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FEDERAL DISTRICT COURT
CENTRAL DIST. OF CALIF.
LOS ANGELES

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12 **UNITED STATES DISTRICT COURT**
13 **FOR THE CENTRAL DISTRICT OF CALIFORNIA**

14 **SACV06 905 AG (ANx)**

15 **SECURITIES AND EXCHANGE**
16 **COMMISSION,**

17 Plaintiff,

18 vs.

19 **STEVEN V. COTTON,**

20 Defendant.

Case No.

COMPLAINT FOR
VIOLATIONS OF THE
FEDERAL SECURITIES LAWS

21 Plaintiff Securities and Exchange Commission ("Commission") alleges as
22 follows:

23 **JURISDICTION AND VENUE**

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

1 acts, practices, and courses of business alleged in this Complaint.

2 2. Venue is proper in this district pursuant to Section 22(a) of the
3 Securities Act, 15 U.S.C. § 77v(a), and Section 27 of the Exchange Act, 15 U.S.C.
4 § 78aa, because certain of the transactions, acts, practices, and courses of conduct
5 constituting violations of the federal securities laws occurred within this district,
6 and because the defendant resides in this district.

7 **SUMMARY**

8 3. This action involves a financial fraud on the investing public
9 perpetrated by Steven V. Cotton, who, during the relevant period, was the chief
10 financial officer (“CFO”) and chief operating officer of Lantronix, Inc., a
11 computer networking company. Cotton caused Lantronix to fraudulently overstate
12 its revenues by up to 21% and to understate its pre-tax losses by up to 98% for the
13 second and third quarters of its fiscal year 2001, for its fiscal year 2001, and for
14 the first quarter of its fiscal year 2002.

15 4. At the time of the violations, Lantronix relied on sales to its
16 distributors for the majority of its revenue. Cotton artificially inflated reported
17 revenue and earnings by deliberately sending excessive product to distributors and
18 granting them undisclosed return rights and unusual extended payment terms (a
19 fraudulent practice known as “channel stuffing”). In addition, as part of his
20 channel stuffing scheme and to prevent imminent product returns, Cotton caused
21 Lantronix to loan funds to a third party to purchase Lantronix product from one of
22 its distributors. The third party later returned the product. Cotton also engaged in
23 other improper revenue recognition practices, including shipping product that had
24 not been ordered and causing Lantronix to recognize revenue on a contingent sale.

25 5. Public companies, like Lantronix, report the financial results of their
26 operations in periodic reports filed with the Commission. Lantronix publicly
27 reported its financial results in quarterly reports on Commission Form 10-Q, and
28 in annual reports on Commission Form 10-K.

1 enable network connectivity and system management for a broad range of devices
2 and equipment. Lantronix sells its products directly to end-users and through
3 multiple channels, including distributors which resell Lantronix's products to a
4 variety of customers. At the time of the violations, Lantronix relied on sales to its
5 distributors for the majority of its revenue.

6 10. As a public company, Lantronix is required to comply with federal
7 statutes, rules, and regulations to maintain public trading of its stock and to sell its
8 securities to the public. These statutes, rules, and regulations require Lantronix to,
9 among other things: (a) make and keep books, records, and accounts, which, in
10 reasonable detail, accurately and fairly reflect its transactions and dispositions of
11 assets; (b) devise and maintain a system of internal accounting controls sufficient
12 to provide reasonable assurances that the transactions are recorded as necessary to
13 permit preparation of financial statements in conformity with Generally Accepted
14 Accounting Principles ("GAAP"), or any other criteria applicable to such
15 statements and to maintain accountability for assets; and (c) file with the
16 Commission accurate annual and quarterly reports on the appropriate Commission
17 forms, which include financial statements containing the company's balance sheet
18 and statements of income and cash flows prepared in conformity with GAAP.

19 11. Pursuant to the Commission's rules and regulations, Lantronix reports
20 sales revenue and income at the end of each quarter and the end of its fiscal year.
21 Lantronix's fiscal calendar commences July 1 and concludes on June 30. In 2000
22 and 2001, Lantronix's first quarter ended September 30; its second quarter ended
23 December 31; its third quarter ended March 31; and its fourth quarter ended June
24 30.

25 **THE FRAUDULENT SCHEME**

26 12. As part of his duties as CFO, Cotton monitored whether Lantronix
27 was likely to meet the quarterly revenue and earnings expectations of Wall Street
28 analysts. Cotton ensured that analysts' expectations were met by engaging in a

1 number of fraudulent revenue recognition practices, including recognizing
2 revenue on product that had not been ordered during the quarter; improperly
3 recognizing revenue on sales that gave distributors "full stock rotation rights,"
4 which allowed the distributors to exchange all of the product received for
5 different product; entering into undisclosed side agreements with distributors that
6 included return rights; shipping product in excess of the amount ordered or
7 shipping product that was not ordered at all; and recognizing revenue on a
8 contingent sale. In addition to causing Lantronix's financial statements to be
9 materially misstated in Commission quarterly and annual filings, Cotton concealed
10 these fraudulent revenue recognition practices from Lantronix's auditor, Ernst &
11 Young.

12 13. As a result of these fraudulent practices, Cotton caused Lantronix's
13 revenues to be overstated. Additionally, he caused Lantronix's pre-tax losses to
14 be understated. By causing the pre-tax losses to be understated, Cotton caused
15 Lantronix's earnings per share ("EPS"), a key figure focused on by analysts, to be
16 overstated.

17 14. Cotton personally financially benefitted from his fraud in several
18 ways. First, Lantronix's quarterly bonus program was partially tied to corporate
19 financial goals, and Cotton received bonuses directly as a result of his meeting
20 corporate financial goals, including analysts' revenue and earnings expectations.
21 Second, as explained below, Cotton exercised stock options and engaged in other
22 transactions in Lantronix securities while the stock price was artificially inflated
23 because of the company's false financial information. Third, Cotton obtained
24 loans from Lantronix for the exercise of his options and to pay taxes; he failed to
25 repay Lantronix approximately \$1.2 million in principal on these loans.

26 *
27 *
28 *

1 **A. Cotton Causes Lantronix To Fraudulently Recognize \$272,605 In**
2 **Revenue For Its Quarter Ended December 31, 2000, For Product Not**
3 **Ordered Until January 4, 2001**

4 15. During the relevant period, one of Lantronix's largest distributors was
5 a German company named Transtec AG ("Transtec").

6 16. On Saturday, December 30, 2000, or Sunday, December 31, 2000,
7 which was the last day of Lantronix's fiscal 2001 second quarter, the Lantronix
8 manager for manufacturing and distribution and its vice president of product
9 fulfillment were on-site at Lantronix. The manager ran a report of the high-dollar
10 inventory items on hand and advised Cotton of its contents over the telephone.
11 Several hours later, Cotton caused Lantronix personnel to enter an order in
12 Lantronix's books consisting of a subset of the products from the list that the
13 manager had run earlier. Lantronix then shipped \$272,605 of product to Transtec
14 on December 31, 2000, without having received a purchase order from Transtec.

15 17. On January 4, 2001, Transtec issued a purchase order for the exact
16 amount of the shipment. Cotton caused Lantronix to improperly record revenue
17 from this transaction in the quarter ended December 31, 2000, even though
18 Transtec did not actually issue the purchase order until January 4, 2001, four days
19 into the next quarter.

20 18. Statement of Financial Accounting Concepts No. 5, "Recognition and
21 Measurement in Financial Statements of Business Enterprises" ("CON 5") ¶ 83(b),
22 a GAAP provision, states that "[r]evenues are not recognized until earned" and
23 revenues are considered to have been earned when the entity has substantially
24 accomplished what it must do to be entitled to the benefits represented by the
25 revenue.

26 19. GAAP CON 2 ¶ 63 further requires that for revenue to be recognized
27 during a particular quarter, there must be persuasive evidence of a sales
28 arrangement with the customer. In this regard, Lantronix's own internal

1 procedures for recognizing revenue in a particular quarter required (1) a purchase
2 order from the distributor that included the terms and conditions of sale, including
3 price, quantities, and payment and shipping terms; (2) receipt by Lantronix of the
4 purchase order prior to Lantronix shipping the product; and (3) shipment of the
5 product to the distributor before quarter end. Consistent with this policy, the Form
6 10-Q filed on behalf of Lantronix for the quarter ending December 31, 2000,
7 explicitly represented that "We recognize revenues upon product shipment."

8 20. Recognition of revenue from the above transaction in the quarter
9 ended December 31, 2000, violated GAAP and Lantronix's own revenue
10 recognition procedures because no persuasive evidence existed of a sales
11 arrangement with Transtec. In particular, the precondition to shipment of the
12 product and revenue recognition -- receipt of a purchase order by Lantronix -- did
13 not exist.

14 21. Cotton reviewed and signed the Form 10-Q filed on behalf of
15 Lantronix for the quarter ended December 31, 2000. The Form 10-Q contained
16 Lantronix's financial statements which included the above inflated revenues.

17 22. By causing Lantronix to recognize the \$272,605 in revenue during the
18 December 2000 quarter, Cotton ensured that Wall Street analysts' expectations for
19 Lantronix's revenues and earnings were met for that quarter. Recognition of this
20 revenue resulted in a 2.24% overstatement of Lantronix's quarterly revenues and a
21 44% understatement of Lantronix's pre-tax losses.

22 **B. Cotton Causes Lantronix To Fraudulently Recognize \$1,795,584 In**
23 **Revenue For Its Quarter Ended March 31, 2001, By Granting**
24 **Undisclosed Full Stock Rotation Rights To A Distributor For \$1.5**
25 **Million Of Product And By Shipping To It \$263,925 Of Additional**
26 **Unordered Product**

27 23. Lantronix represented in its Forms 10-Q for the quarters ended
28 December 31, 2000, and March 31, 2001, that "We have granted several customers

1 limited return privileges,” and that “Estimated reserves have been recorded” to,
2 among other things, “reflect these agreements.”

3 24. In a March 21, 2001, email to Manfred Rubin-Schwartz, CFO of
4 Transtec, Cotton requested that Transtec consider a new stocking order for \$1.3
5 million of product for the quarter ending March 31, 2001. To induce Transtec to
6 make this purchase, Cotton offered Transtec “the ability to rotate any unsold
7 inventory” at the end of June 2001. The stock rotation terms associated with this
8 order were not included on either the purchase order or the invoice.

9 25. Cotton caused Lantronix to recognize \$1,531,659 in revenue on this
10 transaction for the quarter ended March 31, 2001. Recognition of this revenue on
11 a transaction allowing for 100% stock rotation by the buyer was improper under
12 both Lantronix’s own stock rotation policy disclosed in its Form 10-Q of allowing
13 “limited return privileges” and GAAP.

14 26. Specifically, Financial Accounting Standards Board Statement No. 48
15 (“FAS 48”), a GAAP provision, provides that, for a company to recognize revenue
16 on a sale with a right of return, a number of conditions must be met. Among other
17 conditions, there must be a history of such sales which provides a basis for
18 estimating the amount of future returns, and income must be reduced to reflect the
19 estimated future returns.

20 27. Stock rotation rights constitute rights of return and, therefore, in order
21 to conform to GAAP, must meet all the requirements of FAS 48 before a sale can
22 be recognized as revenue, including the requirement to establish a returns reserve
23 that is based on a history of sales used to estimate future returns. Lantronix did
24 not meet this requirement because it did not have a history of giving full return
25 rights or full stock rotation rights. Accordingly, Lantronix did not have the
26 historical data to estimate a proper returns reserve, and should not have recognized
27 revenue from sales giving such rights to its distributors.

28 28. At the same time as the \$1,531,659 in product described above was

1 shipped to Transtec, Cotton caused the shipment of an additional \$263,925 of
2 unordered product to Transtec. The product was shipped without a purchase order
3 from Transtec, and Cotton then caused the \$263,925 to be recorded improperly as
4 revenue.

5 29. Lantronix's revenue recognition on the overshipment was not in
6 conformity with GAAP. CON 5, ¶ 83(a) provides that "revenues . . . generally are
7 not recognized until realized. Revenues . . . are realized when products . . . are
8 exchanged for cash or claims to cash." Lantronix should not have recognized
9 revenue on the overshipment to Transtec because Lantronix had no claims to cash.
10 Specifically, Lantronix had no reasonable expectation that Transtec would pay on
11 an invoice for product that it had not ordered.

12 30. Cotton reviewed and signed the Form 10-Q filed on behalf of
13 Lantronix for the quarter ended March 31, 2001. The Form 10-Q contained
14 Lantronix's financial statements which included the above inflated revenues.

15 31. By causing Lantronix to recognize the \$1,795,584 in revenue during
16 the March 2001 quarter, Cotton ensured that Wall Street analysts' expectations for
17 Lantronix's revenues and earnings were met for that quarter. Recognition of this
18 revenue resulted in a 14.56% overstatement of Lantronix's quarterly revenues and
19 a 98% understatement of Lantronix's pre-tax losses.

20 **C. Cotton Causes Lantronix To Fraudulently Recognize \$2,922,654 In**
21 **Revenue For Its Quarter Ended June 30, 2001, By Granting**
22 **Undisclosed Full Stock Rotation Rights To Two Distributors And By**
23 **Recognizing Revenue On A Contingent Sale**

24 32. Lantronix's fiscal year ended June 30, 2001. Less than two weeks
25 before the end of that reporting period, Cotton caused Lantronix to enter into two
26 transactions granting full stock rotation rights as well as a contingent sale. Cotton
27 caused Lantronix to recognize revenue on each of these transactions, in violation
28 of GAAP, as well as Lantronix's revenue recognition policies disclosed in its

1 Forms 10-Q and 10-K and its internal procedures.

2 **1. Cotton Causes Lantronix To Grant Full Stock Rotation Rights To**
3 **Transtec In A \$2.3 Million Transaction**

4 33. In a June 19, 2001, email to Manfred Rubin-Schwartz and Franz
5 Bochtler of Transtec, Cotton requested Transtec's participation in a conference
6 call with Lantronix and Lehman Brothers, Inc. ("Lehman"). Lehman was the lead
7 underwriter for a public offering of securities Lantronix intended to make in July
8 2001. Cotton apprised Transtec that Lehman would want to confirm with Transtec
9 its sell-through of Lantronix product, noting that "we are telling them it is going
10 up each quarter"; its inventory levels of Lantronix product; and Lantronix's
11 shipment to Transtec that quarter. Cotton further explained that he "would like to
12 tell" Lehman that Lantronix was shipping \$2.3 million of product to Transtec for
13 the June quarter, as described in a spread sheet attached to the email. Cotton then
14 added that for the next quarter (ending September 30), his "game plan" would be
15 to suggest an order size of no more than \$500,000 of product and that Transtec
16 "rotate back" \$1.5 million, explaining that "this would bring your inventories
17 down to the acceptable levels by the end of September." Cotton closed the email
18 by stating:

19 I know this [is] asking a lot from you and your team. I hope you will
20 find the terms in the spread sheet acceptable as well as my thinking
21 on how we reduce the inventory levels in the next two quarters. I will
22 call you in one hour.

23 34. On June 27, 2001, Transtec issued two purchase orders to Lantronix
24 that totaled \$2,269,861, when Transtec already had six months of Lantronix
25 product on hand. These orders included \$1,597,170 of Lantronix product (over
26 \$900,000 of which was new product) and \$671,691 of product of a subsidiary of
27 Lantronix, Lightwave Communications, Inc. Lantronix had no previous sales
28 history for either the new Lantronix product or the Lightwave Communications,

1 Inc. product since Lantronix had just acquired Lightwave Communications, Inc.
2 earlier in June 2001. Because the bulk of this order involved new products for
3 Transtec, Transtec's vice president of strategic business unit storage, Franz
4 Bochtler, required return rights with this order, rather than simply rotation rights.
5 Bochtler told Cotton that he would not agree to purchase the \$2.2 million of
6 product without return rights and Cotton orally agreed that Transtec would have
7 the right to return \$1.1 million of goods in early August 2001, and any remaining
8 goods later in the year.

9 35. Through his granting of return rights, and his accommodation of
10 Transtec's concern regarding its excess Lantronix inventory, Cotton stuffed the
11 distribution channel through Transtec and caused Lantronix to improperly
12 recognize \$2,157,234 of revenue on this transaction for the quarter ended June
13 2001. Lantronix's recognition of this revenue was improper because Cotton
14 caused Lantronix to ship Transtec more product than Transtec would have
15 otherwise ordered to artificially inflate Lantronix's reported revenue and earnings.

16 **2. Cotton Causes Lantronix To Grant Full Stock Rotation Rights To**
17 **Lightwave GmbH In A \$421,900 Transaction**

18 36. Cotton caused Lantronix to grant another foreign distributor,
19 Lightwave GmbH, undisclosed full stock rotation rights for 90 days in connection
20 with a \$421,900 sale in June 2001. Cotton negotiated the transaction and
21 informed Lantronix's director of sales operations of the terms. She then noted the
22 stock rotation terms for this transaction in a June 26, 2001 email to Lightwave
23 GmbH. Cotton was copied on the email. Lightwave GmbH never transmitted a
24 purchase order to Lantronix for this transaction. Additionally, Lantronix had not
25 previously made a sale of similar magnitude to Lightwave GmbH. Cotton
26 nevertheless caused Lantronix to recognize \$421,900 in revenue on this
27 transaction for the quarter ended June 2001.

28 37. Recognizing revenue on the Lightwave GmbH transaction absent

1 adequate history of similar transactions enabling Lantronix to properly reserve for
2 this transaction violated FAS 48 and was accordingly not in conformity with
3 GAAP. Recognizing the revenue when full stock rotation rights were granted was
4 also inconsistent with Lantronix's description of its stock rotation rights policy set
5 forth in its March 31, 2001, Form 10-Q (quoted above), and in its Form 10-K for
6 the year ended June 30, 2001, which similarly represented as follows:

7 The company grants certain distributors *limited* rights to return
8 products. . . . The Company establishes an estimated allowance for
9 future product returns *based on historical returns experience* when
10 the related revenue is recorded. . . .

11 [emphasis supplied]

12 38. Recognition of revenue was further improper because Lightwave
13 GmbH had transmitted no purchase order to Lantronix. As explained above,
14 Lantronix's own internal procedures required that it receive a purchase order prior
15 to shipping product. As in its prior filings, Lantronix's Form 10-K for the year
16 ended June 30, 2001 explicitly represented that "Revenue is generally recognized
17 upon product shipment." Recognition of revenue without a purchase order thus
18 violated Lantronix's own internal procedures, contradicted its representations in
19 its Form 10-K, and violated revenue recognition requirements of GAAP
20 provisions CON 2 and CON 5 .

21 39. Lightwave GmbH never paid for the product and ultimately returned
22 it during Lantronix's quarter ended December 2001.

23 **3. Cotton Causes Lantronix To Improperly Recognize Revenue On**
24 **A Transaction Involving A Contingent Order**

25 40. In June 2001, Lantronix sales personnel were attempting to close a
26 sale with Hewlett-Packard (HP) for about \$300,000 worth of product, but HP
27 would not place the order because it did not yet have an order from its end-user.
28 Lantronix's vice president of worldwide sales explained the situation with HP to

1 Cotton, who suggested that KMJ, one of Lantronix's other distributors, agree to
2 take the product, hold it for HP until HP could authorize a purchase order, and
3 then ship the product to HP. On or about June 30, 2001, Cotton caused Lantronix
4 to ship \$343,000 worth of product to KMJ pursuant to this arrangement.

5 41. Cotton caused Lantronix to recognize \$343,520 in revenue on the
6 contingent transaction with KMJ for the quarter ended June 30, 2001.

7 Recognition of this revenue was improper under GAAP. Specifically, one of the
8 requirements for revenue recognition under FAS 48 ¶ 6 when a right of return
9 exists is that, "The buyer has paid the seller, or the buyer is obligated to pay the
10 seller and the obligation *is not contingent on resale* of the product" [emphasis
11 supplied]. Because KMJ's obligation to pay Lantronix was contingent on resale of
12 the product to HP, the conditions for Lantronix to recognize revenue under GAAP
13 were not met.

14 42. KMJ eventually paid Lantronix \$62,500 for this transaction in the
15 quarters ended December 2001 and March 2002 and returned the remainder of the
16 product in the quarter ended March 2002.

17 **4. Cotton Causes Lantronix To Materially Overstate Revenues And**
18 **Understate Pre-tax Losses For Its Quarter Ended June 30, 2001**

19 43. Cotton reviewed and signed the Form 10-K filed on behalf of
20 Lantronix for the year ended June 30, 2001. The Form 10-K contained
21 Lantronix's annual financial statements, which included the inflated revenues for
22 the quarters ended December 31, 2000, and March 31 and June 30, 2001.

23 44. By causing Lantronix to recognize the \$2,922,654 in revenue relating
24 to the above transactions during the June 2001 quarter, Cotton ensured that Wall
25 Street analysts' expectations for Lantronix's revenues and earnings were met for
26 that quarter. Recognition of this revenue resulted in a 21.42% overstatement of
27 Lantronix's quarterly revenues and a 21% understatement of Lantronix's pre-tax
28 losses.

1 **D. Cotton Causes Lantronix To Fraudulently Recognize \$496,927 In**
2 **Revenue For Its Quarter Ended September 30, 2001, By Granting A**
3 **Distributor Return Rights; He Also Brokers A Deal To Stop A Return**
4 **From Transtec In Order To Prevent A Reduction In Revenues**

5 **1. Cotton Grants A Distributor Full Return Rights**

6 45. In late September 2001, Lantronix sold \$496,927 of product to Arrow
7 Electronics, a components distributor, on terms Cotton suggested and approved.
8 These terms included Lantronix granting Arrow the right to return any unsold
9 product by December 27, 2001, as well as 60-day payment terms. Cotton caused
10 Lantronix to recognize \$496,927 in revenue on this transaction for the quarter
11 ended September 2001. Recognition of revenue was improper because of the
12 extended terms; because Lantronix's revenue recognition policy (as disclosed in
13 previously filed Forms 10-Q and 10-K, and as again disclosed in its Form 10-Q for
14 the quarter ended September 30, 2001), provided for only "limited rights to return
15 products"; and because Lantronix did not reserve for the return rights, as it also
16 represented it had in its Forms 10-Q and 10-K. Arrow returned virtually the entire
17 order in January 2002.

18 46. Cotton reviewed and signed the Form 10-Q filed on behalf of
19 Lantronix for the quarter ended September 30, 2001. The Form 10-Q contained
20 Lantronix's financial statements which included the inflated revenues.

21 47. By causing Lantronix to recognize the \$496,927 in revenue during the
22 June 2001 quarter, Cotton ensured that Wall Street analysts' expectations for
23 Lantronix's revenues and earnings were met for that quarter. Recognition of this
24 revenue resulted in a 3.04% overstatement of Lantronix's quarterly revenues and a
25 12% understatement of Lantronix's pre-tax losses.

26 **2. Cotton Brokers A Deal To Prevent A Return From Transtec**

27 48. In order to further ensure that Lantronix met Wall Street analysts'
28 expectations for the quarter ended September 30, 2001, Cotton brokered a deal

1 with another Lantronix customer to prevent a product return from Transtec that
2 would have reduced Lantronix's quarterly revenue. As set forth above, pursuant
3 to a deal negotiated at the end of the quarter ended June 30, 2001, Transtec had the
4 right to return at least \$1.1 million of product that Lantronix previously had
5 shipped to Transtec by August 1, 2001, and for which Lantronix had recognized
6 revenue. In order to reduce this return, Cotton negotiated a deal whereby Transtec
7 would ship \$498,240 of product from its March and June orders to a Texas-based
8 company called TECSys Development, Inc. ("TDI"); TDI would then pay Transtec
9 for the product. The terms stated in the purchase order issued on September 27,
10 2001, by TDI to Transtec were negotiated by Cotton, and included: (1) full
11 rotation rights; (2) no interest charges; (3) payment net 45 days for the first
12 \$114,000 with "further financial terms out to 5 months subject to conversations
13 between TDI and Steve Cotton"; (4) "retain rights to fulfill orders after period -- to
14 be determined by TDI and Steve Cotton"; and (5) shipping and handling charges
15 to be paid by Lantronix.

16 49. TDI wanted the Lantronix product for a future sale to a customer in
17 the Philippines. Although not stated on the purchase order, TDI negotiated with
18 Cotton a right to return the product if the Philippines deal did not go through
19 because TDI did not want to be obligated for a payable of this magnitude.

20 50. In December 2001, Transtec attempted to collect payment from TDI
21 for this transaction. Because the Philippines deal had not yet come through and
22 TDI did not have the money to pay Transtec for the product, Cotton caused
23 Lantronix to lend money to TDI to pay Transtec. On or about December 20, 2001,
24 Lantronix wired \$475,000 to TDI, and issued a check to TDI for \$50,000, which
25 was signed by Lantronix's controller and Cotton by an apparent signature stamp.
26 After Lantronix issued the funds to TDI, TDI paid Transtec. In conjunction with
27 the loan from Lantronix, on or about December 19, 2001, TDI's owner signed
28 promissory notes on behalf of TDI for \$475,000 and \$50,000 for the benefit of

1 Lantronix.

2 51. This transaction was fraudulent because Lantronix essentially paid for
3 its own product when Cotton sent funds to TDI to pay Transtec for the purpose of
4 avoiding the return of Lantronix's product and a corresponding reduction in
5 revenue.

6 52. In June 2002, TDI returned the entire order to Lantronix.

7 **E. Cotton's Fraudulent Scheme Causes Lantronix To Overstate Revenues**
8 **And Understate Pre-Tax Losses**

9 53. As a result of Cotton's fraudulent scheme, Lantronix overstated
10 revenues and understated pre-tax losses for the quarters ended December 2000,
11 March 2001, fiscal year ended June 2001, and the quarter ended September 2001.
12 The approximate amount of the revenue overstatement and understatement of pre-
13 tax losses is set forth below:

14

15	Period	Q2 2001 (ended 12/00)	Q3 2001 (ended 3/01)	Q4 2001 (ended 6/01)	FY 2001 (ended 6/01)	Q1 2002 (ended 9/01)
16	Revenue Overstatement	\$272,605	\$1,795,584	\$2,922,654	\$4,990,843	\$496,927
17	Percentage Revenue Overstatement	2.24%	14.56%	21.42%	9.94%	3.04%
18						
19	Pre-tax Loss Understatement	\$148,189	\$984,298	\$1,324,454	\$2,587,376	\$263,183
20	Percentage Pre-tax Loss Understatement	44%	98%	21%	34%	12%
21						
22						

23 54. Cotton reviewed and signed Lantronix's false and misleading filings,
24 including the Forms 10-Q for the quarters ended December 2000 and March 2001,
25 the Form 10-K for the fiscal year ended June 2001, and the Form 10-Q for the
26 quarter ended September 2001.

27 *

28 *

1 **F. Cotton Knowingly Makes False And Misleading Statements To The**
2 **Auditors**

3 55. As part of an audit, the auditor obtains letters that contain the written
4 representations of management in order to support the auditor's opinion whether a
5 company's financial statements are presented fairly in conformity with GAAP.
6 These letters are commonly referred to as "management representation letters."

7 56. In connection with the 2001 audit of Lantronix, Cotton signed two
8 management representation letters to Lantronix's auditor, Ernst & Young LLP,
9 dated August 8, 2001, and September 28, 2001. In the August 8 letter, Cotton
10 falsely represented, among other things, that (1) the financial statements were
11 fairly presented in conformity with GAAP; and (2) there were no material
12 transactions that were not properly recorded in the accounting records underlying
13 the financial statements. This management representation letter also falsely
14 represented that adequate provision had been made for returns that may be
15 incurred in the collection of Lantronix's accounts receivable. The September 28
16 letter made similar representations by incorporating by reference the August 8
17 letter and stating that the representations in that letter remained current.

18 57. In addition to the misleading management representation letters in
19 support of the fiscal 2001 audit, on or about February 12, 2002, Cotton signed a
20 letter to the auditors which stated that Lantronix's new method of recognizing
21 revenue when the distributor sold through the product to the end user was
22 preferable to the current method of recognizing revenue upon shipment (the
23 "preferability letter"). This preferability letter falsely stated that Lantronix did not
24 have a history of significant returns or stock rotations and that historically returns
25 and stock rotations were properly provided for in accordance with Lantronix's
26 return policy.

27 *

28 *

1 **G. Cotton Causes Lantronix To File A False And Misleading Registration**
2 **Statement In Connection With Its July 2001 Offering**

3 58. On June 14, 2001, Lantronix filed a false and misleading Form S-1
4 registration statement to register an offering of shares of common stock to the
5 public. Cotton signed the Form S-1. The inflated financial statements supporting
6 the offering included improper transactions occurring in the quarters ended
7 December 2000 and March 2001. While the prospectus for this offering, which
8 was filed with the Commission on July 17, 2001, also disclosed that Lantronix
9 granted several customers limited return privileges, it failed to disclose that
10 Lantronix had also granted full return rights. The prospectus further falsely stated
11 that estimated reserves had been recorded to reflect these agreements. The July
12 2001 offering resulted in the sale of more than eight million shares of Lantronix
13 stock at \$8 per share, of which Lantronix sold over six million shares and selling
14 shareholders sold over two million shares.

15 **H. Lantronix Restates Its Financial Statements For The Fiscal Year Ended**
16 **June 2001 And The Quarter Ended September 2001**

17 59. On May 3, 2002, Lantronix terminated Cotton for conduct unrelated
18 to the financial fraud. After his termination, his fraudulent conduct came to light.
19 On May 15, 2002, Lantronix announced that the company's audit committee had
20 commenced an "internal review" focused on the recognition of revenue related to
21 certain sales transactions and that the filing of its Form 10-Q for the third fiscal
22 quarter of 2002 would be delayed. On May 30, 2002, Lantronix issued another
23 press release disclosing that the company intended to restate its financial results
24 for fiscal year 2001 and the first two quarters of fiscal year 2002 based on the
25 results of the internal review. On May 30, 2002, Lantronix's stock closed at
26 \$1.02, down approximately 16% from the previous day's closing price of \$1.22.

27 60. On June 25, 2002, Lantronix restated the financial statements
28 contained in its reports on Forms 10-K and 10-Q for its fiscal year ended June

1 2001 and its quarter ended September 2001, respectively. As a result of the
2 restatements, the revenue and earnings reported pursuant to the above-described
3 fraudulent transactions was corrected.

4 **I. Cotton Profits From His Fraud**

5 61. Cotton profited from his fraud. During the period that Lantronix's
6 stock price was inflated due to Cotton's fraudulent scheme, Cotton received a
7 salary and bonuses. Lantronix's quarterly Executive Incentive Compensation Plan
8 took into account only two factors: (1) "Corporate Financial Goals" and (2)
9 "Individual Objectives." Pursuant to Cotton's December 6, 1999 employment
10 agreement with Lantronix, Cotton was eligible to receive up to 30% of his base
11 salary of \$180,000 as a bonus.

12 62. For its fiscal year ended June 2001, Lantronix paid Cotton a salary of
13 \$183,403 and a bonus of \$43,539. For its fiscal year ended June 30, 2002,
14 Lantronix paid Cotton a salary of \$218,933 and a bonus of \$161,503. This bonus
15 included a \$144,722 "signing bonus" which Cotton received in January 2002
16 pursuant to a new employment agreement. In fact, this "signing bonus" was for
17 past services performed by Cotton for Lantronix.

18 63. Cotton also exercised stock options, and sold and "collared"
19 Lantronix shares during the period in which Lantronix's stock price was
20 artificially inflated due to the improper revenue transactions. A "collar" is an
21 options trading strategy that protects against a decline in the market price by
22 forfeiting some of the potential gain. A collar establishes a floor for the loss (with
23 the purchase of a put option) and a ceiling for the gain (with the writing of a call
24 option). Cotton's approximate realized gains on sales of Lantronix stock
25 ("LTRX") and collar positions for the period May 8, 2001, to May 30, 2002, are
26 detailed below:
27
28

Date	Security	Quantity	Share Price	Gross Receipt	Share Cost	Cost Basis	Gain (realized)
5/8/01 ^{1/}	LTRX	4,000	\$7.0000	\$28,000.00	\$4.88	(\$19,500.00)	\$8,500.00
5/8/01	LTRX	2,800	\$7.0000	\$19,600.00	\$0.50	(\$1,400.00)	\$18,200.00
5/9/01	LTRX	3,800	\$7.0000	\$26,600.00	\$0.50	(\$1,900.00)	\$24,700.00
5/10/01	LTRX	19,300	\$6.9930	\$134,964.90	\$0.50	(\$9,650.00)	\$125,314.90
5/30/01	LTRX	10,000	\$8.8418	\$88,418.00	\$0.50	(\$5,000.00)	\$83,418.00
11/20/01	LTRX Collar	42,941	\$1.5100	\$64,840.91	--	--	\$64,840.91
TOTAL							\$324,973.81

64. As of May 30, 2002, Cotton had 249,636 shares in his Bear Stearns Securities Corp. account, of which 245,373 shares were collared as of November 20, 2001, and 4,263 shares were not collared. The unrealized gain as of May 30, 2002, on these shares (each of which was acquired by Cotton at a cost basis of \$0.50 per share) was approximately \$1,204,544, as follows:

As of 5/30/02	Quantity	Share Price	Source of Price	Gross Receipt	Cost Basis	Gain (unrealized)
Collared Shares	245,373	\$5.40	collar floor (put strike price)	\$1,325,014.20	(\$122,686.50)	\$1,202,327.70
Common Stock	4,263	\$1.02	5/30/02 (Bloomberg)	\$4,348.26	(\$2,131.50)	\$2,216.76
TOTAL						\$1,204,544.46

^{1/} The sale on 5/8/01 was for 6,900 shares. The cost basis for these shares was 100 shares at \$10 per share (8/4/00 buy); 4,000 shares at \$4.875 per share (11/14/00 buy); and 2,800 shares at 0.50 per share (3/23/01 option exercise). The remaining shares included in the table were acquired by Cotton pursuant to his exercise of stock options he was granted pursuant to Lantronix's 1999 stock option plan. Accordingly, his cost basis for these shares was only \$0.50 per share.

1 c. engaged in transactions, practices or courses of business which
2 operated or would operate as a fraud or deceit upon the
3 purchaser.

4 69. By engaging in the conduct described above, defendant Cotton
5 violated, and unless restrained and enjoined will continue to violate, Section 17(a)
6 of the Securities Act, 15 U.S.C. § 77q(a).

7 **SECOND CLAIM FOR RELIEF**

8 **FRAUD IN CONNECTION WITH THE PURCHASE**

9 **OR SALE OF SECURITIES**

10 **Violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder**

11 70. The Commission realleges and incorporates by reference paragraphs
12 1 through 66 above.

13 71. Defendant Cotton, by engaging in the conduct described above,
14 directly or indirectly, in connection with the purchase or sale of a security, by the
15 use of means or instrumentalities of interstate commerce, of the mails, or of the
16 facilities of a national securities exchange, with scienter:

- 17 a. employed devices, schemes, or artifices to defraud;
- 18 b. made untrue statements of a material fact or omitted to state a
19 material fact necessary in order to make the statements made, in the
20 light of the circumstances under which they were made, not
21 misleading; or
- 22 c. engaged in acts, practices, or courses of business which operated or
23 would operate as a fraud or deceit upon other persons.

24 72. By engaging in the conduct described above, defendant Cotton
25 violated, and unless restrained and enjoined will continue to violate, Section 10(b)
26 of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R.
27 § 240.10b-5.

28 *

1 through 66 above.

78. Lantronix violated Section 13(b)(2)(A) of the Exchange Act by failing to make or keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflected its transactions and disposition of its assets.

79. Defendant Cotton knowingly provided substantial assistance to Lantronix in its violations of Section 13(b)(2)(A) of the Exchange Act.

80. By engaging in the conduct described above and pursuant to Section 20(e) of the Exchange Act, 15 U.S.C. § 78t(e), defendant Cotton aided and abetted Lantronix'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).

81. By engaging in the conduct described above, defendant Cotton violated Exchange Act Rule 13b2-1 by, directly or indirectly, falsifying or causing to be falsified, Lantronix's books, records, or accounts subject to Section 13(b)(2)(A) of the Exchange Act. Unless restrained and enjoined, defendant Cotton will continue to violate Rule 13b2-1, 17 C.F.R. § 240.13b2-1.

FIFTH CLAIM FOR RELIEF

INTERNAL CONTROLS VIOLATIONS

Aiding and Abetting Violations of Section 13(b)(2)(B) of the Exchange Act

82. The Commission realleges and incorporates by reference paragraphs 1 through 66 above.

83. Lantronix violated Section 13(b)(2)(B) of the Exchange Act by failing to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that:

- a. transactions were executed in accordance with management's general or specific authorization;
- b. transactions were recorded as necessary (I) to permit preparation of financial statements in conformity with generally

1 accepted accounting principles or any other criteria applicable
2 to such statements, and (II) to maintain accountability for
3 assets;

4 c. access to assets was permitted only in accordance with
5 management's general or specific authorization; and

6 d. the recorded accountability for assets was compared with the
7 existing assets at reasonable intervals and appropriate action
8 was taken with respect to any differences.

9 84. Defendant Cotton knowingly provided substantial assistance to
10 Lantronix in its violations of Section 13(b)(2)(B) of the Exchange Act.

11 85. By engaging in the conduct described above and pursuant to Section
12 20(e) of the Exchange Act, 15 U.S.C. § 78t(e), defendant Cotton aided and abetted
13 Lantronix's violations, and unless restrained and enjoined will continue to aid and
14 abet violations, of Section 13(b)(2)(B) of the Exchange Act, 15 U.S.C.
15 § 78m(b)(2)(B).

16 **SIXTH CLAIM FOR RELIEF**

17 **BOOKS AND RECORDS VIOLATIONS**

18 **Violations of Section 13(b)(5) of the Exchange Act**

19 86. The Commission realleges and incorporates by reference paragraphs
20 1 through 66 above.

21 87. Defendant Cotton, by engaging in the conduct described above,
22 knowingly circumvented or knowingly failed to implement a system of internal
23 accounting controls, or knowingly falsified books, records or accounts described
24 in Section 13(b)(2) of the Exchange Act.

25 88. By engaging in the conduct described above, defendant Cotton
26 violated, and unless restrained and enjoined will continue to violate, Section
27 13(b)(5) of the Exchange Act, 15 U.S.C. § 78m(b)(5).

28 *

1 **SEVENTH CLAIM FOR RELIEF**

2 **FALSE STATEMENTS TO AUDITORS**

3 **Violation of Exchange Act Rule 13b2-2(a)**

4 89. The Commission realleges and incorporates by reference paragraphs
5 1 through 66 above.

6 90. Defendant Cotton, by engaging in the conduct described above,
7 directly or indirectly:

- 8 a. made or causing to be made materially false or misleading
9 statements to accountants in connection with; or
- 10 b. omitted to state, or caused another person to omit to state,
11 material facts necessary in order to make statements made, in
12 light of the circumstances under which such statements were
13 made, not misleading, to accountants in connection with:
 - 14 i. an audit, review or examination of the financial
15 statements of the issuer required to be made; or
 - 16 ii. the preparation or filing of a document or report required
17 to be filed with the Commission.

18 91. By engaging in the conduct described above, defendant Cotton
19 violated, and unless restrained and enjoined will continue to violate, Exchange Act
20 Rule 13b2-2(a), 17 C.F.R. § 240.13b2-2(a).

21 **PRAYER FOR RELIEF**

22 WHEREFORE, the Commission respectfully requests that the Court:

23 **I.**

24 Issue findings of fact and conclusions of law that the defendant committed
25 the alleged violations.

26 **II.**

27 Issue a judgment, in a form consistent with Rule 65(d) of the Federal Rules
28 of Civil Procedure, permanently enjoining defendant Cotton, and his agents,

1 servants, employees, and attorneys, and those persons in active concert or
2 participation with any of them, who receive actual notice of the order by personal
3 service or otherwise, from violating Section 17(a) of the Securities Act and
4 Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B) and 13(b)(5) of the Exchange Act,
5 and Rules 10b-5, 12b-20, 13a-1, 13a-13, 13b2-1 and 13b2-2(a) thereunder.

6 **III.**

7 Order defendant Cotton to disgorge all ill-gotten gains from his illegal
8 conduct, together with prejudgment and post-judgment interest thereon.

9 **IV.**

10 Order defendant Cotton to pay civil penalties under Section 20(d) of the
11 Securities Act, 15 U.S.C. § 77t(d), and Section 21(d)(3) of the Exchange Act,
12 15 U.S.C. § 78u(d)(3).

13 **V.**

14 Enter an order, pursuant to Section 20(e) of the Securities Act, 15 U.S.C.
15 § 77t(e), and Section 21(d)(2) of the Exchange Act, 15 U.S.C. § 78u(d)(2),
16 prohibiting defendant Cotton from acting as an officer or director of any issuer
17 that has a class of securities registered pursuant to Section 12 of the Exchange Act,
18 15 U.S.C. § 781, or that is required to file reports pursuant to Section 15(d) of the
19 Exchange Act, 15 U.S.C. § 78o(d).

20 **VI.**

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

25 *

26 *

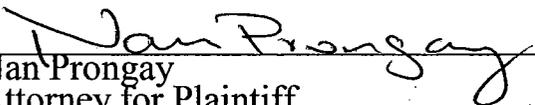
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28 *

VII.

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

DATED: September 27, 2006


Nan Prongay
Attorney for Plaintiff
Securities and Exchange Commission