlett-Packard's chief executive awake at night. . . And one executive repeats a recent line of Xerox CEO Mr. Allaire, who said, "Our competition is momentarily stunned." [Emphasis added.]

Just two days after this article appeared, defendant Allaire sold 200,000 shares of Xerox for a profit of approximately \$8.27 million.

66. The statements referenced above in ¶¶ 59-65 were each materially false or misleading when issued because they misrepresented and omitted the adverse facts set forth above in ¶¶ 31-52 and further failed to disclose, among others, the following adverse facts which then existed, and disclosure of which was necessary to make the statements not false and misleading:

- a. Xerox accomplished its restructuring by cutting vital support personnel;
- b. The Company's customer service centers were severely understaffed as a result of the Company's job cuts;
- c. The Company was experiencing deep and widespread operating problems at its customer service centers;
- d. Centralizing customer administration centers negatively impacted on the company's revenues, profits and cash flow;
- e. The sales force was spending its time on paperwork and dealing with customer complaints instead of building new customers.
- f. Xerox was losing sales because it could not book orders and deliver products on time;
- g. Xerox was losing customer relationships because of its undisclosed customer service problems;

h. The sales force had communicated to management that it was being hindered by the problems of excessive paperwork, the lack of customer support, customer dissatisfaction, commission structure changes, and unrealistic quotas; and

i. European operations were also crippled by the restructuring as management time was consumed in dealing with regulatory problems.

The Massive January and February Insider Sell-Off

67. Taking advantage of the artificial inflation in the value of Xerox stock, which defendants' materially false and misleading statements had created, during January and February 1999, twelve Company insiders, including the three top executives named as the Individual Defendants herein, profited over \$24.7 million from suspiciously timed sales of their personal Xerox stock. These sales, led by defendants Allaire and Thoman, grossed over \$41.4 million, *more than in any one-month period in Xerox's history*, according to Washington Service, which began tracking stock sales by insiders in 1986. Defendant *Allaire collected over \$8.27 million*, exercising options to buy over 100,000 shares for \$35.52 each, which he then immediately sold for \$118.19 each. Defendant *Thoman realized \$7.91 million* through the exercise of options and defendant *Romeril sold over 10,000 shares to realize over \$1.2 million* (a detailed list of insider sales appears herein *infra*). According to a *Bloomberg* news report, published on March 16, 1999, *the sales were the first for defendant Thoman*. In addition, *Bloomberg* reported that Xerox company spokesman, Judd Everhart, refused to comment on the insiders' stock sales.

<u>DATE</u>	<u>SELLER</u>	<u># OF SHARES</u>	<u>PRICE</u>	<u>GROSS PROCEEDS</u>
02/04/99	Paul A. Allaire	200,000	59.09	\$ 11,818,740.00
02/01/99	Richard G. Thoman	200,000	61.20	\$ 12,240,505.00
02/03/99	Richard G. Thoman	100,000	61.13	\$ 6,112,500.00
Total	Richard G. Thoman	300,000		\$18,353,005.00
02/04/99	Barry D. Romeril	20,524	58.50	\$ 1,200,654.00
01/29/99	Richard S. Paul	10,000	62.41	\$ 624,050.00
05/03/99	Richard S. Paul	10,000	63.72	\$ 637,200.00
Total	Richard S. Paul	20,000		\$ 1,261,250.00
02/01/99	Stuart B. Ross	20,000	61.32	\$ 1,226,300.00
02/01/99	Anne M. Mulcahy	20,000	62.50	\$ 1,250,000.00
02/01/99	Anne M. Mulcahy	2,000	62.56	\$ 125,110.00
Total	Anne M. Mulcahy	22,000		\$ 1,375,110.00
02/11/99	William F. Buehler	53,998	60.19	\$ 3,250,258.00

Xerox's First Quarter 1999

68. On April 22, 1999, notwithstanding a decrease in the Company's revenues, defendants caused Xerox to announce over the *Business Wire*, increased earnings for the first quarter of 1999, claiming that such results were:

primarily due to improved operating margins that reflected *[the] ongoing benefits from the company's worldwide restructuring program* and a heightened focus on productivity and expense controls.

* * *

In connection with the restructuring program which was announced a year ago to enhance the company's competitive position and further align costs with the demands of the digital world, approximately 1,000 employees left the company in the first quarter, bringing the total to 6,400.

* * *

"The operating margin improvement *reflects the benefits of our restructuring program, as well as our sharpened focus on productivity and expense controls*

* * *

"Our global growth opportunities remain substantial and *our sales force is energized and motivated to aggressively market our broad and technologically innovative line of products, services and industry solutions,*" said CEO Thoman.

* * *

"several in-country facilities relocations, whilst *very cost effective going forward,* added to the reduction in customer focus." [Emphasis added.]

69. Following the release of the Company's first quarter results, Xerox conducted a teleconference with analysts, money and portfolio managers, large Xerox shareholders, brokers, and stock traders, to discuss the Company's restructuring and update them on the Company's operations.

During the conference call, defendant Romeril stated:

Sales development included *in-depth training on targeted industries* as well as digital and color sales skills enhancements. These initiatives temporarily reduced selling time with customers and impacted first quarter sales productivity more than we had anticipated

* * *

Our restructuring provision provides for large savings in 1999 and future years and with the amount of savings that we can reinvest being somewhat discretionary, it really does widen to a degree the envelope of economic environments in which we can achieve our

earnings objectives, and you have seen that demonstrated with our first quarter results.

Despite the obvious concerns some of you will have, there should be no ambiguity about Xerox management's firmly held belief that our global growth opportunities remain substantial and *our sales force is energized and motivated to aggressively market our broad and technologically innovative line of products, services and industry solutions. The focus of the entire organization is on getting in front of the customer* and accelerating revenue growth in part by delivering industry-specific solutions and services to our major customers and we will be demonstrating this at major presentations in the U.S. and Europe next week. [Emphasis added.]

70. On May 14, 1999, defendants caused Xerox to file its Form 10-Q for the first quarter 1999 with the SEC. The Form 10-Q stated, among other things:

Restructuring - the Registrant's ability to ultimately reduce pre-tax annual expenditures by approximately \$1 billion is dependent upon its ability to successfully implement the 1998 restructuring program including the elimination of 9,000 jobs, net, worldwide, the closing and consolidation of facilities, and the successful implementation of process and systems changes.

* * *

There have been no material changes to the program since its announcement in April 1998, and the majority of the remaining reserve will be utilized throughout the remainder of 1999 and 2000.

* * *

First quarter revenue growth in both the U.S. and Europe was disappointing, slowing significantly from prior quarters due to substantial one-time investments, including enhanced sales training and development, and some changes in customer relationships, associated with the initiatives announced in January 1999 to provide industry-oriented global document solutions for major customers. These initiatives temporarily reduced sales time with customers and impacted sales productivity more than anticipated.

71. The statements referenced above in ¶¶ 68-70 were each materially false or misleading when issued because they misrepresented and omitted the adverse facts set forth above in ¶¶ 31-52 and further failed to disclose, among others, the following adverse facts which then existed, and disclosure of which was necessary to make the statements not false and misleading:

- a. The Company's sales realignment, in the first quarter of 1999, had occurred only with respect to its government related sales personnel, and had yet to occur in divisions responsible for sales to commercial enterprises, the majority of Xerox's sales force;
- b. The real cause of reduced time with customers was not one time training initiatives, but ongoing customer service problems;
- c. Xerox accomplished its restructuring by cutting vital support personnel;
- d. The Company's customer service centers were severely understaffed as a result of the Company's job cuts;
- e. The Company was experiencing deep and widespread operating problems at its customer service centers;
- f. The sales force was spending its time on paperwork and customer complaints instead of building new customers;
- g. The sales force was spending half its time on paperwork. The "focus of the entire organization" was not on "getting in front of the customer;"
- h. Xerox was losing sales because it could not book orders and deliver products on time;
- i. Xerox was losing customer relationships because of its undisclosed customer service problems;

j. The sales force had communicated to management the problems of excessive paperwork, lack of support, customer dissatisfaction, commission structure changes, and unrealistic quotas;

k. European operations were also crippled by the restructuring as management time was consumed in dealing with regulatory problems.

72. The market reacted to the April 22, 1999 press release and began to adjust the stock price from its high in early February when the insiders sold, toward its nadir which it would hit when the full truth came out. Following the announcement of Xerox's disappointing first-quarter 1999 revenues, *Bloomberg* reported that analysts appeared to accept the Company's explanation that the results of the first quarter were *not* indicative of Xerox's results going forward, and that the Company expected a significant rebound in the second quarter of 1999. As evidence of this, on April 22, 1999, *Bloomberg* reported that Prudential Securities analyst, B. Alex Henderson, who maintained a "Strong Buy" rating on Xerox stock stated that, "*They are adamant that revenues are going to snap back sharply in the second quarter and I think they have a compelling argument.*" [Emphasis added.] As a result of defendants' positive and materially false statements the price of Xerox stock declined only a marginal amount, falling \$1.56 to \$58.56 per share.

Xerox's Second Quarter 1999

1999 Investor Conference

73. In order to further condition the market to believe that the Company's reorganization was proceeding according to plan, on May 14, 1999, the Company told analysts that it expected critical second quarter revenue to rise by a respectable five percent, following the disappointing first quarter 1999. According to a *Bloomberg* report, also published on May 14, 1999, the Company

announced at an analyst and investor conference its expected revenue increase. Xerox also reiterated its forecast of "mid-to-high teens" annual per share earnings growth in 1999 and beyond. *Bloomberg* further reported that, "according to analysts present at the meeting, Xerox announced that it had fixed most of its salesforce realignment problems and that the Company was, therefore, on course to deliver results in line with expectations." [Emphasis added.] These positive statements [May 14, 1999] also acted to support the price of Xerox stock which closed trading on that day at \$58.62 per share.

74. As further evidence that the materially false and misleading statements issued by the Company misled analysts, on May 17, 1999, based substantially upon the Company's representations regarding the initial success of its purported reorganization plan, and the growth prospects presented thereby, Prudential, Morgan Stanley and PaineWebber each issued analyst reports on Xerox in which they rated Xerox common stock "Buy," "Outperform," and "Buy," respectively:

Morgan Stanley: May 17, 1999

Management believes these were one-time issues and that the company will get back on its growth track going forward -- with material improvement in the second quarter.

PaineWebber : May 17, 1999

Overall, we believe XRX did a good job addressing key investor concerns including revenue growth, Brazil and working capital management.

* * *

Xerox indicated that it believed training initiatives in the first quarter took 500 basis points of growth due to salesforce inactivity.

75. The statements referenced above in ¶¶ 73-74 were each materially false or misleading when issued because they misrepresented and omitted the adverse facts set forth above in ¶¶ 31-52 and further failed to disclose the following adverse facts, among others, which then existed, and disclosure of which was necessary to make the statements not false and misleading:

a. Xerox accomplished its restructuring by cutting vital support personnel;

b. The real cause of sales inactivity was not the sales force realignment, which had not even begun yet for commercial clients -- but was the failed restructuring;

c. The Company's customer service centers were severely understaffed as a result of the Company's job cuts;

d. The Company was experiencing deep and widespread operating problems at its customer service centers;

e. The sales force was spending its time on paperwork and customer complaints instead of building new customers;

f. Xerox was losing sales because it could not book orders and deliver products in a timely fashion;

g. Xerox was losing customer relationships because of its undisclosed customer service problems;

h. The sales force had communicated to management the problems of excessive paperwork, the lack of customer support, customer dissatisfaction, commission structure changes, and unrealistic quotas; and

i. European operations were also crippled by the restructuring as management time was consumed in dealing with regulatory problems.

76. On July 22, 1999, defendants caused Xerox to announce over the *Business Wire* increased earnings for the second quarter of 1999, claiming that:

The earnings increase reflects improved revenue growth, particularly in the United States and Europe, and *ongoing benefits from the company's worldwide restructuring program and the continuing focus on productivity and expense controls.*

* * *

Longer term, our growth will be driven by our expanding product, document outsourcing and solutions offerings as well as indirect distribution channels, and by realizing the *ongoing benefits of the restructuring program* and our productivity and expense controls," Thoman added. [Emphasis added.]

77. Following the release of the Company's second quarter results, Xerox conducted a teleconference with analysts, money and portfolio managers, large Xerox shareholders, brokers, and stock traders, to discuss the Company's restructuring and update them on the Company's operations. During the conference call, defendant Romeril stated:

The earnings increase reflects improved revenue growth, particularly in the United States and Europe, and *ongoing benefits from our worldwide restructuring program* and continuing focus on productivity and expense controls.

SG&A expenses declined 2 percent in the quarter driven by a substantial decline in general and administrative expense which *reflected the benefits of our 1998 restructuring program, our sharpened focus on productivity and expense controls.*

* * *

Our restructuring provision provides for large savings, a significant portion of which we have to reinvest in the first year or two to enable the savings -- particularly in Europe as we centralize our front and back office operations. In addition, we will continue to invest in areas such as advertising to drive future revenue growth. We are less inclined to hold back on some of these more discretionary

reinvestment as more and more they are essential to future profitable revenue growth. *But our SG&A commitments as a percentage of revenue are not in question.*

With receivables we have had to work through the bow wave of USA customer administration dislocation and are now looking forward to substantial improvements in the coming months in the U.S. to complement the improvement already evident in the second quarter in Europe. [Emphasis added.]

78. On May 14, 1999, defendants caused Xerox to file its Form 10-Q for the second quarter 1999 with the SEC, which stated, among other things:

Restructuring - the Registrant's ability to ultimately reduce pre-tax annual expenditures by approximately \$1 billion is dependent upon its ability to successfully implement the 1998 restructuring program including the elimination of 9,000 jobs, net, worldwide, the closing and consolidation of facilities, and the successful implementation of process and systems changes.

Selling, administrative and general expenses (SAG) declined 2 percent in the 1999 second quarter from the 1998 second quarter and 2 percent in the 1999 first half from the 1998 first half driven by a substantial decline in general and administrative expenses reflecting the benefits of our 1998 restructuring program, our continued focus on productivity and expense controls to mitigate the impact of the economic turmoil in Brazil.

79. The statements referenced above in ¶¶ 76-77 were each materially false or misleading when issued because they misrepresented and omitted the adverse facts set forth above in ¶¶ 31-52 and further failed to disclose the following adverse facts, among others, which then existed, and disclosure of which was necessary to make the statements not false and misleading:

- a. The Company had no chance for "substantial improvements" because its "customer administration dislocation" had not been solved and continued to deteriorate;
- b. Xerox accomplished its restructuring by cutting vital support personnel;

- c. The Company's customer service centers were severely understaffed as a result of the Company's job cuts;
- d. The Company was experiencing deep and widespread operating problems at its customer service centers;
- e. The sales force was spending its time on paperwork and customer complaints instead of building new customers;
- f. Xerox was losing sales because it could not book orders and deliver products in a timely fashion;
- g. Xerox was losing customer relationships because of its undisclosed customer service problems;
- h. The sales force had communicated to management the problems of excessive paperwork, the lack of customer support, customer dissatisfaction, commission structure changes, and unrealistic quotas; and
- i. European operations were also crippled by the restructuring as management time was consumed in dealing with regulatory problems.

80. On September 16, 1999, Xerox shares fell an additional 9.2 percent after the Company said it would realign its salesforce for the second time this year. In reaction to this announcement, *Bloomberg* reported that some investors were wary of further changes in the Company's sales organization, especially in the last two weeks of the quarter when a large portion of sales are purportedly made. *Bloomberg* also reported that investors were nervous after defendant Romeril said that *third-quarter revenue will rise only 3.5 percent to 4.5 percent.*" [Emphasis added.] In reaction to this news, shares of Xerox stock fell \$4.25 to \$42.75 per share, after touching a low

of \$41.88 per share for the day, on exceptional high trading volume of 10 million shares, more than three times the three-month daily average. This decline, however, was not fully reflective of the inflation of the stock, because of the disclosure that still awaited shareholders. The disclosure was not complete. It only hinted at the real and deep customer service operation problem that was like sand in the Company's machinery.

81. The representation of this disclosure so misstated the Company's operating conditions that market participants, unaware of the condition of the Company's sales force, billing, shipping, and customer service, and more importantly, unaware of the Company's deteriorating customer relationships, still recommended the stock. Based substantially upon the Company's representations regarding Xerox's second purported reorganization plan, and the growth prospects presented thereby, on September 22, 1999, SG Cowen issued an analyst report on Xerox in which it rated the Company's common stock a "Strong Buy." In making its recommendations, the analysts relied in part, on the following:

We Rate XRX Stock Strong Buy...

* * *

INVESTOR CONCERNS SEEM OVERBLOWN - - Past problems in sales have almost always been associated with changes in the sales comp plan, not the organization per se. While Xerox will be completing a shift to an industry-focused selling model in Q1, we expect no meaningful change in sales incentives other than to institute a reward for sales consummated in Q1 that were proposed by the former sales person in Q4. Moreover, the disruption in *Q1: 99 caused by extra training and necessary attention in the U.S. to curing billing glitches should not repeat*. Thus, given the very easy base for competition, we are optimistic re double-digit top-line growth in Q1 : 2000 and beyond. [Emphasis added.]

82. On September 23, 1999, based substantially upon the same representations regarding its second purported reorganization plan and the growth prospects presented thereby, PaineWebber issued an analyst report on Xerox in which it rated Xerox common stock a "Buy." In making its recommendations, the analysts relied in part, on the following:

In general, Xerox management was far more upbeat in yesterday's call than it was during its 2Q 1999 earnings call. CFO Barry Romeril addressed erroneous reports that he had recently lowered guidance for the second half of 1999, reiterating that the company maintains its goal for 8-9% pre-currency growth for 3Q 1999 (excluding currency and Brazil). In addition, he stated that the salesforce restructuring in 2000 is not new, but part of its previously announced 1999 plan. While only a portion of the salesforce in the US is already realigned by industry focus (predominantly the public sector), about two-thirds of the US salesforce will be realigned by industry by January 2000. However, about 80% of all salespeople being realigned already have over one-half of their customers in one industry today (meaning salespeople should be familiar with the way most new customers do business anyway). [Emphasis added.]

83. This representation squarely contradicted the explanations previously set forth by defendants, in April 1999, concerning Xerox's disappointing results. At that time, defendants relied upon the false explanation that the realignment had caused the sales force disruptions. Now, defendants finally admitted that only the government sector, and *not* Xerox's commercial-related operations, had been aligned by September.

84. The statements referenced above in ¶¶ 81-82 were each materially false or misleading when issued because they misrepresented and omitted the adverse facts set forth above in ¶¶ 31-52 and further failed to disclose the following adverse facts, among others, which then existed, and disclosure of which was necessary to make the statements not false and misleading:

- a. Xerox accomplished its restructuring by cutting vital support personnel;

b. The Company's customer service centers were severely understaffed as a result of the Company's job cuts;

c. The Company was experiencing deep and widespread operating problems at its customer service centers;

d. The sales force was spending its time on paperwork and customer complaints instead of building new customers;

e. Xerox was losing sales because it could not book orders and deliver products in a timely fashion;

f. Xerox was losing customer relationships because of its undisclosed customer service problems;

g. The sales force had communicated to management the problems of excessive paperwork, the lack of customer support, customer dissatisfaction, commission structure changes, and unrealistic quotas; and

h. European operations were also crippled by the restructuring as management time was consumed in dealing with regulatory problems.

Xerox's Third Quarter 1999: Defendants Finally Admit to the Company's True Condition

85. On October 8, 1999, only two weeks after the Company reassured investors that its restructuring plan was proceeding according to plan and that Xerox would report a revenue increase of up to 4.5 percent in the third quarter of 1999, Xerox shocked the market by issuing a press release, over *Business Wire*, in which it announced that third quarter results would fall materially short of analysts expectations which the Company had endorsed only weeks before. According to the press

release, *the Company would report essentially flat revenues for the third quarter and about a 10 - 12 percent decline in diluted earnings per share*, to \$0.47 per share, from \$0.53 per share reported in the third quarter of 1998. Analysts' consensus estimates called for the Company to report \$0.58 per share in the third quarter of 1999. According to the press release, the Company now admitted that the restructuring was not proceeding according to plan and that the "*sales productivity was affected by . . . the ongoing impact of the customer administration restructuring.*" [Emphasis added.]

86. The stock market's reaction to Xerox's shocking admissions was punitive and immediate. On October 8, 1999, *Bloomberg* news service reported that Xerox shares fell more than 25 percent, or \$11.00 per share, to close at \$31.75 per share, a new 52-week low. This decline represented an almost 50 percent decline in the value of the Company's stock from the Class Period high during the Class Period -- or a reduction of almost \$21.6 billion of Xerox's market capitalization. With over 46 million shares traded, Xerox was the most active stock on the NYSE that day. To place the significance of this decline in historical context, prior to this day, the biggest single-day drop in Xerox's stock during the past two decades occurred on October 19, 1987, the last stock market crash, when Xerox shares fell only 20 percent.

87. Following the remarkable decline in the value of Xerox stock, on October 9, 1999, *The New York Times* reported, in part, the following:

The Xerox Corporation, reeling from inroads that competitors are making into its markets even as *its own salesforce is in disarray*, warned analysts yesterday that its third-quarter results would be dismal.

* * *

The document-processing company, which is based in Stamford, Conn., said its revenue would not top the \$4.61 billion it reported in

the quarter last year, and its earnings could be as much as 12 percent below the 53 cents a diluted share it earned in the third quarter of 1998.

That comes out to less than 47 cents a share, below the 58 cents a share analysts had been predicting. Analysts rushed to downgrade their earnings estimates for this year and next, and to pull their "buy" recommendations off the stock. Xerox shares plunged \$10.25, or 24 percent, to close at \$32.50.

"This was more than just fine-tuning estimates, *this was a sign of a really big disappointment*," said Charles L. Hill, director of research at First Call/Thomson Financial, which tracks analysts' estimates. [Emphasis added.]

88. On October 18, 1999, defendants caused Xerox to announce over *Business Wire* the Company's purported results for the third quarter of 1999. Defendants, through this press release, admitted:

Xerox Corporation's third quarter diluted earnings per share decreased 11 percent to 47 cents and income decreased 11 percent to \$339 million, the company announced today following its preliminary earnings report issued October 8. Issues affecting third quarter results are expected to continue into the fourth quarter and the first half of 2000.

The operating profit decline was due to an unfavorable product mix, pricing pressures, a U.S. customer administration reorganization and sales organization realignment.

* * *

Implementing the substantial changes to align our sales force to sell products, services and solutions by industry sector, *overcoming issues in centralizing our customer administrative centers* and attacking our still unacceptably high cost base will pressure our results for the next several quarters -- but these are all the necessary elements in building a foundation for growth. Improving our performance in Brazil and Fuji Xerox is also key to our overall recovery.

Revenue growth slowed to 6 percent in the United States and 3 percent in Europe, reflecting an unfavorable product mix, increasing competition and pricing pressures, and lower sales productivity associated with the realignment to an industry approach. *A significant additional factor in the U.S. related to the ongoing disruptive effects of the customer administration reorganization.* [Emphasis added.]

89. On November 12, 1999, defendants caused Xerox to file its Form 10-Q for the third quarter 1999 with the SEC, in which the Company acknowledged, for the first time, the possibility that the centralization of the Company's customer administration centers could act to the Company's detriment, stating, among other things:

Restructuring - the Registrant's ability to ultimately reduce pre-tax annual expenditures by approximately \$1 billion is dependent upon its ability to successfully implement the 1998 restructuring program including the elimination of 9,000 jobs, net, worldwide, the closing and consolidation of facilities, and the successful implementation of business process and systems changes. *In addition, the timing and effectiveness in overcoming issues in centralizing its customer administration centers can impact the timing of improvements in revenue, profit and cash flow.*

Sales Force Realignment - the Registrant's ability to increase future revenue and profits is in part dependent upon its ability to successfully implement the substantial changes in the alignment of its sales force to sell products, services and solutions by industry sectors. [Emphasis added.]

90. On October 19, 1999, the day that the Company formally reported its third quarter financial results, in light of the Company's admissions, *The New York Times* reported the following:

Ten days after warning that its third-quarter results would be dismal, the Xerox Corporation made good on that promise yesterday, and then some.

The company, which is based in Stamford, Conn., said that its net income fell 11 percent, to \$339 million, or 47 cents a diluted share, compared with \$381 million, or 53 cents a share, in the quarter a year

earlier. Until Xerox's warning on Oct. 8, analysts had expected third-quarter earnings to be 58 cents a share.

Revenue, meanwhile, was flat, rising to just \$4.63 billion from \$4.61 billion.

* * *

Xerox may be in worse shape than its earnings indicate. The company accrued money in the first two quarters to pay out as profit-sharing; now, with profits looking low, it returned that money to the income stream, benefitting the quarter's profits by 7 cents a share. Xerox picked up an additional 3 cents a share from stock and asset sales.

"Back those out and you get 37 cents, way below the guidance of 10 days ago," Mr. [B. Alex] Henderson said.

* * *

Xerox recently consolidated 36 administrative centers into 3, but did not provide adequate staff. The result was severe problems with billing and accounts receivable.

"Our sales people have had to spend 40 percent of their time dealing with administrative matters instead of selling," Mr. Thoman said. [Emphasis added.]

91. Analysts, as reported by *Bloomberg*, gave their final assessment of the real problem, now disclosed for the first time, as well as their observations about the credibility of Xerox management in light of this disclosure:

J. P. Morgan: October 19, 1999

Xerox sales force has spent far too much time off line, some 40% of it in the U.S., as these people essentially filled in for a delinquent back office. The source of the problem was the aggressive consolidation of administrative functions related to sales (the processing of and follow-through on orders). In the U.S., Xerox went from 36 regionally-focused fulfillment locations to three organized by account type, with a concentration of activity in Chicago, where the ranks were understaffed and lacked experience. That's the diagnosis: Daniel Kunstler.

Prudential Securities: October 18, 1999

"The laundry list of issues is substantial. . . . They're basically going to talk about all of the issues but nobody is going to believe them."
B. Alex Henderson.

Morgan Stanley Dean Witter: October 18, 1999

"I'd like to believe him [Thoman], but I'd also like to understand better what he knows that gives him the visibility and the confidence." Rebecca Runkle.

T. Rowe Price: October 8, 1999

"It calls into question the credibility of management," said David Giroux, an analyst at T. Rowe Price Associates Inc., which owned 600,000 shares at the end of June. He declined to say how many Xerox shares the company now owns.

92. As recently as April 27, 2000, the undisclosed problems that Xerox had concealed from investors during the Class Period have been noted by the press: For example, on this date, with respect to the failed restructuring, *Investors Business Daily* reported:

[The t]rouble was, the company botched its billing center consolidation. Xerox overcharged customers. New sales reps spent their days handling customer complaints and fixing faulty invoices instead of building new customers. Receivables shot up when outraged customers refused to pay inflated bills. Xerox was forced to settle accounts at prices below market value to placate clients.

Once you have that kind of problem, you're stuck with it until it works its way through," said Xerox spokesman Jeffrey Simiek.

ADDITIONAL SCIENTER ALLEGATIONS

93. As alleged herein, defendants acted with scienter in that defendants knew or recklessly disregarded the fact that the public documents and statements issued or disseminated in the name of the Company were materially false and misleading. They knew or recklessly disregarded that such statements or documents would be issued or disseminated to the investing public and they substantially participated or acquiesced in the issuance or dissemination of such statements or documents as primary violations of the federal securities laws. As set forth elsewhere herein in detail, defendants, by virtue of their receipt of information reflecting the true facts regarding Xerox, their control over, and/or receipt and/or modification of Xerox's materially misleading misstatements and/or receipt their associations with the Company that made them privy to confidential proprietary information concerning Xerox, participated in the fraudulent scheme alleged herein.

94. As set forth above, defendants personally benefitted from selling a substantial quantity of Xerox common stock during the same period that they were disseminating the false and misleading statements described above. Overall, the Company's insiders sold over \$51.77 million worth of their personally held Xerox common stock throughout the Class Period. The Individual Defendants, themselves, sold approximately \$31.4 million of Xerox common stock in the weeks after the January 25, 2000 announcement, having made false statements that had the effect of falsely inflating the value of the stock to a new high.

95. During the height of the Company's undisclosed internal restructuring problems, in January 1999, defendants caused the Company to issue a favorable announcement with respect to the restructuring, in which it described a realignment that, in reality, would not occur until many months later. Defendants caused the Company to make this misleading announcement shortly before the Company announced a two-for-one stock split, and an increase in the dividend. Defendants also made many other statements about the success of and benefits the Company was getting from the restructuring at a time suspiciously close to such large and widespread insider sales. These statements were squarely contradicted by both internal evidence known to defendants at that time, and the later admissions about known events then existing.

96. The timing and magnitude of the insider selling also demonstrates scienter. The Individual defendants, along with other senior executives, two of whom -- Ann Mulcahy and William Buehler -- were just promoted to carry out the announced realignment, sold a substantial number of shares in the weeks following the false statements. The concentration of sales -- 77.8% of all the insider sales made during 1999 -- in this one month eclipsed any of the preceding three years by almost a two to one margin. These sales occurred during the first opportunity defendants had following the issuance of the Company's favorable Form 10-K for 1998 and at a time that, as discussed above, notwithstanding the undisclosed failures set forth above, the Company was thought to be "rock solid" and the Company's competition said to be "momentarily stunned."

Xerox Corporation
Insider Open Market Sales by Month: 1998 - 1999

Year	Month	Open Market Sales	% of Year
1998	January	39,482	4.3%
	February	62,452	6.8%
	March	0	0.0%
	April	228,382	25.0%
	May	145,562	16.0%
	June	0	0.0%
	July	219,424	24.1%
	August	134,000	14.7%
	September	0	0.0%
	October	40,872	4.5%
	November	41,992	4.6%
	December	0	0.0%
1998 Total		912,166	100.0%
1999	January	10,000	1.2%
	February	674,496	77.8%
	March	0	0.0%
	April	51,628	6.0%
	May	112,971	13.0%
	June	0	0.0%
	July	0	0.0%
	August	0	0.0%
	September	100	0.0%
	October	0	0.0%
	November	17,973	2.1%
	December	0	0.0%
1999 Total		867,168	100.0%

97. Moreover, defendants learned firsthand of the undisclosed failures set forth herein, as the sales personnel had communicated to them the substantial problems that emanated from the massive paperwork that management now required them to deal with in light of the impairments that developed in the Company's understaffed and under-skilled customer service centers. The sales personnel further conveyed to management the fact that the sales quotas that they had imposed on the sales personnel were unattainable and without basis. Finally, sales representatives also informed management of the problems with customer relationships during this time.

98. Defendants also learned firsthand of the undisclosed failures set forth above, as, according to the Company's 1998 Form 10-K, Xerox's procedure was to "regularly survey customers on their satisfaction, measure the results, analyze the root causes of dissatisfaction, and take steps to correct any problems." This surveying process, which the Company purported to follow, provided defendants with a measure of Xerox's customers' dissatisfaction and direct feedback concerning the detrimental impact that its failed restructuring program was having on the Company's sales operations.

99. Defendants used unusual accounting techniques during the Class Period to make revenues and earnings look consistent. In so doing, defendants were able to avoid the scrutiny that would have resulted in the true status of the Company's operations coming to light. Moreover, this conduct demonstrates the attention that defendants paid to meeting analysts earnings projections and the fact that they closely managed the Company's earnings. Defendants expressions of shock and surprise with respect to the Company's third quarter 1999 earnings shortfall contradicts the fact that

