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) Honorable Jean C. Hamilton

REPLY IN SUPPORT OF SHANAHAN JR.'S MOTION FOR SUMMARY JUDGMENT

Faced with a lack of record evidence that Shanahan Jr. actually knew of the options dating improprieties at ESSI, the SEC addresses the defects in its aiding and abetting case by hand-waving in the general direction of evidence that is both undisputed and besides the point. No doubt there is a wealth of evidence that options at ESSI were improperly priced. No doubt the evidence also shows that ESSI's controller and lead accountant, Steven Landmann, implemented the dating improprieties at the direction of ESSI's Chief Financial Officer, Gary Gerhardt. No doubt a multitude of persons at ESSI had something to do with options administration. But the central question raised in this motion is a different one: what evidence is there, if any, that Shanahan Jr. *knew* about the options improprieties at ESSI, and what evidence, if any, is there that he *aided and abetted* that wrongdoing? On these points, the SEC's Response falls woefully short.

Although summary judgment is the time to test whether the plaintiff has developed enough evidence to create material issues of fact sufficient to go to the jury, the SEC does little in its Response to marshal any evidence at all. Instead, the Response spins a narrative largely consisting of irrelevant and inflammatory detail, coupled with conjecture, rhetoric, and vaporous

references to the "Commission's documentary, testimonial and expert evidence."[1]

With respect to materiality, the SEC tries to avoid summary judgment in several ways, none of them successful. Most notably, it attempts to inject into these proceedings, for the first time, evidence of the financial impact of ESSI's improperly-dated options by means of a "summary" attached to the Declaration of Scott Hlavacek, an SEC staff accountant who simply relied on supposedly "actual" grant dates *given to him by SEC staff attorneys*. The Hlavacek Declaration offers no admissible support for the SEC's position. With nothing concrete to support its claims of materiality, the SEC cites extensively (but unpersuasively) to out-of-circuit authority in order to avoid the particularly stringent standard of materiality under prevailing Eighth Circuit law. And finally, the SEC invites the Court to bypass the standard of materiality altogether by finding that investors can always find allegations pertaining to intentional wrongdoing by management to be material, or by finding that the scope of disclosure under SEC regulations is coextensive with materiality. The Court should decline all of these invitations.

I. ARGUMENT

A. The SEC Has Adduced No Competent Evidence of "Knowledge" and/or "Substantial Assistance" to Withstand Summary Judgment on Claim VI (Aiding and Abetting "Reporting" Violations)

The parties agree that in order to establish aiding and abetting liability, the SEC 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. The SEC's Response confirms its theory of aiding and abetting in Claim VI of the Complaint (aimed at "reporting" violations): ESSI committed the primary violation by including in its 10-K reports the Options Pricing Sentence ("Options granted are at an option price equal to the market value on the date the option is granted"), which Shanahan Jr. aided and abetted by electronically signing the 10-Ks despite his alleged knowledge that options had not been priced on the "date of the grant."[2] This theory fails as a matter of law

[1] See Pl.'s Resp. to Shanahan Jr.'s Mot. for Summ. J. ("Plaintiff's Response") at 10, filed November 2, 2009 (Docket No. 130).

[2] Plaintiff's Response at 8.

and undisputed fact for several reasons.

1. The SEC, in Trying to Promote a Theory that the Options Pricing Sentence Was "Obviously" False, Ignores the Evidence as to How Options Were Actually Granted at ESSI

First and foremost, the SEC's theory fails because it presumes – contrary to all the evidence in this case – that the "date of the grant" was easily ascertainable even to a layman. The SEC's unspoken assumption underlying its theory is that the proper grant date was the date of an imagined and ideal Compensation Committee meeting in which all of the members of the Committee met in person at the same time, and approved all of the grants at the end of the meeting, with no changes or mistakes between approval and paperwork implementation. This theory's fatal flaw, however, is that it *completely disregards what the evidence has shown as to how options were actually granted and administered at ESSI* .

What discovery has shown is that the granting of options at ESSI was not a simple process of approval at a single meeting, but an unstructured, perhaps even disorganized, process with multiple steps. It typically started with the making of recommendations as to which employees should get how many options; continued with refinements to the lists of optionees; included input from management and the Compensation Committee; involved approval by the Compensation Committee but not necessarily all at once in a formal meeting; often involved refinements to the list after initial approval by the Compensation Committee; and culminated in paperwork and accounting by the Finance Department.

This process was so disorganized because the two people who knew the rules – Landmann and Gerhardt – gave no direction. And absent any guidance as to how the option granting process should be done, a collection of lay people were left to do the best they could, believing (understandably) that the company's lead CPA (Landmann) and CFO (Gerhardt) would ensure that the procedures were in compliance with applicable accounting and disclosure rules. A prime example is the option dated July 24, 2002, cited extensively by the SEC in its Response.[3] On July 16, 2002, Shanahan Jr. wrote to Gerhardt that ESSI "might as well issue the

[3] The relevant email trail is set forth in SEC's Statement of Facts at Exhibit 11. See Pl.'s Statement of Facts as to Which a Genuine Issue Exists ("Plaintiff's Statement"), Ex. 11, filed

options at the price that we agreed upon at the last meeting with Gen. Lewi. Let's get the options to the office of the Chairman done today and we can issue the others when the final list is completed."[4] Later that day, Shanahan Jr. wrote to Gerhardt conveying that "[p]er Comp Committee" options should be issued to four individuals in certain amounts (but without naming any particular strike price).[5] On July 24, ESSI stock hit a low point for the quarter. The next day, Shanahan Jr. sent an email to Gerhardt, Landmann, and Gen. Lewi, noting that the stock price had hit a low and inquiring: "Can we go with the lower number? Do we need to have a comp. meeting to do it? Let me know."[6] The testimony is in dispute as to what if anything Landmann said in response,[7] but in any event, the options still had not been issued as of August 8, apparently due to the fact that the company's general counsel (David Mattern) had been inadvertently excluded from the options list.[8] Later on August 8, Shanahan Jr. suggested that Gerhardt and two other executives contribute 10,000 options apiece to Mattern, and on August 12, the last of the paper trail shows Shanahan asking Gerhardt "what did you decide."[9] 40,000 options were given to Mattern as part of this grant; another 40,000 to Landmann; and varying amounts to the four executives on the July 16 email.[10] When the options were eventually issued by the Finance Department, they bore a grant date of July 24 and a strike price consisting of the fair market value of ESSI stock on that date.

November 2, 2009 (Docket No. 131).

[4] See *id.*, Ex. 11 at 2.

[5] *Id.* at 3.

[6] *Id.* at 4.

[7] Shanahan Jr. testified that he was looking to Landmann, Gerhardt, and Gen. Lewi "for direction." See Declaration of Stuart L. Gasner ("Gasner Decl."), Ex. A (Shanahan Jr. Depo.) at 307:25-308:6. Landmann testified that he informed Shanahan Jr. that "ideally," a meeting should be held, but did *not* say that he told Shanahan Jr. that it would be wrongful not to hold a Comp Committee meeting. See Gasner Decl., Ex. B (Landmann Depo.) at 172:12-174:4.

[8] Shanahan Jr. testified that it was not uncommon for Mattern to be "forgotten" by the Comp Committee. See Gasner Decl., Ex. A (Shanahan Jr. Depo.) at 234:19-235:8 (explaining that because Mattern "was kind of general counsel and he was kind of off to the side, he was the conduit to the outside professionals…he's not in manufacturing. He's not in accounting. He's not in marketing. Sometimes [the Comp Committee] would forget about him."); see also *id.* at 311:23-312:6.

[9] See Plaintiff's Statement, Ex. 11 at 8.

[10] Hlavacek Decl., Ex. A at 9.

Under the SEC's theory, Shanahan Jr. aided and abetted ESSI's securities violation when in January 2003 (roughly five months later) he signed a 10-K stating that "[o]ptions granted are at an option price equal to the market value on the date the option is granted." But when *was* the July 24, 2002 option "granted" if not on July 24, 2002?

- Arguably that *was* a correct grant date given Shanahan Jr.'s contemporaneous inquiry on July 25. Had a Comp Committee meeting been convened that day (as Shanahan Jr. essentially volunteered to do) before the stock market closed, it could have been appropriate to use the stock price from the day before, which would have been the last stock price known at the time of the Comp Committee meeting.

- Should the proper grant date have been at the time of the "last meeting with General Lewi," as referred to in Shanahan Jr.'s July 16 email?

- Why shouldn't the proper grant date be the date of the July 16 email itself, when Shanahan Jr. noted that "per the Comp Committee" options in particular amounts were to be issued that day for the Office of the Chairman?

- Why shouldn't the grant date be no later than July 25, when Shanahan Jr. noted the relative low point in the stock?

- If Mattern was inadvertently omitted, why wouldn't his options be deemed granted on the date the rest of the group was awarded their options?

Whatever the "correct" answer is, it strains credulity for the SEC to claim that the average lay person would have discerned that the date of the grant – and not just for Mattern, but for *all* of the persons on the list – should have "obviously" been any particular date. Indeed, against the backdrop of these haphazard practices for obtaining approval for option decisions, Shanahan Jr. was entitled to rely upon Landmann – a Certified Public Accountant and author of the stock option plans – to ensure that ESSI's securities filings conformed to accounting rules and ESSI's stock option plans.

Nor can the Options Pricing Sentence as it appeared in the 2002 10-K months later be deemed obviously false. In fact, when reminded of the facts of the July 2002 option grant at his deposition, and asked whether a meeting of the Comp Committee – either face-to-face or over the telephone – would have made it appropriate to use a grant date of July 25, Landmann himself – ESSI's controller and top-ranking CPA – could not say.[11]

The SEC's theory – that Shanahan Jr. aided and abetted a securities violation because the Option Pricing Sentence was somehow so obviously false that any lay person could have seen it as such – is just wrong, and is not supported by any evidence. The reality is that the option granting process at ESSI was an ongoing, and somewhat haphazard, process for which determining the "date of the grant" had no easily discernible answer.

2. The Grant Date is an Accounting Concept and the SEC Should Not Be Permitted to Play Word Games to Avoid Its Judicial Admissions

In any event, whatever answer there is to the question of when the July 24, 2002 option (or any other option in this case) was "actually" granted was largely governed by *accounting* principles.[12] According to plaintiff's own expert, the "grant date" of options issued under ESSI's stock option plan was the same as the "measurement date" – an accounting principle.[13] During the period in question, the relevant authority was an accounting opinion known as "APB 25," which provided that the "measurement date" of an option should be "the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any."[14]

While the accounting rule is easy to state, it can be difficult to apply to particular fact patterns. With respect to the July 2002 option, for example, when *was* the earliest date that one could say the identity of the optionees was known, together with the number of shares and the price? What is to be made of the efforts to rectify the inadvertent exclusion of Dave Mattern, which apparently resulted in some optionees "giving" Mattern some of their shares? Indeed, when asked whether it would have been appropriate to use an earlier grant date with respect to an

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[11] See Gasner Decl., Ex. B (Landmann Depo.) at 174:14-177:19.

[12] As Ernest Ten Eyck testified, some issues relating to option grant dates are essentially legal in nature, because there is no "plain English understanding of the date the option is granted" and ESSI's stock option plan itself provided no definition. See Gasner Decl., Ex. C (Ten Eyck Depo.) at 124:15-126:21.

[13] See Gasner Decl., Ex. D (Heron Depo.) at 50:17-23, 52:11-15. Similarly, one of ESSI's former auditors testified that he believed the term "grant date" was defined in APB 25. See Gasner Decl., Ex. E (Briggs Depo.) at 188:18-189:9.

[14] See Huber Decl., Ex. 15 (Ten Eyck Report) at 6 (quoting APB 25 ¶ 10(b)); Gasner Decl., Ex. D (Heron Depo.) at 220:13-17. APB 25 also states that for most plans, the "measurement date" is "the date an option or purchase right is granted or stock is awarded to an individual employee." See Huber Decl., Ex. 15 (Ten Eyck Report) at 9.

employee who had been inadvertently omitted from a list of option recipients as an "oversight," Dan Kreher – the head of Investor Relations at ESSI and a CPA who assisted Landmann in the preparation of public filings – candidly stated that he would have to "look to accounting literature and see what the accounting definition of a grant date might be."[15] While the SEC's position appears to be that the July 24, 2002 grant should have been priced as of August 8, 2009,[16] that determination necessarily relies on *accounting* tools that require the exercise of accounting judgment. And even for a CPA who knew where to look, the accounting literature often did not provide definitive guidance as to the right answer under specific facts and circumstances.[17] Potential confusion under APB 25 was amply illustrated throughout the testimony of various CPAs and experts in this very litigation, who wrestled with determinations of the appropriate grant date for a variety of factual scenarios.[18] Indeed, in September 2006, the Office of the Chief Accountant of the SEC took the unusual step of issuing a letter to provide its own interpretive gloss on "whether a company's determination of the measurement date of past stock option awards was appropriate."[19] And in that opinion, the SEC went in a completely different direction than most companies and CPAs had gone in the past, opining that the proper grant date should be postponed until the granting process was complete and the terms and recipients of option awards were known with finality, a ruling that typically served to shift the grant date to a later date.[20]

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[15] See Gasner Decl., Ex. F (Kreher Depo.) at 196:1-21.

[16] See Hlavacek Decl., Ex. A (using August 8 price for basis of calculation of backdating "gain").

[17] See Gasner Decl., Ex. F (Kreher Depo.) at 199:11-200:6; Huber Decl., Ex. 15 (Ten Eyck Report) at 8. For example, accountants struggled with questions such as "(1) Did changes to lists mean the grant dates changed for an entire grantee list, or just for those grantees that had their number of options adjusted? (2) Did administrative errors, subsequently corrected, require an adjustment to the grant date?" See Huber Decl., Ex. 15 (Ten Eyck Report) at 10.

[18] See, e.g., Gasner Decl., Ex. D (Heron Depo.) at 223:23-225:6; Gasner Decl., Ex. B (Landmann Depo.) at 174:18-177:19; Gasner Decl., Ex. F (Kreher Depo.) at 196:1-21; Gasner Decl., Ex. G (Harsin Depo.) at 25:21-26:3, 50:11-51:2, 61:1-18; see also Huber Decl., Ex. 15 (Ten Eyck Report) at 9-10 (describing a number of questions relating to grant date determinations that arose "during a time when the accounting profession's best 'brain power' was focused on this issue in connection with restating many registrant filings").

[19] See Huber Decl., Ex. 15 (Ten Eyck Report) at 11-12.

[20] See *id.*

The SEC has admitted that Shanahan Jr. had no knowledge of the accounting rules governing option grants.[21] As such, Shanahan Jr. could not have appreciated the wrongfulness of Landmann's and Gerhardt's improper options dating activities – the essence of the aiding and abetting violation.

Seeking to avoid this logic, the SEC's Response engages in semantic somersaults, arguing that "Shanahan Jr. was not required to determine the measurement date, but rather the closing stock price on the *actual date of the grant decision*."[22] But determining the "actual date of the grant decision" is no different than determining the "date of the grant." Both inescapably require an understanding of the applicable accounting concepts. The SEC attempts to defuse the impact of its judicial admissions by claiming that its expert, Randall Heron, has opined that "no special knowledge of accounting was required to understand the language of ESSI's stock option plans." But that subtly changes the question, and in any event misstates Heron's expert report. What Heron actually wrote was that "no special knowledge of *APB 25* was required to *administer* the stock option plan."[23] When read in context, it is clear that what Heron meant was that a person administering the stock option plan did not have to know that if the "date of the grant" or award was not the same as the "measurement date" as defined by APB 25, it would require the company to record a compensation expense. Heron did not say that one did not have to know anything about accounting principles in order to determine when the proper grant date should be. Indeed, he testified otherwise at his deposition: based on his reading of ESSI's option plan, he concluded that the definition of "grant date" is the same as APB 25's definition of "measurement date."[24]

The SEC has properly and candidly admitted that Shanahan Jr. had no idea what the accounting rules were that governed options dating. In light of this admission, it is also true that Shanahan, Jr. could not have aided and abetted options dating conduct that he was not in a

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[21] See Huber Decl., Ex. 12 (Plaintiff's Admissions) at 9 and 12.

[22] Plaintiff's Response at 11 n.5.

[23] Gasner Decl., Ex. H (Heron Rebuttal Report) at 3-4 (emphases added).

[24] Gasner Decl., Ex. D (Heron Depo.) at 50:15-52:15.

position to understand as wrongful.

B. The SEC Has Adduced No Competent Evidence of Knowledge and/or Substantial Assistance to Withstand Summary Judgment on Claim VII (Aiding and Abetting "Recordkeeping" Violations)

Claim VII of the Complaint purports to assert that Shanahan Jr. aided and abetted ESSI's recordkeeping violations under a variety of statutory provisions. In an earlier motion to dismiss before this Court, Shanahan Jr. contended that the Complaint was defective because it made no effort to indicate which factual allegations were pertinent to Count VII. In opposition to the motion, the SEC replied that dismissal was not appropriate because it "did separately allege the basis for its claim of aiding and abetting violations of Section 13(b)(2)(A) of the Exchange Act – that Shanahan Jr. failed to ensure that the Compensation Committee kept records reflecting the dates on which the committee authorized option grants. (See Compl. at ¶ 26)."[25]

Armed with this characterization of Claim VII and hearing no other allegations of a primary recordkeeping violation, the defense proceeded to take discovery. What the depositions revealed was that the members of the Comp Committee – including the Chairman, Gen. Lewi – did not believe that it was a requirement to keep Comp Committee minutes;[26] that Gen. Lewi took on the role of serving as the liaison to the rest of the Board and that he considered it a matter of discretion as to whether he should keep a written record of Comp Committee meetings at all;[27] and that ESSI's former auditors knew that there were no written Compensation Committee records, and did not view it as a required practice.[28]

Faced with this undisputed evidence, the Plaintiff's Response attempts to shift the factual predicate of Count VII by claiming that the primary violation is directed to unidentified "books and records." Having already avoided dismissal of this count by unequivocally limiting itself to

[25] Pl.'s Resp. to Shanahan Jr.'s Mot. to Dismiss at 14 n.12, filed September 26, 2008 (Docket No. 43). The SEC repeated this factual basis in the body of its opposition: "The Commission has alleged that the Compensation Committee was responsible for administering the option program and that, as a member of the Committee, Shanahan Jr. failed to ensure that the Committee kept records of their actions. (Compl. at ¶ 26)." *Id.* at 14.

[26] See Plaintiff's Statement at 10-11.

[27] *Id.*

[28] *Id.* at 12.

the factual allegations asserted in Paragraph 26 of the complaint,[29] the SEC may not avoid judgment by shifting the target. Cf. *Romine v. Acxiom Corp.*, 296 F.3d 701, 706 (8th Cir. 2002) ("While notice pleading does not demand that a complaint expound the facts, a plaintiff who does so is bound by such exposition.") (citation and quotation marks omitted); see also *Wasco Prods. Inc. v. Southwall Technologies, Inc.*, 435 F.3d 989, 992 (9th Cir. 2006) ("Simply put, summary judgment is not a procedural second chance to flesh out inadequate pleadings.") (internal quotations omitted)

The Court should grant summary judgment to Shanahan Jr. on Count VII because no reasonable factfinder could conclude that any action on Shanahan Jr.'s part constituted knowing and substantial assistance of a wrongful failure to keep Comp Committee minutes. 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").

C. The SEC Cannot Rely on Recklessness, Inadmissible Speculation, "Red Herrings" or Procedural "Gotchas" as a Substitute for Evidence of Aiding and Abetting

With no competent evidence to back its actual theories of aiding and abetting, the SEC's Response dwells at length on sideshows, suggesting variously: (1) the SEC need not show actual knowledge at all, but can show recklessness instead; (2) Shanahan Jr.'s acceptance of responsibility in his Diversion Agreement is evidence of aiding and abetting; (3) Shanahan Jr.'s assertion of his Fifth Amendment privilege during the SEC's investigation is evidence of a guilty state of mind, even though Shanahan Jr. has since testified at length; (4) Shanahan Jr.'s handling of compensation issues that have nothing to do with backdating should be used to infer knowledge of a wrongful scheme; and (5) the Court should rely on the speculative and foundation-less proffer of Gary Gerhardt, prepared by his lawyers during aborted plea

[29] Paragraph 26 of the Complaint reads in entirety: "Shanahan Jr. also assisted in the Company's concealment of its backdating and caused the Company to fail to keep proper records reflecting its option grants. As 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."

negotiations.

None of these sideshows have merit, nor do they prevent the Court from granting summary judgment and narrowing this case.

1. The SEC Cannot Rely on Recklessness to Show Actual Knowledge

As the Eighth Circuit has long observed, knowledge is a "critical" element for a claim of aiding and abetting liability, lest liability be imposed for simply "aiding." See *Camp v. Dema*, 948 F.2d 455, 459 (8th Cir. 1991). While reciting the stringent standard above, the SEC tries to avoid it by suggesting that "severe recklessness" will suffice as a substitute for knowledge under certain circumstances. That argument fails for two reasons.

First, the SEC's Complaint alleges *only* that the defendants "knowingly" aided and abetted the primary violations.[30] The SEC knew how to plead reckless behavior where it intended to do so. See Compl. at ¶¶ 53, 56, 59 (alleged "knowingly" and "recklessly"). Having limited its pleading to "knowing" behavior, the SEC cannot now resurrect a recklessness theory.

Second, while some older cases permitted severe recklessness to satisfy the knowledge requirement of the aiding and abetting violation where the defendant owed a fiduciary duty, see *Camp*, 948 F.2d at 459-60, that is no longer the law. In *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), the Supreme Court held that private plaintiffs may not maintain aiding and abetting suits at all under Section 10b-5 of the Securities Exchange Act. As part of the Private Securities Litigation Reform Act in 1995, Congress (in addition to more well-known reforms to securities litigation discovery) allowed the Securities and Exchange Commission to bring such aiding and abetting claims, but limited those actions to instances of "knowing" behavior. The statute provides:

> For purposes of any action brought by the Commission under paragraph (1) or (3) of section 78u(d) of this title, any person that knowingly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

[30] See Compl. at ¶¶ 70, 74, filed July 12, 2007 (Docket No. 1-1). Nor is the SEC entitled to claim that when it alleged "knowing" conduct, it meant both knowing and reckless behavior. The complaint must be read as a whole.

15 U.S.C. § 78t(e) (1995) (emphasis added). Therefore, under the plain language of the statute, it must now be shown that the defendant had "actual knowledge" of the wrongful purpose of the primary violator. See *SEC v. Fehn*, 97 F.3d 1276, 1288 n.11 (9th Cir. 1996) ("Section 104, by its plain terms, requires 'knowledge' as an element of aiding and abetting.").[31] The Eighth Circuit would plainly follow the logic of *Fehn* and similar cases: in *United States v. Cacioppo*, 460 F.3d 1012, 1016-17 (8th Cir. 2006), the court rejected the insertion of "reckless disregard" in a jury instruction on another statute because of "the fairly obvious observation that 'reckless disregard' appears nowhere in [the statute], as authored by Congress," and noted that "knowledge" and "recklessness" are distinct states of mind.

As such, both the Complaint and the plain language of the aiding and abetting statute preclude the SEC from relying on recklessness.

2. No Proper Inference Can Be Drawn from the Pretrial Diversion Agreement

The SEC also claims that Shanahan Jr.'s pretrial diversion agreement somehow constitutes circumstantial evidence of knowledge of wrongdoing. This is preposterous. The agreement's reference to "acceptance of responsibility" recites no facts as to his alleged involvement in any crime, does not identify any statute that was violated, and contains no statement that Shanahan Jr. acted improperly.[32] Although the phrase "acceptance of responsibility" represents an acknowledgment of the consequences of one's actions or inaction, it does not suggest wrongdoing. A diversion agreement certainly warrants no inference as to Shanahan Jr.'s knowledge of specific primary violations of the securities laws. Cf. *Iqbal v. Bryson*, 604 F. Supp. 2d 822, 826-27 (E.D. Va. 2009) (recognizing negligible probative value of

[31] See also *SEC v. Hilsenrath*, No. C 03-03252 WHA, 2008 U.S. Dist. LEXIS 50021, at *25 (N.D. Cal. May 30, 2008) (noting that "[t]he Ninth Circuit … requires that there be actual knowledge by the alleged aider and abettor of the primary violation and of his own role in furthering it"); *SEC v. Johnson*, 530 F. Supp. 2d 296, 303 & n.4 (D.D.C. 2008) (noting that although the SEC alleged knowing or reckless conduct, its arguments would be analyzed "under the correct 'knowing' standard for aiding and abetting violations"); *SEC v. Cedric Kushner Promotions, Inc.*, 417 F. Supp. 2d 326, 334-35 (S.D.N.Y. 2006) (holding that "recklessness, even for fiduciaries, is no longer sufficient"); *SEC v. Sandifur*, No. C05-1631C, 2006 U.S. Dist. LEXIS 12243, at *35 (W.D. Wash. Mar. 2, 2006) (same).

[32] The Court has access to the document and can review it without a public filing of the document as the SEC suggests, and as to which Shanahan Jr. objects because it is precluded by the terms of the agreement.

"mere boilerplate" acceptance of responsibility language in pretrial diversion agreement).

The diversion agreement is also inadmissible under Federal Rules of Evidence 402 and 403 – and has no bearing on summary judgment – because it is irrelevant and unfairly prejudicial. Indeed, a *more* reasonable inference to draw from the Diversion Agreement is that that the government dismissed its criminal case against Shanahan Jr. because there was insufficient evidence for the government to prevail. Even if the Court were to credit the SEC's inference from the diversion agreement, it would also have to credit the defense's inference, and where two inferences are equally likely, the party bearing the burden of proof has not demonstrated a genuine issue of material fact. See *James v. Otis Elevator Co.*. 854 F.2d 429, 432 (11th Cir. 1988).

3. No Inference of Actual Knowledge Can be Drawn from Shanahan Jr.'s Silence During an Investigative Deposition

Unable to identify specific evidence to support its aiding and abetting case, the SEC tosses an inflammatory hand grenade by contending that an adverse inference pertaining to consciousness of wrongdoing should be drawn against Shanahan Jr. because he invoked his constitutional privilege during an investigative deposition conducted by the SEC on April 16, 2007, months before the SEC had even filed its complaint in this action. After the SEC filed its case, Shanahan Jr. waived his Fifth Amendment privilege and submitted to a full day of deposition by the SEC.

An adverse inference makes absolutely no sense under these circumstances. As the Ninth Circuit explained in *Doe v. Glanzer*, 232 F.3d 1258 (9th Cir. 2000), when one party presents evidence to support a material fact and another party refuses to respond to that evidence, the fact finder can infer that the fact is true. Without the relevant testimony and without an inference regarding its absence, the party trying to prove that fact is "deprived of a source of information that might conceivably be determinative in a search for the truth." *Id.* at 1264 (citation omitted). See also *SEC v. Shanahan*, 504 F. Supp. 2d 680, 683 n.2 (E.D. Mo. 2007) ("[The rule] is appropriate because it tends to mitigate the disadvantage caused by silence which deprives a litigant of relevant information." (quotation marks and citation omitted)). Here the SEC has been

not been deprived of information because Shanahan Jr. has testified at length.[33] Nor was his silence meaningful at the time of the investigative deposition requests,[34] making it doubly nonsensical to infer anything negative from his assertion of his constitutional rights.

In any event, such an inference – even if it were appropriate, which it is not – is "not enough to create an issue of fact to avoid summary judgment." See *Curtis v. M&S Petroleum, Inc.*, 174 F.3d 661, 675 (5th Cir. 1999) (noting that plaintiffs had presented no other evidence that the defendant's actions were intentional). There must be other independent, material and probative evidence. See *Koester v. Am. Republic Invs.*, 11 F.3d 818, 824 (8th Cir. 1993) (noting "that silence alone is insufficient to support an adverse decision"); *Avirgan v. Hull*, 932 F.2d 1572, 1580 (11th Cir. 1991) ("The negative inference, if any, to be drawn from the assertion of the fifth amendment does not substitute for evidence needed to meet the burden of production."). Because the SEC has presented no other evidence that Shanahan Jr. had actual knowledge that ESSI's option pricing was wrongful, the SEC cannot rely on an adverse inference to create an issue of genuine fact.

4. No Inference of Actual Knowledge of Backdating Can be Drawn from the Allegation that Shanahan Sr. Received Stock Options Pursuant to a Contract

The SEC casts an even wider and even more inappropriate net when it argues it can support its aiding and abetting claims by reference to a complicated set of facts *having nothing to do with backdating at all*. The SEC devotes pages of text and numerous exhibits to a complex narrative concerning a proposal that Shanahan Sr. receive certain *quantities* of incentive stock

[33] The SEC's reliance on *Pagel, Inc. v. SEC*, 803 F.2d 942, 946-47 (8th Cir. 1986), for the proposition that an adverse inference may be drawn "even in the face of subsequent testimony and an acquittal in a criminal case" is misplaced. In that case, there was no subsequent testimony in the same civil proceeding that filled the "information vacuum" regarding a variety of securities law violations; rather, the defendant's testimony was in a separate criminal matter involving tax fraud charges. See *id.* at 947.

[34] In his first investigative deposition, Shanahan Jr. took the position that his silence could not be interpreted as an assertion of the Fifth Amendment. See Gasner Decl., Ex. I (Aug. 31, 2006 Shanahan Jr. Depo.) at 29:4-31:3. In addition, no allegations of wrongdoing had been asserted against Shanahan Jr. at that time. *Id.* at 5:15-21. Similarly, at the second investigative deposition, counsel for Shanahan Jr. made clear that he had not been presented with any probative evidence against him. See Gasner Decl., Ex. J (April 16, 2007 Shanahan Jr. Depo.) at 7:12-8:1. This undercuts the premise for an adverse inference. As the Supreme Court explained in *Baxter v. Palmigiano*, 425 U.S. 308, 318 (1976), an adverse inference must be based on a "refus[al] to testify in response to probative evidence offered against" the defendant.

options based on new highs in the company's stock price. These allegations span activity over the course of a decade, and cannot even be described, let alone rebutted, in the context of a reply brief.[35]

But for purposes of this motion, one thing is plain: these allegations have no probative value as to Shanahan Jr.'s knowledge of a wrongful backdating scheme. The SEC has repeatedly insisted that its allegations pertain to the "pricing" of options, not the "number" of options issued, most recently in its Statement of Facts.[36] Allegations that Shanahan Sr. received (or was entitled to receive) certain *quantities* of stock options pursuant to an escalator clause have nothing to do with their pricing.

The SEC seems to suggest that the proposal or Shanahan Sr.'s supposed receipt of these options shows Shanahan Jr.'s motive because he stood to benefit from his father's receipt of in-the-money options, but that is surely too attenuated to support the specific mental state required for aiding and abetting liability. So, too, is the claim that Shanahan Jr.'s participation in his father's contract discussions shows that he was inclined to "hide compensation": this is blatant predisposition evidence that must be disregarded here.

5. The SEC Tries to Make it *Sound* as Though it has Evidence of Shanahan Jr.'s Direct Involvement in a Backdating Scheme – But No Such Evidence Exists

As noted above, the crux of an aiding and abetting claim is the defendant's appreciation of the wrongful purpose of the scheme and his substantial assistance in furthering that wrongful purpose. As one court put it, "it is necessary that the defendant in some sort associate himself with the venture, that he participate in it as something that he wishes to bring about, and that he

[35] Shanahan Jr. objects to evidence of Shanahan Sr.'s receipt of options pursuant to a contract being presented in connection with this motion as irrelevant, confusing, more prejudicial than probative, and otherwise inadmissible under Federal Rules of Evidence 401, 402 and 403. To the extent that the Court plans to base any decision on this theory, Shanahan Jr. respectfully requests the opportunity to submit a more substantial brief to explain why the evidence offered in support of this theory is inadmissible.

[36] See Plaintiff's Statement at 21 (Disputed Fact No. 32) ("The relevant inquiry in this case is the price of the options awarded to ESSI's officers and directors as undisclosed compensation."); Huber Decl., Ex. 12 (Plaintiff's Admissions) at 14 (Requests No. 51 and 52) (insisting that "allegations of misconduct relate to ESSI's pricing of stock options, not the number of options issued by the Company") (emphases added).

seek by his action to make it succeed." *SEC v. Johnson*, 530 F. Supp. 2d at 306 (citation and quotation marks omitted). With no evidence of awareness of wrongful purpose, the SEC strains mightily to exaggerate Shanahan Jr.'s assistance, going so far as to suggest that the "low point" options dates and strike prices came directly from him.

But there is no such evidence. What the evidence does show is that Landmann was given low point grant dates *by Gerhardt*, or was told *by Gerhardt* to select the low point from a range of dates.[37] There is not a shred of contemporaneous documentary evidence to suggest that the low point dates originated with Shanahan Jr. And neither Landmann nor Gerhardt could point in their depositions to a single instance in which a specific grant date came from Shanahan Jr. Counsel for Shanahan Jr. addressed each option grant charged in the complaint during Gerhardt's deposition, asking for his direct knowledge of Shanahan Jr.'s involvement, and Gerhardt offered none.[38] While Gerhardt suggested in his deposition that dates and strike prices for options *may* have come to him over the years from four different people including Shanahan Jr.,[39] Gerhardt was plainly offering inadmissible speculation.[40] And in any event, his testimony is so vague that with respect to Shanahan Jr., it may refer to nothing more than the July 24, 2002 email in which Shanahan Jr. *asked* Landmann whether a particular date might appropriately be used – hardly evidence of aiding and abetting a wrongful scheme.[41]

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[37] See Huber Decl., Ex. 6 (Landmann Depo.) at 40:7-10, 124:8-24, 163:23-164:11.

[38] See Gasner Decl., Ex. K (Gerhardt Depo.) at 18:23-19:10, 27:9-28:6, 30:1-31:18, 45:5-47:1, 54:21-55:4, 60:4-61:25, 66:14-19, 74:5-10, 75:7-14, 102:25-103:3, 120:13-23.

[39] See *id.* at 45:5-47:1 ("No. I would guess at that time frame it was probably Mike Jr., would be my guess."); 60:4-60:14 ("That probably came from somebody like Mike Jr., would be my guess here, but I don't specifically recollect that."). While the SEC has submitted a "proffer" document apparently prepared by Gerhardt's lawyers when he was trying to negotiate a plea bargain with the U.S. Attorney, Plaintiff's Statement, Ex. 8, the proffer itself is plainly inadmissible hearsay and therefore not properly part of the record on summary judgment.

[40] Such speculative testimony is inadmissible for lack of personal knowledge. See Fed. R. Evid. 602. As the Eighth Circuit held in *Shaver v. Independent Stave Co.*, courts ignore speculative testimony in considering whether a party can defeat summary judgment. 350 F.3d 716, 723 (8th Cir. 2003) ("There are limits on what kinds of evidence a judge may consider in reviewing a motion for summary judgment, and inadmissible evidence obtained during discovery cannot be used to defeat such a motion"); see also *Howard v. Columbia Public School Dist.*, 363 F.3d 797, 800 (8th Cir. 2004) (recognizing that courts do not accept "sheer speculation as fact" on motions for summary judgment).

[41] Gerhardt himself testified that he believed Shanahan Jr. was asking a sincere question and was

While the SEC claims that Gerhardt's testimony is "corroborated" by four documents, none of them show that Shanahan Jr. selected the prices for option grants. Indeed, these documents show nothing more than Shanahan Jr. seeking guidance from Landmann and Gerhardt on option practices, or option allocation activity taking place after a purported grant date had been set by someone other than Shanahan Jr., which would have been innocuous to anyone not thoroughly conversant with the requirements of APB 25.[42] Indeed, on one of these documents Shanahan Jr. placed a *handwritten note with the contemporaneous date*,[43] undercutting any claim that this document supports his "knowing" participation in a backdating scheme.

From these slender reeds, the SEC apparently feels justified in writing in its Response that "Shanahan Jr. conveyed false grant dates within ESSI" and similar hyperbole,[44] but the evidence does not support this rhetoric and as such, the Court must disregard it.

6. Shanahan Jr.'s Routine Actions as an Outside Director Do Not Constitute Substantial Assistance of ESSI's Purported Filing of False or Misleading Annual Reports

Despite the SEC's insistence on the fact that Shanahan Jr. was part of the Comp Committee, which in turn was "charged" by ESSI's stock option plans with administering the stock option plan, such general assertions pertaining to Shanahan Jr.'s assigned role are insufficient to form the basis of a finding that he knowingly and substantially assisted the filing of false or misleading annual reports.

"trying to do it the right way." See Gasner Decl., Ex. K (Gerhardt Depo.) at 99:13-100:16.

[42] Cf. *SEC v. Todd*, No. 03CV2230 BEN, 2006 U.S. Dist. LEXIS 41182, at *20 (S.D. Cal. May 30, 2006) ("[K]knowledge of the existence of the transactions does not allow a reasonable fact-finder to draw an inference that [defendant] had knowledge of their impropriety….[Defendant] was not an accountant, nor has evidence been proffered that he had any reason to have accounting expertise sufficient to challenge the treatment given to any particular transaction.").

[43] See, e.g., Huber Decl., Ex. 19 (May 5, 2000 option document).

[44] In a similar vein, the SEC feels justified in asserting, without citation, that "Shanahan Jr. actively and routinely directed the use of backdated grant dates." Plaintiff's Response at 13. To the extent this rhetoric is intended to suggest that Shanahan Jr. knowingly and intentionally directed the backdating of options, this extravagant claim is completely false and backed by no evidence whatsoever. If the SEC merely intends to suggest that Shanahan Jr. was involved in issuing options that turned out to have been backdated by others, that was true of countless other people at ESSI and says nothing about aiding and abetting liability.

In *SEC v. Cedric Kushner Promotions, Inc.*, the defendant Angel, one of three directors of a public company, was alleged to have aided and abetted the company's violation of Section 10(b) and Rule 10b-5 for filing false and materially misleading SEC filings. 417 F. Supp. 2d at 327. At the time of the events in question, the 25-year-old Angel undisputedly had some connection to the preparation of the forms in question; he gathered backup documentation for the company's accountants and outside auditors, answered questions about subsequent events and pending litigation against the company, and reviewed those portions of drafts which related to his open items. Indeed, as the SEC pointed out, one of Angel's duties was "compliance and SEC filings" and was "in constant communication" with the auditors. See *id.* at 335. Nonetheless, the court found that this "very limited," "very background role" was insufficient to support a finding of substantial assistance. In granting summary judgment for Angel, the court pointed out that he was "not involved in preparing or reviewing the financial or accounting statements that contained the alleged misstatements or omissions," *id.* at 336; specifically, he had no hand in the preparation or review of "any of the subjects – cash flow, etc. – which turned out to be falsely presented." *Id.* at 335.

Similarly here, the evidence in the record falls far short of this mark. That Shanahan Jr. served as an outside director on the Comp Committee and that his electronic signature appeared on ESSI's annual reports do not constitute substantial assistance of any securities law violation by ESSI in filing false or misleading annual reports. Furthermore, the SEC has already admitted that Shanahan Jr. was not responsible for ensuring that ESSI's option grants conformed to appropriate accounting rules.[45]

7. The SEC's Cases are Inapposite

Finally, the SEC's citations to out-of-circuit authorities do nothing to shore up their aiding and abetting claims. Both *Middlesex Retirement System v. Quest Software Inc.*, 527 F. Supp. 2d 1164, 1182-83 (C.D. Cal. 2007), and *In re Comverse Tech. Inc. Securities Litigation*, 543 F. Supp. 2d 134, 142-45 (E.D.N.Y. 2008), concerned motions to dismiss, where the courts were willing to indulge the allegations of the complaint without regard to what the evidence

actually shows, as is required in a motion for summary judgment. Moreover, both cases involved claims for primary violations of Section 10(b) and Rule 10b-5, for which a theory of recklessness, not just actual knowledge, could suffice under the PSLRA. Not so with an aiding and abetting theory, as set forth above.

* * *

Even with respect to questions of intent, summary judgment is proper where the nonmoving party has adduced no competent evidence of intent and "rests merely upon conclusory allegations, improbable inferences, and unsupported speculation." *Demerath Land Co. v. Sparr*, 48 F.3d 353, 355 (8th Cir. 1995) (citation and quotation marks omitted). Once scrubbed of its rhetoric and improper inferences, the SEC's Response offers no competent evidence to avoid summary judgment of the aiding and abetting claims.

D. The SEC has Failed to Adduce Evidence of Materiality to Avoid Summary Judgment

While giving lip service to the idea that materiality must be gauged against the "total mix" of information, the SEC ultimately relies on a handful of inadequate or inadmissible facts, coupled with decisions from outside this jurisdiction that are distinguishable.

1. The Hlavacek Declaration is Inadmissible

First, the Court should deem inadmissible the Declaration of Scott Hlavacek and attachments. The SEC – apparently in an effort to distinguish cases such as *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 546 (8th Cir. 1997), in which the Eighth Circuit deemed fairly sizeable accounting misstatements to be immaterial – enlisted one of its staff accountants to "calculate" the relationship between ESSI's "in-the-money gains for recipients of backdated ESSI stock options" and ESSI's pre-tax operating earnings and net income.[46] The SEC concedes in a footnote that Hlavacek's methodology is inexact,[47] but they ignore the far bigger problem: that

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[45] Huber Decl., Ex. 12 (Plaintiff's Admissions) at 12.

[46] See Hlavacek Decl.

[47] The SEC acknowledges that its calculations do not purport to represent "the exact amount of earnings overstatement," because "[t]here 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." See Plaintiff's

the central driver of the "in-the-money" gains calculation is the supposed "date of actual approval" for each of the options grants in the complaint, *and those were dates provided to Hlavacek by SEC counsel*.[48] For the July 2002 grant, for example (discussed in detail above), Hlavacek used August 8, 2002 as the "date of actual approval."[49] But Hlavacek has no understanding as to why that date was chosen, has not reviewed the evidence to support such a date, and performed no independent accounting analysis as to whether such a date would be proper under APB 25 or any other criteria.[50] There is no support in the record for these dates, as neither Hlavacek nor the SEC takes the trouble to explain where this information came from. For all we know, they were picked out of thin air, which renders the declaration inadmissible. See *White Indus. Inc. v. Cessna Aircraft Co.*, 611 F. Supp. 1049, 1071-73 (W.D. Mo. 1985) (refusing to consider summaries for which calculations "made up" figures used in calculations); *U.S. v. Grajales-Montoya*, 117 F.3d 356, 360 (8th Cir. 1997) (holding that ostensible "summary" evidence prepared by lawyer was an inadmissible "written argument").

Hlavacek's charts relating to ESSI's stock performance are equally premised on self-serving data supplied by SEC staff. The stock price comparison is to the entire NASDAQ composite index (even though hundreds of other indices exist), but Hlavacek had no idea why that index was chosen. Similarly as to the time period: SEC staff picked a time period for Exhibits C, D, and E which shows NASDAQ "ending" at a price that is higher than ESSI.[51] But these charts "end" in March 2000 – when NASDAQ hit an all time high due to the dotcom bubble.[52] Again, Declarant Hlavacek purported at his deposition to know nothing of the reasons these self-serving time periods were selected.[53]

Response at 18 n.8.

[48] Hlavacek Decl. at 2; Gasner Decl., Ex. L (Hlavacek Depo.) at 36:18-37:8.

[49] Hlavacek Decl., Ex. A at 9.

[50] Gasner Decl., Ex. L (Hlavacek Depo.) at 34:12-14; 35:14-36:17.

[51] *Id.* at 51:21-52:11.

[52] *Id.* at 55:18-56:2; 57:15-58:3.

[53] *Id.*

The Court must disregard the declaration of Hlavacek, because it plainly does not satisfy Federal Rule of Civil Procedure 56(e)'s requirement that affidavits in opposition to summary judgment "shall be made on personal knowledge, shall set forth such facts as would be admissible in evidence, and shall show affirmatively that the affiant is competent to testify to the matters stated therein."[54] Hlavacek himself concedes, "I do not have any personal knowledge of the facts at issue."[55] Nor can the SEC get this evidence in through the back door as a "summary" under Federal Rule of Evidence 1006. The SEC does not even attempt to show, as the rule requires, that the documents Hlavacek seemingly relies upon are admissible in evidence. See *Ford Motor Co. v. AutoSupply Co.*, 661 F.2d 1171, 1175 (8th Cir. 1981); see also *In re Citric Acid Litig.*, 191 F.3d 1090, 1102 (9th Cir. 1999) (refusing to consider ostensible summary under Federal Rule of Evidence 1006 on summary judgment where party failed to show "that the underlying document that it neglected to attach as evidence to its opposition" qualified under Rule 1006). The SEC does not include the underlying documents with Hlavacek's declaration, and its description of these documents is inadequate. See Hlavacek Decl. at 2 (documents reviewed include "[s]tock option award recipient lists from 2002"). For all of these reasons, the declaration is of no value to the Court and must be deemed inadmissible.

2. The SEC's Analyst and Investor Testimony Is Insufficient to Withstand Summary Judgment

Without the Hlavacek declaration, the SEC is left for factual support with a handful of snippets of testimony that are insufficient to avoid summary judgment. The SEC's Response relies on the deposition testimony of two analysts (Selman Akyol and Walter Kirchberger) and an investor (Jay Weinstein), who testified that they "would have wanted to know" about backdating generally. Such testimony says nothing about the magnitude of the information's importance or its relation to the "total mix" of information about ESSI. "The mere fact that an investor might find information interesting or desirable is not sufficient to satisfy the materiality requirement." See *Milton v. Van Dorn Co.*, 961 F.2d 965, 969 (1st Cir. 1992). Rather, there

[54] See also *McSpadden v. Mullins*, 456 F.2d 428, 430 (8th Cir. 1972) (noting the same).

[55] Hlavacek Decl. at 2.

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" about the particular company in question. *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (emphases added) (quotation marks and citation omitted)); *Parnes*, 122 F.3d at 547 (noting that evidence of materiality must be "[t]aken in context" of the specific circumstances of the company).

Indeed, Kirchberger testified that the only reason he would have wanted to know about option pricing practices was so that he could be sure he was "comparing apples to apples" across financial reports, and that otherwise, whether or not the options had been expensed was "not particularly important."[56] The SEC also mischaracterizes the testimony of investor Weinstein's views of backdating. While Weinstein agreed that he generally "would want to know" whether a company was backdating options, he did not indicate whether he would have considered the information to be important in light of the "total mix" of information about ESSI, which is what the law requires.[57] Instead, when asked whether backdating would have affected his investment decisions in ESSI, he replied that he did not "know for sure."[58]

Some of the witnesses also noted how unimportant options expenses were to their investment decisionmaking. Selman Akyol noted, for example, that analysts routinely *disregarded* compensation expense as a non-cash expense when calculating the company's earnings.[59] Most investors would simply "pro forma" out compensation expenses as a non-cash expense.[60] The SEC presents no competent evidence to the contrary.[61]

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[56] See Gasner Decl., Ex. M (Kirchberger Depo.) at 102:22-103:7.

[57] See *Parnes*, 122 F.3d at 547 ("While there may certainly be many cases where this amount of money would be material and would dramatically affect the total mix of information relied on by a reasonable investor, this simply is not the situation in this case.") (emphasis added).

[58] See Gasner Decl., Ex. N (Weinstein Depo.) at 78:18-81:7.

[59] See Gasner Decl., Ex. O (Akyol Depo.) at 104:4-107:25.

[60] The SEC's contention that options expenses cannot be a non-cash expense because they "represent a clear cost to a company's existing shareholders," see Plaintiff's Statement at 17-18, is nonsensical. Whether an expense is a "non-cash expense" refers to an accounting concept, not to a general notion of shareholder value. See Huber Decl., Ex. 15 (Ten Eyck Report) at 6-7 ("Stock option compensation expense is a 'non-cash' expense; the company does not disburse any cash when it grants a stock option and will never actually pay cash in connection with

3. The SEC's Materiality Cases Are Unpersuasive

With little factual support for its claims of materiality, the SEC retreats to a variety of out-of-circuit backdating cases that have found materiality to exist. All are distinguishable and unpersuasive.

SEC v. Reyes, 491 F. Supp. 2d 906 (N.D. Cal. 2007), endorses a view of the law of materiality that conflicts with the Eighth Circuit's decision in *Parnes*, 122 F.3d at 546. The *Reyes* court ruled in a way that would find materiality in virtually every options backdating case based on a variety of suppositions and assumptions about investor and corporate behavior. The *Parnes* court, it is submitted, would disagree with this approach and would instead (as the defense has done in this motion) analyze the evidence of record against the *Basic Inc. v. Levinson* standard requiring that the facts in question significantly alter the total mix of information.

Equally unpersuasive is the SEC's string of backdating cases in which courts denied *motions to dismiss* on materiality grounds.[62] Those cases depend in large part on the procedural deference given to mere allegations at the outset of a case, and have little bearing in the context of a summary judgment motion after extensive discovery.

So, too, with the cases cited by the SEC that suggest that backdating is material simply because it relates to allegations of deliberate wrongdoing by management, or because such allegations reflect on "integrity of management." Securities fraud cases *always* involve allegations that reflect poorly on management integrity (hence the "fraud" in "securities fraud"), so a rule that finds materiality based on the presence of such allegations would eliminate

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granting stock options. In fact, companies ordinarily generate cash inflows upon the exercise of stock options when the employee must pay the stated exercise price for each option exercised."). Even the SEC's expert acknowledges that options expense is a non-cash expense. See Gasner Decl., Ex. D (Heron Depo.) at 194:20-195:18; 197:15-25.

[61] The SEC claims in its Statement of Facts that Selman Akyol "acknowledged that other analysts did include stock option expenses in calculating earnings per share," citing to page 105 of his deposition. Not so. Akyol testified that analysts might sometimes include non-cash expenses when calculating EPS figures, see Gasner Decl., Ex. O (Akyol Depo.) at 104:4-13, 105:9-12, but when the non-cash expenses in question were stock option expenses, the practice was not to include option expenses. See *id.* at 107:23-25 ("I don't think analysts were considering option expense at the time when making their earnings calculations.").

materiality as a statutory requirement. This cannot be: as the Supreme Court emphasized in *Basic*, the securities laws are only concerned with lies about material facts. 485 U.S. at 231-32.

4. The SEC's Evidence of Materiality is No Better as to its Proxy Claim

The SEC's argument that it fares better with materiality as to its proxy claim (Claim III) is also faulty. Contrary to the SEC's claim, courts often observe that the materiality standard for Section 14(a) is comparable to the stringent materiality standard for Section 10(b) claims. See *Basic*, 485 U.S. at 232 ("We now expressly adopt the *TSC Industries* standard of materiality [concerning § 14(a)] for the § 10(b) and Rule 10b-5 context."); *Gen. Electric Co. v. Cathcart*, 980 F.2d 927, 932 n.11 (3d Cir. 1992) ("It should be noted that the standard of materiality in a Section 14(a) case is identical to that in a Section 10(b) case.").

Here, as with Hlavacek declaration discussed above, the SEC has attempted to inject improper material to shore up its evidence of materiality, this time with a declaration from Steven Landmann. None of the hearsay statements in the Landmann declaration – including what certain investors purportedly told Landmann – are admissible and therefore may not be considered on a motion for summary judgment. See Fed. R. Civ. P. 56(e); *Johnson v. Baptist Med. Ctr.*, 97 F.3d 1070, 1073 (8th Cir. 1996); *Pink Supply Corp. v. Hiebert, Inc.*, 788 F.2d 1313, 1319 (8th Cir. 1986). These and other inadmissible or unsupported statements on the issue of proxy statement materiality are objectionable and should be disregarded by the Court.[63]

The SEC offers little else of a factual nature to oppose summary judgment. The testimony of the two analysts and an investor (discussed above) who blandly agreed that they "would have wanted to know about options backdating" are equally inadequate to support a finding of materiality with respect to proxy statements.[64] Neither the analysts nor the investor

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[62] Plaintiff's Response at 20.

[63] For example, the SEC's claims that Fidelity was "required to follow" certain guidelines as a fiduciary and voted against ESSI's stock option plans in 2000 and 2002 "because the plans did not comport with another aspect of those guidelines" do not even appear in the Landmann declaration, and are unsupported by any citation to record evidence. See Plaintiff's Response at 22-23. Furthermore, the argument that investors rejected ESSI's proposed stock option plan due to "large share allotment" has no bearing on the materiality of allegations of backdating.

[64] The SEC's characterization of events relating to changes made to ESSI's stock option plans in 2000 and 2002 may not properly be considered on a motion for summary judgment to the extent

testified that the information was important enough to them to create a substantial likelihood that the information would have assumed actual significance in the deliberations of the reasonable ESSI shareholder. To the contrary, Weinstein testified that in deciding whether to approve stock option plans, it *made no difference to him* whether the plans allowed for in-the-money option grants, at-the-money option grants, or out-of-the-money option grants.[65]

Lacking factual support, the SEC urges this Court to find that the Option Pricing Statement was somehow material "as a matter of law." In so doing, the SEC seeks to marginalize the Supreme Court's direction in *TSC Industries, Inc.* that courts focus on whether there is 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." 426 U.S. at 449. Instead, the SEC prefers to rely on *Parsons v. Jefferson-Pilot Corp.*, 789 F. Supp. 697 (M.D.N.C. 1992), as its lone support for the claim that "misstatements relating to the nature, purpose, or value of stock grants are often deemed to be material as a matter of law." Perhaps unsurprisingly, no other court has cited *Parsons* for this proposition, and *Parsons* itself makes the freewheeling assertion that such misstatements are material as a matter of law without any citation to authority. The Court should decline the SEC's invitation to apply the unsupported holding of an out-of-circuit district court.

The SEC further attempts to marginalize *TSC Industries* by claiming that SEC regulations govern the legal standard of materiality under Section 14(a). The SEC cites *Resnik v. Swartz*, 303 F.3d 147, 151 (2d Cir. 2002) for the proposition that information omitted 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." Other courts note, however, that while Schedule 14(A) is "persuasive," it is "not determinative" of the scope of required disclosure in proxy materials. See *Gen. Electric Co.*, 980 F.2d at 937; *In re Browning-Ferris Industries, Inc.*, 830 F. Supp. 361, 366 (S.D. Tex. 1993) (same); cf. *TSC Industries*, 426 U.S. at 449 n.10 ("[T]he SEC's

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they consist of inadmissible hearsay and unsupported assertions.

[65] See Gasner Decl., Ex. N (Weinstein Depo.) at 41:1-42:3.

view of the proper balance between the need to insure adequate disclosure and the need to avoid the adverse consequences of setting too low a threshold for civil liability is entitled to consideration."). The touchstone of liability remains materiality.

Moreover, even if the court were to adopt the view that Schedule 14A somehow supersedes the materiality standard, Item 10 of Schedule 14A does not "specifically" require the disclosure of whether the exercise price of an option is the same as the closing price of the stock on the date that the option was granted. What Item 10 does require is disclosure of the material conditions upon which a specific grant of options may be exercised: "[t]he prices, expiration dates and other material conditions upon which the options, warrants or rights may be exercised." 17 C.F.R. § 240.14a-101, Item 10 at (b)(2)(i)(B). There is no dispute that the exercise price of the stock options was disclosed by ESSI in its public filings,[66] and the disclosure of other "material conditions" relating to the exercise of options does not relate to any allegation in this case.

II. Conclusion

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

[66] See Plaintiff's Statement at 21.

Respectfully submitted,

Dated: November 13, 2009

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CERTIFICATE OF SERVICE

I hereby certify that on the 13th day of November, 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:

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