IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF MISSOURI
EASTERN DIVISION

Securities and Exchange Commission,	)	
	)	
Plaintiff,	)	
	)	
vs.	)	**Case No. 4:07-CV-270-JCH**
	)	
Michael F. Shanahan, Sr., et. al.	)	
	)	
Defendants.	)	

PLAINTIFF'S RESPONSE TO SHANAHAN JR.'S
MOTION FOR SUMMARY JUDGMENT

Plaintiff U.S. Securities and Exchange Commission ("the Commission") states as follows:

Defendant Michael F. Shanahan, Jr. ("Shanahan Jr.") contends that the Court should grant him summary judgment on all of the Commission's claims against him, for two reasons: (1) Shanahan Jr. claims he lacked the "wrongful intent" and did not provide the "substantial assistance" required to find him liable for aiding and abetting ESSI's financial reporting and recordkeeping violations; and (2) the false statements that are the bases for the Commission's securities fraud and proxy fraud claims against Shanahan Jr. purportedly are immaterial as a matter of law. However, Shanahan Jr.'s motion is an unvarnished request that the Court improperly weigh the evidence, resolve disputes of fact, and make credibility determinations, in order to find that Shanahan Jr. did nothing wrong, or lacked *scienter*, or that ESSI's investors could not have cared about the company's false statements regarding its stock option granting practices. Because there are numerous disputes of material fact, and the Court cannot decide these disputed factual questions on summary judgment, Shanahan Jr.'s motion must be denied.

PRELIMINARY STATEMENT

A. Summary Judgment Standard

When evaluating a motion for summary judgment, the Court must view the facts in the light most favorable to the nonmoving party. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 261 n.2 (1986). Credibility determinations, weighing of evidence, and drawing of inferences from the facts are the functions of a jury, not those of a judge on summary judgment. *Id.* at 255. The evidence of the nonmoving party is to be believed, and all justifiable inferences are to be drawn in its favor. *Id.* The nonmoving party need not prove each issue of material fact, and need only present sufficient evidence supporting a material factual dispute to require resolution by a trier of fact. Reich v. ConAgra, Inc., 987 F.2d 1357, 1359-60 (8th Cir. 1993).

B. Factual Background for Purposes of Summary Judgment

1. ESSI Backdated Stock Option Awards and Misrepresented Its Option Pricing in Commission Filings.

Between 1997 through 2002, Engineered Support Systems, Inc. ("ESSI") issued backdated in-the-money stock options to officers, employees, and nonemployee directors. (Plaintiff's Statement of Material Facts as to which a Genuine Issue Exists ("Statement of Disputed Facts") at Ex. 23, Shanahan Plea Agreement at 10) These stock options were issued with nine different purported grant dates, ranging from December 2, 1996 to October 17, 2002. (*Id.*) The dates assigned to these stock options were selected because they were low points in ESSI's stock price during relevant quarters, thus resulting in a lower exercise price for the issued options and an increased value for the underlying stock options. (*Id.*) Because ESSI's stock options vested immediately, from the moment the backdated stock options were granted they constituted an immediately realizable economic benefit upon option recipients. (*Id* at 10-11)

ESSI never disclosed this backdating arrangement to shareholders. On the contrary, during this period, ESSI made numerous misrepresentations in its Commission filings regarding how stock options had been and would be priced. (*Id.* at 11) Among other things, ESSI represented in its proxy statements that "All options granted to date have been awarded at an exercise price equal to the fair market value of the stock on the date of the award" and that "[t]he option price of shares subject to any Stock Option shall be the closing price of the Stock on the date that the Stock Option is granted". (*Id.*) Shanahan Jr. reviewed and approved ESSI's proxy statements. (Statement of Disputed Facts at ¶¶ 9-10) Similar misrepresentations appeared in ESSI's Forms 10-K and S-8, documents that were signed by Shanahan Jr.[1] (*Id.* at ¶ 8) These statements were misleading, and suggested that ESSI had tied management's interests directly to shareholder return. This was not true.

2. Shanahan Jr. Was Indispensable to the Option Granting Process and to Decisions Regarding Executive Compensation.

According to ESSI's employee stock option plans, ESSI's Compensation Committee was the Plan Administrator with the exclusive authority to grant stock options to ESSI employees. (*See* Statement of Disputed Facts at ¶ 3) Shanahan Jr. was a member of ESSI's Compensation Committee during the entire period of ESSI's backdating. (*Id.* at ¶ 2) Although never the Chairman of the Compensation Committee, Shanahan Jr. took a leading role in Compensation Committee matters. (*Id.*) He also served as the conduit between ESSI management and the Compensation Committee, and he communicated the Compensation Committee's decisions regarding stock options to management. (*Id.*)

[1] The phrasing of ESSI's misrepresentations varied slightly over the years and the misrepresentations in the Forms 10-K were worded slightly different than those in the proxy statements and Forms S-8. (Statement of Disputed Facts at ¶¶ 8-10 and Ex. 23 at 10-11) The essence of all of these disclosures was the same – that ESSI's stock options were issued "at-the-money", or with an exercise price equal to ESSI's stock's market value at the time they were granted.

In August of 1995, Shanahan Jr. proposed that his father, Michael F. Shanahan, Sr. ("Shanahan Sr.") receive a sizable increase in his base compensation. (Statement of Disputed Facts at ¶ 2) In June 1998, Shanahan Jr. proposed to the Chairman of the Compensation Committee that Shanahan, Sr. receive another sizable raise, as well as an option to purchase 10,000 shares of ESSI every time the company's stock price reached a new all-time high point. (*Id.*) Guilfoil thought this idea was "ridiculous" and ignored it. (*Id.*) However, Shanahan Jr. pushed the proposal forward and obtained the approval of certain officers and directors. (*Id.*) This proposal was incorporated into Shanahan Sr.'s employment agreement with ESSI, but was never disclosed to shareholders. (*Id.*) This scheme became of the basis for awarding Shanahan Sr. options to purchase more than 1.2 million shares of company stock before it was abandoned.[2] (*See* Statement of Disputed Facts at Ex. 4)

ESSI never disclosed the incentive stock option arrangement with Shanahan Sr. in its proxy statements describing the CEO's compensation and employment agreement. As a director and member of the Compensation Committee, Shanahan Jr. reviewed all of ESSI's proxy statements – and even offered written comments the portion of ESSI's 1999 proxy statement that discussed Shanahan Sr.'s employment agreement. (Statement of Disputed Facts at ¶ 9 and Ex. 19) However, Shanahan Jr.'s comments revealed nothing about his father's secret compensation arrangement. (*See Id.* at Ex. 19)

Shanahan Jr. also took a leading role in other executive compensation matters. When ESSI hired Gerald Daniels as its new Chief Executive Officer in 2003, Shanahan Jr. handled the compensation negotiations. (Statement of Disputed Facts at ¶ 2, Ex. 14 at 17-20) When Daniels

[2] In 2001, Shanahan Jr. approved similar incentive compensation arrangements for other ESSI executives, and authorized a new, three year compensation arrangement with his father which substantially increased his base compensation, bonus amount and potential stock option awards. (*See* Statement of Disputed Facts at ¶ 2 and Ex. 2 at 2)

asked him whether ESSI had a Compensation Committee, Shanahan Jr. answered, "You're looking at it." (*Id.*, Ex. 14 at 132-36)

2. Shanahan Jr. Proposed Backdated Grant Dates and Directed ESSI Management to Backdate Stock Options.

As part of the option granting process, Shanahan Jr. also took the lead in informing ESSI's management about the Compensation Committee's decisions with respect to stock options. (Statement of Disputed Facts at ¶ 2 and Ex. 5) Shanahan Jr. also provided Gary Gerhardt with some of the grant dates and exercise prices to use for backdated stock options. (*Id.* at ¶ 2; Ex. 7 at 189-93; Ex. 8 at 2) According to the documentary evidence in this case, Shanahan Jr. did this on at least four occasions: *i.e.*, on July 17, 2000, January 3, 2001 and twice in July 2002. (*See* Statement of Disputed Facts at ¶ 2; Ex. 9; Ex. 10; Ex. 11)

The most noteworthy communications between Shanahan Jr. and Gerhardt occurred by email. On July 16, 2002, Shanahan Jr. instructed Gerhardt to issue stock options to senior management "at the price that we agreed upon at the last meeting with Gen. Lewi." (*See* Statement of Disputed Facts at Ex. 11) On July 25, 2002, Shanahan Jr. emailed Gerhardt, Steven Landmann and Kenneth Lewi, noting that ESSI's stock price reached a new quarterly low on the previous day; Shanahan Jr. asked Landmann whether they could use the lower exercise price for the options that were being issued, and if they needed to have another Compensation Committee meeting in order to use the lower price. (*Id.*) Landmann testified that he responded by calling Shanahan Jr. and informing him that another meeting of the Compensation Committee meeting would be necessary in order to set a new option price. (*Id.* at ¶; Ex. 17 at 172-74) On August 8, 2002, Shanahan Jr. suggested that Gerhardt and two other ESSI executives "give 10,000 [stock option] shares each to ESSI's general counsel (and Shanahan Jr.'s brother-in-law) David Mattern. (Statement of Disputed Facts at Ex. 11) Later that same day, Shanahan Jr. again wrote

to Gerhardt noting that there was now a "Much better price". (*Id.*) ESSI then issued stock options with a July 24, 2002 grant date and corresponding exercise price.[3] (Docket No. 105, Hlavacek Declaration at ¶¶ 29-31)

3. Shanahan Jr. Asserted the Fifth Amendment During the Commission's Investigation.

During the Commission's investigation into ESSI's options grant practices, the Commission subpoenaed Shanahan Jr. to appear for testimony. On August 31, 2006, Shanahan Jr. appeared for testimony but refused to answer nearly all of the Commission's substantive questions. After litigating a subpoena enforcement action for five months, Shanahan Jr. was ordered to appear for testimony and testify or assert a valid legal privilege. *SEC v. Shanahan*, 504 F. Supp. 2d 680, 681 (E.D. Mo. 2007). On April 21, 2007, Shanahan Jr. appeared again for testimony and asserted his Fifth Amendment privilege to questions about ESSI and options backdating. (Statement of Disputed Facts at Ex. 16)

4. Shanahan Jr. Entered Into Pretrial Diversion.

In his Memorandum, Shanahan Jr. notes that all charges against him were dismissed in the parallel criminal matter. (Docket No. 108, Shanahan Jr. Memo. at 2) In fact, those charges were dismissed upon Shanahan Jr.'s agreement to enter into a Pretrial Diversion program, accept responsibility for his actions and pay $92,000 in restitution.[4]

[3] There is no evidence that ESSI's Compensation Committee met in July, 2002. To the contrary, Shanahan Jr.'s own email of July 25, 2002 precludes the possibility that the Compensation approved the issuance of these stock options on July 24, 2002.

[4] Shanahan Jr.'s Pretrial Diversion Agreement is not part of the public record, and the agreement provides that "the Government" will not disclose the document unless pursuant to court order. Although the Commission was not a party to that agreement, and has obtained a copy of the agreement through discovery. Accordingly, the Commission hereby requests that this Court order the parties to file the agreement, such the Court can review it in conjunction with this motion.

ARGUMENT

A. Shanahan Jr. Aided and Abetted ESSI's Reporting and Recordkeeping Violations.

The Commission has alleged that Shanahan Jr. has aided and abetted ESSI's violations of Sections 13(a) and 13(b)(2)(A) of the Securities Exchange Act of 1934 ("Exchange Act"), and Rules 13a-1 and 12b-20 thereunder. In order to establish aiding and abetting liability under Section 20(e) of the Exchange Act, 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 455, 459 (8th Cir. 1991) (citation omitted). Prongs two and three should be viewed relative to one another. 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. Severe recklessness constitutes "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." K&S P'ship v. Cont'l Bank, N.A., 952 F.2d 971, 978 (8th Cir. 1991). General awareness of one's overall role in the primary violator's illegal scheme is sufficient knowledge for aiding and abetting liability. *Id.* Knowledge may be proven by and inferred from circumstantial evidence, including facts available to the defendant. *Id.* *See also* Pagel, Inc. v. SEC, 803 F.2d 942, 946 (8th Cir. 1986) (same).

To satisfy the substantial assistance requirement, the Commission must establish that the defendant provided assistance that was "'a substantial factor in causing the resulting' violation." Dema, 948 F.2d at 460 (citation omitted). Silence can constitute substantial assistance if there was a duty to disclose. *Id.* Here, Shanahan Jr. does not challenge the existence of the violations of these sections by ESSI. Instead, he claims that the Commission cannot establish his knowledge of the violations or his substantial assistance in furtherance of those violations. (Docket No. 108, Shanahan Jr. Memo. at 4)

1. Shanahan Jr. Aided and Abetted ESSI's Reporting Violations.

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.

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 that options were priced with an exercise price equal to the closing price of ESSI's common stock on the dates the options were awarded. (*See* Statement of Disputed Facts, Ex. 23, Shanahan Sr. Plea Agreement, at 10-11) Shanahan Jr. electronically signed these Forms 10-K in his capacity as a member of ESSI's Board of Directors. (*Id.* at 11)

a. A Reasonable Jury Could Find that Shanahan Jr. Had the Requisite Knowledge.

Shanahan Jr. contends that the Commission has no evidence that he was aware that any of his conduct was part of an overall activity that had a wrongful purpose. (Docket No. 108,

Shanahan Jr. Memo. at 4) He further argues that because he was unaware of the accounting rules governing option grants, he could not have appreciated the wrongfulness of the backdating, and that because he did not know what the proper strike price should have been, he could not have evaluated the propriety of ESSI's disclosure regarding how options were priced. (*Id.* at 5) Shanahan Jr. claims that the date on which an option is "granted" is a conclusion based on accounting principles, and he therefore lacked the ability to understand what that meant. (*Id.*) The Commission's expert has offered an opinion to the contrary, that no special knowledge of accounting was required to understand the language of ESSI's stock option plans. (Statement of Disputed Facts at ¶¶ 20-24; Ex. 20 at 3-4)

"[I]ssues of knowledge and intent are particularly inappropriate for resolution by summary judgment, since such issues must often be resolved on the basis of inferences drawn from the conduct of the parties." Riehl v. Travelers Ins. Co., 772 F.2d 19, 24 (3d Cir. 1985) (citation omitted); *see also* Pfizer, Inc. v. Int'l Rectifier Corp., 538 F.2d 180, 185 (8th Cir. 1976) (summary judgment is "notoriously inappropriate" when issues of intent, good faith, and other subjective feelings play dominant roles). Summary judgment on the issue of scienter is appropriate only where there is no rational basis in the record for concluding that the defendant acted with scienter. Provenz v. Miller, 102 F.3d 1478, 1490 (9th Cir. 1996). On summary judgment, the Commission is entitled to inferences from the evidence, such as motive, that demonstrate that Shanahan Jr. may have acted with scienter. *See* In re Homestore.com, Inc. Sec. Litig., 347 F. Supp. 2d 769, 785-88 (C.D. Cal. 2004).

In Middlesex Ret. Sys. v. Quest Software Inc., the court denied the defendants' motion to dismiss an options backdating claim, rejecting the defendants' argument that option granting procedures are highly technical and were the result of complex accounting rules. 527 F. Supp.

2d 1164, 1181 (C.D. Cal. 2007). The court concluded that backdated stock options and the concurrent option granting practices were "highly suspicious" and "lean heavily toward a finding of scienter." *Id.* The court held that "no amount of 'highly technical' accounting treatments can obscure the obvious: that someone at Quest was engaging in substantial, prolonged, and *intentional* backdating of stock options." *Id.* at 1182. The Court further concluded that the extremely beneficial option grant dates, the defendants' positions in the company -- including a defendant on the Compensation Committee -- and the substantial number of shares awarded to the defendants demonstrated a strong inference that the defendants knew or were deliberately reckless in not knowing that the purported option grant dates were improper. *Id.* at 1182-83. The Court held that because the defendants reaped substantial rewards as a result of the backdating and thus knew how favorable the option grant dates were, they did not need to understand the process and methodologies had accounting consequences to know that the grant dates were improper. *Id.*

These holdings should apply here. The Commission's documentary, testimonial and expert evidence would allow a reasonable trier of fact to conclude that Shanahan Jr. provided backdated grant dates to Gerhardt, which were chosen because they represented low points in ESSI's stock price. Shanahan Jr. did not need any training in accounting to understand that such backdating was improper, and violated ESSI's stock option plans, and that the information ESSI was disclosing to its shareholders concerning the pricing of stock options was false. Moreover, Shanahan Jr.'s own expert rejects Shanahan Jr.'s contention that the date an option is granted is an accounting concept that can be understood only by an accountant. (*See* Docket No. 110, Huber Declaration at Ex. 15, Ten Eyck Expert Report, at 8-9 ("But grant date determinations,

including whether the requisite granting actions were complete, are legal and practical considerations that are of little consequence from an accounting perspective.”))[5]

In the final analysis, Shanahan Jr.’s professed inability to understand ESSI’s stock option plans collide with one critical fact: *i.e.*, on at least six separate occasions, Shanahan Jr. signed ESSI’s Forms 10-K, which contained the false statement that “Options granted are at an option price equal to the market value on the date the option is granted.” (*See, e.g.,* Plaintiff’s Statement of Disputed Facts at Ex. 23, Shanahan Plea Agreement, at 10-11)[6] The Commission is entitled to the reasonable inference that Shanahan Jr. read the Forms 10-K that he signed. *See* Homestore.com, 347 F. Supp. 2d at 787-88. In light of Shanahan Jr.’s involvement in the backdating, and receipt of draft securities filings, a reasonable jury could find that Shanahan Jr. knew, or was severely reckless in not knowing, that the options pricing statement in the company’s Form 10-K was false. *See* In re Comverse Tech., Inc. Sec. Litig., 543 F. Supp. 2d 134, 144-45 (E.D.N.Y. 2008) (compensation committee members faced “red flags” when provided with falsely dated unanimous consent forms, giving rise to strong inference of *scienter*); Camp, 948 F.2d at 459.

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[5] Shanahan Jr. citation to In re Sportsline.com Sec. Litig., 366 F. Supp. 2d 1159, 1168-69 (S.D. Fla. 2004), which held that interpretations of *measurement date* criteria are not obvious, is in apposite. As a member of the Compensation Committee, Shanahan Jr. was not required to determine the measurement date, but rather the closing stock price on the actual date of the grant decision. Moreover, in U.S. v. Reyes, in denying the defendant’s motion for a dismissal, the Court held that APB 25 may be confusing in certain circumstances, but that “[i]f APB 25 precludes *anything*, it prohibits companies from deliberately choosing a strike price based on a favorable historical date and then . . . pretending that the option was granted earlier than it actually was.” United States v. Reyes, 2007 U.S. Dist. LEXIS 41632, at **10-11 (N.D. Cal. May 30, 2007), *reversed on other grounds*, 577 F.3d 1069 (9th Cir. 2009).

[6] ESSI’s Forms 10-K also incorporated ESSI’s proxy statements by reference, which contained additional misrepresentations about ESSI’s pricing of stock options. (*See* Statement of Disputed Facts at Ex. 23, Shanahan Sr. Plea Agreement, at 11)

A reasonable jury could also infer the requisite scienter from the inference of motive demonstrated by Shanahan Jr.'s persistent efforts to shovel as much salary, bonus and stock options to his father as possible, including incentive stock options under an "agreement", which was never disclosed to shareholders. The fact that Shanahan Jr. corrected certain items on ESSI's proxy disclosure, without disclosing his father's secret agreement, and excluded members of the Compensation Committee from his communications with Gerhardt regarding option pricing, would allow a reasonable jury to conclude that Shanahan Jr. had the requisite state of mind to support a finding of *scienter*.

A reasonable jury is permitted to conclude that if Shanahan Jr. had no consciousness of wrongdoing, he would have had no reason to invoke his Fifth Amendment right and refuse to testify (twice!) during the Commission's investigation into alleged backdating at ESSI. (*See, e.g.*, Statement of Disputed Facts at Ex. 16, at 29-31, 38-41) *See also* Baxter v. Palmigiano, 425 U.S. 308, 318-19 (1976) (because "silence in the face of accusation is a relevant fact not barred from evidence", "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"); *see also* Pagel, 803 F.2d at 946-47 (adverse inference was appropriate in SEC disciplinary proceeding, even in the face of subsequent testimony and an acquittal in criminal case).

In addition, it bears repeating that Shanahan Jr. was not acquitted of all charges in the parallel criminal case. In return for his dismissal, he agreed to accept responsibility for his actions and pay restitution – presumably to benefit those harmed by his actions. A reasonable jury could also infer from this agreement that Shanahan Jr. has acknowledged that he acted improperly with respect to options backdating, and did so with a wrongful purpose.

b. A Reasonable Jury Could Find That Shanahan Jr. Provided Substantial Assistance.

Shanahan Jr. also contends that the Commission cannot establish that he provided substantial assistance because it was not the job of the Compensation Committee to price options. (Docket No. 108, Shanahan Jr. Memo. at 6) Shanahan Jr. further argues that his role of considering the allocation of options was an everyday business practice, and thus a high level of intent is required to find aiding and abetting liability. (*Id.* at 6-7) Shanahan Jr. argues that he had minimal duties and responsibilities at ESSI, and that he was not responsible for ensuring that ESSI's option grants conformed to appropriate accounting rules. (*Id.* at 6) The facts uncovered during discovery establish otherwise. The entire premise of Shanahan Jr.'s "substantial assistance" argument fails, because there is significant documentary evidence and testimony that Shanahan Jr. actively and routinely directed the use of backdated grant dates. Gerhardt testified that Shanahan Jr. was one of four individuals at ESSI who provided him with grant dates for option grants, and Gerhardt's testimony is corroborated by faxes, notes and emails demonstrating Shanahan Jr.'s involvement in pricing decisions.[7] In fact, Shanahan Jr. was not a passive recipient of such communications but rather was the instigator of discussions regarding option pricing. (*Compare* Statement of Disputed Facts at ¶ 3; Ex. 7; Ex. 8; Ex. 10; Ex. 11) Even Shanahan Jr.'s own expert acknowledged that the evidence showed Shanahan Jr. was involved in pricing stock options. (*Id.*, Ex 15 at 182-85)

In addition, ESSI's stock option plans charged the Compensation Committee with administration of the stock option plan -- not Gerhardt and Landmann. This fact cannot be

[7] The testimony of other the other Compensation Committee members about their own roles in the options process is essentially irrelevant. It may well be that the other Committee members were not involved in pricing decisions, and there is little evidence to suggest that they were. But their testimony highlights the unusual and clandestine nature of Shanahan Jr.'s option pricing activities, rather than exonerating him.

reconciled with Shanahan Jr.'s assertion that pricing determinations were not the job of the Compensation Committee. If his option pricing discussions were not undertaken as a member of the Compensation Committee, then it is unclear exactly what purpose (and whose interests) he was serving when he passed those option prices to Gerhardt. A reasonable jury could find that Shanahan Jr. was part of scheme with Gerhardt, Landmann and Shanahan Sr. to backdate stock options, in order secretly boost executive compensation at ESSI.

2. Shanahan Jr. Aided and Abetted ESSI's Recordkeeping Violations.

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." 15 U.S.C. § 78m(2)(A). ESSI violated Section 13(b)(2)(A) by failing to make and keep books and records that accurately reflected the dates ESSI's options were awarded, a necessary component to determining the options' exercise prices. (*See* Ex. 23, Shanahan Sr. Plea Agreement, at 12-13)

On summary judgment, the Commission satisfies the knowledge requirement for the same reasons set forth above. Shanahan Jr. signed numerous Forms 10-K and Forms S-8 containing the false disclosures about option pricing. (*Id.* at 10-11) He also reviewed and signed ESSI's proxy statements, which were approved by ESSI's Board of Directors, and which contained the false option pricing disclosures. Indeed, the recurring statement that all options granted to date had an exercise price equal to the fair market value of ESSI's common stock on the dates the options were awarded resided in the Report of the Compensation Committee. A reasonable jury could conclude that this report would have been of particular interest to the members of the Compensation Committee, since it bore their individual names. Therefore, for purposes of summary judgment, it can be inferred that Shanahan Jr. was aware of the

misrepresentations about option pricing. It must also be assumed that he provided Gerhardt with false grant dates.

Because Shanahan Jr. conveyed false grant dates within ESSI and misrepresented how options were priced to the public, he should have reasonably foreseen that his actions would cause ESSI to incorrectly record the date for which ESSI's stock options were granted. This easily satisfies the substantial assistance requirement for aiding and abetting liability. *See* SEC v. Johnson, 530 F. Supp. 2d 325, 337 (D.D.C. 2007) (substantial assistance occurs where primary violation is "'direct or reasonably foreseeable result'" of aider and abettor's conduct) (citation omitted). By providing false grant dates to Gerhardt and Landmann, Shanahan Jr. provided substantial assistance to ESSI's failure to properly record the grant dates and exercise prices of its options. The evidence shows that Shanahan Jr. was the actual conduit between the Compensation Committee and management about his father's compensation, and about stock options.

Indeed, according to their testimony Gerhardt (and ultimately Landmann) both were dependent upon Shanahan Jr. and certain others to accurately report to them the dates the Compensation Committee granted the options, as they had no independent knowledge of those dates. Thus, Shanahan Jr.'s involvement was an actual cause of ESSI's violations. *See* SEC v. May, 2009 WL 2634876, at *7 (D.D.C. Aug. 28, 2009) (denying summary judgment for aiding-and-abetting claim based upon evidence that defendant helped facilitate improper deferral of revenue recognition until fourth quarter by providing a rationale for such deferral and by executing payment the first day of the quarter); SEC v. Delphi Corp., 2008 WL 4539519, at **22-23 (E.D. Mich. Oct. 8, 2008) (defendant's artful drafting of vague side letter constituted aiding-and-abetting of fraud by the counterparty to letter).

Shanahan Jr. argues that he cannot be liable for aiding and abetting books and records violations because the Compensation Committee had no obligation to keep records. Docket No. 108, (Shanahan Jr. Memo. at 7) However, this argument does not authorize Shanahan Jr. to transmit false dates to Gerhardt, who passed them to Landmann. Shanahan Jr.'s actions had the effect of corrupting ESSI's books and records – which is more than sufficient to establish aiding and abetting liability.

B. ESSI's Misstatements Were Material.

Securities fraud claims may not be dismissed on summary judgment on materiality grounds unless the misstatements "would have been so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." Azrielli v. Cohen Law Offices, 21 F.3d 512, 518 (2d Cir. 1994); *see also* Connett v. Justus Enters, 68 F.3d 382, 384 (10th Cir. 1995) (same). Shanahan Jr. offers practically nothing to show that such information was unimportant to investors, and does not even attempt to address the Commission developed during discovery. (*See e.g.*, Landmann Declaration at ¶¶ 3-11; Statement of Disputed Facts at ¶¶ 27-29) Therefore, it would be improper to conclude at this stage that options backdating was immaterial to investors as a matter of law. Courts have routinely rejected similar arguments in other options backdating cases. Finally, Shanahan Jr. ignores the different materiality standard for Section 14(a) of the Exchange Act, and appears to apply the same materiality standard to all of the Commission's claims.

1. The Commission Has Developed Evidence that Options Backdating Was Important to Investors and Their Evaluation of ESSI.

For a false statement to be material, there must be a substantial likelihood that the misstatement would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available to the investor. Basic v. Levinson, 485 U.S. 224,

231-32 (1988) (*quoting* TSC Indus. Inc. v. Northway Inc., 426 U.S. 438, 449 (1976)). A fact is material if a reasonable investor would attach importance to it in determining his choice of action. SEC v. First Am. Bank & Trust Co., 481 F.2d 673, 679 (8th Cir. 1973). A fact need not be outcome determinative in a reasonable investor's decision-making to be material. Folger Adam Co. v. PMI Indus., Inc., 938 F.2d 1529, 1534 (2d Cir. 1991) (reversing jury finding based on district court's materiality charge and erroneous jury instruction suggesting fact must be outcome-determinative).

Shanahan Jr. has failed to establish that the misrepresentations relating to the options plans would have been indisputably immaterial to investors' evaluation of ESSI. In fact, the Commission has developed evidence that proves that options backdating and options pricing was material to investors. 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. (Docket No. 106, Plaintiff's Statement of Undisputed Material 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, another prominent investor, who at one time managed as much as $130 million for clients and controlled approximately 3% to 4% of ESSI's outstanding common stock, testified that he regularly reviewed ESSI's annual reports and proxy statements, and that he reviewed the proxy statements specifically for information about management compensation, including stock options. This investor testified that he 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 Jr. has neither addressed nor refuted this testimony.

The cases cited by Shanahan Jr. are poor comparisons due to the size of the misstatements. One involved a 2% overstatement of assets. Parnes v. Gateway 2000, Inc., 122 F.3d 539, 547 (8th Cir 1997). Another had a mere 0.19% overstatement of revenues, SEC v. Thielbar, 2007 U.S. Dist. LEXIS 72986, at *7 (D.S.D. Sep. 28, 2007). In SEC v. Cohen, the court refused to accept defendants' proposed 2% litmus test for materiality, noting that such a test failed to account for the cumulative effect of several misstatements. 2007 U.S. Dist. LEXIS 28934, at **42-43 (E.D. Mo. Apr. 19, 2007). The district court ruled that the misstatements were immaterial only after a trial on the merits. *Id.* at **45-46. Many courts have rejected making hasty determinations on materiality based on the size of the misstatements. *See, e.g.*, In re Global Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319, 342 (S.D.N.Y. 2004) (denying motion to dismiss, $20 million overstatement of revenue for company that reported $3.7 billion revenue was not per se immaterial).

However, the intrinsic value of ESSI's stock option grants on the day they were granted constituted a significant amount relative to ESSI's earnings, with the amounts ranging from 5% to 42% of net income each year.[8] (*See* Hlavacek Declaration at ¶¶ 5-7) Thus, a reasonable jury could conclude that backdating was material to ESSI investors. *See* SEC v. Lucent Techs, Inc., 363 F. Supp. 2d 708, 725 (D.N.J. 2005) (13% overstatement of pretax income was not immaterial as a matter of law); Primavera Invs. v. Liquidmetal Tech., Inc., 403 F. Supp. 2d 1151,

[8] There are many considerations that go into calculating the amount by which ESSI's financial statements were misstated, including tax considerations as well as variable accounting rules for ESSI's options that were repriced. Since the Commission is not alleging accounting fraud, such an analysis is unnecessary in this case. These percentages do not purport to represent the exact amount of earnings overstatement, but are provided merely as a guide to show the significance of the backdated awards relative to ESSI's earnings.

1155, 1157 (M.D. Fla. 2005) (denying motion to dismiss, 20% overstatement of earnings from continuing operations due to failure to properly expense stock options under GAAP was material). In 2004, ESSI recognized a $4.96 million expense resulting from the modification of terms of stock options for ESSI's Chief Executive Officer, Gerald Daniels. By comparison, the intrinsic value of ESSI's backdated stock options approximated $6.8 million in 2001 and $9.9 million in 2002, at a time when ESSI had significantly less revenues and earnings.

The cases cited by Shanahan Jr. are also poor comparables because ESSI's misrepresentations were not mere accounting errors. In fact, most of the misstatements appeared in the proxy statements, not the financial statements and involved executive compensation and abuse by management and directors, which is an area of heightened significance to investors *regardless* of materiality to the company's financial statements. *See* Disclosure of Mgmt. Remuneration, Sec. Act Rel. No. 5,856, 1977 SEC LEXIS 1023, at **6-7 (Aug. 18, 1977) ("Full disclosure of remuneration is necessary to informed voting and investment decisions"); 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 for the Commission and finding president's misappropriation of approximately $500,000 through kickbacks and false travel claims was material); Siemers v. Wells Fargo & Co., 2007 U.S. Dist. LEXIS 31287, at *26 (N.D. Cal. Apr. 17, 2007) ("*any* intentional misappropriation from the common fund would have been material to investors. The integrity of management is always of importance to investors. That a fiduciary has been misappropriating the common fund -- even in

small amounts – would be important to investors, for the next misappropriation or defalcation could be larger.").

In stock option backdating cases, courts routinely recognize that backdating is material to investors – both from a quantitative and qualitative perspective. *See*, *e.g.*, Bendaoud v. Hodgson, 578 F. Supp. 2d 257, 279 (D. Mass. 2008) (materiality could not be determined on motion to dismiss despite minimal impact on net income; proper disclosure of backdated options may have made reasonable investor question whether other malfeasance would occur in the future, particularly in the face of alleged fraud by officers over a substantial period of time); In re Zoran Corp. Derivative Litig., 511 F. Supp. 2d 986, 1015 (N.D. Cal. 2007) ("A reasonable shareholder would consider information revealing self-dealing by the board material in deciding how to vote. A reasonable shareholder would certainly want to know that the board was feathering the nests of insiders via backdated options to the detriment of stockholders at large."); Britton v. Parker, 2009 U.S. Dist. LEXIS 87829, at **25-26 (D. Col. Sep. 23, 2009) (finding omission of backdating to be material; "[i]t does not strain credulity to believe that an investor deciding whether to approve an Incentive Plan would likely consider it important to know that the company's Directors had previously disregarded and abused a similar Incentive Plan. Nor can the Court say that a reasonable shareholder would consider such conduct by a Director unimportant when considering whether to re-elect that Director to another term."); Comverse, 543 F. Supp. 2d at 151 ("it is plainly material to investors that executives of a company are acting fraudulently"; noting that executives who engage in fraud may subject company to risk of legal action and may use company's resources for their own ends rather than to benefit shareholders).

In SEC v. Reyes, 491 F. Supp. 2d 906 (N.D. Cal. 2007), the district court faced identical arguments posed to this Court, and it denied the defendants' motion for summary judgment.[9] Like ESSI, Brocade Communications Systems, Inc. enjoyed tremendous growth, with revenue growing from $68 million to $600 million in six years.[10] *Id.* at 909. However, the court rejected the argument that Brocade's incredible growth made backdating immaterial as a matter of law, noting that "it does not matter that Brocade was, or is, a successful business enterprise. Profitable companies, too, owe a duty of honesty to their shareholders." *Id.*

The court also rejected the defendants' argument that non-cash option expenses cannot be material. *Id.* at 910-11. The court noted that:

> Investors may care most that a company is profitable, but they may also find it significant that a profitable company is meanwhile giving away assets in the form of discounted treasury stock. However inchoate such expenses may be, the Court cannot conclude that they are necessarily unimportant to investors. To hold that such non-cash or non-GAAP expenses are immaterial as a matter of law would provide amnesty for companies to deceive shareholders about any items or expenses that do not appear on "pro forma" or "non-GAAP" earnings statements.

Id.

Lastly, the court rejected the argument that a company's fair value footnote disclosures would cure the misrepresentations regarding option pricing. *Id.* at 914. The court noted that FAS 123 footnotes do not require summary judgment because: (1) they appear only once a year,

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[9] Counsel for Shanahan Jr. represented a defendant in that case as well, and joined the motion for summary judgment at issue. (*See* SEC v. Reyes, Case No. 06-cv-04435-CRB in the U.S. District Court for the Northern District of California, at Docket No.125)

[10] ESSI's stock performed well during from 1996 through 2002, but most of that strong performance came in 2001 and in the post-9/11 years. From 1997 through 1999, which encompassed half of the period of ESSI's backdating scheme, ESSI substantially underperformed as compared to the NASDAQ Composite Index. (Hlavacek Decl. at ¶¶ 8-14 and Exs. B- E) Shanahan Jr.'s argument that ESSI was a "can't miss" investment ignores the years when the company's stock price lagged behind other investments, and actually declined. Accordingly, a reasonable jury could conclude that ESSI's stock price success would not have insulated the company from investor scrutiny about executive compensation, particularly undisclosed compensation in the form of backdated stock options.

as opposed to quarterly for APB 25 expenses; (2) the FAS 123 disclosures never disclosed the granting of in-the-money options and the immediate transfer of wealth; and (3) the fact that the company chose to apply APB 25 and relegate a fair value calculation to footnote disclosures shows that it mattered, as the company could avoid recognizing formal stock option expenses. Id. at 914-15. The court held that, "[a] reasonable juror could conclude that shareholders would find it important that a company is giving away treasury stock at below-market rates." Id. at 914. The court noted the difference in incentives from in-the-money and at-the-money grants, and concluded that:

> By disguising grants with intrinsic value as having none, backdating gives a distorted picture of the incentives actually created by stock options. It suggests to investors that the option is a carrot, when it is truly, at least in part, a gift . . . investors recognize and care about the incentives created by stock options, which are arguably mischaracterized by backdating. A jury could conclude that this illusory incentive – which is not dispelled by any of the information contained in the FAS 123 footnotes – would be material to reasonable investors.

Id. Shanahan Jr. has offered no explanation of how this case is distinguishable from Reyes.

2. The Commission Has Developed Evidence that Options Pricing Was Important to How Investors Voted.

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.'" Northway, 426 U.S. at 449. It is not necessary to show that accurate disclosure would have caused an investor to act differently. *Id.* 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.

The Commission has developed evidence to create a genuine issue of fact as to the materiality of ESSI's misrepresentations in its proxy statements, and Shanahan Jr. has not refuted this evidence. As discussed above, two analysts and an ESSI investor testified that they would have wanted to know about options backdating. In addition, Fidelity Investments, ESSI's largest

institutional shareholder, had guidelines against voting for any stock option plan that permitted pricing at below fair market value that, as a fiduciary, the firm was required to follow. (Landmann Declaration at ¶¶ 6, 8 and Exs. B-C) In fact, Fidelity voted against ESSI's stock option plans in 2000 and 2002 because the plans did not comport with another aspect of those guidelines. Also undercutting Shanahan Jr.'s argument that backdating would have been immaterial to investors, is the fact that ESSI's investors actually rejected ESSI's proposed stock option plan in 2002 due to the large share allotment. (*Id.* at ¶¶ 7, 9) Only after lowering the number of allocated shares did ESSI receive shareholder approval for a new option plan later that year. Similarly, in 2000, after initially resisting, ESSI amended its 2000 employee stock option plan to include a clause prohibiting repricing of options in order to obtain institutional support for the plan. ESSI's investors scrutinized ESSI's stock option plans, and there is no support for Shanahan Jr.'s contention that how ESSI priced its stock options would not have mattered to a reasonable investor.

To the contrary, misstatements relating to the nature, purpose, or value of stock grants are often deemed to be material as a matter of law. *See* Parsons v. Jefferson-Pilot Corp., 789 F. Supp. 697, 702 (M.D.N.C. 1992) The facts in this case are very similar to Parsons, as ESSI misled investors that ESSI's stock option program was designed to tie management's interests to shareholder return, yet it offered instant compensation to option recipients through in-the-money grants.

Finally, 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 v. Swartz, 303 F.3d 147, 151 (2d Cir. 2002). 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). Thus, the misrepresentations regarding the pricing of stock options under ESSI's stock option plans were material. Resnik, 303 F.3d at 151; *see also* Shaev 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).

CONCLUSION

Wherefore, for all of the foregoing reasons, the Court should deny Shanahan Jr.'s Motion for Summary Judgment.

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