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UNITED STATES DISTRICT COURT

WESTERN DISTRICT OF WASHINGTON

AT SEATTLE

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. ISILON SYSTEMS, INC. Defendant.	Case No. C09-1293 RAJ **COMPLAINT**

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

SUMMARY OF THE ACTION

1. This case involves false financial reporting by defendant Isilon Systems, Inc., a Seattle-based data storage device company. In December 2006, Isilon had the most successful Initial Public Offering for a technology stock since the autumn of 2000. On the first day of trading, Isilon's stock price rose from $13.00 to $23.10 per share, a 77 percent increase from the initial offering price. The successful stock offering placed significant

pressure on Isilon's management, however, to maintain the stock price gains.

2. As Isilon's actual sales results came in for the three quarters following the Initial Public Offering, Isilon's then Chief Financial Officer, Stuart W. Fuhlendorf ("Fuhlendorf"), knew that the Company would not meet the analysts' revenue forecasts and that Isilon's share price was at risk of a significant decline. Fuhlendorf therefore engaged in a scheme to inflate Isilon's reported revenues in violation of the requirements of the Company's own accounting policies as well as Generally Accepted Accounting Principles ("GAAP").

3. Isilon, through Fuhlendorf, improperly recognized revenue on five transactions in its first three quarters as a public company. Isilon, on multiple occasions, booked "sales" to resellers who did not have firm commitments from end-users or the ability to pay without the resale. Isilon also improperly booked revenue on a roundtrip transaction where it purchased software from a customer who used the software revenue from Isilon to "purchase" Isilon product. Isilon also improperly booked revenue on a transaction where the terms were not fixed until after the quarter ended.

4. By improperly recognizing revenue on these five transactions, defendant Isilon reported revenues that were materially inflated by a total of $4.8 million over the first three quarters following the Initial Public Offering.

5. The Commission seeks an order enjoining Isilon from future violations of the securities laws.

JURISDICTION AND VENUE

6. The Commission brings this action pursuant to Section 21(d) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§ 78u(d)]. This Court has jurisdiction over this action pursuant to Sections 21(e) and 27 of the Exchange Act [15 U.S.C. §§ 78u(e) and 78aa].

7. Isilon, directly or indirectly, has made use of the means and instrumentalities of interstate commerce, of the mails, or of the facilities of a national securities exchange, in connection with the acts, practices, courses of business, and transactions alleged herein.

8. This District is an appropriate venue for this action under Section 27 of the Exchange Act [15 U.S.C. § 78aa]. Certain of the acts, practices, courses of business, and transactions constituting the violations alleged herein occurred within the Western District of Washington, where the defendant is headquartered. Assignment to the Seattle Division is appropriate because much of the relevant conduct took place in King County.

THE DEFENDANT

9. Isilon Systems, Inc. is a Delaware corporation headquartered in Seattle, Washington. The Company's common stock is registered with the Commission under Section 12(b) of the Exchange Act [15 U.S.C. § 78*l*]. Isilon sells systems for storing and managing file-based data to end-users and resellers to store electronic unstructured, file-based data such as video, audio, and digital images.

RELEVANT PARTY

10. Stuart W. Fuhlendorf, age 47, resides in Seattle, Washington. At the time of the events alleged herein, Fuhlendorf was the CFO of Isilon. Fuhlendorf's employment with Isilon terminated in October 2007. Prior to joining Isilon in 2004, Fuhlendorf served as CFO for two companies in the technology and manufacturing sectors.

FACTUAL ALLEGATIONS

11. Isilon went public in December 2006 in the most successful IPO for a technology stock since autumn 2000. On the first day of trading, Isilon's stock price rose from \$13.00 to \$23.10, a 77 percent increase from the initial offering price. The success, however, placed significant pressure on Isilon's management at the time. Analysts covering Isilon projected revenue for the company to grow from \$21.5 million in the fourth quarter 2006 to \$29.9 million for the second quarter of 2007 and revenue to remain in "hyper-growth" through 2009.

12. At the time of the events alleged herein, Isilon's policy, as described in multiple SEC filings, was to recognize revenue on sales to end-users and resellers when it (1) had entered into a legally binding arrangement with a customer, (2) delivery had occurred, (3)

the fee was deemed fixed or determinable and free of contingencies and significant uncertainties, and (4) collection was probable. With sales to resellers, Isilon had an internal written policy that the company did not recognize revenue on sales to resellers without persuasive evidence of a firm arrangement with an end-user customer. Isilon typically accepted purchase orders from resellers and end-users as the legally binding arrangement outlining the terms of the sale.

13. In response to pressure from the market to perform, Fuhlendorf fraudulently caused Isilon to improperly recognize revenue on five transactions in its first three quarters as a public company, totaling $4.8 million. Fuhlendorf knew or was reckless in not knowing that Isilon, on multiple occasions, sold to resellers who did not have firm commitments from end-users or the ability to pay without the resale. He also participated in a roundtrip transaction where Isilon purchased software from a customer who used the software revenue from Isilon to purchase Isilon product. Fuhlendorf also played a part in a sale where the terms were not fixed until after the quarter ended.

A. Fourth Quarter 2006: Isilon Improperly Recognized Revenue on a $1.1 Million Transaction with an Isilon Reseller.

14. For the fourth quarter of 2006, Isilon expected one of its largest resellers ("Reseller 1") to place a $1 million order, but as the quarter progressed, Reseller 1 advised Isilon that, because its end-user did not yet need the product, the order would not be forthcoming in 2006.

15. After the IPO, in mid-December 2006, Fuhlendorf and Isilon's former CEO called the CEO of Reseller 1 and asked if Reseller 1 would accept shipment of over $1 million in product before the end of the year as a "favor" to Isilon. Fuhlendorf and Isilon's former CEO made this request for a favor, knowing that Reseller 1 did not have a purchase commitment from an end-user. During this call, Fuhlendorf or Isilon's former CEO told Reseller 1's CEO that Reseller 1 would not have to pay Isilon for product until it received an order and payment from an end-user.

16. The CEO of Reseller 1 agreed to order and warehouse $1.1 million in Isilon product based on the assurance it would not have to pay for the product until it received an order and payment from an end-user. The assurance provided to Reseller 1 by Fuhlendorf or Isilon's former CEO did not appear in the purchase order issued by Reseller 1 on December 20, 2006.

17. The purchase order from the end-user never materialized, and Reseller 1 refused to pay for the product and instead sought to return the product. In 2008, Isilon agreed to accept the return of the product, less $382,000 in product Reseller 1 was able to sell to other end-users in the third and fourth quarters of 2007.

18. Despite the oral side agreement, Isilon improperly recognized $900,000 in revenue on the transaction in the fourth quarter of 2006. On February 7, 2007, Isilon filed a current report on Form 8-K announcing its results for the fourth quarter and year-ended December 31, 2006. Isilon reported revenue for the fourth quarter of $20.7 million, $900,000 of which came from the Reseller 1 transaction. This was improper under GAAP because Isilon had no firm commitment from Reseller 1 to pay for the product without a resale and thus the sale was not free of contingencies.

19. Isilon reported the same false and misleading financial information in its Form 10-K for 2006, filed with the Commission on March 15, 2007.

20. Isilon knew or was reckless in not knowing that its statements in its Forms 8-K and 10-K to be false and misleading because Fuhlendorf, in his capacity as Isilon's CFO, directly participated in the Reseller 1 transaction that caused Isilon to overstate its revenue for the quarter.

B. First Quarter 2007: Isilon Improperly Recognized $3.1 Million in Revenue on Three Separate Transactions.

21. The pressure that Isilon felt after the very successful IPO only increased during its first full quarter as a public company. There was significant pressure on Isilon to meet analysts' expectations or to at least meet the projections Isilon had provided to the market. By

the end of the first quarter the pressure to bring in revenue hit a peak with Fuhlendorf and Isilon's Vice President of Sales arranging an 8:00 a.m. conference call with the entire sales organization on Saturday, March 31, where Fuhlendorf told the sales force to do whatever needed to be done to get sales booked before the quarter-end and in particular, to close deals that had previously been categorized as probable first-quarter sales.

22. In the final days of the first quarter, Fuhlendorf directly participated in three transactions that accounted for $3.1 million in reported revenue for the quarter. Two of the transactions involved sales to resellers where Fuhlendorf knew or was reckless in not knowing that collection was not reasonably assured and the third involved a fraudulent round-trip transaction with an end-user where collection was not assured without Isilon's cash payment to the end-user. As Fuhlendorf knew, recognizing revenue on these transactions was improper under GAAP.

i. The Undisclosed Oral Side Agreement in Sale to Reseller 2

23. In the first quarter of 2007, a small reseller that serves companies in the film industry ("Reseller 2") told Isilon that it might place an order for approximately $500,000 worth of product before the end of the quarter. However, as the quarter-end approached, Reseller 2 declined to place an order because it had not received a purchase order from its anticipated end-user.

24. On the second-to-last day of the quarter, Saturday March 31, the Isilon sales representative on the Reseller 2 account scheduled a three-way conference call among himself, the president of Reseller 2, and Fuhlendorf. During the call, the president of Reseller 2 informed Fuhlendorf that Reseller 2 did not have a purchase order from the end-user and that Reseller 2 would not be able to pay for the product until it resold. Fuhlendorf assured Reseller 2 that lack of a purchase order from the end-user would not be a problem and that Isilon would help Reseller 2 resell the product to another end-user if necessary. Reseller 2 asked Fuhlendorf to memorialize his assurances in writing and Fuhlendorf declined.

25. Reseller 2 decided to go forward with the deal based on Fuhlendorf's oral

assurances, assurances that did not appear – at Fuhlendorf's insistence – in the purchase order issued by Reseller 2. Reseller 2 placed an order the night of Saturday, March 31, 2007, for $517,000 of Isilon product, of which Isilon improperly recognized $453,000 in revenue for the first quarter. Isilon's recognition of revenue on the sale was in violation of GAAP because, as Fuhlendorf knew, there was no firm commitment from Reseller 2 and collectability was not reasonably assured. Additionally, Fuhlendorf knew that, in violation of GAAP, Isilon had an ongoing involvement in the transaction since Isilon sales people were obliged to help the buyer find an end-user.

26. Ultimately, Reseller 2's end-user did not issue a purchase order. The product was resold by Isilon's sales force, working on behalf of Reseller 2, to other end-users in the fourth quarter of 2007 and the first quarter of 2008. Reseller 2 did not pay Isilon for the product until it was sold through to the end-users.

ii. The Undisclosed Oral Side Agreement in Sale to Reseller 3

27. Also during the first quarter of 2007, another small reseller serving the entertainment industry ("Reseller 3") informed Isilon that it anticipated a $600,000 order from an end-user soon. As quarter-end approached, Fuhlendorf asked the president of Reseller 3 to take the Isilon product without a final purchase order from the end-user. Reseller 3 advised Fuhlendorf that Reseller 3 could not pay without an end-user and Reseller 3 could not have non-payment hurt its relationship with Isilon. Fuhlendorf responded that non-payment would not result in a credit hold and that Isilon would find another home for the product if necessary. None of Fuhlendorf's oral promises appeared in the purchase order issued by Reseller 3.

28. With the assurances from Fuhlendorf, Reseller 3 ordered $638,000 in Isilon product on March 31, 2007, of which Isilon recognized $612,000 in revenue in the first quarter. Isilon's recognition of revenue was in violation of GAAP because, as Fuhlendorf knew, there was no firm commitment and collectability on the sale was not reasonably assured. Moreover, Fuhlendorf knew that, in violation of GAAP, Isilon had an ongoing involvement in the transaction since Isilon sales people were continuing to try to sell the

product.

29. The end-user did not materialize for Reseller 3, which, per the oral side agreement, did not pay Isilon for the product until it was sold to another end-user. About $200,000 in product was ultimately resold by Reseller 3; the remaining product was returned to Isilon in June 2008.

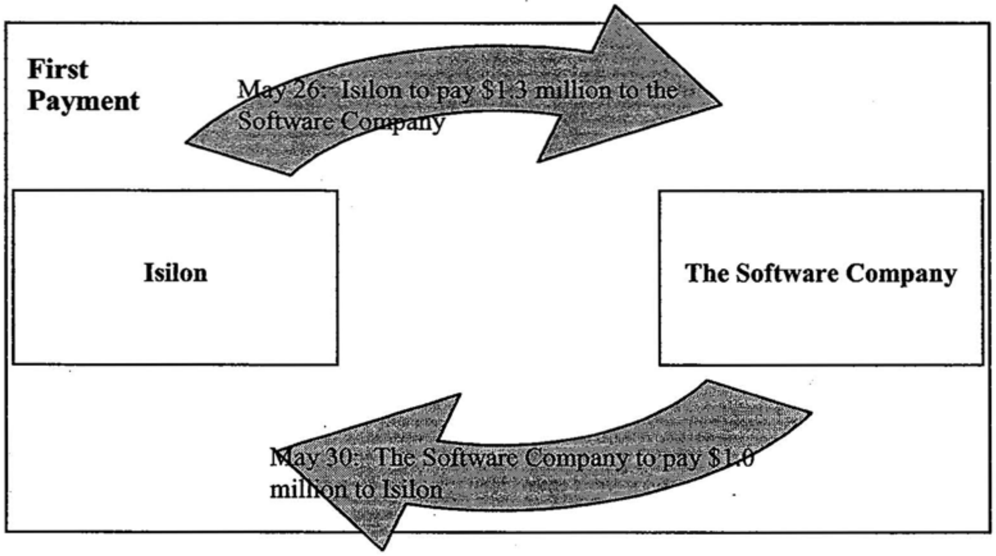
iii. The Bogus Roundtrip Transaction

30. In mid-February 2007, a small start-up software company ("Software Company"), issued a purchase order to Isilon for $2.8 million in product. The purchase order stated it was contingent on the Software Company receiving authorization from the Italian government for use of its product.

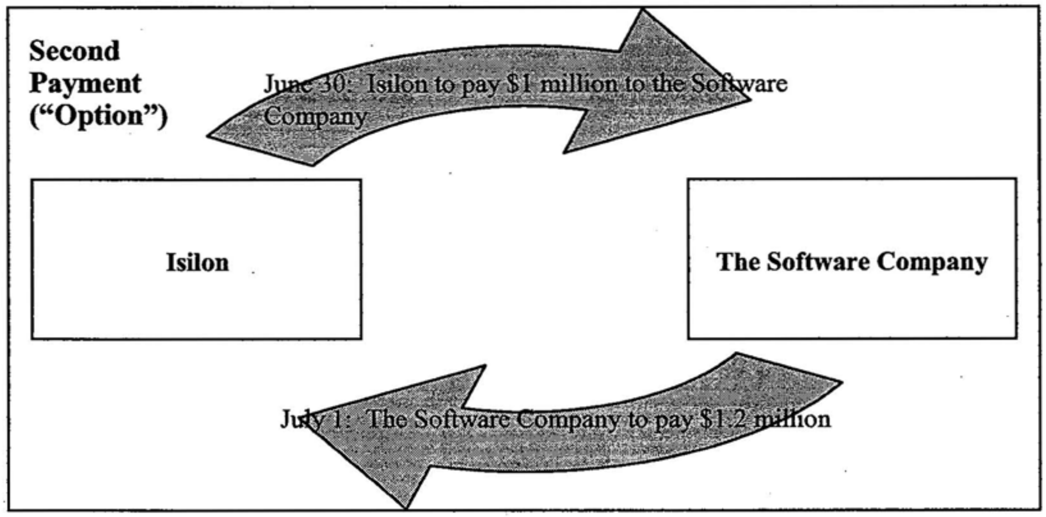
31. By late March, Fuhlendorf learned that it was unlikely that the Italian government would authorize use of the product before the end of the quarter, and thus the contingency would not be lifted – preventing revenue recognition under GAAP. In response, Fuhlendorf called the president of the Software Company and negotiated a deal whereby the Software Company would complete its purchase of Isilon hardware before the end of the first quarter and in return Isilon would purchase the Software Company's software in the second quarter of 2007. Fuhlendorf committed Isilon to buy the Software Company's software knowing that the product had not been tested with Isilon's hardware and knowing that neither sales nor marketing plans had been established. Because the president of the Software Company told Fuhlendorf during the call that he did not want this deal to impact the Software Company's cash flow, Fuhlendorf structured the transaction so that Isilon's cash payments to the Software Company would flow back to Isilon.

32. The deal struck by Fuhlendorf and the Software Company's president was memorialized in two separate documents dated March 30. In one document, the Software Company agreed to immediately lift the contingency on $2.2 million of the $2.8 million ordered in February with $1 million due to Isilon by May 30, 2007 and the other $1.2 million due by July 1. In the second document that was signed by Fuhlendorf, Isilon agreed to

purchase $1.3 million of the Software Company's product on April 26 and pay for it by May 26 (four days before the Software Company would pay $1 million to Isilon).



33. Additionally, according to the agreement signed by Fuhlendorf, Isilon had the option to purchase $1.0 million of the Software Company's product by June 30 (four days before the Software Company was to pay $1.2 million to Isilon for the Isilon product). Although the written agreement signed by Fuhlendorf stated that Isilon had the "option" to order $1.0 million in additional Software Company product on or before June 30, during the phone call negotiating the transaction, Fuhlendorf characterized the additional order to the president of the Software Company not as an option, but as an actual commitment to purchase.



34. Of the $2.2 million sale of product to the Software Company, Isilon recognized revenue on $2.0 million in the first quarter of 2007. Isilon's recognition of the revenue on the transaction with the Software Company was in violation of GAAP because, as Fuhlendorf knew, it was a round-trip transaction in which the essence of the transaction was a circular flow of cash and there was no economic substance to the deal. Isilon, through Fuhlendorf, also knew that collectability was not assured.

35. After the first quarter ended, per the agreements, Isilon paid $1.2 million to the Software Company and the Software Company paid $1 million to Isilon. Isilon, however, did not purchase additional Software Company product as it found no business use for the Software Company's software and no way to sell it bundled with Isilon's hardware. In response to Isilon's failure to place the second order, the Software Company refused to make the second scheduled payment of $1.2 million and instead, made a partial payment of approximately $200,000 to offset the $1.2 million Isilon had paid to the Software Company on May 22.

36. On April 25, 2007, Isilon filed a Form 8-K announcing its results for the first quarter ended April 1, 2007. Isilon reported revenue of $21.6 million, of which $3.1 million came from revenue improperly recognized in transactions with Reseller 2, Reseller 3, and the

Software Company. The recognition of the \$3.1 million was improper because Fuhlendorf knew of oral side agreements with Reseller 1 and Reseller 2 and knew collectability was not reasonably assured on any of the three transactions. Isilon, through Fuhlendorf, further knew that recognition of the revenue on the roundtrip transaction with the Software Company was improper because there was no economic substance to the transaction.

37. Isilon also reported this inflated revenue in its Form 10-Q, filed with the Commission on May 10, 2007.

38. Isilon knew or was reckless in not knowing that its statements in its Forms 8-K and 10-Q to be false and misleading because Fuhlendorf, in his capacity as Isilon's CFO, directly participated in the transactions that caused Isilon to overstate its revenue for the quarter.

C. Second Quarter 2007: Isilon Improperly Recognized \$800,000 in Revenue in a Transaction with an Isilon End-User.

39. In June 2007, a French video file-sharing company (the "Video Company") started discussions with Isilon about purchasing product. By late June, the Video Company and Isilon had come close to finalizing a deal for the sale of \$1 million in Isilon product. Before the deal closed, however, the Video Company's CFO advised an Isilon sales representative that the Video Company could not enter into the transaction until it received approval from its board. The CFO also informed the sales representative that the board would not meet to approve the transaction until early July, after the close of Isilon's second quarter.

40. Fuhlendorf learned about the contingency in June from the sales manager. Despite the fact that the Video Company's board had not yet approved the deal, Isilon shipped over \$1 million of product to the Video Company on July 1, 2007 (the last day of Isilon's second quarter) and recognized the revenue in Isilon's second quarter.

41. As it turned out, the Video Company's board did not approve the deal. Instead, on or around July 3, 2007, before Isilon filed its financial statements for the second quarter of 2007, the Video Company proposed different terms, nearly doubling the amount of

product Isilon would provide at no additional charge. Isilon accepted the new terms and on July 5, the Video Company's CFO confirmed the new deal with the additional product by e-mail to Fuhlendorf.

42. On July 26, 2007, Isilon filed a Form 8-K announcing its results for the second quarter-ended July 1, 2007. Isilon reported revenue of $25.1 million. This revenue included $800,000 from the Video Company transaction. Isilon's recognition of revenue for this sale was in violation of GAAP because, as Fuhlendorf was aware, the terms were not fixed and determinable at quarter-end.

43. On August 9, 2007, Isilon filed its Form 10-Q for the second quarter reporting the same results.

44. Isilon knew the Forms 8-K and 10-Q to be false because Fuhlendorf, in his capacity as Isilon's CFO, directly participated in the transaction that caused Isilon to overstate its revenue for the quarter.

D. Isilon Restated Its Past Financial Statements.

45. On October 23, 2007, Fuhlendorf's employment with Isilon terminated. On November 8, 2007, Isilon publicly announced that its audit committee was conducting an independent internal investigation.

46. On February 29, 2008, Isilon disclosed that, as a result of the investigation, it would restate its financial statements in its Form 10-K for the fiscal year ended December 31, 2006 and in its Forms 10-Q the first and second quarters of fiscal 2007. In the restatement, the company corrected $7.0 million of the $67.4 million of revenue reported from the fourth quarter of 2006 through the second quarter of 2007. Of the $7.0 million restated, $4.8 million derived from the improper revenue recognition on the sales described above.

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Quarter	Isilon GAAP revenue reported	Isilon revenue guidance	Analyst revenue consensus	Impact of improper revenue recognition on revenue and net loss
Q4 2006	$20.7M	N/A	$21.5M	**$900,000 or 4.6%** overstatement of revenue and **5.1%** understatement of net loss
Q1 2007	$21.6	$21-23M	$22.4M	**$3.1M or 16.9%** overstatement of revenue and **26.7%** understatement of net loss
Q2 2007	$25.1	$24.5-27.5M	$29.9M	**$800,000 or 3.4%** overstatement of revenue and **9.6%** understatement of net loss

FIRST CLAIM FOR RELIEF

Violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder

47. The Commission realleges and incorporates by reference Paragraphs 1 through 46 above.

48. Isilon filed with the Commission current, quarterly, and annual reports on Forms 8-K, 10-Q, and 10-K that contained untrue statements of material fact and omitted to state material information required to be stated therein or necessary in order to make the required statements, in the light of the circumstances under which they were made, not misleading, in violation of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder.

49. Isilon has violated and, unless restrained and enjoined, will continue to violate Section 13(a) [15 U.S.C. § 78m(a)] and Rules 12b-20, 13a-1, 13a-11, and 13a-13 [17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11, and 240.13a-13] thereunder.

SECOND CLAIM FOR RELIEF

Violations of Section 13(b)(2)(A) of the Exchange Act

50. The Commission realleges and incorporates by reference Paragraphs 1 through 46 above.

51. Isilon failed to make and keep books, records, or accounts which, in reasonable

detail, accurately and fairly reflected its transactions and dispositions of its assets, in violation of Section 13(b)(2)(A) of the Exchange Act.

52. Isilon has violated and, unless restrained and enjoined, will continue to violate Section 13(b)(2)(A) [15 U.S.C. § 78m(b)(2)(A)].

THIRD CLAIM FOR RELIEF

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

53. The Commission realleges and incorporates by reference paragraphs 1 through 46 above.

54. Isilon violated Section 13(b)(2)(B) of the Exchange Act, which obligates issuers of securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78*l*] to devise and maintain a sufficient system of internal accounting controls.

55. Isilon has violated and, unless restrained and enjoined, will continue to violate Section 13(b)(2)(B) [15 U.S.C. § 78m(b)(2)(B)].

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that this Court:

I.

Permanently enjoin Isilon from violating Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(a), 78m(b)(2)(A), and 78m(b)(2)(B)] and Rules 12b-20, 13a-1, 13a-11, and 13a-13 [17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11, and 240.13a-13] thereunder.

II.

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.

IIII.

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

Dated: September 14, 2009

Respectfully submitted,

Eric Brooks

Eric M. Brooks
Attorney for Plaintiff
SECURITIES AND EXCHANGE COMMISSION