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UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. JOHN J. TODD, ROBERT D. MANZA, and JEFFREY WEITZEN, Defendants.	Case No. **COMPLAINT FOR VIOLATIONS OF THE FEDERAL SECURITIES LAWS**

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

JURISDICTION AND VENUE

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

2. Venue is proper in this district 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 defendants reside, and certain of the transactions, acts, practices and courses of conduct constituting violations of the federal securities laws occurred, within this district.

SUMMARY

3. This case involves a fraudulent earnings manipulation scheme to meet Wall Street analysts' expectations by San Diego-based computer manufacturer Gateway, Inc. ("Gateway" or the "Company") and certain of its senior management during the second and third quarters of 2000. Through this scheme, and by making false statements and concealing from the investing public important information about its financial performance and the success of its personal computer ("PC") business, Gateway gave the false and misleading impression that, unlike many of its competitors, it was outpacing an industry trend of decreasing sales of personal computers. In fact, throughout 2000, Gateway's sales growth from personal computers was declining significantly — a trend that Gateway's senior management went to great lengths to conceal from the public.

4. The Company's Chief Financial Officer, defendant John J. Todd ("Todd"), was the architect of a plan to "close the gap" between analysts' expectations and the Company's anticipated revenues through a variety of improper and extraordinary transactions and sales efforts. Gateway's Controller, defendant Robert D. Manza ("Manza"), assisted in the scheme by, among other things, initiating certain unusual transactions and then preparing financial statements knowing that these transactions failed to comply with generally accepted accounting principles ("GAAP"). Gateway's Chief Executive Officer, Jeffrey Weitzen ("Weitzen"), knew that Gateway's third quarter 2000 reported revenues were inflated as a result of certain extraordinary one-time transactions, knew that Gateway was resorting to increasingly desperate measures to boost its

revenues to meet analysts' expectations, ignored red flags about the earnings manipulation scheme, failed to take any action to ensure that Gateway's disclosures to the public were complete and accurate, and misled the investing public as to the true state of Gateway's business.

5. In 2000, Gateway's internal sales projections showed that the Company would not meet the expectations of Wall Street analysts who followed its stock. Starting in the second quarter of 2000, Todd took steps to prop up sales with a scheme to offer pre-approved financing to individuals whose credit applications had previously been denied by the Company. This effort continued into the third quarter with even riskier credit candidates and became known within Gateway as the "DDS program," which stood for "deep, deep sh[--]." As a result, Gateway misleadingly announced that its consumer sales had increased substantially without disclosing that sales were made to a far riskier credit class of consumers.

6. The fraudulent actions became more aggressive in the third quarter of 2000, when defendants recognized that they could not "close the gap" simply by increasing the amount of PC sales to high-risk customers. Todd authorized a wider variety of improper accounting actions, including improperly reducing certain reserves, improperly recognizing revenue on several one-time transactions, improperly recognizing revenue from Gateway's relationship with America Online, Inc. ("AOL"), and improperly making additional undisclosed accounting adjustments.

7. Despite defendants' knowledge of and participation in this scheme, in Gateway's Forms 10-Q, earnings press releases, and conference calls with analysts, defendants misrepresented or failed to disclose significant trends in Gateway's business and that revenue and earnings included various one-time transactions.

8. As a result of defendants' improper accounting actions, Gateway announced that it had exceeded analysts' expectations for revenue and had met

analysts' expectations for earnings per share ("EPS") for the third quarter 2000. In October 2000, just after Gateway's third quarter earnings press release, the Company's stock price increased, in stark contrast to the Company's competitors' falling stock prices during the same period. In early 2001, after defendants' departure from the Company, Gateway reversed most of its "close the gap" transactions, resulting in large reductions in reported revenue for the period and a dramatic decrease in Gateway's stock price.

9. As alleged more specifically below, Todd and Manza each violated the antifraud, record-keeping, lying to accountants and internal controls provisions, and aided and abetted Gateway's violations of the reporting and record-keeping provisions, of the federal securities laws. Weitzen violated the antifraud and lying to the accountant provisions and, as a control person of Gateway, also is liable for Gateway's third quarter 2000 violations of the antifraud and reporting provisions. By this complaint, the Commission seeks to enjoin each of the defendants from future violations of the federal securities laws, to obtain disgorgement of all benefits received by defendants from their violations, to obtain civil penalties, and to prohibit them from serving as officers or directors of publicly-traded companies.

THE DEFENDANTS

10. John J. Todd, age 43, resides in Rancho Santa Fe, California. Todd served as Senior Vice President and Chief Financial Officer of Gateway from October 1998 to January 2001. As CFO, Todd was responsible for Gateway's financial disclosures throughout 2000. He signed Gateway's 1999 annual report on Form 10-K as CFO and Principal Accounting Officer. In the second and third quarters of 2000, he reviewed, edited and signed Gateway's Forms 10-Q as CFO and Chief Accounting Officer. Todd reviewed and edited Gateway's earnings press releases, and personally made representations about Gateway to investors and analysts in Gateway's earnings conference calls.

11. Robert D. Manza, age 42, resides in Plano, Texas. Manza obtained his certified public accountant ("CPA") license, which is currently inactive, in Michigan in 1985. Manza served as Gateway's Controller from October 1999 to June 2001, and as the CFO of Gateway's Business Division from June 2001 to February 2002. During 2000, Manza was responsible for the preparation of Gateway's financial statements as well as the Management's Discussion and Analysis ("MD&A") section of Gateway's Forms 10-Q.

12. Jeffrey Weitzen, age 47, resides in Rancho Santa Fe, California. Weitzen served as President and Chief Operating Officer of Gateway from January 1998 until January 2000, when he became Chief Executive Officer. He resigned from Gateway in January 2001. Weitzen signed Gateway's 1999 annual report on Form 10-K as President, Chief Operating Officer, and Director. As CEO during 2000, Weitzen ultimately was responsible for Gateway's public disclosures. He also was involved in the day-to-day running of the Company. He held weekly meetings with his direct staff (including Todd) in which financial results were discussed. He also held weekly meetings with the consumer team and monthly meetings with the business team. Weitzen knew how the consumer and business teams were performing as compared to company plans and what actions had to be taken to make up any difference between the two. During the year 2000, Weitzen reviewed and edited Gateway's quarterly earnings press releases, and personally made representations about Gateway to investors and analysts in Gateway's earnings conference calls.

RELATED ENTITIES

13. Gateway, Inc. is incorporated in Delaware and headquartered in San Diego, California. Gateway is a direct marketer of PCs and related products. Its stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and trades on the New York Stock Exchange.

14. PricewaterhouseCoopers LLP ("PwC" or the "outside auditor") has

been Gateway's independent auditor from the mid-1980s through the present. PwC conducted quarterly reviews of Gateway's financial results. With respect to the second and third quarters of 2000, PwC conducted its reviews after the close of each quarter but before Gateway made its public earnings announcements.

BACKGROUND

A. Gateway's Reporting Obligations and Public Announcements

15. As a public company, Gateway was required to comply with federal statutes, rules and regulations to maintain public trading of its stock and to sell its securities to the public.

16. These statutes, rules and regulations, designed to ensure that financial information is accurately recorded and publicly disclosed, required Gateway to, among other things: (a) make and keep books, records and accounts, which, in reasonable detail, accurately and fairly reflected its transactions and dispositions of assets; (b) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that the transactions were recorded as necessary to permit preparation of financial statements in conformity with GAAP or any other criteria applicable to such statements and to maintain accountability for assets; (c) file with the Commission quarterly reports on the appropriate form (known as a "Form 10-Q") including a financial statement containing the company's balance sheet and statements of income and cash flows prepared in conformity with GAAP; and (d) file with the Commission periodic reports that did not make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

17. As part of the MD&A section of Gateway's Forms 10-Q, Gateway management was required to discuss and analyze the Company's financial condition, changes in financial condition, and results of operations, with a specific focus on material events and uncertainties known to management that would cause

reported financial information not to be necessarily indicative of future operating results or future financial condition. Gateway's management thus was required specifically to disclose known trends or uncertainties that have had or that they reasonably expected would have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.

18. Under GAAP, the Commission's rules and regulations, and Gateway's own publicly-stated accounting policies, Gateway recorded and reported sales revenue and income for specific periods, i.e., as of the end of each quarter and at the end of its fiscal year. Gateway used a calendar year as its fiscal year. In 2000, Gateway's first quarter ended March 31; its second quarter ended June 30; its third quarter ended September 30; and its fourth quarter ended December 31.

19. In addition to filing annual and quarterly reports with the Commission, Gateway also issued earnings press releases and held conference calls with analysts and investors to discuss its financial performance on a periodic basis, usually after the end of a quarter and before Gateway made its filings with the Commission.

20. Under GAAP and the Commission's rules and regulations, Gateway could recognize revenue from a sale during a particular reporting period only if: (1) persuasive evidence existed of a sales arrangement with a customer; (2) delivery of the product had occurred; (3) the price for the product was fixed or determinable; (4) collectibility of the sales price was reasonably assured; and (5) Gateway had substantially performed all of its obligations to the customer. As set forth in its annual report for 1999 on Form 10-K, Gateway's revenue recognition policy provided that it generally recognized revenue from product sales at the time of shipment, provided that no significant obligation remained.

21. GAAP does not permit companies to recognize revenue for consignment sales. As used herein, a "consignment sale" refers to a sale in which a reseller (Gateway's purported customer) does not have an obligation to pay for

the systems purchased. A consignment sale may arise when a reseller has a right to cancel a sale before any payment is made, or to delay payment until a final sale is made to an end-user. Under GAAP, consignment sales may not be recognized as revenue because, among other things, collectibility of the sales price is not assured.

22. In addition, under GAAP, to recognize revenue on sales in which Gateway, as the seller, maintained inventory of the sold goods (called "bill-and-hold" sales), Gateway had to satisfy the following requirements: (1) the risks of ownership for the goods had to have passed to the buyer; (2) the customer must have made a fixed commitment to purchase the goods, preferably reflected in written documentation; (3) the buyer, not the seller, must have requested that the transaction be on a bill-and-hold basis and must have had a substantial business purpose for ordering the goods on a bill-and-hold basis; (4) there must have been a fixed schedule for delivery of the goods that was reasonable and consistent with the buyer's business purpose; (5) the seller must not have retained any specific performance obligations such that the earnings process was not complete; (6) the ordered goods must have been segregated from the seller's inventory and not have been subject to being used to fill other orders; and (7) the equipment must have been complete and ready for shipment.

23. GAAP also does not permit recognition of revenue on a sale with a right of return, except when there is a history of such sales to provide a basis for estimating the amount of future returns and if income is reduced to reflect the estimated future returns through the establishment of a reserve for returned goods.

B. <u>Gateway's "Beyond the Box" Strategy as Employed in 1999</u>

24. In 1999, Gateway took steps to diversify its income stream beyond traditional PC sales by offering other products and services, such as software, peripherals, Internet access services, training programs, and support programs. Gateway called this strategy of selling non-PC products and services "beyond the

box."

25. As part of this strategy, in April 1999, Gateway expanded into the business of financing consumer loans by entering into an agreement with a supplier of consumer financing, pursuant to which the supplier would originate the loans and Gateway would purchase a 95% participation interest in the loans. As part of its consumer financing strategy, in June 1999, and again in December 1999, Gateway lowered the credit standards for the consumer loans it purchased, greatly increasing the risky nature of and potential losses from such loans.

26. Also in December 1999, Gateway initiated a program to contact applicants who had been previously declined for credit and offer them a pre-approved loan. The purpose of this consumer financing program was to sell Gateway PCs to customers who would not otherwise be able to afford them. This program was referred to as "outbound," because the loans were generated by Gateway initiating a call with an offer of pre-approved credit, as distinguished from the customary "inbound" program where a potential customer contacted Gateway and applied for credit.

27. By the end of 1999, beyond-the-box income made up 20% of Gateway's total pre-tax income.

C. Despite Industry-Wide Declining PC Sales, Gateway Announced Aggressive Future Performance Targets for 2000 and Beyond

28. Despite the fact that the PC industry was experiencing a decline in sales and profit by 2000, Gateway declared at the beginning of 2000 that its products and market plans were strong and would allow it to deliver results to shareholders in 2000. Indeed, Gateway, through Todd and Weitzen, not only confirmed its confidence in meeting analysts' expectations of $1.83 per share in earnings for 2000, but also announced aggressive future performance targets, including plans to grow revenue at 21% and EPS at 35% annually to reach a target of $30 billion in revenue by 2004.

29. Gateway also announced at the beginning of 2000 that it anticipated non-system, or "beyond the box," income to reach 40% of total income by the end of 2000. During a January 20, 2000 conference call, however, Weitzen assured analysts that the Company's "bread and butter" was still the PC, which continued to account for the "lion's share" of Gateway's revenue.

THE FRAUDULENT SCHEME TO OVERSTATE REVENUE AND EARNINGS IN THE SECOND AND THIRD QUARTERS OF 2000

A. Gateway Took on High-Risk Debt to Increase PC Sales to Potential Customers with Bad Credit

30. In the second quarter of 2000, Todd authorized Gateway to pursue an aggressive outbound loan financing program directed to customers whose applications for credit in Gateway's inbound program had been rejected because they failed to satisfy the credit standards. Todd initially commenced the second quarter program as a test, with the intention of financing only $10 million of such high-risk loans. As sales results began to slip in the quarter and Todd realized that Gateway might not meet analysts' revenue expectations, however, he continued the program to bolster sales.

31. In late May 2000, Todd authorized Gateway's consumer financing department to contact customers that Gateway previously had declined for credit because they failed to satisfy the credit standards and offer them a pre-approved PC package. Employees from Gateway's subsidiary bank informed Todd to anticipate loan losses on the program of approximately 38% (which was roughly equivalent to the profit margin on the PC package included in the program). The employees also repeatedly warned Todd that there were inherent risks in any new sub-prime consumer loan program, that management should expect variations from the loss estimates, and that losses could be as high as 50%.

32. Todd initially authorized the program to continue only until it generated $10 million in sales. By June 8, 2000, Gateway had generated $10

million in these high-risk loans, but Todd decided to continue the program with the revised goal of $20 million.

33. On June 10, the Vice President of Gateway's Consumer Division told Todd that he was counting on $30 million from the outbound program to meet his revenue target of $975 million. Accordingly, Todd instructed the consumer finance team to continue the program until the $30 million sales target was reached.

34. On or about June 16, 2000, Todd received a spreadsheet, internally referred to as a "scoresheet," that compared Gateway's actual financial performance against Gateway's internal budget and consensus analysts' expectations. This scoresheet projected that Gateway would not meet consensus analysts' expectations for revenue by $80 million, due to slow consumer and business-to-business PC sales. To fill in this gap, Todd authorized the continued use of the outbound loan financing program to the end of the third quarter 2000.

35. Todd approved use of the outbound loan financing program to generate more revenue for Gateway despite receiving repeated warnings from Gateway employees. Weitzen approved the strategy of taking on riskier credits through offering pre-approved financing to customers who Gateway had previously declined for credit, and understood that the program materially contributed to Gateway's revenue.

36. Ultimately, the outbound loan financing program generated $112 million, or 5%, of Gateway's second quarter revenue of $2.14 billion.

B. <u>Todd Pursues a Sale of Gateway's Best Performing Consumer Loans to Increase Second Quarter Earnings</u>

37. In addition to recording revenue from the high-risk loans generated by the outbound financing program, Todd also initiated the idea of selling Gateway's consumer loans to increase second quarter earnings. In June 2000, Todd instructed Gateway's Director of Global Financing to pursue a potential sale

of $50 million of the Company's consumer loan receivables. Todd informed Gateway's Director of Global Financing that Gateway would need this sale "for the quarter."

38. On June 30, 2000, the last day of the second quarter, Gateway recorded the sale of $54 million in loan receivables to its consumer financing supplier. To consummate this transaction, however, Gateway loaned the supplier $50 million at a below-market interest rate to use in purchasing the loan receivables. Without the loan from Gateway, the consumer financing supplier would not have agreed to the deal. Gateway made its wire transfer of the $50 million it loaned to the supplier on June 30, at the same time that the supplier made its wire transfer payment to Gateway for the loan receivables.

39. As part of this agreement, Gateway also allowed its consumer financing supplier to cherry pick the loans it purchased from Gateway. Not surprisingly, the supplier selected the best performing loans, which further reduced the credit quality of Gateway's loan portfolio.

40. Gateway's sale of the loans receivable made no business sense. Todd knew that while Gateway made only $4.3 million on the loan sale (without taking into account the financial effect of the loan Gateway provided the consumer financing entity), it would have realized an additional $10 million in income (based on present value) had it kept the loans. Todd nevertheless authorized Gateway to sell its future stream of income at less than its present value in order to realize instant income.

41. Gateway recorded an improper gain of $6 million on this purported sale in the second quarter of 2000. This gain resulted in an increase to EPS of over a penny, or 3%. Without the inclusion of the improper $6 million gain from this transaction in the second quarter's financial results, Gateway would not have exceeded analysts' EPS estimates by a penny, as it reported.

C. Todd Caused Gateway's Financial Results for the Second Quarter 2000 to Be False and Misleading

42. On July 13, 2000, Gateway issued a press release announcing "record earnings" of $.37 EPS, 32% over the second quarter 1999 and exceeding consensus analysts' estimates by a penny. Gateway further announced revenues of $2.14 billion, 12% over the second quarter 1999 — missing expectations for revenue by just $8 million. Gateway further reported that beyond-the-box income made up 40% of overall income, meeting its "previously stated goal for the fourth quarter a half-year ahead of schedule." Todd reviewed, edited, and authorized this press release. Todd also authorized and signed Gateway's Form 10-Q for the second quarter, which incorporated these revenue, earnings, and growth claims.

43. Gateway's Form 10-Q and press release for the second quarter of 2000 were misleading because they failed to disclose to investors the percentage of Gateway's sales generated by the high-risk outbound campaign. Investors therefore were not informed that Gateway's revenue and growth would have been significantly lower without the inclusion of the financing to high-risk credits. Indeed, to the contrary, Gateway announced that its year-over-year consumer sales had increased 32%, and unit sales increased 39%, giving the false impression that Gateway's revenues were increasing via sales to the same credit class of customers who had purchased PCs in prior periods. Todd's failure to disclose the sales attributable to the high-risk campaign obscured a material, negative trend in consumer demand.

44. Todd also failed to disclose the increasing risk exposure within Gateway's loan portfolio in the MD&A section of Gateway's Form 10-Q. By the end of the second quarter 2000, the riskier loans amounted to $153.36 million, or 32% of Gateway's total portfolio, compared to 0% at the end of the second quarter 1999. Because the increased risk exposure in Gateway's loan portfolio was a significant trend in Gateway's business, Todd's failure to disclose it was

misleading to investors.

45. Gateway's second quarter Form 10-Q and press release also were false and misleading because Gateway improperly accounted for a transaction with its consumer loan service provider that resulted in an increase of 3% in earnings and without which Gateway would not have exceeded analysts' estimates. The recording of the $6 million gain was improper under GAAP because Gateway did not take into account the financial effect of the loan Gateway provided to fund this one-time purchase. To properly record the sale under GAAP, Gateway was required to treat the sale of the receivables and the loan for the purchase as related transactions, and to allocate a sufficient portion of the cash received from the sale to the supplier's loan receivable to permit recognition of interest income on the loan receivable at an appropriate interest rate over the life of the loan. Because Todd knew that the loan to Associates was essential to the sale, he knew, or was reckless in not knowing, that the accounting for the gain without reference to the loan was not in accordance with GAAP.

46. In any event, even if Gateway's accounting had been appropriate, Gateway's failure to disclose the sale as a one-time event affecting quarter earnings was misleading in light of its claim that its "record second quarter profits" were caused by "[r]obust year-over-year growth in PC sales to consumers" and "strong and increased sales of PC-related products and services." Todd also authorized this misleading disclosure with knowledge of the effect of the loan sale on Gateway's earnings.

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D. Because Gateway Faced a Wider Gap Between its Operating Results and Analysts' Expectations, Defendants Resorted to More Desperate Measures to Increase Revenue and Earnings in the Third Quarter of 2000

47. Throughout the third quarter of 2000, various computer companies reported that PC sales were slow and/or that they would not achieve their projected results. For example, on August 10, 2000, Dell Corp. reported slower-than-expected sales and shipment growth for the quarter ended in July. Dell also missed analysts' expectations for revenues, and its stock price fell nearly 10%. On September 13, SCI Systems, Inc., a maker of components and PCs for companies such as Dell and Hewlett-Packard, lowered its revenue forecast by 13% and its EPS forecast by 11%, attributing the revised forecast to seasonal weaknesses in consumer electronics and PC demand. SCI Systems' stock fell nearly 30% following the news. Similarly, on September 21, 2000, Intel Corp. pre-announced that its revenue and earnings for that quarter would fall below expectations, and its stock price dropped 24%. On September 28, 2000, Apple Computer, Inc., also warned that its quarter profits would miss previous forecasts, due to disappointing sales of computer products, and its stock price fell more than 50%.

48. Consistent with this negative trend in the computer industry, Todd and Weitzen learned in the third quarter of 2000 that Gateway faced a significant gap between its operating results and analysts' expectations for the third quarter. As early as May 2000, Gateway's market research group told senior management, including Weitzen, that based on current trends in demand, the Company's third and fourth quarter forecasts were extremely aggressive and would require additional efforts to achieve the company's targets.

49. In early August 2000, the executive staff of Gateway, including Weitzen, met to discuss the Company's financial results for July and the third

quarter projections. In that meeting, Todd disseminated a written presentation showing that, for the month of July, sales growth over the prior year was only 9%. Gateway internal documents as of August 2000 reflected that unit growth was only 6% for July, a sharp contrast to reported unit growth of 39% in the second quarter.

50. On September 15, 2000, Todd received a document from Gateway's financial planning department — entitled "Gap to Consensus" — showing a significant shortfall between Gateway's actual results and analysts' estimates for the third quarter 2000 (the "Gap to Consensus Spreadsheet"). The document reflected that, through the end of August 2000, Gateway had achieved only $1.4 of $2.5 billion in revenue necessary to meet analysts' expectations. The document predicted that, taking into account the projected income from September sales, and various corporate items, Gateway likely would achieve only $.36 EPS, which was 10 cents shy of analysts' expectations. The Gap to Consensus Spreadsheet also specifically referenced various items "being worked" on to bridge the gap, including a loan loss reserve adjustment of $10 million and a sale to VenServ, Inc. ("VenServ") of $10 million.

51. On September 17, 2000, Todd sent an e-mail to Gateway's senior staff, including Weitzen, informing them that they were "coming down to the wire" for the third quarter's results. He told them that, based on current forecasts, the Company was likely to be $110 million short of analysts' revenue expectations for the third quarter 2000 and that, as of the end of August, the company had generated only $.06 of the $.46 necessary to meet consensus analysts' EPS estimates. Todd referenced several potential "gap closures," including an item called "AOL accounting" for $30 million and what he termed potential "sales pull forwards" to Rent-Way, Inc. ("Rent-Way") and VenServ of $10-20 million. Weitzen's staff then met and discussed the anticipated revenue and EPS gaps, and the potential gap closures identified in Todd's e-mail.

52. Despite these internal indications, Gateway did not inform analysts

that it was likely to fall short of analysts' expectations for third quarter revenue and earnings. Indeed, to the contrary, Todd and Weitzen repeatedly assured analysts that Gateway, unlike its competitors, was on track to meet its revenue and earnings targets. For example, on August 3, 2000, Todd specifically told analysts in a conference call that July had been a solid month. Similarly on September 6, 2000, Gateway's management told analysts that market conditions would not stand in the way of Gateway's plan to accelerate revenue growth in the second half of 2000. On September 22, 2000, Todd further assured analysts, in direct response to the decline in Gateway's stock price after Intel Corp. issued its September 21 earnings warning, that demand for Gateway PCs was still "solid" and that Gateway was on track to reach consensus analysts' expectations for EPS. Analysts expected 16% year-over-year sales growth for the third quarter 2000.

53. To bridge the gap between analysts' expectations — which Todd and Weitzen had fostered through their public comments and their failure to provide downward guidance — and Gateway's true financial results, Todd engaged in the increasingly improper activities described below, with Manza's participation. Then, along with Weitzen, Todd issued false and misleading public disclosures concerning Gateway's third quarter results which obscured Gateway's true financial condition and the significant trends affecting its business.

E. <u>Todd Further Lowered Gateway's Credit Standards to Increase Consumer Sales Through High-Risk Loans</u>

54. Gateway continued to support slipping PC sales in the third quarter with its outbound program, but had to seek even riskier credit candidates. Early in the third quarter, Gateway exhausted its list of declined applicants who met the second quarter's criteria. Todd therefore authorized Gateway to continue the outbound loan financing program, despite the fact that Gateway had to lower the consumer credit cutoffs used in the second quarter 2000 even further. The third quarter outbound program was dubbed internally at Gateway the "DDS program,"

which stood for "deep, deep sh[—]." Todd made the decision to reach deeper into the declined applicant pool based on the need to increase third quarter revenues. In so doing, Todd ignored warnings from Gateway's bank employees who estimated losses for the outbound loan financing program at over 50%.

55. The outbound calling to high-risk declined applicants in the third quarter generated $84 million, or 3%, of Gateway's reported revenue. In its earnings press release and Form 10-Q for the third quarter, however, Gateway failed to inform investors of the portion of its sales resulting from the high-risk outbound campaigns. Gateway ultimately announced that it exceeded consensus analysts' expectations for revenue by $30 million, but failed to disclose that it would not even have met expectations had it not engaged in the outbound campaigns to high-risk customers. Further, Gateway announced that its consumer sales had increased 27% over the third quarter 1999, without disclosing the reason for the increase, again giving the false impression that its third quarter 2000 sales were of the same quality as its third quarter 1999 sales.

56. Gateway's third quarter press release and Form 10-Q also were misleading in failing to provide information concerning the deteriorating quality of Gateway's consumer loan portfolio. At the end of the third quarter, the riskier loan receivables had risen to $243 million, or 37%, of Gateway's total portfolio, an 1191% increase over the same quarter in 1999. Furthermore, the portfolio included outbound loans on which Gateway anticipated losses of more than 50%. This increased risk exposure within Gateway's consumer loan portfolio, as well as the volume of risky loans, were significant trends that Gateway should have disclosed but did not.

57. Todd, Manza, and Weitzen knew that the risk level of the consumer loan portfolio had increased substantially on a year-over-year basis and that high-risk loans contributed materially to Gateway's revenues. Todd approved the use of this program to generate sales to meet the company's revenue targets. At least by

the third quarter 2000, Manza had received reports that the company was engaging in special programs to offer loans to high-risk customers, and was apprised of the anticipated loss rates on those programs. Yet Manza prepared, and Todd approved, Gateway's MD&A section for the third quarter Form 10-Q, without disclosing this increasingly risky trend in Gateway's business. Todd and Weitzen also approved Gateway's press release touting revenue growth without disclosing this trend.

F. <u>Todd and Manza Manipulated Gateway's Loan Loss Reserve to Offset Gateway's Earnings Gap</u>

58. By September 15, Todd's Gap to Consensus Spreadsheet reflected that one of the items "being worked" to close the gap was Gateway's loan loss reserve. Gateway anticipated generating $10 million in income from relieving the reserve that had been established during the second quarter.

59. Early in the third quarter, the increasingly risky nature of the outbound loan financing program, as well as the significant increase in the loan loss reserve due to the aggressive outbound program in the second quarter, drew the attention of Gateway's senior management. Consequently, on July 31, Todd, Manza, officers of Gateway's bank, and Gateway's Director of Global Financing ("GF Director") met to discuss the Company's loan portfolio. One of the topics at this meeting was whether there was a "shortage in the loan loss reserve."

60. Nevertheless, following the meeting, Todd instructed the GF Director and Manza to investigate the reserve and come up with a new methodology. In response, the GF Director devised a new methodology (named internally at Gateway after the GF Director and referred to herein as the "GF Director's Method") that was based on a straight-line approach to loss provisioning rather than on actual loss curves.

61. Todd directed the implementation of this new methodology in August 2000. Following Todd's directive, and consistent with the GF Director's Method,

Manza instructed his staff to book a reserve of $3 million in August and September rather than the approximately $9 million per month that would have been booked under the prior method. Near the end of the third quarter 2000, Todd instructed Gateway management to reduce the reserve by another $22 million.

62. Ultimately, notwithstanding its increasing portfolio of high risk loans, Gateway decreased its third quarter 2000 loan loss reserve by $34.5 million from what would have been booked under Gateway's prior methodology. This change increased third quarter income as reported in the Form 10-Q and earnings press release for this period by $34.5 million, causing an overstatement of EPS of $.067. The overstatement was material because, without it, Gateway would not have been able to report that it precisely met consensus expectations of $.46 EPS.

63. Gateway's change of its loan loss reserve methodology in the third quarter 2000 was improper under GAAP because Gateway failed to employ a consistent approach between reporting periods, and because the new method was not demonstrably preferable to the old method. Under the old method, which had been adopted in 1999, Gateway took a portion of the anticipated losses up front, and amortized the remaining portion over the life of the loans. This old method was more consistent with historical data available at the time for consumer loan portfolios like Gateway's that showed the majority of loan losses occurred in the first twelve months of a loan.

64. Todd and Manza knew, or were reckless in not knowing, that the new methodology did not comply with GAAP. By using the GF Director's Method to calculate the reserve, Todd and Manza knowingly ignored Gateway's internal loss estimates for the high-risk loans under the outbound financing program. Indeed, Todd and Manza knew that the loss estimates on which the GF Director's Method relied did not include any data from the high-risk campaigns commenced in the second quarter 2000, much less the newer loans with worse credit criteria from the third quarter 2000. Todd also ignored data illustrating that the majority of loan

losses occur in the early life of a loan. Employees of Manza raised concerns about the revised reserve methodology, but Manza ignored these concerns.

65. Even if Gateway's new loan loss reserve methodology had been appropriate, however, it would have been improper for Gateway to reduce the reserve without disclosure because the reserve reduction had a material effect on Gateway's third quarter earnings. Disclosure of the methodology changes also was required under applicable Commission regulations requiring disclosure of any significant change in any accounting principle or estimate. Furthermore, Commission regulations required Gateway to disclose the amount of its loan loss reserve, the activity in the reserve throughout the third quarter, and the fact that the reserve had increased 793% over year-end 1999. Gateway did not disclose any of this information to the public.

66. Todd and Manza also participated in the drafting of Gateway's Form 10-Q, including the portion addressing Gateway's consumer financing program. PwC suggested to Manza that Gateway disclose the loan loss reserve and the underlying methodology. Todd and Manza also were apprised by an employee within Gateway's accounting department that Gateway should disclose, in its Form 10-Q, the amount of Gateway's loan loss reserve, the activity in the reserve, and Gateway's reserve methodology. They elected, however, not to make these disclosures, or to disclose the fact that the underlying methodology had changed. In so doing, they knew or were reckless in not knowing that these omissions were materially misleading to investors.

G. Todd and Manza Authorized Gateway's Improper Recognition of $21 Million in Revenue from a Consignment Sale

67. Another item reflected as a potential gap closer on the September 15 Gap to Consensus Spreadsheet, and Todd's September 17 e-mail to Gateway's senior staff, was a potential $10 million sale to VenServ, a small, privately-held company whose principal business was to facilitate financing transactions for

small businesses. In the summer of 2000, Gateway started discussions with VenServ concerning the possibility of this company providing financing to some of Gateway's customers who had poor credit. Specifically, the parties contemplated that Gateway would provide VenServ with referrals to customers who had been declined for credit by Gateway, and that VenServ would find an underwriter to service the loans and act as an agent to close the sales.

68. At some point in early September 2000, the parties began to discuss a computer purchase by VenServ as part of the contemplated arrangement. On September 12, the GF Director sent an e-mail to a Vice President at VenServ, with a copy to Manza, describing the potential parameters of a deal. This e-mail suggested that VenServ purchase $10 million in product from Gateway prior to September 30; that Gateway ship the product to a secured warehouse; that Gateway lend VenServ $10 million to fund the purchase; and that VenServ repay Gateway for the loan only if Gateway referred sufficient customers to VenServ to purchase the PCs.

69. The parties ultimately reached a deal on September 22, 2000. Under a Reseller Agreement and a Referral Agreement, VenServ agreed to purchase approximately $21 million of PCs, which would be stored at third-party warehouses designated by VenServ. Gateway in turn was required to refer sufficient customers to VenServ to facilitate VenServ's resale of the PCs by December 31, 2000, or VenServ could terminate the agreement and Gateway would have to take the PCs back.

70. Although Gateway ultimately did not provide a loan to VenServ to facilitate its purchase of the PCs, VenServ was not obligated to pay for any PC under the parties' agreement until 24 hours after it was shipped from a warehouse to an end customer, or within 120 days from September 22, whichever came first. Gateway later agreed to amend the contract to extend the payment terms to March 31, thus permitting VenServ to defer any payment until the PCs actually were

shipped to end customers.

71. Before the end of the third quarter 2000, Gateway shipped PCs to warehouses for VenServ and improperly recognized revenue of almost $21 million. Despite the contractual requirement that VenServ designate and pay for the warehouses, VenServ had no role in procuring the storage and Gateway paid all of the storage charges. The VenServ transaction increased Gateway's third quarter reported revenue by $21 million, and EPS by $.0076.

72. Gateway's purported sale of PCs to VenServ in the third quarter failed to meet requirements for revenue recognition under GAAP because, at the end of the third quarter 2000, Gateway had not fulfilled its contractual obligation of referring sufficient customers to VenServ to facilitate VenServ's resale of the PCs. Indeed, because VenServ had the right to return the PCs if Gateway did not refer enough customers, and because VenServ was not required to make payments for any PCs until VenServ consummated a sale, the Gateway-VenServ transaction was, at best, a consignment sale. As such, it was improper for Gateway to recognize revenue on this transaction in the third quarter 2000.

73. Revenue recognition also was improper because Gateway's purported sale to VenServ failed to meet other requirements for a bill-and-hold transaction under GAAP. First, the VenServ transaction failed the bill-and-hold requirement that the risk of ownership pass to the buyer at the purported time of sale because: (1) Gateway procured the storage and paid the storage charges; (2) VenServ could terminate the arrangement if Gateway failed to refer VenServ sufficient customers to resell the PCs; and (3) VenServ was not required to pay for any PC until it was resold to an end customer. Second, the transaction failed the bill-and-hold requirement that there be a fixed schedule of delivery for the goods, because shipment of any PCs from the warehouses to VenServ was dependent on Gateway's referral of a customer to VenServ and VenServ's consummation of a sale. Third, Gateway maintained significant post-sale obligations, including: (1)

the obligation to refer customers to VenServ; (2) an obligation to lease sales personnel and facilities to VenServ; and (3) an obligation to remove a PC from a warehouse at VenServ's direction, send it back to Gateway's manufacturing facility for recording of warranty information, ship it to the VenServ end customer, and reissue an invoice to VenServ for the PC.

74. Todd was aware that revenue had been recognized on the VenServ transaction, and that VenServ's payment for the PCs was tied to Gateway referring a sufficient number of customers to VenServ to facilitate resale. VenServ appeared on Todd's Gap to Consensus Spreadsheet, and was listed in his September 17, 2000 e-mail. Further, before Todd signed the Form 10-Q on November 14, 2000, Todd learned that the VenServ PCs were sent to warehouses and used to fill an order of another Gateway customer.

75. Manza also was aware of the VenServ transaction. On October 2, 2000, Manza was informed by Gateway's Ethics Officer that PCs had been sent to warehouses on behalf of VenServ, and that manufacturing employees had complained that some PCs that Gateway shipped to warehouses had been returned to Gateway for warranty registration and reshipping. Manza also learned in late October 2000 that VenServ PCs had been used by Gateway to satisfy another customer order.

76. Defendants did not disclose to PwC during its review of the third quarter 2000 financial results that Gateway had entered into a transaction with VenServ, that the PCs that had been sold to VenServ were being stored in warehouses, or that Gateway had sent VenServ PCs to another customer.

H. Todd and Manza Authorized Gateway's Improper Recognition of Revenue on a $16.5 Million Bill-and-Hold Sale

77. Gateway commenced its relationship with Rent-Way, a rent-to-own consumer leasing company, in April 2000. Rent-Way entered into an agreement to purchase PCs from Gateway to rent to its customers. Pursuant to this agreement,

Rent-Way issued an initial blanket purchase order for PCs for each of its stores throughout the country. Rent-Way then placed smaller purchase orders with Gateway based on the needs of a particular store. Gateway shipped the PCs directly to the store that needed the PCs and invoiced Rent-Way's corporate office for the order.

78. On September 12, 2000, Gateway asked Rent-Way to purchase $12 million in product that the parties previously had forecasted Rent-Way would buy in September. Rent-Way responded that this was a "stretch" given that as of September 12, Rent-Way had purchased only $3.2 million in product. Gateway replied that it wanted to find a way "to get to that [$12 million] number" and could "get creative."

79. On September 19, Gateway's sales representative proposed to Rent-Way a "September buy in" in which Rent-Way would issue a purchase order for $15 million for which it would be granted a 2% discount, and the equipment would be built near the end of September and shipped to arrive in October. Rent-Way rejected this proposal, because Rent-Way's existing loan covenants prohibited it from making a large PC purchase in September.

80. On September 21, Gateway's sales representative sent an e-mail to Rent-Way confirming that Rent-Way would issue a purchase order for $16.5 million of PCs, for which it would receive a 5% discount, that Rent-Way would be billed by September 30, and would take the PCs by October 31 pursuant to subsequent purchase orders from its individual stores. Ultimately, the parties agreed that Rent-Way would be invoiced and pay for the PCs not based on the initial $16.5 million purchase order, but when the subsequent store purchase orders were received.

81. On September 21, Rent-Way issued a purchase order for $16.5 million in PCs and peripherals. The purchase order provided, at Gateway's request, that the equipment would be shipped to "local warehousing for

subsequent distribution," and stated that the order was FOB destination. Gateway then purportedly "shipped" the products by segregating them in the third-party warehouses located adjacent to Gateway's manufacturing facilities — the same warehouses that housed VenServ's computers. Rent-Way did not make any arrangements or have any contact with the warehouses.

82. As agreed between the parties, Rent-Way was not invoiced in September for the $16.5 million purchase order, but was invoiced in October and November 2000, as Rent-Way began to take the warehoused PCs, based upon the individual store purchase orders.

83. Gateway recognized revenue of $16.5 million on the third quarter sale, and failed to apply Rent-Way's 5% discount on the sale until the fourth quarter. Thus, the Rent-Way transaction increased Gateway's third quarter reported revenue by $16.5 million, and EPS by $.003.

84. Gateway's recognition of revenue on the Rent-Way transaction was improper, because the transaction did not meet the bill-and-hold requirements under GAAP. First, the risk of ownership did not pass to Rent-Way at the purported time of the sale as evidenced by the fact that Gateway procured and paid for storage of the PCs. Second, Rent-Way did not request that the transaction be on a bill-and-hold basis, and had no business purpose for ordering the goods on a bill-and-hold basis. Finally, Gateway retained specific performance obligations that precluded revenue recognition, including, upon receipt of a second purchase order from Rent-Way, obligations to ship the PCs back to Gateway's manufacturing facility to record warranty information, to issue a new invoice to Rent-Way, and to ship the PCs to Rent-Way's individual store locations.

85. Todd knew that Rent-Way had placed a large third quarter order and that the PCs were being shipped to warehouses. Todd sent the September 17, 2000 e-mail to his senior staff stating that the Company was working on a potential "pull forward" to Rent-Way of $10-20 million as a way to help bridge

Gateway's revenue gap.

86. Manza also knew that revenue had been recognized on the Rent-Way PCs shipped to Gateway's warehouses by at least October 2, 2002, and before Gateway filed its Form 10-Q. As with VenServ, on October 2, 2002, he was informed of this by Gateway's Ethics Officer, who had received complaints from manufacturing employees because PCs shipped to warehouses on behalf of Rent-Way were being returned to Gateway for warranty registration and then reshipped to Rent-Way stores.

87. Neither Todd nor Manza advised PwC of the Rent-Way transaction during PwC's review of the third quarter 2000 financial results.

I. Defendants Authorized the Improper Recognition of $70 Million in Revenue from AOL Bounty Payments

88. Gateway looked to another business transaction, one involving AOL, to further bridge the gap in the third quarter. Gateway's relationship with AOL began in 1999 when it entered into a "strategic alliance" with AOL. One of the critical components of the strategic alliance with AOL was an arrangement by which Gateway agreed to bundle the AOL Internet service with the sale of Gateway PCs. Several aspects of the bundling arrangement were open to renegotiation on a quarterly basis, including the percentage or type of PCs with which the service would be bundled and the price of each bundle.

89. The initial agreement, entered into in December 1999, provided, among other things, that AOL would make an up-front bounty payment to Gateway of either $132.06 or $164.56 for each end user who purchased a PC bundled with an AOL one-year ISP service package (a "bundled product") and registered for the AOL service, and Gateway in turn would pay AOL $219.45 for each such end user. Gateway recorded the initial bounty payment received from AOL per subscriber as revenue and the $219.45 it paid to AOL as cost of goods sold. Gateway disclosed to investors that it had an arrangement with AOL to

bundle its Internet service with a Gateway PC. However, Gateway did not disclose that it received direct bounty payments from AOL for new subscribers, or that it booked these payments as revenue.

90. In July 2000, early in the third quarter, the parties entered into a letter agreement setting forth the bounty arrangement for the third and fourth quarters of 2000 (the "letter agreement"). The letter agreement provided that Gateway would continue to pay AOL $219.45 per subscriber who purchased a bundled product and registered for the AOL service, but AOL would increase its bounty payment to Gateway to $219.45 per registered user.

91. In September 2000, Manza suggested to Todd that Gateway should accelerate its revenue relating to the AOL bundling arrangement by recognizing revenue based on shipments of PCs bundled with the AOL product rather than recognizing revenue based on customers who actually registered for the AOL service. The next day, Manza inquired whether Gateway could approach AOL to amend the contract to reflect that bounty payments would be made upon shipment.

92. On September 15, 2000, Todd received the Gap to Consensus Spreadsheet, which listed a $30 million item called "AOL subs" under the items being worked on to bridge the gap. In handwritten notes, Todd personally calculated the effects of various transactions and adjustments on quarter results, and also referenced a $30 million item called "AOL acct." Todd informed Weitzen on September 17 that one of the potential "gap closures" was a $30 million item called "AOL accounting."

93. Before the third quarter 2000, Gateway had recognized revenue only with respect to those Gateway customers who registered with AOL for the service. Because only about 50% of Gateway customers actually registered for AOL service, revenue from AOL's bounty payments would double if Gateway could recognize revenue when the PCs were shipped to the end customer without regard to whether or not that customer ultimately registered for AOL.

94. For this reason, Todd contacted AOL directly on September 22 and September 26 to request that AOL agree to change the third quarter bundling arrangement to provide for the respective bounty and service payments upon shipment rather than registration. On September 28, representatives of Gateway and AOL, including Todd, met in person at Gateway to discuss various aspects of the strategic alliance, including the proposed change to the bundling arrangement.

95. Shortly thereafter, on September 30, a representative of AOL notified the CFO of Gateway's Consumer Division that AOL had signed an amended agreement. The Consumer Division CFO then signed a version of the amended agreement. That agreement, which was back-dated to July 1, 2000, was identical to the letter agreement signed in July 2000, except that it provided that Gateway and AOL would pay their respective $219.45 payments per customer who purchased a PC bundled with the AOL Internet service, rather than per customer who registered for the AOL service. On October 1, 2000, Weitzen sent an e-mail to AOL thanking AOL for the "favorable accounting treatment."

96. Based on the parties' amendment to the letter agreement, Gateway retroactively adjusted its revenues from the AOL bounties back to the beginning of the third quarter, thereby increasing its third quarter revenues by $70 million, in a quarter in which it exceeded analysts' expectations for revenue by just $30 million. Without the revenue associated with the amended agreement, Gateway would not have met analysts' expectations.

97. Defendants were aware that Gateway had increased revenue by $70 million as a result of the amendment to the AOL agreement, and that this amendment would materially impact Gateway's quarter results in a misleading way. Before the end of the third quarter 2000, the potential change in revenue recognition was brought to the attention of the CFO of Gateway's Consumer Division. At the time, the Consumer Division CFO understood that his division expected to miss its third quarter revenue forecast, and was concerned that the

proposed change represented an improper attempt to manipulate the Company's AOL revenue to meet targets. He informed Todd and Manza that he was concerned that in pursuing the amendment Gateway's intent might be to overstate revenue. Todd dismissed this concern, responding that it was the proper role of finance personnel to "go after revenue," and to "focus on growth and business."

98. The Consumer Division CFO also raised with Manza and Todd the possibility of disclosing the change in revenue recognition in the company's financial statements given its significant revenue impact. Todd told him that Manza was in charge of determining the materiality of the change, in conjunction with PwC, and indicated that he would follow up with Manza.

99. Weitzen also was informed of the Consumer Division CFO's concerns. Todd thanked Weitzen for his supporting in resolving the concerns. In turn, Weitzen thanked Todd for addressing the concerns with "respect and caring (as well as aggressiveness)."

100. Defendants did not perform or direct any analysis of the concerns raised by the Consumer Division CFO, determine whether Gateway's disclosure of the change was appropriate or required, or inform PwC about the change in Gateway's revenue recognition policy relating to AOL bounty payments.

101. It was improper under GAAP for Gateway to change the event triggering the recognition of revenue on the AOL bounty payments, because this change provided no net economic benefit to Gateway. GAAP requires that a transaction or event be accounted for in accordance with its economic substance.

102. Even if the change in the method of calculating the AOL bounty revenue had satisfied GAAP, Gateway still was required to disclose this change and its material impact on the Company's third quarter 2000 financial results. Because the AOL bounty revenue recognition change nearly doubled the amount of AOL revenue Gateway recorded and increased third quarter revenues by more than $70 million, it represented a material transaction that Gateway should have

disclosed but did not. Disclosure also was required for two other reasons. First, the increase in AOL bounty revenue was a significant component and known trend in revenue in the current period as compared to the comparable periods in the prior year. Second, the revenue recognition change was a significant change in Gateway's accounting principles and practice.

J. Defendants Authorized an Eleventh Hour Sale of $47 Million of Certain Gateway Fixed Assets and Reported It as PC Revenue

103. Late in the third quarter 2000, Todd held a meeting at Gateway with Gateway's finance managers, including Manza, to discuss the likely third quarter results. Todd was concerned about revenue and earnings, and the finance managers discussed potential ways to generate revenue.

104. At the meeting, Manza suggested that Gateway attempt to sell the Gateway-manufactured computer equipment used in Gateway's internal operations, including servers and desktop equipment valued at approximately $47 million, to Lockheed Martin Integrated Business Solutions ("Lockheed"). At the time, Lockheed served as Gateway's third-party information technology ("IT") services provider and therefore was responsible for managing and servicing Gateway's computer infrastructure. Todd directed Manza to work on completing such a transaction before the end of the third quarter 2000.

105. On September 22, 2000, Gateway approached the Lockheed manager about purchasing certain of the computer equipment used in the Gateway IT infrastructure. Lockheed rejected this proposal, because Lockheed was not in a position to take on $47 million in debt. Gateway then suggested that Lockheed purchase the equipment from Gateway, and simultaneously enter into a revised outsourcing contract to permit Lockheed to lease the equipment back to Gateway to recover its cash outlay.

106. The Lockheed deal was put together in a matter of days and signed on September 29, 2000, one day before the end of the quarter.

107. Under the parties' agreement, Lockheed was required to pay Gateway $47.2 million for the hardware over a five-month period, beginning on October 30, 2000, and Gateway in turn was required to lease the equipment back from Lockheed over a 36-month period. Gateway verbally agreed to discharge this obligation by making an up front payment to Lockheed of $47.2 million on October 2, 2000. The structure of the transaction was designed specifically to neutralize any financial impact to Lockheed.

108. In the course of negotiating the Lockheed fixed asset sale, Manza learned that only approximately $14 to 15 million of the approximately $50 million of Gateway-owned equipment managed by Lockheed was Gateway-branded equipment. Based on his discovery, Manza informed Todd that Gateway could properly book only about $14 million in revenue on the transaction. Todd nevertheless instructed Manza to book the entire sale as revenue.

109. Despite his own concerns, Manza directed a subordinate to record the entire sale as revenue, to recognize $3 million of earnings on the sale, and to establish a reserve account of approximately $10 million to reconcile the transaction in the fourth quarter.

110. Gateway improperly booked revenue on the sale of $47.2 million on September 30, 2000. Without the revenue from the Lockheed sale, Gateway would not have met consensus analysts' expectations for revenue. This revenue, along with the other fraudulently reported revenue, allowed Gateway to report that it exceeded analysts' expectations by $30 million.

111. Weitzen learned of the possibility of selling equipment to Lockheed in the third quarter as a measure to close the gap between Gateway's forecasted revenue and earnings and consensus analysts' expectations. He knew that the transaction was going to be booked as revenue, but did not object to the accounting treatment or disclose the impact of the transaction on Gateway's

reported revenue.

112. Gateway's recording of revenue on the Lockheed fixed asset sale was not in accordance with GAAP. Under GAAP, revenue consists of cash flows that result from a company's ongoing major or central operations. Gateway's central operations involve the manufacture and sale of new PCs for use by end customers, not the sale and lease back of used assets. Thus, Gateway's sale of used assets could not properly be booked as revenue from computer sales. In addition, under GAAP, the accounting for a sale and leaseback required Gateway not only to record the sale in other income rather than revenue, but also to amortize any gain or loss over the life of the lease or period of the lease payments.

113. Defendants knew, or were reckless in not knowing, that recording the Lockheed fixed asset sale as revenue was not in conformity with GAAP. Defendants did not inform PwC that the fixed asset sale to Lockheed was recorded as revenue, or seek their advice as to the propriety of the accounting.

114. Defendants also knew that Gateway's recording of revenue on the fixed asset sale was inconsistent with Gateway's own published accounting policy. Gateway's 1999 Form 10-K provided that, upon sale or retirement of property, plant and equipment, such as the used computer assets, Gateway's practice was to remove "the related costs and accumulated depreciation or amortization . . . from the accounts and [include] any gain or loss . . . in the determination of net income." Thus, by recognizing as PC revenue, rather than other income, the entire proceeds from the sale and leaseback of the Company's fixed assets, Gateway violated its own accounting policy in addition to failing to comply with GAAP.

K. <u>Todd and Manza Failed to Correct Gateway's Arbitrary and Improper Reduction of Legal Reserves</u>

115. Also during the third quarter 2000, Gateway arbitrarily and improperly reduced a reserve for potential patent infringement claims from $15 million to $8 million, resulting in an increase to income of $.015 EPS. This

reserve was created, along with other intangible assets, as part of the purchase accounting in connection with Gateway's 1997 acquisition of the server company, Advanced Logics Research ("ALR"), to cover potential patent claims against ALR, although there were no pending or threatened infringement claims against ALR for which such a reserve was required at the time of its creation.

116. Gateway's reduction of the ALR legal reserve in the third quarter of 2000 was improper. Under GAAP, a recognized liability, such as a legal reserve, is measured at the amount initially recognized until an event that changes the liability or its amount occurs. No event occurred during the third quarter 2000 that changed the amount of the legal reserve liability or that supported a write-down. Indeed, the reserve had been on the company's books for over two years, had never been altered, and no claims had ever been made against it. Moreover, under GAAP, any reduction of the reserve in 2000 should have been recorded and accounted for as a correction of an error and excluded from the determination of net income.

117. Manza and Todd were aware of the reduction in the reserve, and that the reserve had increased EPS by over a penny. In an Audit Committee meeting at which Todd and Manza were present, Todd and Manza were informed that the item was an unusual adjustment. Despite their knowledge of the material effect of this adjustment on Gateway's results, combined with their other improper accounting actions, neither Todd nor Manza recommended reversal or disclosure of the adjustment.

L. Todd and Manza Failed to Correct Gateway's Improper Retroactive Adjustment of its Warranty Expense

118. Also in the third quarter 2000, Gateway improperly made a retroactive reduction of its second quarter warranty expense, which decreased Gateway's warranty expense for the third quarter by $4 million and increased EPS by $.008. During the third quarter, Gateway reassessed the costs associated with

its product warranties and, based on the reassessment, adjusted its warranty accrual rate for business product sales retroactively to the second quarter. This retroactive application was inappropriate because, under GAAP, changes in estimates apply only to the period of such a change and future periods, not to prior periods.

119. Manza and Todd were aware of the retroactive adjustment, its effect, and its noncompliance with GAAP. In an Audit Committee meeting at which Todd and Manza were present, PwC identified the retroactive warranty adjustment as improper, but did not require the Company to reverse it because PwC concluded that the improper actions it had identified were not cumulatively material to quarter results. Todd and Manza, however, knew that the cumulative effect of Gateway's various improper accounting actions throughout the third quarter 2000 were in fact material. Nevertheless, neither Todd nor Manza recommended reversal or disclosure of the warranty expense adjustment.

M. As a Result of Defendants' Conduct, Gateway Overstated Revenue and Earnings for the Third Quarter of 2000

120. On October 12, 2000, Gateway issued a press release (the "October 12 Release") announcing record third quarter profits of $152.6 million on revenues of $2.53 billion, precisely meeting analysts' expectations of $.46 EPS, and exceeding analysts' expectations for revenue by $30 million. Gateway also reported that it had "accelerated year-over-year revenue growth to 16 percent" — again precisely meeting expectations — and that the consumer unit had posted revenue growth in sales of 27% over 1999. Gateway's press release also touted that it was "Gateway's third consecutive quarter of 30-percent-plus net income and earnings-per-share (EPS) growth." Todd and Weitzen read, edited, and approved the October 12 Release.

121. These financial results were false and misleading in that, due to the improper accounting actions, Gateway's reported revenue was overstated by 6%

and earnings by 30%. The false financials also were incorporated in Gateway's Form 10-Q for the third quarter, which was filed with the Commission on November 14, 2000.

122. In the analysts' call following the October 12 Release, Todd emphasized to analysts that Gateway had distinguished itself from its competitors. Specifically, Todd trumpeted that Gateway "had a great quarter despite the noise in the marketplace." He highlighted the company's revenue growth, and noted that the revenue of $2.530 billion was "[$]30 million better than guidance." Weitzen touted that, in contrast to the performance of Gateway's competitors, the Company had met analysts' expectations, stating that the company had "deliver[ed] on [its] commitments . . . in the face of so much troubling industry news." Weitzen also stated that the Company was tracking toward the aggressive goals laid out in February 2000, due to its "acceleration of revenue growth." Similarly, Todd claimed that the "combination of accelerating revenue and profit growth that leads the traditional PC industry further illustrates the difference in the Gateway business model." Todd also underscored that Gateway's EPS growth of 32% for the first three quarters of 2000 exceeded the 20% average of its competitors. These claims were false and misleading, because Todd and Weitzen knew that Gateway would have missed analysts' expectations for revenue without AOL or Lockheed alone. Todd also knew that earnings were overstated because of the improper accounting actions he had authorized.

123. The market reacted positively to Gateway's public disclosures. On October 13, 2000, Gateway's stock jumped from $43.63 to $53.11.

124. Gateway's financial results also garnered great praise in analyst circles. One financial analyst commented that Gateway had become "increasingly immune to the vagaries of the PC market." Another stated that Gateway's model "gives them an advantage over everyone."

N. Todd and Weitzen Also Misrepresented the Percentage of Gateway's Third Quarter Income Associated With PC Sales

125. Gateway also reported in its October 12 Release that "non-PC income was more than 50 percent of income, exceeding the fourth quarter 2000 target by five percentage points." Weitzen authorized the release. Given that Gateway previously had announced that its fourth quarter goal was 45%, the press release implied that the actual figure was approximately 50%. Todd made a similar disclosure in the analysts' call following the release, stating that the non-PC, or "beyond the box" income accounted for "almost 50 percent or 50 percent plus of profits." He also stated that "[b]eyond-the-box performance of 50 percent exceeded our year-end goal of 45 percent." When asked about the state of consumer demand in the PC market, Todd stated "the sky is not falling."

126. These statements were false and misleading. Before these public statements were made, Todd reported to Gateway's Board of Directors that non-PC income actually amounted to 90% of net income for the third quarter 2000. Weitzen attended the board meeting and was aware of the actual figure. Todd and Weitzen's failure to disclose the actual amount of income flowing from Gateway's non-PC products and services disguised the fact that the sale of PCs — Gateway's core business — had declined and was increasingly less profitable.

O. Todd and Weitzen Further Misled Investors By Failing to Disclose Gateway's Third Quarter Unit Sales Data

127. Also in the October 12 Release and Gateway's third quarter Form 4410-Q, defendants Todd and Weitzen elected for the first time not to disclose the number of PC units sold. This omission made Gateway's other disclosures materially misleading, in that defendants obscured the softening of consumer demand for PCs that Gateway experienced in the third quarter 2000.

128. For example, in the conference call with analysts following the issuance of Gateway's third quarter earnings, Todd responded to a question

concerning consumer demand by asserting that "the market is still solid." Gateway's third quarter report to the Board of Directors, however, indicated that the PC industry had negative 5% growth compared to 1999 for retail sales for the quarter, and that Gateway's unit growth had been only 10% over 1999. The unit growth rate was significantly lower than the growth rates Gateway published — 16% overall sales growth, and 27% growth for the consumer division. Notably, in an October e-mail to Todd immediately preceding Gateway's release of earnings, Manza observed that Gateway's demand, as well as industry demand, was weak, and cautioned Todd against making a bullish statement about consumer demand.

129. In making positive statements concerning demand in the PC industry generally, and concerning Gateway's PC sales specifically, without disclosing Gateway's unit sales data to the public, Todd and Weitzen misled the public and prevented analysts and investors from realizing that, as with its competitors, demand for Gateway's PCs had decreased significantly.

P. Defendants Lied to Gateway's Auditors

130. In connection with the third quarter Form 10-Q, Todd, Manza, and Weitzen signed a management representation letter to PwC that they knew, or were reckless in not knowing, was false and misleading. The letter contained a representation that the "interim consolidated financial statements . . . [were] fairly presented in conformity with accounting principles generally accepted in the United States, and include[d] all disclosures necessary for such fair presentation and disclosures otherwise required to be included therein by the laws and regulations to which the Company [was] subject." The letter also contained a representation that Gateway's financial statements for the quarter:

> [had] been prepared on a basis consistent with the corresponding interim periods ended September 30, 1999 and, to the degree appropriate, for the audited financial statements for the year ended December 31, 2000 [sic].

131. The management representation letter was false and misleading, because defendants knew that Gateway's interim financial statements were not prepared in conformity with GAAP, their own internal accounting policies, or with applicable Commission regulations. They also knew that the financial statements did not include all disclosures necessary for their fair presentation. Specifically, the financial statements did not disclose the increased risk of Gateway's consumer finance portfolio, or the percentage of Gateway's sales that were generated from approving loans to the high-risk credits. They also failed to disclose that approximately $70 million of third quarter revenue was associated with the revenue recognition change pertaining to the ISP bounty payments, and that $50 million of quarter revenue stemmed from the sale of fixed assets to Lockheed. They also knew that, given the change in revenue recognition on the AOL bundles, the financial statements were not prepared on a basis consistent with corresponding interim or year-end financial statements

Q. Gateway Restated Its Financial Results for the First Three Quarters of 2000

132. In early 2001, Gateway amended its Forms 10-Q and restated its financial results for the first three quarters of 2000. In April 2003, Gateway amended its 2001 Form 10-K, restating its 2001 financial statements and further restating its 2000 financial statements.

133. These restatements related to Gateway's revenue and earnings and were caused in part because of the fraudulent scheme perpetrated by defendants.

R. Defendants Caused Gateway's September 15, 2000 Prospectus To Be False and Misleading

134. On April 30, 1999, Gateway filed a registration statement on Form S-3 to register $1 billion of securities, to be offered on a delayed or continuous registered basis pursuant to Rule 415 of the Securities Act. This "shelf" registration statement was declared effective on May 11, 1999. Pursuant to a

prospectus supplement filed on September 15, 2000, Gateway issued and sold 30,000 shares of its common stock to a software developer for $3,000,000. One of Gateway's initiatives in the third quarter was to launch a partnership with this software developer. Todd gave a presentation to the Board of Directors regarding this initiative. Gateway incorporated by reference its misstated Form 10-Q for the second quarter of 2000 in the September 15, 2000 prospectus supplement.

DEFENDANTS' COMPENSATION DURING THE FRAUD

135. Gateway compensated each of the defendants during and after the fraudulent reporting of Gateway's financial results for the second and third quarters of 2000.

136. Through Gateway's Management Incentive Plan ("MIP"), managers were given bonus targets throughout the year 2000 that were based on whether the company met consensus analysts' estimates for revenue and EPS on a quarterly basis.

137. Todd received a salary in the amount of $412,500 in 2000. His 2000 bonus, which was determined according to the MIP and thereby tied directly to Gateway's revenue and earnings, was $224,500. Upon his termination in January 2001, he received a cash severance payment of $1,567,500.

138. Weitzen received a salary of $1 million in 2000, and a bonus of $880,000, which was determined based on the same MIP. Weitzen exercised options and sold the acquired shares on two occasions during the year 2000, for a combined gain of $4.95 million. The first exercise and sale occurred in February 2000 and the second on August 18, 2000. Upon his termination, Weitzen received a cash payment of $5.64 million.

139. Manza received a salary of $235,000 and a bonus of $105,600 for 2000.

FIRST CLAIM FOR RELIEF

FRAUD IN THE OFFER OR SALE OF SECURITIES

Violations of Section 17(a) of the Securities Act

(Against Defendant Todd)

140. The Commission realleges and incorporates by reference paragraphs 1 through 139 above.

141. Defendant Todd, by engaging in the conduct described above, directly or indirectly, in the offer or sale of securities by the use of means or instruments of transportation or communication in interstate commerce or by use of the mails:

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 purchaser.

142. By engaging in the conduct described above, defendant Todd 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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<u>SECOND CLAIM FOR RELIEF</u>

FRAUD IN CONNECTION WITH THE

PURCHASE OR SALE OF SECURITIES

Violations of Section 10(b) of the Exchange Act

and Rule 10b-5 thereunder

(Against All Defendants)

143. The Commission realleges and incorporates by reference paragraphs 1 through 139 above.

144. Defendants Todd, Manza, and Weitzen, and each of them, by engaging in the conduct described above, directly or indirectly, in connection with the purchase or sale of a security, by the use of means or instrumentalities of interstate commerce, of the mails, or of the facilities of a national securities exchange, with scienter:

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

b. made untrue statements of a material fact or omitted to state a material fact 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.

145. By engaging in the conduct described above, each of the defendants 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 FOR RELIEF

VIOLATIONS OF COMMISSION PERIODIC REPORTING REQUIREMENTS

Aiding and Abetting Violations of Section 13(a) of the Exchange Act, and Rules 12b-20, 13a-1 and 13a-13 thereunder

(Against Defendants Todd and Manza)

146. The Commission realleges and incorporates by reference paragraphs 1 through 139 above.

147. Gateway violated Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), and Rules 12b-20, 13a-1 and 13a-13 thereunder, 17 C.F.R. §§ 240.12b-20 and 240.13a, by filing with the Commission materially false and misleading quarterly and annual reports on Form 10-Q and Form 10-K for the second and third quarters of 2000 and year-end 2000.

148. Defendants Todd and Manza, and each of them, knowingly provided substantial assistance to Gateway's violation of Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-13 thereunder.

149. By engaging in the conduct described above and pursuant to Section 20(e) of the Exchange Act, 15 U.S.C. § 78t(e), defendants Todd and Manza aided and abetted Gateway's violations, and unless restrained and enjoined will continue to aid and abet violations, of Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), and Rules 12b-20 and 13a-13 thereunder, 17 C.F.R. §§ 240.12b-20 and 240.13a-13.

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FOURTH CLAIM FOR RELIEF

RECORD-KEEPING VIOLATIONS

Aiding and Abetting Violations of Section 13(b)(2)(A) of the Exchange Act and Violations of Rule 13b2-1 thereunder

(Against Defendants Todd and Manza)

150. The Commission realleges and incorporates by reference paragraphs 1 through 139 above.

151. Gateway violated Section 13(b)(2)(A) of the Exchange Act, 15 U.S.C. § 78m(b)(2)(A), by failing to make or keep books, records and accounts that in reasonable detail accurately and fairly reflected its transactions and disposition of its assets.

152. Defendants Todd and Manza, and each of them, knowingly provided substantial assistance to Gateway's violation of Section 13(b)(2)(A) of the Exchange Act.

153. By engaging in the conduct described above and pursuant to Section 20(e) of the Exchange Act, 15 U.S.C. § 78t(e), defendants Todd and Manza aided and abetted Gateway'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).

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

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FIFTH CLAIM FOR RELIEF

LYING TO AUDITORS

Violations of Exchange Act Rule 13b2-2

(Against All Defendants)

155. The Commission realleges and incorporates by reference paragraphs 1 through 139 above.

156. By engaging in the conduct described above, and in connection with audits or examinations of the financial statements of Gateway and the preparation and filing of statements and reports required to be filed with the Commission, defendants, directly or indirectly, made or caused to be made materially false or misleading statements to accountants and omitted to state, or caused another person to omit to state to accountants, material facts necessary in order to make statements made to the accountants, in light of the circumstances under which such statements were made, not misleading.

157. By reason of the foregoing, defendants violated, and unless restrained and enjoined will continue to violate, Exchange Act Rule 13b2-2, 17 C.F.R. § 240.13b2-2.

SIXTH CLAIM FOR RELIEF

INTERNAL CONTROL VIOLATIONS

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

(Against Defendants Todd and Manza)

158. The Commission realleges and incorporates by reference paragraphs 1 through 139 above.

159. By engaging in the conduct described above, defendants Todd and Manza violated Section 13(b)(5) of the Exchange Act, by circumventing or failing to implement a system of internal accounting controls, or by knowingly falsifying any book, record or account described in Section 13(b)(2) of the Exchange Act. Unless restrained and enjoined, defendants Todd and Manza will continue to

violate Section 13(b)(5) of the Exchange Act, 15 U.S.C. § 78m(b)(5).

SEVENTH CLAIM FOR RELIEF

CONTROL PERSON LIABILITY

Violations of Section 20(a) of the Exchange Act

(Against Defendant Weitzen)

160. The Commission realleges and incorporates by reference paragraphs 1 through 139 above.

161. During the period of approximately July 1 through November 14, 2000, defendant Weitzen was, directly or indirectly, a control person of Gateway for purposes of Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a).

162. During the period of approximately July 1 through November 14, 2000, Gateway violated Sections 10(b) and 13(a) of the Exchange Act and Rules 10b-5, 12b-20, and 13a-13 thereunder, as alleged above.

163. As a control person of Gateway during the period of approximately July 1 through November 14, 2000, defendant Weitzen is jointly and severally liable with and to the same extent as Gateway for Gateway's violations of Sections 10(b) and 13(a) of the Exchange Act and Rules 10b-5, 12b-20, and 13a-13 thereunder during this time period, as alleged above.

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that the Court:

I.

Issue findings of fact and conclusions of law that the defendants committed the alleged violations.

II.

Issue a judgment, in a form consistent with Fed. R. Civ. P. 65(d), permanently enjoining defendant Todd and his officers, agents, servants, employees and attorneys, and those persons in active concert or participation with any of them, who receive actual notice of the order by personal service or otherwise, and each of them, from violating Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(5) of the Exchange Act and Rules 10b-5, 12b-20, 13a-13, 13b2-1, and 13b2-2 thereunder.

III.

Issue a judgment, in a form consistent with Fed. R. Civ. P. 65(d), permanently enjoining defendant Manza and his officers, agents, servants, employees and attorneys, and those persons in active concert or participation with any of them, who receive actual notice of the order by personal service or otherwise, and each of them, from violating Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(5) of the Exchange Act and Rules 10b-5, 12b-20, 13a-13, 13b2-1, and 13b2-2 thereunder.

IV.

Issue a judgment, in a form consistent with Fed. R. Civ. P. 65(d), permanently enjoining defendant Weitzen and his officers, agents, servants, employees and attorneys, and those persons in active concert or participation with any of them, who receive actual notice of the order by personal service or otherwise, and each of them, from violating Sections 10(b) and 13(a) of the Exchange Act and Rules 10b-5, 12b-20, 13a-13, and 13b2-2 thereunder.

V.

Order defendants to disgorge all ill-gotten gains from their illegal conduct, together with prejudgment interest thereon.

VI.

Order defendant Todd to pay civil penalties under Section 20(d) of the Securities Act, 15 U.S.C. § 77t(d), and order all defendants to pay civil penalties under Section 21(d)(3) of the Exchange Act, 15 U.S.C. § 78u(d)(3).

VII.

As to all defendants, enter an order, pursuant to Section 21(d)(2) of the Exchange Act, 15 U.S.C. § 78u(d)(2), and as to defendant Todd also pursuant to Section 20(e) of the Securities Act, prohibiting defendants, and each of them, from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act, 15 U.S.C. § 781, or that is required to file reports pursuant to Section 15(d) of the Exchange Act, 15 U.S.C. § 78o(d).

VIII.

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.

IX.

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

DATED: November 13, 2003

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Keri Curtis Axel
Attorney for Plaintiff
Securities and Exchange Commission