United States Courts
Southern District of Texas
FILED
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Michael N. Milby, Clerk

ORIGINAL

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

CHARLES D. ERWIN and
MICHAEL J. McGHAN,

Defendants.

H 03 -5764

COMPLAINT

Plaintiff Securities and Exchange Commission alleges as follows:

SUMMARY

1. Charles D. Erwin ("Erwin") and Michael J. McGhan ("McGhan") (collectively "Defendants"), former executives of Hanover Compressor Company ("Hanover" or "the Company"), inflated Hanover's pre-tax income during the third and fourth quarters of 2000 and, with respect to Erwin, the second and third quarters of 2001, in connection with their efforts to meet earnings goals and estimates.

2. Erwin and McGhan both were at least severely reckless in failing to provide critical information to Hanover's accountants or, consequently, its auditors, concerning side agreements and other facts relating to Hanover's sales of equipment to a joint venture for a project in Nigeria.

3. Erwin, moreover, failed to disclose the true facts relating to three turbine sales to Hanover's accountants and, consequently, its auditors and structured certain

transactions to deceive Hanover's accountants and auditors about the true facts surrounding payments for the turbines.

4. As a result of Defendants' misconduct, Hanover failed to account for the sales of equipment in accordance with Generally Accepted Accounting Principles ("GAAP"), and Hanover included false financial statements in its Form 10-K for the year ended December 31, 2000, and in its Forms 10-Q for the third quarter 2000 and the second and third quarters of 2001.

5. Erwin reaped the benefits of the inflated financial statements by selling stock in a March 2001 secondary offering.

6. Hanover's woefully deficient internal controls facilitated Erwin's and McGhan's misconduct. McGhan, among others, was responsible for Hanover's deficient internal controls and its filing false financial statements with the Commission.

7. In 2002, Hanover restated its financial results after an internal inquiry revealed the fraudulent or grossly reckless conduct and other erroneously recorded transactions.

8. The Commission, in the interest of protecting the public from such activities, brings this action seeking a permanent injunction against Erwin and McGhan, enjoining them from further violations of the antifraud provisions of the federal securities laws, disgorgement of ill-gotten gains, plus prejudgment interest thereon, officer and director bars, and civil monetary penalties as allowed by law.

JURISDICTION AND VENUE

9. The Commission brings this action pursuant to the authority conferred upon it by Section 20(b) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. §

77t(b)], and Section 21(d) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. § 78u(d)], to permanently enjoin Defendants from future violations of the federal securities laws.

10. This Court has jurisdiction over this action, and venue is proper, pursuant to Section 22(a) of the Securities Act [15 U.S.C. § 77v(a)], and Section 27 of the Exchange Act [15 U.S.C. § 78aa].

11. Defendants, directly or indirectly, made use of the means or instruments of transportation and communication, and the means or instrumentalities of interstate commerce, or of the mails, in connection with the transactions, acts, practices and courses of business alleged herein. Certain of the transactions, acts, practices and courses of business alleged herein took place in the Southern District of Texas.

DEFENDANTS

12. **Charles D. Erwin**, 42, of Houston, Texas, served as Hanover's senior vice president of sales until mid-2001, when he was appointed COO. He served as COO until he resigned on August 1, 2002.

13. **Michael J. McGhan**, 48, of Houston, Texas, was Hanover's President, CEO, and a director from October 1991 through August 1, 2002, when he resigned.

RELEVANT ENTITY

14. **Hanover Compressor Company**, a Delaware corporation based in Houston, Texas, has been engaged in the manufacture, sales, rental and operation of oil field equipment, primarily natural gas compressors, since its 1990 formation. Hanover's common stock is registered with the Commission under Section 12(b) of the Exchange Act [15 U.S.C. § 78*l*(b)] and trades on the New York Stock Exchange.

FACTS

Hanover's Deficient Internal Controls

15. Hanover grew rapidly throughout its history, in significant part through acquisitions, and its growth was most pronounced in 2000 and 2001, when the Company tripled in size, from $756 million in assets and $323 million in revenues at year end 1999 to $2.3 billion in assets and $1 billion in revenues at year end 2001.

16. The Company failed, however, to effectively integrate its acquisitions from a management and accounting perspective. Hanover had approximately 30 different accounting systems, which its employees manually consolidated.

17. The Company lacked adequate accounting personnel, and the staffing levels were not increased sufficiently as the Company grew.

18. The Company's CFO beginning in mid-2000 had a limited accounting background and experience, and the company did not have an overall controller.

19. The Company did not have an internal legal staff to provide consistent documentation and processes for handling large transactions.

20. Despite advice from Hanover's outside auditor, McGhan and Hanover's management did not adequately strengthen the Company's internal controls to deal with the changing size and nature of its operations, and they were slow to implement improvements in staffing and internal controls.

21. To the extent that Hanover had internal controls procedures, they were not adequately enforced.

22. Hanover's poor internal controls caused or contributed to its improper recording of numerous transactions, including approximately 17 transactions to which Hanover's restatements related.

23. As a result, Hanover materially overstated its pre-tax income in its Forms 10-K for fiscal 1999 and fiscal 2000 and its Forms 10-Q for the first, second and third quarters of 2000 and the second and third quarters of 2001, and the company materially understated pre-tax income in its Form 10-Q for the first quarter of 2001.

24. McGhan, among others, contributed to the deficient internal controls that contributed to Hanover improperly recording the transactions that were later restated.

Hanover's Focus on Earnings and Meeting Earnings Estimates

25. Hanover management focused closely on Hanover's earnings and its ability to meet earnings estimates.

26. Because Hanover's stock price fell by approximately 15% in August 2000, when the Company failed to meet earnings estimates by $0.01, Hanover management was keenly aware of the consequences of failing to meet earnings estimates, even by small amounts.

27. Erwin led periodic staff meetings, sometimes attended by McGhan, during which Erwin reviewed the status of transactions needed to meet quarterly budget and earnings estimates.

28. In their forecasting and budgeting process, Hanover management set aggressive earnings and growth goals.

The Nigerian Barge Transaction

29. Facilitated by Hanover's weak internal controls and motivated by aggressive earnings goals, Erwin and, in one instance McGhan, entered into transactions

that ultimately led to overstatement of Hanover's pre-tax income for the third and fourth quarters of 2000, the year ended 2000, and the second and third quarters of 2001.

30. In the third quarter 2000, Hanover recognized material income from the sale of barges and equipment to a Hanover joint venture for a project in Nigeria. Despite advice from Hanover's auditor to the Company that it could recognize revenue from the purported sale only if it received cash, had no obligations to return the cash, and did not guarantee debt, Hanover entered into a loan commitment letter, signed by McGhan, that obligated Hanover to finance the project if third party financing could not be obtained and a Guarantee of Refund (the "Guarantee"), agreed to by McGhan and Erwin, that obligated Hanover to return the down payment, with interest and expenses, under certain circumstances.

31. McGhan and Erwin failed to disclose the Guarantee or loan commitment letter to Hanover's accountants and, consequently, its auditors, and Hanover failed to disclose these agreements in its Commission filings.

32. McGhan was severely reckless in signing an April 2, 2001, management representation letter to Hanover's auditors that falsely stated that the Company was not contingently liable under any guarantees.

33. Because of the Guarantee and loan commitment letter, recognition of revenue on the sale of equipment to the joint venture was not in accordance with GAAP. Hanover improperly recognized $2.9 million in third quarter 2000 pre-tax income from the equipment sale, representing over 11.7% of its pre-tax quarterly income; $1.2 million in pre-tax income and $500,000 in improperly capitalized expenses related to the equipment sale in the fourth quarter 2000, thereby increasing its pre-tax fourth quarter

2000 income by 5.6%; and, in total, $4.6 million in pre-tax income and capitalized expenses related to the equipment sale in fiscal 2000, which was equivalent to approximately 5% of its pre-tax income for the year. Consequently, Hanover's pre-tax income in its Form 10-K for fiscal 2000, its Form 10-Q for the quarter ended September 30, 2000, and its March 2001 registration statement was materially overstated.

The Turbine Sales

34. During the fourth quarter 2000 and the second and third quarters 2001, Hanover recognized revenue from the sale of three turbines.

35. In each of these sales, Erwin entered into undisclosed side arrangements, including indirect funding of some payments on the turbines, that precluded revenue recognition on the sales under GAAP. Revenue recognition was improper on these sales because Hanover did not effectively transfer ownership of, or risks associated with, the turbines, it retained specific performance obligations after the purported sales, and collectibility of the turbine receivables was not reasonably assured.

36. Erwin structured some of the payments on the turbines to deceive Hanover's accountants and, consequently, its auditors, and he failed to disclose the true facts relating to these turbine sales to the Company's accountants and, consequently, its auditors.

37. Hanover failed to disclose all of these facts in its Commission filings.

38. In connection with the turbine sales, Hanover improperly recorded pre-tax income of $1.3 million in the fourth quarter 2000, representing 4.2% of its fourth quarter 2000 pre-tax income and 1.4% of its fiscal 2000 pre-tax income; pre-tax income of $1.8 million in the second quarter, or 4.7% of the second quarter 2001 pre-tax income; and pre-tax income of $2.8 million in the third quarter, or 7.8% of its third quarter 2001 pre-tax

income. Consequently, Hanover's pre-tax income for the fourth quarter 2000 and fiscal 2000, and for the second and third quarters 2001, was materially overstated in the company's Form 10-K for fiscal 2000 and Forms 10-Q for the second and third quarters 2001.

Hanover's Securities Offerings

39. In March 2001, Hanover made two securities offerings for which the prospectus included third quarter 2000 financial statements inflated by Hanover's improper recording of the sale of equipment to its joint venture in Nigeria. In these offerings, Hanover issued both debt and equity securities, and Erwin sold 70,000 shares of common stock.

Hanover's Restatements

40. In late January 2002, Hanover initiated an internal inquiry after a financial publication and an analyst raised questions regarding the company's financial reporting of its joint venture for a project in Nigeria. Hanover subsequently restated its 2000 and 2001 financial statements, and continued its inquiry, which resulted in additional restatements. In total, the restatements reduced Hanover's pre-tax income for fiscal year 1999 by $3.123 million, or 4.9%; for fiscal year 2000 by $14.4 million, or 5.5%; and by as much as $5.5 million, or 22.6%, in one individual quarter.

FIRST CLAIM
Violations of Section 17(a) of the Securities Act

41. Paragraphs 1 through 40 are realleged and incorporated herein by reference as if set forth in full.

42. Defendants Erwin and McGhan, in the offer or sale of securities, by the use of means or instruments of transportation or communication in interstate commerce, or by the use of the mails, directly or indirectly, have:

(a) employed devices, schemes or artifices to defraud;

(b) obtained money or property by means of untrue statements of material facts or omissions of material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or

(c) engaged in transactions, practices or courses of business, which operated or would operate as a fraud or deceit upon the purchaser.

43. Defendant Erwin knowingly or recklessly, and Defendant McGhan recklessly, engaged in the conduct described in this claim.

44. By reason of the foregoing, Erwin and McGhan violated, and unless enjoined, will continue to violate Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)].

SECOND CLAIM
Violations of Section 10(b)
of the Exchange Act and Rule 10b-5 Thereunder

45. Paragraphs 1 through 40 are realleged and incorporated herein by reference as if set forth in full.

46. Defendants Erwin and McGhan, in connection with the purchase or sale of securities, have: (a) employed devices, schemes or artifices to defraud; (b) made untrue statements of material facts or omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not

misleading; or (c) engaged in acts, practices or courses of business which operate as a fraud or deceit upon purchasers, prospective purchasers, and other persons.

47. Defendant Erwin knowingly or recklessly, and Defendant McGhan recklessly, engaged in the conduct described in this claim.

48. By reason of the foregoing, Erwin and McGhan violated, and unless enjoined, will continue to violate Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 [17 C.F.R. § 240.10b-5] thereunder.

THIRD CLAIM
Violations of Section 13(b)(5) of the Exchange Act
and Rule 13b2-1 Thereunder

49. Paragraphs 1 through 40 are realleged and incorporated herein by reference as if set forth in full.

50. Defendant Erwin knowingly circumvented Hanover's system of internal accounting controls or knowingly falsified books, records, or accounts described in Section 13(b)(2) of the Exchange Act.

51. By reason of the foregoing, Erwin violated, and unless enjoined, will continue to violate Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m(b)(5)] and Rule 13b2-1 [17 C.F.R. § 240.13b2-1] thereunder.

FOURTH CLAIM
Violations of Commission Rule 13b2-2 Under the Exchange Act

52. Paragraphs 1 through 40 are realleged and incorporated herein by reference as if set forth in full.

53. Defendant Erwin, as an officer of Hanover, and Defendant McGhan, as an officer and director of Hanover, directly or indirectly, made or caused to be made materially false or misleading statements, or omitted to state, or caused another person to

omit to state, material facts 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

(1) any audit or examination of the financial statements of the issuer required to be made; or

(2) the preparation or filing of any document required to be filed with the Commission.

54. By reason of the foregoing acts and practices, Defendants Erwin and McGhan violated Commission Rule 13b2-2 under the Exchange Act [17 C.F.R. §240.13b2-2], directly or indirectly.

FIFTH CLAIM
Aiding and Abetting Hanover's Violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 Thereunder

55. Paragraphs 1 through 40 are realleged and incorporated herein by reference as if set forth in full.

56. Based on the conduct alleged herein, Hanover violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

57. Defendant Erwin knowingly or recklessly and Defendant McGhan recklessly, in the manner set forth above, provided substantial assistance to Hanover, as an issuer of a security registered pursuant to Section 12 of the Exchange Act, in its:

(a) failure to file with the Commission, in accordance with Commission rules and regulations

(1) such information and documents as the Commission requires to keep reasonably current the information and

documents required to be included in or filed with an application or registration statement filed pursuant to Section 12 of the Exchange Act [15 U.S.C. §78*l*], and

(2) such annual reports, certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports, as the Commission may prescribe;

(b) failure to add such further information, if any, as may be necessary to make required statements, in the light of the circumstances under which they are made not misleading, to that information expressly required to be included in a statement or report;

(c) failure to file in a timely fashion with the Commission annual reports on the appropriate form authorized or prescribed for each fiscal year;

(d) failure to file in a timely fashion with the Commission quarterly reports, as required by Commission Rules 13a-13 [17 C.F.R. §240.13a-13].

58. By reason of the foregoing, Erwin and McGhan aided and abetted Hanover's violations of, and unless restrained and enjoined, will aid and abet further violations of Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20, 13a-1 and 13a-13 thereunder [17 C.F.R. §§ 240.12b-20, 240.13a-1 and 240.13a-13].

SIXTH CLAIM
Aiding and Abetting Hanover's Violation
of Section 13(b)(2) of the Exchange Act

59. Paragraphs 1 through 40 are realleged and incorporated herein by reference as if set forth in full.

60. Based on the conduct alleged herein, Hanover violated Section 13(b)(2) of the Exchange Act.

61. Defendant McGhan, in the manner set forth above, recklessly provided substantial assistance to Hanover in connection with its:

(a) failure 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;

(b) failure to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that

(1) transactions are executed in accordance with management's general or specific authorization;

(2) transactions are recorded as necessary (A) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (B) to maintain accountability for assets;

(3) access to assets is permitted only in accordance with management's general or specific authorization; and

(4) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences;

62. By reason of the foregoing, McGhan aided and abetted Hanover's violation of, and unless restrained and enjoined, will aid and abet further violations of Section 13(b)(2) of the Exchange Act [15 U.S.C. § 78m(b)(2)].

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that the Court:

I.

Find that the defendants committed the alleged violations.

II.

Permanently restrain and enjoin Defendants from violating, or aiding and abetting, directly or indirectly, the provisions of law and rules alleged in this Complaint.

III.

Order that each defendant disgorge all ill-gotten gains, including pre-judgment and post-judgment interest, resulting from their participation in the alleged conduct, including salaries, bonuses, stock, or other compensation of any kind.

IV.

Order each defendant to pay civil penalties, including post-judgment interest, pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)] and Section 20(d) of the Securities Act [15 U.S.C. § 77t(d)] in an amount to be determined by the Court.

V.

Prohibit each defendant from acting as an officer or director of any issuer required to file reports pursuant to Sections 12(b), 12(g) or 15(d) of the Exchange Act [15 U.S.C. §§ 78l(b), 78l(g) and 78o(d)], pursuant to Section 21(d)(2) of the Exchange Act [15 U.S.C. § 78u(d)(2)].

VI.

Grant such other relief as this Court may deem just or appropriate.

VII.

Retain jurisdiction over this action in order to implement and carry out the terms of all orders and decrees that may hereby be entered, or to entertain any suitable application or motion by the Commission for additional relief within the jurisdiction of this Court.

Respectfully submitted,

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