IN THE UNITED STATES DISTRICT COURT

FOR THE EASTERN DISTRICT OF MISSOURI

EASTERN DIVISION

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. MICHAEL F. SHANAHAN, SR. and MICHAEL F. SHANAHAN, JR. Defendants.	Case No. 4:07-CV-270-JCH (Consolidated with Case No. 4:07-CV-1262) Judge: Honorable Jean C. Hamilton

MEMORANDUM IN SUPPORT OF MOTION FOR SUMMARY JUDGMENT

I. INTRODUCTION

Plaintiff the Securities and Exchange Commission ("SEC") alleges that defendant Michael F. Shanahan Jr., formerly an outside director at the highly successful St. Louis company Engineered Support Systems Inc. ("ESSI"), participated in a scheme to "backdate" options at ESSI in the time period 1996-2002. While this case was started with great fanfare at the height of the options backdating enforcement push (now largely forgotten in the wake of more serious problems in the economy), civil discovery has revealed the SEC's case to be painfully lacking. After 31 depositions and the production of hundreds of thousands of pages of documents, the facts show that:

- The ESSI Compensation Committee (which included Shanahan Jr. and distinguished members of the community such as Tom Guilfoil and retired 3-star Army General Kenneth Lewi) played no role in pricing the options that are at the heart of the SEC's allegations.[1]

- Rather, it was Steven Landmann, ESSI's former controller, who priced the options at relative low points in the stock price and did so at the direction of his

[1] See cites at footnote 22, infra.

superior, former ESSI CFO Gary Gerhardt.[2]

- While Gerhardt has tried to blame others as the persons who picked the low points in ESSI stock as option strike prices, all uniformly denied as much in their depositions.[3]

- Although the gravamen of the guilty pleas in this case was the backdating of certain stock option award letters, Landmann testified that he placed these inaccurate dates on the letters as a matter of "convention" and not out of any desire to mislead auditors or anyone else.[4]

A full exposition of the facts and the weaknesses in the SEC's case will await the trial now scheduled for February 1, 2010. But it may be that no trial will be required in this case because of two reasons favoring summary judgment. First, the undisputed facts show that the SEC cannot meet the stiff requirements of "aiding and abetting" law, which eliminates Claims VI and VII. Second, the SEC cannot establish materiality as a matter of law, which eliminates the remaining claims against Shanahan Jr. (I, II, III), as well as providing an alternative ground for dismissing Claim VI.

II. FACTUAL BACKGROUND

As a result of presiding over the now-concluded criminal matter in which all charges against Shanahan Jr. were dismissed, the Court is familiar with the background facts surrounding ESSI and the Government's allegations of stock option backdating.[5] While some background facts are set forth for context in the Argument section below, little purpose would be served by attempting an exhaustive narrative of this complex case.

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[2] See Declaration of Jennifer A. Huber at Exhibit 6 (Landmann Depo.) at 40:7-10, 124:8-24, 163:23-164:11. See also cites at footnote 23, infra. Exhibits to the Huber Declaration will be referred to herein as "Ex."

[3] Ex. 33 (Gerhardt Depo.) at 191:13-192:16; Ex. 2 (Shanahan, Jr. Depo.) at 160:16-25; Ex.34 (Shanahan, Sr. Depo.) at 95:21-96:12; Ex. 35 (Wichlenski Depo.) at 66:21-67:10; Ex. 16 (Lewi Depo.) at 99:6-100:4.

[4] Ex. 6 (Landmann Depo.) at 125:25-126:22, 158:11-159:14; 160:13-161:3.

[5] See, e.g., Memorandum in Support of Defendants' Motion to Dismiss the Superseding Indictment Because of Fundamental Ambiguity in the Underlying Accounting Pronouncements, Case 4:07-cr-00175-JCH-DDN, filed October 24, 2007 (Docket No. 107).

The SEC's allegations in this civil case overlap substantially with those of the now-dismissed Superseding Indictment, culminating in five civil causes of action against Shanahan Jr.: securities fraud in violation of Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act (Claims I and II); soliciting proxies using false materials in violation of Section 14(a) and Rule 14a-9 of the Exchange Act (Claim III); and aiding and abetting ESSI in filing false annual reports with the SEC in violation of Section 13(a) and Rules 12b-20 and 13a-1 of the Exchange Act (Claim VI), and in failing to maintain accurate books and records in violation of Section 13(b)(2)(A) of the Exchange Act (Claim VII).

III. ARGUMENT

A. Claims VI and VII Fail Because Shanahan Jr. Lacked the "Wrongful Purpose" and "Substantial Assistance" Necessary for Aiding and Abetting Offenses as a Matter of Law

Two claims of the Complaint rely on an aiding and abetting theory.

In Claim VI, the SEC contends that Shanahan Jr. aided and abetted ESSI's securities violations premised on ESSI's 10-K filing of annual reports that contained the statement "[o]ptions granted are at an option price equal to the market value on the date the option is granted."[6] This disclosure concerning options pricing appeared in a note to the financial statements attached to ESSI's 10-K filings.[7] The disclosure appeared in substantially the same form year after year, in portions of the documents that witnesses characterized as "boilerplate" not requiring their close review.[8] In Claim VII, the SEC contends that Shanahan Jr. aided and abetted ESSI's failure to maintain accurate books and records, presumably by the failure to keep minutes of the Compensation Committee (of which Shanahan Jr. was a member).[9]

Aiding and abetting requires a particularly high level of awareness of wrongdoing, especially in the context of violations of the securities laws. The process of issuing securities and filing periodic reports with the SEC involves so many people playing different roles in the

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[6] Complaint at ¶¶ 43, 68-70.

[7] Ex. 1 (excerpts from 10-Ks from 1997-2003).

[8] See Ex. 5 (Guilfoil Depo.) at 77:20-78:25; Ex. 4 (Saint Depo.) at 148:10-150:15.

process – from one who initially types the first drafts of 10-K filings to the accountants and lawyers who ultimately review them – that there must be a line between those who merely "aid" the process by doing their jobs and those who wrongfully "aid and abet" a securities law violation. To show that the line has been crossed here under Eighth Circuit law, the SEC must demonstrate: (1) that ESSI committed a primary violation of the securities laws; (2) that Shanahan Jr. had knowledge that his role or conduct was part of an overall activity that had a "wrongful purpose"; and (3) that Shanahan Jr. knowingly and substantially assisted in the primary violation. See *Camp v. Dema*, 948 F.2d 455, 459-60 (8th Cir. 1991).[10] As the court explained in *Camp*, "[i]f it were otherwise, aiding and abetting would be indistinguishable from simply aiding. This would cast too wide a net, bringing under it parties involved in nothing more than routine business transactions." *Id*. at 459.

As a matter of law, Shanahan Jr. lacked both the "wrongful purpose" and the kind of knowing and substantial assistance sufficient to constitute aiding and abetting in both Claims VI and VII.

1. Shanahan Jr. Did Not Wrongfully Aid and Abet the Securities Law Violations Alleged in Claim VI (the "Options Pricing Sentence")

Shanahan, Jr. did not aid and abet the securities violation alleged in Claim VI, namely, that ESSI made a false or misleading statement in 10-K filings that "Options granted are at an option price equal to the market value on the date the option is granted."[11]

Discovery has made plain that Shanahan Jr. had no idea that any of his conduct at ESSI was part of "an overall activity that had a wrongful purpose." Although Landmann testified that he felt the instructions he received from former CFO Gerhardt to use retrospectively selected dates for options prices were wrongful,[12] Landmann certainly never shared that secret with

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[9] See Complaint at ¶ 26.

[10] See also *SEC v. Thielbar*, CIV 06-4253, 2007 U.S. Dist. LEXIS 72986 (D.S.D. Sept. 28, 2007); *SEC v. Cohen*, No. 4:05CV371-DJS, 2007 U.S. Dist. LEXIS 28934 (E.D. Mo. Apr. 19, 2007).

[11] Ex. 1 (10-K excerpts). To avoid repetition, these motion papers will refer to this sentence as the "Options Pricing Sentence."

[12] Ex. 6 (Landmann Depo.) at 43:14-45: 5.

Shanahan Jr.[13] Indeed, of the 31 witnesses deposed in this case, Landmann was the only one to testify that he knew that ESSI options were retrospectively priced, let alone that this was in any way wrongful.[14] Not only did Landmann fail to disclose any improper activity to Shanahan Jr., he did the opposite, repeatedly trying to cover up or minimize the fact that ESSI was engaged in improper options dating practices. For example, when the St. Louis Post-Dispatch ran an article in May 2006 suggesting that options backdating had occurred at ESSI, Landmann initially told auditors and others concerned about the allegations that no backdating had occurred.[15]

Further, the SEC has candidly admitted that Shanahan Jr. was unaware of the accounting rules governing option grants.[16] He therefore could not have appreciated the wrongfulness of Landmann's and Gerhardt's options backdating activities even if he knew about them (which he did not). Because Shanahan Jr. did not know what the proper strike price should have been or how to set it properly, he could not have evaluated the propriety of the Options Pricing Sentence that is at the heart of Claim VI. The date on which an option is "granted" is a conclusion based on accounting principles. Plaintiff's own expert admits as much, testifying at his deposition that the strike price of an option under APB 25 ought to be determined by reference to concepts of "grant date" and "measurement date" that are defined in the accounting literature,[17] albeit imperfectly.[18] Shanahan Jr. therefore could not have determined whether or not the options dating statement in ESSI's securities filings was accurate, because (as the SEC concedes) he lacked the accounting tools necessary to assess their truth or falsity.[19] As the court observed in

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[13] Ex. 6 (Landmann Depo.) 117:12-15; Ex. 23 (Memorandum of Interview of Landmann containing no mention of Shanahan Jr.)

[14] Ex. 6 (Landmann Depo.) at 44:17-45:5.

[15] See Ex. 28, Ex. 9 (Briggs Depo.) at 112:6-114:4; Ex. 10 (Kent Depo.) at 171:1-172:4; Ex. 11 (Wims Depo.) at 106:18-107:16.

[16] Ex. 12 (Plaintiff's Admissions) at 9 and 12.

[17] Ex. 14 (Heron Depo.) at 52:7-15 (equating "grant date" to "measurement date"), 220:13-17 (citing to APB 25 for definition of "measurement date").

[18] The accounting literature does not conclusively establish how to determine the "grant date" for all possible scenarios. Ex. 8 (Kreher Depo.) at 199:11-200:6; Ex. 15 (Expert Report of Ernest Ten Eyck); Ex. 13 (Ten Eyck Depo.) at 121:11-122:8.

[19] See generally Ex. 15 (Expert Report of Ernest Ten Eyck).

In re Sportsline.com Sec. Litig., 366 F. Supp. 2d 1159, 1168-69 (S.D. Fla. 2004), "interpretations of the measurement date criteria embodied in APB No. 25 are far from obvious."

Shanahan Jr.'s role and conduct at ESSI also did not constitute "substantial assistance" to the wrongdoing of others, as a claim of "aiding and abetting" requires. *Camp*, 948 F.2d 455 at 459-60. He was not an employee of ESSI during the relevant time period, but an "outside" director with no office at ESSI and no day-to-day responsibilities at the company.[20] His primary role was to attend quarterly Board meetings and to serve on at least one committee of the Board. Like other outside directors, and as the SEC has admitted, Shanahan, Jr. was not responsible for ensuring that ESSI option grants conformed to appropriate accounting rules.[21]

Although he did serve on the Compensation (or "Comp") Committee, that function did not amount to "substantial assistance" because it was not the job of the Comp Committee to price options in the first place. The Chairman of the Comp Committee (three-star General Kenneth Lewi), as well as several other members, were unanimous in testifying that the Comp Committee concerned itself only with allocating the number of options to be awarded, and played no role in setting the strike price.[22] In considering the allocation of options, the members of the Comp Committee were simply doing the corporate jobs that had been assigned to them, and thereby rendered no "substantial assistance" to the option-pricing activities of Gerhardt and Landmann.[23] When the defendant engages merely in actions that are "routine and part of normal everyday business practices" (the "daily grist of the mill"), that is not substantial assistance absent a high

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[20] See Ex. 1 (excerpts from 10-Ks showing members of ESSI's Board of Directors).

[21] Ex. 12 (Plaintiff's Admissions) at 12.

[22] Ex. 16 (Lewi Depo.) at 74:20-23, 99:21-24, 137:16-18; Ex. 11 (Wims Depo.) at 47:14-24, 129:19-130:6; Ex. 2 (Shanahan, Jr. Depo.) at 158:24-159:16; Ex. 17 (Kaste Depo.) at 124:17-22; Ex. 4 (Saint Depo.) at 117:15-18; see also Ex. 6 (Landmann Depo.) at 142:9-16 and Ex. 18 (July 14, 2006 Memorandum of Interview of Lewi).

[23] Landmann testified that it was Gerhardt who directed him to price options at relative low points in the stock price. Ex. 6 (Landmann Depo.) at 40:7-10; 124:8-24; 163:23-164:11. Landmann was primarily responsible for preparing ESSI's public filings, including annual reports and proxy statements. Ex. 6 (Landmann Depo.) at 197:7-198:10, 212:16-214:18, 219:12-220:5; Ex. 7 (Harsin Depo.) at 69:5-70:5, 71:4-22; Ex. 8 (Kreher Depo.) at 18:3-15, 20:6-19. Moreover, it was Landmann who was responsible for properly accounting for ESSI's stock options in ESSI's financial statements. Ex. 7 (Harsin Depo.) at 41:1-6; Ex. 6 (Landmann Depo.)

level of intent to assist a securities violation not present in this case. *Camp*, 948 F.2d at 459, 464.

Aiding and abetting also requires that "[t]he assistance must be such that it is a substantial factor in causing the resulting violation." *Id.* at 460 (emphasis added, internal quotation marks omitted). It cannot be said that the actions of Shanahan Jr. and many others involved generally in the options process were a substantial factor in causing the violations. Discovery revealed that scores of other ESSI employees and directors participated the options process in various essential ways,[24] but none of them (including Shanahan Jr.) can fairly be said to have been a "substantial factor" in causing ESSI's securities violations simply by doing their jobs.

The undisputed facts, including the SEC's admissions, make clear that Shanahan Jr. did not "aid and abet" ESSI's securities violations premised on the Options Pricing Sentence. Summary judgment should be granted as to Claim VI.

2. Shanahan Jr. did not Aid and Abet ESSI's Failure to Keep Proper Books and Records

Claim VII fails for similar reasons. In that claim, the SEC alleges that Shanahan, Jr. aided and abetted ESSI's books and records violations of Section 13(b)(2)(A). In particular, the Complaint alleges that "[a]s a member of the Compensation Committee, Shanahan Jr. failed to ensure that the Compensation Committee kept records reflecting the dates on which the committee authorized the Company's option grants." Complaint at ¶ 26.

Discovery has shown, however, that the Comp Committee had no obligation to keep such records in the first place. The Chairman of the committee, Lt. General Kenneth Lewi, testified that note-taking during meetings was a matter of discretion, and that there was no requirement that the committee maintain a written record of the performance of its duties.[25] Gen. Lewi

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at 65:10-23, 66:16-23, 67:11-21.

[24] See Ex. 17 (Kaste Depo.) at 39:7-19 (HR VP worked on options allocations); Ex.7 (Harsin Depo. at 16:19-17:7 (involved in record-keeping for options accounting); Ex. 25 (Potthoff Depo.) at 93:22-94:14 (CEO negotiated options for certain new employees); Ex. 24 (Bush Depo.) at 54:12-55:5 (Audit Committee reviewed work of accounting department).

[25] Ex. 16 (Lewi Depo.) at 63:12-64:2. Moreover, other members of the Comp Committee did

testified that he was the "principal spokesman for the Comp Committee in terms of reporting what the Comp Committee did to others on the Board," and he exercised his judgment as to whether such a report needed to be recorded in writing.[26] Auditors at PWC responsible for reviewing ESSI's financial records were well aware that the committee kept no minutes or notes, but raised no objection and agree that it was not a requirement.[27] Because it was not Shanahan Jr.'s responsibility to maintain the books and records, his failure to do so cannot be aiding and abetting. See *SEC v. Cedric Kushner Promotions, Inc.*, 417 F. Supp. 2d 326, 337 (S.D.N.Y. 2006) (granting summary judgment for aiding and abetting claim under Section 13(b)(2)(A) where there was no evidence that the defendant "was responsible for CKP's books and records or for maintaining adequate controls").

Nor did Shanahan Jr. do anything that could be construed as "substantial assistance" to the Comp Committee's lack of written recordkeeping. Shanahan Jr. never served as Chairman of the Comp Committee.[28] He attended and participated in meetings, but that is the kind of routine business practice that is the regular "grist of the mill." See *Camp*, 948 F.2d at 464. There is no evidence that Shanahan Jr. tried to prevent or dissuade anyone from taking or preserving notes or minutes, or took any steps designed to obscure the dates on which the committee met. To the contrary, Shanahan Jr. often placed handwritten notes with the contemporaneous date on documents he signed.[29]

Finally, for the same reasons as noted above with respect to Claim VI, there is no evidence that Shanahan Jr. acted with an appreciation of any "wrongful purpose." Formal minutes or notes do not accompany every business meeting, and the recordkeeping practices of

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not believe that they had any formal responsibility to take notes. *See* Ex. 4 (Saint Depo.) at 71:22-72:2); Ex.11 (Wims Depo.) at 49:6-25.

[26] Ex. 16 (Lewi Depo.) at 194:6-194:19. Members of the Compensation Committee, including Gen. Lewi himself, believed that it was indeed the responsibility of the Chairman himself to report decisions to the Board of Directors. Ex. 4 (Saint Depo.) at 72:12-73:5; Ex.11 (Wims Depo.) at 47:10-24, 52:3-18; Ex. 16 (Lewi Depo.) at 194:6-19.

[27] See Ex. 9 (Briggs Depo.) at 62:8-22, 184:3-185:13; Ex. 10 (Kent Depo.) at 115:23-116:20.

[28] Ex. 12 (Plaintiff's Admissions) at 11.

[29] See, e.g., Ex. 19 (May 5, 2000 option document); Ex. 20 (April 11, 2001 email with

the Compensation Committee would not have appeared wrongful. Only with a keen appreciation of APB 25 (which the SEC has conceded Shanahan Jr. lacked)[30] *and* an awareness of Landmann's and Gerhardt's retrospective pricing practices (as to which there is no evidence) could Shanahan Jr. have seen the comp committee's failure to keep minutes or preserve notes as part of any "wrongful purpose."

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For the reasons set forth above, summary judgment should be granted in favor of Shanahan Jr. as to the aiding and abetting causes of action (Claims VI and VII).

B. Claims I, II, III and VI Fail Because the Alleged Misstatements were Not Material as a Matter of Law

Claims I, II, III and VI – the remaining claims in the Complaint against Shanahan, Jr. – fail as a matter of law because the alleged misstatement was not material. Each of these claims hinge, once again, on the Options Pricing Sentence ("Options granted are at an option price equal to the market value on the date the option is granted").[31] But that statement, taken in the context of other information in the securities filings and otherwise available to the market, could not possibly have swayed any reasonable investor in ESSI, which was one of the most successful stocks on the NASDAQ.

"[A] court may determine as a matter of law, that the alleged misrepresentation is immaterial, if a reasonable investor could not have been swayed by the alleged misrepresentation." *Romine v. Acxiom Corp.*, 296 F.3d 701, 706 (8th Cir. 2002) (internal quotation omitted). For an omitted fact 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 Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (quoting *TSC Indus. Inc. v. Northway Inc.*, 426 U.S. 438, 449 (1976)).

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handwritten notes).

[30] See Ex. 12 (Plaintiff's Admissions) at 12.

[31] These claims additionally rely on a similar statement that appeared in ESSI's SEC Schedule 14A or proxy statements. See Ex. 3 (excerpts from proxy statements 1997-2003).

Eighth Circuit precedent underscores how information can relate to a company's financial statements and yet still not be "material" under the securities laws. In *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539 (8th Cir. 1997), for example, the court found that a two percent overstatement of assets was not material, stating that it was "clear that a reasonable investor, faced with a high-risk/high-yield investment opportunity in a company with a history of very rapid growth, would not have been put off by an asset column that was 2% smaller." *Id*. at 547. An Eighth Circuit panel went even further in *Romine v. Acxiom Corp.*, 296 F.3d at 706, finding no materiality as a matter of law as to an overstatement of earnings based on accounting adjustments that allowed the company to meet analysts' guidance. *Id*. at 705-08. District courts in the Eighth Circuit have been similarly skeptical in evaluating plaintiffs' claims of materiality, especially as to accounting entries. See, e.g., *SEC v. Thielbar*, CIV 06-4253, 2007 U.S. Dist. LEXIS 72986 (D.S.D. Sept. 28, 2007) (overstatement of $3.2 million in revenue not material given overall quantitative and qualitative circumstances); *SEC v. Cohen*, No. 4:05CV371-DJS, 2007 U.S. Dist. LEXIS 28934 (E.D. Mo. Apr. 19, 2007) (no materiality based on qualitative factors even with accounting restatement).

In this case, the Option Pricing Sentence was no more material as a matter of law than the accounting information in comparable cases in this Circuit. ***First***, it cannot fairly be disputed that the Options Pricing Sentence was a miniscule part of the "total mix of information" available to investors and others, especially in light of the nature of ESSI's business and its extraordinary record of success. ***Second***, although ESSI did not recognize a compensation charge for options expenses under APB 25, it did provide investors with an estimate of compensation expense for stock option awards using the alternative Black-Scholes method under SFAS 123. This alternative calculation of options expense was included in the same note to ESSI's financial statement as the alleged misstatement, making an alternative form of options expense information readily available to any investor who cared (although none did).

1. The Options Pricing Sentence and ESSI's Options Pricing Practices Were Miniscule and Immaterial Parts of the Total Mix of Information

The assertion that any reasonable investor would have found the Options Pricing

Sentence to be material has to be assessed against other undisputed facts about ESSI that were part of the total mix of information. From the time that the alleged misstatement began to appear in ESSI's SEC filings in 1996 until DRS purchased the company in 2006, ESSI's stock price increased astronomically.[32] As a defense contractor manufacturing troop support equipment in the midst of two wars taking place in remote desert locations, ESSI manufactured exactly what the military needed, and Shanahan Sr.'s strategy of making "accretive" acquisitions had perfectly positioned the company for success. During the relevant period, ESSI's revenues increased by more than 400%, from $81 million in 1996 to $408 million in 2002.[33] The company's accomplishments earned it a reputation as one of St. Louis' top companies for shareholder value,[34] and as one of the fastest growing stocks on the NASDAQ.[35] Common sense suggests that any rational investor would have found these basic facts about ESSI's business to be compelling, regardless of whether a note in a financial statement attached to ESSI's 10-K filings was modified or not.

Investors and analysts who testified in discovery pointed to a multitude of factors that led them to invest in or recommend ESSI stock.[36] ESSI (like Gateway in the *Parnes* case) was a growth stock in which investors were principally interested in percentage increases in value.[37] Virtually all of the factors analysts considered, accordingly, were forward-looking, growth-oriented factors about ESSI's business, such the geopolitical prospects for increased military spending,[38] prospects for future accretive acquisitions that would contribute to earnings,[39] and

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[32] Ex. 26 (chart of stock prices); Ex. 27 (list of stock price data).

[33] Ex. 1 (excerpts from 10-Ks showing revenue in 1996 compared to 2002).

[34] Ex. 29 (articles on shareholder value and other aspects of ESSI business).

[35] Ex. 21 (Akyol Depo.) at 184:19-185:2.

[36] See generally Ex. 30 (Pauli & Co. analyst reports), Ex. 31 (Stifel Nicolaus analyst reports), Ex. 32 (CIBC Oppenheimer analyst report).

[37] Ex. 21 (Akyol Depo.) at 121:10-122:12.

[38] Ex. 21 (Akyol Depo.) at 128:22-129:5; id. at 133:19-134:5.

[39] Ex. 21 (Akyol Depo.) at 137:8-141:24.

the "backlog" of booked business that would enhance revenues,[40] none of which had anything to do with non-cash expenses such as those attributable to options that were merely accounting entries.[41] Investors and analysts also looked at ESSI's past performance, but primarily to determine the percentage increase over time.[42] Many analysts would exclude stock option expenses when calculating the company's earnings, so as to get a more accurate sense of the earnings attributable to the company's business as opposed to artificial accounting entries.[43] One analyst deposed by the SEC stated that he had never had an investor ask him about the expensing of stock options for any company he had covered in 33 years at PaineWebber.[44] Even Landmann admitted to government agents that the flaws in ESSI's options pricing would not have had a material impact on the company's earnings in his view.[45]

Here, as in *Romine*, *Gateway* and other cases in this Circuit, the Court should find as matter of law that a modified version of the Options Pricing Sentence would not have altered the total mix of information in a way material to a reasonable investor, given the undisputed facts about ESSI's spectacular performance and other factors. While some courts have found that disclosures as to options backdating expenses could alter the total mix of information,[46] the circumstances and testimony as to ESSI in particular – as well as Eighth Circuit precedents such as *Romine* and *Gateway* – warrant a different result in this case.

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[40] Ex. 21 (Akyol Depo.) at 125:20-126:21.

[41] Stock options are a non-cash expense, which is an accounting expense only, meaning no money actually leaves the company. Ex. 21 (Akyol Depo.) at 106:17-107:4, 117:17-119:16.

[42] Ex. 22 (Kirchberger Depo.) at 99:4-101:6; Ex. 21 (Akyol Depo.) at 121:3-23.

[43] Ex. 21 (Akyol Depo.) at 104:4-107:25.

[44] Ex. 22 (Kirchberger Depo.) at 106:17-107:4.

[45] Ex. 23 (June 9, 2006 Memorandum of Interview Steven Landmann).

[46] In *United States v. Reyes*, 577 F.3d 1069, 1076 (9th Cir. 2009), for example, the Ninth Circuit found options expense misstatements to be material, observing blandly that "information regarding a company's financial condition is material to investment." The view that it is sufficiently material that information be merely "regarding" the financial condition of a company, however, flies in the face of Eighth Circuit precedent.

2. ESSI Provided Investors with an Estimate of its Stock Options Expenses for Those Who Cared

Even if a hypothetical investor were concerned about non-cash expenses relating to stock options – real investors plainly were not – the non-disclosure alleged in this case would not have been material because ESSI's SEC filings actually contained an estimate of the stock options' expense amount. From 1997 through 2003, a note to ESSI's financial statement disclosed the reduction in ESSI's earnings that would result from charging the "fair value" of stock options as a non-cash expense.[47] The difference between the "fair value" disclosure that ESSI actually made as to its option expenses and the disclosure the SEC apparently prefers (a change to the Option Pricing Sentence to reveal Landmann's use of retrospective pricing) was immaterial as a matter of law.

The materiality of a disclosure cannot be assessed in isolation, but must be compared to other information made available to the investing public. In *Romine*, 296 F.3d at 705, for example, plaintiffs alleged that Acxiom failed to disclose that a new five-year contract with its largest customer, Allstate Insurance, would result in lower pricing and major competitive disadvantages set forth in a *Barrons* article that appeared shortly after the plaintiffs purchased their stock. The court found that the failure to disclose the negative impact of the Allstate contract on pricing and competitive trends was immaterial because the contract itself was attached to a 10-K attached to the prospectus, and that therefore "hard data" as to the contract had been provided in an alternate form. *Id*. at 708.

Similarly, ESSI provided an alternative form of "hard data" as to its options grants and expenses. At the outset, of course, it is important to recognize that all calculations of option "expense" are theoretical. Options cost the company nothing when issued, and may or may not ever cost the company anything, depending on whether, when, and at what price the options are exercised. Even if ESSI got it wrong in describing to the investing public how it priced options in the Options Pricing Sentence, ESSI provided another detailed calculation of the fair value expense of its stock option grants in another part of its disclosures, using the Nobel Prize-

[47] Ex. 1 (excerpts from 10-Ks).

winning "Black-Scholes" pricing model. Many other public companies at the time also used the "Black-Scholes" model. Accordingly, a hypothetical investor who cared about theoretical non-cash stock option expenses could easily find in ESSI's financial statements a fair valuation of that expense and how it would impact earnings, and those figures could be compared with similar disclosure notes publicly reported throughout corporate America. Moreover, ESSI's public filings offered other information on option grants,[48] all of which taken together would have permitted any interested investor to assess both the potential dilutive impact of all stock options and their economic value.

Accordingly, no reasonable investor would have found it material that ESSI's 10-Ks stated that "no compensation expense has been recognized for stock option awards" because that same paragraph contained an estimate of those options expenses.

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[48] Public filings disclosed, inter alia, the number of shares of ESSI stock issued as option grants and the exercise prices of such grants during relevant time period. See Ex. 12 (Plaintiff Admissions at 14, 15).

IV. CONCLUSION

For the foregoing reasons, the Court should grant Shanahan Jr.'s Motion for Summary Judgment.

Respectfully submitted

Dated: October 7, 2009

MICHAEL F. SHANAHAN, JR.

BY: */s/ Stuart L. Gasner*

Stuart L. Gasner
Michael D. Celio
KEKER & VAN NEST LLP
710 Sansome Street
San Francisco, California 94111-1704
(415) 391-5400
(415) 397-7188 (facsimile)
sgasner@kvn.com
mcelio@kvn.com

James Martin (#11651)
ARMSTRONG TEASDALE LLP
One Metropolitan Square, Suite 2600
St. Louis, Missouri 63102
(314) 621-5070
(314) 552-4874 (facsimile)
jmartin@armstrongteasdale.com
sgolde@armstrongteasdale.com

Attorneys for Defendant Michael F. Shanahan, Jr.

CERTIFICATE OF SERVICE

I hereby certify that on the 7th day of October, 2009, the foregoing was filed electronically with the Clerk of the Court to be served by operation of the Court's electronic filing system upon the following:

For Plaintiff SEC

Robert M. Moye
Jeffrey A. Shank
SECURITIES AND EXCHANGE COMMISSION
175 W. Jackson, Suite 900
Chicago, IL 60604
Email: MoyeR@sec.gov
Email: shankj@sec.gov

For Defendant Michael Shanahan, Sr.

Barry A. Short
Evan Z. Reid
LEWIS AND RICE
500 N. Broadway
Suite 2000
St. Louis, MO 63102-2147
Email: bshort@lewisrice.com
Email: ereid@lewisrice.com

/s/ Stuart L. Gasner