

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**  
**FORM 20-F**

☐ **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

**OR**

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended December 31, 2005**

**OR**

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**OR**

**SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Date of event requiring this shell company report .....

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-28724

ORCKIT COMMUNICATIONS LTD.

(Exact name of Registrant as specified in its charter  
and translation of Registrant's name into English)

ISRAEL

(Jurisdiction of incorporation or organization)

126 Yigal Allon Street, Tel Aviv 67443, Israel

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act.

Title of each class

Name of each exchange on which registered

None

Securities registered or to be registered pursuant to Section 12(g) of the Act.

Ordinary Shares, no par value

(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.

None

(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

As of December 31, 2005, the Registrant had outstanding 14,629,431 Ordinary Shares, no par value.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. [ ] Yes [X] No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. ☐ Yes ☒ No

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  
☒ Yes ☐ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

Indicate by check mark which financial statement item the Registrant has elected to follow.

Item 17 ☐ Item 18 ☒

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ☐ Yes ☒ No

## **PART I**

Unless the context otherwise requires, “Orckit,” “us,” “we” and “our” refer to Orckit Communications Ltd. and its subsidiaries.

All share and per share information in this Annual Report has been adjusted to give retroactive effect to (i) a one-for-five reverse split of our ordinary shares that became effective as of November 27, 2002 and (ii) a three-for-one split of our ordinary shares that became effective as of April 5, 2005.

### **ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS**

Not applicable

### **ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable

### **ITEM 3. KEY INFORMATION**

#### **A. *SELECTED FINANCIAL DATA***

The following selected consolidated financial data as of December 31, 2004 and 2005 and each of the years ended December 31, 2003, 2004 and 2005 are derived from our audited consolidated financial statements set forth elsewhere in this Annual Report, which have been prepared in accordance with generally accepted accounting principles in the United States. The selected consolidated financial data for the years ended December 31, 2001 and 2002 and as of December 31, 2001, 2002 and 2003 are derived from our audited consolidated financial statements not appearing in this Annual Report. The selected consolidated financial data set forth below should be read in conjunction with “Item 5. Operating and Financial Review and Prospects” and the consolidated financial statements and the notes thereto and the other financial information appearing elsewhere in this Annual Report.

|  | Year Ended December 31,                      |               |             |              |               |
|--|--|---------------|-------------|--------------|---------------|
|  | <u>2001</u>                                  | <u>2002</u>   | <u>2003</u> | <u>2004</u>  | <u>2005</u>   |
| <b><u>Statement of</u></b>                                     | <b>(in thousands, except per share data)</b> |               |             |              |               |
| <b><u>Operations Data:</u></b>                                 |  |               |             |              |               |
| Revenues   | \$141,647                                    | \$53,420      | \$1,683     | \$11,276     | \$101,247     |
| Cost of revenues   | <u>112,007</u>                               | <u>32,963</u> | <u>748</u>  | <u>5,901</u> | <u>51,872</u> |
| Gross profit   | 29,640                                       | 20,457        | 935         | 5,375        | 49,375        |
| Research and development expenses                              | 22,429                                       | 22,266        | 20,803      | 17,725       | 16,320        |
| Less grants  | 3,344  | 2,975         | 5,800       | 2,682        | 173           |
| Research and development expenses, net                         | 19,085                                       | 19,291        | 15,003      | 15,043       | 16,147        |
| Selling, general and administrative expenses                   | 16,993                                       | 14,699        | 12,656      | 11,993       | 16,086        |
| Amortization and impairment of goodwill                        | <u>26,101</u>                                | <u>=</u>      | <u>=</u>    | <u>=</u>     | <u>=</u>      |
| Operating income (loss)  | (32,539)                                     | (13,533)      | (26,724)    | (21,661)     | 17,142        |
| Financial income, net  | 33,395                                       | 17,616        | 5,108       | 1,529        | 2,636         |
| Other income   | <u>=</u>                                     | <u>=</u>      | <u>=</u>    | <u>=</u>     | <u>2,448</u>  |
| Net income (loss)  | \$856  | \$4,083       | \$(21,616)  | \$(20,132)   | \$22,226      |
| Net income (loss) per share – basic                            | \$0.06                                       | \$0.28        | \$(1.66)    | \$(1.54)     | \$1.59        |
| Net income (loss) per share – diluted                          | \$0.06                                       | \$0.26        | \$(1.66)    | \$(1.54)     | \$1.30        |
| Weighted average number of ordinary shares outstanding–basic   | 13,896                                       | 14,796        | 12,996      | 13,074       | 13,984        |
| Weighted average number of ordinary shares outstanding–diluted | 14,625                                       | 15,489        | 12,996      | 13,074       | 16,345        |

|  | As of December 31,    |             |             |             |             |
|--|-----------------------|-------------|-------------|-------------|-------------|
|  | <u>2001</u>           | <u>2002</u> | <u>2003</u> | <u>2004</u> | <u>2005</u> |
| <b>Balance Sheet Data:</b>   | <b>(in thousands)</b> |             |             |             |             |
| Cash, cash equivalents, bank deposits, marketable securities and long-term investments | \$112,924             | \$116,677   | \$79,041    | \$77,221    | \$117,760   |
| Working capital (1)  | 103,895               | 55,193      | 34,480      | 16,488      | (6,260)     |
| Total assets   | 166,300               | 135,850     | 86,331      | 148,526     | 129,946     |
| Convertible subordinated notes   | 66,416                | 38,179      | 16,238      | -           | -           |
| Share capital and additional paid-in capital   | 318,651               | 320,204     | 317,071     | 319,795     | 326,371     |
| Shareholders' equity   | \$76,785              | \$82,421    | \$57,672    | \$40,264    | \$69,066    |

(1) Total current assets net of total current liabilities

#### **B. CAPITALIZATION AND INDEBTEDNESS**

Not applicable

#### **C. REASONS FOR THE OFFER AND USE OF PROCEEDS**

Not applicable

#### **D. RISK FACTORS**

*We believe that the occurrence of any one or some combination of the following factors could have a material adverse effect on our business, financial condition and results of operations.*

#### ***Risks relating to our business and industry***

#### **We have a history of substantial losses and might not sustain profitability.**

During 2002, 2003 and 2004, we incurred aggregate operating losses of approximately \$61.9 million. We also incurred significant operating losses in the years prior to 2002. We incurred a significant portion of our operating losses during the period through 2003, when our primary business was the sale of asymmetric digital subscriber line, or ADSL, products, which we no longer sell. Since 2001, we have made significant investments in technology projects, mainly for new telecom equipment products addressing high transmission of data for the metropolitan area, through our subsidiary, Corrigent Systems Inc. We only began to recognize significant revenues from sales of these products in the second half of 2004. As a result, we were able to generate both operating income and net income for the first time in 2005. We cannot be sure that we will be able to continue to be profitable for any sustained period of time.

**Our revenues in 2004 and 2005 were dependent on sales of one product line to one telecom carrier in Japan, and we expect to continue to depend on sales of this product line to this customer for a substantial majority of our revenues in 2006. The loss of this customer, or a significant decrease in revenues from it, would have a material adverse effect on our results of operations.**

Almost all of our revenues in 2004 and all of our revenues in 2005 were the result of the sales of our metro products, the Corrigent CM-100. Approximately 81.5% of our revenues in 2004 and 99.8% of our revenues in 2005 were derived from sales of these products to KDDI, a Japanese telecom carrier. We expect that substantially all of our revenues in 2006 will be comprised of sales of Corrigent CM-100 products to KDDI. We do not know for how long a period of time KDDI will continue to purchase products from us, nor do we have any control or influence over the purchasing decisions of KDDI, including the quantities, price and timing of the deployment of the CM-100 product line in its network. KDDI is purchasing the CM-100 for initial coverage deployment in its metropolitan area network. We do not know when KDDI will conclude its initial deployment of our metro products. It is likely that once this stage is concluded, additional demand for the CM-100 product from KDDI will be derived from growth in the number of subscribers for new IP services offered by KDDI. We cannot predict whether KDDI will be successful in offering new services or securing additional subscribers. Sales to KDDI are dependent on their success in offering new services and securing additional subscribers. The loss of this customer, or a significant decrease in revenues from it, would have a material adverse effect on our results of operations. We will need to make sales to additional customers and to develop additional products to be able to sustain profitability for any period of time.

**We have a history of extreme fluctuations in our cash from operations and might not sustain positive cash flow from operations.**

In 2003, we used \$16.1 million of cash in our operating activities. In 2004 we generated \$938,000 of cash from operating activities and in 2005 we generated \$72.6 million of cash from operating activities. We realized substantially all of our positive cash flow from operations in 2005 due to the significant increase in sales to KDDI in Japan and the payment of receivables owed to us in advance of the recognition of the related revenue in our financial statements. We do not expect to continue to generate significant amounts of cash from operations in 2006 and expect to use cash in our operating activities in the six-month period ending June 30, 2006 as we will be recognizing revenue in the first half of 2006 with respect to sales that were paid for in 2005.

**We depend on third party distributors in Japan for the sale of our products. If these distributors do not succeed in selling our products, or if we are not able to maintain our relationship with them, our results of operations will suffer.**

Our sales of products to KDDI have been made through Net One Systems Co., Ltd. and, since 2005, primarily through OKI Electric Industry Co., Ltd., distributors located in Japan. Our relationship with OKI began in 2005 and we do not have a long history of dealing with them. We are dependent on their marketing and sales efforts to convince KDDI and other customers or end-users in Japan to purchase our products and to provide local support services. If either of our distributors terminates or adversely changes its relationships with us, we may be unsuccessful in replacing it. The loss of a distributor could impair our ability to sell our products and materially adversely affect our results of operations.

**The purchasing patterns in the markets we address will likely result in our revenues being highly volatile.**

Sales of the Corrigent CM-100 product line are dependent on the capital equipment plans of telecom carriers for metro network equipment. The purchasing patterns of telecom carriers for this type of expansion project are subject to high volatility. We experience a concentrated and inconsistent pattern of purchasing by KDDI in Japan. While product selections and subsequent deliveries may last several years, the purchasing pattern during the deployment period is highly uncertain and, accordingly, our revenues are likely to be subject to high volatility.

**Substantially all of our sales are currently in Japan. We have limited experience in selling and servicing products in Japan, which could materially adversely impact our results of operations.**

Substantially all of our sales are currently in Japan, a country in which prior to 2004 we had no sales experience. Telecom equipment sales in Japan are subject to high quality and strict delivery requirements. We have limited experience in making sales into the Japanese market and could face business requirements for quality, delivery, service and support that we may not meet. Since significantly all of our sales in 2006 are expected to be in Japan, failure to meet these requirements could have a material adverse effect on our results of operations.

**WilTel Communications, a company that recently became a customer for our CM-100 product, was subsequently acquired by Level 3 Communications. We cannot predict the affect this acquisition will have on sales of our products to WilTel.**

WilTel Communications, a wholesale telecommunications carrier in the United States, selected our CM-100 product in late 2005 for deployment in its metropolitan networks. Soon after the selection, WilTel was acquired by Level 3 Communications, another U.S.-based wholesale telecommunications carrier. It is expected that Level 3 Communications will seek to create a single unified metropolitan area network, as well as to reduce the number of equipment suppliers to the combined company. Level 3 Communications is currently evaluating the need for the CM-100 product in its network. We cannot predict the affect this acquisition will have on sales of our products to WilTel. If Level 3 Communications elects to eliminate the CM-100 product from its metro architecture, our sales to WilTel will be adversely affected.

**Successful introduction of service applications by telecommunication carriers that are expected to drive demand for our metro products could be delayed or slow to emerge.**

Service applications that drive the demand for our metro telecommunication products are related to the offering of television services and other media services by telecommunication carriers over data networks. These types of services require very high bandwidth for packet-based transmissions and, as a result, require an upgrade of metropolitan, or metro, network equipment and access equipment. The availability of these services is limited today. It is expected that these services will emerge first with carriers in Asia and later in Europe and the United States. The launch of these services requires significant capital investment in equipment by telecom carriers in the access and metro networks for a range of products, as well as for content packages to be provided by the telecommunication carriers. Delays in the launch of these services or slow subscriber additions to these services will have an adverse effect on the demand for our metro products.

**The slow down in capital expenditures by telecommunications service providers in prior years had a material adverse effect on our results of operations. Another down turn in technology spending could have a material adverse effect on our results of operations.**

The global economic deterioration and economic uncertainty in the telecommunications market resulted in a curtailment of capital investment by telecommunications carriers and service providers beginning in late 2000 and continuing into 2003. Our results of operations were materially adversely affected during this period. There is still uncertainty with respect to the direction of the economy and the telecommunications market. Recent and continuing consolidation of telecommunication carriers in the United States is expected to reduce the number of telecommunication equipment vendors and to increase price pressures. Capital investment by wireline telecom carriers in 2005 with respect to metro networks moderately exceeded 2004 levels. We are uncertain as to whether the improvement in technology spending will continue. A slow capital investment environment in Asia, the United States and Europe is likely to have negative effect on the demand for new technologies and new types of equipment. This could have an adverse effect on us as we attempt to sell our products. Any future industry downturn could increase our inventories, decrease our revenues, result in additional pressure on the price of our products and prolong the time until we are paid, each of which could have a material adverse effect on our results of operations.

**We plan to continue to invest substantial capital and other resources in the development and commercial launch of new telecom equipment.**

We intend to make substantial investments in the development of telecom solutions capable of supporting high bandwidth services in telecommunications networks located in metropolitan areas. Almost all of our research and development and other operating expenses in 2005 were related to our CM-100 product. Our expenditures with respect to the development of new telecommunications equipment could reduce our cash balances and impede our ability to develop new products in addition to the Corrigent CM-100 product line.

**We may need additional financing to continue our growth.**

We may need to raise additional capital to continue our longer term expansion plans. To the extent that we cannot fund our activities through our resources and any cash we may



generate from operations, we may need to raise equity or debt funds through public or private financing. We may be unable to obtain additional financing on acceptable terms or at all. To obtain funds through arrangements with strategic partners or others, we may need to relinquish rights to certain of our technologies or potential markets.

**Our future growth will depend upon the acceptance of the technologies developed by us and the development of markets for our products.**

The markets for our products are dependant on resilient packet ring, or RPR, multi protocol label switching, or MPLS, and a range of emerging technologies that address migration to a metropolitan area IP metro ring network at a 10 giga bits per second transmission rate. We believe that these technologies will support the upgrade of existing metro networks on a cost efficient basis in order to provide IP transmissions addressing high numbers of subscribers and multiple services, at significantly higher transmission speeds than are currently available. The markets for our products are also dependent on the need to support legacy services and new data services over a single unified metro network. The market for products based on RPR and MPLS technologies in the metropolitan area may not fully develop, whether as a result of competition, alternative technologies, such as Ethernet over fiber in the metro area, changes in technology, product standards or otherwise. Our success depends on the acceptance of our products and technologies and the purchase of high-transmission services from telecommunications companies. We have no control over the development of these target markets. Even if our technologies are accepted, relationships with providers of telecommunications services must be developed in order to be successful. Furthermore, competing technologies in the targeted areas may be utilized in the majority of such target markets. This would leave us with a small market to address.

**We may not be able to keep pace with emerging industry standards for products we are developing. This could make these products more costly or unacceptable to potential customers.**

Industry-wide standards for RPR and MPLS have been recently adopted and continue to be enhanced. We design our products to support these standards and evaluate new requirements as they are proposed by industry working groups. The adoption of standards different from those currently used by us could result in us having to incur additional time and expense to have our products comply with these standards. Standards may be adopted by various industry groups or may be proprietary and nonetheless accepted broadly in the industry. The failure to support evolving standards could limit acceptance of our products. Since these products will be integrated into networks consisting of elements manufactured by various companies, they must support a number of current and future industry standards and practices. It may take us a significant amount of time to develop and design products incorporating these new standards. We may also have to pay licensing fees to the developers of the technologies that constitute newly adopted standards. This would increase our expenses and could adversely affect our results of operations.

**Because telephone companies must obtain in-house and regulatory approvals before they can order our products, expected sales of our products to new customers or new products to existing customers are likely to be subject to a long sales cycle, which may harm our business.**

Before telephone companies can purchase our products, these products must undergo a lengthy approval process. Evaluations and modifications of our products to meet customers'

requirements are likely to take several years prior to commercial selection. Accordingly, we are required to submit enhanced versions of products undergoing the approval process and products in development for approval.

The following factors, among others, affect the length of the approval process:

- the time required for telephone companies to determine and publish specifications;
- the complexity of the products involved;
- the technological priorities and budgets of telephone companies; and
- the regulatory requirements applicable to telephone companies.

Delays in the product approval process could seriously harm our business and results of operation.

**Because of rapid technological and other changes in the market for telecommunications products, we must continually develop and market new products and product enhancements while reducing production costs.**

The market for our products is characterized by:

- rapid technological change;
- frequent product introductions and enhancements;
- evolving industry standards;
- changes in end-user requirements; and
- changes in services offered by telephone companies.

Technologies or standards applicable to our products could become obsolete or fail to gain widespread, commercial acceptance, resulting in losses and inventory write-offs. Rapid technological change and evolving technological standards are resulting in shorter life cycles for our products. Shorter life cycles for our products could cause decreases in product prices at the end of the product life cycle, inventory write-offs and a lower rate of return on our research and development expenditures. We may not be able to respond effectively to technological changes or new product announcements by others or successfully develop or market new products.

**Our quarterly results of operations, including revenues, profit and loss and cash flow, have fluctuated significantly in the past, and these fluctuations are expected to continue in 2006 and beyond. Fluctuations in our results of operations may disappoint investors and result in a decline in our share price.**

We have experienced and expect to continue to experience significant fluctuations in our quarterly results of operations. In some periods, our operating results may be below the guidance we provided, below public expectations or below revenue levels and operating results reached in prior quarters or in the corresponding quarters of the previous year. If this

occurs, the market price of our ordinary shares could decline. The following factors have affected our quarterly results of operations in the past and are likely to affect our quarterly results of operations in the future:

- size and timing of orders, including order deferrals and delayed shipments;
- launching of new product generations;
- length of approval processes or market testing;
- technological changes in the telecommunications industry;
- accuracy of telephone company, distributor and original equipment manufacturer forecasts of their customers' demands;
- changes in our operating expenses;
- the timing of approval of government research and development grants;
- disruption in our sources of supply;
- competitive pricing pressures;
- funding required for our operations;
- general economic conditions;
- terms and conditions of supply agreements with our customers and their impact on our recognition of revenues from these agreements;
- determination of the fair value (also known as vendor-specific objective evidence) of some of the services we provide, as well as changes in our revenue recognition policies as a result of changes in the commercial terms between us and our customers;
- timely payments of receivables by customers; and
- changes in payment terms between us and our suppliers which could accelerate the timing of payments by us and negatively affect our working capital and cash balances.

Therefore, the results of any past periods may not be relied on as an indication of our future performance.

**We may be required to recognize our deferred income, which would accelerate recognition of revenues and cause significant fluctuations in our results of operations.**

In 2004 and 2005, we recognized revenues from our major customer in Japan ratably over the fourteen-month period of post-contract hardware and software support services, or PCS. This revenue recognition policy was required by generally accepted accounting

principles since the fair value of the PCS could not be determined. We received the cash payments for these sales over a shorter period than the revenue recognition period. As a result, changes in our cash and investment balances were not correlated with the amount of our quarterly revenues. If we become able to determine, in accordance with generally accepted accounting principles, the fair value of the PCS that we undertook to provide to our major customer in Japan, it is likely that the remaining unrecognized revenue, which was \$54.8 million as of December 31, 2005, as well as the related amount of deferred income, which was \$28.7 million as of December 31, 2005, will be required to be recognized. This would result in a one time recognition of a significant amount of revenues and income. No cash from operations will result from this revenue recognition, if required. If we are able to make this determination with respect to our product and services offerings and if we continue to experience a volatile pattern of orders and related product delivery schedules similar to what we experienced in 2004 and 2005, we will likely recognize revenues over a shorter period of time than in 2004 and 2005 and could experience extreme fluctuations in our quarterly revenues, cash flows and results of operations.

**We may accumulate excess or obsolete inventory that could result in unanticipated price reductions or write downs and adversely affect our results of operations.**

Telephone companies typically require prompt delivery of products. Sales are typically shipped within a period of up to three months from the date we receive a purchase order. As a result, we are required to maintain or have available sufficient inventory levels or make advance lengthy lead-time component orders to satisfy anticipated demand on a timely basis. Rapid technological change, evolving industry standards or shifts in demand can also result in shorter life cycles for our inventory. This increases the risk of decreases in selling prices, inventory obsolescence and associated write-offs, all of which could adversely affect our results of operations.

**The market for our telecommunication products is intensely competitive. Because substantially all of our competitors have much greater resources than we have, it may be difficult for us to effect commercial sales or to achieve operating profitability.**

The market for our products is intensely competitive, and we expect competition to increase in the future. Many of our current and potential competitors are large and established companies and have better name recognition and greater financial, technical, manufacturing, marketing and personnel resources than us. Increased competition could adversely affect our future revenues and ability to remain profitable due to pricing pressure, loss of market share and other factors. The expansion of research and design facilities in China and India, where engineering costs are significantly lower compared to the U.S., Western Europe or Israel, is expected to increase competition and price pressure for our products. In addition, it is also expected that manufacturers of telecom equipment in China will attempt to leverage their success in supplying telecom equipment to local carriers in Asia and will increase their marketing and sales efforts outside China.

The competitors in our markets are numerous and we expect competition to increase in the future. The principal competitors for our products include Alcatel, Cisco Systems, Inc., ECI Telecom Ltd., Fujitsu, Hitachi, Huawei, Lucent Technologies Inc., Nortel Networks, Siemens AG and UTStarcom.

**Government regulation of telephone companies could adversely affect the demand for our products.**

Telecommunication regulatory policies affecting the availability of telephone companies' services, and other terms on which telephone companies conduct their business, may impede the market penetration of our metro products. For example, the Corrigent CM-100 product line addresses high bandwidth packets, and is dependent on new service offerings, such as video services, which require regulatory approvals for introduction by telecom carriers, including for the scope of content, service packages and tariffs. Telephone companies in the markets in other countries in which we will attempt to sell our products are also subject to evolving governmental regulation or state monopolies. Changes in laws or regulations in Japan, the U.S., or elsewhere could materially adversely affect our ability, and the ability of our customers, to deploy our products.

**Because a limited number of subcontractors manufacture and assemble our products and since we have a number of single source suppliers of components, our business could suffer if we cannot retain or replace them.**

We use third-party subcontractors to assemble our products. We have not entered into multi-year agreements with assurances of supply with any of our suppliers or subcontractors.

Our expected reliance on third-party subcontractors involves several risks, including:

- the potential absence of adequate capacity if we are able to sell a significant amount of our products;
- the unavailability of, or interruption in access to, certain process technologies; and
- reduced control over product quality, delivery, schedules, manufacturing yields and costs.

Shortages of raw materials or production capacity constraints at our subcontractors could negatively affect our ability to meet product delivery obligations and result in increased costs for affected products that we may not be able to recover. Use of subcontractors also involves the risk of reduced control over product quality, delivery schedules and manufacturing yields, as well as limited negotiating power to reduce costs.

We obtain a number of key semiconductor components used in our products from single source providers. In order to have an adequate supply of components with a long lead-time for delivery, we may order significant quantities of components from single source suppliers in advance of receiving a purchase order from our customer. A shortage in the supply of key semiconductor and other components could affect our ability to manufacture and deliver our products and result in lower revenues. We may be unable to find alternative sources in a timely manner, if at all, if any of our single source suppliers were unwilling or unable to provide us with key components. In addition, supply from single source suppliers

limits our ability to purchase components at competitive prices and in many cases requires us to maintain higher inventory levels. This increases our need for working capital and increases the risk of an inventory write-off. If we cannot obtain sufficient key components as required, or develop alternative sources if and as required in the future, product shipments may be delayed or reduced. This could adversely affect our end-user relationships, business and results of operations.

**We are subject to new regulations that will require us to use components based on environmentally friendly materials. Compliance with these regulations may increase our costs and adversely affect our results of operations.**

We are subject to new telecommunications industry regulations requiring the use of environmentally-friendly materials in telecommunications equipment. For example, pursuant to a European Community directive, telecom equipment suppliers are required to stop using specified materials that are not “environmentally friendly” by July 1, 2006. In addition, telecom equipment suppliers are required under this directive to eliminate the lead solders from their products by 2010. We will be dependent on our suppliers for components and sub-system modules, such as semiconductors and printed circuit boards, to comply with these requirements. We do not expect to be able to comply with this directive in 2006. We will attempt to comply with this directive in 2007. This may harm our ability to sell our products in Europe and in any other countries that may adopt this directive.

Compliance with this directive, especially with respect to the requirement that products be lead free, will require us to undertake significant expenses with respect to the re-design of our products. In addition, we may be required to pay higher prices for components that comply with this directive. We may not be able to pass these higher component costs on to our customers. We cannot at this point estimate the expense that will be required to redesign our products in order to include “environmentally friendly” components. We cannot be sure that we will be able to timely comply with these regulations, that we will be able to comply on a cost effective basis or that a sufficient supply of compliant components will be available to us. Compliance with these regulations could increase our product design costs. Our inability or failure to comply with these regulations could have a material adverse effect on our results of operations. In addition, manufacturers of components that we use in our products that do not comply with these regulations may decide to stop manufacturing these components prior to the July 2006 compliance date. Similarly, manufacturers of components that require lead solders may decide to stop manufacturing those components prior to the 2010 compliance date. These actions by manufacturers of components could result in a shortage of components that could adversely affect our business and results of operations.

**We could incur substantial costs if customers assert warranty claims or request product recalls.**

Any significant product returns or claims under our warranty or PCS could have a material adverse effect on our business and results of operations. We offer complex products that have in the past and may in the future contain errors, defects or failures when introduced or as new versions are released. If we deliver products with defects, errors or bugs or if we undergo a product recall as a result of errors or failures, market acceptance of our products could be lost or delayed and we could be the subject of substantial negative publicity. This could have a material adverse effect on our business and results of operations. We commenced commercial sales of our metro product in the second half of 2004. Because of the recent deployment of these products, we cannot predict the level or expense of warranty

claims that we will experience. We have agreed to indemnify our customers in some circumstances against liability from defects in the products sold by us and expect to continue to provide a similar indemnity in connection with future sales. In some cases, our indemnity also covers indirect damages. Product liability claims could seriously harm our business, financial condition and results of operations.

**We are subject to international business risks.**

We have sold our Corrigent products mainly in Japan and are marketing our products primarily in Asia, the United States and Europe. Expansion of our international business requires significant management attention and financial resources. Our international sales and operations are subject to numerous risks inherent in international business activities, including:

- compliance with foreign laws and regulations;
- staffing and managing foreign operations;
- import or currency control restrictions;
- burdens that may be imposed by tariffs and other trade barriers;
- local taxation;
- increased risk of collections;
- transportation delays; and
- seasonal reduction of business activities.

These factors, as well as different technical standards or product requirements for our systems in different markets, may limit our ability to penetrate foreign markets.

**We depend on a limited number of key personnel who would be difficult to replace. If we lose the service of these individuals, our business will be harmed.**

Our growth and success largely depends on the managerial and technical skills of members of senior management. If any of them is unable or unwilling to continue with us, our results of operations could be materially and adversely affected.

**We have experienced a period of rapid growth, and if we cannot adequately manage our growth, our results of operations will suffer.**

We have experienced rapid growth in our operations from sales of our metro products and our anticipated future growth may place a significant strain on our managerial, operational and financial resources. We cannot be sure that we have made adequate allowances for the costs and risks associated with our expansion, or that our systems, procedures and managerial controls will be adequate to support our operations. Any delay in implementing, or transitioning to, new or enhanced systems, procedures or controls may adversely affect our ability to manage our product inventory and record and report financial and management information on a timely and accurate basis. We believe our growth may

require us to hire additional engineering, technical support, sales, administrative and operational personnel. Competition for qualified personnel can be intense in the areas where we operate. The process of locating, training and successfully integrating qualified personnel into our operations can be lengthy and expensive. If we are unable to successfully manage our expansion, we may not grow our business, our expenses may increase and our results of operations may be adversely affected.

**Our proprietary technology is difficult to protect and unauthorized use of our proprietary technology by third parties may impair our ability to compete effectively.**

We may not be able to prevent the misappropriation of our technology, and our competitors may independently develop technologies that are substantially equivalent or superior to ours. We have filed U.S. patent applications covering certain of our technologies. To protect our unpatented proprietary know-how, we rely on technical leadership, trade secrets and confidentiality and non-disclosure agreements. These agreements and measures may not adequately protect our technology and it may be possible for a third party to copy or otherwise obtain and use our technology without our authorization or to develop similar technology.

**There is a risk that we may violate the proprietary rights of others.**

We are subject to the risk of adverse claims and litigation alleging infringement of the intellectual property rights of other companies. Many participants in the telecommunications industry have an increasing number of patents and patent applications and have frequently commenced litigation based on alleged infringement. We indemnify our customers with respect to infringement of third party proprietary rights by our products. Third parties may assert infringement claims in the future and these claims may require us to enter into license arrangements or result in costly litigation, regardless of the merits of these claims. Licensing may be unavailable or may not be obtainable on commercially reasonable terms.

**We face foreign exchange currency risks.**

We operate in a number of territories and, although our prices are determined in U.S. dollars, we link payments due to us from sales of products and services to local currencies of the countries in which we operate. We hold cash deposits in the currencies we operate with, that is, in U.S. dollar, Japanese Yen and Israeli Shekel, or NIS. In 2006, we expect that substantially all of our revenues will be derived from Japan and will be linked to the Yen and a major part of our expenses will be denominated in U.S. dollars and in NIS. We currently do not use hedge instruments. We are likely to face risks from fluctuations of the Yen and the NIS compared to the U.S. dollar, the functional currency in our financial statements. In 2005, the value of the U.S. dollar increased against the Yen, which caused us to recognize lower dollar revenues and gross profit in our financial statements. A further increase of the value of the U.S. dollar against the Yen in 2006 would cause a decrease in our revenues and gross profit.

**We are subject to risks from our financial investments.**

We invest the majority of our cash on hand in a variety of financial instruments, including different types of corporate and government bonds, and other financial instruments. Some of these bonds and instruments may be rated below investment grade or not rated. If the obligor of any of the bonds or instruments we hold defaults or undergoes a reorganization



in bankruptcy, we may lose all or a portion of our investment in such obligor. This will harm our financial condition. For information on the types of our investments as of December 31, 2005, see Item 11 - "Quantitative and Qualitative Disclosures About Market Risk-Interest Rate Risk Management."

**We are subject to taxation in several countries.**

Because we operate in several countries, mainly in Israel, Japan and the U.S., we are subject to taxation in multiple jurisdictions. We are required to report to and be subject to local tax authorities in Israel, the U.S and Japan. In addition, our income that is derived from sales to customers in one country might also be subject to taxation in another country. We cannot be sure of the amount of tax we may become obligated to pay in Israel, the U.S or Japan. The tax authorities in the countries in which we operate may not agree with our tax position. Our tax benefits from carry forward losses and other tax planning benefits such as Israeli approved enterprise programs, may prove to be insufficient due to Israeli tax limitations, or may prove to be insufficient to offset tax liabilities from foreign tax authorities. Foreign tax authorities may also use our gross profit in each territory as the basis for determining our income tax, and our operating expenses might not be considered for related tax calculations. This could adversely affect our results of operations.

**We have not yet evaluated our internal controls over financial reporting in compliance with Section 404 of the Sarbanes-Oxley Act.**

We are required to comply with the internal control evaluation and certification requirements of Section 404 of the Sarbanes-Oxley Act by no later than the end of our 2006 fiscal year. We have only recently begun the process of determining whether our existing internal controls over financial reporting systems is compliant with Section 404. This process may divert internal resources and will take a significant amount of time and effort to complete. If it is determined that we are not in compliance with Section 404, we may be required to implement new internal control procedures and reevaluate our financial reporting. We may experience higher than anticipated operating expenses as well as higher independent auditor fees during the implementation of these changes and thereafter. Further, we may need to hire additional qualified personnel in order for us to be compliant with Section 404. If we are unable to implement these changes effectively or efficiently, it could harm our operations, financial reporting or financial results and could result in our being unable to obtain an unqualified report on internal controls from our independent auditors.

***Risks relating to our operations in Israel.***

**Potential political, economic or military instability in Israel may adversely affect our results of operations.**

Our principal offices and many of our subcontractors and suppliers are located in Israel. Accordingly, political, economic and military conditions in Israel affect our operations. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors. A state of hostility, varying in degree and intensity, has led to security and economic problems for Israel. Since October 2000, there has been a marked increase in hostilities between Israel and the Palestinians, and in January 2006, Hamas, an Islamic movement responsible for many attacks against Israelis,

won the majority of the seats in the Parliament of the Palestinian Authority. The election of a majority of Hamas-supported candidates is expected to be a major obstacle to relations between Israel and the Palestinian Authority, as well as to the stability in the Middle East as a whole.

The future of relations between Israel and the Palestinian Authority is uncertain. Terror attacks, armed conflicts or political instability in the region could negatively affect local business conditions and harm our results of operations. We cannot predict the effect on us of the increase in the degree of violence by Palestinians against Israel or the effect of military action elsewhere in the Middle East. Furthermore, several countries restrict doing business with Israel and Israeli companies, and additional companies may restrict doing business with Israel and Israeli companies as a result of the increase in hostilities. This may also seriously harm our operating results, financial condition and the expansion of our business.

**Our results of operations may be negatively affected by the obligation of our personnel to perform military service.**

Most of our male employees in Israel are obligated to perform annual military reserve duty. In addition, in the event of a military conflict or other attack on Israel, including the ongoing conflict with the Palestinians, these persons could be required to serve in the military for extended periods of time. The absence of a number of our officers and employees for significant periods could disrupt our operations and harm our business.

**Because almost all our revenues are generated in non-U.S. dollar currencies and a substantial portion of our expenses are incurred in New Israeli Shekels and other non-U.S. dollar currencies, our results of operations may be adversely affected by inflation and currency fluctuations.**

Almost all of our revenues in 2006 are expected to be generated in Japanese Yen, while the majority of our payroll expenses and a portion of our other expenses are incurred in NIS, and a significant portion of our cost of revenues is incurred in U.S. dollars. An increase in the value of the U.S. dollar against the Yen would adversely affect the amount of revenues we report in our financial statements. We could be further exposed to risk that the rate of inflation in Israel may exceed the rate of devaluation of the New Israeli Shekel in relation to the Japanese Yen, U.S. dollar and other foreign currencies or that the timing of such devaluation lags behind inflation in Israel. In that event, the dollar cost of our operations in Israel would increase and our U.S. dollar-measured results of operations would be adversely affected. For example, in 2004 the value of the U.S. dollar declined in relation to the New Israeli Shekel by 1.6%, while inflation increased by 1.2%. As a result, our salary expenses, which are primarily linked to the New Israeli Shekel, increased in U.S. dollar terms. In 2005, the value of the U.S. dollar increased in relation to the New Israeli Shekel by 6.8%, while inflation increased by only 2.4%. As a result, our salary expenses, which are primarily linked to the New Israeli Shekel, decreased in U.S. dollar terms. Subject to such exchange rate differences as of the end of each reporting period, we may incur higher or lower expenses.

**We benefit from government grant programs that have been reduced and may be unavailable to us in the future. Our participation in these programs restricts our ability to freely transfer manufacturing rights and technology out of Israel.**

Since our inception, we have relied on Israeli government grants for the financing of a significant portion of our product development expenditures. Due to a continuing reduction of the budget of Israel's Office of the Chief Scientist of the Ministry of Industry, Trade and Labor, and a focus of that office's resources on the support of venture stage companies rather than more developed companies, it is expected that the amount of grants we receive in the future will be lower than in prior years, if we receive any at all. We did not receive any grants for our research and development in 2005. This resulted in an increase in our research and development expenses.

According to Israeli law, any products developed with grants from the Office of the Chief Scientist are required to be manufactured in Israel, unless we obtain prior approval of a governmental committee. As a condition to obtaining this approval, we may be required to pay the Office of the Chief Scientist up to 300% of the grants we received and to repay these grants at an accelerated rate, depending on the portion of manufacturing performed outside Israel. We have obtained an approval from the Office of the Chief Scientist to manufacture outside Israel. We intend to keep sufficient manufacturing activities in Israel so that we will be subject to a repayment percentage of up to 150% of the grants we received. In addition, we are prohibited from transferring to third parties the technology developed with these grants without the prior approval of a governmental committee. See "Item 5 - Operating and Financial Review and Prospects - Liquidity and Capital Resources – Government and Other Grants" for additional information about these programs of the Office of the Chief Scientist.

**The tax benefits that we currently receive require us to meet several conditions and may be terminated or reduced in the future, which would increase our taxes.**

We benefit from certain government programs and tax benefits, particularly as a result of the "Approved Enterprise" status of most of our existing facilities. If we fail to meet eligibility conditions in the future, the tax benefits could be canceled.

These tax benefits may not continue in the future at their current levels or at any level. From time to time, we submit requests for expansion of our approved enterprise programs or for new programs to be designated as approved enterprises. These requests might not be approved, particularly in light of difficult economic conditions in Israel. The termination or reduction of these tax benefits could seriously harm our financial condition and results of operations. For more information about Approved Enterprises, see "Item 5B - Liquidity and Capital Resources – Effective Corporate Tax Rates in Israel" below and Note 6a to the financial statements included elsewhere in this annual report.

**We may be required to pay stamp duty on agreements executed by us on or after June 1, 2003. This would increase our taxes.**

The Israeli Stamp Duty on Documents Law, 1961, or the Stamp Duty Law, provides that most documents signed by Israeli companies are subject to a stamp duty, generally at a rate of between 0.4% and 1% of the value of the subject matter of such document. It has been common practice in Israel not to pay such stamp duty unless a document is filed with a governmental authority or with the courts. As a result of an amendment to the Stamp Duty Law that came into effect on June 1, 2003, the Israeli tax authorities have approached many

companies in Israel and requested disclosure of all agreements signed after June 1, 2003 with the aim of collecting stamp duty on such agreements. Although it is not yet possible to evaluate the effect, if any, on us of the amendment to the Stamp Duty Law, there could be a material adverse affect our results of operations.

Under an order published in December 2005, the obligation to pay stamp duty was cancelled with respect to documents signed on or after January 1, 2006.

**It may be difficult to enforce a U.S. judgment against us, our officers and directors and our Israeli auditors or to assert U.S. securities law claims in Israel.**

Service of process upon our directors and officers and our Israeli auditors may be difficult to effect in the United States because almost all these parties reside outside the United States. Any judgment obtained in the United States against such parties may be unenforceable outside the United States.

It is not clear whether civil liabilities under the Securities Act and the Securities Exchange Act can be enforced in Israel. However, subject to time limitations, Israeli courts may enforce a U.S. judgment in a civil matter, if:

- adequate service of process has been effected and the defendant has had a reasonable opportunity to be heard;
- the judgment and its enforcement are not contrary to the law, public policy, security or sovereignty of the State of Israel;
- the judgment was rendered by a court of competent jurisdiction, in compliance with due process and the rules of private international law prevailing in Israel;
- the judgment was not obtained by fraudulent means and does not conflict with any other valid judgment in the same matter between the same parties;
- no action between the same parties in the same matter is pending in any Israeli court at the time the lawsuit is instituted in a U.S. court; and
- the U.S. courts are not prohibited from enforcing judgments of the Israeli courts.

Foreign money judgments enforced in Israel, are generally awarded in New Israeli Shekels, based on the U.S. Dollar/NIS exchange rate in effect on the date of payment. The NIS can be converted into non-Israeli currency and transferred out of Israel. Pending collection, the amount of the NIS-denominated judgment is linked to the Israeli CPI and accrues interest at the annual statutory rate set by Israeli law. Judgment creditors bear the risk of unfavorable exchange rates.

**Provisions of Israeli law may delay, prevent or make an acquisition of us more difficult, which could depress our share price.**

The Israeli Companies Law generally requires that a merger be approved by the board of directors and a majority of the shares voting on the proposed merger. Upon the request of any creditor of a party to the proposed merger, a court may delay or prevent the merger if it concludes that there is a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy its obligations. In addition, a merger may generally not be completed unless at least (i) 50 days have passed since the filing of the merger proposal with the Israeli Registrar of Companies and (ii) 30 days have passed since the merger was approved by the shareholders of each of the parties to the merger.

Also, in certain circumstances an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become a 25% or greater or 45% or greater shareholder of the company (unless there is already a 25% or greater or a 45% or greater shareholder of the company, respectively). If, as a result of an acquisition, the acquirer would hold more than 90% of a company's shares, the acquisition must be made by means of a tender offer for all of the shares.

The described restrictions could prevent or make more difficult an acquisition of Orckit, which could depress our share price.

***Risks Relating to the Market for our Ordinary Shares***

**Holders of our ordinary shares who are U.S. residents face income tax risks.**

Based on the composition of our gross income and the composition and value of our gross assets during 2005, we do not believe that we would be treated as a passive foreign investment company, or PFIC, for U.S. federal income tax purposes for the 2005 tax year. It is likely, however, we would be deemed to have been a PFIC in 2002, 2003 and 2004. In addition, there can be no assurance that we will not be treated as a PFIC for any subsequent tax year. If we are a PFIC for any tax year, U.S. holders who owned our ordinary shares during such year may be subject to increased U.S. federal income tax liabilities and reporting requirements for such year and succeeding years, even if we are no longer a PFIC in such succeeding years.

U.S. residents should carefully read Item 10.E "Taxation – United States Federal Income Tax Considerations" for a more complete discussion of the U.S. federal income tax risks related to owning and disposing of our ordinary shares and the consequences of PFIC status.

**We do not intend to pay cash dividends.**

We have never declared or paid any cash dividends on our ordinary shares. We currently intend to retain future earnings, if any, for funding growth. Accordingly, we do not expect to pay any cash dividends in the foreseeable future.

**Two shareholders who are also our senior officers may be able to control us.**

As of March 1, 2006, Eric Paneth, our Chairman and Chief Executive Officer, and Izhak Tamir, our President, each beneficially owned an aggregate of 1,294,063 ordinary shares representing 8.2% of our outstanding ordinary shares, including 480,000 ordinary

shares issuable upon the exercise of options that are currently vested. Subject to the decision of our audit committee, each of Mr. Paneth and Mr. Tamir might also be entitled to exchange his vested options to purchase shares of Corrigent common stock for options to purchase approximately 400,000 of our ordinary shares (based on data as of March 1, 2006). For a further explanation of this possible exchange, see “Item 6E– Share Ownership – Exchange of Corrigent Options”.

Each of Mr. Paneth and Mr. Tamir is an executive officer and member of our Board of Directors. Currently, Messrs. Paneth and Tamir are not party to a shareholders agreement. However, if Messrs. Paneth and Tamir act together, they may have the power to control the outcome of matters submitted for the vote of shareholders, including the approval of significant change in control transactions. The equity interest in Orckit of Mr. Paneth and Mr. Tamir may make certain transactions more difficult and result in delaying or preventing a change in control of us unless approved by one or both of them.

**Our shareholder bonus rights plan, the potential exchanges of Corrigent options for Orckit options and the super-majority voting requirements in our articles of association may delay, prevent or make more difficult a hostile acquisition of us, which could depress our share price.**

In November 2001, we adopted a shareholder bonus rights plan pursuant to which share purchase bonus rights were distributed to our shareholders. These rights generally will be exercisable and transferable apart from our ordinary shares only if a person or group acquires beneficial ownership of 15% or more of our ordinary shares, or commences a tender or exchange offer upon consummation of which that person or group would hold such a beneficial interest. Once these rights become exercisable and transferable, the holders of rights, other than the person or group triggering their transferability, will be generally entitled to purchase our ordinary shares at a discount from the market price. The rights will expire on December 31, 2011. While these rights remain outstanding, they may make an acquisition of us more difficult and result in delaying or preventing a change in control of Orckit.

In addition, pursuant to a plan approved by our shareholders at the Annual General Meeting in June 2005, we may offer holders of vested options to purchase Corrigent common stock at a price of \$0.01 per share that have been issued to employees and directors of Corrigent and Orckit the opportunity to exchange those options for vested options to purchase our ordinary shares at a price of \$0.01 per share. Based on the terms of the plan, as of March 1, 2006, the maximum number of options for our ordinary shares that could have been issued in exchange for options to purchase Corrigent shares would have been options for approximately 1,500,000 of our ordinary shares (excluding approximately 500,000 of our shares issuable pursuant to exchanges already made). The issuance of this number of shares to employees and directors of Orckit and Corrigent could also delay or prevent a change of control in our company.

In addition, our articles of association require the approval of the holders of at least 75% of our ordinary shares voting on the matter to remove a director from office and the approval of at least two-thirds of our ordinary shares voting on the matter to elect director. These requirements could also delay or prevent a change of control of our company.

**Our stock price has fluctuated significantly and could continue to fluctuate significantly.**

The market price for our ordinary shares, as well as the prices of shares of other technology companies, has been volatile. Since January 1, 2004, our share price has fluctuated from a low of \$4.82 to a high of \$31.22. The following factors may cause significant fluctuations in the market price of our ordinary shares:

- fluctuations in our quarterly revenues and earnings or those of our competitors;
- shortfalls in our operating results compared to levels forecast by securities analysts;
- announcements concerning us, our competitors or telephone companies;
- announcements of technological innovations;
- the introduction of new products;
- changes in product price policies involving us or our competitors;
- market conditions in the industry;
- the conditions of the securities markets, particularly in the technology and Israeli sectors; and
- political, economic and other developments in the State of Israel and world-wide.

In addition, stock prices of many technology companies fluctuate significantly for reasons that may be unrelated or disproportionate to operating results. The factors discussed above may depress or cause volatility of our share price, regardless of our actual operating results.

**There may be an adverse effect on the market price of our shares as a result of shares being available for sale in the future.**

If our shareholders sell substantial amounts of our ordinary shares, including shares issued upon the exercise of outstanding options or pursuant to the exchange of options to purchase Corrigent shares for options to purchase Orckit shares, the market price of our ordinary shares may fall. These sales also might make it more difficult for us to sell equity or equity-related securities in the future at a time and place that we deem appropriate.

**Our ordinary shares are listed for trading in more than one market and this may result in price variations.**

Our ordinary shares are listed for trading on the Nasdaq Stock Market, or Nasdaq, and on The Tel-Aviv Stock Exchange, or TASE. Trading in our ordinary shares on these markets is made in different currencies (U.S. dollars on Nasdaq and New Israeli Shekels on TASE), and at different times (resulting from different time zones, different trading days and different public holidays in the United States and Israel). Actual trading volume on the TASE is

generally lower than trading volume on Nasdaq, and as such could be subject to higher volatility. The trading prices of our ordinary shares on these two markets often differ, resulting from the factors described above, as well as differences in exchange rates. Any decrease in the trading price of our ordinary shares on one of these markets could cause a decrease in the trading price of our ordinary shares on the other market.

#### **ITEM 4. INFORMATION ON THE COMPANY**

##### **A. HISTORY AND DEVELOPMENT OF THE COMPANY**

###### **Our History**

Orckit Communications Ltd. was incorporated in 1990 under the laws of the State of Israel. Our principal executive offices are located at 126 Yigal Allon Street, Tel Aviv 67443 Israel and our telephone number is (972-3) 696-2121. Our agent in the United States, Puglisi & Associates, is located at 850 Library Avenue, Suite 204 Newark, Delaware 19711.

We were originally engaged in the development of various products based on digital subscriber line technology. For several years ending in 2003, our primary business was the sale of asymmetric digital subscriber line, or ADSL, products. We incurred significant operating losses in connection with the sale of these products and we no longer sell these products. Since 2001, we have invested significant funds in other technology products, mainly for new telecom equipment products addressing high transmission of data for the metropolitan area. We began to recognize significant revenues from sales of these products in the second half of 2004 and were able to generate operating income and net income for the first time in 2005.

###### **Major Developments since January 1, 2005**

We continued in 2005 to direct our resources to the development and marketing efforts related to our technology and products that address the need for solutions capable of supporting very high bandwidth services. We are in the process of developing and commercializing the CM-100 product line, which consists of telecommunications equipment supporting high bandwidth services over fiber networks in telecommunications networks located in metropolitan, or metro, areas. In 2005, we continued to sell our CM-100 product to KDDI in Japan for their national deployment of a new metropolitan area network that is expected to carry new IP-based services, including high-definition TV, or HDTV, cellular network transmissions, Internet access and voice over IP, or VoIP. These services, if carried over a single network, are also known as “quadruple play” services. Substantially all of our operating expenses in 2005 were related to our efforts to develop and market the CM-100 product line. WilTel, a U.S. based wholesale telecommunications carrier, selected CM-100 for deployment in its metro ring network in late 2005. Level 3 Communications acquired WilTel after this selection and, as part of the reorganization of their network after the acquisition, Level 3 is evaluating the need of WilTel for CM-100 products.

###### **Principal Capital Expenditures**

Our principal capital expenditures to date have been the purchase of equipment and other software tools in Israel used in our business. These purchases totaled \$862,000 in 2003, \$3.9 million in 2004 and \$1.9 million in 2005. We used internal resources to finance these capital expenditures.



## **B. BUSINESS OVERVIEW**

### **General**

We develop, market and sell telecommunication transport equipment capable of supporting the growing capacity demands for high bandwidth video services, including HDTV, Internet Protocol television, or IPTV, and video on demand, or VOD, interactive television (together known also as “video services”), as well as other types of data services and voice services, whether transmitted over wireline or cellular networks, in metropolitan networks. Our target customers are telecommunications service providers active in metropolitan areas, with a focus on incumbent local exchange carriers. Our current product line, the CM-100, was developed by our subsidiary, Corrigent Systems Inc. The CM-100 solution is designed to enable the provision and management of data and voice transport services in an efficient manner that is expected to reduce the costs of transport service providers. Supporting fiber-optic infrastructures, the CM-100 supports a wide range of interfaces for video, data, voice and storage.

Our CM-100 metropolitan product line is an optical transport solution that can handle not only the growing demand for video and data services by telephone company customers and small to medium size businesses, but also support the full range of traditional voice services, in compliance with the technical specifications required by existing synchronous voice transmission on optical media, or SONET, transfer protocol. The CM-100 product line is designed to provide the benefits of both Ethernet and SONET protocols. It is also designed to avoid integrating costly protocol-dependant routing and switching functionalities that are generally required in adopting SONET platforms to cover data traffic, as well as the costs of adopting additional Ethernet platforms to handle packet-based traffic.

We focus on the need of metropolitan area networks designed in a ring configuration that primarily addresses a transmission capacity of 10 Gigabits per second, or Gbps. A majority of the metropolitan area rings are currently operating at a capacity of 2.5Gbps or below because they were primarily designed to address voice traffic and, since 1998, to support high speed Internet connection services. It is expected that as new video and data services emerge, both for residential and small business enterprises, there will be an increased need to expand capacity of the metro ring.

The CM-100 product line was first delivered for commercial deployment in 2004. In 2004, this product was selected for commercial deployment by KDDI Corporation in Japan, a major telecom carrier in Japan. A small amount of sales was also made to Vic Tokai, a regional telecom provider in Japan targeting Ethernet-based services. Sales to our customers in Japan are made through distributors. Sales to KDDI accounted for approximately 81.5 % of our revenues in 2004 and 99.8% of our revenues in 2005. We expect that substantially all of our revenues in 2006 will be derived from sales of the CM-100 to KDDI. KDDI is deploying the CM-100 product line as part of a nation-wide build up in Japan of an advanced metro network that is expected to carry “quadruple play” services, that is, voice over IP, data services over the Internet, video services and cellular transmission services.

In late 2005, the CM-100 was selected for deployment by WilTel, a U.S. wholesale telecommunications carrier subsequently acquired by Level 3 Communications. No revenues were derived from WilTel in 2005. Level 3 Communications is re-evaluating the need for CM-100 products in its converged network following this acquisition.

In 2005, we opened offices in Korea and India, as well as increased the resources allocated for marketing and sales activities in our office in Japan. We expect that in the next several years telecommunication carriers in Asia will invest in the expansion of their metropolitan area networks and will evaluate solutions that significantly enhance the delivery and support of quadruple play services.

## **Metro Transport Telecom Markets, Technology and Products**

### *The Metro Transport Market*

The fiber optic networks of many telephone companies in metropolitan areas are experiencing a shift from carrying primarily voice traffic to carrying a growing mix of data, video and voice traffic. Data transmissions are based on internet protocol, or IP, and carry services such as voice over IP, or VoIP, Internet access, and various video services. Video services include broadcasting streaming video and multicasting streaming video that is either identical or can be differentiated by subscriber choice, either at standard definition capacity or at HDTV capacity. In addition, these services include transmission of all of these services over a cellular network to advanced handheld devices over third generation, or 3G, cellular networks. Coupled together, these data services (voice over IP, Internet access, video services and cellular network services) are referred to as “quadruple play” services. Data traffic volumes carried over these metropolitan area networks are surpassing voice traffic volumes. Data traffic is forecasted for further growth over the coming years. This increase in data relative to voice traffic is mainly a result of the rapid growth of the Internet, video services and local area networks.

Offerings of high data services at rates of up to 100 mega bits per second, or Mbps, have reached millions of subscribers in a number of Asian markets, including Japan and Korea. These services are offered either over fiber connections or a combination of fiber and fast access technologies, such as ADSL release 2, very high speed digital subscriber line, or VDSL, and VDSL release 2, wireless or cable networks. In 2004 and 2005, U.S. telecom carriers began plans for expansion of fiber rings in metro areas, promoting connectivity of fiber to the premise and fiber to the curb. Connecting subscribers with fiber is expected to allow for significantly higher speed services, mainly data and video services and, as a result, will require an upgrade of metro telecom equipment with technologies that address very high speed transmissions of data services over fiber networks.

Telephone companies have typically managed their data transfer capacity needs through their existing metro transport technologies. These technologies were originally designed for transporting voice services. These traditional solutions, however, are not designed to support expected future levels of data services traffic. Traditional networks are also inefficient when transporting data as they fail to utilize inherent differences in the type of network support that is required for the transmission of data traffic. Data traffic is generally less susceptible to corruption resulting from minor time delays and less time-sensitive than voice traffic. In addition, data traffic often exhibits a bursty nature, with dynamically varying levels of utilization of communication channels, as opposed to voice traffic which normally requires constant levels of channel utilization. Substantially all of the metropolitan area networks are based on transmission equipment that is limited to transmission capacities of 2.5 Gbps and below. Telecommunications carriers are expected to upgrade their metro networks over the next few years to be able to support transmission capacities of up to 10Gbps in order to better support high bandwidth data services.

A range of new solutions is being developed to address the need of carriers and service providers to be able to support higher levels of data traffic within and between metropolitan areas, commonly referred to as metro transport. One type of solution, consisting of a router or switch that transports packets of data, focuses on the characteristics of data traffic without supporting legacy voice and other circuit-based data services. In this type of solution, data services and legacy services are transmitted and maintained in different metro networks. Another type of solution, attempts to take advantage of the characteristics of data traffic while continuing to support traditional voice traffic over a converged metro network. We offer this second type of solution that offers transmission capacities of 10 Gbps and, to a lesser extent, 2.5 Gbps, and supports transmission of both packets of data and traditional circuit-based voice and data services over the same network. Data services supported include the transmission of a range of video services, whether in standard or high definition mode, as well as over cellular networks. We expect that the metro transport solution for the transmission of traditional voice and increased data traffic will combine the efficient transport of data services based on Ethernet protocol with high reliability voice services based on SONET/SDH protocol.

Major metro transport technologies include the following voice and/or data protocols:

*SONET / SDH.* SONET is the American National Standards Institute, or ANSI, standard for synchronous voice transmission on optical media. The international equivalent of SONET is synchronous digital hierarchy, or SDH. Together, these two voice protocols ensure standards to enable digital networks to interconnect internationally and existing conventional transmission systems to utilize fiber with the help of interfaces that connect network end-users, called tributary attachments.

*Ethernet.* Ethernet is the most widely-installed local area network, or LAN, technology. It is often used in college dormitories and office buildings. The most commonly installed Ethernet systems are called 10BASE-T and provide transmission speeds up to 10 Mbps.

*RPR.* Resilient packet ring, or RPR, is an emerging technology that is being designed to integrate Ethernet data protocols for the efficient transmission of data with traditional SONET voice protocols. An industry standard for RPR, IEEE 802.17, was approved in June, 2004. Corrigent has been instrumental in establishing this standard, serving actively as a member of the industry work group charged with defining the RPR protocol.

RPR is being developed as an alternative to SONET transport for networks that support high levels of data traffic, while allowing carriers to maintain traditional SONET attributes, such as resiliency. Resiliency refers to the ability to employ a back-up or alternate route in the event of a system or optical fiber failure, as well as the fast restoration of service in the event of any other failure. RPR is expected to allow carriers to conduct performance monitoring of transmission rates, traffic volume, and failures and alarms, comparable to the monitoring available with traditional SONET-based networks.

*Multiprotocol Label Switching.* Multiprotocol label switching, or MPLS, is a standards-approved technology for speeding up network traffic flow and making it easier to manage. MPLS involves setting up a specific path for a given sequence of packets, identified by a label put in each packet, thus saving the time needed for a router to look up the address to the next node to forward the packet to. MPLS is called *multiprotocol* because it works with the Internet Protocol, or IP, Asynchronous Transport Mode, or ATM, and frame relay

network protocols. In addition to moving traffic faster overall, MPLS makes it easy to manage a network for quality of service, or QoS. For these reasons, MPLS is expected to be adopted as networks begin to carry more and different mixtures of traffic.

#### *RPR's Advantages over Existing Data and Voice Transport Protocols*

We believe that RPR is a more efficient voice and data transport protocol than traditional SONET rings that have been retrofitted to handle data traffic for the following reasons:

*Usage of a single fiber ring and spatial reuse capabilities.* SONET utilizes only one ring of optical fibers. A second ring is available in case of a failure in the first ring, but is otherwise not used. This creates unutilized capacity in SONET, as half of the network capacity is idle during normal operations. RPR enables the use of this redundant bandwidth under normal operating conditions, while maintaining the redundancy capabilities. In addition, RPR supports spatial reuse, which allows the re-use of the same ring bandwidth over different spans of the ring.

*Statistical multiplexing qualities.* With SONET, data transmitted from one specific network element, or node, to another may be sent only using bandwidth that has been dedicated for that transmission. RPR increases bandwidth efficiency by allowing data transmissions to be broken up into packets and inserted in bandwidth that might have otherwise been dedicated (but not used) for a separate transmission. This process is called statistical multiplexing. When less than all network users are actively transmitting or receiving data at the same time, it results in a more efficient utilization of the total available bandwidth on a network.

#### *CM-100 Product*

Our CM-100 metropolitan product line is an optical transport solution that can handle not only the growing demand for data services by telephone company customers and small to medium size businesses, but also support the full range of traditional voice services, in compliance with SONET technical specifications. The CM-100 product line is designed to provide the benefits of both Ethernet and SONET protocols. It is also designed to avoid integrating costly protocol-dependant routing and switching functionalities that are generally required in adopting SONET platforms to cover data traffic, as well as the costs of adopting Ethernet platforms to handle voice traffic.

The CM-100 product line utilizes SONET, RPR, and MPLS technologies to effectively support a range of SONET services, Ethernet, Time Division Multiplexer, or TDM, services which are commonly used for voice transmissions and other data services. Data services supported include video services, whether standard or HDTV streams, in a broadcasting or multicasting mode, that allows for broader customization of transmission based on a customer's selection. This product line is designed to interoperate with both legacy SONET and emerging MPLS core devices. Our product can support transmission capacities of up to 10 Gbps and interfaces with:

- 10 megabits/100 megabits Ethernet;

- 1 Gigabit Ethernet;
- 10 Gigabit Ethernet, and
- a range of TDM SONET interfaces including:
  - 1.544 Mbps Plesiochronous (PDH) interface (known also as T1) and 2.048 megabits per second PDH interface (known also as E1);
  - 44.736 Mbps Plesiochronous (PDH) interface (known also as DS3);
  - 155 Mbps SONET interface (known also as OC3);
  - 622 Mbps SONET interface (known also as OC12); and
  - 2.5 gigabit per second SONET interface (known also as OC48).

The CM-100 product line is designed to deliver both Ethernet and TDM/Sonet –based services over a packet-based network. These services are carried over MPLS tunnels over an RPR ring in a packetized form that is expected to enable both bandwidth efficiency and lower cost architecture. The CM-100 allows legacy data services, such as frame relay, asynchronous transfer mode, or ATM, and packet over SONET, to be carried in their native form allowing a reduction in the bandwidth used to provide these services. MPLS is used to provide both end-to-end automatic provisioning capabilities and isolation between different users’ services, thus providing a preferred method of traffic engineering. MPLS also aids end-to-end interoperability between the transport systems of different vendors.

In 2006, we expect to focus on the development of additional software features and hardware capabilities of the CM-100 product line, to support customer requirements and address emerging “quadruple play” service applications, that is, a bundled service offering by telecom carriers to residential subscribers which is comprised of voice services, Internet connection and a range of video and other media services that address high transmission rates (typically of 10 Mbps and beyond), all over IP protocols. Quadruple play also supports cellular services of the “third generation”, or 3G, carried over IP networks that include video transmission over the cellular network. In addition, we expect to invest resources with respect to the development of hardware and software capabilities that will allow higher transmission capacity for the CM product line as a result of specific requirements of our customers to support their network architectures. This higher transmission capacity will allow for more types of high bandwidth services supported by a converged metro network based on the CM-100 platform.

## **Sales, Marketing and Service**

*Sales and Marketing.* We market our products to telephone companies both directly and indirectly through original equipment manufacturers, strategic alliances and agency and distribution arrangements. Our direct sales and marketing efforts are carried out through our

offices in the United States, Japan, Korea and India. In addition, we believe that our participation in technology committees involved in the establishment of industry standards is a strong marketing tool. As of December 31, 2005, overall marketing and sales efforts were conducted by approximately 32 employees located in Israel, the United States and Japan.

The following is a summary of revenues by geographic area for the last three years:

|                 | Year ended December 31 |                  |                  |
|-----------------|------------------------|------------------|------------------|
|                 | 2003                   | 2004             | 2005             |
|                 | (In thousands)         |                  |                  |
| Japan           | -                      | \$ 10,216        | \$101,247        |
| Israel          | \$35                   | -                | -                |
| Europe          | 1,510                  | 901              | -                |
| Other countries | 138                    | 159              | -                |
|                 | <u>\$1,683</u>         | <u>\$ 11,276</u> | <u>\$101,247</u> |

Substantially all of our revenues in 2004 and 2005 were generated from our CM-100 metro product line, with sales to KDDI accounting for 81.5% of our revenues in 2004 and 99.8% of our revenues in 2005. We expect to depend on purchases by a limited number of telecommunication carriers for our product revenues.

In 2003, our revenues were generated from sales of our FastInternet DSL product line. We no longer sell these DSL products.

*Telco Approval Process.* Telephone companies are significantly larger than us and consequently are able to exert a high degree of influence over us. Prior to selling our products to telephone companies, we are required to undergo lengthy approval processes. Evaluation can last for over one year for enhanced products or products based on newer technologies.

The length of the approval process is affected by a number of factors, including the complexity of the product involved, technological and budgetary priorities of the telephone companies and regulatory issues affecting telephone companies. A telephone company will usually conduct technical trials after completing a laboratory evaluation that tests a new product's function and performance against industry standards. After completion of technical trials, field trials simulate operations to evaluate performance and to assess ease of installation and operation. Throughout the approval process, we commit senior technical and marketing personnel to participate in technology, field and market trials and to actively support the evaluation efforts.

Commercial deployment of a new product usually involves substantially greater numbers of systems and locations than the field trial stage. In the first phase of commercial deployment, a telephone company installs the equipment in selected locations for certain applications. This phase is followed by general deployment which involves greater numbers of systems and locations. Telephone companies typically select a number of suppliers for general deployment to ensure that their needs can be met. Subsequent orders, if any, are placed under a single or multi-year supply agreement.

Following selection for commercial deployment, the introduction of successive generations of products or upgraded software versions is vital to our business, because it enhances functionality and reduces costs. Our growth substantially depends on commercial

acceptance of advanced products and technology by telephone companies and acceptance of new data services by subscribers, as well as our ability to develop new technologies and sell new products.

*Telco Services and Support.* We offer repair services as part of our warranty services and technical support services for our products. We do not offer installation services. We expect that our local distributor or reseller will provide first level of service and support. More extensive repair and technical support is offered at our headquarters in Israel pursuant to software support and hardware warranty obligations. We also offer telephone support during working hours and provide product training to our carrier customers on a case-by-case basis. In Japan, we deliver the CM-100 products to our resellers and they are responsible for installations. Second level support services that address identification and documentation of field failures are provided by our office in Japan.

Our CM-100 products are subject to a fourteen-month warranty and support protection period. Our warranty generally covers defects in materials or workmanship and failure to meet published specifications, but excludes damages caused by improper use and other express or implied warranties. In the event that there are material deficiencies or defects in the design or manufacture of our products, the affected products could be subject to recall. Our exposure to indirect damages arising from failures covered by our warranty could be significant.

#### *Customers and End-users.*

The CM-100 product line was first delivered for commercial deployment in 2004. To date, our product has been commercially deployed by KDDI Corporation in Japan, and, in limited amounts, by Vic Tokai, a regional telecom provider in Japan targeting Ethernet-based services. WilTel, a U.S. wholesale telecommunications carrier selected the CM-100 for deployment in late 2005. WilTel was subsequently acquired by Level 3 Communications, which currently is reevaluating this selection and its network needs after this acquisition.

Sales to our customers in Japan are made through distributors. Our sales to KDDI in Japan are made pursuant to agreements and related terms of sale with OKI and to a lesser extent with NetOne Systems, two distributors of telecom and enterprise products in Japan. We provide a fourteen-month product warranty and post-contract hardware and software support services with respect to products sold. Our distributors provide on-site product support services and training. Our distribution agreements set general distribution terms regarding sales to KDDI. Our distributors submit purchase orders for products on an as needed basis.

### **Manufacturing**

We use two major subcontractors for component sourcing, inventory warehousing, board assembly, testing and shipment. These contracting and manufacturing arrangements have enabled us in the past to produce reliable, high quality products at competitive prices and to achieve on-time delivery of our products. We expect to continue to utilize third parties to manufacture, assemble and test our new products.

Telephone company orders are short-term and typically involve short delivery time frames. We expect that the manufacture of products will be mainly against purchase orders, although we are likely to order products based on sales forecasts only and also to keep certain

levels of products in inventory. We and our manufacturers perform final quality control and extensive testing prior to shipping. Product quality and reliability are of prime concern in all phases of the manufacturing process. Our facilities are subject to the ISO9001 certification process. This certification is required in order to sell to many of the telephone companies.

In procuring components, we and our subcontractors rely on a number of suppliers of semiconductor solutions that are the sole source for certain of the components. In order to have an adequate supply of components with a long lead-time for delivery, we periodically order significant quantities of components from single source semiconductor component suppliers.

### **Industry Standards and Government Regulations**

Our products must comply with industry standards relating to telecommunications equipment. Before completing sales in a country, our products must comply with local telecommunications standards, recommendations of quasi-regulatory authorities and recommendations of standards-setting committees. In addition, public carriers require that equipment connected to their networks comply with their own standards. Telecommunication-related policies and regulations are continuously reviewed by governmental and industry standards-setting organizations and are always subject to amendment or change. Although we believe that our products currently meet applicable industry and government standards, we cannot be sure that our products will comply with future standards.

We are subject to telecom industry regulations and requirements set by telecommunication carriers that address a wide range of areas including quality, final testing, packaging and use of environmentally friendly components. We are making efforts to comply with the European Union's Restriction of Hazardous Substances Directive that requires telecom equipment suppliers to stop the usage of some materials that are not environmentally friendly by July 1, 2006. However, we believe that we will not be able to comply with this directive until 2007. These materials include cadmium, hexavalent chromium, lead, mercury, polybrominated biphenyls and polybrominated diphenyl ethers. Under the directive, an extension for compliance through 2010 was granted with respect to the usage of lead in solders in telecommunication equipment. We expect that other countries, including countries we operate in, will adopt similar directives or other additional regulations.

### **Competition**

We compete on the basis of technological capability, price, customer service, product features, adherence to standards, quality, reliability, availability and technical support. With respect to our metro products, competition is based primarily on technological capability and the ability to develop a product that can be manufactured and sold with a cost structure that will allow for mass deployment to customers of telephone companies. Many of our competitors and potential competitors have greater financial, technological, manufacturing, marketing and personnel resources than we have. We also expect that companies with facilities in Asia where engineering and production costs tend to be lower will increasingly provide competition to us and our products.

Our competitors in our targeted markets of metro and access telecom equipment are numerous and we expect competition to increase in the future. Our principal competitors for



our products include Alcatel, Cisco Systems, Inc., ECI Telecom Ltd., Fujitsu, Hitachi, Huawei, Lucent Technologies Inc., Nortel Networks, Siemens AG and UTStarcom.

### **Intellectual Property Rights**

We regard certain areas of technology as proprietary. We have obtained several patents and have filed U.S. patent applications covering certain key areas of our technologies. In general, we have relied on a combination of technical leadership, trade secret, copyright and trademark law and nondisclosure agreements to protect our unpatented proprietary know-how. Our proprietary technology incorporates algorithms, software, system design and hardware design that we believe is not easily copied. We believe that, because of the rapid pace of technological change in the telecommunications industry, patent and copyright protection are less significant to our competitive position than factors such as the knowledge, ability and experience of our personnel, new product development, market recognition and ongoing product maintenance and support.

### **Legal Proceedings**

On December 29, 2005, Luminous Networks, Inc. filed a lawsuit against Corrigent and Orckit in the Supreme Court of the State of New York, County of New York. The complaint alleges that Corrigent and Orckit breached a nondisclosure and confidentiality agreement and alleges that Corrigent and Orckit committed tortious interference with prospective economic advantage. Corrigent and Orckit filed an answer on February 13, 2006 denying the allegations in the complaint. We believe that this lawsuit is without merit and intend to vigorously defend against it.

We are not a party to any other material pending legal proceedings, nor is any of our property the subject of any other material pending legal proceedings.

### **C. ORGANIZATIONAL STRUCTURE**

#### **List of Significant Subsidiaries**

Corrigent Systems Inc., a subsidiary, is a Delaware corporation. As of March 1, 2006, Orckit owned approximately 93% of the shares of Corrigent Systems on a fully-diluted basis.

### **D. PROPERTY, PLANT AND EQUIPMENT**

Our principal offices in Tel Aviv occupy approximately 50,000 square feet of rental space rented through a series of leases. Our major lease in Tel Aviv expires in December 2007. We have an option to terminate these lease agreements with six months' prior written notice. We also maintain offices in San Jose, California, Tokyo, Japan and, in 2005, opened offices in Mumbai, India and Seoul, South Korea. We believe that our offices and facilities are adequate for our current needs and that suitable additional or substitute space will be available when needed.

### **ITEM 4A. UNRESOLVED STAFF COMMENTS**

None.

## ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*Statements in this Annual Report concerning our business outlook or future economic performance; anticipated revenues, expenses or other financial items; introductions and advancements in development of products, and plans and objectives related thereto; and statements concerning assumptions made or expectations as to any future events, conditions, performance or other matters, are “forward-looking statements” as that term is defined under the United States Federal Securities Laws. Forward-looking statements are subject to risks, uncertainties and other factors which could cause actual results to differ materially from those stated in such statements. Factors that could cause or contribute to such differences include, but are not limited to, those set forth under “Risk Factors” in this Annual Report as well as those discussed elsewhere in this Annual Report and in our other filings with the Securities and Exchange Commission.*

### A. OPERATING RESULTS

Our operating and financial review and prospects should be read in conjunction with our financial statements, accompanying notes thereto and other financial information appearing elsewhere in this Annual Report.

#### Overview

Orckit was founded in 1990. We are an Israeli corporation engaged in the design, development, manufacture and marketing of telecom equipment that enables transmission of broadband services. Substantially all of our revenues in 2004 and 2005 were derived from the sale of our metro products, the CM-100 product line, to KDDI. Our historical revenues through December 31, 2003 were generated primarily from the sale of systems and customer premises modems based on digital subscriber line, or DSL, technology. We have terminated the sale of these DSL products and do not expect to generate additional revenues from them. We expect to generate substantially all of our revenues in 2006 from the sale of our metro products.

The end-user base for our products is comprised primarily of large telephone companies, and has historically been concentrated in each year among a small number of telcos. Sales to KDDI accounted for approximately 81.5% of our revenues in 2004 and 99.8% of our revenues in 2005. We expect that in 2006 substantially all of our sales will also be to KDDI. We expect that we will continue to experience high customer concentration for the foreseeable future.

Our products undergo lengthy approval and procurement processes prior to their sale due to the quality specifications of our end-users and the regulated environment in which they operate. Accordingly, we make significant expenditures in product and market development prior to actually commencing sales of new products. In addition, frequently we are required to make significant expenditures to tailor our products to specific end-user needs during the initial commercialization phase. Our product sales to end-users are subject to fluctuation from quarter to quarter and year to year.

We intend to continue to evaluate new technologies and related product opportunities and engage in extensive research and development activities related to new technologies. Accordingly, we expect to continue to make significant expenditures for research and development.

Substantially all of our operating expenses in 2005 related to research and development expenses, selling, general and administrative expenses and capital expenditures for the operations and support related to our CM-100 product and related technologies.

Prior to 2005, we generated operating losses in each of our past five years. Our revenues were insignificant in 2003 and the first half of 2004. We began for the first time to generate revenues from sales of our metro products in the second half of 2004. In 2005, we generated over \$100 million of revenues from sales of our metro products, while controlling our operating expenses, and were able to generate operating and net income for the first time.

The telecommunications equipment market is undergoing continuous and rapid change. Companies with research and development activities in Asia, particularly in China, are leveraging the lower engineering cost structure and also building on the success they have had in supplying products to telecom carriers in their local markets. In addition, Asian equipment manufacturers have begun to make sales in commercial volumes of high end telecommunication equipment to carriers in Europe, Asia and the Middle East. These sales have increased price competition in these areas. These equipment vendors have access to lower cost research and development resources, and are able to sell their products to government-owned local carriers. These manufacturers are likely to become strong competitors in the markets we target. As a result, we are focusing our resources on bringing to market highly-advanced products with innovative technology components. We also concentrate on cost efficiencies in our design process to be able to respond to expected price competition going forward.

Our metro products address very high-bandwidth packet services. We expect that “quadruple play” services will grow and drive the demand for our metro products. However, the growth of these services will be subject to the ability of telecom carriers to offer services at a price that is attractive to subscribers while generating profits to the carriers sufficient to justify a significant investment in new equipment. Our success will be directly affected by the ability of our customers to add subscribers for these new data services.

### **Critical Accounting Policies and Estimates**

We prepare our consolidated financial statements in conformity with accounting principles generally accepted in the United States. These accounting principles require management to make certain estimates, judgments and assumptions based upon the information available at the time they are made, historical experience and various other factors believed to be reasonable under the circumstances. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods presented. Management evaluates its estimates and judgments on an on-going basis. Some of those judgments can be subjective and complex, and consequently actual results may differ from those estimates.

We are also subject to risks and uncertainties that may cause actual results to differ from estimates and assumptions, such as changes in the economic environment, competition, foreign exchange, taxation and governmental programs. Certain of these risks, uncertainties and assumptions are discussed in “Item 3.D - Risk Factors.” To facilitate the understanding of our business activities, described below are certain accounting policies that are relatively more important to the portrayal of our financial condition and results of operations and that require management's subjective judgments. We base our judgments on past experience and

various other assumptions that are believed to be reasonable under the circumstances. Please refer to Note 1 to our consolidated financial statements included in this Annual Report for a summary of all of our significant accounting policies.

### *Revenue Recognition*

Revenues from sales of products are recognized when title passes to the customer, provided that appropriate form of arrangement exists, the fee is fixed or determinable and collectibility is reasonably assured.

EITF Issue No. 03-5, “Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software” states that the revenue recognition guidance in Statement of Position 97-2 (“SOP 97-2”) also applies to non-software deliverables, such as computer hardware, if the software is essential to the functionality of the non-software deliverables. We applied Sop 97-2, as amended, in our financial statements. According to SOP 97-2, revenues from sales of software products are recognized when title passes to the customer, provided that appropriate form of arrangement exists, the fee is fixed or determinable, collectibility is reasonably assured and vendor-specific objective evidence, or VSOE, of fair value for undelivered elements exists. VSOE is typically based on the price charged when an element is sold separately or, if an element is not sold separately, on the price established by authorized management, if it is probable that the price, once established, will not change before market introduction.

In 2004 and 2005, we granted post-contract hardware and software support services, or PCS, in our sales to KDDI. The VSOE of the fair value of the PCS relating to these sales could not be determined. Accordingly, revenues for substantially all sales in 2004 and 2005 are being recognized ratably over the fourteen-month term of the PCS. Deferred income of \$28.7 million as of December 31, 2005, represents \$54.8 million of deferred revenues less the \$26.1 million deferred cost of goods associated with these revenues. The deferred revenues and costs will be included in our statements of operations over the term of the PCS. Applicable costs that were deferred consist of a) cost of components used in manufacture and assembly, b) subcontractors fees for component procurement, manufacture, assembly, testing, shipment and final testing, c) expenses related directly to operational activities: salaries of manufacturing planning, support, procurement personnel, premises lease and related expenses of those departments, travel expenses of those employees, related expenses of subcontractors and depreciation of equipment used in the testing process, d) expenses addressing Post Contract Services of “level 3” and maintenance services including provisions for salary and travel expenses, e) warranty provisions for hardware repair, and f) OCS royalties on products sold.

We do not expense these costs upon product delivery since these expenses are costs of the products and, therefore, until the revenues from the sale of the corresponding products are recognized, these costs should not be expensed. We offset these cost of goods sold against the corresponding deferred revenues rather than presenting these deferred costs as an asset. We use this presentation because the products have been delivered to the customer, title has passed to the customer and we deferred the gross margin to be recognized in future periods.

We expect to recognize deferred revenues ratably over the applicable PCS period. If we are able to determine the VSOE relating to the PCS services, we will be required to recognize the balance of deferred income, including the related deferred revenues and

deferred expenses, with respect to the same deliveries for which VSOE was determined, at one time on a current basis. We will re-evaluate in 2006 the existence of VSOE regarding our sales made to KDDI after the termination of the term of the first PCS services that we provided with respect to CM-100 products. If we are able to determine the VSOE, we will recognize the balance of the deferred income, including the related deferred revenues and deferred expenses, with respect to that VSOE.

Under GAAP, we may be required to change our revenue recognition policies, including the method in which we recognize revenues over the applicable PCS period, if there are changes in the commercial terms of sales to our customers relating to the scope of product and service deliveries and payment terms, as well as because of changed commercial terms with our resellers and distributors.

#### *Provision for doubtful accounts*

Allowances for doubtful accounts are determined based on an analysis made for each of our customers. If bad debts are found to be higher than expected, we may need to increase these provisions and our bad debt expenses. As of March 1, 2006, we had collected all of the trade receivables that appeared on our balance sheet as of December 31, 2005.

#### *Provision for servicing products under warranty*

Sales of our metro products to KDDI are subject to warranty for a period of fourteen months. The majority of our legacy DSL products were sold subject to up to a three-year warranty period. We have agreed to indemnify our customers in some circumstances against liability from defects in our products. In some cases our indemnity also covers indirect damages. We provide an estimate for warranty expense at the time revenues from the related sales are recognized. The annual provision for warranty and PCS is calculated as a percentage of the sales, based on historical experience, or where historical experience is not available, based on management estimates for expenses which may be required, to cover the amounts necessary to settle product-related matters existing as of the balance sheet date and which may arise during the warranty and PCS period.

The amount of our estimated warranty liability may change if the costs incurred due to product failures increase in the future and exceed our estimates. In the event of any future problems with our products, we may need to increase the amount of our reserves.

#### *Stock-based compensation expense*

Effective July 1, 2005, we account for stock-based compensation costs in accordance with Statement of Financial Accounting Standards No. 123R – “Share-Based Payment” (“SFAS 123R”). We utilize the Black-Scholes option pricing model to estimate the fair value of stock-based compensation at the date of grant, which requires subjective assumptions, including expected volatility of our share price and expected life of the option. Further, as required under SFAS 123R, we estimate forfeitures for options granted which are not expected to vest. Changes in these inputs and assumptions can materially affect the measure of estimated fair value of our stock-based compensation.

Prior to July 1, 2005, we accounted for stock-based compensation costs in accordance with Accounting Principle Board Opinion number 25 (Accounting for Stock Issued to Employees), known as APB25, and related interpretations. Under this treatment, compensation cost for employee stock option plans was measured using the intrinsic value based method of accounting. The total amount expensed by us in 2005 for stock-based compensation was \$616,000, of which \$263,000 was recorded for the period January 1 through June 30, 2005 and was calculated based on APB 25 and the balance of \$353,000 was recorded for the period July 1 through December 31, 2005 and was calculated based on SFAS 123R. If we had used SFAS 123R from January 1, 2005 through December 31, 2005, our stock-based compensation expense for 2005 would have been \$5.5 million. As of December 31, 2005, there was approximately \$2.0 million of total unrecognized stock-based compensation expense related to non-vested stock-based compensation arrangements granted by us. That expense is expected to be recognized by us over a weighted-average period of 1.6 years.

## Results of Operations

The following table sets forth certain items from our consolidated statement of operations as a percentage of total revenues for the periods indicated:

|  | <b><u>For the years ended December 31,</u></b> |                    |                    |
|--|--|--------------------|--------------------|
|  | <b><u>2003</u></b>                             | <b><u>2004</u></b> | <b><u>2005</u></b> |
| Revenues                                     | 100.0%   | 100.0%             | 100.0%             |
| Cost of revenues                             | 44.4   | 52.3               | 51.2               |
| Gross profit                                 | 55.6   | 47.7               | 48.8               |
| Research and development expenses, net       | 891.4  | 133.4              | 15.9               |
| Selling, general and administrative expenses | 752.0  | 106.4              | 15.9               |
| Operating income (loss)                      | (1,588.0)                                      | (192.1)            | 17.0               |
| Financial income, net                        | 303.5  | 13.6               | 2.6                |
| Other income                                 |  |                    | 2.4                |
| Net income (loss)                            | (1,284.4)%                                     | (178.5)%           | 22.0%              |

*Revenues.* The substantial majority of our revenues of \$11.3 million in 2004 and all of our revenues of \$101.2 million in 2005 was generated from sales of our CM-100 product line to KDDI. We expect that substantially all of our revenues in 2006 will result from sales of the CM-100 product line to KDDI. In 2003, our revenues were insignificant as we transitioned our business from legacy DSL products to the development of new metro products. We do not expect to generate additional revenues from the sale of our legacy DSL products.

*Gross Profit.* Cost of revenues consists primarily of raw materials, subcontracting costs, costs for integration, assembly and testing of finished products, expenses related directly to operational activities, cost related to PCS and maintenance services and the

repayment of grants received from the Office of the Chief Scientist. Gross profit was \$49.4 million (48.8% of revenues) in 2005 compared to \$5.4 million (47.7% of revenues) in 2004 and \$935,000 (55.6% of revenues) in 2003. The substantial majority of our gross profit in 2005 and 2004 was a result of sales of our CM-100 products, which commenced in the second half of 2004.

### *Operating Expenses*

|                                     | Year ended December 31,<br>(\$ in millions) |             |             | % Change             |                      |
|-------------------------------------|---|-------------|-------------|----------------------|----------------------|
|                                     | <u>2003</u>                                 | <u>2004</u> | <u>2005</u> | <u>2004 vs. 2003</u> | <u>2005 vs. 2004</u> |
| Research and development, net       | 15.0  | 15.0        | 16.1        | (0.0)%               | 7.3%                 |
| Selling, general and administrative | 12.7  | 12.0        | 16.1        | (5.5)                | 34.2%                |
| Total operating expenses            | 27.7  | 27.0        | 32.2        | (2.5)                | 19.3%                |

*Research and Development Expenses, net.* Research and development expenditures consist primarily of materials, depreciation and salaries and related costs for engineering and technical personnel and subcontracting costs associated with developing new products and features. Our costs for research and development are expensed as incurred. Grants from the government of Israel for research and development are offset against our gross research and development expenditures. Research grants were \$5.8 million in 2003, \$2.7 million in 2004 and \$173,000 in 2005. Our research and development expenses were higher in 2005 compared to 2004, mainly due to an increase in the number of research and development employees and in the costs of materials and the use of sub-contractors for the continued development of the CM-100 product line. We anticipate that we will incur a similar or higher level of research and development expenditures in 2006 compared with 2005. We expect that the amount of government research grants in 2006 will be insignificant, if any, due to the policy of Israel's Office of the Chief Scientist to focus on venture stage companies and requirement to repay grants from all sources of revenues, without regard to sales related to the project funded.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses consist primarily of costs relating to promotion, trade shows, compensation costs for marketing and sales personnel, and other general corporate expenses. Selling, general and administrative expenses increased in 2005 compared to 2004 due to an increase in marketing, promotion and sales activities with respect to the increased efforts of distribution of our metro products. These expenses decreased in 2004 compared to 2003 due to a reduction of our marketing and sales activities related to our legacy DSL products. We expect that marketing and sales expenses will increase in 2006 as we increase our marketing activities and sales efforts as we attempt to expand the distribution of our metro products.

*Financial Income, net.* Financial income consists primarily of interest on short term and long term investments and on bank deposits. Prior to 2004, it also included gain on early retirement of our convertible subordinated notes. Through 2004, financial expense consisted primarily of interest payments with respect to our convertible subordinated notes, bank loans and amortization of the issuance costs of our convertible subordinated notes. It also included exchange rate differentials. In 2005, financial expense consisted primarily of interest payments with respect to bank loans and exchange rate differentials.

During 2003, we retired \$22.0 million principal amount of our convertible subordinated notes, resulting in a gain of \$3.1 million. In 2004, we retired the remaining balance of our convertible subordinated notes in a principal amount of \$16.2 million at par value. This retirement did not result in a financial gain.

Financial income, net was \$5.1 million in 2003, \$1.5 million in 2004 and \$2.6 million in 2005. The fluctuations in our financial income were primarily driven by the financial income derived in 2003 from the principal amount of notes retired and the prices at which they were retired, net of interest payments. In 2005, exchange rate currency losses also impacted our financial income, net mainly due to fluctuations of the Japanese Yen versus the U.S. dollar which resulted in expenses of approximately \$972,000, offset in part by income of approximately \$410,000 from fluctuations of other currencies (mainly NIS) versus the U.S. dollar.

*Other Income.* Other income consisted of capital gain in the amount of \$2.4 million that we recognized in 2005 in connection with a sale for \$4.2 million of our holdings in Siliquent Technologies Inc., a venture backed private technology entity.

### **Impact of Inflation, Devaluation and Fluctuation of Currencies on Results of Operations, Liabilities and Assets**

As of December 31, 2005, the majority of our assets in non-dollar currencies are in Japanese Yen (Yen) and in New Israeli Shekels (NIS). A devaluation of the Yen or NIS in relation to the U.S. dollar would have the effect of decreasing the dollar value of assets in Yen or NIS of Orkit, to the extent the underlying value is Yen or NIS based. Such a devaluation would also have the effect of reducing the U.S. dollar amount of any of our liabilities that are payable in NIS (unless such payables are linked to the U.S. dollar).

Almost all of our sales in 2005 were denominated in Yen. A substantial part of our expenses, principally payroll and payments to Israeli vendors, is in NIS, while a significant portion of the cost of goods sold is in U.S. dollars. Our results of operations are adversely affected by increases in the rate of inflation in Israel when such increases are not offset by a corresponding devaluation of the new Israeli shekel against the U.S. dollar. The results are also affected by the currency rate between the U.S. dollar and Yen. Due to the strengthening of the U.S. dollar exchange rate against the Yen in 2005, sales that were denominated in Yen were recognized based on higher Yen/U.S. Dollar exchange rates, resulting in lower revenues and gross margins and lower income than if the exchange rate had not changed from 2004.

We are not presently engaged in hedging transactions. We may, however, enter into foreign currency derivatives, mainly forward exchange contracts, in order to protect our cash flows in respect of existing assets.

The following table presents information about the rate of inflation in Israel, the rate of devaluation of the NIS, the rate of inflation in Israel adjusted for the devaluation and, for 2004 and 2005, the devaluation rate of the Yen against the U.S. dollar:



| <b>Years Ended<br/>December 31,</b> | <b>Israeli<br/>Inflation<br/>Rate</b> | <b>Israeli<br/>Devaluation<br/>Rate</b> | <b>Israel Inflation<br/>Adjusted for<br/>Devaluation</b> | <b>Japanese<br/>Devaluation<br/>Rate</b> |
|-------------------------------------|---------------------------------------|---|--|--|
| 2001.....                           | 1.4                                   | 9.3                                     | (7.8)  | n\                                       |
| 2002 .....                          | 6.5                                   | 7.3                                     | (0.8)  | a  |
| 2003 .....                          | (1.9)                                 | (7.6)                                   | 5.7  | n\                                       |
| 2004.....                           | 1.2                                   | (1.6)                                   | 2.8  | a  |
| 2005.....                           | 2.4                                   | 6.8                                     | (4.4)  | (4.1)                                    |
|                                     |                                       |   |  | 14.3                                     |

## B. LIQUIDITY AND CAPITAL RESOURCES

We have historically financed our operations primarily through sales of equity, issuance of convertible notes and the receipt of grants to fund research and development, as well as from bank loan proceeds. In 2005, we used cash from operations to finance our operations.

Our working capital (total current assets net of total current liabilities) decreased from \$34.5 million as of December 31, 2003 to \$16.5 million as of December 31, 2004 and to \$(6.3) million in 2005. The decrease in our working capital has occurred as a result of the following: a) through 2004, using our cash to fund our operating losses and to repurchase our convertible subordinated notes; b) our decision to invest funds in long-term marketable securities, which are not included in working capital; and c) using short-term borrowings in the amount of \$31.0 million at the end of 2004 to purchase the remaining principal amount of our convertible subordinated notes and to provide working capital in anticipation of increased sales.

We had cash, cash equivalents, long-term marketable securities and bank deposits of \$117.8 million as of December 31, 2005, compared to \$77.2 million as of December 31, 2004 and compared to \$79.0 million as of December 31, 2003. Since all of our revenues in 2005 were recognized ratably over a 14-month period from product delivery, due to the inability to value the PCS services, the increase of cash, cash equivalents and marketable securities did not result in a corresponding increase in revenues recognized in 2005. Therefore, it is expected that a significant portion of our revenues in the six-months ending June 30, 2006 will not generate cash since the cash related to such revenues was already received by us in 2005 and as a result, our balance of cash, cash equivalents, long-term marketable securities and bank deposits is likely to decline as of June 30, 2006.

The majority of the amount of cash, cash equivalents and marketable securities was invested in securities denominated in U.S. dollars. In 2005, we repaid all of our bank borrowings that were outstanding as of December 31, 2004 in the amount of \$31.0 million.

We used approximately \$16.2 million in cash in April 2004 to redeem the remaining outstanding principal amount of our convertible subordinated notes. We believe that we have sufficient working capital to meet our anticipated working capital and capital expenditure requirements for 2006 and 2007. If we do not have available sufficient cash to finance our

operations, we may be required to obtain equity or debt financing. We cannot be certain that we will be able to obtain additional financing on acceptable terms or at all.

#### *Net Cash Provided by/Used in Operating Activities*

In 2005, we generated \$72.6 million of cash from operating activities primarily as a result of our net income and a decrease of \$54.1 million of trade receivables and other receivables, offset by a decrease of \$9.0 million in trade payables and accrued expenses and an increase of \$6.9 million in deferred income. A substantial majority of the sales related to the receivables collected by us in 2005 were not recognized as revenue in 2005. The decrease in the accounts receivable balance as of December 31, 2005 in comparison to December 31, 2004 resulted from a decrease in deliveries to customers in the last quarter of 2005 in comparison to the last quarter of 2004.

In 2004, we generated \$938,000 of cash from operating activities primarily as a result of an increase in trade payables, and deferred income and trading of marketable securities, offset in part by our net loss and an increase in trade receivables. In 2003, we used \$16.1 million of cash in operating activities, primarily as a result of our net loss, decreases in payables and non-cash gain from the early retirement of our convertible subordinated notes, offset in part by depreciation and impairment of property and equipment, amortization of deferred compensation related to employee stock option grants and trading marketable securities.

#### *Net Cash Provided by/Used in Investing Activities*

Our principal investing activity relating to our operations has been the purchase of equipment and other fixed assets used in our business. These purchases totaled \$862,000 in 2003, \$3.9 million in 2004 and \$1.9 million in 2005. Our capital expenditures in 2005, 2004 and 2003 were primarily for the procurement of telecommunications equipment and related software tools.

In 2005 and 2004, our investing activities also included primarily the receipt of \$15.0 million in 2005 and \$10.0 million in 2004 from marketable securities that came to maturity, offset by \$63.8 million in 2005 and \$3.0 million in 2004 of investments in marketable securities. In 2003, our investing activities also included the receipt of \$26.3 million of marketable securities, the receipt of \$7.0 million from Tikcro in repayment of our loan to Tikcro and the receipt of \$10.3 million from bank deposits.

#### *Convertible Subordinated Notes*

In March 2000, we sold \$125 million aggregate principal amount of 5.75% convertible subordinated notes due on April 1, 2005. From 2000 to 2004, we repurchased and redeemed the outstanding balance of the principal amount of our convertible subordinated notes for an aggregate amount of \$70.4 million. As a result, as of December 31, 2004, there were no convertible subordinated notes outstanding. The repurchase and redemption of convertible subordinated notes constituted our primary use of cash in financing activities in 2003 and 2004.

#### *Bank Borrowings*

On March 30, 2004, we borrowed \$16.0 million from a bank in order to finance the early redemption of our convertible subordinated notes. This borrowing bore interest at a rate between 2.08% and 2.17% per year until maturity in May and July 2005. We have paid this loan on its maturity date from the proceeds of our long-term marketable securities.

In December 2004, we borrowed \$15.0 million from a bank at an interest rate of 3.8% per year in order to enhance our working capital in anticipating an increase of sales. This loan was fully repaid in January 2005.

#### *Loan to Tikcro*

As part of the spin-off of Tikcro, we loaned \$20 million to Tikcro at an interest rate of approximately 6% per annum. The loan was required to be repaid by March 1, 2005. In 2002, Tikcro repaid \$13.0 million of the principal of this loan from the proceeds of a transaction it entered into with STMicroelectronics. In May 2003, Tikcro announced the closing of the sale of its remaining operating assets to STMicroelectronics. Promptly thereafter, Tikcro repaid the remaining amounts outstanding under this loan.

#### *Repurchases of our Ordinary Shares*

During 2003, we repurchased for \$5.6 million in cash approximately 2,646,000 of our ordinary shares.

### **Government and Other Grants**

The Government of Israel encourages research and development projects through the Office of Chief Scientist of the Israeli Ministry of Industry, Trade and Labor, or the OCS, pursuant to the Law for the Encouragement of Industrial Research and Development, 1984, commonly referred to as the “R&D Law”. In June 2005, an amendment to the R&D Law came into effect, which intends to make the R&D Law more compatible with the global business environment by, among other things, relaxing restrictions on the transfer of manufacturing rights outside Israel and on the transfer of OCS-funded know-how outside of Israel, as described below.

Under the R&D Law, a research and development plan that meets specified criteria is eligible for a grant of up to 50% of certain approved research and development expenditures. The plan must be approved by the Office of the Chief Scientist.

In prior years, we relied on grants from the Office of the Chief Scientist to finance a portion of our product development expenditures. During the three years ended December 31, 2005, we recognized research and development grants in an aggregate amount of approximately \$8.7 million. As of December 31, 2005, total contingent liabilities to the Office of the Chief Scientist were approximately \$6.6 million. Since the budget for grants continues to be cut and the focus for grants is shifting to venture stage companies, we may not receive additional grants.

Under the terms of the grants we received from the Office of Chief Scientist, we are obligated to pay royalties of 3% during the first three years following commencement of royalty payments, and 4% to 5% thereafter. Pursuant to a proposed amendment to the R&D Law described below, we expect our royalty rate to be 3% - 5% per annum. Royalties are payable up to 100% of the amount of such grants, or up to 300% as detailed below, linked to

the U.S. Dollar, plus annual interest at LIBOR. The payment of royalties is on all revenues derived from the sale of the products developed pursuant to the funded plans, including revenues from licensed ancillary services.

The Israeli government is currently in the process of formulating a proposed amendment to the royalty regulations promulgated under the R&D Law. The amendment is expected to include changes to the royalty rates, which would vary from company to company based on the amount of its revenues and approval date of its program, up to a rate of 6%, and, as of 2006, to increase the rate of interest accruing on grants by 1% per year. The amendment is expected to have retroactive effect from January 1, 2006, although there is no assurance as to whether and when it will be adopted.

The R&D Law generally requires that a product developed under a program be manufactured in Israel. However, upon the approval of the Chief Scientist, some of the manufacturing volume may be performed outside of Israel, provided that the grant recipient pays royalties at an increased rate, which may be substantial, and the aggregate repayment amount is increased up to 300% of the grant, depending on the portion of the total manufacturing volume that is performed outside of Israel. The recent amendment to the R&D Law further permits the OCS, among other things, to approve the transfer of manufacturing rights outside Israel in exchange for an import of different manufacturing into Israel as a substitute, in lieu of the increased royalties. We have obtained an approval from the Office of the Chief Scientist for manufacturing outside Israel. We intend to keep sufficient manufacturing activities in Israel so that, under certain assumptions, we will be subject to a repayment percentage of up to 150% of the grants we received and an increased royalty percentage payment. The R&D Law also allows for the approval of grants in cases in which the applicant declares that part of the manufacturing will be performed outside of Israel or by non-Israeli residents and the research committee is convinced that doing so is essential for the execution of the program. This declaration will be a significant factor in the determination of the Office of Chief Scientist whether to approve a program and the amount and other terms of benefits to be granted. For example, the increased royalty rate and repayment amount will be required in such cases.

The R&D Law also provides that know-how developed under an approved research and development program may not be transferred to third parties in Israel without the approval of the research committee. Such approval is not required for the sale or export of any products resulting from such research or development. The R&D Law further provides that the know-how developed under an approved research and development program may not be transferred to any third parties outside Israel, except in certain circumstances and subject to the OCS' prior approval. The OCS may approve the transfer of OCS-funded know-how outside Israel, generally in the following cases: (a) the grant recipient pays to the OCS a portion of the sale price paid in consideration for such OCS-funded know-how (according to certain formulas), or (b) the grant recipient receives know-how from a third party in exchange for its OCS-funded know-how, or (c) such transfer of OCS-funded know-how arises in connection with certain types of cooperation in research and development activities.

The R&D Law imposes reporting requirements with respect to certain changes in the ownership of a grant recipient. The law requires the grant recipient and its controlling shareholders and foreign interested parties to notify the Office of the Chief Scientist of any change in control of the recipient or a change in the holdings of the means of control of the recipient that results in a non-Israeli becoming an interested party directly in the recipient and requires the new interested party to undertake to the Office of the Chief Scientist to comply

with the R&D Law. In addition, the rules of the Office of the Chief Scientist may require additional information or representations in respect of certain of such events. For this purpose, “control” is defined as the ability to direct the activities of a company other than any ability arising solely from serving as an officer or director of the company. A person is presumed to have control if such person holds 50% or more of the means of control of a company. “Means of control” refers to voting rights or the right to appoint directors or the chief executive officer. An “interested party” of a company includes a holder of 5% or more of its outstanding share capital or voting rights, its chief executive officer and directors, someone who has the right to appoint its chief executive officer or at least one director, and a company with respect to which any of the foregoing interested parties owns 25% or more of the outstanding share capital or voting rights or has the right to appoint 25% or more of the directors. Accordingly, any non-Israeli who acquires 5% or more of our ordinary shares will be required to notify the Office of the Chief Scientist that it has become an interested party and to sign an undertaking to comply with the R&D Law.

### **Effective Corporate Tax Rates in Israel**

Generally, Israeli companies are subject to corporate tax on their taxable income at the rate of 34% for the 2005 tax year. Following an amendment to the Israeli Income Tax Ordinance [New Version], 1961 (the “Tax Ordinance”), which came into effect on January 1, 2006, the corporate tax rate is scheduled to decrease as follows: 31% for the 2006 tax year, 29% for the 2007 tax year, 27% for the 2008 tax year, 26% for the 2009 tax year and 25% for the 2010 tax year and thereafter. Israeli companies are generally subject to capital gains tax at a rate of 25% for capital gains (other than gains deriving from the sale of listed securities) derived from assets purchased after January 1, 2003. However, the effective tax rate payable by a company that derives income from an Approved Enterprise program (as further discussed below) may be considerably less.

Under the Law for Encouragement of Capital Investments, 1959, known as the Investments Law, by virtue of the “Approved Enterprise” status granted to some of our investment programs, we are entitled to various tax benefits. The period of tax benefits is seven years, commencing in the first year in which we earn taxable income from the approved enterprise, subject to certain limitations. Under this law, our taxable income derived from an investment program designated as an Approved Enterprise is fully exempt from corporate tax for a period of two years, after which the income from these enterprises is taxable at the rate of up to 25% for the remainder of the five-year period of tax benefits. The exemption is applicable as long as the gains are not distributed. Upon distribution, a 25% tax rate will apply, as described below.

After the applicable benefit period expires, income generated from these Approved Enterprise programs, including income generated from the grant of a usage right with respect to know-how developed by the Approved Enterprise, income generated from royalties and income derived from a service which is auxiliary to such usage right or royalties, provided that such income is generated within the Approved Enterprise’s ordinary course of business, under the terms and conditions set by the Approved Enterprise programs, will be subject to tax at the full corporate tax rate.

On April 1, 2005, an amendment to the Investments Law came into force. Pursuant to the amendment, a company’s facility will be granted the status of “Approved Enterprise” only if it is proven to be an industrial facility (as defined in the Investments Law) that contributes to the economic independence of the Israeli economy and is a competitive facility

that contributes to the Israeli gross domestic product. The amendment provides that the Israeli Tax Authority and not the Investment Center will be responsible for an Approved Enterprise under the alternative package of benefits, referred to as a “Benefiting Enterprise”. A company wishing to receive the tax benefits afforded to a Benefiting Enterprise is required to select the tax year from which the period of benefits under the Investment Law are to commence by simply notifying the Israeli Tax Authority within 12 months of the end of that year. In order to be recognized as owning a Benefiting Enterprise, a company is required to meet a number of conditions set forth in the amendment, including making a minimal investment in manufacturing assets for the Benefiting Enterprise and having completed a cooling-off period of no less than three years from the company’s previous year of commencement of benefits under the Investments Law. The amendment will apply to approved enterprise programs in which the year of election under the Investments Law is 2004 or later, unless such programs received approval from the Investment Center on or prior to December 31, 2004 in which case the amendment provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. There can be no assurance that we will receive future benefits under such amendment to the Investments Law.

Part of our income has been generated through our Approved Enterprises. If a company that has elected the “alternative package” distributes to its shareholders a cash dividend from tax-exempt income attributable to it, it would incur a tax liability on the amount distributed at the rate (10% to 25%) which would have been applicable had the company not elected the alternate package, and it will have to withhold tax at the rate of 15% with respect to the dividend distributed. Our taxes outside of Israel, mainly in Japan and the United States, are dependent on our operations in each jurisdiction as well as relevant laws and treaties. See “Item 18 Financial Statements”. Under Israeli tax law, at December 31, 2005, we had accumulated losses for tax purposes amounting to approximately \$130 million. These losses are available indefinitely to offset future taxable business income. As of December 31, 2005, our carry forward of capital losses for tax purposes were \$38 million. Orckit and each of our subsidiaries are assessed on a stand-alone basis. Therefore, accumulated tax losses in each of the entities can offset future taxable business income only in the entity in which the losses were generated.

## **Dividend Policy**

We have never declared or paid cash dividends on our capital stock. In the foreseeable future, we intend to use any future earnings for the operation and expansion of our business. Accordingly, we do not anticipate paying any cash dividends. Payment of future dividends, if any, will be at the discretion of our board of directors and the audit committee of the Board and will depend on various factors, such as our statutory retained earnings, financial condition, operating results and current and anticipated cash needs.

If we declare cash dividends, we will pay those dividends in New Israeli Shekels. Current Israeli law permits holders of our ordinary shares who are non-residents of Israel and who acquired their shares with a non-Israeli currency to repatriate all distributions on these shares in that non-Israeli currency.

## **Inventory**

Inventory in 2005 consisted primarily of finished products and raw materials, in 2004 primarily of finished products, and in 2003 of raw materials for the assembly of our products.

Our inventory was \$3.3 million as of December 31, 2005, \$5.5 million as of December 31, 2004 and \$100,000 as of December 31, 2003. The decrease in inventory levels in 2005 resulted from a decrease in the volume of finished products due to a lower volume of shipments expected in the first quarter of 2006 in comparison to the first quarter of 2005. The increase in inventory levels in 2004 resulted from a build up of product inventories for the supply of our CM-100 products.

#### C. RESEARCH AND DEVELOPMENT

We focus our research and development efforts on developing new products that address the need for solutions capable of supporting very high bandwidth services in telecommunications networks in metropolitan areas. We obtain extensive product development input from potential users and through participation in industry organizations and standards-setting bodies.

Our research and development staff consisted of 118 employees as of December 31, 2003, 104 employees as of December 31, 2004, and 133 as of December 31, 2005, most of whom are located in Israel and hold engineering or other advanced technical degrees. The number of research and development employees was similar in the years 2003 and 2004 since we maintained our research and development efforts, focusing on new product lines. The number of research and development employees increased in 2005 compared with 2004 because we increased our research and development efforts related to our CM-100 product line. Our gross research and development expenses were approximately \$20.8 million in 2003, \$17.7 million in 2004 and \$16.3 million in 2005. These expenses were offset by grants from the Office of the Chief Scientist of the Ministry of Industry, Trade and Labor of the Government of Israel of approximately \$5.8 million in 2003, \$2.7 million in 2004 and \$173,000 in 2005.

In 2005, the majority of our research and development work was focused on the CM-100 product line, addressing software and hardware capabilities. We expect that these efforts will continue and comprise substantially all of our 2006 research and development plan. We expect that we will continue to commit substantial resources to research and development in the future. We believe that a continued commitment to research and development is required to maintain our technical excellence and launch new innovative products in the metro transport and access markets. If our applications for Office of Chief Scientist grants are not approved or partially approved, or if we elect not to receive these grants, our net research and development expenses will increase.

#### D. TREND INFORMATION

In 2005, the capital investment expenditures of wireline telecom carriers for metro equipment were similar to capital expenditure levels in 2004. It is expected that capital investment of wireline telecom carriers in metro equipment in 2006 will be similar or slightly higher than the levels in 2005. The introduction of new services to residential users and enterprises is expected to require significantly higher bandwidth support over metro networks. In areas where new high bandwidth services are likely to be offered, it is expected that demand for more robust metro products will increase. In response to this trend, we have focused on innovative telecom products for the metro area, where we expect to see a need for equipment upgrade over the coming years with the growth of new high bandwidth service offerings. These services are expected to include “quadruple play” services, that is, a bundled offering of voice, Internet access and high end video services, all based on IP protocols,

offered by traditional telecom carriers, as well as TV over cellular services, that address video transmissions to advanced 3G handheld devices.

#### E. OFF-BALANCE SHEET ARRANGEMENTS

We do not have any “off-balance sheet arrangements” as such term is defined in Item 5E of Form 20-F.

#### F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

The following table of our material contractual obligations as of December 31, 2005 summarizes the aggregate effect that these obligations are expected to have on our cash flows in the periods indicated.

|  | Payment due by period<br>(\$ in thousands) |                     |                  |           |                         |
|--|--|---------------------|------------------|-----------|-------------------------|
|  | Total                                      | Less than<br>1 year | 1-3 years        | 3-5 years | More<br>than 5<br>years |
| Contractual Obligations  |  |                     |                  |           |                         |
|  |  |                     |                  |           |                         |
| Operating Lease Obligations  | 730  | -                   | 730 <sup>1</sup> | -         | -                       |
| Purchase Obligations   | 2,952                                      | 2,952               | -                | -         | -                       |
| Other Long-Term Liabilities Reflected on our Balance Sheet under U.S. GAAP | 60,880                                     | 57,191 <sup>2</sup> | -                | -         | 3,689 <sup>3</sup>      |
| <b>Total</b>   | <b>64,562</b>                              | <b>60,143</b>       | <b>730</b>       | <b>-</b>  | <b>3,689</b>            |

<sup>1</sup> Our major premises leases allow for early termination upon advance notice. Accordingly, this amount reflects lease payments for the applicable notice period. For total projected annual rent payments, see note 4b to our financial statements for the year ended December 31, 2005. The amount is presented in the 1-3 years column since this is the average life period of our lease obligations.

<sup>2</sup> These amounts reflect the trade payables, accrued expenses, deferred income and other payables presented in our balance sheet.

<sup>3</sup> This amount reflects our accrued severance pay liability. The time of its payment, in whole or in part, cannot be predicted and, as a result, this amount is presented in the more than 5 years column. Out of this amount, \$3.3 million has been previously funded by our contributions to employee plans.

In addition, as of December 31, 2005, our contingent liability to the Office of the Chief Scientist in respect of grants received was approximately \$6.6 million. This liability is



required to be repaid only by royalties based on revenues derived from products (and related services) whose development was funded with these grants.

## **ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES**

### **A. DIRECTORS AND SENIOR MANAGEMENT**

The following table sets forth certain information with respect to Orckit's directors and executive officers.

| <b><u>Name</u></b> | <b><u>Age</u></b> | <b><u>Position</u></b>  |
|--------------------|-------------------|---|
| Eric Paneth        | 56                | Chairman of the Board and Chief Executive Officer             |
| Izhak Tamir        | 53                | President and Director  |
| Ehud Rokach        | 42                | Chief Executive Officer of Corrigent Systems                  |
| Aviv Boim          | 39                | Chief Financial Officer                                       |
| Eran Tamir         | 48                | Vice President Operations                                     |
| Leon Bruckman      | 48                | Vice President, Chief Technology Officer of Corrigent Systems |
| Zvi Menahemi       | 38                | Vice President, R&D of Corrigent Systems                      |
| Akio Ogiso         | 51                | Vice President, Asia Pacific of Corrigent Systems             |
| Yair Shamir        | 60                | Outside Director  |
| Miri Gelbman       | 54                | Outside Director  |
| Moshe Nir          | 56                | Outside Director  |
| Jed M. Arkin       | 42                | Director  |
| Moti Motil         | 53                | Director  |

The business experience of each of our directors and executive officers is as follows:

*Mr. Paneth* has been Chairman of the Board of Directors and Chief Executive Officer of Orckit since its founding in 1990. From 1975 until 1983, Mr. Paneth was a senior engineer in the Israeli Government, and from 1985 to 1990, was a technical department head in the Israeli Government. From 1983 until 1985, he was employed by Linkabit Inc., in San Diego, California. Mr. Paneth holds an advanced engineering degree from the Israel Institute of Technology, commonly known as the Technion. Since January 2000, Mr. Paneth has been a director of Tikcro Technologies Ltd.

*Mr. I. Tamir* has been President and a Director of Orckit since its founding in 1990. Mr. Tamir has served as a Director of Gilat Satellite Networks Ltd. and of Scopus Video Networks since 2005. From 1987 until 1989, Mr. Tamir was employed by Comstream Inc., in San Diego, California. From 1985 until 1987, he was vice president of A.T. Communication Channels Ltd., a subsidiary of Bezeq. From 1978 to 1985, he was a senior engineer in the Israeli Government. Mr. Tamir holds an engineering degree from the Technion and an M.B.A. from Tel Aviv University. Mr. Tamir has been chairman of the board of directors of Tikcro since January 2000 and its chief executive officer since August 2003.

*Mr. Rokach* joined Orckit in 1992 and has served as Chief Operating Officer of Orckit since February 2000 and as Chief Executive Officer of Corrigent Systems since October 2000. From 1998 to 2000, Mr. Rokach served as Vice President—Network Access Systems. From 1992 to 1998, Mr. Rokach held several research and development and other positions with Orckit. From 1987 to 1992, he was a senior engineer with the Israeli Government. Mr. Rokach holds an engineering degree from the Technion.

*Mr. Boim* joined Orckit as Chief Financial Officer in February 1998. From August 1996 until February 1998, he was a banker with BT Alex. Brown Incorporated, an investment banking firm. From August 1993 until August 1996, Mr. Boim was a vice president of Giza Ltd., Tel Aviv, an investment banking firm. Mr. Boim holds a B.A. and an M.A. in economics and management from Tel Aviv University and an L.L.B. from Tel Aviv University Law School.

*Mr. E. Tamir* joined Orckit as Vice President Operations in April 2000. From 1996 until 2000, Mr. E. Tamir, who was one of founders of Wizcom Technologies Ltd., served as vice president operations of Wizcom. From 1990 until 1996, Mr. E. Tamir served as director of worldwide logistics of Indigo Ltd. From 1985 to 1990, Mr. E. Tamir served as director of acquisitions of Scitex Corporation Ltd. Mr. E. Tamir holds a B.Sc. in Machine Engineering from Tel Aviv University and is a business economics graduate of the Israeli Institute for Management.

*Mr. Bruckman* joined Orckit in 1999 and is currently serving as the Chief Technology Officer of Corrigent Systems. From September 2000 to February 2005, Mr. Bruckman served as Vice President and Chief System Architect of Corrigent Systems and from November 1999 to September 2000 Mr. Bruckman served as Vice President of system engineering of Corrigent Systems. From April 1996 to October 1999, Mr. Bruckman was Vice President of research and development and system engineering at HyNEX, which was acquired by Cisco. From August 1982 to March 1996, Mr. Bruckman held several positions with the access division of Tadiran Telecommunications, of which the last position was director of research and development. Mr. Bruckman holds a B.Sc. in Electrical Engineering from the Technion Institute and an MBA from Bar-Ilan University, Israel.

*Mr. Menahemi* has been Vice President of R&D of Corrigent Systems since April 2005. From January 2000 until April 2005, Mr. Menahemi was a project manager for Orckit. From 1997 to 2000, Mr. Menahemi served as hardware director for ADC Teledata Ltd. From 1995 until 1997, Mr. Menahemi served as senior system architecture engineer in Lannet. From 1989 to 1995, he was served as a senior engineer in the Israeli Defense Forces. Mr. Menahemi holds a B.Sc. degree in Electrical Engineering from Tel Aviv University.

*Mr. Ogiso* has been Vice President of Asia Pacific for Corrigent Systems since November 2005. From 2003 until 2005, Mr. Ogiso served as a country manager in Japan for Corrigent. From 1990 until 2002, Mr. Ogiso was employed by AT&T, which later became Lucent Technologies, where he served as managing director of customer operations/project management in Tokyo, Japan. From 1988 to 1990, he was a system division director for Raychem Corporation. From 1980 until 1988, he was employed by SECOM Co., Ltd. Mr. Ogiso holds a B.Sc. in Applied Mathematics from the Science University of Tokyo.

*Mr. Shamir* has been a Director of Orckit since October 1995. Mr. Shamir has served as the Chairman of the Board of Israel Aircraft Industries since July 2005. He served as the Chairman of the Board of EL-AL Airlines from May 2004 until January 2005. He served as the Chairman of VCON Telecommunications Ltd., an Israeli technology company listed on *Le Nouveau Marche* in France, from 2001 to 2005. He also served as its Chief Executive Officer from 1998 to 2004. Since April 2000, Mr. Shamir has also served as chairman of Catalyst Investment L.P., an Israeli venture capital firm. From July 1995 through February 1997, Mr. Shamir served as the Executive Vice President of The Challenge Fund LLP, the general partner of the Challenge Fund-Etgar, L.P. From December 1993 to July 1995, he served as the Chief Executive Officer of Elite Food Industries Ltd. Mr. Shamir served as

Executive Vice President and general manager of Israel operations of Scitex Corporation Ltd. from February 1988 through December 1994. Mr. Shamir is a director of Mercury Interactive Corp., DSP Group Corporation, and the Chairman of Shamir Optical Industry Ltd. Mr. Shamir holds a B.Sc. in Electrical Engineering from the Technion and has served on the board of governors of the Technion since 1993.

*Ms. Gelbman* has been a Director of Orckit since November 2002. Ms. Gelbman has served since 1999 as founder and General Manager of Milgal Ltd., an Israeli privately-owned appliance distribution and service company. From 1984 to 1998, she was employed by IBM Israel in various positions. Her last role with IBM was as Manager of Quality and Customer Relationship Management (CRM).

*Mr. Nir* has been a Director of Orckit since November 2002. Mr. Nir has served since 1990 as Founder and CEO of privately-held Business Directions Ltd., a distributor of analytic management software. From 1985 to 1990, he served as manager of the economics and control department and member of the Executive Board of Elite Industries Ltd., a publicly traded food manufacturer in Israel. From 1974 to 1985, he held senior financial and control positions with Tempo Breweries and Soft Drinks Ltd., Tadiran Electronics Industries Ltd. and Clal Israel Ltd. He holds a B.A. degree in economics from Tel Aviv University, and an M.B.A. and Post Graduate Diploma in Computer and Information Sciences from the Recanati School of Management, Tel Aviv University.

*Mr. Motil* has been a Director of Orckit since November 2002. Mr. Motil has served since 1996 as Vice President Finance and an associate of Palmot Ltd., an investment company based in Israel. From 1991 until 1996, he served as Chief Financial Officer of the Israeli subsidiary of Jan-Bell Marketing Inc., a retail company. Mr. Motil holds a B.A. degree in economics and accounting from Tel-Aviv University and he is a C.P.A.

*Mr. Arkin* has been a Director of Orckit since August 2001. Since January 2000, Mr. Arkin has served as Chairman of MadahCom Communications Ltd., a manufacturer of digital wireless public alerting systems. Since March 2005, he has served as a director of Shamir Optical Industries (Nasdaq: SHMR). From 1999 to 2001, he served as General Manager of merchant banking for Oscar Gruss & Son, a New York-based investment bank. From 1995 to 1998, Mr. Arkin served as Vice President of The Challenge Fund, an Israeli venture capital firm. He holds a B.A. from St. John's College in Annapolis, Maryland, an M.B.A. from Harvard Business School and a J.D. from Harvard Law School.

There are no family relationships between any of our directors or executive officers. There are no arrangements or understandings between any of our directors or executive officers and any other person pursuant to which our directors or executive officers were selected.

## **B. COMPENSATION**

The aggregate direct remuneration paid by us to all persons as a group (15 persons, including two employees who ceased to be officers during 2005) who served in the capacity of director or executive officer in 2005, including the remuneration of Eric Paneth and Izhak Tamir detailed below, was approximately \$3.7 million, which includes \$450,000 of pension, retirement or similar benefits, expenses reimbursed (including professional and other business association dues and expenses) and other fringe benefits. In 2005, we granted to this group (excluding Messrs. Paneth and Tamir) options to purchase an aggregate of 440,500

ordinary shares under the Orckit Israeli Share Incentive Plan. A part of these options are contingent upon meeting various performance goals in addition to their vesting period. Excluding options that are contingent upon meeting various performance goals, the options have an exercise price of \$8.25 per share, which represented the market price of our ordinary shares on the date of grant. In 2005, we granted to each of Eric Paneth and Izhak Tamir options to purchase 420,000 of our ordinary shares at \$27.14 per share, which represented the market price of our ordinary shares on the date of grant. These options are fully vested and expire in June 2012.

#### *Employment Agreements with Eric Paneth and Izhak Tamir*

In 1993, we entered into an employment agreement with each of Mr. Paneth and Mr. Tamir. These agreements were extended several times without modification of the employment terms. The original agreement of each provided, among other things, for an annual bonus based on specified percentages of our pre-tax income for the applicable year. No bonus was paid under this provision in 2003 or 2004. After review of our expected results for 2005, we concluded that the bonus based on pre-tax income for 2005 was going to be significant. Based on our publicly announced projection in April 2005 of \$15.0 million of net income for 2005, the bonus for each of Mr. Paneth and Mr. Tamir based on pre-tax income of 2005 would have amounted to approximately \$730,000. With the consent of Messrs. Paneth and Tamir, we reduced the rate of the annual bonus based on pre-tax income and eliminated any such bonus for 2005 with respect to the first \$15.0 million of pre-tax income, as detailed below. Since our actual pre-tax income for 2005 was \$22.2 million, the related bonus for each of Mr. Paneth and Mr. Tamir would have been approximately \$1.1 million under the original agreement. Pursuant to the amended agreement, the related bonus for each of them was approximately \$217,000.

Pursuant to the amended employment of each of Mr. Paneth and Mr. Tamir, each is entitled to an annual bonus based on our results of operations for 2006 and each subsequent fiscal year equal to the sum of: (i) 1.0% of the first \$5.0 million of pre-tax income; (ii) 2.0% of pre-tax income between \$5.0 million and \$15.0 million; (iii) 3.0% of pre-tax income in excess of \$15.0 million; and (iv) 0.25% of revenues. However, for 2005, the bonus with respect to pre-tax income was payable only to the extent that the amount of our pre-tax income exceeded \$15.0 million and then only to the extent of 3% of the excess. The rate of the bonus based on revenues, equal to 0.25% of our revenues in each year, was not modified from the original agreement.

The original employment agreement of each of Mr. Paneth and Mr. Tamir provided for a base salary payable in NIS, linked to the Israeli consumer price index, and customary employee benefits, such as managers' insurance and employment fund, which are grossed up to cover income tax liabilities, and a company car (or, at the employee's election, a cash payment added to the base salary in lieu of a car). Under the original employment agreement, the base salary and employee benefits increased by 15% per year. Accordingly, the base salary and employee benefits for each of Mr. Paneth and Mr. Tamir for 2005 would have been approximately \$630,000 (based on the exchange rate on March 31, 2005 of NIS 4.361 to one U.S. dollar).

In the amended employment agreements, we have reduced the base salary and employee benefits for 2005 of each of them, effective January 1, 2005, to the amount of NIS equal to \$570,000 (based on the exchange rate on March 31, 2005 of NIS 4.361 to one U.S. dollar) and reduced the annual percentage used to adjust base salary from 15% to 5%, but subject to adjustments pursuant to the Israeli consumer price index beginning in 2006. The

dollar equivalent of the salary will fluctuate in accordance with fluctuations of the exchange rate of the NIS to the U.S. dollar. There also may be adjustments as a result of changes in tax, national insurance and other applicable laws from time to time.

The employment agreement of each of Mr. Paneth and Mr. Tamir is not for a specific term and requires six months advance notice by either us or the employee to terminate the employment agreement. Upon termination of the employment for any reason by either us or by the employee, we would make a severance payment equal to the employee's last monthly salary multiplied by the number of years that he worked for us. According to Israeli labor law, this is the amount of severance generally payable to any employee who is terminated by his employer. In the event that the employment of Mr. Paneth or Mr. Tamir is terminated under circumstances in which we would not be required to pay the full amount of severance pursuant to Israeli labor law, his non-competition period will be extended from one to two years in consideration of receiving the additional amount. Since we reserve for these severance payments in our financial statements on an ongoing basis, as required by generally accepted accounting principles, we do not expect to recognize an additional accounting expense for these severance payments upon the termination of employment. Neither employment agreement provides for any other payments or "golden parachutes" upon termination of employment. The amendments to the employment agreements with Mr. Paneth and Mr. Tamir were approved by our shareholders at our Annual General Meeting held on June 23, 2005.

### *C. BOARD PRACTICES*

#### **Nasdaq Requirements**

Under the listing requirements of the Nasdaq Stock Market, a majority of our directors are required to be "independent directors" as defined in Nasdaq's rules. We are also required to have an audit committee, all of whose members are "independent directors" as defined in Nasdaq's rules. Five out of the seven members of our board of directors, namely, Messrs. Shamir, Arkin, Nir and Motil and Ms. Gelbman, are independent directors under the Nasdaq requirements. Messrs. Shamir, Nir and Motil and Ms. Gelbman are the members of our audit committee.

#### **Israeli Companies Law**

We are also subject to the provisions of the Israeli Companies Law, 5759-1999, and regulations adopted thereunder.

#### Board of Directors

According to the Companies Law and our articles of association, the oversight of the management of our business is vested in our board of directors. The board of directors may exercise all powers and may take all actions that are not specifically granted to our shareholders. As part of its powers, our board of directors may cause us to borrow or secure payment of any sum or sums of money for our purposes, at times and upon terms and conditions as it thinks fit, including the grant of security interests in all or any part of our property. Our board of directors may consist of between three and seven directors and currently consists of seven directors.

Our directors are elected at annual meetings of shareholders by a vote of the holders of at least 66-2/3% of the ordinary shares voting thereon. Directors generally hold office

until the next annual meeting of shareholders. Our annual meeting of shareholders is required to be held at least once during every calendar year and not more than fifteen months after the last preceding meeting. The board of directors generally may temporarily fill vacancies in the board. Directors may be removed earlier from office by a resolution passed at a general meeting of shareholders by a vote of the holders of at least 75% of the ordinary shares voting thereon.

A resolution proposed at any meeting of the board of directors is deemed adopted if approved by a majority of the directors present and voting on the matter.

## Outside Directors

### *Qualifications of Outside Directors*

Under the Israeli Companies Law, companies incorporated under the laws of Israel whose shares are listed for trading on a stock exchange or have been offered to the public in or outside of Israel are required to appoint at least two outside directors. Pursuant to our articles of association, we may appoint up to three outside directors. The Companies Law provides that a person may not be appointed as an outside director if the person or the person's relative, partner, employer or any entity under the person's control has, as of the date of the person's appointment to serve as an outside director, or had, during the two years preceding that date, any affiliation with:

- the company;
- any entity controlling the company; or
- any entity controlled by the company or by its controlling entity.

The term affiliation includes:

- an employment relationship;
- a business or professional relationship maintained on a regular basis;
- control; and
- service as an office holder, excluding service as an office holder during the three-month period in which the company first offers its shares to the public.

The Companies Law defines the term "office holder" of a company to include a director, the chief executive officer and any officer of the company who reports directly to the chief executive officer.

Pursuant to an amendment to the Companies Law, effective as of April 19, 2006, (1) each outside director must have either "accounting and financial expertise" or "professional qualifications" (as such terms are defined in regulations promulgated under the Companies Law) and (2) at least one of the outside directors must have "accounting and financial expertise." These requirements will apply to us upon the election of one or more outside directors.

No person can serve as an outside director if the person's position or other business creates, or may create, a conflict of interest with the person's responsibilities as an outside director or may otherwise interfere with the person's ability to serve as an outside director.

Until two years from termination of office, a company may not engage an outside director to serve as an office holder and cannot employ or receive services from that person, either directly or indirectly, including through a corporation controlled by that person.

### Election of Outside Directors

Outside directors are elected at meetings of shareholders by a vote of the holders of at least 66-2/3% of the ordinary shares voting thereon, provided that either:

- at least one third of the shares of non-controlling shareholders voted at the meeting vote in favor of the outside director's election; or
- the total number of shares of non-controlling shareholders that voted against the election of the outside director does not exceed one percent of the aggregate voting rights in the company.

The initial term of an outside director is three years and may be extended for an additional three years. Outside directors may be removed from office only by a vote of the holders of at least 66-2/3% of the ordinary shares voting thereon, or by a court, and only if the outside directors cease to meet the statutory qualifications for their appointment or if they violate their duty of loyalty to the company. Each committee of a company's board of directors that exercises a power of the board of directors is required to include at least one outside director, except for the audit committee, which is required to include all the outside directors. Our outside directors are: Mr. Shamir, who was re-elected to a second three-year term in 2003, and Ms. Gelbman and Mr. Nir, who were re-elected to a second three-year term in 2005. Accordingly, Mr. Shamir's service on our board of directors will cease in March 2006.

### **Committees**

Subject to the provisions of the Companies Law, our board of directors may delegate its powers to committees consisting of board members. Our board has formed an audit committee and an option committee.

### Audit Committee

#### *Israeli Companies Law Requirements*

Under the Israeli Companies Law, our board of directors is required to appoint an audit committee, comprised of at least three directors, including all of the outside directors, but excluding:

- the chairman of our board of directors;
- a controlling shareholder or a relative of a controlling shareholder; and
- any director employed by us or who provides services to us on a regular basis.

The role of the audit committee is to identify flaws in the management of our business, including in consultation with the internal auditor and our independent accountants, to suggest remedial measures and to approve specified related party transactions. Our audit committee consists of Mr. Shamir, Mr. Nir, Ms. Gelbman and Mr. Motil.

#### *Nasdaq Requirements*

We have adopted an audit committee charter as required by the Nasdaq rules. Our audit committee assists the board of directors in fulfilling its responsibility for oversight of the quality and integrity of our accounting, auditing and financial reporting practices and financial statements and the independence qualifications and performance of our independent auditors. The audit committee also has the authority and responsibility to oversee our independent auditors, to recommend for shareholder approval the appointment and, where appropriate, replacement of our independent auditors and to pre-approve audit fees and all permitted non-audit services and fees. Our audit committee is also authorized to act as our “qualified legal compliance committee”. As such, our audit committee will be responsible for investigating reports, made by attorneys appearing and practicing before the SEC in representing us, of perceived material violations of U.S. federal or state securities laws, breaches of fiduciary duty or similar material violations of U.S. law by us or any of our agents.

As of July 2005, Nasdaq rules require that director nominees be selected or recommended for the board’s selection either by a committee composed solely of independent directors or by a majority of independent directors. The compensation of a company’s chief executive officer and other executive officers is required to be approved either by a majority of the independent directors on the board or a committee comprised solely of independent directors. Our audit committee, which is composed solely of independent directors, is authorized to also act as the nominating committee and compensation committee.

#### ***Approval of Related Party Transactions***

Under the Companies Law and the rules of Nasdaq, the approval of the audit committee is required to effect specified related-party transactions. Under the Companies Law, the audit committee may not approve an action or a transaction with related parties or with its office holders unless at the time of approval at least two outside directors are serving as members of the audit committee and at least one of whom was present at the meeting in which any approval was granted.

#### *Option Committee*

Our Option Committee administers our share option plan, including the grant of options in exchange for Corrigent options, subject to certain exceptions. Our Option Committee is empowered, among other things, to approve option grants, optionees, dates of



grant and the exercise price of options, subject to guidelines adopted by our board of directors. Grants of options to executive officers and directors require additional approvals pursuant to the Nasdaq rules and the Companies Law. Messrs. Paneth, Tamir and Shamir (whose term will end on March 16, 2006) are currently the members of our option committee. The Board elected Mr. Nir to join the Option Committee as of March 16, 2006.

### **Internal Auditor**

Under the Companies Law, our board of directors is required to appoint an internal auditor proposed by the audit committee. The role of the internal auditor is to examine, among other things, whether our actions comply with the law and orderly business procedure. The internal auditor may not be an interested party, an office holder, or a relative of any of the foregoing, nor may the internal auditor be our independent accountant or its representative.

The Companies Law defines the term “interested party” to include a person who:

- holds 5% or more of our outstanding share capital or voting rights;
- has the right to appoint one or more directors or the general manager; or
- who serves as a director or as the general manager.

### ***Approval of Specified Related Party Transactions Under Israeli Law***

#### ***Fiduciary Duties of Office Holders***

The Israeli Companies Law imposes a duty of care and a duty of loyalty on all office holders of a company. The duty of care requires an office holder to act with the level of care with which a reasonable office holder in the same position would have acted under the same circumstances. The duty of care includes a duty to use reasonable means to obtain:

- information on the advisability of a given action brought for his approval or performed by him by virtue of his position; and
- all other important information pertaining to these actions.

The duty of loyalty of an office holder includes a duty to:

- refrain from any conflict of interest between the performance of his duties for the company and the performance of his other duties or his personal affairs;
- refrain from any activity that is competitive with the company;
- refrain from exploiting any business opportunity of the company to receive a personal gain for himself or others; and
- disclose to the company any information or documents relating to a company's affairs which the office holder has received due to his position as an office holder.

#### *Disclosure of Personal Interest of an Office Holder*

The Israeli Companies Law requires that an office holder of a company disclose to the company any personal interest that he may have and all related material information known to him, in connection with any existing or proposed transaction by the company. The disclosure is required to be made promptly and in any event no later than the board of directors meeting in which the transaction is first discussed. If the transaction is an extraordinary transaction, the office holder must also disclose any personal interest held by:

- the office holder's spouse, siblings, parents, grandparents, descendants, spouse's descendants and the spouses of any of these people; or
- any corporation in which the office holder is a 5% or greater shareholder, director or general manager or in which he has the right to appoint at least one director or the general manager.

Under Israeli law, an extraordinary transaction is a transaction that is:

- not in the ordinary course of business;
- not on market terms; or
- likely to have a material impact of the company's profitability, assets or liabilities.

Once an office holder complies with the above disclosure requirement, the board of directors may approve a transaction between the company and an office holder, or a third party in which an office holder has a personal interest. A transaction that is adverse to the company's interest may not be approved.

If the transaction is an extraordinary transaction, approval of both the audit committee and the board of directors is required, in that order. Under specific circumstances, shareholder approval may also be required. A director who has a personal interest in a proposed transaction which is considered at a meeting of the board of directors or the audit committee generally may not be present at this meeting or vote on this matter, unless a majority of the members of the board of directors or the audit committee, as the case may be, has a personal interest in the matter. If a majority of members of the board of directors has a personal interest therein, shareholder approval is also required.

### *Disclosure of Personal Interests of a Controlling Shareholder*

Under the Israeli Companies Law, the disclosure requirements which apply to an office holder also apply to a controlling shareholder of a public company. A controlling shareholder is a shareholder who has the ability to direct the activities of a company, including a shareholder that owns 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights, but excluding a shareholder whose power derives solely from his or her position on the board of directors or any other position with the company. Extraordinary transactions with a controlling shareholder or with a third party in which a controlling shareholder has a personal interest, and the terms of engagement of a controlling shareholder as an office holder or employee, require the approval of the audit committee, the board of directors and the shareholders of the company, in that order. The shareholder approval must be by a majority of the shares voted on the matter, provided that either:

- at least one-third of the shares of shareholders who have no personal interest in the transaction and who vote on the matter vote in favor thereof; or
- the shareholders who have no personal interest in the transaction who vote against the transaction do not represent more than one percent of the voting rights in the company.

For information concerning the direct and indirect personal interests of our office holders and principal shareholders in specified transactions with us, see Item 7A of this Annual Report.

### *D. EMPLOYEES*

The numbers and breakdowns of our employees as of the end of the past three years are set forth in the following table:

|  | As of December 31, |      |      |
|--|--------------------|------|------|
|  | 2003               | 2004 | 2005 |
| Numbers of employees by geographic location  |                    |      |      |
| Israel                                       | 157                | 161  | 197  |
| United States                                | 11                 | 10   | 10   |
| Elsewhere                                    | 2                  | 10   | 12   |
| Total workforce                              | 170                | 181  | 219  |
| Numbers of employees by category of activity |                    |      |      |
| MIS, finance and administration              | 32                 | 23   | 28   |
| Research and development                     | 118                | 104  | 133  |
| Manufacturing, testing and quality assurance | 4                  | 26   | 26   |
| Sales and marketing                          | 16                 | 28   | 32   |
| Total workforce                              | 170                | 181  | 219  |

Our number of employees increased by 38 between December 31, 2004 and December 31, 2005 mainly due to an increase in the number of employees engaged in product development.

Our number of employees increased by 11 between December 31, 2003 and December 31, 2004 due to an increase in the number of employees required to support the initiation of commercial sales of our metro products.

We believe that we have been able to attract talented engineering and other technical personnel. None of our employees is represented by a labor union and we have not experienced a work stoppage. We believe that our relationship with our employees is good and that our future success will depend on a continuing ability to hire, assimilate and retain qualified employees.

Certain provisions of the collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordination Bureau of Economic Organizations, including the Industrialists Associations, are applicable to our employees by order of the Israeli Ministry of Labor and Welfare. These provisions principally concern cost of living increases, recreation pay and other conditions of employment.

Israeli labor laws and regulations are applicable to all of our employees in Israel. The laws principally concern matters such as paid annual vacation, paid sick days, the length of the workday, payment for overtime, insurance for work-related accidents, severance pay and other conditions of employment. Israeli law generally requires severance pay, which may be funded, in whole or in part, by Managers' Insurance described below, in certain circumstances, including the retirement or death of an employee or termination of employment without cause, as defined under Israeli law. The payments to Managers' Insurance in respect of severance obligations amount to approximately 8.3% of wages. Furthermore, Israeli employees are required to pay predetermined sums to the National Insurance Institute. The payments to the National Insurance Institute are approximately 18% of wages of which the employee contributes approximately 12% and the employer contributes approximately 6%.

A general practice followed by us, although not legally required, is the contribution of funds on behalf of most of its employees to a fund known as Managers' Insurance. This fund provides employees with a lump sum payment upon retirement or with payments on account of severance pay, if legally entitled, upon termination of employment. Each employee who agrees to participate in the Managers' Insurance plan contributes an amount equal to 5% of such employee's base salary and the employer contributes approximately 15% of such salary, which 15% includes the 8.3% for severance pay.

#### *E. SHARE OWNERSHIP*

As of March 1, 2006, Messrs. Eric Paneth and Izhak Tamir, each beneficially owned 1,294,063 ordinary shares, or 8.2% of our ordinary shares. This includes options to purchase (i) 60,000 of our ordinary shares at nominal value, which expire in August 2010, and (ii) 420,000 of our ordinary shares at \$27.14 per share, which expire in June 2012. In addition, each of Messrs. Eric Paneth and Izhak Tamir hold stock options of Corrigent. Pursuant to the exchange program described below under "—Exchange of Corrigent Options", on or after

June 23, 2007, such options might be exchanged for options of the Ordinary Shares of Orckit. Including the options that might be granted in exchange for their options in Corrigent (based on data as of March 1, 2006), Messrs. Paneth and Tamir each would own approximately 1,700,000 ordinary shares, or 10.4% of our outstanding ordinary shares, as of March 1, 2006.

Except for Messrs. Paneth and Tamir, none of our executive officers or directors beneficially owns 1% or more of our outstanding ordinary shares.

At December 31, 2005, outstanding options to purchase a total of 3,769,670 ordinary shares had been granted by us pursuant to our share incentive plan, of which options to purchase a total of 1,991,362 ordinary shares were held by our directors and officers (13 persons) as a group. Our share incentive plan is administered by an option committee of our board of directors, which is empowered, subject to applicable law, to determine the optionees, dates of grant and the exercise price of options. Unless otherwise decided by our board of directors or the option committee, options granted under the share incentive plan are non-assignable except by the laws of descent. The outstanding options are exercisable at purchase prices which range from \$0 to \$28 per share, vest mainly over up to periods of four years, and have expiration dates which range from 2006 to 2015.

#### *Exchange of Corrigent Options*

At our annual meeting of shareholders held in June 2005, our shareholders approved the potential exchanges, from time to time, of all of the vested stock options of Corrigent, which constituted approximately 10% of the outstanding share capital of Corrigent (on a fully diluted basis), for vested options for up to 10% of our outstanding ordinary shares (on a fully diluted basis after giving effect to such issuances). The goal of this program is to simplify our capital structure by increasing our fully diluted ownership percentage of Corrigent to up to 100%. Generally, our option committee, along with the board of directors of Corrigent, will determine the persons who will be offered to exchange and the amount and terms of such exchange. Our audit committee will determine the amount and terms with respect to exchanges of Corrigent stock options held by Messrs. Paneth and Tamir, which will be on substantially the same terms as those of other option holders and will not occur prior to June 23, 2007. Corrigent options are exercisable for the par value of Corrigent shares, \$0.01 per share, and the Orckit options granted in the exchanges would be exercisable at the same price. The issuance of our ordinary shares upon the exercise of our options received in any exchange will be covered by a Registration Statement on Form S-8 filed with the SEC under the Securities Act of 1933, as amended.

Corrigent will not issue any additional options. Since the outstanding Corrigent options vest through the end of 2008, it is expected that the series of exchanges will not be completed earlier than the end of 2008. During 2005 our option committee approved certain exchanges, effective as of January 1, 2006, of approximately 3% of Corrigent capital stock on a fully diluted basis for options to purchase approximately 497,000 of Orckit's ordinary shares. Following these exchanges, Orckit's holding in Corrigent was increased from 90% to approximately 93% of Corrigent's capital stock on a fully diluted basis. After giving effect to this exchange, as of March 1, 2006, additional options to purchase approximately 1,500,000 ordinary shares of Orckit (excluding shares of Orckit issuable pursuant Orckit options as a result of exchanges for Corrigent options already made) that could be issued in exchange for Corrigent options.

We will not be required to record an expense in our financial statements under U.S. generally accepted accounting principles in connection with these exchanges to the extent that the fair value of the Orckit options that we grant in exchange for Corrigent options does not exceed the fair value of the Corrigent options being exchanged. Our audit committee and board of directors determined that the fair market value of 10% of the outstanding capital stock of Corrigent (on a fully diluted basis) at the time the exchange program was approved was equal to the value of 10% of the outstanding ordinary shares of Orckit (on a fully diluted basis).

If further exchanges are made based on the approval of our shareholders, that is, the fair market values of the exchangeable options are equal, then we will not record an expense in our financial statements in connection with the exchange. As a result, in any exchange, we will not issue Orckit options that represent a percentage of the fully diluted ownership of Orckit that is greater than the percentage of the fully diluted ownership of Corrigent represented by the Corrigent options to be exchanged. For example, if an exchange is for stock options constituting 2.5% of the outstanding capital stock of Corrigent (on a fully diluted basis), then we would issue in this exchange the lesser of (i) an amount of options for Ordinary Shares of Orckit equal to the fair market value of these Corrigent stock options on the exchange date or (ii) options for Ordinary Shares constituting 2.5% of the Ordinary Shares of Orckit outstanding (on a fully diluted basis after giving effect to such issuance) on the exchange date.

## **ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**

### **A. MAJOR SHAREHOLDERS**

To our knowledge, (A) we are not directly or indirectly owned or controlled (i) by another corporation or (ii) by any foreign government and (B) there are no arrangements, the operation of which may at a subsequent date result in a change in control of Orckit.

As of March 1, 2006, each of Eric Paneth and Izhak Tamir beneficially owns 8.2% of our ordinary shares and collectively beneficially own approximately 15.8% of our ordinary shares. Including options which might be granted in exchange for stock options of Corrigent held by Messrs. Paneth and Tamir (based on data as of March 1, 2006), as of March 1, 2006, each of Messrs. Paneth and Tamir would beneficially own 10.4% of our ordinary shares and they collectively would beneficially own approximately 19.8% of our ordinary shares.

Accordingly, Messrs. Paneth and Tamir, if they voted together, may have the power to control the outcome of matters submitted to a vote of our shareholders, including the approval of significant change of control transactions.

The following table sets forth, as of March 1, 2006, the number of our ordinary shares, which constitute our only voting securities, beneficially owned by (i) all shareholders known to us to own more than 5% of our outstanding ordinary shares, and (ii) all of our directors and executive officers as a group. The voting rights of all major shareholders are the same. As of March 1, 2006, 15,386,734 of our ordinary shares were outstanding.

| <u>Identity of Person or Group</u>                              | <u>Amount Owned</u>      | <u>Percent of Class</u> |
|---|--------------------------|-------------------------|
| Eric Paneth <sup>(1)</sup>                                      | 1,294,063                | 8.2%                    |
| Izhak Tamir <sup>(2)</sup>                                      | 1,294,063                | 8.2%                    |
| Phylon Fund Limited and affiliate <sup>(3)</sup>                | 1,400,000                | 9.1%                    |
| Oberweis Asset Management, Inc. <sup>(4)</sup>                  | 948,963                  | 6.2%                    |
| All directors and executive officers as a group<br>(13 persons) | 2,800,428 <sup>(5)</sup> | 16.9%                   |

- 
- (1)(2) Includes, in the case of each of Messrs. Tamir and Paneth, 480,000 ordinary shares issuable upon the exercise of options that are currently vested or vest within the next 60 days but excludes ordinary shares issuable upon the exercise of options that may be issued in the future in exchange for stock options of Corrigent held by each of them (see Item 6.E above). This figure also includes, in the case of each of Messrs. Tamir and Paneth, 420,000 ordinary shares subject to a six-year variable forward sale contract entered into with Credit Suisse Capital LLC on March 1, 2006. Under each such contract, 420,000 ordinary shares were pledged to Credit Suisse as collateral.
- (3) Based on a Schedule 13G/A of Phylon Fund Limited and Phylon Investment Advisers LLP filed on February 1, 2006 with the Securities and Exchange Commission.
- (4) Based on a Schedule 13G of Oberweis Asset Management, Inc filed on February 14, 2006 with the Securities and Exchange Commission.
- (5) Includes 1,172,302 ordinary shares which may be purchased pursuant to options exercisable within sixty days following March 1, 2006. As discussed in Item 6.E above, stock options of Corrigent held by directors and executive officers of Orckit may be exchanged for options of Orckit.

As of March 31, 2004, each of Mr. Paneth and Mr. Tamir beneficially owned 2,255,313 ordinary shares, or 16.7% of our outstanding ordinary shares. The reduction in each of their holdings was caused principally by (i) the waiver on February 14, 2005 of an option to purchase 420,000 ordinary shares at a 10% premium over the market price on the date of exercise, (ii) the vesting of 3,750 options which were not vested within 60 days from March 31, 2004 (iii) the sale of 300,000 ordinary shares on Nasdaq between February 1, 2005 and April 26, 2005, (iv) the sale of 450,000 ordinary shares on Nasdaq between July 1, 2005 and February 27, 2006 pursuant to a trading plan under Rule 10b5-1(c) entered into in May 2005 with respect to 600,000 ordinary shares and (v) the transfer of 215,000 ordinary shares on December 8, 2005 to a blind trust for a period of two years, offset by (vi) the grant on June 23, 2005 of an option to purchase 420,000 ordinary shares at the market price on the date of grant with a seven year term. The objective of the blind trust referenced in clause (v) above is to extract value from the volatility of the shares while enabling Messrs. Paneth and Tamir to maintain their holdings in the shares, subject to market conditions. Commencing March 2006, the trust will run a yield enhancement program with respect to the shares. The program will be run by actively managing the selling and buying back of options with respect to the shares. Shares of the trust might be assigned and delivered pursuant to transactions effected under the program. After two years, if the trust is not extended, the shares owned by the trust at that time will be distributed from the trust back to Messrs. Paneth and Tamir. The foregoing information is based on reports on Schedule 13D filed with the SEC by Messrs. Paneth and Tamir.

As of March 1, 2006, there were 32 holders of record of our ordinary shares in the United States who collectively held approximately 80% of our outstanding ordinary shares. The number of record holders in the United States is not representative of the number of beneficial holders nor is it representative of where such beneficial holders are resident since many of these ordinary shares were held of record by brokers or other nominees.

**B. RELATED PARTY TRANSACTIONS**

*Tikcro Management Agreement*

Following the sale of Tikcro's business to STMicroelectronics in April 2003, we agreed to provide Tikcro administrative services. For the services rendered in 2004, Tikcro paid us \$100,000. Fees to be paid by Tikcro for 2005 were reduced to \$72,000. Fees to be paid by Tikcro for 2006 were reduced to \$48,000.

*Siliquent Technologies*

Siliquent Technologies, a provider of technology for the storage network applications industry, was founded in 2000 as a technology project. In October 2001, Siliquent Technologies, raised \$10.0 million in equity financing from third parties. Certain of our directors, officers and employees had previously been granted securities in Siliquent with a nominal exercise price. In 2003, we participated in follow-on investment rounds in Siliquent and increased our investment by \$1.0 million. In 2004, we participated in another follow on investment rounds in Siliquent for \$1.4 million. In 2005, Broadcom acquired Siliquent, and the consideration paid for our holdings in Siliquent was \$4.4 million. In addition, the consideration paid to certain of our directors and officers who were granted securities in Siliquent upon incorporation was approximately \$198,000 in the aggregate.

We believe that any transactions involving affiliated parties were on terms no less favorable to us than could be obtained with non-affiliated parties.

**C. INTERESTS OF EXPERTS AND COUNSEL**

Not applicable

**ITEM 8. FINANCIAL INFORMATION**

**Consolidated Statements and Other Financial Information**

See Item 18.

**Legal Proceedings**

For a discussion of our legal proceedings, please see "Item 4 – Information on the Company – Legal Proceedings."

**Dividend Policy**

For a discussion of our dividend policy, please see "Item 5.B – Operating and Financial Review and Prospects – Liquidity and Capital Resources – Dividend Policy."



## Significant Changes

No significant change has occurred since December 31, 2005, except as otherwise disclosed in this annual report.

## ITEM 9. THE OFFER AND LISTING

### A. OFFER AND LISTING DETAILS

Our ordinary shares are quoted on the Nasdaq Stock Market and the Tel-Aviv Stock Exchange under the symbol “ORCT”.

The following table sets forth, for the periods indicated, the high and low sales prices of our ordinary shares as reported on the Nasdaq Stock Market. The price per share of our ordinary shares and share count has been retroactively adjusted to reflect the (i) three-for-one stock split of our ordinary shares as of April 5, 2005 and (ii) one-for-five reverse share split effective as of November 27, 2002.

| <u>Calendar Year</u> | <u>Price Per Share</u> |            |
|----------------------|------------------------|------------|
|                      | <u>High</u>            | <u>Low</u> |
| 2005                 | \$29.55                | \$8.03     |
| 2004                 | \$8.57                 | \$4.82     |
| 2003                 | \$7.87                 | \$0.98     |
| 2002                 | \$7.20                 | \$0.90     |
| 2001                 | \$7.08                 | \$1.80     |

| <u>Calendar Period</u>                | <u>Price Per Share</u> |            |
|---------------------------------------|------------------------|------------|
|                                       | <u>High</u>            | <u>Low</u> |
| 2006                                  |                        |            |
| First Quarter (through March 8, 2006) | \$31.22                | \$23.11    |
| 2005                                  |                        |            |
| First Quarter                         | \$20.50                | \$8.03     |
| Second Quarter                        | \$28.15                | \$17.14    |
| Third Quarter                         | \$29.55                | \$21.97    |
| Fourth Quarter                        | \$25.76                | \$12.22    |
| 2004                                  |                        |            |
| First Quarter                         | \$7.67                 | \$4.82     |
| Second Quarter                        | \$8.01                 | \$5.20     |
| Third Quarter                         | \$8.04                 | \$5.08     |
| Fourth Quarter                        | \$8.57                 | \$5.15     |

| <u>Calendar Month</u> | <u>Price Per Share</u> |            |
|-----------------------|------------------------|------------|
|                       | <u>High</u>            | <u>Low</u> |
| 2006                  |                        |            |
| February              | \$31.00                | \$24.25    |
| January               | \$31.22                | \$23.11    |
| 2005                  |                        |            |
| December              | \$25.76                | \$20.51    |
| November              | \$22.36                | \$19.05    |
| October               | \$25.33                | \$12.22    |
| September             | \$26.88                | \$22.46    |

The following table sets forth, for the periods indicated, the high and low sales prices of our ordinary shares as reported on the Tel-Aviv Stock Exchange.

| <u>Calendar Year</u> | <u>Price Per Share</u> |            |
|----------------------|------------------------|------------|
|                      | <u>High</u>            | <u>Low</u> |
| 2005                 | \$29.43                | \$7.95     |
| 2004                 | \$8.53                 | \$4.93     |
| 2003                 | \$7.79                 | \$1.18     |

| <u>Calendar Period</u>                | <u>Price Per Share</u> |            |
|---------------------------------------|------------------------|------------|
|                                       | <u>High</u>            | <u>Low</u> |
| 2006                                  |                        |            |
| First Quarter (through March 8, 2006) | \$26.51                | \$24.41    |
| 2005                                  |                        |            |
| First Quarter                         | \$20.40                | \$7.95     |
| Second Quarter                        | \$27.82                | \$17.63    |
| Third Quarter                         | \$29.43                | \$22.10    |
| Fourth Quarter                        | \$25.71                | \$16.23    |
| 2004                                  |                        |            |
| First Quarter                         | \$7.88                 | \$5.02     |
| Second Quarter                        | \$8.05                 | \$5.09     |
| Third Quarter                         | \$8.22                 | \$4.93     |
| Fourth Quarter                        | \$8.53                 | \$5.14     |

| <u>Calendar Month</u> | <u>Price Per Share</u> |            |
|-----------------------|------------------------|------------|
|                       | <u>High</u>            | <u>Low</u> |
| 2006                  |                        |            |
| February              | \$30.48                | \$24.37    |
| January               | \$30.91                | \$21.85    |
| 2005                  |                        |            |
| December              | \$25.71                | \$20.37    |
| November              | \$22.35                | \$19.03    |

|           |         |         |
|-----------|---------|---------|
| October   | \$24.52 | \$16.23 |
| September | \$26.69 | \$22.71 |

The share prices as presented above in US dollars were originally denominated in New Israeli Shekels and were converted to US dollars using the average exchange rate between the US dollar and the New Israeli Shekels for the presented period.

Our shares began trading on the Tel-Aviv Stock Exchange in April 2002. The trading volume of our shares on the TASE in 2002 was insignificant and, accordingly, we do not believe sales price information with respect to the limited trading of our ordinary shares on TASE in 2002 is meaningful.

**B. *PLAN OF DISTRIBUTION***

Not applicable

**C. *MARKETS***

Our ordinary shares are quoted on the Nasdaq Stock Market under the symbol ORCT. Our ordinary shares are also quoted on the Tel-Aviv Stock Exchange. Options relating to our ordinary shares began trading on the Chicago Board Options Exchange, the American Stock Exchange and the Philadelphia Stock Exchange in May 2005.

**D. *SELLING SHAREHOLDERS***

Not applicable

**E. *DILUTION***

Not applicable

**F. *EXPENSES OF THE ISSUE***

Not applicable

**ITEM 10. *ADDITIONAL INFORMATION***

**A. *SHARE CAPITAL***

Not applicable

**B. *MEMORANDUM AND ARTICLES OF ASSOCIATIONS***

**Objects and Purposes**

We were first registered under Israeli law on January 22, 1990 as a private company, and, on July 22, 1996, became a public company. Our registration number with the Israeli registrar of companies is 52-004287-0. Our object is to engage, directly or indirectly, in any lawful undertaking or business whatsoever, including, without limitation, as stipulated in our memorandum of association, which was filed with the Israeli registrar of companies.

## **Transfer of Shares and Notices**

Fully paid ordinary shares may be freely transferred pursuant to our articles of association unless the transfer is restricted or prohibited by another instrument. Unless otherwise prescribed by law, we will provide at least 21 calendar days' prior notice of any general shareholders meeting.

## **Dividend and Liquidation Rights**

Dividends on our ordinary shares may be paid only out of profits and other surplus, as defined in the Companies Law, as of our most recent financial statements or as accrued over a period of two years, whichever is higher. Our board of directors, with the approval of our audit committee, is authorized to declare dividends, provided that there is no reasonable concern that the dividend will prevent us from satisfying our existing and foreseeable obligations as they become due. In the event of our liquidation, after satisfaction of liabilities to creditors, our assets will be distributed to the holders of ordinary shares in proportion to their respective holdings. These dividend and liquidation rights may be affected by the grant of preferential dividends or distribution rights to the holders of a class of shares with preferential rights that may be authorized in the future.

## **Voting, Shareholders' Meetings and Resolutions**

Holders of ordinary shares have one vote for each ordinary share held on all matters submitted to a vote of shareholders. Under the Companies Law and our articles of association, most resolutions of our shareholders require approval by a simple majority of the ordinary shares voting thereon. Amendments to our articles of association and the election of directors require approval of 66-2/3% of our ordinary shares voting thereon, and liquidation and the removal of directors (other than outside directors) require approval of 75% of our ordinary shares voting thereon.

These voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future.

We have two types of general shareholders meetings: the annual general meetings and extraordinary general meetings. Directors are elected only at annual general meeting. These meetings may be held either in Israel or in any other place the board of directors determines. An annual general meeting must be held in each calendar year, but not more than 15 months after the last annual general meeting. Our board of directors may convene an extraordinary meeting, from time to time, at its discretion and is required to do so upon the request of shareholders holding at least 5% of our ordinary shares.

The quorum required for a meeting of shareholders consists of at least two shareholders present in person or by proxy who hold or represent between them at least 25% of the outstanding voting shares, unless otherwise required by applicable rules. Nasdaq generally requires a quorum of 33-1/3%, but we have received an exemption and instead follow the generally accepted business practice for companies in Israel. A meeting adjourned for lack of a quorum generally is adjourned to the same day in the following week at the same time and place or any time and place as the chairman may designate with the consent of a majority of the voting power represented at the meeting and voting on the matter adjourned. At such reconvened meeting the required quorum consists of any two members present in person or by proxy, unless otherwise required by applicable rules.

## **Duties of Shareholders**

Under the Companies Law, each and every shareholder has a duty to act in good faith in exercising his rights and fulfilling his obligations towards us and other shareholders and to refrain from abusing his power in us, such as in voting in the general meeting of shareholders on the following matters:

- any amendment to the articles of association;
- an increase of our authorized share capital;
- a merger; or
- approval of certain actions and transactions which require shareholder approval.

In addition, each and every shareholder has the general duty to refrain from depriving other shareholders of their rights.

Furthermore, any controlling shareholder, any shareholder who knows that it possesses the power to determine the outcome of a shareholder vote and any shareholder that, pursuant to the provisions of the articles of association, has the power to appoint or to prevent the appointment of an office holder in us or any other power toward us is under a duty to act in fairness towards us. The Companies Law does not describe the substance of this duty of fairness. These various shareholder duties may restrict the ability of a shareholder to act in what the shareholder perceives to be its own best interests.

## **Anti-Takeover Provisions; Mergers and Acquisitions**

The Israeli Companies Law includes provisions that allow a merger transaction and requires that each company that is a party to a merger have the transaction approved by its board of directors and a vote of the majority of its shares, at a shareholders' meeting called on at least 21 days' prior notice. For purposes of the shareholder vote, unless a court rules otherwise, the statutory merger will not be deemed approved if a majority of the shares present that are held by parties other than the other party to the merger, or by any person who holds 25% or more of the shares or the right to appoint 25% or more of the directors of the other party, vote against the merger. Upon the request of a creditor of either party of the proposed merger, the court may delay or prevent the merger if it concludes that there exists a reasonable concern that as a result of the merger, the surviving company will be unable to satisfy the obligations of any of the parties to the merger. In addition, a merger may not be completed unless at least (i) 50 days have passed from the time that the requisite proposal for the merger has been filed by each party with the Israeli Registrar of Companies and (ii) 30 days have passed since the merger was approved by the shareholders of each party.

The Companies Law also provides that an acquisition of shares of a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become a 25% or greater shareholder of the company and there is no existing 25% or greater shareholder in the company. An acquisition of shares of a public company must also be made by means of a tender offer if as a result of the acquisition the purchaser would become a 45% or greater shareholder of the company and there is no existing 45% or greater shareholder in the company. These requirements do not apply if the acquisition (i) occurs in

the context of a private placement by the company that received shareholder approval, (ii) was from a 25% shareholder of the company and resulted in the acquirer becoming a 25% shareholder of the company or (iii) was from a 45% shareholder of the company and resulted in the acquirer becoming a 45% shareholder of the company. The tender offer must be extended to all shareholders, but the offeror is not required to purchase more than 5% of the company's outstanding shares, regardless of how many shares are tendered by shareholders. The tender offer may be consummated only if (i) at least 5% of the company's outstanding shares will be acquired by the offeror and (ii) the number of shares tendered in the offer exceeds the number of shares whose holders objected to the offer.

If, as a result of an acquisition of shares, the acquirer will hold more than 90% of a company's outstanding shares, the acquisition must be made by means of a tender offer for all of the outstanding shares. If less than 5% of the outstanding shares are not tendered in the tender offer, all the shares that the acquirer offered to purchase will be transferred to it. The law provides for appraisal rights if any shareholder files a request in court within three months following the consummation of a full tender offer. If more than 5% of the outstanding shares are not tendered in the tender offer, then the acquirer may not acquire shares in the tender offer that will cause his shareholding to exceed 90% of the outstanding shares.

Israeli tax law also treats stock-for-stock acquisitions between an Israeli company and a foreign company less favorably than does U.S. tax law. For example, Israeli tax law may, under certain circumstances, subject a shareholder who exchanges his ordinary shares for shares of another corporation to taxation prior to the sale of the shares received in such stock-for-stock swap.

Our articles of association provide that our board of directors may, at any time in its sole discretion, adopt protective measures to prevent or delay a coercive takeover of us, including, without limitation, the adoption of a shareholder rights plan. In November 2001, our board of directors adopted a shareholder bonus rights plan pursuant to which share purchase bonus rights were distributed on December 6, 2001 at the rate of one right for each of our ordinary shares held by shareholders of record as of the close of business on that date.

The rights plan is intended to help ensure that all of our shareholders are able to realize the long-term value of their investment in us in the event of a potential takeover which does not reflect our full value and is otherwise not in the best interests of us and our shareholders. The rights plan is also intended to deter unfair or coercive takeover tactics.

Each right initially will entitle shareholders to buy one-half of one of our ordinary shares for \$21.67. The rights generally will be exercisable and transferable apart from our ordinary shares only if a person or group becomes an "acquiring person" by acquiring beneficial ownership of 15% or more of our ordinary shares, subject to certain exceptions set forth in the rights plan, or commences a tender or exchange offer upon consummation of which such person or group would become an "acquiring person." Subject to certain conditions described in the rights plan, once the rights become exercisable, the holders of rights, other than the acquiring person, will be entitled to purchase ordinary shares at a discount from the market price.

The rights will expire on December 31, 2011 and are generally redeemable by our board of directors, at \$0.01 per right, at any time until the tenth business day following public disclosure that a person or group has become an "acquiring person."

Our articles of association also provide that as long as any of our securities are publicly traded on a United States market or exchange, all proxy solicitations by persons other than our board of directors must be undertaken pursuant to the United States proxy rules, regardless of whether those proxy rules are legally applicable to us. These provisions of our articles of association could discourage potential acquisition proposals and could delay or prevent a change in control of us.

### **Modification of Class Rights**

Our articles of association provide that the rights attached to any class (unless otherwise provided by the terms of that class), such as voting, rights to dividends and the like, may be varied by a shareholders' resolution, subject to the sanction of a resolution passed by a majority of the holders of the shares of that class at a separate class meeting.

### **Indemnification, Exculpation and Insurance of Office Holders**

#### ***Exculpation of Office Holders***

Under the Companies Law, an Israeli company may not exempt an office holder from liability for breach of his duty of loyalty, but may exempt in advance an office holder from liability to the company, in whole or in part, for a breach of his duty of care (except in connection with distributions), provided the articles of association of the company allow it to do so. Our articles of association allow us to exempt our office holders to the fullest extent permitted by law.

#### ***Insurance of Office Holders***

Our articles of association provide that, subject to the provisions of the Companies Law, we may enter into an insurance contract which would provide coverage for any monetary liability incurred by any of our office holders, with respect to an act performed in the capacity of an office holder for:

- a breach of his duty of care to us or to another person;
- a breach of his duty of loyalty to us, provided that the office holder acted in good faith and had reasonable cause to assume that his act would not prejudice our interests; or
- a financial liability imposed upon him in favor of another person.

We obtained liability insurance covering our officers and directors.

#### ***Indemnification of Office Holders***

Our articles of association provide that we may indemnify an office holder against:

- a financial liability imposed on or incurred by an office holder in favor of another person by any judgment, including a settlement or an arbitrator's award approved by a court concerning an act performed in his capacity as an office holder. Such indemnification may be approved (i) after the liability has been incurred or (ii) in advance, provided that the undertaking is limited to types of events which our



board of directors deems to be foreseeable in light of our actual operations at the time of the undertaking and limited to an amount or criterion determined by our board of directors to be reasonable under the circumstances, and further provided that such events and amounts or criterion are set forth in the undertaking to indemnify;

- reasonable litigation expenses, including attorney's fees, expended by the office holder as a result of an investigation or proceeding instituted against him by a competent authority, provided that such investigation or proceeding concluded without the filing of an indictment against him and either (A) concluded without the imposition of any financial liability in lieu of criminal proceedings or (B) concluded with the imposition of a financial liability in lieu of criminal proceedings but relates to a criminal offense that does not require proof of criminal intent; and
- reasonable litigation expenses, including attorneys' fees, expended by the office holder or charged to him by a court, in proceedings instituted against him by or on our behalf or by another person, or in a criminal charge from which he was acquitted, or a criminal charge in which he was convicted for a criminal offense that does not require proof of intent, in each case relating to an act performed in his capacity as an office holder.

We have undertaken to indemnify our directors and officers pursuant to applicable law.

#### ***Limitations on Exculpation, Insurance and Indemnification***

The Companies Law provides that a company may not exculpate or indemnify an office holder, or enter into an insurance contract which would provide coverage for any monetary liability incurred as a result of any of the following:

- a breach by the office holder of his duty of loyalty unless, with respect to insurance coverage or indemnification, the office holder acted in good faith and had a reasonable basis to believe that the act would not prejudice the company;
- a breach by the office holder of his duty of care if the breach was committed intentionally or recklessly;
- any act or omission committed with the intent to derive an illegal personal benefit; or
- any fine imposed on the office holder.

In addition, under the Companies Law, exculpation of, indemnification of, or procurement of insurance coverage for, our office holders must be approved by our audit committee and our board of directors and, if the beneficiary is a director, by our shareholders. We have obtained such approvals for the procurement of liability insurance covering our officers and directors and for the grant of indemnification letters to our officers and directors and have granted amended and restated indemnification and exculpation letters to our

directors and officers that require us to indemnify them to the fullest extent permitted by applicable law.

Our articles of association also provide that, subject to the provisions of applicable law, we may procure insurance for or indemnify any person who is not an office holder, including without limitation, any of our employees, agents, consultants or contractors.

#### *C. MATERIAL CONTRACTS*

For a description of our bank loan agreements, see: –“Liquidity and Capital Resources” under Item 5B of this Annual Report on Form 20-F.

#### *D. EXCHANGE CONTROLS*

There are currently no Israeli currency control restrictions on payments of dividends or other distributions with respect to our ordinary shares or the proceeds from the sale of the shares, except for the obligation of Israeli residents to file reports with the Bank of Israel regarding certain transactions. However, legislation remains in effect pursuant to which currency controls can be imposed by administrative action at any time.

The ownership or voting of our ordinary shares by non-residents of Israel, except with respect to citizens of countries which are in a state of war with Israel, is not restricted in any way by our memorandum of association or articles of association or by the laws of the State of Israel.

#### *E. TAXATION*

The following is a general summary only and should not be considered as income tax advice or relied upon for tax planning purposes.

##### ***United States Federal Income Tax Considerations***

The following summary describes the material U.S. federal income tax consequences to “U.S. Holders” (as defined below) arising from the purchase, ownership or disposition of our ordinary shares. This summary is based on current provisions of the Internal Revenue Code of 1986, as amended, or the “Code,” the final, temporary and proposed U.S. Treasury Regulations promulgated thereunder and administrative and judicial interpretations thereof, all of which are subject to change, possibly with retroactive effect. For purposes of this summary, a “U.S. Holder” will be deemed to refer only to any of the following holders of our ordinary shares:

- ☐ an individual who is either a U.S. citizen or a resident of the U.S. for U.S. federal income tax purposes;
- ☐ a corporation or partnership (or other entity taxable as a corporation or a partnership) created or organized under the laws of the U.S. or any political subdivision thereof;
- ☐ an estate, the income of which is subject to U.S. federal income tax regardless of the source of its income; and

- a trust, if either (a) a U.S. court is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust, or (b) the trust has a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person.

This summary does not consider all aspects of U.S. federal income taxation that may be relevant to particular U.S. Holders by reason of their particular circumstances, including potential application of the alternative minimum tax, or any aspect of state, local or non-U.S. federal tax laws. In addition, this summary is directed only to U.S. Holders that hold our ordinary shares as capital assets and does not address the considerations that may be applicable to particular classes of U.S. Holders, including financial institutions, regulated investment companies, real estate investment trusts, pension funds, insurance companies, broker-dealers, tax-exempt organizations, grantor trusts, or other pass-through entities, holders whose functional currency is not the U.S. dollar, U.S. Holders who have elected mark-to-market accounting, U.S. Holders who acquired our ordinary shares through the exercise of options or otherwise as compensation, U.S. Holders who hold our ordinary shares as part of a “straddle,” “hedge” or “conversion transaction” and holders, directly, indirectly or through attribution, of 10% or more (by vote or value) of our outstanding ordinary shares. If a partnership is a beneficial owner of our ordinary shares, the U.S. federal income tax treatment of a partner in the partnership generally will depend upon the status of the partner and the activities of the partnership. A partnership that is a beneficial owner of our ordinary shares, and partners in such partnership, are urged to consult their own tax advisors regarding such partnership’s ownership of our ordinary shares.

Each U.S. Holder should consult with its own tax advisor as to the particular tax consequences to it of the purchase, ownership and sale of our ordinary shares, including the effects of applicable state, local, foreign or other tax laws and possible changes in the tax laws.

### **Sale, Exchange or Other Taxable Disposition of Ordinary Shares**

Subject to the discussion below under “Passive Foreign Investment Company Status,” a U.S. Holder’s sale, exchange or other taxable disposition of ordinary shares generally will result in the recognition by such U.S. Holder of capital gain or loss in an amount equal to the difference between the U.S. Dollar value of the amount realized and the U.S. Holder’s tax basis in the ordinary shares sold. This gain or loss will be long-term capital gain or loss if the ordinary shares sold have been held for more than one year at the time of the sale, exchange or other taxable disposition. Individual U.S. Holders currently are subject to a maximum tax rate of 15% on long-term capital gains for tax years beginning on or before December 31, 2008. Short-term capital gains generally are taxed at the same rates applicable to ordinary income. If the U.S. Holder’s holding period on the date of the sale, exchange or other taxable disposition is one year or less, such gain or loss will be a short-term capital gain or loss. See “—Israel—Capital Gains Tax” for a discussion of taxation by Israel of capital gains realized on sales of our ordinary shares. Any capital loss realized upon the sale, exchange or other taxable disposition of ordinary shares generally is deductible only against capital gains and not against ordinary income, except that in the case of non-corporate U.S. Holders, a capital loss is deductible to the extent of capital gains plus ordinary income up to \$3,000. In general, any capital gain recognized by a U.S. Holder upon the sale, exchange or other taxable disposition of ordinary shares will be treated as U.S.-source income for U.S. foreign tax credit purposes. Under the tax treaty between the United States and Israel, gain derived from the sale, exchange or other taxable disposition of ordinary shares by a U.S. Holder who is a

resident of the United States for purposes of the treaty and who sells the ordinary shares within Israel may be treated as foreign-source income for U.S. foreign tax credit purposes.

A U.S. Holder's tax basis in his, her or its ordinary shares generally will be the purchase price paid therefore by such U.S. Holder. The holding period of each ordinary share owned by a U.S. Holder will commence on the day following the date of the U.S. Holder's purchase of such ordinary share and will include the day on which the ordinary share is sold by such U.S. Holder.

In the case of a U.S. Holder who uses the cash basis method of accounting and who receives NIS in connection with the sale or other taxable disposition of ordinary shares, the amount realized will be based on the "spot rate" on the settlement date of such sale or other taxable disposition. If such U.S. Holder subsequently converts NIS into U.S. Dollars at a conversion rate other than the spot rate in effect on the settlement date, he, she or it may have a foreign currency exchange gain or loss treated as ordinary income or loss for U.S. federal income tax purposes. A U.S. Holder who uses the accrual method of accounting may elect the same treatment required of cash method taxpayers with respect to a sale or other taxable disposition of ordinary shares, provided that the election is applied consistently from year to year. Such election may not be changed without the consent of the U.S. Internal Revenue Service. If an accrual method U.S. Holder does not elect to be treated as a cash method taxpayer (pursuant to the Treasury regulations applicable to foreign currency transactions), such U.S. Holder may be deemed to have realized an immediate foreign currency gain or loss for U.S. federal income tax purposes in the event of any difference between the U.S. Dollar value of the NIS on the date of sale or other taxable disposition and the settlement date. Any such currency gain or loss would generally be treated as U.S. source ordinary income or loss and would be subject to tax in addition to any gain or loss recognized by such U.S. Holder on the sale or other taxable disposition of ordinary shares.

### **Treatment of Distributions**

For U.S. federal income tax purposes, the amount of a distribution with respect to our ordinary shares will equal the amount of cash, the fair market value of any property distributed and the amount of any Israeli taxes withheld as described below under "Israel -- Tax on Dividends." Other than distributions in liquidation or in redemption of stock that are treated as exchanges, a distribution with respect to our ordinary shares paid by us to a U.S. Holder generally will be treated as a dividend to the extent that the distribution does not exceed our current and accumulated earnings and profits, as determined for U.S. federal income tax purposes. The amount of any distribution that exceeds these earnings and profits will be treated first as a non-taxable return of capital, reducing the U.S. Holder's tax basis in his, her or its ordinary shares, and then generally as capital gain from a deemed sale or exchange of such ordinary shares. Corporate U.S. Holders generally will not be allowed a deduction under Section 243 of the Code for dividends received on our ordinary shares and thus will be subject to tax at the rate applicable to their taxable income. Currently, a noncorporate U.S. Holder's "qualified dividend income" generally is subject to tax at a rate of 15%. For this purpose, "qualified dividend income" generally includes dividends paid by a foreign corporation if, among other things, the noncorporate U.S. Holder meets certain minimum holding period requirements and either (a) the stock of such corporation is readily tradable on an established securities market in the U.S., including the Nasdaq National Market, or (b) such corporation is eligible for the benefits of a comprehensive income tax treaty with the U.S. which includes an information exchange program and is determined to be satisfactory by the U.S. Secretary of the Treasury. The U.S. Secretary of the Treasury has

indicated that the income tax treaty between the U.S. and Israel is satisfactory for this purpose. Dividends paid by us will not qualify for the 15% U.S. federal income tax rate, however, if we are treated, for the tax year in which the dividends are paid or the preceding tax year, as a “passive foreign investment company” for U.S. federal income tax purposes. See the discussion below under the heading “Passive Foreign Investment Company Status.” U.S. Holders are urged to consult their own tax advisors regarding the U.S. federal income tax rate applicable to their receipt of any dividends paid with respect to our ordinary shares.

A dividend paid by us in NIS will be included in the income of U.S. Holders at the dollar amount of the dividend, based on the “spot rate” of exchange in effect on the date of receipt or deemed receipt of the distribution, regardless of whether the payment is in fact converted into U.S. dollars. U.S. Holders will have a tax basis in the NIS for U.S. federal income tax purposes equal to that dollar value. Any subsequent gain or loss upon the conversion of the NIS into dollars or other disposition of the NIS will be taxable as ordinary income or loss and will be treated as U.S.-source income or loss for U.S. foreign tax credit purposes.

Dividends received with respect to our ordinary shares will constitute “portfolio income” for purposes of the limitation on the use of passive activity losses and, therefore, generally may not be offset by passive activity losses. Dividends received with respect to our ordinary shares also generally will be treated as “investment income” for purposes of the limitation on the deduction of investment interest expense and as foreign-source passive income for U.S. foreign tax credit purposes or, in the case of a U.S. Holder that is a financial services entity, financial services income. Subject to certain limitations, U.S. Holders may elect to claim as a foreign tax credit against their U.S. federal income tax liability any Israeli income tax withheld from dividends on our ordinary shares. U.S. Holders that do not elect to claim a foreign tax credit may instead claim a deduction for Israeli income tax withheld. In addition, special rules may apply to the computation of foreign tax credits relating to “qualified dividend income,” as defined above. The calculation of foreign tax credits and, in the case of a U.S. Holder that elects to deduct foreign income taxes, the availability of deductions are complex and involve the application of rules that depend on a U.S. Holder's particular circumstances. U.S. Holders are urged to consult their own tax advisors regarding the availability to them of foreign tax credits or deductions in respect of any Israeli tax withheld or paid with respect to any dividends which may be paid with respect to our ordinary shares.

### **Passive Foreign Investment Company Status**

Generally, a foreign corporation is treated as a passive foreign investment company (“PFIC”) for U.S. federal income tax purposes for any tax year if, in such tax year, either (i) 75% or more of its gross income, including its pro rata share of the gross income of any company in which it owns 25% or more of the shares by value, is passive in nature (the “Income Test”), or (ii) the average percentage of its assets during such tax year, including its pro rata share of the assets of any company in which it owns 25% or more of the shares by value, which produce, or are held for the production of, passive income (determined by averaging the percentage of the fair market value of its total assets which are passive assets as of the end of each quarter of such year) is 50% or more (the “Asset Test”).

There is no definitive method prescribed in the Code, U.S. Treasury Regulations or administrative or judicial interpretations thereof for determining the value of a foreign corporation's assets for purposes of the Asset Test. The legislative history of the U.S.

Taxpayer Relief Act of 1997 (the “1997 Act”), however, indicates that for purposes of the Asset Test, “the total value of a publicly-traded foreign corporation's assets generally will be treated as equal to the sum of the aggregate value of its outstanding stock plus its liabilities.” It is unclear under current interpretations of the 1997 Act whether other valuation methods could be employed to determine the value of our assets.

Based on the composition of our gross income and the composition and value of our gross assets during 2005, we do not believe that we were a PFIC in 2005. However, it is likely, under the approach set forth in the legislative history to the 1997 Act, that we would have been classified as a PFIC in 2002, 2003 and 2004, primarily because (a) a significant portion of our assets consisted of cash, short- and long-term deposits and marketable securities from the remaining proceeds of our offerings, and (b) the relatively low public market valuation of our ordinary shares. In addition, there can be no assurance that we will not be deemed a PFIC in any future tax year.

Accordingly, U.S. Holders are urged to consult their own tax advisors for guidance as to our status as a PFIC in any tax year. For those U.S. Holders who determine that we are a PFIC in any future tax year and notify us in writing of their request for the information required in order to effectuate the QEF Election described below, we will promptly make such information available to them.

If we are treated as a PFIC for U.S. federal income tax purposes for any year during a U.S. Holder’s holding period of ordinary shares and the U.S. Holder does not make a QEF Election or a “mark-to-market “ election (both as described below):

- “Excess distributions” by us to a U.S. Holder would be taxed in a special way. “Excess distributions” with respect to any U.S. Holder are amounts received by such U.S. Holder with respect to our ordinary shares in any tax year that exceed 125% of the average distributions received by such U.S. Holder from us during the shorter of (i) the three previous years, or (ii) such U.S. Holder’s holding period of our ordinary shares before the then-current tax year. Excess distributions must be allocated ratably to each day that a U.S. Holder has held our ordinary shares. A U.S. Holder must include amounts allocated to the current tax year in his, her or its gross income as ordinary income for that year, pay tax on amounts allocated to each prior tax year in which we were a PFIC at the highest rate on ordinary income in effect for such prior year and pay an interest charge at the rate applicable to deficiencies for income tax.
- The entire amount of any gain realized by a U.S. Holder upon the sale or other disposition of our ordinary shares also would be treated as an “excess distribution” subject to tax as described above.
- The tax basis in ordinary shares acquired from a decedent who was a U.S. Holder would not receive a step-up to fair market value as of the date of the decedent's death, but would instead be equal to the decedent's basis, if lower.

Although we generally will be treated as a PFIC as to any U.S. Holder if we are a PFIC for any year during the U.S. Holder’s holding period, if we cease to satisfy the

requirements for PFIC classification, the U.S. Holder may avoid the consequences of PFIC classification for subsequent years if he elects to recognize gain based on the unrealized appreciation in his, her or its ordinary shares through the close of the tax year in which we cease to be a PFIC.

A U.S. Holder who beneficially owns shares of a PFIC must file Form 8621 (Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund) with the U.S. Internal Revenue Service for each tax year in which he, she or it holds shares in a PFIC. This form describes any distributions received with respect to these shares and any gain realized upon the disposition of these shares.

For any tax year in which we are treated as a PFIC, a U.S. Holder may elect to treat his, her or its ordinary shares as an interest in a qualified electing fund (a “QEF Election”), in which case the U.S. Holder would be required to include in income currently his, her or its proportionate share of our earnings and profits in years in which we are a PFIC regardless of whether distributions of our earnings and profits are actually made to the U.S. Holder. Any gain subsequently recognized by the U.S. Holder upon the sale of his, her or its ordinary shares, however, generally would be taxed as capital gain and the denial of the basis step-up at death described above would not apply.

A U.S. Holder may make a QEF Election with respect to a PFIC for any tax year of the U.S. Holder. A QEF Election is effective for the tax year in which the election is made and all subsequent tax years of the U.S. Holder. Procedures exist for both retroactive elections and the filing of protective statements. A U.S. Holder making the QEF Election must make the election on or before the due date, as extended, for the filing of the U.S. Holder’s income tax return for the first tax year to which the election will apply. Upon his, her or its request, we will provide to each U.S. Holder, who wishes to make a QEF Election for any year in which we are treated as a PFIC, the information required to make a QEF Election and to make subsequent annual filings.

As an alternative to a QEF Election, a U.S. Holder generally may elect to mark his, her or its ordinary shares to market annually, recognizing ordinary income or loss (subject to certain limitations) equal to the difference, as of the close of the tax year, between the fair market value of his, her or its ordinary shares and the adjusted tax basis of such shares. If a mark-to-market election with respect to ordinary shares is in effect on the date of a U.S. Holder’s death, the normally available step-up in tax basis to fair market value will not be available. Rather, the tax basis of the ordinary shares in the hands of a U.S. Holder who acquired them from a decedent will be the lesser of the decedent’s tax basis or the fair market value of the ordinary shares. Once made, a mark-to-market election generally continues unless revoked with the consent of the U.S. Internal Revenue Service.

The implementation of many aspects of the Code’s PFIC rules requires the issuance of regulations which in many instances have yet to be promulgated and which may have retroactive effect. We cannot be sure that any of these regulations will be promulgated or, if so, what form they will take or what effect they will have on the foregoing discussion. Accordingly, and due to the complexity of the PFIC rules, U.S. Holders should consult their own tax advisors regarding our status as a PFIC and the eligibility, manner and advisability of making a QEF Election or a mark-to-market election if we are treated as a PFIC.

## **Information Reporting and Backup Withholding**

Payments in respect of our ordinary shares that are made in the U.S. or by certain U.S.-related financial intermediaries may be subject to information reporting and backup withholding tax at rates equal to 28% through 2010 and 31 % after 2010. Backup withholding will not apply, however, to a U.S. Holder that (i) is a corporation or comes within certain exempt categories, and demonstrates that fact when so required, or (ii) furnishes a correct taxpayer identification number and furnishes other required certifications. U.S. Holders required to establish their exemption from backup withholding generally must provide a certification on IRS Form W-9. Backup withholding is not an additional tax. Amounts withheld under the backup withholding rules may be credited against a U.S. Holder's U.S. tax liability, and a U.S. Holder may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the U.S. Internal Revenue Service.

### ***Israel***

The following discussion, which represents a summary of certain Israeli tax laws affecting our shareholders, including U.S. shareholders, is for general information only and is not intended to substitute for careful or specific tax planning. To the extent that the discussion is based on legislation yet to be judicially or administratively interpreted, there can be no assurance that the views expressed herein will accord with any such interpretation in the future by the tax authorities or by the courts. This discussion is not intended, and should not be construed, as legal or professional tax advice, and does not cover all possible tax considerations. Accordingly, each investor should consult his or her own tax advisor as to the particular tax consequences of an investment in the ordinary shares including the effects of applicable Israeli or foreign or other tax laws and possible changes in the tax laws.

## **Capital Gains Tax**

Israeli law generally imposes a capital gains tax on the sale of any capital assets by residents of Israel, as defined for Israeli tax purposes, and on the sale of assets located in Israel, including shares in Israeli companies, by both residents and non-residents of Israel, unless a specific exemption is available or unless a tax treaty between Israel and the shareholder's country of residence provides otherwise. The law distinguishes between the inflationary surplus and the real gain. The inflationary surplus is a portion of the total capital gain which is equivalent to the increase of the relevant asset's purchase price attributable to the increase in the Israeli consumer price index, or in certain circumstances, a foreign currency exchange rate, between the date of purchase and the date of sale. The real gain is the excess of the total capital gain over the inflationary surplus.

Generally, up until the 2006 tax year, capital gains tax was imposed on Israeli residents at a rate of 15% on real gains derived on or after January 1, 2003 from the sale of shares in, among others, (i) Israeli companies publicly traded on Nasdaq or a recognized stock market in a country that has a treaty for the prevention of double taxation with Israel; or (ii) companies traded on both the TASE and Nasdaq or a recognized stock market outside of Israel (such as Orckit). This tax rate was contingent upon the shareholder not claiming a deduction for financing expenses in connection with such shares (in which case the capital gain was taxed at a rate of 25%), and did not apply to: (i) the sale of shares to a relative (as defined in the Israeli Income Tax Ordinance); (ii) the sale of shares by dealers in securities who are taxed at corporate tax rates for corporations and at marginal tax rates of up to 49%



for individuals; (iii) the sale of shares by shareholders that report in accordance with the Income Tax Law (Inflationary Adjustments), 5745-1985, referred to as the Inflationary Adjustments Law, who were taxed at corporate tax rates for corporation and at marginal tax rates of up to 49% for individuals; or (iv) the sale of shares by shareholders who acquired their shares prior to the issuer's initial public offering (that may be subject to a different tax arrangement).

As of January 1, 2006, the tax rate applicable to capital gains derived from the sale of shares, whether listed on a stock market or not, is 20% for Israeli individuals, unless such shareholder claims a deduction for financing expenses in connection with such shares, in which case the gain will generally be taxed at a rate of 25%. Additionally, if such shareholder is considered a "significant shareholder" at any time during the 12-month period preceding such sale (i.e., such shareholder holds directly or indirectly, including with others, at least 10% of any means of control in the company) the tax rate will be 25%. Israeli companies are subject to the corporate tax rate on capital gains derived from the sale of shares, unless such companies were not subject to the Adjustments Law (or certain regulations) at the time of publication of the aforementioned amendment to the Tax Ordinance that came into effect on January 1, 2006, in which case the applicable tax rate is 25%. However, the foregoing tax rates will not apply to dealers in securities and shareholders who acquired their shares prior to an initial public offering.

The tax basis of shares acquired prior to January 1, 2003 will be determined in accordance with the average closing share price in the three trading days preceding January 1, 2003. However, a request may be made to the tax authorities to consider the actual adjusted cost of the shares as the tax basis if it is higher than such average price.

Non-Israeli residents are exempt from Israeli capital gains tax on any gains derived from the sale of shares of Israeli companies publicly traded on Nasdaq or a recognized stock market outside of Israel, provided that such capital gains are not derived from a permanent establishment in Israel, that such shareholders are not subject to the Inflationary Adjustments Law and that such shareholders did not acquire their shares prior to the issuer's initial public offering. However, non-Israeli corporations will not be entitled to such exemption if an Israeli resident (i) has a controlling interest of 25% or more in such non-Israeli corporation, or (ii) is the beneficiary of or is entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

In some instances where our shareholders may be liable for Israeli tax on the sale of their ordinary shares, the payment of the consideration may be subject to the withholding of Israeli tax at the source.

Pursuant to a treaty between the governments of the United States and Israel, known as the U.S.-Israel Tax Treaty, the sale, exchange or disposition of shares by a person who holds the ordinary shares as a capital asset, who qualifies as a resident of the United States within the meaning of the treaty and who is entitled to claim the benefits afforded to a U.S. resident by the treaty will generally not be subject to Israeli capital gains tax. This exemption does not apply if the person holds, directly or indirectly, shares representing 10% or more of our voting power during any part of the 12-month period preceding the applicable sale, exchange or disposition, subject to specified conditions. However, under the treaty, such person would be permitted to claim a credit for the capital gains tax paid in Israel against the U.S. federal income tax imposed with respect to the applicable sale, exchange or disposition,

subject to the limitations in U.S. laws applicable to foreign tax credits. The treaty does not relate to U.S. state or local taxes.

## **Tax on Dividends**

Non-residents of Israel are subject to income tax on income accrued or derived from sources in Israel. These sources of income include passive income such as dividends, royalties and interest, as well as non-passive income from services rendered in Israel. On distributions of dividends other than bonus shares, or stock dividends, we would be required to withhold income tax at the source at the following rates: (i) for dividends distributed prior to January 1, 2006 - 25%; (ii) for dividends distributed on or after January 1, 2006 - 20%, or 25% for a shareholder that is considered a significant shareholder at any time during the 12-month period preceding such distribution; unless a different rate is provided in a treaty between Israel and the shareholder's country of residence and a special certificate is provided. If the income out of which the dividend is being paid is attributable to an Approved Enterprise (or Benefiting Enterprise), the rate is generally 15%. Under the U.S.-Israel Tax Treaty, if the income out of which the dividend is being paid is not attributable to an Approved Enterprise (or Benefiting Enterprise), then income tax with respect to shareholders that are U.S. corporations holding at least 10% of our issued voting power during the part of the tax year which precedes the date of payment of the dividend and during the whole of its prior tax year, is required to be withheld at the rate of 12.5%. For more information on Approved Enterprises, please refer to Item 5B of this annual report.

### ***F. DIVIDENDS AND PAYING AGENTS***

Not applicable

### ***G. STATEMENT BY EXPERTS***

Not applicable.

### ***H. DOCUMENTS ON DISPLAY***

We are subject to the informational requirements of the Securities Exchange Act of 1934, as amended, applicable to foreign private issuers and fulfill the obligations with respect to such requirements by filing reports with the Securities and Exchange Commission, or SEC. You may read and copy any document we file, including any exhibits, with the SEC without charge at the SEC's public reference room at 100 F Street, N.E., Washington, D.C. 20549. Copies of such material may be obtained by mail from the Public Reference Branch of the SEC at such address, at prescribed rates. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. Certain of our SEC filings are also available to the public at the SEC's website at <http://www.sec.gov>.

As a foreign private issuer, we are exempt from the rules under the Exchange Act prescribing the furnishing and content of proxy statements, and our officers, directors and principal shareholders are exempt from the reporting and "short-swing" profit recovery provisions contained in Section 16 of the Exchange Act. In addition, we are not required under the Exchange Act to file periodic reports and financial statements with the SEC as frequently or as promptly as United States companies whose securities are registered under the Exchange Act. We have obtained an exemption from Nasdaq's requirement to send an

annual report to shareholders prior to our annual general meetings. We file annual reports on Form 20-F electronically with the SEC and post a copy on our website, [www.orckit.com](http://www.orckit.com).

*I. SUBSIDIARY INFORMATION*

Not applicable

**ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**General**

We are exposed to market risk, including movements in interest rates and foreign currency exchange rates. Our primary market risk exposure occurs because we generate most of our revenues in Japanese Yen but incur a majority of our salaries and related expenses and part of our other expenses in New Israeli Shekels.

From time to time, in management's discretion, we engage in hedging or other transactions intended to manage risks relating to foreign currency exchange rates. As of March 1, 2006, we were not involved in any hedging transactions. We may in the future undertake hedging or other similar transactions or invest in market risk sensitive instruments when our management determines that it is necessary to offset these risks.

Our interest rate and foreign exchange exposures are monitored by tracking actual and projected commitments.

**Exchange Rate Risk Management**

Our functional currency and that of our subsidiaries is the U.S. dollar.

From time to time, we assess our exposure to exchange rate risks and endeavor to limit this exposure through natural hedging, or by attempting to maintain a similar level of assets and liabilities in any given currency.

The table below presents our balance sheet exposure as of December 31, 2005 at fair value related to market risk sensitive instruments, mainly short term receivables cash, cash equivalents and payables in currencies other than U.S. dollars. Substantially all of such balance is in the currencies set forth in the table below. The information is presented in U.S. dollars (in millions), which is our reporting currency.

Please see also the explanatory notes below the table.

|  | New<br>Israeli<br>Shekels | Japanese<br>Yen (3) | Total |
|--|---------------------------|---------------------|-------|
|  | (7.8)                     | 21.5                | 13.7  |

Explanatory notes:

1) Total balance sheet exposure relating to market risk sensitive instruments is the sum of the absolute figures (excess of assets over liabilities in the amount of 13.7 million). A devaluation of 5% of the U.S. dollar compared to the NIS would cause an

increase in expenses of approximately \$390,000. A devaluation of 5% of the U.S. dollar compared to the Japanese Yen would cause a decrease in expenses of approximately \$1.1 million.

2) The data presented in the table reflects the exposure after taking into account the effect of the “natural” hedging.

3) As of March 1, 2006, the balance sheet exposure in Japanese Yen was approximately \$22.5 million.

### **Interest Rate Risk Management**

As of December 31, 2005, we had \$33.6 million of cash and cash equivalents, \$11.7 million of short-term marketable securities, \$70.9 million of long-term marketable securities and \$1.5 million of long-term bank deposits. Our trading securities mature as follows: \$11.7 million in 2006, and \$70.9 million over a period from 2007 to 2009. Due to the relatively short-term maturities of the Company’s cash, deposits and securities portfolio, an immediate 10% change in the current interest rates (for example, from 5.0% to 5.5%) is not expected to have a material effect on its near-term financial condition or results of operations.

### **ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

Not applicable

## **PART II**

### **ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES**

None

### **ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS**

None

### **ITEM 15. CONTROLS AND PROCEDURES**

We performed an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of December 31, 2005. The evaluation was performed with the participation of our senior management and under the supervision and with the participation of our chief executive officer and chief financial officer. Based on this evaluation, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures are effective to alert them on a timely basis to material information required to be included in our periodic reports with the Securities and Exchange Commission.

In addition, there were no changes in our internal control over financial reporting that occurred during 2005 that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

**Item 16A. Audit Committee Financial Expert**

Our board of directors has determined that Mr. Motil qualifies as an “audit committee financial expert” as defined in Item 16A of Form 20-F and is “independent” as defined in the applicable regulations.

**Item 16B. Code of Ethics**

On March 30, 2004, our board of directors adopted our Code of Ethics, a code that applies to all of our officers, directors and employees. We will provide our Code of Ethics free of charge to any person who requests a copy of it. Such requests may be sent to our offices in 126 Yigal Alon Street, Tel Aviv, Israel, attention: Controller.

**Item 16C. Principal Accountant Fees and Services**

In the annual meeting held in June 2005, our shareholders re-appointed Kesselman & Kesselman, a member of PricewaterhouseCoopers International Limited, to serve as our independent auditors. These accountants billed the following fees to us for professional services in each of the last two fiscal years:

|                    | Year Ended December 31, |                  |
|--------------------|-------------------------|------------------|
|                    | <u>2005</u>             | <u>2004</u>      |
| Audit Fees         | \$112,000               | \$80,500         |
| Audit-Related Fees | 32,000                  | 18,000           |
| Tax Fees           | 43,000                  | 49,500           |
| All Other Fees     | --                      | --               |
| <b>Total</b>       | <u>\$187,000</u>        | <u>\$148,000</u> |

“Audit Fees” are the aggregate fees billed for the audit of our annual financial statements. This category also includes services that generally the independent accountant provides, such as statutory audits including audits required by the Office of the Chief Scientist and other Israeli government institutes, consents and assistance with and review of documents filed with the SEC. “Audit-Related Fees” are the aggregate fees billed for assurance and related services that are reasonably related to the performance of the audit and are not reported under Audit Fees. These fees include mainly accounting consultations regarding the accounting treatment of matters that occur in the regular course of business, implications of new accounting pronouncements and other accounting issues that occur from time to time. “Tax Fees” are the aggregate fees billed for professional services rendered for tax compliance, tax advice, other than in connection with the audit. Tax compliance involves preparation of original and amended tax returns, tax planning and tax advice.

Our Audit Committee has adopted a pre-approval policy for the engagement of our independent accountant to perform certain audit and non-audit services. Pursuant to this policy, which is designed to assure that such engagements do not impair the independence of

our auditors, the audit committee pre-approves annually a catalog of specific audit and non-audit services in the categories of Audit Service, Audit-Related Service, Tax Services and other services that may be performed by our independent accountants, and the maximum pre-approved fees that may be paid as compensation for each pre-approved service in those categories. Any proposed services exceeding the maximum pre-approved fees require specific approval by the Audit Committee.

None of the fees paid by us to our independent auditors during 2005 were for services approved pursuant to 2-01(c)(7)(i)(C) of Regulation S-K.

The Audit Committee may delegate its pre-approval authority to one or more of its members, subject to ratification by the entire Audit Committee.

Requests or applications to provide services that require specific approval by the Audit Committee are submitted to the Audit Committee by an executive officer of the Company, together with detailed back-up documentation and a statement as to whether, in the requesting executive officer's view, the provision of such services by the outside auditor would impair its independence.

#### **ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES.**

Not applicable.

#### **ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS**

None.

#### **ITEM 17. FINANCIAL STATEMENTS**

See Item 18.

#### **ITEM 18. FINANCIAL STATEMENTS**

Attached. See Item 19(a).

#### **ITEM 19. EXHIBITS**

- (a) The following consolidated financial statements and related auditors' report are filed as part of this Annual Report:

|   | Page |
|---|------|
| Table of Contents to 2005 Consolidated Financial Statements | F-1  |
| Report of Independent Registered Public Accounting Firm     | F-2  |
| <b>Consolidated Financial Statements:</b>                   |      |
| Balance Sheets at December 31, 2004 and 2005                | F-3  |
| Statements of Operations for the Years Ended                |      |
| December 31, 2003, 2004 and 2005                            | F-4  |
| Statements of Changes in Shareholders' Equity for the       |      |

|  |            |
|--|------------|
| Years Ended December 31, 2003, 2004 and 2005 | F-5        |
| Statements of Cash Flows for the Years Ended |            |
| December 31, 2003, 2004 and 2005             | F-6        |
| Notes to Financial Statements                | F-7 – F-33 |

(b) Exhibits:

The following exhibits are filed as part of this Annual Report:

| <u>Exhibit<br/>No.</u> | <u>Exhibit</u>   |
|------------------------|--|
| †1.1*                  | Memorandum of Association, as amended.   |
| 1.2 <sup>9</sup>       | Sixth Amended and Restated Articles of Association.  |
| 1.3 <sup>4</sup>       | Bonus Rights Agreement, dated as of November 20, 2001, between Orckit Communications Ltd. and American Stock Transfer & Trust Company, as Rights Agent.  |
| 1.4 <sup>1</sup>       | Amendment No. 1, dated as of February 5, 2003, to Bonus Rights Plan, dated as of November 20, 2001, between Orckit Communications Ltd. and American Stock Transfer & Trust Company, as Rights Agent. |
| 4.1 <sup>9</sup>       | Orckit Israeli Share Incentive Plan, as amended.   |
| †4.5 <sup>3</sup>      | Lease Agreement, dated September 28, 1999, between Orckit Communications Ltd. and Gush 7093 Helka 162 Ltd., private company # 51-058315-6.   |
| 4.6 <sup>5</sup>       | Corrigent Stock Option Plan (2001).  |
| 4.8 <sup>6</sup>       | Promissory Note dated March 30, 2004 made by Orckit Communications Ltd. to HSBC Bank USA   |
| 4.10 <sup>7</sup>      | Orckit Communications Ltd. 2003 Subsidiary Employee Share Incentive Plan.  |
| 4.11 <sup>8</sup>      | Letter of undertaking dated December 5, 2005 of Orckit Communications Ltd. to Bank Hapoalim B.M.   |
| 4.12 <sup>8</sup>      | Undertaking dated December 5, 2005 of Orckit Communications Ltd. to Bank Hapoalim B.M.   |
| 4.13 <sup>8</sup>      | Debenture dated December 5, 2005 of Orckit Communications Ltd. to Bank Hapoalim B.M.   |
| 4.14 <sup>8</sup>      | Debenture dated December 5, 2005 of Corrigent Systems Ltd. to Bank Hapoalim B.M  |
| 4.15*                  | Amended and Restated Employment Agreement, dated as of June 23, 2005, between Orckit Communications Ltd. and Eric Paneth.  |
| 4.16*                  | Amended and Restated Employment Agreement, dated as of June 23, 2005, between Orckit Communications Ltd. and Izhak Tamir.  |
| 8.1*                   | Subsidiaries of Orckit Communications Ltd.   |
| 12.1*                  | Certification of Principal Executive Officer pursuant to 17 CFR 240.13a-14(a), as adopted pursuant to §302 of the Sarbanes-Oxley Act   |



- 12.2\* Certification of Principal Financial Officer pursuant to 17 CFR 240.13a-14(a), as adopted pursuant to §302 of the Sarbanes-Oxley Act
- 13.1\* Certification of Principal Executive Officer pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act
- 13.2\* Certification of Principal Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to 906 of the Sarbanes-Oxley Act
- 15.1\* Consent of Kesselman & Kesselman, independent auditors of Orckit Communications Ltd.

---

† Translated in full or summary version; the original language version is on file with Orckit Communications Ltd. and is available upon request.

<sup>1</sup> Incorporated by reference to Orckit Communications Ltd.'s Registration Statement (File No. 000-28724) on Form 8-A/A.

<sup>2</sup> Incorporated by reference to Orckit Communications Ltd.'s Registration Statement (File No. 333-12178) on Form S-8.

<sup>3</sup> Incorporated by reference to Orckit Communications Ltd.'s Annual Report on Form 20-F for the fiscal year ended December 31, 2000.

<sup>4</sup> Incorporated by reference to Orckit Communications Ltd.'s Registration Statement (File No. 000-28724) on Form 8-A.

<sup>5</sup> Incorporated by reference to Orckit Communications Ltd.'s Annual Report on Form 20-F for the fiscal year ended December 31, 2001.

<sup>6</sup> Incorporated by reference to Orckit Communications Ltd.'s Annual Report on Form 20-F for the fiscal year ended December 31, 2003.

<sup>7</sup> Incorporated by reference to Orckit Communications Ltd.'s Annual Report on Form 20-F for the fiscal year ended December 31, 2002.

<sup>8</sup> Incorporated by reference to Orckit Communications Ltd.'s Annual Report on Form 20-F for the fiscal year ended December 31, 2004.

<sup>9</sup> Incorporated by reference to Orckit Communication Ltd.'s Registration Statement on Form S-8 (File No. 333-131991).

\* Filed herewith.

## **SIGNATURES**

The Registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

ORCKIT COMMUNICATIONS LTD.

By: /s/ Izhak Tamir

Name: Izhak Tamir

Title: President

Date: March 9, 2006

**ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

2005 CONSOLIDATED FINANCIAL STATEMENTS

**ORCKIT COMMUNICATIONS LTD.**  
(An Israeli Corporation)  
2005 CONSOLIDATED FINANCIAL STATEMENTS

TABLE OF CONTENTS

|  | <b>Page</b> |
|--|-------------|
| <b>REPORT OF INDEPENDENT REGISTERED PUBLIC<br/>ACCOUNTING FIRM</b> | 2           |
| <b>CONSOLIDATED FINANCIAL STATEMENTS:</b>                          |             |
| Balance sheets   | 3           |
| Statements of operations   | 4           |
| Statements of changes in shareholders' equity                      | 5           |
| Statements of cash flows   | 6           |
| Notes to financial statements                                      | 7-33        |

The amounts are stated in U.S. dollars (\$) in thousands.

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

## **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the shareholders of

### **ORCKIT COMMUNICATIONS LTD.**

We have audited the consolidated balance sheets of Orckit Communications Ltd. (the "Company") and its subsidiaries as of December 31, 2004 and 2005, and the related consolidated statements of operations, of changes in shareholders' equity and of cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's Board of Directors and management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States) and with auditing standards generally accepted in Israel, including those prescribed by the Israeli Auditors (Mode of Performance) Regulations, 1973. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Company's Board of Directors and management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2004 and 2005 and the consolidated results of their operations, the changes in shareholders' equity and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States.

As discussed in note 1p to the consolidated financial statements, effective July 1, 2005, the Company changed its method for accounting for stock-based compensation to employees, to conform with Statement of Financial Accounting Standard No. 123 (Revised).

Tel Aviv, Israel  
March 12, 2006

/s/ Kesselman & Kesselman  
Certified Public Accountants (Isr.)

**ORCKIT COMMUNICATIONS LTD.**  
(An Israeli Corporation)  
**CONSOLIDATED BALANCE SHEETS**  
(U.S. dollars in thousands)

|  | <b>December 31</b>       |                         |
|--|--------------------------|-------------------------|
|  | <b>2004</b>              | <b>2005</b>             |
| <b>A s s e t s</b>   |                          |                         |
| <b>CURRENT ASSETS:</b>   |                          |                         |
| Cash and cash equivalents  | \$ 26,615                | \$33,647                |
| Marketable securities (note 8a)  | 25,354                   | 11,732                  |
| Bank deposits (note 8d)  | 6,811                    | -                       |
| Trade receivables (note 8b)  | 54,814                   | 702                     |
| Other receivables (note 8c)  | 1,492                    | 1,520                   |
| Inventories  | 5,533                    | 3,330                   |
| T o t a l current assets   | <u>120,619</u>           | <u>50,931</u>           |
| <b>LONG-TERM INVESTMENTS:</b>  |                          |                         |
| Marketable securities (note 8a)  | 18,441                   | 70,881                  |
| Other (notes 1c, 3a, 8d)   | 5,255                    | 4,394                   |
|  | <u>23,696</u>            | <u>75,275</u>           |
| <b>PROPERTY AND EQUIPMENT</b> - net (note 2):  | <u>4,211</u>             | <u>3,740</u>            |
| T o t a l assets   | <u><u>\$ 148,526</u></u> | <u><u>\$129,946</u></u> |
| <b>Liabilities and shareholders' equity</b>  |                          |                         |
| <b>CURRENT LIABILITIES:</b>  |                          |                         |
| Bank loans (note 8e)   | \$ 31,000                | -                       |
| Trade payables   | 25,824                   | 9,282                   |
| Accrued expenses and other payables (note 8f)  | 11,645                   | 19,173                  |
| Deferred income (note 8g)  | 35,662                   | 28,736                  |
| T o t a l current liabilities  | <u>104,131</u>           | <u>57,191</u>           |
| <b>LONG-TERM LIABILITIES -</b>   |                          |                         |
| Accrued severance pay (note 3)   | 4,131                    | 3,689                   |
| <b>COMMITMENTS AND CONTINGENT LIABILITY</b> (note 4)   |                          |                         |
| T o t a l liabilities  | <u>108,262</u>           | <u>60,880</u>           |
| <b>SHAREHOLDERS' EQUITY</b> (note 5):  |                          |                         |
| Share capital - ordinary shares of no par value and paid-in capital<br>(authorized: December 31, 2004 - 30,000,000 shares;<br>December 31, 2005- 50,000,000 shares;<br>issued: December 31, 2004 - 15,827,985 shares; December 31, 2005 - 17,274,270 shares;<br>outstanding: December 31, 2004 - 13,183,146 shares;<br>December 31, 2005 - 14,629,431 shares)* | 325,656                  | 332,015                 |
| Deferred compensation  | (217)                    |                         |
| Accumulated deficit  | (279,531)                | (257,305)               |
| Treasury shares, at cost (2,644,839 ordinary shares)*  | (5,644)                  | (5,644)                 |
| T o t a l shareholders' equity   | <u>40,264</u>            | <u>69,066</u>           |
| T o t a l liabilities and shareholders' equity   | <u><u>\$ 148,526</u></u> | <u><u>\$129,946</u></u> |

\* After giving retroactive effect to the three-for-one stock split in April 2005, see note 5a(2).

**The accompanying notes are an integral part of the consolidated financial statements.**

**ORCKIT COMMUNICATIONS LTD.**  
(An Israeli Corporation)  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(U.S. dollars in thousands, except per share data)

|   | <b>Year ended December 31</b> |                    |                  |
|---|-------------------------------|--------------------|------------------|
|   | <b>2003</b>                   | <b>2004</b>        | <b>2005</b>      |
| <b>REVENUES</b> (note 8h)   | \$ 1,683                      | \$11,276           | \$101,247        |
| <b>COST OF REVENUES</b> (note 8i)                                     | 748                           | 5,901              | 51,872           |
| <b>GROSS PROFIT</b>   | 935                           | 5,375              | 49,375           |
| <b>RESEARCH AND DEVELOPMENT EXPENSES</b> - net (note 8j)              | 15,003                        | 15,043             | 16,147           |
| <b>SELLING, GENERAL AND ADMINISTRATIVE EXPENSES</b>                   | 12,656                        | 11,993             | 16,086           |
| <b>OPERATING INCOME (LOSS)</b>  | (26,724)                      | (21,661)           | 17,142           |
| <b>FINANCIAL INCOME</b> - net (note 8k)                               | 5,108                         | 1,529              | 2,636            |
| <b>OTHER INCOME</b> (note 8l)   |                               |                    | 2,448            |
| <b>NET INCOME (LOSS)</b>  | <u>\$ (21,616)</u>            | <u>\$ (20,132)</u> | <u>\$ 22,226</u> |
| <b>EARNINGS (LOSS) PER SHARE (“EPS”)</b> *(note 8n):                  |                               |                    |                  |
| Basic   | <u>\$ (1.66)</u>              | <u>\$ (1.54)</u>   | <u>\$1.59</u>    |
| Diluted   | <u>\$ (1.66)</u>              | <u>\$ (1.54)</u>   | <u>\$1.30</u>    |
| <b>WEIGHTED AVERAGE NUMBER OF SHARES USED IN COMPUTATION OF EPS*:</b> |                               |                    |                  |
| Basic   | <u>12,996</u>                 | <u>13,074</u>      | <u>13,984</u>    |
| Diluted   | <u>12,996</u>                 | <u>13,074</u>      | <u>16,345</u>    |

\* After giving retroactive effect to the three-for-one stock split in April 2005, see note 5a(2).

**The accompanying notes are an integral part of the consolidated financial statements.**

**ORCKIT COMMUNICATIONS LTD.**  
(An Israeli Corporation)  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
(U.S. dollars in thousands)

|   | <u>Share capital</u>                             |               | <u>Additional<br/>paid-in<br/>capital</u> | <u>Deferred<br/>Compensation</u> | <u>Accumulated<br/>deficit</u> | <u>Treasury<br/>shares</u> | <u>Total<br/>shareholders'<br/>equity</u> |
|---|--|---------------|---|----------------------------------|--------------------------------|----------------------------|---|
|   | <u>Number of<br/>shares *<br/>(in thousands)</u> | <u>Amount</u> |   |                                  |                                |                            |   |
| <b>BALANCE AT JANUARY 1, 2003</b>   | 14,940   | \$-,-         | \$322,227                                 | \$(2,023)                        | \$(237,783)                    |                            | \$82,421                                  |
| <b>CHANGES DURING 2003:</b>   |  |               |   |                                  |                                |                            |   |
| Net loss  |  |               |   |                                  | (21,616)                       |                            | (21,616)                                  |
| Issuance of shares to employees, exchangeable to options, see note 5a(5)  | 1,800  |               | 2,496                                     | (2,496)                          |                                |                            | -,-                                       |
| Exercise of options granted to employees  | 711  |               | 112                                       |                                  |                                |                            | 112                                       |
| Acquisition of treasury stock   | (2,645)  |               |   |                                  |                                | (5,644)                    | (5,644)                                   |
| Exchange of shares into options, see note 5a(5)   | (1,800)  |               | 1,284                                     | (1,284)                          |                                |                            | -,-                                       |
| Amortization of deferred compensation related to employee<br>stock option grants, net of elimination of paid-in capital in respect of<br>employee stock option grants due to forfeiture |  |               | (607)                                     | 3,006                            |                                |                            | 2,399                                     |
| <b>BALANCE AT DECEMBER 31, 2003</b>   | 13,006   | -,-           | 325,512                                   | (2,797)                          | (259,399)                      | (5,644)                    | 57,672                                    |
| <b>CHANGES DURING 2004:</b>   |  |               |   |                                  |                                |                            |   |
| Net loss  |  |               |   |                                  | (20,132)                       |                            | (20,132)                                  |
| Exercise of options granted to employees  | 177  |               | 144                                       |                                  |                                |                            | 144                                       |
| Amortization of deferred compensation related to employee<br>stock option grants  |  |               |   | 2,580                            |                                |                            | 2,580                                     |
| <b>BALANCE AT DECEMBER 31, 2004</b>   | 13,183   | -,-           | 325,656                                   | (217)                            | (279,531)                      | (5,644)                    | 40,264                                    |
| <b>CHANGES DURING 2005:</b>   |  |               |   |                                  |                                |                            |   |
| Net income  |  |               |   |                                  | 22,226                         |                            | 22,226                                    |
| Deferred compensation related to employee stock option grants   |  |               | 46  | (46)                             |                                |                            | -,-                                       |
| Exercise of options granted to employees  | 1,446  |               | 5,960                                     |                                  |                                |                            | 5,960                                     |
| Compensation related to employee stock option grants  |  |               | 353                                       | 263                              |                                |                            | 616                                       |
| <b>BALANCE AT DECEMBER 31, 2005</b>   | 14,629   | \$-,-         | \$332,015                                 | \$-,-                            | \$(257,305)                    | \$ (5,644)                 | \$69,066                                  |

\* The figures prior to January 1, 2005 are after giving retroactive effect to three-for-one stock split in April 2005, see note 5a(2).

**The accompanying notes are an integral part of the consolidated financial statements.**



**ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(U.S. dollars in thousands)

|  | <b>Year ended December 31</b> |             |             |
|--|-------------------------------|-------------|-------------|
|  | <b>2003</b>                   | <b>2004</b> | <b>2005</b> |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                               |             |             |
| Net income (loss) for the year   | \$ (21,616)                   | \$ (20,132) | \$22,226    |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |                               |             |             |
| Depreciation and amortization:   |                               |             |             |
| Property and equipment   | 3,039                         | 1,781       | 2,390       |
| Deferred charges   | 139                           | 147         | -, -        |
| Impairment of property and equipment   | 1,800                         | -, -        | -, -        |
| Trading marketable securities, net   | 4,623                         | 10,937      | 9,594       |
| Gain from early extinguishment of convertible subordinated notes                                   | (3,125)                       | -, -        | -, -        |
| Capital gain from the sale of long-term investment   | -, -                          | -, -        | (2,448)     |
| Interest and premium amortization on long-term investments   | (2,019)                       | 780         | 350         |
| Increase (decrease) in accrued severance pay   | 170                           | 696         | (442)       |
| Amortization of deferred compensation related to employee stock option grants, net                 | 2,399                         | 2,580       | 616         |
| Changes in operating assets and liabilities:   |                               |             |             |
| Decrease (increase) in trade receivables and other receivables                                     | 1,486                         | (54,563)    | 54,084      |
| Increase (decrease) in trade payables, accrued expenses and other payables                         | (2,999)                       | 28,483      | (9,014)     |
| Increase (decrease) in deferred income   | -, -                          | 35,662      | (6,926)     |
| Decrease (increase) in inventories   | -, -                          | (5,433)     | 2,203       |
| Net cash provided by (used in) operating activities  | (16,103)                      | 938         | 72,633      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                               |             |             |
| Purchase of property and equipment   | (862)                         | (3,899)     | (1,919)     |
| Bank deposits, net   | 10,272                        | (280)       | 5,311       |
| Change in funds in respect of accrued severance pay, net   | (557)                         | (641)       | 454         |
| Investment in (proceeds from) long term investments  | (499)                         | (1,407)     | 4,355       |
| Collection of long-term loan granted   | 7,000                         | -, -        | -, -        |
| Maturities of marketable securities held to maturity   | 26,310                        | 9,950       | 15,083      |
| Purchase of marketable securities held to maturity   | (1,667)                       | (3,000)     | (63,845)    |
| Net cash provided by (used in) investing activities  | 39,997                        | 723         | (40,561)    |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |                               |             |             |
| Short-term bank loan, net  | -, -                          | 15,000      | (15,000)    |
| Long-term bank loan received (repaid)  | -, -                          | 16,000      | (16,000)    |
| Cost of acquisition of treasury shares   | (5,644)                       | -, -        | -, -        |
| Exercise of options granted to employees   | 112                           | 144         | 5,960       |
| Early extinguishment of convertible subordinated notes   | (18,479)                      | (16,238)    | -, -        |
| Net cash provided by (used in) financing activities  | (24,011)                      | 14,906      | (25,040)    |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>  | (117)                         | 16,567      | 7,032       |
| <b>BALANCE OF CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR</b>                                   | 10,165                        | 10,048      | 26,615      |
| <b>BALANCE OF CASH AND CASH EQUIVALENTS AT END OF YEAR</b>   | \$ 10,048                     | \$ 26,615   | \$33,647    |
| <b>SUPPLEMENTARY DISCLOSURE OF CASH FLOW INFORMATION - CASH PAID DURING THE YEAR FOR:</b>          |                               |             |             |
| Interest paid  | \$ 1,077                      | \$ 674      | \$349       |
| Advances paid to income tax authorities  | \$ 95                         | \$ 62       | \$44        |

**The accompanying notes are an integral part of the consolidated financial statements.**

## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES:**

##### **a. General:**

##### *1) Nature of operations*

Orckit Communications Ltd. ("Orckit") and its subsidiaries (together - the "Company") is an Israeli corporation engaged in the design, development, manufacture and marketing of advanced telecom equipment, targeting high capacity broadband services. In 2004 and 2005, substantially all of the Company's revenues were derived from the sale of the CM-100 product line, which is a transport telecommunication equipment targeting high capacity packetized metropolitan networks. In 2003, substantially all of the Company's revenues were derived from the sale of ADSL (Asymmetric Digital Subscriber Line) broadband equipment for access networks. The Company does not expect to have additional revenues from the ADSL broadband equipment line.

The CM-100 product line, which since 2004 has generated substantially all of the Company's revenues, was initiated and funded by Orckit as a technology project through its subsidiary, Corrigent Systems Inc. ("Corrigent").

During 2004, the Company entered into a distribution agreement relating to the deployment in Japan of its CM-100 products. During 2005, the Company signed follow-on agreements addressing the same opportunity. Under the distribution agreements and related terms, the Company is obligated to provide warranty and support services with respect to products purchased. Purchases of products are made pursuant to purchase orders. The substantial majority of the Company's revenues in 2004 and 2005 related to these agreements, see note 8h.

##### *2) Functional currency*

The currency of the primary economic environment in which the operations of the Company and each of its subsidiaries are conducted is the U.S. dollar ("dollar" or "\$"), since most purchases of materials and components are made in dollars, most of the financing activities of the Company are in dollars and most of its assets are denominated in dollars.

Transactions and balances originally denominated in dollars are presented in their original amounts. Balances in non-dollar currencies are translated into dollars using historical and current exchange rates for non-monetary and monetary balances, respectively. For non-dollar transactions reflected in the statements of operations, the exchange rates at transaction dates are used. Depreciation and amortization and changes in inventories derived from non-monetary items are based on historical exchange rates. The resulting currency transaction gains or losses are carried to financial income or expenses, as appropriate.

## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES:**

3) *Accounting principles*

The consolidated financial statements are prepared in accordance with generally accepted accounting principles ("GAAP") in the United States.

4) *Use of estimates in the preparation of financial statements*

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reported years. Actual results could differ from those estimates.

**b. Principles of consolidation**

The consolidated financial statements include the financial statements of the Company and its subsidiaries.

Intercompany balances and transactions have been eliminated.

**c. Marketable securities and other investments:**

1) *Marketable securities*

Marketable securities classified as trading securities are recorded at fair market value, with unrealized gains and losses included in financial income or expenses.

Debt securities that the Company plans to hold to maturity, and based on its assessment has the ability to hold to maturity, are classified as "held to maturity" and are recorded at amortized cost. The premium or discount is amortized over the period to maturity and included in financial income or expenses.

2) *Other investments*

These investments include severance pay funds, long-term bank deposits and other long-term investments.

## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES:**

##### **d. Inventories**

Inventories, are valued at the lower of cost or market. Cost is determined as follows:

Raw materials and supplies - on moving average.

Finished products - on basis of production costs:

Raw materials and supplies - on moving average basis.

Labor and overhead component - on average basis.

Cost of finished products that are manufactured completely by subcontractors are determined based on the specific cost of each product.

##### **e. Property and equipment:**

- 1) These assets are stated at cost.
- 2) The assets are depreciated by the straight-line method on the basis of their estimated useful life, as follows:

|                                   | <u>Years</u> |
|-----------------------------------|--------------|
| Computers, software and equipment | 2-5          |
| Office furniture and equipment    | 6-10         |

Leasehold improvements are amortized by the straight-line method, over the term of the lease, or over the estimated useful life of the improvements - whichever is shorter.

##### **f. Impairment in value of property and equipment**

Long-lived assets, held and used by the Company are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Under FAS 144, if the sum of the expected future cash flows (undiscounted and without interest charges) of the long-lived assets is less than the carrying amount of such assets, an impairment loss would be recognized, and the assets would be written down to their estimated fair values.

##### **g. Treasury shares**

Company's shares purchased by the Company are presented as a reduction of shareholders' equity, at their cost to the Company.

## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (continued):**

##### **h. Revenue recognition**

Revenues from sales of products are recognized when delivery occurs and title passes to the customer, provided that appropriate signed documentation of an arrangement exists, the fee is fixed or determinable and collectibility is reasonably assured.

EITF Issue No. 03-5, "Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software" affirms that the revenue recognition guidance in Statement of Position 97-2 ("SOP 97-2") also applies to non-software deliverables, such as computer hardware, if the software is essential to the functionality of the non-software deliverables. According to SOP 97-2, revenues from sales of software products are recognized when, in addition to the criteria mentioned above, vendor-specific objective evidence ("VSOE") of fair value for undelivered elements exists. VSOE is typically based on the price charged when an element is sold separately or, if an element is not sold separately, on the price established by authorized management, if it is probable that the price, once established, will not change before market introduction.

The Company granted customer post-contract hardware and software support services ("PCS") in connection with sales in 2004 and 2005. Accordingly, where VSOE of the fair value of PCS could not be determined, the Company recognizes revenue for the entire arrangement ratably over the term of the PCS.

The Company does not, in the normal course of business, provide a right of return to its customers. In multiple element arrangements where VSOE of undelivered elements does not exist, the Company recognizes revenues upon delivery of those undelivered elements.

The deferred income balance as of December 31, 2004 and 2005 equals the amount of revenues that were invoiced and due on delivery, but deferred, less applicable product, PCS and warranty costs. See also note 8g.

The cost of the delivered products are offset from deferred revenues and not presented as inventory – finished goods, since the title has passed to the customer upon delivery.

##### **i. Accrual for legal costs**

In instances where legal costs are expected to be incurred in connection with a loss contingency, the Company accrues for legal costs that are reasonably estimable.

##### **j. Provision for warranty**

The Company grants warranty servicing for products sold. The Company provides for such warranty at the time revenues from the related sales are recognized (see also 1h. above). The annual provision is calculated as a percentage of the sales, based on historical experience.

## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (continued):**

**k. Research and development expenses**

Research and development expenses, which consist mainly of labor costs, are charged to income as incurred. Government grants received for development of projects are recognized as a reduction of the expenses.

**l. Allowance for doubtful accounts**

The allowance in respect of trade receivables has been determined for specific debts doubtful of collection. See also note 7c.

**m. Cash equivalents**

The Company considers all highly liquid investments, which include short-term bank deposits (up to three months from date of deposit) that are not restricted as to withdrawal or use, to be cash equivalents.

**n. Earnings (loss) per share**

Basic earnings per share is computed by dividing net income (loss) by the weighted average number of shares outstanding during each year, net of treasury and restricted shares.

In computing diluted earning per share, the potential dilutive effect of outstanding stock options was taken into account using the treasury stock method. See also note 8n.

**o. Comprehensive income**

The Company has no comprehensive income components other than net income (loss).

**p. Stock based compensation**

Until June 30, 2005, the Company accounted for employee stock based compensation in accordance with Accounting Principles Board Opinion ("APB") No. 25 "Accounting for Stock Issued to Employees" ("APB 25") and related interpretations. On July 1, 2005 the Company adopted FAS 123 (R) under which compensation cost for employee stock option plans is measured using the fair value-based method

# ORCKIT COMMUNICATIONS LTD.

(An Israeli Corporation)

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (continued):

as defined in FAS 123 (R). Under APB 25, compensation cost for employee stock option plans was measured using the intrinsic value based method of accounting (see also note 5a(5)). The Company has applied the modified prospective application transition method, as permitted by FAS 123(R). Accordingly, commencing July 1, 2005, compensation cost for the unvested portion of previously granted awards that remained outstanding on that date, are recognized on a going forward basis as the related services are rendered, based on the award's grant date fair value as previously calculated for the pro forma disclosure under FAS 123 with respect to those outstanding awards.

In accordance with Statement of Financial Accounting Standards ("FAS") No. 123 of the Financial Accounting Standards Board of the United States ("FASB") - "Accounting for Stock-Based Compensation", the Company discloses pro forma data, for periods prior to the adoption of FAS 123 (R), assuming the Company had accounted for employee stock option grants using the fair value-based method defined in FAS 123.

The following table illustrates the effect on net income (loss) and earnings (loss) per share assuming the Company had applied the fair value recognition provisions of FAS 123 to its stock-based employee compensation through June 30, 2005:

|  | Year ended December 31                  |                    |                 |
|--|---|--------------------|-----------------|
|  | 2003                                    | 2004               | 2005            |
|  | In thousands, except for per share data |                    |                 |
| Net income (loss), as reported   | \$ (21,616)                             | \$ (20,132)        | \$22,226        |
| Add: stock based employee compensation expense, included in reported net income (loss) (2005 – for the period prior to July 1, see above)                  | 2,399                                   | 2,580              | 263             |
| Deduct: stock based employee compensation expense determined under the fair value method for all awards (2005 – for the period prior to July 1, see above) | (3,177)                                 | (3,027)            | (5,147)         |
| Pro forma net income (loss)  | <u>\$ (22,394)</u>                      | <u>\$ (20,579)</u> | <u>\$17,342</u> |
| Earnings (loss) per share *:   |   |                    |                 |
| Basic - as reported  | \$ (1.66)                               | \$ (1.54)          | \$1.59          |
| Basic - pro forma  | \$ (1.72)                               | \$ (1.57)          | \$1.24          |
| Diluted - as reported  | \$ (1.66)                               | \$ (1.54)          | \$1.30          |
| Diluted - pro forma  | \$ (1.72)                               | \$ (1.57)          | \$1.00          |

\* Earnings (loss) per share data for 2003 and 2004 are calculated after giving retroactive effect to the three-for-one share split see note 5a(2).

## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

#### **NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (continued):**

**q. Deferred income taxes**

Deferred taxes are determined utilizing the asset and liability method, based on the estimated future tax effects differences between the financial accounting and tax bases of assets and liabilities under the applicable tax laws. Valuation allowances are included in respect of deferred tax assets when it is more likely than not that no such assets will be realized.

Taxes which would apply in the event of disposal of investments in non-Israeli subsidiaries have not been taken into account in computing the deferred taxes, as it is the Company's policy to hold these investments, and not to realize them.

**r. Shipping and handling fees and costs**

Shipping and handling costs are classified as a component of cost of revenues.

**s. Recently issued accounting pronouncements:**

*FAS 151 Inventory Costs - an amendment of ARB 43, Chapter 4*

In November 2004, the FASB issued FAS No. 151, "Inventory Costs - an amendment of ARB 43, Chapter 4" (FAS 151). This Statement amends the guidance in ARB No. 43, Chapter 4, "Inventory Pricing", to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material, requiring that these items be recognized as current-period charges. In addition, this Statement requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This Statement will be effective for inventory costs incurred during fiscal years beginning after June 15, 2005 (January 1, 2006 for the Company); however earlier application of FAS 151 is permitted. The provisions of this Statement shall be applied prospectively. The Company does not expect this Statement to have a material effect on its financial statements or its results of operations.

*FAS 154 - Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and FASB Statement No. 3*



## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

#### **NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (continued):**

In June 2005, the Financial Accounting Standards Board issued FAS No. 154, "Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and FASB Statement No. 3". This Statement generally requires retrospective application of changes in accounting principles to financial statements in respect of prior periods. Previously, Opinion No. 20 required that most voluntary changes in accounting principle were recognized by including the cumulative effect of changing to the new accounting principle in net income of the period of the change. FAS 154 applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual circumstance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. This Statement shall be effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 (Year ending December 31, 2006 for the Company). The Company does not expect the adoption of this statement to have a material impact on its results of operations, financial position or cash flow.

#### **NOTE 2 - PROPERTY AND EQUIPMENT**

Composition of assets, grouped by major classification, is as follows:

|   | <b>December 31</b>  |                 |
|---|---------------------|-----------------|
|   | <b>2004</b>         | <b>2005</b>     |
|   | <b>In thousands</b> |                 |
| Cost:   |                     |                 |
| Computers, software and equipment                   | \$ 20,788           | \$22,674        |
| Office furniture and equipment                      | 1,407               | 1,408           |
| Leasehold improvements                              | 2,205               | 2,235           |
|   | <u>\$ 24,400</u>    | <u>\$26,317</u> |
| Less - accumulated depreciation<br>and amortization | 20,189              | 22,577          |
|   | <u>\$ 4,211</u>     | <u>\$3,740</u>  |

Depreciation and amortization expenses totaled \$ 3,039,000, \$ 1,781,000 and \$2,390,000 in the years ended December 31, 2003, 2004 and 2005, respectively.

## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

#### **NOTE 3 - SEVERANCE PAY:**

- a.** Israeli labor laws and agreements require payment of severance pay upon dismissal of an employee or upon termination of employment in certain other circumstances. The Company's severance pay liability to its employees, mainly based upon length of service and the latest monthly salary (one month's salary for each year worked) is reflected by a balance sheet accrual under "accrued severance pay". The Company records the liability as if it were payable at each balance sheet date on an undiscounted basis.

The liability is partly funded by purchase of insurance policies or pension funds and by deposit of funds in dedicated deposits. The amounts funded are included in the balance sheet under "long term investments - other". The policies are the Company's assets and under labor agreements, subject to certain limitations, they may be transferred to the ownership of the beneficiary employees. The amounts funded as of December 31, 2004 and 2005 are approximately \$ 3,348,000 and \$2,894,000, respectively.

In substantially all of the Company's current agreements, the Company makes regular deposits with the insurance companies in order to secure the employee rights upon retirement. Thus, in accordance with these agreements, the Company is fully relieved from any severance pay liability. The liability accrued in respect of these employees and the amounts funded, as of the agreement date, are not reflected in the balance sheets, since the amounts funded are not under the control and management of the Company.

The Company accounts for the severance pay liability as contemplated by EITF 88-1 "Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan" and, accordingly, records the obligation on an undiscounted basis as if it was payable at each balance sheet date.

- b.** The amounts of pension and severance pay expense were \$ 776,000, \$905,000 and \$1,120,000 for the years ended December 31, 2003, 2004 and 2005, respectively, of which \$ 15,000, \$300,000 and \$800,000 in 2003, 2004 and 2005, respectively, were in respect of the insurance policies that were expensed but not reflected in the balance sheet as described above.
- c.** The Company expects to contribute approximately \$ 1.3 million in 2006 to the insurance companies and pension funds, in respect of its severance pay liabilities expected for 2006 operations.
- d.** The Company does not expect to pay any future benefits to its employees upon their normal retirement age in the years 2006 through 2015 since there are no current employees who reach retirement age until year 2015.

The statement in item d above does not include amounts that might be paid to employees who will cease working with the Company before their normal retirement age.

## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

#### **NOTE 4 – COMMITMENTS AND CONTINGENT LIABILITY:**

##### **a. Royalty commitment**

The Company is committed to pay royalties to the Government of Israel on proceeds from sales of products whose research and development was funded, in part, by Government grants. At the time the grants were received, successful development of the related projects was not assured.

In the case of failure of a project that was partly financed by royalty-bearing Government participations, the Company is not obligated to pay any royalties to the Government.

The royalty rate, based on the sales of products resulting from funded research and development projects, was fixed at 3% during the first three years and 4-5% thereafter. Royalties are paid biannually and are payable up to 100% of the amount of such grants, with the addition of annual interest based on LIBOR. Royalty expenses are classified as part of cost of sales.

In the event that any of the manufacturing rights or technology is transferred out of Israel, subject to the approval of the Government of Israel, the Company would be required to pay royalties at a higher rate and an increased aggregate payback amount in the range of 120% to 300% of the grants received, based on the applicable project.

The total aggregate contingent liability of the Company in respect of royalties to the Government of Israel at December 31, 2005 was approximately \$6.6 million.

##### **b. Lease commitments**

The Company has entered into several operating lease agreements with respect to its offices. The main agreement is for the premises it uses in Israel. The Company has an option to terminate this lease agreement with a six-month notice in advance.

The projected annual rental payments for 2006, at rates in effect at December 31, 2005, are approximately \$1 million.

Lease expenses totaled \$ 803,000, \$785,000 and \$935,000 in the years ended December 31, 2003, 2004 and 2005, respectively.

## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

#### **NOTE 4 – COMMITMENTS AND CONTINGENT LIABILITY (continued):**

##### **c. Employment agreement**

In 1993, the Company entered into an employment agreement with each of the Company's CEO and President, who serve as Chairman of the Board of Directors and as a director, respectively (hereafter - the Directors). These agreements were extended several times without modification of the employment terms. The original agreement of each provided, among other things, for an annual bonus based on specified percentages of the Company's pre-tax income for the applicable year. No bonus was paid under this provision in 2003 or 2004. Upon analyzing the expected results for 2005, the Company concluded that the bonus based on pre-tax income for 2005 was going to be significant. With the consent of the Directors, the Company reduced the rate of the annual bonus based on pre-tax income and eliminated any such bonus for 2005 with respect to the first \$15.0 million of pre-tax income, as detailed below. The related bonus for each of the Directors would have been approximately \$1.1 million under the original agreement. Pursuant to the amended agreement, the related bonus for each of them was approximately \$217,000.

Pursuant to the amended employment of each of the Directors, each is entitled to an annual bonus based on results of operations for 2006 and each subsequent fiscal year equal to the sum of: (i) 1.0% of the first \$5.0 million of pre-tax income; (ii) 2.0% of pre-tax income between \$5.0 million and \$15.0 million; (iii) 3.0% of pre-tax income in excess of \$15.0 million; and (iv) 0.25% of revenues. However, for 2005, the bonus with respect to pre-tax income was payable only to the extent that the amount of pre-tax income exceeded \$15.0 million and then only to the extent of 3% of the excess. The rate of the bonus based on revenues, equal to 0.25% of the Company's revenues in each year, was not modified from the original agreement.

The original employment agreement of each of the Directors provided for a base salary payable in NIS, linked to the Israeli consumer price index, and customary employee benefits, such as managers' insurance and employment fund, which are grossed up to cover income tax liabilities, and a company car (or, at the employee's election, a cash payment added to the base salary in lieu of a car). Under the original employment agreement, the base salary and employee benefits increased by 15% per year. Accordingly, the base salary and employee benefits for each of Mr. Paneth and Mr. Tamir for 2005 would have been approximately \$630,000 (based on the exchange rate on March 31, 2005 of NIS 4.361 to one U.S. dollar).

In the amended employment agreements, the Company has reduced the base salary and employee benefits for 2005 of each of them, effective January 1, 2005, to the amount of NIS equal to \$570,000 (based on the exchange rate on March 31, 2005 of NIS 4.361 to one U.S. dollar) and reduced the annual percentage used to adjust base salary from 15% to 5%, but subject to adjustments pursuant to the Israeli consumer price index beginning in 2006. The dollar equivalent of the salary will fluctuate in accordance with fluctuations of the exchange rate of the NIS to the U.S. dollar. There also may be adjustments as a result of changes in tax, national insurance and other applicable laws from time to time.

## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

#### **NOTE 4 – COMMITMENTS AND CONTINGENT LIABILITY (continued):**

The employment agreement of each of the Directors is not for a specific term and requires six months advance notice by either us or the employee to terminate the employment agreement. Upon termination of the employment for any reason by either the Company or by the one of the Directors, the Company would make a severance payment equal to the Director's last monthly salary multiplied by the number of years that he worked for us. According to Israeli labor law, this is the amount of severance generally payable to any employee who is terminated by his employer. In the event that the employment of any of the Directors is terminated under circumstances in which the Company would not be required to pay the full amount of such severance pursuant to Israeli labor law, his non-competition period will be extended from one to two years in consideration for receiving the additional

amount. Since the Company reserves for these severance payments in the financial statements on an ongoing basis, as required by generally accepted accounting principles, the Company does not expect to recognize an additional accounting expense for these severance payments upon the termination of employment. Neither employment agreement provides for any other payments or "golden parachutes" upon termination of employment. The amendments to the employment agreements with the Directors were approved by the shareholders at the Annual General Meeting held on June 23, 2005.

#### **d. Contingent liability**

The Company is subject to commercial litigation regarding the alleged breach of a non-disclosure agreement. The Company can not assess the amount of expenses that it could be liable to pay as a result of resolving these claims. The Company has provided for such claims; see also note 1i.

#### **NOTE 5– SHAREHOLDERS' EQUITY:**

##### **a. Share capital:**

- 1) The Company's ordinary shares are traded in the United States on the Nasdaq National Market, under the symbol "ORCT". Beginning in April 2002, the Company's ordinary shares were also traded on the Tel-Aviv Stock Exchange in Israel.

##### *2) Stock split*

On February 27, 2005, the Company's board of directors approved a three-for-one stock split, effected in the form of a 200% stock dividend, as of April 5, 2005. All share and per share data included in these financial statements have been retroactively adjusted to reflect the stock split. The number of options and their exercise prices were also adjusted as a result of the stock split.

## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

#### **NOTE 5– SHAREHOLDERS’ EQUITY (continued):**

##### *3) Treasury shares*

During 2003, the Company acquired 2,644,839 ordinary shares of the Company at a cost of \$5,644,000.

##### *4) Exercise of options*

Under the Employee Share Option Plan (see note 5b. below), options to purchase 712,104, 178,206 and 1,446,285 ordinary shares were exercised in the years ended December 31, 2003, 2004 and 2005, respectively.

- 5) In January 2003, the Company adopted the “Orckit Communications Ltd. 2003 Subsidiary Employee Share Incentive Plan” (the “2003 Plan”). Pursuant to the 2003 Plan and subject to applicable laws and regulations, the Company issued, for no consideration, 1,800,000 of its ordinary shares to employees of its subsidiaries, excluding directors of the Company. The shares were duly authorized and validly issued, fully paid and nonassessable. The shares were deposited with a trustee and were to vest after a period of 3 years. According to the 2003 Plan, the shares issued may be exchanged at any time by the Company, in its discretion, for a number of options to purchase shares of the applicable subsidiary.

During 2003, 180,000 shares were forfeited and 1,620,000 shares were exchanged to options to purchase shares of subsidiaries. Significantly all of these exchanged options were subject to vesting through January 2005. The accounting treatment applied in respect of the plan is variable accounting until the exchange occurred. Accordingly, compensation in respect of the grant of the shares was measured according to the share price of Orckit and updated to reflect the changes in the share price through the date of the exchange. The compensation measured totaled approximately \$ 3.8 million, which is to be amortized over the vesting period of the options granted, and of which approximately \$1.3 million, \$2.3 million and \$200,000 were amortized in 2003, 2004 and 2005, respectively. Upon the exchange, the plan became a fixed plan and the compensation was fixed according to the share price of Orckit on that date. At the date of exchange, the intrinsic value of options to purchase shares of subsidiaries granted to employees was zero.

**ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

**NOTE 5– SHAREHOLDERS' EQUITY (continued):****b. Employee Share Option Plan**

Commencing July 1, 2005, the Company early adopted FAS 123(R), see also note 1p. The Company recorded compensation costs of \$ 2,399,000, \$ 2,580,000, and \$ 616,000 for the years ended December 31, 2003, 2004, and 2005, respectively. The compensation cost for the year ended December 31, 2005 includes \$353,000 which was recorded after July 1, 2005, according to FAS 123(R). No income tax benefit was recognized in the income statement for the options granted.

In February 1994, the Company's Board of Directors approved an Employee Share Option Plan (the "Plan"). The total aggregate number of shares authorized for which options could be granted under the Plan (as amended in 2003), was 8,886,142 at December 31, 2005, of which options to purchase 4,821,541 shares have been exercised, options to purchase 3,769,670 shares have been granted and are outstanding and options to purchase 294,931 are available for future grant. Option awards are granted with an exercise price as determined by the Company. Option awards generally vest over four years and generally have seven year contractual terms.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option-pricing model. Expected volatilities are based on historical volatility of the Company's share price (eliminating nonrecurring one-time events) and other factors. The Company uses historical data to estimate option exercise and employee termination within the valuation model. The expected term of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

The following assumptions were made in the computation of the fair value of each option award using the Black-Scholes option-pricing model:

|                          | <b>Year ended December 31</b> |             |             |
|--------------------------|-------------------------------|-------------|-------------|
|                          | <b>2003</b>                   | <b>2004</b> | <b>2005</b> |
| Expected dividend yield  | <u>0%</u>                     | <u>0%</u>   | <u>0%</u>   |
| Expected volatility      | <u>59%</u>                    | <u>40%</u>  | <u>53%</u>  |
| Risk-free interest rate  | <u>1.5%</u>                   | <u>2.0%</u> | <u>3.9%</u> |
| Expected life - in years | <u>2.5</u>                    | <u>2.4</u>  | <u>2.6</u>  |

# ORCKIT COMMUNICATIONS LTD.

(An Israeli Corporation)

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### NOTE 5– SHAREHOLDERS' EQUITY (continued):

A summary of option activity under the Plan as of December 31, 2005, and changes during the year then ended is presented below:

| Options                          | Number of<br>options | Weighted<br>average<br>exercise price<br>(per option) | Weighted<br>average<br>remaining<br>contractual term | Aggregate<br>intrinsic<br>value (in<br>thousands) |
|----------------------------------|----------------------|---|--|---|
| Outstanding at January 1, 2005   | 4,008,348            | \$ 4.5  |  |   |
| Granted (1)(2)                   | 1,603,900            | \$ 17.22  |  |   |
| Exercised                        | (1,446,285)          | \$ 4.11   |  |   |
| Forfeited or expired             | (396,293)            | \$ 5.84   |  |   |
| Outstanding at December 31, 2005 | <u>3,769,670</u>     | \$ 9.91   | <u>5.97</u>  | <u>44,484</u>                                     |
| Exercisable at December 31, 2005 | <u>1,877,255</u>     | \$ 14.55  | <u>5.53</u>  | <u>18,453</u>                                     |

- (1) Includes options that in addition to their vesting period, are contingent upon meeting various performance goals. The fair value of these options was estimated on the date of grant using the same option valuation model used for non-contingent options. The Company assumes that performance goals will not be achieved, therefore these options are included above with a fair value of \$0 and no compensation cost as been recorded in their respect.
- (2) Includes options to purchase 840,000 shares granted to the Company's CEO and to the Company's President (420,000 options each) at \$27.14 per share, which represented the market price of the Company's ordinary shares on the date of grant. These options are fully vested and expire in June 2012.

The weighted-average grant-date fair value of options granted during the years 2003, 2004, and 2005 was \$0.17, \$0.70, and \$5.25, respectively. The total intrinsic value of options exercised during the years ended December 31, 2003, 2004, and 2005, was \$2.6 million, \$1.0 million, and \$24.2 million, respectively.

A summary of the status of the Company's nonvested options as of December 31, 2005, and changes during the year ended December 31, 2005, is presented below:

| Nonvested options              | Number of<br>options | Weighted<br>average<br>grant-date<br>fair value |
|--------------------------------|----------------------|---|
| Nonvested at January 1, 2005   | 2,620,515            | 0.42  |
| Granted                        | 1,603,900            | 5.25  |
| Vested                         | (1,936,269)          | 2.57  |
| Forfeited                      | (395,731)            | 0.75  |
| Nonvested at December 31, 2005 | <u>1,892,415</u>     | 1.35  |



## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

#### **NOTE 5– SHAREHOLDERS' EQUITY (continued):**

As of December 31, 2005, there was \$1,970,603 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over a weighted-average period of 1.6 years. The total fair value of options vested during the year ended December 31, 2005 was approximately \$5 million.

During 2005, the Company modified the exercise price of 59,600 share options held by 11 employees. As a result of that modification, the Company recognized additional compensation expense of \$7,000 for the year ended December 31, 2005.

#### **c. Grant of stock and option plans of subsidiaries**

In 2001, the Board of Directors of the Company's major subsidiary, Corrigent, approved an employee share option plan (the "Corrigent Subsidiary Plan"). Corrigent has granted, and reserved for grant, shares and options under its Plan, as applicable, to its employees, officers and directors and to personnel of Orckit, including employees, officers and directors of Orckit. As determined by the respective stock option committee, the exercise price of options granted is zero, which represents the value of the shares on grant day. The vesting period of options granted is up to four years from the date of grant.

As of December 31, 2004 and 2005, on a fully diluted basis, Orckit's holding in Corrigent was approximately 90%.

At the grant date, the intrinsic value and the weighted fair value of options granted by Corrigent was \$ 0. Accordingly, no compensation expense in respect of the options granted was recorded other than the amortization of \$ 1.3 million, \$2.3 million and \$200,000 of compensation expense measured upon exchange of Orckit shares, in 2003, 2004 and 2005 respectively, see note 5a(5) above. At the annual general meeting of shareholders held on June 23, 2005 the Company's shareholders approved a plan for potential exchanges of Corrigent's options for options for up to 10% of the outstanding Ordinary Shares of Orckit. Under the terms of the plan all the outstanding stock options of Corrigent are exchangeable for options to purchase shares of Orckit in an exchange ratio calculated based on the ratio between the fair market value of Corrigent and Orckit. Under the terms of the plan, only vested stock options of Corrigent will be offered to be exchanged commencing January 1, 2006. On July 18, 2005 Orckit's option committee approved an exchange, effective as of January 1, 2006, of a certain amount of Corrigent's options for approximately 500,000 Orckit's options. Following the occurrence of this exchange, which occurred in January and February, 2006, Orckit's holding in Corrigent increased from 90% to approximately 93% on a fully diluted basis.

#### **d. Dividends**

In the event cash dividends are declared by the Company, such dividends will be declared and paid in Israeli currency.

## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

#### **NOTE 5 - SHAREHOLDERS' EQUITY (continued):**

##### **e. Shareholder Bonus Rights Plan**

On November 21, 2001, the Company's Board of Directors adopted a Shareholder Bonus Rights Plan (the "Rights Plan") pursuant to which share purchase bonus rights (the "Rights") were distributed on December 6, 2001 at the rate of one Right for each of the Company's ordinary shares held by shareholders of record as of the close of business on that date.

The Rights Plan is intended to help ensure that all of the Company's shareholders are able to realize the long-term value of their investment in the Company in the event of a potential takeover which does not reflect the full value of the Company and is otherwise not in the best interests of the Company and its shareholders. The Rights Plan is also intended to deter unfair or coercive takeover tactics.

The Rights will be exercisable and transferable apart from the Company's ordinary shares only if a person or group becomes an "Acquiring Person" by acquiring beneficial ownership of 15% or more of the Company's ordinary shares, subject to certain exceptions set forth in the Rights Plan, or commences a tender or exchange offer upon consummation of which such person or group would become an Acquiring Person. Subject to certain conditions described in the Rights Plan, once the Rights become exercisable, the holders of Rights, other than the Acquiring Person, will be entitled to purchase ordinary shares at a discount from the market price.

#### **NOTE 6 - TAXES ON INCOME:**

##### **a. Tax benefits under the Law for the Encouragement of Capital Investments, 1959 (the "law")**

Under the law, by virtue of the "approved enterprise" status granted to the enterprises of Corrigentthe holder of the "approved enterprise" status is entitled to various tax benefits, including the following:

###### **1) *Reduced tax rates***

The period of tax benefits is 7 years, commencing in the first year in which the Company earns taxable income from the approved enterprise, subject to certain limitations. Income derived from the approved enterprise is tax exempt for a period of 2 years, after which the income from these enterprises is taxable at the rate of 25% for 5 years, the remainder of the period of tax benefits.

## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

#### **NOTE 6 - TAXES ON INCOME (continued):**

##### **2) *Conditions for entitlement to the benefits***

The entitlement to the above benefits is conditional upon fulfilling the conditions stipulated by the law, regulations published thereunder and the instruments of approval for the specific investments in approved enterprises. In the event of failure to comply with these conditions, the benefits may be cancelled and the Company may be required to refund the amount of the benefits, in whole or in part, with the addition of linkage differences to the Israeli consumer price index (the "Israeli CPI") and interest.

In the event of distribution of cash dividends out of income which was tax exempt as above, the Company would have to pay 25% tax in respect of the amount distributed.

##### **b. Tax rates applicable to income from other sources:**

###### **1) Income from other sources in Israel**

Income not eligible for approved enterprise benefits mentioned in note 6a. above is taxed at the regular rate. Through December 31, 2003, the corporate tax rate in Israel was 36%. In July 2004 and in August 2005, amendments to the Israeli Income Tax Ordinance were enacted. One of the provisions of these amendments is that the corporate tax rate is to be gradually reduced from 36% to 25%, in the following manner: the rate for 2004 - 35%, 2005 - 34%, 2006 - 31%, 2007 - 29%, 2008 - 27%, 2009 - 26% and 2010 and thereafter - 25%.

###### **2) Income of non-Israeli subsidiaries**

Non-Israeli subsidiaries are taxed according to the tax laws in their countries of residence.

##### **c. Measurement of the results for tax purposes under the Income Tax (Inflationary Adjustments) Law, 1985**

Results for tax purposes are measured on a real basis - adjusted for the increase in the Israeli CPI. As explained in note 1a(2), the financial statements are presented in dollars. The difference between the change in the Israeli CPI and the NIS-dollar exchange rate - both on annual and cumulative bases - causes a difference between taxable income and income reflected in these financial statements.

Paragraph 9 (f) of FAS 109, "Accounting for Income Taxes", prohibits the recognition of deferred tax liabilities or assets that arise from differences between the financial reporting and tax bases of assets and liabilities that are measured from the local currency into dollars using historical exchange rates, and that result from changes in exchange rates or indexing for tax purposes. Consequently, the abovementioned differences were not reflected in the computation of deferred tax assets and liabilities.

## **ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

#### **NOTE 6 - TAXES ON INCOME (continued):**

##### **d. Deferred income taxes**

At December 31, 2005, the Company and its subsidiaries had accumulated tax losses amounting to approximately \$130 million (December 31, 2004 - approximately \$134 million) and carry forward capital losses for tax purposes of approximately \$ 38 million (December 31, 2004 - \$ 39 million). These losses are mainly denominated in NIS, linked to the Israeli CPI and are available indefinitely to offset future taxable business income. The Company and each of its subsidiaries are assessed on a stand-alone basis. As a result, accumulated tax losses in each of the entities can offset future taxable business income in the entity in which they were generated.

At December 31, 2005, the Company and its subsidiaries had a net deferred tax asset (mostly in respect of carry forward losses and capital losses), in the amount of approximately \$41 million (December 31, 2004 - approximately \$37 million). A valuation allowance for the entire amount of such asset was set up, and consequently no deferred tax asset is recorded in the balance sheet, since it is more likely than not that the deferred tax assets will not be realized in the foreseeable future.

##### **e. Tax rate reconciliation**

In 2005, the main reconciling item from the statutory tax rate of the Company (34%, representing a theoretical tax expense of approximately \$7.6 million) to the effective tax rate (0%) is the use of carry forward tax losses to offset income in 2005. In 2004 and 2003, the main reconciling item from the statutory tax rate of the Company (36% and 35%, representing theoretical tax benefit of approximately \$ 7.0 million and \$8.0 million respectively) to the effective tax rate (0%) is the release of valuation allowance provided against the deferred taxes created in respect of carry forward tax losses (see note 1q).

##### **f. Tax assessments**

The Company has received final assessments through the year ended December 31, 2000. The Company's subsidiaries have not been assessed since incorporation.

# ORCKIT COMMUNICATIONS LTD.

(An Israeli Corporation)

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### NOTE 7 - FINANCIAL INSTRUMENTS AND RISK MANAGEMENT:

#### a. Balances in non-dollar currencies:

1) As follows:

|             | <b>December 31,<br/>2005</b> |
|-------------|------------------------------|
|             | <b><u>In thousands</u></b>   |
| Assets      | <u>26,407</u>                |
| Liabilities | <u>12,609</u>                |

The U.S. dollar amounts above mainly represent balances in Japanese Yen ("Yen") and to lesser extent - in Israeli currency.

2) Data regarding the rate of exchange and the Israeli CPI:

|  | <b>Year ended December 31</b> |                    |                    |
|--|-------------------------------|--------------------|--------------------|
|  | <b><u>2003</u></b>            | <b><u>2004</u></b> | <b><u>2005</u></b> |
| Rate of devaluation (evaluation) of the Israeli<br>Currency against the dollar | (7.6)%                        | (1.6)%             | 6.8%               |
| Rate of evaluation of the Yen<br>against the dollar                            |                               | (4.1)%             | 14.3%              |
| Rate of increase (decrease) in the Israeli CPI                                 | (1.9)%                        | 1.2%               | 2.4%               |
| Exchange rate at end of year - \$ 1=   | NIS 4.379                     | NIS 4.308          | NIS 4.603          |

#### b. Fair value of financial instruments

The fair value of financial instruments included in working capital is usually identical or close to their carrying value.

As to the fair value of the Company's securities that are held to maturity, see note 8a(2).

#### c. Concentrations of credit risks

At December 31, 2004 and 2005, substantially all of the Company's and its subsidiaries' cash and cash equivalents were held by Israeli and international bank institutions. Substantially all of the Company's marketable securities were held by international bank institutions. Such securities represented debentures issued by a number of US and Israeli corporations and agencies.

The Company evaluates on a current basis its financial exposure with any financial institution or commercial issuer.

All of the trade receivable balance at December 31, 2005 were derived from one customer. The Company is of the opinion that the exposure to credit risk relating to these trade receivables is limited. In regard of the trade receivable balance at December 31, 2004, an appropriate allowance for doubtful accounts has been included in the accounts, see note 8b.

# ORCKIT COMMUNICATIONS LTD.

(An Israeli Corporation)

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### NOTE 8 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION:

#### Balance sheets:

##### a. Marketable securities:

###### 1) *Trading securities*

At December 31, 2004, the Company held trading securities in the amount of \$ 9.5 million. At December 31, 2005, there were no such securities. These securities were classified as short-term investments.

###### 2) *Held-to-maturity marketable securities*

The securities mature over the following years:

|  | <b>December 31</b>      |                 |
|--|-------------------------|-----------------|
|  | <b>2004</b>             | <b>2005</b>     |
|  | <b>In thousands</b>     |                 |
|  | <b>Carrying amounts</b> |                 |
| Mature within 12 months - Classified as short-term investments | \$ 15,760               | \$11,731        |
| Mature after 1 year up to 4 years                              | 18,441                  | 70,881          |
|  | <u>\$ 34,201</u>        | <u>\$82,612</u> |

At December 31, 2005, the fair value of the Company's held-to-maturity tradable securities was \$ 81.8 million (December 31, 2004 - \$ 31.6 million). The difference between the carrying amounts and the fair value results from a decrease in market value in comparison to the amortization of the premium paid for the securities in the amount of approximately \$840,000 (December 31, 2004 - \$2.5 million). It is expected that the debt securities would not be settled at a price less than the amortized cost of the investment. Because the Company has the ability and intent to hold this investment until a recovery of fair value, which may be maturity, it does not consider the investment in these debentures to be other-than-temporarily impaired at December 31, 2005.

**ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

**NOTE 8 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION** (continued):

|  |  | <b>December 31</b>            |                |             |
|--|--|-------------------------------|----------------|-------------|
|  |  | <b>2004</b>                   | <b>2005</b>    |             |
|  |  | <b>In thousands</b>           |                |             |
|  |  |                               |                |             |
| <b>b. Trade receivables:</b>           |  |                               |                |             |
| Open accounts                          |  | \$ 54,893                     | \$702          |             |
| Less - allowance for doubtful accounts |  | 79                            | -,-            |             |
|  |  | <u>\$ 54,814</u>              | <u>\$702</u>   |             |
|  |  |                               |                |             |
|  |  | <b>Year ended December 31</b> |                |             |
|  |  | <b>2003</b>                   | <b>2004</b>    | <b>2005</b> |
|  |  | <b>In thousands</b>           |                |             |
| Allowance for doubtful accounts:       |  |                               |                |             |
| Balance at beginning of year           |  | \$ 83                         | \$ 83          | \$79        |
| Increase during the year               |  | 63                            |                |             |
| Bad debt written off                   |  | (63)                          | (4)            | (79)        |
| Balance at end of year                 |  | <u>\$ 83</u>                  | <u>\$ 79</u>   | <u>-,-</u>  |
|  |  |                               |                |             |
|  |  | <b>December 31</b>            |                |             |
|  |  | <b>2004</b>                   | <b>2005</b>    |             |
|  |  | <b>In thousands</b>           |                |             |
|  |  |                               |                |             |
| <b>c. Other receivables</b>            |  |                               |                |             |
| Employees and employee institutions    |  | \$ 42                         | \$13           |             |
| Government of Israel                   |  | 743                           | 780            |             |
| Prepaid expenses                       |  | 683                           | 709            |             |
| Sundry                                 |  | 24                            | 18             |             |
|  |  | <u>\$ 1,492</u>               | <u>\$1,520</u> |             |

**d. Bank deposits**

At December 31, 2005, the Company had bank deposits in the amount of \$ 1.5 million classified as long-term investments, which are denominated in dollars and bear annual interest at a rate of 5.1%. At December 31, 2004, the Company had bank deposits in the amount of \$ 6.8 million classified among current assets, which are denominated in dollars and bear annual interest at a rate of 4.29%.

**ORCKIT COMMUNICATIONS LTD.**  
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

**NOTE 8 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION** (continued):

**e. Bank loans**

The balance at December 31, 2004 consisted of a short-term bank loan of \$15 million and current maturities of long-term bank loans of \$16 million. The loans, received in dollars, bore annual interest at a weighted average rate of 2.94%. In 2005 all bank loans were repaid.

In addition, in 2004, the Company entered into an agreement for a bank credit facility, pursuant to which the Company may, subject to certain conditions, from time to time, borrow an aggregate principal amount of up to \$20 million. Under the terms of the agreement, the amounts will be denominated in dollars and will bear interest at Libor plus a fixed rate.

**f. Accrued expenses and other payables:**

|  | <b>December 31</b>  |                 |
|--|---------------------|-----------------|
|  | <b>2004</b>         | <b>2005</b>     |
|  | <b>In thousands</b> |                 |
| Accrued expenses in respect of deferred income, see g. below | \$ 6,944            | \$4,352         |
| Employees and employee institutions                          | 1,637               | 7,715           |
| Provision for vacation pay                                   | 1,515               | 686             |
| Provision for warranty *                                     | 556                 | 2,768           |
| Accrued royalties  | 489                 | 2,327           |
| Accrued interest   | 127                 | -,-             |
| Sundry   | 377                 | 1,331           |
|  | <u>\$ 11,645</u>    | <u>\$19,179</u> |

|  | <b>December 31</b>  |                |
|--|---------------------|----------------|
|  | <b>2004</b>         | <b>2005</b>    |
|  | <b>In thousands</b> |                |
| * The changes in the balance during the year:            |                     |                |
| Balance at beginning of year                             | \$434               | \$556          |
| Payments made under the warranty                         | (107)               | (640)          |
| Product warranties issued for new sales                  | 382                 | 3,039          |
| Changes in accrual in respect of pre-existing warranties | (153)               | (187)          |
| Balance at end of year                                   | <u>\$ 556</u>       | <u>\$2,768</u> |



**ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

**NOTE 8 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION** (continued):**g. Deferred income:**

|   | <b>December 31</b>  |                 |
|---|---------------------|-----------------|
|   | <b>2004</b>         | <b>2005</b>     |
|   | <b>In thousands</b> |                 |
| Revenues to be recognized in future periods | \$ 74,491           | \$54,836        |
| Applicable product costs                    | (28,909)            | (19,943)        |
| Applicable PCS, warranty and other costs    | (9,920)             | (6,157)         |
|   | <u>\$ 35,662</u>    | <u>\$28,736</u> |

**Statements of operations:****h. Segment information and revenues from principal customers**

The Company operates in one operating segment.

Disaggregated financial data is provided below as follows: (1) revenues by geographic area; and (2) revenues from principal customers:

1) *Geographic information*

Following is a summary of revenues by geographic area. The Company sells its products mainly to telecommunications carriers. Revenues are attributed to geographic areas based on the location of the end users as follows:

|                 | <b>Year ended December 31</b> |                  |                  |
|-----------------|-------------------------------|------------------|------------------|
|                 | <b>2003</b>                   | <b>2004</b>      | <b>2005</b>      |
|                 | <b>In thousands</b>           |                  |                  |
| Japan           | -,-                           | \$ 10,216        | \$101,247        |
| Israel          | \$ 35                         | -,-              | -,-              |
| Europe          | 1,510                         | 901              | -,-              |
| Other countries | 138                           | 159              | -,-              |
|                 | <u>\$ 1,683</u>               | <u>\$ 11,276</u> | <u>\$101,247</u> |

Most of the Company's property and equipment are located in Israel.

**ORCKIT COMMUNICATIONS LTD.**

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

**NOTE 8 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION** (continued):

- 2) Revenues from principal customers - revenues from single customers each of which exceeds 10% of total revenues in the relevant year:

|            | Year ended December 31 |          |            |
|------------|------------------------|----------|------------|
|            | 2003                   | 2004     | 2005       |
|            | In thousands           |          |            |
| Customer A | -, -                   | \$ 9,195 | \$ 101,060 |
| Customer B | \$530                  | \$863    | -, -       |

**i. Cost of revenues:**

|  | Year ended December 31 |                 |                 |
|--|------------------------|-----------------|-----------------|
|  | 2003                   | 2004            | 2005            |
|  | In thousands           |                 |                 |
| Materials consumed, subcontractors and other production expenses | \$ 533                 | \$ 9,508        | \$37,497        |
| Payroll and related expenses                                     |                        | 488             | 2,161           |
| Depreciation   | 199                    | 340             | 1,283           |
| Decrease (increase) in inventories of finished products          |                        | (5,433)         | 4,061           |
| Other  | 16                     | 998             | 6,870           |
|  | <u>\$ 748</u>          | <u>\$ 5,901</u> | <u>\$51,872</u> |

The Company currently procures a number of major components of its products from single source suppliers.

**j. Research and development expenses - net:**

|  | Year ended December 31 |                  |                 |
|--|------------------------|------------------|-----------------|
|  | 2003                   | 2004             | 2005            |
|  | In thousands           |                  |                 |
| Total expenses                               | \$ 20,803              | \$ 17,725        | \$16,320        |
| Less - grants and participations, see note 4 | 5,800                  | 2,682            | 173             |
|  | <u>\$ 15,003</u>       | <u>\$ 15,043</u> | <u>\$16,147</u> |

In 2003, the Company recorded an impairment of property and equipment in the amount of approximately \$1.8 million, representing write-off of property and equipment relating to the Company's ADSL product line. The majority of the impairment was recorded as research and development expenses. The Company does not expect to generate additional revenues from this product line.

**ORCKIT COMMUNICATIONS LTD.**  
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

**NOTE 8 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION** (continued):

**k. Financial income - net:**

|  | Year ended December 31 |                 |                |
|--|------------------------|-----------------|----------------|
|  | 2003                   | 2004            | 2005           |
|  | In thousands           |                 |                |
| Income:                                    |                        |                 |                |
| Interest on bank deposits                  | \$ 557                 | \$ 367          | \$511          |
| Gain and interest on marketable securities | 2,883                  | 1,883           | 3,022          |
| Gain from early extinguishments of notes * | 3,125                  | -,-             | -,-            |
| Interest on long-term loan                 | 114                    | -,-             | -,-            |
| Other (including currency transactions)    | 62                     | 80              | 7              |
|  | <u>\$ 6,741</u>        | <u>\$ 2,330</u> | <u>\$3,540</u> |

\* Regarding issuance of convertible subordinated notes by the Company in March 2000, which were originally due on April 1, 2005, but were extinguished earlier. The Company recorded financial income of \$ 3.1 million in 2003 from gains on early extinguishments of Notes. The redemption of notes in 2004 did not result in any financial income.

|  | Year ended December 31 |                 |                |
|--|------------------------|-----------------|----------------|
|  | 2003                   | 2004            | 2005           |
|  | In thousands           |                 |                |
| Expenses:  |                        |                 |                |
| Interest in respect of convertible subordinated notes and bank loans | \$ 1,114               | \$ 566          | \$ 219         |
| Amortization of convertible subordinated notes issuance costs        | 139                    | 147             | -,-            |
| Other (2003 and 2005 - mainly currency transaction gains and losses) | 380                    | 88              | 685            |
|  | <u>1,633</u>           | <u>801</u>      | <u>904</u>     |
|  | <u>\$ 5,108</u>        | <u>\$ 1,529</u> | <u>\$2,636</u> |

**l. Other income**

During 2005, the Company sold an investment in another company in a venture stage, for a consideration of \$4.4 million. The investment was previously recorded at cost in the amount of \$1.9 million.

**ORCKIT COMMUNICATIONS LTD.**  
(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

**NOTE 8 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION** (continued):

**m. Transactions with related parties:**

1. Commencing July 1, 2003, the Company provides Tickro, a related party, with certain administrative services. The annual consideration for such services in the year ended December 31, 2005 was \$72,000 (Each of year ended December 31, 2004 and 2003 - \$100,000).
2. Regarding transactions with the Company's CEO and with the Company's president, see notes 4c and 5b.

**n. Earnings (loss) per share:**

|   | Year ended December 31 |             |          |
|---|------------------------|-------------|----------|
|   | 2003                   | 2004        | 2005     |
|   | In thousands           |             |          |
| Numerator - Basic   |                        |             |          |
| Net income (loss)   | \$ (21,616)            | \$ (20,132) | \$22,226 |
| Denominator - Basic   |                        |             |          |
| Weighted average ordinary shares outstanding<br>(net of treasury shares)                | 12,996                 | 13,074      | 13,984   |
| Basic net income (loss) per share   | \$ (1.66)              | \$ (1.54)   | \$1.59   |
| Numerator - Diluted   |                        |             |          |
| Net income  | \$ (21,616)            | \$ (20,132) | \$22,226 |
| Minority share in subsidiary's net income -<br>assuming exercise of Corrigent's options | -,-                    | -,-         | (1,017)  |
|   | \$ (21,616)            | \$ (20,132) | \$21,209 |
| Denominator – Diluted   |                        |             |          |
| Weighted average ordinary shares outstanding  | 12,996                 | 13,074      | 13,984   |
| Dilutive potential of ordinary shares<br>equivalents - options                          |                        |             | 2,361    |
|   | 12,996                 | 13,074      | *16,345  |
| Diluted net income (loss) per share   | \$ (1.66)              | \$ (1.54)   | \$1.30   |

In 2003 the potential effect of the convertible subordinated notes was not taken into account, since its effect was anti-dilutive. In 2003 and 2004, the potential effect of 2,023,917 and 4,008,348 of the Company's options, respectively, was not taken into account, because of their anti-dilutive effect, since the Company had net loss applicable to ordinary shares.

\* The weighted average number of shares used for diluted net income per share calculation for the year ended December 31, 2005 taking into account Orckit's option exchange, see note 5c, as if the exchange was performed on the date it was approved by Orckit's option committee is 16,593,000. The diluted net earnings per share derived from this calculation method is \$1.30.

Convenience translation from Hebrew

As amended through March 31, 2005

COMPANIES ORDINANCE  
COMPANY LIMITED BY SHARES  
MEMORANDUM OF ASSOCIATION  
OF  
ORCKIT COMMUNICATIONS LTD.

1. Name of the Company: ORCKIT COMMUNICATIONS LTD.
2. Objectives for which the Company was established:
  - (a) To deal in the development, manufacture, marketing, and rendering consultation services in all things related to the products in the electronics, communications, and satellites communications markets.
  - (b) To buy, to acquire, to receive, to hold, to hire, to lease, to deliver, to lend, to invest, to mediate, to transfer, to pawn, to mortgage, and to enter any deal involving chattels, rights and properties required for the management of the Company's business, to achieve its objectives, and in particular real estate, funds, buildings, rights, credit, use of machines, devices, raw materials, articles, processed or unprocessed goods.
  - (c) To invest and to use, as the Company should decide from time to time, the Company's funds, assets and profits, its capital and its estate as it should deem convenient and efficient in order to achieve the Company's objectives and its business.
  - (d) To borrow and to get funds from any source whatsoever, including the issue and sale of promissory notes, bonds or securities, and by levying mortgages on the Company's assets or part thereof. To agree to transfer mortgages, pawns, liens, to set their conditions, to change them, to cancel them, to redeem them, and to invest all kinds of funds and considerations which the Company obtains by the above-mentioned means, in

any way or manner which the Company deems convenient, as well as to register and receive mortgages and liens to the Company's credit.

- (e) To purchase all kinds of shares, companies or rights from any corporate, or to belong in any other manner to bodies or corporations as mentioned above, dealing in the same business in which this Company is entitled to deal in, or which may provide for the efficiency of the Company's business or its objectives.
- (f) To divide among the Company's members the Company's assets, or part thereof, in any manner which the Company should deem convenient, provided that any division which brings about a reduction or a decrease or a limitation in the Company's capital shall be undertaken only in keeping to the provisions in the law.
- (g) To merge with any Company, or any other juridical entity, and to associate with all kinds of companies, partnerships and other bodies for purposes of the Company's business.
- (h) To purchase the assets, business and goodwill of any person, partnership, Company, corporation or body which deals in business having similar objectives as those of the Company, as well as to deal in the assets of any such person, partnership, corporation, company or body, and to take upon itself its obligations or part thereof.
- (i) To purchase shares, stock or securities of any company, corporation or enterprise, and to deal with them, insofar as such purchase or such dealings can assist in promoting the Company's business.
- (j) To purchase patents, rights on patents, trademarks and secret processes and to deal therein, to grant on them or part thereof rights or benefits as well as to sell them or part thereof, or to assign them in any other way.
- (k) To hire and get into contract with workers, employees, contractors, clerks, agents, and other persons for purposes of the Company business.
- (l) To perform all things which the Company is entitled to perform in accordance with the powers and authorities granted to the Company in accordance with the provisions of the Companies Ordinance, or in accordance with any other legislation, and to perform

any act or deed which the Company deems to be attached or to be a part of all of the above-mentioned objectives, or any part thereof, and each and everyone of the above-mentioned objectives shall be considered an objective *per se* for which the Company was established, and independent of any other objective.

3. The members' responsibility is limited.

4.

- (a) The share capital of the Company is fifty million (50,000,000) Ordinary Shares of no nominal value.
- (b) The rights granted by the shares shall comply with the provisions stated in the Company's Statutes from time to time.
- (c) The Company shall be entitled to issue the original or enlarged share stock, in full or in part, with preferential shares as regards voting rights, dividends, under the conditions established from time to time by resolution of the General Assembly.

The rights granted at any given time to every type of the Company's stock shares may be changed, increased or dealt with in any manner provided for in the Statutes of the Company, as they should be in force at the time.

- (d) The Company shall be entitled to increase its capital and to issue new shares, whether ordinary or with preferential rights, priority rights, or other special rights, as per the conditions that the Company should deem convenient. The Company shall also be entitled to divide the registered and existing shares to different types with bundles of rights, different rights or special rights.

5. Each shareholder resolution shall be adopted by the holders of a simple majority of the voting rights participating in such vote.

The persons whose names and their addresses are stated hereunder wish to associate as a Company as per the provisions of this Memorandum of Association, and we agree to subscribe the number of shares of the Company capital indicated next to our names:

| <u>Name</u>                           | <u>I.C.</u>    | <u>Address</u>                           | <u>Number of</u><br><u>Ord. "A"</u> | <u>Shares</u><br><u>Ord. "B"</u> | <u>Signature</u> |
|---------------------------------------|----------------|--|-------------------------------------|----------------------------------|------------------|
| <u>1) Idith Tamir</u>                 | <u>6929731</u> | <u>Jabotinsky</u><br><u>14, Givataim</u> | <u>200</u>                          | <u>199</u>                       | <u>(signed)</u>  |
| <u>2) Kalman</u><br><u>Ruttenberg</u> | <u>6929729</u> | <u>Allenby 113,</u><br><u>Haifa</u>      | <u>-</u>                            | <u>1</u>                         | <u>(signed)</u>  |

Date: 7/1/1990

Witness to the above signatures: (signed) Doron Levy, Attorney-at Law

Registrar of Companies 2/85



AMENDED AND RESTATED EMPLOYMENT AGREEMENT

This AMENDED AND RESTATED EMPLOYMENT AGREEMENT (this "Amended Agreement"), dated as of June 23, 2005, between Orckit Communications Ltd. (the "Company") and Eric Paneth (the "Office Holder").

W I T N E S S E T H:

WHEREAS, the Company and the Office Holder are party to an Employment Agreement dated as December 6, 1993 (as extended from time to time, the "Employment Agreement");

WHEREAS, the Employment Agreement provides, among other things, for a bonus for the Office Holder based on specified percentages of the Company's revenues and pre-tax income, and, based on the Company's anticipated results of operations for 2005, the bonus based on pre-tax income for 2005 is expected to be significant (*viz.*, \$730,000, based on current projections of the Company of pre-tax income of \$15,000,000);

WHEREAS, under the Employment Agreement, the base salary (including employee benefits) of the Office Holder increases by 15% per year, in addition to an adjustment linked to the Israeli consumer price index, which means that the Office Holder's salary and employee benefits for 2005 would be an amount in NIS equal to approximately \$630,000 (based on the exchange rate on March 31, 2005 of NIS 4.361 to one U.S. dollar and the CPI for January 2005);

WHEREAS, the Company believes that, following many years of operating losses of the Company, the rate of the Office Holder's bonus based on pre-tax income should be decreased, the Office Holder's base salary should be decreased to a level that, together with all employee benefits, would aggregate to an amount in NIS equal to \$570,000 for 2005 (based on the exchange rate on March 31, 2005 of NIS 4.361 to one U.S. dollar), and the rate of the Office Holder's annual salary raises should be decreased to 5% per year (plus CPI adjustment from January 2006), and the Office Holder has agreed to such decreases;

WHEREAS, the Employment Agreement does not require prior notice of termination;

WHEREAS, the severance provisions in the Employment Agreement are ambiguous;

WHEREAS, the parties desire to take this opportunity to rectify such provisions; and

WHEREAS, the Company's audit committee, board of directors and shareholders have approved the amendments made herein to the Employment Agreement;

NOW, THEREFORE, the parties hereby agree as follows:

1. The preamble to this Amended Agreement constitutes a principal and integral part of the Amended Agreement.
2. The Company shall continue to employ the Office Holder in the position of Chief Executive Officer on a full time basis.
3. The terms of this Amended Agreement shall be effective as of January 1, 2005 and shall continue for so long as the Office Holder is employed by the Company, unless this Amended Agreement is amended in writing by the parties hereto.
4. The Office Holder hereby undertakes to fulfil his position faithfully, dutifully and to devote all time required to fulfilling his position in the Company.
5. The Office Holder undertakes that during the term of his employment and for one year afterwards, he shall not be involved in any way whatsoever, directly and/or indirectly, in any business or employment competing with that of the Company or which would constitute a conflict of interests with his positions as an Office Holder in the Company, provided, however, that in the event that the Office Holder's employment terminates under circumstances in which the Office Holder would not be entitled to severance pay pursuant to applicable labor laws, the post-employment non-competition period shall be increased to two years in consideration for receiving the Supplemental Amount (as defined in sub-paragraph 7.D below).
6. The positions of the Office Holder under this Amended Agreement belong to those requiring a special degree of personal trust as such is defined in the Work Hours and Rest Law, 5711 – 1951 and therefore the provisions of this law will not apply to the Office Holder.
7. The Office Holder's terms of employment are as follows:
  - A. His monthly gross salary shall be NIS 160,215 (hereinafter: the “**Monthly Salary**”), subject to sub-paragraph E below. The Monthly Salary shall be linked to the consumer price index and shall be updated monthly. Furthermore, the Monthly Salary, as so adjusted to the consumer price index, shall be raised by the rate of 5% at the beginning of each year, commencing January 1, 2006.
  - B. The Company shall monthly transfer an amount equal to 13.333% of the Office Holder's Monthly Salary to a 'manager's insurance' policy for the benefit of the Office Holder, as follows: 8.333% of the Monthly Salary for the accumulation of severance pay compensation (the “Severance Component”); and 5% of the Monthly Salary for a providence fund. In

addition, the Company shall pay the cost of disability insurance for the benefit of the Office Holder (the "Disability Insurance") in an amount not to exceed 2.5% of the Monthly Salary. A further amount at the rate of 5% of the Office Holder's Monthly Salary shall be deducted from his salary and transferred by the Company to his credit in the 'manager's insurance' account. If any tax applies to the 'manager's insurance' allotments as provided in this sub-paragraph, the Company shall gross it up at its expense.

- C. The Company shall monthly pay an amount equal to 7.5% of the Office Holder's Monthly Salary to an educational fund (*keren hishtalmut*). A further amount at the rate of 2.5% of the Office Holder's Monthly Salary shall be deducted from his salary and transferred by the Company to his credit in the educational fund. If any tax applies to the educational fund allotments as provided in this sub-paragraph, the Company shall gross it up at its expense.
  
- D. Termination of the employment of the Office Holder by either the Company or the Office Holder shall require six months' prior written notice, and the Monthly Salary and all benefits shall continue during such six-month period. Upon termination of the Office Holder's employment with the Company by either the Company or the Office Holder for any reason whatsoever and at any time whatsoever, the Office Holder shall be entitled to receive all amounts accumulated in the said 'managers' insurance' and educational funds provided in sub-paragraphs B and C above. In addition, in the event that the Office Holder's employment terminates under circumstances in which the Office Holder would be entitled to severance pay pursuant to applicable labor laws, the Severance Component shall be supplemented by the Company in the amount necessary to ensure that the Office Holder receives a severance payment equal to his last Monthly Salary *multiplied* by the number of years (including a fraction of a year) that the Office Holder worked for the Company (the "Supplemental Amount"). In the event that the Office Holder's employment terminates under circumstances in which the Office Holder would not be entitled to severance pay pursuant to applicable labor laws, the Company shall pay the Supplemental Amount to the Office Holder in consideration for the extension of the Office Holder's covenant not to compete with the Company, as set forth in paragraph 5 above. The receipt of the amounts set forth in this sub-paragraph D shall fully exhaust all rights owing to the Office Holder from the Company in connection with the termination of his employment with the Company, other than amounts owing to the Office Holder pursuant to applicable law or pursuant to this Amended Agreement or any other agreements, including without limitation, any indemnification agreement between the Company and the Office Holder.

E. The Monthly Salary set forth in sub-paragraph A above includes a payment in lieu of a company car. However, the Office Holder shall be entitled to the use of a car with an engine of 1,800 cc. at the expense of the Company. The Company shall also absorb, at its expense, any tax applicable for making the car available to the Office Holder. In the event that the Office Holder exercises his right to receive the said car, his Monthly Salary shall be reduced by NIS 19,225, as adjusted pursuant to sub-paragraph A above from the date of this Amended Agreement. The Office Holder thereafter shall be entitled, at any time, to waive his right to a car, and in such a case such reduction of his Monthly Salary (as adjusted) will be cancelled.

F. Once a year, upon the signing of the Company's financial statements for that year, a bonus shall be paid to the Office Holder based on the Company's financial results for the year referred to by the financial statements, at the following rates:

- (1) 0.25% of the Company's revenues, and a further -
- (2) 1.0% of the annual (pre-tax) income of the Company up to an income ceiling of \$5,000,000, and a further -
- (3) 2.0% of the annual (pre-tax) income of the Company of any income between \$5,000,000 and \$15,000,000, and a further -
- (4) 3.0% of the annual (pre-tax) income of the Company above \$15,000,000;

provided, however, that no bonus based on pre-tax income for 2005 shall be paid to the Office Holder except to the extent that the amount of the Company's pre-tax income exceeds \$15,000,000, and then only to the extent of 3.0% of such excess.

G. The Office Holder shall be entitled to the following for each year of employment:

- (1) To 26 days of vacation which may be accumulated and redeemed at the election of the Office Holder and without any limitation set forth in the Annual Vacation Law, 5711 – 1951, but subject to any limitations imposed by the Company's audit committee from time to time.
- (2) To 14 days of paid convalescence leave according to the daily rate accepted from time to time for executives in Israel.

- (3) For 18 paid sick leave days pursuant and subject to the provisions of any relevant law.
- H. The Office Holder shall be entitled to continue to enjoy insurance for the contents of his private house granted to him free of charge by the insurance agent insuring the Company, provided that such endorsement does not involve any cost whatsoever on the part of the Company.
- I. The Office Holder shall be entitled to enjoy the accumulation of miles on the frequent flyer program of various airlines which shall be accumulated by the Office Holder during his trips overseas for the Company and he shall be entitled to make use of the benefits given by the airlines due to the accumulation of such for his personal travels.
- J. The Company shall pay the premiums for the medical insurance policies covering the Office Holder and his immediate family, provided that the cost of such policies together with the cost of the Disability Insurance does not exceed 2.5% of the Monthly Salary.
8. Notwithstanding the foregoing, the total salary and employee benefits of the Office Holder for the year 2005 shall not exceed \$570,000 (based on the exchange rate on March 31, 2005 of NIS 4.361 to one U.S. dollar), and the total salary and employee benefits of the Office Holder for 2006 and each subsequent year shall not exceed such amount as adjusted pursuant to paragraph 7.A above (the "Limitation"), provided, however, that adjustments to the Office Holder's total salary and employee benefits for 2006 and each subsequent year as a result of changes in tax laws (including changes in tax ceilings in respect of the educational fund, manager insurance, car holding and other components), national insurance laws and other applicable laws and regulations from time to time may cause such total to exceed the Limitation (such adjusted amount, the "Adjusted Limitation"). For the avoidance of doubt, the Limitation and the Adjusted Limitation shall not limit any bonuses payable pursuant to sub-paragraph 7F.
9. For avoidance of doubt, it is understood that the monthly payment to the Office Holder and his benefit accounts shall be made in NIS according to paragraph 7 of this Amended Agreement. The dollar amount of the monthly payments will fluctuate, subject to paragraph 8 above, due to fluctuations in the shekel/dollar exchange rate. The bonus payment under paragraph 7.F above will be paid in NIS according to the shekel/dollar exchange rate at the date of the preparation of the salary, *less* the amount of the overpayment, if any, of total salary and employee benefits for the applicable year in excess of the Adjusted Limitation, as confirmed by the accounting firm that serves as the Company's independent auditor (an "Overpayment"). To the extent that the proposed bonus payment is less than the Overpayment, the balance of the Overpayment shall be offset from the next payment(s) made by the Company to the Office Holder.

10. It is agreed that should the Office Holder decide, at any time, not to take or to exercise any right or benefit under this Amended Agreement, it shall not be construed as constituting a waiver on that right or benefit, and he shall be entitled to exercise such right or benefit at any time and at his election.

In witness whereof the parties have set their hand:

/s/ Izhak Tamir, President  
Orckit Communications Ltd.

/s/ Eric Paneth  
Eric Paneth

AMENDED AND RESTATED EMPLOYMENT AGREEMENT

This AMENDED AND RESTATED EMPLOYMENT AGREEMENT (this "Amended Agreement"), dated as of June 23, 2005, between Orckit Communications Ltd. (the "Company") and Izhak Tamir (the "Office Holder").

W I T N E S S E T H:

WHEREAS, the Company and the Office Holder are party to an Employment Agreement dated as December 6, 1993 (as extended from time to time, the "Employment Agreement");

WHEREAS, the Employment Agreement provides, among other things, for a bonus for the Office Holder based on specified percentages of the Company's revenues and pre-tax income, and, based on the Company's anticipated results of operations for 2005, the bonus based on pre-tax income for 2005 is expected to be significant (*viz.*, \$730,000, based on current projections of the Company of pre-tax income of \$15,000,000);

WHEREAS, under the Employment Agreement, the base salary (including employee benefits) of the Office Holder increases by 15% per year, in addition to an adjustment linked to the Israeli consumer price index, which means that the Office Holder's salary and employee benefits for 2005 would be an amount in NIS equal to approximately \$630,000 (based on the exchange rate on March 31, 2005 of NIS 4.361 to one U.S. dollar and the CPI for January 2005);

WHEREAS, the Company believes that, following many years of operating losses of the Company, the rate of the Office Holder's bonus based on pre-tax income should be decreased, the Office Holder's base salary should be decreased to a level that, together with all employee benefits, would aggregate to an amount in NIS equal to \$570,000 for 2005 (based on the exchange rate on March 31, 2005 of NIS 4.361 to one U.S. dollar), and the rate of the Office Holder's annual salary raises should be decreased to 5% per year (plus CPI adjustment from January 2006), and the Office Holder has agreed to such decreases;

WHEREAS, the Employment Agreement does not require prior notice of termination;

WHEREAS, the severance provisions in the Employment Agreement are ambiguous;

WHEREAS, the parties desire to take this opportunity to rectify such provisions; and

WHEREAS, the Company's audit committee, board of directors and shareholders have approved the amendments made herein to the Employment Agreement;

NOW, THEREFORE, the parties hereby agree as follows:

1. The preamble to this Amended Agreement constitutes a principal and integral part of the Amended Agreement.
2. The Company shall continue to employ the Office Holder in the position of President on a full time basis.
3. The terms of this Amended Agreement shall be effective as of January 1, 2005 and shall continue for so long as the Office Holder is employed by the Company, unless this Amended Agreement is amended in writing by the parties hereto.
4. The Office Holder hereby undertakes to fulfil his position faithfully, dutifully and to devote all time required to fulfilling his position in the Company.
5. The Office Holder undertakes that during the term of his employment and for one year afterwards, he shall not be involved in any way whatsoever, directly and/or indirectly, in any business or employment competing with that of the Company or which would constitute a conflict of interests with his positions as an Office Holder in the Company, provided, however, that in the event that the Office Holder's employment terminates under circumstances in which the Office Holder would not be entitled to severance pay pursuant to applicable labor laws, the post-employment non-competition period shall be increased to two years in consideration for receiving the Supplemental Amount (as defined in sub-paragraph 7.D below).
6. The positions of the Office Holder under this Amended Agreement belong to those requiring a special degree of personal trust as such is defined in the Work Hours and Rest Law, 5711 – 1951 and therefore the provisions of this law will not apply to the Office Holder.
7. The Office Holder's terms of employment are as follows:
  - A. His monthly gross salary shall be NIS 160,215 (hereinafter: the “**Monthly Salary**”), subject to sub-paragraph E below. The Monthly Salary shall be linked to the consumer price index and shall be updated monthly. Furthermore, the Monthly Salary, as so adjusted to the consumer price index, shall be raised by the rate of 5% at the beginning of each year, commencing January 1, 2006.
  - B. The Company shall monthly transfer an amount equal to 13.333% of the Office Holder's Monthly Salary to a 'manager's insurance' policy for the benefit of the Office Holder, as follows: 8.333% of the Monthly Salary for the accumulation of severance pay compensation (the “Severance Component”); and 5% of the Monthly Salary for a providence fund. In



addition, the Company shall pay the cost of disability insurance for the benefit of the Office Holder (the "Disability Insurance") in an amount not to exceed 2.5% of the Monthly Salary. A further amount at the rate of 5% of the Office Holder's Monthly Salary shall be deducted from his salary and transferred by the Company to his credit in the 'manager's insurance' account. If any tax applies to the 'manager's insurance' allotments as provided in this sub-paragraph, the Company shall gross it up at its expense.

- C. The Company shall monthly pay an amount equal to 7.5% of the Office Holder's Monthly Salary to an educational fund (*keren hishtalmut*). A further amount at the rate of 2.5% of the Office Holder's Monthly Salary shall be deducted from his salary and transferred by the Company to his credit in the educational fund. If any tax applies to the educational fund allotments as provided in this sub-paragraph, the Company shall gross it up at its expense.
- D. Termination of the employment of the Office Holder by either the Company or the Office Holder shall require six months' prior written notice, and the Monthly Salary and all benefits shall continue during such six-month period. Upon termination of the Office Holder's employment with the Company by either the Company or the Office Holder for any reason whatsoever and at any time whatsoever, the Office Holder shall be entitled to receive all amounts accumulated in the said 'managers' insurance' and educational funds provided in sub-paragraphs B and C above. In addition, in the event that the Office Holder's employment terminates under circumstances in which the Office Holder would be entitled to severance pay pursuant to applicable labor laws, the Severance Component shall be supplemented by the Company in the amount necessary to ensure that the Office Holder receives a severance payment equal to his last Monthly Salary *multiplied* by the number of years (including a fraction of a year) that the Office Holder worked for the Company (the "Supplemental Amount"). In the event that the Office Holder's employment terminates under circumstances in which the Office Holder would not be entitled to severance pay pursuant to applicable labor laws, the Company shall pay the Supplemental Amount to the Office Holder in consideration for the extension of the Office Holder's covenant not to compete with the Company, as set forth in paragraph 5 above. The receipt of the amounts set forth in this sub-paragraph D shall fully exhaust all rights owing to the Office Holder from the Company in connection with the termination of his employment with the Company, other than amounts owing to the Office Holder pursuant to applicable law or pursuant to this Amended Agreement or any other agreements, including without limitation, any indemnification agreement between the Company and the Office Holder.

E. The Monthly Salary set forth in sub-paragraph A above includes a payment in lieu of a company car. However, the Office Holder shall be entitled to the use of a car with an engine of 1,800 cc. at the expense of the Company. The Company shall also absorb, at its expense, any tax applicable for making the car available to the Office Holder. In the event that the Office Holder exercises his right to receive the said car, his Monthly Salary shall be reduced by NIS 19,225, as adjusted pursuant to sub-paragraph A above from the date of this Amended Agreement. The Office Holder thereafter shall be entitled, at any time, to waive his right to a car, and in such a case such reduction of his Monthly Salary (as adjusted) will be cancelled.

F. Once a year, upon the signing of the Company's financial statements for that year, a bonus shall be paid to the Office Holder based on the Company's financial results for the year referred to by the financial statements, at the following rates:

- (1) 0.25% of the Company's revenues, and a further -
- (2) 1.0% of the annual (pre-tax) income of the Company up to an income ceiling of \$5,000,000, and a further -
- (3) 2.0% of the annual (pre-tax) income of the Company of any income between \$5,000,000 and \$15,000,000, and a further -
- (4) 3.0% of the annual (pre-tax) income of the Company above \$15,000,000;

provided, however, that no bonus based on pre-tax income for 2005 shall be paid to the Office Holder except to the extent that the amount of the Company's pre-tax income exceeds \$15,000,000, and then only to the extent of 3.0% of such excess.

G. The Office Holder shall be entitled to the following for each year of employment:

- (1) To 26 days of vacation which may be accumulated and redeemed at the election of the Office Holder and without any limitation set forth in the Annual Vacation Law, 5711 – 1951, but subject to any limitations imposed by the Company's audit committee from time to time.
- (2) To 14 days of paid convalescence leave according to the daily rate accepted from time to time for executives in Israel.

- (3) For 18 paid sick leave days pursuant and subject to the provisions of any relevant law.
- H. The Office Holder shall be entitled to continue to enjoy insurance for the contents of his private house granted to him free of charge by the insurance agent insuring the Company, provided that such endorsement does not involve any cost whatsoever on the part of the Company.
- I. The Office Holder shall be entitled to enjoy the accumulation of miles on the frequent flyer program of various airlines which shall be accumulated by the Office Holder during his trips overseas for the Company and he shall be entitled to make use of the benefits given by the airlines due to the accumulation of such for his personal travels.
- J. The Company shall pay the premiums for the medical insurance policies covering the Office Holder and his immediate family, provided that the cost of such policies together with the cost of the Disability Insurance does not exceed 2.5% of the Monthly Salary.
8. Notwithstanding the foregoing, the total salary and employee benefits of the Office Holder for the year 2005 shall not exceed \$570,000 (based on the exchange rate on March 31, 2005 of NIS 4.361 to one U.S. dollar), and the total salary and employee benefits of the Office Holder for 2006 and each subsequent year shall not exceed such amount as adjusted pursuant to paragraph 7.A above (the "Limitation"), provided, however, that adjustments to the Office Holder's total salary and employee benefits for 2006 and each subsequent year as a result of changes in tax laws (including changes in tax ceilings in respect of the educational fund, manager insurance, car holding and other components), national insurance laws and other applicable laws and regulations from time to time may cause such total to exceed the Limitation (such adjusted amount, the "Adjusted Limitation"). For the avoidance of doubt, the Limitation and the Adjusted Limitation shall not limit any bonuses payable pursuant to sub-paragraph 7F.
9. For avoidance of doubt, it is understood that the monthly payment to the Office Holder and his benefit accounts shall be made in NIS according to paragraph 7 of this Amended Agreement. The dollar amount of the monthly payments will fluctuate, subject to paragraph 8 above, due to fluctuations in the shekel/dollar exchange rate. The bonus payment under paragraph 7.F above will be paid in NIS according to the shekel/dollar exchange rate at the date of the preparation of the salary, *less* the amount of the overpayment, if any, of total salary and employee benefits for the applicable year in excess of the Adjusted Limitation, as confirmed by the accounting firm that serves as the Company's independent auditor (an "Overpayment"). To the extent that the proposed bonus payment is less than the Overpayment, the balance of the

Overpayment shall be offset from the next payment(s) made by the Company to the Office Holder.

10. It is agreed that should the Office Holder decide, at any time, not to take or to exercise any right or benefit under this Amended Agreement, it shall not be construed as constituting a waiver on that right or benefit, and he shall be entitled to exercise such right or benefit at any time and at his election.

In witness whereof the parties have set their hand:

\_\_\_\_\_/s/ Eric Paneth, CEO

Orckit Communications Ltd.

\_\_\_\_\_/s/ Izhak Tamir

Izhak Tamir

## **Exhibit 8.1**

### **Subsidiaries of Orckit Communications Ltd.**

Corrigent Systems Inc., a Delaware corporation.

Corrigent Systems Ltd., an Israeli corporation.

Corrigent Systems KK., a Japanese corporation.

Certification of Principal Executive Officer pursuant to 17 CFR 240.13a-14(a),  
as adopted pursuant to §302 of the Sarbanes-Oxley Act

I, Eric Paneth, certify that:

1. I have reviewed this annual report on Form 20-F of Orckit Communications Ltd.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;
4. The company's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the company and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
5. The company's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of the company's board of directors (or persons performing the equivalent functions):

- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
- (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

Date: March 12, 2006

By: /s/ Eric Paneth

---

Eric Paneth, Chief Executive Officer

Certification of Principal Financial Officer pursuant to 17 CFR 240.13a-14(a),  
as adopted pursuant to §302 of the Sarbanes-Oxley Act

I, Aviv Boim, certify that:

1. I have reviewed this annual report on Form 20-F of Orckit Communications Ltd.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;
4. The company's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the company and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
5. The company's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of the company's board of directors (or persons performing the equivalent functions):



- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
- (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

Date: March 12, 2006

By: /s/ Aviv Boim

---

Aviv Boim, Chief Financial Officer

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report on Form 20-F of Orckit Communications Ltd. (the "Company") for the year ended December 31, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, Eric Paneth, Chief Executive Officer of the Company, certifies, pursuant to 18 U.S.C. sec. 1350, as adopted pursuant to sec. 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

March 12, 2006

By: /s/ Eric Paneth

---

Eric Paneth, Chief Executive Officer

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report on Form 20-F of Orkit Communications Ltd. (the "Company") for the year ended December 31, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, Aviv Boim, Chief Financial Officer of the Company, certifies, pursuant to 18 U.S.C. sec. 1350, as adopted pursuant to sec. 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

March 12, 2006

By: /s/ Aviv Boim

---

Aviv Boim, Chief Financial Officer

---

**Kesselman & Kesselman**  
Certified Public Accountants  
Trade Tower, 25 Hamered Street  
Tel Aviv 68125 Israel  
P.O Box 452 Tel Aviv 61003  
Telephone +972-3-7954555  
Facsimile +972-3-7954556

Exhibit 15.1

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We hereby consent to the incorporation by reference in the Registration Statements on Form S-8 (File nos. 333-131991, 333-05670, 333-08824 and 333-12178) of Orckit Communications Ltd. of our report dated March 12, 2006, relating to the financial statements which appear in this Form 20-F.

Tel-Aviv, Israel  
March 15, 2006

/s/ Kesselman & Kesselman  
Certified Public Accountants (Isr.)