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SECURITIES AND EXCHANGE COMMISSION

UNITED STATES DISTRICT COURT  
DISTRICT OF OREGON

SECURITIES AND EXCHANGE  
COMMISSION,

CV. \_\_\_\_\_

Plaintiff,

COMPLAINT

vs.

JOHN E. ISSELMANN, JR.,

Defendant.

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Plaintiff Securities and Exchange Commission (“Commission”) alleges:

**SUMMARY OF THE ACTION**

1. John E. Isselmann, Jr. (“Isselmann” or “Defendant”), the former General Counsel of Electro Scientific Industries, Inc. (“ESI” or “Company”), failed to provide important information to ESI’s Audit Committee, Board of Directors, and auditors regarding a significant accounting transaction that enabled ESI to report a profit rather than a loss. Isselmann’s failure to fulfill his gatekeeper role was a cause of ESI reporting materially false financial results to the public, and violated the Commission’s rule barring

officers and directors of public companies from omitting to state or causing another person to omit to state a material fact to their accountants.

2. ESI's former Chief Financial Officer and Controller had fraudulently decided to eliminate retirement and severance benefits for ESI's Asian employees in order to increase ESI's bottom line by \$1 million. Isselmann later received written legal advice that the law prohibited the unilateral elimination of the benefits. Despite having opportunities to provide the advice to ESI's Audit Committee, Board of Directors, and auditors, Isselmann failed to do so. Isselmann's failure allowed the CFO and Controller to hide an ongoing fraud.

3. By his actions, Isselmann violated Rule 13b2-2 under the Securities Exchange Act of 1934 [17 C.F.R. § 240.13b2-2], which, among other things, prohibits officers and directors of public companies from omitting to state or causing another person to omit to state a material fact to accountants. Through this action, the Commission seeks to enjoin Isselmann from future violations of the federal securities laws and obtain civil monetary penalties against him.

### **JURISDICTION**

4. This Court has jurisdiction over this action pursuant to Sections 21(d), 21(e), and 27 of the Exchange Act [15 U.S.C. §§ 78u(d), 78u(e), and 78aa]. Defendant, directly or indirectly, has made use of the means and instrumentalities of interstate commerce or of the mails or of the facilities of a national securities exchange in connection with the acts, transactions, practices, and courses of business alleged in this Complaint.

### **AUTHORITY TO BRING THIS ACTION**

5. The Commission brings this action pursuant to Sections 21(d) and 21(e) of the Exchange Act [15 U.S.C. §§ 78u(d) and 78u(e)].

### **DEFENDANT**

6. Isselmann, age 35, resides in Portland, Oregon, and is licensed to practice law in the State of Oregon. He served as General Counsel of ESI from May 2000 until his resignation in August 2003.

### **FACTUAL ALLEGATIONS**

7. ESI is an Oregon corporation with its principal place of business in Portland. The Company makes manufacturing equipment for electronics and other high technology companies. ESI common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act and trades on the Nasdaq National Market.

8. In order to meet external expectations that ESI would be profitable, the Company's CFO and Controller engaged in a scheme to fraudulently inflate ESI's financial results for its quarter ended August 31, 2002. ESI's CFO and Controller reduced expenses and increased ESI's bottom line by \$1 million by secretly and unilaterally deciding to eliminate vested retirement and severance benefits in ESI's Asian offices (which included primarily Japan, but also Taiwan and Korea). This accounting transaction violated generally accepted accounting principles because ESI could not legally eliminate the benefits as it had purported to do. The accounting transaction enabled the CFO and the Controller to avoid a loss and report a profit in line with external expectations.

9. Isselmann was not involved, present, or consulted when the CFO and the Controller made the accounting decision described above.

10. On September 17, 2002, Isselmann participated in a meeting with ESI's Audit Committee and auditors to review the quarterly financial results, including the financial impact of eliminating the retirement and severance benefits. During the

meeting, ESI's CFO told the Audit Committee that the Japanese benefits were not legally required and that the decision to eliminate them had been approved by legal counsel. During the same discussion, Isselmann identified ESI's legal counsel in Japan, causing an Audit Committee member to believe that outside legal counsel had reviewed the decision. Although Isselmann was unaware that the CFO had decided to eliminate the benefits in order to fraudulently inflate ESI's financial results, and did not question the CFO about his statements, Isselmann was aware that at that time he had not reviewed or approved the decision to eliminate benefits nor had he, as General Counsel, sought any outside legal review of the issue. At the conclusion of the meeting, the Audit Committee approved the inclusion of the \$1 million transaction relating to the benefits in ESI's financial results for the quarter.

11. During the same time frame, Isselmann was informed that ESI's auditors had been told that the elimination of the benefits had legal support. In connection with the auditors' review of ESI's quarterly financial results, ESI provided the auditors with a written memorandum stating that the benefits had been eliminated because ESI was under "no legal obligation" to pay them and that the change was approved by ESI's CFO and CEO. Isselmann subsequently received a copy of this memorandum and was told that it had been written for the auditors. However, Isselmann did not speak directly with the auditors and did not inform them that he had not reviewed the retirement benefits issue and that he had not retained outside counsel to do so.

12. On October 3, 2002, Isselmann sought legal advice from ESI's counsel in Japan on whether ESI could eliminate the benefits.

13. On October 7, 2002, the outside counsel informed Isselmann in writing that ESI could not unilaterally eliminate its retirement and severance benefits in Japan and that if ESI wanted to terminate the benefits it was required to first consult with and obtain the consent of ESI's Japanese employees. As Isselmann was aware, ESI had neither consulted the Japanese employees nor obtained their consent to the elimination of

their retirement benefits. Despite the contradiction with information Isselmann had been told had been written for ESI's auditors, Isselmann did not speak directly with the auditors. Nor did Isselmann provide the information to the Audit Committee, despite the fact that they had questioned the legal review of the matter.

14. ESI's Disclosure Committee met on October 7, 2002 to review and ensure the accuracy of ESI's quarterly report to the Commission on Form 10-Q. Isselmann, other ESI officers and employees, ESI's external auditors, and its Portland-based outside corporate counsel attended the meeting, which had been arranged by Isselmann. During the meeting, Isselmann tried to raise the issue of the termination of the Asian retirement benefits. However, the CFO objected and, as a result, Isselmann provided no further detail and did not provide the written legal advice to the participants in the meeting. After the meeting, Isselmann spoke with the CFO and provided him with a copy of the written legal advice. The CFO subsequently signed the Form 10-Q, which included the \$1 million increase to the bottom line resulting from the elimination of the benefits.

15. On October 15, 2002, ESI filed its Form 10-Q, reporting net income of \$158,000 and earnings per share of \$0.01 for the quarter. Before the Form 10-Q was filed with the Commission, an Audit Committee member questioned Isselmann about the language describing the elimination of the benefits and the \$1 million accounting entry. Isselmann failed to convey the legal advice to the Audit Committee member in response. As a result, the Form 10-Q was not changed.

16. On March 31, 2003, Isselmann learned that the CFO (who had been promoted to CEO in December 2002) had eliminated the accrued liability for the benefits late at night after learning of an accounting error that negatively impacted earnings. On the night of March 31, 2003, Isselmann reported to ESI's outside counsel his suspicions that the CFO had engaged in misconduct. The next day, Isselmann informed the Audit Committee.

17. On April 1, 2003, after receiving the written legal advice, the Audit Committee commenced an internal investigation. In August 2003, following the completion of an internal investigation by its Audit Committee, ESI restated its financial results for the quarter ended August 31, 2002. The previously recorded accounting transaction was reversed and the accrued liability of \$1 million for the payment of Asian retirement and severance benefits was restored. .

### **FIRST CLAIM FOR RELIEF**

#### *Violation of Rule 13b2-2 Under the Exchange Act*

18. The Commission incorporates by reference Paragraphs 1 through 17.

19. Exchange Act Rule 13b2-2 [17 C.F.R. § 240.13b2-2] prohibits an officer of director of an issuer from, directly or indirectly, making or causing to be made a materially false or misleading statement or omitting to state, or causing another person to omit to state, a material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading to an accountant in connection with an audit or examination of the financial statements of the issuer required to be made and the preparation and filing of documents and reports required to be filed with the Commission.

20. By engaging in the conduct described above, Isselmann, directly or indirectly, omitted to state, or caused another person to omit to state, a material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading to an accountant in connection with an audit or examination of the financial statements of ESI required to be made and the preparation and filing of documents and reports required to be filed with the Commission.

21. By reason of the foregoing, Isselmann has violated Rule 13b2-2 [17 C.F.R. § 240.13b2-2] and must be enjoined to ensure such violations will not continue.

### **PRAYER FOR RELIEF**

WHEREFORE, the Commission respectfully requests that the Court:

1. Permanently enjoin Isselmann and his agents, servants, employees, attorneys, and all persons in active concert or participation with them who receive actual notice of the judgment by personal service or otherwise from directly or indirectly violating, or aiding and abetting violations of, Exchange Act Rule 13b2-2;
2. Order Defendant to pay civil penalties under Section 21(d) of the Exchange Act [15 U.S.C. § 78u(d)];
3. Retain jurisdiction of this action in accordance with the principles of equity and the Federal Rules of Civil Procedure in order to implement and carry out the terms of all orders and decrees that may be entered, or to entertain any suitable application or motion for additional relief within the jurisdiction of this Court; and
4. Grant such other and further relief as the Court may deem just, equitable, and appropriate.

Dated: September 21, 2004

Respectfully submitted,

By: \_\_\_\_\_  
Robert S. Leach

Attorney for Plaintiff  
SECURITIES AND EXCHANGE  
COMMISSION