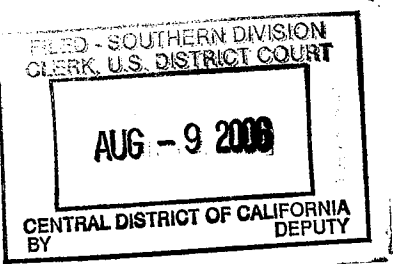


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9 **UNITED STATES DISTRICT COURT**
10 **FOR THE CENTRAL DISTRICT OF CALIFORNIA**

11 **SECURITIES AND EXCHANGE**
12 **COMMISSION,**

13 **Plaintiff,**

14 **vs.**

15 **PAUL W. MIKUS and JOHN V.**
16 **CRACCHIOLO,**

17 **Defendants.**

Case No. **SACV06-734 JVS (MLGx)**

COMPLAINT

18
19 Plaintiff Securities and Exchange Commission ("Commission") alleges:

20 **JURISDICTION AND VENUE**

21 1. The Court has jurisdiction over this action pursuant to Sections 20(b),
22 20(d)(1), and 22(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. §§
23 77t(b), 77t(d)(1), and 77v(a), and Sections 21(d)(3)(A), 21(e), and 27 of the
24 Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §§ 78u(d)(3)(A),
25 78u(e), and 78aa. Defendants have, directly or indirectly, made use of the means
26 or instrumentalities of interstate commerce, of the mails, or of the facilities of a
27 national securities exchange, in connection with the transactions, acts, practices,
28 and courses of business alleged in this Complaint.

1 by at least 16% for 2001, 17% for the first quarter of 2002, and 33% for the second
2 quarter of 2002 as reported in the financial statements included in its periodic
3 filings. Endocare's financial statements also understated its pre-tax loss for 2001
4 by 20%, and it falsely reported pre-tax earnings for the first two quarters of 2002,
5 rather than properly reporting substantial pre-tax losses. Endocare's financial
6 statements for the third quarter of 2002 would have similarly contained
7 misstatements, but Endocare never filed its Form 10-Q for the third quarter of
8 2002, because its acting controller raised serious questions about Endocare's
9 accounting practices. Endocare also included a misleading consolidated income
10 statement for the third quarter of 2001 in an amended Form S-3 registration
11 statement that Endocare filed on November 14, 2001 to register an offering of
12 common stock, from which Endocare realized gross proceeds of \$78.2 million.
13 Furthermore, Endocare incorporated its inflated third quarter 2001 financial results
14 into another registration statement that it filed in March of 2002 for the issuance of
15 additional common stock.

16 7. After Endocare's acting controller raised questions about Endocare's
17 accounting practices, Endocare committed further securities laws violations in the
18 course of investigating the allegations. The company made misleading disclosures
19 in its Forms 8-K and its press releases. First, on December 19, 2002, Endocare
20 announced in a Form 8-K and press release the termination of the acting controller
21 for conduct "materially injurious to the company." Both Mikus and Cracchiolo
22 approved the Form 8-K and press release. One week before issuing the December
23 19 Form 8-K and concurrent press release, Endocare had disclosed that the
24 company's independent auditors, KPMG LLP, had concluded that KPMG could no
25 longer rely on the representations of management. The December 19 Form 8-K
26 and press release falsely implied that Endocare had terminated the bad actors
27 responsible for KPMG's concerns. The bad actors, however, included Mikus and
28 Cracchiolo, who remained at the company and who approved Endocare's

1 December 19 disclosure regarding termination of the acting controller. Second, on
2 March 11, 2003, Endocare issued a press release in which it announced that after
3 an independent investigation, the audit committee had concluded that there “was
4 no indication of fraud or intentional wrongdoing by management.” This statement
5 was false because the company had not conducted an “independent” investigation,
6 and because an internal review, in fact, had uncovered evidence suggesting
7 intentional manipulation. The company then filed a Form 8-K containing a similar
8 false and misleading statement. Mikus approved both the misleading press release
9 and the Form 8-K.

10 8. Mikus authorized, reviewed and/or signed Endocare’s false and
11 misleading filings, including Forms 10-Q for the second and third quarters of 2001
12 and for the first and second quarters of 2002, the Form 10-K for 2001, the Form S-
13 3 filed on November 14, 2001, the Form S-8 filed on March 26, 2002, and the
14 Forms 8-K filed on December 19, 2002 and March 14, 2003. Cracchiolo prepared,
15 reviewed, and/or signed the false and misleading filings, including Forms 10-Q for
16 the second and third quarters for 2001 and for the first and second quarters of
17 2002, the Form 10-K for 2001, the Form S-3 filed on November 14, 2001, the
18 Form S-8 filed on March 26, 2002, and the Form 8-K filed on December 19, 2002.

19 9. As alleged more specifically below, Mikus and Cracchiolo each
20 violated the antifraud, record-keeping, false statements to the auditors, books and
21 records, and internal controls provisions of the federal securities laws, and aided
22 and abetted Endocare’s violations of the reporting, record-keeping, and internal
23 controls provisions of the federal securities laws. By this complaint, the
24 Commission seeks an order permanently enjoining Mikus and Cracchiolo from
25 future violations of the federal securities laws, directing them to disgorge all their
26 ill-gotten gains and to pay civil penalties, and prohibiting them from serving as
27 officers or directors of publicly-traded companies.

1 **THE DEFENDANTS**

2 10. Paul W. Mikus, age 40, is a resident of Irvine, California. Mikus was
3 Endocare's president and chief executive officer from November 1995 through
4 March 2003. Mikus served as the chief financial officer of Endocare when the
5 company's shares first began trading in February 1996, and continued in that
6 position through 1997. Mikus also served as the company's chairman of the board
7 from November 1995 until September 23, 2003, when he resigned from the board.

8 11. John V. Cracchiolo, age 50, is a resident of Gardnerville, Nevada.
9 Cracchiolo was Endocare's chief operating officer and chief financial officer from
10 the time he joined Endocare in June 2001, until March 3, 2003, when he resigned
11 from these positions and became the president of Endocare's radiological
12 intervention business. Endocare terminated Cracchiolo effective July 31, 2003.
13 Cracchiolo is a certified public accountant, although his license has been inactive
14 since 1982.

15 **BACKGROUND**

16 **A. Endocare's Reporting Obligations**

17 12. Endocare, Inc. is incorporated in Delaware, with its principal place of
18 business in Irvine, California. Endocare's common stock is registered with the
19 Commission pursuant to Section 12(g) of the Exchange Act and, at all relevant
20 times, was listed on the Nasdaq Stock Market. Endocare's common stock
21 currently trades in the Over-the-Counter Bulletin Board.

22 13. As a public company, Endocare was required to comply with federal
23 statutes, rules, and regulations to maintain public trading of its stock and to sell its
24 securities to the public. These statutes, rules, and regulations required Endocare to,
25 among other things: (a) make and keep books, records, and accounts, which, in
26 reasonable detail, accurately and fairly reflected its transactions and dispositions of
27 assets; (b) devise and maintain a system of internal accounting controls sufficient
28 to provide reasonable assurances that the transactions were recorded as necessary

1 to permit preparation of financial statements in conformity with Generally
2 Accepted Accounting Principles (“GAAP”), or any other criteria applicable to such
3 statements and to maintain accountability for assets; (c) file with the Commission
4 accurate annual, current, and quarterly reports on the appropriate forms including a
5 financial statement containing the company’s balance sheet and statements of
6 income and cash flows prepared in conformity with GAAP; and (d) file with the
7 Commission periodic reports that did not make any untrue statement of material
8 fact or omit to state a material fact necessary in order to make the statements made,
9 in the light of the circumstances under which they were made, not misleading.

10 14. Pursuant to the Commission’s rules and regulations, Endocare
11 reported sales revenue and income for specific periods, such as at the end of each
12 quarter and the end of its fiscal year. Endocare used a calendar year as its fiscal
13 year. In 2001, Endocare’s first quarter ended March 31; its second quarter ended
14 June 30; its third quarter ended September 30; and its fourth quarter ended
15 December 31. In addition to filing annual and quarterly reports with the
16 Commission, Endocare also periodically issued press releases announcing its
17 earnings and held conference calls with securities analysts and investors to discuss
18 its financial performance. The earnings releases and conference calls usually
19 occurred after the end of a quarter and before Endocare filed its periodic reports
20 with the Commission.

21 **B. Applicable Accounting Rules**

22 15. By improperly booking false sales, engaging in improper revenue
23 recognition practices, and improperly understating or delaying Endocare’s
24 recognition of expenses, Mikus and Cracchiolo violated, and caused Endocare to
25 violate, numerous accounting rules that Endocare was obligated to follow. These
26 accounting rules are designed to ensure that financial information is accurately
27 recorded and publicly disclosed.

28 16. Under GAAP, which are the accounting conventions, standards, and

1 rules required for preparing financial statements, and the Commission's rules and
2 regulations, Endocare could recognize revenue from a sale during a particular
3 reporting period only if (1) persuasive evidence existed of a sales arrangement with
4 a customer; (2) delivery of the product had occurred; (3) the price for the product
5 was fixed or determinable; (4) collectibility of the sales price was reasonably
6 assured; and (5) Endocare had substantially performed all of its obligations to the
7 customer.

8 17. One of the accounting standards that governs the criteria that
9 companies must meet to properly recognize revenue is Financial Accounting
10 Standards Board Statement of Concepts No. 5 ("CON 5"). GAAP and, in
11 particular, CON 5 provide that it is not appropriate for a company to recognize
12 revenue before merchandise is exchanged for cash or claims to cash.

13 18. Another accounting standard that governs the criteria for revenue
14 recognition is Accounting Principles Board Opinion No. 29 ("APB 29"). APB 29
15 directs that the amount of revenue that a company can recognize from a non-
16 monetary asset that the company acquires in exchange for another non-monetary
17 asset is the fair value of the asset that the company surrendered. APB 29 also
18 requires that a company disclose material, non-monetary transactions in the
19 company's public filings.

20 19. Another accounting standard is Financial Accounting Standards
21 Board Statement No. 57 ("FAS 57"). FAS 57 states that a company's financial
22 statements shall include disclosures of transactions with related parties, if the
23 transactions are material.

24 20. Financial Accounting Standards Board Statement No. 48 ("FAS 48")
25 provides that revenue should not be recognized when the buyer's obligation to the
26 seller is contingent on resale of the product. FAS 48 also does not normally permit
27 a company to recognize revenue on a sale with a right of return. The only
28 exception to this rule exists when there is a history of such sales to provide a basis

1 for estimating the amount of future returns and if income is reduced to reflect the
2 estimated future returns by establishing a reserve for returned goods.

3 21. Two other accounting standards that govern the criteria companies
4 must meet, Accounting and Auditing Enforcement Release (“AAER”) No. 108 and
5 Staff Accounting Bulletin (“SAB”) No. 101, set forth certain criteria that must be
6 met to recognize revenue from “bill-and-hold” sales. Under GAAP, in order to
7 recognize revenue from sales in which the seller maintains inventory of the sold
8 goods (otherwise referred to as “bill-and-hold” sales), the transaction must satisfy
9 the following requirements: (1) the risks of ownership for the goods must have
10 passed to the buyer; (2) the customer must have made a fixed commitment to
11 purchase the goods, preferably reflected in written documentation; (3) the buyer,
12 not the seller, must have requested that the transaction be on a bill-and-hold basis,
13 and the buyer must have had a substantial business purpose for ordering the goods
14 on a bill-and-hold basis; (4) there must have been a fixed schedule for delivery of
15 the goods that was reasonable and consistent with the buyer’s business purpose; (5)
16 the seller must not have retained any specific performance obligations such that the
17 earnings process was not complete; (6) the ordered goods must have been
18 segregated from the seller’s inventory and not have been subject to being used to
19 fill other orders; and (7) the equipment must have been complete and ready for
20 shipment.

21 22. Finally, GAAP also requires that a company recognize expenses in
22 the period in which the company incurs liabilities for goods and services that are
23 expended either simultaneously with the purchase or soon after.

24 **C. Endocare’s Revenue Recognition Policies And “Record Revenue”**

25 **Trend**

26 23. According to Endocare’s public filings in 2001 and 2002, the
27 company’s revenue recognition policy required that revenue, including revenue
28 generated by Endocare’s sales to distributors, could be recognized once the boxes

