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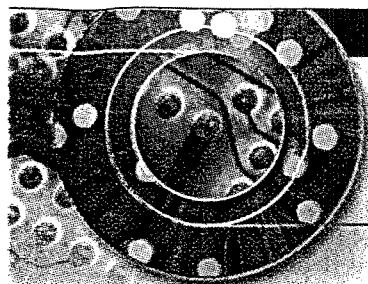
# San Francisco Chronicle

NORTHERN CALIFORNIA'S LARGEST NEWSPAPER

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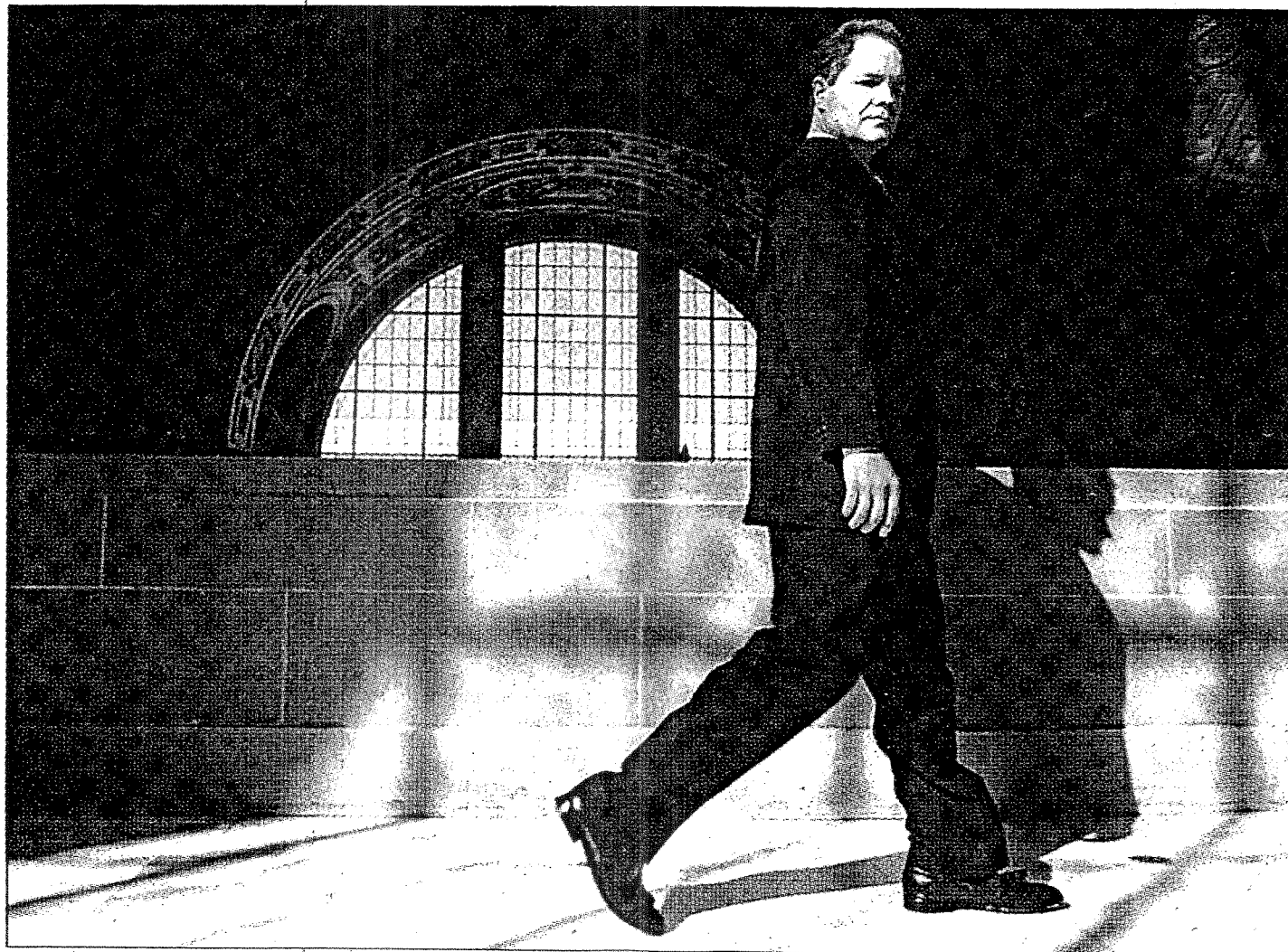
TUESDAY, NOVEMBER 16, 1999

**DARK SIDE OF THE VALLEY: SECOND OF FIVE PARTS**



## Hollow Words

Federal prosecutors say white-collar crime is a priority, but they have filed only a few charges against Silicon Valley executives



Robert Crowe says he felt he was single-handedly fighting fraud in Silicon Valley when working as assistant U.S. attorney in the San Francisco office

## Hollow Words

### Federal prosecutors say white-collar crime is a priority, but they have filed only a few charges against Silicon Valley executives

Reynolds Holding, and William Carlsen, Chronicle Staff Writers

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(Second of five parts)

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Silicon Valley is the epicenter of the fastest creation of wealth in history. But the high-tech miracle has a dark side: untold stories of ruined investors, betrayed entrepreneurs and regulators who are overmatched and overwhelmed.

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Robert Crowe was afraid he wouldn't be ready.

For months, the assistant U.S. attorney had been preparing a securities fraud case against executives at California Micro Devices, a Milpitas chip manufacturer. But as the 1998 trial neared, Crowe was inundated with 600,000 pages of documents and didn't even have a clerk to work the copy machine.

Meanwhile, the FBI and the Securities and Exchange Commission continued to bring him promising cases against other Silicon Valley companies. But Crowe was the only federal prosecutor in San Francisco working full time on investment fraud, and there was nothing he could do with them.

"The inventory of cases kept building," said Crowe. "I couldn't keep up."

Cal Micro was the first major Silicon Valley fraud case tried by the U.S. attorney's office in San Francisco. It was also the last -- even though shareholders have sued more than 60 high-tech companies in Northern California's federal courts since 1995.

Silicon Valley executives contend that most of the complaints are frivolous, but Crowe and others say the rising number of class-action suits shows that fraud is rampant in the high-tech industry.

"If they put together a special federal task force and sent it into the valley, they could bring a ton of fraud cases," said one senior prosecutor at the U.S. Department of Justice.

But the U.S. attorney's office has done little to deter securities fraud in Silicon Valley, filing criminal charges against only a handful of high-tech executives the entire decade.

Since shaking the recession of the early 1990s, Silicon Valley has become the epicenter of the fastest creation of wealth the world has ever seen. And the opportunities and motives for financial deceit have never been greater.

Silicon Valley executives face intense pressure to meet Wall Street's expectations. Missing quarterly projections can mean financial disaster for a company -- and for the executives whose compensation packages depend on the company's stock price.

For many corporate officers, the temptation to "cook the books" -- and then unload shares before the company's stock price collapses -- is overwhelming. And unless federal prosecutors crack down, experts warn, securities fraud will continue to flourish.

"More executives should be going to jail," said Stanford University law Professor Joseph Grundfest, a former SEC commissioner and national expert in securities fraud. "That will grab their attention . . . and hand a valuable lesson to the entire economy."

This is the story of how federal prosecutors have allowed securities fraud to spread through Silicon Valley like a virus. It is an account of the one major case that the U.S. attorney's office in San Francisco prosecuted, desperately hoping the trial would serve as a warning to the high-tech industry.

And it is about an even bigger case, one of the most flagrant in Silicon Valley history, that federal prosecutors let sit on the shelf.

Yamaguchi's Vow, 1993

When Michael Yamaguchi was appointed U.S. attorney for the Northern District of California in 1993, he took over an office that had been adrift for years under a string of temporary chiefs.

As one of his first priorities, Yamaguchi pledged an aggressive campaign against white-collar crime. But the soft-spoken tax specialist quickly learned it wasn't going to be easy. "We did not have nearly enough resources," said Richard Seeborg, a former prosecutor in the agency's San Jose office. "When you compare our office to U.S. attorney's offices around the country, we were grossly understaffed."

In the 1990s, the Northern California district office had, on average, only one-quarter of the federal prosecutors per capita that were assigned to lower Manhattan and one-third the number of prosecutors posted to Southern California.

Yamaguchi's first test came in June 1994, when former Chronicle columnist Herb Greenberg reported allegations from former employees at California Micro Devices that the company had been booking fake or premature revenue for years.

Shortly after the disclosures, as the FBI and SEC investigated, the company's senior financial officer, Steven Henke, resigned. A few weeks later, the board of directors fired Chief Executive Officer Chan Desai, and Cal Micro's stock plummeted an estimated \$139 million.

As Yamaguchi's prosecutors conducted interviews and pored over Cal Micro's records, they found that the company had booked millions of dollars in revenue for products that had not been shipped. They also discovered double bookkeeping, false financial filings and illegal write-offs. At the same time, the prosecutors discovered, Desai and Henke had dumped more than \$1.1 million of their own stock before its price collapsed.

It was the perfect case for Yamaguchi to demonstrate that his office was serious about white-collar crime.

The Mastermind, 1989

Phil White was always ambitious -- even before he was accused of masterminding one of the largest securities fraud scandals in Silicon Valley.

The sandy-haired White grew up in small-town Illinois, the son of an accountant and a public school teacher.

He majored in business at Illinois Wesleyan University and later graduated from the University of Illinois' business school.

He first worked for a travel company, leading tours through Latin America, Europe and Canada and running the company's Hawaii office. But when he realized he had no chance to head the family-owned business, he quit.

"I didn't go to school," he once told a financial trade magazine, "to be second or third fiddle."

Next, he moved to IBM's St. Louis office, where he consistently won sales awards. But he knew he would never challenge for the top job at IBM, either, and after 15 years, nearing middle age, he decided to change course.

In 1982, White moved to a sales and marketing job in Silicon Valley and two years later joined the board of Wyse Technology. In 1986, when the company needed an aggressive new president and chief operating officer, White seized the chance.

Wyse had been a prosperous manufacturer of video display terminals for many years, but its market niche was doomed by a new generation of desktop computers that could operate without mainframes. Shortly after White took over, Wyse moved into the personal computer market, and White's management team promised 20 percent revenue increases every three months. It was an ambitious goal, and almost immediately it led to disaster.

In the haste to meet the target, Wyse made a lot of shoddy computers. They overheated, erased information and ejected circuit boards during shipping. The pressure to meet revenue goals grew so intense that in December 1987 the company shipped computers in garbage bags after the anti-static containers ran out.

According to court documents, the company claimed sales on computers that were

actually sent ``around the corner'' to shippers' warehouses, then returned to Wyse after the end of the financial quarter. Some computers were not shipped at all, merely entered into records as ordered and ``processed."

On Feb. 16, 1988, the company reported quarterly revenue of \$128 million

-- an astonishing 75 percent increase over the quarter one year earlier. At an industry conference in September, White proclaimed that 1988 ``looks to be a banner year for all of us."

But on Jan. 5, 1989, the company abruptly announced that revenues for the previous quarter were down by half from a year earlier.

The stock price plunged to \$5 a share, far below its high of \$25.50. Almost 600 employees -- 15 percent of the company's workforce -- would soon be fired. Before the year was over, a Taiwanese company would buy Wyse for \$10 a share.

Investors, mutual funds and pension funds lost tens of millions of dollars. Bill Lerach and other plaintiffs' attorneys sued White and other company officials for securities fraud and insider trading.

The suit was settled in 1992 for \$15.5 million in cash -- with no admission of wrongdoing.

It was not the last time White would be accused of ``cooking the books."

## **THE PROSECUTOR, 1990**

Robert Crowe charged out of Cornell University law school in 1983, eager to become a criminal defense lawyer.

But he quickly found positions as a public defender more difficult to find than prosecutor jobs, so he wound up as an assistant district attorney in Brooklyn, N.Y., and loved it.

After several years of prosecuting street crimes, the Chicago native began looking for something more challenging. He found it in 1989 when he went to work in the U.S. attorney's branch office in San Jose.

In 1990 he got his first securities fraud case. It involved a company in Campbell called StarSignal Inc.

At the time, the U.S attorney's office didn't pay much attention to investment-fraud cases. According to several former prosecutors, the lawyer responsible for them just sat on the complaints in the San Francisco office. It got so bad, they said, that frustrated SEC officials stopped sending cases over.

``The head of SEC enforcement was thrilled when I began working on StarSignal," Crowe said.

StarSignal was the brainchild of an excitable and brilliant engineer named Robert Widergren. With several million dollars raised from private investors, the company developed the world's first commercial color fax machine. But the early machines were expensive, costing as much as \$26,000, and sales never took off.

In 1990, a former executive tipped the SEC that the company was raising money by sending investors false information -- including news of an imminent sale in Spain worth \$83 million. The figure, said the tipster, was "extracted from the air."

That August, the FBI moved in, arresting Widergren after learning that he planned to transfer money to Belize in Central America. Widergren was charged with bilking investors of more than \$3 million.

The StarSignal case gave Crowe his first inkling that securities fraud was more widespread in Silicon Valley than anyone suspected.

"Why are you doing this to me?" Crowe remembers Widergren asking during breaks in the 1991 StarSignal trial. "My case is just a few million dollars. There's fraud going on all over the valley worth hundreds of millions."

### **INFORMIX'S TURNAROUND, 1993**

For nearly a decade, Informix flourished as one of Silicon Valley's leading makers of software for managing computer databases.

But in 1989 the Menlo Park company bought a software firm in Kansas City, and the acquisition started to drag revenues down. So Informix founder Roger Sippl turned to White, unfazed by Wyse's collapse and the allegations of securities fraud.

White quickly swung into action, firing a fifth of the company's workforce. He expanded the company's business to Europe and Asia. He directed Informix's engineers to change the database software so it would work in networks of personal computers rather than just mainframes.

When PC networks became the rage, Informix cleaned up.

Within four years, the company rebounded from a \$46.3 million annual loss to post a \$56 million profit. Its stock rose from 56 cents a share to more than \$30. The numbers dazzled Wall Street, and White looked like a genius.

But then the industry began to slow. And the next year, company executives found new ways to keep revenues growing.

### **THE FIRST WARNING, 1994**

Something was wrong with the numbers.

In May 1994, internal auditors at Informix were examining the Australian accounts, and

the figures didn't add up. The company's Australian subsidiary had booked sales a full quarter before the software products were even shipped.

A few months later, the company's outside auditors -- Ernst & Young -- warned company officers of similar problems in Europe.

The auditors also chided Informix for selling software in Latin America on "handshake" agreements. "Shareholders will expect agreements with customers to be documented," the auditors wrote in a draft memo for the 1994 year-end audit.

Informix executives dismissed the incidents as aberrations.

But at an annual meeting in January 1995, Chief Financial Officer Howard Graham met with sales representatives to backdate contracts so that January deals appeared to have closed in December, according to a shareholders' suit. The result was inflated revenues for 1994.

The executives joked among themselves that they were closing the quarter on "December 45th."

## A COMPANY ON A ROLL, 1996

In early 1996, White negotiated Informix's \$400 million purchase of Oakland-based Illustra Information Technologies.

It seemed a stiff price for a company with less than \$10 million in annual sales and an unproven technology that stored images and sound in electronic databases. But White touted the acquisition and the wonders of Illustra's technology.

"This stuff is going to change the way people think," he said.

And Informix, it seemed, was on a roll. White declared that he expected the firm "to become a billion-dollar company in 1996."

But for nearly two years, auditors had warned Informix's board of directors that White, Graham and other executives were inflating revenues through a variety of questionable accounting practices, including backdated sales, "burn deals," barter transactions and side letters.

Under what Informix employees called "Howard's rule," Graham would allow sales contracts to count toward revenue even before they were fully signed.

In barter transactions or "Phil deals" -- named for Phil White -- Informix would agree to buy another company's products if that company would license Informix's software. Informix would then count as revenue the entire value of the software licenses -- without disclosing that it still had to buy the other products before it could get paid. In some cases, it never received payment because the software was returned.

And in complex "burn" transactions, Informix would agree to sell software licenses to a

The tactics served their immediate purpose: They increased revenues and kept the share price high.

By December, before leaving to become chief financial officer at Siebel Systems, a San Mateo software company, Graham had sold more than \$2.8 million worth of his Informix stock.

During the next two months, White and other executives dumped more than \$20 million in shares.

Then, suddenly, everything began to come apart.

## **INFORMIX IN FREE FALL, 1997**

Despite its inflated revenues and soaring stock price, Informix was starved for cash.

And as the company tried to collect on the burn deals it had written, customers objected, and, in some cases, refused to conduct further business with the company.

British software firm Logical Systems International, for example, had agreed to "buy" Informix software with the understanding that Informix would resell it and not make Logical Systems pay.

"Informix asked us to do them a favor," wrote managing director Stewart Ashton in a March 27, 1997, letter to the company, a favor that would "artificially inflate the quarter numbers (of Informix) for last June and September."

But when Informix squeezed Ashton for payment, he howled at having been "coerced into this . . . arrangement."

Finally, Informix could no longer hide its crumbling finances.

On May 14, in its quarterly filing with the Securities and Exchange Commission, Informix announced that it had lost \$140.1 million in the first quarter of 1997, and that "almost half of the licenses sold to resellers" since 1995 "have not been resold."

White blamed an "overemphasis" on selling the new Illustra-based technology rather than traditional software, but financial analysts knew better.

"An unmitigated disaster," one analyst called the company's announcement.

Yamaguchi's Retreat, 1997

Robert Crowe watched from his desk in San Francisco as much of the U.S. attorney's office sank slowly into disarray.

He had transferred from the San Jose office after Widergren's conviction in the StarSignal case. He had taken charge of screening most investment-fraud prosecutions and

coordinating investigations with the SEC.

But Yamaguchi's vow to crack down on white-collar crime in Silicon Valley quickly turned hollow.

In December 1996, Sen. Diane Feinstein recommended Yamaguchi to fill a vacancy on the U.S. District Court in San Jose. The judgeship should have been a crowning achievement for the 46-year-old prosecutor, whose father, grandparents and thousands of other Japanese Americans were kept in World War II internment camps after a series of rulings by federal judges.

But five months later, Yamaguchi withdrew his name after his public comment about an important drug prosecution led to a mistrial in the case.

"After that, and all the bad press around the case, Mike just disengaged and hid out in his office," said one former assistant U.S. attorney.

Even Yamaguchi acknowledged later that he had "crawled into a shell."

Veteran prosecutors were leaving the office in droves. Case filings and conviction rates were plunging. And criminal referrals from the SEC and FBI -- some involving serious allegations of fraud in the high-tech industry

-- were going unprosecuted.

Even the Cal Micro case, the office's best hope for sending Silicon Valley executives a message, seemed in jeopardy.

A Day of Reckoning, 1997

Informix was at the threshold of disaster.

On July 30, 1997, directors and top company executives gathered to hear the devastating news in the Palo Alto offices of Wilson Sonsini Goodrich & Rosati, the most powerful law firm in Silicon Valley.

The board had already stripped White of his title as chief executive officer and hired a replacement, former 3Com executive Robert Finnochio, to review Informix's financial records. After asking White to excuse himself from the meeting, the directors listened raptly as Finnochio described the widespread accounting irregularities that White and other company executives had allegedly engaged in or condoned.

Finnochio's grim report meant that White was finished. When Finnochio completed his presentation, the directors severed all ties with White and replaced him as chairman with Finnochio.

It took Ernst & Young three months to determine the full extent of the questionable accounting schemes. On November 18, Finnochio made what he described as "the mother of all financial announcements."

Informix would have to restate financial results for the previous three years. The company disclosed that it had improperly claimed a staggering \$278 million in revenues and \$236 million in profits.

On the brink of insolvency, Informix laid off thousands of employees. Offices were closed and operations consolidated. The company abandoned plans to build showrooms around the world and announced that it would sell a 27-acre parcel of land in Santa Clara, the planned site for new headquarters.

Immediately, Lerach and other plaintiffs' attorneys filed class-action suits on behalf of the thousands of investors who had lost millions of dollars, and Informix braced for the onslaught.

## THE EVE OF TRIAL, 1998

It was well past midnight in the warren of cramped offices on the 11th floor of the Phillip Burton Federal Building, and Crowe was still working. He had been at it for days, his frustration mounting.

More than three years had passed since the investigation into Cal Micro had opened. In the middle of trial preparations, Leo Cunningham, then Richard Seeborg, the two prosecutors who had worked the case from the beginning, left the U.S. attorney's office to join big law firms in Silicon Valley.

Crowe had replaced them, and now, in early 1998, he was handling the case alone.

He looked over the 600,000 pages of documents with a mixture of disbelief and terror.

"I got started so late," he said. "There was no secretary, no paralegal, no resources I could count on from the office

-- nothing.

"At one point I had to decide between spending 80 hours with (a key witness) or going through every document. I chose the witness, but I was afraid the defense would find something in those papers, and I would be blindsided during the trial."

Finally, the Department of Justice dispatched Pamela Merchant, a senior fraud specialist in Boston, to help him try the case.

Meanwhile, fraud cases from the SEC and the FBI continued to pile up on his desk. But there was little Crowe could do.

He tried to farm them out to other prosecutors, but he couldn't force anyone to take them. And he was acutely aware of how Silicon Valley would view the inaction.

"These big white-collar cases . . . should have high impact," he said. "But if you screw around for four or five years, no one takes you seriously."

An Empty Victory, 1998

The Cal Micro case finally went to trial in June.

Crowe and Merchant believed they had a strong case, a tour de force constructed around a stack of financial records and the testimony of two former Cal Micro executives who agreed to testify for the prosecution.

In their defense, former CEO Desaigoudar and treasurer Henke told the jury that they had done nothing wrong, that they never saw memos or attended meetings where the fraud was discussed. And they repeatedly blamed the wrongdoing on their subordinates.

Their testimony proved unpersuasive. On July 14, 1998, after a five-week trial, jurors found each man guilty of five felony charges, including conspiracy, securities fraud, insider trading and making false SEC filings.

It was a major victory for the demoralized U.S. attorney's office. But for Crowe it was the end of the road.

Just before the trial, his supervisor entered his office and complained that Crowe hadn't done anything with the mounting inventory of criminal fraud referrals.

"I exploded," Crowe said. "I had given him the cases to reassign months earlier so I could concentrate on the trial, and he had done nothing."

Crowe was sick with frustration. He had relished prosecuting Widergren, Desaigoudar, Henke and other white-collar criminals. He had even won an award for his representation of financial fraud victims.

In August, he cleared out his desk in the federal building. When he submitted his resignation, he had no idea who would take over the inventory of cases the office still hadn't dealt with, including one potentially explosive case referred to him months before.

The case against Informix.

## THE VERDICT, 1998

On December 8, a vast Pacific Gas and Electric Co. power failure left only dim, backup lighting in the San Francisco courtroom of U.S. District Judge Vaughn Walker.

Despite the jury's verdict against Chan Desaigoudar and Steven Henke, the former Cal Micro executives refused to acknowledge their crimes, insisting that their subordinates had betrayed them.

"If I have a regret about my conduct as a former CEO and chairman," a defiant Desaigoudar told the judge, "it is simply this: I might have trusted my employees. For this, I and my family will suffer and have been suffering."

Walker tentatively ruled that he would impose prison terms of 36 months for Desai and 32 months for Henke, far less than the government had requested.

Merchant was furious.

"Your honor, the government is deeply troubled," she said. She reminded Walker that the fraud had cost investors tens of millions of dollars. "This is a significant, as the court has said, grave matter."

She urged Walker to reconsider and to send a strong message "to the public and the investing community that this type of crime would not be treated differently than any other crime."

Walker was unswayed. He praised the accomplishments of the two defendants. He extolled their civic and charitable contributions. He even called their situations tragic.

"This cannot by any stretch of the imagination," he said, "be rendered equivalent to fraud which takes advantage of helpless and uninformed or particularly gullible individuals."

## EPILOGUE

In August 1998, Yamaguchi resigned as U.S. attorney amid growing criticism from judges and attorneys about his ineffectiveness. Several months later he became an immigration law judge in San Francisco.

Yamaguchi was immediately replaced by Robert Mueller, a tough, career prosecutor from Washington, D.C., who immediately promised to step up prosecutions of white-collar crime, focusing on Silicon Valley.

A month later, after a four-year investigation, two former executives of Media Vision, a Fremont chip developer, were indicted on charges of securities fraud and insider trading. The case has yet to come to trial.

Mueller said the agency has "a number of cases in the hopper," but he declined to comment further.

In July of this year, the shareholders' class-action suits against Informix were settled. Without admitting any wrongdoing, the company and Ernst & Young agreed to pay investors a total of \$142 million, the largest securities fraud settlement in Silicon Valley history. White, who was not held personally liable for any of the settlement, currently lives in Atherton and sits on the boards of several companies, as well as his college alma mater. He denies any wrongdoing and has declined to comment further.

Howard Graham, who also paid nothing under the settlement, refused to comment.

No criminal charges have been filed against White, Graham or any other Informix executives by the U.S. attorney's office.

Desaigouadar and Henke have appealed their convictions, and they remain free on bail.

Crowe practices law in San Francisco, representing investors.

## **INFORMIX**

Roger Sippl founded Informix in 1980 after Hodgkin's disease forced him to put his medical education on hold. The company quickly grew into one of Silicon Valley's hottest companies, and after Phil White took over in 1989 it seemed poised to surpass Oracle, Sybase and other competitors as the top maker of data-base management software.

A troubled fling with a multimedia-database product and charges of accounting fraud and illegal insider trading derailed the company in 1997. The company has attempted to recover ever since, and last year posted net income of \$57.7 million after a \$357 million loss the year before.

## **CALIFORNIA MICRO DEVICES**

Based in Milpitas, California Micro Devices makes silicon chips, filters and electronic circuitry for workstations and personal computers.

Since its former top officers were accused of securities fraud in 1994 and then convicted last year, the company has attempted to recover by expanding into new markets. For the fiscal year ended in March, Cal Micro lost \$2.8 million on sales of \$33.6 million. It has 150 employees in Milpitas and 110 in Tempe, Ariz.

## **ABOUT THIS SERIES**

For the past 10 months, Chronicle staff writers Reynolds Holding and William Carlsen investigated allegations of widespread legal and ethical misconduct in Silicon Valley.

This five-part series is based upon thousands of pages of financial reports, internal company memorandums, government records and court documents, as well as scores of interviews with corporate executives, government officials, state and federal prosecutors, judges, lawyers, academicians and entrepreneurs.

Some of those court documents were unsealed only as a result of a court order obtained by The Chronicle in San Mateo Superior Court.

## **YESTERDAY**

Phantom Riches

Beneath the glimmer of booming Silicon Valley, executives have been accused of lying about products and doctoring their books

## **TODAY**

## Hollow Words

Federal prosecutors say white-collar crime is a priority, but they have filed only a few charges against high-tech executives

## TOMORROW

### Double-Crossed

Silicon Valley entrepreneurs say they have been betrayed by venture capitalists and lawyers, the very people they asked for help

## THURSDAY

### Stolen Secrets

Technological breakthroughs are so valuable in Silicon Valley that some company executives are willing to do almost anything to get them

## FRIDAY

### Beyond the Law

As the SEC attempts to crack down on improper accounting, a recent federal court ruling threatens future investor lawsuits

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