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### PRELIMINARY STATEMENT

There is no real dispute in this matter that Engineered Support Systems, Inc. (“ESSI”) backdated a number of stock option awards over a period of years in order to correspond with low points in the company’s stock price, and made false statements regarding option pricing in its filings with the Commission. Nor is there any dispute that Michael F. Shanahan, Sr. (“Shanahan”) shares some of the blame. He has entered a guilty plea to the falsification of company records, and paid \$7.8 million in restitution. The issue before this Court is whether Shanahan has any viable factual or defenses against the Commission’s securities fraud claims.

For purposes of this motion, the Commission must accept Shanahan’s testimony that he did not realize ESSI was manipulating its option grants.<sup>1</sup> However, the Commission can prevail on all of its claims against Shanahan by showing he was reckless or, in certain cases, negligent. As set forth more fully in the Commission’s Statement of Undisputed Material Facts (“Statement of Facts”), Shanahan knew that ESSI was required to price its options at-the-money, and he could not have ignored the fact that ESSI was granting options in-the-money. (Statement of Facts at ¶¶ 23-39, 60-71) He already has admitted he was reckless in signing stock option award letters and certificates. (*Id.* at ¶¶ 70, 129-130) Further, Shanahan monitored the company’s stock price and exercised his in-the-money stock options. (*Id.* at ¶¶ 96-102) Shanahan also failed completely in his obligation to ensure that ESSI granted only the appropriate number of options to its nonemployee directors. (*Id.* at ¶¶ 40-48)

The Court may conclude that Shanahan’s actions were reckless because he concealed an obvious and important aspect of his stock option compensation from company shareholders, and

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<sup>1</sup> The Commission does not concede that it cannot prove additional or disputed facts in the event a trial of this matter were deemed necessary. More specifically, the Commission does not waive its right to offer evidence which contradicts or disputes Shanahan’s testimony in this case. However, for purposes of its motion for summary judgment, the Commission will treat Shanahan’s testimony as undisputed.

also because he invoked his Fifth Amendment privilege during the Commission's investigation. (Statement of Facts at ¶¶ 49-59, 120-125) Shanahan should not be permitted to avoid the responsibility for ESSI's false statements in its public filings, because he has admitted that he reviewed each of those statements carefully before signing them. (*Id.* at ¶¶ 72-81) The Commission has gathered evidence that investors, analysts and accountants relied upon ESSI's financial statements, proxy solicitations and required certifications in considering whether to invest in the company's stock, in voting on stock option plans, and in performing their audit responsibilities. (*Id.* at ¶¶ 82-95)

Based on all of the Commission's evidence and authorities, Shanahan does not appear to have any viable defenses against the Commission's claims. Accordingly, there is no need for every possible factual dispute between Shanahan and the Commission to be resolved at trial. Rather, the Commission should be permitted to focus its energies and resources on preparing for a trial of its claims against Michael Shanahan, Jr. There is no reason to allow Shanahan to go to trial, merely because he hopes the jury will ignore the Commission's evidence. Because Shanahan profited so handsomely from his receipt of backdated and improper stock options, at the expense of the company's shareholders, the Court should not hesitate to order him to disgorge the remainder of his ill-gotten gains, along with prejudgment interest. (*Id.* ¶¶ at 103-119, 131-137)

## ARGUMENT

### I. SUMMARY JUDGMENT STANDARD

In its recent opinion in Livingston v. Bartis, 2008 U.S. Dist. LEXIS 4316, at \*\*8-9 (E.D. Mo. Jan. 18, 2008), this Court has described the standard for summary judgment as follows:

The Court may grant a motion for summary judgment if, "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and

that the moving party is entitled to judgment as a matter of law.” Fed. R. Civ. P. 56(c); Celotex Corp. v. Catrett, 477 U.S. 317, 322 (1986). The substantive law determines which facts are critical and which are irrelevant. Only disputes over facts that might affect the outcome will properly preclude summary judgment. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 248, 106 S. Ct. 2505, 91 L. Ed. 2d 202 (1986). Summary judgment is not proper if the evidence is such that a reasonable jury could return a verdict for the nonmoving party. *Id.*

A moving party always bears the burden of informing the Court of the basis of its motion. Celotex, 477 U.S. at 323. Once the moving party discharges this burden, the nonmoving party must set forth specific facts demonstrating that there is a dispute as to a genuine issue of material fact, not the “mere existence of some alleged factual dispute.” Fed. R. Civ. P. 56(e); Anderson, 477 U.S. at 247. The nonmoving party may not rest upon mere allegations or denials of its pleadings. Anderson, 477 U.S. at 256.

In passing on a motion for summary judgment, the Court must view the facts in the light most favorable to the nonmoving party, and all justifiable inferences are to be drawn in its favor. Anderson, Anderson, 477 U.S. at 255. The Court's function is not to weigh the evidence, but to determine whether there is a genuine issue for trial. *Id.* at 249.

The United States Supreme Court has also recognized that: “[w]hen opposing parties tell two different stories, one of which is blatantly contradicted by the record, so that no reasonable jury could believe it, a court should not adopt that version of the facts for purposes of ruling on a motion for summary judgment.” Scott v. Harris, 550 U.S. 372, 380-81 (2007) (reversing denial of summary judgment because nonmoving party's version of events was “utterly discredited”). Here, the Commission is entitled to summary judgment against Shanahan because the essential facts are not in dispute, Shanahan has offered no viable defense against the Commission's claims, and no reasonable jury could find in his favor.

## **II. EFFECT OF SHANAHAN'S PREVIOUS TESTIMONY AND ADMISSIONS**

### **A. Shanahan's Plea Agreement and Other Admissions**

Admissions in pleadings and in responses to requests for admission are binding on the party and obviate the need for evidence on that issue. In re Crawford, 274 B.R. 798, 804-05 (8th Cir. BAP 2002); Bender v. Xcel Energy, Inc., 507 F.3d 1161, 1168 (8th Cir. 2007); State Farm

Mut. Auto. Ins. Co. v. Worthington, 405 F.2d 683, 686 (8th Cir. 1968) (judicial admissions act as substitute for evidence and do away with need for evidence on the issue).

In addition, findings from a criminal case can operate as collateral estoppel in subsequent civil proceedings. SEC v. Gruenberg, 989 F.2d 977, 978 (8th Cir. 1993). In the Eighth Circuit, the doctrine of issue preclusion prevents relitigation of certain factual issues where: (1) a litigant was a party to a prior action; (2) the issue is the same as in the prior action; (3) the issue was actually litigated in the prior action; (4) the issue has been determined by a valid and final judgment; and (5) the determination in the prior action was essential to the prior judgment. Anderson v. Genuine Parts Co., 128 F.3d 1267, 1273 (8th Cir. 1997) (citing Tyus v. Schoemehl, 93 F.3d 449, 453 (8th Cir. 1996)). Here, Shanahan was a party to the parallel criminal case. Many of the facts that he admitted in his plea agreement are at issue in this civil action. Shanahan had a “full and fair opportunity to litigate the issues” before executing his plea agreement, and the facts he admitted were central to the criminal charges against him. See In re Miera, 926 F.2d 741, 743 (8th Cir. 1991); SEC v. Freeman, 290 F. Supp. 2d 401, 404-05 (S.D.N.Y. 2003) (defendant who pled guilty had full and fair opportunity to litigate); SEC v. Svoboda, 409 F. Supp. 2d 331, 340 (S.D.N.Y. 2006) (defendant who pleads guilty accepts the truth of charges against him); Charter Communications, Inc. v. McCall, 2005 U.S. Dist. LEXIS 30970, at \*\*10-11 (E.D. Mo. Nov. 18, 2005) (admission in plea agreement prohibited defendant from contradicting admission in criminal case). Therefore, the facts which Shanahan admitted in his plea agreement should be deemed undisputed for purposes of this case.<sup>2</sup>

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<sup>2</sup> Even if Shanahan is not bound by issue preclusion, the admissions in his plea agreement would still be evidentiary admissions for purposes of this case. See State Farm, 405 F.2d at 686; Pagett v. Allied Mut. Ins. Co., 2006 U.S. Dist. LEXIS 54258, at \*11 n.4 (E.D. Mo. Aug. 4, 2006).

## **B. Shanahan's Fifth Amendment Testimony**

A witness can only invoke the protections of the Fifth Amendment when he or she “has reasonable cause to apprehend danger from a direct answer.” Hoffman v. United States, 341 U.S. 479, 486 (1951). Moreover, a witness must have a reasonable fear of prosecution for each question as to which he or she asserts the Fifth Amendment. SEC v. First Fin. Group, Inc., 659 F.2d 660, 668-69 (5th Cir. 1981) (Fifth Amendment assertion must be done on a question-by-question basis).

Because “silence in the face of accusation is a relevant fact”, “the Fifth Amendment does not forbid adverse inferences against parties to civil actions when they refuse to testify in response to probative evidence offered against them”. Baxter v. Palmigiano, 425 U.S. 308, 318-19 (1976); *see also* Pagel, Inc. v. SEC, 803 F.2d 942, 946-47 (8th Cir. 1986) (adverse inference was appropriate in SEC disciplinary proceeding). “Parties are free to invoke the Fifth Amendment in civil cases, but the court is equally free to draw adverse inferences from their failure of proof.” SEC v. Collelo, 139 F.3d 674, 677 (9th Cir. 1998) (shifting burden of proof and granting Commission summary judgment) An assertion of the Fifth Amendment privilege may even allow an inference of scienter sufficient to impose summary judgment. SEC v. Lyttle, 538 F.3d 601, 603-04 (7th Cir. 2008). *See also* SEC v. Ficken, 546 F.3d 45, 49, 54 (1st Cir. 2008) (upholding grant of summary judgment for SEC; defendant could not rely on earlier testimony to create genuine issue of fact as to his scienter when he asserted Fifth Amendment at his deposition).

A district court may draw an adverse inference from a defendant's assertion of the Fifth Amendment even if a defendant subsequently waives the privilege and testifies. *See* SEC v. Herman, 2004 U.S. Dist. LEXIS 7829, at \*\*14, 19-20 (S.D.N.Y. May 5, 2004) (noting no attempt by defendants to reconcile deposition testimony with prior Fifth Amendment assertion);

SEC v. Cassano, Fed. Sec. L. Rep. (CCH) ¶ 91,238, 2000 U.S. Dist. LEXIS 15089, at \*5 n.1 (S.D.N.Y. Oct. 11, 2000) (defendants' explanation for asserting privilege and later waiving it was susceptible to inference that they were unwilling to testify until their stories were straight); SEC v. DiBella, 2007 U.S. Dist. LEXIS 33951, at \*\*7-13 (D. Conn. May 8, 2007) (assertions of Fifth Amendment and subsequent waiver of privilege after receiving documents from Plaintiff conferred a strategic advantage).

During the Commission's investigation of ESSI's option granting practices, Shanahan was asked numerous direct questions regarding his knowledge of and participation in the backdating of stock options, and he refused to answer any of those questions. (Statement of Facts at ¶ 125 and Ex. 3) It was only appropriate for Shanahan to do this if he honestly believed that his answers to those questions might incriminate him. Shanahan's deposition testimony and discovery responses in this case follow the completion of the parallel criminal proceedings, where he presumably became familiar with all of the documentary evidence against him.<sup>3</sup> It is impossible to reconcile Shanahan's recent testimony that he was unaware of any stock option backdating at ESSI (*see id.* at ¶¶ 60-61, 63), with his prior assertions of the Fifth Amendment. Under these circumstances, this Court may draw an adverse inference against Shanahan for his failure to answer the questions during the Commission's investigation.<sup>4</sup> *See* SEC v. DiBella,

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<sup>3</sup> Shanahan did not appear for deposition in this matter until May 6, 2009, after the depositions of Gary Gerhardt, ESSI's former Chief Financial Officer, and Steven Landmann, ESSI's former Controller.

<sup>4</sup> Shanahan was actually in a far better position than most witnesses in Commission investigations to consider whether to invoke his Fifth Amendment privilege. He had already appeared for testimony, heard the Commission's questions and saw certain documentary evidence, but refused either to testify or assert his Fifth Amendment privilege until he was ordered to do so. *See* SEC v. Shanahan, 504 F. Supp. 2d 680, 681 (E.D. Mo. 2007). Only after hearing the Commission's questions and viewing documentary evidence did Shanahan decide to invoke his Fifth Amendment privilege.

2007 U.S. Dist. LEXIS 33951, at \*7 (D. Conn. May 8, 2007) (trial court has broad discretion in determining whether adverse inference is appropriate).

### **III. SHANAHAN IS LIABLE ON ALL OF THE COMMISSION'S CLAIMS**

As set forth in the Commission's Statement of Undisputed Material Fact, the uncontroverted facts and Shanahan's admissions in this proceeding and in the criminal proceeding demonstrate that the Commission is entitled to judgment as a matter of law on all of its claims against Shanahan.

#### **A. Shanahan Violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5.**

Section 17(a) of the Securities Act of 1933 ("Securities Act") prohibits fraud in the offer or sale of securities. *See U.S. v. Naftalin*, 441 U.S. 768, 771-72 (1979). Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") prohibits the use of any "manipulative or deceptive device or contrivance" in connection with the purchase or sale of a security. 15 U.S.C. § 78j(b). Under Section 10(b) and Rule 10b-5, the Commission must show that defendants: (1) made a false statement or omission; (2) of material fact; (3) with scienter; and (4) in connection with the purchase or sale of securities. *SEC v. Tambone*, 550 F.3d 106, 130 (1st Cir. 2008). The elements of a securities fraud claim under Section 10(b) of the Exchange Act and Section 17(a)(1) of the Securities Act are essentially the same. *SEC v. Shanahan*, 2008 U.S. Dist. LEXIS 100641, at \*15 n.8 (E.D. Mo. Dec. 12, 2008). The Commission need not show scienter to establish violations of Sections 17(a)(2) or 17(a)(3) of the Securities Act, because mere negligence will suffice. *Aaron v. SEC*, 446 U.S. 680, 691, 697 (1980).

#### **1. Shanahan Made False Statements.**

Shanahan's criminal plea agreement establishes that, between 1996 and 2002, ESSI issued backdated stock options that were "in the money" when issued, despite ESSI's public

representations that options were issued “at the money.” (*See* Statement of Facts at ¶¶ 31-34, 72) From 1998 through 2003, ESSI filed six annual reports that contained a “false and misleading assertion that options were granted ‘at-the-money.’” (*Id.* at ¶ 73) These annual reports were electronically signed by Shanahan. (*Id.*) Shanahan acknowledged that he reviewed the draft Forms 10-K closely before they were filed. (*Id.* at ¶ 74)

From 1998 through 2003, ESSI filed six proxy statements that contained false statements regarding how ESSI’s stock options had been and would be priced. (Statement of Facts at ¶¶ 75-77) Shanahan reviewed the draft proxy statements closely, before he would sign, or cause his name to be affixed to, the proxy statements. (*Id.* at ¶¶ 78-79) Finally, from 1998 to 2000, ESSI filed three registration statements that were signed electronically by Shanahan, which contained false statements that options were granted, or would be granted, “at the money.” (*Id.* at ¶ 80) Shanahan reviewed these draft registration statements closely, and then would sign, or cause his name to be affixed to, the Forms S-8. (*Id.* at ¶ 81)

Based on Shanahan’s admissions in this case and in his plea agreement, it is undisputed that ESSI filed at least fifteen documents with the Commission that contained false statements regarding the pricing of ESSI’s stock options, all of which Shanahan reviewed closely and signed. Accordingly, Shanahan is deemed to have made the statements contained in those filings. *See Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061-62 (9th Cir. 2000); *SEC v. Berry*, 580 F. Supp. 2d 911, 921-22 (N.D. Cal. 2008). Shanahan may be held liable for the false statements in these documents, regardless of his role in preparing the statements. *Howard*, 228 F.3d at 1062 (“Key corporate officers should not be allowed to make important false financial statements knowingly or recklessly, yet still shield themselves from liability to investors simply by failing to be involved in the preparation of those statements.”).

## 2. The False Statements Were Material.

For a false statement to be material, “there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.” Basic v. Levinson, 485 U.S. 224, 231-32 (1988). Although materiality is normally a question for the trier of fact, it is appropriate to grant summary judgment if reasonable minds cannot differ as to the materiality of the undisclosed information. In re Biogen Sec. Litig., 179 F.R.D. 25, 35 (D. Mass. 1997).

There are a number of reasons why Shanahan’s misstatements about ESSI’s pricing of stock options were indisputably material. It is axiomatic that reasonable investors consider the compensation of company executives to be important information in making their investment decisions. The Commission has explained:

Full disclosure of remuneration is necessary to informed voting and investment decisions, regardless whether the company’s board of directors or its security holders have approved the remuneration package received by management because of the substantial influence of management in determining its remuneration. In addition, [in] a determination of the value of any new securities being offered and of any already owned, an analysis of the use of corporate funds and assets and an assessment of the value of management to a corporation necessitate the presentation of complete remuneration information.

Disclosure of Management Remuneration, Sec. Act Rel. No. 5,856,1977 SEC LEXIS 1023, at \*\*6-7 (Aug. 18, 1977).

Further, Item 10 of Schedule 14A of the Exchange Act requires disclosure in the proxy statements of certain material features of compensation plans submitted for shareholder approval. For stock option plans, such information includes the prices, expiration dates and other material conditions upon which the options may be exercised. 17 C.F.R. § 240.14a-101, Item 10, (b)(2)(i)(B). ESSI’s proxy statements failed to meet these requirements because they included false statements regarding ESSI’s option pricing. The fact that such information is required by

Commission regulations demonstrates that the information is material to investors. *See Resnik v. Swartz*, 303 F.3d 147, 151 (2d Cir. 2002) (omitted information is material under Rule 14a-9 if fact is specifically required by SEC regulations); *Shae v. Saper*, 320 F.3d 373, 383 (3d Cir. 2003) (failure to disclose material features of bonus plan, pursuant to Schedule 14A, was material for 14a-9 claim); *Parsons v. Jefferson-Pilot Corp.*, 789 F. Supp. 697, 702 (M.D.N.C. 1992) (in Rule 14a-9 claim, for stock grants, misstatements relating to the nature, purpose, or value of stock grants “are deemed material as a matter of law”).

Moreover, misrepresentations regarding the compensation and benefits paid to executives are material under Section 10(b). *See SEC v. World-Wide Coin Invs., Ltd.*, 567 F. Supp. 724, 733, 753-54 (N.D. Ga. 1983) (omissions and misrepresentations relating to value of consideration given by CEO in exchange for corporate stock, which was overvalued by less than \$175,000, were material to investors); *SEC v. Benson*, 657 F. Supp. 1122, 1125-28, 1131 (S.D.N.Y. 1987) (granting summary judgment and finding president’s misappropriation of approximately \$500,000 through kickbacks and false travel claims was material). Shanahan has admitted that he received \$7,871,662.50 in proceeds from backdated stock options. (Statement of Facts at ¶ 132) This undisclosed compensation was more than Shanahan’s aggregate salary, bonus, and other compensation from 1997 to 2002 (*see* Hlavacek Decl. at ¶ 5), and involved substantially more compensation than what was at issue in *World-Wide Coin* or *Benson*.

But even if Shanahan’s false statements were not material as a matter of law, several witnesses in this case have testified as to the materiality of option backdating in their evaluation of ESSI. Two experienced financial analysts that followed ESSI’s stock testified that they relied on ESSI’s proxy statements in analyzing and rating the investment potential for ESSI’s common stock, including the disclosures regarding management compensation and stock option grants.

(Statement of Facts at ¶¶ 82-84) Both analysts testified that they would have wanted to know that ESSi was backdating stock option grants. (*Id.* at 85)

In addition, Jay Weinstein is an investment adviser who has been quoted in Kiplinger's Personal Finance magazine, and at one time managed as much as \$130 million for clients. (*Id.* at ¶ 88) At one point, Weinstein held approximately 3 to 4% of ESSi's outstanding common stock for his investment clients. (*Id.*) Weinstein regularly reviewed ESSi's annual reports and proxy statements, and he reviewed the proxy statements specifically for information about management compensation, including stock options. (*Id.* at ¶ 89) Weinstein would have wanted to know about backdating as an investor in ESSi, because backdating was "not the kind of practice that I would either approve of or wanted to be invested with – with a company that would do that." (*Id.* at ¶ 92)

Shanahan has not produced or identified any evidence suggesting that the issue of backdating was not important to investors. Thus far, the Commission's evidence remains unchallenged, so there is no good reason to question the materiality of Shanahan's misrepresentations regarding option pricing. See Anderson, 477 U.S. at 247-48 (nonmoving party may not rest upon mere denials, but must set forth specific facts demonstrating dispute of material fact, not the mere existence of some alleged factual dispute.).

### **3. Shanahan Acted With Scienter.**

Scienter is the intention to deceive, manipulate, or defraud. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976), *reh'g denied*, 425 U.S. 986 (1976). Scienter can be shown by recklessness, which has been defined as "highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it."

Fla. State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 654 (8th Cir. 2001) (*quoting* Camp v. Dema, 948 F.2d 455, 461 (8th Cir. 1991)). Recklessness may be established if defendants had access to information contradicting their public statements, or “failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud.” Kushner v. Beverly Enterp., 317 F.3d 820, 828 (8th Cir. 2003). Proof of a defendant’s scienter need not be direct, but may be inferred from circumstantial evidence. Pagel, 803 F.2d at 946. On summary judgment, a court may draw an inference of scienter from the defendant’s assertion of the Fifth Amendment, if accompanied by other evidence. SEC v. Druffner, 517 F. Supp. 2d 502, 510-11 (D. Mass. 2007). Where, at a minimum, a defendant’s conduct in a securities fraud case *must* be viewed as reckless, summary judgment is appropriate. SEC v. Autocorp Equities, Inc., 292 F. Supp. 2d 1310, 1322 (D. Utah 2003).

Where a defendant “consciously participate[s] in a scheme to conceal executive compensation,” and permits a corporation “to issue false public disclosures regarding executive compensation and related party transactions,” it is reasonable to infer that the defendant “knew, or was severely reckless in not knowing, that [the] disclosures were incomplete and that he was making misrepresentations to [the company’s] shareholders.” In re JDN Realty Sec. Litig., 182 F. Supp. 2d 1230, 1248 (N.D. Ga. 2002). Backdating of stock options over a series of years is “highly suspicious” conduct that “lean[s] heavily toward a finding of scienter” establishing that a defendant either knew, or was deliberately reckless in not knowing, of the backdating.<sup>5</sup>

Middlesex Ret. Sys. v. Quest Software Inc., 527 F. Supp. 2d 1164, 1181-82 (C.D. Cal. 2007).

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<sup>5</sup> In Quest Software, in denying a motion to dismiss, the district court stated that it was “simply incomprehensible” that defendants who received very large option grants would not have been aware of the option measurement date and the resulting value of the option grants. *Id.* at 1183.

Shanahan has admitted that he “knowingly and intentionally” signed falsely dated stock option award letters dated July 25, 2002 “with at least conscious and reckless disregard as to the false date” on the backdated award letters.<sup>6</sup> (Statement of Facts at ¶ 129 and Ex. 1) Under the Eighth Circuit’s definition of recklessness, the false date on those letters was either known to Shanahan or was so obvious that he must have been aware of it. *See Green Tree*, 270 F.3d at 654. Thus, Shanahan was *at least* reckless in not knowing that ESSI was backdating its stock option grants. As in *Quest Software*, it is “simply incomprehensible” that Shanahan received at least \$7.8 million in profits from backdating, within a six-year period, while regularly signing both backdated option award letters and ESSI’s public disclosure documents, and remained unaware of the practice. However, Shanahan is at least reckless in not knowing of the misrepresentations in ESSI’s Commission filings.

Accordingly, if for whatever reason the Court does not find that the Commission has met its burden with regard to Shanahan’s scienter for purposes of its 10(b) and Rule 10b-5 Exchange Act claims, but that it has established all of the other elements of a Section 17(a) claim, Shanahan should at least be found liable for violations of Sections 17(a)(2) and (3) of the Securities Act, which do *not* require a showing of scienter. *See Aaron*, 446 U.S. at 697.

#### **4. Shanahan’s False Statements Were Made In Connection with the Offer and Sale of Securities.**

Material misstatements or omissions in a company’s public filings with the Commission meet the “in connection with” requirement for Section 17(a) of the Securities Act and Section

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<sup>6</sup> Shanahan Sr. also signed stock option award letters for seven other stock option grants that he has admitted were backdated. (*See e.g.*, Statement of Facts at ¶ 33, 36-39) He has offered nothing to distinguish his conduct in signing the July 25, 2002 stock option award letters from any of the letters he signed for earlier grants. Therefore, it is reasonable to conclude that Shanahan was reckless in signing the award letters for each of those grants as well. However, the Commission need only demonstrate that Shanahan was reckless with respect to a single option grant in order to establish a violation of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act.

10(b) of the Exchange Act because the fraudulent conduct relates to the purchase and sale of publicly-traded securities. SEC v. Wolfson, 539 F.3d 1249, 1257 (10th Cir. 2008); *see also* SEC v. Rana Research, 8 F.3d 1358, 1362 (9th Cir. 1993). Misstatements in proxy statements can also be the basis for a Section 10(b) claim. Golub v. PPD Corp., 576 F.2d 759, 764 (8th Cir. 1978). Shanahan's false statement in annual reports and proxy statements clearly meet the "in connection with" requirement because the misstatements were made in Commission filings that are routinely disseminated to and relied upon by investors in making their investment decisions. (*See* Statement of Facts, at ¶¶ 88-92)

**B. Shanahan Violated Section 14(a) of the Exchange Act and Exchange Act Rule 14a-9.**

Exchange Act Rule 14a-9, promulgated under Section 14(a) of the Exchange Act, provides that a proxy statement may not contain any statement which is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading. 15 U.S.C. § 78n(a); 17 C.F.R. § 240.14a-9. "The purpose of section 14(a) is 'to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation.'" Shidler v. All Am. Life & Fin. Corp., 775 F.2d 917, 927 (8th Cir. 1985) (*quoting* J.I. Case Co. v. Borak, 377 U.S. 426, 431 (1964)).

**1. ESSI's Proxy Statements Contained False and Misleading Statements of Material Fact.**

Shanahan has admitted that ESSI's proxy statements contained false statements regarding the manner in which ESSI priced its stock options. (Statement of Fact at ¶¶ 75-77) In the context of a proxy statement, a fact is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1090 (1991) (*quoting* TSC Indus. v. Northway,

426 U.S. 438, 449 (1976)). It is not necessary to show that accurate disclosure would have caused an investor to act differently. TSC Indus., 426 U.S. at 449. Where there is doubt as to whether a fact is critical, doubts should be resolved in favor of those the statute is designed to protect. Id. at 448.

Because materiality is a mixed question of law and fact, for purposes of summary judgment the misstatements must be “so obviously important to an investor, that reasonable minds cannot differ on the question of materiality”. TSC Indus., 426 U.S. at 450. However, if the misstatements meet this standard and the underlying facts and the inferences to be drawn from those facts are free from controversy, summary judgment should be granted. Gould v. Am.-Hawaiian S.S. Co., 535 F.2d 761, 771 (3d Cir. 1976) (affirming summary judgment for plaintiff on Section 14(a) and Rule 14a-9 claims).

In Parsons v. Jefferson-Pilot Corp., 789 F. Supp. 697 (M.D.N.C. 1992), the district court granted summary judgment for the plaintiff on a Rule 14a-9 claim, holding that misstatements relating to the nature, purpose, value, or recipients of stock grants are material as a matter of law. In that case, a misstatement that stock granted was restricted, when it was in fact, unrestricted, was inarguably material because restricted stock grants would have best served the ultimate goals of the stock issuances by vesting over time and serving as an enhancement for future performance of key employees; whereas unrestricted stock vested immediately and could be instantly turned into money. *Id.* at 702. Labeling the stock grants as restricted also misled investors as to the value of the stock, as unrestricted stock has considerably more economic value. *Id.* The district court determined that it was appropriate to draw inferences from undisputed facts in order to determine the issue of materiality. *Id.* at 703.

The facts in this case are very similar to Parsons. Here, ESSI and Shanahan made misstatements regarding the value of stock options granted to ESSI's employees and directors, in that those options were being granted in-the-money and the public disclosures stated that all stock options were granted at-the-money. Also, the goal of ESSI's stock option program was to "ensure that management's interests are directly tied to shareholder return". (See Statement of Facts at Ex. 11, Jan. 28, 2003 ESSI Proxy Statement, at L 629) This goal would have been accomplished, or at least promoted, had options been granted at-the-money. In that case, option recipients would profit only if ESSI's stock price increased. ESSI's backdated options, by contrast, provided instant compensation to the option recipients; they could be immediately exercised and sold for a profit since there was no vesting period for the options.<sup>7</sup> Just like the misstatements in Parsons, the false statements by Shanahan in ESSI's proxy statements should be deemed material as a matter of law.

Moreover, courts have held that omission of information from a proxy statement is actionable "if either the SEC regulations specifically require disclosure of the omitted information in a proxy statement, or the omission makes other statements in the proxy statement materially false or misleading." Resnik, 303 F.3d at 151. As discussed above, Schedule 14A of the Exchange Act specifically required disclosure regarding pricing for stock option plans presented for shareholder approval. See 17 C.F.R. § 240.14a-101, Item 10 at (b)(2)(i)(B); Shaev, 320 F.3d at 383 (failure to disclose features of bonus plan, pursuant to Schedule 14A, was material). Thus, Shanahan's misrepresentations regarding the pricing of stock options under the option plans were material.

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<sup>7</sup> On April 11, 2001, Shanahan received an option to acquire 645,000 shares of ESSI stock dated March 29, 2001. He already was in-the-money by \$3,547,500. (Hlavacek Decl. at ¶ 13) Five months later, Shanahan exercised these same options, and obtained a profit of \$15 million, including \$3.5 million from the backdating. (Hlavacek Decl. at ¶ 22, 24-28)

Finally, Shanahan's misrepresentations regarding ESSI's option pricing were indisputably material. Two analysts and a significant ESSI investor have all testified that they would have wanted to know that ESSI was backdating stock options. (Statement of Facts at ¶¶ 82-85, 90-92) In addition, Fidelity Investments, ESSI's largest institutional shareholder, had a policy against voting for any stock option plan that permitted pricing at below fair market value. (*Id.* at 86-87) Thus, there is no genuine dispute of fact on the question of whether the misrepresentations in ESSI's stock option plans regarding option pricing could affect how an investor would vote.

## 2. **Scienter is Not Required Under Section 14(a) and Rule 14a-9.**

There has been a split among the circuit courts on the question of whether scienter is a required element of claims under Rule 14a-9.<sup>8</sup> The Eighth Circuit has not directly ruled on this point, although it declined to correct the district court's holding that scienter was not required for such a claim, on an appeal before it. *See Shidler v. All American Life & Fin. Corp.*, 775 F.2d 917, 926-27 (8th Cir. 1985). The district courts within the Eighth Circuit, including one in this district, have consistently held that scienter is not required. *See In re BankAmerica Corp. Sec. Litig.*, 78 F. Supp. 2d 976, 988-89 (E.D. Mo. 1999) ("No showing of intent to deceive or recklessness is required") (*citing Shidler*, 775 F.2d at 926-27); *Int'l Broadcasting Corp. v. Turner*, 734 F. Supp. 383, 390 (D. Minn. 1990); *Little Gem Life Sciences, LLC v. Orphan Med., Inc.*, 2007 U.S. Dist. LEXIS 68004, at \*\*7-8 (D. Minn. Sep. 13, 2007); *Shidler v. All Am. Life & Fin. Corp.*, 1982 U.S. Dist. LEXIS 15939 (S.D. Iowa Sep. 30, 1982), *aff'd in part & remanded in part*, *Shidler*, 775 F.2d at 926-27.

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<sup>8</sup> *See Gould v. Am. Hawaiian S.S. Co.*, 535 F.2d 761, 776-77 (3d Cir. 1976) (only negligence required); *Gruss v. Curtis Pub. Co.*, 534 F.2d 1396, 1403 (2d Cir. 1976) (same); *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422, 428 (6th Cir. 1980) (scienter required).

It should also be noted that the Commission has interpreted Rule 14a-9 claims to require only negligence. *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on potential Exchange Act Section 10(b) and Section 14(a) liability, Exchange Act Rel. No. 51,283, 2005 SEC LEXIS 448, at \*5 (Mar. 1, 2005) (14a-9 only requires showing of negligence; 10(b) requires showing of scienter). The Commission's interpretation is entitled to judicial deference in the face of statutory silence or ambiguity. Chevron, U.S.A., Inc. v. NRDC, Inc., 467 U.S. 837, 842-44 (1984) (courts should defer to agency's reasonable interpretation of statute which it administers).

Directors may be held liable for misrepresentations in proxy statements even if they had no active role in the preparation of the proxy statements and never investigated the truthfulness or validity of the proxy statements. *See* Berman v. Thomson, 403 F. Supp. 695, 699 (N.D. Ill. 1975). Their failure to correct or refute any misleading statement in a document as vital as a proxy statement gives rise to liability under Section 14(a) and Rule 14a-9. *Id.*; *see also* Gould v. Am. Hawaiian S.S. Co., 351 F. Supp. 853, 865 (D. Del. 1972) (directors liable for failing to read proxy statements and correct statements they knew or should have known were erroneous or misleading), *vacated on other grounds*, 535 F.2d 761 (holding that district court did not err in applying due diligence standard for Section 14(a) liability); Chris-Craft Indus., Inc. v. Indep. S'holders Comm., 354 F. Supp. 895, 915 (D. Del. 1973) (individual who participates in solicitation which utilizes materially false or misleading statements is liable if knew or should have known of falsity). Reliance on legal or financial counsel does not prevent liability where a director knew or should have known a statement was erroneous or misleading. Gould, 351 F. Supp. at 865 ("Section 14(a) imposes liability on individuals soliciting proxies, and not on the attorneys or accountants preparing them").

Shanahan contends that he closely reviewed each of ESSI's proxy statements before signing them. (Statement of Facts at ¶¶ 75-79) He was at least reckless in not knowing that ESSI was using backdated grant dates for its option grants. Therefore, his failure to discover and correct the false statements in ESSI's proxy statements is at least negligent, and he may be held liable under Section 14(a) and Rule 14a-9.

**C. Shanahan Violated Section 13(b)(5) of the Exchange Act and Exchange Act Rule 13b2-1.**

Section 13(b)(5) of the Exchange Act provides that no person shall knowingly falsify any book, record, or account or circumvent an issuer's system of internal accounting controls. Exchange Act Rule 13b2-1 prohibits a person from, directly or indirectly, falsifying or causing to be falsified any book, record, or account subject to Section 13(b)(2)(A) of the Exchange Act. 17 C.F.R. § 240.13b2-1. The books and records referred to in Section 13(b)(2)(A) include those which "reflect the transactions and dispositions of the assets of the issuer." 15 U.S.C. § 78m(b)(2)(A). Section 13(b)(2)(A) makes clear that the issuer's records should "reflect transactions in conformity with accepted methods of recording economic events . . ." SEC Rel. No. 34-15570 (Feb. 15, 1979) (*quoting* H.R. Rep. No. 98-831, at 10)

In light of his conviction for violating Section 13(b)(2) and 13(b)(5) of the Exchange Act for falsifying an ESSI record, (Statement of Facts at ¶¶ 129-130, and Ex. 1 at 12-13), Shanahan should not be permitted to argue that he did not violate Section 13(b)(5) and Rule 13b2-1 for purposes of this proceeding. *See Gruenberg*, 989 F.2d at 977-78.

**D. Shanahan Violated Exchange Act Rule 13a-14.**

Exchange Act Rule 13a-14 provides that reports on Forms 10-K and Forms 10-Q shall include certifications signed by the principal executive and financial officer of the issuer. The CEO and CFO each must certify, among other things, that they reviewed the report, and that the

Form 10-K and Form 10-Q, to the best of their knowledge, includes no material misstatements and omits no material information and that they have disclosed all instances of fraud, whether or not material, involving management or others with responsibility over internal controls to the company's Audit Committee and auditors. 17 C.F.R. § 240.13a-14. Where the Commission establishes that the defendant certified Commission filings that contained material misstatements, and that the defendant was reckless with regard to those misstatements, summary judgment is appropriate for a claim under Rule 13a-14. SEC v. Indigenous Global Dev. Corp., Fed. Sec. L. Rep. (CCH) ¶ 94,768, 2008 U.S. Dist. LEXIS 50434, at \*\*43-44 (N.D. Cal. June 30, 2008).

Shanahan signed a Sarbanes-Oxley certification in connection with ESSI's fiscal year-end 2002 Form 10-K. (Statement of Facts at ¶ 95) ESSI's Form 10-K, which incorporated the company's 2003 Proxy Statement, contained the same false and misleading statements regarding the pricing of stock options discussed previously. Shanahan also admitted that he closely reviewed ESSI's Forms 10-K before signing them. (*Id.* at ¶ 74) Shanahan admitted to being reckless in signing stock option award certificates for options granted in fiscal year 2002. (*Id.* at ¶ 70) Therefore, Shanahan was reckless in not knowing that ESSI's Forms 10-K contained false and misleading statements about stock option pricing, and Shanahan should be found liable for violating Exchange Act Rule 13a-14.

**E. Shanahan Aided and Abetted Engineered Support's Violations of Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-1.**

Section 13(a) of the Exchange Act and Rules 13a-1 require issuers of registered securities to file with the Commission factually accurate annual reports. SEC v. IMC Int'l, Inc., 384 F. Supp. 889, 893 (N.D. Tex. 1974), *aff'd mem.*, 505 F.2d 733 (5th Cir. 1974), *cert. denied sub nom.*, Evans v. SEC, 420 U.S. 930 (1975). Exchange Act Rule 12b-20 further requires the

inclusion of any additional material information that is necessary to make required statements, in light of the circumstances under which they were made, not misleading. 17 C.F.R. § 240.12b-20. Financial statements incorporated in Commission filings must comply with Regulation S-X, which in turn requires conformity with GAAP. *See SEC v. Savoy Indus.*, 587 F.2d 1149, 1165 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979). No showing of scienter is necessary to establish a violation of Section 13(a). *SEC v. McNulty*, 137 F.3d 732, 740-41 (2d Cir. 1998). ESSI violated Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-1 by filing reports on Forms 10-K containing false and misleading disclosures regarding the pricing of ESSI's stock options. (*See* Statement of Facts at ¶ 73 and Ex. 1)

Section 20(e) of the Exchange Act authorizes the Commission to bring an aiding and abetting charge against a person who “knowingly provides substantial assistance to another person” in violation of the Exchange Act or rules published thereunder. 15 U.S.C. § 78t(e). In order to establish liability under this Section, the Commission must show: “(1) a securities law violation by the primary party; (2) ‘knowledge’ of the violation on the part of the aider and abettor; and (3) ‘substantial assistance’ by the aider and abettor in the achievement of the primary violation.” *Camp v. Dema*, 948 F.2d at 459. The second and third requirements are related. Thus, “[a] party who engages in atypical business transactions or actions which lack business justification may be found liable as an aider and abettor with a minimal showing of knowledge.” *Id.* (citation omitted). Severe recklessness satisfies the knowledge requirement where the defendant owes a duty to disclose, which is “‘limited to those highly unreasonable omissions that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers and sellers which is either known to the defendant or is so obvious that the defendant must have been

aware of it.” *Id.* at 459-461 (citations omitted). This standard is identical to the recklessness standard used in the Eighth Circuit. *See Green Tree*, 270 F.3d at 654. Silence can constitute providing substantial assistance if the individual had a duty to disclose the misrepresentation. *Dema*, 948 F.2d at 460.

To satisfy the substantial assistance requirement, the Commission must establish that a defendant provided assistance that was ““a substantial factor in causing the resulting” violation.” *Id.* Shanahan signed falsely dated option award letters, which substantially assisted the backdating scheme and concealed it from auditors. (Statement of Facts at ¶ 93) As previously explained, he acted recklessly in signing the letters, thereby satisfying the scienter requirement of aiding and abetting liability. Therefore, Shanahan should be held liable for aiding and abetting ESSI’s violations of Section 13(a) of the Exchange Act and Rule 13a-1 thereunder.

**F. Shanahan Aided and Abetted Engineered Support’s Violations of Sections 13(b)(2)(A) of the Exchange Act.**

Section 13(b)(2)(A) of the Exchange Act requires issuers like ESSI to “make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer.” No showing of scienter is necessary to establish a violation of this provision. *See World-Wide Coin*, 567 F. Supp. at 749-51; *Ponce v. SEC*, 345 F.3d 722, 737 n.10 (9<sup>th</sup> Cir. 2003); *SEC v. McNulty*, 137 F.3d at 740-41; *SEC v. Cohen*, 2006 WL 2225410, at \*5 (E.D. Mo. Aug. 2, 2006). ESSI violated Section 13(b)(2)(A) by failing to make and keep books and records that are accurate, in reasonable detail, with respect to the dates options were awarded and the compensation expense associated with option grants. Shanahan admitted that he violated Section 13(b)(2) by recklessly signing option award letters and thus falsifying company records. (Statement of Facts at ¶ 70) Thus, he cannot dispute that ESSI failed to make and keep accurate books and records with respect to its stock option grants.

His falsification of the award letters constitutes substantial assistance to ESSI's failure, and his recklessness in signing those letters satisfies the scienter requirement for aiding and abetting.

#### **IV. THE COMMISSION IS ENTITLED TO THE THREE FINANCIAL REMEDIES SOUGHT IN ITS COMPLAINT**

As a result of Shanahan's violations of the securities laws, the Commission seeks the following relief on summary judgment.<sup>9</sup>

##### **A. Shanahan Should Be Required to Disgorge All Ill-Gotten Gains With Prejudgment Interest.**

###### **1. The Court Should Order Disgorgement Against Shanahan.**

District courts have the equitable power to order disgorgement of profits acquired through securities fraud. *See SEC v. Midwest Inv., Inc.*, 1996 U.S. App. LEXIS 14424, at \*22, Fed. Sec. L. Rep. (CCH) ¶ 99,250 (6th Cir. 1996), *cert. denied*, 520 U.S. 1165 (1997). Disgorgement is an equitable remedy designed to deprive wrongdoers of their unjust enrichment and to deter others from violating the securities laws. *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1230 (D.C. Cir. 1989). “The effective enforcement of the federal securities laws requires that the SEC be able to make violations unprofitable. The deterrent effect of an SEC enforcement action would be greatly undermined if securities law violators were not required to disgorge illicit profits.” *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1474 (2d Cir. 1996) (*quoting SEC v. Manor Nursing Ctrs.*, 458 F.2d 1082, 1104 (2d Cir. 1972)); *SEC v. Cohen*, 2007 U.S. Dist. LEXIS 28934, at \*65 (E.D. Mo. Apr. 19, 2007).

“[D]isgorgement need only be a reasonable approximation of profits causally connected to the violation.” *First City Fin. Corp.*, 890 F.2d at 1231-32. Where there is uncertainty as to the exact amount of disgorgement, “the risk of uncertainty should fall on the wrongdoer whose

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<sup>9</sup> If the Court finds liability for any of the Commission's claims, the Commission respectfully requests the opportunity to submit briefing in support of the Commission's requests for non-monetary relief: *i.e.*, a permanent injunctive relief and an officer-and-director bar.

illegal conduct created that uncertainty.” *Id.* (citations omitted); SEC v. Patel, 61 F.3d 137, 140 (2d Cir. 1995).

Shanahan’s admission in his plea agreement that he received in-the-money gains of \$7,871,662.50 can be used to support a finding of liability in that amount on the Commission’s motion for summary judgment. Appley v. West, 1990 U.S. Dist. LEXIS 852, at \*\*6-7 (N.D. Ill. Jan. 26, 1990) (plaintiff entitled to \$495,000 damages based on defendant’s admission in guilty plea that he stole at least \$495,000), *aff’d*, 929 F.2d 1176 (7th Cir. 1991).

Moreover, there is no dispute of fact with regard to the difference between the \$7.8 million restitution amount which Shanahan paid in the criminal case, and the \$8.9 million sought by the Commission in this action. So this issue can and should be decided on summary judgment. The only difference between the amounts claimed by the Department of Justice and the Commission pertains to Shanahan’s March 29, 2001 stock option grant. Shanahan and the criminal authorities agreed on a restitution figure which used April 5, 2001 as the actual approval date for one of Shanahan’s option grants. (Statement of Facts at ¶ 135 and Ex. 37 at ¶ 6)

However, the evidence presented by the Commission in connection with this motion demonstrates that Shanahan’s option grant of 645,000 shares was not, and could not have been, finalized until April 11, 2001. (*See* Statement of Facts at ¶ 68 and Ex. 26) Exhibit 26 clearly shows that, as of April 11, 2001, Shanahan printed an email from Shanahan Jr. containing a recommended number of options for Shanahan from the Compensation Committee; all of these options still needed to be approved and issued. Sometime thereafter, Shanahan’s number of options was increased to 645,000 shares. Therefore, the Court has an acceptable basis to find that Shanahan’s stock options were approved on April 11, 2001, rather than April 5, 2001. This

six day difference results in the Commission's calculation of \$8,916,562.50 profit from backdating. (See Hlavacek Decl. at ¶ 13)

The Commission respectfully requests that the Court order disgorgement against Shanahan in the amount of \$8,916,562.50, with credit for the amount of restitution he has already paid in the criminal case. See SEC v. Palmisano, 135 F.3d 860, 863-64 (2d Cir. 1998) (disgorgement and prejudgment interest appropriate in parallel civil case, with credit for restitution paid in criminal case). Alternatively, the Commission requests that the Court order disgorgement of \$7,871,662.50, the amount already paid in the criminal case, so that the Commission has a numerical basis to calculate and request prejudgment interest. See SEC v. Opulentica, 479 F. Supp. 2d 319, 331 (S.D.N.Y. 2007) (ordering disgorgement in amount equal to restitution, plus prejudgment interest on disgorgement amount).

## **2. The Court Should Order Prejudgment Interest Against Shanahan.**

It is well established that an award of prejudgment interest in a case involving violations of the federal securities laws rests within the equitable discretion of the district court. See SEC v. Falbo, 14 F. Supp. 2d 508, 528 (S.D.N.Y. 1998); SEC v. Stephenson, 732 F. Supp. 438, 439 (S.D.N.Y. 1990). “Generally, prejudgment interest should be awarded “unless exceptional circumstances exist making the award of interest inequitable.” Murphy v. Fedex Nat’l LTL, Inc., 2009 U.S. Dist. LEXIS 39772, at \*23 (E.D. Mo. May 11, 2009) (quoting Frazier v. Iowa Beef Processors, Inc., 200 F.3d 1190, 1194 (8th Cir. 2000)). In addition, an award of prejudgment interest is “warranted to prevent the defendant from profiting from the use of the money” he obtained unlawfully. SEC v. Brethren, 1992 WL 420867 (S.D. Ohio, Oct. 15, 1992).

In this case, Shanahan profited by millions from backdating, and he had the benefit of using that money for several years. As a result, prejudgment interest on his backdated profits would range from approximately \$4.5 million to \$5.2 million. (See Hlavacek Decl. ¶¶ 14-15)

*See also First Jersey Sec.*, 101 F.3d at 1476-77 (in Commission cases, use of IRS underpayment rate to calculate prejudgment interest is appropriate). Thus, even after paying \$7,871,662.50 in restitution in the criminal case, Shanahan has still profited by several million dollars from ESSI's backdating of stock options. He should not be permitted to keep these ill-gotten gains, which belonged to the company's shareholders, and continue to profit from his own unlawful conduct.

**B. The Court Should Order Shanahan to Pay a Civil Penalty.**

Section 20(d) of the Securities Act and Section 21(d)(3) of the Exchange Act provide this Court with the power to impose civil penalties. Congress enacted these penalty provisions "to achieve the dual goals of punishment of the individual violator and deterrence of future violations." SEC v. Kenton Capital, Ltd., 69 F. Supp. 2d 1, 17 (D.D.C. 1998) (*citing* SEC v. Moran, 944 F. Supp. 286, 296 (S.D.N.Y. 1996)). A civil penalty is necessary because "disgorgement...does not result in any actual economic penalty or act as a financial disincentive to engage in securities fraud..." and "...is necessary for the deterrence of securities law violations that otherwise may provide great financial returns to the violator." SEC v. Moran, 944 F. Supp. at 296 (*quoting* H.R. Rep. No.101-616 (1990)).

Section 20(d) of the Securities Act and Section 21(d)(3) of the Exchange Act permits the court to order a civil penalty in an amount up to the defendant's pecuniary gain as a result of the unlawful conduct.<sup>10</sup> 15 U.S.C. § 77t(d); 15 U.S.C. § 78u(d)(3). This would permit the Court to impose a civil penalty of up to \$8,916,562.50, or \$7,871,662.50 if the amount of Shanahan's criminal restitution is used as Shanahan's pecuniary gain. Even if the statute of limitations were

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<sup>10</sup> While there is a five-year statute of limitations on civil penalties, this limitation should be equitably tolled by operation of the fraudulent concealment doctrine, in light of Shanahan's falsification of records that concealed ESSI's backdating. *See Holmberg v. Armbrecht*, 327 U.S. 392, 396-97 (1946); Kansas City v. Fed. Pac. Elec. Co., 310 F.2d 271, 276-77 (8th Cir. 1962).

applied, Shanahan could still be subject to a civil penalty of still up to \$3,941,662.50 based on his backdating profits within the five-year limitation period. (*See* Hlavacek Decl. at ¶ 13)

Accordingly, if the Court finds Shanahan liable for a civil penalty, the Commission respectfully requests the opportunity to submit additional briefing regarding the appropriate penalty amount that should apply in this case, including an analysis of the number of violations established, of the seriousness of each violation, and of the type of civil penalties imposed in comparable cases.

### CONCLUSION

Wherefore, for all of the foregoing reasons, Plaintiff U.S. Securities and Exchange Commission respectfully requests this Court enter an order of summary judgment against Defendant Michael F. Shanahan, Sr., and order the relief sought in the Commission's motion.

Dated: October 7, 2009.

/s/Robert M. Moye

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**CERTIFICATE OF SERVICE**

I hereby certify that I caused a copy of the foregoing document to be served upon:

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by operation of the District Court's electronic filing system, this 7th day of October, 2009.

/s/ **Robert M. Moya**  
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