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UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, vs. RALPH K. UNGERMANN, ALAN J. MCMILLAN, AND JAMES O. MITCHELL, Defendants.	C02 05013 Civil Action No. **COMPLAINT FOR VIOLATIONS OF THE FEDERAL SECURITIES LAWS**

Plaintiff Securities and Exchange Commission (the "Commission") alleges:

JURISDICTION AND VENUE

1. This Court has jurisdiction over this action pursuant to Sections 20(d)(1) and 22(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. §§ 77t(d)(1) and 77v(a), and Sections 21(d)(3)(A), 21(e), and 27 of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §§ 78u(d)(3)(A), 78u(e), and 78aa.

2. Venue is proper in the Northern District of California pursuant to Section 22(a) of the Securities Act, 15 U.S.C. § 77v(a), and Section 27 of the Exchange Act, 15 U.S.C. § 78aa, because certain of the transactions and acts

constituting violations of the federal securities laws occurred within the Northern District of California and because certain of the defendants reside in the Northern District of California.

INTRADISTRICT ASSIGNMENT

3. This matter is proper in the San Jose Division because certain of the transactions and acts constituting violations of the federal securities laws occurred within Santa Clara County and because certain of the defendants reside in Santa Clara County.

SUMMARY

4. This is a financial fraud action arising out of the publication of materially false financial information for a public company, First Virtual Communications, Inc. ("FVC"), located in Silicon Valley, California, by FVC's former Chief Executive Officer ("CEO"), Ralph K. Ungermann ("Ungermann"), former Vice President of Sales, Alan J. McMillan ("McMillan"), and former Chief Financial Officer ("CFO"), James O. Mitchell ("Mitchell"). Specifically, Ungermann, McMillan, and Mitchell (collectively the "Defendants") caused FVC to overstate revenues and earnings figures in a January 28, 1999 press release and then sold FVC shares before this misleading financial information was corrected. Ungermann, McMillan, and Mitchell also did not provide accurate financial information to FVC's auditors. Ungermann and Mitchell also caused falsification of FVC's books and records. As a result of defendants' fraud, FVC improperly recognized as revenue approximately $5.9 million in sales associated with product shipments for the fourth quarter and fiscal year 1998, in clear violation of Generally Accepted Accounting Principles ("GAAP"). Thus, FVC overstated its fourth quarter revenue by 114%, and annual 1998 revenue by 16%. FVC reported annual earnings of $1.1 million instead of a loss of $2 million.

5. The Commission seeks relief against Ungermann, McMillan, and Mitchell for violating the antifraud provisions of Section 17(a) of the Securities

Act, 15 U.S.C. § 77q(a), and Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, and the lying to auditors provision of Rule 13b2-2 under the Exchange Act, 17 C.F.R. § 240.13b2-2. Further, the Commission seeks relief against Ungermann and Mitchell for violating the record keeping provisions of Section 13(b)(2)(A) of the Exchange Act, 15 U.S.C. 78m(b)(2)(A), and Rule 13b2-1 thereunder, 17 C.F.R. § 240.13b2-1. The Commission requests that this Court permanently enjoin Ungermann, McMillan, and Mitchell from any future violations of the federal securities laws, and order Ungermann, McMillan, and Mitchell to pay disgorgement, prejudgment interest thereon, and civil penalties.

THE DEFENDANTS

6. Ralph K. Ungermann resides in Los Altos Hills, California. In 1993, he co-founded FVC and was its CEO, president, and chairman of the board until January 1999. In January 1999, Ungermann resigned as CEO and president, but continued to attend FVC's regular executive staff meetings. Ungermann currently is FVC's chairman of the board and owns 5.5% of the outstanding FVC shares.

7. Alan J. McMillan resides in Palo Alto, California. McMillan was FVC's vice president of sales from 1995 to mid-1999. Part of his responsibilities included helping FVC to maintain its relationship with its largest distributor.

8. James O. Mitchell resides in Cupertino, California. Mitchell was FVC's CFO from January 1995 to June 1999 and Vice President of Operations from January 1995 to January 1999. At FVC, he was responsible for, oversaw, and reviewed all financial bookkeeping for FVC. He also reviewed all financial press releases before their publication. Mitchell worked closely with FVC's largest distributor.

RELATED ENTITY

9. First Virtual Communications, Inc. is a Silicon Valley software company that was incorporated in Delaware. FVC completed its initial public

offering in April 1998. At all relevant times alleged in this complaint, FVC's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act, 15 U.S.C. § 78l(g), and traded on Nasdaq. FVC's primary business is engineering and manufacturing video-conferencing products. FVC has worked closely with distributors to market and sell FVC's products to the ultimate customer.

THE FRAUDULENT SCHEME

A. FVC's Agreement With Its Largest Distributor

10. During the fourth quarter 1998, FVC relied heavily on its largest distributor (the "Distributor") for sales. In an effort to increase fourth quarter 1998 revenues, Ungermann and McMillan repeatedly asked the Distributor to buy $3 million of new product before the end of 1998 at discounted prices. The Distributor initially refused these solicitations because it had just learned that one of its own resellers would return $2.5 million of product that FVC had previously sold to the Distributor (the "Reseller Return"), and the Distributor had in its warehouses $1.9 million of excess inventory that FVC had previously sold to the Distributor.

11. In late fourth quarter 1998, the defendants were concerned that FVC would not meet its revenue goals. As a result, in December 1998, Ungermann and McMillan again solicited the Distributor to buy $3 million of new product. Ungermann and McMillan assured the Distributor that FVC had customer leads for the $3 million of new product, for the $2.5 million Reseller Return, and for some of the Distributor's $1.9 million in excess inventory.

12. As further incentive, Ungermann and McMillan offered the Distributor exchange rights on the $3 million of new product if the end-user required a different product, and return rights on the equipment currently in the Distributor's inventory or at one of the Distributor's resellers. There were no other conditions on this initial proposal.

13. The Distributor conditionally accepted FVC's offer provided that the Distributor could confirm the validity of FVC's customer leads and that the Distributor could sell this new product by the end of the first quarter 1999. Thereafter, FVC and the Distributor negotiated the following language of the exchange rights provision to be included with the $3 million of purchase orders: "This order is subject to return by [the Distributor] at anytime before June 30, 1999 in exchange for purchase of material of the same or greater value that may be better suited to fulfill end-user demand on [the Distributor]."

14. On December 23, 1998, with Ungermann's approval, McMillan left a message on the Distributor's voicemail system confirming the agreement between the Distributor and FVC.

15. The December 1998 agreement had three parts. First, the Distributor agreed to issue purchase orders to FVC by December 28, 1998, for $3 million of new product. Ungermann had agreed to exchange rights for these purchase orders. Second, FVC and the Distributor would jointly market to find new purchasers for the $2.5 million Reseller Return. To the extent that the $2.5 million Reseller Return could not be resold, FVC agreed to accept the return of a certain portion of the unsold balance by February 15, 1999, and the remaining portion of the unsold balance by March 31, 1999. FVC thereby granted return rights as to these products. Third, FVC agreed to work with the Distributor to ensure that the $1.9 million of excess inventory "was good and salable." FVC thereby granted rotation rights as to these products.

16. During the negotiations, Ungermann asked Mitchell about the accounting implications of the exchange rights in the $3 million of purchase orders. Mitchell told Ungermann that the accounting implications would be minimal and that FVC had adequate reserves. Ungermann and McMillan did not tell Mitchell about the return or rotation rights in December 1998. As discussed below, Mitchell's advice was incorrect.

17. Based on FVC's agreement to the exchange, return, and rotation rights, the Distributor issued purchase orders totaling $3 million to FVC on December 29, 1998. In response to the purchase orders, FVC shipped $1.5 million of product to the Distributor before the end of December 1998 and recognized $1.5 million as revenue.

B. <u>FVC Improperly Recorded Revenue From Sales To The Distributor</u>

18. In January 1999, FVC initially recorded and announced revenue of $12.3 million for the fourth quarter 1998 and $44.4 million for fiscal 1998, which improperly included $5.9 million in revenue from the $1.5 million sale with exchange rights, the $2.5 million sale with return rights, and the $1.9 million sale with rotation rights. FVC initially recognized and announced earnings of $1.2 million for the fourth quarter 1998 and $1.1 million for fiscal year 1998 (excluding interest, miscellaneous income, and a one-time charge relating to an acquisition). Without the overstatement of revenue from the sales to the Distributor with the exchange, return, and rotation rights, FVC would have recognized and announced a loss of $1.9 million for the fourth quarter and a loss of $2 million for fiscal 1998.

19. Under GAAP, "return rights" include exchange and rotation rights, unless the seller grants the exchange and rotation rights to the ultimate customer and limits the rights to product of the same kind, quality, and price.

20. A return right allows a buyer to return product to a seller in exchange for another product, for a refund of the purchase price, or for a credit against the balance owed by the buyer to the seller. An exchange right allows a buyer to return a product to the seller in exchange for another product or for the upgraded version of the same product. A rotation right permits a similar product exchange but tends to be used to refer to slow moving or obsolete products. Here, all of the exchange, return, and rotation rights were "return rights" under GAAP because FVC granted the exchange and rotation rights to the Distributor, not the ultimate

customer, and FVC did not expressly limit the exchange and rotation rights to product of the same kind, quality, and price.

21. For a seller to recognize revenue at the time of sale when the buyer has return rights, GAAP requires, among other things, that the seller must be reasonably able to estimate the amount of future returns.

22. Here, under GAAP, FVC should not have recognized revenue from the sales with the Distributor that contained exchange, return, and rotation rights in 1998, because, among other things, FVC could not reasonably estimate the amount of future returns.

C. <u>Mitchell And McMillan Deny Existence Of Return Rights To FVC's Auditors</u>

23. In January 1999, FVC's auditor (the "Auditor") conducted its fieldwork for the FVC fiscal year 1998 audit. As part of this audit, the Auditor explored whether FVC had granted any "unusual rights of return or stock rotation." During the fieldwork, no one at FVC told the Auditor of the December 1998 agreement. Indeed, the Auditor asked McMillan if FVC had granted any unusual return rights, stock rotation rights, or sales terms in 1998. McMillan replied that FVC had not, even though McMillan was aware of the exchange and return rights to the Distributor in December 1998. Mitchell also denied to the Auditor that FVC had granted any unusual return or stock rotation rights. Further, Mitchell knew that FVC had granted exchange rights, yet he did not tell the Auditor that FVC had granted exchange rights.

24. When Ungermann asked Mitchell about the accounting treatment for the exchange rights in December 1998, he did not disclose the return and rotation rights. In addition, Ungermann did not disclose the December 1998 agreement to FVC's auditors.

25. On January 28, 1999, after the Auditor had substantially completed its fieldwork, FVC issued a press release announcing preliminary financial results for

the fourth quarter and fiscal year 1998. The press release positively announced that "[r]evenues for [the fourth quarter 1998] were $12.3 million, a 61 percent increase over revenues of $7.6 million in the fourth quarter 1997, and a 2.5 percent increase over revenues of $12.0 million for [the third quarter 1998] . . . . Revenues for the year were $44.4 million, up 136 percent over revenues of $18.8 million in 1997." The press release also announced that income for the fourth quarter 1998 was $1.2 million, or $0.07 per share, and income for fiscal 1998 was $1.1 million (excluding a one time acquisition charge), or $0.07 per share.

26. In the two days following the press release, FVC's share price increased 37.5%, from $11 to $151/8, and, over the next three weeks, FVC's share price fluctuated between $127/16 and $143/8. In the day following the press release, the trading volume increased over 500% to 1,126,600 shares, as compared to an average daily trading volume in January 1999 of 221,534 shares.

27. Before FVC issued the press release, Ungermann and Mitchell reviewed drafts of the press release for accuracy. The new CEO and president, who had only joined FVC in January 1999, discussed the press release with Ungermann, McMillan, and Mitchell before its publication, and no one contested its accuracy.

D. <u>Mitchell Learns Of The Distributor's Return Rights</u>

28. In December 1998, Mitchell knew about the exchange rights for the $3 million purchase orders because Ungermann had discussed it with him. By at least February 15, 1999, Mitchell also learned about the return rights for the $2.5 million Distributor Return.

29. On February 12, 1999, the Distributor e-mailed to Mitchell a request to return $1.25 million of the Reseller Return to FVC, pursuant to the December 1998 return rights. Mitchell responded with a February 15, 1999 e-mail that referenced the terms of the return rights granted in the December 1998 agreement. Mitchell first stated his understanding of the "arrangement" between FVC and the

Distributor that FVC would either refer new orders of the product or "pull from [the Distributor's] stock to fulfill orders" from other FVC customers (i.e., the joint marketing in the December 1998 agreement). In that email, Mitchell further stated that a $600,000 purchase order that he had placed with the Distributor on February 10, 1999, was part of the latter process. Finally, Mitchell stated that he had to ascertain from FVC's sales department the amount of product resold through the Distributor to determine the amount of product that the Distributor could return during the "first phase of the program." (i.e., the December 1998 agreement provided for the Distributor to return the unsold half of the Distributor Return by February 15, 1999).

E. Ungermann, McMillan, And Mitchell Sell FVC Stock In February 1999

30. Ungermann, McMillan, and Mitchell sold FVC shares after FVC had announced its overstated financial results in the January 28, 1999 press release. These sales were their first sales of FVC stock.

31. From February 3 to 11, 1999, Ungermann sold 200,000 shares of FVC stock and made illegal profits of $384,192.

32. From February 4, to 23, 1999, McMillan sold 70,000 shares of FVC stock and made illegal profits of $133,848.

33. From February 19 to 23, 1999, Mitchell sold 60,000 shares of FVC stock and made illegal profits of $102,737.

F. FVC'S Acceptance Of Product Returns

34. In the first quarter 1999, FVC authorized four returns from the Distributor totaling over $2.6 million of product. FVC received two of these returns totaling $1.6 million of product in the first quarter of 1999 and the remaining two returns totaling $1.029 million of product in the second quarter of 1999. FVC accounted for these returns by subtracting the value of the return from the balance the Distributor owed FVC.

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35. First, on February 10, 1999, FVC issued a purchase order to buy back $600,000 of FVC product from the Distributor, and the Distributor shipped the product to FVC on February 16, 1999. As discussed above, Mitchell issued this purchase order pursuant to the December 1998 agreement. Second, in early March 1999, FVC authorized a return from the Distributor of $1 million of FVC product, and the Distributor shipped the product to FVC on March 16, 1999. FVC accepted the $1 million return based on the December 1998 agreement. Third, on March 24, 1999, FVC authorized another return of $29,250 of product, and the Distributor shipped this product to FVC on April 6, 1999. Finally, on March 26, 1999 FVC authorized the return of another $1 million of FVC product.

G. <u>The Auditor's Discovery Of The December 1998 Agreement</u>

36. On March 29, 1999, FVC's new CEO and president told the Auditor about the December 1998 agreement and the returns that FVC accepted in the first quarter of 1999. From March 29 to April 5, 1999, the Auditor conducted additional audit work and determined that revenue recognition for the product associated with the December 1998 agreement was not in accordance with GAAP. The Auditor concluded that the exchange, return, and rotation rights in the December 1998 agreement should have all been characterized as return rights and that, because FVC had no experience with product returns, it could not have estimated the amount of potential returns under the December 1998 agreement. Consequently, FVC should not have recorded revenue on the $5.9 million in sales associated with the December 1998 agreement.

37. Based on this determination, the Auditor told FVC that, according to GAAP, FVC should not have recorded revenue in 1998 on the products with exchange, return, and rotation rights. The Auditor recommended that FVC account for sales to the Distributor on a sell-through basis (i.e., FVC would not recognize revenue on sales to the Distributor until the Distributor had sold the product to the end-user). Under this accounting treatment, FVC had to reverse any

revenues for sales in which the product was in the Distributor's or Distributor's resellers' inventories and had not been resold to the ultimate customer. When the Auditor applied this methodology, it resulted in the reversal of the $5.9 million in 1998 sales associated with the December 1998 agreement and a further adjustment of $1.2 million for additional unsold inventory with the Distributor's resellers as of December 31, 1998.

H. The April 6, 1999 Press Release And The Form 10-K

38. After the close of the market on April 6, 1999, FVC issued a press release announcing revised results for the fourth quarter of 1998. The press release announced that FVC would change its accounting to recognize revenue from its sales to the Distributor when the product was sold to the end-user, implementing that change effective December 31, 1998. In the press release, FVC also stated it was reducing its previously announced fourth quarter 1998 revenues of $12.3 million by approximately $7 to $7.5 million, to between $4.7 million and $5.2 million.

39. At the same time, but not disclosed in the press release, FVC revised downward its fourth quarter 1998 earnings by $4.41 million, from a profit of $1.2 million to a loss of $3.21 million (excluding interest, miscellaneous income, and a one-time charge relating to an acquisition). As discussed above, $3.1 million of the earnings adjustment related to the $5.9 million in product with exchange, return, and rotation rights. The remaining $1.21 million of the earnings related to inventory with the Distributor's resellers that had not been sold to end users as of December 31, 1998.

40. FVC reported the revised revenue results in its Form 10-K that it filed on April 15, 1999. FVC reported that its fiscal 1998 revenue was $37.3 million with a loss of $3.31 million (excluding interest, miscellaneous income, and a one-time charge relating to an acquisition), as compared to fiscal 1998 revenues of $44.4 million and earnings of $1.1 million announced in the January 28, 1999

press release.

41. On April 7, 1999, the day after the April press release, FVC's share price fell 60%, from $173/8 to $615/16 per share, and the trading volume increased 77%, from 2,748,100 shares to 4,854,200 shares. In the month before the day of the press release, FVC shares traded at an average daily price of $13 per share and on an average daily volume of 195,500 shares.

FIRST CLAIM

FRAUD IN THE OFFER OR SALE OF SECURITIES

Violations of Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a)

(Against All Defendants)

42. Paragraphs 1 through 41 of this Complaint are realleged and incorporated herein by reference.

43. Defendants Ungermann, McMillan, and Mitchell, and each of them, by engaging in the conduct described above, in the offer or sale of securities, by the use of means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly:

a. with scienter, employed devices, schemes, or artifices to defraud;

b. obtained money or property by means of untrue statements of a material fact or by omitting to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

c. engaged in transactions, practices, or courses of business which operated or would operate as a fraud or deceit upon the purchasers of such securities.

44. By engaging in the above conduct, defendants Ungermann, McMillan, and Mitchell violated, and unless restrained and enjoined will continue to violate, Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a).

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SECOND CLAIM

FRAUD IN CONNECTION WITH THE PURCHASE OR SALE OF SECURITIES

Violations of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5

(Against All Defendants)

45. Paragraphs 1 through 41 of this Complaint are realleged and incorporated herein by reference.

46. Defendants Ungermann, McMillan, and Mitchell, and each of them, with scienter, by engaging in the conduct described above, directly or indirectly, in connection with the purchase or sale of securities, by the use of means or instrumentalities of interstate commerce, or of the mails, or of a facility of a national securities exchange:

a. employed devices, schemes or artifices to defraud;

b. made untrue statements of material facts or omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or

c. engaged in acts, practices or courses of business which operated or would operate as a fraud or deceit upon other persons.

47. By engaging in the above conduct, defendants Ungermann, McMillan, and Mitchell violated, and unless restrained and enjoined will continue to violate, Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5.

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THIRD CLAIM

RECORD KEEPING VIOLATIONS

Aiding and Abetting Violations of Section 13(b)(2)(A) of the Exchange Act, 15 U.S.C. §78m(b)(2)(A), and Violations of Rule 13b2-1 thereunder,

17 C.F.R. § 240.13b2-1

(Against Defendants Ungermann And Mitchell)

48. Paragraphs 1 through 41 of this Complaint are realleged and incorporated herein by reference.

49. FVC violated Section 13(b)(2)(A) of the Exchange Act, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange, by failing to make and keep accurate books, records, and accounts, which, in reasonable detail, accurately and fairly reflected the transactions and disposition of the assets of the issuer.

50. Defendants Ungermann and Mitchell knowingly provided substantial assistance to FVC's violation of Section 13(b)(2)(A) of the Exchange Act.

51. By engaging in the conduct described above and pursuant to Section 20(e) of the Exchange Act, 15 U.S.C. § 78t(e), defendants Ungermann and Mitchell aided and abetted FVC's violations, and unless restrained and enjoined, will continue to aid and abet violations of Section 13(b)(2)(A) of the Exchange Act, 15 U.S.C. § 78m(b)(2)(A).

52. Defendants Ungermann and Mitchell also violated Rule 13b2-1 under the Exchange Act, 17 C.F.R. § 240.13b2-1, which prohibits falsifying any book, record, or account subject to Section 13(b)(2)(A) of the Exchange Act. Unless restrained and enjoined, defendants Ungermann and Mitchell, will continue to violate Rule 13b2-1 under the Exchange Act.

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FOURTH CLAIM

LYING TO THE AUDITORS

Violations of Rule 13b2-2 under the Exchange Act,

17 C.F.R. § 240.13b2-2

(Against All Defendants)

53. Paragraphs 1 through 41 of this Complaint are realleged and incorporated herein by reference.

54. By engaging in the conduct described above, defendants Ungermann, McMillan, and Mitchell, and each of them, directly or indirectly; made or caused to be made a materially false or misleading statement; or omitted to state, or caused another person to omit to state, a material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading, to an accountant in connection with (1) an audit or examination of the financial statements of FVC required to be made pursuant to Exchange Act regulations, or (2) the preparation or filing of reports or documents required to be filed with the Commission.

55. By engaging in the above conduct, defendants Ungermann, McMillan, and Mitchell each violated, and unless restrained and enjoined will continue to violate, Exchange Act Rule 13b2-2, 17 C.F.R. § 240.13b2-2.

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that this Court:

I.

Issue findings of fact and conclusions of law that Ungermann, McMillan, and Mitchell each committed the violations charged and alleged herein.

II.

Permanently enjoin Ungermann and Mitchell from violating Section 17(a) of the Securities Act, 15 U.S.C. § 77(q)(a), and Sections 10(b) and 13(b)(2)(A) of the Exchange Act, 15 U.S.C. §§ 78j(b) and 78m(b)(2)(A) and Rules 10b-5, 13b2-1 and 13b2-2 thereunder, 17 C.F.R. §§ 240.10b-5, 240.13b2-1, and 240.13b2-2.

III.

Permanently enjoin McMillan from violating Section 17(a) of the Securities Act, 15 U.S.C. § 77(q)(a), and Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rules 10b-5 and 13b2-2 thereunder, 17 C.F.R. §§ 240.10b-5 and 240.13b2-2.

IV.

Order Ungermann, McMillan, and Mitchell each to pay disgorgement and prejudgment interest.

V.

Order Ungermann, McMillan, and Mitchell each to pay civil money penalties pursuant to Section 20(d) of the Securities Act, 15 U.S.C. § 77t(d), and Section 21(d)(3) of the Exchange Act, 15 U.S.C. § 78u(d)(3).

VI.

Retain jurisdiction of this action in accordance with the principles of equity and the Federal Rules of Civil Procedure in order to implement and carry out the terms of all orders and decrees that may be entered, or to entertain any suitable application or motion for additional relief within the jurisdiction of this Court.

VII.

Grant such other and further relief as this Court may determine to be just and necessary.

DATED: November 26, 2002

Christyne J. Vachon
Attorney for Plaintiff
Securities and Exchange Commission