

IN THE UNITED STATES DISTRICT
FOR THE DISTRICT OF COLORADO

Civil Action No. 03-Z-0328 (OES)

SECURITIES AND EXCHANGE COMMISSION,

PLAINTIFF,

v.

JOEL M. ARNOLD
WILLIAM L. EVELETH
GRANT P. GRAHAM
THOMAS W. HALL
DOUGLAS K. HUTCHINS
BRYAN K. TREADWAY
JOHN M. WALKER
RICHARD L. WESTON

DEFENDANTS.

COMPLAINT

Plaintiff Securities and Exchange Commission for its complaint alleges as follows:

I. SUMMARY

- 1) In a fraudulent scheme orchestrated to meet at all costs Qwest Communications International Inc.'s predictions of double-digit revenue growth, defendants engineered two manipulative transactions solely for the purpose of inflating materially the company's revenues and overstating its business performance. Defendants determined that they were falling short of quarterly revenue targets for the quarters ending September 30, 2000, and June 30, 2001, which would in turn cause Qwest to miss announced revenue projections for the quarters. To avoid this, defendants artificially filled the

revenue gap by fraudulently accelerating revenue for the two transactions described in this complaint.

- 2) The first fraudulent transaction was concocted for the purpose of fraudulently recognizing revenue in the quarter ending September 2000 in violation of Generally Accepted Accounting Principles ("GAAP").
- 3) In June 2000, Genuity Inc., an internet service provider, and Qwest, began negotiation of a proposed agreement in which Qwest would provide Genuity with internet services using equipment owned and operated by Qwest.
- 4) Defendants Arnold, Eveleth, Graham, and Weston participated in a scheme in which Qwest artificially split the agreement into two separate contracts. In the first contract Qwest purported to sell equipment to Genuity at an inflated price. In a second contract Qwest agreed to provide services to Genuity at a loss to Qwest and reassumed all risk of loss and obsolescence on the equipment purportedly sold pursuant to the first contract. There was no business purpose for separating the original agreement between Qwest and Genuity. Rather, Arnold, Eveleth, Graham, and Weston used the separation of the contracts solely to justify the fraudulent immediate recognition of revenue.
- 5) As a result of the fraudulent transaction, Qwest recognized improperly \$100 million in revenue and claimed \$80 million in earnings before interest, taxes, depreciation, and amortization ("EBITDA") in its quarter ended September 30, 2000. Additionally, for the quarters ended September 30, 2000, December 31, 2000, March 31, 2001 and June 30, 2001 Qwest fraudulently recognized revenue of approximately \$10.6 million despite the fact that Qwest had not begun providing any services. Qwest's September 30, 2000 quarterly report, December 31, 2000 annual report, March 31, 2001 quarterly report, June 30, 2001 quarterly report, September 30, 2001 quarterly report, and December 31, 2001 annual report were all materially false and misleading.

- 6) The second fraudulent transaction was concocted to recognize fraudulently revenue for the quarter ending June 30, 2001 in violation of GAAP.
- 7) In January 2001, the Arizona School Facilities Board ("ASFB") and Qwest entered into agreements providing that Qwest would design and implement a statewide network and provide internet and local area network services for Arizona schools using equipment provided by Qwest.
- 8) To fraudulently meet aggressive revenue targets, defendants Arnold, Graham, Hall, Walker, Hutchins, and Treadway, planned and carried out an elaborate scheme to inflate revenues. The scheme involved artificial separation of the equipment sale from the installation services, wrongfully characterizing the sale as a bill and hold transaction under GAAP. Additionally, it included accelerated delivery of equipment necessary for the two-year project and delivery of equipment that was not approved for the ASFB project. Finally, in order to purportedly support immediate recognition of revenue for sale of the equipment, the defendants prepared false letter agreements for ASFB and a fraudulent internal memorandum.
- 9) As a result of the scheme, Qwest fraudulently recognized approximately \$34 million in revenue on the sale of the equipment in the quarter ended June 30, 2001. Accordingly, Qwest's June 30, 2001 quarterly report, September 30, 2001 quarterly report, and December 31, 2001 annual report were all materially false and misleading.
- 10) By this conduct defendants Arnold, Eveleth, Graham, Hall, Hutchins, Treadway, Walker, and Weston violated Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 13(b)(5) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 13b2-1 thereunder [15 U.S.C. §§ 77q(a), 78m(b)(5) and 17 C.F.R. § 240.13b-2], violated and aided and abetted violations of Section 10(b) of Exchange Act the [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5], and aided and abetted

violations of Sections 13(a) and 13(b)(2), of the Exchange Act [15 U.S.C. §§ 78m(a), and 78m(b)(2)] and Rules 12b-20, 13a-1, and 13a-13 thereunder [17 C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-13], and unless restrained and enjoined will in the future violate such provisions.

- 11) The Commission brings this action pursuant to the authority conferred upon it by Section 20(b) of the Securities Act [15 U.S.C. § 77t(b)] and Section 21(d) of the Exchange Act [15 U.S.C. §78u(d)] and seeks an order permanently restraining and enjoining defendants from each of the statutory violations set out above pursuant to Section 20(b) of the Securities Act [15 U.S.C. § 77t(b)] and Section 21(e) of the Exchange Act [15 U.S.C. § 78u(e)] and granting other relief.
- 12) The Commission seeks an order requiring each defendant to pay civil penalties pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)] and Section 20(d) of the Securities Act [15 U.S.C. § 77t(d)].
- 13) The Commission seeks an order pursuant to the equitable authority of the court requiring each defendant to disgorge all ill-gotten gains from their participation in the fraud including all benefits derived from their employment at Qwest such as salary, bonuses, stock, and other remuneration and prejudgment and post-judgment interest thereon.
- 14) The Commission seeks an order pursuant to Exchange Act Section 21(d)(2), as amended by Section 305 of the Sarbanes-Oxley Act. [15 U.S.C. 78u(d)(2)] or pursuant to the equitable authority of the court permanently barring defendants Arnold, Graham, Hall, Treadway, and Weston from being an officer or director of any public company.

II. JURISDICTION AND VENUE

- 15) This Court has jurisdiction over this action pursuant to Section 22(a) of the Securities Act [15 U.S.C. §77u(a)] and Sections 21(e) and 27 of the Exchange Act [15 U.S.C. §§78u(e)

and 78aa]. Venue lies in this Court pursuant to Section 22(a) of the Securities Act and Section 27 of the Exchange Act.

- 16) In connection with the transactions, acts, practices, and courses of business described in this Complaint, defendants, directly and indirectly, have made use of the means or instrumentalities of interstate commerce, of the mails, and/or of the means and instruments of transportation or communication in interstate commerce.
- 17) Certain of the transactions, acts, practices and courses of business constituting the violations of law alleged herein occurred within this district.

III. DEFENDANTS

- 18) **Joel M. Arnold**, age 39, of Los Gatos, California, was hired by Qwest in June 1998 and was promoted to senior vice president of Qwest's Global Business unit in June 1999. In May 2001, Arnold was promoted to executive vice president of Global Business. In December 2001, Arnold resigned from Qwest. He is currently an executive of a public company.
- 19) **William L. Eveleth**, 46, of Evergreen, Colorado, began working for Qwest in July 1997. In July 2000, Eveleth became vice president and chief financial officer of a division of Qwest. He is currently working for Qwest as a senior vice president, Finance, and chief financial officer ("CFO") of Corporate Planning and Operational Finance.
- 20) **Grant P. Graham**, age 36, of Evergreen, Colorado, was senior vice president, Financial Planning and chief financial officer of Global Business during 2000 and 2001. Graham was terminated by Qwest in 2002.
- 21) **Thomas W. Hall**, age 51, of Cherry Hills Village, Colorado, was hired by Qwest in August 2000 and was a senior vice president of the Government and Educational Solutions ("GES") division of Global Business until October 2001 when he became senior vice president-chief quality officer. Qwest terminated Hall in June 2002.

- 22) **Douglas K. Hutchins**, age 32, of Denver, Colorado, was director of finance for Global Business and reported to Graham from January 2001 until February 2002 when he was promoted to senior director of quality. Hutchins resigned from Qwest in October 2002.
- 23) **Bryan K. Treadway**, age 37, of Atlanta, Georgia, was hired by Qwest in April 2001 as assistant controller and was promoted to controller in January 2002. Treadway resigned from Qwest in May 2002 and is currently employed as an executive of a public company.
- 24) **John M. Walker**, age 41, of Highlands Ranch, Colorado, was hired by Qwest in February 1998 and was promoted to vice president of sales for the GES unit of Global Business in November 2000. Walker no longer works for Qwest.
- 25) **Richard L. Weston**, 46, of Lone Tree, Colorado, began working for Qwest in June 1997. In September 1999, Weston was promoted to senior vice president in Product Development for the Internet Solutions division of Qwest. In September 2001, Weston changed positions and became senior vice president of Strategic Sales for Qwest. Weston left Qwest in May 2002 and currently acts as a consultant to a Canadian public company.

IV. RELATED PARTIES

- 26) **Qwest Communications International, Inc.**, is a telecommunications and internet services company with its corporate headquarters in Denver, Colorado. Qwest's common stock is registered with the Commission and the company files annual and quarterly reports with the Commission. Qwest common stock is traded on the New York Stock Exchange. During 2000 and 2001 Qwest made public offerings of its securities. Qwest's financial statements were audited by Arthur Andersen, LLP for Qwest's fiscal years ended December 31, 1999, 2000, and 2001.
- 27) The **Global Business Markets Unit** and its subdivision **Government and Educational Solutions** were units of Qwest focused on selling Qwest services to businesses within the United States, federal, state and local governments, and global multinational

corporations. Global had its own revenue and earnings targets but its earnings and revenues were included in Qwest's consolidated statement of operations.

V. FACTS

A. BACKGROUND

1. Qwest Acquires US West

28) Qwest entered into a merger agreement on July 18, 1999, for a reverse acquisition of US West, Inc. The merger was completed on June 30, 2000, and the surviving company, US West, changed its name to Qwest. Prior to the merger, US West was a regional Bell operating company, or "baby Bell" local telephone company. Prior to the merger Qwest was a broadband internet-based data, voice and image communications company. Qwest was a wholly-owned subsidiary of the Anschutz Company until its initial public offering on June 23, 1997.

29) After the merger, Qwest's executive officers controlled the surviving company.

2. Qwest Senior Executives Publicly Projected Huge Earnings Growth

30) Qwest promoted itself to analysts and the investing public as a progressive, new generation technology company not to be compared with the stodgy, old-style telephone company which had been US West. In earnings releases, Qwest emphasized its EBITDA and emphasized the company's enormous projected earnings and revenue growth. Moreover, analysts and investors following Qwest viewed revenue and EBITDA as a good indicator of Qwest's business performance. Qwest publicly predicted double-digit growth every quarter, both prior to and after the completion of the merger. In addition, senior executives of Qwest authorized public projections by Qwest which set ambitious earnings targets that included significant earnings growth on a quarterly and yearly basis.

3. Qwest Senior Management Demanded Their Subordinates Meet Or Exceed Inflated Earnings Objectives At All Costs

- 31) Beginning in mid-1999, Qwest senior executives made aggressive earnings growth projections. This conduct continued after the merger with US West. Further, Qwest senior executives created rigid and inflexible revenue objectives for the various business units of the company, including the Global Business Unit. They also placed extraordinary pressure on their subordinate executives, managers and employees to meet or exceed those earnings objectives at all costs. Management and employee bonuses were largely dependent on Qwest meeting overall its publicly announced revenue targets and individual managers meeting revenue targets for their business units. Qwest officers, executives and employees understood that falling short of revenue projections was not acceptable and could lead to termination. As a result, no Qwest executive, manager, or employee wanted to be the first to cause a division or the company to miss expectations.

B. FRAUDULENT GENUITY EQUIPMENT SALES AND SERVICE CONTRACT ENGINEERED BY ARNOLD, EVELETH, GRAHAM, AND WESTON

1. Summary

- 32) In the third quarter of 2000, Qwest recognized fraudulently \$100 million in revenue based on a September 22, 2000, transaction with Genuity that provided that Qwest would supply certain equipment and internet-related services. Despite the understanding of both Qwest and Genuity that the entire transaction for equipment and services was a single arrangement for internet connectivity, defendants Arnold, Weston, Eveleth, and Graham fraudulently split this transaction into two purportedly separate contracts solely for the purpose of allowing the Global Business unit to reach its revenue goals for the quarter ending September 30, 2000. The first contract purported to sell equipment to Genuity for

\$100 million. The second contract purported to sell services for \$160 million over five years.

- 33) Qwest's immediate recognition of the \$100 million in revenue did not comply with GAAP. This revenue should not have been recognized immediately because, among other reasons, the risk of loss on the equipment did not transfer to Genuity, Qwest did not substantially accomplish all of the terms of the sales agreement, the revenue apportioned to the equipment sale was not based on the fair value of the equipment, and the equipment sale was part of a related agreement for provision of services.
- 34) Qwest, in violation of GAAP, fraudulently recognized \$100 million in revenue from the equipment sale and \$20.5 million as cost of goods sold in the third quarter of 2000 thereby allowing Qwest to also include EBITDA of approximately \$80 million in its third quarter earnings press release. Qwest also began, in violation of GAAP, to fraudulently recognize revenue in the third quarter of 2000 pursuant to the service agreement ratably over the life of the agreement despite the fact that Qwest had not begun providing the services. Qwest, in violation of GAAP, recognized revenue of \$2.6 million in the third quarter 2000 and \$8 million in the fourth quarter of 2000 from the service contract despite the fact that it did not provide services under the contract in the fourth quarter.
- 35) As a result of this fraudulent transaction Qwest's September 30, 2000 quarterly report, December 31, 2000 annual report, March 31, 2001 quarterly report, June 30, 2001 quarterly report, September 30, 2001 quarterly report, and December 31, 2001 annual report were all materially false and misleading.

2. The Equipment Sale and Services Contract Were Separated Solely For The Purpose Of Recognizing Fraudulent Revenue

a) Background

- 36) Genuity had previously contracted for network services from US West, but prior to the merger Genuity sought a lower price for the services. Following the merger, Qwest entered into negotiations with Genuity. In the negotiations it was contemplated that Qwest would own and operate the equipment used to provide the network services as Genuity did not want to own the equipment.

b) Defendants' Knowledge Of And Participation In The Fraud

- 37) By early September 2000 Arnold made it clear to Weston and others on the Genuity sales team that the equipment sale portion of the agreement needed to generate \$100 million in revenue for the third quarter 2000. To implement this fraudulent scheme, at Weston's suggestion, Arnold decided to split the equipment sales apart from the service portion of the transaction. This was to be done solely for the purpose of recognizing revenue from the purported sale of equipment by the end of the quarter.
- 38) Arnold, Eveleth, Graham and Weston received a September 14, 2000, e-mail from a Qwest financial analyst assigned to the Genuity transaction acknowledging that \$80 million in EBITDA would result from the equipment sale to Genuity but noting a risk that revenue of \$100 million could not be recognized immediately on the transaction.
- 39) In September 2000, a Qwest sales team leader questioned Arnold as to the propriety of immediately recognizing revenue on the equipment sale because previous similar transactions engaged in by US West involved the recognition of revenue only over the life of the service contract. Arnold dismissed the sales team leader's concern.
- 40) Arnold's primary concern was that the revenue be recognized. On at least one occasion, despite knowing that Qwest would lose money on the service contract, Arnold stated that he did not care about the losses on the service contract.

- 41) Weston, in negotiating the contract with Genuity, stated that Qwest needed \$100 million of revenue in the third quarter (that is, a separate equipment and services contract) in order to agree to the contract. On several occasions Weston admitted to lower level employees that he needed \$100 million in revenue for the quarter.
- 42) Qwest paid Genuity a \$4 million bonus to sign the services agreement before the end of the quarter. Defendants Arnold and Weston knew of this \$4 million payment and that it was paid to induce Genuity to sign the contract before the end of the third quarter.
- 43) Eveleth was asked to approve the structure of the equipment purchase agreement with Genuity and knew that contrary to GAAP, the services contract placed the risk of ownership of the equipment with Qwest.
- 44) To recognize revenue, Qwest needed to deliver the equipment to Genuity by September 30, 2000. The normal shipping method for this type of equipment was ground delivery, but Weston approved shipping the equipment to Genuity by air freight on a chartered jet at substantially higher cost so that the equipment could be delivered by the last day of the quarter, which was a Saturday.
- 45) Separating the equipment part of the deal from the services was unusual in the industry. Genuity's five other vendors at that time owned the equipment on which they provided services to Genuity.
- 46) Genuity considered the transaction with Qwest as a single overall package for a total price of \$260 million. Genuity never expressed a need to purchase, or an interest in purchasing, \$100 million in equipment.

c) Qwest's Accounting for the Genuity Transaction was Improper

(1) The Contracts Were Inextricably Linked

- 47) Immediate recognition of revenue for the equipment sale was improper under GAAP because the equipment and services were inextricably linked as they were part of a single transaction.
- 48) Arnold, Weston, Eveleth, and Graham each knew that the equipment and services contracts with Genuity were in reality part of a single transaction and that the equipment sale and services provisions had been artificially split in order to justify the immediate recognition of \$100 million of revenue from the equipment side of the transaction.

(2) There Was No Evidence Of Fair Value

- 49) Recognition of the revenue from the equipment sale violated GAAP because there was no evidence the contract price was the fair value of the equipment and because Qwest would lose money on the services contract. The price of the equipment was determined arbitrarily by dividing the number of units sold into the predetermined revenue number of \$100 million. This per unit cost of \$500 per unit was not reasonably related to the market price of such equipment.
- 50) Weston knew that Qwest had sold similar equipment to another company for \$250 per unit in the first half of 2000. Moreover, Weston, Arnold, Eveleth, and Graham received an e-mail on September 14 from a Qwest financial analyst that cautioned them that immediate revenue recognition might be questioned due to the \$500 per unit price. Weston, Arnold, Eveleth, and Graham knew the price of the equipment was arbitrary and not related to its fair value. They also knew the price was derived solely for the purpose of recognizing immediately \$100 million of revenue.
- 51) The Qwest financial analyst warned Arnold and Eveleth that the services contract, standing alone, would cause Qwest to lose money. Prior to his approval of the contract,

Eveleth knew that an analysis of the services contract showed that the net present value of the services contract standing alone was negative \$38 million. Arnold and Eveleth knew that it was not normal business practice for Qwest to enter into a transaction with such a large negative net present value.

(3) Cost of Goods Sold Was Fraudulently Recorded After The Third Quarter of 2000

52) Qwest violated GAAP in accounting for the cost of goods sold related to the equipment purchase. In the subsequent quarter, the fourth quarter of 2000, Qwest booked an additional \$17 million in cost of goods sold, for total cost of goods sold associated with the Genuity equipment sale of approximately \$37.5 million. The additional \$17 million, which should have been booked in the third quarter of 2000, included \$7 million for routers and switches necessary to make the equipment delivered in the third quarter of 2000 fully operational. The remaining \$10 million of cost of goods sold was for equipment originally intended to be used as part of the contracted services to Genuity.

53) Arnold, Eveleth, Graham, and Weston knew that the cost of goods sold in the third quarter was understated because they received an e-mail on September 14, 2000, from the Qwest technical accountant on the Genuity transaction expressing a concern about the apparent understatement of the cost of goods sold for the equipment due to the unusually high margin for the transaction.

(4) The Services Agreement Placed Risk of Ownership With Qwest

54) Under GAAP, in order for Qwest to recognize any revenue from the sale of the equipment to Genuity, among other things, the risk of ownership of the equipment had to pass to Genuity. The services contract provided that the risks of ownership purportedly transferred to Genuity in the equipment sale were reassumed by Qwest. Specifically, the services agreement stated "... Qwest shall be responsible for safeguarding and protecting

such [equipment] from and against all risks of destruction or damage, failures, whether functional, operational or otherwise, and any cost, expenses and liabilities arising therefrom."

- 55) Arnold, Eveleth, Graham, and Weston knew that the services agreement placed the risk of ownership of the equipment with Qwest, but nonetheless caused the recognition of the revenue from the sale in the third quarter of 2000.

(5) Initial Required Capacity Of Services Not Provided to Genuity

- 56) GAAP did not allow recognition of the revenue from the equipment sales because Genuity was not required to pay for the services until after all the equipment being sold was delivered and operating in accordance with the terms of the Genuity services contract.
- 57) Under the services agreement, Qwest was required to provide services on 140,000 of the 200,000 units sold to Genuity by September 30, 2000. However, Genuity was not obligated to pay Qwest until services were provided on this equipment beginning in August 2001. Weston was aware services would not be provided on this equipment by the end of the third quarter of 2000 when the revenue from the equipment sale was recognized.

3. Financial Statement Impact of Improper Accounting

- 58) Qwest's Form 10-Q for the third quarter of 2000 and Form 10-K for fiscal year 2000 filed with the Commission contained materially false and misleading financial statements as a result of the Genuity transaction. Qwest announced that the \$4.8 billion in revenue for the third quarter 2000 reflected an increase of 12.4 percent from the same period in the prior year thus meeting the company prediction of double-digit growth every quarter. If the Genuity equipment sale transaction had not been recognized in that quarter, Qwest would have fallen short of its double-digit revenue increase promises by management and

had to report revenue growth of 9.8 percent, a material difference given management's earlier promises about revenue growth. In addition, Qwest reported net loss of \$248 million and net income of \$36 million for three and nine months ended September 30, 2000 respectively. The impact of the Genuity transaction resulted in an understatement of the net loss of 32 percent for the three months then ended and an overstatement of net income changing it from a net income to a net loss of \$44 million for the nine months then ended. Qwest also claimed EBITDA of \$1.9 billion and \$5.4 billion in its third quarter earnings press release for the three and nine months ended September 30, 2000, respectively. This amounted to a material overstatement of EBITDA of 4.3 percent and 1.5 percent, respectively, for the periods then ended.

- 59) Further, there was no public disclosure by Qwest at the time it recognized revenue from the Genuity transaction that the revenue was the result of a fraudulent and contrived equipment sale transaction that was non-recurring and accounted for inappropriately.

C. FRAUDULENT ARIZONA FACILITIES SCHOOL BOARD TRANSACTION

1. Summary

- 60) In January 2001, the Arizona School Facilities Board ("ASFB" - ASFB is an agency of the Arizona state government that contracts for private services to ensure adequate facilities for Arizona's public schools) and Qwest entered into an agreement providing that Qwest would design and implement a statewide network and provide internet and local area network connections for Arizona schools within a two-year period using equipment provided by Qwest.
- 61) In an effort to meet Qwest's aggressive revenue targets, Arnold, Graham, Hall, Hutchins, Treadway, and Walker, planned and carried out an elaborate scheme to inflate Qwest revenues for the second quarter of 2001.

- 62) To accomplish the fraud they separated the equipment sale from the installation services of the ASFB contract, wrongfully characterizing the sale as a bill and hold transaction under GAAP. Additionally, they accelerated delivery of equipment necessary for the two-year project and delivery of equipment that was not approved for the ASFB project. They also executed fraudulent letter agreements with ASFB that purportedly supported recognition of revenue. Further, they participated in creating false documents designed to justify the transaction after it had been entered into. As a result of the scheme, Qwest fraudulently recognized approximately \$34 million in revenue on the sale of the equipment in its second quarter ended June 30, 2001.
- 63) As a result of this fraud Qwest's June 30, 2001 quarterly report, September 30, 2001 quarterly report, and December 31, 2001 annual report were materially false and misleading.

2. The Arizona Contract

- 64) In January 2001, an official of ASFB issued purchase orders to Qwest for Qwest to design and implement a statewide computer network, and provide internet access and local area networks for Arizona schools. The project was to be completed within a two-year period for an amount not to exceed \$100 million. Qwest agreed to provide the equipment necessary for the ASFB project and agreed to bear the risk of loss on the equipment. On February 1, 2001, ASFB formally approved the agreement.
- 65) On April 26, 2001, Qwest issued a purchase order to Cisco Systems, Inc. ("Cisco") for approximately \$30 million of equipment for the ASFB project. The April 2001 purchase order provided that Qwest could request that Cisco deliver equipment from the order on an "as-needed" basis so that Qwest could avoid storage costs and risks of loss or damage to the equipment prior to installation. Hall approved the terms of the order. Accordingly, after Qwest engineers completed network designs and determined what equipment was

needed for each school, Qwest issued individual purchase orders per school site referencing the original April 26, 2001, Cisco purchase order. This process of ordering the ASFB equipment continued until June 2001, by which time ASFB had approved Qwest's designs for only a few of the more than 1,500 Arizona schools.

3. Arnold, Graham, And Hall Devise A Fictitious And Fraudulent Bill And Hold Transaction

- 66) Solely for the purpose of meeting revenue and growth targets Arnold, Graham, and Hall developed the scheme in which Qwest could recognize all the revenue from the sale of the equipment to ASFB by June 30, 2001. The scheme involved artificially separating the equipment sale from the installation services of the ASFB contract, accelerating delivery of the equipment, and characterizing the agreement as a bill and hold transaction. Under GAAP, in a bill and hold transaction, the buyer purchases equipment, but is not ready to take physical possession of the equipment and revenue may be recognized immediately by the seller so long as the mandatory requirements of GAAP are complied with.
- 67) In order to meet the requirements of a bill and hold transaction and immediate revenue recognition, each of the following GAAP requirements must be met: (1) the risks of ownership must pass to buyer; (2) the buyer must make a fixed commitment to purchase the goods, preferably in writing; (3) the buyer, not the seller, must request the transaction be on a bill and hold basis, typically in writing, and must have substantial business reasons for the request; (4) there must be a fixed schedule for delivery with delivery dates that are reasonable and consistent with the buyer's business purpose; (5) the seller must not retain any specific performance obligations such that the earnings process is not complete; (6) the goods ordered must have been segregated from the seller's inventory and not be subject to use to fill other orders; (7) the equipment must be complete and

ready for shipment. As discussed below, none of these requirements were met in the ASFB transaction.

- 68) Graham told Hutchins that Global Business needed to be aggressive in recognizing revenue on the ASFB transaction to help Global Business make up for an anticipated revenue shortfall in the Global Business unit.
- 69) Graham in turn consulted with Treadway and Hutchins and they inappropriately decided to separate the equipment sale from the other elements of the ASFB contract and then to fraudulently characterize the sale as a bill and hold transaction to ensure immediate revenue recognition.
- 70) Accordingly, Graham and Hall ordered the Global Business staff, including Walker and Hutchins, to complete the following tasks by June 30, 2001: (1) have Cisco deliver all of the equipment listed in the April 26, 2001, purchase order; (2) convince ASFB to accelerate its purchase of equipment from the April 26, 2001, purchase order; and (3) have the ASFB official sign letter agreements to give the false appearance that the equipment sale met the very strict bill and hold requirements of GAAP.
- 71) Treadway knew, and informed Graham and Hutchins, that a bill and hold sale would be closely scrutinized by the auditors. Failure to meet any of the seven GAAP requirements for a bill and hold sale would make recognition of the revenue indefensible. As a result, by late June 2001, Graham and Treadway instructed Hutchins and his assistant to begin crafting a memorandum to make it appear that the equipment sale satisfied each of the very strict mandatory bill and hold requirements of GAAP. In fact, Treadway authored an e-mail message on June 23, 2001, saying that he was "very supportive" in making the bill and hold deal work but was concerned about "ensuring the facts hang together" if questioned. Graham and Hutchins received the e-mail message.

- 72) Hutchins prepared the memorandum falsely concluding that Qwest met each requirement for a bill and hold transaction and that revenue could be recognized immediately on the equipment sale. Yet, as discussed below, Hutchins knew the memorandum contained false information. For example, when preparing the memorandum, Hutchins coordinated with sales employees to fabricate a fictitious delivery schedule in an attempt to prove ASFB had agreed to a fixed delivery schedule as required by GAAP.
- 73) Treadway reviewed and edited the memorandum knowing it contained false information. Treadway approved Qwest's accounting treatment of the ASFB equipment sale and provided the memorandum to Qwest's auditors to support Qwest's position, knowing information in the memorandum was false.
- 74) For example, in e-mail messages Treadway expressed concern that Qwest's auditors would discover ASFB had not introduced the bill and hold idea, one requirement for bill and hold accounting under GAAP. Moreover, in e-mail messages sent to Qwest employees after June 30, 2001, Treadway worried that there was no fixed delivery schedule for the transaction as required by GAAP. In fact, Treadway had Hutchins and his assistant alter the ASFB installation schedule to falsely make it appear that it conformed to the strict GAAP delivery requirements for bill and hold transactions.

4. Desperate Efforts To Obtain Delivery of Cisco Equipment

- 75) To ensure revenue recognition on the equipment sale, Graham, Hall and Walker ordered Qwest employees responsible for ordering equipment for the ASFB project to make sure Cisco delivered all equipment listed in the April 26, 2001, purchase order to Qwest's Arizona warehouse by June 30, 2001. However, Cisco and Qwest employees informed Arnold, Graham, Hall and Walker that Cisco did not have enough ASFB equipment available to deliver by the end of June 2001. Arnold then telephoned Cisco and

demanded it manufacture the equipment necessary or pull the equipment from orders already scheduled for delivery to other Cisco customers.

- 76) Desperate to have delivery for revenue recognition within Qwest's second quarter, Graham and Hall ordered Qwest employees to instruct Cisco to ship whatever equipment Cisco had available even if it meant shipment of equipment not suitable for the ASFB project. Hall planned to later exchange the non-conforming equipment for equipment that met ASFB's specifications.
- 77) On Friday, June 29, 2001, Hall unsuccessfully tried to convince Cisco to sign a letter confirming Cisco could ship all of the ASFB equipment by June 30, 2001.
- 78) Also, Arnold and Hall authorized a supplemental purchase order to Cisco for \$7.6 million that included equipment not appropriate for the ASFB project to ensure enough equipment would be shipped by June 30, 2001.
- 79) Despite these desperate attempts to accelerate shipment of all of the ASFB equipment, Cisco only delivered \$17 million of equipment to the Qwest warehouse by June 30, 2001. Some of the equipment delivered was not suitable for, and has never been used for, the ASFB project.

5. False Letter Agreements

- 80) During June 2001, Hall, Walker, and Hutchins instructed the Qwest regional sales director responsible for the ASFB project to convince the ASFB official to sign false letter agreements confirming that Qwest met the mandatory GAAP requirements for a bill and hold transaction. In an e-mail message to Graham, Hall, Hutchins and other Qwest employees, Walker stated, "whether or not Cisco has enough inventory to fulfill this order, we need to get buy-in from [the ASFB official] to agree to take title and pay for the equipment."

- 81) A Qwest regional sales director informed Hall, Walker and Hutchins that it would be difficult to convince the ASFB official to agree to the terms of the proposed letter agreements because the official insisted that: ASFB would not pay for any equipment until Qwest installed it; ASFB could return any unused equipment at any time; and ASFB would take title to the equipment only if Qwest agreed that ASFB could not be held responsible for loss, theft or damage to the equipment. Each of these conditions was inconsistent with the GAAP requirements for a bill and hold transaction. Nevertheless, on June 15, 2001, the Qwest regional sales director convinced the ASFB official to sign a letter purporting to agree to accept title to the equipment so that Qwest could accelerate revenue recognition on the ASFB transaction.
- 82) Treadway, in e-mail messages, emphasized the importance of crafting the letter agreements being prepared for the ASFB official so that no one would discover that Qwest, rather than ASFB, was requesting the bill and hold structure. Under GAAP, bill and hold treatment is allowed only if the customer initiates the bill and hold request for legitimate business reasons.
- 83) Hall notified Arnold in an e-mail message on June 20, 2001 that Qwest's corporate accounting department was troubled by ASFB's desire not to have risk of loss on the equipment and ASFB's insistence on paying only when installation was complete.
- 84) Nevertheless, Hutchins drafted letter agreements for the ASFB official to sign to fulfill the bill and hold requirements, knowing they included terms contrary to the official's oral agreements with Qwest. Hall, Walker, and Treadway reviewed and edited letter agreements, and Hall signed them, knowing they were false.
- 85) The first letter agreement prepared for the ASFB official to sign was drafted by Hutchins and dated June 27, 2001. It falsely stated that, at ASFB's request, Qwest would deliver \$35.5 million in Cisco equipment to Qwest's Arizona warehouse on June 30, 2001, and

store the equipment at Qwest's warehouse in Arizona because of ASFB's purported business reasons. Graham, Hall, Hutchins, and Walker pushed to make sure the ASFB official signed the false letter agreement even though they each knew Qwest, not ASFB, initiated the idea of treating the equipment sale as a bill and hold transaction.

- 86) On June 29, 2001, Hall and Walker convinced the ASFB official to sign another letter agreement acknowledging ASFB's request that Qwest purchase and store equipment on ASFB's behalf and setting forth the following false representations: (1) ASFB shall take legal possession of the equipment; (2) ASFB's acquisition of the equipment will be considered final, provided that ASFB has a right to return up to \$2 million of unused equipment upon Qwest's completion of the project; (3) the agreement does not change any of the terms of the January 2001 purchase orders; and (4) ASFB shall pay Qwest \$35.5 million for the equipment according to a specific payment schedule.
- 87) Hall and Walker gave the ASFB official verbal assurances that the ASFB would not be held to the terms of the letter agreement and that the ASFB would not have to pay until Qwest installed the equipment because it was solely for Qwest's revenue recognition purposes. In other words, ASFB would not be bound by the fictitious letter agreements.
- 88) Graham, Hall, Walker, and Hutchins pushed for the false letter to be signed by the ASFB official even though the Qwest regional sales director had informed them that the ASFB official would not be bound by the letter agreement's terms.
- 89) After June 30, 2001, Treadway consulted with Qwest's auditors regarding the letter agreements. Qwest's auditors indicated that ASFB needed to confirm that the equipment sale was complete and final as of June 30, 2001. Treadway then informed Hutchins and Graham that the earlier letters were not sufficient for revenue recognition purposes and that the ASFB official needed to sign new letters to ensure the revenue could be immediately booked.

- 90) Accordingly, Hall pushed Qwest's regional sales director to convince the ASFB official to sign two additional letter agreements. On July 2, 2001, the ASFB official signed a letter addressed to Hall which fraudulently claimed that: (1) ASFB had received the \$35 million of Cisco equipment; (2) that as of June 30, 2001, Qwest had fulfilled its equipment delivery obligations; and (3) that ASFB and Qwest could decide not to proceed with the rest of the purchase order without penalty. This latter provision was necessary to ensure equipment sale and installation services were separate for revenue recognition purposes under GAAP.
- 91) The July 2, 2001, letter agreement was false because Cisco delivered only \$17 million of equipment for the transaction by June 30, 2001, Qwest had not fulfilled the acquisition of the Cisco equipment, and Qwest was obligated to complete the remaining terms in the original contract.
- 92) On July 11, 2001, Hall signed a letter addressed to the ASFB official admitting that Qwest would be responsible for the ASFB equipment until installation was complete if ASFB chose to use Qwest to install the equipment. Hall signed the false letter knowing that Qwest was already obligated to install the equipment. Furthermore, the language of the July 11, 2001, letter transferred risk of loss back to Qwest, making it impossible to recognize revenue on the equipment sale for Qwest's quarter ended June 30, 2001 in compliance with GAAP.

6. Qwest Made Materially False Statements Concerning The ASFB Transaction

a) The Fraud Is Discovered

- 93) At the end of 2001, Qwest's finance department realized ASFB was not making any payments on the project. After conducting an internal investigation in early 2002, Qwest determined that the company improperly recognized revenue on the equipment sale because of the false letter agreements that violated the bill and hold revenue recognition

requirements of GAAP. As a result, Qwest reversed \$33.6 million in revenue for the Form 10-K for the year ended December 31, 2001, by improperly deducting that amount from fourth quarter results as explained in paragraph 96. Qwest then began recognizing revenue on the ASFB transaction on a percentage-of-completion basis.

b) False Public Statements By Qwest

- 94) Both the revenue and the profit associated with the equipment sale should have been recognized based on the percentage of completion method of accounting. Therefore, Qwest should not have recognized \$33.6 million in revenue and \$27.1 million in cost of goods sold in the second quarter of 2001. Qwest announced that the \$5.2 billion in revenue reflected an increase of 12.2 percent from the same period in the prior year thus meeting the company's estimate of 12 to 13 percent revenue growth for the second quarter 2001. If the ASFB transaction had not been recognized in that quarter, Qwest would have fallen short of its target for the quarter and had to report revenue growth of 11.5 percent.
- 95) Similarly, Qwest's Form 10-Q for the second quarter ended June 30, 2001, contained materially false and misleading statements regarding the ASFB transaction. Qwest improperly recognized \$33.6 million in revenue. This overstated revenue for the quarter by one percent and, more significantly, allowed Qwest to announce that it had met its goal of between 12 and 13 percent revenue increase for the quarter. Further, Qwest never disclosed the manner and method by which the revenue was recognized.
- 96) Qwest claims to have "reversed" the ASFB revenue prior to the filing of its 2001 Form 10-K. However, Qwest did so by reducing fourth quarter revenue by the \$33.6 million recognized in the second quarter rather than restating results for the second quarter as required by GAAP. Thus, in Qwest's Form 10-K for 2001, Qwest repeated the false revenue figures for the second quarter in its breakdown of quarterly revenue. By doing

so, Qwest avoided disclosure of a change to second quarter revenue resulting from the improperly recognized ASFB contract.

FIRST CLAIM FOR RELIEF

(Violations of Section 17(a)(1) of the Securities Act)

[15 U.S.C. § 77q(a)(1)]

- 97) Paragraphs 1 through 96 are re-alleged and incorporated by reference.
- 98) Defendants Arnold, Eveleth, Graham, Hall, Hutchins, Treadway, Walker, and Weston directly and indirectly, with scienter, in the offer or sale of Qwest securities, by use of the means or instruments of transportation or communication in interstate commerce or by use of the mails, have employed a device, scheme, or artifice to defraud in violation of Section 17(a) of the Securities Act.
- 99) By reason of the foregoing, defendants Arnold, Eveleth, Graham, Hall, Hutchins, Treadway, Walker, and Weston violated and unless restrained and enjoined will violate Section 17(a)(1) of the Securities Act.

SECOND CLAIM FOR RELIEF

(Violations of Section 17(a)(2) and 17(a)(3) of the Securities Act)

[15 U.S.C. § 77q(a)(2) and (3)]

- 100) Paragraphs 1 through 96 are re-alleged and incorporated by reference.
- 101) Defendants Arnold, Eveleth, Graham, Hall, Hutchins, Treadway, Walker, and Weston directly and indirectly, in the offer or sale of Qwest securities, by use of the means or instruments of transportation or communication in interstate commerce or by use of the mails, have obtained money or property by means of untrue statements of material fact or omissions to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or engaged in transactions, practices, or courses of business which have been or are operating as a fraud or deceit upon the purchasers of Qwest securities in violation of Sections 17(a)(2) and (a)(3) of the Securities Act.

- 102) By reason of the foregoing, defendants Arnold, Eveleth, Graham, Hall, Hutchins, Treadway, Walker, and Weston violated, and unless restrained and enjoined will violate Sections 17(a)(2) and (3) of the Securities.

THIRD CLAIM FOR RELIEF

(Violations and Aiding and Abetting Violations of Section 10(b) of the Exchange Act and Rule 10b-5)

[15 U.S.C. § 78 j(b) and 17 C.F.R. § 240.10b-5]

- 103) Paragraphs 1 through 96 are re-alleged and incorporated by reference.
- 104) Defendants Arnold, Eveleth, Graham, Hall, Hutchins, Treadway, Walker, and Weston directly and indirectly, with scienter, in connection with the purchase or sale of Qwest securities, by use of the means or instrumentalities of interstate commerce or by use of the mails, have employed devices, schemes, or artifices to defraud; have made untrue statements of material fact or omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or has engaged in acts, practices, or courses of business which have been and are operating as a fraud or deceit upon the purchasers or sellers of such securities in violation of Section 10(b) of the Exchange Act and Rule 10b-5 and aided and abetted such violations.
- 105) By reason of the foregoing, defendants Arnold, Eveleth, Graham, Hall, Hutchins, Treadway, Walker, and Weston violated, and aided and abetted violations and unless restrained and enjoined will violate and aid and abet violations of Section 10(b) of the Exchange Act and Rule 10b-5.

FOURTH CLAIM FOR RELIEF

(Violations of Section 13(b)(5) of the Exchange Act and Rule 13b2-1)

[15 U.S.C. § 78m(b)(5) and 17 C.F.R. § 240.13b2-1]

- 106) Paragraphs 1 through 96 are re-alleged and incorporated by reference.

- 107) Defendants Arnold, Eveleth, Graham, Hall, Hutchins, Treadway, Walker, and Weston knowingly circumvented or knowingly failed to implement a system of internal accounting controls, knowingly falsified books, records, or accounts and directly or indirectly falsified or caused to be falsified books, records or accounts described in Section 13(b)(2) of the Exchange Act.
- 108) By reason of the foregoing, Arnold, Eveleth, Graham, Hall, Hutchins, Treadway, Walker, and Weston violated, and unless restrained and enjoined will violate Section 13(b)(5) of the Exchange and Rule 13b2-1.

FIFTH CLAIM FOR RELIEF

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

[15 U.S.C. § 78 m(a) and 17 C.F.R. §§ 240.12b-20, 240.13a-1 and 240.13a-13]

- 109) Paragraphs 1 through 96 are re-alleged and incorporated by reference.
- 110) Defendants Arnold, Eveleth, Graham, Hall, Hutchins, Treadway, Walker, and Weston aided and abetted Qwest, as an issuer of a security registered pursuant to Section 12 of the Exchange Act, in filing materially misleading annual and quarterly reports with the Commission and failing to file with the Commission, in accordance with rules and regulations the Commission has prescribed, information and documents required by the Commission to keep current information and documents required in or with an application or registration statement filed pursuant to Section 12 of the Exchange Act and annual reports and quarterly reports as the Commission has prescribed.
- 111) By reason of the foregoing, Arnold, Eveleth, Graham, Hall, Hutchins, Treadway, Walker, and Weston aided and abetted violations of, and unless restrained and enjoined will aid and abet violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13.

SIXTH CLAIM FOR RELIEF

(Aiding and Abetting Violations of Section 13(b)(2) of the Exchange Act)
[15 U.S.C. § 78m(b)(2)]

- 112) Paragraphs 1 through 96 are re-alleged and incorporated by reference.
- 113) Defendants Arnold, Eveleth, Graham, Hall, Hutchins, Treadway, Walker, and Weston aided and abetted Qwest's failure to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflected the company's transactions and dispositions of its assets and failure to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions were recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements.
- 114) By reason of the foregoing, Arnold, Eveleth, Graham, Hall, Hutchins, Treadway, Walker, and Weston aided and abetted violations of, and unless restrained and enjoined will aid and abet violations of Section 13(b)(2) of the Exchange Act.

PRAYER FOR RELIEF

The Commission respectfully requests that the Court:

I.

Find that the defendants committed the violations alleged.

II.

Enter an Injunction, in a form consistent with Rule 65(d) of the Federal Rules of Civil Procedure, permanently restraining and enjoining defendants from violating, or aiding and abetting, directly or indirectly, the provisions of law and rules alleged in this complaint.

III.

Order each defendant to pay civil penalties, including post-judgment interest, pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)] and Section 20(d) of the Securities Act [15 U.S.C. § 77t(d)] in an amount to be determined by the Court.

IV.

Order pursuant to its equitable powers and Section 21(d)(2) of the Exchange Act [15 U.S.C § 78u(d)(2) as amended by § 305 of the Sarbanes-Oxley Act that defendants Arnold, Graham, Hall, Treadway, and Weston be permanently barred from serving as an officer or director of any public company.

V.

Order that each defendant disgorge all ill-gotten gains, including pre-judgment and post-judgment interest, resulting from their participating in the scheme, including salaries, bonuses, stock, or other compensation of any kind.

VI.

Grant such other relief as this Court may deem just or appropriate.

JURY DEMAND

Plaintiff demands a jury trial in this matter.

Dated: February 25, 2003

Respectfully submitted,

_____/s/_____
Robert M. Fوسفeld
Direct telephone: 303/844-1080

_____/s/_____
Polly A. Atkinson
Direct telephone: 303/844-1046

Attorneys for Plaintiff
Securities and Exchange Commission
1801 California Street, Suite 1500
Denver, Colorado 80202
Telephone: 303/844-1000
Facsimile: 303/844-1068